

## Section 1. Social and Political Background

### 1.1. The Year of 2003 Economic and Political Problems: Politics as against Economics

#### 1.1.1. Major Factors of the Russian Economic Policies in the Year of 2003

The economic development of the country in the year of 2003 is interesting not only by itself as a fact but from the viewpoint of what the Government have so far done, having survived through the full electoral cycle for the first time in the Russian newest history. This alone makes it a rather unique phenomenon definitely indicating, on the one hand, completion of the revolutionary transformation and on the other – transition to «normal» mechanisms of forming and functioning of power institutions. Another important factor is that the significant institutional reforms of the 2000 – 2001 period were generally expected to start exerting practical impacts on the country's economic life. Previously, this development had been mainly under the influence of short-term factors with the institutional ones manifesting themselves in the economic life but after a certain time lag.

As can be seen from the data in *Table 1* (below), in the year of 2003, the economic situation in the country was on the whole quite favorable. Here are the three major factors which actually determined the nature of Russia's economic policy during that particular period.

First: *economic growth continuation accompanied with rapid jump in the investments rates*, the main here being the higher growth rates, i. e. the fact that the fading trend was at last overcome.

Second: *favorable current economic situation*, with high prices on the basic Russian export products which were not going down even despite various political instabilities in the world. Rather good was the currency situation as well — along with significant decrease of the US dollar rate (only 2 %, both in the nominal and the real form) it strengthened with regard to the main importers' euro-currency which to some extent held down pressure on the national commodity-producers. Such a situation makes impression that the economic situation is very stable while thus creating additional risks for this very stability. The feeling of such would be «retreated» economic danger does really provoke taking exotic economic and, what is more, populist budget measures, including revision-of-property ownership steps which are, in the long run but only pushing towards serious political destabilization.

Third: *more acute political competition in the context of a rather favorable economic situation*. The year of 2003 pre-election nature determined its specific features but only in part. The main political battles were connected not so much with the electoral cycle but rather with the post-revolutionary stabilization logic – stabilization in a critically split society which is only beginning the rapprochement process of different social groups and which is still to go a long way towards reaching the national consensus with regard to the basic values and priorities.

There was indeed certain optimism in the public mood as registered both in the respective public opinion polls and in the obviously greater 2002 – 2003 birth rate.

Finally, neither technological nor financial cataclysms have happened in the world although these, during the whole previous decade, had been insistently forecasted for the year of 2003. The technological obsolescence problems were then being solved mostly evolutionarily which fact was well reflected in the high-rate investment activities. And another important



problem – that of the payment of debts peak – was also successfully solved due to the respective Government's policy in the previous three years.

*Table 1***Some Data on Russia's Social and Economic Development in the Years of 2000 – 2003**

Indicators	2000	2001	2002	2003
GDP, (%) as against the previous year	10,0	5,1	4,7	7,3,
Industrial production, (%) as against the previous year	11,9	4,9	3,7	7,0
Fixed capital investments, (%) as against the previous year	17,4	10,0	2,6	12,5
Gold/currency reserves, \$ mln, end of the year	27951	36622	47703	76938
Oil prices, Brent, \$/barrel, annual average	28,5	24,4	25,0	28,8
URALS oil prices, \$/barrel, annual average	26,6	22,9	23,7	27,0
Index of consumer prices	20,2	18,8	15,1	12,0
Real rouble rate as against \$, 1999 = 1	1,11	1,20	1,29	1,54
Real rouble rate as against Euro, 1999 = 1	1,22	1,40	1,26	1,24
Birth rate, per 1000 of population	8,7	9,1	9,8	10,5*
Natural natality, per 1000 of population	-6,7	-6,5	-6,5	-6,0*
Suicide death rate, per 100000 of population	39,3	39,7	38,6	37,1*

\* Preliminary data.

### 1.1.2. Social – Economic Problems and their Real Impacts on the Economic Development of Russia

The major factor for the social and economic policies in Russia of the time was the coming of the parliamentary and presidential elections. Yet, their expected impacts turned out to be somewhat different than could be expected when thinking in the traditional political-business cycle framework<sup>1</sup>. Nothing in the way of any obvious signs of the budget populism or poorer monetary policies. Populism, even if it did take place, was rather of political but not at all of fiscal nature.

The pre-election context of the previous year manifested itself primarily in certain slowing down of the economic reforms as well as in a somewhat tougher political struggle concerning the results of the past decade including more accurate realization of how fair (social-wise) is the system of power and property in Russia. Strictly speaking, these all are but only indirectly connected with the said elections – in the sense that the pre-election campaign indeed stimulates moving forward some problems to be solved, on the one hand, and slows down solution of others. Even though these problems as such are not at all caused by the elections (as different from rather standard fluctuations in the well-known electoral cycle tied monetary-budget policies).

<sup>1</sup> See: *Alesina A. Political Models of Macroeconomic Policy and Fiscal Reform. Washington D. C.: The World Bank, 1992.*

The Government was able to make a number of important steps with regard to improving efficiency in such areas as reforming the «Unified Energy System of Russia» RJSS and the Russian railways transport system, the pension reform, the local self-government system, the liberal currency legislation. Simultaneous to those first steps, a process of intensive discussion to find optimum solutions in the other no less significant directions – administrative reform, that of the budget fields (education and health service primarily), mortgage crediting, contemporary migration of population legislation, etc – was begun.

Most of the difficulties in this respect are connected not so much with the coming elections but rather with serious internal problems of the government itself: accumulated «tiredness», the non-stop load of obligations and compromises, certain lack of practical developments. In the context of forming the government majority in the State Duma in 2002, this stimulated much faster bill passing thus making the executive power analytical expertise (laws and legal acts) actually the «bottleneck» of the process.

It was only from time to time that the measures needed were too slow due to the pre election situation. Among some of such manifest examples is reforming of the «GASPROM» – the last large natural monopoly existing practically in the same way as it was made shortly before the USSR fall. The very concept of Gasprom reforming was twice suggested for the Government discussion and was both times ignored.

The migration legislation also seems to be a result of the existing pre election situation. First, a populist and very inefficient version of regulating migration flows was adopted which, on the one hand, made it significantly more difficult for the CIS citizens to come to Russia and, on the other, did not at all correspond to the administrative abilities of the state to prevent illegal immigration. However, soon after the law had been passed, the RF president suggested a list of amendments to it formal adoption of which was indeed practically guaranteed but was still put off till after the elections.

So, it was not at all in the policy of the government that the impact of the coming elections was most vividly manifested. No, the main here was a rather sharp growth of populism in both the rhetoric and practical actions of the power bodies in the sphere of politics. These will exert direct and, more likely, long-term impacts on the economic agents' behavior and, hence, on the prospects of the country's economic development. Several new and quite important phenomena should be specifically mentioned in this respect.

*Power and business interrelationships.* The most indicative of the Russia's pre-election period became the situation around «UKOS» the oil company whose problem was connected not only with political activities of M. Khodorkovsky who, for such or other reasons, preferred not to veil his ambitions with regard to the State Duma and/or the executive bodies of power. Such declarations served but only a reason to increase the force division of business and politics when the former is manifestly shown its proper place – outside of politics and under full control of the state. The impact of this happening on the respective economic developments will indeed be long-term and quite ambiguous.

One of the immediate results of the UKOS problem was greater capital out-flow from Russia in the third quarter of 2003 which, however, gradually turned into definite in-flow already in fourth quarter of the same year (see the monetary-crediting policy section, below). Nevertheless, under the present macro-economic the portfolio capital out-flow was a rather favorable factor which was restraining further strengthening of the rouble.



Quite another matter is reaction of the business which really determines direct investments. Even though this is the sphere where it is so far rather difficult to make simple conclusions. On the one hand, foreign investors who are quite used to working with tough (authoritarian) regimes very often preferring them to weak democracies but, on the other, the Russian situation does remain highly uncertain permitting no definite conclusions either with regard to conclusion about authoritarianism or democracy. It is primarily this uncertainty which happens to be most unpleasant for Russia's strategic investors. Refusal of *ExonMobile* to buy UKOS cannot be considered as indicative – under the circumstances, this particular step seemed quite natural although a massive of data regarding the foreign investors situation did cause some concern. *Firstly*, the significant capital out-flow can be mainly explained due to the crediting in-flow into the banking sector which is quite natural given the current energy price situation and continued weakening of the US dollar. That accompanied with simultaneous and quite noticeable capital out-flow in the corporative sector where overall reduction of direct foreign investments took place for the first time since the year of 1994.

Rather nervous reactions have been manifested then by the Russian business, the main problem here being loss of sufficiently clear-cut targets with regard to «rules of the game» in accordance with which relations between power and business should be developing. Yet, the difficulty remains that any promises on the part of the power bodies will be «unheard» in the best case or cause circumspection, in the worst. Business wants practical actions which it must first understand and then get accustomed to. But it is exactly these practical actions of the power bodies that business shall watch and watch. And very attentively at that. Watch and wait...

An important issue here will be the procedural aspect as such, including a possibility to find yourself under police arrest during the period of criminal investigation. The personal security problem has always generally been a key one as can be well seen in the experience of the earlier economic development stages<sup>2</sup>.

Reaction of the national business is critically important for further economic development also because foreign capital comes only in the context of extensive investment activity of the national business. This is particularly important for Russia from which large capital amounts have been taken out to be returning now mostly in the form of the foreign ones.

Another problem is perspective structure of the business community. The new political campaign may very well imply twofold consequences. On the one hand, greater anti-oligarchic rhetoric accompanied with certain actions of the respective law enforcement bodies may lead to weakening (political as well) of the country's largest business corporations and hence stronger economic and political positions of the small and average businesses but on the other, such campaign can be understood in the regions as a definite signal to start fighting against the local (regional) businesses which will inevitably involve irreparable consequences for

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<sup>2</sup> Among the main contemporary economic growth factors mention is also made of adopting of the well-known *Habeus Corpus Act* in England of the late XV11 century which guaranteed personal immunity even though the political rights did remain the privilege of the minority during at least about two hundred years. A similar story is often cited with regard to the initial Russia's New Economic Policy (NEP) period when to the lawyer's question whether rich entrepreneurs would bring money to the bank after a respective safety of bank accounts decree was taken his counterpart answered negatively because «nobody in fact has yet guaranteed immunity of the investor». (V. Mau, *Reforms and Dogmas*, M.: Delo, 1993, p. 120).

entrepreneur activity at all levels. Both these trends were already quite obvious by the end of 2003 and so far it is difficult to assert which of them will take the upper hand.

Finally, the notorious developments around «UKOS» do show in a new light one interesting theoretical discussion which has been continuing in the western economic literature on the subject of Russian economy's institutional development problems. What we mean here is the famous «*state capture*» thesis, that is when business is capturing control over decisions of the state power bodies using it then in its own purely egoistic interests<sup>3</sup>. However it is much more clear now that the role of this problem was then greatly exaggerated and that the «*business capture*» problem is at least no less important<sup>4</sup>.

*Growth of populism.* This has been manifested in both more aggressive populist rhetoric and populist parties. It also shows in the argumentation concerning results, perspectives of Russia's economic policies and the list of political parties which successfully passed the required 5 % votes level to become members of the State Duma. Obviously populist are the CPRF, the «Rodina» block and the LDPR – *organizations either not having any reasonable economic program at all or having such with a crying redistribution emphasis.*

We can also speak about strengthening of both economic and political populism as clearly manifested in the nationalistic rhetoric, in glorifying poverty, in patriotic calls to put certain politicians and/or businessmen into prison, in insistent demands to revise the privatization results, to raise the taxes and increase the respective budget expenses. Yet, even with certain corrections objectively made with regard to the inevitable pre-election passions, quite obvious is the turn of electoral preferences towards the leftist and/or restoration ideologies.

Restoring because much success has been attained by the forces appealing to the experience and achievements of the former USSR as a superpower capable, if necessary, of waging war even against the whole world. Active use of such nostalgic feelings was characteristic for practically all political parties which could win their way into the State Duma.

The beginning of renaissance for the leftist economic ideology can be spoken about in connection with at least two important aspects of the pre-election polemics.

On the one hand, revision of privatization results was demanded and although such, at least to any sufficiently large degree, seemed already hardly possible electoral interest towards this subject turned out to be demonstrated full-scale, even Moscow included. True, subject-matter of the privatization results concerned purely certain economic oligarchs no less than those from the economic-political sphere, a most well-known of whom is Yu. Luzhkov, the Mayor of Moscow. Not even mentioning the fact that starting such revision in the capital of the Russian Federation would, no doubt, be fraught with most serious aggravations.

On the other hand, unusually active for the first time were the forces demanding higher tax burden. That in view of the fact that while the CPRF has always been openly in favor of significantly higher budget expenditures, it did so on the so called «slogan level» not even mentioning any concrete mechanisms of how to try to solve these tasks, the «Rodina» block

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<sup>3</sup> See: *Hellman J., Janes G., Kaufman D.* Seize the State, Size the Day: State capture, Corruption, and Influence in Transition. The World Bank. Policy research working paper – 2444. Washington D. C.: IBRD and EBRD, 2000.

<sup>4</sup> The fate of this interesting discussion does very much remind us discussing of the virtual economy concept which happened to be extremely popular in the Western literature of 1997 – 1999. It seemed then that a rather universal theory was at last found explaining all problems of the Russian economic development for a sufficiently long period of time. However, after the 1998 default crisis, it became quite clear that these hypothetical assumptions simply cannot be practically applied to real life just because of the devaluation of the Russian rouble.



openly proclaimed the slogan of the taxation system revision towards much higher taxes including denouncing the most significant achievement of V. V. Putin's first term – the flat income tax scale.

Success of the populist rhetoric was a sort of a reaction to overcoming the crisis and the burdens of the past decade. Earlier, when the possibility of an economic crash was exceptionally high Russian electors mostly used to support responsible political forces which did not even mask their anti-populist attitudes. But now, after almost five years of continuous economic growth, an illusion is being born that we can relax, play some populism, support those who promise everything «much and fast».

Such reaction is very well known from the Latin American experience when certain political forces responsible for the economic stabilization and growth, made electors somewhat tired involuntarily pushing them to prefer the leftist populists. But the latter led the country to another economic crisis and new upheavals again result in calling back liberals of the right wing.

As to the Russian situation, however, it is too early to speak about real possibility of similar developments. In spite of the obvious success of the populist political parties most of the seats in the State Duma were obtained by the «United Russia» which intends to fill the right-centrist niche in the national political specter. But although so far there are no sufficiently strong reasons to believe that it will really be able to do it the very intention gives some hope to avoid versions of the above said Latin American type.

*New political system.* It was the first time in the modern Russian history when a party was elected to the Parliament with the absolute majority of seats but at the same time was not the only one there. No matter what one may think of that party or causes of its electoral success, it is but to be accepted that a principally new, hitherto not familiar to us – neither in the recent nor in the relatively distant past, situation has been formed. This fact does require serious analysis and will, undoubtedly, exert rather ambiguous impacts on the country's further economic and political development. Let us also pay attention to some circumstances which deem to us particularly important.

Primarily, there has taken place a new turn in the constitutional history of the newest Russia. The focus in both decision-taking and legislation development is now gradually moving into the executive power structures – to the RF President and the Government structures. But the reason is not only absolute loyalty of the «United Russia» party to President. Much more important is the fact that the Duma majority will automatically support any parliamentary bills not even caring to make the necessary expertise which is possible only in the result of competitive political struggle and the need to form a coalition majority for *each* bill to be passed. A new mechanism for bills passing was clearly demonstrated when adopting the budget for the year of 2004: «zero reading» – discussing the draft with the factions forming the majority — was conducted even before its official presenting to the Duma after which this budget went through practically without any changes.

Based on the historical experience of parliamentarism, the new constitutional situation, being formed at present, has but several alternative variants of development.

Accordingly, quite possible is taking on the so called «*sesquialteral democracy*» well known from the post-war experience of Italy and Japan when, after a period of acute parliamentary struggle, large political parties were formed in these countries which were ideologically quite heterogeneous but, even though consisting of several hostile factions, were united

by two important tasks – remaining in power and keeping the left out at any price. The ideology principles in such parties usually play but only the secondary role. Having certain inner potential, this model is quite capable of leading to a rather successful and relatively stable political development. Political crises are indeed quite possible but these are normally localized within the party itself through redistributing offices between its different factions. A serious problem for this model, however, is its exceptional corruption-prone vulnerability which can be easily understood when a political body remains in power for too long a time and at that cannot be replaced by any other political force.

Another development variant is connected with the British parliamentary experience in which case, as a result of forming the parliamentary majority, we find ourselves in a situation when the executive power does concentrate practically all decision-taking levers at that simultaneously getting automatic approval in the parliament. Being all-powerful, the British Prime-Minister can take practically any decision (including even dissolution of the parliament). As to the contemporary Russia, though such power is concentrated mostly in the hands of the President but the Premier can also play quite a significant role here. A similar development is, it goes without saying, so far but just a potential possibility because to implement it there have to be a really existing alternative political force to which electors will deliver the power during the coming elections. Otherwise the above described *sesquialteral democracy* model will indeed be reproduced again and again<sup>5</sup>.

Finally, in case of certain unfavorable development of events, no movement towards the constitutional-authoritarian variant can be excluded when power becomes concentrated virtually in one place even though the Constitution is not violated.

Attitudes towards the acting RF Constitution will be a most significant criterion when estimating both the nature and perspectives of the political and economic model forming in Russia. Preservation of its Constitution deems to be exceptionally important for gradual setting up stable democracy in it. Because in reality forming stable democracy rests not so much on the letter of the constitutional text as on unchangeability of the «rules of the game» (if these, it goes without saying, are sufficiently democratic). Strengthening of democracy in Russia does require primarily accumulation of the respective traditions the basis for which is indeed provided for by the currently acting Constitution of the Russian Federation.

### *1.1.3. Economic Policy and Economic Growth*

In the year of 2003, problems of Russia's economic growth remained a central topic of the respective economic and political discussions. Which was in a way aided by the President himself who, in his Address to the RF Federal Assembly, moved forward a direct task to double the GDP in the course of ten years and that, in its turn, provoked further discussion of a possibility or even expedience of such a target.

*Changing model of growth.* The main here became the changing economic growth trends. During the period of 2000 – 2002, these were somewhat slowing down along with the investment rates and there were at least two explanations for this phenomenon. Some connected such slower rates with inefficiency of the governmental policies, with its inability to make good use of the quite favorable foreign-economic situation, others saw the «dying

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<sup>5</sup> On comparing contemporary Russia's constitutional regime against the British model see: *Mau, V.* 1993 Constitution and Economic Reforms in Russia // *Constitutional Right: Eastern-European Review.* 2003, # 3.



curve» as a manifestation of the so called *restoration patterns*, well known from the Russia's New Economic Policy history<sup>6</sup>. In accordance with this logic, after a deep and long recession, the first growth phase is connected exceptionally with political stabilization, renewed demand and the respective practical involvement of the capacities so far still unused. However, as these gradually become somewhat exhausted, the rate growth is inevitably to be dying out. While the new growth of rates is to take place somewhat later as connected with a whole set of rather complicated and quite ambiguous factors which at this time period do practically determine this country's investment climate.

Results of this past year do permit to make certain prudent hypotheses with regard to the beginning of the new economic growth model transition. For example, in 2003, as compared against the year of 2002, increased were not only the GDP growth rates (from 4.7 % to 7.3 %) but the investments volume as well (from 2.6 % to 12.5 %). The machine-building production also grew by 7.4 % having become the second after the fuel industry. Yet, it seems a bit too early to make any final conclusions as to forming a new growth model.

*Firstly*, the structural consequences of the investment boom are not yet quite clear. In other words, there is no any definite answer as to whether this boom implies possible growth of all economic branches or it is mostly a sign of a rather favorable foreign – economic situation. Generally, the fuel industry continued to lead in the 2003 overall investment volume although still remaining at the 2001 – 2002 levels (about 21 – 22 %). It is noteworthy, nevertheless, that the fuel – industry complex is not to be considered a purely negative factor – it can very well become a locomotive for other industries as well.

*Secondly*, retaining high prices on the basic Russian export commodities may objectively slow down the structural changes in the national economy. Budget favorable oil prices will continue to exert ever more and more depressing impacts – both through setting a too high real rouble rate and high capital return in the raw material industries thus making investing in non raw-materials industries relatively much less efficient. In our opinion, this problem cannot be solved by such ever populist tax methods. At least at present.

*Thirdly*, any stability of the new trend with regard to investments growth normally does depend on political circumstances and particularly so on abilities of the power bodies to create favorable enough conditions for investors, both national and foreign ones. This last question, however, still remains open, with the political happenings of the second half of the year of 2003 not at all helping its further clarification.

Transition process from the reconstruction growth to an investment one is usually quite vulnerable particularly so if taken from the viewpoint of the present political realia. This vulnerability results from natural tangling of at least two objective trends: on the one hand, there is certain strengthening of power which needs growth to get maximum dividends from, but on the other – certain influence is exerted by the absence of deep political stability, high level of mistrust between practically all participants of the ongoing political and economic process: the state, owners, working people (they all lack the necessary «credit story» understood both in the economic and political sense). Outwardly the impression is that stabilization has taken place and the political situation does encourage business activity but in reality there is no consensus between the major political forces with regard to understanding inner problems of the country's functioning which in its turn restrains such business activity. Thus a conflict arises

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<sup>6</sup> On estimating the 2000 – 2002 economic growth as the restorative one see: Russian Economy in 2002: trends and perspectives. M.: IET, 2003. pp. 10 – 13.



between the power which is indeed expecting immediate economic dividends and the whole business community. The power then starts to look for the guilty – in the political or business environment, among officials, but this only further aggravates the situation becoming an additional barrier on the way of economic growth<sup>7</sup>.

The usual set of factors causing discontent with the country's political development is also complemented with certain peculiar features of the current foreign-economic situation which serves to create additional illusion of stability thus further aggravating discontent with the economic policies which, it seems, are giving less than they could have given. However, in this situation, such foreign-economic factors are not so much a source of additional stability but rather bring about additional dangers for taking on a stable economic growth model. The current situation with export prices is becoming a higher uncertainty factor because their dynamics is quite unpredictable for the time interval which is necessary to take the respective economic and political decisions. Besides, favorable situation stimulates serious temptations to say «no» to a prudent economic (primarily with regard to the budget) policy preferring it to populist decisions. So inevitable growth of such populist rhetoric during all the past year does not seem surprising at all.

*Discussion on the policy of growth (nature and perspectives).* Its emotional intensity was not cooled down even by higher growth rates as compared against the year of 2002. Which is not at all surprising since the growth issue is but a cause in the struggle of different political forces for power. The discussion was mainly around the economic growth rates and stimulating favorable structural shifts, i. e. overcoming the raw materials orientation of the country's economy (export included) and accelerated development of the new sectors. Thesis on the necessity to double the GDP in the ten-years time period stimulated further discussion of methods to solve this task including its compatibility with problems of the economy's structural renewal and the role of concrete accelerated economic development instruments. Part of the agenda became working out a more rapid (or catching up) growth.

About a year ago, four growth consolidation models could be singled out which were then intensively discussed: the leftist (dirigist) one, stipulation of the financial-industrial groups development (chabolization), a radically liberal model (sharply falling budget load on the national economy) and that based on developing modern economic and political institutions<sup>8</sup>. As of now, there are only two of them which dominate – the dirigist and the institutional ones.

The government suggested its own vision of the answer to this ever important question formulated fully in accordance with its practical logic of the previous three years, i. e. actual implementation of a whole set of measures of macroeconomic, institutional and sectoral nature which together comprised a complex-type program of actions.

In the macroeconomic sphere, it is supposed to be implementing a prudent, even a rather conservative policy aimed primarily at achieving monetary and financial stability including budget equilibrium as well as the so called «floating currency rate». The government's budget

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<sup>7</sup> This was exactly how the situation was developing in the end of 1920s. The USSR political leadership then were extremely discontent with slowing down of the economic growth rates and tried to explain this fact either by private sector evil intrigues or even by «intentional sabotage» of a number of well-known economists and officers of the governmental bodies. Which resulted in the crash of the New Economic Policy and transition to the policy of forcible industrialization accompanied with huge human losses.

<sup>8</sup> See: Russian Economy in 2002: Trends and Perspectives. M.: IET, 2003. pp. 19—20.



policies are also a subject of telling criticism on the part of populist supporters who demand more active budget means use (including even the RF Central Bank reserves) to stimulate faster economic growth and the respective structural shifts. Such criticism, however, is rather typical for practically all governments adhering to conservative policies – they are usually reproached with keeping growth of the country's economic power down even the growth rates are quite high<sup>9</sup>.

The institutional policies of the past year also went on very much along the previous lines. In certain areas there was some progress: reform of the natural monopolies (except for «Gasprom»), the pension system reform, development of the budget legislation (primarily the Stabilization Fund), forming the system of guarantees for physical entities bank accounts, further liberalization of the foreign currencies legislation, a number of laws in the regulation of foreign economic activity field, etc. Others were characterized by much more intensive work in forming both the concept and its legislative bases, including the administrative and the budget reforms (the social sphere and the military reform viewed through the prism of increasing efficiency of the respective budget expenditures). But although, on the whole, we can openly accept the appearance of certain reserve which was formed in 2003, its practical implementation, however, is a matter of at least several years to come.

The sectoral problems seem to be the most complex ones in forming the contemporary economic policies. Following along the 2002 Strategic Program lines, the government intentionally preferred not to determine obvious sectoral priorities with their further transforming into concrete budget decisions. Such rejection of the sectoral priorities is directly connected with certain specific features of the contemporary technological development stage when it turns out to be virtually impossible to determine, so to say *a priori*, perspective sectors and, accordingly, to allocate them the respective financial funding through any centralized source. Therefore, the traditional industrial policies measures, quite characteristic for the first half of the XX century (i. e., «*appointment of winners*»), making the sectoral budget financing priorities) seem now to be rather unacceptable<sup>10</sup>.

At the same time, a key one for the accelerated «new economic sectors» development was becoming the problem of diversifying production and export. During the whole year of 2003, both the Government and the Ministry of Economic Development continued working at the diversification concept. In this connection, a serious question was raised on using special sectoral policy measures even though somewhat different from the generally accepted (macroeconomic and political) factors to assure favorable investments climate. True again, not exactly the same special support of certain sectors and/or enterprises is meant here. The example being making special economic zones (SEZ), i. e. territories with particularly favorable conditions for business to invest and produce (e. g., much simplified administrative regime and tax privileges). Principally specific for this approach is rejection of determining

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<sup>9</sup> A typical example in our national history is the policy of V. N. Kokovtsov, first finance minister and then Prime-minister of Russia in 1909 – 1913, who was criticized for being too concerned with problems of financial and monetary stability detrimental to the country's economic growth which in that period of time comprised about 6 per cent a year (see *Kahan A.* Government Policies and Industrialization of Russia // *Kahan A.* Russian Economic History. The Nineteenth Century. Chicago and London: The University of Chicago Press, 1989).

<sup>10</sup> This subject was in much greater detail considered in: *Russian Economy in the Year of 2002: Trends and Perspectives*. M.: IET, 2003, pp. 20 – 21.

priority enterprises with privileges being provided to any of them complying with a certain set of criteria.

Using special mechanisms of economic growth stimulation and diversification does cause exceptionally acute discussions even within the very cabinet of ministers itself. That the respective state financial and tax structures are quite negative with regard to such proposals is clear because they are obviously afraid of having to face a lot of financial violations which were typical for Russia during the 1990s and which we now just trying to overcome. It also goes without saying that, although possibility of these violations must always be taken into consideration, certain growth of the so called «administrative resource» (ability of the powers-to-be to practically reach the aims set) is not to be forgotten either. Hence, greater possibilities to use special means of economic growth. Principally important here is use of these methods with no *a priori* «appointment of the winners».

Thus, the main accent in the government's economic policy concept has been made on creating the necessary institutional prerequisites as well as on ensuring macroeconomic stability to become the general economic growth base. It is also to be supposed that such an approach can stimulate stable and long-term growth based on the real and not artifact priorities (imposed by state officials or political/sectoral lobbyists). Yet, politically, this model remains still rather vulnerable. There are no any external effects in it but it does imply lengthy and rather tedious work in «growing» the needed institutions. Besides, this diversification model shall significantly depend on the changing foreign economic situation – retaining high prices on oil will seriously slow down progressive structural shifts.

There has also been formed an alternative understanding of the mechanism intended to really stimulate both economic growth rates and the respective structural shifts. This approach, quite characteristic for the leftist political forces, is most vividly manifested in speeches of the «Rodina» leaders. The block's program includes a rather standard set of macroeconomic steps typical for the leftist-populist political parties of the Latin America in the 1930 – 1950s. The main elements of this program were:

- redistribution of property and incomes («*justice*»);
- higher taxes to get that. True, in the context of the contemporary Russian situation, the accent is made primarily on return to the progressive taxation – both for the income tax and the rent;
- Active industrial policies in the traditional understanding of this notion, i. e. determining priorities (the «national pride» sectors) and their further support through the respective budget and/or tax policies;
- withdrawal of super-incomes from the «comprador bourgeoisie» sectors, i. e. from those export-oriented and then using them in certain priority directions. With regard to contemporary Russia, this thesis is understood as a demand to withdraw rent from the raw materials sector (primarily fuel and energy complex) and to use it then in the interests of the state;
- macroeconomic destabilization including not only rejection of the federal budget proficite but also permissibility of about 3 % GDP deficit simultaneously accompanied with directing the means to increase the state demand. Proposals are also made to use the Central Bank reserves for purposes of economic development;
- partial restoring of the state price regulation.



This concept, however, cannot at all be considered any original. As clearly shown by the experience of the Latin American countries, its use is rather dangerous even with regard to the industrial phase of the productive forces development. Accordingly, practically not a single country of those which tried this approach, proved able to cut down the gap with most developed states; moreover, some of them manifested sharp increase of such lag (for instance, Argentina). This is how the respective standard consequence of events in such programs is duly described in «*The Macroeconomics of Populism in Latin America*», a classical work by R. Dornbusch and S. Edwards<sup>11</sup>. During the *first* phase, the government intensifies growth pumping resources out of the exporting sectors into the so called «national pride» ones (usually machine-building) while at the same time stimulating demand through higher salaries/wages: the economy and population welfare then begin to grow as well as the power's popularity. During the *second* phase, certain macroeconomic imbalances appear (e. g., worse trade and payment balances, decreasing foreign currency reserves, growing foreign debts, more budget problems) but who would care of such «trifles» in the general context of economic growth?! The *third* phase is characterized: by rapid commodity deficit growth in the state controlled sector accompanied with much greater free prices; attempts to freeze prices result in further aggravation of the trade deficit while inevitable national currency devaluation rates is leading to almost catastrophic inflation; much worse tax collections, poorer budget, lower welfare level of the country's population. Phase *four*: fall of the government while the new (very often the military) authorities are trying to undertake radical steps to stabilize the social-political situation according to scenarios of the right-wing liberals. However, there are hardly any serious reasons to believe that such a scenario is by no means applicable to contemporary Russia.

Yet, we have a number of additional arguments causing doubts in any efficiency of such populist policies.

When trying to follow this course, the «choice» of priorities shall inevitably result in close interaction between corrupted officials and the traditional sectors lobbyists. Very much so because it is primarily these traditional sectors that are financially most well off to impose on the state their own interests disguising them as «national». But even if we had had an absolutely transparent system of decision taking no sector priorities determining would have been possible due to the principal considerations already mentioned above.

Unacceptance of the flat taxation scale would inevitably mean a radical revision of the tax policy which has been consecutively implemented during several past years – that of simplifying the tax system and, primarily, of going over to a no-progression-nor-privileges flat scale. The movement in that direction was connected not so much with the government's liberal ideological tasks as with its intentions to bring the economic (taxation included) policies in accordance with sufficiently accessible possibilities to assure the respective state legislation. It was first of all practical inability to use fine tax instruments (in particular, collection of progressive taxes) that to some extent did push the government to adopting the said flat scale. While the budget effect of this step surpassed all expectations. Ignoring these principles now could mean return to the situation when the respective state needs would not quite correspond to real possibilities for their consequent implementation. Then, fiscal efficiency would have been sacrificed to the well-known leftist ideas of «social justice».

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<sup>11</sup> See: Dornbusch R., Edwards S. (eds). *The Macroeconomics of Populism in Latin America*. Chicago and London: The University of Chicago Press, 1991.

Serious questions also arise in connection with proposals concerning rent withdrawal and/or redistribution. But the expediency of higher withdrawals into the budget from the exporting-raw sectors' profits, however, is not so much the problem here – in the context of the current world prices this is more than quite possible. Yet, there are a number of questions requiring concrete interpretations without which the increasing of the taxation problem in this sector can simply not be any responsibly discussed.

*Firstly*, sweet hopes for rent are usually of a well known «situational nature», i. e. they are normally tied up to the currently high world prices. However, there still remains open a question of where the budget get monies after the prices have finally fallen down. This is particularly important should the expected prices go down after a certain time period during which the Russian economy may become stably dependent on oil returns much more than even at present. Actually, it was the inevitable crash of the USSR that resulted in the fact that, having believed in stability of very high prices on raw materials in 1970s, the Soviet political leadership tried to adapt the economic development to this very level. However, when these prices changed the system went down as well.

*Secondly*, important is the problem of using additional resources from the rent. Which, in turn, raises this question: should greater exporting sectors taxation be accompanied with lowering of the general taxation level or do we mean greater state profits?

*Thirdly*, clarity is definitely needed with regard to the mechanism of additional profit withdrawals from the country's raw materials sectors. The rent, in this case, implies individualization of the respective sources since what is meant here is primarily the need to somewhat level up conditions for businessmen who are liable for the adequate return but not to just use the natural resource. Accepting such an approach would practically lead to the situation when any decision on a just and nationally oriented rent withdrawal is nothing more but leased to a faceless department official, i. e. inevitably leading towards much greater corruption in the state politics. Particularly so with regard to the raw materials sector. It is this which could have been one of the most obvious and dangerous consequences of the mineral tax rejection in its present form.

These considerations can not at all be considered as full arguments against greater financial withdrawals from the raw materials branches over into the national budget. In the context of favorable price situation, such withdrawal may very well be taken as quite expedient. However, it is important to do it without provoking growth of corruption or greater dependence of the country (and indeed the budget) on energy resources price fluctuations. More withdrawals from the FEC system can be reached even containing a somewhat universal approach: greater mineral tax increase of the said export withdrawals accompanied with the respective institutional «Gasprom» reform.

Finally, a fact should be noted that the ongoing discussion on the rent is mainly of political nature and has but little relationship to real actions of the acting politicians. This was fully demonstrated in June of the past year during the Duma voting on the government's proposal to increase the mineral tax level which could somewhat stimulate the profitability leveling off between the raw materials and other economic sectors. Both the left-wing and the centrists voted against this proposals then including even those who based their political campaigns on the «confiscate the rent into budget» slogans.

*Administrative reform.* Greater efficiency of administrative decisions is an important priority of improving that of the economic policy. Limited abilities of the state machinery to



solve the problems it is faced with as well as to ensure duly performance of laws is also a significant factor limiting a set of available economic policy instruments. It was to this question that the government tried to pay a particular attention in the year of 2003.

The said administrative reform is becoming a major priority in the policies of the state. The more so because resources to ensure a stable growth by means of economic instruments as such have been practically exhausted, obvious is «falling productivity» of the economic legislation when almost every new development in the area of the legal norms regulating our economic life will be less and less efficient under this system of political institutions. We can endlessly be improving the banking and labor legislation or, say, trying to solve the deregulation problems but all these will be rather futile with no significant progress in such areas as state management, the judicial and law enforcement systems or with no profound military reform.

This subject is nothing new. In 2000, when the Strategic Program was being worked out, it, at first, also included a special section devoted to problems of the state government but then, for such or other reasons, a decision was taken that the program should concentrate mainly on the economic issues. Accordingly, during the late 2002 the government was much more active in working at the administrative reform which efforts were then quite logically complemented, in the second half of 2003, with setting up a special commission under the chairmanship of the then Vice-Premier B. S. Alioshin which initiated detailed and sufficiently scrupulous analysis of functions of different governmental bodies in order to try to optimize them.

The administrative reform problem has two peculiar features making it much more difficult to solve. *First*, it will undoubtedly take a rather long time to be completed because the desirable effect here is gained gradually resulting usually after insistent work aimed at changing the state machinery's «rules of the game». Going over to other traditions, habits, customary things and even a generation in the state government sphere is sometimes much more important than changes in the respective legal base and, as obviously different from a taxation reform, no rapid or sufficiently clear results are to be expected here. Thus, a government attempting to make such changes shall have a wide enough time horizon.

*Second*, this administrative reform is to be carried out by the state machinery officials themselves, i. e. exactly by those who are most concerned. Which does contradict the general principle of the intended reforms: the players should never be allowed either to make the rules of the game or, which is even more important, to be its «impartial» referees! War generals can indeed never be entrusted with a military reform, yet it cannot be as definitely asserted that an administrative reform must be carried out only by «non-officials» just because «there is no one else around». Becoming a serious barrier on the way of the said reforms, this circumstance does require a logical demonstration of political will at the country's highest power levels.

It would be wrong to bring the administrative reform down to the question of the executive power structure or to a number of departments and offices. No, it is indeed a complex problem including a whole range of serious tasks. The main of these being the following:

- reform of the state machinery aimed first of all at greater efficiency and higher responsibility degree of its officials;
- more orderly and concrete functions of the respective ministries and departments including separation of political and controlling function as well as providing of the necessary services;

- reform of the budgetary expenditures understood primarily as a structural (but not fiscal) task which is expected to ensure greater efficiency of the budget means through changing the budgeting rules and procedures as well as through further budget network restructuring;
- lower number of those employed in the state machinery sector which is steadily growing even in spite of the market reforms.

In 2003, the said Commission on the administrative reform was mainly busy with analyzing functions performed by the state machinery bodies. Simultaneously, during the last two – three years, work is carried on to reform the state machinery itself and the budgetary expenditures.

Having concentrated its attention on the functions, the B. S. Alioshin commission principally refused to form a new «more optimal» structure of the respective offices and departments. This in any case would be rather senseless at least because in a democratic society the question of «optimum number of departments or the balance of their functions» can not be at all raised even in principle<sup>12</sup> (12). These should be sufficient enough to ensure government stability in the parliament. Should extreme conditions occur it is not difficult at all to justify making one's own department or even to concentrate all the functions in just one office (something like a «superministry»). Although the practical solution is to be sought rather somewhere in-between.

What is really important now is to formulate the concept of how the state machinery should be functioning as well as put in order the list of its functions. A significant step at the conceptual level was admission of the fact that one and the same body of power must not be entrusted with working out the policy, the respective rules/norms and inspection/control regulation which is absolutely correct because otherwise such a situation would inevitably lead to a well-known conflict of interests: first impracticable rules/procedures are introduced then due fines (or bribes) are imposed on those who are unable to fulfill them. And the private sector must be given all the functions which it can efficiently perform. A good example of the latter is a conclusion that technical realty stock-taking (i. e. functions of the notorious technical stock-taking bureaus) can be made as a market service. Similar proposals relate to vehicle technical inspection concentration of which in the hands of the Ministry of Interior is leading but to further monopolization of this market with all the respective consequences. Of principal importance in this respect may become revocation of the supervision bodies' right to interrupt functioning of business through certain extrajudicial procedures.

The following quite important directions of the administrative reform with regard to limiting and efficiency growth of the state interference into economy can be singled out here:

- working out and further practical implementation of the result-based budgeting system, i. e. allocation of budget funds to solve sufficiently clear-cut tasks;
- sufficiently transparent information on activities of the state executive bodies;
- working out and introduction of the system under which the power bodies suggesting new forms of the state interference into economic activities shall have to openly and publicly prove the real need in such state interference;

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<sup>12</sup> The so called «optimum» number of offices and departments can really be determined only under a totalitarian system. For instance, the 1936 USSR Constitution did contain a separate article with a full enumeration of all the «people's commissariats» (ministries) which with the first democratization rays though was very quickly revoked.



- introduction of procedures aimed at periodic result-effective efficiency estimating of the state regulation measures;
- higher efficiency of the state property regulation;
- full rejection of combining the executive power bodies functions with those of the managerial subjects;
- working out the respective legislation basis for the activities of self regulating organizations which are to take upon themselves a number of functions now performed by the state.

Finally, analysis of the said functions currently performed by the state, shall have to be complemented with really huge work aimed at changing a great number of normative acts in such or other way regulating activities of the state machinery – from federal laws down to innumerable departmental/local instructions. Because the very appearance of practically any such regulative document was in fact mainly intended to add more «weight» to the respective administrative department (or, not quite infrequent, to its immediate boss).

This administrative reform is but only in the beginning of the way and much more is to be done than has so far been done. However, at least one thing is clear – this work will be very and very difficult. Difficult in both technical respect (huge volume of materials to be thoroughly analyzed) and politically (vital interests of too many influential forces are involved).

#### *1.1.4. Economic policies trends and priorities for the period to come*

Summing up the 2003 results implies determining priorities not only for the coming year but for a longer period of time – preferably for the whole following political cycle.

These questions became a subject of intensive discussions already beginning from the middle of 2003 both in the president's administration and the government as well as among economists close enough to the government. In fact, several groups of ideologically sufficiently close to each other politicians, economists, lawyers, worked in parallel then. Among these were:

- the government itself, including its experts who were busy working out legislation priorities for the year of 2004. Although the subject matter actually concerned priorities for a much longer period. A particular place here was devoted to the work of the above said B. S. Alioshin Administrative Reform Commission.
- work group under I. I. Shuvalov, President's Administration Deputy Head. It was initially formed of representatives of various political forces and social groups to determine and further analyze most important questions of the country's social and economic development which can expect broad public support to be then included in the priorities list for the next four years. Five topics were prepared in the course of the preliminary discussion which were considered as priority ones – reform of education, healthcare system, further development of mortgage and house-building, military reform (primarily with regard to solving social problems of servicemen) as well as solving the problems of the Kaliningrad region, an exclave territory of the Russian Federation. These priorities having been clearly defined, there followed their intensive discussion and analysis together with the leading experts and the respective governmental officials.
- the RF Ministry of Economic Development and its Center for Strategic Development (CSD). The latter, like in the year of 2000, did become a major testing area for broad public discussions on the economic policies issues. These also included preparing a number of



important normative documents which may be presented to the RF Duma although only after the presidential elections.

Quite important here is the fact that all these expert groups work closely together and, accordingly, should not be considered as alternative but rather as mutually complementing each other.

The following can be singled out among the most important issues in the area of economic reforms for the medium-term perspective:

1. Implementing the administrative reform as a general condition for further improvement of the state machinery's efficiency, including the respective economic policies as such.
2. Completion of the conceptual development stage and beginning of the large-scale reforms in the budget sphere where procedures of decision-taking should be significantly revised with particular attention paid as regards further development of the result-based budgeting system, budget funding allocation as well as the budget-receiving network (list and status of organizations, principles of their functioning). An important element here is also rather gradual transition to medium-term budget planning. Reforming of the budget expenditures should have followed the taxation reform but unfortunately no significant developments in this direction took place in the two past years.
3. Completing the concept of how to overcome the Russian economy's raw-materials dependence with its further transforming into the system of the respective set of practical measures.
4. Following the logic of the two preceding items (reform of budget expenditures and diversification), it is indeed necessary to start work on raising the healthcare system's efficiency. This sphere, apart from its humanitarian component, may undoubtedly exert a significant multiplicative effect with regard to other economic sectors' development because it does usually stimulate creation of a chain of demand in many other sectors. That directly oriented to real but not imagined needs. A basic development direction here is transition mainly to the insurance principle having practically to do with both funding consolidation and spending (in other words, going over towards individual insurance schemes in the healthcare system).
5. Significant steps should be made in the military reforms sphere, primarily so with regard to changing the principles of armed forces recruitment. This is quite important not only politically or militarily but from the economic point of view as well: solving the vital problems of post-industrial breakthrough are hardly compatible with deriving young people from active creative activity for any long enough time. The said 2002 discussions, especially combined with greater transparency of the budget defense expenditures in the year of 2003, make a better basis for more decisive steps on the way to a really professional national army, as ever done before.
6. Continuous process of reforming the natural monopolies.
7. Completion of negotiations on joining the World Trade Organization (WTO) followed with passing of the necessary legislative acts. Any further delay in such negotiations was indeed quite fraught with dangers of putting this task off for an indefinite period of time as connected with possible reformation problems of the WTO itself.
8. Development of the normative basis and higher efficiency of the respective financial institutions' functioning. Continuous banking system reforming first and primarily aimed at making it more and more reliable. However, it is to be fully understood here that a full-



fledged solution of this important problem will be possible only if accompanied with forming the credit history of the main mass of the respective economic agents (companies, banks, citizens, the state).

9. More clear attitude towards the European Union (EU), at present the major foreign economic partner of Russia. It became clear already in 2003 that the EU will in the feasible future, no doubt, get stuck in its own serious problems (expansion, single currency, etc) and will hardly be able to devote sufficiently enough time and effort to solve the common economic space problems. In this context, it is ever more important for Russia to decide upon its policies with regard to a relative significance of the European legislation (institutions) for «inner use» naturally followed with the respective norm-taking.

Finally, it is no less important to maintain what have already been made and achieved. Which regards both the general principles of the country's functioning and a number of concrete institutions. In the political sphere, it primarily means preservation of the 1993 Constitution and its democratic system; in the economic – preservation of the 2000 – 2003 taxation system model based on low tax rates with a flat scale and privileges minimization.

## Section 2. Monetary and budgetary spheres

### 2.1. Monetary and exchange policy

In 2003, the situation in the monetary sphere was rather stable and tranquil. For the first time in the whole post-crisis period, the growth in consumer prices has been within the limits set by the RF Government in the course of elaboration of the major parameters of the federal budget for year 2003. The increase in the money supply, although still much influenced by the inflow of foreign exchange in the country, was also determined by such processes, as the growth in nominal household incomes, growing confidence in the Russian banking system, and de-dollarization of the economy. In this situation, high rates of growth in monetary aggregates had no strong inflationary impact. The changes observed in the banking sector could also be defined as positive: increasing capitalization of the banking system, expanding spectrum of credit operations (primarily due to the consumer crediting of households), decreasing interest rates, diminishing concentration in the banking sector.

Key shifts were observed in the sphere of exchange policy and the balance of payment of the Russian Federation in 2003. First, in early 2003, the administration of the Bank of Russia in fact announced about the change of priorities in its current monetary policy: the RF CB switched from the support of the Ruble exchange rate to the priority control over inflation rate<sup>1</sup>. Second, in 2003 there was adopted and entered into force since January 1, 2004, (with the exception of a number of articles) the new version of the federal law “On currency regulation and currency control.” Third, in two quarters of the past year alongside with the persisting enormous surplus on the current account there was observed the positive balance of capital transactions of the private sector. All these factors were behind a rather serious nominal rise of the Ruble against US dollar, however, due to the slide of the US dollar on the world currency markets the effective Ruble exchange rate (against the currency basket) rose insignificantly. Besides, in 2003 there was registered the process of de-dollarization of the economy including both a growth in the share of Ruble denominated savings and conversion of a part of foreign exchange denominated savings from US dollars into Euro.

Thus, the section below will focus on the following issues of monetary and exchange policy pursued by the RF Central Bank:

- Annual dynamics and factors of inflation in 2003;
- Situation concerning the balance of payments and the gold and foreign currency reserves of the RF;
- Dynamics of nominal and real Ruble exchange rate;
- Ratio between the demand and supply on the financial market, behavior of banks and households;
- Changes in the foreign exchange legislation and policies of the Bank of Russia.

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<sup>1</sup> In the studies published by IET it has been noted that in the post-crisis period empirical evaluations indicate that the Bank of Russia used the Ruble exchange rate as an actual (implicit) objective of its policy (see: *Drobyshevsky S, Kozlovskaya A. Vnutrenniye aspekty denezhno-kreditnoi politiki Rossii. Nauchnye trudy IET, No. 54, M.: IET, 2002.*

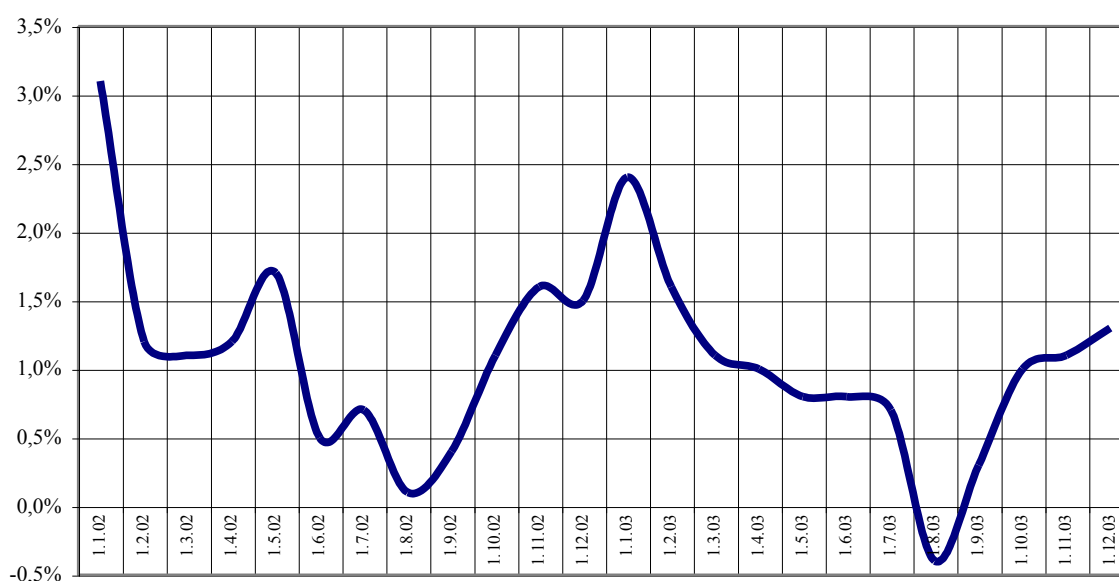


### 2.1.1. Inflationary processes

As concerns the results of 2003, the consumer price index made 12.0 per cent, what was by 3.1 p. p. below the level registered in 2002. At the same time, this indicator corresponded with the upper limit set by the official governmental forecast of inflation for the past year. For the monthly CPI dynamics in 2002 and 2003 see *Fig. 1*. Figure 1 demonstrates that the annual volatility of inflation rates had decreased. According to the RF Goskomstat, the base consumer price index<sup>2</sup> made 111.2 in 2003.

*Figure 1*

**The growth rate of the CPI in 2002 through 2003 (in % per month)**



Source: RF Goskomstat.

For the analysis of the quarterly CPI dynamics in 2003, see below.

In the first three months of the past year, the growth in the Consumer Price Index was below 5.2 per cent (in the respective period of 2002 this indicator made 5.4 per cent). As concerns the dynamics of consumer prices, there were observed the traditional seasonal fluctuations of monthly rates of growth. While in January CPI made 2.4 per cent, already in February its level decreased to 1.6 per cent, and in March the value of CPI was below 1.1 per cent. The commodity structure of growth in consumer prices was in favor of the hypothesis that exactly the seasonal factors were behind the acceleration of the growth in prices in the beginning of the year. Thus, in three months the prices of food goods increased by 4.8 per cent (in the respective period of the past year this indicator made 4.2 per cent). However, without taking into account vegetables and fruits the rise in prices of food products was registered at 2.8 per cent. The most significant rise in prices was observed in paid services rendered to households (10.6 per cent (in March of 2002 consumer prices of paid services rendered to the population

<sup>2</sup> The base consumer price index is an indicator reflecting the rates of inflation on the consumer market excluding the seasonal (prices of vegetables and fruits) and the administrative (tariffs on regulated types of services, etc.) factors is calculated by the RF Goskomstat.

increased by 14.5 per cent in comparison with the figures registered in December of 2001). At the same time, the deceleration of the rates of growth in prices of paid services rendered to households in comparison with the figures registered in the respective period of the preceding year permitted to diminish the growth in prices, since the rates of growth observed in food and nonfood goods accelerated in comparison with the figures observed in 2002.

Over the 2<sup>nd</sup> quarter of 2003, consumer prices increased by 2.6 per cent. Over the respective period of the preceding year, the growth in CPI made 3.4 per cent. As concerns the dynamics of consumer prices, in the 2<sup>nd</sup> quarter of 2003 there was observed a slowdown of the monthly rates of growth in prices. While in April consumer prices increased by 1 per cent, in May and June CPI was below 0.8 per cent. In April through June, the prices of food products grew by 2.5 per cent and prices of non-food goods increased by 1.7 per cent (in the respective period of the preceding year prices rose by 3 per cent and 3.1 per cent respectively). Prices of the paid services rendered to the population demonstrated the highest rates of growth (+ 4.6 per cent). At the same time, in March of 2002 consumer prices of paid services rendered to households rose in comparison with the figures observed in December of 2001 by 14.5 per cent, while in the 3<sup>rd</sup> quarter of 2003 the growth made 10.6 per cent. Therefore, in the first six months of 2002 the rate of inflation in Russia did not exceed 7.9 per cent.

In the 3<sup>rd</sup> quarter of 2003, consumer prices grew by 0.6 per cent. In the respective period of the preceding year, CPI made 1.2 per cent. While in July consumer prices increased by 0.7 per cent, in August, according to the RF Goskomstat, for the first time since September of 1997 on the Russian consumer market there was observed deflation, which made 0.4 per cent by the end of the month. In September, CPI was below 0.3 per cent. In July through September, prices of food products decreased by 1.2 per cent, while prices of non-food goods rose by 2 per cent (in the respective period of the preceding year prices of food products decreased by 1.4 per cent, while prices of non-food items grew by 2.1 per cent). The prices of paid services rendered to the population rose by 3.5 per cent (in the 3<sup>rd</sup> quarter of the preceding year this indicator made 7.3 per cent).

In October, rates of growth in CPI accelerated. According to the data presented by the RF Goskomstat, the consumer price index increased by 1.0 per cent in October. At the same time, the registered growth in consumer prices in November made 1.0 per cent, while in December it made 1.1 per cent. Thus, in the 4<sup>th</sup> quarter of 2003 the Consumer Price Index was registered at 3.1 per cent.

The preceding annual report presented estimates concerning the relative contribution of monetary and non-monetary factors in inflation rates observed in 1999 through 2002 on the basis of a cointegration relationship between the accumulated consumer price indices and the nominal money supply  $M_2$  (the level registered in the end of August of 1998 was taken as one)<sup>3</sup>. This formulation assumes that all components of inflation (i.e. increases in regulated

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<sup>3</sup> Monetary aggregate  $M_2$  was chosen basing on the conclusions made in IET studies: Arkhipov S., Drobyshevsky S. Modelirovaniye dinamiki inflyatsii v 1992 – 1997 gg. (Modeling inflation dynamics in 1992 through 1997) // Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii, 1991 – 1997. M.: IET, 1998; Drobyshevsky S., Kotovskaya A. Vnutrenniye aspekty denezhno-kreditnoi politiki Rossii (Internal aspects of the Russia's monetary policy). Nauchnye trudy IET, No. 45R. M.: IET, 2002. Both series (of the price index and money supply) are integrated series of the first order. The Johansen test for cointegration is in favor of the hypothesis about the existence of one cointegration relationship between the observed variables (taking into account the linear trend). The evaluated relationship looks as follows:  $P_t = \alpha M_{2,t} + \beta Trend$ .



prices and tariffs, changes in demand for real cash balances, and inflationary expectations) except the growth in money supply *per se* are non-monetary factors.

Adding the data for 2003, the evaluation of the parameters of the cointegration relationship (assuming the presence of a constant term and linear trend) for monthly data demonstrated that 1 per cent of increase in money supply  $M_2$  results in an increase in CPI by 0.315 per cent (the standard error is 0.040 per cent), the slope of the linear trend is minus 0.057 per cent per month (the standard error is 0.003 per cent). The decomposition of the increase in the consumer price index taking into account the calculated contribution of monetary and non-monetary factors in 1999 through 2003 is presented in *Table 1*.

*Table 1*

**Contribution of monetary and non-monetary factors in the rates  
of growth in CPI in 1999 through 2003**

	Increase in CPI	Monetary factors		Other (non-monetary) factors	
		Increase in CPI	Share of monetary factors in the total increase	Increase in CPI	Share of monetary factors in the total increase
1999	36,6%	19,5%	53,3%	17,1%	46,7%
2000	20,1%	29,2%	145,3%	-9,%	-45,3%
2001	18,8%	12,8%	68,1%	6,0%	31,9%
2002	15,1%	10,3%	68,2%	4,8%	31,8%
2003	12,0%	9,8%	81,7%	2,2%	18,3%

Source: IET calculations.

As it is demonstrated by the results presented above, the assessment of the contribution of monetary and other factors in the rates of growth in consumer prices somewhat changed in comparison with the preceding year, however, the overall picture remained the same. In 1999, the tight monetary policy was the key factor constraining inflation in the situation of declining demand for the Ruble denominated cash balances and persisting high inflation expectations after the Ruble devaluation in 1998, while in 2000 the growing demand for money resulting from the increase in economic activity and decline in inflationary expectations caused a decrease in CPI in comparison with the value calculated on the basis of actual rates of expansion of money supply in that year.

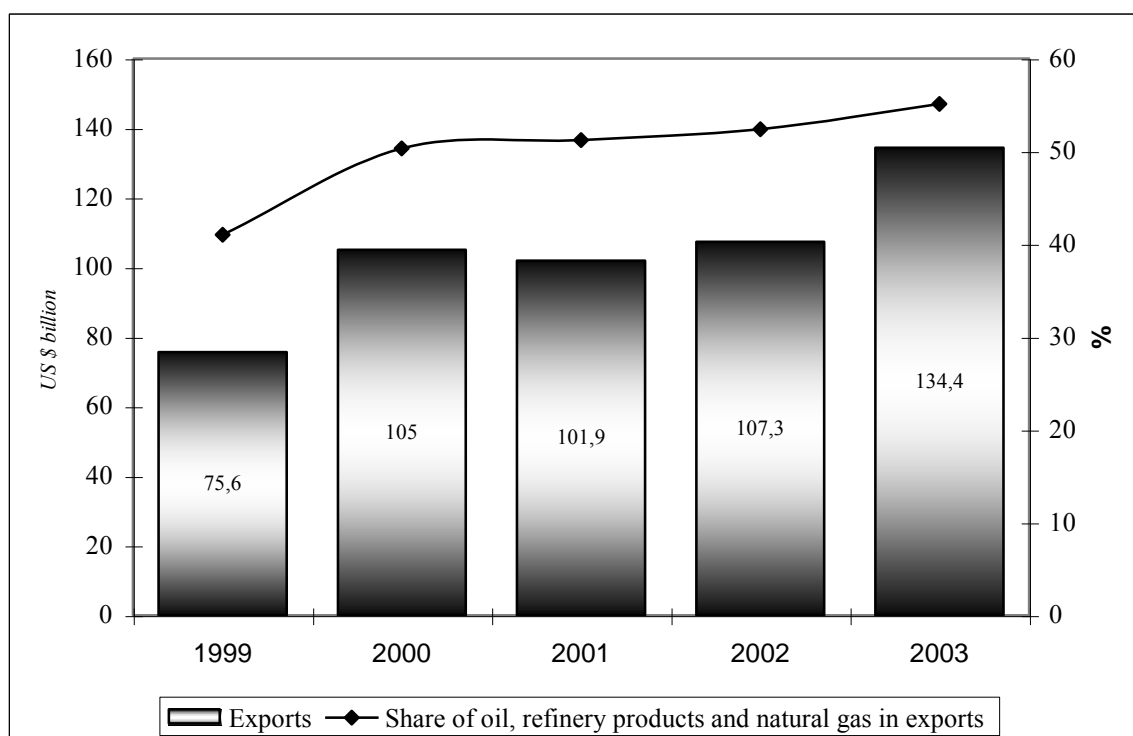
The obtained assessments demonstrate that in 2001 through 2003 the expansion of the money supply *per se* resulted in a less significant increase in consumer prices in comparison with the observed values (the inclusion of the data collected in 2003 increased the calculated values of “monetary” inflation in 2001 and 2002 in comparison with the figures published the year ago). Over this whole period, non-monetary factors (primarily increasing tariffs on products and services of natural monopolies) were responsible for about 20 to 30 per cent of annual growth in prices. However, it should be noted that in 2003 the share of inflation explained by the increase in money supply grew from 68 per cent registered in 2001 and 2002 to 82 per cent in 2003. Besides, it was supposed that in 2003 the impact of both major non-monetary opposing factors – the growth in prices of and tariffs on products and services of natural monopolies and the increase in demand for the Ruble denominated cash balances - were rather significant.

**2.1.2. The state of the RF balance of payments and the dynamics of gold and foreign exchange reserves**

According to the data on the RF balance of payments in 2003 published by the Bank of Russia, the surplus on current account made US \$ 39.1 billion, thus increasing by 32.5 per cent in comparison with the figures registered in 2002 (see *Table 2*). Over the year, the active balance of trade grew by 28.6 per cent (from US \$ 46.3 billion to US \$ 59.6 billion), as exports increased by 25.3 per cent (from US \$ 107.3 billion to US \$ 134.4 billion) and imports grew by 22.7 per cent (from US \$ 70 billion to US \$ 74.8 billion). The share of export of oil, oil products, and natural gas made about 55.1 per cent in the total amount of exports (as compared with 52.4 per cent observed in 2002) (see *Figure 2*). Therefore, the major factor determining the amount of current account surplus was the active balance of trade, which, in turn, fully depended on the changes in prices of energy resources and other staple Russian exports on world markets. The data presented in *Figure 3* demonstrate that the relationship between world oil prices and Russian balance of trade, which was noticeable in 2001 and 2002, also manifested itself throughout 2003.

*Figure 2*

**Dynamics of exports and the share of the Fuel and Energy Complex products in 1999 through 2003**



Source: RF Central Bank.



Table 2

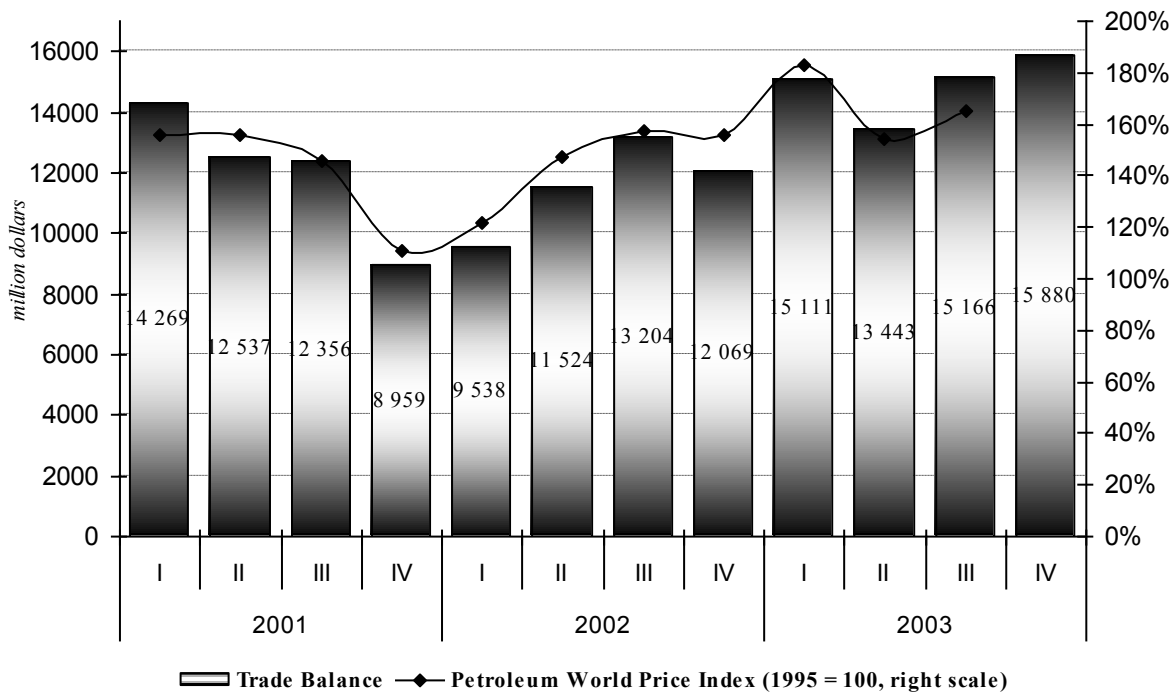
**Major items of the balance of payments in 2001 through 2003 (US \$ billion)**

Balance item	2001				2002				2003			
	Q 1	Q 2	Q 3	Q 4	Q 1	Q 2	Q 3	Q 4	Q 1	Q 2	Q 3	Q 4*
Current account	11,8	9	7,1	6,2	6,4	7,8	7,3	8	11,6	8,8	8,3	10,4
Capital and financial account	-9,1	-7,5	-4,2	-3,6	-5,4	-6,7	-5,2	-5,7	-9,9	-6,9	-5,2	-11,3
Changes in foreign exchange reserves	-1,8	-5,3	-2,5	1,4	-0,5	-6,1	-3,2	-1,6	-7,6	-8,1	2,6	-13,1
Errors and omissions	-2,5	-1,5	-2,9	-2,6	-1	-1	-2,2	-2,2	-1,7	-1,9	-3,1	0,8

Source: RF Central Bank (\* preliminary estimates).

Figure 3

**RF balance of trade and the oil price index in 2001 through 2003**



In 2003, the deficit of the capital and financial account (except changes in foreign exchange reserves) decreased by 39.2 per cent in comparison with the figures registered in 2002 (from US \$ 11.7 billion to US \$ 7.1 billion). At the same time, the inflow of capital in the banking sector grew practically three times (from US \$ 3.6 billion in 2002 to US \$ 10.7 billion in 2003), while the outflow of capital declined by 0.6 per cent and made US \$ 1.1 billion in 2003. The major part of net capital inflow was registered in the 4<sup>th</sup> quarter (US \$ 7.7 billion).

At the same time, last year the net capital outflow as concerns non-financial enterprises grew by 48.4 per cent and made US \$ 6.4 billion. Besides, it should be noted that the activity of crediting of enterprises abroad has significantly increased in comparison with the figures observed in 2002. Thus, in 2003 non-financial enterprises attracted US \$ 12.6 billion in the

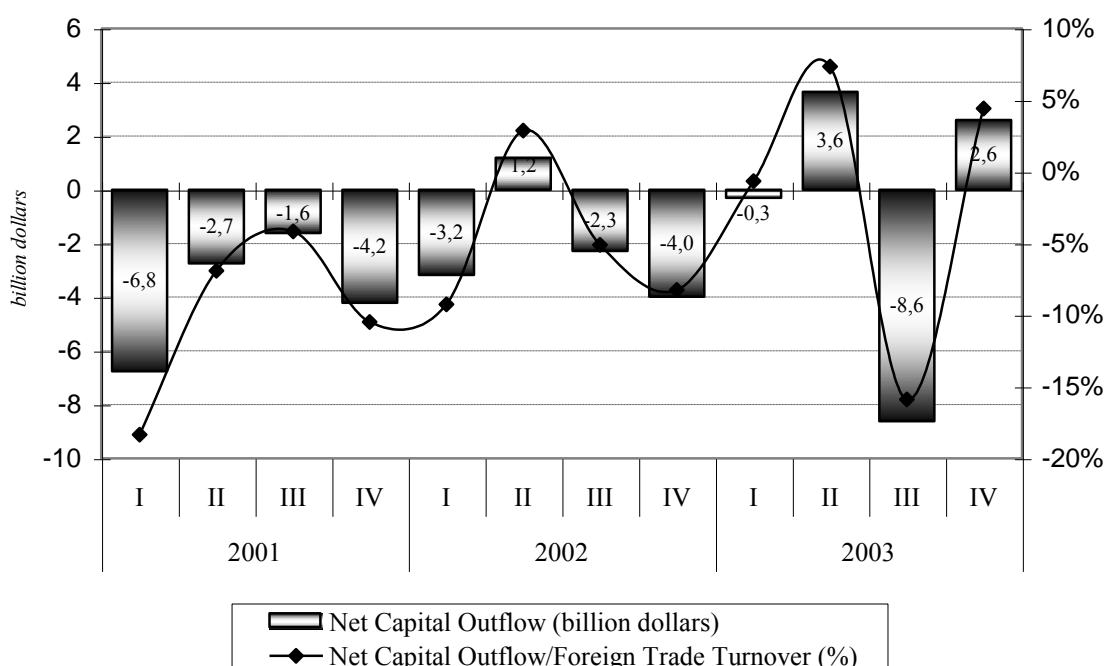


form of loans, what was almost 1.5 times above the level registered in 2002 (US \$ 8.3 billion). In the 4<sup>th</sup> quarter of 2003, the net capital outflow as concerns non-financial enterprises made US \$ 5.9 billion.

Therefore, the total net inflow of capital in the non-financial sector (the balance of official and unofficial flows) made US \$ 2.6 billion in the 4<sup>th</sup> quarter of 2003 (as compared with the outflow of capital from the non-financial sector amounting to US \$ 4 billion in the 4<sup>th</sup> quarter of 2002) (see *Figure 4*). So, in 2003 the total net outflow of capital made about US \$ 2.7 billion (US \$ 9.4 billion in 2002).

*Figure 4*

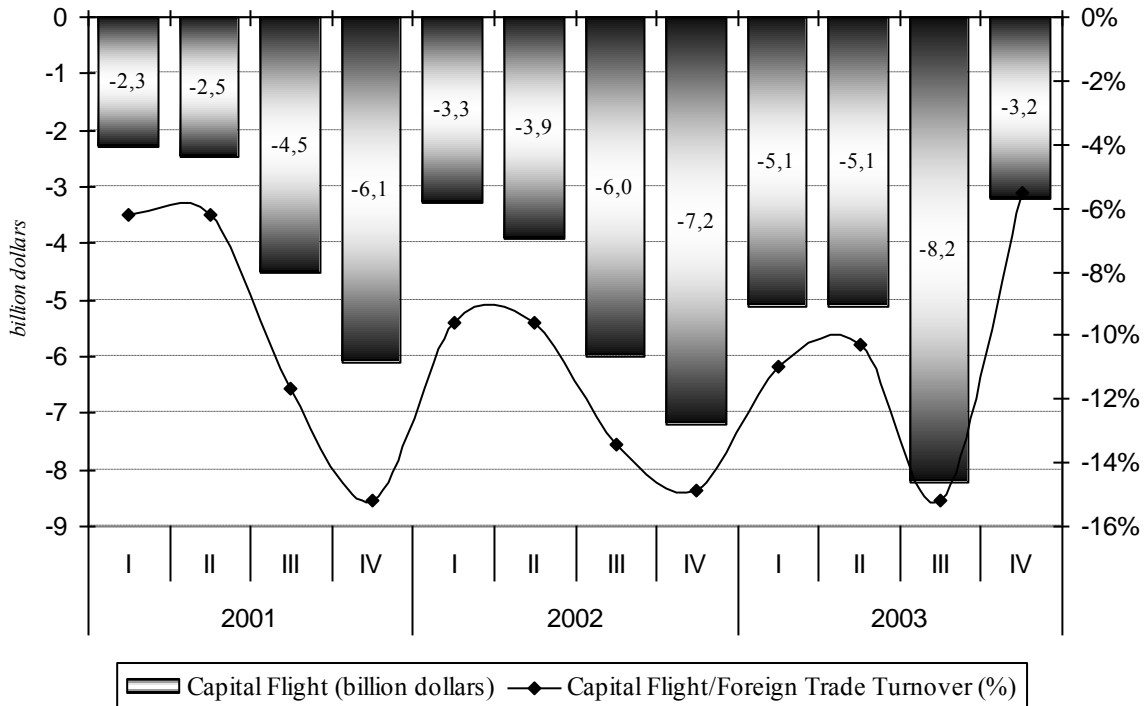
**Dynamics of net capital outflow in 2001 through 2003**



Source: RF Central Bank, IET calculations.

As concerns the unofficial outflow of capital (capital flight)<sup>4</sup> (see *Figure 5*), this indicator declined in real terms in the 4<sup>th</sup> quarter of 2003 by 60.9 per cent as compared with the figures registered in the preceding quarter and by 55.1 per cent in comparison with the figures observed in the respective period of 2002 making, according to the authors' estimates, about US \$ 3.2 billion. As a result, last year the amount of capital flight made about US \$ 21.7 billion, what is 6.4 per cent above the level registered in 2002 (US \$ 20.4 billion).

<sup>4</sup> This indicator is calculated basing on the balance of payments published by the Bank of Russia as a sum of overdue indebtedness of foreign recipients of loans, non-repatriated export proceeds, and non-repatriated import advances, as well as the net errors and omissions (the list of respective items of the balance of payments for the calculation of this indicator was made in accordance with the IMF methodology).

*Figure 5*
**Dynamics of capital flight from Russia in 2001 through 2003**


Source: RF Central Bank, IET calculations.

In the 4<sup>th</sup> quarter of 2003, there was observed a rather significant decline as concerns the indicator of the share of unofficially exported capital in the RF foreign trade turnover (from 15.2 per cent in the 3<sup>rd</sup> quarter of 2003 and 14.9 per cent in the 4<sup>th</sup> quarter of 2002 to 5.5 per cent). On the whole, in 2003 this indicator fell to 10.4 per cent (12.1 per cent in 2002). It should be also noted that in contradistinction to the trend towards acceleration of the rates of capital flight in the last quarter of the year formed over the preceding years, in the 4<sup>th</sup> quarter of the past year there was observed the opposite situation.

An analysis reveals that the major factor behind the change in the trend was a significant import of capital on the part of the banking sector in the 4<sup>th</sup> quarter. This circumstance is primarily related to the increased attractiveness of the Ruble denominated assets resulting from the recent rise of the Ruble exchange rate against the US dollar and falling world interest rates. However, this trend towards import of capital may be of a short-term or even solitary nature and primarily depends on the situation on the foreign exchange market.

The outflow of capital from the non-financial sector is still at a rather high level, what may be partially explained by the situation observed in the corporate sector (the “YUKOS affair”). However, the impact of this factor is weakening, what may be confirmed by the significant decrease in the values of the indicator of capital flight in absolute and relative terms registered in the 4<sup>th</sup> quarter. It should be noted that the ratio between the amounts of unofficial export of capital and the foreign turnover observed in the 4<sup>th</sup> quarter of the preceding year is minimal in the last three years.

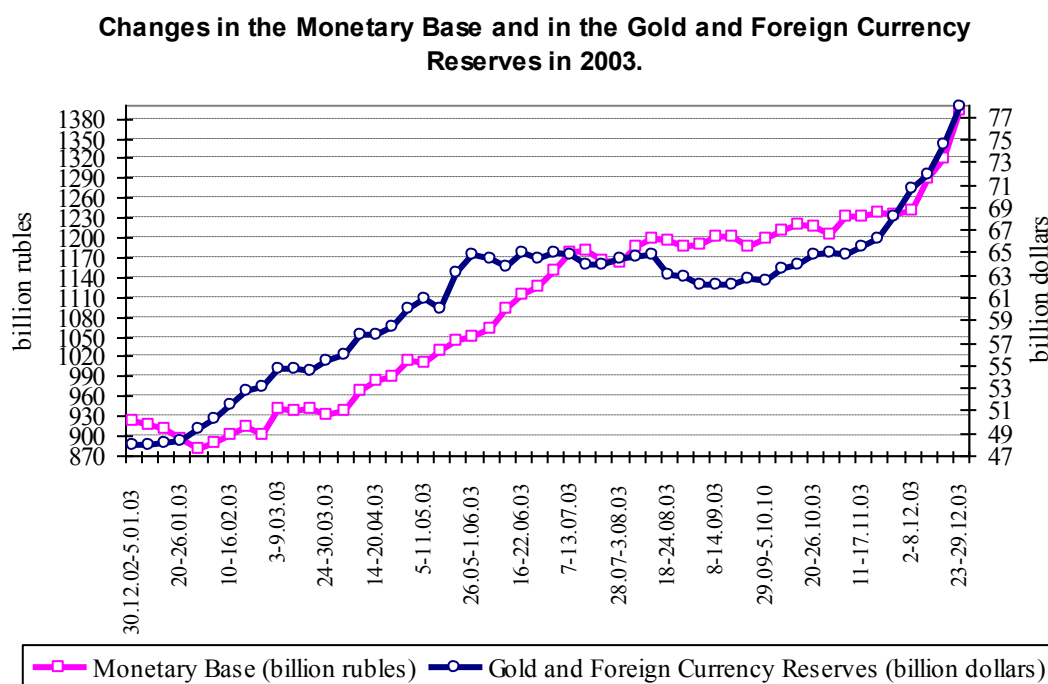
On the whole, in 2003 the net outflow of capital considerably decreased in comparison with the figures registered in the preceding year and was at the minimal level in the last few years. In the future (in the case the stable political situation persists), there should be expected an improvement of the situation as concerns the issue of outflow / inflow of capitals in the non-public sector, since macroeconomic indicators are rather positive.

Besides, basing on the analysis of the balance of payments, it should be noted that the revenues from the export of energy resources still make more than half of the total export revenues and the share of energy resources in the general structure of exports is growing for several years running. All these facts once again confirm that the dependence of the Russian economy on the export of raw materials and the respective price situation is increasing. Without broad structural reforms and significant enhancement of efficiency of the Russia's economy, it may be an evidence of a gradual decrease in the competitiveness of the Russian economy across a number of industries and deterioration of the prospects of its further development in the case the price situation on the world market of energy resources changes.

As concerns the gold and foreign exchange reserves of the Russian Federation, in 2003 these reserves grew by almost US \$ 30 billion, from US \$ 47.8 billion to US \$ 76.9 billion (+ 61.0 per cent). At the same time, the amount of gold in the structure of reserves practically did not change over the year (making about US \$ 3.75 billion), while the share of gold declined from 7.8 per cent to 4.9 per cent. As concerns the year's dynamics of reserves, there may be clearly singled out three sub-periods (see *Figure 6*), which correlate with the time of flows of capital in and out of the country.

*Figure 6*

**Dynamics of the narrowly defined monetary base and gold and foreign exchange reserves of the RF in 2003**



Source: RF Central Bank.



According to the results of the 1<sup>st</sup> quarter, the RF Central Bank increased the amount of gold and foreign exchange reserves from US \$ 47.8 billion to US \$ 55.5 billion (+ 16.1 per cent). It should be noted that gold and foreign exchange reserves accumulated in spite of a significant amount of payments relating to the external debt (in the first three months of 2003, the payments related to the external debt exceeded US \$ 4.6 billion). It should be also noted that in the period under observation the administration of the RF Central Bank has repeatedly made statements concerning the change in the policies pursued by the bank and switch from support of the nominal Ruble exchange rate to the targeting of inflation. This fact might influence the expectations of economic agents and also facilitate a decrease in demand for foreign currencies. In the 2<sup>nd</sup> quarter, the RF Central Bank increased its reserves up to US \$ 64.4 billion (+ 16.2 per cent as compared with the figures registered in the 1<sup>st</sup> quarter).

However, as the outflow of private capital from Russia intensified in the 3<sup>rd</sup> quarter of 2003, in July and September of 2003 the gold and foreign exchange reserves declined from US \$ 64.4 billion to US \$ 62.0 billion (-3.7 per cent). In the 4<sup>th</sup> quarter the growth in the gold and foreign exchange reserves resumed and there was reached the new historical maximum of the amount of reserves (US \$ 76.9 billion), it should be noted that only in December the increase in reserves made about US \$ 8.8 billion (30 per cent of the total year's increment).

### *2.1.3. Nominal and real Russian Ruble exchange rate*

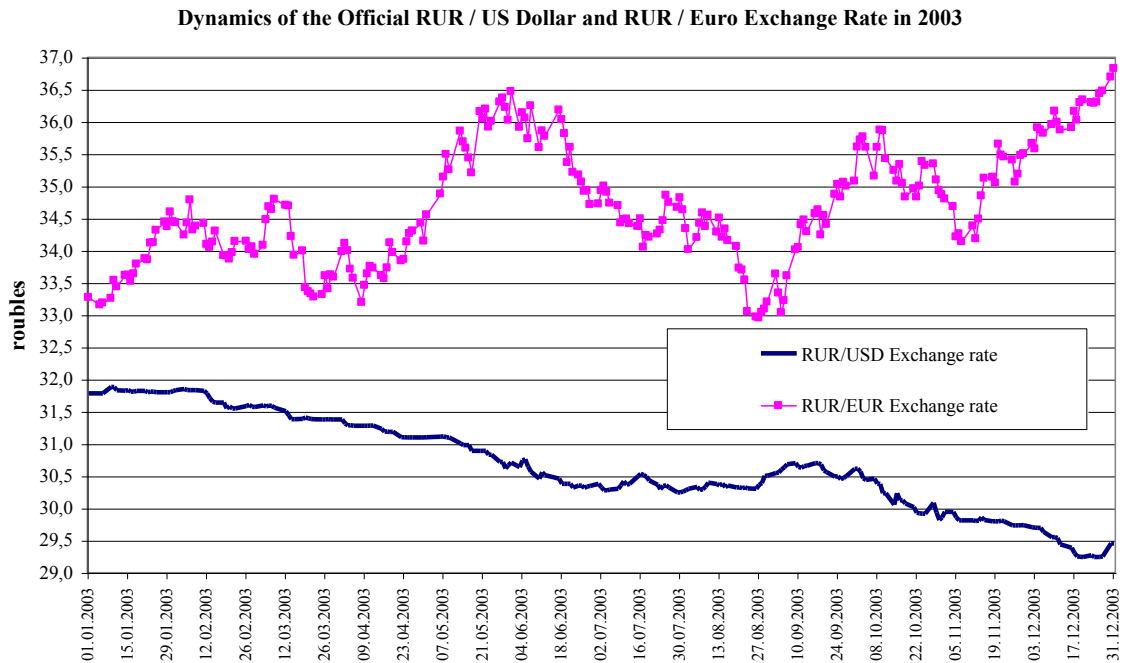
According to the results of 2003, the nominal Ruble / US Dollar exchange rate grew rather significantly. Over the year, the official exchange rate went up by 7.33 per cent from RUR 31.7844 per US Dollar to Rub. 29.4545 per US Dollar. The decrease in the US Dollar exchange rate was rather smooth (see *Figure 7*), only in the second half of August there was observed a certain strengthening of the American currency on the Russian foreign exchange market.

The Ruble / Euro exchange rate dynamics over the year were characterized by a rather significant volatility resulting primarily from fluctuations in the exchange rate of the single European currency on the world market (see *Figure 7*). On the whole, in 2003 the Ruble fell against the Euro from Rub. 33.1098 per Euro to Rub. 36.8240 per Euro, i.e. by 11.22 per cent.

Accordingly, in 2003 there was observed also the real Ruble appreciation (see *Figure 8*). For instance, the real Ruble / US Dollar exchange rate calculated on the basis of changes in the nominal exchange rate and the data on consumer price indices in Russia and the USA appreciated by 18.6 per cent, while the similar indicator calculated basing on the changes in the Ruble / Euro exchange rate and inflation in Russia and the Euro zone, on the contrary, depreciated by 1.25 per cent. The real effective Ruble exchange rate published by the IMF (in relation to the basket of currencies of the major trade partners) grew by 8.74 per cent in January through November of 2003, or by about 40 per cent in comparison with the level registered in September of 1998. Therefore, over 5.5 years after the crisis and Ruble devaluation in August of 1998, on the average the annual real effective Ruble appreciation has made about 6.5 per cent a year, what is only slightly above the rate of Ruble appreciation defined by the RF Government as acceptable (5 to 6 per cent a year). From our point of view, the observed rates of appreciation of the Russian national currency do not pose a serious threat to the competitiveness of Russia's producers, while at the same time diminishing the real costs of attraction of foreign capital, imported machinery, equipment, and technologies necessary for technical and technological modernization of the Russian economy and improvement of its products.

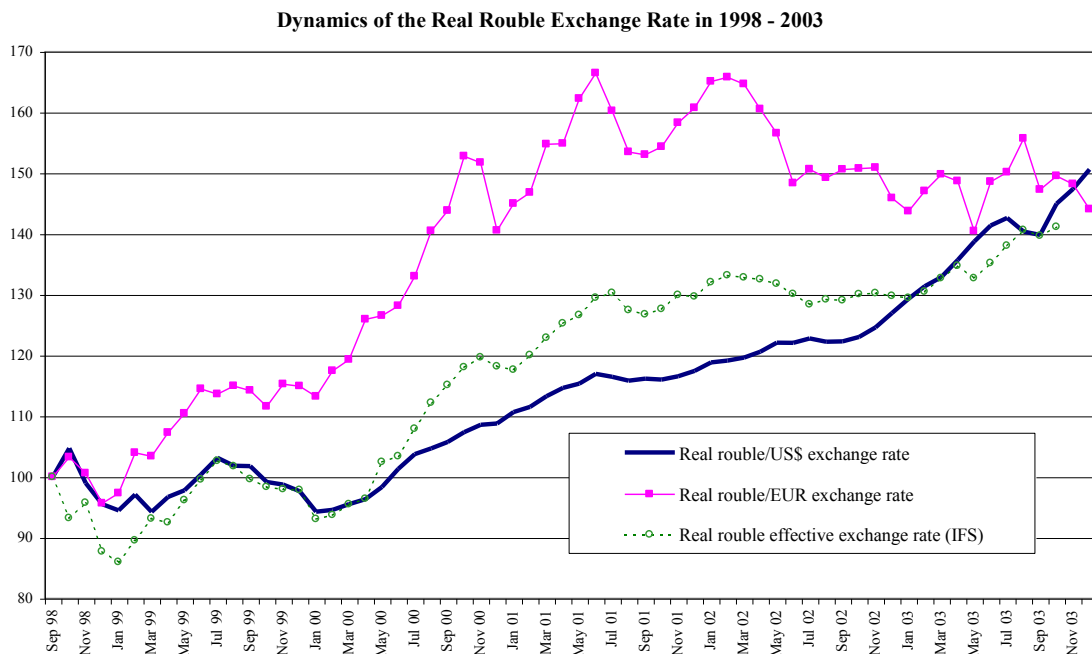
Figure 7

**Dynamics of the official RUR / US \$ and RUR / Euro exchange rate in 2003**



Source: RF Central Bank.

Figure 8



Source: International Financial Statistics, IET calculations based on the data presented by the RF Goskomstat and RF Central Bank.



In order to more thoroughly analyze the structure of the growth in the real effective Ruble exchange rate over the last years, there were calculated relative changes in the nominal and bilateral exchange rates of Ruble in relation to the major world currencies (US Dollar, Euro, British Pound, Japanese Yen, and Switzerland Franc) and national currencies of the countries being Russia's major partners and competitors in the CIS (Ukraine and Kazakhstan). The positive sign of this change means the Ruble appreciation (nominal or real), while the negative sign means Ruble devaluation. The results of the calculations for 2001 through 2003 are presented in *Table 3*.

As it is demonstrated by the Table, the most significant appreciation of Ruble against the majority of currencies (with the exception of the US Dollar and Ukrainian Hryvnia) was observed not in 2002 and 2003, but in 2001. As concerns the results of 2002 through 2003, the Ruble depreciated not only against the Euro, but also against the Switzerland Franc, while remaining practically without change in relation to the British Pound. In other words, although it is impossible to determine the relative power of all factors, the growth of the Ruble against the US Dollar in 2003 was to a considerable extent caused exactly by the US Dollar depreciation in relation to other currencies on the world market and not only due to the situation concerning the RF balance of payments. In the course of the analysis of the Ruble exchange rate dynamics against other leading world currencies over the last 2 to 3 years it becomes apparent that in spite of the excess of supply of foreign exchange over the demand on the domestic market, changes in the nominal Ruble exchange rate over this period roughly satisfy the purchasing power parity (PPP) terms, i.e. the nominal changes in the exchange rate of the national currency are equal to the ratio between the inflation rates in the country and abroad. The annual increments of bilateral real exchange rates of the Ruble and foreign currencies do not exceed 2 to 4 per cent.

*Table 3***Relative changes in the Ruble exchange rate against major world currencies and certain currencies of CIS member countries in 2001 through 2003**

	2001–2003		2002–2003	
	Nominal exchange rate	Bilateral real exchange rate	Nominal exchange rate	Bilateral real exchange rate
<b>US Dollar</b>	–4,60%	+26,56%	+2,27%	+20,73%
<b>Euro</b>	–40,87%	+1,27%	–39,01%	–13,35%
<b>British Pound</b>	–24,46%	+12,70%	–19,84%	+1,92%
<b>Yen</b>	–12,16%	+28,00%	–20,40%	+7,49%
<b>Switzerland Franc</b>	–37,12%	+8,21%	–32,14%	–4,07%
<b>Ukrainian Hryvnia</b>	–7,31%	+9,65%	+2,83%	+13,22%
<b>Kazakhstan Tenge</b>	–5,69%	+12,25%	–2,46%	+6,73%

Source: IET calculations based on the data presented by the RF Central Bank, Goskomstat, and International Financial Statistics.

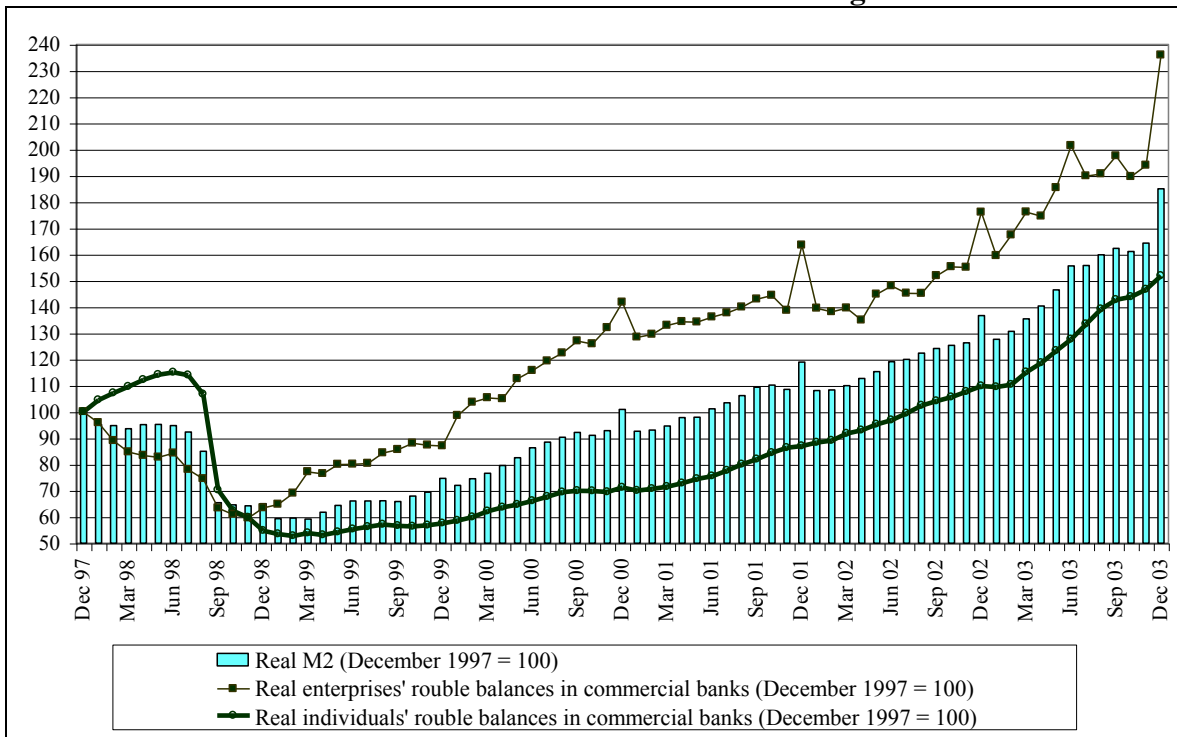
The only exceptions are Ukraine and, probably, China (the latter was not included in the Table because of the unavailability of the data on the Ruble / Yuan exchange rates and inflation in China). We believe that this situation may be explained by the fact that these currencies are pegged to the US Dollar (openly in China) and the changes in the respective exchange rates just follow the dynamics of the Ruble / US Dollar exchange rate.

In this connection, it may be assumed that in the case the US Dollar appreciates on the world currency markets in 2004, the trend observed on the Russian domestic market may reverse, i.e. the Ruble will depreciate against both the Euro and other currencies, and the US Dollar in spite of persisting considerable current account surplus. For instance, in the case the US Dollar appreciates to US \$ 1.10 to 1.15 per Euro by the end of the year (as compared to US \$ 1.25 per Euro exchange rate registered in December of 2003 through January of 2004), the nominal Ruble / US Dollar exchange rate may make Rub. 30.5 to 31.0 per US Dollar in the last quarter of 2004, i.e. return to the levels observed in the first six months of 2003.

#### **2.1.4. Money supply and demand: major factors and trends**

In 2003, the key characteristic feature of the situation in the monetary sphere was a rapid growth in monetary aggregates. In particular, the monetary base (narrowly defined) increased by 46.8 per cent over the year, while reserve money, cash ( $M_0$ ), monetary base  $M_1$ , and  $M_2$  grew by 54.4 per cent, 50.3 per cent, 45.7 per cent, and 51.6 per cent respectively. At the same time, as it is demonstrated by *Figure 6*, the bulk of the increment of money supply was observed in the first six months of the year, when the Bank of Russia issued money purchasing foreign exchange on the domestic market.

By the end of 2003, the real money supply ( $M_2$ ) made 185 per cent of the levels registered in December of 1997. As *Figure 9* demonstrates, there was observed a sharp increase in real balances in accounts of both enterprises and households indicating a growth in disposable resources in hands of all categories of economic agents. The real Ruble denominated cash balances of enterprises' accounts exceeded the pre-crisis level practically 2.5 times. In August of 2002, the balances of household deposits and accounts with commercial banks exceeded the pre-crisis maximum (in real terms) and by the end of December of 2003 made about 152 per cent of the level registered in December of 1997 (+ 38 per cent over 2003).

*Figure 9*
**Real Ruble cash balances in 1998 through 2003**


Source: RF Central Bank, RF Goskomstat, IET calculations.

The annual monetization of GDP (the ratio between  $M_2$  and GDP) made 24.1 per cent by the end of 2003, what is the maximum in the whole period of reforms, however, the monetization of Russia's economy is still significantly below the levels observed in other transitional or developing economies (see *Table 4*).

*Table 4*
**Monetization of East European economies (ratio between broad money and GDP)**

Country	Monetization (in % of GDP), 2002
Bulgaria	43,2%
Hungary	46,3%
Latvia	36,5%
Lithuania	22,1%
Poland	42,7%
Russia (2003)	29,8%
Slovakia	63,9%
Slovenia	55,6%
Croatia	65,7%
Czech Republic	34,3%
Estonia	42,0%

Source: International Financial Statistics, IET calculations.

From our point of view, this situation permits to maintain rather high rates of money supply not causing negative consequences<sup>5</sup>, at least until there is reached the level of moneti-

<sup>5</sup> Nevertheless, it was shown above that the "monetary" component in the growth of consumer prices in 2003 turned out to be more significant than in preceding years.



zation at 35 to 40 per cent (in the case the current trends of development of financial markets persist), i.e. the growth in money supply is absorbed by the economy due to the increase in demand for real cash balances.

It should be noted that the growth in demand for money on the part of households in 2003 was brought about both by the transaction motive, and de-dollarization of savings in the form of bank deposits and securities. Thus, while in 2003 the cash household incomes increased by 30 per cent, the amount of household bank deposits grew by about 55 per cent. Although it should be noted that these figures are rather hard to interpret because of the differences in the bases of comparison and economic categories they represent, such a gap in the rates of increment, we believe, is an indirect indicator of the fact that a considerable portion of the increment of the money supply appeared in the financial sector not affecting the commodity market. Besides, according to the data presented by the RF Goskomstat, yet another factor of growth in demand for real cash balances was the increase in household consumer spending. Thus, the growth in cash by 50 per cent entailed the increase in the retail trade turnover by about 20 per cent, what in fact indicates, taking into account the growth in consumption of goods not registered by the statistics of retail trade (for instance, real estate, services, recreation), as well as the aforementioned increase in savings, only the fact that the ratio between the trade turnover and money supply servicing it remains the same.

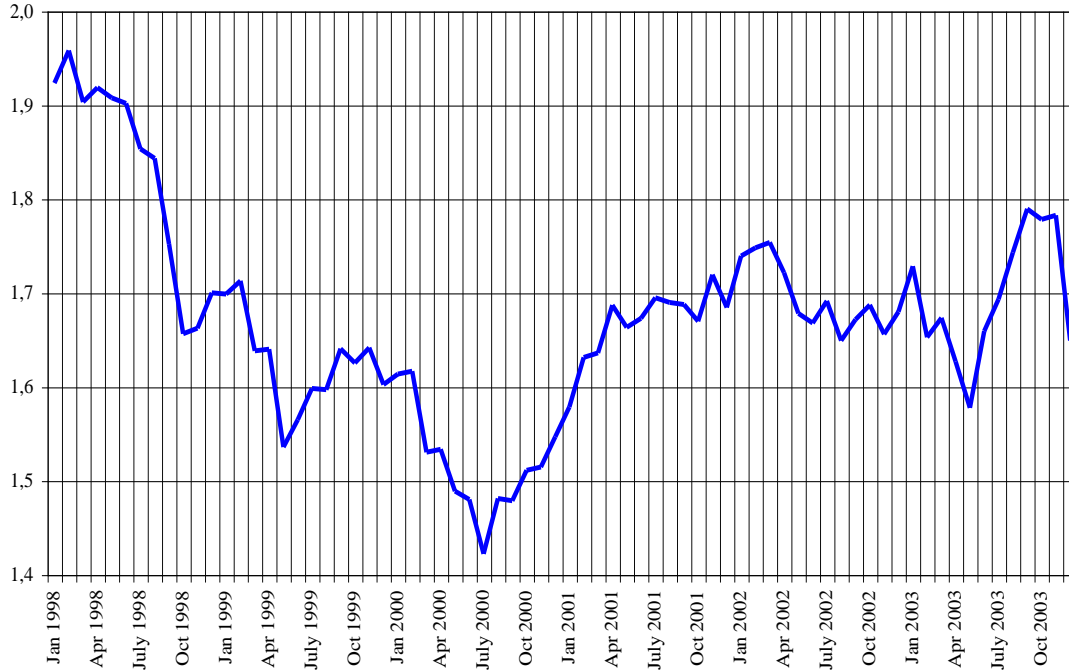
At the same time, the dynamics of the money multiplier (the ratio between  $M_2$  and reserve money) indicates that the mechanisms of money creation in the economy work very unstable (see *Figure 10*). Practically over the whole first half year there was observed a rather sharp decline of this indicator, which was down to the levels registered in early 2001. However, since June of 2003 the multiplier grew not less sharply, and the last autumn it made 1.78 to 1.79, what is the maximum registered since September of 1998. At the same time, the growth in the amount of credits extended by banks to the non-banking sector did not stop throughout the whole year (see *Figure 11*). In other words, banks constantly increased the crediting of the real sector, however, they experienced difficulties concerning the fast transformation of resources into assets in the periods, when the money supply on the part of the Bank of Russia grew. In December, the money supply multiplier again sharply declined (down to 1.65), what may be both related to the seasonal increase in the amount of cash in circulation and decrease in the balances of accounts towards the end of the year, and indicate the emergence of a new trend.

As concerns the aggregate assets of the banking sector, in 2003 they increased from Rub 3.8 trillion to Rub. 4.9 trillion (as on December 1), or from 35.5 per cent to about 40 per cent of GDP. At the same time, from our point of view the structure of both banks' assets and liabilities demonstrated positive changes. As it is shown by *Figure 11*, in 2003 the share of claims on the non-financial sector in the banks' aggregate assets gradually increased and towards the end of December of 2003 they made up to 55 per cent of the total assets (as compared with 50 per cent registered at the end of 2002). The increase in the share of claims on the non-financial sector occurred primarily at the expense of falling shares of foreign assets and claims on the public sector. The share of reserves remained practically constant over the last three years making slightly above 10 per cent of the total assets.



Figure 10

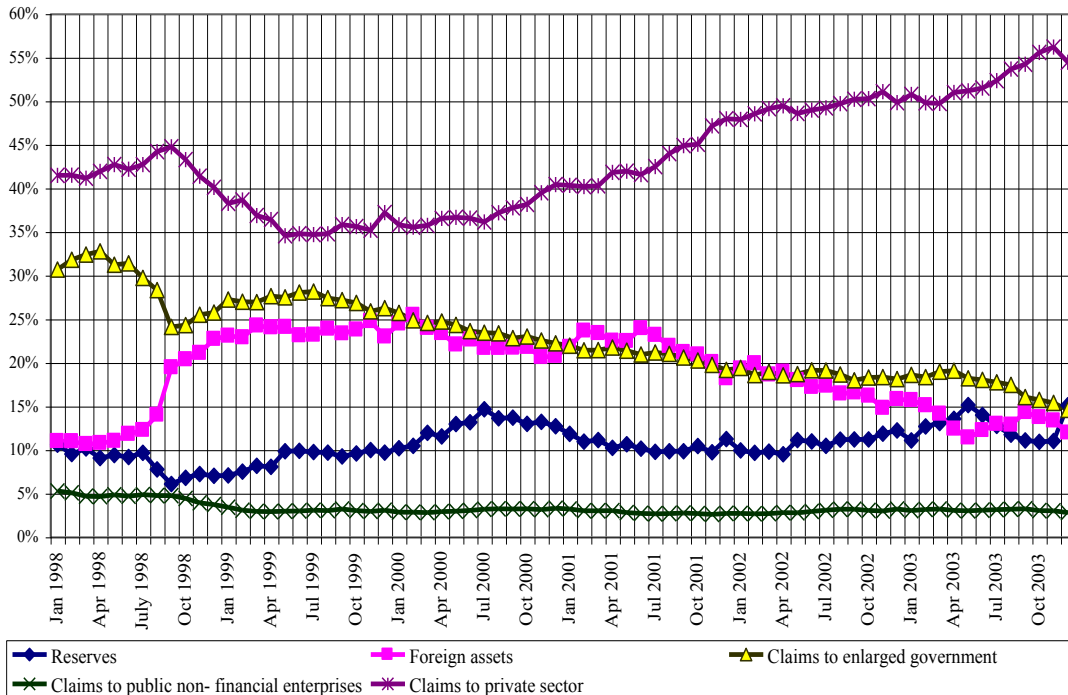
Money multiplier (M2/Reserve money) in 1998 through 2003



Source: RF Central Bank, IET calculations.

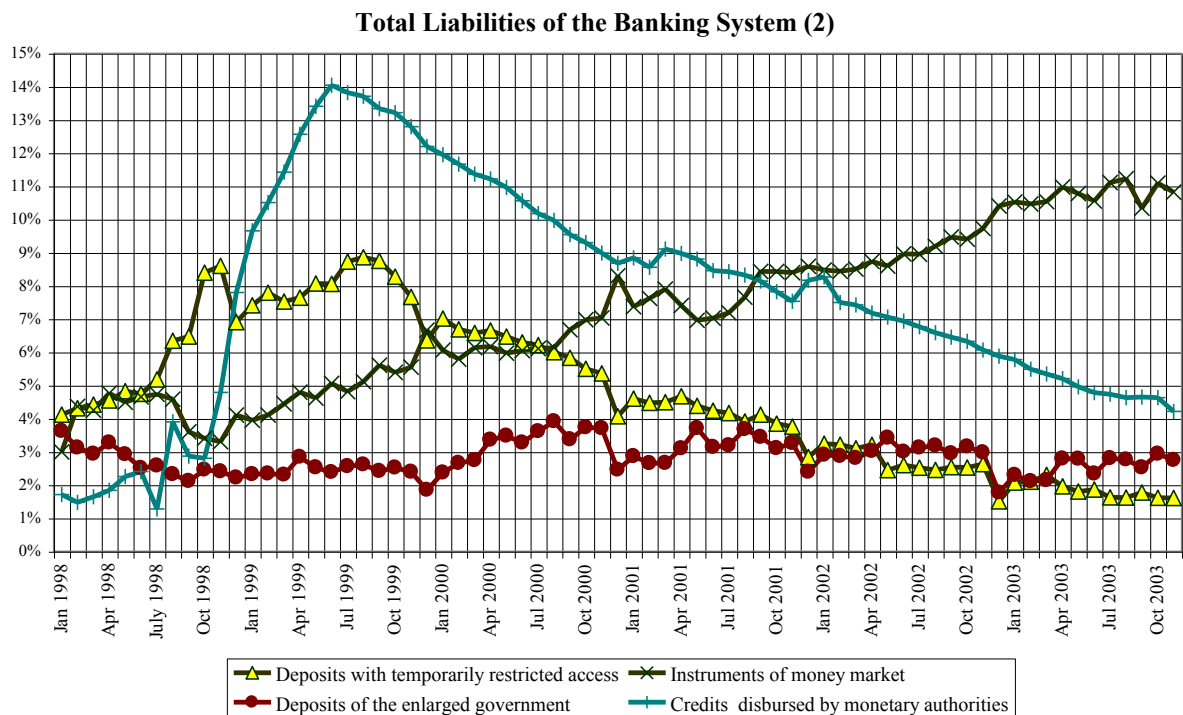
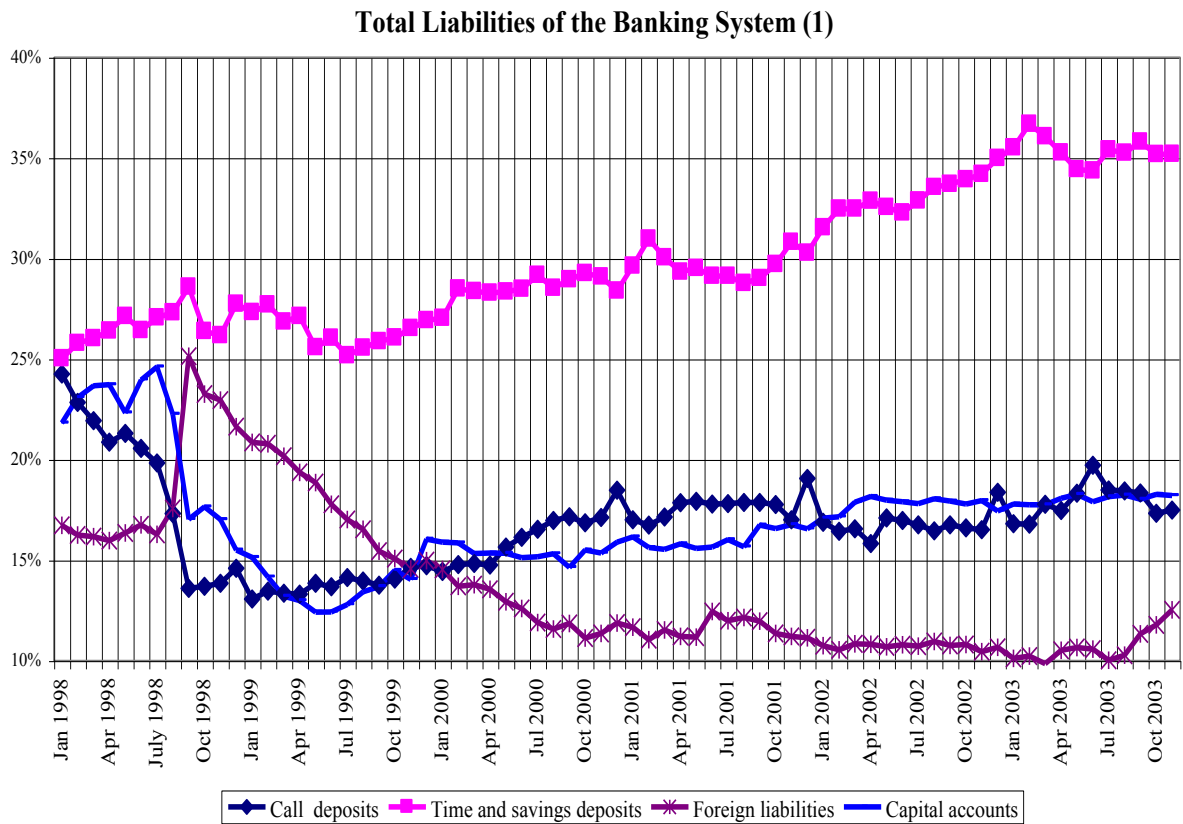
Figure 11

Total Assets of the Banking System



Source: RF Central Bank, IET calculations.

Figure 12



Source: RF Central Bank, IET calculations.



In 2003, noticeable changes were observed in the structure of aggregate liabilities of the banking sector (see *Figure 12*). For instance, the share of time and saving deposits with banks has stabilized at 35 per cent, while call deposits made 17 per cent to 19 per cent of the aggregate liabilities. In the first six months of 2003, foreign liabilities of banks were at 10 per cent of the total liabilities, however, since August there was observed a significant rise in bank foreign liabilities up to 12.5 per cent to 13 per cent, what might be also related to the conversion of a part of banks' own resources in the form of liabilities to non-residents entailed by the intensification of private capital flight from Russia registered in the 3<sup>rd</sup> quarter of 2003. Among other positive changes in the structure of the aggregated balance of the Russian banking system, there should be also mentioned the further decline in the share of liabilities to the money authorities (from 6 per cent to 4 per cent) and the share of temporary restricted deposits (from 2.0 per cent to 1.0 per cent).

As concerns the analysis of the nature of processes occurring in the Russia's banking sector, in particular, on the market of private deposits, there were reviewed the indicators characterizing the concentration in the banking sector calculated on the basis of quarterly statistics across individual banks. These indicators included the share of the largest Russian bank (the RF Savings Bank, Sberbank) in the total assets of the banking system, in the total amount of household deposits (including the breakdown by the currencies in which deposits were denominated), and credits to the non-banking sector, there was also calculated the Herfindahl index (the sum of the squares of the shares of all banks) for each of the indicators mentioned above. For the results of the calculations concerning 2001 through 2003, see *Table 5*.

*Table 5***Concentration in the Russia's banking sector**

	Share of the RF Sberbank (%)			Coefficient of concentration (%)		
	2001	2002	2003	2001	2002	2003
<b>Assets</b>	26,6	28,5	27,8	8,1	9,0	8,7
<b>Household deposits</b>	72,1	67,3	63,3	52,2	45,6	40,3
<b>Ruble denominated deposits</b>	83,8	79,2	71,4	70,3	62,9	51,2
<b>Forex denominated deposits</b>	51,3	48,3	44,7	27,0	24,1	20,8
<b>Credits to the non-banking sector</b>	28,2	28,2	28,4	9,1	9,1	9,3

Source: information agency "Interfax," IET calculations.

As the results presented in the Table demonstrate, on the whole high concentration persists in the Russia's banking system: the share of the RF Sberbank in the aggregate assets and the total amount of credits extended to the non-banking sector remains practically constant at about 28 per cent, while coefficients of concentration registered in 2002 and 2003 were even slightly above the levels observed in 2001. At the same time, as concerns the market of private deposits, the share of the RF Sberbank in both total amount of deposits and Ruble denominated deposits decreased by about 15 per cent over the two last years. It should be noted that the RF Savings Bank concentrates less than 50 per cent of the total amount of deposits on the market of forex denominated deposits.

A similar picture is observed as concerns the coefficient of concentration. The coefficient of concentration relating to both the total amount of deposits, and forex denominated components has steadily declined year on year, at the same time, the concentration on the

market of forex denominated deposits was about 2.5 times below the values registered on the market of Ruble denominated deposits.

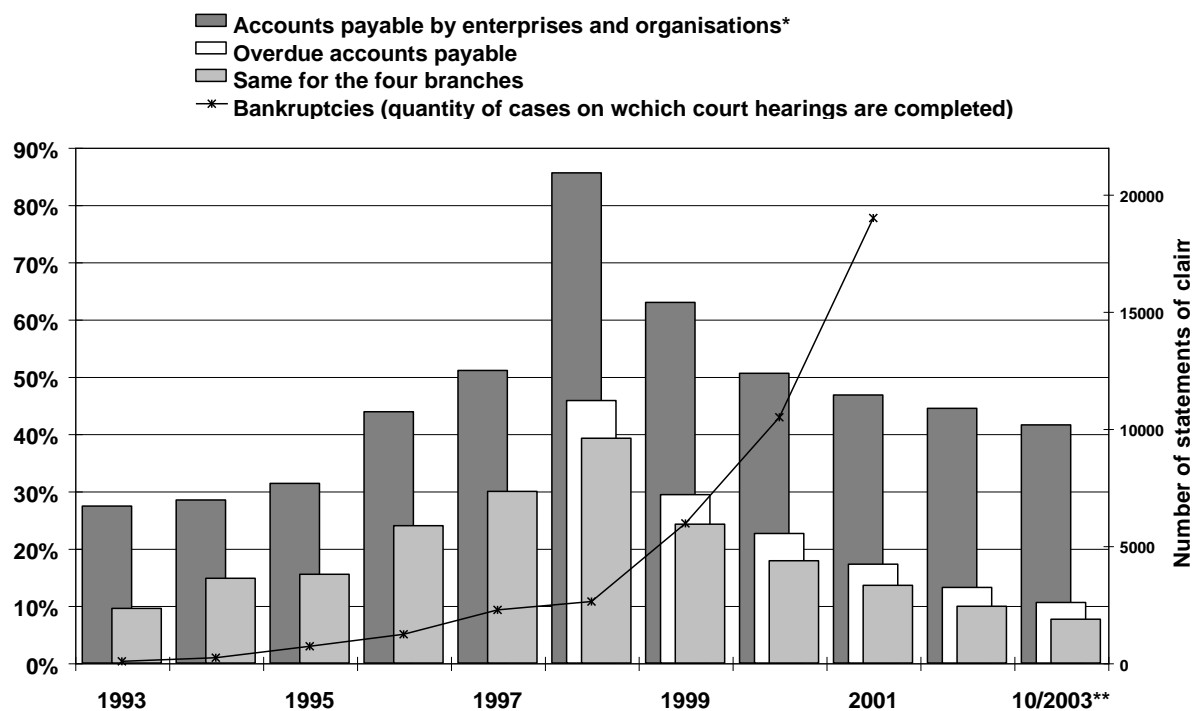
The obtained results indicate that the competition in the banking sector, primarily on the market of household deposits, is intensifying. At the same time, the dominating position of the RF Sberbank in the banking sector at large does not change, primarily due to the fact that the bank has the potential (because of the amount of its resources) to credit largest Russia's companies offering an alternative to foreign financing and due to its leading position on the market of government securities.

### 2.1.5. Enterprises and organizations: the state of payments

In January through October of 2003, the trends towards the decline in payment arrears in the economy persisted. The decline in outstanding and accumulated creditor indebtedness continued. In October of 2003, the accumulated amount of outstanding indebtedness of organizations and enterprises in the economy made about 10.6 per cent of GDP (in 1998, in the period of the acute crisis, this indicator made 46 per cent (see *Figure 13*).

*Figure 13*

#### The level of accumulated payment arrears (as the share of GDP): dynamics in 1993 through 2003



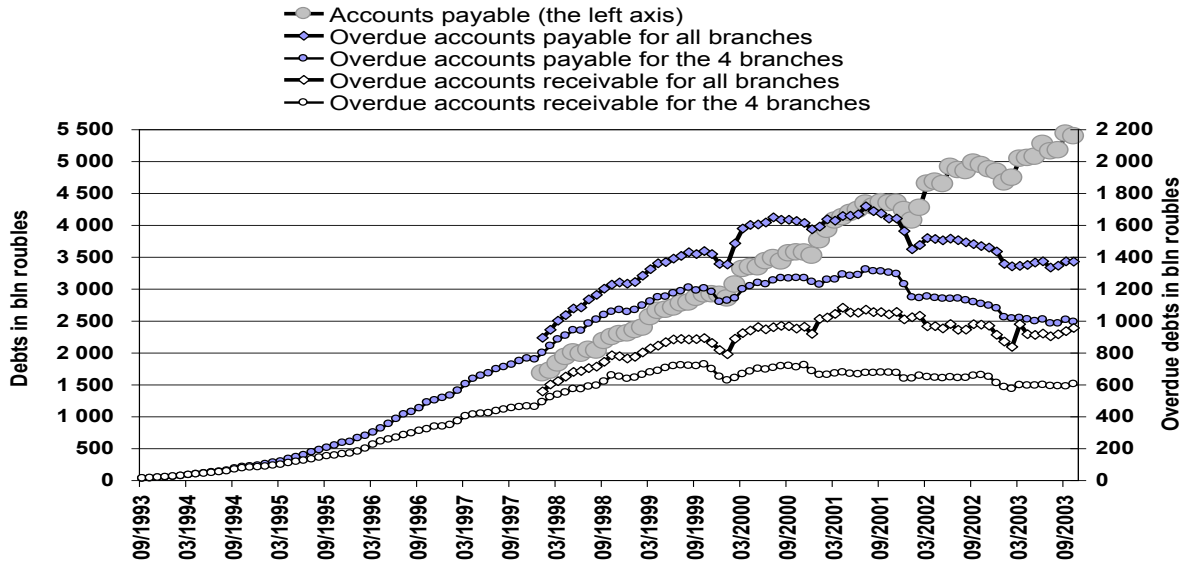
\* Prior to 1998, the RF Goskomstat published payment arrears statistics for four sectors of the economy (industry, agriculture, transport, construction). Since 1998, the aggregate indebtedness in the economy has been calculated across all sectors of the economy.

\*\* Preliminary data.

Source: RF Goskomstat, IET calculations.

*Figure 14*

**Dynamics of outstanding creditor and debtor indebtedness across all sectors of the economy and branches of industry, agriculture, construction, and transport (4 sectors) in current prices**



Source: RF Goskomstat, IET calculations.

The share of outstanding indebtedness in the total indebtedness continues to decline and makes less than 30 per cent (the maximum – 55 per cent was observed in 1998, see *Figure 15*).

In the first 10 months of 2003, the amount of outstanding creditor indebtedness declined by 4.5 per cent (Rub. 64 billion). In the respective period of 2002, the outstanding creditor indebtedness decreased by 6 per cent, while the total decline in outstanding creditor indebtedness in 2002 made 8.2 per cent. Taking into account small amounts of debts written off to financial results (see *Table 6*), the decline in payment arrears may be attributed to the restructuring and direct repayment of debts.

*Table 6*

**Amounts of outstanding indebtedness of economic agents written off to financial results**

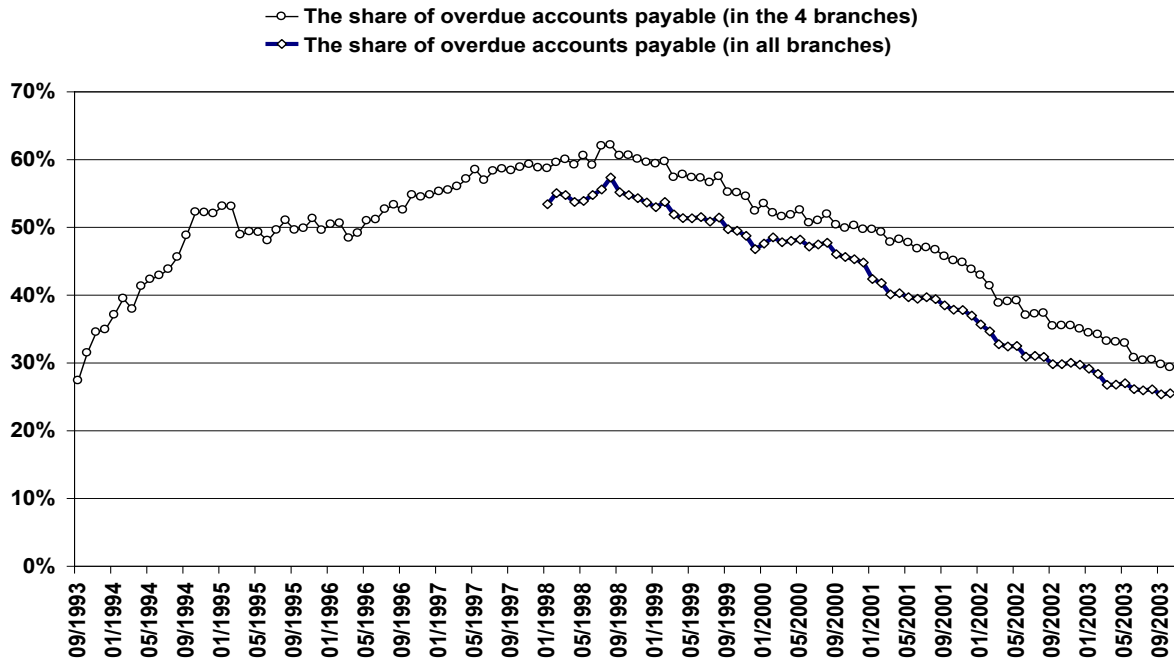
Period	Creditor indebtedness written off to profit			Debtor indebtedness written off to losses		
	Total, Rub mil	in % to overdue creditor indebtedness	in % of annual Increment in overdue creditor indebtedness (including write-offs)	Total, Rub mil	in % to overdue creditor indebtedness	in % of annual Increment in overdue creditor indebtedness (including write-offs)
1997	874	0,1	0,4	1 921	0,4	1,5
1998	2 777	0,2	0,7	7 990	1,0	3,2
1999	5 597	0,4	4,3	12 420	1,5	19,1
2000	6 598	0,4	3,0	21 955	2,4	17,8
2001	10 185	0,7	-774,5	25 783	2,6	22,1
2002	12 861	0,9	-11,2	24 000	2,6	-33,1
10/2003*	9 937	0,7	-18,4	16 514	1,7	28,0

\* according to the results of the first three quarters of 2003.

Source: RF Goskomstat, calculations of the authors.

Figure 15

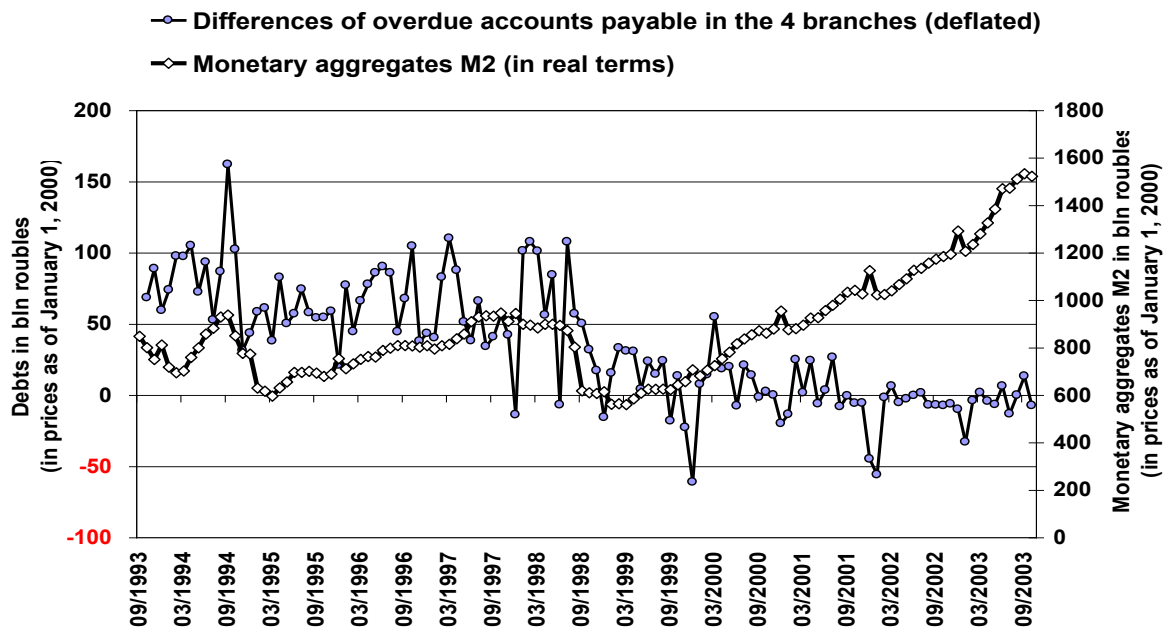
**Dynamics of the share of outstanding creditor indebtedness  
in the total creditor indebtedness**



Source: RF Goskomstat, calculations of the authors.

Figure 16

**Dynamics of increment in outstanding indebtedness and money supply (M2)**



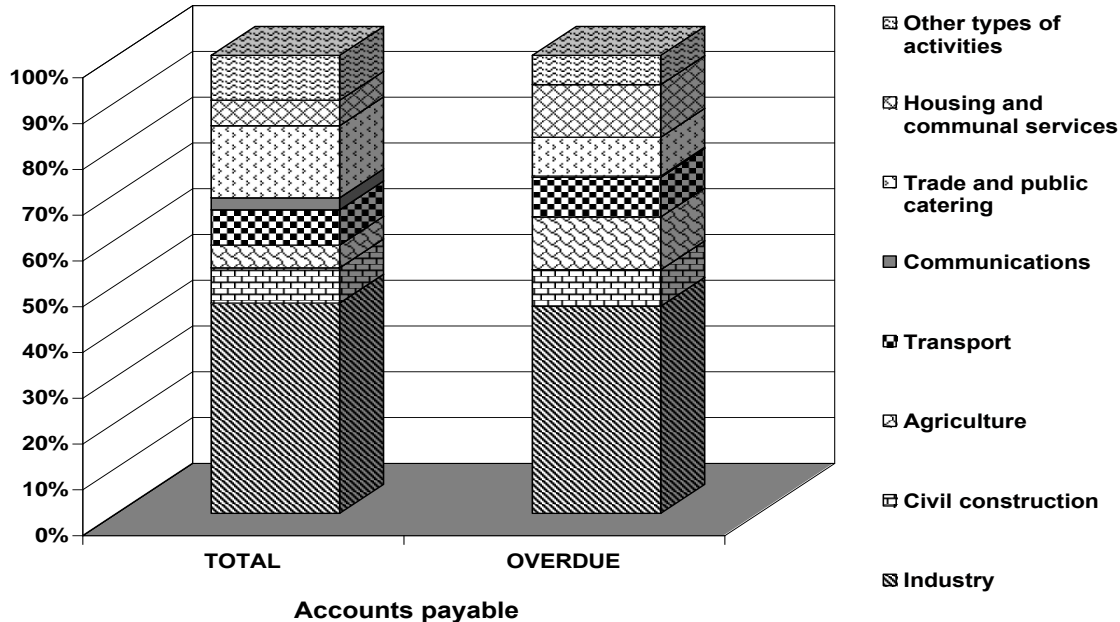
Source: RF Goskomstat, CB of RF, calculations of the authors.

The transition to cash types of payments presupposes an increase in transactional demand for cash balances. It seems that this fact is a factor behind a stable growth in money supply over the last few years. Since 2001, the amount of money supply has reached its highs registered over the period starting in 1993 (see *Figure 16*). Another factor behind this development was expansion of bank crediting of the real sector, what contributed in substitution of the commercial crediting and contraction of payment arrears.

As concerns the sectoral structure, debts of industry stable make the major share of the total and outstanding indebtedness. At the same time, while the share of the industrial sector makes about 43.6 per cent in the total amount of creditor indebtedness, it makes 44.6 per cent in the total outstanding indebtedness (the figures as in October of 2003). It shall be noted that the share of industry has somewhat decreased in comparison with the figures registered in July of 2002. Similarly, housing and public utilities, agriculture, and transport (since January of 2002) have accounted for a larger share in the outstanding creditor indebtedness than in the total amount of indebtedness. This ratio indicates that repayment of commercial credits in these sectors is more often delayed as compared with other sectors. For instance, outstanding debts make 61.4 per cent in creditor indebtedness of agriculture and 54.7 per cent of indebtedness of housing and public utilities. On the average, this indicator makes 25 per cent in Russia.

*Figure 17*

**Structure of creditor indebtedness across base sectors of the economy  
by the end of October, 2003**



Source: RF Goskomstat, CB of RF, calculations of the authors.

Among industries, the leaders in terms of their share of outstanding indebtedness in the aggregate creditor indebtedness are coal industry (68 per cent, see *Table 7*), power engineering (42 per cent), light industry (43 per cent), and microbiological industry (70 per cent). However, while the amounts of indebtedness of two latter industries are relatively small, the debts of



power engineering and branches of fuel industry total to about one third of the total indebtedness in the economy on the whole. The largest consumer of commercial credits in absolute terms are branches of mechanical engineering and metal working, as well as fuel industry. It shall be noted that the amount of outstanding debts in natural gas industry and ferrous metallurgy significantly declined in the first ten months of 2003.

*Table 7*

**Structure of creditor indebtedness across industries as at the end of October of 2003**

Industries	Creditor indebtedness		Share of outstanding indebtedness in the total indebtedness, %		Share of creditor indebtedness of the industry in the aggregate indebtedness of the industry on the whole, %	Share of outstanding creditor indebtedness of the industry in the aggregate indebtedness of the industry on the whole, %
	Total, Rub. billion	Including outstanding debts, Rub. billion	October of 2003	Memorandum, July of 2003		
<b>Industry, total</b>	<b>2347600</b>	<b>610800</b>	<b>26,02</b>	<b>27,48</b>	<b>100,00</b>	<b>100,00</b>
Including, power engineering	234800	98700	42,04	44,84	10,00	16,16
Fuel industry	741900	120000	16,17	17,78	31,60	19,65
Including						0,00
Oil extracting industry	397100	14900	3,75	4,75	16,92	2,44
Oil processing industry	64900	14200	21,88	13,71	2,76	2,32
Natural gas (extraction and processing or natural and casing head gas)	187500	28400	15,15	15,82	7,99	4,65
Coal industry	91200	61900	67,87	68,00	3,88	10,13
Ferrous metallurgy	111100	24000	21,60	20,10	4,73	3,93
Non-ferrous metallurgy	124000	36600	29,52	28,64	5,28	5,99
Chemistry and petrochemistry (without chemical pharmaceutical industry)	116500	40400	34,68	35,82	4,96	6,61
Mechanical engineering and metal working	616400	176300	28,60	28,75	26,26	28,86
Forestry, woodworking, and pulp and paper industry	58700	22300	37,99	40,50	2,50	3,65
Industry of construction materials	60200	23000	38,21	39,13	2,56	3,77
Glass, porcelain, and faience industry	8300	2400	28,92	29,27	0,35	0,39
Light industry	35800	15300	42,74	45,63	1,52	2,50
Food industry	180100	27300	15,16	16,47	7,67	4,47
Including fish industry	26800	5600	20,90	25,17	1,14	0,92
Microbiological industry	4000	2800	70,00	69,23	0,17	0,46
Flour, grits, and combined fodder industries	16500	3700	22,42	26,06	0,70	0,61
Medical industry	9100	1800	19,78	21,43	0,39	0,29
Printing industry	6700	200	2,99	3,39	0,29	0,03

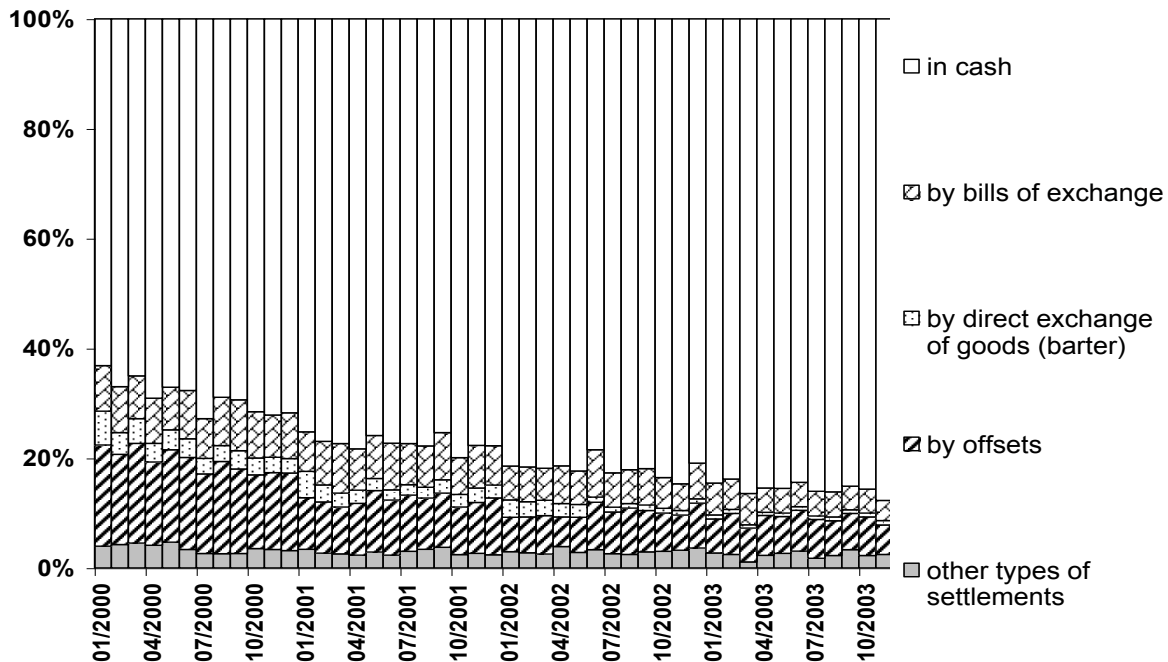
Source: RF Goskomstat, IET calculations.

Energy monopolies played a significant role in the decrease in payment arrears (since 1998) as they significantly diminished the use of all types of non-cash payments for shipped and purchased products. Even a greater decrease in barter operations in favor of offsets may

be singled out among major changes in the structure of payments for shipped products of monopolistic enterprises<sup>6</sup>. The share of cash payments made by these enterprises has stabilized at about the level of 87 per cent (see *Figure 18*).

*Figure 18*

**Monopolistic enterprises: the structure of payments for shipped products**



Source: RF Goskomstat, IET calculations.

At the same time, certain new trends are alarming. First of all, these concerns are related to the factors, which may cause growth in outstanding indebtedness<sup>7</sup>. For instance, since 2002 there has been observed a steady increase in the share of loss making enterprises in the economy (see *Figure 19*). This trend could be reversed only in July of 2003, when there was observed an insignificant decline in the share of loss making enterprises in industry and agriculture (by 0.8 per cent and 0.4 per cent respectively). At the same time, in October of 2003 the share of loss making enterprises in transport increased by 2.2 per cent in comparison with the figures registered in the respective period of the preceding year. In October of 2003, the share of loss making enterprises in industry made 44.7 per cent (as compared with 45.3 per cent reg-

<sup>6</sup> According to RF Government Resolution No. 10 of January 6, 1998, the RF Goskomstat conducts statistical monitoring of payments of largest Russia's taxpayers: "UES of Russia," "Gazprom," "Aeroflot – Russian international airlines," organizations of the federal railroad transport, and industrial monopolistic organizations.

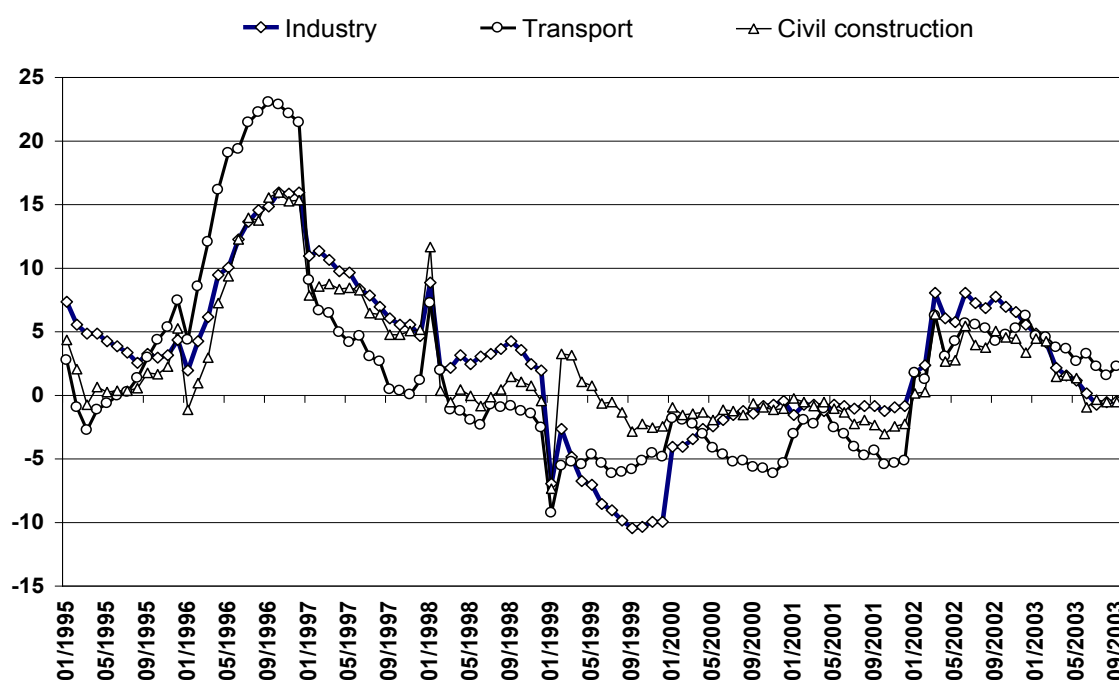
<sup>7</sup> According to the results of econometric studies, the growth in payment arrears is, in particular, related to ineffectiveness of domestic producers, shrinking of bank crediting, etc. See, for instance, R. Entov, A. Radygin, V. Mau, S. Sinelnikov-Murylev et al. "Razvitiye rossiyskogo finansovogo rynka i novye instrumenty privlecheniya investitsiy (Development of the Russian financial market and new instruments attracting investment)," IET, 1998, pp. 96 – 149; O. Lugovoi, D. Semenov "Neplatezhi v Rossiyskoi Federatsii (Payment arrears in the Russian Federation)," IET – USAID, 2000; R. Entov, L. Lederman, O. Lugovoi, A. Zolotareva 'Payment arrears in the Russian Economy and Regions', CEPRA, 2001.

istered in October of 2002), while in transport this indicator made 48.3 per cent (46.1 per cent in October of 2002), and in construction – 39.4 per cent (40.5 per cent in October of 2002).

According to calculations<sup>8</sup>, ineffectiveness, financial insolvency of enterprises was a key factor behind the generation of payment arrears in the economy, which indicated the existence of a “channel of financing of bad firms.” This relationship was most characteristic for the period prior to 1998. After the crisis, the share of ineffective enterprises constantly decreased, and the statistical significance of this factor diminished. Although no increase in payment arrears has been registered, this danger still exists.

Figure 19

**Changes in the share of loss making enterprises across industries  
(seasonal differences to respective periods of the preceding year)**



Source: RF Goskomstat, IET calculations.

Outstanding wage and salary indebtedness has remained stable since 2000 at about Rub. 30 billion to Rub. 40 billion (in current prices, see *Figure 20*). The annual decrease in this indicator in terms of current prices (figures registered in October of 2003 to figures registered in October of 2002) made 15 per cent.

Taking into account the positive experiences of the recent years, the emergence of a new payment crisis of similar scope looks less probable each new year, however, in the case negative economic trends prevail, this threat may arise again. The first issue of concern is the trend towards the real Ruble exchange rate appreciation, what negatively affects the competitiveness of the majority of the Russia’s enterprises and may facilitate a decline in their efficiency. Nevertheless, in the changed institutional environment (tighter budget constraints) it could hardly be expected that external shocks might result in the emergence of a new nonpayment

<sup>8</sup> Ibidem.

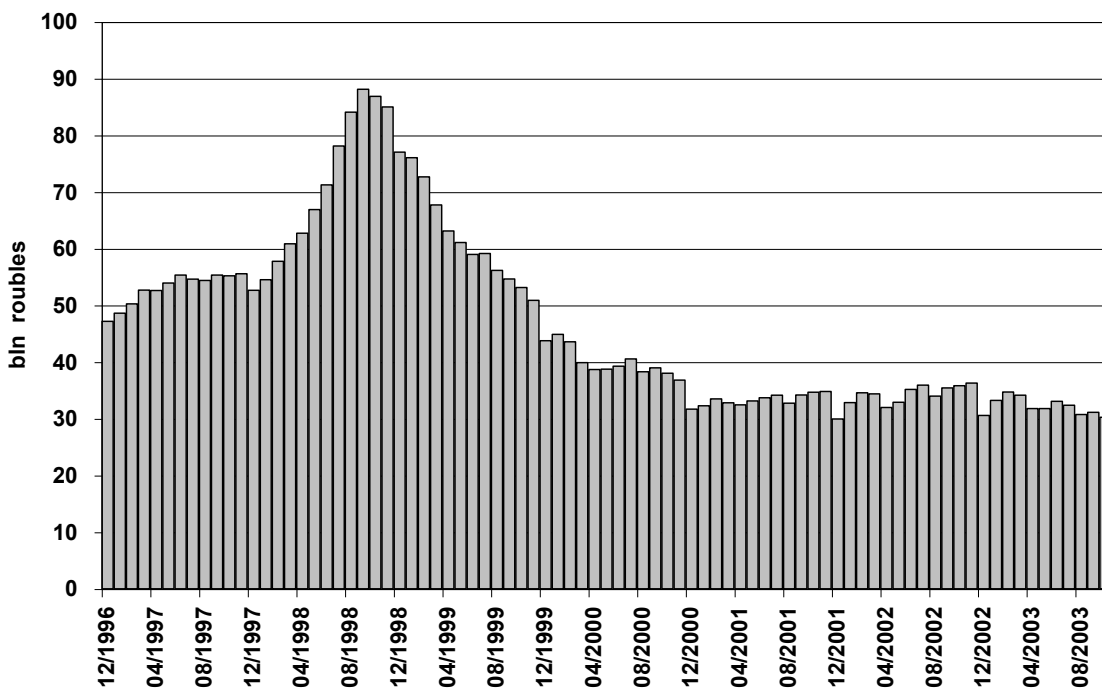


crisis. In the long term, the aggravation of a nonpayment crisis is probable only in the situation of soft budget constraints. In a normal market environment, economic systems react to external shocks by adapting output and employment.

The further developments in the sphere of payments will depend on the situation in the real sector of the economy and the policies pursued by the authorities, which to a considerable extent are determined by the necessity to ensure budget revenues. It should be noted that the most serious threat of the softening of budget constraints (weakening of enforcement) is posed by the probability of a budget crisis. At present, the significant positive rates of growth persisting in spite of certain negative trends, such as the Ruble exchange rate appreciation and an increase in the share of loss making enterprises, give rise to positive expectations concerning the sphere of inter-enterprise payments. It may be stated that the supersession of non-cash types of payments and reduction of payment arrears facilitated the economy to reach a new state of equilibrium.

*Figure 20*

**Dynamics of outstanding indebtedness of organizations relating to wages and salaries<sup>9</sup>**



Source: RF Goskomstat, IET calculations.

<sup>9</sup> Outstanding indebtedness of enterprises and organizations pertaining to industry, construction, agriculture, transport, education, health care, culture and arts, science and science servicing, housing and public utilities, and, since August of 1998, organizations of social security system, state power of the RF subjects, local governments, and public safety militia. The data are presented as registered at the end of respective months.

*2.1.6. Key measures in the sphere of monetary and exchange policies*

As concerns the decisions taken in the sphere of monetary and exchange policies, there should be singled out two instances, when the RF Central Bank reduced its refinancing rate to 18 per cent per annum (in January) and to 16 per cent (in June), what was the historical minimums of this indicator. However, it should be noted that the changes in the rate of refinancing still followed the dynamics of government bond yields and credit rates instead of determining them.

In April of 2003, the RF Central Bank changed the procedures governing the determination of the Ruble official exchange rate against the US Dollar. Since April 15, 2003, at the unified trading session (UTS) of inter-bank currency exchanges the US Dollar has been traded for Russian Rubles on “tomorrow” terms. At the same time, the current UTS risk management system and the equal access of the participants from different regions of Russia was maintained. According to the Bank of Russia, the new segment of the foreign exchange market should become its most liquid part due to significantly longer trading sessions and reduced operational risks as compared with the conversion transactions conducted on “today” terms. At the same time, the exchange rate formed during the trading on “tomorrow” terms is more representative since it is less susceptible to short term market factors, including fluctuations in the current liquidity of authorized banks. In this connection, the RF Central Bank will determine the official Ruble / US Dollar exchange rate basing on the results of trading at the UTS on “today” terms using the weighted average US Dollar exchange rate formed in the course of UTS trading on “tomorrow” terms as of 11:30 a.m.

In May of 2003, the Bank of Russia stated its intention to prolong the term of attraction of banks’ resources for more efficient sterilization of the excess Ruble liquidity. On May 29, 2003, the RF Central Bank held a three month deposit auction for credit organizations being residents of the Russian Federation. According to the decision taken by the Monetary Policy Committee of the Bank of Russia on May 27, 2003, the cutoff interest rate of the three month deposit auction should be at or below 9 per cent per annum. On May 30, the RF Central Bank Board of Directors approved the limits put on transactions concluded on the six month reverse repurchase agreement terms (the sale of bonds to banks with the commitment to repurchase them at a previously fixed price).

As the federal law “On amendments to Article 6 of the law of the Russian Federation ‘On currency regulation and currency control’” enters into force, the Bank of Russia took the decision to set the amount of mandatory sale of forex denominated proceeds from export of goods (works, services, intellectual property) at 25 per cent of the amount of forex denominated proceeds. It should be reminded that the law “On currency regulation and currency control” adopted in 1992 set the amount of mandatory sale of forex denominated proceeds at 50 per cent, however, after the crisis of 1998 this requirement was set at 75 per cent, and in August of 2001 this rate was again reduced to 50 per cent. It is planned to abolish mandatory sales of export proceeds by 2007.

The “Key guidelines of monetary policy in 2004” adopted by the Bank of Russia and the RF Government and approved by the RF State Duma set the major objective as curbing inflation to 8 – 10 per cent. The document contains two versions of the monetary program for year 2004, the first of which proceeds from the assumption that in 2004 the Urals oil price will be at US \$ 18.5 per barrel and the second assumes it to make US \$ 22 per barrel. Accordingly,



the RF Central Bank estimates the growth in money supply ( $M_2$ ) to make 19 to 20 per cent in the framework of the first scenario and 25 per cent in the framework of the second scenario.

## **Annex 1**

### **Certain problems of currency regulation under the amended version of the federal law “On currency regulation and currency control”**

The new version of the federal law “On currency regulation and currency control,” which entered into force on January 1, 2004, is on the whole characterized by a significant liberalization of procedures regulating the sphere of currency legal relations in comparison with the preceding legislation in this area and creates favorable environment for external economic activities on the part of residents and attraction of foreign capitals in the Russian Federation. The law makes a significant step forward as compared with the legislation previously regulating this sphere. The approach to the regulation of foreign exchange operations is based on the general legal principles “everything is permitted except what is specifically prohibited.” At the same time, certain issues, including the new mechanisms of regulation of capital transactions, seem to need a further discussion.

#### Opening of accounts with foreign banks and management of current account balances

The law (Article 14, items 1 and 2) sets forth that opening and maintaining of accounts in foreign banks in member countries of OECD or FATF should be subject only to the resident’s notifying the relevant Russian authorities. However, Russian residents will be allowed to make currency transfers to their foreign bank accounts from accounts with commercial Russian banks in accordance with the rules to be adopted by the RF Central Bank, which may require to open a special account with an authorized bank, i.e. be subject to restrictions. Besides, as concerns such transfers, the Bank of Russia may impose the mandatory reserving from 20 per cent and up to 100 per cent equivalent of the value of the transfer for a period from one year to 60 days, what, from our point of view, may be feasible only in the situation where a crisis situation is aggravating and capitals rapidly outflow from the country.

The law also envisages that accounts may be opened with banks in other countries, however, as concerns such accounts, the RF Central Bank may introduce the preliminary registration procedures, i.e. in fact establish the procedure requiring a permission to open an account.

Residents should report to the relevant authorities in the area of currency regulation as concerns the movement of funds in accounts opened with foreign banks, however, the procedures and purposes of the use of these funds by residents are outside the sphere of this law, i.e. owners should have the right to use such funds in accordance with the regulations set in the countries, where the accounts are opened.

However, it should be mentioned that the law sets forth the requirements concerning repatriation of forex denominated proceeds (see below), i.e. residents should in any case make additional forex denominated transfers from and to the Russian Federation in order to replenish their accounts with foreign banks.

**Mandatory repatriation, conversion of export proceeds,  
and purchase of foreign currency on the domestic market**

Article 19 of the law envisages that residents should in compliance with the terms set forth by the law as concerns current and capital operations (the latter include export transactions envisaging payments deferred for more than 180 days) transfer the total amount of their export proceeds and funds relating to unexecuted import contracts on accounts with authorized banks. Therefore, as it has already been noted above, the law does not permit direct transfer of payments relating to export contracts to residents' accounts with foreign banks.

Article 21, item 1 of the law stipulates that residents' export proceeds should be mandatory converted into Rubles in the amounts determined by the Bank of Russia, however, these amounts should be at or below 30 per cent of the total export proceeds denominated in foreign exchange. Therefore, the law makes a significant progress towards liberalization of this issue as compared with the preceding legislation. The reduction of the cap on the percentage of mandatory sales and vesting with the Bank of Russia the formal right to set a zero rate of mandatory conversion of export proceeds is, no doubt, aimed to soften this requirement. The delegation of the right to regulate the percentage of the mandatory forex sales in the case of changes in the market situation (a sharp acceleration of inflow or outflow of foreign exchange) will permit significantly enhance the efficiency of mandatory conversion as concerns market stabilization due to a shorter time required to take respective decisions (as compared with the procedures governing the amendment of the law).

The transactions relating to purchase and sale of foreign currencies on the RF domestic currency market on the part of residents are regulated by Article 11 of the law. The article does not set forth formal requirements and terms applicable to residents purchasing or selling foreign exchange on the domestic market. According to item 3 of Article 11, the RF Central Bank should have the right to set forth the procedures regulating purchase and sale of foreign currencies, for instance requiring to open a special account with an authorized bank, i.e. introduce certain restrictions. Besides, as concerns such transactions, the Bank of Russia may impose the mandatory reserving from 20 per cent and up to 100 per cent equivalent of the value of the transfer for a period from one year to 60 days, what, as it has been already noted above, may be feasible only in the situation where a crisis situation is aggravating and capitals rapidly outflow from the country.

Therefore, the law does not formally prohibit residents to purchase foreign currencies for transfer of their funds on their accounts with foreign banks or investment in forex denominated securities. These issues should be regulated by bylaws adopted by the Bank of Russia. At the same time, it should be noted that according to item 2 of Article 5 of the law, currency operations to be regulated in the future by additional normative acts of currency authorities should be freely carried out until the RF Central Bank introduces respective requirements.

**Financial investment of residents**

Article 9 (items 1 – 5 and 1 – 6) of the law permits all RF residents (not only commercial banks and investment companies) to carry out operations and make payments in foreign currencies as concerns external securities. Similarly, all categories of residents were granted the right to conduct transactions relating to external securities on the condition that the respective rights should be registered with Russian depositaries and respective payments are denom-



inated in Rubles. However, according to Article 8 (items 3 – 4), residents' transactions involving external securities should be subject to the restrictions related to the opening of accounts with authorized banks, special account requirements, as well as mandatory reserving from 20 per cent and up to 100 per cent equivalent of the value of the transfer for a period from one year to 60 days.

## Forward transactions and derivative financial instruments

The amendments proposed by deputies V. Zubov, Yu. Medvedev, and V. Tarachev by the second reading could have include forward transactions and derivative financial instruments (as concerns these instruments, the amount of respective liabilities depends on changes in prices of foreign currencies, external securities, interest rates, credit resource, price indices, etc.) in the sphere of currency regulation (and, it should be noted, in the sphere of legal regulation at large). According to the IMF and OECD classification, these operations are defined as unsecured debentures, i.e. such operations may be subject to restrictions. According to the proposed amendments, such operations in the Russian Federation could have been carried without restrictions. However, these amendments were not included in the approved law.

## Bank of Russian and RF Government: functions relating to the regulation of foreign exchange transactions

The law clearly delimits the powers vested with the RF Government and the RF Central Bank as concerns the regulation of capital transactions. Thus, the regulation of quasi-capital transactions related to deferment of payments for more than three years granted to non-residents in the course of export of goods indicated in sections XVI, XVII, and XIX of the Commodity Nomenclature of External Economic Activities of the Russian Federation<sup>10</sup>; deferment of payments granted to non-residents for a period of more than 5 years applicable to construction and contract works performed by residents outside the Russian Federation; deferment of payments for a period exceeding 180 calendar days granted by residents to non-residents in relation to external economic activities with the exception of cases indicated in items 1 and 2; extension of commercial credits in the form of advance payments termed for more than 180 calendar days to non-residents in relation to external economic activities; payments (transfers) made in the course of purchase by residents of share or participation interests in foreign entities (authorized or joint capital, or share fund), participation in joint activity (simple partnership) arrangements with non-residents is vested with the RF Government. In other words, the RF Governments regulates currency operations rather for fiscal purposes than to ensure macroeconomic and financial stability.

At the same time, according to Article 8 of the law, regulation of the majority of capital transactions *per se* should be carried out by the RF Central Bank. In particular, the Bank of Russia sets forth the procedures governing: extension of credits and loans denominate in foreign exchange by residents to non-residents; extension of credits and loans denominate in Russian currency by residents to non-residents; foreign exchange denominated borrowings

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<sup>10</sup> SECTION XVI. Machinery, equipment and mechanisms; electrical equipment, parts thereof, sound recording and sound reproducing equipment, equipment for recording and reproducing of TV images and sound, parts and accessories thereof.

SECTION XVII. Land vehicles, aircraft, watercraft, and related equipment

SECTION XIX. Arms, ammunition, parts and accessories thereof.



from residents on the part of non-residents; Russian currency denominated borrowings from residents on the part of non-residents; operations with external securities including payments (transfers) relating to transfer of external securities (titles certified by external securities); discharge of obligations relating to external securities; operations relating to ensuring residents' rights certified by external securities; operations relating to purchase by non-residents of rights for domestic securities owned by residents, including payments (transfers) relating to transfer of domestic securities (titles certified by domestic securities); operations relating to purchase by residents of rights for domestic securities owned by non-residents, including payments (transfers) relating to transfer of domestic securities (titles certified by domestic securities), as well as discharge of obligations relating to domestic securities on the part of residents; transactions conducted by credit organizations with the exception of banking operations.

#### Foreign investment in Russia

According to item 2 of Article 8, the RF Central Bank may impose restrictions with respect to the loans and credits denominated in any currency extended by non-residents to residents such as the opening of accounts with authorized banks, special account requirements, as well as mandatory reserving in the amount of up to 20 per cent equivalent of the value of the currency operation for a period of up a year. Therefore, the law retains rather tight procedures with respect to foreign credits and loans, although the feasibility of these requirements is not quite clear. The reserving requirements seem especially strange since it in fact means imposition of penalties for foreign borrowings notwithstanding the purposes and terms of such borrowings. No doubt that the RF Central Bank can define this provision more clearly in the framework of its powers, however such tight measures stipulated by the law seem excessive.

Similarly, as concerns the sale of securities (denominated both in foreign and national currencies according to items 5 – 6 of Article 8), the RF Central Bank may impose restrictions related to the opening of accounts with authorized banks, or the mandatory reserving from 20 per cent and up to 100 per cent equivalent of the value of the transfer for a period from one year to 60 days. In this case these requirements seem to be more feasible, since they may be reviewed as measures aimed at management of the structure of capital flows. In particular, these restrictions may become a part of the package of measures aimed at formation of the system of non-remunerated reserves.

#### Restrictions on currency operations and terms of abolishment thereof

The law in fact introduces three major types of restrictions on currency operations (over and above the requirements concerning mandatory repatriation and sale of a percentage of currency proceeds):

- Requirement to open special accounts with authorized banks;
- Reserving;
- Advance registration.

According to the law, all restrictions on currency operations should be introduced by by-laws issued by the currency regulatory authorities (RF Central Bank and RF Government), while the law only sets caps on restrictions relating to each type of operations. Two first restrictions may be applied to the majority of transactions subject to currency regulation and may be imposed both by the RF Government, and the Bank of Russia. It should be noted that



the proposed measures are in part novations and were absent (for instance, reserving) in the preceding legislation.

In accordance with item 3 of Article 26, practically all restrictions relating to capital transactions will gradually be abolished, and from 1 January 2007 will no longer be in effect. In particular, there should be abolished provisions of Articles 7 and 8 (regulation of capital operations by the RF Government and Bank of Russia), such as mandatory conversion of a percentage of currency proceeds, restrictions on transfer of funds on residents' accounts with foreign banks, purchase of foreign exchange by residents on the domestic market, while the term "reserving" should be removed from the law. Besides, the notification procedure governing the opening of accounts with foreign banks should be applicable to banks in all countries.

### Conclusions concerning the macroeconomic stability

The new version of the law meets the requirements of maintenance of macroeconomic stability and security of the RF domestic foreign exchange market rather well. Among the key advantages of the law, there may be indicated the lifting of all restrictions on current operations and formation of closed list of capital transaction subject to certain restrictions (the majority of which should remain in force until January 1, 2007).

At the same time, we believe that the law contains a number of negative provisions or fails to address certain important aspects as concerns transition to free conversion of the Ruble as a medium term objective of exchange policy and the policy of control over the movement of capital.

1. In our opinion, due to a rather short term (in fact, 2.5 years, from July 1, 2004 till January 1, 2007) for which the majority of restrictions stipulated in the framework of the law are introduced, it is economically unfeasible to build a principally new system of control over both current and capital operations. Eventually, in 2007 it will again become necessary to design and determine function of all governmental authorized agencies and the Bank of Russia in the sphere of currency control and regulation of capital transactions. At the same time, since according to documents of OECD and IMF a country should have the right to impose any restrictions on any currency operations in a crisis situation, the law should include a separate article stipulating imposition of temporary restrictions in the situations threatening the stability of the financial and banking system similarly to the crisis of 1998, although not aimed to create incentives for respective authorities to impose restrictions in the situation where the economy is steadily developing.

2. At the same time, it would be feasible if the law more clearly and transparently defined the key principles of formation of the system of control over the movement of capital aimed at protection of the domestic market against volatility of flows of short term portfolio investment similar to the system of non-remunerated reserve requirements, which exists in Chile or Columbia..

3. From our point of view, it is exceptionally important to subject forward transactions (derivative instruments) to this law as the basis of formation of a full fledged financial market in the RF, its fast integration in the world financial system, and creation of a market mechanism of hedging currency risks in the RF.

4. In order to faster achieve the free Ruble conversion, at present there may be lifted all restrictions on purchase of foreign exchange by residents on the domestic currency market, transfers of residents' funds on their accounts with foreign banks, and investment in foreign

securities and other financial assets, while the mandatory repatriation of currency proceeds should be abolished.

5. In order to maintain the macroeconomic balance, it seems feasible to coordinate the moment of lifting of restrictions on capital operations and the moment of formation of the stabilization fund in the RF. In this way, there will be excluded the probability of emergence of the double deficit of the RF balance of payments in the case the moment of liberalization of the capital account coincides with an unfavorable market situation.

#### Conclusions concerning changes in the investment climate and activities of Russian companies

In our opinion, the overall changes in the currency legislation enhance the possibilities of Russian companies as concerns lower currency risks, diversification of their assets portfolios, and reduction of transaction costs. In particular, there should be singled out the prolongation of the time of payments and repatriation of proceeds relating to current operations from 90 to 180 days.

1. However, already at present there may be lifted all restrictions on purchase of foreign exchange by residents on the domestic currency market, transfers of residents' funds on their accounts with foreign banks, and investment in foreign securities and other financial assets, while the mandatory repatriation of currency proceeds should be abolished. It is apparent that a significant part of large Russian companies already have accounts with foreign banks and manage flows of export proceeds through the systems of offshore companies. In our opinion, the negative effect on the Russian banking system produced by the mass exodus of small and medium sized companies to foreign banks will be rather limited. First, as it was indicated above, many countries maintain restrictions on opening of accounts by foreign companies; second, foreign banks could be hardly expected to extend credits to companies unknown outside Russia on terms more favorable than those available on the Russian domestic market; and, third, for companies operating on the domestic market the costs associated with constant transborder transfers of funds will be rather significant and may outweigh the advantages of the placement of their forex denominated funds.

2. At the moment it already seems feasible to lift all restrictions on financial borrowings of private companies and banks from non-residents, at least as concerns credits and loans termed for more than one year, what can facilitate the attraction of foreign investment on the part of Russian companies.

3. From our point of view, it would be economically unfeasible to introduce the complete package of restrictions stipulated by item 1 of Article 7 (deferment of payments for more than three years granted to non-residents in the course of export of goods indicated in sections XVI, XVII, and XIX of the Commodity Nomenclature of External Economic Activities of the Russian Federation) in the case there is concluded a contract of insurance against the default risks similarly to provisions of item 6 of this article. Since these items concern export of arms, machinery, equipment, aircraft, vessels, and similar goods, the requirement to reserve up to 50 per cent of the amount of the contract for a term up to two years may negatively affect the financial standing of exporter companies. At the same time, the contract of insurance guarantees that the exporter will receive the respective funds and the export proceeds (in full or in part) will be transferred to the domestic currency market.



4. In our opinion, the transactions between non-residents relating to purchase and sale of domestic securities, as well as transactions between RF residents relating to purchase and sale of external securities were subjected to this law without any grounds. Since in both cases the residency of the owners of such securities does not change, we believe that such transactions should not be subject of currency regulation.

## **2.2. National Budget**

Budget deficit had a marked impact on the Russian economy in the period prior to the 1998 crisis. Excess of expenditures over revenues was sustainable and recurring year by year. The failure to cover expenditures with tax revenues necessitated monetary financing of the deficit (before 1995) and accumulation of borrowings from internal and external financial markets, thus rendering the national economy fairly unstable. The mechanism of reproduction of budget deficit was represented by a constant reduction in tax revenues against substantial liabilities of the government.

In 1996 to 1997, total amount of the general government's expenditures varied from 46 and 48% of GDP (refer to Annex 2, *Tables 19 and 20*). Social expenditures remained fairly high owing to a new social legislation adopted at that time, which in many ways preserved the Soviet social commitments and budgeting network, and failed to promote serious reforms in this sector. This was coupled with a continuous growth in debt servicing expenditures. In 1998, budget expenditures at all levels were reduced against 1996 and 1997 due to the 1998 financial collapse, which made it impossible for the government to finance its liabilities of the previous years. Budget expenditures of the general government were reduced by 9 in terms of percentage points of GDP in 1998 against 1997. Further reduction of budget expenditures in 1999 was caused by adoption of a federal budget 1999 which was unrealistic under the existing macroeconomic situation, including underestimated inflation rate and GDP<sup>11</sup>. Mostly effected were the industries with high share of wages, especially social sector. Total budget expenditures of the general government was reduced by 3,5 in terms of percentage points of GDP in 1999 against the previous year. In the ensuing two years, budget expenditures of the general government was reduced to 34,8% of GDP, which allowed the general government to achieve a surplus over 3% of GDP in the budgets of 2000 and 2001. Then in 2002, budget expenditures grew by almost 5 in terms of percentage points against the previous year and accounted for 39,7% of GDP. Budget expenditures of the general government was reduced by 36,3% of GDP at year-end 2003.

The post-crisis period between 1999 and the present day are represented by a number of macro- and microeconomic trends, as well as various events, which had a strong impact upon economic processes in the country, including the budget policy.

The prices of the traditional Russian export goods – crude oil, gas, nonferrous metals and lumber – established after 1999 had most relevant impact on budget revenues. Since 2000, a considerable share of tax revenues was generated from an excess in actual oil prices over long-term average values. It should be noted that prices of exported raw materials have an impact on budget revenues not only through corresponding taxes (export duties, Mineral Tax, oil product excises) but also a general growth in total demand which promotes a growth in tax base of income and profit taxes.

Another relevant factor which had a positive impact on growing budget tax revenues was improved financial situation of domestic enterprises, which was associated with industrial output recovery caused by import-replacement processes and growth in domestic demand.

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<sup>11</sup> Since local budgets are adopted in accordance with the federal budget and depend largely on the parameters of the latter, many trends which are typical of the federal budget are duplicated at lower levels of the budget system.



The factors that had a positive effect on budget revenues include the measures taken by executive government agencies in order to reduce accrued tax liabilities, which was encouraged by a favorable internal economic situation on the one hand and adoption of the first part of the Tax Code on the other hand, increase non-tax revenues related mostly to public and municipal property, as well as improve accounting of extra-budgetary revenues of budget-funded entities as part of the budgetary revenues.

A tax reform was represented by most relevant and profound reorganizations conducted in the postcrisis period. A whole spectrum of effects resulting from amendments introduced as part of the tax reform only can be revealed within a considerable long-term period<sup>12</sup>. However, there is a set of novations that already effected the revenues of the budget system. In general, a rapid growth in real tax revenues to the consolidated budget was marked in the postcrisis period within the framework of revenues generated to the budget system since 1996. The maximum real growth of tax revenues was registered in 2000, which accounted for about 40% against the previous year, while tax revenues to the consolidated budget reached its maximum in the same period against the entire past period (1997). At year-end 2003 consolidated budget revenues exceeded by 27% that of 1997 in real terms.

Since 1999, redistribution of revenues took place within the budget system, which changed profoundly the balance of revenues between budgets at different levels. Consequently, federal budget revenues in 1999 came to exceed general revenues of subfederal budgets.

A general improvement in budget revenues allowed the government to run budgets not only without deficit, which never occurred throughout the entire period of market reforms in Russia, but also with a considerable surplus during the postcrisis period. Regarding the general budget expenditures over the period since 1996, a relatively quick growth in the consolidated budget expenditures was registered since 1998. In 1999, 2000 and 2002, budget expenditures grew by more than 20% in real terms. In 2002, for the first time in the postcrisis period, the consolidated budget expenditures exceeded that of the 1997 period after allowing for inflation over the given period.

An effective treasury system of budget administration ( primarily at federal level ) allowed non-targeted utilization of public funds to be reduced to zero. At the same time, build-up and administration of liabilities of the budget system according to the *input based* rather than *output based* principles will render impossible radical changes in public services. Though experimental results on introduction of new forms of budget financing ( primarily government registered bonds ), as well as the situation with mandatory medical insurance, testify that there is enough efficiency in support to budget expenditures for transition to the input-based financing, the key factor for implementation of a full budget reform is to reorganize the system of state-financed agencies. Such reform is intended to broaden the spectrum of participants in the market of social services, increase responsibility and provide independency, primarily financial one, of organizations operating in social sector. In prospect, various principles of outcome-based financing can be implemented depending on government's socio-economic performance in social sector.

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<sup>12</sup> For more detailed analysis of tax reform's outcomes refer to: S. Batkibenkov, Yu. Bobylev, P. Kadochnikov, S. Ponomarenko, K. Hepesov, S. Sinelnikov-Myrilev, I. Trunin, E. Shkrebel. Tax reform in Russia: analysis of initial outcomes and development outlook. IET's scientific works. No. 50P.M.: IET, 2003. Refer to electronic version. <http://www.iet.ru/papers/50/index.htm>

Another relevant task, which still remains topical, is to adjust social commitments to government's capacity. The existing ineffective system of financing neither gives way of compliance to the existing and assigned multiple ( often pointless ) social commitments , nor increase in effectiveness of the public sector. Indeed, a huge burden of social commitments, which often render impossible or reflect inadequately the present socio-economic and demographic reality, need to be corrected. Transformation of the system of budgeting and budget administration is a necessary condition for making the Russian financial system less vulnerable to global market fluctuations and relieving the debt load on the economy. This condition can not be dispensed with because the budget will remain vulnerable to any unfavorable situation, even if well balanced.

### 2.2.1. Budget 2003. General Picture

Tax revenues to the federal budget declined by 0,6 in terms of percentage points of GDP at year-end 2003 against the previous year. However, in 2003 tax revenues to the federal budget were 0,2 less than in 2002 and 0,9 less than in 2001 in terms of percentage points of GDP without allowance for the unified social tax. In 2003, tax revenues to local budgets accounted for 10% of GDP, which corresponds to that in 2002. Therefore, the decline in tax revenues of the federal and consolidated budgets in 2003 was governed, in particular, by reduced revenues from the unified social tax, from 3,1% of GDP in 2002 to 2,7% of GDP in 2003.

The revenues of the federal and consolidated budgets in 2003 accounted for 19,4% of GDP and 31,1% of GDP correspondingly. These figures exceed the revenues of the federal and consolidated budgets between 1998 and 2001, while by 0,7 less than revenues of the federal budget and by 1,0 less than revenues of the consolidated budget in terms of percentage points of GDP in 2002 . Budget expenditures at all levels in 2003 were less than in 2002, by 1,4 in terms of percentage points of GDP in the consolidated budget and by 1,0 in terms of percentage points of GDP in the federal budget, whereby the federal budget surplus accounted for 1,7% of GDP at year-end 2003 and 1,4% of GDP for the consolidated budget correspondingly, which exceeds the figures at year-end 2002.

Both budget revenues and expenditures at all levels grew in real terms in 2003 against 2002. In particular, real revenues to the federal budget grew by 5,9% and local budget, by 6,8%. The growth rate of budget expenditures at all levels in 2003 was less than that of budget revenues, a real increase in the federal budget expenditures accounted for 3,8% and local budget expenditures 6,6%, whereby the consolidated budget surplus in 2003 exceeded by 48% the figures of the previous year.

*Table 8*

### **Administration of Revenues and Expenditures of Consolidated, Federal and Local Budgets ( in % of GDP )**

	1998	1999	2000	2001	2002	2003
1	2	3	4	5	6	7
<b>Federal Budget</b>						
Tax Revenues*	8,8	10,7	13,2	16,2	18,6	18,0
including Unified Social Tax	–	–	–	–	3,1	2,7
Revenues	11,3	12,9	15,4	17,6	20,1	19,4



Expenditures	14,5	14,0	13,1	14,7	18,7	17,7
Deficit (-) / Surplus (+)	-3,2	-1,1	2,4	2,9	1,4	1,7

*Table 8 cont'd*

1	2	3	4	5	6	7
<b>Local Budgets</b>						
Tax Revenues*	11,5	10,4	10,2	9,6	10,0	10,0
Revenues	14,8	13,6	14,4	14,3	14,9	14,5
Expenditures	15,2	13,6	14,0	14,3	15,3	14,9
Deficit (-) / Surplus (+)	-0,3	0,0	0,5	0,0	-0,4	-0,4
<b>Consolidated Budget**</b>						
Tax Revenues*	20,3	21,1	23,4	25,8	28,6	28,0
Revenues	24,5	25,2	28,5	29,3	32,1	31,1
Expenditures	28,1	26,3	25,6	26,4	31,1	29,7
Deficit (-) / Surplus (+)	-3,6	-1,1	2,8	2,9	1,0	1,4

\* Excluding revenues of targeted budgetary funds which are raised from taxes and other compulsory payments.

\*\* Without regard for intrabudgetary transfers.

Source: The RF Ministry of Finance and the authors' estimates.

In 2003, a reduction in accrued budget arrears in absolute terms was registered for the first time over the entire period since the crisis 1998 ( refer to *Table 9* ), which accounted for about 2 bln rubles. The amount of arrears increased by 11 bln rubles over 2003, while since 2000 there was noted a gradual reduction of this parameter. Therefore, the reduction in tax arrears in 2003 was governed primarily by reduction of deferred and suspended payments due to the budget system.

*Table 9*

### Tax Arrears to Consolidated Budget

	1999	2000	2001	2002	2003
Tax arrears to consolidated budget (bln rubles)	378	464	475	522	520
including back tax	343	365	245	210	221
Share of back tax in arrears	91%	79%	52%	40%	42,4%
Annual growth in arrears against arrears early in the year, adjusted to inflation.		19%	2%	9%	-0.3%
Growth in arrears in terms of GDP share	1,1%	0,1%	0,4%	0,0%	1,1%

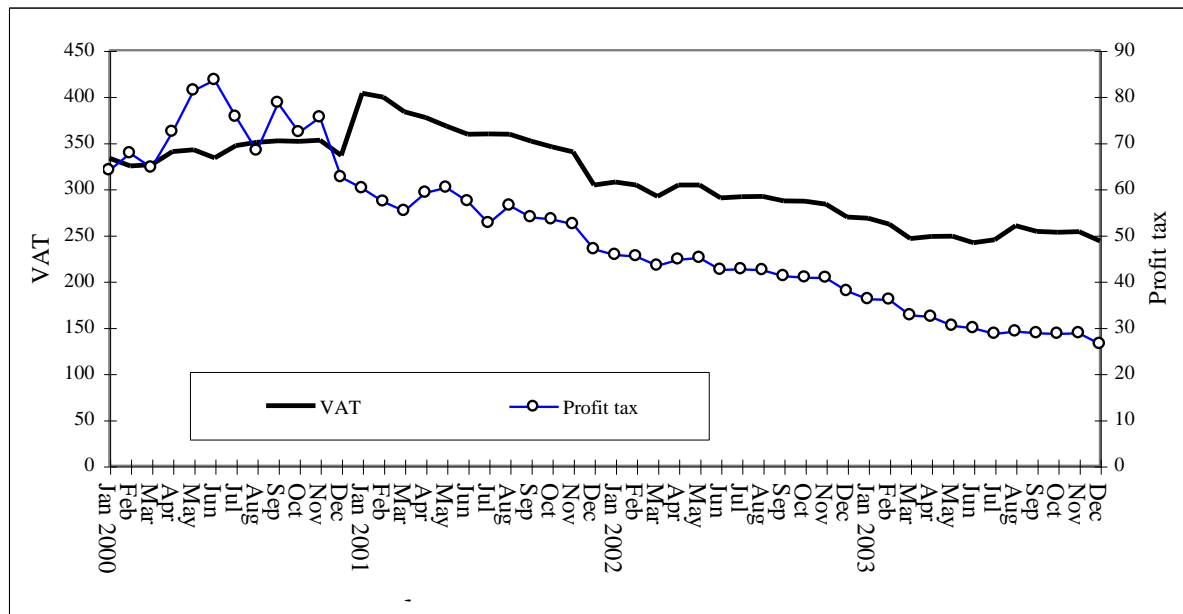
Source: the RF ministry of Taxation and estimates of the Institute for Economy in Transition.

The amount of accrued VAT arrears to the federal budget in 2003 was increased by 2,6 bln rubles against that early in the year and accounted for about 244 bln rubles. However, VAT arrears in real terms was reduced by 9,6% against that at year-end 2002. Profit tax arrears to the federal budget was reduced in 2003 by approximately 7,5 bln rubles and accounted for about 26,4 bln rubles, thereby it reached the minimum since early in 2000 ( *Figure 21* ). In general, despite a stabilization in VAT arrears in the second half of 2003, the figures of the last two years show a gradual decrease in both VAT and profit tax arrears.



Figure 21

**Accrued Real Tax Arrears to Federal Budget,  
bln rubles ( in prices as of December 2003 ).**



**2.2.2. Basic Tax Revenues in 2003**

A series of amendments to the tax legislation came into force since 2003 in accordance with the decisions made in 2002. Among the most relevant amendments are introduction of sections to the Tax Code on taxation of small businesses, definitive abolition of road taxes and introduction of transportation tax, as well as adjustments to the procedure of oil-product excise payment ( introduction of an institution of registration certificates for operations with oil products )<sup>13</sup>.

Referring to *Table 10*, profit tax revenues also tended to decrease in 2003. However, the revenues declined in less amounts than in the previous year ( 0,2 in terms of percentage points of GDP against 1,5 in terms of percentage points of GDP in 2002 ) with consolidated profit of the economy totaling 131% in 2003 against 83% in 2002. Despite a positive macroeconomic trend in 2003, profit tax revenues were reduced due to several reasons, primarily as a consequence to the Tax Code amendments on the corporate income tax, which changed substantially both the structure and the amount of taxable base, mostly in favor of growth in expenditures which can be deducted in defining a taxable base<sup>14</sup>. The decrease in profit tax revenues due to the foregoing factor accounted for 0,12% of GDP according to the estimates of the RF Ministry of Finance.

<sup>13</sup> For more details on these and other amendments to the tax legislation refer to annual summary “Russian Economy in 2002: Trends and Outlook”. Issue No. 24. Analysis of distribution of tax revenues by level of the budget system is given in section “Intrabudget Relations and Subnational Finances” hereafter.

<sup>14</sup> This can be explained by the fact that taxpayers begin to lawfully reduce profit tax as provided for in the Tax Code.



In 2003, the share of income tax revenues in GDP increased by 0,1 in terms of percentage points against 2002 and accounted for 3,3% of GDP. The amount of income tax revenues in 2003 exceeded by 13,6% in real terms that in the previous year, which is mostly explained by a personal income growth.

The share of unified social tax revenues in GDP was reduced by 0,4 in terms of percentage points against the previous year. The unified social tax revenues also declined by 4% in real terms against 2002. The reduction was caused mainly by the fact that a substantial amount of unified social tax revenues in 2002 was achieved by entering the share of the unified social tax arrears, which previously used to be entered to the RF Pension Fund, to the federal budget. Eventually, the growth in the unified social tax arrears to the federal budget in 2002 accounted for about 8,2 bln rubles ( 6,9 bln rubles of redeemed arrears to the RF Pension Fund was entered to the federal budget ), while it accounted for about 15,5 bln rubles ( or a little more than 0,1% of GDP ) in 2003.

Legalization of wages and all personal incomes varies in rate as shown in *Table 10*. This can be explained by enlarged gap between taxable bases of unified social tax and income tax. Though there was no gap whatsoever in 2000, a small gap of 100 bln rubles emerged in 2001, about 600 bln rubles in 2002, and approximately 1 tln rubles in 2003, according to preliminary assessment.

*Table 10*

**Tax Base for Unified Social Tax and Income Tax in B 2000–2003  
(tln rubles), according the RF Ministry of Taxation**

	2000	2001	2002	2003*
Unified Social Tax	1,7	1,9	2,4	2,6–2,8
Income Tax	1,7	2	3	3,5–3,8

\* Preliminary assessment.

Source: the RF Ministry of Taxation.

Evidently, the taxable bases of income tax and unified social tax are imbalanced in favor of the former. It will be recalled that while the taxable base of unified social tax only includes wages and emoluments to physical bodies or earnings less business expenditures of self-employed entrepreneurs and lawyers ( i.e. payment for labor exclusively ), the taxable base of income tax includes all earnings of physical bodies. The foregoing gap that emerged between the taxable bases of unified social tax and income tax in 2002 to 2003 is indicative of two factors.

Firstly, there was an increase in payments to employees from corporate net income, which are not subject to the unified social tax. Conditions for tax arbitration occur if the maximum wage tax rate of a particular employee exceeds the maximum taxable corporate income rate. Such situation occurs if no descending scale of unified social tax is applied to the employee.

Secondly, introduction of a 1% flat rate of income tax resulted mostly in legalization of income which is not related to wages. This hypothesis can be supported by the a survey con-

ducted by the IET's experts<sup>15</sup>, which reveals a big share of legalized income among wealthy individuals, i.e. those who also have non-wage income.

The amount of VAT revenues in 2003 accounted for 6,6% of GDP, which is 0,3 less in terms of percentage points of GDP than in 2002. A corresponding decline in VAT revenues as a share of GDP took place in 2002 as well. Nevertheless, VAT revenues grew by 4,6% in real terms against the corresponding period of the previous year. Among the factors which led to a decrease in VAT revenues in 2003 are an increase in the amount of recoverable VAT in cases of export manufacturing. This factor is responsible for a decrease in revenues by approximately 0,4% of GDP, according to the assessment of the RF Ministry of Finance.

Excise revenues grew by 0,2 in terms of percentage points of GDP in 2003 against 2002, while 0,1 less than in 2000 in terms of percentage points of GDP. The growth in revenues against the previous year is mainly due to an escalation in export prices of gas.

The amount of mineral tax revenues in 2003 accounted for 2,6% of GDP, which corresponds to that in 2002. However, considering a positive and high growth rate of GDP in 2003, the amount of mineral tax revenues exceeds by 7% that in the previous year in real terms. Among the basic factors responsible for the growth in mineral tax revenues in 2003 are high world's oil prices and oil production growth since 2002, by more than 10%.

The amount of foreign trade tax revenues in 2003 accounted for 3,4 in terms of percentage points of GDP, which is more than in 2002, but less than in 2001. The growth of foreign trade tax revenues accounted for 25% in real terms in 2003 against the previous year, which, in particular, was determined by increased oil export prices and high oil prices<sup>16</sup>. For instance, average annual growth in Brent oil prices accounted for about 20% over three quarters of 2003, basically owing to a 49% price rise in the first quarter of 2003 .

Reduction in several tax revenues in 2003 against the previous year is explained to a certain degree by additional chapters expected to be added to the Tax Code of the Russian Federation in 2002 in respect of a simplified taxation system for small businesses and a unified tax on imputed earnings. In particular, application of a simplified taxation system provides for replacement of corporate income tax ( income tax for self-employed entrepreneurs ), VAT, sales tax, property tax and unified social tax with a unified tax to be assessed on the basis of economic operations performed during the fiscal period. In 2003, the total amount of revenues generated from the tax on imputed earnings, as well as the tax levied in connection with application of the simplified taxation system, accounted for about 30 bln rubles, or 1% of the amount of tax revenues of the consolidated budget.

*Table 11*

**Basic Tax Revenues to Budget System of the Russian Federation, in % of GDP**

1	in % of GDP				
	2	3	4	5	6
	1999	2000	2001	2002	2003
Profit tax	4,6	5,4	5,7	4,2	4,0
Income tax	2,5	2,4	2,8	3,3	3,4
VAT	8,8	6,2	7,1	6,9	6,6

<sup>15</sup> Refer to S. Sinelnikov-Myrilev, S. Batkibenkov, P. Kadochnikov, D. Nekipelov. *Assessment of the outcome of the Income tax Reform in the Russian Federation*. M.: IET, 2003.

<sup>16</sup> Refer to section 3.1.2 herein.



*Table 11 cont'd*

1	2	3	4	5	6
Excises	2,2	2,3	2,7	2,4	2,6
Mineral Tax**	1,2	1,6	1,6	2,5	2,5
Foreign trade taxes	1,8	3,1	3,6	3,0	3,4
Contributions to social extrabudgetary funds (Unified Social Tax )	7,2	7,3	7,1	7,7	7.7 *
including Unified Social Tax to Federal budget				3,1	2,7
Tax revenues of consolidated budget and social extrabudgetary funds	28,3	30,7	32,9	36,3	35,4 *

\*\*Until 2001, Mineral Tax was calculated as total amount of oil excises, payments payable for mineral wealth extraction and contributions to BMCБ.

\*Estimated data.

### 2.2.3. Consolidated Budget Expenditures

The expenditure pattern of consolidated budget suffered no changes in 2003 against 2002. Insignificantly reduced were federal budget expenditures on industry, power engineering and construction in whole ( from 1% of GDP 2002 to 0,5% of GDP in 2003 ), as well as consolidated budget expenditures on municipal housing economy and education ( from 2,3% of GDP and 3,8% of GDP in 2002 to 1,9% of GDP and 3,6% of GDP in 2003 ). Considerably reduced were federal budget expenditures on social policy ( from 4,4% of GDP in 2002 to 1,0% of GDP in 2003 ). Also, insignificantly reduced were expenditures on transport, international activity and healthcare, which did not exceed 1 point in terms of percentage points of GDP on the average.

In general, there was no increase in expenditures in 2003, except for local budget expenditures on industry, power engineering and construction which reflected a decrease in total expenditures at all levels in 2003 against the previous year ( reduction by 1,0 in terms of percentage points of GDP for the federal budget and by 1,4 in terms of percentage points of GDP for the consolidated budget, correspondingly ).

*Table 12*

### Expenditures of Federal Budget, Local Budgets and Consolidated Budget in 2001–2003, in % of GDP

	2001			2002			2003		
	Federal Budget	Local budgets	Consolidated budget	Federal Budget	Local budgets	Consolidated budget	Federal Budget	Local budgets	Consolidated budget
1	2	3	4	5	6	7	8	9	10
State administration and local self-government	0,5	0,8	1,2	0,5	0,8	1,4	0,5	0,9	1,4
Judicial power	0,1	0,0	0,1	0,2	0,0	0,2	0,2	0,0	0,2
International activity	0,3	–	0,3	0,3	0,0	0,3	0,2	0,0	0,2
National defense	2,7	–	2,7	2,7	–	2,7	2,7	0,0	2,7
Law enforcement and national security	1,6	0,4	2,0	1,7	0,5	2,2	1,9	0,4	2,3
Basic research and development and technology promotion	0,3	0,0	0,3	0,3	0,0	0,3	0,3	0,0	0,3

*Table 12 cont'd*

1	2	3	4	5	6	7	8	9	10
Industry, power engineering and construction	0,5	1,3	1,8	1,0	1,3	2,3	0,5	2,0	2,5
Agriculture and fishery	0,3	0,5	0,8	0,3	0,3	0,5	0,2	0,3	0,5
Transport, road network, communication and information technology*	0,4	0,7	1,1	0,1	0,4	0,5	0,0	0,3	0,3
Municipal housing economy	–	2,6	2,6	0,0	2,3	2,3	0,0	1,9	1,9
Education	0,6	2,6	3,2	0,7	3,0	3,8	0,8	2,8	3,6
Culture, art and cinematography	0,1	0,3	0,4	0,1	0,4	0,5	0,1	0,3	0,5
Mass media	0,1	0,1	0,2	0,1	0,1	0,2	0,1	0,1	0,2
Health care and physical education	0,3	1,8	2,1	0,3	2,1	2,4	0,3	1,9	2,2
Social policy	1,2	1,2	2,4	4,4**	1,3	5,7**	1,0	1,4	2,4
Government debt service	2,6	0,1	2,7	2,0	0,1	2,2	1,7	0,1	1,8
Financial support to budgets at other levels	2,5	0,0	–	2,7	0,0	–	6,0**	0,0	3,2***
Military reform	0,1	0,0	0,1	0,1	0,0	0,1	0,1	0,0	0,1
Road network	–	–	–	0,4	0,4	0,7	0,3	0,5	0,8
Targeted budget funds	0,2	1,2	1,3	0,1	1,4	1,6	0,1	1,1	1,2
<b>TOTAL EXPENDITURES</b>	<b>14,7</b>	<b>14,3</b>	<b>26,4</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>

\* In 2001, including road network costs;

\*\* Including transfers of the RF Pension Fund for financing basic pension with a share of unified social tax centralized in the federal budget;

\*\*\* Since 2003 the item reflects transfers to public extrabudgetary funds.

Expenditures in 2003 did not grow much against the previous year, exceeding by not more than 1% in absolute terms the corresponding expenditure items of 2002. However, emphasis should be placed upon support to the federal budgets at other levels which increased by about 1,4 in terms of percentage points against 2002.

#### *2.2.4. Federal Budget 2004 and Macroeconomic Forecast of Socio-Economic Development in Russia*

##### Federal Budget 2004

The Federal Budget 2004 was cut off by about 81,6 bln rubles due to all the amendments made to the revenues of the Federal Budget Law 2004 against 2003, according to the estimates of the RF Ministry of Finance. The loss is expected to be compensated by improving administration of tax payments, especially by continuing to reduce accrued tax arrears and implement measures on restructuring tax arrears, as well as optimize public property management.


*Table 13*
**Revenues in Federal Budget Laws in 2003 and 2004**

	Legislative budget 2003	Legislative budget 2004	Legislative budget 2003	Legislative budget 2004	Legislative budget 2004 against budget law 2003*
	ml rubles		% GDP**		%
<b>Tax revenues</b>	1892363,7	2071384,5	14,50	13,54	99,51
Profit tax, income tax, capital gains tax	179550,5	164587,4	1,38	1,08	83,33
Taxes on products and services. License and registration duties.	1178971,2	1088389,6	9,03	7,11	83,92
VAT	946218,5	988368,2	7,25	6,46	94,96
Excises	231368,3	98516,8	1,77	0,64	38,71
Joint income taxes <sup>1</sup>	8478,4	-	0,06	-	-
Unified agricultural tax <sup>2</sup>	-	150,8	-	0,00	-
Stock transfer tax	840,0	824,0	0,01	0,01	89,18
Mineral Tax	183129,5	279381,1	1,40	1,83	138,69
Taxes on foreign trade and foreign economic operations	335975,5	532538,2	2,57	3,48	144,10
Other taxes and duties	5418,6	5335,2	0,04	0,03	89,51
<b>Non-tax revenues</b>	145721,8	219194,4	1,12	1,43	136,75
Revenues from property owned by the government and municipalities or from operations by government and municipal agencies	83158,8	165612,1	0,64	1,08	181,05
Administrative charges	1406,5	1381,2	0,01	0,01	89,27
Penalties, compensation of damage	1353,6	1157,8	0,01	0,01	77,76
Revenues from foreign economic operations	55932,7	45205,2	0,43	0,30	73,47
Other non-tax revenues	3870,0	5827,2	0,03	0,04	136,89
<b>Fund of the Ministry of Atomic Energy of the Russian Federation</b>	14066,3	14061,5	0,11	0,09	90,88
<b>Unified social tax</b>	365640,0	438210,0	2,80	2,86	108,95
<b>TOTAL REVENUES</b>	2417791,8	2742850,4	18,53	17,93	103,13

\* In real terms.

\*\* In % of scheduled GDP.

<sup>1</sup> Since 2004, in order to compensate lost budget revenues of constituent entities of the Russian Federation incurred by abolition of sales tax, the federal share of tax revenues in case of social tax treatments of small business – taxes on aggregate income – is transferred in full to the budgets of constituent entities of the Russian Federation.

<sup>2</sup> Provides for coming into force since January 1, 2004 of a revised chapter of the Tax Code regulating a special tax treatment as a unified agricultural tax.

Source: the RF Ministry of Finance, Russian State Statistics Committee (Goskomstat), authors' estimates.

The revenues which are generated to the federal budget system from tax arrears of the previous years, including interest payments, are estimated to the amount of 13,6 bln rubles on an annual basis. It is recommended to reduce the limit size of deferment, installments and tax

credits to 1,5 bln rubles in 2004 against the budget in 2003, thus cutting it by 0,2 bln rubles, in order to collect additional revenues to the budget system. Furthermore, about 165 bln rubles can be collected by increasing efficiency of all forms of public property management, which is 1,8 as much as the budget law 2003. Growth in revenues from the use of public property is expected to become a reserve for increase in revenues of the budget system and the federal budget in 2004.

Tax revenues to the federal budget account for 2 tln 71 bln rubles or 13,54% of GDP, which is almost by 1 less than in the budget 2003 in terms of percentage points of GDP. Changes in macroeconomic parameters in 2004 against 2003 reduced the share of tax revenues to the federal budget by 1,19 in terms of percentage points of GDP ( from 15,37% of GDP to 14,7% of GDP ), according to the estimates of the RF Ministry of Finance. The RF Ministry of Finance also points to the fact that among the key factors which reduced revenues are forecasting world oil prices declined from 26 US dollars per barrel in 2003 to 22 US dollars per barrel in 2004, which entailed a decrease in the estimated rate of oil production tax and export duty on oil and oil products ( decrease in tax revenues by 130 bln rubles or 0,85 in terms of percentage points of GDP ). Fall in prices of gas exported to foreign countries in 2004 reduced the amount of tax revenues by 2,7 bln rubles or by 0,02 in terms of percentage points of GDP.

An increase in tax allowances through changes in the taxable base structure reduced general tax revenues of the federal budget by 43,3 bln rubles or by 0,28 in terms of percentage points of GDP.

A substantial decrease in tax revenues was caused by amendments to tax and budget legislation ( by 125,2 bln rubles or by 0,81 in terms of percentage points of GDP). The reduction of value added tax rate from 20 to 18% reduced tax revenues to the federal budget by 100 bln rubles or by 0,65 in terms of percentage points of GDP. The federal budget revenues also lost 23,3 bln rubles or 0,15 in terms of percentage points of GDP due to assignment of 1% of profit tax to the revenues of constituent entities of the Russian Federation in order to compensate the loss in revenues of the constituent entities of the Russian Federation incurred by abolished sales tax. In addition, for the same purpose the Russian Federation assigned the federal tax on alcohol products and aggregate income taxes to the constituent entities, which reduced tax revenues to the federal budget by another 46,1 bln rubles or 0,3% of GDP. The compensation measures increased revenues of the constituent entities ( to the amount of 11,1 bln rubles ) which didn't introduced sales tax, which made it possible to centralize 4,5% of the standard of oil production tax to the given amount. An increase in rates of mineral tax on oil and gas provided for additional revenues.

The abolition of gas excise was fully compensated by increased rate of natural gas production tax and export duty on natural gas from 5% to 30%. The scheduled decrease by an average of 20% in the rate of export customs duties on all goods except fuel-and-power goods led to a decrease in tax revenues of the federal budget by 5,1 bln rubles or by 0,03 in terms of percentage points of GDP. It should be noted that the budget system will lose 57,6 bln rubles in 2004 through the amendments to the government draft law, including an increase in the mineral tax rates.

At the same time, transfer of water resources tax from the category of non-tax payments to that of tax payments, as well as increase in the base rate of oil production tax, increased tax revenues of the Federal budget by 6,3 bln rubles ( by 0,04 in terms of percentage points of



GDP ) and by 5,0 bln rubles ( by 0,03 in terms of percentage points of GDP ) correspondingly. In addition, adjustment of excise rates to the inflation rate, as well as additional indexation of several types of goods, increased the federal budget revenues by 14,9 bln rubles or by 0,1 in terms of percentage points of GDP. Adjustments to the standards of payment to the federal budget on the mineral tax increased tax revenues to the Federal budget by 21,7 bln rubles or by 0,14 in terms of percentage points of GDP, while assignment of the forest reserves tax to the federal budget increased revenues by 3,1 bln rubles or by 0,02 in terms of percentage points of GDP. However, assignment of gambling tax in full to the constituent entities of the Russian Federation reduced tax revenues of the Federal budget by 1,7 bln rubles or by 0,01 in terms of percentage points of GDP.

The scheduled decrease in rates of export customs duties for all goods, except for the fuel-and-energy goods, by an average of 20%, reduced tax revenues to the Federal budget by 5,1 bln rubles or by 0,03 in terms of percentage points of GDP.

Eventually, amendments to the tax legislation reduced tax revenues of the Federal budget by 102,2 bln rubles or by 0,66 in terms of percentage points of GDP. Amendments to the budget legislation reduced tax revenues of the federal budget by 23 bln rubles or by 0,15 in terms of percentage points of GDP. The government drew up the budget on the basis of average tax collectability being estimated at 97,4% at present year. In addition, the budget provides for VAT reimbursement which exceeds slightly that in 2003 (251,5 bln rubles).

*Table 14*

**Expenditures in Budget Laws and Administration of Federal Budget  
in 1999, 2000, 2001, 2002, 2003 and 2004 , in % GDP**

	1999		2000		2001		2002		2003		2004
	Legisla- tive budget*	Admin- istration of budget	Legisla- tive budget*	Admin- istration of budget	Legisla- tive budget*	Admin- istration of budget	Legisla- tive budget*	Admin- istration of budget	Legisla- tive budget*	Admin- istration of budget	Legisla- tive budget*
1	2	3	4	5	6	7	8	9	10	11	12
State administration and local self-government	0,34	0,31	0,48	0,34	0,53	0,46	0,52	0,52	0,51	0,50	0,50
Judicial power	0,12	0,10	0,15	0,11	0,15	0,13	0,17	0,18	0,20	0,19	0,22
International activity	0,91	1,22	1,05	0,15	0,29	0,33	0,43	0,31	0,38	0,21	0,29
National defense	2,34	2,40	2,63	2,62	2,77	2,73	2,58	2,72	2,65	2,67	2,69
Law enforcement and national security	1,28	1,15	1,49	1,44	1,70	1,65	1,52	1,75	1,87	1,86	2,03
Basic research and development and technology promotion	0,29	0,23	0,30	0,24	0,29	0,26	0,27	0,29	0,31	0,31	0,30
Industry, power engineering and construction	0,36	0,35	0,38	0,48	0,58	0,49	0,49	0,97	0,48	0,52	0,44
Agriculture and fishery	0,23	0,18	0,22	0,18	0,27	0,26	0,20	0,26	0,23	0,24	0,19
Environmental protection and resources conservation, hydrometeorology, mapping and geodesy	0,07	0,06	0,07	0,06	0,06	0,05	0,09	0,09	0,08	0,09	0,08



**RUSSIAN ECONOMY in 2003**  
trends and outlooks

*Table 14 cont'd*

1	2	3	4	5	6	7	8	9	10	11	12
Transport, communication and information technology	0,02	0,02	0,03	0,03	0,39	0,41	0,05	0,07	0,04	0,05	0,04
Market infrastructure development	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Prevention and elimination of after-effects under emergency conditions and natural disasters	0,18	0,16	0,17	0,13	0,08	0,08	0,08	0,08	0,16	0,18	0,17
Education	0,52	0,43	0,60	0,52	0,63	0,60	0,71	0,75	0,75	0,75	0,77
Culture, art and cinematography	0,08	0,06	0,09	0,07	0,08	0,07%	0,09	0,09	0,11	0,11	0,11
Mass media	0,05	0,04	0,11	0,08	0,08	0,08	0,09	0,09	0,09	0,09	0,07
Health care and physical education	0,26	0,21	0,30	0,23	0,29	0,26	0,28	0,29	0,30	0,30	0,31
Social policy	1,05	1,02	1,18	0,93	1,39	1,24	3,71	4,46	1,15	1,04	1,05
Government debt service	4,17	3,38	4,11	3,53	3,09	2,56	2,65	2,11	2,13	1,66	1,88
State reserves reimbursement	0,00	0,00	0,00	0,00	0,01	0,00	0,00	0,01	0,16	0,16	0,13
Financial support to budgets at other levels	1,09	1,30	1,29	1,39	2,41	2,54	2,24	2,93	5,45	5,99	5,32
Disposition and destruction of weapons, including implementation of international agreements	0,04	0,07	0,04	0,05	0,08	0,07	0,09	0,10	0,08	0,08	0,07
Economy preparedness activity	0,01	0,01	0,01	0,01	0,01	0,01	0,00	0,01	0,00	0,00	0,01
Research and use of space	0,07	0,07	0,06	0,06	0,06	0,08	0,09	0,09	0,06	0,07	0,08
Military reform	0,00	0,00	0,00	0,00	0,05	0,06	0,15	0,13	0,11	0,12	0,05
Other expenditures	-0,24	-0,13	0,09	0,09	-0,05	0,07	-0,03	0,11	-0,05	0,07	-0,03
Road network	0,00	0,00	0,00	0,00	0,00	0,00	0,50	0,36	0,61	0,34	0,52
Targeted budget funds	1,10	1,17	1,13	1,34	0,18	0,16	0,13	0,14	0,11	0,11	0,09
<b>TOTAL EXPENDITURES</b>	<b>14,38</b>	<b>13,83</b>	<b>15,98</b>	<b>14,09</b>	<b>15,40</b>	<b>14,67</b>	<b>17,09</b>	<b>18,91</b>	<b>17,97</b>	<b>17,70</b>	<b>17,38</b>

\* – in % of scheduled GDP.

Source: the RF Ministry of Finance, Russian State Statistics Committee (Goskomstat), estimates of the Institute for Economy in Transition (IET).



*Table 15*

**Budget Laws and Federal Budget Administration  
in 1999, 2000, 2001, 2002 and 2003 in prices of 1999.**

	1999		2000		2001		2002		2003		2004
	Legisla- tive budget	Adminis- tra- tion of budget	Legisla- tive budget	Adminis- tra- tion of budget	Legisla- tive budget	Adminis- tra- tion of budget	Legisla- tive budget	Adminis- tra- tion of budget	Legisla- tive budget	Adminis- tra- tion of budget	Legisla- tive budget
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>11</b>	<b>12</b>
State administration and local self-government	13747	14846	21541	20802	28550	29442	34538	34232	36190	36316	38074
Judicial power	4848	4980	6758	6887	7950	8282	11492	11861	13850	13669	16449
International activity	36594	59077	46688	9047	15561	20825	28433	20845	27037	15240	22303
National defense	93703	115594	117181	159507	150597	173062	171845	180027	188126	193530	203548
Law enforcement and national security	51325	55593	66391	87681	92329	104313	101168	116065	133123	134913	153636
Basic research and development and technology promotion	11635	11312	13250	14473	15498	16617	17916	18927	21877	22624	22854
Industry, power engineering and construction	14583	17122	16698	29201	31329	30973	32527	64278	34247	37411	33440
Agriculture and fishery	9284	8840	9572	11142	14591	16633	13571	16946	16334	17270	14632
Environmental protection and resources conservation, hydro-meteorology, mapping and geodesy	2904	2895	3110	3420	3349	3466	5859	6029	5881	6179	6130
Transport, communication and information technology	902	941	1364	1541	21466	26040	3233	4551	3182	3513	2781
Market infrastructure development	0	0	0	42	63	63	12	12	54	54	0
Prevention and elimination of after-effects under emergency conditions and natural disasters	7345	7499	7510	7862	4443	4864	5120	5357	11268	12891	12989
Education	20866	20930	26705	31720	34234	38229	47612	49793	53124	54333	58269
Culture, art and cinematography	3062	2880	3893	4321	4479	4724	6184	6219	7589	7724	7965
Mass media	2087	1997	4763	5071	4371	5279	6028	6050	6500	6819	5374
Health care and physical education	10239	10138	13306	14043	15577	16194	18707	19264	21399	21452	23298
Social policy	41871	49193	52410	56566	75605	78762	247588	295508	81995	75543	79739
Government debt service	166844	162862	183086	214520	168209	162100	176578	139969	151007	120196	142256
State reserves reimbursement	97	93	140	138	304	209	321	412	11403	11328	10027

*Table 15 cont'd*

1	2	3	4	5	6	7	8	9	10	11	12
Financial support to budgets at other levels	43444	62742	57528	84200	130914	161331	149530	193958	387124	433318	402655
Disposition and destruction of weapons, including implementation of international agreements	1736	3598	1722	2900	4234	4598	6235	6300	5855	5855	5127
Economy preparedness activity	450	597	416	533	351	660	305	387	272	270	544
Research and use of space	2976	3334	2853	3591	3220	4889	5919	5936	4163	4979	5937
Military reform	0	0			2972	3882	10083	8765	7945	8805	3584
Other expenditures	-9532	-6343	4088	5757	-2748	4307	-1692	7464	-3869	5042	-2137
Road network	0	0					33227	23611	43049	24345	39146
Targeted budget funds	44038	56209	50404	81264	9746	10190	8468	9187	7654	7808	6956
<b>TOTAL EXPENDITURES</b>	<b>575047</b>	<b>666930</b>	<b>711375</b>	<b>856226</b>	<b>837195</b>	<b>929934</b>	<b>1140805</b>	<b>1251956</b>	<b>1276377</b>	<b>1281425</b>	<b>1315577</b>

Source: the RF Ministry of Finance, Russian State Statistics Committee (Goskomstat), estimates of the Institute for Economy in Transition (IET).

In 2004, federal budget expenditures is scheduled at 17,38% of GDP with GDP being estimated 15300 bln rubles, of which 438,2 bln rubles ( 16,48% of total expenditures ) is transferred to the RF Pension Fund to finance basic occupational pensions, 287,5 bln rubles of interest expenditures and 1933,7 bln rubles of non-interest expenditures ( 10,81% and 72,71% correspondingly ).

Interest expenditures of the budget 2004 will be reduced almost by three fourths percentage points of GDP or more than by 5% in comparable prices against the budget of the previous year.

Some changes have been made to the composition of non-interest expenditures by including additional items, namely maintenance costs of extradepartmental security guard service under the Ministry of Internal Affairs of Russia, as well as costs of services previously rendered by the State Dispatch Service of Russia, 38,5 bln rubles and 280 ml rubles correspondingly. However, non-tax revenues of the federal budget draft 2004 is scheduled to increase by the same amounts.

Among the top-priority expenditure items are judicial reform, law enforcement and national security, education, healthcare and research and development. Unlike the approved standard of expenditures in 2003, allocations to these items of functional expenditure structure of the federal budget 2004 will be growing: «Judicial power» item by 1,31 (and by 1,19 in comparable prices), «National defense» by 1,19 (by 1,08 in comparable prices), «Law enforcement and national security» by 1,26 (by 1,15), «Basic research and development and technology promotion» by 1,15 (by 1,04), «Education» by 1,21 (by 1,10), «Health care and physical education» by 1,20 (by 1,09), and «Culture, art and cinematography» by 1,15 (by 1,04).



Table 16

**Federal Budget Expenditures in 2003 and 2004 in Comparable Classification (Law)**

	Legislative budget in 2003 in % of GDP in compara- ble classification	Legislative budget of 2004 in % of GDP	Legislative budget of 2004 against budget law of 2003 in compara- ble prices and classifica- tion, %
State administration and local self-government	0,51	0,50	105,21
Judicial power	0,20	0,22	118,77
International activity	0,38	0,29	92,34
National defense	2,65	2,69	108,20
Law enforcement and national security	1,87	2,03	115,34
Basic research and development and technology promotion	0,31	0,30	104,46
Industry, power engineering and construction	0,48	0,44	96,10
Environmental protection and resources conservation, hydrometeorology, mapping and geodesy	0,08	0,08	104,24
Prevention and elimination of after-effects under emergency conditions and natural disasters	0,16	0,17	112,56
Education	0,75	0,77	109,69
Culture, art and cinematography	0,11	0,11	104,21
Health care and physical education	0,30	0,31	108,88
Financial support to budgets at other levels	5,45	5,32	103,72
Economy preparedness activity	0,00	0,01	200,00

Source: the RF Ministry of Finance, Russian State Statistics Committee (Goskomstat), estimates of the Institute for Economy in Transition (IET).

Among the key factors of increased expenditures are full implementation of the decisions on raise since October 1, 2003 of official wages of state-financed employees (by 1,33), wages for military personnel and equal persons and wages of public servants (by 1,11), wages of judges and attorneys (by 1,4), and scholarships ( doubled ) since the beginning of the academic year 2003/2004. Budget expenditures on judicial system in 2003 includes additional funding of new full-time job positions within the entire judicial system's framework. The amount of federal budget expenditures allocated to wages of all categories of state-financed employees will grow to 435,5 bln rubles in 2004 (against 362,3 bln rubles allocated under the approved budget 2003). This will increase by 1,3 the share of federal budget expenditures allocated to wages in terms of percentage points.

The "International activity" item ( by 0,09 in terms of percentage points of GDP or by 18% in comparable prices ) is most of all affected by the reduction in federal budget expenditures. In addition, the budget 2004 provides for reduction in expenditures on industry, power engineering and construction by 0,04 in terms of percentage points of GDP or almost by 2% in real terms against the pervious year in comparable classification, as well as some other items, including military reform ( decrease by 0,06 in terms of percentage points of GDP or by 55%

in comparable prices), mass media ( by 0,02 in terms of percentage points of GDP or by 7%), disposition and destruction of weapons ( by 0,01 in terms of percentage points of GDP or by 12%), road network and social policy ( by 0,09 in terms of percentage points of GDP each item or by 9% and 3% correspondingly in comparable prices). In 2004, unlike the budget approved in 2003, expenditures on economic preparedness was doubled and financial support to budgets at other levels was increased by 0,27 in terms of percentage points of GDP or by more than 3% in real terms.

#### *Macroeconomic Scenario Forecast for 2004*

This section presents forecast on key macroeconomic parameters in 2004, namely GDP, tax revenues, federal budget revenues, CPI, export, import, gold and foreign exchange reserves, real exchange rate. The forecast was conducted on the basis of a system of structural econometric equations. Each of the foregoing parameters was treated by a specified equation including variables with logs having a relevant and economically logical impact on interpretable variable. Moreover, corresponding dummy variables were added to the equations, which enabled us to consider quarterly seasonal fluctuation of variables and their structural movements, as well as moving average components were employed, which allow autocorrelated remainders to be eliminated.

The section also presents a comparison of achieved estimates with those made by the RF Ministry of Economy, as well as the parameters specified in the Federal Budget Law 2004. For this purpose one of the most considered scenarios is based on the parameters of the budget 2004 and corresponds to the estimates of the RF Ministry of Economy.

Macroparameters were estimated on the basis of the preset scenarios of Brent oil prices, capital investments and M2. Basic economic trends are expected to remain the same throughout the entire forecasting interval.

##### Scenario 1:

Average price of Brent oil in 2004 varies from \$24 to 25 US dollars per barrel, which is almost \$4 US dollars less than the corresponding average annual price in 2003. Average growth M2 will not exceed 20% in 2004. Annual capital investment growth rate will account for 8% in 2004.

##### Scenario 2:

Average price of Brent oil is \$28 US dollars per barrel throughout the entire forecasting interval, which corresponds approximately to that of 2003. In 2004, M2 will grow by 30%. Annual capital investment growth rate is about 8% in 2004.

One of the RF Ministry of Economy's scenarios of the Russian economy development in 2004 predicts that the existing trends in economic development will remain the same and average prices of Urals oil will vary between 22 and 23 US dollars per barrel. Under this assumption capital investment growth rate (according to the RF Ministry of Economy's estimates) is expected to account for 8% in 2004. The forecast of the RF Ministry of Economy fully agrees with Scenario 1 given that the estimated growth rate of M2 is 20% in 2004 according to the RF Central Bank.



*Table 17*

**Scenarios of Brent Oil Prices, M<sub>2</sub> and Capital Investments**

	Scenario 1			Scenario 2		
	Oil price ( US dollar/barrel )	M <sub>2</sub> ( bln ru-bles )	Investment rate of increase ( % )	Oil price ( US dollar/barrel )	M <sub>2</sub> ( bln ru-bles )	Investment rate of increase ( % )
1st quarter 2003	31,4	2208,5	10,1	31,4	2208,5	10,2
2nd quarter 2003	26,1	2604,5	13,1	26,1	2604,5	13,1
3rd quarter 2003	28,4	2732,1	12,1	28,4	2732,1	12,1
4th quarter 2003	29,4	3212,7	13,4	29,4	3212,7	13,4
1st quarter 2004	26,0	3373,3	8,0	28,0	3453,7	8,0
2nd quarter 2004	25,0	3534,0	8,0	28,0	3694,6	8,0
3rd quarter 2004	24,0	3694,6	8,0	28,0	3935,6	8,0
4th quarter 2004	23,0	3855,2	8,0	28,0	4176,5	8,0

Till 4<sup>th</sup> quarter of 2003 inclusive – actual data, after 2003 – scenarios.

However, the key parameters of the federal budget law in 2004 are based on the parameters of the Russian socio-economic development forecast in 2004 and medium-term outlook. The key parameters of federal budget revenues are calculated in accordance with the macroeconomic forecast in 2004 which is based on the estimated average annual price of Urals oil of 22 US dollars per barrel, while the federal budget expenditures are based on the estimated basic oil price. The basic oil price is represented by the average Urals oil price over the last five years, 20 US dollars per barrel. Thus, the parameters that provide the basis of the federal budget 2004 agree with Scenario 1 as well.

*Table 18*

**IET's Estimates vs. RF Ministry of Economy's Outlook**

	Scenario 1		
	Outlook for 2004	Outlook for 2004	Outlook for 2004
CPI ( annual growth rate in terms of % )	8–10	8,3	10,5
of GDP ( annual growth rate in terms of % )	5,2	4,0	5,1
Export ( total bln US dollars )	125	118,1	128,5
Импорт ( total bln US dollars )	78,4	73,8	75,7
External reserves ( growth in bln US dollars )	7–15,	9,1	17,1
Real exchange rate ( annual growth rate in terms of % )	4–5,	2,5	3,6

Referring to *Table 18*, inflation growth rate is estimated to be maintained within the range ( 8,3% ) scheduled by the RF Ministry of Economy for 2004. Estimated increase in gold and foreign exchange reserves in 2004 is about \$9 bln US dollars, which also corresponds to the RF Ministry of Economy's estimates ( from 7 to 15 bln US dollars ). However, GDP's growth rate in 2004 is expected to be 1,2% less than the RF Ministry of Economy's forecast.

Volumes of export and import in 2004 are estimated to account for about \$118 bln and \$73,8 bln US dollars correspondingly, which is \$7 and \$4,6 bln US dollars less than the RF Ministry of Economy's estimates. Estimated adjustments ( Scenario 1 ) of the real ruble exchange rate are 2% less on the average than the RF Ministry of Economy's forecast. Even in case of a more optimistic scenario for oil prices ( Scenario 2 ), the real ruble exchange rates are 1% less on the average. The forecast of key parameters based on the structural econometric equations system agree with the RF Ministry of Economy's scenario and hence the forecast.

The reduction in revenues caused by previous amendments to the tax and budget legislation in 2004 vs. 2003 was also considered in calculating predictive federal budget revenues, specifically reduction of VAT rate by 2 percentage points in 2004, growth in specific rate of mineral tax in case of oil production from 340 to 347 rubles per ton, as well as transfer of 1% of profit tax and a share of alcoholic products excise from the federal budget to the budgets of constituent entities of the Russian Federation in order to compensate local budgets' losses incurred by abolition of sales tax. In case Brent oil prices average 24 US dollars per barrel in 2004 ( or Urals oil prices between 22 and 23 US dollars per barrel, which corresponds to the parameters of the federal budget revenues 2004 ) the federal budget is expected to lose about 125 bln rubles<sup>17</sup> in 2004 due to the amendments to the tax and budget legislation. Consequently, the estimated federal budget revenues in 2004 account for about 2725 bln rubles (18,3% of GDP ). Given the expenditures approved to the amount of 2659,4 bln rubles in the federal budget law 2004, the federal budget surplus in 2004 will account for about 66 bln rubles according to our estimates. However, the federal budget law 2004 provides for a surplus to the amount of about 83 bln rubles in 2004. According to the optimistic scenario, federal budget revenues are estimated to be 2810 bln rubles ( 18,9% of GDP ) and surplus 150 bln rubles correspondingly, with average price of Urals oil in 2004 being about 26 US dollars per barrel.

Thus, given the same parameters of budget revenues, our estimates on federal budget surplus is 17 bln rubles less than that provided for in the federal budget law 2004.

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<sup>17</sup> The presented amount of budget losses due to amendments to the tax and budget legislation corresponds to the the RF Government's estimates presented in an explanatory attachment to the federal budget draft 2004.



## Annex 2

## The data on execution of budgets between 1996 through 2003

Table 19

General Government Budget (B %GDP)<sup>18</sup>

	Federal budget	Local budgets	Extra budgetary funds	General Government Budget
1	2	3	4	5
<b>1996</b>				
Total expenditures, including:	13,9	16,1	11,5	38,7
<i>Tax revenues</i>	12,0	12,9	9,2	34,2
Total expenditures, including:	22,0	17,1	11,1	47,1
<i>Healthcare and physical training</i>	0,2	2,6	1,1	3,9
<i>Social policy</i>	0,7	1,3	7,6	9,6
<i>Transport, road network, communication and information technology</i>	0,0	0,8**	1,0	1,8
Deficit/ Surplus	-8,1	-1,0	0,4	-8,5
<b>1997</b>				
Total expenditures, including:	13,8	17,7	12,1	40,5
<i>Tax revenues</i>	12,0	14,3	9,9	36,3
Total expenditures, including:	20,5	19,1	12,0	47,9
<i>Healthcare and physical training</i>	0,4	2,8	1,4	4,6
<i>Social policy</i>	1,0	1,4	8,5	9,9
<i>Transport, road network, communication and information technology</i>	0,2	0,8**	1,4	3,5
Deficit/ Surplus	-6,7	-1,4	0,2	-7,4

<sup>18</sup> Table 19 contains the results of attempts to reconstruct the general budget's government. In the process of collecting this kind of summary data a problem of consolidation is inevitable, which results from the necessity of avoiding double count. Due to ambiguousness in defining some of the data on utilization of extrabudgetary funds and budgets of constituent entities of the Russian Federation ( for instance, uncertainty about including data on the funds consolidated in the budgets of constituent entities of the Russian Federation into summary statistics on local road and ecological funds ), as well as absence of final data on utilization of budgets of extrabudgetary funds, a certain misrepresentation of revenues and expenditures of the general government's budget may occur. However, such misrepresentations can not affect drastically the picture. The Table only presents the revenue items which are financed from budgets at all levels of the budget system, including public extrabudgetary funds. The data on other expenditure items are presented in other tables of the Attachment.



*Table 19 cont'd*

1	2	3	4	5
<b>1998</b>				
	<b>Federal budget</b>	<b>Local budgets</b>	<b>Extra budgetary funds</b>	<b>General Government Budget</b>
Total expenditures, including:	11,5	15,1	11,4	35,5
<i>Tax revenues</i>	9,9	12,4	9,7	31,9
Total expenditures, including:	14,8	15,5	11,1	38,9
<i>Healthcare and physical training</i>	0,2	2,2	1,1	3,5
<i>Social policy</i>	1,4	1,1	7,4	9,9
<i>Transport, road network, communication and information technology</i>	0,7	1,0**	1,9	3,6
Deficit/ Surplus	-3,4	-0,4	0,3	-3,4
<b>1999</b>				
Total expenditures, including:	12,9	13,4	9,5	33,8
<i>Tax revenues</i>	11,7	11,1	8,6	31,4
Total expenditures, including:	13,8	13,5	9,8	35,4
<i>Healthcare and physical training</i>	0,2	1,9	0,9	2,8
<i>Social policy</i>	1,0	0,9	6,3	7,8
<i>Transport, road network, communication and information technology</i>	0,7	1,0**	1,8	3,5
Deficit/ Surplus	-0,9	-0,1	-0,3	-1,6
<b>2000</b>				
Total expenditures, including:	15,5	14,1	10,7	38,3
<i>Tax revenues</i>	14,3	11,8	9,5	35,5
Total expenditures, including:	14,1	13,7	9,1	34,8
<i>Healthcare and physical training</i>	0,2	1,8	0,9	2,7
<i>Social policy</i>	0,9	0,8	5,6	6,9
<i>Transport, road network, communication and information technology</i>	0,8	1,6**	2,2	3,3
Deficit/ Surplus	1,4	0,5	1,6	3,5



*Table 19 cont'd*

1	2	3	4	5
<b>2001</b>				
Total expenditures, including:	17,6	14,3	9,2	38,0
<i>Tax revenues</i>	16,2	10,9	8,2	35,3
Total expenditures, including:	14,7	14,3	9,1	34,8
<i>Healthcare and physical training</i>	0,3	1,8	0,9	2,8
<i>Social policy</i>	1,2	1,2	6,4	8,4
<i>Transport, road network, communication and information technology</i>	0,7	1,7**	1,2	2,2
Deficit/ Surplus	2,9	0,0	0,1	3,2
<b>2002</b>				
Total expenditures, including:	20,3/17,2*	15,0	9,8/6,7****	38,3
<i>Tax revenues</i>	18,7/15,6*	11,5	8,6/5,5****	35,8
Total expenditures, including:	18,8/15,7***	15,4	10,7	39,7
<i>Healthcare and physical training</i>	0,3	2,1	1,2	3,2
<i>Social policy</i>	4,5/1,3***	1,3	7,2	9,5
<i>Transport, road network, communication and information technology</i>	0,6	1,9**	0,9	2,1
Deficit/ Surplus	1,5	-0,4	-0,9	-1,4
<b>2003</b>				
Total expenditures, including:	19,4/16,7*	14,5	9,4/6,8****	37,3
<i>Tax revenues</i>	18,0/15,3*	10,0	8,3/5,7****	33,7
Total expenditures, including:	17,7	14,9	9,3	36,3
<i>Healthcare and physical training</i>	0,3	1,9	1,1	3,2
<i>Social policy</i>	1,0	1,4	6,5	8,4
<i>Transport, road network, communication and information technology</i>	0,0	1,5**	0,9	1,7
Deficit/ Surplus	1,7	-0,4	0,1	1,0

† Assessment.

\* with regard to the unified social tax/without regard for the unified social tax.

\*\* with regard to expenditures of local road funds consolidated in the budgets of constituent entities of the Russian Federation.

\*\*\* with regard to the RF pension Fund's transfers for financing the basic share of labor pension through contributions of the unified social tax centralized in the federal budget/ without regard for the RF pension Fund's transfers for financing the basic share of labor pension through contributions of the unified social tax centralized in the federal budget.

\*\*\*\* Including the unified social tax centralized in the federal budget/ without regard to the unified social tax centralized in the federal budget.

Source: Chief Administration of Financial Control under the RF Ministry of Finances, the Russian State Statistic Committee (Goskomstat), IET's estimates.

*Table 20*

**Consolidated Budget Expenditures  
( in % of GDP )**

	1996	1997	1998	1999	2000	2001	2002	2003
State administration and local self-government	0,8	1,1	1,2	1,0	1,0	1,3	1,4	1,4
National defense	2,9	3,1	2,2	2,4	2,6	2,7	2,7	2,7
International activity	1,2	0,3	0,3	1,2	0,1	0,3	0,3	0,2
Judicial power*	–	–	0,1	0,1	0,1	0,1	0,1	0,2
Law enforcement and national security	1,8	2,2	1,7	1,5	1,8	2,0	2,3	2,3
Basic research and development and technology progress promotion	0,3	0,4	0,2	0,2	0,2	0,3	0,3	0,3
Industry, power engineering and construction ***	1,8	1,8	0,8	0,7	0,8	1,8	2,4	2,5
Agriculture and fishery	1,1	1,2	0,7	0,8	0,8	0,8	0,6	0,5
Транспорт, road network, связь и информатика**	0,8	0,9	1,7	1,7	2,4****	2,4	2,1	0,3
Municipal housing economy	4,0	4,1	3,6	2,6	2,7	2,6	2,3	1,9
Education	3,8	4,2	3,7	3,0	2,9	3,2	3,8	3,6
Culture, art and cinematography	0,4	0,5	0,3	0,4	0,4	0,4	0,5	0,5
Mass media	0,1	0,1	0,1	0,1	0,2	0,2	0,2	0,2
Health care and physical education	2,6	2,9	2,4	2,1	2,0	2,1	2,4	2,2
Social policy	1,7	2,1	2,5	1,9	1,7	2,4	5,8*****	2,4
Government debt service	2,0	1,6	4,1	3,4	3,8	2,7	2,2	1,8
Targeted budget funds	0,9	1,3	1,5	1,9	3,0	1,4	1,5	1,2
TOTAL EXPENDITURES	29,7	30,5	30,3	27,3	27,8	29,0	34,2	29,73

\* Until 1998 “Judicial power” was a part of “Law Enforcement”.

\*\* Including expenditures of local road funds consolidated in the budgets of constituent entities of the Russian Federation.

\*\*\* growth in expenditures on this item since 2001 was caused by increased allocations on the sub-item “Construction and Architecture” and associated with consolidation of all local budgets expenditures on capital construction, which leads concurrently to reduction in expenses on other items. Another reason is implementation of several investment projects at some regions.

\*\*\*\* Additional growth in expenditures is related with financing in 2002 of expenditures on the item “Construction and Architecture ” from the federal budget due to transactions on purchase of Vneshekonombank shares by the Government from the RF Central Bank.

\*\*\*\*\* Growth in financing on this item this year and in the ensuing years is associated with integration of local road funds into budgets.

\*\*\*\*\* In 2002 this item reflected the RF pension Fund’s transfers for financing the basic share of labor pension through contributions of the unified social tax centralized in the federal budget.

Source: The RF Ministry of Finance, estimates of the IET.

*Table 21***Tax Revenues to Budget System of the Russian Federation ( bln rubles )**

	<b>Income tax</b>	<b>Profit tax</b>	<b>VAT</b>	<b>Mineral Tax</b>
1996	57	97	144	
1997	75	102	171	
1998	71	96	157	
1999	117	220	287	58
2000	175	400	457	117
2001	256	514	641	142
2002	358	463	753	275
2003	455	527	876	332

*Table 22***Tax Revenues to Budget System of the Russian Federation (in % of GDP)**

	<b>Income tax</b>	<b>Profit tax</b>	<b>VAT</b>	<b>Mineral Tax</b>
1996	2,8	4,8	7,2	
1997	3,2	4,4	7,3	
1998	2,7	3,7	6,0	
1999	2,4	4,6	5,9	1,2
2000	2,4	5,5	6,2	1,6
2001	2,8	5,7	7,1	1,6
2002	3,3	4,2	6,9	2,5
2003	3,4	4,0	6,6	2,5

*Table 23***Real Tax Revenues to Budget System of the Russian Federation ( in % against 1999 )**

	<b>Income tax</b>	<b>Profit tax</b>	<b>VAT</b>	<b>Mineral Tax*</b>
1996	135	123	140	
1997	162	117	150	
1998	83	60	75	
1999	100	100	100	100
2000	124	151	132	168
2001	153	164	157	171
2002	187	128	160	288
2003	212	130	166	310

According to the Central Federal Board of Treasury of the RF Ministry of Finance and RF Ministry of Taxation. Until 2001, Mineral Tax was calculated as total amount of oil excises, payments payable for mineral wealth extraction and contributions to BMCБ.

### 2.3. Interbudgetary relationships and subnational financing

This past year was quite rich with a whole number of events significantly influencing both the current budget relationships between the state power bodies and the respective local government levels, on the one hand, and the medium-term development perspectives of the said interbudgetary relationships and regional financing, on the other.

Among the most important events of the year of 2003 in the area of fiscal federalism, special mention should be made primarily of the two basic laws resulting from intensive work carried out by the «Presidential Commission for Preparing Proposals on Authority Delimitation between the State Bodies, the RF Subjects and the Respective Local Self-Government Offices», which were passed by the State Duma and then duly came into force. These are: a new version of the Federal Law «On the Local Self-Government General Organizational Principles in the Russian Federation» and that concerning making amendments and/or changes in the Federal Law «On the General Organizational Principles of the Legislative (representative) and Executive Bodies of the Russian Federation's Subjects' State Bodies». Should the new federative principles, the fiscal sphere included, be practically and fully implemented, they would be quite capable of leading to significant changes in the medium-term interbudgetary relationships/subnational financing sphere. A lot, however, may depend on the methods and forms of implementing the said legislative bills during reforming the rest of the federal legislation intended to be completed in the years of 2004 – 2005.

Apart from the legislative defining of the federal reform framework, which, no doubt, became quite a major event of the year of 2003 in the interbudgetary relationships and subnational financing area, considerable impacts on the budget system's parameters, both on the regional and local levels, can be expected from the measures being taken in the ongoing process of the tax reform. These primarily consist in abolition of the tax on sales including the resulting compensations for the regional budgets, as well as adoption of the new Tax Code chapter determining the taxation structure on organizations' property – one of the most significant regional taxes. Both these legislative acts came into force on January 1, 2004.

However, before going into a more detailed analysis of the said events and their possible economic effects, let us take a closer look at the basic indicators characteristic for the 2003 subnational level interbudgetary relationships and the budget situation.

#### 2.3.1. *Basic relationships trends between the Russian Federation different level budgets in the year of 2003*

To analyze the 2003 basic trends in the area of different-level budgets interrelationships, let us first of all have a look at the structure of the RF consolidated budget and then at its dynamic changes during the recent period of time. *Table 24* (below) contains certain data manifesting the share of tax revenues, as well as that of budget incomes/expenditures of the RF subjects in the consolidated budget of the Russian Federation.

As can be clearly seen from the data in *Table 24*, the downward trend for the share of tax revenues in the RF subjects' consolidated budget characteristic for the period through the years of 1999 – 2002 (with due account taken of part of incomes from the unified social tax paid into the federal budget beginning from 2001) has been somewhat corrected. Respectively, in accordance with the RF 2003 budget results, the consolidated budgets of the Russian Federation received over 39 % tax revenues as compared against 35 % in the previous year. At



the same time, however, the share of sumtotal receipts in the RF subjects' budgets (without financial aid from the federal budget) in the «*Total Incomes*» indicator for the Russia's consolidated budget remained at the level but only insignificantly higher than that of the previous year, having comprised a little over 37 %. Similarly, there were practically no changes in the budget system expenditures share as financed from the consolidated budgets of the respective RF subjects, comprising, according to the 2003 results, about 50 %.

*Table 24*

**Share of certain RF subjects' budgets indicators in the consolidated budget  
of the Russian Federation in the years of 1992 – 2003 (%)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
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
Incomes*	44,1	53,1	52,9	47,6	49,5	53,1	54,0	48,9	45,4	40,1	37,4	37,6
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

Without any federal budget financial aid (except for unredeemed loans from the federal budget) and/or proceeds from special-purpose budget funds.

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

It is quite noteworthy in this connection that the 2003 results did show lesser RF consolidated budget incomes per one GDP percentage point – from 31.1 % down to 32.1 % in the year of 2002. That with the respective RF consolidated budget's tax revenues (no account taken of the non-budget funding) having gone down even greater – more than 3 GDP percentage points. This fall took place practically fully at the expense of the federal budget while the tax revenues of the RF consolidated budgets cut down but rather insignificantly and comprised, likewise in the previous year, only something about 10 %. It was mainly this fact which determined further growth in the share of the tax revenues of the RF subjects' consolidated budgets in the respective consolidated budget tax revenues of Russia. This rather insignificant reduction in the 2003 tax revenues was simultaneously accompanied with a certain fall of the sumtotal incomes of the regional budgets: own incomes (with no federal financing taken into account) – down to 11.7 % GDP (12 % GDP in 2002) and the resulting incomes (all non-compensated transfers taken into account) – down to 14.5 % GDP (as compared against 14.9 % GDP in 2002).

When analyzing the situation with tax revenues of the 2003 consolidated regional budgets', it seems quite noteworthy to note that, like before, over half tax incomes were obtained mainly from two sources – income tax on physical entities (34 % of incomes revenues of the regional budgets) and profits tax on legal entities (2.7 %). It is also to be noted that in the year of 2003, absolute proceeds from these two taxes in relation to the GDP practically did not at all go down – those from the legal entities' profits taxes remained on the same level (about 2.7 % GDP) while those from physical entities' income taxes even somewhat grew up (from 3.4 % up to 3.6 % GDP). This was accompanied with rather significant growth of the respective excise-duties (1.5 times up to 0.7 % GDP) and falling incomes from payments for using the natural resources and «small business» taxation.

Analysis of the similar RF subjects' consolidated budget indicators followed with their further comparison against the respective data of the federal budget's performance prompts paying attention to the fact that, beginning from the year of 2003, special measures were taken

to increase the rates of centralizing tax incomes in the federal budget. Let us recall, for instance, such decisions as full revocation of the automobile-roads-users tax as well as going over to full inclusion of the excise-duties on all tobacco products into the federal budget, which came into force in 2003. Although it was supposed to compensate these losses of the regional and municipal budgets through such measures in the area of interbudgetary redistribution of the taxation incomes as decentralizing excise-duties on fuels/lubricants and the land tax, experts claimed, as far back as 2002, that additional tax incomes from these measures will be definitely insufficient for full compensation of the expected budget losses. However, as can be clearly seen from the respective data on budget performance, as per January 1, 2004, on the whole no any significant reductions in the regional tax incomes were observed in the country which can be explained by both greater inflow of excise-duties, on the one hand, and income taxes of physical entities, on the other.

At the same time, according to the resultant per capita indicator of the RF consolidated budgets tax incomes, there were no changes in interregional unevenness of this indicator in 2003 – the respective Gini index value remained then practically unchanged having comprised 0.52 (0.53 in the year of 2002). The greatest downfall in the absolute tax incomes took place in such RF subjects as the city of Moscow, the Republic of Tatarstan, the Khanty-Mansi and Jamal-Nenets autonomous districts, the Samara region, the Krasnodar region, the Komy Republic. Simultaneously, maximum tax incomes growth (in its absolute expression) was achieved in the Moscow region, the Republic of Bashkortostan, the Chelyabinsk region, the city of Saint-Petersburg, the Krasnoyarsk region. Analysis of changes in the per capita tax incomes (relative value) shows that the greatest negative effect (more than 15 % real-term fall) from redistribution of tax incomes was characteristic for such RF subjects as the Evenk autonomous district, the Ingush Republic, the Northern Osetia-Alania, Tatarstan, Karelia, Komi, Altai and Kabardino-Balkaria, the Samara and Magadan regions, the Yamalo-Nenets and Taimyr autonomous districts. At the same time, maximum positive per capita tax incomes growth was observed in such RF regions as the Aginsky, Buriat, Nenets, Koriak and Chukotsk autonomous districts, the republics of Bashkortostan, Adygea, Mordovia, Kalmykia and Mary-El, the Omsk, Saratov, Vologod, Kemerovo and Lipetsk regions.

In other words, the said analytical results do not yet give sufficient grounds to assert that the 2003 tax income distribution measures resulted in any obviously enough manifested redistribution of resources from one region to another: among those which obviously lost, are both highly financed and heavily subsidized regions. And vice versa. Rather, some other factors, apart from the tax and/or budget legislation, exerted influence on the tax incomes value of the respective consolidated RF regional budgets; accordingly, our analysis does not give a sufficiently clear explanation of the pure effect of the measures taken. It is to be noted, however, that the new fuels/lubricants excise-duties redistribution system led to much greater interregional taxation unevenness: hence, because of the logically yet incomplete system of excise taxation of retail and wholesale producers the respective incomes (though generally higher) in 2003 were concentrated in but several regions – 60 % of overall excise-duties on automobile fuels and/or motor lubricants were in the regional budgets of ten (10) RF subjects (the Rostov, Orenburg, Tiumen, Yaroslavl, Saratov, Moscow, Ryazan, Omsk regions the Republic of Bashkortostan and the city of Moscow) all of which have oil refineries on their territories. It was, to a considerable extent, this very fact that caused introduction of the new system of



fuels/lubricants excise-duties distribution between the respective regional budgets in the year of 2004 which is to be discussed in some detail below.

In the year of 2003, likewise in that before, the overall RF subjects' consolidated budgets deficit comprised something at the level of about 0.4 %. Which was duly financed through (a) issuing the state and/or municipal securities, (b) credit involvement, performed in the name of the RF subjects and municipal formations and (c) privatizing the respective state and/or municipal property. Quite noteworthy here is also the negative balance (for the country on the whole in 2003) for such a budget-deficit financing source as the federal budget crediting (i. e., in 2003, overall crediting off-payments of the RF subjects even exceeded the amounts of their new loans). That during a number of the recent years this was actually the first case of returning budget crediting by regions is quite noteworthy.

According to the quantitative analytical data of the federal budget-based financial aid to the RF subjects (see *Table 25*, below), amounts of the respective federally financed resources remains rather high, even taking into account somewhat reduced federal budget tax incomes (in 2003, at the level of about 377 bln. roubles or 2.8 % GDP which is only slightly less than 3 % GDP in the previous year).

Expenditures of the federal budget on providing financial support to RF subjects and/or municipal formations were not any significantly changed as compared against a number of the preceding years. Notwithstanding the reforms, considerable funds allocated through the inter-budgetary regulation system without any reasonable methodological or financial-economic justifications still remain quite distinctive features of this category of federal budget spending. The share of financial support thus distributed, comprises something about 60 % in the total volume of the resources to be provided on a formalized basis. In 2003, similar to the preceding years, such formalized financial support was used but for rather limited amounts (the Federal Fund of Financial Support, the Compensation Fund, the Fund for Co-financing Social Expenditures and the Fund for Regional Finance Reforming). It is noteworthy that practically not a single funding allocation procedure was formally approved at the respective legal act, just one exception being only the Fund for Regional Finance Reforming whose respective methodology was officially approved by the Resolution of the RF Government as conditioned by the World Bank which actually provides the necessary funding for such kind of financial support.

All other frameworks of financial support (or budget loans to finance cash gaps) were provided practically without any clear methodological procedures (probably, except for a small part of budget subsidies to keep up the necessary balance between the subjects of the Russian Federation).

A typical feature of the year of 2003 were amendments to the federal law on the federal budget, formally passed in July and November (1), which, accordingly, resulted in rather significant redistribution of the financial resources in favor of certain RF territories as compared against the original budget plan. After the November amendments, the 2003 federal budget law provided for *gratis* subsidies to the RF subjects in the amounts of 80 bln. roubles (30 %) more than in accordance with the respective end-of-2002 federal law. It is also quite noteworthy that such changes have become rather typical during the three recent years which, naturally, casts doubts on the efficiency value of the regional financial support reform thus conducted.



The problem of annual reviewing the budget laws which include allocation of more funds to be transferred to the respective regional budgets, is not only that such additional funding is not subject to a sufficiently formalized procedure making the basis for preparing and further passing of the federal budget law for the coming financial year. Such annually increased (as compared against the initially planned amounts) financial support unfortunately somehow complemented with a crying lack of clear-cut and open rules of exactly how these additional budget funds shall be distributed inevitably leads to significant relaxation of the respective<sup>19</sup> subnational authorities' budget limitations. In other words, in case when regional authorities do beforehand expect greater amounts of financial resources (as well as almost practical absence of the necessary allocation rules) this will inevitably result in rather negative efficiency of their activities with regard to providing public services to the population on their respective administrative territories. In particular, should these regional authorities decide that the federal powers will base their additional finance support distribution logic primarily on such indicators as, for example, arrears of wages, credit debts value in the living and communal servicing sector, then no adequate measures to raise budget spending efficiency and/or to continue public sector reforms are ever to be expected.

As an example of the existing order and principles to distribute the additional financial support we can cite decision on providing interest-free budget loans to RF subjects in the amounts of up to 5.5 mln roubles for the three year period of return in order to enable them to carry out a set of measures necessary to prepare the living and communal sector, as well as the local self-government bodies under the Russian Federation jurisdiction, for the coming 2003/04 autumn-winter period<sup>20</sup>.

After this particular amendment, the federal budget law became directly controversial to the RF Budget Code. Namely, approval of the time-term non-interest budget loans return does not at all correspond to the # 137 Article of the RF Budget Code on the six-month maximum non-interest loan pay off.

It is also noteworthy that non-interest loans are, in fact, nothing but a form of direct financial support of those receiving; at least, in the beneficial part for the regions due to free-of-charge use of the respective budget funding. Rules of providing RF subjects with non-interest budget crediting to prepare the living and communal sector as well as the local self-government bodies under the RF jurisdiction for the coming 2003/04 autumn — winter season (approved by the RF Government's Regulation # 430, dated July 16, 2003) do not clearly enough explain the reasons exerting impacts on the resultant amounts of the said loans legally given to such or other RF subject. Hence, quite obvious are disproportions in the end-line crediting distribution between the RF subjects some of which did not receive such at all while some others (e. g., the Republic of Sokha, the Archangels, Vladimir, Voronezh, Kamchatka, Murmansk, Pskov, Sakhalin, Ulianov and Chita regions) received the said budget loans in the amounts of over 100 mln roubles while some regions, for instance, the Republic of Adygea, the Komy-Permiak, Chukotka and Evenkia autonomous districts received much lesser financial support.

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<sup>19</sup> See the Federal Law, dated 7. 07. 2003, # 121-FL, «On Making Changes in the *On 2003 Federal Budget*», federal law and the Federal Law, dated 11. 11. 2003, # 150-FL, «On Making Changes in the *On 2003 Federal Budget*», federal law.

<sup>20</sup> See Point 4 of Article 1, the Federal Law dated 7. 07. 2003, # 121-FL «On Making Changes and Amendments in the *On the 2003 Federal Budget* ».



Among other important channels of providing RF regions with «indistinctly framed» financial support were the balancing-the-RF-subjects' budgets state subsidies. It is also noteworthy here that the figures in the initial version of the 2003 federal budget draft comprised but four (4) bln roubles. That with the respective funding allocation methodology official justification (Order of the Russian Federation Ministry of Finance # 128, dated May 7, 2003) which was valid only in regard to the amount of 3.5 bln roubles. The remaining monies, including those added into this said article due to changes in the law on the federal budget (somewhat over 2 bln roubles), did not have any sufficiently formalized distribution basis.

All the above considerations show that the recent years have been characterized by definite slow down of the interbudgetary relationships reforming process (which was actually started somewhere in 1997 – 98) and in some cases (for example, if viewed as a certain balance between formalized and discretionary distributed federal budget resources). This somewhat regressing situation can be explained by several obvious reasons.

*First*, there still remains certain objective budget sphere overloading with federal spending obligations not adequately supported with the respective financing. Under conditions of the general spending – financial resources misbalance, it was quite natural for the power bodies to wish to have free funds which could be easily directed to such or other region of the Russian Federation depending on the needs to come.

*Second*, legal (but not quite transparent) authorities for distributing financial funds between RF regional budgets are considered an important instrument of exerting influence on decisions and policies of the subnational power bodies. In the context of obvious inter-regional budgetary distribution unevenness, which is now quite typical for Russia, a rather high centralization degree of tax incomes in the federal budget, accompanied, respectively, with sufficiently large amounts of budget resources redistributed between the RF regions. Thus, such financial mechanisms can be quite instrumental in influencing decisions of regional authorities which, though rather formally and only within the framework of their particular competence, do have a certain degree of independence. This situation, in our opinion, is but one of the main reasons why the currently existing (during at least several past years) methodologies of the basic financial support distribution have not yet been legally formulated in the respective budget legislation.

*Third*, quite noteworthy are also the discussions, rather intensively carried out during the past two years, on the said federative reform a most significant component part of which shall be reforming the budgetary relationships principles in the Russian Federation (including those of financial support distribution). It can be asserted that certain consensus has already been reached with regard to the basic principles of such reform, its time terms included. Any attempts to try to simultaneously implement some other reform in the same area, in our opinion, would be at least counterproductive.

In any case, however, as very well demonstrated by the practical experience of the several past years, reforming the principles of the federal financial support distribution does remain on the actual agenda because the existing system is not yet sufficiently transparent which, in a way, on the one hand, prevents making objective conclusions on its true efficiency and gives grounds to expect negative stimuli for the budget policies of the regional and/or local power bodies, on the other.

*Table 25*

**Federal budget financial support to RF subjects' consolidated budgets  
in the 1992 –2004 period (% GDP)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004*
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>11</b>	<b>12</b>	<b>13</b>	<b>14</b>
Subsidies & subventions	0,00	0,02	0,09	0,06	0,09	0,13	0,10	0,06	0,15	0,54	0,28	0,29	0,28
<i>Including:</i>													
Closed Administrative Territorial Entities (CATE) Subsidies/subventions and Baikanur									0,11	0,12	0,11	0,11	0,09
CATE subsidies and subventions											0,11	0,06	0,06
Subsidies to Baikanur											0,00	0,00	0,00
CATE subventions for capital investments												0,03	0,03
CATE subventions for removing people from their habitat												0,01	0,01
CATE subventions to finance CATE development programs												0,01	0,00
Other subsidies and subventions									0,04	0,42	0,17	0,18	0,18
Subsidy to the city of Sochi											0,01	0,01	0,01
Subsidies to compensate damages from maintaining housing and utilities transferred under local self-government bodies											0,08	0,08	0,03
Other subsidies to RF subjects' budgets (maintaining budgetary balances and compensation of damages)											0,07	0,09	0,13
Other subsidies and subventions to budgets of RF subjects and municipal formations											0,01	0,01	0,01
<b>Subventions</b>	<b>0,79</b>	<b>0,69</b>	<b>0,42</b>	<b>0,12</b>	<b>0,12</b>	<b>0,09</b>	<b>0,02</b>	<b>0,20</b>					
<b>Transfers from the Federal Fund for Support of Regions (FFSR)</b>	<b>0,00</b>	<b>0,00</b>	<b>0,36</b>	<b>1,17</b>	<b>1,04</b>	<b>1,22</b>	<b>1,12</b>	<b>0,99</b>	<b>0,96</b>	<b>1,14</b>	<b>1,36</b>	<b>1,30</b>	<b>1,15</b>
<i>Including:</i>	0,00							0,00					
Transfers	0,00	0,00	0,36	0,86	0,68	0,86	1,00	0,99	0,96	1,14	1,36	1,30	1,15
Including state support of «Northern Supplies»									0,06	0,08	0,08	0,07	0,05
VAT transfers	0,00	0,00	0,00	0,31	0,36	0,36	0,12						



*Table 25 cont'd*

1	2	3	4	5	6	7	8	9	10	11	12	13	14
<b>Subsidies/subventions from the Fund of Compensations</b>										0,37	0,38	0,36	0,33
<i>Including:</i>													
subsidies to implement Law on Social Protection of disabled										0,13	0,12	0,06	0,05
subventions to implement Law on State Welfare Payments to Citizens with Children										0,24	0,21	0,16	0,14
subventions to compensate for benefits in housing/utilities payments as provided for in the respective federal legislation											0,02	0,10	0,10
Other subventions and subsidies from the Fund of Compensations											0,02	0,04	0,04
<b>Funds of the Fund for Co-financing Social Spending</b>											0,15	0,11	0,02
<b>Funds of the Regional Development Fund</b>									0,03	0,05	0,10	0,10	0,16
State support of road Building and maintenance								0,18	0,11	0,27	0,27	0,31	0,19
<b>Funds of the Fund for Reforming Regional Finance</b>										0,00	0,01	0,01	0,01
<b>Means from mutual settlements</b>	0,61	1,95	2,54	0,42	0,81	0,43	0,36	0,14	0,28	0,05	0,20	0,14	
<b>Loans less payments to other state control levels</b>	0,09	0,03	0,02	0,04	0,23	0,64	-0,03	-0,10	-0,08	0,02	0,09	-0,01	
<b>Underpaid from RF subjects' budgets into the targeted budget funds</b>	0,00	0,00	0,00	0,02	0,05								
<b>Other types of financial support</b>									0,00	0,13	0,18	0,23	0,11
<i>Including:</i>													
Funds transferred to other level budget for implementing state programs									0,00	0,11	0,00		
Regional development, special federal and other programs											0,18	0,23	
<b>Total: means transferred to the respective budgets of other power levels</b>	1,49	2,70	3,4	1,8	2,3	2,5	1,60	1,36	1,54	2,56	3,03	2,84	2,23

\* Planned by the Law # 186-FL «On Federal Budget for the Year of 2004», dated 23.12.2003.

### *2.3.2. Tax reform continuation and 2003 federal budget law*

Continuation of the tax reform in 2003 was directly relevant to the interbudgetary relationships as well as to regional and/or municipal financing. Among the most significant decisions considered by the RF Duma during the pre-election year, were: expediency of canceling the sales tax and passing a chapter of the Tax Code on organizations' property taxation.

It probably seems worth mentioning in this context that in Russia, this discussion on the sales tax has quite a long history with expediency of this tax being openly doubted since the moment it was passed as far back as 1998. In 2001, after the RF Constitutional Court officially recognized that certain provisions of the «On the Bases of the Tax System» Law, particularly so those regulating the said sales tax, did not fully correspond to the RF Constitution, soon approved was another chapter of the Tax Code where this tax was to be considered as cancelled beginning from January 1, 2004. It is also noteworthy that such decision was rather actively discussed in 2001 as well although obvious fears about the resultant possible significant incomes fall in the respective regional and/or local budgets (in particular, as to canceling the turnover tax, lower tax rates on organizations' profits) prevented its practical implementation.

However, this discussion on expediency of the said sales tax was renewed in the spring of 2003 when the agenda was again completed with the problem of extending the time-term of this sales validity tax in Russia within the framework of the RF Government's legislative initiatives in the tax reform area.

It is also to be noted that there is a number of arguments, if indeed considered from the viewpoint of economic efficiency, both for preserving this sales tax along with VAT and against their simultaneous levy. On the one hand, the retail sales tax, particularly so should the authority of the regional powers to regulate it be expanded, could result in the respective sub-national bodies' greater tax autonomy thus practically inevitably becoming a source of the regional/local budgets' own tax profits. While on the other, the sales tax does permit to export the tax burden on citizens of other regions when, much due to practical absence of the respective regional tax bodies, additional costs, normally connected with simultaneous levying of both the VAT and the sales tax, are the responsibility of the federal tax bodies. Besides, over half of the RF budget system' sales tax incomes were concentrated mainly in the budget of three regions – the city of Moscow and St-Petersburg as well as that of the Moscow region.

Although, under Russian conditions, defining of how much the sales tax costs exceed its possible advantages indeed does depend a lot on a certain political choice, yet, in our professional opinion, decision to preserve the sales (especially in the context of the ongoing Russian tax reform) would be quite inefficient because of the following: any changes in the earlier decision on canceling of the sales tax can be interpreted as a signal to taxpayers that the power bodies may at any time change such decisions which, in its turn, could very negatively tell on the end results of the tax reform as a whole.

Finally, no any definite decision on preserving the sales tax was taken although certain financial compensation demands of the respective regional/local authorities were in the long run to a great extent satisfied. One element of this was the decision to transfer to the respective RF subjects' budgets: organizations' profits tax in the amount of the tax rates one percentage point (p. p.); all budget profits coming in the framework of special «small business» tax regimes (except for the part sent to the respective state extra-budget funds); the federal excise-duty share of the alcohol production as levied from the wholesale excise store-houses (along with changing the procedure of paying these excise-duties, such decision may mean



significant re-routing of the said financial incomes). Besides, when reforming the existing tax legislation, including passing a new Tax Code chapter into the RF subjects' budgets beginning as from the year of 2004, fully entered into the budget shall be tax incomes from the gambling business.

The second important decision for the subnational budgets, successfully passed in 2003, was formal approval of the Tax Code's new chapter dealing with regulating taxes on organizations' property. Initially, the respective Government's bill supposed such novelties as, e. g., lesser taxation range due to taking out resources and yet incomplete construction, significant reductions in the list of the tax-free federally stated property items (it has been proposed that the right to introduce any number of additional privileges, likewise now, remains with the RF subjects' power bodies), refusal to exempt from taxes certain categories of taxpayers, transition to the system of granting privileges to some property categories as well as increasing the maximum taxation rates from two (2) to six (6) per cent.

Accordingly, this bill of the RF Government was passed practically as proposed although the end amount of the maximum taxation rates was lowered down to 2.2 per cent. It is also quite noteworthy that, on the one hand, limiting the maximum rates for the regional taxes seems to be rather inexpedient mainly because it results in limited taxation autonomy of regional authorities with regard to one of the generally accepted subnational budgets' tax income sources while in the Russian context, on the other hand, such limitation may very well have its own reasoning.

As has already been mentioned above, quite a large number of budgetary obligations, set up by the Russian legislation, are not adequately supported by the respective financing, with the responsibilities for performing such obligations in most cases having been imposed either on the regional or on local authorities. Setting up the maximum rates of the respective regional tax under these conditions actually means stimulating the regional/municipal authorities to try to raise such rates as high as possible (particularly so in the so called «state subsidized regions»).

An important decision was taken in 2003 with regard to both improving the general taxation system efficiency and to the real state of the regional finance. There was a situation in the 2002 – 2003 period when, fully in accordance with the articles of Chapter 25 of the Tax Code, the regional authorities were granted the right to modify tax rates on organizations' profits (transferred into the RF subjects' budgets) but only within four (4) percentage points. Yet, the law on invalidating the said chapter of the Tax Code stipulated that in case of the investment agreement between a taxpayer and RF subject's power bodies, if duly signed before the said Chapter 25 of the Tax Code came into force, the said taxpayer is granted all the privileges as provided for in this agreement. Accordingly, using the firms which had earlier concluded such agreements with the power bodies of some RF regions in order to minimize their respective tax payments (transfer price forming technology including) then became a most profitable method for taxation planning. In 2003, a decision was taken to terminate this norm beginning from the year of 2004.

The 2004 Federal Budget Law also contains some taxation novelties having to do with both the interbudgetary relationships and subnational financing. As has been already mentioned above, concrete results of practical using the new excise-duties on fuels/lubricants scheme in order to develop somewhat more efficient respective efficient tax incomes distribu-

tion between the federal and regional budgets proved rather poor efficiency of this mechanism if considered from the viewpoint of the total tax incomes value.

A decision was taken in the result that the share of incomes from this tax to be directed to the RF subjects' budgets shall be divided into two parts. The first part (50 % incomes of the RF consolidated budget from excise-duties on fuels/lubricants) shall be distributed between the respective regional budgets, proportionally to the length of the general use automobile roads and the number of officially registered vehicles in that particular subject of the Russian Federation, through centralizing incomes in the federal budget. The second (10 % of the said excise-duties from the territory of the respective RF subject) shall be directed to the regional budget fully in accordance with the procedure which was operative in 2003. Thus, beginning from the year of 2004, a principally new mechanism of distributing tax incomes between federal and regional budgets in the Russian Federation.

The above decisions in the area of transferring tax income down to the regional level opened the way for measures necessary to centralize tax receipt from the rather unevenly placed tax basis – in 2004, for example, the federal budget will receive 4.5 percentage points more mineral tax incomes (hydrocarbon raw materials, in particular) and incomes from this tax on natural gas production will be fully included too.

As concerns financial support of the said subnational budgets, the 2004 Federal Budget Law stipulates that in that very year the respective regional and/or municipal budgets shall receive (in different forms) over 340 bln roubles (or 2.2 % GDP). This figure is indeed somewhat lower than the respective indicators of the last years but then account should be taken of the fact that the yearly resultant amounts of financial support are, as a rule, higher than provided for in the first version of federal budget law – e. g., had the initial amount been allocated as financial support to the RF subjects' budgets in the year of 2003 (with no account taken of 2003 summer and/or autumn changes) its total volume would have comprised less than 2 % GDP.

### *2.3.3. Beginning of the federative reform practical implementation*

As already mentioned above, the beginning of the federative reform's practical implementation – a result of work of the special Commission for preparing proposals on delimiting authorities and jurisdictions between the respective federal bodies of state power, the state power bodies of the RF subjects and the local self-government bodies, directly under the President of the Russian Federation, which was set up by President's Decree # 741, dated June 21, 2001. Initially, the tasks of this Commission included preparing recommendations in such areas as improving efficiency of delimiting authorities and/or jurisdictions between the respective federal bodies of power the state power bodies of the RF subjects and the local self-government bodies, regulating the RF Constitution stipulated mutually agreed upon delimiting authorities between different level power bodies, mechanisms of transferring power functions down to the respective local self-government bodies, settlement procedures of differences between level different power bodies in the area of authorities and/or jurisdictions delimiting.

The Commission also was to assist in positive removing possible contradictions which may well arise in the course of work at bringing the respective constitutions, regulations, laws and/or other normative acts of the Russian Federation subjects, legal agreements on delimiting authorities and/or jurisdictions between the respective federal and local state power bodies fully in accordance with the RF Constitution and the respective federal laws.



An important result of Commission's activities was, on the one hand, «stock-taking» of the overall authorities range of the federal, regional and local power bodies as well as preparing of amendments to various RF legislation acts aimed at more accurate definition/delimitation of the scope and functions of different level authorities, their administrative performance and financing, on the other. The most significant among the Commission's recommendations, from the viewpoint of fiscal federalism, were: draft project of the new version of the «On General Organizational Principles of Local Self Government in the Russian Federation» law and the draft project of the law «On General Organizational Principles of Legislative (representative) and Executive State Power Bodies of the Subjects of the Russian Federation».

Both these documents were officially presented to the State Duma in the end of 2003 – 2004 and to be then, accordingly, approved and signed by the RF President. It is also noteworthy, though, that both these legislative acts do contain provisions according to which all significant novelties (having anything to do with regulating fiscal relationships between the respective different level state power bodies) come into force only provided the respective amendments to the Tax and Budget Codes which in fact stipulate practical implementation of the said laws.

One of the most important elements in the basically new construction of the Russian budget system to be adopted after the new version of the «On General Organizational Principles of Local Self Government in the Russian Federation» law will be setting up on the whole RF territory a uniform local self-government structure including municipal formations of three types. To make it a little clearer let us explain that a mixed budget system has been formed at the sub-regional level in Russia when the local power bodies with the respective budget rights (i. e., those having their own budgets and enjoying full rights as subjects of interbudgetary relationships with the respective regional authorities) are formed at the regional level cities and/or settlements districts (one level system). In some cases, RF subjects form either a two-level local power bodies system or a somewhat similar one when the first, a higher government level, is the respective state power body and the second – the respective local self-government one. Practically in all the above cases, the said one or two level local self-government power bodies can very well be deprived of the budget rights with the respective spending on the local public utilities being financed strictly in accordance with the accepted regional power scheme (3). Accordingly, the interbudgetary mechanisms of relationships between regional and local power bodies do greatly differ from each other depending on the concrete subject of the Russian Federation in question.

It is necessary to note that although proposals on unifying the budget system structure and principles of interbudgetary relationships at the level of the RF subjects are already contained in the Development Program of Budgetary Federalism till the Year of 2005 this document has but proposals of a rather general character concerning possibility to create adequate legislative conditions on the federal level to form various budget system organization types on the subregional<sup>21</sup> levels, including the two-level one. Fully in accordance with the results of the said Commission, a decision was taken to recommend the federal legislature to set up a uniform structure of local self-government bodies consisting of municipal formations

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<sup>21</sup> For more details with regard to the subregional level interbudgetary relationships, see: *Kurliandskaya G.* «Budget Pluralism of the Russian Power Bodies/Further Improvement of Interbudgetary Interrelations in Russia». Collection of articles. IET Research works # 24P, M. IET, 2000, pp. 365 – 409.



of three types – settlements, municipal districts and city okrugs (the latter combining functions/authority of settlements and municipal districts). That with the federal legislature now determining the scope of authority for all types of municipal formations as well as regulating both the principles and procedures of budgetary relationships between all types of municipal formations themselves and/or with the respective regional power bodies as well.

Possibly, such decision in the new version of the Law «On General Principles of Local Self-government in the Russian Federation» can be deemed a sufficiently radical change as compared against the currently existing situation. Yet, improvement of the budget system structure was taking place in parallel with a whole number of other tasks – in particular, greater clarity with regard to the authority scope of each power/government level, the order of authority delimiting and delegation, increasing the efficiency of the financial support distribution system at the sub-regional level, etc. Therefore, it could easily be assumed that giving, e. g. the respective RF subjects' power bodies, the right to chose between the federally determined structural variants of the budget systems on their territories (along with practical implementation of a number of other novelties) would result in significantly growing complexity of the taxation – budget and other relationships between the respective different level power bodies in the period of reforms also strongly implying practical impossibility of establishing a unified delimiting-of-the spending authority-and-taxation incomes scheme (primarily so in the federal budget legislation). However, leaving the issue of economic efficiency of the said new regional level administrative-territorial structure outside the framework of this particular analysis, it should be nevertheless reminded that it was mainly this task of delimiting authority which was set up before the presidential Commission – the actual initiator and author of these laws.

Apart from establishing new organization principles for the local self-government bodies and, accordingly, changing the budget system structure at the sub-regional levels, the federative reform in its fiscal part includes the following areas:

- determining the scope and content of authority for each level of power and/or government body;
- determining the scope and content of taxation authority and tax incomes for each level of power and/or government body;
- delimiting procedures for spending obligations between different levels of the budget system;
- legislative support of procedures for distributing interbudgetary transfers from the respective federal, regional and local budgets;
- order of setting up provisional finance administration in the RF subjects and municipal formations.

In the autumn of 2003, after the final passing by the State Duma of the basic laws in the above said federal reform area, the Russian Federation government submitted to the parliament several bills on changes in the respective budget and taxation legislation. Apart from this, among other aims of these bills were: correcting certain obvious shortcomings in the Budget and Tax Codes as well as clarifying some budgetary legislation terms in the area of interbudgetary relationships, taxation legislation terms, etc. In November, 2003, all the said bills were fully approved by the State Duma of the third convocation in the first reading; the second reading, the key one, is planned for the first half of 2004 (as will be shown below, these bills imply taking a number of unpopular steps, probably, that is why their contentual discussion was put off till after the parliamentary and presidential elections).



Let us now consider in greater detail the contents of the RF Government-proposed changes in the respective budgetary and taxation legislation. Such analysis is deemed exceptionally important for us primarily because these documents (particularly so with regard to making changes in the Budgetary Code) are in fact a conceptual program of the Government in the area of reforming the interbudgetary relationships which, in our opinion, is much more significant than the two preceding programs of this reform<sup>22</sup> the more so since they (the documents) already do exist as bills and are at present under consideration by the RF State Duma.

The bill on making changes and/or amendments in the Budgetary Code with regard to interbudgetary relationships is a rather voluminous document with quite a lot of novelties suggested in the respective area of legal-normative regulation. In particular, the said bill provides for the following sufficiently significant changes to be made in the current legislation:

1. More clear and precise definitions of the basic terms/notions actively used in the present budget legislation as well as introducing, if necessary, new and more modern terminology. Among these, e. g., such notions as «spending obligations», «budgetary obligations», ‘interbudgetary transfers».
2. Defining the new scope of budgetary authority for the state power and different types local self-government bodies of all levels.
3. More clear functioning of the RF budget system with due account taken of the changes in the local self-government bodies structure – e. g., inclusion budgets of the municipal/city districts, the rural settlements and inside city territories as component parts of the RF budget system.
4. New principles of the legislative regulating the different levels’ budgets spending. Fully in accordance with the latest version of defining the self-dependence of budgets principle, it is suggested not to permit setting up spending obligations subject to performance simultaneously from budgets of two and more levels or with no defining the budget from which the said spending obligation shall be performed. Such formulation is evidently more clear and simple as compared against the similar definition in the present version of the Budget Code.
5. Legislatively confirmed normatives for distributing incomes from the respective federal, regional and local taxation between different budgets of the RF budgetary system (at present, such norms are partly contained in the Budgetary Code, in laws on the federal budget for the current year, in the respective taxation legislation). Fully in accordance with the proposed normatives for distributing tax incomes between different level budgets, it is suggested to abandon centralization of incomes from the regional and local taxes in the respective higher level budgets as well as the said normative decentralization of incomes from the regional taxation into the local budgets. Another proposal in this regard consists in going over to a new order of distributing tax incomes between the autonomous okrug, component part of the respective region (territory), and the budget of this region (territory) – in accordance with the bill proposed, in case there is no formal agreement between the respective state bodies of power of this particular autonomous okrug and those of the respective region (territory) incomes from the federal taxation, according to the new version

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<sup>22</sup> Implied here are: the «Concept of improving interbudgetary relationships in the Russian Federation in 1998 – 2001» and the «Program of budget federalism development in Russia for the period till the year of 2005».

the Budgetary Code, subject to be entered into the RF subject's budget shall be entered into the budget of the respective region (territory).

6. Legislative regulation of the order for setting normative deductions from federal and regional taxation into the respective local budgets made by the RF subjects' state bodies of power. It is suggested that regional laws set up long-term normative uniform for all municipal formations as well as additional short-term (annual) normative for deductions from federal and regional taxation into the respective local budgets with certain limitations on their possible discretionary use.
7. Introduction of a principally new order of delimiting the spending obligations of the Russian Federation, those of RF subjects and municipal formations which practically completely excludes existence of non-financed federal and/or regional spending mandates. Accordingly, the Government proposed norms stipulate that should the federal bodies of state power take upon themselves any spending obligations which are not within direct authority of the Russian Federation (i. e. those of the respective regional and/or local bodies of power) such obligations then are subject to financing through subventions from the federal budget. The respective federal legislation should necessarily include the order of calculating such subventions which are to be annually taken by the federal law for the next financial year provided the respective subventions were duly approved by the state law. It is suggested that similar norms shall be developed and applied to spending obligations set up by the higher-level authorities for the respective local budgets.
8. Introduction in the budgetary process of a new document – register of the spending obligations of the state power and local self-government bodies understood as a code of legal acts and signed agreements providing for possible appearance of certain spending obligations to be paid from the respective budgets.
9. Sufficiently detailed legislative regulation of the order for calculating and providing the interbudgetary transfers down to the lower-level budgets. The respective chapter in the new version of the Budgetary Code proposes to establish forms of interbudgetary transfers and procedures for distributing such federal budget transfers as subsidies from the RF Subjects Financial Support Fund as well as from the Federal Compensations Fund. It is to be specially mentioned though that this order of distributing the said funds is, on the whole, rather similar to the current practice.

At the same time, however, it is suggested that certain articles in the Budgetary Code should duly stipulate the respective order for distributing financial support at the regional level. Moreover, since the government system of financial support at the level of RF subjects is, on the whole, rather similar to that federal financial support of the respective regional budgets (with due account, indeed, taken of an obviously more complex budget structure at the sub-regional level) it is also suggested to establish, for example, such forms of interbudgetary transfers to the respective local budgets as:

- subsidies from the regional financial support of rural settlements funds;
  - subsidies from the regional financial support of municipal (urban) districts funds;
  - subsidies from the local financial support of settlements funds;
  - subventions to local budgets from the regional compensation funds;
  - other financial support means.
10. Introduction of rather well-known inter-budgetary transfers, principally new for the Russian budgetary process – the so called «negative transfers», i. e. subventions from



the local budget into the RF subject's budget (municipal district), the right to receive such may arise in case of significantly enough excess in the budget financing of a middle level RF subject's municipal formation.

11. Besides, recommended is also introduction of such inter-budget transfer as subvention from the settlements' budgets to the municipal district budget for purposes of solving certain inter-municipal problems.
12. (11) Introduction of the new budgetary regulation instrument – budgetary authority of the RF subjects' state power bodies and the respective local self-government ones under provisional financial administration.
13. Fully in accordance with the said proposed bill, the provisional financial administration (i. e., federal executive body or that of the RF subject authorized to prepare and take measures necessary to restore this RF subject's (municipal formation's) paying capacity as well as to implement and control certain budget authority of RF subjects' (local) executive power bodies can be established for the term of up to one year by the respective decision of the Supreme Arbitration Court (the arbitration court of the given RF subject) if officially requested by the Government of the Russian Federation. At that, the said provisional financial administration may be introduced only if the outstanding debts of the RF subject's (municipal formation) budget in question which was caused through certain decisions, actions or inactivity by the respective authorities, exceed 30 per cent of its own budget income amounts.
14. The bill under consideration stipulates reasoning and procedures for the practical introduction of the said provisional financial administration, the scope of its authority, the contentual plan for restoring the given RF subject's (municipal formation) paying capacity, the respective budget performance order of such RF subject's (local budget) and practical control over its duly execution should the said provisional financial administration is introduced.

Practical and efficient performance of all federal system budgets through the Federal Treasury bodies.

Since the need in reforming the federal budgetary legislation with regard to most of the directions, mentioned above, causes little doubt among both the respective experts and representatives of the federal, regional and local bodies of power, expediency of passing the said legislative act aimed at efficient solution of the respective problems is therefore quite obvious. It is to be noted, however, that although the document under consideration does have certain shortcomings these are not of conceptual nature. The basic provisions of the concept, in our opinion, will be quite instrumental in stimulating much higher efficiency of fiscal federalism in Russia. Particularly so among these:

- regulating the delimitation order of the spending obligations and declaration of intention to stop using non-financed spending mandates in the respective budgetary relationships;
- fixing budgetary incomes of all levels on a long-term basis and introduction of federal regulation in the area of distributing incomes from the respective regulating taxes on the RF subjects' level;
- legislative regulation of inter-budgetary transfers distribution from the federal, regional and local budgets based on a uniform approach towards all participants of this process and objective criteria characterizing the need in such financial resources;

- all the above provisions of this concept of the said bill, if practically implemented, are expected to be leading to greater self-dependence of subnational budgets but such growth should indeed be accompanied with a possibility to impose sanctions against those RF subjects and/or municipal formations which tolerate growth of budgetary indebtedness. Accordingly, the said bill provides for regulating the order of introducing and functioning of the provisional financial administration in the respective Russian Federation subject and/or municipal formation.

However, even though this bill contains a number of conceptual approaches which, in our opinion will indeed exert positive effect on the budgetary legislation certain directions of this document do need some improvement. Particular attention should be paid to the following shortcomings:

1. Although there are norms in the document which are directly aimed against possibility to use non-financed spending mandates with regard to lower-level budgets, the mechanism of their practical implementation is not yet quite clear. For instance, the current legislation contains a great number of norms imposing non-financed or but only partially financed obligations down on the respective regional and local budgets. Fully in accordance with provisions of the bill under consideration, should the law on the federal budget not contain norms regulating subventions to finance such obligations with the law itself having no calculation criteria for such subventions, the respective norms are not subject to be practically applied during the period in question.

It is also noteworthy that the said bill contains neither recommendations to repeal the current laws and to replace them with new legislative acts meeting the requirements of the Budget Code's latest version, nor the order of practical performing such obligations when the said law will be being introduced. Such a situation, on the one hand, will be instrumental in ceasing most obligations under discussion the moment this bill has been enacted (indeed, should it be passed in the said new version) but, on the other hand, it can provoke both refusal to reject non-financed mandates when passing it in the State Duma and mass court examinations as connected with refusal to finance legitimate obligations subject to the Budget Code's new norms.

Thus the actual need in a more thorough study of the means/methods to implement the new order of transferring the said spending obligations down to the respective lower-level power bodies with further financing such obligations.

2. Apart from reforming the order of delimiting the said spending obligations between the respective budgets of the budget system, the main conceptual discussions may center around normative values of distributing taxation incomes between the respective budgets. It is necessary to note that the existing regional and municipal budgets sufficiency estimations, formed in accordance with the normatives thus proposed in order to adequately finance their own spending obligations, usually greatly differ from each other. According to the RF Government's estimations, budgets in the country will, on the whole, be quite balanced while other estimations predict a possible situation when certain budgets may be well overfinanced while others – obviously underfinanced.

In our opinion, when the said reform is implemented under conditions of such large-scale changes, as explicitly implied, an important role is often played not so much by concrete normative values of taxation incomes distribution but rather by the respective principles of their establishing. With due account taken of changes not only in the spending obligations



composition but in the principles of their distribution, including indeed those of taxation incomes and/or inter-budgetary transfers, as well, any estimations of tax and/or non-tax sufficiency at the level of individual Russian Federation subjects and municipal formations shall simply have to be characterized by an extremely high error degree.

To conclude this particular item, it seems quite expedient that the RF Government proposed normatives for distributing tax and/or non-tax incomes do deserve approval in the first reading, indeed with their further correcting as regards both more clearly-cut spending obligations and better defining directions of the said tax reform.

3. In spite of the fact that the said bill formally meets all the requirements concerning the legislative regulation of financial support funding at the federal and regional levels, the RF Government proposed order of inter-budget transfers distributing from the respective RF subjects' budgets has a number of significant defects.

The following circumstances should be kept in mind when considering possible areas for regulating the distribution procedures of providing inter-budget transfers to municipal formations. *Firstly*, the federal legislation must contain provisions providing for possibilities to use uniform formal enough subsidies distribution criteria for evening up budget financing levels with regard to all the participants of such process as well as for using uniform objective criteria concerning distribution of other financial support types. *Secondly*, the self-dependence factor of the RF subjects in defining the major budget policy directions at the regional level are also to be taken into due consideration.

In our opinion, reasonable combination of the two above mentioned principles should inevitably result in shaping in the said federal legislation of the general structural outlines of both the inter-budgetary evening up system and that of inter-budgetary transfers on the sub-regional level, including unified methodologies applied objectively used to calculate the inter-budgetary transfers amounts indicators of inadmissibility any symmetric municipalities' incomes withdrawals should their respective taxation incomes objectively grow, etc. Quite a significant role in the respective legislation, at that, should belong to interpreting the said norms by the RF judicial system bodies.

Unfortunately, authors of the bill preferred another way, i. e. rather detailed regulation of the interbudgetary principles at the RF subject level. On the one hand, in view of the present state of the said judicial system we have a situation where most RF subjects are characterized by discrimination of some municipal formations in the process of budgetary evening but, on the other hand, such approach significantly limits abilities of the respective regional and municipal authority in establishing sufficiently adequate inter-budgetary regulation system with due account taken of regional peculiarities, traditional approaches to inter-budgetary relationships, etc. Moreover, the system of calculating the amounts of inter-budgetary transfers, as proposed in the bill, does not always permit objective financial support distribution encouraging, in some cases, practical use of various corrections, ration differentiations, etc.

The said chapter of the bill, containing principles of inter-budgetary transfers distributing (particularly from the budgets of the Russian Federation subjects), it seems, does need significant revision although with no changes in its basic principles.

4. The norm in the bill providing for possible application of the so called «negative transfers» also requires thorough analysis and significant improvement.

On the one hand, the need in withdrawing part of budgetary incomes of municipal formations with high budgetary financing is, in fact, just the reverse side of the decision to ex-

pand the municipal formations' income basis – under conditions of a high level of the tax basis inter-municipal differentiation and absence of efficient property taxation, raising normatives for other local budgets' tax incomes (in particular income taxes) will lead to super incomes for certain municipal formation and relatively low increment of incomes for the others. Accordingly, in order to even up budget financing a need arise in inter-municipal budgetary incomes redistributing not only through inter-budgetary transfers and differentiated regulating tax deductions but through centralizing (withdrawing) part of incomes from the budgets of highly financed municipal formations.

On the other hand, however, as different from the detailed order of distributing subsidies and subventions to local budgets from the respective RF subject's budget, the bill under discussion does not contain a similarly detailed order of calculating and collect the above said negative transfers. In particular, the bill permits rather arbitrary application of this interbudgetary regulation instrument without exceeding the set up limitations (practical application of such negative transfers to municipal formations where the expected per capita tax incomes were two and more times higher than the average regional level, calculating the negative transfers amounts proportionally to the excess of the expected tax incomes of double average regional level, impossibility of exceeding of the negative transfer amounts the half difference between the expected per capita tax incomes and the double average regional level of the expected per capita tax incomes.

Hence, we are faced with the situation when in addition to comparatively inefficient system of regulating inter-budgetary transfers from the RF subjects' budgets to the respective local budgets the bill under discussion provides for one more instrument making it possible to collect, if deemed necessary, additional incomes of the respective local budgets. It is quite obvious that in certain cases such a situation creates incentives to use the new system for purposes of income discrimination of some municipal formations which but proves the need in rather significant revising the bill in this particular part.

5. The order of introducing and practical implementing certain budgetary authority of the above said provisional finance administration, as proposed in this bill on making changes and amendments in the RF Budgetary Code, indeed meets the efficiency criteria requirements much better than all the previous versions discussed when preparing this legislative bill. Nevertheless, however, that this part of the bill does need some revision too is quite obvious. Particularly so to achieve the following aims:

- -raising the degree of account taken regarding the interests of those crediting regional and local budgets both when setting up the provisional finance administration and when preparing and practically implementing steps deemed necessary to restore the respective RF subject's (municipal formation) paying capacity;
- -higher degree of judicial bodies' participation in the process of introducing and practical functioning of the said provisional finance administration.

At the same time, quite justified also seems the concept of setting up and practical functioning of such provisional finance administration as proposed by the RF Government.

6. The requirement of the bill on obligatory performance of all budgets of the system through the Federal Treasury bodies, on the whole, does not seem to be so very necessary. With due account taken of the more general reasoning with regard to budgetary self-



dependence of the respective regional and/or local authorities as well as of the traditional approaches to performing different level budgets the system of such performance, in our opinion, should be of a more decentralized nature and be based on the following assumptions:

- -the respective federal legislation must contain a set of requirements (standards) for performing budgets of all levels including such for performing the federal budget through the respective RF Federal Treasury bodies;
- -the respective federal legislation must provide for the right of the RF subjects' (municipal formations' included) power bodies to set up their own budgetary bodies (treasuries); it is also possible to legally empower the respective federal power bodies (Federal Finance Ministry) to test compliance of regional and local budgetary performance (as well as the needed certification) to the standards required;
- the respective federal legislation must provide for the possibility to perform the regional and local budgets fully in accordance with the respective agreement on the return basis done through the RF Federal Treasury (except the cases when performance of the regional and/or local budgets through the Federal Treasury bodies is but obligatory).

Whatever the case, it seems necessary to abandon the norm requiring compulsory performance of all budget system's budgets only through the respective Federal Treasury bodies. Presence of such a norm in this bill is, in our opinion, one of the most serious shortcomings of the bill under consideration.

7. The draft project of the Federal Law on Introducing Changes and Amendments into the RF Budgetary Code does not consider the budgetary status of the Closed Administrative Territorial Entities (CATE). Following the general logic of the said bill, it is proposed to make their budgetary status equivalent to that of the city settlements or city districts. Although this seems to be just one of possible decisions but in case it is passed a number of legislative changes and amendments will indeed be necessary to respectively change the special status of the said closed administrative territorial entities.

At the same time, however, these changes in the CATE status may seem to be quite inexpedient from the viewpoint of those ministries and/or departments under which such or other CATEs function.

The bill under consideration should in any case sufficiently thoroughly regulate both the place and the status of such CATEs under new conditions of the Russian budgetary system's functioning.

8. In spite of the fact that the bill under consideration has been developed to implement (among other things) provisions of the new version of the respective laws «On General Local Self-Government Organizational Principles in the Russian Federation» and «On General Legislative (representative) and Executive State Power Bodies Organizational Principles of the Russian Federation Subjects», certain provisions of the said bill are somehow in contradiction with those of the said laws. In a number of cases (for instance, when regulating the inter-budgetary evening up system at the RF subjects level) presence of similar provisions in the above laws does not seem enough expedient.

Thus, legislative passing amendments in the Budgetary and Tax Codes should be accompanied with respective changes in the laws «On General Local Self-Government Organizational Principles in the Russian Federation» and «On General Legislative (representative) and Executive State Power Bodies Organizational Principles of the Russian Federation Sub-



jects» worked out with due account taken of the recommendations of the said RF President's Commission.

This document explicitly implies introduction of the following changes in the RF Tax Code:

The second of the bills intended mainly to provide the necessary taxation-budgetary support of the federative reform under discussion – the draft project of the federal law «On Making Changes and Amendments in the Russian Federation Taxation Code» and recognition as having lost validity the law of the Russian Federation «On the Bases of the Taxation System in the Russian Federation» – implies completing of the RF Taxation Code with provisions practical implementation of which naturally follows from the respective provisions of the federal laws «On Making Changes and Amendments in the Russian Federation Taxation Code».

The following changes are expected to be introduced in the RF Taxation Code in accordance with provisions of this document:

- 1) More clear definitions of the respective federal, regional and local taxes. Local taxation authority delimitation between self-government bodies of settlements and those of city okrugs (municipal districts).
- 2) Making certain changes in the list of federal, regional and local taxes. Of the whole set of taxes comprising the taxation system of the Russian Federation, it is proposed to include in the regional taxes those on the organization's property and on the gambling business. The respective local taxes category should include the land tax, the physical entities' property tax, the transport tax and the commercial dues. As to the latter two, it is proposed that only local self-government bodies of city okrugs (municipal districts) shall have the right to establish such.
- 3) More clear definition of the Taxation Code's provisions in the area of special taxation regimes regulation; requirement to enter all tax payments into the respective Federal Treasury bodies' accounts to be then duly distributed between respective budgets of the budgetary system.
- 4) Cessation of validity of the law «On the Bases of the Taxation System in the Russian Federation» as well as that of provisions of a number of other legal-normative acts.

On the whole, it is noteworthy that the bill under consideration is to a considerable extent rather technical, except for provisions regulating the composition of the respective federal, regional and local taxes. Proposed here is but only one significant change – transferring the transport tax from regional to local ones (set up by local self-government bodies of city okrugs and/or municipal districts). It should also be mentioned in this respect that because of stopping the normative 50 % decentralization of incomes from the organizations' property tax into the respective local budgets such status alteration of the transport tax is deemed quite expedient.

A significant shortcoming of the bill under consideration is the lack of prerequisites for introducing the realty tax which is normally considered as the main income source of the sub-national budgets in most countries of the world. In our opinion, therefore, reforming the property taxation system seems to be one of the key questions of the fiscal federalism reform since it does presuppose making up a stable income basis for both regional and local budgets. Moreover, the practical start of the said federative reform expected to take place in the year of 2006, is a good reason to intensify efforts in going over to much more efficient realty taxation principles widely used in the world practice.



We are of the opinion that the realty taxation system, as different from the principles proposed in the above said bills, is to be based on taxation authority and realty taxation incomes distribution between all the three levels of the sub-national power bodies:

- the settlement tax on housing and/or small business commercial realty should be levied at the level of settlements;
- the production and commercial realty tax incomes should be transferred to the RF subjects level;
- municipal districts (city okrugs) should be empowered to complement the regional production realty taxation rates with regional (city) additions followed with entering the said amounts in the respective budget as concerns this particular addition.

The said tasks, as well as the problems of defining the realty taxation methodology bases, are to be practically solved within the year to come.

On the whole, it is quite noteworthy that should these bills be passed and come into force they shall result in most significant changes in the relationships between budgets of different level power bodies since the early 1990s economic reforms. At the same time, however, it does not seem possible at present to estimate their logical consequences in any unambiguous way. On the one hand, practical implementation of the novelties proposed could indeed stipulate much higher transparency of the inter-budgetary relationships system (at the sub-regional level in particular). Besides, there appears a prospect to efficiently solve some of the most important problems for the Russian budget federalism system – underfinanced spending mandates, the sub-regional level structure of the budgetary system, formalization degree of financial support and distribution scheme. But, on the other hand, practical implementation of the norms under consideration does not give enough reason to assert that these aims can be sufficiently fully achieved.

## 2.4. The Market for Government Debt

### 2.4.1. Government debt market

In 2003, the Russian Federation's state domestic debt grew approximately by 1,4 %, from 654,7 to 663,7 bln rubles in terms of securities (the debt was reduced from 6,0 % to 5,0 % in terms of GDP shares). OFZ (federal loan bonds) accounted for 97,8 % of the government debt.

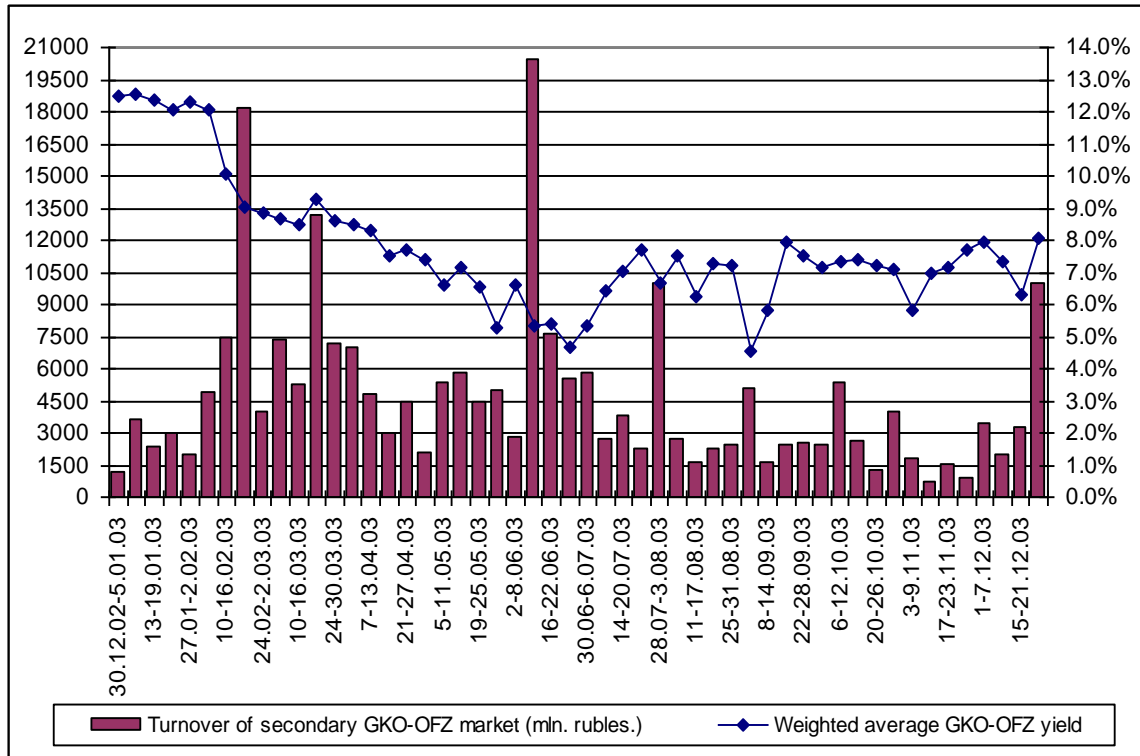
*Table 26*

Government domestic debt in the Russian Federation (bln rubles)		
Type of securities	as of 01.01.2003	as of 01.01.2004
GKO	18,82	2,72
OFZ-PK	24,1	24,1
OFZ-PD	350,74	50,48
OFZ-FK	207,07	199,31
OFZ-AD	42,29	375,42
OGNZ	11,5	11,5
OPVVZ 1992	0,08	0,04
OGSZ	0,11	0,1
Total	654,7	663,67

The foreign national debt of the Russian Federation was reduced from \$104,3 to \$100,6 bln US dollars (according to the RF Central Bank) as of October 1, 2003. Thus, the gross amount of foreign national debt of the government accounted for 3,55 %. In 2003, the government honored its financial obligation on the 4<sup>th</sup> tranche Minfin bonds (in May), as well as two Eurobond issues (in April and June). The private sector (banks and companies) increased its debt to non-residents from \$47,8 to \$63,7 bln US dollars (+33,3 %) over the same period. Thus, the total foreign national debt of the Russian Federation grew from \$152,1 to \$165,4 bln US dollars within nine months in 2003.

### Domestic Debt

The government ruble debt market continued to decline in yield last year. It fell approximately by 5 %, from 12 % to 7 and 8 % yearly, reaching 5 % in some cases. It is noteworthy that the decline was registered as investors became more active against the previous year. Thus, the total transfer quantity in the GKO-OFZ market amounted to about 243,16 bln rubles, which is approximately 1,9 as much as in 2002.

*Figure 22*
**GKO-OFZ Market Movement in 2003**


Source: «Finmarket» Information Agency, IET's estimates.

In addition, average weekly figures reached 4,67 bln rubles in 2003 against 2,53 bln rubles in the previous year. In 2003, the maximum weekly transfer quantity reached about 20,43 bln rubles against 7,1 bln rubles in 2002, while the minimum was 754 ml rubles against 193 ml rubles in 2002. Thus, the ruble government bond market saw a substantial boost in trading in the past 2003.

There were several stages in yield movement in 2003 that are worth mentioning. The first stage embraces a period between January and June when yield dropped to 4,54 % yearly (first week in September), reaching its minimum since the beginning of the year. It is in this very period that transfer quantity in the market was registered relatively high against that of the second half of the year. The key factors of yield movement are as follows. A considerable amount of ruble liquidity at banking sector stimulated the demand at the market. In February, the market increased quotes in response to a Statement made by the RF Central Bank on leveling the yield at foreign and domestic debt markets. In April, the RF Central Bank stimulated a rise in bond quotes. All in all, the GKO-OFZ yield movement reflected a favorable situation in the Russian economy. However, the decline in yield automatically rendered this segment of the Russian stock market less attractive, which caused migration of investments to the stock market showing a better growth rate of most liquid shares. Furthermore, the arrest of the President of YUKOS in June had an adverse effect on investors considering this event as an increasing political risk, thereby market trading responded instantly by decreased quotes, particularly at the GKO-OFZ market. The foregoing factors encouraged stabilization of yield at the

state domestic debt market which was increased up to 7 to 8 % yearly till the beginning of autumn.

The yield movement was governed mainly by liquidity at the banking sector and situation at the foreign exchange market. It should be noted that there was a short-term decline in yield in September which reached its historic minimum as the average weighted GKO–OFZ yield dropped to 4,54 % yearly in the first week of September. Thereafter, the price risk was included in the ruble instruments price due to unstable dollar exchange rate, and, as a consequence, stock quotes dropped slightly again. The «hottest» month for investors at the ruble bonds market was October. A strong upward trend developed at the market on October the 8<sup>th</sup> in response to a new credit rating on Russia raised unexpectedly by Moody`s. In two weeks, however, a strong downward pressure was registered due to a political instability represented by the YUKOS case. The new credit rating prevailed and kept its positive effect in spite of falling quotes late in the month. The market activity declined significantly throughout the entire November due to an uncertainty associated with the upcoming parliamentary elections. The quotes of the government ruble bonds varied within a short range. In December, the market was governed mostly by economic factors (liquidity at banking sector, Ruble vs. Dollar exchange adjustments in favor of the former, stable macroeconomic figures), as well as eliminated uncertainty with the parliamentary elections.

The RF Ministry of Finance held 28 auctions on GKO–OFZ placement throughout the entire 2003. The volume of borrowed funds accounted for 111,1 bln rubles without regard to secondary market transactions. A decline in share of GKO–OFZ transactions in total volume of borrowed funds at the secondary market was governed by a specific policy of the RF Ministry of Finance`s in the year under review.

#### Foreign debt

A substantial decline in all traded instruments` yield was registered at the Russian Eurobonds market throughout the entire year. In particular, the yield of the 5<sup>th</sup> tranche Minfin bonds accounted for 5,62 % yearly, while the 6<sup>th</sup> tranche was 4,18 % late in December. The yield of RUS–30 and RUS–28 securities dropped from about 9 % to 7,3 % yearly over the year, yield to maturity of RUS–07 securities accounted for 4,4 % yearly, and RUS–18 securities were traded according to the yield of 6,97 % yearly.

Most positive trends of the year were as follows. The Government`s political and economic reforms were under support; efforts were made in resolving key problems, namely liberalization of the natural monopoly market of goods and services, stable macroeconomic performance and positive economic growth rates; and a new sovereign credit rating on Russia. Most negative trend was a conflict between the oil company YUKOS and the government, which reminded foreign investors of political risks in Russian assets.

In January 2003, the Russian market proved again its attractiveness by demonstrating a sustained growth. Though the situation in Iraq affected markets at all developing countries, the Russian market proved less exposed. In addition, the general situation in the country remained stable: Russia went on in an effort to conduct economic reforms, restructure monopolies and reduce oil export dependence.

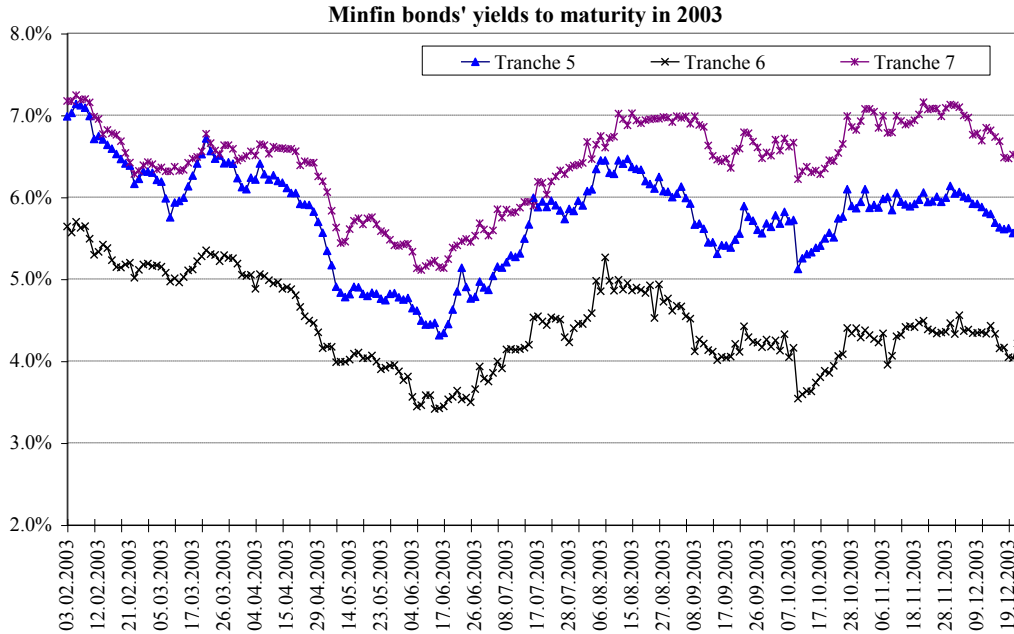
In February, the Russian Eurobond market fully recovered from an impact caused by the Iraq problem of the previous month. A neutral behavior of the Russian market in response to



the Iraq problem had a positive impact on investors which considered Russian Eurobonds as safest investment instruments to hedge military risks.

Figure 23

**Minfin Bonds Yield to Maturity in 2003**



Source: «Finmarket Information Agency.

Figure 24

**Russian Eurobonds Yield in 2003 to Maturity in 2030, 2028 and 2007**



Source: «Finmarket Information Agency.

An agreement concluded in February between one of the world's major oil companies British Petroleum and Russian TNK was a positive signal for investors, which gave evidence of increasing interest of foreign companies in Russian assets. The growth was registered since early in March. For instance, on March 7 quotes of RUS-30 eurobonds reached the historical maximum 87,75 % of the par value with 8,25 % yield yearly. It should be noted that the trend in the Russian eurobond segment at that period was governed mainly by external factors as evidenced by the demand for Russian securities in spite of economic growth retardation. Nevertheless, some investors favored to realize their profit as the warfare started in Iraq and global oil prices declined, which made Russian security quotes go down.

This segment of financial market was also influenced by growth of liquidity in April. New historical maximums were reached during the month: for instance, RUS-30 grew up to 90,2 % of the par value, which corresponded to a yield drop of 8,3 % to 7,94 % yearly during the month. The funds generated from redemption of several Eurobond issues was the main supporting factor to the market, hence quotes varied technically. In addition, gold and foreign exchange reserves of the Russian Federation and a favorable environment at the neighboring markets, primarily in Brazil and Turkey, also encouraged growth in the Russian Eurobond market.

In May, quotes were governed by redemption of the 4<sup>th</sup> tranche Minfin bonds (\$3,41 bln US dollars at par value) and expected RUS-03 redemption. The RF Central Bank enlarged gold and foreign exchange reserves as oil prices remained high, which supported largely the Eurobond quotes. In June, the «rally» of the Russian Eurobond market came to its end when correlation of Russian Eurobonds and US Treasuries became a key factor – market strategy was governed by expectation of new rates at the US market. Further decline was caused by several factors. Firstly, a decrease in the market investment share of the RF Pension Fund was noted. Secondly, the YUKOS case could produce political risks in investing in Russian debt securities.

In the period between August and September, Russian Eurobonds recovered from decline. Late in September, for instance, the RUS-30 redemption yield accounted for 7,46 % yearly, RUS-28, 7,26 %, and RUS-18, 6,85 %.

As noted above, a very special event occurred in Russia early in October: Moody's upgraded the sovereign credit rating on the Russian Federation by two points up to Ba3, which is considered as initial investment rating. This made the Russian Eurobond market open for foreign investors which previously had no wish to buy Russian assets due to a credit risk. However, a positive effect of the new rating was eliminated by news of unlikely settlement of the YUKOS case with the Attorney-General's Office, and hence Eurobonds dropped to the point they were registered early in the month.

There was no any definite trend at the Eurobond market near year-end 2003. The market was slightly supported by decline in US Treasuries in mid-November due to a statement made at the US Federal Reserve System to the effect that the basic interest rate would remain stable in the nearest future. However, the uncertainty related to the upcoming parliamentary elections forced quotes down. The above uncertainty was eliminated upon the parliamentary elections, which somehow supported the market by increased sovereign foreign currency bonds.



## 2.4.2. Municipal and Subfederal Borrowings Market

### Market movement

In 2003, the consolidated regional budget ran a deficit of 50,0 bln rubles, i. e. 2,6 % of its (revenues), or 0,38 % of the GDP. The budgets of the constituent entities of the Russian Federation ran a deficit of almost 33,9 bln rubles (2,3 % of revenues), and the budgets of municipalities ran a deficit of 27,4 bln rubles (3,2 % of revenues).

The deficit to expenditures ratio of the consolidated budget was slightly reduced against the previous year (2,6 % in 2003, while 2,7 % in 2002). A share of deficit financing of the constituent entities of the Russian Federation was reduced significantly from 3,0 до 2,3 %, while the deficit of municipal budgets increased from 2,8 to 3,2 % (*Table 27*).

*Table 27*

### Deficit to Expenditures Ratio of Territorial Budgets (%)

	Consolidated regional budget	Regional budget	Municipal budget
2003	2,6	2,3	3,2
2002	2,7	3,0	2,8
2003 against 2002	96,0	77,7	112,8

*Source:* IET's estimates according to the data from the RF Ministry of Finance.

As of January 1, 2004, consolidated budgets of 62 constituent entities of the Russian Federation ran a deficit totaling 61,7 bln rubles, or 3,34 of their revenues.

The median level of budget deficit accounted for 2,38 % of the consolidated budget revenues. The biggest deficit to revenues ratio was registered at the Evenkiysky Autonomous National Area – 37,3 %, Chechen Republic – 11,1 %, Novosibirsk Oblast – 8,9 %, Republic of Kareliya – 8,1 %, and the Tula Oblast – 7,4 %.

Seven constituent entities of the Russian Federation accounted for about 58 % of the total deficit: Moscow – 27,7 % or 17,08 bln rubles, Moscow Oblast – 9,7 % or 6,0 bln rubles, Novosibirsk Oblast – 4,7 % or 2,89 bln rubles, Sakha Republic (Yakutiya) – 4,6 %, or 2,85 bln rubles, Karasnoyarsk Krai – 4,3 % or 2,67 bln rubles, Khabarovsk Krai – 3,8 % or 2,32 bln rubles, and Samara Oblast – 3,0 % or 1,86 bln rubles.

In 2003, budgets of 27 constituent entities of the Russian Federation ran surplus. The total of budget surplus at these regions represented 11,7 bln rubles or 2,53 % of the budget revenues. The median figure of budget surplus accounted for 1,54 % of the budget revenues.

The biggest surplus to revenues ratio of the consolidated budget was achieved at the Chelyabinsk Oblast – 8,4 %, Ust-Ordynsk Buryat Autonomous National Area – 4,7 %, Republic of Kalmykiya – 4,0 %, and Aginsk Buryat Autonomous Area – 4,0 %.

Four constituent entities of the Russian Federation achieved over 66 % of the total budget surplus: Chelyabinsk Oblast – 31,0 % or 3,64 bln rubles, Republic of Bashkortostan – 18,9 % or 2,22 bln rubles, Tyumen Oblast – 9,7 % or 1,14 bln rubles, and Perm Oblast – 6,9 % or 0,81 bln rubles (*Table 30*).



### Accumulated debt structure

In 2003, the amount of accumulated debt of the consolidated regional budget grew by 48,7 bln rubles or by 0,37 % of GDP. The increase in debt was governed by growing domestic debt (i. e. debt in terms of Rubles). The foreign debt of regional consolidated budgets was reduced by 3,8 bln rubles, while the domestic debt grew by 52,5 bln rubles (*Table 28*).

*Table 28*

### Net Borrowings of Regional and Domestic Budgets (in terms of % of GDP)

Year	1995	1996	1997	January – August 1998	January-December 1998	1999	2000	2001	2002	2003
Borrowings by subfederal and domestic authorities, including:	0,38	0,87	1,43	0,71	0,33	0,15	-0,29	-0,04	0,47	0,37
repayable loans from budgets at other levels	0,07	0,23	0,66	0,05	-0,09	-0,11	-0,03	0,04	0,12	-0,01
Subfederal (municipal) bonds	н. д.	0,16	0,22	0,08	-0,01	-0,05	-0,27	-0,07	0,16	0,31
other borrowings	0,31	0,48	0,55	0,58	0,43	0,31	0,01	-0,02	0,19	0,06
Reduction of budget account balances	...	0,03	-0,18	0,09	0,02	-0,19	-0,30	-0,05	-0,04	-0,18
Deficit financing through borrowings and reduction of budget account balances	0,38	0,9	1,25	0,8	0,35	-0,04	-0,59	-0,09	0,38	0,19

*Source:* IET's estimates based on the data from the RF Ministry of Finance.

### Borrowings structure

In 2003, total of borrowings of the regional consolidated budget was 232,2 bln rubles, which included 2,4 bln rubles of external borrowings. The recipients of external loans were St. Petersburg – 1 183,5 ml rubles, Moscow – 798,8 ml rubles, Republic of Bashkortostan – 470,8 ml rubles and Stavropol Krai – 5,5 ml rubles.

The total of domestic borrowings at regions and municipalities was 229,8 bln rubles. The major borrowers were Novosibirsk Oblast, 52,6 bln rubles, Moscow – 35,3 bln rubles, Moscow Oblast – 18,8 bln rubles, and St. Petersburg – 8,9 bln rubles.

In 2003, borrowings grew up to 18,7 bln rubles or 8,8 % in nominal terms against 2002, and hence the volume of borrowings was reduced by over 3 % in nominal terms. This seemed to be caused mainly by the fact that the accumulated debt's duration, which reduces the need in frequent refinancing by the territories, was not considered by budget statistics. This trend is supported by an ongoing decrease in net borrowings of the territories which was reduced by 16,9 % in real terms. The volume of net borrowings of the consolidated regional budget 2003 accounted for 48,7 bln rubles in 2003 against 51,6 bln rubles in 2002.

The biggest budget debt to revenues ratio was revealed at the regions with a marked budget deficit, namely Evenkiysky Autonomous National Area where net borrowings accounted for 68,9 % of the revenues (including transfers), Novosibirsk Oblast – 8,8 %, Tula Oblast – 7,5 %, Samara Oblast – 7,2 %, Republic of Kareliya – 6,6 %, and Kostroma Oblast – 6,0 %.



The biggest net borrowers were Moscow – 18,8 bln rubles, Moscow Oblast – 5,3 bln rubles, Krasnoyarsk Krai – 2,9 bln rubles, Sakha Republic (Yakutiya) – 2,8 bln rubles, Novosibirsk Oblast – 2,6 bln rubles, Samara Oblast – 2,5 bln rubles, Yamalo-Nenets Autonomous National Area – 1,5 bln rubles, Evenkiysky Autonomous National Area – 1,3 bln rubles, and Tula Oblast – 1,2 bln rubles.

Among the regions which reduced most of the accumulated debt were as follows. Perm Oblast by 0,8 bln rubles, Stavropol Krai by 0,7 bln rubles, Tyumen Oblast by 0,4 bln rubles, Kemerovsk Oblast by 0,4 bln rubles, and Omsk Oblast by 0,3 bln rubles.

Issuance of securities accounted for 26,9 % of the total domestic borrowings of the consolidated regional budget, while federal budget loans represented 7,9 %, and other borrowings (primarily bank loans) – 65,3 %. A special emphasis should be placed upon a quick securitization of subfederal debt. Securities in regional borrowings was almost doubled in share in 2003 against the previous year, from 18,3 to 33,8 %, while the share was increased by 2,5 in the volume of the municipal borrowings (initial share, however, was fairly small – 1,0 %) (Table 29).

Table 29

**Domestic Borrowings Structure of Subnational Budgets in 2003 (%)**

	2002			2003		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Total (ml rubles)	211 135,2	154 077,4	101 206,3	229 789,0	174 852,6	108 436,3
Security issuance	13,8	18,3	1,0	26,9	33,8	2,5
Budget loans	11,9	16,7	43,1	7,9	10,6	48,9
Other borrowings	74,2	65,0	56,0	65,3	55,6	48,6

In 2003, total balance of regional and local budgetary accounts increased by 23,8 bln and hence reached 94,7 bln rubles, which represented a 28,5 % growth in real terms. Thus, the the balance of budgetary accounts of the territories was increased by 49 % of their total net borrowing worth 48,7 bln rubles.

Table 30

**Administration of Consolidated Budgets of Constituent Entities of the Russian Federation in 2003 (%)**

	Budget revenues (ml rubles)	Budget (deficit) surplus (ml rubles)	Surplus (deficit) against revenues	Borrowed funds against revenues	Net borrowings against revenues	Interest spending against revenues	Budget account balance against revenues	Net borrowings against surplus (deficit)
1	2	3	4	5	6	7	8	9
<b>Central Federal District</b>								
Belgorod Oblast	12 777,2	-835,5	-6,54	7,94	1,84	7,03	1,98	-28,1
Bryansk Oblast	11 856,8	-212,8	-1,79	3,32	1,24	2,37	0,50	-69,0
Vladimir Oblast	15 616,9	-119,5	-0,77	2,99	0,27	2,84	3,42	-35,8
Voronezh Oblast	20 460,4	-1 009,2	-4,93	18,35	3,74	15,80	1,50	-75,9
Ivanovo Oblast	12 245,5	-115,4	-0,94	2,36	1,41	1,02	1,64	-149,4
Калужская обл.	12 051,2	132,0	1,10	2,31	-0,72	3,24	2,55	-65,7

**RUSSIAN ECONOMY in 2003**  
trends and outlooks

*Table 30 cont'd*

1	2	3	4	5	6	7	8	9
Kostroma Oblast	8 193,3	-541,7	-6,61	11,29	6,04	6,13	1,25	-91,4
Kursk Oblast	9 776,5	151,4	1,55	3,17	-2,75	6,00	1,14	-177,7
Lipetsk Oblast	15 827,0	175,9	1,11	0,36	0,24	0,12	10,67	21,4
Moscow Oblast	89 387,9	-6 006,9	-6,72	21,07	5,93	17,44	4,91	-88,3
Orel Oblast	9 024,2	241,9	2,68	3,01	-1,76	4,77	3,53	-65,7
Ryazan Oblast	13 402,8	163,7	1,22	2,89	-0,25	3,31	3,59	-20,4
Smolensk Oblast	9 171,1	-170,9	-1,86	9,18	1,69	7,96	0,88	-90,9
Tambov Oblast	11 889,6	181,0	1,52	1,28	-1,88	3,18	0,69	-123,4
Tver Oblast	14 790,7	-176,3	-1,19	15,41	2,14	14,18	2,30	-179,4
Tula Oblast	16 577,6	-1 320,3	-7,96	19,17	7,49	12,90	0,97	-94,1
Yaroslavl Oblast	19 617,0	-1 082,9	-5,52	12,92	4,28	9,33	0,99	-77,6
Moscow	339 188,8	-17 075,9	-5,03	10,64	5,54	7,04	9,17	-110,0
<b>Total</b>	<b>641 854,4</b>	<b>-27 621,3</b>	<b>-4,30</b>	<b>11,23</b>	<b>4,33</b>	<b>8,41</b>	<b>6,34</b>	<b>-100,5</b>
<b>Northwest Federal District</b>								
Republic of Kareliya	10 165,8	-898,4	-8,84	11,92	6,55	6,31	0,90	-74,1
Komi Republic	20 298,7	-289,2	-1,42	10,23	1,65	10,09	2,03	-115,5
Arkhangelsk обл.	20 096,5	-168,7	-0,84	3,09	0,72	2,65	1,20	-86,1
Vologda Oblast	19 383,2	116,7	0,60	4,72	0,72	4,23	4,63	119,3
Kaliningrad Oblast	10 991,1	-437,2	-3,98	7,60	1,78	6,09	1,30	-44,7
Leningrad Oblast	22 297,8	-988,5	-4,43	8,43	3,16	5,88	4,78	-71,3
Murmansk Oblast	14 755,4	-782,6	-5,30	11,39	5,20	6,70	3,05	-98,0
Novgorod Oblast	7 197,1	-254,1	-3,53	7,67	3,41	4,33	1,56	-96,7
Pskov Oblast	8 620,5	-253,2	-2,94	3,70	2,30	1,82	1,08	-78,4
St. Petersburg	77 654,2	-1 092,6	-1,41	13,04	0,51	14,87	4,16	-36,2
Nenets Autonomous National Area	3 518,4	-21,6	-0,61	2,42	0,57	2,16	3,34	-92,6
<b>Total</b>	<b>214 978,7</b>	<b>-5 069,3</b>	<b>-2,36</b>	<b>9,44</b>	<b>1,77</b>	<b>8,89</b>	<b>3,19</b>	<b>-75,2</b>
<b>South Federal District</b>								
Adygei Republic	5 123,3	-58,8	-1,15	1,49	-1,95	3,47	1,85	170,2
Dagestan Republic	23 613,3	-188,9	-0,80	0,30	-0,03	0,32	1,74	3,3
Ingush Republic	4 893,0	-27,9	-0,57	0,65	0,00	0,65	1,73	0,0
Kabardino-Balkarian Republic	7 065,9	-243,6	-3,45	15,22	2,41	13,78	0,53	-70,0
Kalmyk Republic	5 038,0	203,7	4,04	1,27	-4,35	5,72	1,28	-107,7
Karachayevo-Cherkess Republic	4 805,6	-219,5	-4,57	1,94	-1,25	3,20	0,90	27,4
Severnaya Osetiya-Alaniya Republic	8 523,6	118,4	1,39	1,89	-3,22	5,21	2,54	-231,6
Chechen Republic	9 091,9	-1 132,8	-12,46	0,71	0,71	0,00	1,90	-5,7
Krasnodar Krai	53 466,1	-1 129,4	-2,11	2,93	0,73	2,37	4,10	-34,5
Stavropol Krai	20 794,1	329,1	1,58	1,77	-3,41	5,20	4,83	-215,5
Astrakhan Oblast	9 200,5	-182,8	-1,99	6,33	3,49	2,93	2,90	-175,5
Volgograd Oblast	22 694,2	-575,5	-2,54	13,68	2,22	12,20	1,76	-87,6
Rostov Oblast	41 830,4	316,2	0,76	1,73	-0,36	2,32	3,23	-47,1
<b>Total</b>	<b>216 140,1</b>	<b>-2 791,8</b>	<b>-1,29</b>	<b>3,69</b>	<b>-0,03</b>	<b>3,94</b>	<b>2,93</b>	<b>2,5</b>



*Table 30 cont'd*

1	2	3	4	5	6	7	8	9
<b>Privolzhskiy Federal District</b>								
Republic of Bashkortostan	60 606,5	2 217,1	3,66	1,94	-0,16	2,45	11,50	-4,5
Mari-El Republic	7 581,3	1,6	0,02	5,32	-1,54	7,12	0,80	-7 436,5
Mordovian Republic	13 442,6	418,1	3,11	13,89	-1,32	15,75	2,82	-42,5
Republic of Tatarstan	67 409,9	-1 474,2	-2,19	3,33	0,21	3,37	1,96	-9,6
Udmurt Republic	18 346,1	-498,3	-2,72	5,76	1,78	4,20	2,71	-65,5
Chuvash Republic	14 612, 0	-214,9	-1,47	5,36	1,54	4,25	2,83	-104,6
Kirov Oblast	15 377, 7	-207,7	-1,35	4,43	1,36	3,25	0,83	-101,0
Nizhni Novgorod Oblast	31 648,8	-1 609,9	-5,09	17,59	1,71	18,54	1,98	-33,7
Orenburg Oblast	20 498,3	-380,5	-1,86	3,82	1,77	2,25	1,48	-95,5
Penza Oblast	12 675,5	17,7	0,14	1,67	-0,10	1,87	1,94	-69,3
Perm Oblast	35 028,4	812,9	2,32	6,21	-2,16	8,67	4,83	-93,1
Samara Oblast	34 889,4	-1 861,7	-5,34	16,08	7,22	9,79	7,76	-135,3
Saratov Oblast	24 246,8	238,8	0,98	6,16	-0,60	7,36	0,44	-61,4
Ulyanov Oblast	10 221,5	-574,1	-5,62	7,88	4,69	3,44	2,74	-83,5
Komi-Permyak Autonomous National Area	2 878,3	9,1	0,32	1,74	0,83	0,98	1,67	262,7
<b>Total</b>	<b>369 463,0</b>	<b>-3 106,0</b>	<b>-0,84</b>	<b>6,74</b>	<b>0,95</b>	<b>6,36</b>	<b>4,27</b>	<b>-113,4</b>
<b>Ural Federal District</b>								
Kurgan Oblast	11 499,2	68,7	0,60	2,23	-0,18	2,55	1,29	-29,6
Sverdlovsk Oblast	45 780,1	-944,3	-2,06	3,17	0,61	2,72	1,28	-29,5
Tyumen Oblast	32 874,9	1 137,8	3,46	0,32	-1,34	2,17	7,59	-38,6
Chelyabinsk Oblast	43 113,3	3 636,7	8,44	0,66	-0,10	0,79	11,38	-1,2
Khanty-Mansi Autonomous National Area	127 234,3	-27,6	-0,02	3,72	0,58	3,28	3,42	-2 685,4
Yamalo-Nenets Autonomous National Area	61 215,4	-592,1	-0,97	7,77	2,38	5,95	4,94	-246,2
<b>Total</b>	<b>321 717,3</b>	<b>3 279,2</b>	<b>1,02</b>	<b>3,60</b>	<b>0,61</b>	<b>3,24</b>	<b>4,82</b>	<b>60,2</b>
<b>Siberian Federal District</b>								
Altai Republic	6 076,2	233,1	3,84	2,23	1,05	1,30	5,64	27,4
Buryat Republic	18 911,1	-57,3	-0,30	17,11	0,27	18,06	0,47	-90,2
Tyva Republic	7 320,4	-29,1	-0,40	1,91	0,27	1,64	0,27	-69,2
Khakass Republic	6 351,2	71,3	1,12	3,14	-1,32	4,59	1,12	-117,7
Altai Krai	28 520,1	-291,9	-1,02	4,99	0,59	4,44	0,31	-57,2
Krasnoyarsk Krai	54 573,4	-2 668,2	-4,89	16,21	5,35	12,37	2,71	-109,5
Irkutsk Oblast	33 440,8	-816,9	-2,44	6,64	1,07	5,91	1,90	-44,0
Kemerovsk Oblast	38 567,4	-26,6	-0,07	2,64	-0,94	3,60	2,75	1 368,5
Novosibirsk Oblast	29 717,2	-2 889,2	-9,72	177,16	8,76	172,34	1,41	-90,1
Omsk Oblast	21 194,7	335,4	1,58	19,97	-1,35	22,67	1,52	-85,6
Tomsk Oblast	16 629,3	-541,1	-3,25	27,75	2,94	26,27	2,02	-90,3
Chita Oblast	19 280,6	-128,2	-0,67	1,19	0,92	0,27	1,67	-138,7

*Table 30 cont'd*

1	2	3	4	5	6	7	8	9
Agin-Buryat Autonomous National Area	3 020,3	120,6	3,99	0,05	0,01	0,05	6,45	0,2
Taimyr (Dolgano-Nenets) Autonomous National Area	4 543,1	-179,0	-3,94	0,99	0,99	0,00	6,43	-25,1
Ust-Ordynsk Buryat Autonomous National Area	2 643,2	123,5	4,67	0,85	-1,74	2,59	4,03	-37,2
Evenki Autonomous National Area	2 043,7	-1 215,3	-59,47	128,35	63,86	91,90	10,54	-107,4
<b>Total</b>	<b>292 832,7</b>	<b>-7 958,9</b>	<b>-2,72</b>	<b>27,88</b>	<b>2,53</b>	<b>26,53</b>	<b>2,05</b>	<b>-93,2</b>
<b>Far-East Federal District</b>								
Sakha Republic (Yakutiya)	53 740,5	-2 851,4	-5,31	9,78	5,12	5,09	1,47	-96,5
Primorskiy Krai	32 962,8	-415,6	-1,26	4,93	0,90	4,26	0,98	-71,4
Khabarovsk Krai	28 994,9	-2 321,5	-8,01	10,96	1,77	10,04	2,54	-22,1
Amur Oblast	17 250,9	-163,9	-0,95	6,03	0,72	5,73	0,86	-76,2
Kamchatka Oblast	12 459,2	167,3	1,34	6,05	0,76	5,59	3,13	56,6
Magadan Oblast	10 297,7	-12,9	-0,13	3,29	-0,37	3,67	1,88	296,0
Sakhalin Oblast	15 416,3	-362,4	-2,35	7,47	3,08	4,70	1,82	-131,1
Jewish Autonomous Oblast	3 930,1	-50,9	-1,30	1,48	0,49	1,03	3,68	-37,9
Koryak Autonomous National Area	2 377,0	-115,0	-4,84	13,88	5,78	8,41	1,64	-119,5
Chukotka Autonomous National Area	11 760,6	-566,0	-4,81	0,26	-0,67	0,93	4,39	14,0
<b>Total</b>	<b>189 190,0</b>	<b>-6 692,4</b>	<b>-3,54</b>	<b>7,27</b>	<b>2,27</b>	<b>5,38</b>	<b>1,88</b>	<b>-64,2</b>
<b>Total Federal Districts</b>	<b>2 246 176,3</b>	<b>-49 960,7</b>	<b>-2,22</b>	<b>10,34</b>	<b>2,17</b>	<b>9,05</b>	<b>4,22</b>	<b>-97,5</b>

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

### Domestic bond loans

In 2003, 23 constituent entities of the Russian Federation and 7 municipalities (against 20 regional and 5 municipal loans in 2002) registered their bond loans. Total volume of the placed bonds was 67,1 bln rubles in 2003 versus 29,1 bln rubles in 2002, and hence grew from 0,27 to 0,46 % of the GDP (*Table 31*).

Eighty six percent (41,9 bln rubles) out of the total net borrowings (48,7 bln rubles) was accounted for an increase in net borrowings in the securities market in 2003.

Bond placement was promoted by low interest rates in the government securities market: the spread between OFZ and bonds of Moscow and St. Petersburg was registered 2 to 5 %, while it was 6 to 7 % regarding other issuers, for instance, at the Murmansk Oblast and the Republic of Kareliya, which exceeded insignificantly the inflation rate. The subfederal bond market was tripled over the year thus reaching 78 bln rubles by late November 2003.

*Table 31*



**Issuing of Subfederal and Municipal Securities (% of the GDP)**

Year	1996	1997	1998	1999	2000	2001	2002	2003
Issue	0,63	0,77	0,47	0,31	0,19	0,17	0,27	0,46
Redemption	0,47	0,56	0,48	0,36	0,46	0,23	0,10	0,15
Net financing	0,16	0,22	-0,01	-0,05	-0,27	-0,07	0,16	0,31

Source: IET's estimates по данным The RF Ministry of Finance.

In 2003, the following regions registered their prospectus for bonds issue with the RF Ministry of Finance. Moscow, St. Petersburg, Chuvash Republic, Volgograd Oblast, Tomsk Oblast, Komi Republic, Leningrad Oblast, Irkutsk Oblast, Moscow Oblast, Belgorod Oblast, Tver Oblast, Khanty-Mansi Autonomous National Area, Khabarovsk Krai, Murmansk Oblast, Kostroma Oblast, Sakha Republic (Yakutiya), Mari-El Republic, Novosibirsk Oblast, Yamalo-Nenets Autonomous National Area, Yaroslavl Oblast, Samara Oblast, Tambov Oblast, Krasnoyarsk Krai, Volgograd, Ekaterinburg, Ufa, Uzhno-Sakhalinsk, Krasnoyarsk, Novosibirsk, and Tomsk.

Among the major issuers of debt securities were Moscow which accounted for 29,7 bln rubles or 48,1 % of the total territorial issue, St. Petersburg – 8,9 bln rubles or 14,5 %, Moscow Oblast – 3,6 bln rubles or 5,8 %, Khanty-Mansi Autonomous National Area – 3,0 bln rubles or 4,9 %. Thus, the four major issuers accounted for 73,3 % of the total regional and municipal issues placed.

Substantial bond issues were also placed at Krasnoyarsk Krai – 2,2 bln rubles, Novosibirsk Oblast – 2,1 bln rubles, Yamalo-Nenets Autonomous National Area – 1,9 bln rubles, Sakha Republic (Yakutiya) – 1,5 bln rubles, Samara Oblast – 1,2 bln rubles, and Tver Oblast – 1,0 bln rubles (*Table 32*).

*Table 32*

**Placement of Securities in 2003**

Constituent entity of the Russian Federation	Size of issuance (thousand rubles)	Size of issuance in domestic borrowings (%)	Share in total issuance (%)
1	2	3	4
Belgorod Oblast	320 000	31,5	0,5
Voronezh Oblast	50	...	...
Kostroma Oblast	169 259	18,3	0,3
Moscow Oblast	3 568 718	18,9	5,8
Tver Oblast	1 000 000	43,9	1,6
Yaroslavl Oblast	500 000	19,7	0,8
Moscow	29 701 532	84,1	48,1
Republic of Kareliya	248 910	20,5	0,4
Komi Republic	672 700	32,4	1,1
Vologda Oblast	200 000	21,9	0,3
Leningrad Oblast	822 392	43,8	1,3
Murmansk Oblast	200 000	11,9	0,3
St. Petersburg	8 939 398	100,0	14,5
Volgograd Oblast	891 611	28,7	1,4
Republic of Bashkortostan	672 512	95,2	1,1
Mari-El Republic	492	0,1	...

*Table 32 cont'd*

1	2	3	4
Chuvash Republic	271 957	34,7	0,4
Samara Oblast	1 185 000	21,1	1,9
Sverdlovsk Oblast	103 000	7,1	0,2
Khanty-Mansi Autonomous National Area	3 000 000	63,4	4,9
Yamalo-Nenets Autonomous National Area	1 864 500	39,2	3,0
Krasnoyarsk Krai	2 241 647	25,3	3,6
Irkutsk Oblast	506 330	22,8	0,8
Novosibirsk Oblast	2 088 025	4,0	3,4
Tomsk Oblast	488 734	10,6	0,8
Sakha Republic (Yakutiya)	1 463 868	27,9	2,4
Khabarovsk Krai	300 000	9,4	0,5
Sakhalin Oblast	292 000	25,4	0,5
<b>Total</b>	<b>61 712 635</b>	<b>26,9</b>	<b>100,0</b>

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

To date, it is mostly the major issuers that provide a high securitization, namely Moscow – 84 %, St. Petersburg – 100 %, and Khanty-Mansi Autonomous National Area – 63 %. However, small issues appeared to be costly due to a considerable transaction expenses associated with issuing, and hence municipalities continued to borrow from banks. Nevertheless, the major cities took more interest in security issuing which tripled placement volumes of municipal bonds last year (*Table 33*).

*Table 33*

**Net Borrowings Volumes at the Domestic Market of Subfederal and Municipal Securities (thousand rubles)**

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
<b>2003</b>			
Net borrowings	41 908 199	40 043 511	1 864 688
Borrowing of funds	61 712 635	59 012 901	2 699 734
Principal redemption	19 804 436	18 969 390	835 046
<b>2002</b>			
Net borrowings	17 696 530	17 153 760	542 770
Borrowing of funds	29 141 777	28 169 158	972 619
Principal redemption	11 445 247	11 015 398	429 849
<b>2001 r</b>			
Net borrowings	6 601 447	6 667 592	-66 145
Borrowing of funds	15 123 785	14 226 931	896 854
Principal redemption	8 522 338	7 559 339	962 999
<b>2000</b>			
Net borrowings	-1 877 328	-2 286 175	408 847
Borrowing of funds	13 042 220	10 090 208	2 952 012
Principal redemption	14 919 548	12 376 383	2 543 165

Source: The RF Ministry of Finance PΦ.

The regions with regular access to the capital market were increased in number due to stabilized financial market. Moscow, St. Petersburg, Chuvash Republic, Volgograd Oblast, and Volgograd issued securities annually on regular basis since 1999. Tomsk Oblast, Komi Republic and Ekaterinburg, since 2000. Leningrad Oblast and Irkutsk Oblast, since 2001 (*Table 34*).



Table 34

**Issuance of Subfederal and Municipal Securities in 1999 – 2003**

Issuer	Emission registered	Issuer	Emission registered	Issuer	Emission registered
<b>Constituent entities of the Russian Federation</b>					
	1999	2000	2001	2002	2003
Moscow	*	*	*	*	*
St. Petersburg	*	*	*	*	*
Chuvash Republic	*	*	*	*	*
Volgograd Oblast	*	*	*	*	*
Tomsk Oblast		*	*	*	*
Komi Republic		*	*	*	*
Leningrad Oblast			*	*	*
Irkutsk Oblast			*	*	*
Moscow Oblast				*	*
Belgorod Oblast				*	*
Tver Oblast				*	*
Khanty-Mansi Autonomous National Area				*	*
Khabarovsk Krai				*	*
Murmansk Oblast				*	*
Kostroma Oblast				*	*
Sakha Republic (Yakutiya)				*	*
Mari-El Republic		*			*
Novosibirsk Oblast	*				*
Yamalo-Nenets Autonomous National Area					*
Yaroslavl Oblast					*
Samara Oblast					*
Tambov Oblast					*
Krasnoyarsk Krai					*
Republic of Bashkortostan			*	*	
Mordovian Republic				*	
Sakhalin Oblast				*	
Kursk Oblast				*	
Stavropol Krai			*		
Primorskiy Krai		*			
Kabardino-Balkarian Republic		*			
<b>Municipalities</b>					
Volgograd	*	*	*	*	*
Ekaterinburg		*	*	*	*
Ufa				*	*
Uzhno-Sakhalinsk					*
Krasnoyarsk					*
Novosibirsk					*
Tomsk					*
Nizhny Novgorod				*	
Novocheboksarsk	*		*		
Kostroma	*	*			
Cheboksary	*				
Arkhangelsk	*				
Dzerzhinsky	*				

Source: The RF Ministry of Finance.



## Internal Credit Rating

### *Credit rating*

A stable growth of the Russian economy over the last few years resulted in upgraded sovereign and internal ratings. However, no investment grade was granted to territorial government authorities yet. The credit rating of Moscow, which used to be the same as the sovereign one, was upgraded to Ba 1, only one point up, by Moody's early in January 2004. In spite of a positive financial performance (accumulated debt to annual budget revenues and GNP ratio) and no default on the 1998 obligations, Moscow is graded below the federal government because of risks of low tax revenues associated with the ongoing tax reform at the city.

Unlike Moody's, Standard & Poor's and Fitch Ratings also upgraded the sovereign rating on Russia during the year, but early in February 2004 it was one point below the investment grade, BB+. The same BB+ credit rating was granted to Moscow (*Table 35*).

*Table 35*

### **Standard & Poor's International Credit Rating**

Russia: international scale ratings			
Issuer	Date of promotion (latest amendment)	In terms of foreign exchange / Forecast	In terms of national currency / Forecast
<b>Sovereign ratings</b>			
Russian Federation	27.01.2004	BB+/Stable	BBB-/Stable
<b>Ratings of regional and local authorities</b>			
Balashikha Region	03.11.2003	B-/Stable	—/—
Bashkortostan	25.04.2003	B+/Stable	—/—
Vologda Oblast	04.02.2003	B/Stable	—/—
Irkutsk Oblast	01.10.2003	B/Stable	—/—
Klin Region	02.09.2003	B-/Stable	—/—
Moscow	02.02.2004	BB+/Stable	—/—
Moscow Oblast	18.08.2003	B+/Stable	—/—
Samara Oblast	25.04.2003	B+/Positive	—/—
St. Petersburg	02.02.2004	BB/Positive	BB/Positive
Sverdlovsk Oblast	06.01.2004	B/Positive	B/Positive
Surgut	21.01.2004	B/Stable	B/Stable
Tatarstan	22.09.2003	B-/Stable	—/—
Khanty-Mansi Autonomous National Area	20.12.2002	BB-/Stable	—/—
Yamalo-Nenets Autonomous National Area	23.05.2003	B/Positive	—/—

*Source:* Standard & Poor's.

## Arrears Settlement Problems

In spite of a relatively high rating on several constituent entities of the Russian Federation, the problem of arrears remain to be addressed. Since 2003 the RF Ministry of Finance



started to publish credit and budget disbursement ratings on the constituent entities of the Russian Federation<sup>23</sup> and data on their arrears (outstanding debts) including:

- data on liabilities of constituent entities of the Russian Federation to the federal budget on tied loans of foreign governments, banks and companies, as well as on budget foreign exchange loans granted by the RF Ministry of Finance;
- size of liabilities of constituent entities of the Russian Federation (at par value) resulted from placement of securities with expired maturity or the RF Ministry of Finance has no data on their redemption;
- liabilities (including guarantees) of constituent entities and municipalities of the Russian Federation on loans extended by international financial organizations.

Though the published data on arrears of constituent entities of the Russian Federation may need verification and in some cases outstanding amounts may be found smaller, the existence of a considerable volume of arrears (outstanding debts) will have an adverse effect on credit risk assessment of the region as a borrower.

The total arrears of the constituent entities of the Russian Federation is 20,3 bln rubles according to the RF Ministry of Finance. The biggest arrears are reported at the regions as follows: Karachayevo-Cherkess Republic – 1,0 bln rubles or 34,5 % of the budget revenues, Orel Oblast – 1,6 bln rubles or 32,9 % of the budget revenues, Yaroslavl Oblast – 1,0 bln rubles or 23,9 % of the budget revenues, and Orenburg Oblast – 1,8 bln rubles or 18,2 % of the budget revenues (*Table 36*).

The major part of outstanding debt is represented by liabilities of the territories due to the RF Ministry of Finance. It is scheduled for next year to verify the existing arrears in order to specify exact amounts and maturities as well as identify substantive disagreements and controversial debts available.

The verification should be followed by settlement of controversial debts of the constituent entities of the Russian Federation, i. e. to define the exact amount and type of liabilities, draw up payment schedules, and check validity of the previously charged penalties.

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<sup>23</sup> Under the Decree of the RF Ministry of Finance dated 18.92.2003, No. 43.

*Table 36*

**Arrears of Constituent Entities of the Russian Federation**

	Arrears volume*	Arrears in terms of %**
1	2	3
<b>Central Federal District</b>		
Belgorod Oblast	57 317	0,9
Vladimir Oblast	41 469	0,6
Kostroma Oblast	318 491	7,0
Lipetsk Oblast	21	0,0
Moscow Oblast	97 595	0,2
Orel Oblast	1 574 883	32,9
Ryazan Oblast	3 794	0,0
Tambov Oblast	890	0,0
Tver Oblast	459 561	5,6
Tula Oblast	124 859	1,5
Yaroslavl Oblast	2 009 067	23,9
Moscow	34 893	0,0
<b>Total</b>	<b>4 722 841</b>	<b>0,9</b>
<b>Northwest Federal District</b>		
Arkhangelskaya область	52 797	0,5
Kaliningrad Oblast	36 953	0,7
Leningrad Oblast	164 758	1,3
Novgorod Oblast	385 383	11,9
Pskov Oblast	204 043	4,1
St. Petersburg	619 634	0,8
<b>Total</b>	<b>1 463 567</b>	<b>1,0</b>
<b>South Federal District</b>		
Adygei Republic	35 700	1,1
Kalmyk Republic	48 920	1,5
Karachayevo-Cherkess Republic	1 009 490	35,4
Severnaya Osetiya-Alaniya Republic	460 013	8,3
Krasnodar Krai	81 959	0,3
Astrakhan Oblast	941 074	20,8
Volgograd Oblast	127 058	1,1
<b>Total</b>	<b>2 704 270</b>	<b>2,2</b>
<b>Privolzhsky Federal District</b>		
Republic of Bashkortostan	92 827	0,3
Mordovian Republic	439 703	4,4
Republic of Tatarstan	56 268	0,1
Udmurt Republic	587 529	6,1
Kirov Oblast	71 640	0,9
Nizhni Novgorod Oblast	642 009	4,0
Orenburg Oblast	1 791 422	18,2
Penza Oblast	361 988	5,2
Samara Oblast	172 878	0,9
Ulyanov Oblast	101 516	2,0
<b>Total</b>	<b>4 317 780</b>	<b>2,1</b>



Table 36 cont'd

1	2	3
<b>Ural Federal District</b>		
Sverdlovsk Oblast	524 058	2,4
Tyumen Oblast	888 507	3,9
Chelyabinsk Oblast	344 576	1,5
<b>Total</b>	<b>1 757 141</b>	<b>1,0</b>
<b>Siberian Federal District</b>		
Buryat Republic	13 000	0,1
Tyva Republic	539 600	11,6
Khakass Republic	2 002	0,1
Altai Krai	117 888	0,8
Krasnoyarsk Krai	291 071	1,4
Irkutsk Oblast	563 420	3,5
Kemerovo Oblast	1 631 924	8,1
Novosibirsk Oblast	12 129	0,1
Omsk Oblast	1 040 768	6,9
Taimyr (Dolgano-Nenets) Autonomous National Area	21 840	0,7
<b>Total</b>	<b>4 236 543</b>	<b>2,7</b>
<b>Far-East Federal District</b>		
Sakha Republic (Yakutiya)	121 786	0,4
Primorskiy Krai	453 548	2,5
Kamchatka Oblast	495 246	6,9
Magadan Oblast	24 340	0,5
<b>Total</b>	<b>1 094 920</b>	<b>1,0</b>
<b>Total Federal Districts</b>	<b>20 297 061</b>	<b>1,4</b>

\*as of November 1, 2003.

\*\*Arrears against regional (nonconsolidated) budget revenues as of November 1, 2003.

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

## Regulation of Regional and Municipal Borrowings

A set of regulations was adopted in 2003, which can promote development of market subfederal and municipal borrowings.

1. Amendments to the Law «On Taxation of Securities Transactions» came into force since January 2004, which reduced the tax rate payable during registration of prospectus for issue to 0,2 % of the nominal amount of issue, but not more than 100 000 rubles.

The amendments are expected to promote securitization of borrowings and growth in issuing of subfederal, municipal and corporate bonds. The previous tax rate hampered considerably the issuing activity of borrowers.

2. A Federal Law «On General Principles of Local Self-Government at the Russian Federation» and amendments to the Federal Law «On General Principles in Organization of Legislative (Representative) and Executive Agencies of State Power at the Constituent Entities of the Russian Federation» were adopted in 2003.

The laws introduced a set of new regulations associated with regulation of territorial government agencies in the cases of arrears and/or regional and municipal budget debt, as well as they provided a positive impact by a well-defined differentiation between revenue and ex-

penditure authorities of territorial government agencies at different levels aimed at increasing their budget stability.

In the event of decisions, actions (no actions) of local government agencies that have resulted in arrears and/or budget arrears of municipalities, some of their authorities can be delegated to government agencies at constituent entities of the Russian Federation with introduction of a temporal financial administration, pursuant to Article 75 of the Federal Law «On General Principles of Local Self-Government at the Russian Federation».

The temporal financial administration can be introduced provided that arrears do not exceed 30 % of budget revenues of municipalities and/or 40 % of budget allocations in the financial year under review. Fulfillment of liabilities of the federal budget and budgets of constituent entities of the Russian Federation to the budgets of the foregoing municipalities is required for introduction of the temporal financial administration.

The temporal financial administration is introduced on application of a top executive person of a constituent entity of the Russian Federation (chief of a superior government agency of a constituent entity of the Russian Federation) and/or by the representative agency of a municipality, head of a municipality, according to a decision of the court of arbitration of the constituent entity of the Russian Federation.

The temporal financial administration may remain in force within a period of one year. The temporal financial administration can not be introduced on application of a top executive of a constituent entity of the Russian Federation within a period of one year from the date of empowerment of a municipal representative.

The temporal financial administration is authorized to restore the capacity of a municipality to pay debt pursuant to the Federal Law. The temporal financial administration is intended to:

- take actions aimed at restructuring arrears of a municipality;
- develop amendments to a municipal budget for the current financial year and draw up a municipal budget draft for the current financial year;
- submit the foregoing documents to a representative municipal agency for consideration and approval and for approval under the law of a constituent entity of the Russian Federation in the cases provided for in the Federal Law;
- monitor utilization of a municipal budget and undertake other authorities under the existing Federal Law.

A similar procedure is applicable in introducing the temporal financial administration at a constituent entity of the Russian Federation in accordance with Article 26.9 of a new edition of the Law «On General Principles in Organization of Legislative (Representative) and Government Executive Agencies at the Constituent Entities of the Russian Federation». The temporal financial administration is introduced in the event of arrears and/or budget arrears (due to the fault of government agencies at a constituent entity of the Russian Federation) to the amount not exceeding 30 % of budget revenues of the latest accounting year.

The temporal financial administration is introduced according to a decision of the Supreme Court of Arbitration of the Russian Federation for a period within one year on application of the Government of the Russian Federation. The temporal financial administration can not be introduced within a period of one year from the date of empowerment of a legislative (representative) government agency of a constituent entity of the Russian Federation. The



functions of the temporal financial administration at a constituent entity of the Russian Federation are similar to those established for a municipal temporal financial administration.

The provision on temporal financial administration is to come into force on January 1, 2006 at municipalities and on January 1, 2007 at the constituent entities of the Russian Federation. Introduction of the temporal financing administration increases the probability of a relatively quick budget recovery at the territories facing financial crisis, thereby promoting creditability of Russian municipalities and regions.

3. In 2003, the RF Ministry of Finance published «Provisional Methodological Recommendations on Management of State and Municipal Debts for Constituent Entities and Municipalities of the Russian Federation». The document is permissive and subject to revision as the Federal Law is amended and practical experience gained.

The key role of management of debt mechanisms and conditional liabilities<sup>24</sup> of a constituent entity of the Russian Federation (municipality) proposed in the recommendations is to «enlarge the list of objects governed by these mechanisms versus the list of debt obligations specified in the Budget Code of the Russian Federation».

The recommendations provide for introduction of a concept of *funded debt*, which, among *direct liabilities* (liabilities on loans and credits, and payables in arrears), includes:

- debt of state unitary enterprises of a constituent entity of the Russian Federation (municipal state-owned enterprises);
- debt of the enterprises in which a constituent entity of the Russian Federation (municipality) owns over 25 % of the voting shares in the authorized capital<sup>25</sup>;
- funded debt of municipalities integrated in a constituent entity of the Russian Federation (this makes sense only with regard to constituent entities of the Russian Federation).

Implementation of the proposed mechanisms should allow regions and municipalities to reduce budget risks and hence increase their creditability.

### 2.4.3. Stock Market

In 2003, growth trends dominated again at the Russian stock market. This was basically governed by high macroeconomic figures demonstrating a stabilized economy, favorable situation with liquidity at the banking sector due to high oil prices at world's markets, the RF Central Bank's activity aimed at stabilizing the national exchange, and the upgraded investment rating on Russia. However, though macroeconomic risks were lessened, the events that took place in 2003 revealed higher political risks associated with investment in Russian assets. This was evident primarily due to the conflict between the government and YUKOS oil company, as well as the parliamentary elections at which Russian democrats failed to pass the voting minimum to be elected to the State Duma.

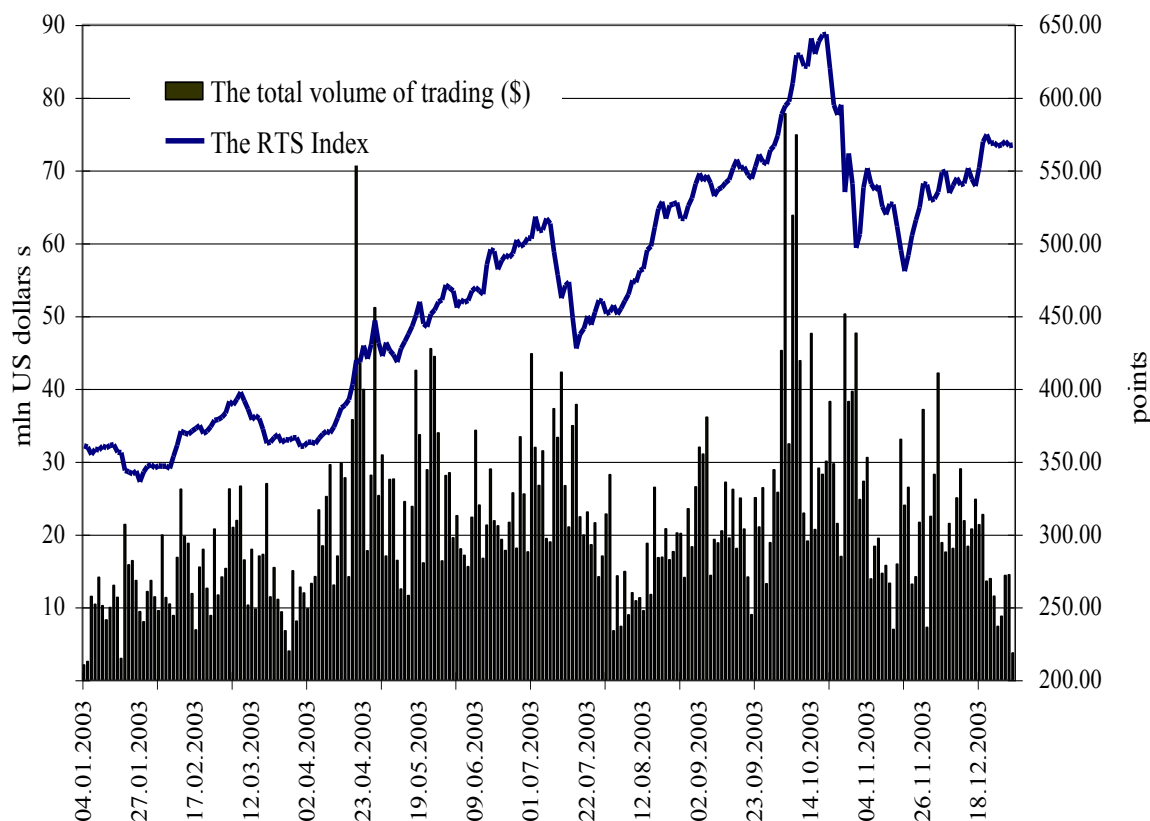
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<sup>24</sup> The term of *conditional liabilities* including budget guarantees as well as liabilities of organizations and enterprises owned by a region ( municipality ), on which the owner may have subsidiary liability resulted under the Federal Law of the Russian Federation.

<sup>25</sup> Such share of administrations in the equity of enterprises was selected according to the Law "On Joint-Stock Companies" No. 208-FZ of 26.12.1995, specifying that 25% of voting stocks represent a minimum set which allows decisions on several issues to be blocked. A smaller share deprives the administration of efficient controls of the enterprises.

Figure 4

**RTS Index and Transfer Quantity Movements in 2003**



Source: RTS Stock Market.

The Russian RTS stock index grew by 206,46 points in 2003, which corresponds to a 57,22 % growth (in 2002 the RTS index grew by 101.1 points or by 38,88 %). The total turnover at the Classic RTS market increased by 33,3 % up to \$6,1 bln US dollars in 2003 against \$4,57 bln US dollars in 2002. Thus, the year 2003 was characterized by a substantial growth at the domestic stock market against the previous year. However, no considerable growth in activity of investors was revealed: 56 269 transactions were carried out in 2003 against 58 296 ones in 2002. The average daily transaction turnover was \$24 ml US dollars, which accounted for a 34,5 % increase against 2002 (\$18,14 ml US dollars).

Several typical periods in market movement are distinguished. A slight decrease in quotes was registered early in the year, and the index reached its maximum, 336,08 points, by January 27.

This was followed by a sustained market growth. From January 27 the RTS index grew by 61,39 points by March 6 and hence by 18,27 %. A certain correction was noted at the market the following month, which gave way to a sustained growth period. Since April 1 the Russian stock indicator reached its postcrisis maximum of 518,07 points, and hence grew by 120,6 points (30,34 %) against the figures of March 6. The volume of transactions varied significantly during these four months. In March the total transactions volume amounted to \$300 ml US dollars, in April it was almost doubled (about \$601 ml US dollars), while in May



and June it was stabilized within \$450 ml US dollars. It should be noted that in April the daily turnover reached its annual maximum, 82,45 ml US dollars. This was followed by a decline – the RTS index was 427,64 points at closing on July 17, hence it dropped by 90,4 points (–17,46 %) over two weeks. The decline was mainly associated with the YUKOS case, a major shareholder P. Lebedev was arrested, which had a negative impact on the investors.

The second half of summer and first half of autumn were featured by an unprecedented growth at the stock market: on October 20 the RTS index reached its historic maximum, 643,30 points. Thus, the index grew by 215,66 points (50,43 %) over the three months. It should be especially noted that the RTS transaction volume in October amounted to over 876 ml US dollars and hit the maximum in 2003. However, such a favorable situation lived short. The market saw a sharp decline the following month which went far beyond the growth in August-October. It took the RTS index only three months (at closing on November 19) to drop by 162,65 points, which accounted for 25,28 % against closing figures on October 20. The collapse was caused by an aggravating YUKOS case, mainly by the arrest of the President of NK YUKOS M. Khodorkovsky. A slight correction was noted at the market by late in October. The RTS index stopped at the point of 515,75 on November 24. It is noteworthy that the market dropped as investors became notably less active: transactions turnover at the RTS exceeded slightly 286 ml US dollars over the three weeks in November. Obviously, market growth was also limited by an uncertainty associated with the upcoming parliamentary elections.

The market grew late in the year. In spite of unfavorable corporate news (Sibneft shareholders tended to cancel the merging deal with NK YUKOS, and extended detention of M. Khodorkovsky), the market grew due to a victory of the pro-president political party at the elections, favorable macroeconomic figures and high oil prices.

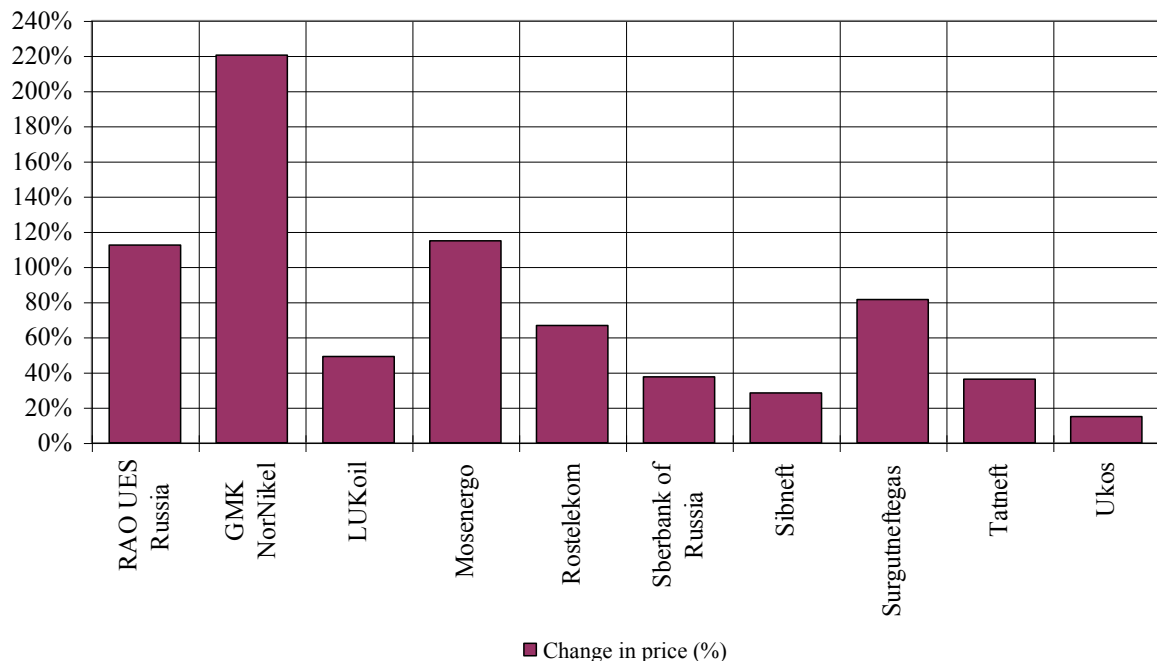
All Russian blue chips grew in price over the year, especially GMK Norilsky Nickel – 220,38 % (21,97 % over 2002), Mosenergo – 114,79 % (–17,07 % over 2002) and RAO Unified Energy System of Russia – 112,36 % (–20,87 % over 2002). Such a substantial growth in Norilsky Nickel stocks was reflected by entering the global steel market and favorable export prices. The expected restructuring of the power industry promoted demand for electric-power companies, primarily RAO Unified Energy System of Russia and «Mosenergo. Surgutneftegaz – 81,40 %, Rostelekom – 66,67 %, LUKOIL – 49,07 % and Sberbank of Russia – 37,43 % declined slightly. YUKOS and Sibneft grew very slow against 2002 when they were leaders in growth. In 2003, stocks of these oil companies grew by 14,89 % and 28,33 % correspondingly. Among the «second line» companies were Chelyabinsk integrated iron-and-steel works (650,0 %), Yarenergo (609,19 %) and Nizhy-Tagil integrated iron-and-steel works (500,0 %), which showed the maximum growth in market value in 2003. However, the transfer quantity of the aforementioned three stocks remained relatively low, not more than 100 transactions during the year.

The RAO Unified Energy System of Russia resumed leadership in the RTS turnover, hence grew in share by 30,23 % in 2003 against 26,3 % in 2002. However, the share of LUKOIL declined from 19,31 % in 2002 to 17,87 % in 2003. Transactions with NK YUKOS accounted for 14,28 % (10,41 % in 2002), while the Surgutneftegaz remained unchanged, its share being 10,23 % against 10,65 % in 2002. GMK Norilsky Nickel is at the bottom of the list of maximum turnover leaders at the RTS, its share being 4,74 %. Thus, the share of the five aforementioned issuers at the RTS accounted for 77,35 % in 2003 against 72,18 % in 2002.



Figure 26

**Blue Chips Market Value Movement in 2003**



Source: RTS Stock Market.

As of December 31, 2003, five leaders in capitalization were distinguished according to the RTS market's data: YUKOS – \$28,76 bln US dollars (\$21,04 bln US dollars in 2002), Surgutneftegaz – \$20,76 bln US dollars (\$11,4 bln US dollars in 2002), LUKOIL – \$19,77 bln US dollars (\$13,09 bln US dollars in 2002), GMK Norilsky Nickel – \$13,94 bln US dollars (\$4,3 bln US dollars in 2002), Sibneft – \$13,5 bln US dollars (\$10,5 bln US dollars in 2002). In 2003, LUKOIL stood down from the third place for Surgutneftegaz listed fourth in 2002 among most capitalized companies in Russia. It should be noted that oil and gas companies still represent a significant share in total capitalization of the Russian stock market. It seems reasonable to say that the growth in global oil prices was among the key factors responsible for such a significant increase in capitalization, which attracted instantly more investors to oil and gas sector. Thus, once again structural defects of the Russian economy and raw-materials-export orientation proved available. At economic sectors other than those related to raw materials, the Sberbank of Russia has the biggest capitalization (as was the case in 2002) which amounted to \$4,99 bln US dollars (\$3,63 bln US dollars in 2002) at year-end 2003.

**Forward contracts market**

In September 2003, the forward contracts market (FORTS) accomplished two years. It is noteworthy that this segment of the Russian stock market has been growing year to year. Over the period between January 4 and December 31, the total turnover at the FORTS (futures and options) amounted to \$214 bln rubles, which is approximately 2,3 as much as in 2002. It should be noted that the total transfer quantity on options increased by 8,7, while on futures by 2,2. Traders carried out about 901 thousand transactions, which corresponded approximately



to 34 ml contracts. For reference, the similar figures in 2002 were 546 thousand transactions and 22 ml contracts correspondingly.

The total quantity of open positions on standard contracts reached 2,335 bln rubles, 339 thousand contracts (1,191 bln rubles, 292 thousand contracts in December 2002) and grew by 96 % in terms of rubles and 16 % in terms of contracts at year-end 2003, December 31.

Future transactions accounted for a major share in forward contracts in 2003: over 94,4 % of the total transaction quantity (201,9 bln rubles), while options transactions amounted to nothing more than 12,1 bln rubles. Future contracts on market value of RAO Unified Energy System of Russia and NK LUKOIL remained most attractive instruments for investors. In particular, in 2003 their share in the total transactions accounted for 66,4 % and 12,9 % correspondingly. Two new contracts emerged at the market in 2003, option on OAO LUKOIL future contract as well as the first interest rate future on Moskomzaim bonds. All future contracts became sale and delivery except for US dollars and S&P/RUIX futures.

### Corporate bond market

In 2003, the Russian corporate bond market was governed by upward trends too. Corporate bonds' indices, which are calculated by Zenit Bank on the basis of MICEX corporate bonds' quotes, grew noticeably at year-end 2003.

Several periods of upward or downward trends were most evident in 2003. A quick growth in Russian corporate bonds took place since early in the year till approximately mid-May, on 16<sup>th</sup> of May the ZETBI-Corp<sup>26</sup> index reached its historical maximum of 113,65 points (grew by 108,39 % against the index value as of January 4, 2003), while the index of most liquid corporate bonds, ZETBI-Corp10, hit its maximum of 117,33 points (grew by 111,74 % against the index value as of January 4, 2003) on May 19.

The decline that occurred early in the year can be explained by macroeconomic factors: expectations of disinflation and further reduction of interest rates stimulated bull speculations, while a marked decline in par of dollar vs. ruble with better yield on ruble instruments stimulated a transfer of funds from the exchange bonds sector to the domestic bonds market. The inflow of currency earnings from oil export boosted liquidity at the banking sector and, as a consequence, an excess demand, which also supported quotes early in the year. In other words, it was the deficient revenues of debt instruments that became a key factor of such a quick growth. The situation went on till mid-March, when the number of investors, those who decided to realize their profit, grew significantly due to a favorable situation at the market and lack of primary offering. Thus, the market saw a marked decline for the first time since long: on March 20, ZETBI-Corp and ZETBI-Corp10 indices dropped to 109,69 and 112,11 points correspondingly (by 104,61 % and 106,76 against January 4, 2003).

In April, excess ruble liquidity effected bonds prices due to a stable inflow of foreign exchange to the country, which grew because of higher demand among investors. However, each upward movement was followed by some technical correction. Investors tended to generate more profit by investing in high-risk securities under the circumstances of declining redemption yield, which instantly boosted prices of the «third echelon» bonds. Early in May the redemption yield continued to fall. However, quotes began to decline by mid-May. It seems reasonable to say that a considerable volume of original placement and «overloaded» portfoli-

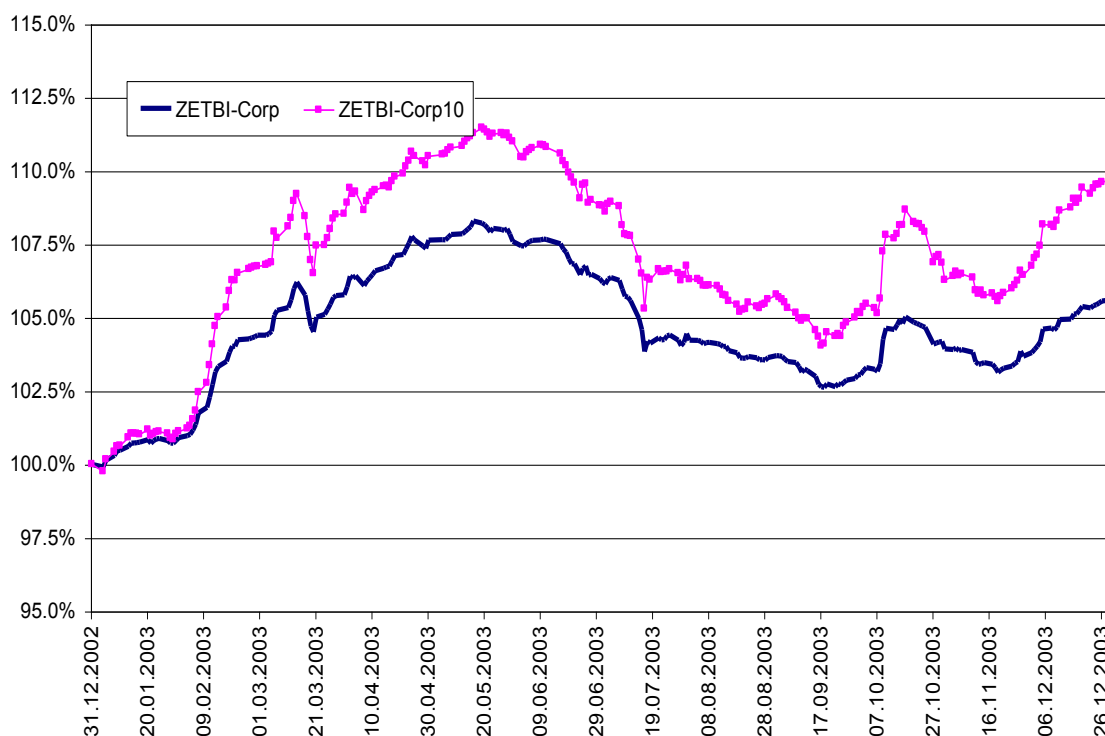
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<sup>26</sup> Indices ZETBI-Corp and ZETBI-Corp10 are calculated by Zenit Bank since 03.01.2002.

os of major underwriters due to the auctions in May became the key factors, in spite of a favorable environment in the money market.

*Figure 27*

**Corporate Bonds Price Index Movement in 2003**  
(December 31, 2002 = 100 %)



Source: Zenit Bank.

In June, the downward trend was finally strengthened due to an ongoing increase in volumes at the primary market, which was represented by a marked increase in corporate bonds yield. Quotes continued to fall between July and early in September: on September 18, ZETBI-Corp and ZETBI-Corp10 indices dropped to 107,7 and 109,59 points correspondingly (by 102,72 % and 104,36 against January 4, 2003). However, though only domestic factors influenced the market correction in the period between May and June, the impact was strengthened by an aggravation of external factors by July-August, primarily growth in political instability and uncertainty at the foreign exchange market. The majority of investors decided to realize their profit and withhold active transactions for the time being due to a decline at the stock market and increasing general instability. Low-liquidity instruments were most vulnerable at the market throughout the entire summer period, hence quotation on them was discontinued at the least market slump. In other words, transition to a new condition of equilibrium between demand and supply of corporate bonds took place at the market.

However, there was a turn in the bonds market in September. It is in September that investors received positive earnings after a long-term slump. Among the key factors that effected market movement in autumn were the YUKOS case, increase in securities offering and de-



crease in ruble liquidity at the banking sector. In October, the movement at the corporate bonds market followed generally the movement at other segments of the Russian financial sector. The demand was focused on most liquid securities, and nonresidents were major buyers. The reason they valued Russian corporate bonds was the spread to Eurobonds which was enlarged by 4 % to 5 % in mid-2003 and could compensate exchange risks, rather than the MBK level which represents liquidity at the financial sector. A quick growth early in the month resulted from the upgraded investment rating on Russia, but its effect was eliminated by further deterioration of political situation due to the YUKOS case. Further decline was stopped by low bond quotes which became attractive for some of the investors with uncovered positions.

In November, the corporate bonds market was inactive. Even the strengthened ruble and better liquidity could not boost the demand for securities due to the existing «political factor». A small upward correction at the end of the second week was short. The market was pushed down by selling in small volumes. Since late in November corporate bonds started to decrease with this trend being predominant in December. The growth was mostly encouraged by further strengthening of the Russian ruble, maintaining inflation within the scheduled 12 % and a fairly high liquidity at the banking sector. All in all, as of December 30, 2003, the ZETBI–Corp and ZETBI–Corp10 corporate indices were quoted 111,06 and 115,71 points correspondingly (105,9 % and 110,2 % against January 4, 2003).

As mentioned above, issuers' activity in the primary market differed largely during the year. The maximum volume of placements at the primary market was registered in July and amounted approximately to 11,88 bln rubles, while the minimum one was 250 ml rubles, as was registered in January 2003. The total revenues of corporate bonds amounted to approximately 84 bln rubles in 2003.

### *Factors effecting Russian stock market*

The Russian stock market in 2003 were governed by a set of factors which can be arbitrarily classified into the groups as follows:

- domestic political situation;
- interactions with international financial organizations;
- international financial markets;
- global raw material markets (in particular global oil market).

Each of the aforementioned factors differed in impact on movements at various segments of the Russian market in 2003. Therefore, the impact of each of these factors will be analysed in details.

#### Domestic political situation

It should be noted that the government's commitment to the originally elected economic course had a positive impact on the development of financial markets, especially the Russian stock market. Favorable macroeconomic statistics rendered Russian stocks attractive for internal and foreign investors. However, in spite of macroeconomic stabilization in 2003, there was registered a substantial growth in political risks for investment in Russian financial assets. This was caused by the conflict between the government and leading Russian oil company YUKOS. The arrests of P. Lebedev and later M. Khodorkovsky were considered a fairly negative news for investors, which, as a consequence, resulted in further fall of securities. Criminal

proceedings were instituted against major shareholders. The market responded to these events less negatively than late in spring and summer, but investors became more cautious in investment decision making.

Further growth in political risks was governed by the parliamentary elections in December 2003. The political party *Edinaya Rossiya*, which supports the incumbent President of the Russian Federation, polled the majority of votes. None of the Russian democratic parties could poll a 5 % minimum of votes required for election in the State Duma. The upcoming presidential elections became the final political factor which had an impact on the movement of Russian stocks at year-end 2003. In spite of the fact that the incumbent President is likely to be reelected and he is firmly committed to the program of economic reforms, the current relationships between business community and the government represent political risk since they give no way of forecasting for investors.

#### Interactions with international financial organizations

Interactions between Russia and international financial organizations developed successfully in 2003. Russia honored the debt liabilities in full according to the schedule. Obviously, the most significant event for Russia was the Moody's decision to upgrade the sovereign rating on Russia. On October 8, 2003, the agency upgraded the sovereign rating on Russia from Ba2 to Baa3 on international bonds and all external RF Eurobonds, which corresponds to an investment grade. In addition, the agency upgraded the rating on ruble-denominated bonds up to Baa3, and bank foreign exchange deposits from Ba3 to Ba1. The ratings on the tranches of foreign currency bonds of the so-called «Russian Era» (6<sup>th</sup> and 7<sup>th</sup> tranches) were upgraded from Ba1 to Ba3. The «Soviet» 5<sup>th</sup> tranche OGVVZ bonds was upgraded Ba2. The outlook is *Stable* according to all ratings.

According to Moody's, the new ratings reflect commitment of the Russian Government to prudent tax policy and debt management, significant improvements in debt-to-liquidity ratio, creation of a Stabilization Fund intended to cushion the impact of a possible decline in the raw materials market, and reduced political risks at this country. The new ratings had a tremendous impact on all segments of the Russian financial market because they made it possible for a lot more foreign investors to invest in Russian financial assets.

#### International financial markets

All in all, 2003 became the year of growth in global stock markets, especially in the United States and the European Union. However, quotes also moved down at the markets of the First World's countries and developing countries over the year. Quotes fell in January last year in the US, European and Asian markets. The US stock market got discouraged by uncertainty regarding Iraq and the likelihood of warfare in the country. In addition, the decline in basic stock indices was governed by a unfavorable forecast for technology sector development, decline in production of the US economy, substantial foreign trade deficit and decline in consumer confidence index. European stock markets were also characterized by a negative growth in indices, which made investors concern about growth rate of the European economy and global economy as a whole.

The decline in the US market continued till mid-March, when US indices reached their historic minimum: on March 11 DJIA was 7524,06 points and high-tech NASDAQ was 1271,47 points at closing. Basic European markets were declining as well. European indices



dropped to their minimum over the last six years. Finally, in Japan, NIKKEI dropped below 8000 points to reach its minimum since January 1983, 7862,34 points. In March, the European Central Bank reduced the basic interest rate to 2,5 %, while the US Federal Reserve System maintained the basic interest rate at 1,25 %, which is the minimum rate over the last 40 years. A marked recovery was registered at the leading global markets upon the beginning of the warfare in Iraq, DJIA grew to its maximum since October 1982, and NIKKEI reached its maximum over the last four months.

In April, the American stock market indices grew slightly regardless of any visible progress in the US economy. From March 31 till April 30, DJIA and NASDAQ grew by 487,9 (6,11 %) and 123,1 (9,18 %) points correspondingly. European stock market indices also grew up: FTSE100 by 8.65 % in Great Britain, DAX-30 by 21.38 % in Germany, and CAC-40 by 12.80 % in France. The situation in Iraq became one of the key driving factors. Upon the news of assault on Baghdad in April 7, the European indices grew to their previous points of the past trimester. However, unfavorable situation in the US economy and, in particular, the crisis at the labor market pushed down the US stock market.

In May through August, the US stock market was dominated by positive index trends. From April 30 to August 29, DJIA and NASDAQ grew by 11,03 % and 23,64 % correspondingly and reached 9415,8 and 1810,45 points. Particular emphasis should be placed on other growth factors like the July 1 % decline in the US basic interest rates, which followed by a statement of the Federal Reserve System to the effect that it would be maintained unchanged within a long-term period, published macroeconomic statistics supporting a gradual progress in the US economy (in particular, reduced unemployment rate and industrial output growth), as well as favorable corporate performance figures in the 2<sup>nd</sup> quarter of 2003. The EU market also demonstrated a positive movement which was similar to that in the US market. The growth in European indices was governed mainly by stock prices of export-oriented companies benefiting from the growth in the US economy. However, the European indices grew at slower rates against those in the United States, due to the fact that the European economy was recovering slower than the US economy. In particular, FTSE 100 growth rate accounted for 5,99 %, DAX-30 – 18,44 %, and CAC-40 – 12,11 %.

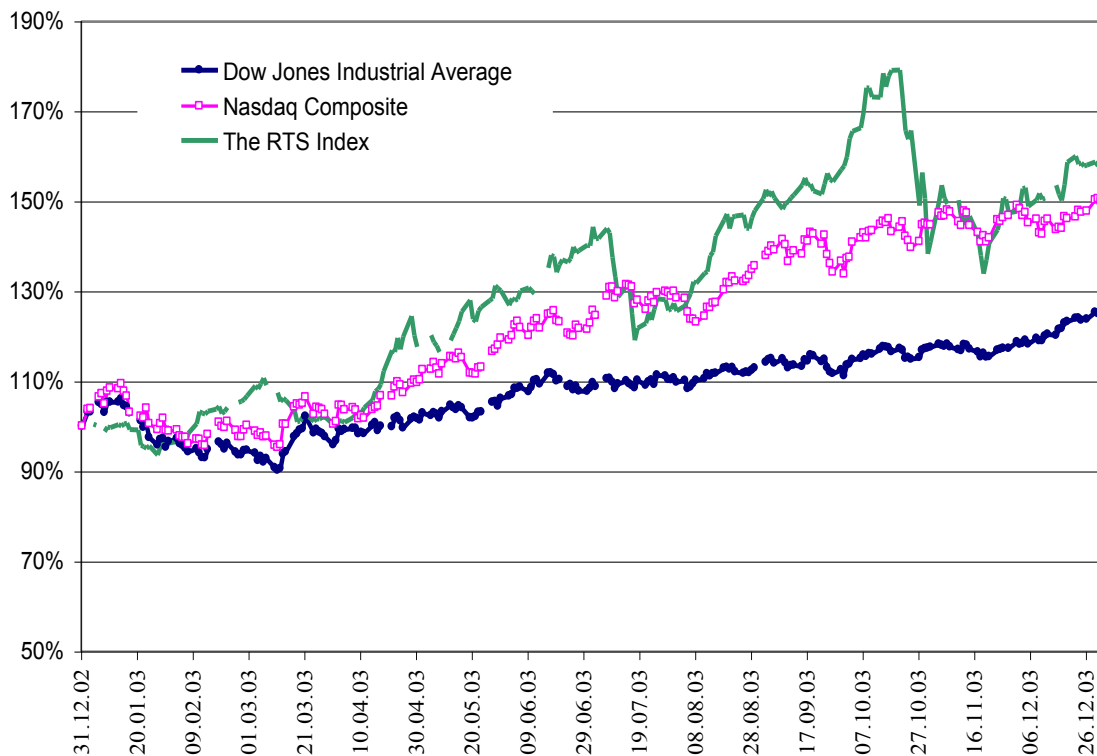
The US stock market was then dominated by a positive trend in quotes movement in spite of a temporal decline in prices. Late in September, the basic US stock indices demonstrated a zero growth against increased unemployment in the United States and a markedly weakening US dollar against other major currencies. Between October and November, the US stock quotes continued to grow moderately partly in response to published statistics on new macroeconomic figures indicating economic growth, and positive financial performance in the corporate sector. In December 2003, the US stock market movement was governed by the same factors as in November 2003. The stock indices grew positively in spite of various unfavorable factors affecting the market, namely weakening of the US dollar at the global currency market and high oil and gold prices. All in all, DJIA and NASDAQ indices grew up by 21,45 % and 44,66 % correspondingly.

The European stock markets were marked by the fact that they continued to follow the movement of the US stock market in absence of any internal news. In addition, due to the fact that the EU economy depends on the US economy, the quotes of export-oriented companies were effected by the situation at the foreign exchange market. It was this factor that governed the movement of European indices between September and November: the market value of

export-oriented companies was instantly effected by a marked strengthening of the euro against the dollar, which resulted in stock index decline. However, high oil prices promoted growth in oil stock prices of European oil companies at year-end 2003, which pushed the stock indices upwards. In 2003, basic stock indices of the EU countries grew as follows. FTSE100 grew by 11,5 %, DAC-30 by 27,7 %, and CAC-40 by 10,46 %.

*Figure 28*

**Dow Jones and NASDAQ Movement  
in 2003 (December 31, 2002 = 100 %)**



### Global oil market

The global oil market was characterized by a visible volatility throughout the entire year. However, a few periods of a well-marked growth and decline of «black gold» prices can be distinguished. Brent oil grew constantly in price since early in the year to reach 34,93 US dollars/barrel by March 11, thus increasing by 4,87 US dollars (16,2 %) against January 13. Such a substantial price rise can be explained by strikes held in Venezuela and Nigeria, ultimate crude oil reserves in the United States (lowest over the last 28 years), and the beginning of warfare in Iraq. Even an OPEC's decision of February 1 on increasing oil output quotas by 1,5 ml barrels daily failed to promote any decrease in oil prices.

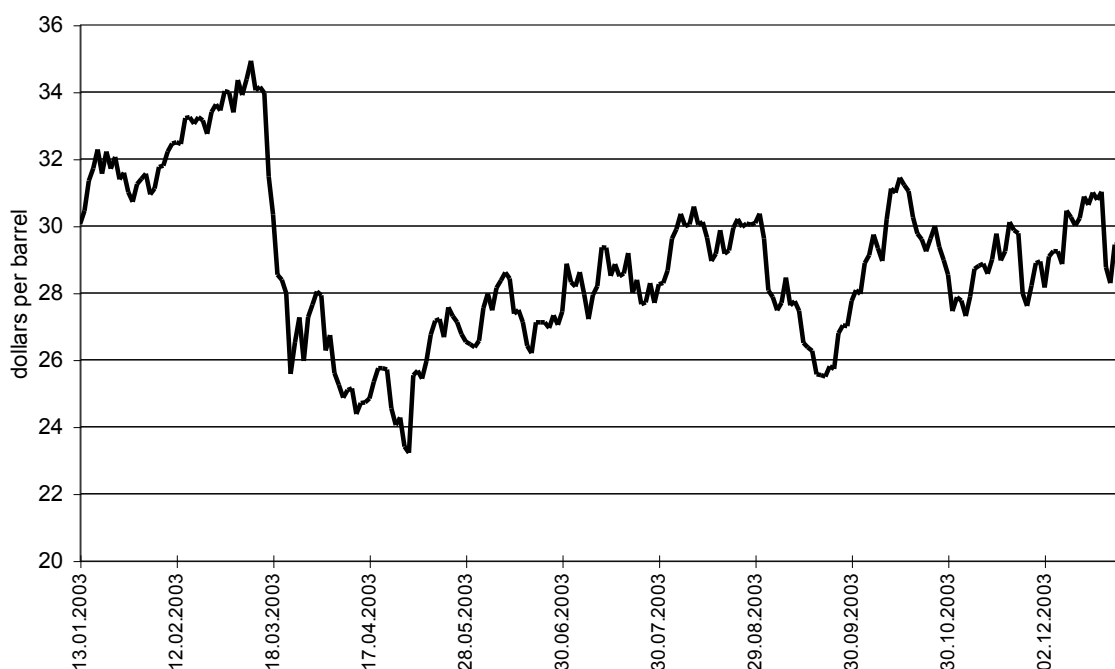
The market, however, collapsed over the following two weeks: by March 24, Brent oil dropped by 9,35 US dollars (-26,77 %), 25,58 US dollars per barrel. The collapse was followed by a short-term correction which gave way to further decline in global prices. At closing on April 30 Brent oil was worth 23,22 US dollars per barrel at the world's market, thus it



dropped to 2,36 US dollars (–9,23 %). The situation in Iraq and especially news on the interallied troops marching in Baghdad was considered as a quick settlement of the conflict. In addition, the market also went down due to cessation of disturbances in Nigeria.

*Figure 29*

**Brent Oil Global Price Movement in 2003**



Between May and early in August, the global oil market moved upwards in general. By August 11, Brent oil prices raised by 7,36 US dollars (31,7 %) by August against April 30 despite unchanged OPEC's quotas (which were expected to be reduced in May), shrinkage of crude oil reserves in the United States, strike in Nigeria, tropical hurricane at the Gulf of Mexico and unstable operation of one of the major oil refinery in Iraq (in Basra region) and Kirkuk–Djeikhan pipe line.

A marked fall in oil prices to 25,5 US dollars per barrel in September (on September 22), which was caused by investors' wish to realize their profit, as well as replenished oil reserves in the United States by way of increased oil import, was followed by a new rapid growth. Upon the reduction of OPEC's quotas on oil production and import by member countries, Brent oil price was increased by 5,72 US dollars (22,43 %) at closing on October 16 and was traded at 31,22 US dollars per barrel. This was followed by a certain fall in quotes reaching 27,46 US dollars per barrel by late October. However, further destabilization of the situation in the Middle East due to acts of terrorism in Iraq, Saudi Arabia and Turkey led to a growth in political risks and, as a consequence, increased oil prices. On November 20, Brent oil was traded at 30,12 US dollars per barrel at the world's market.

In December, a set of factors boosted the price: the OPEC did not change oil production quotas for the member countries and the US reserves of oil and oil products diminished in bulk. However, by late in December the prices fell sharply for a day due to a statement of the



Minister of Petroleum Industry of Indonesia (OPEC Chairman since January 1, 2004) on too high oil prices and the need to raise quotas, which did not meet the market expectations of lower quotas. The Brent oil price dropped by 2,25 US dollars within a day from December 22 to 23, from 31,02 to 28,77 US dollars per barrel. All in all, the Brent oil prices went down by 2,99 % within a period between January 13 and December 30, which accounted for 29,16 US dollars per barrel at year-end 2003.

There were several mechanisms by which high oil prices in the global market effected the movement of the Russian stock market during the year. Firstly, high prices of oil and energy sources promoted a higher amount of foreign currency revenues of export-oriented companies which had to convert it into rubles. Under these conditions, there was registered an upsurge of liquidity at the Russian banking sector, which entailed the demand for the shares of domestic companies and, as a consequence, boosted their market value. Secondly, the strengthening of the ruble due to an increasing foreign currency inflow made the US dollar less attractive as an alternative asset in favor of the demand for shares. Thirdly, under the circumstances of rising world's oil prices, the shares of oil companies represented an attractive instrument for investment due to their efficient financial performance and the expected increase in market value and dividends. It should be noted, however, that the impact of this factor on oil shares may be evened because the petroleum industry is likely to have to take a heavier tax burden and, as a consequence, yield less revenues and dividends in 2004.

#### Corporate news

Marked improvements in efficiency of several Russian corporations was reflected in upgraded long-term credit ratings or revision of the existing rating in favor of further upgrade. In January 2003, Moody's Investors Service granted for the first time the foreign currency rating Ba2 and basic rating Ba1 on NK YUKOS (outlook is *Stable*). It is noteworthy that the basic rating of the company exceeded the sovereign rating on the Russian Federation, Ba2, which is accounted for an exceptional performance of the company. However, there were key problems to note, namely excessive concentration of equity capital, dependency on oil prices in the world markets and indefinite long-term development plans.

A month later, Standard & Poor's raised the long-term credit rating on OAO «VolgaTelekom from B- to B owing to a consolidation of fixed communication operators of the Volga Region, which resulted in improvement of company's position in the market and business performance. In addition, Fitch raised the individual rating on Sberbank of Russia from D to C/D, while other ratings remained unchanged (long-term rating – BB-, short-term rating – B). The upgraded rating reflects an improved efficiency of the bank after 2000 to the level which meets or outperforms other Russian banks.

In March, Standard & Poor's announced a revision of the rating on OAO Sibneft from *Negative* to *Stable*, thereby confirming B+ on the long-term credit and on priority unsecured liabilities of the company, and upgrading its national rating from ruA+ to ruAA-. Furthermore, Standard & Poor's raised the long-term credit rating on the Russian diamond-production company ZAO «AK ALROSA from «B-« to «B owing to the fact the company obtained a five-year quota on export of diamonds in March 2003. The outlook is *Stable*.

In October, Moody's granted the long-term rating Ba2 and Ba3 on unsecured public foreign exchange offerings on OAO LUKOIL. The outlook is *Stable*, while the long-term credit



rating on OAO Rostelekom was raised by Standard & Poor's from B- to B with a positive outlook.

In October through December 2003, many companies published their financial reports in 2003, of which the following should be noted.

Net profit of NK LUKOIL in the second half of 2003 amounted to \$2,36 bln US dollars against \$840 ml US dollars in the first half of 2002, according to US GAAP. Profit before interests, taxation, depreciation and amortization reached \$3,18 bln US dollars in the period under review against \$1,66 bln US dollars over the same period of the previous year. Oil production in the second quarter grew by 3,5 %, which was doubled against 2002.

NK YUKOS also published its report on the first half of 2003 according to the US GAAP standards, indicating that sales proceeds and other earnings generated from the core business accounted for \$7,7 bln US dollars in the first half of 2003 against \$4,5 bln US dollars in the first half of 2002. Earnings before interests, taxation, depreciation and amortization (EBITDA) over the first half of 2003 and previous year accounted for \$2,9 and \$1,68 bln US dollars correspondingly, while net profit amounted to \$2,22 bln US dollars in the first half of the year against \$1,22 bln US dollars in 2002.

Late in October, OAO Rostelekom published its financial reports in compliance with the international standards of financial reporting. Consolidated earnings of OAO Rostelekom over the first half of 2003 grew by 10,6 % according to the international standards of financial reporting. EBITDA accounted for \$175,8 ml US dollars over the period, thus increasing by 1,7 % against the first half of 2002. Net profit grew by 42,1 % against the previous year and amounted to \$29,7 ml US dollars.

On October 30, 2003 OAO Sibneft published its financial report over a period of six months. Net profit of the company over the first half of 2003 was almost tripled to \$1,38 bln US dollars against 476 ml US dollars in 2002, according to the US GAAP standards. The revenues over 6 months accounted for \$3,4 bln US dollars against \$1,9 bln US dollars over the same period in 2002, thereby increasing by 73 %. Earnings before interests, taxation, depreciation and amortization grew by 139 % and accounted for \$1,7 bln US dollars against \$743,8 ml US dollars in 2002. The record financial performance were achieved due to a substantial production growth, favorable oil prices in the world's market and successful financial investments.

OAO Gazprom presented interim financial reports over a period of three and six months in 2003: over a period of six months last year, returns from sales (after VAT and customs duties) was increased by 115,3 ml rubles, or by 38 % against the same period in 2002. Operating costs grew by 22 % against the same period in 2002, which was caused mainly by transit costs, wages, refining, gas purchase, and increased amortization. Net profit accounted for 47,789 and 103,761 ml rubles correspondingly over three and six months in 2003.

On November 11, RAO Unified Energy System of Russia published financial reports of the Group RAO Unified Energy System of Russia over the first half of 2003 according to the international standards of financial reporting. Total assets of the Group as of June 30, 2003 accounted for 1,075 bln rubles, earnings from core activity – 300,8 bln rubles, which is 59,6 bln as much as at the same period in 2002. Expenses on core activity increased by 35,9 bln rubles mostly due to fuel and power energy. In the first half of 2003, net profit of the Group RAO Unified Energy System of Russia amounted to 16,9 bln rubles, which is less than in 2002 (18,8 bln rubles).

Over 9 months in 2003, earnings of OAO Rostelekom accounted for 20 749 ml rubles or grew by 36,7 % against the same period of the previous year. Sales proceeds grew by 12,1 % over the same period, reaching 6859 ml rubles. Net profit dropped by 2,4 % against nine months in 2002 and accounted for 4781 ml rubles.

In 2003, several Russian companies continued to purchase new assets, including foreign assets, and establish long-term relationships aimed at consolidating business and improving efficiency.

On February 11, Tyumen Oil Company and BP announced consolidation of the TNK assets with Russian assets held by BP, the third largest company in the world by oil production, which became the major deal in the history of domestic business. Daily oil production of the new company will account for 1,2 ml barrels and proved oil reserves, 9,5 bln barrels. Therefore, the new company will be listed among the three major petroleum companies in this country.

The most significant event in the Russian stock market occurred in April 2003, when a merger of the Russian major companies YUKOS and Sibneft was announced with the view to setting up a new company NK YUKOS – Sibneft, which could have become the fourth largest oil company in the world by oil production. The deal was to be completed till year-end, however in November the representative of Sibneft announced the merger suspended by mutual agreement of the shareholders of both companies. Had the merger happened, the reserves of the joint company YUKOS – Sibneft (including Sibneft's shares in the reserves of Slavneft) would have accounted for 19,4 bln barrels of oil and gas equivalent, according to the data at year-end 2001 obtained by the SPE method. Proved reserves (by the SPE method) of oil is 18,4 bln barrels, gaz – 5,9 trln cu ft. The joint company (including Sibneft's share in Slavneft's production) could have produced about 2,3 ml barrels daily (YUKOS and Sibneft account for about 30 % of the total oil produced in Russia). In 2002, all together production of the two companies accounted for 103.2 ml tons of oil.

Another major event of the last year was the purchase of 51 % of the Stillwater's shares (major palladium producer in the United States) by GMK Norilsky Nickel by approval of the shareholders of the US company and the US Federal Trade Commission. This will allow Norilsky Nickel to sell palladium directly to US motor plants under long-term contracts. The merger was followed by GMK Norilsky Nickel giving out the results of a tender offer on purchase of shares from shareholders of Stillwater Mining Company in September, which was completed on August 26, 2003. Norimet Limited Company, a 100 % affiliate of GMK Norilsky Nickel, was scheduled to purchase 4,35 ml shares, which accounts for about 12,8 % of the total shares offered for repurchase.

In 2003, companies pursued intensively a policy of additional borrowings both in the domestic and foreign markets, as well as strengthened their positions in the global capital markets. In February last year, OAO Gazprom placed successfully a new 10-year bonded debt to the amount of \$1,750 bln US dollars. The bonds were placed at par value with coupon 9,625 % and payments twice a year. Drezdner Klainvort Vasserstin and Morgan Stanley jointly were lead managers of the issue as well as of the application book.

Standard & Poor's included the corporate governance rating on OAO Mobilnye Tele-Sistemy (MTS) (7.4) into the Governance Watch list with «Developing» outlook due to the fact that AFK Sistema was reported to hold 40,4 % of MTS's shares, and an option agreement concluded with T-Mobile International AG (an affiliate company of Telekom AG), which is



holding 40,1 % of MTS's shares, on a possible purchase of 10 % of its share in the equity capital of MTS. AFK Sistema was authorized under the option agreement to purchase the foregoing share at the market value at any time till September 30, 2003. Since early in the month Deutsche Telekom also announced its intention to sell other 5 % of MTS's shares at the stock market, whereby AFK Sistema could increase its share to 55,4 %, while the share of Deutsche Telekom could drop to 25,1 %.

The experts of Standard & Poor's believe that changes in the structure of shareholders may effect MTS corporate governance. When MTS was initially granted a corporate governance rating 7,4 (the highest rating in Russia), Standard & Poor's noted that a highly efficient governance and monitoring was achieved by maintaining parity between the two major strategic shareholders. Such parity implied a rigid monitoring system, as well as equal representation and active participation of both parties in the Board of Directors. Any further changes in the structure of shareholders may disrupt the existing balance in the authority of the two major shareholders and have an adverse effect on the corporate governance standards of MTS.

Early in November, LUKINTER FINANCE B. V., a company incorporated in the LUKOIL Group, redeemed all outstanding bonds which still were in circulation from the issue of convertible bonds in November 1997 to the amount of \$350 ml US dollars with maturity in November 2003. Bonds of total par value \$51,48 ml US dollars were redeemed and interest paid on November 3, 2003.

The amount of transactions with OAO LUKOIL's shares in the London Stock Exchange in October 2003 grew by 121,4 % against the total in the present September and accounted for over 1,8 bln US dollars.

Furthermore, one way to render corporate securities, specifically shares, more attractive is to pursue a prudent dividend policy which should be aimed at increasing shareholders' well-being. It was the last year that companies pursued this kind of active dividend policy. For instance, late in October, a shareholders' meeting of NK YUKOS decided to pay dividends to the amount of 59,9 bln rubles for the first 9 months in 2003, which accounted for 26,78 rubles per common stock. According to the decision made at the meeting, dividends are to be paid till February 28, 2004 to the NK YUKOS shareholders registered in the shareholders' ledger as of September 25, 2003. Therefore, YUKOS became the first Russian company to pay such a substantial amount of dividends.

Late in December, an extraordinary general meeting of shareholders OAO GMK Norilsky Nickel approved interim dividends to the amount of 42,1 rubles per share. The interim dividends were paid at the suggestion of the Board of Directors of the company according to the performance achieved over a period of 9 months in 2003. The total amount of dividends distributed on the common registered uncertified stocks of OAO GMK Norilsky Nickel will account for 9 bln rubles.

An extraordinary general meeting of the shareholders of OAO NGK Slavneft in December 24 also made a decision to pay dividends, 78 kopeks per common share, according to the performance achieved over 9 months in 2003. Therefore, the dividends to pay will total 3,7 bln rubles.

## Section 3. The real sector

### 3.1. Trends and Factors Effecting Final Demand

#### 3.1.1. GDP: Trends and Structure of Production and Consumption

The period between 1999 and 2003 was represented by dynamic development in the majority of economic sectors and industries. The economy was growing against the backgrounds of a favorable external economic environment and stable internal social and political situation. Over the last five years, the GDP grew up to 37,5% to reach in 2003 almost 80% of the 1990 parameters as against the maximum decline of 57,7% in 1998. The economic recovery period was represented by an outstripping growth rate of investments over production and consumption. The scale of capital investments at the same period grew by 1,55 in the economy as a whole with final consumption increasing by 26,6%. The growth in investment demand had a most material impact upon the behaviour of structural changes in the produced and consumed GDP.

Table 1

**Basic Macroeconomic Parameters between 1991 and 2003, as % against previous year**

	Annual average			Against previous year				
	1991–1995	1996–2000	2001–2003	1999	2000	2001	2002	2003
Gross domestic product	90,9	101,6	105,4	106,4	110,0	105,1	104,7	107,3
Actual final consumption of households	98,6	100,1	108,3	97,6	105,9	108,6	107,9	108,9
Capital investments	78,0	91,4	107,8	105,3	117,4	108,7	102,6	112,5
Industrial output	87	103	105,1	111,0	111,9	104,9	103,7	107,0
Agricultural production	92,3	98,7	103,5	104,1	107,7	107,5	101,7	101,5
Freight turnover	90,3	99,7	105,4	105,8	104,8	103,2	105,6	107,4
Volume of communication services	-	-	119,8	133,1	113,8	119,1	115,6	127,5
Retail turnover	98,2	100,9	109,3	93,9	108,8	110,7	109,1	108,0
Fee-based services for population	65,4	102,3	102,8	107,0	105,0	102,8	100,4	105,1
Foreign trade turnover	108,2	100,9	112,4	86,7	129,7	105,4	108,1	125,3
Real disposable income	92,4	96,5	110,6	86,4	109,1	108,5	108,8	114,5
Real wages	87,6	98,2	115,5	78,0	121,0	119,9	116,6	110,4
Annual average number of people employed in economy	97,4	99,4	100,3	100,5	100,6	100,6	101,0	99,2
Unemployment strength ( at year-end )		109,7	97,8	102	77	90,0	98,0	106,0

Source: the Russian State Statistics Committee (Goskomstat).

Comparative analysis of annual movement of macroeconomic parameters reveals significant fluctuations in rates by economic sector under specific factors and conditions in a specific period. Concurrent growth in internal and external demand was responsible for a brand new element in recovery growth of the Russian economy between 1999 and 2003.

At the initial stage ( between 1999 and 2000 ) of post-devaluation development, the GDP average annual rate gained 8,5% under the conditions of dominating intensive development of the internal market. This trend was caused by almost doubled reduction of imports in 1999 as against the pre-crisis figures in 1997, as well as a boost in business activity of Russian manufacturers. The internal market environment was drastically changed as businesses took a

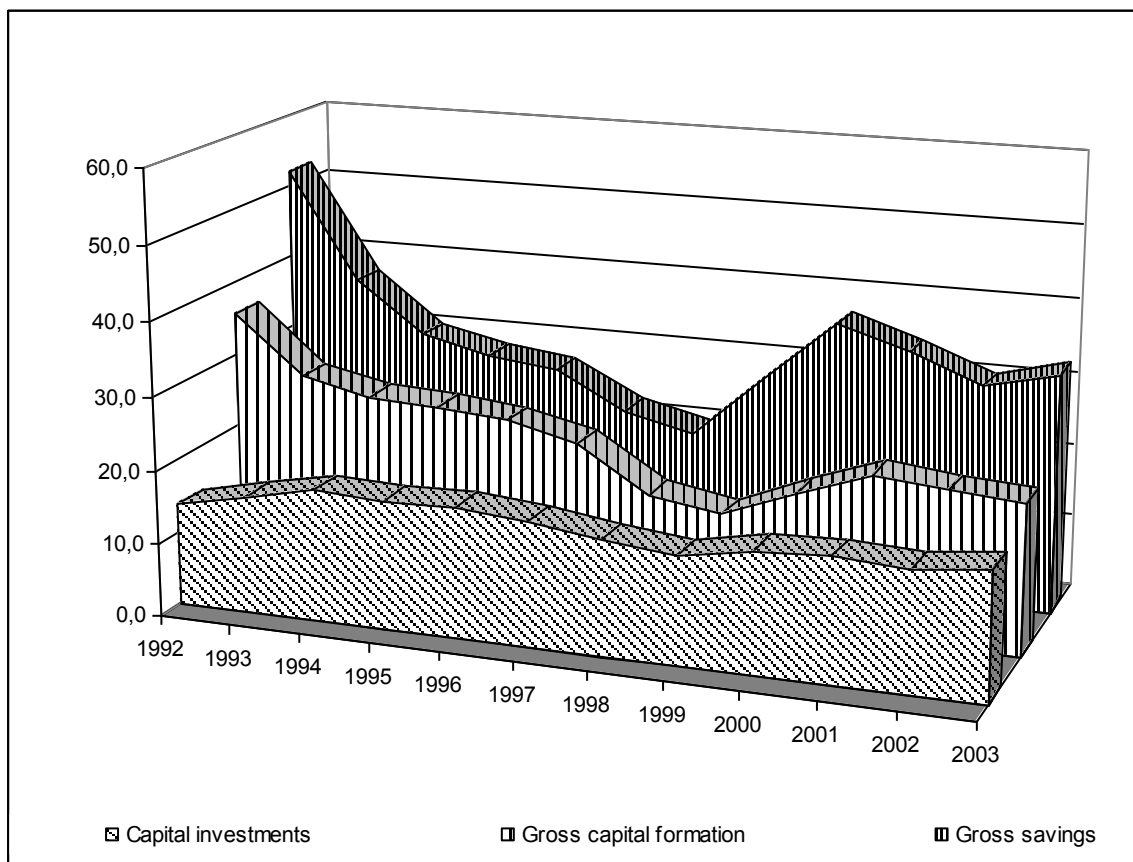


new course aimed at engaging competitive capacities and developing production that could replace imported goods. A share of domestic products in retail turnover was increased by 8 percentage points, with decreasing imports to 40% over the first two years after post-devaluation development. In 2000, internal demand gained its maximum during a period of economic recovery between 1999 and 2003 .

A fairly favorable environment in global markets of fuel resources and raw materials had a positive impact upon economic growth since the 2<sup>nd</sup> quarter of 1999. A cumulative effect of increasing production in the export-oriented sector of economy was represented not only by accelerated rate in development of allied industries, but also specified conditions and factors of development. In 1999, a long-lasting diminution in labor demand was noted to be stopped. Annual average quantity of people employed in economy was increased from 63,8 ml people in 1998 to 64,3 ml people in 2000 and 65,4 ml people in 2002, while the annual average quantity of unemployed people was reduced from 8,9 ml people to 6,7 ml and 6,15 ml people correspondingly. A positive trend in capital investment was recorded for the first time from the wedge of reforms in 1994. Since 2000, the real income of the population, real wages and real amount of granted pensions began to grow intensively, which governed the recovery of final consumption of households in 2001 to reach the level of 1997 .

*Figure 1*

**Rate of Increase in Internal and External Demand between 1992 and 2003 ,  
as % against previous year**



A distinguishing feature of behavior and structural changes of the economy from the end of 1999 and at the first half of 2001 was enlargement of the internal market against the backgrounds of a dynamic growth in consumption and investment demand.

The growing impact of external factors upon the development pattern of the Russian economy was noted from the second half of 2001 till the 4<sup>th</sup> quarter of 2002 and was governed by a reserved external demand and the existing prices in the global markets of raw materials and product markets. In addition, it is this period that the decaying wave of the effect from devaluated ruble occurred in. It should be noted that throughout the entire period between 2001 and 2002 a shrinking demand in the internal market was not compensated by expansion of production in the export-oriented sector, and eventually resulted in growth retardation to the minimum level over the last five years. The average annual growth rate of GDP between 2001 and 2002 accounted for 104,5%. However, even with fairly substantial fluctuations in annual and quarterly growth rates by industry, a contribution of the internal demand to the GDP growth in the period between 2001 and 2002 remained at the level 2000 which proved more favorable.

Positive changes in the global market's environment had a stimulating effect on production and economic growth structure in 2003. With an increase in the average price of Russian export by approximately 10%, the price of energy sources grew by 20%, ferrous metals by 16%, aluminum by 5%, and nickel by 36%. The price rise was supported by a strong demand for fuel and raw materials. The gain in exports volume in value terms, according to the data from the Bank of Russia, was achieved in equal proportion by physical increase in volume and price factor. The Russian volume of exports, according to the estimates of the Ministry of Economic Development, in 2003 accounted for 135,4 bln US dollars and was increased by 26,2% as against the previous year.

The volume of imports over the same period reached 75,4 bln US dollars and exceeded by 23,6% the volume of 2002. A relative cheapening of imports of raw materials and material and technical resources had a substantial impact upon the competitive environment and revealed growth problems. In particular, though the mainline import behavior was constrained by a sufficiently strong competitive position of the Russian manufacturers of food products, an increase in investment import was accompanied by ousting Russian manufacturers from the markets. The growth rate of foreign trade turnover was increased from 108,3% in 2002 to 125,3% in 2003. The balance of foreign trade accounted for nearly 5 bln US dollars on the average per month, which is comparable with the record figures achieved in 2000. Improved trading conditions resulted in export surplus in 2003 up to 59,6 bln US dollars as against 46,6 bln US dollars in 2002.

The global and Russian markets' environment led to a fairly quick response by the domestic business community aimed at restoring the processes of transformation of export earnings into development of the internal market. Since early in 2003, an intensive growth in investment demand had a dominating impact on behavior and structure of the Russian economy. A share of capital investments in GDP at year-end 2003 accounted for 17,4%, thus exceeding by 1 percentage point the average figure achieved between 1999 and 2002. The accumulated development potential had a positive effect on the consumers' sector. In the structure of commodity resources of retail trading a share of import was practically stabilized in 2003. In the 1st quarter it accounted for 45%, in the 2nd and 3rd quarters – 43%, which corresponds to the figure of 2002. Therefore, the growth in effective demand of the population was satisfied in

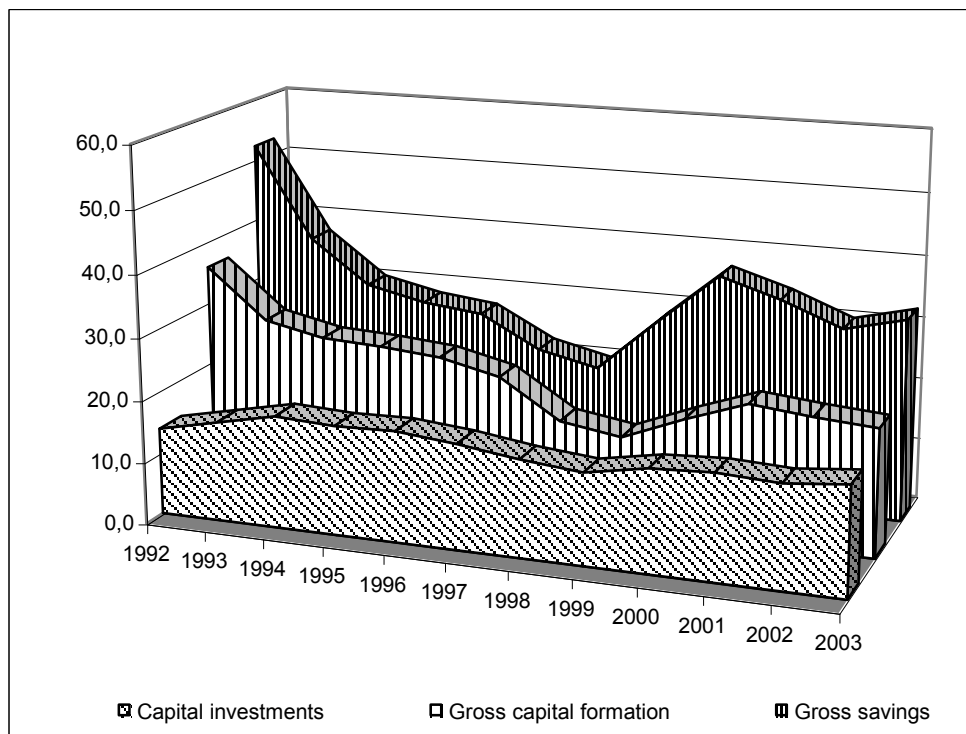


equal proportion by imported and exported goods. A share of internal demand in GDP remained at the average level achieved between 1999 and 2000. The volume of GDP in 2003 accounted for 13304,7 bln rubles and exceeded by 7,3% the level of the previous year. The growth rate was accelerated against the backgrounds of priority foreign trade turnover. According to the estimates of the Ministry of Economic Development, nearly 60% of gain in the GDP in 2003 is due to internal factors – increased capital investments and personal incomes, and 30% due to the increase in average annual price of Russian oil in the global market.

The economic growth between 1999 and 2003 was featured by increased gross savings. A share of gross savings in the GDP over the last five years varied within 28,6% and 36,7% with a fairly favorable combination of stepping-up domestic business and high prices of raw material resources in the global market. This allowed the government to honor in full its liabilities on national debt and social programs. In 2003, gross national savings grew to 32,5% of the GDP, as against 30,1% of the GDP in 2002, under the influence of growing export earnings and foreign investment inflow on the one hand, and retarded growth in final consumption of households due to an intention to save on the other hand. Analysis of capital transaction accounts demonstrates a gradually weakening load on the economy by transactions with other countries, however, the asymmetry of gross savings, resources of gross capital formation and capital investments did not diminish. The share of capital investments in the GDP over the period between 2000 and 2003 remained at the level of 16,5% on the average, which accounted for nearly one half the savings.

*Figure 2*

**Share of Gross Savings and Capital Investments as percentage of GDP between 1992 and 2003**





An investment burst between 1999 and 2001 had an effect on a small group of export-oriented industries but was unstable under changed market conditions. Given the low investment activity in the last year, the scale of investments over the last few years did not meet the real demand of upgrading of productive facilities. The problem of investment maneuver in favor of the industries producing goods and services with a higher added value, which can provide competitive ability for the Russian economy, remains to be resolved. With a potentially high level of investment demand in the domestic market, the trend to stabilization of the share of investment expenditures in the GDP reflected the lack of mechanisms of transformation of savings and eventually restricted economic growth.

In 2002, a retardation in investment growth was noted, down to 102,6% as against 108,7% in the previous year. The economy in 2003 was marked in terms of quality by transformation to the investment growth pattern. A special focus should be made upon the fact that this is supported by upward trend in labor productivity and transformational changes in the pattern of employment and demand for labor. In the 1<sup>st</sup> and 3rd quarter 2003, the gain in labor productivity accounted for nearly 8% with this parameter being changed within 0,2% ( 1st quarter ) and 3,6% ( 4th quarter ) during 2002.

According to a sample survey of employment ( the Russian State Statistics Committee), the number of employed in the economy in December 2003 dropped by 0,6 ml people and amounted to 64,6 ml people as opposed to the same period in 2002. The number of replaced work places in the first half of 2003 decreased by 876 thousand people as opposed to the same period of the previous year. The tension coefficient ( number of unemployed registered with employment services per vacancy ) increased from 1,3 to 2,0. Enterprises pursue an active policy aimed at restructuring employment and improving efficiency of labor time utilization. Compared to the first half of 2002, the number of part-time employees decreased by 20%, with the number of workers with forced leaves being reduced by 360 thousand people, or by 26%.

The decline in employment was noted mainly in good-producing industries, while employment in the service-producing industries increased by 271 thousand people. According to the estimates of the Ministry of Economic Development, within a period between January and June the increase in labor productivity in industry accounted for 112,1% and exceeded dynamics of production by 5,3 percentage points. The increase in labor productivity was revealed almost in all industries.

The labor force demand decreased against the backgrounds of a significant increase in business profits and corporate investments. Collation of data on the number of the employed by industry with other macroeconomic figures reveals that the increased labor productivity, especially in the goods-producing sector of the economy, allowed enterprises to reduce wage costs by restructuring employment, including extra job cuts.

The demand for skilled personnel increased considerably under a general tendency for job cuts. The share of those who lost jobs due to liquidation of their enterprises or own business is reducing against an increase in the share of unskilled and unqualified labor force. Such tendency is critical for further economic growth.

In the period of recovery growth a gap between the rates of labor productivity and wages is increased in favor of the latter. However, maintaining internal demand on the basis of increasing real wages and personal income is accompanied by redistribution of earnings from enterprises to individuals and results in increased operating costs.

*Table 2***GDP Structure by Earnings between 1999 and 2003, as % of total**

	1999	2000	2001	2002	2003
Gross domestic product	100	100	100	100	100
Including					
wages of employees ( including hidden wages )	40,1	40,2	43,0	46,6	46,0
net tax on production and import	15,7	17,1	15,7	14,1	13,7
Gross profit of economy and gross mixed income	44,2	42,7	41,3	39,3	40,3

*Source:* the Russian State Statistics Committee ( Goskomstat )

The share of wage costs in the structure of costs of goods manufactured over the period between 1999 and 2002 grew by 1,3 percentage points in the economy in general and by 2,2 percentage points in industry. A systematic growth in wage costs had a negative effect in production profitability. In general, profitability in 2002 accounted for 10,9% in the economy, 14,4% in industry and decreased almost by 10% as compared to the figures 2000 .

In addition, in the period between 2002 and 2003, further increase in wage costs became limited by changed competitive environment in the commodity markets due to strengthening of the ruble and stronger import-related pressure. In 2003, на фоне intensive output growth обозначилось сближение темпов производительности труда и заработной платы the rates of labor productivity and wages. However, the impact of this process on performance efficiency of enterprises and organizations still remains extremely weak and unstable.

According to the practice gained over the last few years, it is the ratio between investment demand and final consumption that responds most to changes in export revenues and features the internal market.

The financial crisis of October 1997 – August 1998 had a most adverse affect on the social sector. Due to the ruble devaluation and sharp increase in consumer costs between 1998 and 1999 real income of the population dropped almost by quarter.

Under these circumstances, raising of living standards of the population was the necessary condition for the internal market's recovery. Since the 3rd quarter of 1999, the real income of the population, as well as expenses on final consumption of households is characterized by a stable tendency for growth. Over the period between 2000 and 2003, real income of the population grew nearly by 1,5 times, and over  $\frac{4}{5}$  of gain of the GDP is explained by the growth in final consumption of the population. The number of population with income below the poverty line decreased to 33 ml people ( between 22 and 23% of the total population ) in 2003, compared with 35,8 ml people in 2002 and 39,4 ml people in 2001. The gain in real income of the population in 2003 accounted for 14,5% as opposed to the previous year, real wages – 10,4%, and pensions – 104,5%.

Positive dynamics of final consumption was one of the key factors of sustained development of the internal market. Final consumption grew against the backgrounds of a fairly stable ratio of households consumption to social transfers received from government agencies and nonprofit organizations.

Figure 3

**GDP Movement by Final Demand Component between 1999 and 2003 , as % against previous year**

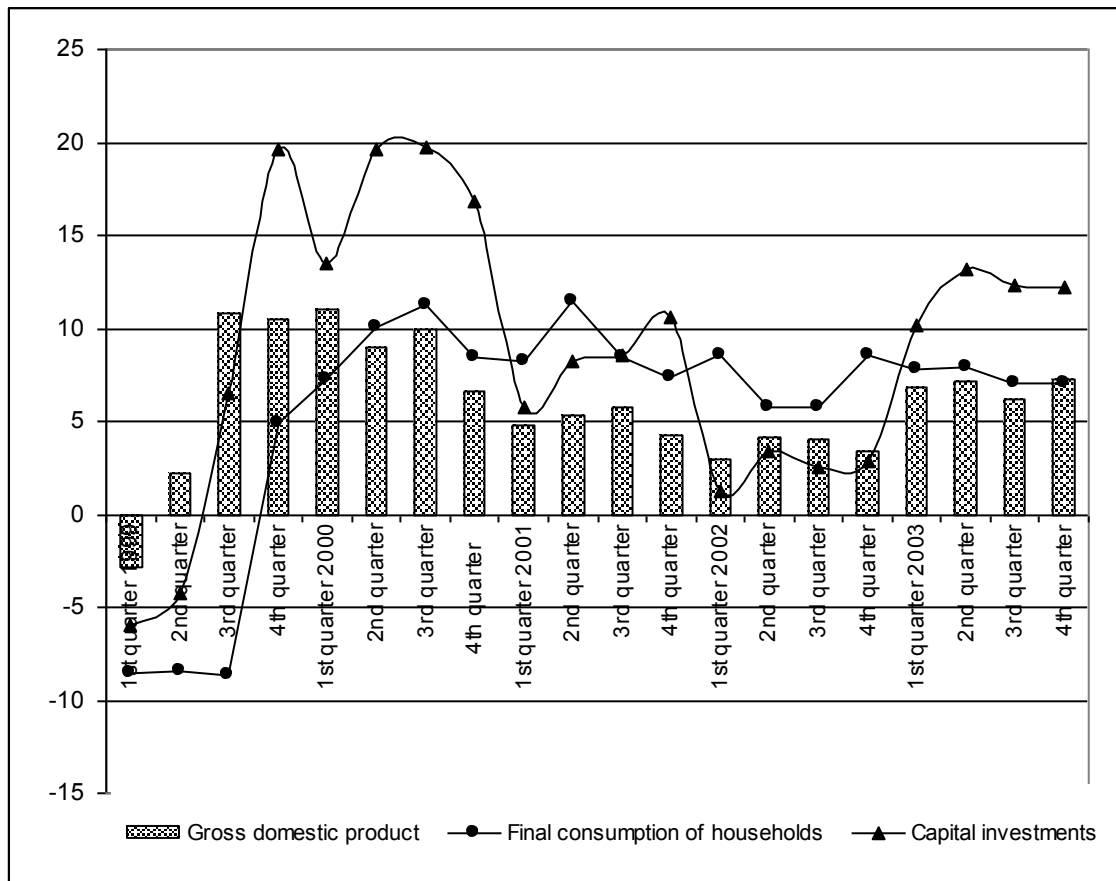


Table 3

**Gross Domestic Product Utilization Structure between 1998 and 2003 , as % of total**

	1998	1999	2000	2001	2002	2003
Gross domestic product	100	100	100	100	100	100,0
Final consumption expenditures	77,8	68,0	61,3	65,1	68,1	67,4
Including:						
households	56,8	52,2	45,2	47,7	49,8	49,3
government agencies	19,1	14,6	14,9	16,2	16,9	16,9
Gross savings	15,4	15,0	18,6	22,1	21,1	20,4
Including:						
Gross capital savings	16,5	14,5	16,9	18,7	17,9	18,1
Net export of goods and services	6,8	17,0	20,1	12,8	10,8	11,2

Source: the Russian State Statistics Committee (Goskomstat).



Recovery of social development parameters led to substantial changes in the structure of earnings and spending. The structure of the employed population accounts for 92,1% of employees and only 7,9% of the self-employed: full-time employees hired by employers and self-employed individuals. Consequently, this has an effect on the structure of earnings of the population and the GDP. Wages account for 65% of the earnings of the population, while the share of wages of the employees account for 46% of the GDP structure. Analysis of the dynamics of real earnings in the recovery period reveals that outgrowing wages had a dominant impact on the character of changes in social parameters. Wage increase of the employees in the GDP structure is linked to the existing drift in outgrowing wages as against labor productivity. Such a wage growth was accompanied by a decrease in gross profit on the economy from 42,7% in 2000 to 40,3% in 2003. In spite of the fact that growth of these two parameters was noted to become more balanced in 2003, this process has no material impact on integrating parameters. The share of earnings of enterprise and property income in the GDP remains smaller than that prior to the crisis of 1998 and accounts for nearly 17% in earnings of the population.

*Table 4*

**Money Earnings Structure of Population between  
1999 and 2003 , as % of total**

	1999	2000	2001	2002	2003
Total money earnings	100	100	100	100	100
wages, including hidden wages	66,5	62,8	64,6	66,5	66,7
Earnings of enterprise	12,4	15,4	12,6	12,1	11,4
Property income	7,1	6,8	5,7	4,8	5,4
Social payments	13,1	13,8	15,2	14,7	14,3
Other earnings	0,9	1,2	1,9	1,9	2,2

*Source:* the Russian State Statistics Committee (Goskomstat).

Structural changes in money earnings of the population were accompanied by changes in distribution of the population by the amount of average per capita earnings. In 2002, with the average per capita earnings of the population being 3950 rubles and wages – 4360 rubles, the share of population with earnings between 3000 and 4000 rubles accounted for 15,2% as against 10,5% in 2000. In 2003, with a growth in the average per capita earnings by 129,3% and wages by 125,5%, the share of population with earnings between 4000 and 7000 rubles increased by nearly 4,7 percentage points as opposed to the previous year, while the share of the population with earnings being up to 3000 rubles increased almost by 12,6 percentage points as opposed to 2002. However, the socio-economic differentiation of the population by earnings remained the same. According to the estimates of 2003, the fund coefficient which represents the mean ratio of average figures of highest to lowest earnings of corresponding decile groups of population, increased to 14,3 as against 14,0 between 2001 and 2002, while the Gini coefficient increased to 0,400 as against 0,398. The principle of distribution of earnings also governed the dynamics of current expenses and saving level in the households sector.

Over the last five years the structure of consumer spending changed due to an increased share of spending on nonfood products and services with decreasing share of food spending. It should be noted according to the statistics that with the prevailing earnings level there was

noted a gradual shift of product line sales structure towards more expensive food products and imported nonfood products of better quality. In 2003, as opposed to the previous year, there was a certain balance between growth in fee-based services to the population and retail trading turnover regardless of a substantial leadership of growing rates and fees of fee-based services as against products. It should be noted that actually the entire increase in sales turnover in 2003 was driven by expansion of sales of nonfood products. Changes in consumer behavior were governed to a certain degree by disinflation, as well as structural changes in main family groups of goods. All in all, in 2003 consumer prices increased by 12,0% as against 15,1 % in the previous year, with food price index accounting for 108,6% (111,0%.in 2002), nonfood products for 108,6% (110,9%) and for services for 121,2% (136,2%).

*Table 5*

**Structure of Cash Expenses of Population between 1997 and 2003, as % of total**

	1997	1998	1999	2000	2001	2002	2003
Total cash expenses of the population	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Including:							
Purchase of goods and payment for services	69,8	79,0	79,8	77,6	75,9	73,2	69,5
compulsory payments and contributions	6,4	6,2	6,8	8,0	9,1	9,2	8,2
savings	2,4	2,5	5,4	7,8	9,2	10,4	12,1
Purchase of foreign exchange	21,3	12,2	7,9	6,6	5,8	5,5	7,4
increase, decrease (-) of cash in hand	1,6	1,7	1,8	2,9	2,0	1,7	2,8

*Source:* the Russian State Statistics Committee (Goskomstat).

In 1999, a sharp price rise due to the ruble devaluation led to an increase in current consumption spending. The share of savings in available earnings and GDP was negative. The population developed a propensity to save as the living standard parameters and growth in available earnings of the population were recovered as opposed to final consumption. Accordingly, the consumer demand grew at a slower rate than real earnings, but not too slow. With increased gross available earnings in the household sector from 48% of GDP in 2000 to 55% of GDP in 2002 – 2003, savings of the population increased from 3,2% of GDP in 2000 to 4,6% in 2002 and 5,8% in 2003 .

A special emphasis should be placed upon a drifting tendency in gross savings from the nonfinancial business sector towards households over the last few years. An upward drift in personal deposits in banks was noted due to restored credibility of the population in thrift institutions. The year 2003 was featured by redistribution of savings between ruble deposits and foreign exchange deposits due to strengthening of the ruble. If in 2002 personal deposits in banks were mostly foreign exchange accounts (154,7%) as opposed to ruble accounts (138,8%), in 2003 the picture was quite opposite. Ruble account savings as of December 1, 2003 increased by 1,52 as opposed to the beginning of the year, while foreign exchange accounts by 17,6%. The growth in savings of the population made actual the issue of its transformation into investments.

In 2003, a share of self-financing decreased and that of borrowed funds increased in the investment financing structure and, as a consequence, the banking system began to play a more important role. A positive effect of the growth in household savings and nonfinancing businesses was supported by decreasing net outflow and became a strong factor in stepping up business activity in the Russian economy.



### 3.1.2. *Production of Goods and Services*

The Russian economy in 2003 developed under the influence of the most relevant factors as follows.

- Increased influence of external demand and increased contribution of fuel industry to industrial boom ;
- Growth acceleration of import of final consumption goods as against internal demand;
- Advanced growth of capital investments as against dynamics of the GDP and final demand ;
- Intensive growth of service sector ;
- Approximation of dynamics of real wages and labor productivity ;
- Sustained strong consumer demand against the backgrounds of growing thrift propensity of the population ;
- Disinflation under the tendency for the stronger ruble and growing money supply.

#### The service sector

The economic upturn between 1999 and 2003 took place against the backgrounds of simultaneous recovery of positive dynamics in the sectors of production of goods and services. Over the period between 1992 and 1998, the material, technical and labor potential created in the sector of services was fully employed by the market under the economic upturn. An advanced growth of production of goods over the period between 1999 and 2003 is supported by the market infrastructure developed during the period of reforms. Market services grew by 32,1% with the increase in production of goods by 44,3% over the last five years.

Commercial freight turnover in 2003 increased by 29,0% as opposed to 1998, while volume of communication services increased nearly by 2,56x over the same period. Over the last few years retail trading has been among most dynamic industries of the Russian economy. Upon reduction of retail trading volumes by more than 10% between 1998 and 1999 as opposed to 1997, on the following four years retail turnover grew at the rates outstripping the GDP's dynamics as the purchasing power of the population recovered. The retail turnover index in 2003 accounted for 145,1% as against 1999 with the GDP growth by 29,8%.

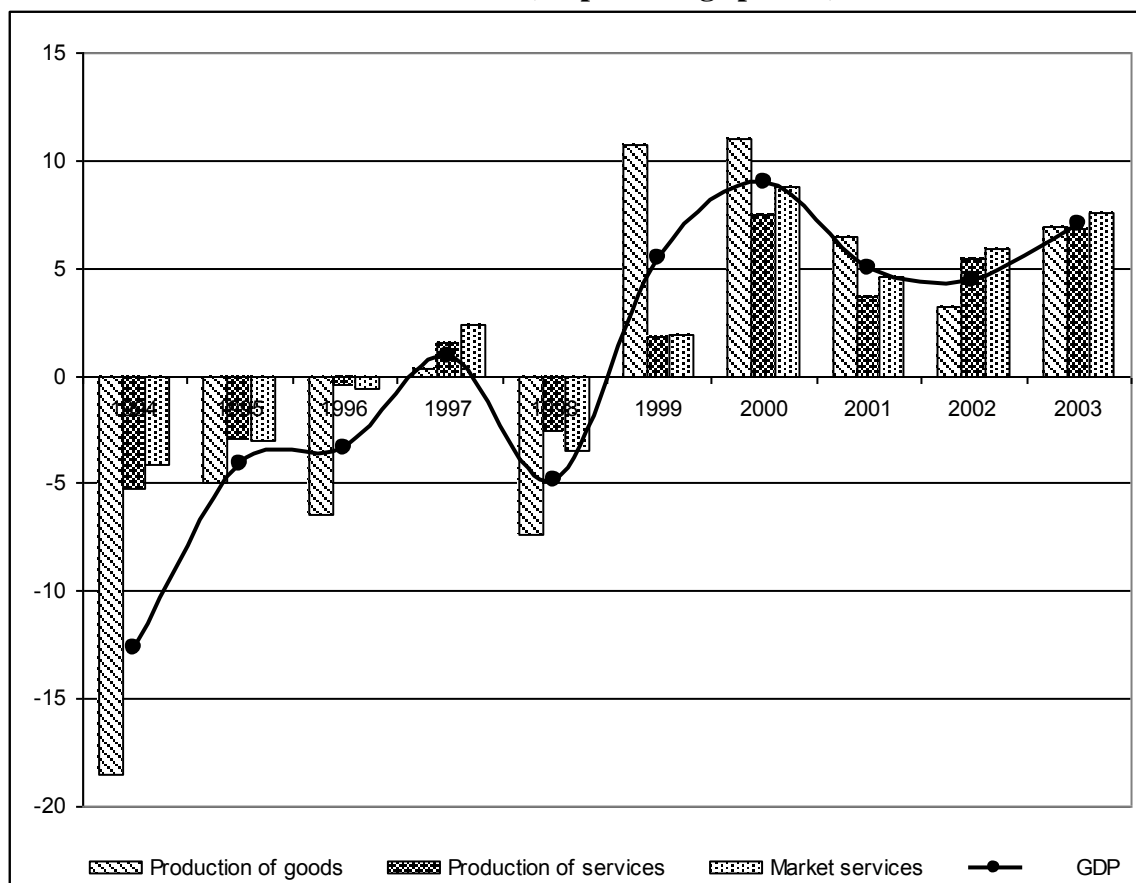
Between 2002 and 2003, growth acceleration in market services was noted in the Russian economy. Market services grew by 8,3% with added value increasing by 7,0% in the sector of production of goods in 2003. Upward figures of the sector of services correspond closely to the level of business and structural changes in the economy. In 2003, the market was dominated by advanced growth in services of transportation, communication, trading, market operation support, and real property business.

Accretion of demand for industrial products both in the internal and external markets was accompanied by expansion of transportation operations. In 2003, commercial freight turnover increased by 7,4% with the industrial output growing by 7,0%. Export-oriented industries made the biggest contribution to the increased demand for transportation services. The increase in freight turnover in the pipeline industry accounted for 8,1% as opposed to 2002, with the oil carriage volume increasing by 12,4%, oil products by 7,6% and gas by 5,7%. Oil export capacity increased due to placing in operation of the second stage of the Baltic pipeline system with a capacity for 18 ml tons. Oil and oil products, ores of ferrous and

nonferrous metals, and products of ferrous industry remain leaders in freight volumes of general railway cargos.

Figure 4

**Production Rate of Goods and Services between 1994 and 2003 ( as percentage points )**



The communication industry is the most advanced and fast-developing industries of the economy. The gross value added volume of the communication industry in 2003 amounted to 241,9 bln rubles, or 1,8% of GDP. Growth rates in volumes of communication services in 2003 accounted for 27,5%, and exceeded by 17,2 percentage points the level of the previous year. New communication operators account for nearly  $\frac{3}{5}$  of the total volume of communication services with more than a half being rendered to the population. Telephonic communication gained most acceptance among other types of electrical communication. This type of communication generates  $\frac{2}{3}$  of the total earnings from services of the industry, while mobile telecommunications generate  $\frac{1}{3}$ . As of January 2004, the total number of users of cellular communication amounted to 35,5 ml and doubled as opposed to January 1, 2003 .

The share of trade in the produced GDP in 2003 accounted for 23,0%, which corresponds to the average figure of the last five years. It should be noted that the industry was characterized by dynamic structural changes. First, favorable changes in the demand in the global market governed an overstepping growth and increase in the share of foreign trade in



the trade turnover structure. Second, the Russian economy features nearly double increase in wholesale trade volumes as opposed to retail trade volumes. With increased economic activity an intensive growth in wholesale trade was supported by increasing demand for material and technical resources in the internal market.

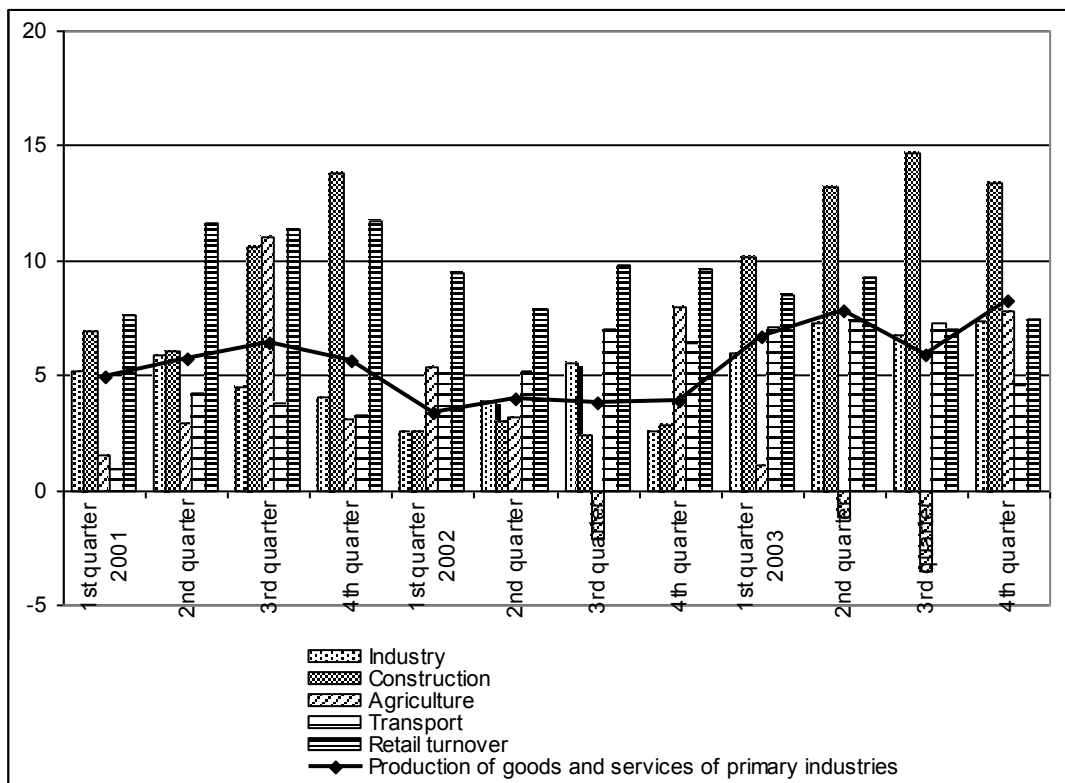
Retail trading in 2003 was characterized by the final figures as follows:

- increased role of small business in retail trading: small businesses achieved 49,8% of the retail trade turnover as against 48,7% in 2001, and 46,1% in 2000 ;
- the share of non-food products in the retail trade turnover, which is a key parameter of the quality of life the population, remained practically unchanged and accounted for 53,8% as against 53,5% in 2002 , and 53,8% in 2001 .
- trading stock remained stable and maintained at the level of 36 - 37 days;
- the share of imported goods in the volume of retail trading accounted for 43% and increased by 2 percentage points as opposed to 2001;
- growth retardation in prices of consumer goods was noted as opposed to December 2002, the consumer price index accounted for 112,0% against 115,1% in 2002.

The turnover growth index of retail trading accounted for 108,0% as opposed to the previous year, with increasing share of the GDP, up to 8,1% as against 7,6% in 2000, as the result of additive effect of the foregoing factors.

*Figure 5*

**Production Rate by Industry between 2001 and 2003 , as % against corresponding period in previous year**





### Production of Goods

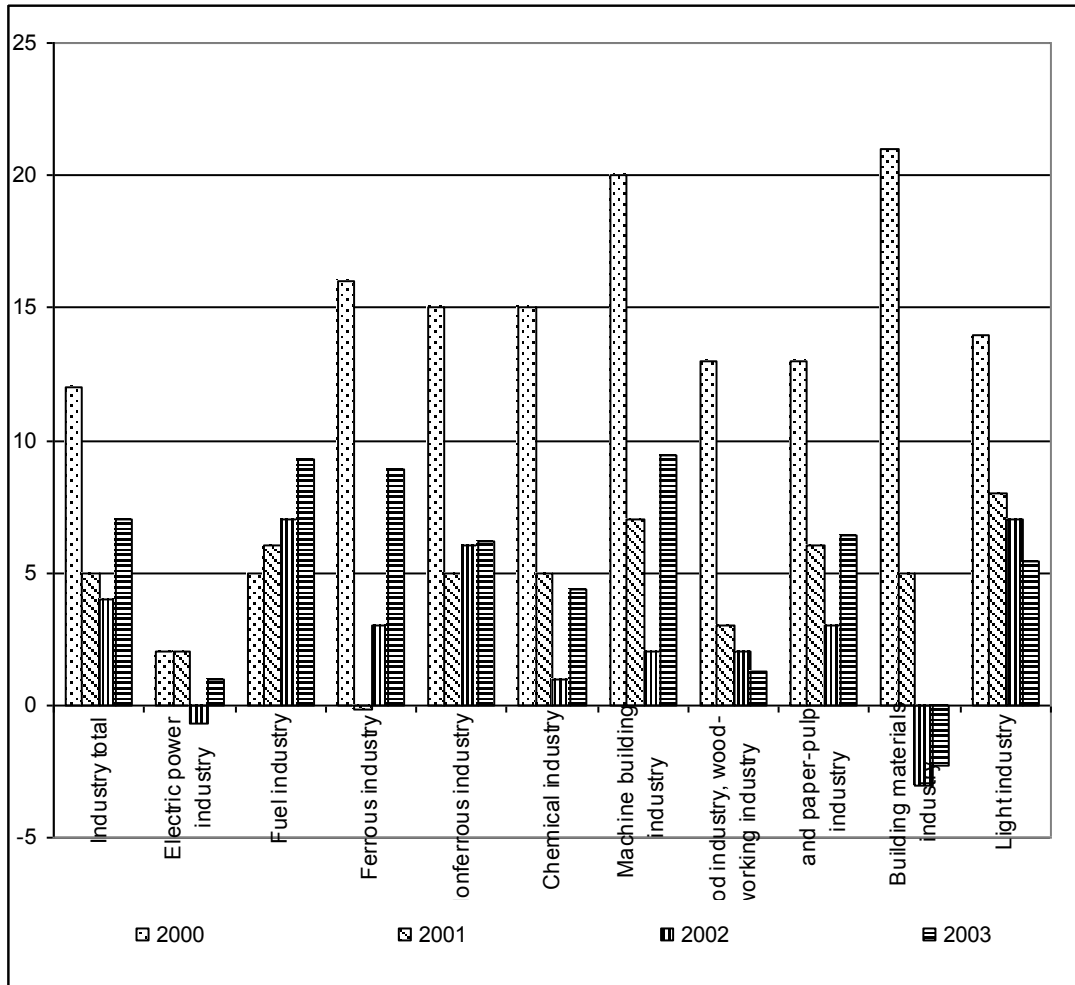
The production structure in the sector of goods is most influenced by the ratio of industry to construction. Positive dynamics of growth in construction was recorded from the 3rd quarter of 1999 and supported by increased production of capital goods and expansion of capital investments. The economic growth between 2000 and 2001 governed by increased efficiency of foreign trade transactions and market capacity, had an additional impact on accretion of demand for building and construction work. The average annual rates of increase in building and construction work in that period accounted for 13,4%, while the industrial production of construction materials was 8,3%. In between 2001 and 2002, a gradual growth retardation to 4,2% in the economic development was noted under the influence of restrained export and relative contraction of world market prices. It took the investment sector too long to respond to the changed situation in the internal market due its high inertance, however the response was sharp. The decrease in investment demand in the 1st quarter of 2002 governed a sluggish growth in building and construction work, as well as production of capital goods throughout the entire year. The increase in output of building and construction products in 2002 reached its minimum level over the period of recovery growth, 2,7%.

At the initial stage of post-devaluation period of development, production growth was supported by increased production of final demand goods due to growing activity of the domestic business in development of import-replacing production and expansion of market niches for Russian products. Machine building industry, light industry and food-processing industry were developed by outstripping growth rate as compared to the general output dynamics. These tendencies were resulted from active transformation of export earnings into expansion of the domestic market of investment and consumer goods. The manufacturers, which were primarily oriented to the internal market, were behind in price indices of the raw material industries, as well as rates and services of natural monopolies.

In the period between 2002 and 2003, the industrial growth dynamics and financial performance figures were found to be effected by disinflation and transformation of price structure in the internal market. Though in 2003 the tendency for outstripping growth rate of producers' prices against consumer prices continued, the parameters of these values were more constrained. The growth in producers' prices in 2003 accounted for 13,1% as against 17,1% in 2002, while the consumer prices grew by 12,0% as against 15,1% correspondingly. Obviously, a positive effect was achieved by administrative regulation of prices and rates of products and services of natural monopolies. This allowed the government to suppress the inflationary wave of 2002 initiated by accelerated growth of prices and rates of natural monopolies. The year 2003 was featured by a smooth growth of rates of products of the electric power industry. Price index in the electric power industry exceeded only by 0,8 percentage points the prices of industrial manufacturers, while the gap in 2002 accounted for 10 percentage points, and nearly 20 percentage points in 2001. The first fall in gas prices by 22,9% was recorded in the gas industry in 2003 since the beginning of the reforms. With a big share of transport component in the structure of both production costs and final consumption costs, the outstripping growth of freight rates had a significant impact on dynamics and structure of various industries of the economy.

Figure 6

**Industrial Output Movement by Industry between 2000 and 2003, as % against previous year**



Another specific feature of 2003 was growth acceleration of prices of manufacturers of consumer and capital goods. In price index of manufacturers in 2003 accounted for 115,2% in light industry and 114,8% in food-processing industry as against 105,8% and 105,3% in 2002 correspondingly. The price movement in the investment was as follows. The price index of manufacturers in the construction engineering accounted for 110,3% as against 112,6% in 2002, with prices of building materials industry increasing by 17,0%, and prices of the products of machine building industry by 11,2%. Such price policy deteriorated the competitiveness of the Russian products and increased the demand for imported goods against the backgrounds of strengthening ruble.

Figure 7

**Price Movement of Natural Monopolies between 2002 and 2003 against Prices of Industrial Products Manufacturers, as % against December of previous year ( industry =1)**

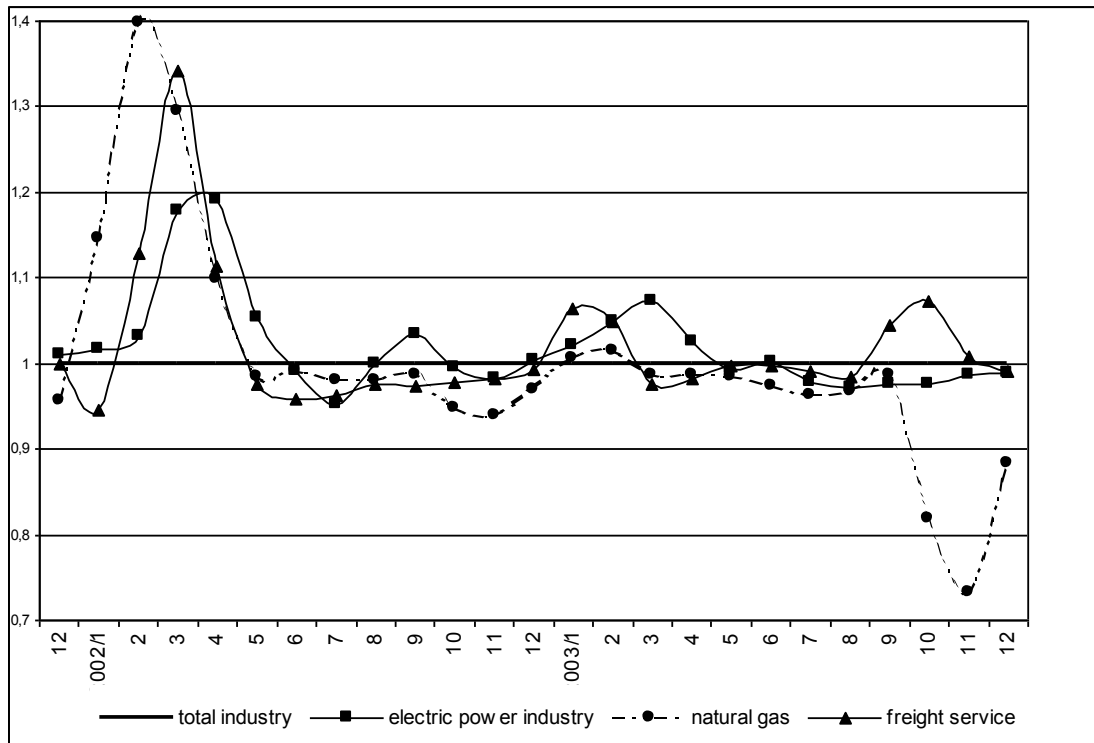


Table 6

**Manufacturers' Price Indices by Industry between 1999 and 2003 , in December against December of previous year, in terms of percentage**

	1999	2000	2001	2002	2003
Industry total	167,3	131,6	110,7	117,1	113,1
Electric power industry	114,4	139,9	130,2	127,3	113,9
Fuel industry	234,9	155,2	102,2	124,3	101,4
Oil industry	249,2	158,0	97,1	125,6	101,6
Oil-refining industry	342,3	147,5	84,5	119,9	114,8
Gas industry	122,1	163,1	141,5	130,2	77,1
Coal industry	132,2	144,3	122,4	109,1	110,1
Ferrous industry	189,2	129,2	103,5	123,3	128,8
Nonferrous industry	215,8	108,7	89,4	130,1	127,2
Chemical industry	143,8	126,8	119,8	108,3	115,1
Petrochemical industry	166,5	135,8	101,2	108,7	111,3
Machine building industry	149,6	128,0	116,5	110,6	111,2
Wood industry, wood-working industry and paper-pulp industry	167,7	124,6	107,7	108,2	107,9
Building materials industry	137,3	136,6	119,5	117,4	117,0
Light industry	156,0	122,3	110,9	105,3	115,2
Food-processing industry	162,6	118,6	115,0	105,8	114,8

Source: the Russian State Statistics Committee (Goskomstat).



The lack of serious and qualitative changes in the technology and structure of production prevented a complex of consumer good industries from maintaining high growth rate for a long-term period.

The growth index of the consumer complex in 2003 decreased to the minimum over the last five years and accounted for 4,6% as against 5,9% in 2002 and 7,6% in 2001. The structure of consumer goods production was effected mostly by a decline tendency in production in light industry recorded since 2002 (approximately by 4% annually). In 1999 – 2003, investment activity in the industry continued to curtail. The light industry is incorporated in the group of processing industry's branches with critical depreciation coefficients. The coefficient of physical property mortality due to за ветхостью износа exceeds by more than 6 times the asset renewal index. An absolute reduction of capital stock took place in the industry. Crisis in the industry resulted in a sharp decrease in labor demand. Over the last two years the average number of employees in light industry was reduced by more than 10%. The industry became poorly attractive because of the existing level of wages. Wages in the industry accounted for nearly 44% of the industry's average, and though wages remained unchanged over the last five years, the share of wage costs in the total production costs in light industry grew from 17,5% in 2000 to 21,8% in 2002, and 22,6% in 2003. In 2002, product profitability accounted for 2,1%, while losses were recorded at year-end 2003. Outdated plant and semiskilled personnel determined poor competitive ability of domestic goods in light industry against imported goods and further led to expansion of niches for imported goods under the existing currency exchange rates. According to the estimates, the share of imports in the structure of nonfood products in 2003 increased by 3,4 percentage points as opposed to the previous year.

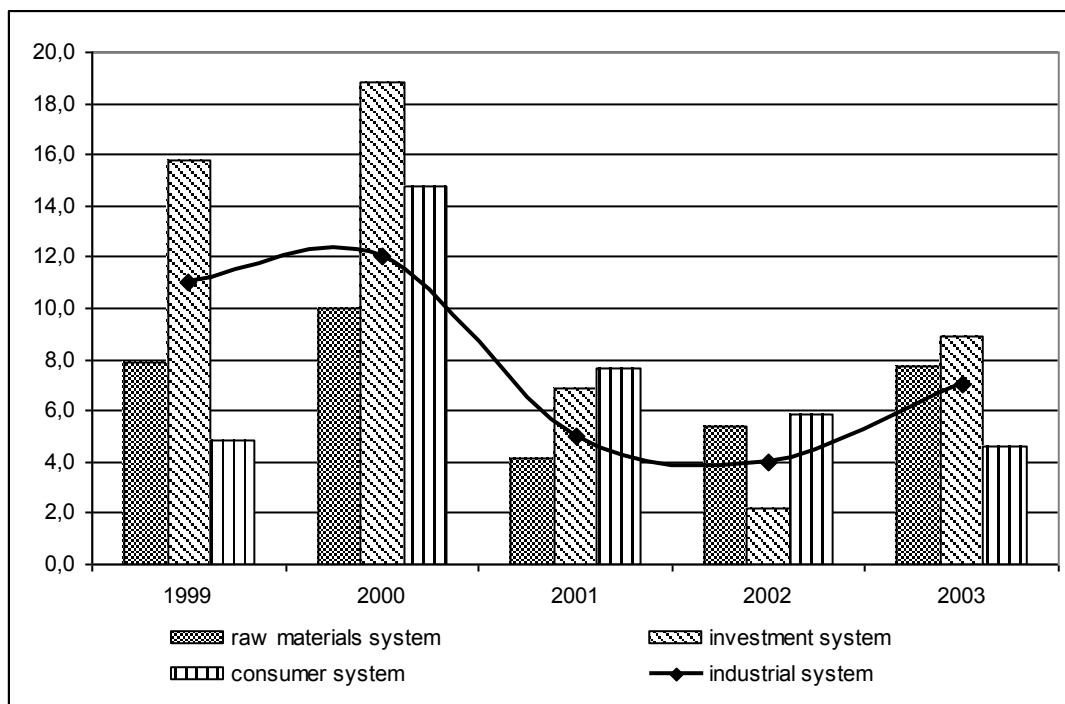
Among the conditions mitigating an adverse effect of light industry on the resources of the market of nonfood domestic products are acceleration of production of household equipment (branches of machine building industry), products of furniture industry (food industry system), and home improvement items (branches of building materials industry, glass industry and porcelain industry). Increased output of furniture and building materials correspond to intensive growth in residential construction and high business activity in the real estate market. Introduction of new technologies, as well as increase in output of products assembled on the basis of imported parts and elements, had a significant impact on the mode of operations of these industries and strengthened their competitive ability.

In 2003, the output growth index of food-processing industry accounted for 105,1% and for the first time over the last four years was recorded beyond the production output index at the industry as a whole. Capital investments in food-processing industry increased nearly by one third over the period between 2001 and 2003, capital consumption decreased by more than 10 percentage points over the period and accounted for 35,7%. The level of profitability of food-processing industry accounted for 10,6% in 2002 and increased to 11,6% in 2003 by initial estimates. Obviously, there is a positive performance represented in the fact that the industry maintained its position in the internal consumer market. В объеме товарных ресурсов of food products, the share of domestic goods accounted for 65% in the 1<sup>st</sup> quarter of 2003, 66% in the 2<sup>nd</sup> quarter and 68% in the 3<sup>rd</sup> quarter. Therefore, the accumulated development potential in food-processing industry was among the factors partially compensating adverse effects resulted from a decline in production of light industry.

The post-devaluation period of the Russian economy was featured by intensive growth in investment industries system. Modest output of capital goods against the industrial growth rate over the last five years was recorded only in 2002, when accretion in production of investment industries decreased to the minimum and accounted for 2,2% against 6,8% in 2001 and 18,9% in 2000.

*Figure 8*

**Production Growth Rate by System between 1999 and 2003 ,  
as % against previous year**



The situation was changed profoundly in 2003. As in the period between 2000 and 2001, the investment sector responded to accelerated growth in production and earnings of the export-oriented sector by intensive increase in production capacities of capital goods. In 2003, however, the determinal factors of the production growth in machine building industry were increased internal gross demand by railway machine building industry, instrument making industry, and household appliances industry, including the state demand, rather than orders by principal export industries. The output volume of machine building industry increased by 9,4% in 2003 as against 2,0% in 2002, while in the building materials industry it grew by 6,4% as against 3,0%. Improved trading conditions of high-tech domestic products in the external markets was an additional growth factor in machine building industry. Export of civil-purpose products increased to 11 bln US dollars in 2003 against 8 bln US dollars in 2002, and defense-purpose products nearly to 4,6 – 4,7 bln US dollars, which exceeded by 10% the figures of the previous year.

Machine building industries differ largely in output of products. Among the negative factors affecting the dynamics of machine building industry in 2003 are permanent crisis of overproduction in the automobile industry and maintained tendency for narrowing of the fuel



industry's investment demand for domestic machinery against the background of growing export earnings and expansion of import of machinery and equipment. In addition, the growth in purchases of machinery and equipment was restricted substantially by inadequate competitive capacity of many machine building enterprises. Import of machinery and equipment increased by 20,3%, and the share of imported equipment in the structure of investments in machinery and equipment was nearly  $\frac{1}{4}$ , as compared to the period between January – November 2002. Maintaining a fairly high growth rate in machinery and equipment in 2003 was mainly due to an expanded demand for the products of railway machine building industry, instrument-making industry, and communication industry. A sustained growing demand for the equipment of consumers' sector industries has been maintained over the last four years.

*Table 7*

**Industrial Dynamics by Machine Building Industry  
in 1998 – 2003, as % against previous year**

	1998	1999	2000	2001	2002	2003
Total industry	94,8	108,1	109,0	104,9	103,7	107,1
Machine building industry	92,5	115,9	115,5	107,2	102,0	109,4
of which						
railway machine building industry	87	108,9	107,4	126,0	121,7	135,8
metallurgic machine building industry	70,6	91,8	130,2	86,1	82,6	94,0
Electrical engineering industry	85,7	127,0	130,1	112,6	93,8	105,5
Chemical and oil machine building industry	96,1	120,7	119,5	121,6	96	93,0
Machine-building and tool-making industry	82,3	99,6	111,5	99,4	81,7	100,5
Instrument-making industry	103,4	140,8	118,4	98,0	90,9	144,8
Automobile industry	88,5	114,7	103,3	101,7	97,8	106,0
Communication industry	93,7	95,7	330,0	90,0	174,6	118,0
Tractor and agricultural machine building industry	70,7	159,3	148,4	129,1	77,6	76,4
Machine building industry for light industry, food-processing industry and household appliances industry	90,6	115,8	109,5	107,1	115,9	106,6

*Source:* the Russian State Statistics Committee (Goskomstat).

The situation in the investment machine building's industries is the key technological factor restricting solution of topical problems related to reconstruction and modernization of production on a new technological basis – the out-of-date structure of the machine building industry can only reproduce overage reproduction proportions. A long-term tendency for decline in production of the machine tool industry provides an example of slow rates of replacement of fixed assets inside the machine building industry. Though over the period between 1999 and 2003 the investment growth in the machine building industry accounted for nearly 40% against 1998, this had no significant effect on technical and economic characteristics of capital assets of the industry. Depreciation exceeded the average industrial level by more than 2 percentage points, with the average replacement rate of fixed assets in the industry being 0,8% over the last three years. The lack of skilled personnel is a special feature of the industry. The raise in wages from 75,7% of the average in the industry in 1999 to 82,7% in 2003 had no effect on attractiveness of the industry in the labor market. Outstripping growth rate of wages against labor productivity increased the share of wages in the production costs structure from 15,3% in 2000 to 18,8% in 2002 and 20,1% in 2003. This resulted in decrease in level of profitability from 14,0% in 2000 to 9,8% in 2003.

Dynamics of the building materials industry correlate closely with the volume of works in the construction industry. Recovery in positive dynamics of residential construction was a positive factor for increased volume of production in the industry since 2001. Over the period between 2001 and 2003, new dwelling housing spaces increased nearly by 20%. In 2003, the increment of output of building materials accounted for 6,4% with increasing production in the construction industry by 14,4% as opposed to the previous year. The growth in the cement industry to 8,7% was accompanied by a tendency for increasing role of energy-efficient technologies. Intensive growth in production of building ceramics ( 122,9% by 2002 ) and building materials of polymer raw materials ( 118,5% ) was in many ways due to modernization and reconstruction of production: over the period between 1999 and 2003, the volume of investments in building materials industry doubled as against 1998, the coefficient of renewal of machinery and equipment increased from 1,2% in 1999 to 2,1% in 2003. The share of tangible costs in the total production costs decreased nearly by 1,7 percentage points, which encouraged an increase in production profitability. Changes in technical and technological provision of the production was accompanied by increase in labor productivity and restructuring of employment.

#### Export-oriented Industries

Export-oriented industries made the biggest contribution to the total increase in production in 2003. Consequently, the effect of processing industry on general dynamics decreased. In 2001 nearly  $\frac{1}{3}$  of the industrial output growth was related to expansion of extractive industries, while in 2002 – 2003 the contribution of fuel and metallurgical industries accounts for more than  $\frac{1}{2}$  of industrial output increment. With increasing industrial output by 7,0% as opposed to 2002, the export-oriented sector gained nearly 7,7% in production, which exceeded nearly by 2,2 percentage points the level of the previous year. As compared to the period between January and November 2002, the amount of consolidated revenues in the export-oriented industries increased by 13,3% with this parameter grown by 10,0% in the industry as a whole.

B metallurgical sector in 2003 nonferrous industry lost its dominant impact on growth rate movement. Production gains in the nonferrous metallurgy accounted for 6,2% in 2003. As compared to 2002, the growth rate in aluminum industry increased by 2,9 percentage points and accounted for 103,9%, and by 105,3% in the nickel-cobalt production industry, which compensated in full the downturn of the previous year. High growth rates were maintained by purchasing of nickel raw materials abroad, which increased by 4,6 times. The general downturn in growth rates of the industry was caused by changes in the demand for basic exported goods. At the end of three quarters in 2003, export gains were noted only in raw aluminum (10,6%). At the same time, given a favorable price movement of nonferrous metals, manufacturers intended to maintain stability in the traditionally flexible and cyclic nonferrous metals market, rather than increase the supply.

Ferrous industry gained the leadership in the sector with growth rates being at the level of 108,9% as against the previous year. The production growth rates in the ferrous metallurgy was supported by simultaneous growth of internal and external demand. The demand for construction materials increased with investment growth in the national economy. Sales of rolled ferrous metals in the internal market increased by 17,9% in 2003 as against 7,0% in 2002. Favorable changes in business environment and positive price movement in the global market



encouraged an additional growth in metallurgy and other industries manufacturing industrial goods. Export of ferrous metals grew by 25,6% as opposed to January – November 2002, and that of ferrous alloys grew by 34,7%. Consolidated revenues in the ferrous metallurgy increased by 3,4 times at the end of the three quarters in 2003.

### *The Oil and Gas Sector*

The oil and gas sector is a basic sector of Russia's economy and contributes considerably to the federal budget and the country's positive balance of payment. In 2003, the price situation in the world market for oil had a major impact on the state of Russia's oil and gas sector. As over 65% of the national oil output is exported as a crude oil or in the form of oil products, while domestic sales imply the price level being substantially lower than the international one, the latter de-facto forms the major factor that determines revenues to, and financial state of the national oil sector. Because of the fall in the Iraqi oil output in the aftermath of the US-led military operation to topple Saddam Hussein and cuts in OPEC members' oil output, in 2003 international oil prices sky-rocketed, and during the year the average price for the OPECF oil basket mostly had been overshooting the Organization's price target range of USD 22-28/ barrel, and by the results of the year it averaged USD 28.13/barrel. During the period in question the Russian Urals international (European) prices averaged USD 27.04/barrel (*Table 8*). At its 2003 (September) conference, OPEC ruled to cut down the oil output by its members by 900,000 barrels a day effective as of November 1, 2003, and that has had a considerable impact on the rise in international oil prices in the 4<sup>th</sup> quarter 2003.

*Table 8*

**International Oil Prices in 1997-2003, USD/Barrel**

	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Prices for Brent, UK	19,12	12,72	17,97	28,50	24,44	25,02
Prices for Urals, Russia	18,33	11,83	17,30	26,63	22,97	23,73
Price for the OPEC oil basket	18,68	12,28	17,47	27,60	23,12	24,34
	<b>2002 4<sup>th</sup> Q.</b>	<b>2003 1<sup>st</sup> Q.</b>	<b>2003 2<sup>nd</sup> Q.</b>	<b>2003 3<sup>rd</sup> Q.</b>	<b>2003 4<sup>th</sup> Q.</b>	<b>2003</b>
Prices for Brent, UK	26,81	31,49	26,03	28,38	29,43	28,83
Prices for Urals, Russia	25,55	29,24	23,86	27,05	27,99	27,04
Price for the OPEC oil basket	26,63	30,45	25,87	27,43	28,79	28,13

*Source:* OECD International Energy Agency.

The development of Russia's oil and gas sector in 2003 retained the trend to the rise in oil and oil products output that had emerged between 2002-03. In 2003, the oil production, including that of gas condensate, for the first time exceeded the 1992 level and reached 421 mn.t. The increment in oil output in 2003 vs. the prior year accounted for 11.1% (a record-breaking level ever noted through the whole period of reforms), while the increment in the volume of primary refining made up 2.7%. The rise in the natural gas output that first started in 2002 continued in 2003, and it ultimately accounted for 3.4% (*Table 9*). In parallel with that, investment activity grew slightly, too, especially in the gas sector: the volume of operational oil drilling in 2003 grew by 2.7% vs. the prior year, while the one for gas – by 58.6%. At the same time, due to the fall in the volume of drilling in 2002, the placement of new oil wells into operation dropped by 5.0%, coupled with the fall in the volume of oil prospecting



drilling (by 10.7% as compared with the prior year), which can be explained by a high sufficiency of the existing reserves. By contrast, the gas prospecting drilling was growing (by 31.2% vs. the prior year). In the oil refinery sector, the output of petroleum derivatives with the use of intense technologies soared by 13.1%, while the intensity of crude oil refinery grew from 69.6% in 2002 up to 70.3% in 2003. The share of high-octane gas in the overall output of automobile gas grew from 49.4% in 2002 up to 52.0% in 2003.

*Table 9*

**Production of Oil, Petroleum Derivatives and Natural Gas, as % to the Prior Year**

	1999	2000	2001	2002	2003
Oil and gas condensate	100,5	106,0	107,7	109,0	111,0
Oil	100,3	105,9	107,7	108,7	111,1
Gas condensate	104,7	103,8	106,7	112,8	108,7
Primary oil refining	102,9	102,7	103,2	103,3	102,7
Automobile gas	102,2	103,6	100,6	104,9	101,2
Diesel fuel	104,2	104,9	102,0	104,7	102,0
Mazut	94,8	98,3	104,2	107,1	100,3
Natural gas	99,7	98,5	99,2	101,9	103,4
Oil gas	103,2	102,5	105,0	110,5	119,3

*Source:* Goskomstat of Russia, the RF Ministry of Energy.

The leaders in oil production in 2003 were: YUKOS ( 80.75 mn.t.), LUKoil (78.91 mn.t.), Surgutneftegas (54.03 mn.t.), TNK (42.96 mn.t.) and Sibneft (31.39 mn.t.). It should be noted that in 2003 YUKOS for the first time ever overran the leader, that is, LUKoil. YUKOS also demonstrated the highest oil production rate (15.5% vs. its respective index of 2002), followed by Sibneft (19.2%). A notable rise in Rosneft's oil output was propelled by the contribution of recently acquired 'Severnaya neft'. At the same time, as they operate largely on old oil fields, Tatneft and Bashneft's annual increment in output accounted for less than 1%, which resulted in their lower proportion on the market (*Table 10*). Finally, the operators of projects basing on production-sharing agreements produced 2.1 mn.t. of oil, or a meager 0.5% of Russia's total output.

LUKoil, though, retained the first position as a major producer of petroleum derivatives in the country (18.0% of the total amount of oil refinery), followed by YUKOS (16.3%), TNK (8.3), Surgutneftegas (8.1), and Sibneft (7.3%).

With its share in the 2003 gas output amounting to 84.9% (according to the RF Ministry of Energy), Gasprom traditionally dominated the gas production area. At the same time, the national oil companies have been vigorously boosting their gas output (by 16.2% vs. 2002, given the 3.6% average increment across the sector). However, the proportion of oil companies in the total gas output has remained relatively low, with Surgutneftegas and Rosneft beating the others with 2.2% and 1.2% of Russia's total gas output, respectively.



Table 10

**The Structure of Oil and Gas Output in 2003**

	Oil output, mn. t.	The share in the total output, as %	Gas output, c.m. bn.	The share in the total output, as %
YUKOS	80,75	19,2	3,45	0,6
LUKoil	78,91	18,7	4,70	0,8
Surgutneftegas	54,03	12,8	13,88	2,2
TNK	42,96	10,2	4,97	0,8
Sibneft	31,39	7,4	1,99	0,3
Tatneft	24,67	5,9	0,73	0,1
Rosneft	19,57	4,6	7,02	1,2
SIDANCO	18,61	4,4	1,84	0,4
Slavneft	18,10	4,3	0,82	0,1
Bashneft	12,05	2,9	0,37	0,1
Gasprom	11,02	2,6	540,17	84,9

Source: the RF Ministry of Energy

The year of 2003 witnessed a notable price rise for oil and oil products in the domestic market. That to a significant extent can be explained by the extension of oil export capacities (chiefly thanks to the extension of the Baltic pipeline system). In December 2003 the average domestic price for oil (producer price) reached, in the USD equivalent, 70.1/t., while the automobile gas price averaged USD 236.9/t., which appeared record-breaking values through the reform period. At the same time, there has been a considerable gap between domestic and international oil prices: in 2003 the respective correlation did not exceed 45-50%. After approaching the pre-depreciation level, the gas prices consequently fell notably (Table 11).

Table 11

**The Domestic Prices for Oil, Oil Products and Natural Gas in the USD Equivalent between 1997 through 2003 (Enterprises' Averaged Wholesale Prices), USD/t.**

	1997 December	1998 December	1999 December	2000 December	2001 December
Oil	63,1	16,4	37,0	54,9	49,9
Automobile gas	169,6	63,4	171,9	199,3	151,5
Diesel fuel	170,0	52,9	125,0	185,0	158,5
Mazut	73,8	22,0	46,1	79,7	47,1
Gas, USD/c.m.thos.	6,6	2,1	2,2	3,1	4,8
	2002 December	2003 March	2003 June	2003 September	2003 December
Oil	60,7	54,3	53,8	67,5	70,1
Automobile gas	168,8	192,4	191,9	223,6	236,9
Diesel fuel	153,8	201,9	182,2	205,5	214,3
Mazut	66,1	78,2	59,9	90,4	66,0
Gas, USD/c.m.thos.	5,9	6,2	6,2	6,1	4,4

Source: computed basing on the data of Goskomstat of Russia.

Between January through October 2003 vs. the respective period of the prior year oil exports grew by 17.9%, while that of petroleum derivatives – by 1.9% (Table 12). In the period in question the proportion of export supplies in the commodity resources of diesel fuel accounted for 56.5%, mazut – 56.3%, automobile gas – 13.7% (for reference, in 1999 the share of export supplies in the automobile gas output accounted just for 7.2%). High international prices for oil boosted oil export revenues. In value equivalent, the oil exports during the period in question grew by 34.4% vs. the respective period of the prior year, which proved to be

nearly twice as high vs. the rise in the physical volume of oil exportation. The aggregate value of oil and main oil products export over the period concerned amounted to USD 41.97 bn., or at 34% more than in the respective period of the prior year.

The domestic price rise for oil products and the real appreciation of the Rb. fueled the rise in importation of oil products. More specifically, the import supplies of automobile gas grew at 69.0% over the period in question vs. the respective period of 2002.

When compared with the prior year, the export growth rate of gas dropped notably, which was caused by a low effective demand on the part of the CIS countries (gas supplies to those countries fell by 8.7% over the period in question).

*Table 12*

**Export of Oil, Oil Products and Natural Gas from Russia,  
as % to the Respective Period of the Prior Year**

	2002 January-October	2003 January-October
Oil, total	112,8	117,9
Including:		
To the non-CIS countries	108,2	118,6
To the CIS countries	141,5	114,4
Oil products, total	117,0	101,9
Including:		
To the non-CIS countries	117,6	101,3
To the CIS countries	100,9	119,0
Gas, total	104,1	102,1

*Source:* Goskomstat of Russia

The evaluation of the data on the production and export of oil and petroleum derivatives (*Table 13*) shows that most (nearly 85%) of extra oil output was exported (either directly, or in the form of petroleum derivatives). The 2003 net export of oil and oil products reached 291.0 mn.t., i.e grew by 34.9 mn.t. vs. the prior year (including by 33.5 mn. t. falling on the growth in the export of oil and 1.4 mn. t. – on the export of oil products). In other words, as in 2000-2002, it was again the rise in exportation in 2003 that propelled a considerable growth in oil output. As a result, the proportional weight of net export of oil and oil products in the oil output reached 69.1%, with the net oil export exceeding 50% of its output. Similarly, the rise in demand for gas in the domestic and external markets in 2003 boosted the natural gas output notably, with the proportional weight of next export in gas production accounting for 29.4%

The aggregate export volume of oil and oil products grew from 262.5 mn.t. in 2002 up to 297.4 mn.t. in 2003, or by 13.3%. Crude oil supplies still dominated the structure of oil export and accounted for nearly three-fourth of the overall export of oil and oil products. As concerns export supplies of the latter, the major part fell on diesel fuel and mazut. Export supplies of natural gas grew by 2.1%. The main part of energy sources (83% of oil, 96% of oil products and 75% of gas) was exported to countries other than the CIS.

As the analysis of the Russian oil export dynamics over a long period of time shows, the 2003 aggregate net export of oil and oil products for the second time in line already bet its 1990 level (246.3 mn.t.) and nearly hit the 1998 level with record-breaking 291.6 mn. t. output. At the same time, the oil exports witnessed a substantial rise in the share of exported oil products that has grown steadily since 1996. As a result, the proportional weight in the oil-



refinery produce in the total oil export grew from 18.2% in 1990 up to 26.2% in 2003 (*Table 14*). A sharp decline in the domestic oil consumption (according our computations, it plunged from 269.9 mn. t. in 1990 to 130.0 mn.t. in 2003, i.e. more than twice), the proportional weight of exported oil and oil products in oil output grew from 47.7 up to 69.1% over the period in question. By contrast to export of oil and petroleum derivatives, net gas export has lately failed to exceed the level noted over the late 1990s, and it proved to be close to the one of the early 1990s, though the proportional weight of net gas export in its output remained slightly over the pre- reform period (29.4% in 2003 vs. 28% in 1990).

*Table 13*

**The Correlation between Production, Consumption and Export of Energy Sources in 1997-2003**

	1997	1998	1999	2000	2001	2002	2003 (estimated)
<b>Oil, mn. t.</b>							
Output	305,6	303,4	305,0	323,2	348,1	379,6	421,0
Export, total	126,9	137,1	134,5	144,5	159,7	187,5	221,0
Export to the non-CIS countries	109,8	117,9	115,7	127,6	137,1	154,8	183,6
Export to the CIS countries	17,1	19,2	18,8	16,9	22,7	32,7	37,4
Net export	119,0	129,2	128,5	138,7	154,7	181,3	214,8
Domestic consumption	132,2	125,1	120,5	123,0	122,9	123,5	130,0
Net export as % to output	38,8	42,4	42,1	42,9	44,4	47,8	51,0
<b>Petroleum derivatives, mn.t.</b>							
Export, total	60,6	53,8	56,9	61,9	70,8	75,0	76,4
Export to the non-CIS countries	58,4	51,2	53,9	58,4	68,3	72,5	73,4
Export to the CIS countries	2,2	2,6	3,0	3,5	2,5	2,6	3,0
Net export	56,6	51,0	50,3	61,5	70,5	74,8	76,2
<b>Oil and petroleum derivatives, mn.t.</b>							
Net export of oil and petroleum derivatives	173,4	178,3	184,5	200,2	225,2	256,1	291,0
Net export of oil and petroleum derivatives as % to oil output	56,7	58,8	60,5	61,9	64,7	67,5	69,1
<b>Natural gas, c.m. bn.</b>							
Output	571,1	591,0	590,7	584,2	581,5	594,5	620,0
Export, total	200,9	200,6	205,4	193,8	180,9	185,5	189,4
Export to the non-CIS countries	120,9	125,0	131,1	133,8	131,9	134,2	142,6
Export to the CIS countries	80,0	75,6	74,3	60,0	48,9	51,3	46,8
Net export	196,4	197,6	201,3	189,7	176,8	178,3	182,2
Domestic consumption	374,7	393,4	389,4	394,5	404,7	416,2	437,8
Net export as % to output	34,4	33,4	34,1	32,5	30,4	30,0	29,4
<b>Overall indicators</b>							
Oil and gas output, as mn. t. of oil equivalent	819,6	835,3	836,6	849,0	871,5	914,7	979,0
Net export of oil, oil products and gas, as mn. t. of oil equivalent	350,2	356,1	365,7	370,9	384,3	416,6	473,2
Domestic consumption of oil and gas, as mn. t. of oil equivalent	469,4	479,2	470,9	478,1	487,2	498,1	505,8
Net export of oil, oil products and gas as % to oil and gas output	42,7	42,6	43,7	43,7	44,1	45,5	48,3

*Source:* Goskosmstat of Russia, the RF Ministry of Energy, the State Customs Committee of RF, the author's computations.

*Table 14*

**Structure of net Export of Oil and Oil products**

	1990		2002		2003 (estimated)	
	Mn. t.	%	Mn. t.	%	Mn. t.	%
Oil and oil products	246,3	100,0	256,1	100,0	291,0	100,0
Oil	201,5	81,8	181,3	70,8	214,8	73,8
Oil products	44,8	18,2	74,8	29,2	76,2	26,2

*Source:* Goskomstat of Russia, the RF State Customs Committee, the OECD International Energy Agency, author's computations.

The 2003 aggregate net export of oil, oil products and natural gas for the first time over the recent period of time has exceeded the respective levels noted both in 1990 and 1988. We estimate it rose from 407.6 mn. t. of oil equivalent in 1990 up to 473,2 mn. t. in 2003, or by 16.1%. At the same time, the proportional weight of net export in the aggregate oil and gas output grew from 37.3% up to 48.3%. The above testifies to an intensification of the focus on export in the sector vs. the pre-reform period. However, it should be noted that such a rise is associated both with the growth in absolute export volumes and with a reduction in the production of carbohydrates generated by their lowering domestic consumption and the fall in their supplies to the Near- Abroad countries.

The high level of international oil prices in 2003 ensured the maintenance of a fairly high revenue inflow into the Russian oil sector. Between January through October 2003 the aggregate revenues from export of oil and oil products accounted for USD 41.97 bn., while the aggregate profit (balanced financial results) of the sector, including the oil-producing and oil-refining sectors, accounted for USD 4.91 bn. over the period in question. More specifically, the profit of the oil sector alone accounted for 34% of the overall profit of the national industrial sector as a whole and 15.5% of the profit earned by the national economy as a whole (the respective indices made up 39.4 and 20.7% in 2001, and 31.3 and 15.0% in 2002, respectively). The fall in the oil sector's profit in 2002 vs. 2001 when the international oil prices had stood lower to a significant extent can be attributed to the introduction of the 2002 mineral tax. As concerns oil, the tax was collected at a rate higher than those of earlier collected levies (the subsoil user tax, contributions to the mineral base reproduction and oil excise), coupled with fairly high export duties rates and rising production costs.

*Table 15*

**Financial Performance Indicators in the Oil Sector between 1997-2003, USD Bn.**

	1997	1998	1999	2000	2001	2002	2003*
Export receipts from oil and main kinds of oil products	21,09	13,96	18,82	34,89	33,43	38,72	41,97
Profit (balance-sheet financial result)	3,52	0,60	6,32	10,42	8,14	4,32	4,91
Accounts payable (as of the end of the year)	6,79	2,41	1,61	1,35	1,01	0,90	0,98
Including:							
to suppliers	2,38	0,94	0,72	0,55	0,52	0,59	0,69
to the budget	2,53	0,66	0,43	0,27	0,15	0,10	0,08

\*As concerns oil and oil products export gains, the data are provided for the period between January through October, profits – between January through September, accounts payable – as of late September.

*Source:* computed upon the Goskosmnat data.

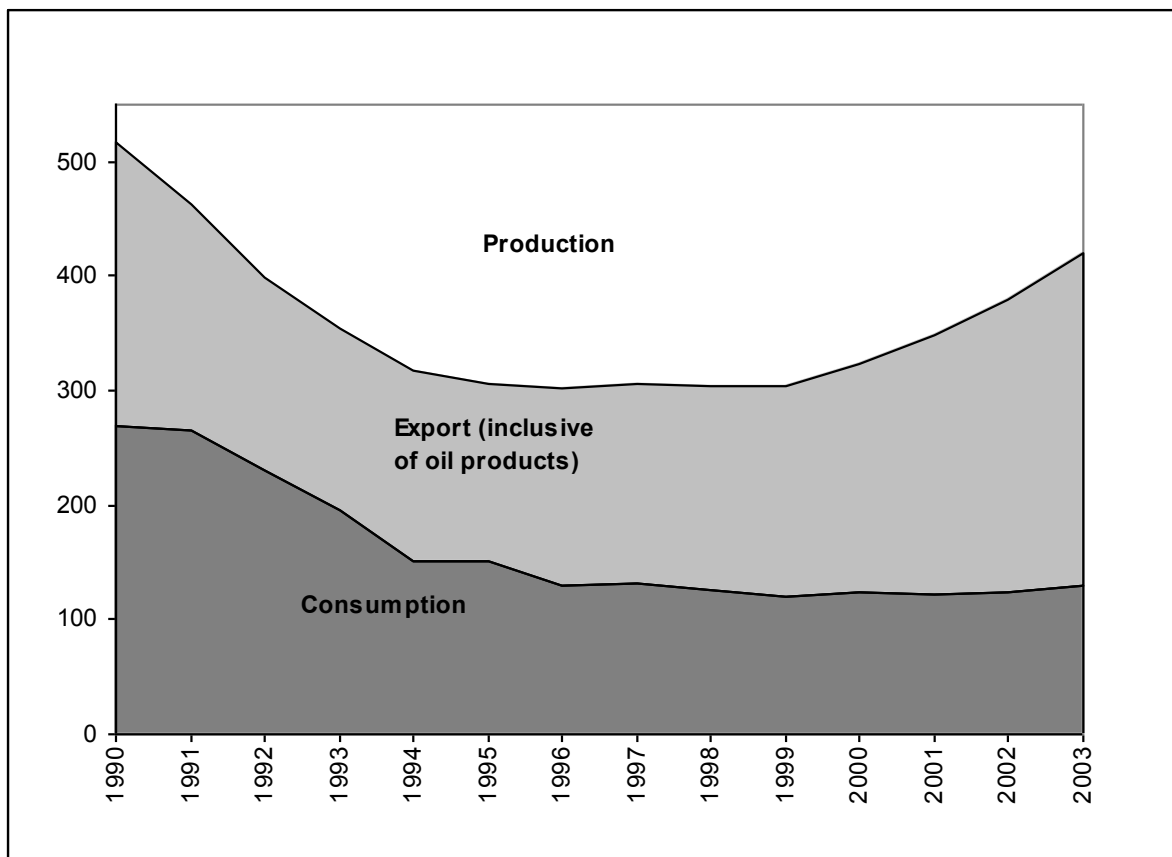


Overall, revenues the oil sector accumulated over the period in question ensured a high level of tax revenues to the state budget and enabled Russian oil companies to stabilize their accounts payable to suppliers and to reduce their debts before the budget. By late September 2003 payments due by the oil sector to the budgets of all levels in the USD equivalent slid to the minimum level reported lately, that is, USD 0.8 bn. (*Table 9*).

Changes in major indicators of the oil sector's development (output, domestic and overseas sales, prices, investment activity, and the state of payments and settlements) are presented on *Fig. 9–16*.

*Fig. 9*

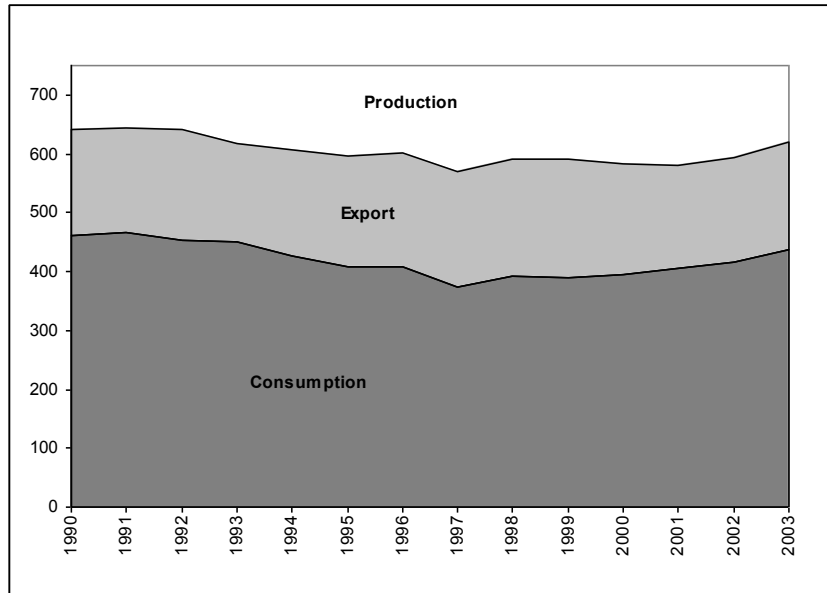
**Production, Consumption and Export of Oil in 1990-2003, mn .t.**



*Source:* Goskomstat of Russia, the RF Ministry of Energy, the RF State Customs Committee, author's computations.

*Fig.10*

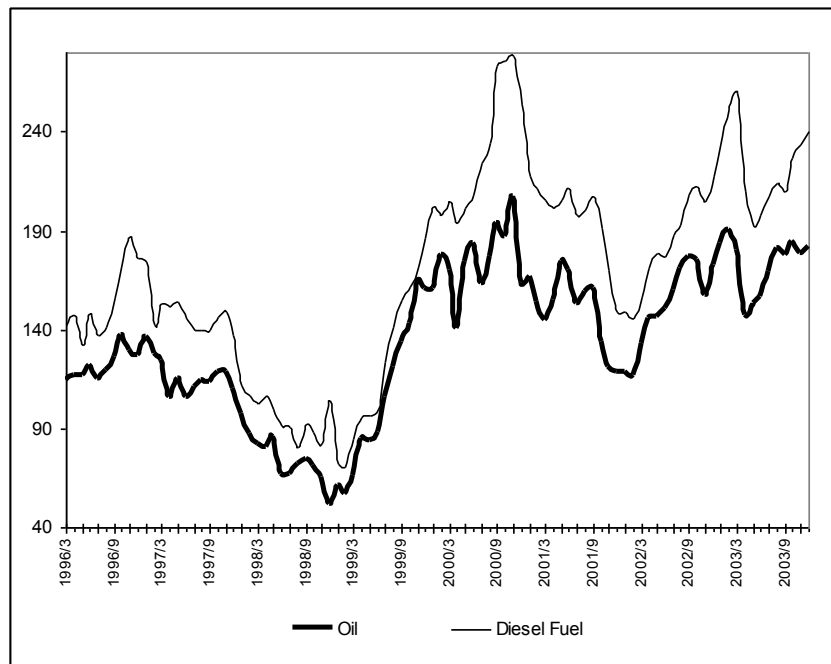
**Production, Consumption and Export of Natural Gas in 1990-2003, c. m. bn.**



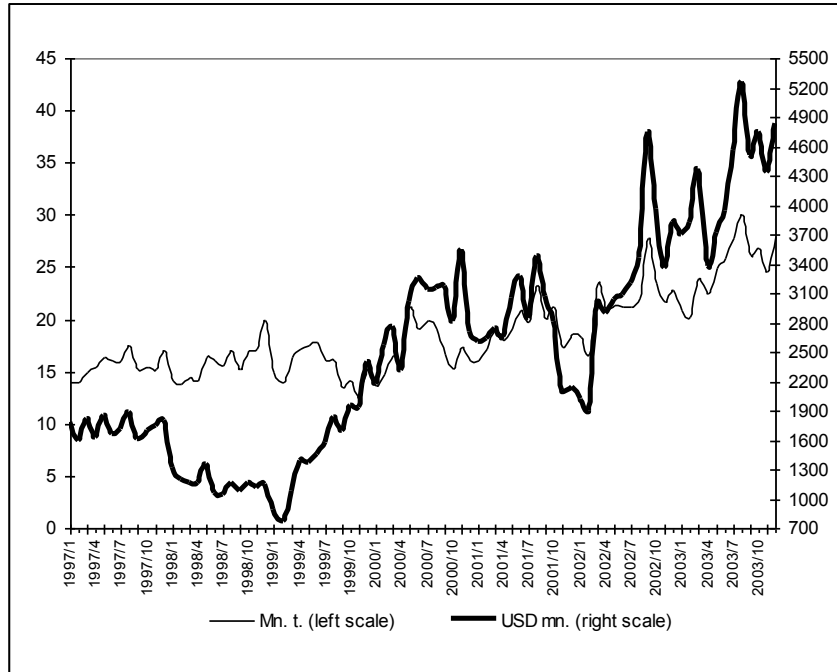
Source: Goskomstat of Russia, the RF Ministry of Energy, the RF State Customs Committee, author's computations.

*Fig.11*

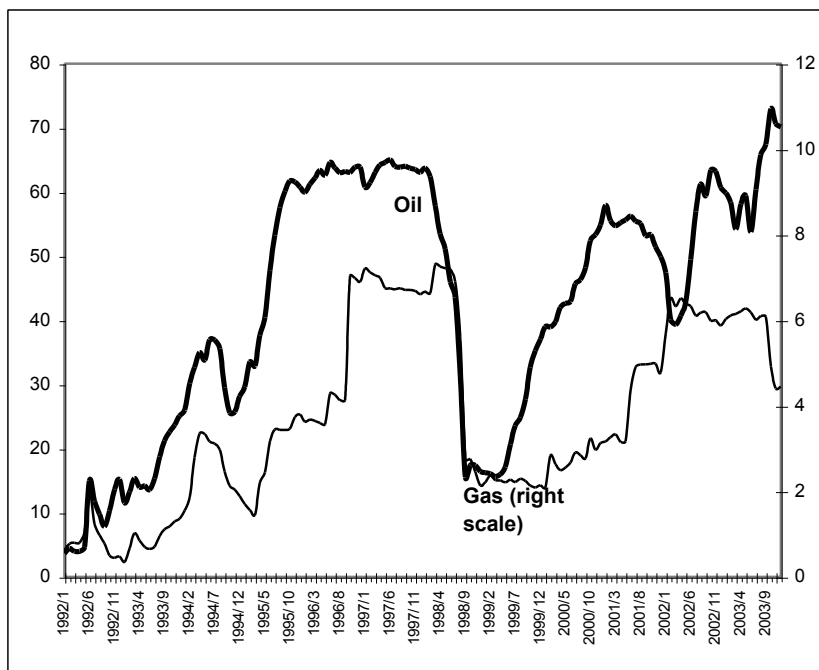
**The Averaged Export Prices for Oil and Diesel Fuel in 1996-2003, USD/t.**



Source: computed basing on Goskomstat of Russia's data.

*Fig. 12***Export of Oil and Oil Products in Natural and Value Equivalent  
between 1997-2003, as mn. t., USD mn.**

Source: computed basing on Goskomstat of Russia's data.

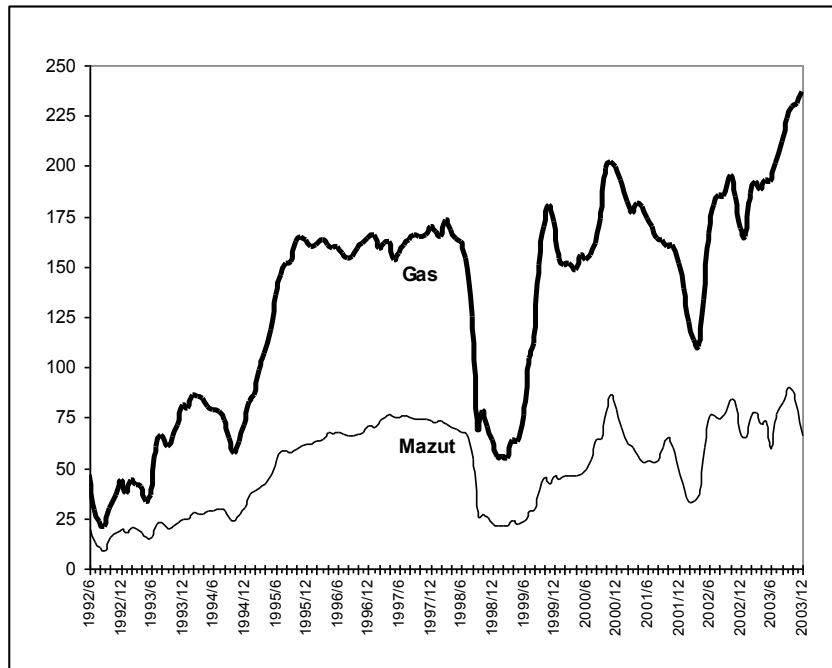
*Fig. 13***The Enterprises' Averaged Prices for Oil and Gas in the USD Equivalent between  
1992 through 2003, USD/t., USD/Thos. C.m.**

Source: computed basing on Goskomstat of Russia's data.



*Fig. 14*

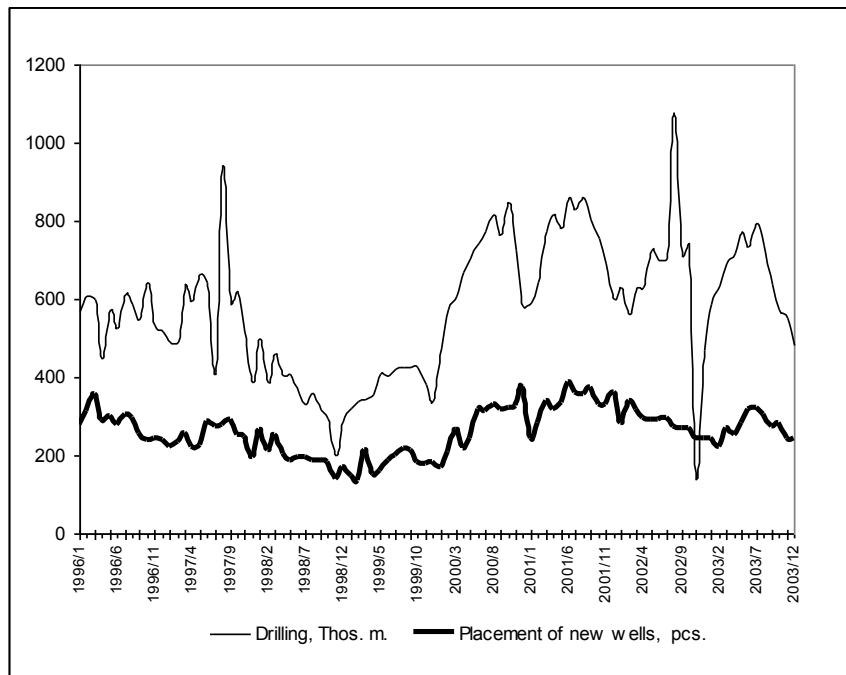
**The Enterprises' Averaged Prices for Automobile Gas and Mazut in the USD Equivalent in 1992 through 2003, as USD/t.**



Source: computed basing on Goskomstat of Russia's data.

*Fig. 15*

**Operational Oil Drilling and Placement of new Wells into Operation in 1996- 2003**

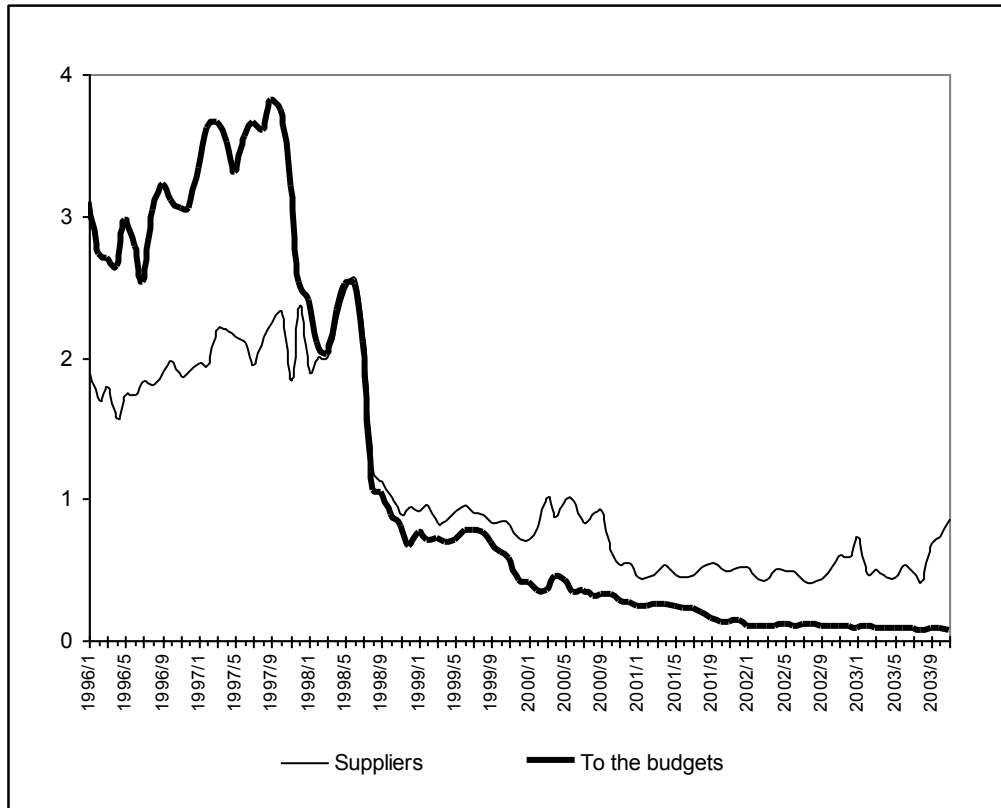


Source: Goskomstat of Russia.



*Fig. 16*

**Outstanding Accounts Payable by the Oil Sector to Suppliers  
and Budgets of All Levels in 1996-2003, as USD bn.**



Source: computed basing on Goskomstat of Russia's data.

## 3.2. The Situation in the Industrial Sector<sup>1</sup>

### 3.2.1. Dynamics of Demand for Industrial Produce

The last months of 2002 appeared a hard time for the national industrial sector. Similar to November 2001, the rise in effective demand discontinued completely over the period in question. In December the decline rates of cash sales grew from  $-4\%$  up to  $-15\%$  (according to the respective balance) thus exceeding the respective indices reported in December 2001. Effective demand continued to fall in January 2003. As a result, between the last quarter 2002 through January 2003 sales change rates dropped from  $+15\%$  to  $-22\%$  (as per the balance), with the former value appearing the best for the whole 2001—02 period, while the latter – the worst one over the whole post-default period. So the 2003 January decline in sales also proved to be more intense than the one of 2002. The volumes of non-cash deals continued to shrink in early 2003, too. The balance of changes in barter deals plunged to  $-15\%$ , while that involving promissory notes and offsets fell to  $-14\%$ . The effective demand decline rates ( $-22\%$ ) proved to be highest vs. other kinds of demand. An absolute rise in the volumes (i. e. a positive balance) of deals involving promissory notes and offsets was registered only in the electricity sector ( $+9\%$ ).

But the acceleration of the effective demand decline rates did not result in a fundamental change in assessment of its volume. Slightly over 30 % of enterprises still considered the existing assessments of its volumes as normal. Between August through September 2002 the respective rate was a. 40 %. By contrast, the situation with the assessments of barter, promissory note and offsets demand is different. Unsatisfactory assessments of these particular kinds of demand have begun to dominate the industrial sector: enterprises started to experience shortage of non-monetary deals to secure sales of their whole produce. The shortage became record-breaking by early 2003. The balance of assessments ('above-below norm') fell to  $-8\%$ , and that with respect to promissory notes and offsets – to  $-10\%$ . The Russian industrial sector reported a maximum prevalence of enterprises that considered volumes of non-monetary deals as insufficient.

The period of early 2003 raised pessimistic sentiments.

But the situation began to improve in February. The rise in sales for cash was registered in all the sectors but the light, food-processing, electricity, and building industry. Clearly, as concerns the last two sectors, the decline was propelled by seasonality. That gave certain grounds to enterprises to hope there would be no repetition of the situation noted in early 2002, and forecasts of effective demand consequently immediately grew by 16 p. p. Such optimistic expectations were never registered prior to and after February 2003, and the following months proved the forecasts.

The situation in the industrial sector continued to improve in March. The industrial optimism index IET computes basing on the adjusted European methodology grew at 14 points between February through March and reached values that have not been registered since October 2001 (*Fig.17*).

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<sup>1</sup> This section is based upon the ET business surveys on heads of industrial enterprises. The IET has conducted such surveys monthly since October 1992. The surveys are nationwide. The size of the survey panel is a. 1,200 companies that employ some 20% of industrial employees. The panel is lifted towards large enterprises in each of 61 sub-sectors. The questionnaire return rate is a. 70%.



Fig.17



It is changes in effective demand that contributed most greatly to the rise in the index. As enterprises themselves assessed the situation, the intensity of the rise in cash sales grew by 42 balance points since early 2002 (without regard to seasonality adjustment). Given that in January the monetary demand was falling fairly intensively (with the respective balance accounting for -24 %), sales demonstrated nearly the equal rise in March (+18 %). Such high rates have not been registered since October 2000. The rising demand was reported by all the industry branches, except the electricity sector (due to seasonality factor). However, the balance of forecasts of demand dropped by 5 points in March, for enterprises had quite rationally revised their expectations on the threshold of the national holidays in May. The adjusted forecasts began to come true already in April, when the industrial sector began to lose its momentum. In April, the industrial optimism index lost all the achievements of the prior two months. The decline was propelled by all three components of this aggregate index, namely, the actual change in effective demand, assessments of finished products in stock, and expected changes in output. The intensity of the change in effective demand plunged by 10 balance points over the month, while the forecasts of the change in demand lost at once 17 points. But the positive balance was retained, as enterprises basically maintained hopes for a rise in cash sales even during the idle May. And indeed, they managed to avoid a fall in sales in May, but growth rates fell nearly to zero level. The deceleration of growth was noted in all the industries, but metallurgy and the food-processing sector. The negative sales dynamics did not affect assessments of their volume, though. The share of responses 'normal' grew by 4 points between April through May and reached 41 %. Similarly, the balance of forecasts of effective demand improved in May and showed the 9 % rise across the industrial sector on the whole.

The enterprises' forecasts justified already in June: the cash sales growth rate began to renew, the balance of the change in effective demand became positive and significantly differing from zero. Such a change in the sales dynamics proved to be sufficient to ensure improvement of assessments of their volume on the 'above-below norm' scale. The balance of assessments grew up to -50 %, which proved to be the best value over the past decade. The June survey also registered a rising proportion of assessments 'normal' up to 46 %, which has

also become the best value since 1993. In parallel with that, the balances of assessments of volumes of non-monetary kinds of demand remained negative since early 2002, which proved the enterprises' eagerness to increase volumes of such deals. The June forecasts of changes in effective demand soared by another 5 balance points, while their rise between May through June accounted for 13 points. All the industries but the electricity sector (due to seasonality) reported prevalence of hopes for a rise in their sales.

The second half-year showed the further strengthening of positive trends in dynamics of the demand for industrial produce. The sales growth rate rose by another few points. In July, the balance of assessments of the volume of demand ('above-below norm') improved at once by 12 points. The proportion of enterprises that considered the volume of effective demand for their output normal grew up to 51 %, which became a peak value for all the surveys (since March 1992).

The August survey registered both an acceleration of growth rate of the effective demand and output, and the industrial enterprises' rising optimism in their forecasts. As a result, the industrial optimism index reached the best values over the 2001-03 period. In August, the growth rate of cash sales of industrial products grew at once by 5 balance points and reached their maximum for the past 34 months. There was no such rise in sales since October 2000. This particular phenomenon was registered in all the industries, except for the ferrous metallurgy and forestry. That generated improvement of assessments of sales volumes, with already 52 % of enterprises assessing them as 'normal' (the 12 p. p. rise over the past three months). The metallurgical enterprises seemed most enthusiastic in this respect (90 %), followed by chemical, petrochemical and building companies (70 %), and representatives of the light industry (60 %).

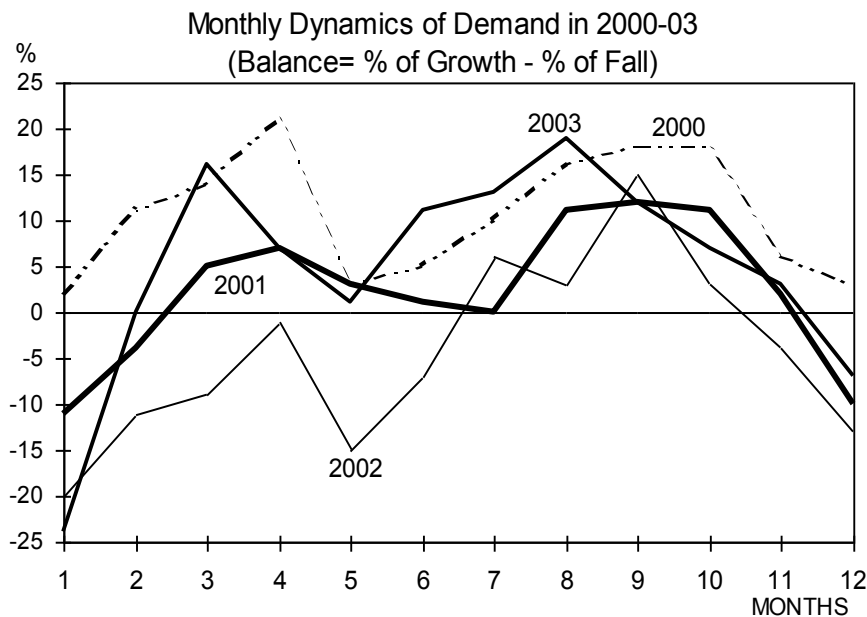
In autumn the national industrial sector once again faced sales challenges. The September survey registered declining rates of sales, stabilization of the rise in output and lowering forecasts of changes in these indices. The rise in optimism registered in the industrial sector since April no longer was in place. The intensity of the growth in effective demand dropped by 7 points over the month. The balance of assessments of demand on the 'above-below norm' scale roved to be unchanged vs. August, which can also be assessed as a negative factor. This particular index had risen from -65 % up to -39 % over the over the prior 8 months with a sole stop in May. Nevertheless, the proportion of 'normal' assessments anyway grew in September and reached 56 %, which became an absolute maximum. The forecasts of the change in effective demand lost 12 points in September. Only 21 % of companies hoped to boost their sales volumes in late 2003 vs. 36 % reported earlier that year. The negative trends in the dynamics of major indicators of the national industrial sector continued to aggravate in the beginning of the 4<sup>th</sup> quarter 2003. The effective demand growth rates fell by another 5 points, and the aggregate decline in this particular index accounted for 12 p. p. between September through October. All the industries but electricity (seasonality) and the food-processing sector experienced reduction in sales growth rates. The sectors for construction, chemicals and petrochemicals faced an absolute decline in demand, with the proportion of companies that reported contraction in sales exceeding the one of enterprises that increased the respective volumes. In the other sectors balances remained positive. As a result, the balance of the indicator became negative. However, the autumn slowdown in the sales growth rates did not seriously concern enterprises. In these particular sectors, the proportion of the demand assessments as normal still was over 50 %. For the first time (over the whole period



of conducting the surveys) that was registered in July 2003, and since then most of enterprises seemed to be satisfied with volumes of effective demand for their output. The respective results over that period proved to be highest in the metallurgical sector (84 %), forestry and building (64 % each), and the food-processing sector (58 %), while minimum indices were reported by the machine-engineering complex (47 %) and the light industry (46 %). Some fall in the balance of demand assessments ('above-below norm') occurred between September through October has not introduced any fundamental changes in the overall picture – the national enterprises find themselves increasingly involved in market economy that began to unfold since the 1998 default.

December 2003 proved the conclusion on the maintenance of the negative trend that had emerged in the dynamics of the national industrial sector over several past years. Late 2003 once again witnessed an absolute fall in sales and slowdown of growth in output. The effective demand balance plunged by another 10 points in December and became negative – the national manufacturing sector reported an absolute decline in cash-based sales. The index lost 26 points since August 2003. In 2002, the respective process started yet in November, while by December the balance hit -13 %, while in late 2003 it accounted for -7 %, which proved to be the best value over the past three years. (Fig.18).

*Fig.18*



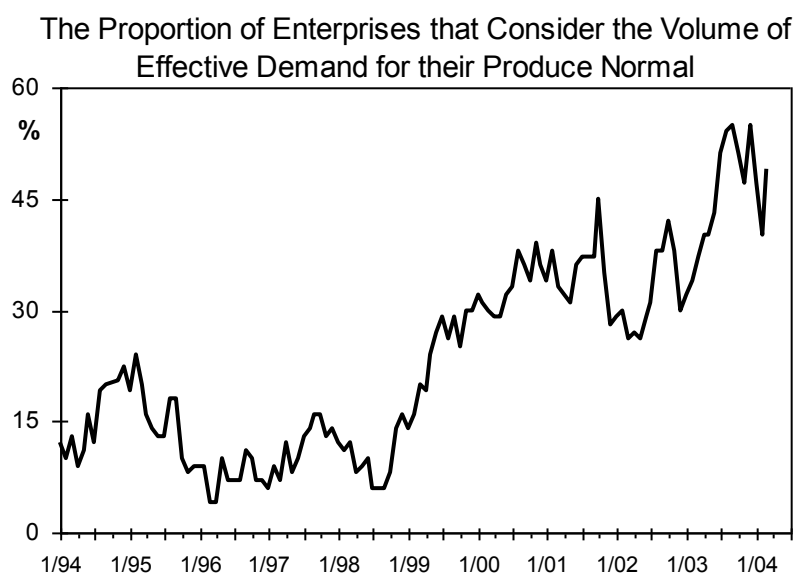
However, the output did not follow demand in December. While the balance of changes in demand was falling constantly and became negative, the balance of changes in output discontinued its fall in December and froze at the level of +14 ... +15 %, i. e. output was growing under the declining demand. This conclusion was also proved by computations of micro data. The proportion of enterprises whose output advanced demand grew up to 32 %, while the average index of the prior 11 months was 25 %. The December 2002 index accounted for 27 %, with enterprises more conservatively following the demand. The advanced rise in output so far has not resulted in overstocking of enterprises storages. In December 2003 the balance of assessments of finished produce in stock grew by just 5 points and only approached

the averaged level reported between January through September that year. Let us remind that October witnessed peculiarly rapid for the past three years sales of finished produce in stock. So, in late 2003 enterprises were just restoring the former (traditional) produce stock that is used to promptly satisfy new orders.

### The Specifics of Enterprises' Perception of Demand in 2003

Assessments of demand on the 'above norm-normal-below norm' scale testify to the emergence in 2003 of a new for the national industrial sector perception by enterprises of major (at least, for the 1990s) sales channels. The year 2003 there happened a sharp change in assessments of effective demand. The balance grew from -65 % to -39 % (in August), while the share of responses 'normal' rose from 32 to 55 % (in September). The best results of 2003 have also proved to be the best indices for the last 10 years of observations (*Fig.19*)

*Fig.19*



An analogous situation was noted on the sectoral level, too (see *Table 16*). All the industries reported high balance of assessments, with maximum values registered in the forestry, wood-working and paper and pulp sectors. The constant improvement of this particular index was interrupted in 2002 when the national industrial sector faced the hardest and longest sales challenges over the post-default period. It was only the forestry and the building sector that managed to survive without breaking the positive trend, while the machine-engineering sector reported the worst difference of the effective demand assessments (-65 %).

The situation in the light industry and the sector for electricity was slightly better (60 %). It was the ferrous metallurgy that held a leading position with its aggregate balance over the past 4 years (-36 %), followed by the forestry (-43 %). Let us note that the balances of demand assessments have always been, and still are negative, which means that the 'below norm' assessments still dominate the industrial sector. In other words, enterprises so far have lacked effective demand to load their maintained and idle capacities.

*Table 16***Average Values of Balances and Proportions of the ‘Normal’ Reports  
in the Course of Estimating Volumes of Effective Demand by Industries, as %**

Sectors	Balances				The share of responses			
	2000	2001	2002	2003	2000	2001	2002	2003
Electricity	-73	-55	-60	-53	20	45	39	32
Chemicals and petrochemicals	-59	-56	-58	-38	35	41	38	47
Machine engineering	-73	-69	-71	-49	25	29	25	37
Forestry, wood-working, and paper and pulp	-43	-56	-45	-29	50	38	49	59
Construction	-72	-62	-59	-42	19	30	34	46
Light	-60	-64	-68	-47	35	32	28	40
Food-processing	-64	-49	-50	-36	30	44	46	52

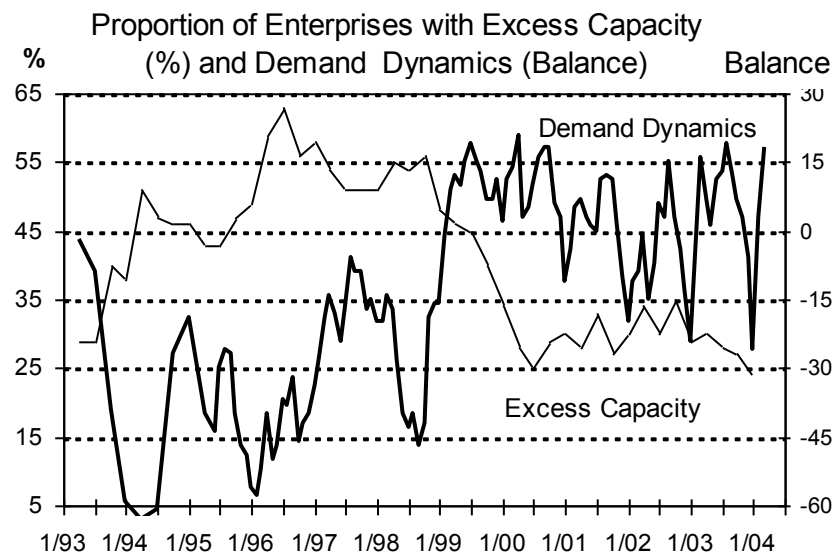
This assumption is proved by enterprises' direct assessments of their capacities in relation to effective demand. IET has been conducting such a monitoring since 1993 and accumulated more than enough data for an analysis. In the pre-default period, the proportion of enterprises that had excessive (relative to envisaged demand) capacities would be very high, with an absolute maximum reported in 1996, when 63 % of them considered their capacities as excessive (*Fig.20*). Every soar of excess capacity was related to a rise in the intensity of contraction in the effective demand. Thus three peaks of contraction in demand resulted in the respective three peaks of excess capacity. The default radically changes the scene. Enterprises did not immediately believe in chances for a normal recovery growth and capacity loading, though. October 1998 witnessed the year's maximum, when 56 % of them still believed that possessed more than sufficient capacities to meet the envisaged growth. However, already in January 1999 the index dropped to 48 %, and consequently to 40 % by the end of the year. The index hit the bottom line in 2000, when only 25 % of enterprises considered their capacity excessive. The progress was fueled by the longest period of positive growth of effective demand. Having passed their peak, growth rates began to descend and sometimes even turn into negative ones. That of course compelled companies to restrain their optimism with respect to capacity assessments. In 2002 (which became the hardest year for the national industrial sector over the pos-default period) the respective index would soar up to 34-35 %. The year 2003 was more favorable, and the excess capacity averaged across the industrial sector dropped to 27 % by October.

Excess capacity assessments differed from sector to sector (*Table 17*), with forestry, wood-working and paper and pulp companies to the least extent being affected by the existence of excess capacity. The average value of the index in question for 11 years of monitoring accounted for 31 %. More specifically, it had been 42 % pre- and 11 % post-default. The difference (24 %) shows that after default the companies could re-galvanize nearly one-fourth of their capacity. In 2003, the respective index across the forestry sector made up just 13 %. This index was beaten only by the one of metallurgical plants (12 %). In the metallurgical sector, the average post-default excess capacity index accounted for 22 %, while it had been 43 % in the pre-



default period. The sector holds the third position by the post-default placement of capacities into operation. However, post-default, stars were luckiest for chemical and petrochemical companies. Given that between 1993 through 1998 the average level of excess capacity in the sector accounted for 61 % (which was an absolute record for the whole industrial sector), post default, it plunged to 27 %. The least effect the default had on the food-processing and building sectors. The difference between the respective indexes there was just 7 %, with the post-default index values accounting for 37 and 38 %, respectively. In the machine-engineering complex, the situation was yet worse. First, prior to the default, its average excess capacity assessments accounted for 51 %, thus being higher than in the other sectors and inferior only to those of the oil and petrochemical complex. Second, post-default, the index lowered only to 39 %, which became the worst value across the industrial sector on the whole. Third, in 2003 the machine-engineering sector likewise retained the highest excess capacity rate.

*Fig. 20*



*Table 17*

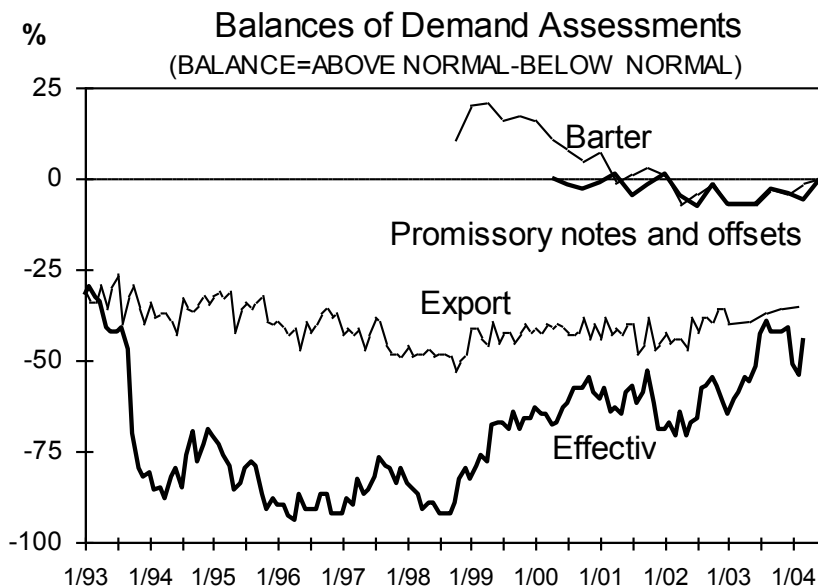
**The Average proportion of Enterprises with Excessive Production Capacities in Relation to Envisaged Demand in some industries, as %**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Metallurgy	45	49	43	44	46	35	25	15	22	34	12
Chemicals and petrochemicals	41	66	70	73	63	52	33	30	24	23	23
Machine engineering	38	48	43	60	55	62	53	36	36	37	34
Forestry, w. — w. and paper and pulp	20	34	50	53	47	45	21	18	18	18	13
Construction	34	23	43	54	56	58	52	42	35	31	31
Light	24	44	56	67	64	54	52	31	27	31	30
Food	31	38	40	45	53	59	43	38	34	42	29



While capacities remaining excessive and sales for cash – unstable, the national industrial sector feels the shortage of non-monetary deals. Companies believe they need a greater volume of barter, promissory note and offset deals. The year 2003 did not introduce any fundamental changes into the enterprises' attitude to such transactions. The respective balance values remain negative, which means the enterprises believe that volumes of such deals in the overall sales volume of their produce is 'below norm' (see *Fig.21*). The 2003 surveys registered the lack of barter, promissory notes and offsets nearly in all the industries, but the electricity sector, chemicals and petrochemicals, whose annual balances were positive. These three industries were dominated by enterprises for whom volumes of non-monetary deals proved to be excessive. The greatest shortage of non-monetary transactions was reported by the industry of building materials, whose balance of barter assessments accounted for -12 %, while that of promissory notes and offsets — -21 %. The industry was followed by the forestry, wood-working and paper and pulp sector (-10 and -16 %, respectively), and the light industry (-10 and -10 %).

*Fig. 21*



However, non-monetary settlements are losing their former role in the industrial sector (*Table 18*). In 2003, the proportion of cash in settlements averaged 83 %, barter -6 %, promissory notes and offsets -9 %.

As in the prior years, it was electricity that became a leader in terms of collection of payments in cash – 92 % of all payments on average (see *Table 19*), — followed by the ferrous metallurgy and the food-processing industry (89 and 88 %, respectively), while the light industry, chemicals and petrochemicals held the third position with 86 % and 85 %, respectively. Enterprises of the building materials industry turned out to be losers in this respect, for their share of cash payments hardly reached 77 %, while the share of barter in the sector as well as promissory notes and offsets accounted for 11 %.

*Table 18*

**The Proportion of Cash, Barter, Promissory Notes and Offsets  
in the Industrial Sector as a Whole (as %)**

Proportion of	1 <sup>st</sup> Q.	2 <sup>nd</sup> Q.	3 <sup>rd</sup> Q.	4 <sup>th</sup> Q.
Cash	84	82	84	85
Barter	7	6	5	5
Promissory notes and offsets	8	10	9	8

*Table 19*

**The Proportion of Cash in Sales in 2003, across Sectors (as %)**

Sectors	1 <sup>st</sup> Q	2 <sup>nd</sup> Q	3 <sup>rd</sup> Q	4 <sup>th</sup> Q
Electricity	90	88	98	90
Ferrous metallurgy	88	84	94	90
Non-ferrous metallurgy	78	88	90	93
Chemicals and petrochemicals	83	75	76	84
Machine engineering	83	81	82	84
Forestry, wood-working and paper and pulp	81	78	82	78
Building materials	74	77	81	75
Light	84	86	87	87
Food	89	88	88	89

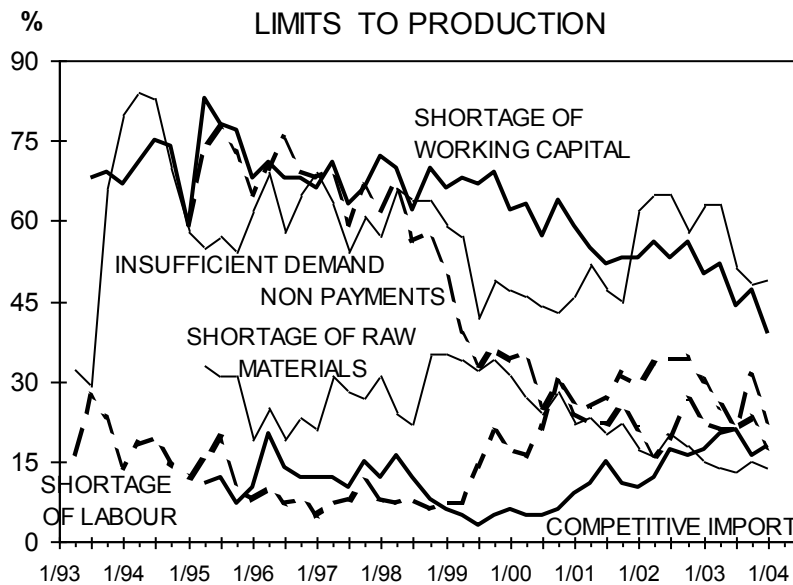
### The Impact of Demand for Enterprises' Output and State

The low demand in 2003 posed a major obstacle to the rise in output in the national industrial complex (*Fig. 22*), as considered by 56 % on average. This particular factor also poses the biggest obstacle to most of industries, except the forestry complex and the light industry. These two sectors specified some other major challenges: while the former complained about lack of liquid capital (51 %), equipment (35 %) and qualified personnel (33 %) that proved to be far more crucial than the low demand (only 30 % of enterprises on average mentioned that in 2003), the light industry companies referred primarily to the lack of liquid capital (59 %), while low effective demand was cited only by 47 %. Demand most frequently posed the greatest obstacle to the ferrous metallurgy (65 %), electricity (63 %) and machine engineering (62 %). By frequency of references across the industrial sector on the whole, this particular obstacle was followed by the lack of liquid capital (48 %), insufficient export demand (25 %), consumers' non-payments (25 %), and the shortage of qualified personnel (24 %).

The lack of qualified staff began holding the third (after demand and liquid capital) position by late 2003. When compared with the 3<sup>rd</sup> quarter that year, the frequency of citing this particular challenge grew by 10 points, and 31 % of enterprises began to feel the lack of personnel to meet the task of boosting their output in the 4<sup>th</sup> quarter. The respective index accounts for 51 % in the light industry, 39 % in the forestry complex and 35 % in the machine-engineering sector, while electricity enterprises do not cite this problem at all, but complain

about consumers' non-payments (72 %) and a low demand (61 %). The latter has the least effect on output in the chemical and petrochemical sectors, and the forestry complex (30 % each). Despite the appreciation of the Ruble, the domestic enterprises began to more seldom refer to the competitive import as an obstacle to their production: 16 % after 21 % reported in the 3<sup>rd</sup> quarter. It poses the greatest challenge to the ferrous (50 %) and non-ferrous (26 %) metallurgical companies, and those of the light industry (24 %). In the machine-engineering sector, the frequency of mentioning this particular obstacle accounted for 18 %, with the post-default sectoral maximum (25 %) was reported in the 2<sup>nd</sup> quarter 2003.

Fig. 22

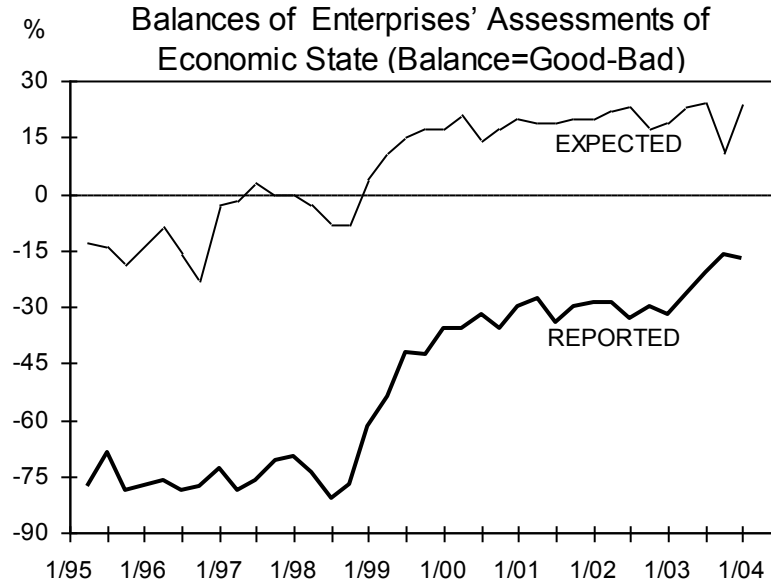


The stabilization of dynamics of growth in effective demand in 2003 has fueled a constant improvement in enterprises' actual financial and economic state. The balance of assessments of this index was growing from quarter to quarter: given that in the 1<sup>st</sup> quarter it was 32 %, it hit -16 % by the 4<sup>th</sup>. It was only the period between July 1998 through July 1999 when a greater growth pace was registered in the national industrial sector (Fig.23). These periods, of course, do not allow an absolutely accurate comparison. By late 2003 enterprises' self-assessments of their financial and economic state reached their maximum.

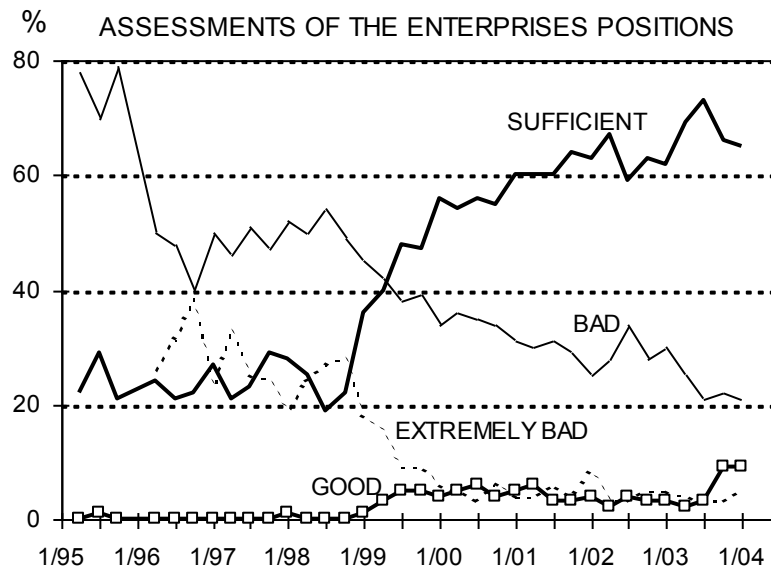
However, the values of the balance of the assessments of enterprises' state remain negative, with the answers 'bad' still prevailing over 'good'. Most of enterprises assessed their state as 'satisfactory' (Fig. 16). Though the proportion of such assessments notably dropped by the end of the year. But it became possible largely thanks to an increase in the proportion of the answers 'good'. The rate of such assessments grew in the electricity sector (up to 15 %), ferrous metallurgy (up to 30 %), forestry and food-processing industries (up to 23 % in each). By contrast, the answers 'bad' plunged to their historical minimum in 2003, and in the second half-year their proportion accounted for 21-22 %. It was only the ferrous metallurgy, chemi-

cals and petrochemicals, and the industry of building materials that failed to progress in this respective area until the end of the year.

*Fig. 23*



*Fig. 24*



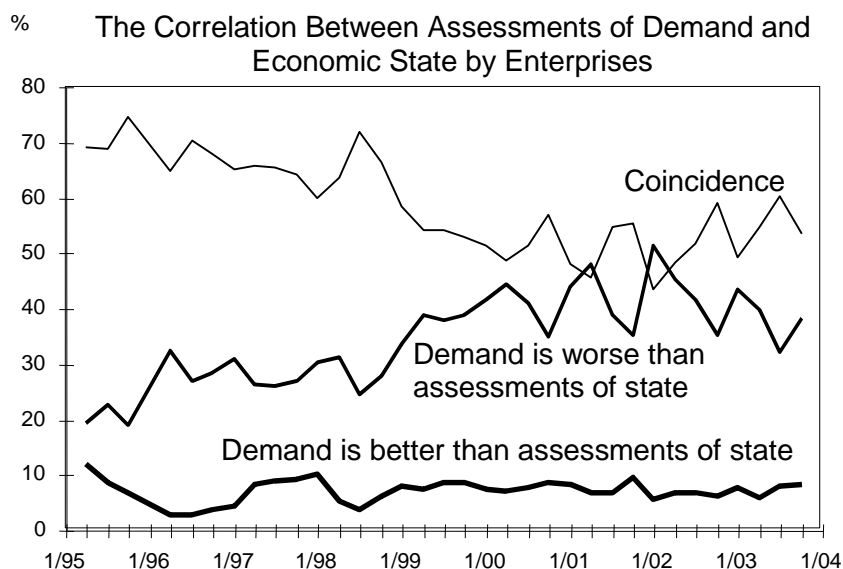
Fluctuations of effective demand have recently exercised an increasingly loosening impact on the enterprises' financial and economic state (*Fig. 25*). This may seem strange at the first glance, for the existence of normal cash sales once had enabled enterprises to prosper on absolutely legal grounds. In our view, this is associated with the fact that they began to feel more confidently and have no longer put the assessment of their well-being in dependence on short-term fluctuations in sales. In other words, they have believed in the sustainability of the



normal development of the national economy and perceive problems with their sales as temporary, which cannot reverse the economy back to the times of barter, promissory notes and offsets. Pre-default, the situation was harder, and enterprises' assessments of their state were strongly related to assessments of effective demand. The assessments coincidence rate would reach 75 % (October 1995) and accounted for 67 % on average for the period between 1995-98. Some part of companies managed to maintain their state in a better shape vs. effective demand assessments (see 'demand is worse than assessments of state' below). This means that, for instance, under assessments of demand being 'below norm', the enterprises considered their state good or satisfactory. A very insignificant part of the industrial enterprises did not capitalize on the effective demand capacity to improve their state (see 'demand is better than assessments of state'), i. e. even with the demand assessments being normal, they considered their state as bad. The proportion of such companies has steadily been under 10 %.

Post-default, the situation began to change. The proportion of coincidences between the demand assessments and those of the state fell from 72 to 54 %, and further to 49 % by mid-2000. At the same time, the proportion of enterprises whose assessments of their state 'over-run' those of demand has shown some growth, Enterprises are no longer steered by just momentary problems, and they realized that their actual state began increasingly solidifying an less dependent on the cash sales fever. This became especially notable in 2002, when the average proportion of coincidences between the respective assessments became minimum (50 %), with the absolute minimum (43 %) reported in January, while the proportion of companies with advanced assessments of their state relative to demand assessments reached its maximum.

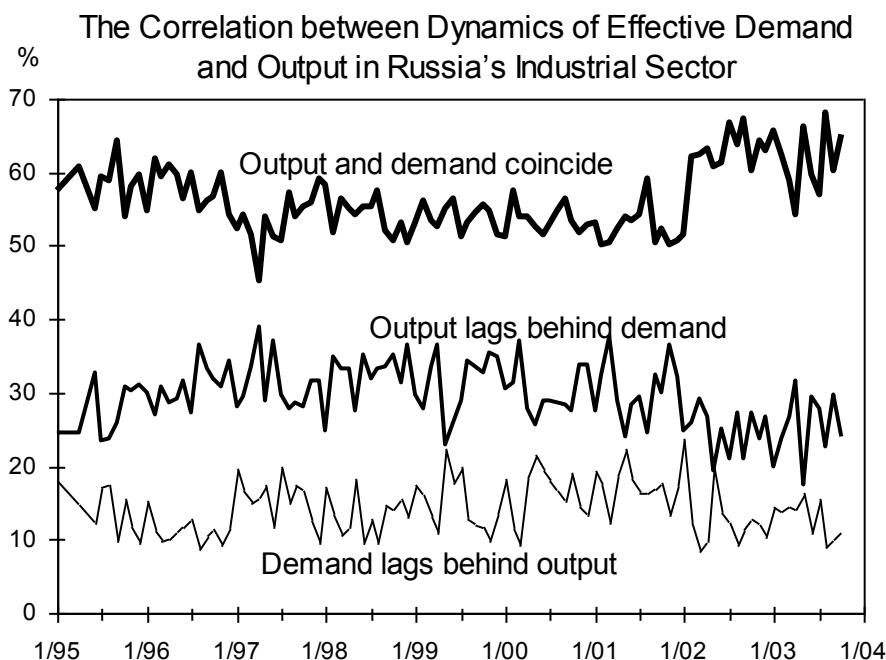
*Fig. 25*



The fickle dynamics of the national industrial sector has always been among the most debated issues since the start of Russian reforms. A drastic production slump in the 1990s, a mass outspread of non-cash settlements, the 1998 default and the consequent sudden and ro-

bust (i. e. propelled by effective demand) renewal of output make the analysis of the correlation between effective demand and output a hot issue. Without reliable data on dynamics of effective demand, one can assume that in the mid-‘90s the national industrial enterprises had to orient their output towards non-monetary kinds of output. However, computations made on the basis of the survey results show an absolutely opposite picture (*Fig.26*).

*Fig.26*



First, an absolute majority of enterprises oriented their output towards effective demand – the respective figure averaged 56 % over 1995-2003. The annual minimum value of the index falls on 2001 (53 %). So, in the pre-default period, Russian enterprises had been quite market oriented, and their output fairly adequately mirrored the dynamics of demand, while non-monetary settlements were used more frequently to ensure a minimum necessary volume of output.

Second, enterprises most likely conceived the post-default rise in demand as an unexpected (or suspicious) phenomenon. Between 1999-2001 the proportion of coincidences between demand and output appeared minimum for the period in question. The same period became notable due to a maximum annual average indices that characterize the proportion of enterprises whose output lags behind demand. In other words, the share of enterprises that failed to meet the demand for their produce began to grow, as the demand was rising at a pace greater than their output.

Third, it was only between 200-03 that enterprises grew capable (or, perhaps, dared) to greater extent to follow the dynamics of effective demand with the dynamics of their output. Between 2002-03 the share of coincidences reached its maximum (62 %), while on the contrary the proportion of enterprises whose output advanced demand reached the minimum value (25 %). The latter was most likely to be generated by changes in managing the stock of finished produce – while between 1993-94 and 1995-96 enterprises had tried to minimize their



stored reserves to avoid their extreme amounts, they now try to accumulate those to meet a sudden rise in demand.

### 3.2.2. Dynamics of Competition Relations in Russia's Industrial Sector

The year 2003 became another year of a persistent progress of the national industrial sector in the conditions of intensification of competition. Its major indicators the IET tracks in the monitoring mode gives grounds to draw this very conclusion. The IET's monitoring is based upon regular surveys on enterprises' heads on competition challenges, and such an approach has a number of substantial advantages<sup>2</sup>. Surveys enable one to collect data on the broadest range of issues in conjunction with competition, which do not have a quantitative measurement. Hence no need in collection and evaluation of a huge volume of detailed technical and economical information, for every enterprise tackles this problem by its own. Only by this way can one receive aggregate assessments of a competition level in industrial enterprises' sales markets, as well as comparable assessments of the domestic competition and the one with imports.

First, the share of competition markets has grown (*Fig.27*). let us note at this juncture that the data therein says nothing of the level of competition, but just show the proportion of markets where the competition takes place. According to enterprises, in 2003 they perceived the presence of the domestic competition already on 93 % of markets, which made up a peak value for the whole period of monitoring since 1995. At the time the competition was felt on 76 % of markets. In 2003 the proportion of markets where national goods competed with imports grew at most, and by the end of the year Russian producers perceived that already on 62 % of markets. The pre-default maximum (July 1998) accounted for 60 %. So, the presence of imports in 2003 already exceeded the 1998 level, but that did not result in any catastrophic consequences in Russia's industrial sector.

The proportion of competitive markets in all the cases (along all the competition avenues) was, and still is under 100 %, i. e. there have always been sales markets that were free from any visible (by enterprises) competition. In 2003, the least non-competitive markets with domestic competition fell on the forestry complex (5 %), the food-processing sector (5 %), and chemicals and petrochemicals (2 %). The minimum level of uncompetitive markets with competition from Far Abroad was reported by ferrous metallurgy (23.5 %), machine engineering (30 %) and the light industry (34 %).

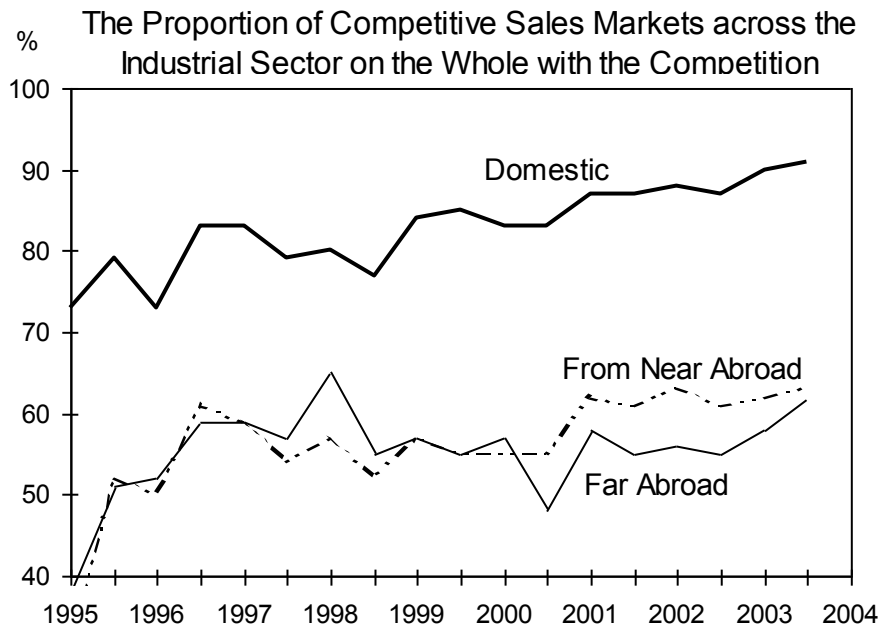
Secondly. Results of the monitoring of the competition level on Russian industrial enterprises' sales markets in 2003 still testify to the fact that it is other Russian companies the whose form the most serious rivals to the surveyed enterprises (*Fig.28*). The competition with overseas (Far Abroad) producers still appears inferior to the domestic one, as the gap between the respective levels of competition remaining unchanged in 2003. The aggregate assessments of the competition with the Far Abroad producers exceeded the level 'weak', though did not hit the record-breaking pre-default level, while assessments of the domestic competition were increasingly approaching the level 'moderate'. The competition with import goods from Far Abroad held the last position. Overall, an absolute level of competition across the industrial sector remained low.

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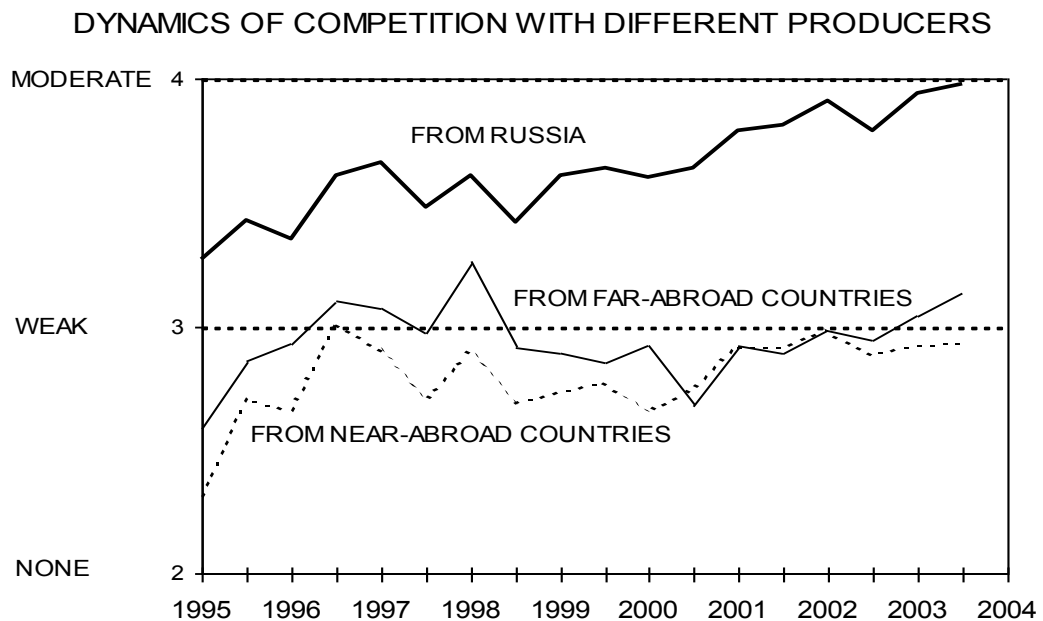
<sup>2</sup> Tsukhlo S.V. Otsenka konkurentssii v rossiyskoy promyshlennosti. Vozmozhnosti oprosov rukovoditeley predpriyatiy//Voprosy statistiki, 2000. # 11.



*Fig.27*



*Fig.28*



### The Impact of Competition on Enterprises' Costs, Prices and Profits

The growing level of competition cannot help but affect Russian industrial enterprises' operations. While the competition level remains relatively low, it is perhaps premature and hard to argue that it formed an important factor of market development. Equally hard would be to assess its impact on the major indicators of enterprises' performance. But the survey methodology suggests a simple solution, namely, to ask respondents what competition com-



pels enterprises to undertake on their sales markets. In doing that, we proceed from the assumption that the group of respondents to the IET's business surveys is formed by heads of enterprises, who can better than anybody else assess the competition level on their sales markets. They appear equally unbeatable in visioning what competition would bring about to their enterprises, i. e. whether it forces to decrease producer prices and cut down production costs, or, on the contrary to increase both upon the improvement of the quality of their produce that has requested purchases of new equipment and technologies. Do they practice downsizing or are they in search of new personnel to arrange for the after-sales servicing of their produce? Have they managed to locate new sales markets and consequently to boost output, or rivals supplant their produce from the traditional markets? How, ultimately, does competition affect the enterprise's performance?

Competition can have a dual impact on the production costs and price for the given output. On the one hand, lowering production costs and prices drives the produce's competitiveness upwards and boosts sales. On the other hand, improving the produce's quality pushes the enterprise's production costs upwards and requires increase in producer prices. In such a situation, producers have to look for a compromise, albeit the shortage of investment resources is most unlikely to allow Russian companies to realize the latter way in full, though it seems more preferable. The final assessments of the impact of competition on production costs show that influenced by market forces, the national enterprises more often tend to cut down their production costs (*Table 20*).

*Table 20***Impact of Intensity of Competition on Production Costs, as %**

	<b>Towards increase</b>	<b>No impact</b>	<b>Towards decline</b>	<b>Hard to assess</b>	<b>balance</b>
1995	16	39	30	15	-14
1996	17	30	34	19	-17
1997	14	28	37	21	-23
1998	17	26	33	24	-16
1999	14	35	33	19	-19
2000	17	40	28	15	-11
2001	22	41	24	13	-2
2002	22	33	28	18	-6
2003	25	36	25	14	0

To be accurate, the intensity (or, more precisely, the spread) of the trend was changing through years. First, the surveys registered an increase in the intensity of costs decrease. The first post-default months were characterized by a rapid rise in demand for domestic products. That enabled enterprises not only to sell the accumulated by that time stock, but also to boost output. This situation, coupled with the price rise for minerals and other materials, was likely to stop the growth in intensity of cutting down costs under the impact of competition. The pressure of competition on costs intensified once again in 1999, but competition has increasingly exercised weaker influence on the Russian companies' costs. That happened against the backdrop of rise in competition or, at least, maintenance of its level. Most likely the main cause underpinning such a development of the situation was the exhaustion of reserves of idle

capacities and the need in their modernization and creation of new capacities. That inevitably led to a rise in the enterprises' costs.

Different sectors reacted differently to competition on their sales markets. The most intense cutting down of costs under the pressure of competition took place in metallurgy (*Table 21*), where the respective balance has almost always been negative and reached very high values. The average value of the balance of changes in production costs under the pressure of competition in the sector accounted for –24 points.

*Table 21*

**Balances of the Impact of Competition Intensity on production  
Costs across Sectors, as %**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Metallurgy	-30	-11	-26	-29	-43	-38	14	-48	-8
Chemicals and petrochemicals	-1	-16	-21	-6	7	5	12	-8	13
Machine engineering	-27	-24	-29	-19	-21	-13	-10	0	-6
Forestry, wood-working and paper and pulp	9	-10	2	6	-9	15	12	-4	1
Building industry	-7	-17	-29	8	-20	-7	-2	6	9
Light	-4	-18	-28	-13	-12	-3	6	1	9
Food	3	-17	-18	-18	6	14	10	28	6

The machine-engineering sector held the second place in terms of intensity of drop of costs under the impact of competition. The average value of the balance (with account of the sign) in the sector accounted for –17 points. Competition has almost always compelled machine-engineering companies to cut down their production costs, which became especially notably on the eve of the default. It was 2002 when the balance proved to be zero, with the share of responses on increase in costs being equal to the one of their decrease.

Machine engineering is followed by the light industry and the building sector, that likewise on average have been cutting down their costs under the impact of competition over the past 9 years. Between 1995 through 1997 the intensity of impact (with the negative sign) of competition grew substantially and while measured for the last time before default, it reached – 28 and –29 points, accordingly. Right after default the decrease in the costs in the sector for building materials was replaced by their rise, that, again, affected by competition, was replaced by their fall. The fading fall had been in place until 2001, followed, again, by a rise in production costs. In the light industry, after the peak of intensity of their decline in 1997, the surveys registered a gradual slowdown of the rise in production costs that was replaced by their rise under the impact of competition in 2001-03. Notably, the process unfolded under the strongest pressure of competition on these particular sectors. The only explanation of such a change in costs is that producers by any means attempt to protect their position in the market, and they modernize their production for the sake of transition to a minimum competitive produce.

Competition has always led to decrease in producer prices in the national industrial sector. The balances were always negative, and their values were significant (*Table 22*). The most



intense impact on prices competition exercised between 1996-98. Interestingly, in September 1998 enterprises likewise believed that competition forced them to decrease prices to the same extent as prior to the default. It was only in 1999 that the intensity of the pressure fell to – 43 points, which proved to be a minimum impact by competition on prices over all the 9 years of monitoring. But, starting early next year its effect on prices began to intensify once again, and by 2002 it reached nearly the maximum level registered pre- and right after the default. So competition certainly exercises a positive influence on enterprises' pricing policy by compelling them *en mass* to cut prices. Not less than a half of the surveyed enterprises confirm this every year, while only 6 % of companies on average believed that competition leads to a price rise for their output.

*Table 22*

**The Impact of Intensity of Competition on Producer Prices, as %**

	Increase	No influence	Decrease	Hard to assess	Balance
1995	6	33	52	9	-46
1996	5	23	60	12	-55
1997	3	20	58	19	-55
1998	4	18	58	20	-54
1999	9	27	52	12	-43
2000	7	25	53	15	-46
2001	6	27	54	13	-48
2002	5	24	57	14	-52
2003	7	23	58	12	-51

The same situation was also noted across all the industry branches. The competition influence balance have always been negative and significant (*Table 23*). The pressure on prices was strongest in the sector for chemicals and petrochemicals where the proportion of reports on price drops fluctuated between 55 to 73 % and accounted for 67 % on average. These are the peak sectoral values of this particular index. Price rise was reported by 4 to 19 % of enterprises, with its maximum falling on 2002, which is most likely to be associated with their investment activity.

*Table 23*

**Balances of Influence by Competition on Producer Prices in Industry Branches, as %**

	11995	11996	11997	11998	11999	22000	22001	22002	22003
Metallurgy	-22	-53	-62	-56	-32	-60	-46	-68	-41
Chemicals and petrochemicals	-70	-70	-51	-61	-50	-61	-57	-50	-49
Machine engineering	-49	-51	-55	-56	-49	-51	-50	-51	-53
Forestry, wood-working and paper and pulp	-53	-53	-59	-47	-47	-35	-56	-67	-49
Construction	-22	-54	-69	-44	-42	-28	-53	-56	-61
Light	-26	-58	-55	-48	-52	-39	-51	-68	-60
Food-processing	-43	-41	-67	-59	-45	-39	-44	-53	-40

The presence in the questionnaire of questions about influence of competition on the enterprises' prices and costs enables one in an analogical way to assess its impact on their profits, too. This necessitates building a matrix of the correlation between answers on the respective influence on enterprises' prices and costs and the sum of over-diagonal and under-diagonal elements of the matrix. The result are two values (measured as %), of which the first one assesses the proportion of enterprises whose profit grows resulting from the impact of competition on prices and costs, while the other one – the respective proportion of companies that report the opposite. The difference between these values constitutes the balance and shows which enterprises dominate the industrial sector, namely, those that boosted their profits, or those whose profits fell under the impact of competition.

In the years of monitoring, competition always led to falling profits in the national industrial complex (*Table 24*). But, at the same time, quite a significant part of enterprises would fell under the 'no influence' category. That comprises the companies that chose the same variants of answers while assessing the impact of competition on their prices and costs. The other enterprises' assessments of the impact of competition varied, however, in favor of a more intense, relative to prices, rise in the costs. That became especially notable in 2000-03. Prior to the default, when the pressure of imports was traditionally considered more substantial, Russian companies would more seldom loose their profits.

*Table 24*

**The Impact of Intensity of Competition  
on Enterprises' Profits, as %**

	Towards increase	No influence	Towards decline	Balance
1995	14	59	26	-12
1996	15	54	31	-16
1997	13	57	29	-16
1998	16	52	32	-16
1999	18	54	28	-10
2000	10	56	35	-25
2001	10	54	37	-27
2002	16	46	38	-22
2003	15	44	41	-25

The same was also noted on the sectoral level (*Table 25*). Truth to say, the default itself (the September 1998 survey or the first post-default year) suspended the decline of profits in the sectors. First to perceive that were the chemical, petrochemical and food-processing companies. In 1999 the default effect reached metallurgy, forestry and the light industry, while only the machine-engineering sector and the industry of building materials did not feel such affects. Profits have been declining steadily over the past 5 years in all the sectors but the building industry. It was food-processing companies that had the hardest life in 2002, and it is not coincidental then that the greatest negative balance was reported by this particular sector, for their profits were declining at the highest pace.



*Table 25*

**Balances of Impact of Intensity of Competition on Profits in Sectors, as %**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Metallurgy	4	-10	-27	-27	1	-26	-22	-16	-30
Chemicals and petrochemicals	-18	-24	-22	-1	-29	-52	-43	-1	-27
Machine engineering	-9	-7	-12	-13	-12	-26	-25	-26	-22
Forestry, wood-working and paper and pulp	-20	-13	-7	-31	6	-19	-42	-25	-41
Construction	-10	-22	-28	-40	-19	-11	-21	-24	-45
Light	-16	-31	-16	-15	3	-18	-34	-35	-43
Food-processing	-13	-32	-26	0	-26	-41	-40	-56	-19

**The Impact of Competition on Employment and Output**

The question about impact of competition on employment first appeared in the questionnaire only in 2000. This limits possibilities for the respective analysis, albeit allows to draw some conclusions. First, competition certainly compels enterprises to decrease the number of their personnel. Second, post-default, steered by competition, the intensity of personnel downsizing was growing. In 2002, the process reached its maximum, both across the industrial sector on the whole and in most of sectors. Thirdly, the most intense downsizing was registered in the food- processing and machine-engineering industries in 2002, while the most moderate decreasing impact on employment competition showed in metallurgy: in 2001 there even occurred some rise in employment. (*Table 26*).

*Table 26*

**Balances of Impact of Competition on Employment in the Sector, as %**

	2000	2001	2002	2003
Industrial sector on the whole	-11	-17	-28	-27
Metallurgy	-9	9	-11	-8
Chemicals and petrochemicals	-19	-31	-15	-20
Machine engineering	-12	-22	-34	-33
Forestry, wood-working and paper and pulp	-15	-16	-27	-16
Building industry	-2	-8	-21	-17
Light	-12	-16	-27	-32
Food-processing	-17	-18	-38	-22

However, most enterprises did not experience any changes in employment influenced by competition, which can be proved by the proportion of the ‘no influence’ answers. While assessing the impact on employment, this particular proportion turned out to be maximum vs. assessments of impact on other indicators. Employment definitely found itself beyond the influence of competition at 47 % of enterprises on average, while the respective rate for other indices did not exceed 38 % (for the same period between 2000-02).

At this juncture, the period of observations matters. By 2000, when we started putting the question about the influence of competition on employment, enterprises to a significant extent had managed to get rid of the excessive personnel. On the one hand, workers quitted idle plants themselves, and especially vigorously — between 1994-98. On the other hand, the 1999-2002 recovery growth demanded new employees, who naturally were picked up among the former personnel of the enterprise, rather than from outside. As a result, enterprises quite justifiably responded that competition had no impact on employment.

The impact competition exercised on output during all the years of monitoring was negative: under the pressure of luckier rivals enterprises had to cut down their production volumes. The process was most intense, in enterprises' view in the pre-default years (*Table 27*). In 1998 the respective balance was –43 %, while its average value over the period 1995-98 accounted for –38 %. But already in 1999 it grew up to –12 %, i. e. enterprises clearly felt some relaxation. But then the situation began to 'deteriorate' once again. The balance began sliding and reached –30 % in 2002, which was nearly equal to its respective index of 1997. However, during several last years the balance is formed in a different fashion compared with the pre-default period. The proportion of the 'towards increase' reports did not fall under 12 % between 1999-2002, while it would hit only 8 % in the pre-default era. The average pre-default value of the index had been 6 %, while post-default – 15 %, i. e. it grew 2.5 times. So the market (competition) situation enables a far greater number of Russian enterprises to boost their output vs. the pre-default period of time.

*Table 27*

**Impact of Competition on Output, as %**

	<b>Towards increase</b>	<b>No influence</b>	<b>Towards decline</b>	<b>Hard to assess</b>	<b>Balance</b>
1995	3	40	42	15	–39
1996	5	29	47	19	–42
1997	8	29	39	23	–31
1998	6	25	49	20	–43
1999	17	30	30	22	–13
2000	17	33	32	18	–15
2001	12	30	39	18	–27
2002	14	23	45	18	–31
2003	16	27	45	12	–29

During the period of monitoring, on average competition exercised a constraining impact on output in all the sectors (*Table 28*). The strongest (most outspread) impact was registered in the food-processing sector that reported an absolute minimum of the respective balance, that is, — 80 % in 1997. The default has mitigated the negative influence by competition on the output in the industry, which was mirrored by the balance climbing up to –43 % in 1999 and consequently by 33 % in 2001. However, it plunged substantially in 2002. But through all these years the balance of impact of competition on output in this particular sector remained less intense than in any other one. The food-processing industry had to more often restrict its limit of output under the pressure of competition, primarily, the domestic one,



for the competition with import in the industry was insignificant, which became especially notable post-default.

*Table 28***Balances of Impact of Competition Intensity on Output across Sectors, as %**

	11995	11996	11997	11998	11999	22000	22001	22002	22003
Metallurgy	-7	-33	-22	-46	9	-28	-21	-10	-26
Chemicals and petrochemicals	-52	-50	-33	-37	-36	-5	-53	-44	-19
Machine engineering	-34	-43	-32	-45	-15	-16	-29	-42	-31
Forestry, wood-working and paper and pulp	-46	-51	-22	-22	-9	-15	-25	-4	-8
Construction	-37	-50	-37	-43	-2	-7	-3	-34	-34
Light	-43	-54	-44	-42	-17	-10	-21	-38	-40
Food-processing	-55	-26	-80	-57	-43	-44	-33	-67	-36

The sector for chemicals and petrochemicals was ranked the second in terms of the constraining impact by competition on output volumes. The pressure of competition on enterprises of the sector was most intense in the mid-'90s, but it consequently began to weaken (the minimum pressure fell on 2000). But already in 2001 the output was constrained by competition to the same extent as in the 1990s. As a result, the sector's post-default benefit from the loosening impact of the competition pressure on output volumes proved to be one of the modest ones. The balance computed basing on the post-default surveys grew just by 9 points. Vs. the pre-default period, i. e. post default, the pressure of competition on output volumes weakened only by 9 percentage points. More modest results were reported only by the food-processing sector, given that it is considered the least prey to competition with imports.

By contrast, the light industry benefited most greatly among the industries in question, with the respective balance plunged by 25 percentage points there. Overall (for the nine years of monitoring) it was holding the third place, albeit substantially lagging behind the leader, that is the food-processing sector. These assessments (provided by enterprises themselves) certainly challenge the traditional picture of the light industry as the most vulnerable sector in terms of competition with imports. While ranked the fourth in the general rating, the machine-engineering industry benefited fairly modestly from the default, as the change in its pre-and post -default balances accounted just for 13 points. The minimum pressure of competition on its output fell on 1999-2000. Then the situation once again complicated there, and in 2002 the force of the negative influence of competition hit the pre-default level.

It was the industry of building materials that benefited the most from the default, with the respective balance changed by 30 points. Post-default, it had the weakest pressure of competition on output (the average balance between 1999-2003 accounted for -11 %), given that in 1999-2001 it found itself within the range between -7 % ... - 2 %, and only its fall to - 34 % in 2002 diminished the value of the post-default benefit of the sector.

Metallurgy proved to be the sole sector whose balance of impact of competition on volumes of output, resulting from the default, became positive, i. e. the depreciation of the Ruble enabled Russian metallurgical companies to supplant their rivals from the sales and thus to



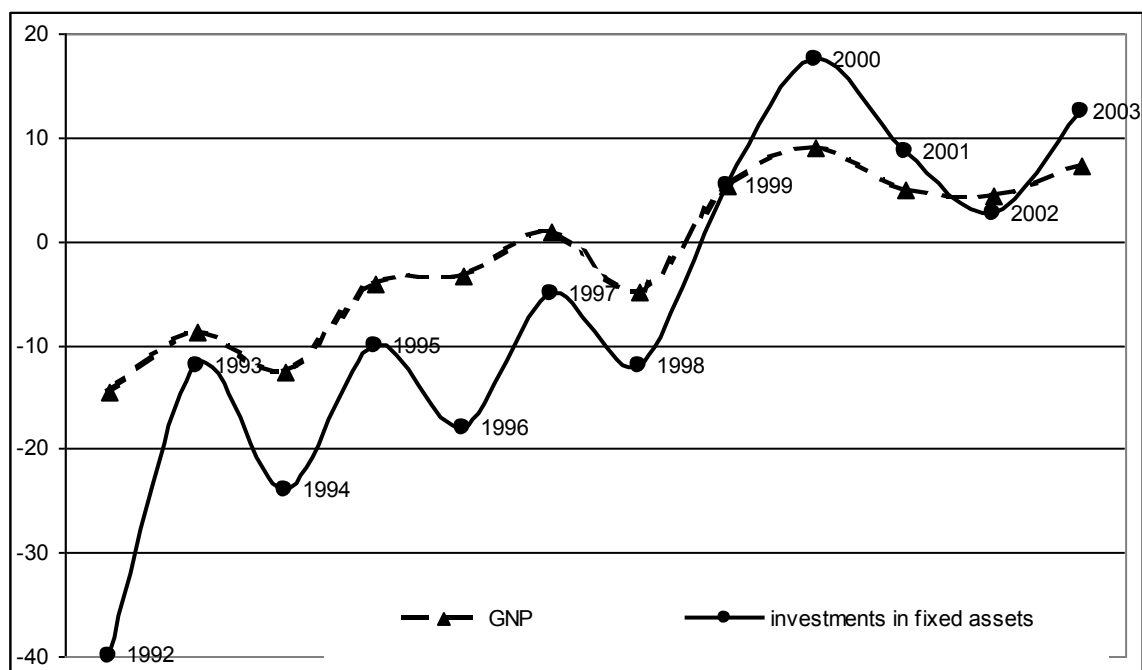
boost their output. This particular phenomenon was registered only in 1999, and in already in 2000 the situation got back to its earlier state, and enterprises once again began to believe that competition once again compelled them to restrict their output.

### 3.3. Investment processes in the real sector of the economy

Increase in investment demand is one of the distinctive features of rehabilitative growth of the Russian economy. Throughout the years 2000-2003, there was a noticeable tendency of accelerated growth of investments in fixed assets in comparison with the development of the GDP and the output of production in the basic sectors of the economy. The share of investments in fixed assets as regards the GDP increased to 16.4% in the year 2003 against the average 14.9% in 1998-1999. The development of this trend was favored by the expansion of internal demand, by the preservation of a relatively high profitability of production and by a reduction in the growth rate of manufacturing prices in industry and construction. All the sources of financing combined, the volume of investments in fixed assets from amounted to 2183.3 bln roubles or 112.5% of the level of the year 2002.

Figure 29

**Growth rates of the GDP and investments in fixed assets  
in the years 1992-2003, as a percentage of the previous year**



An analysis of the behavior and the character of formation of investment demand under the conditions of investment growth invoke the years 1999-2003 in respect to the degree of influence exerted by different factors, makes it possible to single out several stages:

- active involvement of compatible capacities taking place against the background of a profound decline in import of capital goods;
- expansion of internal demand for investment resources starting from the third quarter of the year 1999, which was preconditioned by the growth of profitability of production and the increase in the economy's yield caused by the favorable situation on the world markets;
- deceleration of the rate of investment in fixed assets starting from the third quarter of the year 2000 caused by the expansion of internal consumer demand, and the decline in profitability of production owing to the changes of relative prices at the internal and external markets;

- increase in the volume of export of machinery and equipment starting from early 2003 under the influence of growth in the economy's yield, the rise in the population's savings and the positive trends in capital account operations.

After the investment pause, the natural response of producers to the growth in demand in the years 1998-2001 was to intensify the use of the accumulated productive resources by increasing the load on the competitive reserve capacities and the degree of their involvement in production. This factor exerted a significant influence on the character of economic growth and the proportions of production in the post-crisis period. The stable and positive behavior of production changed the situation in the investment sector. In the years 1999-2001, there was an accelerated growth of accumulation and investment in comparison with the development of the GDP. With the level of business activity in the Russian economy going up, the rise in investment demand alone accounted for nearly one quarter of growth in the physical volume of the GDP.

From the second half of the year 1999, the most significant influence on the character of investment activity has been exerted by the growth of the economy's yield. It resulted from the most favorable changes of the price situation at the world market of hydrocarbon raw materials and metals on the one hand, and the active policy of Russian businesses aimed at filling the gaps in the internal market by domestic products, on the other, the growth of profitability of production and a sharp increase in income from foreign economic activity initiated an expansion of demand for capital goods. In the year 2000, the growth of investments in fixed assets amounted to 17%, a record high for thirty years. The intensive expansion of investment demand was based on the acceleration of the rate of output in associated sectors. In the years 1999-2000, the growth of production in machine building amounted to more than 40%, and that of the construction materials producing industry - to 22%, while the volume of import of machinery, equipment and transport vehicles declined by 36%, in comparison with the level of the year 1998. At the same time, both the export sector and the processing industry started to manifest an ever increasing demand for domestic equipment.

In the years 1992-1997, the motor-vehicle industry played the role of a factor restraining the rate of decline in machine building, while in the years 1999-2003 this role was played by the industry producing technical equipment of general industrial purposes. The leading positions in production of investment goods passed to the sectors producing equipment for the oil and chemical industries. The intensive development of the infrastructure branches gave a jolt to the increase in the volume of output of road-construction engineering, the industry producing hoisting-and-conveying machinery, the communications-facilities industry and instrument making. The rise in competitiveness of Russian machine-building in respect to imported analogues as far as the prices are concerned has stimulated the expansion of output of equipment for the needs of the consumer complex.

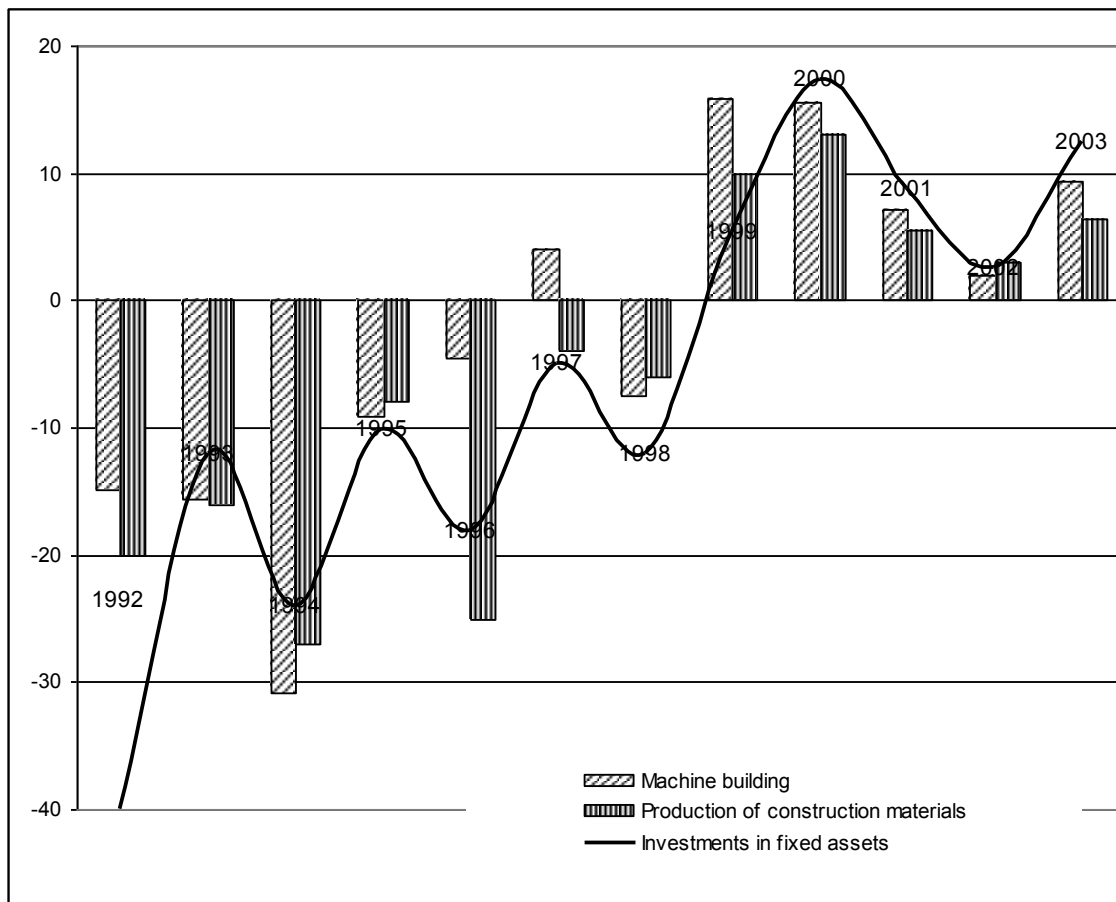
From the fourth quarter of the year 2000, a decline in enterprises' profits has been going on, which initiated a shrinkage of investment demand and a gradual waning of the tendency for accelerated growth of investments in fixed assets in comparison with the behavior of the GDP and the indices of production in the basic sectors of the economy.

It should be noted that given the existing disproportions in the movement of fixed assets and investment expenditures, the domestic market of capital goods has become considerably influenced by the dynamic growth of import of machinery and equipment. The decline in the share of imports, not counting seasonal factors, had begun in the fourth quarter of the year

1998 and had been over in the third quarter of the year 1999. In the year 2000, there was a sharp rise in demand for imported machinery, and then the tendency for accelerated rates of growth in respect to import of machinery and equipment in comparison with the development of domestic machine building became well entrenched and corresponded to the behavior of investment activity. In the years 2001-2002, import of machinery and technical goods increased by 1.72 times, while the output of machine building grew by 9.1%, as compared to the level of the year 2002.

*Figure 30*

**Growth rates of investments in fixed assets and production of capital goods in the years 1992-2003, as a percentage of the previous year**



The increase in the economy's income and the population's savings as well as the growth of activity of the banking sector exerted a positive influence on the character of development and made it possible to overcome the tendency towards deceleration of investment activity which became manifest in the years 2001-2002.

A radically new aspect of economic growth was the shift from financing the investments in fixed assets by the means owned by enterprises and organizations to widening the participation of attracted resources. The said shift is a vivid illustration of qualitative changes taking place in the mechanism of investment development orientated towards rationalization of the flows of investment resources. In the year 2003, the share of resources owned by enterprises

and organizations was 46.2% of the general amount of investments in fixed assets, while in the year 2000, which witnessed the peak of investment demand as regards the entire period of rehabilitation, this figure was 47.7%. The change in the proportion of attracted means was determined by the accelerated growth of bank credits and loans provided by other organizations against the background of a rather modest participation of budgetary sources of financing. The 0.8 point-decline in the share of budgetary funds allocated to finance investment expenditures took place against the background of changes in proportions of the federal budget and the budgets of the Federation's subjects. It should be noted that while during the last few years, there was a gradual reduction in the share of budgetary funds aimed at financing investments taking place against the backdrop of the role of the resources from the budgets of the Federation's subjects being enhanced, in January-September 2003 it were the expenditures of the federal budget that exerted a considerable influence on the behavior of investment activity.

The increase in the efficiency of economic activity is accompanied by rationalization of the flows and by the formation of additional sources of investment resources. The mobilization of resources both on the internal and external markets has stimulated the acceleration of growth of credits in the economy. According to some estimates, their growth in the year 2003 exceeded 46% against 36% in the previous year. The volume of credits provided by credit organizations to enterprises, banks and natural persons, including the credits provided by foreign states, amounted, by 1 December 2003, to 2863.2 billion roubles in comparison with 1964.0 billion roubles in the year 2002. The resources redistributed via bank crediting on behalf of non-financial enterprises amounted to 8.5% of the GDP in comparison with 4.1% of the GDP in the year 2002. The share of banks in investment crediting went up to 5.2% in the year 2005 against 4.8% in the year 2002 and 2.9% in the year 2000.

*Table 29*

**The structure of investments in fixed assets, by the sources  
of financing, as a percentage of the final amount**

	1998	1999	2000	2001	2002	2003*
Investments in fixed assets, total	100	100	100	100	100	100
including by source of financing:						
<i>own funds</i>	53.2	52.4	47.7	49.4	48.0	46.2
including:						
profit	13.2	15.9	23.4	24.0	20.5	17.2
<i>attracted resources</i>	46.8	47.6	52.5	50.6	52.0	53.8
including:						
bank credits	4.8	4.2	2.9	4.4	4.8	5.2
including those from foreign banks			0.6	0.9	0.5	0.8
loans from other organizations	4.3	5.6	7.2	4.9	6.0	8.6
budgetary resources:	19.1	17.0	22.0	20.4	19.6	18.8
федерального бюджета	6.5	6.4	6.0	5.8	6.0	6.5
budgets of RF subjects and local budgets	12.6	10.6	16.0	14.6	13.6	11.5
Of total amount of investments in fixed assets provided from abroad	3.5	6.6	4.7	4.5	4.1	4.7

\*In accordance with the data for January-September 2003.

Source: Goskomstat of Russia.



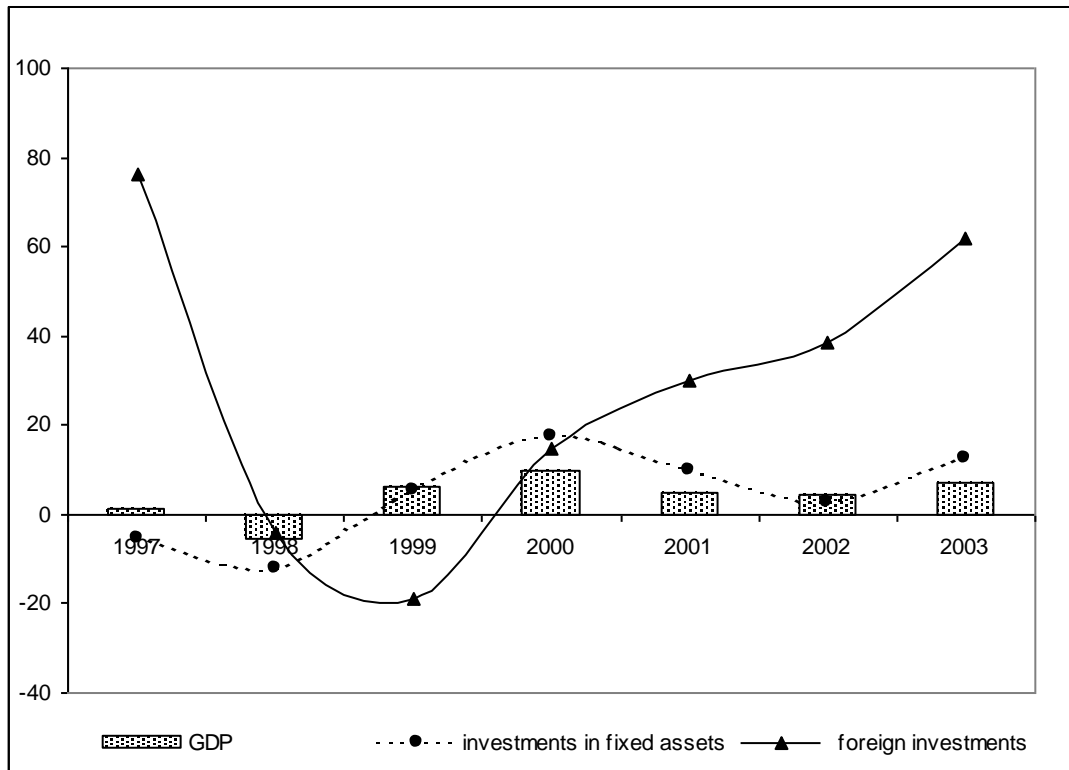
Among the factors which have predetermined the enhancement of the role played by banks and that of borrowed funds provided by other organizations, one could single out the de-dollarization of the population's savings and a reduction in the net amount of capital outflow. The decrease in the amount of foreign currency held in cash by the population and its conversion into roubles were accompanied by the increase in the volume of deposits including those in banking structures. The net inflow of funds to fixed deposits has reached, according to some estimates, 5.6% of the GDP. Given the average level of profitability existing in the economy, the low real value of credit resources has predetermined the widening of the range of borrower enterprises in the domestically-oriented sector of the economy. The attractiveness of the money-and-credit market has been considerably influenced by the lowering of the Bank of Russia's credit rate of refinancing from 25% in March 2002 to 18% in February 2003 and 16% in June 2003, and also by the rising of the share of medium and long-term funds accumulated by the banking system. At the same time, given the conditions of economic growth, it became evident that investment management was not coordinated with the dynamic processes of restructuring taking place in the Russian economy. The absence of investment financial institutes, the underdevelopment of the stock market, and the instability of the legal sphere make the process of procurement of capital more difficult. As a matter of fact, the economy has not developed, so far, a mechanism for inter-sector movement of capital the lack of which complicates investment activity at the level of enterprises as well as at those of sectors and regions. Experience indicates that given the existing amount of reserves, the adoption of investment decisions requires great caution and necessitates rationalization of the flows of investment funds. The absence of any long-term strategy of development and any schedule of activity has become a factor lowering the impetus to undertake long-term investments.

The situation at the external financial markets which is favorable to Russia also predetermines the tendencies for lowering the net amount of capital outflow. Also, the increasing strength of the rouble stimulates the banks to attract more foreign credits simultaneously reducing the amount of investments in foreign assets. In the situation of intensive economic growth throughout the year 2003, the observer noted a restoration of positive trends in the behavior of foreign investments in the Russian economy. In the year 2003, foreign investments grew by 69.4%, while direct investments increased by 64.9% which was nearly six times more than the growth rate of investment expenditures financed from internal sources. The increase of the inflow of foreign exchange resulting from capital transactions was a completely new phenomenon of a very radical nature; the net inflow of foreign investments amounted to nearly 6.4 billion dollars.

With the rating rising to the investment level, it becomes reasonable to expect the improvement of loan conditions. To a certain extent, this would make it possible to reduce the strain caused by peak repayments of the external debt as regards their influence on the behavior of economic growth, and to correct the mechanism of regulation of investment activity. At the same time, there emerge some real opportunities for increasing the inflow to Russia of the funds of institutional portfolio investors whose activity is regulated by the demand to invest only in the instruments with a certain investment rating. With the annual rates of growth approaching 7%, the Russian market looks sufficiently attractive to foreign investors. At the same time, the issues of political stability as well as economic risks dealing with the behavior of prices of basic Russian exports are becoming increasingly important.

Figure 31

**Changes in the behavior of investments in fixed assets and that of foreign investments in the years 1997-2003, as a percentage of the previous year**



The behavior of investment demand in the year 2003 was determined by the aggregate influence exerted by the factors of change in the sectoral, technological and reproductive structures of the national economy. The redistribution of investment flows was accompanied by the increase of the share of the services sector. The distinctive feature of economic growth is the intensive development of the infrastructure sectors. In the years 1999-2003, transport, communications and trade accounted for 1/4 of the general volume of investments in fixed assets in comparison with 15% on the average in the years 1992-1996. The rise in investment activity registered in the infrastructure sectors as well as the rise in demand for services provided by these sectors indicated to the existence of a potential for growth, especially because of the fact that investment activity in this sector is mainly oriented towards the solution of perspective problems. This made it possible for entrepreneurs not only to widen the segments of their presence at the services market -but also to also to build a certain potential for further development.

When analyzing the behavior of investments by the sectors it is necessary to take into account the specific features of both the behavior and the structure of investments in housing construction. The positive behavior of investments in housing construction has been registered since the year 1999, and since then it has been determining the changes in the typological structure of investments.

*Table 30***The structure of investments in fixed assets by the types, as a percentage of the total**

	1998	1999	2000	2001	2002	2003*
Investments in fixed assets, total	100	100	100	100	100	100
including:						
dwellings	16,3	14,3	11,3	11,4	12,8	13,1
buildings (except for dwellings) and constructions	45,1	41,4	43,1	41,8	41,9	41,7
machinery, equipment	29,9	36,4	36,6	35,0	38,9	39,2
other	8,7	7,9	9,0	11,8	6,4	6,0

\* Estimates are based on the preliminary data provided by the Ministry of Economics.

Source: Goskomstat of Russia.

An analysis of the structure of housing construction indicates that business activity in this sector of the economy is maintained, mainly, owing to the increasing role of private investors who accounted for nearly 80% of dwellings put into use. At the same time, throughout the past decade there was observed a considerable enhancement of the role played by the population in financing housing construction, as well as its increased participation in this financing. The level of investment activity of the population depends heavily on the behavior of housing prices and the population's savings rates. In the structure of putting dwelling space into operation the share of dwellings built by the population at their own expense or with the help of credits amounted to 41.8% in the year 2003.

It should be noted that a stronger deceleration of growth in machine building in comparison with the behavior of investments in the years 2001-2003, has limited the possibilities for transformational shifts in the sphere of reproduction of fixed assets. The increase in the share of machinery and equipment by 3.9 points in the year 2002 in comparison with the previous year was predetermined by a substantial rise in expenditures on the acquisition of imported equipment and machinery. Investments in imported machinery and equipment accounted for more than 1/4 of the total amount of investments in machinery and equipment.

The increase in the intensity of investment activity in the real sector of the economy in the year 2003 was taking place against the background of changes in their sectoral structure. The general volume and behavior of investments were mainly determined by the sectors of natural monopolies, by the oil industry and by the housing and communal sector. Since transport, communications and the fuel sector account for nearly one half of the volume of investments in the national economy, it becomes apparent that it is business activity in these sectors that exerts the most significant influence on the behavior and the structure of investment demand. The share of investments in fixed assets of manufacturing industries grew by 1.1 point in the year 2003 as compared with the results of the previous year, and reached 50.3%. The distribution of investments by the sectors of the economy was almost completely determined by the increase in investment demand on the part of industry. In comparison with January-September of the year 2002, the share of investments in industry increased by 1.4 point against the background of a 2-points reduction in the share of transport.

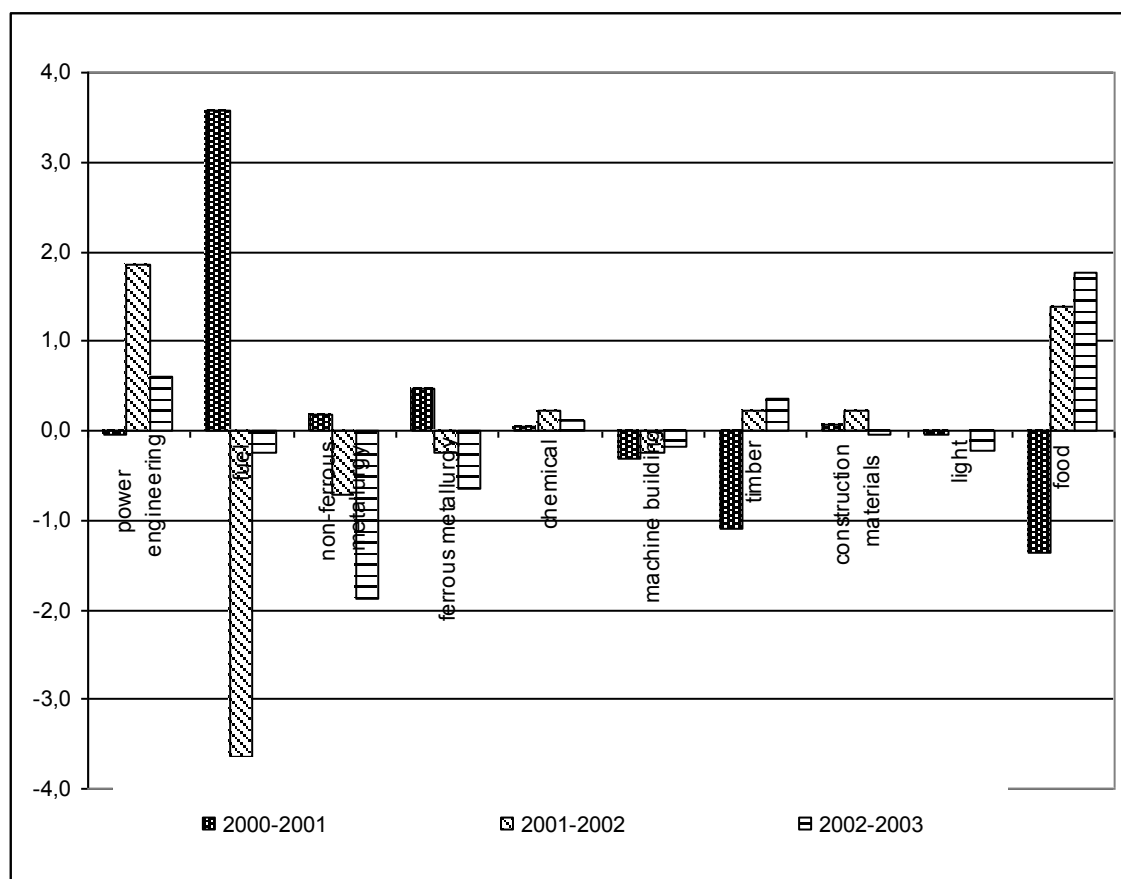
Despite the fact that in the years 2001-2003 there was a certain rise in the share of investments in the processing sector of the economy, it should be taken into consideration that the investment branches of industry accounted for 7.6% of the general volume of investments



in industry, and the investment branches of the consumer complex - for 9.3% thereof. Given the existing age, technological and reproductive structure of fixed assets, the low rates of investment in the branches of processing industry represent a factor reducing the rate of economic growth.

*Figure 32*

**Changes in the structure of investments in fixed assets by the branches of industry in the years 2000-2003, as a percentage of the previous year**



The fuel industry preserves its dominant positions in the structure of investments by accounting for more than 50% of the volume of investments in industry, with nearly one third of investments going into the oil-processing industry. During the past four years, the intensive rise in demand for investment goods on the part of the oil and gas complex was a powerful factor in the rise of business activity demonstrated by machine building and by the construction-materials producing industry. In the year 2002, as a result of the cumulative influence exerted by internal and external factors, the profitability of production in the fuel industry declined nearly two times in comparison with the previous period, which, in turn, produced a negative effect on the level of investment demand. In the year 2003, the oil sector of the economy was characterized by a relatively inactive behavior of investment activity. While the rate of investment in industry on the whole rose by 20.5% in comparison with the first six months



of the year 2002, and by 19.6% in the fuel industry, investments in fixed assets as regards the oil-extraction industry went up by 13.0%, and in the oil-processing industry they declined by 4.4%. Bearing in mind the traditionally high concentration of income within the export-oriented branches of the oil and raw-materials sectors and the absence of mechanisms for the inter-sectoral movement of capital, it would have been unrealistic to expect any acceleration of the rate of investment and any cardinal changes in the character of reproduction of fixed assets. By the results achieved in January-September 2003, there was registered a 0.4-point decline in the share of the fuel complex in respect to the general volume of investments in industry.

The prospects for a further growth of the Russian economy depend heavily on the intensity of changes in the structure of investments in favor of the branches oriented to the internal market. Reform of the tax system and of the budgetary process should stimulate the processes of diversification of the economy's structure by the means of enhancing the investment attractiveness of the processing branches of industry as well as by equalizing the conditions for the effective use of investment resources through the redistribution of the fiscal load between the raw-materials sector and the sector not dealing with raw materials.

## Foreign investments in the Russian economy

In the year 2003, the RF investment sphere was characterized by the growth of business activity conducted to by the improvement of the investment climate and by the stable expansion of the Russian economy. According to the FDI Confidence Index published in September 2003 by the consulting company "Kearney", in the year 2003 Russia moved to the 8th position from the 17th in 2002 and the 32nd in 2001.

The next step was the rising of Russia's credit rating to the Baa3 investment level. The accordance to Russia of the Moody's Investor Service's investment rating which took place on 8 October 2003 meant that one of the leading rating agencies has recognized the capability of the Russian economy to timely and completely fulfill its debt liabilities not only in the short run but also in the long-term perspective. Among the positive achievements of the Russian economy Moody's experts have singled out the considerable improvement of its liquidity- and debt-equity ratios; the decision to form a stabilization fund to smooth the fluctuations of state revenues, and the lowering of political risks. It should be noted that according to Moody's classification the Baa-level rating is the lowest among the investment rating categories, and the bonds of such issuers have the features of bonds of the speculative level. Therefore, despite the fact that Moody's action was a grand event for the Russian financial market, this by no means meant a transition to another category because the leading Western investors usually take into consideration the ratings published by at least two agencies. In accordance with the methodologies of other leading rating agencies, Russia is still one or two steps below the level of investment rating. Moreover, representatives of these rating agencies have voiced their opinion that it was too early to accord the investment rating to Russia. According to the estimates published by the international agency "Fitch", the long-term rating of Russian financial instruments nominated in foreign currency is BB+, and the forecast is stable. Given the low degree of diversification of the Russian economy and its significant dependence on the world prices of energy resources, "Standard & Poor's" places its credit rating on the BB level, and the forecast is also stable.

By the end of the year 2003, foreign capital accumulated in the economy of the Russian Federation amounted to approximately 57.0 billion dollars including investments from the CIS countries. The total volume of foreign investments received by the non-financial sector of the Russian economy in the year 2003 amounted to 29.7 billion dollars. The distinctive feature of the year 2003 was the positive dynamics of the net inflow of foreign investments: investments in the Russian economy exceeded the outflow of capital by 6.4 billion dollars.

*Table 31*

**Foreign investments in the Russian economy**

	In mln USD			
	Total	Direct	Portfolio	Other
1999	9 560	4 260	31	5 269
2000	10 958	4 429	145	6 384
2001	14 258	3 980	451	9 827
2002	19 780	4 002	472	15 306
2003	29699	6781	401	22517

Source: Goskomstat of Russia.

A clear sign of the improving investment climate and the increased confidence in the Russian economy on the part of foreign investors is the growth of volumes of direct investments. By the results of the year 2003, the rate of growth of direct foreign investments exceeded that of aggregate foreign investments which resulted in the growth of the share of direct investments in the aggregate amounts to 22.8% in comparison with 20.2% in the year 2002.

The dynamic growth of foreign investments in the Russian economy took place against the background of considerable changes in the sectoral make-up. In comparison with the year 2002, there was an increase in the share of foreign investments in industry. In the sphere of priorities, the infrastructure sectors continue to hold very strong positions.

*Table 32*

**Sectoral make-up of foreign investments in the Russian economy in the years 2001-2003**

	In mln dollars			As % of total		
	2001	2002	2003	2001	2002	2003*
Industry	5 662	7 332	12330	39.7	37.1	41.5
Transport and communications	1 259	610	1083	8.8	3.1	3.6
Trade and public catering	5 290	8 800	10516	37.1	44.5	35.4
Commercial activity servicing the market	792	1 355	3403	5.6	6.9	11.4
Finance, credit, insurance, pension provision	127	130	640	0.9	0.7	2.1
Other sectors	1 128	1 553	1722	7.9	7.9	5.8

\* Preliminary data.

Source: Goskomstat of Russia.



Foreign investors continue to show interest in the traditional branches of the extraction industry accounting for more than three fifths of the total volume of foreign investments in Russian industry. However, in the year 2003 there was a change in the sectoral proportions in comparison with the situation in the previous year. The approximately 15-points reduction in the share of the metallurgical complex's branches in comparison with the figures of the year 2002 was compensated by a more than 17-points rise in the share of fuel branches. By the results of the year 2003, the volume of investments in the fuel complex amounted to 5.3 billion dollars - 2.7 times more than in the year 2002.

In the year 2003, the share of machine-building in the aggregate amount of investments in industry amounted to 6.2%, as compared to 6.7% in the year 2002 and 12.4% in the year 2001, though the net volume of foreign investments in machine-building amounted to 769 mln dollars, which was 1.6 times more than in the year 2002.

In the year 2003, the tendency towards & reduction in the volumes of foreign investments in the food industry continued to manifest itself. In comparison with the year 2002, the volume of investments declined by 15%.

*Table 33***Sectoral make-up of foreign investments in industry in the years 2001-2003**

	In mln dollars			As % of total		
	2001	2002	2003	2001	2002	2003*
<b>Industry, total including:</b>	5662	7332	12330	100	100	100
Fuel	1023	1943	5305	18.1	26.5	43.0
Metallurgy	1547	2469	2306	27.3	33.7	18.7
Machine-building and metal-processing	703	490	769	12.4	6.7	6.2
Food	1557	1210	1024	27.5	16.5	8.3
Timber processing and pulp-and-paper industry	241	312	599	4.3	4.3	4.9
Other sectors	591	908	1470	10.4	12.4	11.9

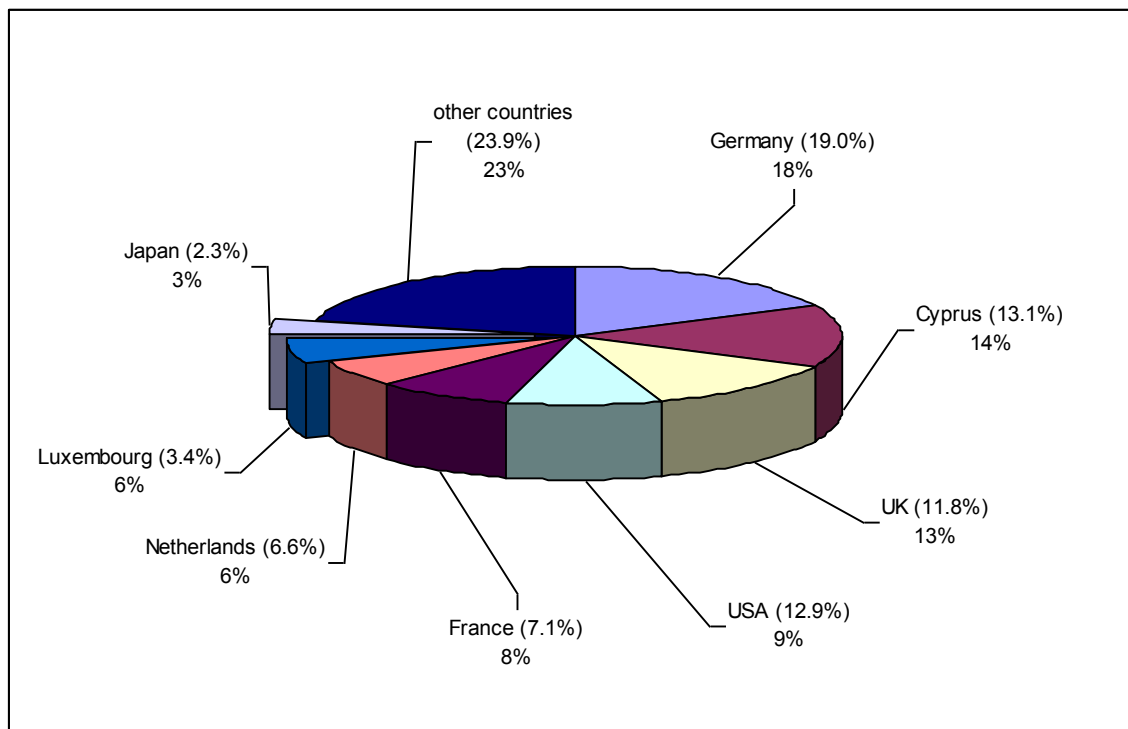
\* Preliminary data.

Source: Goskomstat of Russia.

As far as the geographical structure of foreign investments in the year 2003 is concerned, the clear leader is the United Kingdom (4.6 bln dollars), followed by Germany (4.3 bln dollars) and France (3.7 bln dollars). In the year 2003, investments from France increased more than three-fold in comparison with the year 2002, while those from the United Kingdom increased two-fold. Investments from Germany grew by approximately 7%, and investments from the USA stabilised at the previous level. Correspondingly, there was an increase in the share of the United Kingdom and France as regards the structure of accumulated foreign investments in the Russian economy in comparison with the figures of the year 2002.

Figure 33

**Geographical make-up of accumulated foreign investments in the Russian economy in the year 2003, as a percentage of the total**



\* In brackets are figures for the year 2002.

The high intensity of the inflow of investments in the Russian economy is determined, on the one hand, by the stable growth of production of goods and services in the major sectors of the economy, the growth which provides a means for the expansion of the real sector's zone of efficient investment with profitability and risks comparable with those observed in western countries, and on the other hand, by a relatively slack economic growth in the leading countries of the West resulting in a decline in profitability and a rise in investment risks at the traditional capital markets.

One of the substantial factors stimulating the growth of foreign investments was the realization of the investment projects based on the corresponding production-sharing agreements (PSA); "Sakhalin-1", "Sakhalin-2" and "Hariaginskoe SRP".

In the year 2003, the state revenues from the implementation of the existing projects were as follows; the "Sakhalin-1" project – 184.3 thousand USD in payments for the sea area specified in the agreement; the "Sakhalin-2" project - regular payments for the extraction of mineral resources (royalty) in the course of implementation of the PSA (hydrocarbon raw materials) in the amount of 404.8 million roubles, in the form of the investor's compensation for the expenditures incurred by the State in the process of geological prospecting in the amount of 10 million USD, and nonrecurrent payments (bonuses) in the amount of 8 million USD (bonuses paid on announcement of the beginning of the second stage of the project and on the beginning of exploitation of the Lunsk gas-condensate field); and the "Hariaginskoe SRP" - regular payments for the extraction of mineral resources (royalty) in the course of implementa-



tion of the PSA (in the form of hydrocarbon raw materials) in the amount of 128.9 million roubles.

*Table 34*

**State revenues from implementation of production-sharing agreements  
(in the year 2003)**

Category of payment	Sakhalin-1	Sakhalin-2	Hariaginskoe SRP
Regular payments for extraction of mineral resources (royalty) in course of implementation of PSA (in form of hydrocarbon raw materials)		404.8 mln roubles	128.9 mln roubles
Investor's compensation for State expenditures on geological prospecting		10 mln USD	
Payment for sea area specified by agreement	184.3 thousand USD		
Lumpsum payments (bonuses)		8 mln USD (bonus on announcement of beginning of second stage of project, and beginning of exploitation of Lunsk gas-condensate field)	

*Source:* data presented by the Ministry of Economics.

On 28 November 2003, the Commission for the elaboration of the terms of exploitation of mineral resources and for the preparation of a production-sharing agreement in respect to the Prirazlomnoe oil field concluded its work. It has worked out a draft Agreement which envisaged the introduction of economic parameters reflecting the interests of the State and corresponded to the provisions of legislation of the Russian Federation.

In accordance with the established procedure, the draft agreement was submitted to the Government and to the federal bodies of executive power as well as to the bodies of state power of Murmansk and Archangel Oblasts and the Nenetsk Autonomous Okrug in whose territory the works envisaged in the agreement would be conducted) whereat the draft would be agreed upon.

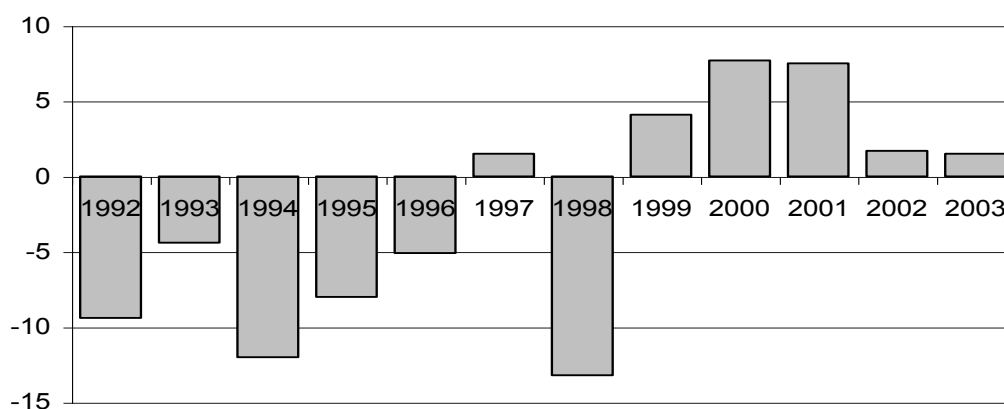
The issues pertaining to the preparation of production-sharing agreement in respect to the Prirazlomnoe oil field were discussed on 28 January 2004 at a session of the Commission of the Government of the Russian Federation for the Coordination of the Activity of the Federal Bodies of Executive power and the Bodies of State Power of the Subjects of the Russian Federation in the Sphere of Implementation of Production-Sharing Agreements. As a result of the discussion, it has been decided to approve the draft agreement as a basis for further elaboration after which it should be submitted to the Government in accordance with the established procedure.

### 3.4. Agrifood Sector

In 2003 the growth of Russia's agrifood sector has markedly slowed down as compared with the peak years after 1998 crisis (*Picture 35 – Picture 36*). Agricultural output is up only 1.5%, output of the food industry – slightly over 5%. These notably lower rates cannot be attributed to weather conditions: although the crop of grains in the last season was poor, the yields of other crops were high (in the previous season the situation was just the opposite, and the growth rates were approximately the same). The 2002 and 2003 indicators evidence that the after-crisis growth factors in the agrifood sector are exhausted while new impulses haven't been created. In this situation state policies aim to sustain the sector's dynamics with the help of protectionist measures but haven't brought any result as yet.

*Picture 34*

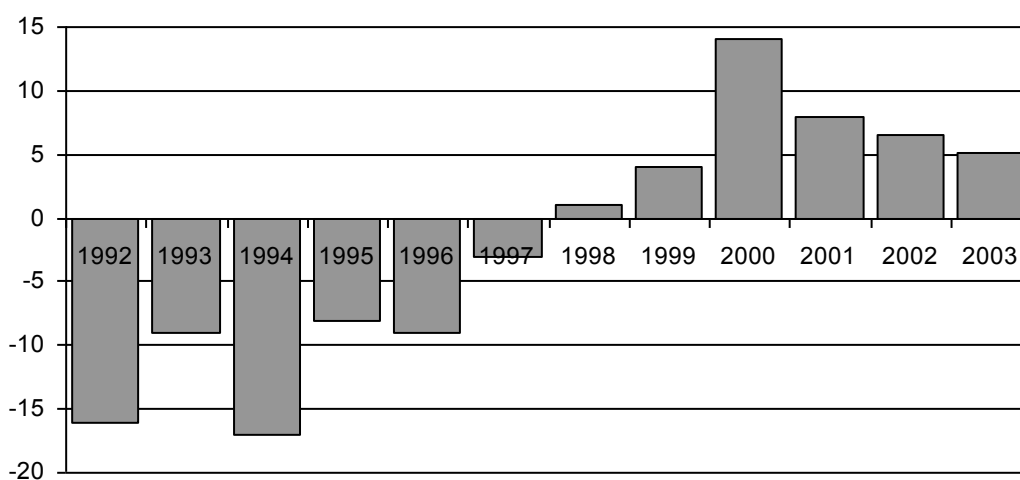
**Russian agriculture: percent change of annual output in 1992-2003**



Source: RF State Committee for Statistics.

*Picture 35*

**Russian food industry: percent change of annual output in 1992-2003**



Source: RF State Committee for Statistics.



By the end of 2003 the output of Russian agriculture was as low as 70% of the corresponding 1991 indicator, the output of food industry – 75%. On the whole the pre-reform production volumes haven't been restored. At the same time the differentiation of agricultural producers escalates meaning that some of them managed to benefit from the “window of opportunities” in 1999-2001 while others are on the edge of closing and still keep afloat only due to soft budget constraints in agriculture.

### 3.4.1. Agricultural production

As compared with 2002 the total size of areas planted reduced by 6.3% down to 78.9 million hectares. In major grain-growing regions producers shifted to planting sunflower and sugar beets instead of grains. This was due to both weather conditions (winter-kill of winter grains, late spring preventing re-sowing of killed areas in summer grains) and economic factors: over-production of grain in 2002 resulted in a sharp drop of prices for it on the domestic market. Still, it's worth noting, that growth of areas planted in sunflower, sugar beets and vegetables has become a trend (*Table 35*).

The share of individual private farms in the total areas planted continues to grow.

*Table 35*

#### Areas planted in major agricultural crops, million ha

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Grains	54.7	53.4	53.6	50.8	46.8	45.9	47.6	48.2	42.5
Sunflower	4.1	3.9	3.6	4.1	5.5	4.6	3.8	4.089	5.3
Sugar beets	1.1	1.1	0.9	0.8	0.9	0.8	0.8	0.814	0.924
Potatoes	3.4	3.4	3.4	3.3	3.3	3.2	3.3	3.2	3.2
Vegetables	0.8	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.9

Source: RF State Committee for Statistics.

In 2003 production of grains and legumes reduced by 22.4% down to 67 million tons (weight after primary processing). The reduction was due to both smaller areas planted and lower yields (down 9.4%).

*Table 36*

#### Gross output of major agricultural crops, million tons (weight after primary processing)

	1998	1999	2000	2001	2002	2003
Grains	47.9	54.7	65.5	85.2	86.6	67.2
Flax fiber	0.0	0.0	0.1	0.1	0.0	0.1
Sugar beets	10.8	15.2	14.1	14.6	15.7	19.3
Sunflower seeds	3.0	4.2	3.9	2.7	3.7	4.9
Potatoes	31.4	31.3	34.0	35.0	32.9	36.6
Vegetables	10.5	12.3	12.5	13	13.3	14.8

Source: RF State Committee for Statistics.

The output of sunflower seeds has set a new historic record due to both larger areas planted and higher yields.



Production of sugar beets, potatoes and vegetables also grew markedly. In 2003 sugar beet yields were notably up and approached the pre-reform level (however, gross output of this crop is still below the 1992-1993 indicator to say nothing of the Soviet period). The outputs of potatoes and especially vegetables are even above the annual average of the last 5-year period before the start of reforms.

As compared with previous years the situation in livestock production deteriorated. Cattle number shrank even faster than before, inventories of sheep and goats increased at a slower rate and those of pigs started to decrease after several years of growth. The latter fact can be attributed to higher prices for the new crop grain: number of pigs began to fall in September when poor crop started to affect prices for grain feeds. Cow and total cattle inventories decreased evenly throughout the year.

*Table 37*

**Livestock inventories, million heads**

	1991	2000	2001	2002	2003
Cattle	57.0	27.2	26.9	26.6	25.0
Pigs	38.3	16.4	15.9	17.0	16.5
Sheep and goats	58.2	14.4	14.8	15.6	16.2

The continuing growth of meat output can be explained by decrease of cattle inventories: livestock producers sell meat of animals whose slaughter was forced by shorter availability of feeds. However, nearly the same gross output of milk despite dropping number of cows is an evidence of noteworthy intensification in the dairy sector. The decline of milk production during the reform years was halted in 1999-2000 and at present equals the 1998 level (although it's only about 60% of the 1986-90 average). Production of meat was restored up to 80% of the pre-reform level, production of eggs – to over  $\frac{3}{4}$  (*Table 38*).

*Table 38*

**Total production of major livestock products, million tons**

	1991	2000	2001	2002	2003
Slaughter livestock and poultry, live weight	9.3*	7.0	7.0	7.3	7.7
Milk	51.9	31.9	32.9	33.5	33.3
Eggs, billion pieces	46.9	33.9	35.0	36.2	36.4

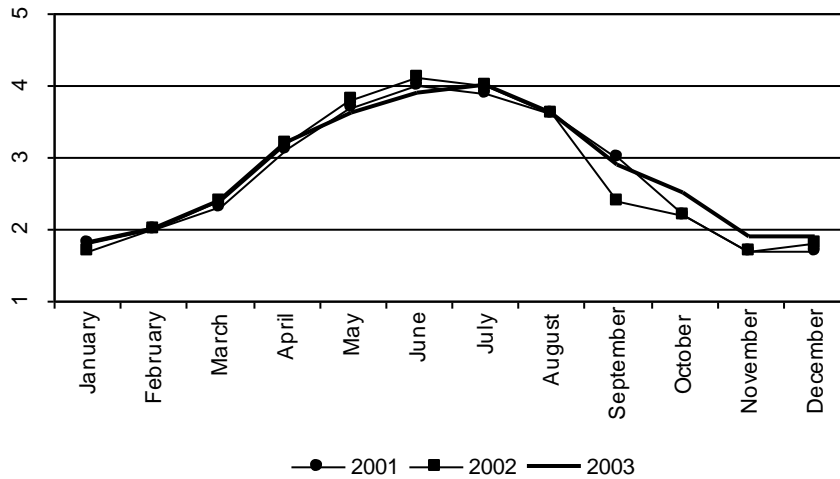
\*- slaughter weight.

Source: RF State Committee for Statistics.

The key problem of milk production is its extreme seasonality (*Picture 36*). It determines non-stability of dairy farms' financial performance, hampers the rhythmical work of dairy industry and induces over-production of non-perishable milk products (butter, dried milk).

Picture 36

**Total monthly output of milk, million tons**



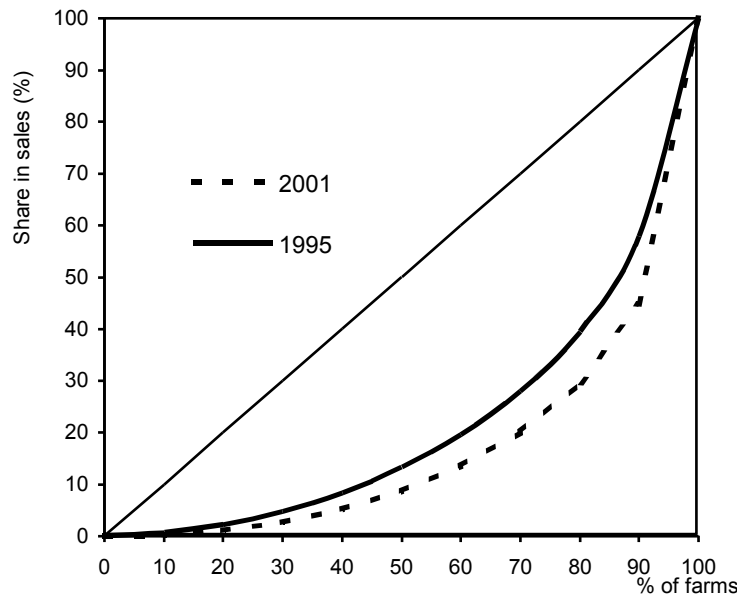
Source: RF State Committee for Statistics.

**3.4.2. Differentiation of agricultural producers**

One of the basic trends of current agriculture’s development in Russia is the remarkable differentiation of farm producers. Lorenz curves on *Picture 30* show concentration of corporate farms’ returns from marketing agricultural products. Gini coefficient grew from 0.65 in 1995 to 0.75 in 2001, 10% of farms account for over half of the sector’s sales.

Picture 37

**Concentration of agricultural production (Lorenz curves)**



Source: V.Uzun. Farm structure in Russia: adjustment to market and efficiency. 2003. Mimeo.

Sales concentration coefficients illustrate the situation even better (*Table 39*). The 10 largest corporate farms get almost 3% of the total returns from marketing, farms with annual sales over 1 million dollars – nearly half of them although their share in the total number of farms in Russia (26 thousand) is less than 7%.

*Table 39*

**Concentration of agricultural production  
(share of the largest producers in sales), 2001**

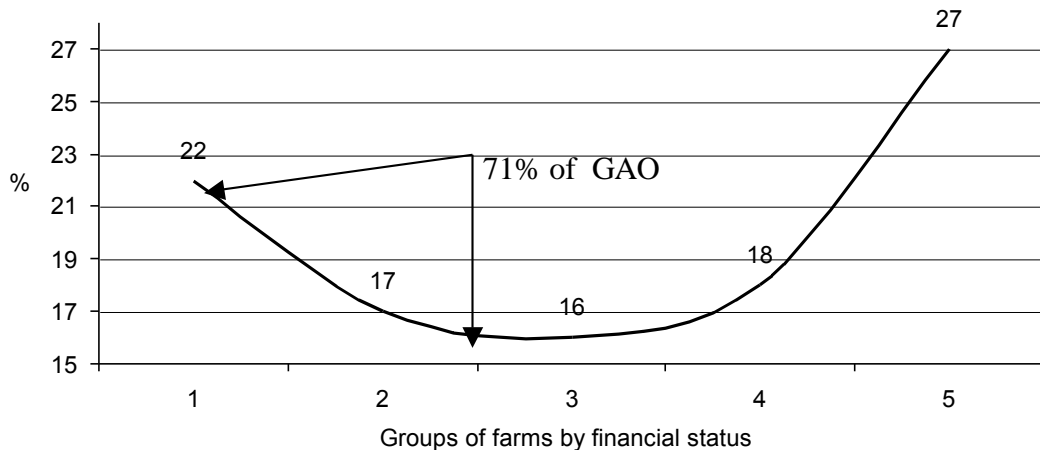
Largest agricultural producers		Returns from marketing	
number	% of the total	Billion rubles	% of the total
10	0.00	8.5	2.9
300 (Club "AGRO-300")	1.2	54.7	18.5
1734 (with annual sales over 1 million dollars)	6.9	142.3	47.9

*Source:* V.Uzun. Farm structure in Russia: adjustment to market and efficiency. 2003. Mimeo.

The implementation of Law on financial recovery of agriculture envisages the division of all corporate farms into 5 groups by their financial status. This division is very relative but yet it gives a certain idea of producers' differentiation (*Picture 38*). The first and the second groups include farms with good financial performance: accounting for about 40% of all farms they produce over 70% of the sector's gross output.

*Picture 38*

**Distribution of corporate farms by their financial status, 1999**



*Source:* calculated using data in V.Uzun. Farm structure in Russia: adjustment to market and efficiency. 2003. Mimeo.

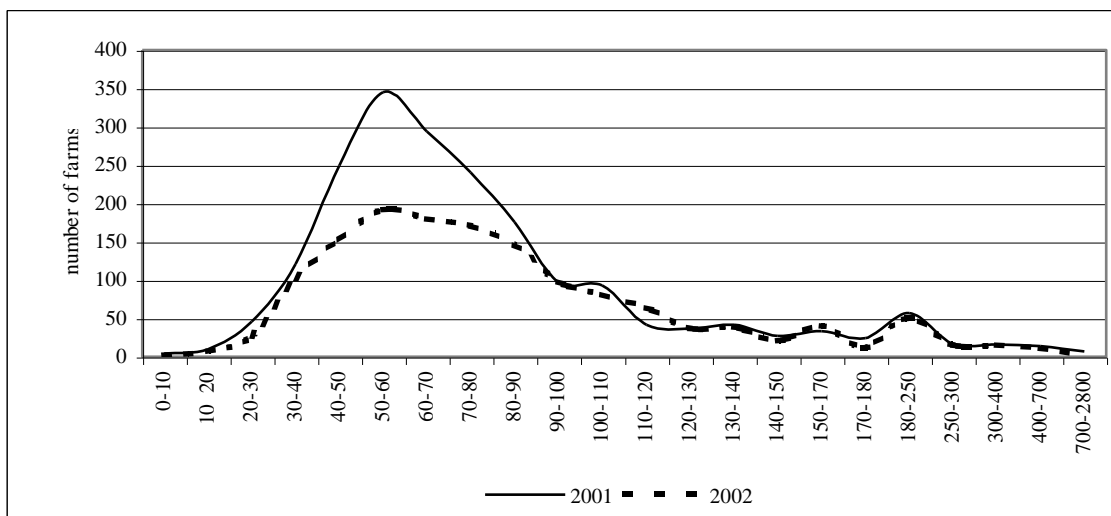
In other words, a group of large financially stable farms is forming in agriculture that shapes the sector's dynamics. On the other pole one can see quite a numerous group of farms that are actually non-commercial institutions. They still survive due to obvious social and political functions (upkeep of local social activities, providing of jobs, etc.) that they perform and to soft budget constraints in agriculture.

The softness of budget constraints is illustrated by largely distorted distribution of all basic farm efficiency parameters. For instance, the distribution of sugar beet growers by pro-

duction costs has a clear right “tail” (*Picture 39*). The situation in other crop segments is similar. In case of a normal economic environment the distribution of farms by such parameters as production costs and other efficiency indicators would be close to normal. The survival of low-efficient farms is in no way economically justified, the more so as the bulk of output is produced by efficient producers. The latter could noticeably enlarge supply if not for competition of low-efficient farms that remain on the market thanks to subsidies and other preferences.

*Picture 39*

**Distribution of sugar beet growing farms in 6 regions by production costs (rubles per 100 kg), number of farms**



*Source:* calculated using data of RF State Committee for Statistics.

To our mind the solution of non-efficient farms’ problem lies beyond the development of farming as a business. This is a big and urgent social problem the solution of which requires other adequate measures of state policies.

### 3.4.3. Production of food

Growth in the food industry continues. But similarly to growth in agriculture it’s slowing down (*Table 40*). Gross output of such products as vegetable oils, sugar, beer and some other largely surpassed the pre-reform level. Production of many commodities (cheese, sausage, confectionery, macaroni, margarine, etc.) is restored up to 70-75% of the Soviet period volumes while production of some other (e.g. meat and whole milk products) is still far below them.

Trends in production of food products are determined by several factors. One of the central factors is the dynamics of real personal incomes. Their relatively low level entails poorer restoration of milk and meat production. However, the stable growth of these incomes after 1999 causes shifts in food consumption structure: in recent years the output of bread and groats decreases while that of meat and whole milk products grows steadily following the respective demand trends.

The second group of factors is shaped by state agrifood policies. For instance, the self-sufficiency in white sugar and vegetable oil was largely attained due to the state regulation of respective markets in recent years.

Russian food industry is greatly affected by the world trade situation. For instance, meat industry trends are largely shaped by import of cheap (subsidized) raw meat from the EU; as a result meat processing grows at a higher rate than domestic production of meat by farms.

On the whole, the restoring Russian food industry is undoubtedly undergoing a noticeable structural transformation. It is an important integral part of reform and therefore one should not expect a 100% restoration of all food production segments. At present Russia's comparative advantages in production of one or another product are being identified.

*Table 40*

**Production of basic food products, as % of the previous year**

	2000	2001	2002	2003
Meat	107.2	107.6	108.3	110.5
Sausage	111.0	116.3	117.9	110.1
Butter	101.9	101.1	103.0	99.8
Whole milk products	110.7	108.1	111.9	105.1
Vegetable oils	156.1	93.2	92.6	126.6
Sugar	121.9	111.5	100.0	94.6
Flour	95.3	99.2	88.3	99.5
Groats	103.7	106.7	90.0	86.9
Macaroni	99.6	108.5	108.8	104.5
Margarine products	121.9	111.5	100.0	100.6
Canned meat	90.7	106.7	91.3	92.3

*Source:* RF State Committee for Statistics.

#### *3.4.4. Production of agricultural inputs*

In 2003 the decline in agricultural machine building that started in 2002 after a short growth continued (*Table 41*). This is a proof that agricultural producers' demand for farm machinery has been overestimated. In 2002 their financial performance sharply deteriorated due to extraordinary worsening of price parity. In 2003 the parity somewhat bettered and farms got certain funds for medium-term investments in machinery and equipment but they apparently preferred to use these money for other purposes.

Demand for farm machinery is certainly influenced by funds allocated to the leasing program – a component part of the current government agrifood policies. In 2003 these funds were cut more than three fold in nominal terms, and this factor could have played the key role in sluggish demand.

In the framework of joint Russian-US study BASIS<sup>3</sup> a sample survey of agricultural producers in three regions was carried out. Among other issues the demand for farm machinery was examined. The survey showed that at present farm machinery is not a limiting factor in Russian agriculture.

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<sup>3</sup> The study is carried out from 2001 and is financed by USAID. See: <http://www.iet.ru/afe/projects.html>.



Table 41

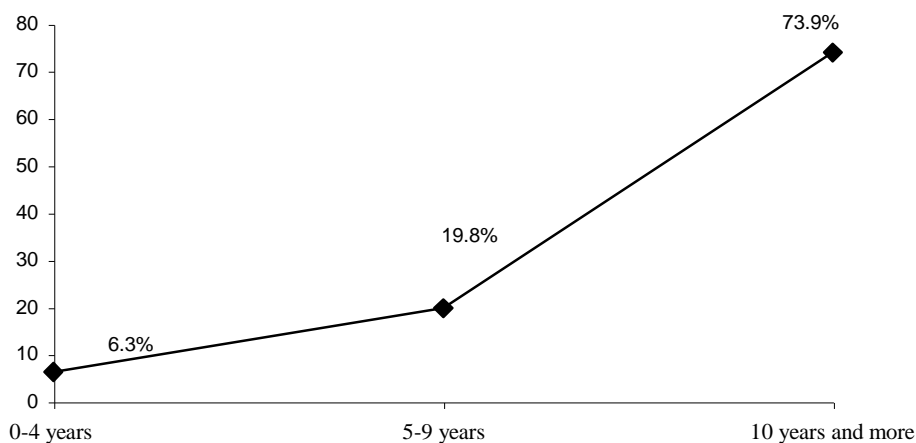
**Production of agricultural inputs, as % of the previous year**

	2000	2001	2002	2003
Tractors	137.2	78.8	63.5	87.3
Tractor ploughs	170.8	113.0	68.9	44.6
Tractor seeders	166.9	122.0	82.2	77.4
Tractor cultivators	165.9	118.5	93.4	71.3
Grain harvesters	2.2 fold	174.3	83.4	80.4
Mineral fertilizers	106.2	106.9	104.0	103.0

Source: RF State Committee for Statistics.

Picture 40

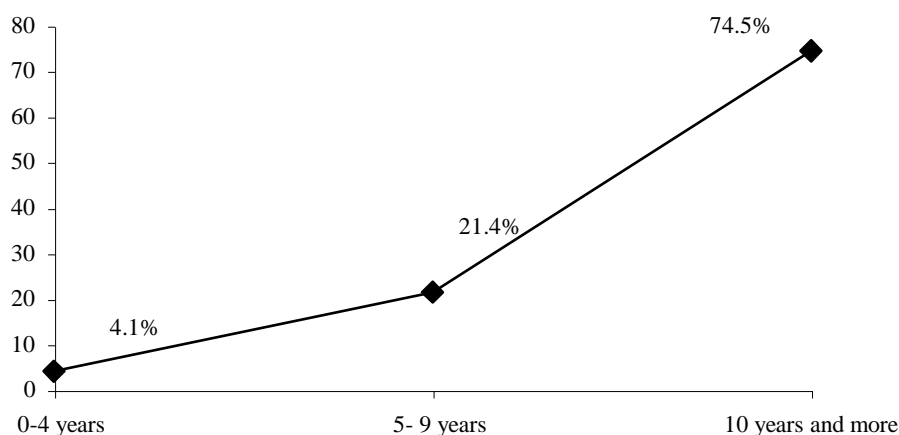
**Corporate farms: distribution of tractors by age, 2001**



Source: survey results, <http://www.iet.ru/afe/bulletin.html>.

Picture 41

**Corporate farms: distribution of grain harvesters by age, 2001**



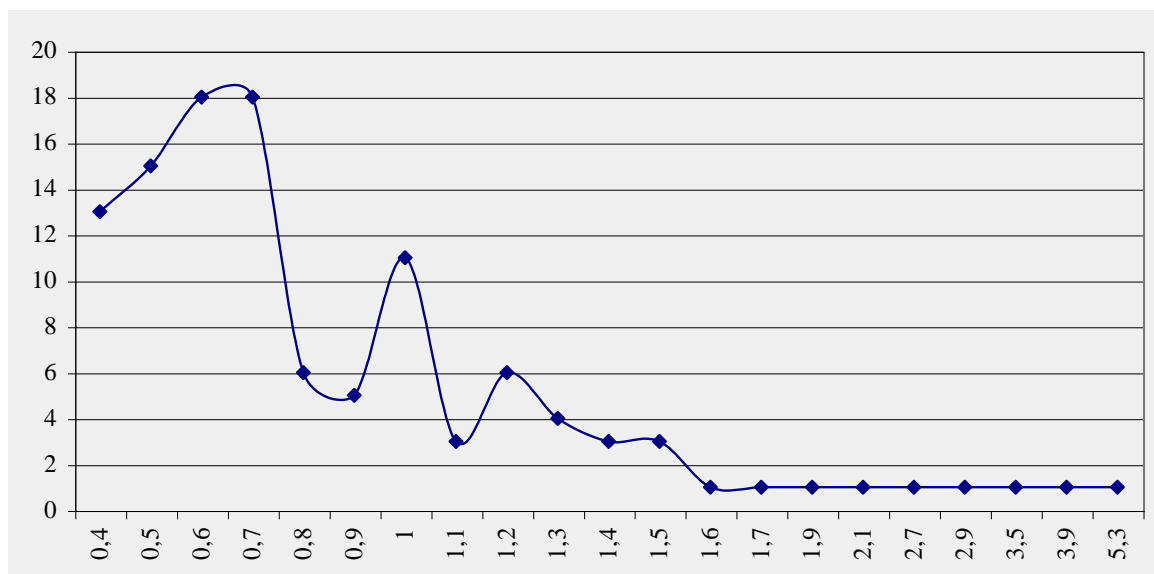
Source: survey results, <http://www.iet.ru/afe/bulletin.html>.

*Pictures 40 and 41* show the distribution of tractors and grain harvesters by age in corporate farms. One can easily detect that within the 10 recent years over one fourth of machinery has been renewed. In 1991-1997 the rate of this renewal was even higher than after the 1998 crisis.

At the same time *Picture 42* demonstrates that in three fourths of corporate farms tractor power is below 1 h.p. per 1 hectare of arable land while in one fourth it's apparently surplus as compared with the bulk of producers. Similarly, almost 60% of the surveyed corporate farms have less than 20 tractors while the remaining 40% - over 20 tractors.

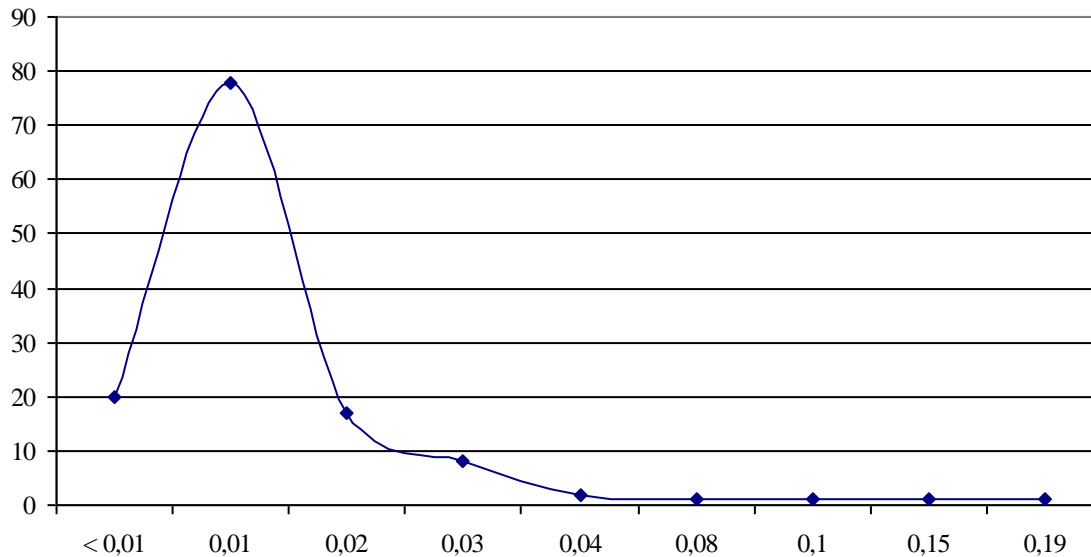
*Picture 42*

**Distribution of 115 corporate farms by available tractor power in 2001, horse power per hectare**



Source: survey results, <http://www.iet.ru/afe/bulletin.html>.

The situation is even more vivid for grain harvesters (*Picture 43*): their sum bunker capacity in nearly 90% of surveyed farms is below 20 kg per hectare of area under grains. At the same time there are farms where this capacity is 40, 80 and even 190 kg. In the chief grain growing region of the surveyed sample – Rostov oblast – the distribution of harvesters is even more uniform: the sum bunker capacity of grain harvesters is below 20 kg in 97% of corporate farms. The calculation of bunker capacity per ton of harvested grain reveals that in Ivanovo and Nijny Novgorod oblasts grain harvesters' capacity is well above the Rostov indicator.

*Picture 43***Distribution of 129 corporate farms by available grain harvesters per hectare of area under grains in 2001, tons of bunker capacity per hectare**

Source: survey results, <http://www.iet.ru/afe/bulletin.html>.

It's generally believed that there is an acute deficiency of tractors and other agricultural machines in corporate farms. But actually many of them have accumulated excessive stocks of machinery as compared with production volumes. Aging of this stock is a natural process but farm managers make no efforts to renew it. The potential demand for machinery assessed on the basis of its cumulative aging on farms is therefore over-estimated.

### 3.4.5. Financial performance of farm producers

In January-November 2003 the support of Russian agriculture from consolidated budget was approximately the same as the year before: the corresponding outlays amounted to 55 billion rubles. The federal agricultural budget in 2003 was executed by 98.5% and could have been executed in full if not for funds that were allocated to state purchase interventions in 2003 but will be used in 2004. The federal budget provided for the increase of sector's financing by 7% in real terms.

However, the allocation of funds throughout the year was very uneven. While in the first half of the year their amount equaled budget projections, by the end of November federal expenditures on agriculture were 10% below the corresponding 2002 level, and the bulk of them was financed in December.

Federal funding failures were primarily due to complicated administrative procedures needed to get subsidies, e.g. partial compensation of expenditures on melioration and purchase of mineral fertilizers, compensation of interest on credits.

Subsidies to producers of flax and hemp, compensations of insurance costs haven't been paid in full. The worst disciplined is the financing of programs aimed at the development of social and engineer infrastructure in rural areas, including regional development efforts fund-



ed from the federal budget and all kinds of fixed capital investments. In particular, 67 million rubles of fixed capital investments were to be spent under the special federal program “Social development of rural areas till 2010”, but no funds have been allocated at all. So, rural development programs included into the list of “green box” measures (not banned by WTO rules) are financed least accurately.

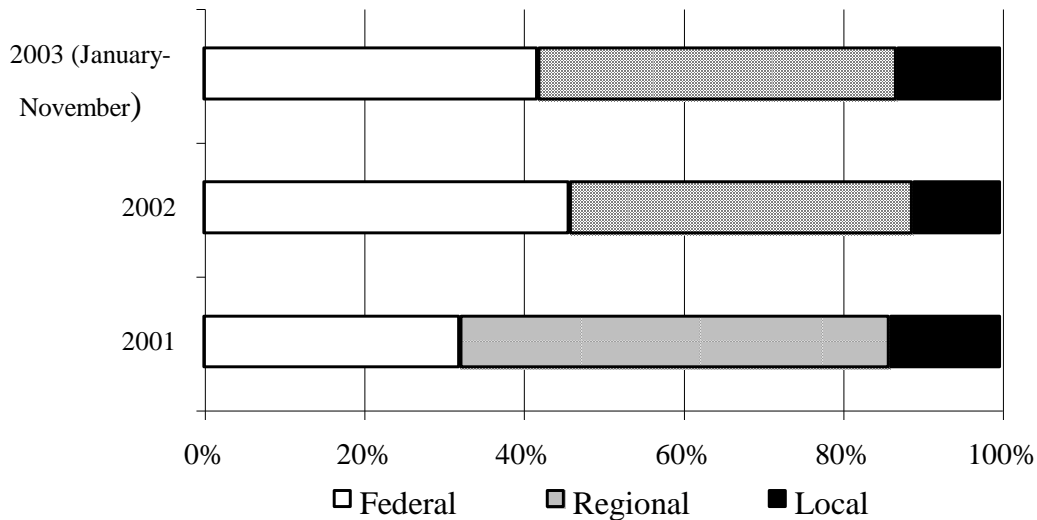
*Table 42*

**RF Ministry of Agriculture: budget execution in January-November 2003**

	<b>Plan (1000 rubles)</b>	<b>Allocated in January- November (1000 rubles)</b>	<b>Execution of annual budget provisions (%)</b>
Fixed capital investments	1138790	465130.4	41%
Purchase interventions on grain market	1424708	714620	50%
Pedigree stock-breeding	743737.8	548737.8	74%
Subsidies to wool producers	350000	350000	100%
Reindeer breeding	100000	100000	100%
Elite seed growing	269970.5	206154.9	76%
Subsidies to producers of flax and hemp	100000	3847.9	4%
Insurance	900000	-	0%
Maintenance of subordinate institutions	8893687	6223843	70%
Subsidies to waste disposal plants	45000	31803.9	71%
Subsidizing of interest on credits	3200000	1887523	59%
Education	6462208	4609135	71%
Health care and physical culture	12100	10617.8	88%
Social policies	5386.9	4040.1	75%
State administration	167223.7	129768.1	78%
International activities	278851.6	83745.9	30%
Science	200429.5	144635.9	72%
Regional development	132100	59995	45%
Other expenditures under special federal program “Improving soil fertility in Russia in 2002-2005”	4530772	3751334	83%
Other expenditures under special federal program “Social development in rural areas till 2010”	910	910	100%
Transferred to regional and local budgets under special federal program “Social development in rural areas till 2010”	1469090	1009777	69%
Fixed capital investments under special federal program “Social development in rural areas till 2010”	67850	-	0%
RF Government reserve for prevention and liquidation of damage from natural disasters or emergency	467.8	117.2	25%
<b>Ministry of Agriculture: total expenditures</b>	<b>31929621</b>	<b>22343014</b>	<b>70%</b>

Source: www.mcx.ru.

In 2003 the role of regional budgets in supporting agriculture grew again. In January-June federal funds for the first time exceeded 50% of consolidated state expenditures on agriculture, but by the end of the year the ratio reversed primarily due to the non-execution of budget provisions on the federal level. In the second half of the year support to agriculture from regional budgets expanded by 10% as compared with the previous year.

*Picture 44*
**Structure of consolidated agricultural budget, %**


Source: RF Ministry of Finance.

A large part of regional funds continues to be spent in the framework of producer support programs, and the role of regional budgets in financing direct support is still important. Many regional programs for supporting production of selected products lead to the disruption of common market space in the country. Still, when funding obligations are re-distributed from regional to federal budget, regional authorities tend to cut financing of budget services in favor of program expenditures. Therefore, the reduction of support to agriculture from regional budgets urges to solve the problem of dividing funding responsibilities between the federal center and regions.

The lowering of prices for agricultural products in the first half of 2003 became the basic factor of deteriorating financial performance of farm producers. During 7 months prices received by them dropped not only in real but also in nominal terms. As different from early 2002 when prices for livestock products were rather stable, in 2003 they fell from the very beginning of the year, and prices for crop products dropped even faster. But by August the upper trend prevailed and by the year-end prices both in the livestock and the crop sector soared and their growth rates exceeded those in industry. By November 2003 as compared with the same period previous year prices for electricity grew by 13.9%, for fuels and oils – by 16.3%, for agricultural products – by 20.2%.

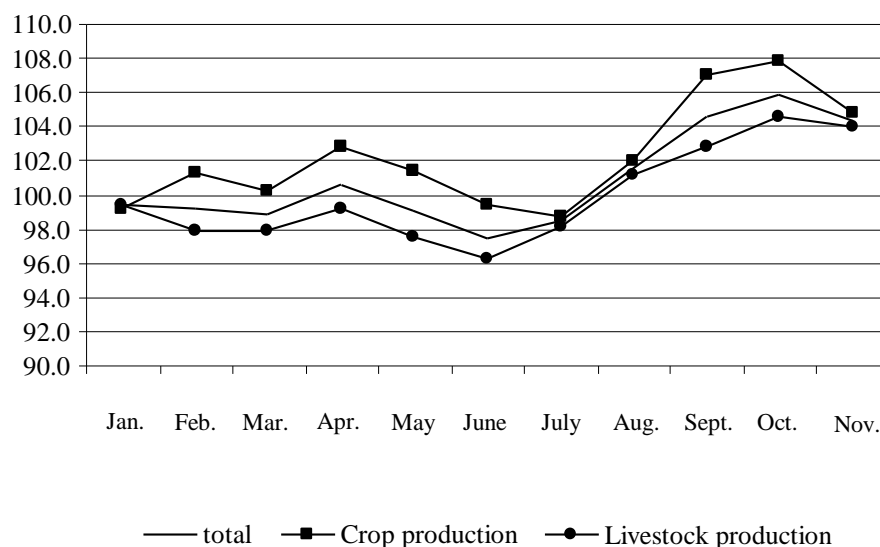
In addition to stabilization of budget financing, the sector was positively affected by growth of foreign investments that started this year. In the first half of 2003 foreign investments in Russian agriculture amounted to 37 million US dollars (while in the same period previous year they were as small as 7 million dollars) and by September grew to 60 million US dollars. The principal investor was Belgium (64.5% of investments in agriculture). The largest share of direct investments came from the Netherlands (6 million US dollars).

Larger investments in agriculture, predictable budget support and continuing growth of solvent demand for farm products allow speaking of preconditions for a steady growth in the

agrifood sector. But to make them work it's necessary to settle a number of budget support problems, such as the division of responsibilities between federal and regional budgets, improving the quality of budget planning. Besides, the problem of farm producers' financial performance needs to be solved.

Picture 45

**Index of real (deflated by CPI) prices received by agricultural producers in 2003 (as % of corresponding month 2002)**



Source: calculated using data of "Social and economic situation in Russia, January – November 2003", RF State Committee for Statistics, 2003, pp. 132, 144.

The federal government made an attempt to solve the sector's financial problems by adopting in July 2002 the Law "On financial recovery of agricultural producers". But the full year of operation revealed its insufficiency since the law does not cure deep-rooted problems the solution of which requires actions beyond restructuring of debts and reorganization of farms. Besides, there are factors hindering the law's implementation. The basic of them are the persisting price disparity preventing agricultural producers from meeting the restructuring terms and the compulsory bankrupting of non-efficient farms. Not the least by their negative effect are bureaucratic hindrances encountered by producers when preparing required documents.

In September 2003 the total creditor indebtedness of farm producers amounted to 331.6 billion rubles including 156.7 billion rubles of outstanding debts. According to the data of Commission for financial recovery of agriculture (formed in the Ministry of Agriculture) agri-food sector's debts to budget and non-budget funds exceeded 120 billion rubles. The number of farms having outstanding debts reduced from 20 thousand in September 2002 to 19.1 thousand in September 2003.

Net profit received by corporate farms in January-September 2003 is only 70% of that in the same period previous year. The share of profitable farms amounted to 54.5%, i.e. exceeded one half.



According to the Ministry of Agriculture's data as of July 1, 2003 only 6124 farms (whose debts totaled 44.5 billion rubles) could join the restructuring program. The rest were either undergoing bankruptcy proceedings (that are currently conducted against 3378 corporate farms) or could not sustain the 3-months schedule of current payments.

As of November 1, 2003 over 3500 farms (i.e. 17.5% of corporate farms in the country) filed applications for restructuring 25.4 billion rubles of debts (20% of their total amount in the sector). However, in the first half of the year the program of financial recovery was actually put into practice only in 1644 farms, with which agreements were signed on restructuring of debts amounting to 10.4 billion rubles, or about 8% of the total indebtedness. So, a year of the Law's operation has proved its non-workability.

In order to encourage producers joining the financial recovery program the Government resolved to write off by April 1, 2004 57 billion rubles of penalties and fines imposed on farms for delayed payments to the budget. However, only farms that joined the restructuring program are eligible for this writing-off, and since they are still few such an amount is unlikely to be written off by the specified date.

#### *3.4.6. Foreign trade in agricultural and food products*

In recent years foreign trade in agricultural and food products steadily grows due to both larger imports and exports. The primary contributor to this growth is export, the value of which is up 83% as compared with the crisis 1998. As generally known, its expansion was conditioned by ruble devaluation as well as strengthening of domestic agrifood sector's positions on the world markets of some products. After a sharp drop in 1999 imports of food by 2003 restored up to the pre-crisis level.

So, the process of Russian agrifood sector's integration in the world economy in recent years accelerated and it becomes an active player on a number of food markets (*Picture 46*). In 2003 the ratio of foreign trade to gross output of agriculture amounted to 61% (which is almost twice above the 2002 level), but this leap is primarily due to ruble revaluation in respect to dollar in which foreign trade turnover is measured. But even 30-40% integration into the world agrifood trade is quite a good indicator.

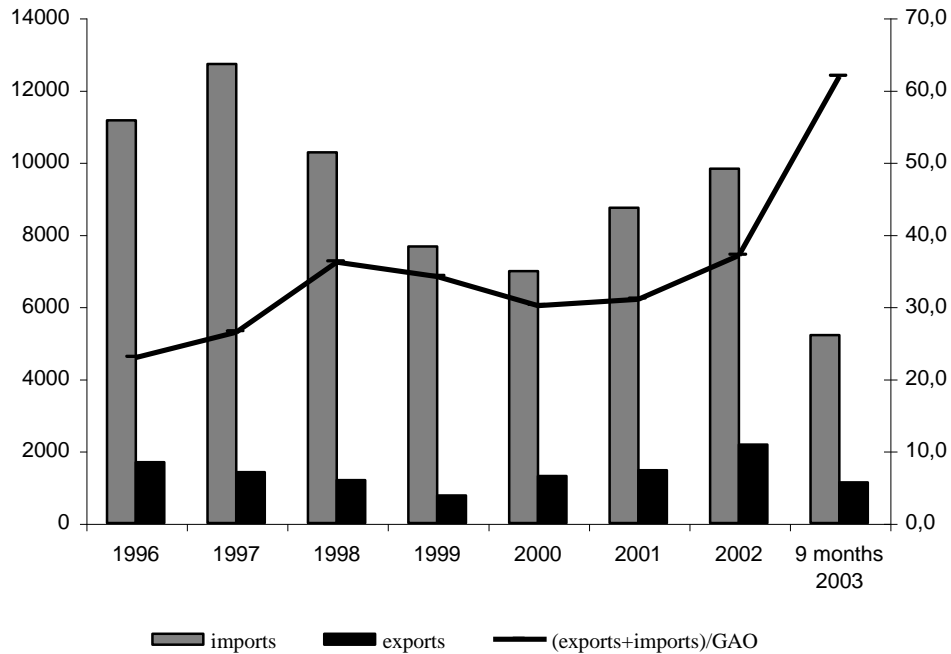
Non-CIS countries continue to account for the bulk of Russia's foreign trade in agricultural and food products. At the same time after a short drop in the previous year, in 2003 the CIS share in the country's agrifood trade grew again due to protectionist trends in Russian foreign trade regulation not affecting countries-members of the Customs Union. In 9 months 2003 foreign trade in food products with the CIS countries exceeded the corresponding annual indicator of 2002 (*Picture 47*).

The commodity structure of foreign trade in agricultural and food products in recent years changed as well (*Picture 48*). Due to its massive export supplies in 2001-2003, grain has become the basic item of Russian agrifood export leaving behind even such traditional items as fish, sea products and alcoholic beverages. The share of sugar in exports sharply dropped.

In the two recent years the share of exported oilseeds also fell due to the growth of domestic processing capacities and of home production of vegetable oil. However, in 2003 exports of sunflower seeds expanded again: volumes exported in 9 months exceed the previous year annual indicator. This growth is due to a very good crop harvested in 2003.

Picture 46

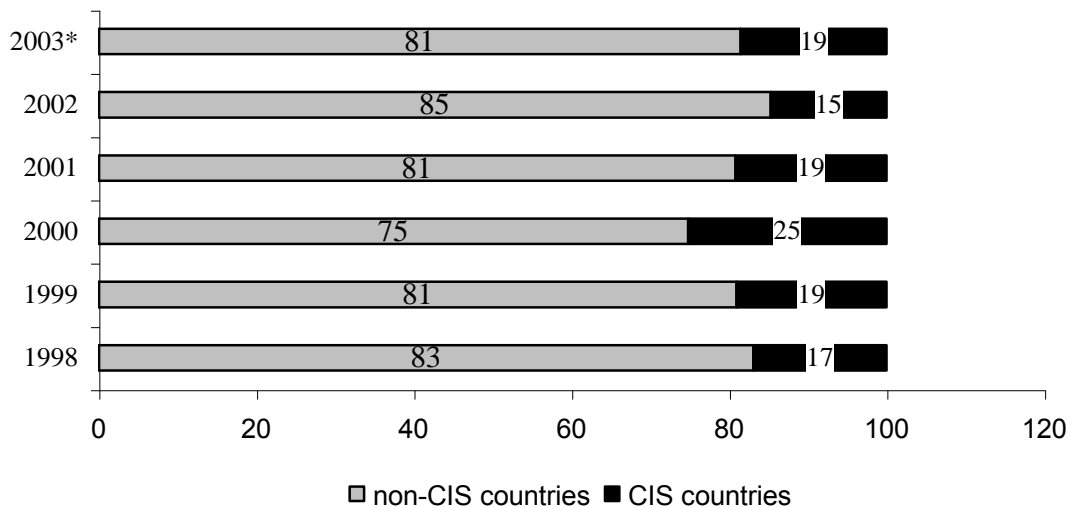
**Foreign trade in agricultural and food products  
in 1996 - 9 months 2003\***



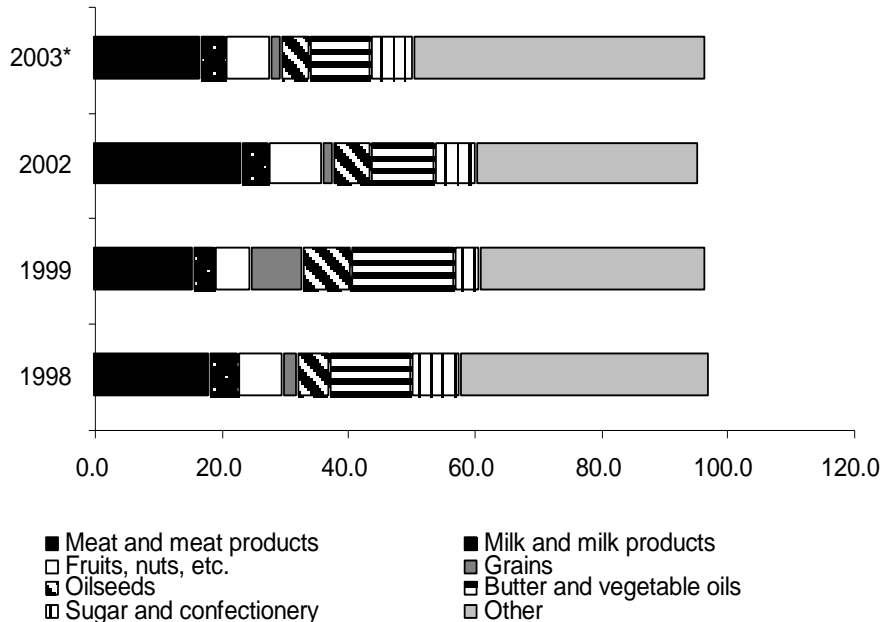
\* - less trade with Belarus.  
Source: Customs statistics of RF foreign trade.

Picture 47

**Share of CIS and non-CIS countries in Russia's foreign  
trade in agricultural and food  
products in 1998 – 9 months 2003, %**



Source: Customs statistics of RF foreign trade. RF Customs Committee, 3, 6 and 9 months 2003.

*Picture 48*
**Structure of Russia's agrifood imports, %**


\* - 9 months 2003.

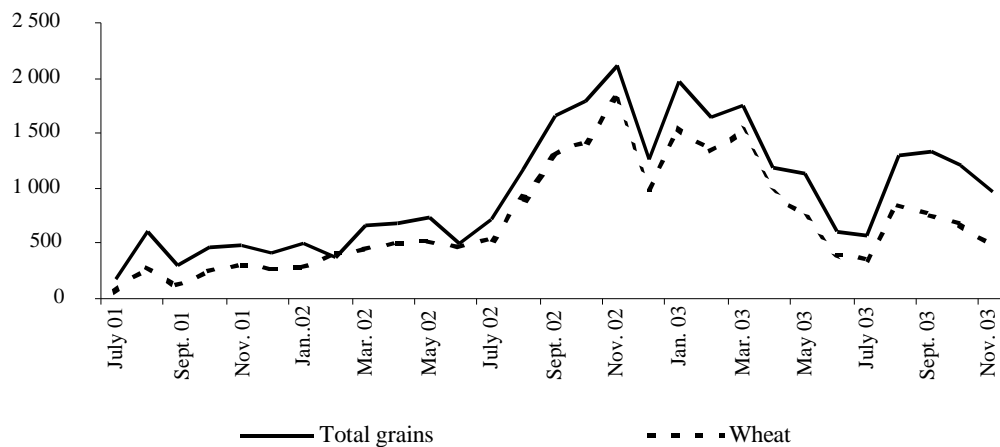
Source: Customs statistics of RF foreign trade. RF Customs Committee, corresponding years.

Relatively high grain yields in 2001 and 2002 that coincided with favourable for export situation on the world market in a short time made Russia a large exporter of grain. All pessimistic forecasts saying that the country has traditionally been an importer of grain, has no export infrastructure and thus cannot export more than 5 million tons of grain a year, have been disproved by massive export supplies. Market operators took an advantage of low domestic and high world prices and exported 12 million tons of grain in 2002 and 13 million tons – in 2003 (*Picture 49*). Moreover, not waiting for the state export support private business started to make large investments in construction of grain export facilities in sea ports. It's clear now that Russia has occupied its niche on the world market and becomes a stable exporter of grain capable to supply 5-10 tons a year depending on the domestic situation. Later the government supported private investors and in 2003 allocated 130 million rubles from the federal budget for subsidizing a part of interest on long-term investments in construction of port elevators.

In 2003 the output of grain was far below indicators of the two preceding years – 67 million tons. Taking into account 9.5 million tons of beginning stocks, this volume is sufficient both to cover the domestic demand for food and coarse grain and to export 5-6 million tons of grain. Export situation developed according to this estimate: thanks to the high world prices slightly over 5 million tons of grain (including 3 million tons of wheat) were exported from the beginning of the year. In spite of that there was no deficit of grain on the domestic market in 2003.

Picture 49

**Russian grain exports in 2001-2003, thousand tons**



Source: data of Unidell company.

### 3.4.7. Agricultural policies

Agricultural policies of the two recent years were determined by three basic factors, the combination of which resulted in stronger government's adherence to protectionist measures. First, exhaustion of the sector's growth factors engendered by 1998 crisis urges to look for new short-term and efficient mechanisms to support lowering rates. The after-crisis development proved that import substitution is quite an efficient but a very short-term tool: it brought good results when ruble was devaluating but cannot do the same when it is strengthening

As paradoxical as it may seem, the second factor of stronger protectionism are negotiations on Russia's accession to WTO. The WTO Agreement on Agriculture requires all countries to reduce support to agriculture by a single percent beginning from the base (i.e. effective by the date of Agreement's enforcement) level<sup>4</sup>. This is its basic difference from most other WTO agreements – at the end of transitional period countries come not to the uniform protection level but to inequality on a lower level. Respectively, the newcomers (and first of all countries-members of the former USSR) have an incentive to elevate this base level to get an opportunity for rendering larger support to their producers after the transitional period. During the accession procedure they start to rapidly enhance protectionism – so did almost all post-Soviet countries (Lithuania, Ukraine, Russia, Kazakhstan). As a result, Russia hurries to introduce such measures that are probably not needed and even contradict national interests. Some of these measures will be examined below.

As to the third factor, budget resources for funding agrarian protectionism are very constrained. Therefore, domestic support cannot be increased and protectionism is enhanced by means of “free” for budget measures – import quotas and tariffs.

For instance, the three years of conducting sugar quota auctions have proved their inefficiency for supporting agricultural producers (although this goal was declared at the moment of their introduction) and immense detriment for consumers (price for sugar on the domestic

<sup>4</sup> Here we do not take into account preferences to developing countries since they have no bearing on the following conclusions.



Russian market is one of the highest in the world). In 2003 the auctions were abolished but ways are still found to maintain quoting in order to strengthen position at negotiations with WTO. Similarly, meat quotas introduced this year demonstrate both inefficiency (they didn't help to constrain import of meat) and negative effect on domestic meat processors and traders. Still, instead of abolishing the quotas Russian lawmakers keep on modifying their mechanism.

In 2003 the Law on agricultural land transferability came into force. As we predicted a year ago, it has not fostered the transfer of farmland. But what is more important, the Law actually does not work – contrary to its provisions the practice of renting land shares persists. On the one hand, it helps to retain in agribusiness large investors that in the recent 4-5 years secured the inflow of capital in the sector. But on the other hand, it supports legal nihilism in the agrarian community since violation of the law is not punished.

## Federal programs in agriculture

Actually no amendments have been introduced in the 2003 funding schemes as compared with the previous years. The size of subsidies under most programs is still fixed in nominal amounts. This is an evidence that the adopted programs are not substantiated and no analysis of their efficiency is made on the basis of annual results. The adopted 2004 budget has the same drawbacks. Given inflation fixed amounts mean shrinking funding. As a result budget funds are gradually redistributed towards support of general services and this is quite a positive shift. But instead of a gradual reduction it would be more rational to abruptly stop financing of non-efficient programs and thus to save a lot of budget funds.

Still, some positive shifts have occurred. Subsidies on sale of breeding bulls' semen were discontinued. This seems to be quite rational since the rate of corresponding regional subsidies is almost ten fold above the federal one, and thus the latter loses its stimulating effect. The decision is taken to stop compensation of expenditures on purchase of mineral fertilizers. This program existed since the start of reforms. In 1999 it was modified but the modification didn't help to raise its efficiency. Thus the program's abolition will result in a better use of budget funds.

One more novelty is the adoption of hop-growing support program. The need to support domestic hop-growers from the federal budget raises no doubt but we find that the main hindrance to this sector's development are bulky imports of hop and processors' common practice to use imported input. Solution of this particular problem could have a better stimulating effect on domestic hop-growing.

The program of subsidizing interest rate on credits (including the investment ones) was actively implemented in 2003. It helped to bring 36.7 billion rubles of short-term and about 7.7 billion rubles of investment credits into the sector.

## Execution of new land legislation

The new land legislation introduced in 2002-2003 is aimed to foster transfer of agricultural land. However, the effect of favourable legal environment is undermined by organizational constraints capable to stop official land transfer (here we speak of official transfer since in case there is demand, transfer will continue in a latent form creating unstable land titles of corporate farms and individuals.)

For instance, the RF Land Code no longer finds legitimate such earlier granted land titles as permanent (term-less) use of land by legal bodies and life-long inheritable possession



by individuals. It means that these lands should be re-registered and either be rented or bought out into ownership. 173.5 million hectares of corporate farms' land and 18.9 million hectares of individuals' land are subject to such re-registration. But the lack of cadastre plans of state-owned plots resulted in an actual blocking of this legal provision.

The Federal Law "On agricultural land transferability" requires to re-register earlier signed agreements on land shares' renting within 2 years. Otherwise the rules of trustee management agreement will be applied to them. Such an agreement is very inconvenient for businesses that sometimes rent thousands of land shares since, first, it's not adequate to the purpose of land use (the beneficiary in this case is the land owner but not its actual user) and, second, it requires to keep a separate bank account under each agreement which is absurd for a single entity. Therefore big companies cultivating large areas of rented land shares are now re-registering land agreements in accordance with the new law, and this process engendered a vast stratum of consultants-middlemen. So, a part of capital resource that otherwise could be invested in agriculture goes to such consulting services.

### Regulation of selected markets

#### *Meat market*

The dominating factor on Russian meat market in 2003 was the introduction of import quotas. The purpose of this measure was to protect domestic livestock sector from massive imports.

*Table 43*

### Quotas on import of meat in 2003

	Quota size	Duty on import within the quota	Duty on import in excess of the quota	Term	Distribution mechanism
Poultry meat	744 thous. tons	25%, but not less than 0.2 EUR/kg	-	30.04-31.12.2003	Historical principle
Pork					
- fresh of chilled	337.5 million tons	15%, but not less than 0.25 EUR/kg	80%, but not less than 1.06 EUR/kg	1.04-31.12.2003	90% of quota – according to historical principle, 10% - at auctions
- frozen		15%, but not less than 0.2 (0.25) EUR/kg			
Beef					
- fresh or chilled	11.5 thous. tons	15%, but not less than 0.2 EUR/kg	60%, but not less that 0.8 EUR/kg	1.08-31.12.2003	Historical principle
- frozen	315 million tons	15%, but not less than 0.15 (0.2) EUR/kg	60%, but not less that 0.6 EUR/kg	1.04-31.12.2003	90% of quota – according to historical principle, 10% - at auctions

*Source:* corresponding normative acts.

Meat quotas concern a large number of operators on this market. Meat is a very heterogeneous product and many other products are produced out of it. Thus the distribution of quotas and determining of its mechanism raised a lot of debate on all levels of state governance throughout 2003. What's the result of their application within 9 months?

First of all, it should be noted that agricultural producers have hardly noticed their existence. In 2002 sales of livestock and poultry by farms grew by 4.3%, in 2003 – by 4.8%. At the same time livestock inventories fell (see Section 3.4.1) and thus the increase of meat output is quite possibly due to larger slaughter forced by shorter availability of grain feeds. Consumers



surely felt the quotas' introduction as in 2003 prices for meat and meat products grew faster than in 2002 (8.4% as compared with 2.6%).

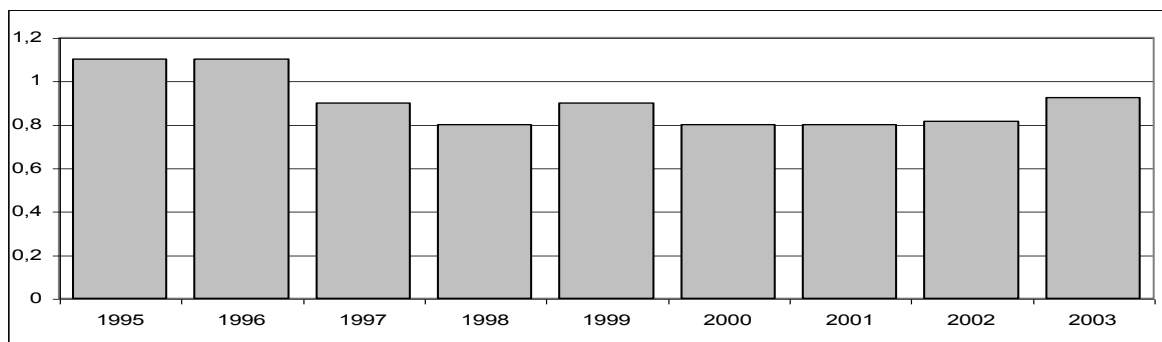
In 11 months 2003 imports of beef and pork from non-CIS countries reduced by nearly 9%, imports of poultry – by nearly 20%. However, this reduction was offset by growing imports of sausage and meat products (up 22%) and larger imports from the CIS countries that supplied 29% more beef and pork and over twice more meat products. So, Russia has actually introduced a regression scale of import duties. All countries strive to raise tariff protection as degree of processing grows while the introduction of meat quotas in Russia stimulated import of processed products and discouraged import of raw meat.

#### *Sugar market*

The mechanism of tariff quotas for raw sugar and seasonal duties on white sugar applied in the past three years has failed to notably increase sugar beets production in Russia (*Picture 50* and *Picture 51*). In 2003 the planted area expanded but this was due to a sharp drop of grain production profitability in the previous season rather than to sugar import constraints. On the other hand, the then effective mechanism of quotas was accompanied with the growth of domestic retail prices for white sugar (and, correspondingly, for products containing sugar) and also of wholesale sugar prices for industrial consumers. Finally, the quota mechanism for raw sugar in combination with seasonal duty on white sugar resulted in larger imports of sugar substitutes. Quota auctions not only increased direct costs of purchasing raw sugar but also resulted in higher associated costs: consumers of raw sugar had to get credits for buying quotas and thus enlarged their expenditures even more.

*Picture 50*

**Russia: Areas planted in sugar beets, million hectares**



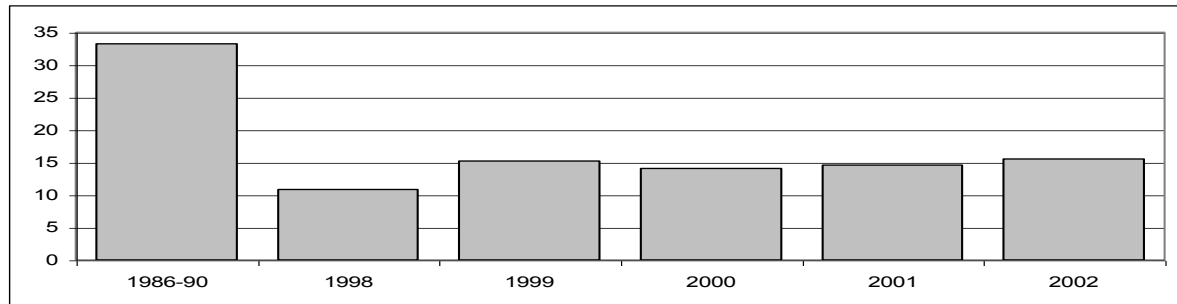
Source: RF State Committee for Statistics.

In December 2003 a new mechanism of sugar market regulation was introduced in Russia – the flexible import tariff. It actually sets the level of raw sugar support price at 470 US dollars per ton presuming that the basis of “Caribbean Sea – Krasnodar region” deliveries is 100 dollars per ton. The world price is determined on the basis of New York Board of Trade (CSCE/NYCE) quotations. The principal formula for calculating the size of duty is as follows: the support price less delivery basis and less the average monthly price for raw sugar at the exchange. Since the first two variables are fixed, the duty will be determined by the world price: the higher it is, the lower is the duty and vice versa. So, the world market fluctuations are mitigated on the domestic market ensuring certain stability for both buyers and sellers.

So, the idea is good but its implementation details may result in its utter discredit.

Picture 51

**Russia: Gross production of sugar beets, million tons**



Source: RF State Committee for Statistics.

First, the support price for raw sugar is set at 470 US dollars per ton although such an amount could be enough even for white sugar (the difference between prices for white and raw sugar is approximately 50 US dollars per ton). In other words, the support price for raw sugar is at least 50 US dollars per ton higher than it should be thus fostering further retail price rise.

Second, the method of binding import tariff to the average exchange price is non-transparent. The new regulation specifies 9 intervals of exchange price change, and the import duty size is to be determined for each of them. However, the exchange price intervals and import duty intervals do not coincide. Besides, the mechanism of import duty calculation also provokes uncertainty on the market. The draft specifies that the Ministry of economic development and trade publishes mean arithmetical exchange price by the 15<sup>th</sup> next month. The duty comes in force beginning from the 1<sup>st</sup> following month. So, the duty for  $t$  month will be based on exchange price in  $t-2$  month. It's too a risky mechanism: e.g. exchange prices in  $t$  month can be low and the duty is correspondingly high, while in  $t+1$  month the situation can differ radically. Then the import of raw sugar in  $t+2$  month will be unduly costly. In other words, the proposed mechanism does not mitigate the world market volatility and can even aggravate it thus inciting speculative trends on the market.

Third, the flexible duty is introduced only on raw and white sugar while the mechanisms for other sugar products remain as they were. This is certainly fraught with the market situation when import of sugar products will become much more lucrative than import of raw sugar. This will entail forming of a group of speculators, i.e. the phenomenon that contradicts the strategy of ensuring stability on agrifood markets in the country.

Besides, import of sugar from Belarus and Kazakhstan is not subject to constraints thus eliminating effect of any economic mechanisms on this market.

*Grain market*

At the end of December 2003 the Government decided to levy a temporary 25 EUR per ton duty on export of rye, wheat and their mix to countries not being members of the Customs Union. The duty will be effective from January 1 till May 1, 2004. Its ad valorem ratio to the current domestic price for grain is about 15-20%.

Generally speaking export duties may pursue two goals – the fiscal and constraining ones. After 1994 export duties in Russia rarely serve as an export constraint mechanism. While in 1992 ad valorem export duties were imposed on all food products, in 1993-1995 they were effective only for wheat and corn (10-25%); in 1999 Russia limited export of oilseeds

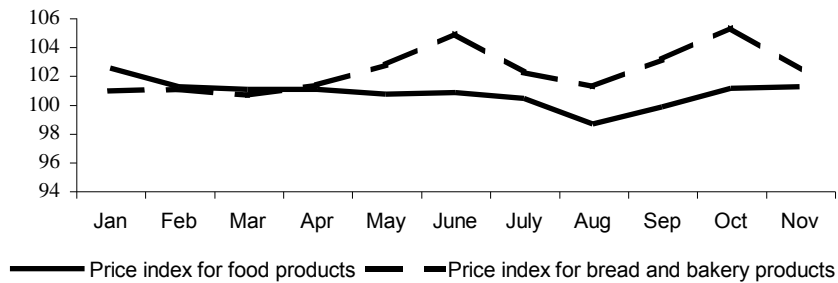


(the initial duty was 10% but not less than 15-20 ECU; afterwards it was lifted up to 20% but not less than 30-35 EUR). Throughout the transition period export of fish, fish products and alcohol was also subject to duties pursuing fiscal rather than constraining goal. In view of the above the current introduction of export duties on food grain is a novelty for Russian agricultural policies.

The declared basic reason for introducing this measure is the wish to constrain growth of domestic prices for bread due to poor grain crop in Russia in 2003/2004 season. Indeed, prices for bread in 2003 started to rise already in spring (*Picture 52*) and the harvest of grain was far below those of the two preceding years.

*Picture 52*

### Prices for bread and bakery products in 2003, as % of preceding month

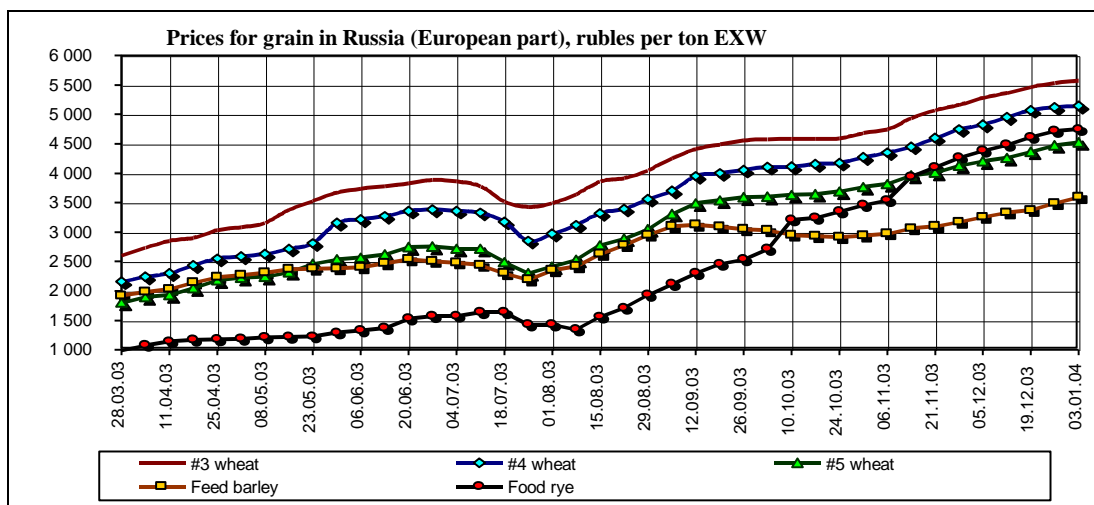


Source: RF State Committee for Statistics.

Poor crop conditioned swift rise of grain prices (*Picture 53*) that in the previous bumper-crop year were heavily depressed and served as one of the causes of financial crisis in agriculture.

*Picture 53*

### Prices for grain in Russia



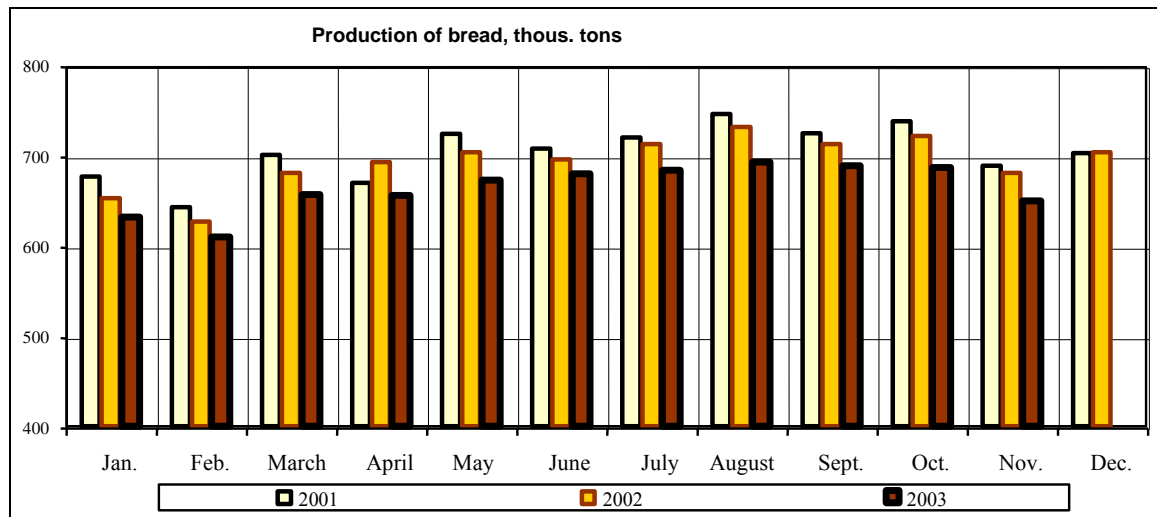
Source: Unidell group of companies.

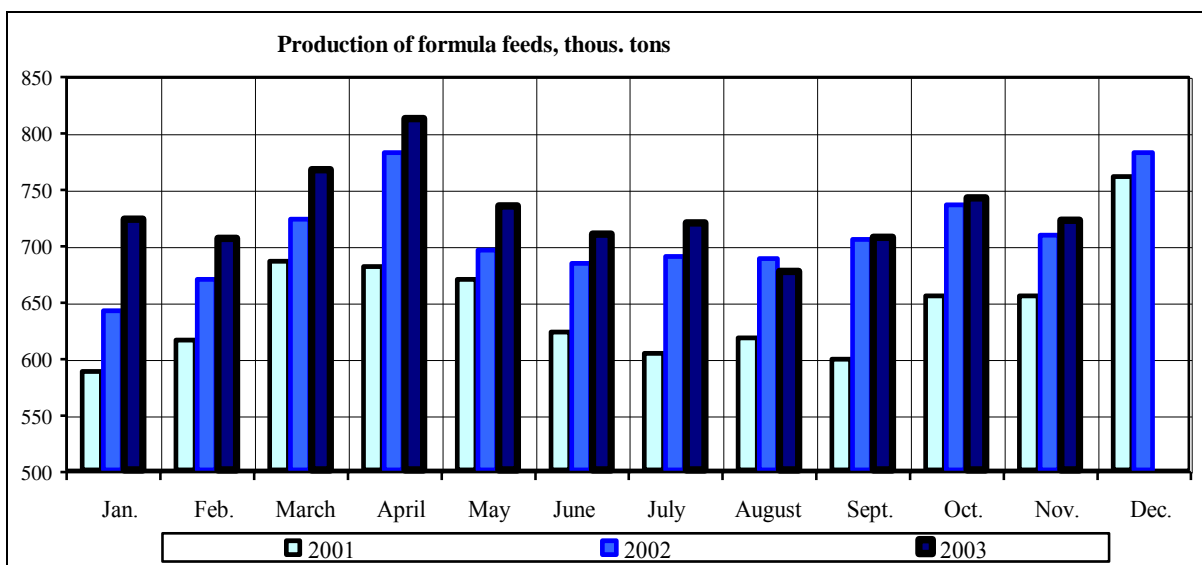
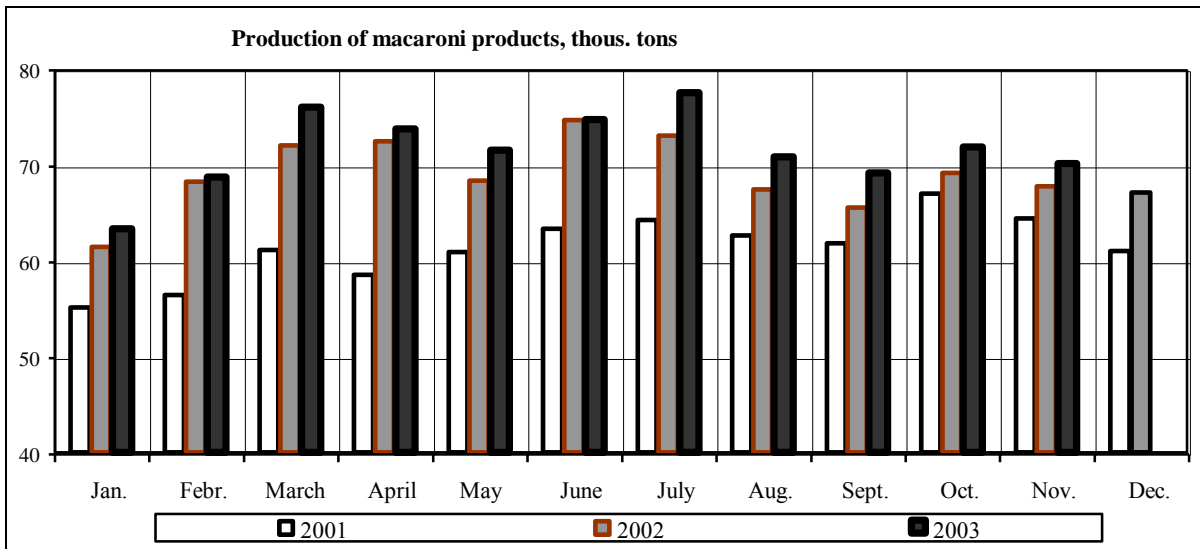
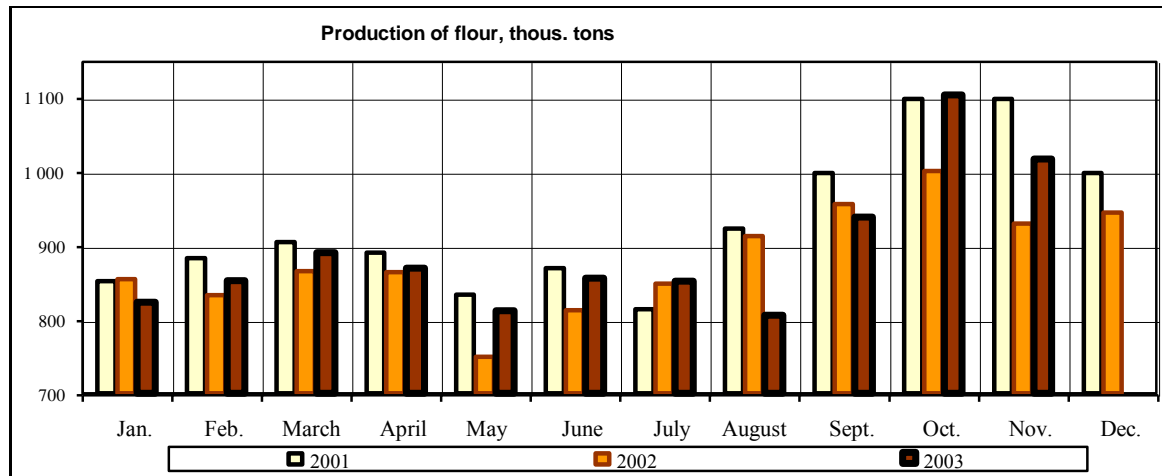
On the other hand the steady growth of real personal incomes beginning from 1998 resulted in smaller demand for bread, production of which reduces year after year (*Picture 54*). During the reform years prices for bread haven't been liberalized completely: first the federal government and later authorities in almost all regions continued to control rise of prices for this product being of particular social importance. The holding back of bread prices became most apparent after the 1998 crisis. In 1998-2003 prices for all food products grew by 495% while prices for bread – by 283%. The accumulated lagging behind inescapably resulted in an upsurge of bread prices. Projections of poor grain crop that prevailed since May were probably the trigger of their escalation.

This conclusion is supported by the fact that production of all other grain products (except bread) demonstrates quite a steady growth in recent years including 2003. In other words, in spite of poor crop and large grain exports there is enough grain in the country for producing bakery products.

*Picture 54*

**Production of basic grain products in Russia in 2001-2003**





Source: Unidell group of companies.

In view of the above one can conclude that export duties on food grain will hardly stop the rise of prices for bread since its causes are other than poor supply of grain.

At the same time higher prices (now including duties) are undermining grain export opportunities. Definitely, given the current domestic prices for grain its export becomes less attractive for exporters. Export of food grain started to shrink even before the government interference<sup>5</sup>. On the other hand, large traders are motivated not only by prices but also by the wish to preserve their image forcing them to remain on the world market even if price situation deteriorates. Besides, the introduction of export duties was announced only half a month before their enforcement and thus traders had no time to cancel contracts and will have to meet them despite the duty. This will lower the profitability of export transactions.

In other words, the introduction of grain export duties fails to achieve its goal but can notably undermine positions of Russian grain traders on the world market that strengthened markedly in 2002/2003. These traders launched large investment projects aimed at creation of export port infrastructure and got support of the government that allocated funds from the federal budget to subsidize interest on credits for construction of port grain loading facilities<sup>6</sup>. Most likely this measure will have a purely populist effect that is not surprising in a year of elections.

In addition to wheat and rye, rice was also subject to import constraints: in 2003 import duty on rice and rice flour was introduced – 10% but not less than 0.03 EUR per kilogram. Protection of domestic producers is hardly the main goal of this measure. First, rice growing in Russia is not a traditional business. Only a few regions are engaged in it but they cannot meet the corresponding market demand in full. Therefore, some quantities of rice (300-500 thousand tons) have always been imported from other countries. Second, no massive imports of this crop that could depress domestic production are observed (*Table 44*). The support to several administrative units (primarily within Krasnodar region) depending on production of rice could be rendered in a more adequate form. Third, the principal suppliers of rice to Russia (China, Thailand and some other countries) are granted preferential customs regime.

*Table 44*

**Russia: production, imports and exports of rice  
in 1997-2002, thousand tons**

	1981-85	1986-90	1997	1998	1999	2000	2001	2002	2003
Imports	N.a.	N.a.	376.6	266.2	561.8	351.5	346.9	466.4	452.3*
Production	1132	1054	328	413	444	586	497	490	448
Exports	N.a.	N.a.	13.2	14	5.8	27	12.1	9.6	n.a.

\* - data of Unidell company.

Source: Customs statistics of RF foreign trade, RF State Committee for Statistics.

<sup>5</sup> It's noteworthy that rumors about the introduction of export duties, on the contrary, fostered grain export in last months 2003.

<sup>6</sup> Supplement № 36 to Federal Law "On 2003 federal budget".

### 3.5. Research and Development Sector

In 2003, public science and technology policy was governed by two basic documents, namely «The Principles of the Russian Federation's Policy in Development of Science and Technology till 2010 and in Prospect» (hereinafter «Principles») and the Russian Federation's Medium-Term Socio-Economic Development Program (2003—2005) in the section which concerns development of the national science and innovation. However, the efforts made were not always in line with the objectives proclaimed. In fact, implementation of several initiatives had to be deferred to 2004 as they were kept under coordination till late 2003.

#### 3.5.1. Public Priorities in Science and Technology in 2003

A «new economy» (in other words a «knowledge-based economy») is becoming a top-priority objective under the Russian Federation's Medium-Term Socio-Economic Development Program, which can be built up by restructuring the economy for the benefit of process industries, mainly high technology sector. It was stated for the first time that the «science and technology sector needs a considerable optimization, efficiency and definite accomplishment in terms of its scope and framework», i. e. it should become a part of the National Innovation System (NIS).

All things considered, this country is doing its first steps in developing a knowledge-based economy. The new economy's progress is measured by volume of investments in the knowledge-based sector, growth in development of small innovation enterprises, number of patent inventions, number of people employed at high technology sector of economy, etc. Today the Russian figure falls 2 to 3 times behind in the world's aggregative average in terms of support for the knowledge-based economy.

Among the top-priority trends in 2003 were as follows:

- attempts were made to optimize the organizational and human resources structure of science;
- creating new elements of the national innovation system;
- developing high technology industries (in particular, information and communication technologies (ICT));
- providing more concern for research and development in the defense industry.

A special public emphasis was made upon a mutual agreement between the NIS's elements. In particular, a task of creating a technological corridor between science and business was set with the view to commercializing knowledge and providing entrance to new high technology markets. The term «technological knowledge» means creating interaction between key participants of innovation process, developing special innovation projects, supporting venture industry, and improving the existing intellectual property legislation.

Development of high technology industries, primarily information and communication technologies, is an integral element in creation of the NIS. The concept of «knowledge-based economy» is associated with such industries. At present, Russia is playing quite a moderate role in this area because the number of Internet users is below the threshold figure, 10 % of the country's population. Only 8 % of the Russian population are Internet users according to sociological surveys. Only Moscow and St. Petersburg overcome the threshold, and thereby show the presence of «information society». The ICT accounts for about 0,2 % of the total Russian export volume according to the State Customs Committee of the Russian Federation. The ICT development can be encouraged by measures stimulating Russian and foreign investment inflow in this industry, especially in the development of venture financing system.



Research and development at the defense industry is acquiring more significance among the top-priority trends. In 2003, the share of research and development accounted for 38 % of the total budgetary allocations («national defense» item), and research and development arrears were settled in full. Research and development financing increased by 22 % in terms of constant prices versus the previous year. The research and development budget is scheduled to grow in 2004 as well. The share of defense-related research and development grew up to 29,7 % (from 22,6 % in 1998)<sup>7</sup> among internal research and development expenditures by socio-economic objective. The share of civil research and development in the defense sector is big enough, 48–52 %<sup>8</sup>. The emphasis is placed upon the projects involving double-purpose products and technologies as defense-related research and development outlays are growing.

### *3.5.2. Public Financing in Science Sector*

Research and development budgetary expenditures demonstrate actual public priorities which complied only in part with the proclaimed development guidelines in 2003.

Expenditures of the national budget's item 06 «Fundamental Research and Technical Progress Promotion» grew up to 25,3 %. However, with the amount of financing taken as a relative value, i. e. as a share of the supply, it develops that the Principles were not fulfilled. The research allocations accounted for 1,67 % of the supply, while the minimum amount of financing scheduled for 2003 in the Principles was 2,18 %. The same is true to the 2004 budget which allocates 1,74 % with the target figure of 2,21 % as specified in the Principles. In 2004, the estimated growing expenditures of item 06 is expected to be allocated primarily to support the Russian Academy of Sciences (RAS), its share being 61,9 % of the total. The efficiency of this financing is quite arguable with due regard to the fact that promotion of innovation is set as a strategic task.

Positive changes in the budgetary expenditure structure imply that for the first time the RF Ministry of Education was financed to support basic research at colleges and upgrade research and training equipment (140 ml rubles), for the first time over a 10-year period. The Ministry may allocate the funds both as basic financing and on competition basis. At present however, institutions under the Ministry can not receive subventions pursuant to the current regulation, i. e. receive financing the way which is most favorable for basic research, since colleges under the Ministry are supposed to be financed as scheduled in the budget.

Expenditures in item 02, «Technical Progress Promotion», allocated to research equipment upgrade programs seems to be scarce, namely «Development of Equipment for Research Organizations and Higher Education Establishments» and «Public Support to Community Centers». Total expenditures are worth 1030 ml rubles, which is a fairly moderate financing with due regard to the current depreciation rate of research equipment.

The structure of expenditures revealed that no fundamental revision of high technology priorities was made. About 83,0 % will be allocated to the four programs in the same way as before, namely «Federal Space Program of Russia, 2001 to 2005», «Civil Aviation Development Program of Russia for 2002 to 2010 and till 2015», «National Technological Base Program» and «Research and Development under Top-Priority Research and Technology Guide-

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<sup>7</sup> Russian Science in Figures, 2003. Statistical Reports. M.: CISN, 2003. P. 80.

<sup>8</sup> No Nationalization Plans at RF Ministry of Industrial Science // *Nezavisimaya Gazeta*, 14.01.2003.



lines». In this case, however, financing of research and development of biomedical programs, which are of top priority worldwide, is quite moderate.

Financing of the Federal Space Program of Russia accounted for 123,5 % which exceeds the amount of allocated funds for all top-priority research and technology trends under the Federal Targeted Program «Research and Development in Top-Priority Research and Technology Trends in 2002–2006». However, the amount allocated is insufficient for a breakthrough in the space industry. The Russian space research budget in 2003 totaled 6,5 bln rubles, while the United States allocate annually over 2 bln US dollars for space research. A few Russian space research programs shrank by two-thirds over the last decade. Nevertheless, space research is regarded as a «national concept» pursuant to the national doctrine, and its implementation is eventually expected to boost economic activity of the population. It sounds fairly unconvincing since there are many ways other than space research that could improve the country's status. In the case that space research is taken as a strategic priority the government should reduce voluntarily other expenditures for the benefit of space exploration.

In 2003, more efficient ways of budget disbursement were considered. The work of a public Commission for Budget Disbursement Optimization (CBDO) was met with strong antagonism of the scientific society. The key proposals of the Commission boiled down to reduce the number of principal budgetary fund managers (including state scientific funds, Moscow State University and Russian Academy of Science), consolidate public research expenditures within top-priority trends, and hence reduce the number of budgetary recipients. Indeed, item 06 of the budget classification includes currently a redundant number (59) and big variety of direct recipients because the network inherited from the Soviet period is continued to be financed. However, if research funds go to ministries, the concept of independent grant financing can be degraded. In addition, orienting budget classification towards priority trends is arguable since priorities undergo frequent revisions and simultaneous revision of recipients requires substantial labor costs.

The government admitted after several rounds of approvals that «the Russian Academy of Sciences and the Moscow State University are symbolic organizations» eligible for a special item in the budget. The Federal Law «On Amendments in Articles 24, 158 and 160 of the Budget Code» (No. 158 — FZ dated 8.12.2003) was adopted in December, which secured the right of the Moscow State University, public academies and public research foundations to be principle managers of budgetary funds. A new edition of Article 158 of the Budget Code reads that principle manager of the Federal Budget is «a public authority of the Russian Federation which is eligible to allocate the budget funds to its subordinate budget-fund managers and recipients, as well as a significant state-financed organization of science, education, culture, healthcare and mass media. A significant state-financed organization of science, education, culture, healthcare and mass media is entitled to allocate budgetary funds to its subordinate managers and recipients of budgetary funds». The Law will become effective in January 1, 2005.

No changes were made in the number of principle recipients of budgetary funds in the 2004 Budget as compared to the previous year, as well as in their share. Reduction of allocations remain in the same order. The Ministry of Industry, Science and Technology (Minpromnauka), the Russian Academy of Science, the Siberian Department of the Russian Academy of Science, the Ministry of Education, the Russian Foundation for Basic Research (RFBR) and the Russian Academy of Medical Sciences (RAMS). Regarding the funds allocated for public

foundations – the RFBR, the Russian Humanitarian Scientific Foundation (RHSF) and the Foundation for Small Enterprises Promotion in High Technology Sector (FSEPSTE) – they did not receive their size of financing according to the law in force. For the first time the share of the foundations was reduced to 6,9 % in the 2003 Budget, and they remain underfinanced in the Draft Budget 2004. The RFBR is estimated to receive 5,1 % of the total allocations in item 06 against the usual 6 %; the RHSF, 0,84 % instead of 1 %; and the FSEPSTE, 1,28 % instead of 1,5 %.

The Russian Academy of Science has developed new principles of budget allocations with the view to stimulating competition in making research and development plans by its subordinate organizations and shaping them into public contracts. In June, the Presidium<sup>9</sup> of the Academy issued a Resolution strengthening its central role, leadership and authority as a public agency.

A first test contest on research and development in «physicochemical biology» was held. The Russian Academy of Sciences approved two annual grants worth 2 and 4 ml rubles for the period of 3 to 5 years to finance large laboratories. This is 10 to 20 times as much as the average size of the RFBR's grant. The total of 150 ml rubles was allocated to finance the initiative, which accounts for about 1 % of the RAS's budget, and 49 grants were paid as part of the contest. Impact-factor, citation index, number of patents, number of young people employed at laboratory, and a share of middle managers, scientists at the age of 35-45, Among the election criteria were used as election criteria. However, only a few organizations applied for the contest (1,5 to 3 applications per grant depending on grant type): firstly, this is because of stringent election criteria; secondly, some were not aware of the contest. A conflict of interests failed to be avoided, and, as a consequence, it was a substantive problem during the contest. Six out of the 7 members of the expert committee received the biggest grants of 4 ml rubles annually for a period of 5 years. In addition, most of the grants were received by the scientists of the institutes where the members of the expert committee are employed. Several leading Russian scientists employed at other countries also participated in the contest, which added a positive element to the contest.

### *3.5.3. Financing of Science By Private Domestic and Foreign Foundations*

Though the total amount of research and development allocations grew up (including constant prices in 1989), the financing was possible mostly due to increase in budgetary expenditures. The share of budgetary research allocations is close to the figure of 1996 when any other financing sources were minimal. It means that science still runs short of extrabudgetary resources. However, domestic philanthropic trends along with changed priorities at foreign organizations and foundations supporting the Russian science claim attention.

The size of research financing by domestic philanthropists remains unchanged as being beyond the list of priorities of corporations and private individuals. Science is viewed as a sector with commercial potential and contractual relationship rather than charitable endowments. Basic science is supported only by the «Dynasty» Foundation which pays grants for theoretical research and development in physics. Financial support is expected to come from private charita-

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<sup>9</sup> Resolution of the Presidium of the Russian Academy of Sciences dated 01.07.2003, No. 217 "On Approval of Research and Development Planning Principles of Organizations under the Russian Academy of Sciences".



ble endowments rather than corporate ones. However, private philanthropy is not fully accepted at the Russian society. In addition, secondary philanthropic objective for corporations is their image which can be improved by supporting education, healthcare and culture. Finally, science employs more complicated and less certain evaluation criteria with the likelihood of unobvious and delayed return on investment. Eventually, charitable endowments in science total several million US dollars annually, which is scarce vs. companies' profits.

A new foundation, «Scientific Potential», was set up among the existing private domestic foundations (*Table 45*). It was founded by A. Vavilov, Chairman of the Penza Oblast Legislative Assembly in the RF Counsel of Federation. The foundation will pay both individual and collective annual grants, up to 10 thousand US dollars before taxes, for a group of 2 to 3 people. The grants will be paid only to the scientists employed in power engineering, economy, information and computer technologies.

*Table 45* shows that «Dynasty» Foundation is fully private owned, not corporative. D. Zimin allocated 10 ml US dollars of his personal assets to set up the foundation. This is a precedent in support to Russian science by private domestic sector. Nobody has followed the lead of Zimin so far. The Foundation is extending the range of grant recipients: a first post-graduate contest was announced in 2003. Fifty winners, postgraduates in physical science, will be receiving grants from 2004 according to the contest.

*Table 45*

**Basic Private Domestic Charitable Foundations Supporting Science Development**

Foundation	Year of foundation and founder	Supported areas	Size and type of grants
Vernadsky Non-Governmental Ecological Foundation	1995, «Gazprom», «LU-KOIL», RAO «UESR», RAMS, Department for State Sanitary and Epidemiological Supervision.	Scholarships for ecology-students.	Annual grant of 2000 rubles monthly.
Vladimir Potanin's Charitable Foundation	1999, V. Potanin, President of «INTERROS» Holding Company	Support for students and young professors in scientific investigation/	1260 grants of 1500 rubles monthly. Lump-sum individual grants 1200 US dollars for professors, (26 grants in 2003).
Foundation for Domestic Science Promotion	2000, Presidium of the Russian Academy of Sciences, »Sibneft« and »Russian Aluminum« companies.	Annual grants for scientists employed in the framework of the Russian Academy of Sciences/	Grants of 10 thousand US dollars annually for 10 academicians and associates (before income tax), 5 thousand US dollars for 100 doctors of science, 3 thousand US dollars for 100 candidates of science/
Dynasty Foundation	2001, D. Zimin, former Director General of «Vympelcom» Company.	Support for young scientists (till age of 35) and students engaged in theoretical physics.	Annual grants of 15 thousand rubles monthly for 10 young scientists, 2000 rubles monthly for 100 students within a period of 9 months.
Alfyorov's Foundation	2001, G. Alfyorov, academician.	Support for higher education in natural sciences and 1 grand for a young scientist (till age of 33) at St. Petersburg and Leningrad Oblast.	Grants of 1200 rubles monthly for students during the entire academic year. Grant of 100 thousand rubles for a young scientist.
Open Russia Foundation	2002, «YUKOS» company and a group of private individuals.	Support in the field of science and education. Building up Internet-centers.	Size of financing depends on a project; pure theoretical research is not supported.
Scientific Potential Foundation	2003, A. Vavilov, Chairman of the Penza Oblast Legislative Assembly in the RF Counsel of Federation.	Grants for scientists engaged in the field of power engineering, economy, information and computer technologies	Grant up to 10 thousand US dollars annually before taxes, 6 annual grants in each of the 6 fields.

It is evident that the majority of private foundations support only young students, post-graduates or scientists engaged mostly in the fields adjoining education. The second feature is that 3 of the 7 private foundations are in cooperation with public academies. For instance, the Presidium of the Russian Academy of Sciences is among the founders of the Foundation for Domestic Science Promotion where grants are allocated for academic scientists for their past services rather than current projects, and only upon the recommendation of academic councils of the institutions where potential grant recipients are employed. A new grant for the same person is not only acceptable but also complimented. The mechanism in use could barely be considered as a close competition.

Companies begin to cooperate not only with government agencies but also foreign scientific foundations. «YUKOS» granted 1 million US dollars to the «Eurasia» Foundation in support of a small business promotion program; Potanin's Charitable Foundation and «Dynasty» Foundation are also negotiating programs of cooperation with foreign organizations. Searching for partners for the purpose of joint implementation of scientific initiatives is typical of both domestic and foreign philanthropists.

All in all, the picture of foreign grant financing in 2003 was shaped up as follows.

*Firstly*, a decrease in financing from the US Government became evident, which, as a consequence, led to budget cutbacks in several foundations funded in part or in full from the state budget. The US Department of State intends to cut off Russian science funding by 2006. In addition, the US Administration is changing its policy towards non-government, non-profit organizations like most of the foundations supporting the Russian science. From now on, all foundations funded from public sources must pursue the progovernment policy, while independent status is no longer acceptable. This can affect both the concept of programs and the attitude towards Russian foundations. The Administration has enough pressure to put upon non-government, non-profit organizations. There is a tax status regarding such organizations in the United States which can be changed in principle.

At the same time, the EC countries admitted Russia's participation in a set of All-European initiatives as part of its gentle integration into the European scientific environment. Today Russia can enter any projects of the EC 6<sup>th</sup> Framework Program (6FP), under special conditions though. Russian scientists can not be among principal participants of projects, but they can join implementation of these projects only after the basic team has been lined up. In addition, the 6FP is intended to promote the European science by stimulating research and technology cooperation in the EC countries. Therefore, it is this challenge that Russia should meet. Finally, Russian scientists compete on equal terms with the strongest European teams without any preferred treatment. Russian scientists are welcome mostly in programs on power engineering development, nonproliferation of weapons, ecological (including nuclear) security and healthcare.

In 2003, the INTAS – a European Program intended exclusively to support joint research and development of the teams from the CIS and EC countries – announced a new contest in support of innovation projects (500 thousand € allocated) as well as increased the budget up to 2,5 ml € for young scientists. The Program's mandate is extended till 2006, while the INTAS's budget for 2002–2006 is worth 70 ml €.

In November 2003, the German Research and Development Society (DFG) opened its bureau in Moscow. Russia maintains cooperation with this organization for many years, including joint contests with the RFBR, and today the DFG shows a well-defined priorities re-



garding Russia, namely support to young scientists, interdisciplinary research and promotion of science internationality. The focus is made on joint Russian-German scientific projects with the German party playing a key role. It is the German party that can apply to the DFG for funding, while participation of the Russian party is limited by 10 thousand € annually.

Thus, both foreign foundations and domestic private philanthropists give priority to young scientists, students and postgraduates as well as consider support for cooperation and «brain drain» prevention as the key tasks. However, it should be noted that the peak of support for the Russian science dropped from its highest point and hence new significant financing should not be expected. The share of foreign sources in the total research and development financing dropped to 8 % (in 2000 it accounted for 12 %) <sup>10</sup>.

*Secondly*, the need for regional development of science and innovation is getting more importance. It is evident that interactions with separate institutions and colleges are being replaced with direct contacts with regional or local administrations due to the fact that such policy consults regional interests. However, regional interests often appear to be personified and hence run the risk of conflict of interests.

*Thirdly*, more emphasis is placed upon a gradual replacement of charity with investment. Therefore, organizations and foundations which intend to support innovation projects (MNTS, British Council, INTAS, DFG, American Foundation for Civil Research and Development) are proliferating. Consequently, the requirements for project's efficiency and performance are getting more sever. The MNTS remains the major organization supporting military conversion and partnership (innovation) projects developed by the scientists who used to be employed in the defense industry. The MNTS financed 1910 projects to the total of 570 ml US dollars as of mid-November 2003.

*Fourthly*, foundations remain highly motivated in supporting reforms in science. This is reflected in sustained financing of institutional projects like creating research universities and supporting major telecommunication projects. For instance, the Macarthur Foundation and Carnegie Corporation continue to support new scientific and educational centers which are set up at Russian universities for the purpose of research in the field of both natural and social sciences. Overall strengthening and further gradual reorganization of such universities into strong research institutions is a strategic guideline. Another case is the TACIS Program which allocates 10 to 15 % of its budget to finance domestic information and telecommunication projects.

All in all, the period of approval of new initiatives and partnership projects became longer as compared to that between the early and middle nineties when the Russian science was in need of an urgent support. This is caused by a general cutback in financing for Russia and strengthening of requirements for project co-financing.

For instance, the issue of a new Foundation, «New Russia», was kept under approval throughout the entire year. The Foundation was supposed to become the major successor to the «Open Society» Institute which was to be closed up as announced by its founder G. Soros back in 2002 <sup>11</sup>. All in all, the «New Russia» Foundation was not officially opened, while the scheduled initiatives, especially an education development program, are supported by G. Soros through the reorganized «Eurasia» Foundation. G. Soros is most unlikely to provide

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<sup>10</sup> Russian Science in Figures – 2003. M.: CISN, 2003. P. 79.

<sup>11</sup> For more information refer to Russian Economy in 2002. Trends and Perspectives. Iss. 24. M.: IET, 2003. P. 303.

the originally offered funding (inception contribution of 5 ml US dollars for the «New Russia») because one of the conditions for his participation was co-financing from Russian sources, including private ones. The only domestic corporation that wished to participate in the project was «YUKOS». However, participation of «YUKOS» is currently uncertain.

In the mean time, the renewed «Eurasia» Foundation announced its decision to terminate and redesign the program on small business promotion (including innovation one) and discontinue financing of the related research projects, as well as training, seminars, exhibitions and fairs. This is partly because of the US Agency for International Development (USAID), major sponsor the Foundation, which is also diminishing its presence in Russia.

#### *3.5.4. Manpower in Science: Status, Trends, Efficiency*

The manpower problem in science remained topical last year. The total number of researchers decreased. Their number per 10 thousand persons of economically active population dropped to the minimum over the last 8 years, while the total number of researchers in the public sector increased. At the same time, personnel continued to age. The most severe situation was reported at the institutions under the Russian Academy of Sciences where the age of scientists averaged almost five times the age of their fellows in this country, according to the report by V. Kostyuk, Academic Secretary of the Presidium of the Russian Academy of Sciences, in May 2003.

Young scientists continued to emigrate to other countries, which results not only in manpower imbalance but also losing of most talented and promising researchers. In 2003, a questionnaire among the graduates of the Moscow State University<sup>12</sup> revealed that only 56 % of the respondents intended to work as researchers in Russia. Ten percent of biologists, 11 % of physics and 13 % of chemists were already offered a job abroad before graduation. The similar situation was reported by a questionnaire of young scientists employed at Moscow scientific organizations: in 2003, 44 % of respondents intended to get employed abroad, including 7 % of those who intended to emigrate for residency to other countries<sup>13</sup>.

Among new developing trends emerged in the human resources sector is autosourcing, i. e. employment of researchers on the territory of Russia for the benefit of foreign companies. Autosourcing is well applied in software production (offshore software engineering). Autosourcing can become a mechanism of preventing manpower outflow to other countries. However, offshore software engineering can not be a remedy because Russia can not compete with the leaders in this sector, India and China. The Indian offshore software engineering market is worth 9 bln US dollars against 300–350 ml US dollars in Russia. India and China have the competitive advantage of low cost and highly disciplined human recourses. Programmers in these two countries do not produce sophisticated products, while their Russian fellows are apt to create more intellectual products. Therefore, Russia may have its own «niche» in the segment related to systemic product fragments. However, such niche can not be big enough.

Public initiatives in manpower policy are constantly increasing in number. However, they are related mostly to young researchers (age 33 to 35) and recognized as bonuses, scholarships, grants and supplements (normally, not more than 3000 rubles monthly), and do not have an impact on the situation as a whole. In 2003, the biggest supplements were approved

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<sup>12</sup> Nekipelova E., Ledeneva L. Russian Students for Exports // *Inostranets*, 11.03.2003. No. 8.

<sup>13</sup> Nekipelova E., Ledeneva L. Brain Hunting: Lost Round // *Poisk*, 14.11.2003. No. 46.



for academicians and academic secretaries of the Russian Academy of Sciences, 20 thousand and 10 thousand rubles monthly correspondingly. Official wages of the presidium members and secretariat members of six public academies and secretariat members of two public scientific foundations were increased by 1,1 from the 1<sup>st</sup> of November. The funds were raised in the scientific budget of the country. However, supplements for academic ranks should have been tripled for public sector researchers last year. In some institutes researchers were offered either to accept staff reduction or half payment.

Low basic salaries in science tend to result in manpower imbalance and even more severe systemic consequences. The so called «scientific day-labor» is spreading among scientists, when they have to participate in several short-term (several months to one year) projects on different subjects in order to receive decent earnings. The scientific day-labor results in poor efficiency because a serious research requires better conditions. This also leads to the fact when a growing number of scientists have to replace a basic research with a single applied research. Short-term research is also risky because it interferes with labor balance at innovation cycle stages.

A Concept of manpower protection at the research and technology system and a Draft Federal Targeted Program «Scientific Manpower of the Russian Federation» for 2004 to 2009 which is intended to be the basic to a single system of manpower reproduction in science, were under development at government level throughout the entire year. However, the Program was not considered at a meeting of the President Council for Science and High Technology due to repeated delays. The existing draft project sets the objective of public manpower policy in science in terms of «protecting» the most efficient scientific personnel, meeting the demand for young scientists and «reducing their emigration rate from the country or science quitting rate». However, some of the proposed methods and techniques of manpower protection and reproduction are of prohibitive character. For instance, it is planned to «tighten control over implementation of international cooperation agreements on exchange of scientists and specialists» and «provide for stage-by-stage introduction of free postgraduate or doctorate education only under the condition of a 5-year employment in the public sector of economy»<sup>14</sup> in order to prevent emigration of Russian scientists. The project includes a lot of bonuses, grants and supplements for young scientists in association with support for leading scientific schools and scientific manpower engaged in top-priority research and development. A mortgage scheme is offered for the scientists employed in public research, and the issue of granting a civil servant status to scientists is under consideration. The need for physical infrastructure development is mentioned in passing and only with regard to «leading higher-education institutions of the country» without providing criteria of a «leading» institution, not even conceptually.

A program on «Integration of Research and Education in Russia» which is designed to support young postgraduates and scientists by integrating research and educational activity of institutions and colleges is under way for the last few years. In 2003, the program was supported by the same amount of financing as in the precious year, which in fact means that financing was reduced. Thus, the existing network of 150 education research centers is not employed the way that could improve the current situation in science with having in mind that these centers are backbone elements of the modern infrastructure of science. Though the pro-

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<sup>14</sup> Measures of manpower protection in science. Concept. Draft.  
The President Council for Science and High technology. Moscow, 2003.



gram also provides for upgrade of equipment at education research centers, this task remains unresolved because of the scarcity of funds. Among disadvantages of the Program are an overgrowing number of participants (at present including 247 public colleges, 320 institutes of the Russian Academy of Sciences, and 168 public industry research organizations), lack of well-defined criteria of support, and complicated reporting procedures. However, the concept of the Program remains topical and it could be turned into an effective instrument for a system solution of manpower problem in science by removing the disadvantages and improving public financing. In doing so, there would be no necessity in introducing another federal targeted program.

The experience of the last few years shows that no balance in manpower structure in science is gained by placing extra emphasis on the till-35-year requirement. The middle-age generation of scientists continues to decline and hence young people become scientists on a provisional basis in the same way as before, according to the RFBR. Perhaps, it could make sense to limit «young» age by the period from taking a degree rather than physical age. In addition, young scientists value not only their wage rate but also a potential for upward movement which should provide an opportunity to take a certain position (for instance, chief of laboratory, leading scientist, etc.). At present, only a few institutes can offer such prospects, where directors carry out a goal-oriented policy of saving positions for middle-age scientists with corresponding appointment of old-age ones to decent, non-administrative positions (for instance, chief research engineer).

The «brain drain» problem could be relieved by letting a scientific manpower in from other countries, especially from the CIS countries. However, immigration from the CIS countries is not supported by the state policy. The criteria and conditions in selecting skilled specialists from the CIS countries need a rational consideration in the course of the ongoing immigration policy reforms.

The existing rules and regulations regarding employment and postgraduate education of young people from the CIS countries should be revised concurrently with improving of the migration policy at local (departmental) level. A set of regulatory amendments should be made (in particular, to afford a budget scholarship opportunity under the particular conditions). At present, such issues are regulated mostly by administrative orders and decrees.

There are cases of successful integration of CIS scientists into research institutions and universities at some Russian cities. In some cases the inflow of Russian-speaking scientists from the Middle Asia boosted development of humanitarian science at Veliky Novgorod and Severodvinsk, geosciences at Arkhangelsk, biological sciences at Omsk. The Universities and research institutes assisted the immigrants in housing issues at these cities. This experience shows that the inflow of skilled specialists not only encourages development of science but also has a positive impact upon social environment in small cities.

The year 2003 was marked by the Russian Nobel prizewinners in physics V. Ginsburg and A. Abrikosov. It should seem that this event testifies in behalf of the fact that science is so well-balanced and slow-response that neither financial nor institutional crises had impact on efficiency and quality of scientific research. The event proves nothing about the quality of the Russian contemporary scientific potential, since the prize was given for a 40-year-old research.

At the same time, evaluation of the citing rate of Russian scientists testifies that the citing index grows mostly due to the reference to their old works. However, the citing index of



the latest works of Russian scientists have been increased over the last few years, while it concerns mostly those who cooperate with foreign partners or got a temporary employment abroad. Russia is ranked 46 by citing index per 10 thousand of population.

### *3.5.5. Changes in Organizational Structure of Science*

To date, auto-reformation, i. e. reforms carried out by the Russian Academy of Sciences and the Ministry of Industry, Science and Technology (Minpromnauka), is believed to be the principal mechanism in changing organizational structure of science in Russia. However, it became evident that any reforms meet with resistance not only on the administration side but also scientific community itself as being reluctant to drastic changes.

Indeed, the last year testifies once more that no real changes took place in the scientific organizational structure. The public science sector accounts for over 70 % of the internal research and development expenditures<sup>15</sup>. For reference, the US public science sector accounts for 7,2 % of the research and development, 10,8 % in Canada<sup>16</sup>. Moreover, the USA government intends to assign research function to the private sector with corresponding job cuts at public research laboratories.<sup>17</sup>

An inventory check was carried out within the framework of the Russian Academy of Sciences. The criteria in cases of merging, separation and liquidation were not always clear, which raised several big discussions on justification of organizational reforms. Generally, the institutions under the Russian Academy of Sciences grew in number because, for instance, several integrated institutions under the Academy were liquidated to become independent. At the same time, another regional center, South Scientific Center at Rostov-on-Don, was set up within the framework of the Russian Academy of Sciences. The overgrowth in academic organizations leads to a growth in supporting personnel which is 10 times the number of research manpower<sup>18</sup>. The changes took place against a Decree of the RF Ministry of Finance on reduction of state-financed institutions within the framework of the Russian Academy of Sciences.

The contradictory status of the Russian Academy of Sciences as a self-directed public organization and a government unit at one time invited a conflict involving not only the units under the Academy but also the membership. The Letter of the RF Ministry of Finances dated 17.11.2003 specified that the Academy membership is defined by the Government of the Russian Federation because academician and correspondent member degrees of the Russian Academy of Sciences are financed from the state budget. Though this means a strike at the basic principles of the Russian Academy of Sciences, the position of the RF Ministry of Finances is easy to explain and justify under the existing law. Obviously, the law needs amendment with regard to the Russian Academy of Sciences, and the law «On Science» and other regulations should either provide for all preferences subject to a special status of the Russian Academy of Sciences or bring its legal status in balance with the current legislation.

The Russian Academy of Sciences made constant efforts in making contracts and agreements on cooperation with other organizations and institutions, namely the Ministry of Industry, Science and Technology, the Association of Public Research Centers (APRC) and

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<sup>15</sup> Scientific Potential and Technical Level in Production. M.: PIET, 2003. P. 22.

<sup>16</sup> Science Indicators – 2002. NSF, NSB, 2003. Vol. 2, Appendix tables, A4 - 4.

<sup>17</sup> Nature. Vol. 424. July 31. 2003. P. 478.

<sup>18</sup> [http://ng.ru/science/2003-11-12/12\\_academy.html](http://ng.ru/science/2003-11-12/12_academy.html)

the Ministry of Education and the Russian Academy of Medical Sciences (RAMS). In general, this corresponded with the state policy on «reintegration of the Russian Academy of Sciences, colleges and industry institutions within the government order system»<sup>19</sup>. In April, the Russian Academy of Sciences concluded an agreement on cooperation with the APRC with the aim of creating new competitive products. The agreement is expected to open new opportunities of building up joint creative teams, research and innovation units and equipment sharing centers.

Feasibility and conditions of creating an association for academic universities and education research centers under the auspices of the Russian Academy of Sciences are currently considered with the Ministry of Education. In addition, the Russian Academy of Sciences would like to be entitled to establish public schools within its own framework and thereby hopes to resolve a severe manpower problem.

The Russian Academy of Sciences and the Russian Academy of Medical Sciences became more active in developing a mutually beneficial cooperation. In particular, 64 projects were selected, including the research works at academic institutions which could be applicable in medicine. Eleven projects were found innovative. The representatives of two academies estimate that development of advanced projects for the benefit of the two Academies can be integrated into a single program to be financed from the state budget by 2005.

An Innovation Agency of the Russian Academy of Sciences was set up in May 2003 for centralized coordination and implementation of research and development at the academy institutions. All of the aforementioned initiatives intend to centralize all functions and trends of activity, while many of them develop more effectively if being delegated to institutions (joint research with organizations of other departmental affiliation and involvement of intellectual property into economic turnover).

In 2003, the Ministry of Industry, Science and Technology also took an inventory at Russian research organizations, which revealed that 500 out of 2800 public research organizations were not accredited and hence lost their research status. It was also revealed that public industry institutions remained in numbers, while the corresponding industries had been completely privatized. For instance, 97 % of chemical industry enterprises are private, while 21 public industry chemical institutes are available. The similar situation was revealed at automobile industry and pharmaceuticals. Thus, the state has to bear extra maintenance expenses by financing the frameworks of these organizations which logically should be attributed to the intra-company (corporate) sector of science. Consequently, the task was to shrink public sector of science and integrate similar public research organizations into major inter-industry structures at federal level, create advanced research centers under the existing research organizations or by uniting most effective research groups of different organizations. These issues were specified in the Russian Federation's Medium-Term Socio-Economic Development Program. However, no explicit list of organization selection is available yet. Accreditation is planned to be carried out in compliance with the international standards ISO 9 000 and ISO 14 000 as well as by number of publications in literature and citing index, which is not applicable to some institutions of applied science.

The APRC system under the auspices of the Ministry of Industry, Science and Technology underwent no changes. The APRC's network reform has been delayed in consideration

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<sup>19</sup> Interview with B.Alyoshin, Vice-Premier of the Government of the Russian Federation for Industrial Policy // *Izvestiya*, 15.05.2003.



for several years, and no restructuring has been started yet. The APRC differ largely in efficiency, while the funding ratios provided for in the state budget of 1993 still remain in force.

### 3.5.6. Updating Legislation

In 2003, the legislation was updated by:

- developing legislation in the science sector;
- improving norms, regulations and rights to intellectual property;
- amending the general legislation, including science-related provisions.

The amendments to be inserted in the basic law on science, i. e. Federal Law «On Science, Public Research and Technology Policy», were under consideration and coordination throughout the entire year. Coordination of the status of the Russian Academy of Sciences (Article 6 under the Law) is most complicated, because the current status of the Academy does not comply to the Law in force, primarily the Civil Code. The question is about giving a «special» status to the Russian Academy of Sciences, which means leaving the Academy beyond the law. Another problem is to change research status criteria for organizations, especially to repeal the existing 70:30 regulation under which research and development should account for no less than 70 % of the total volume of works at research organizations. This hampers innovation and interferes with accreditation of colleges as research organizations. The above ratio is expected to be changed so that any organizations with research potential, as well as any other organizations may participate at government contract competitions.

Development of a special Law on Public Research Foundations specifying basic principles for such foundations was considered aside from the Law «On Science», namely extra-departmental status, competitiveness, targetability, gratuitousness and irretrievability of financial support, which will secure the right of budget fund managers to finance research by paying grants (by defining a «grant» concept correspondingly) and participate in research and development support. Indeed, a special law is vital because the corresponding provisions of the existing law are poorly developed. Such law should specify competition procedures (which differ from the research and development public contract procedure) and provide for rules of transfer of intellectual property to developers (organizations).

A new Patents Law adopted in 2003 became the major event in regulation of intellectual property<sup>20</sup> of the year. Its draft was made with due consideration of the provisions of several international agreements on intellectual property protection, mainly the Agreement on trade aspects of intellectual rights (TRIPS) and Patents Law Agreement.

Section III of the Patents Law was supplemented with provisions (Article 9.1) regulating the rights to state-funded industrial property objects, including works for federal and public purposes as well as for the purpose of the constituent entities of the Russian Federation under public contracts and contracting. The abovementioned Article specifies that patent can be issued to the state under the conditions as follows.

1. An invention must be achieved during execution of work under a special contract recognized as a « public contract for federal, public purposes or for the purpose a constituent entity of the Russian Federation ».

The federal, public purposes mean the Russian Federation's need in products required for making this country viable, tenable and secured, as well as implementing federal targeted

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<sup>20</sup> The Federal Law dated 07.02.03 , No. 22 - Φ3.

programs and intergovernmental targeted programs in which Russia participates. The terminology and expressions used by the Law cover any type of significant public objects, including those which have nothing to do with national defense and security. Therefore, the range of legal relationship that can be regulated under public contracts was enlarged.

2. In the event a public contract do not specify that the contractor is eligible to patent.

The contractor may receive a patent in concluding a government contract since the public customer, for instance, may not wish to receive a patent or such right is not specified under the agreement. Legal protection of inventions is estimated to cost approximately 10 % of the research and development expenses. The general practice shows that public customers in the name of federal executive agencies are reluctant to assume responsibility for commercialization of final research and development products due to the lack of the required information, human and financial resources. However, the pilot Patents Law testifies that public ministries and departments choose to include provisions into contracts specifying that final research and development products belong to the customer without making provision for additional financial expenses on patent search and further commercialization of final research and development products.

3. In the event the public customer applies for patent within six months from receipt of written notification from the contractor about the achieved research and development product which is subject to legal protection as invention, utility model or industrial prototype.

In all other cases any legal entity of individual or their legal successors may possess the right.

It should be noted that the Patents Law is precise with regard to the cases of final research and development products under public contracts, while it provides no regulation for the cases of budget funding following other forms, for instance, subventions or subsidies.

Furthermore, the Patents Law does not specify the transfer procedure to organizations (contractors) in the cases of intellectual property transfer, and thereby intellectual property is not stimulated to get involved into economic turnover. Thus, the Patents Law can not settle contradictions of the current legislation.

Unresolved problems in transfer of rights to intellectual property objects funded from the state budget result in their non-commercialization. Only 40 % out of all patented inventions were funded from budgetary sources, and the share of ever licensed patents accounts for less than 2 %, while at the OECD (Organization for Economic Cooperation and Development) countries <sup>21</sup> this figure varies between 20 and 40 %, according to the Rospatent. Taking into account that 80 % of the intellectual property objects are funded from the state budget, the Rospatent's data demonstrate a fairly poor commercialization of state-funded inventions.

Interests of science were concerned in revising the general legislation by amending Part II of the Tax Code of the Russian Federation and Article 20 of the RF Law «On Principles of Tax System of the Russian Federation». The case at hand was forfeiting public research organizations' tax allowance on property with corresponding increase in financing. A conciliation commission issued a list of organizations to be exempted from property tax, which included six public academies and the APRC network. However, the tax allowance is only applicable

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<sup>21</sup> Turning Science into Business: Patenting and Licensing at Public Research organizations. OECD, 19 Feb. 2003, DSTI/STP (2003) 22. P. 70.



to the property which is used for research purposes, while the allowance will cease to be force from January 1, 2006.

### *3.5.7. Innovation Development*

To date, Russia's presence at the international market of high technology products is insignificant, its share being estimated 0,35 % to 1 %. This is below the figures of both the First World's countries and Asian developing countries. The figures of trading in Russian technologies at the international market demonstrate its growth and geographic escalation. However, unprotectable types of intellectual property, which are of lesser commercial value, still continue to prevail in the export structure. Agreements on patents, patent licenses and trade marks account for mere 2 % of the export and 10 % of the import of technologies. In general, the inventor's activity factor (number of domestic applications for patent per 10 thousand of population) dropped last year<sup>22</sup>.

Another key factor of innovation economic development is number and activity of technological alliances, transnational companies and joint research organizations. Russian companies participate in 90 to 180 international technological alliances according to various estimates, which is by 3 to 4 times below the figures of the countries like Italy, Sweden, and Switzerland, and by 8 to 12 times below those of Great Britain, Germany and France. However, the share of foreign and joint ownership within the Russian scientific and research sector is growing.

To date, the innovation sector has not enough «critical mass» of funding from various sources; there is growing disproportion between fundamental, applied and basic research and development; there is inadequate infrastructure and unstable relationship between the key elements of innovation system, namely higher education establishments, scientific organizations, small innovation enterprises and industry. Hence, the share of applied research dropped to 15,9 %<sup>23</sup>, thus demonstrating weakened links between the stages of innovation cycle.

The share of innovation-active enterprises remains small, while small innovation enterprises are gradually decreasing in number due the aforementioned factors (over the last two years the number of small innovation enterprises dropped to 23,2 % at the sector of «Science and science service»).

In 2003, small companies intended to get back to the organizations they had previously separated from. Many small innovation enterprises were set up on the basis of old projects; research and development funding was scarce; intellectual property issues were hardly cared for; legal environment for small intellectual enterprises was unfavorable in general, and thereby some enterprises lost their innovation efficiency, while others were ready to do research back at research and development institutes and colleges. Today, small intellectual enterprises account for 1 % of the total Russia patents issued to domestic applicants, while only 2 % of all patents are licensed<sup>24</sup>. It testifies that small intellectual enterprises manufacture off-the-shelf final products without employing intellectual property.

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<sup>22</sup> Russian Science in Figures – 2003. M.: CISN, 2003. P. 103.

<sup>23</sup> The share of applied research accounted for 17,4% in the best performance year, 1999. Source: Russian Science in Figures – 2003. M.: CISN, 2003, p. 87.

<sup>24</sup> Materials on parliamentary hearings at the State Duma of the Russian Federation “Legal Support to Research and Technology Products in Civil Turnover”. M., 22.05.2003

At present, there is a set of factors impeding development of small innovation enterprises which vary in type in time. The lack of funds and unstable economic situation in the country were limiting factors in 1999 and 2000, while undeveloped infrastructure in commercialization of technologies and imperfection of the law pushed down the lack-of-funds factor to the third place in 2003<sup>25</sup>. Undeveloped infrastructure for small enterprises manifests itself in the fact that the state supports small businesses on modest scales, while it provides no guarantees so that small intellectual enterprises can employ more borrowings.

Imperfection of the law manifests itself in tax overburden on small intellectual enterprises. Total taxes to be paid by small enterprises account for up to 60 % of their profit. A simplified reporting scheme is hardly taken into account by tax authorities. In addition, a compulsory exclusion of small enterprises from VAT payers (which came into force from January 1, 2003 according to Chapters 26.2 and 26.3 of the Tax Code) brings more problems to the relationship between small intellectual enterprises and counteragents, especially large businesses which are interested in deducting VAT paid to suppliers. Therefore, it could be expedient to allow small enterprises to pay VAT if they are ready to do so.

The lack of investment results in equipment obsolescence at small intellectual enterprises and, as a consequence, long-term prototype production and noncompetitiveness. Developed countries have programs for boosting innovative research and development projects. Empirically, 70 % out of the targeted subsidy recipients need no less than two years to accelerate manufacturing of new products and technologies for<sup>26</sup>.

However, success factor analysis of a set of small innovation enterprises reveals that in spite of the existing obstacles they can set up innovative production due to such factors as professional management by scientists or business initiators, contacts with parent institution (research school), and internal market orientation.

In November 2003, the Foundation for Small Business Promotion in Science announced the inception of a new START program on financing of innovation projects at their initial development period, i. e. the so-called «seed» financing which is in short supply nowadays. The Foundation plans to allocate almost half of its budget (10 ml US dollars) to the program.

The new initiative resembles in some degree the SBIR Program (Small Business Innovation Research Program) which was launched in the United States in 1982 following the recent Act on small innovation business development. The state is represented as a sort of venture capitalist in this program by investing in high-risk projects. The Program consists of three stages. At the first stage, till 6 months, small business applicants should demonstrate how characteristics of their innovations meet the requirements previously announced by a federal department. Financing does not exceed 100 thousand US dollars at this stage. At the second stage, 2 to 3 years, small enterprises should create a prototype of the product. The amount of financing at this stage is worth 750 thousand US dollars. The third stage includes commercialization of the product. No public funding is provided for at this stage.

In general, an enterprise needs an average of 5 to 9 years to evolve a product from the concept till a commercial project. About 12 % of the supported enterprises are capable to

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<sup>25</sup> Express-poll of 400 directors of small innovation enterprises. Source: Saltykov B. Socio-Economic Efficiency Assessment of the Innovation Framework Development Project. Report for the World Bank. M.: 2003, p. 10.

<sup>26</sup> *Acs Z.J.* Public Policies to Support New Technology-Based Firms // Science a. publ. policy. Guildford, 1999. Vol. 26. No 4. P. 254.



commercialize their research and development projects in four years after financing is discontinued.

The public funding was paid off in full according to the data on 50 most successful enterprises supported under the Program. However, performance assessment criteria should be well defined. The question is whether the traditionally accepted measures are appropriate or not, namely the number of emerged leading enterprises and the volume of repaid initial expenses. The point of view that such assessment may be misleading is gaining more acceptance since such programs are supposed to support enterprises which by no means could be attractive for private sector at the stage of their applying to the program due to a high risk involved with their projects, rather than those which also could receive funds from private sources due to their commercial appeal. The task is to avoid this classic crowding-out effect<sup>27</sup>.

The Russian version of the Program is as follows. At first stage (till 1 year) applicants perform research and development, develop a prototype of the product, carry out tests, patenting, and lay out a business plan by «seed» financing (up to 750 thousand rubles) on a grant basis. This should prove the likelihood of research and development commercialization. In two and three years the Foundation will increase its financial support depending on research progress and amount of extrabudgetary funds, but it should not exceed 4.5 ml rubles over three years.

The project selection procedure differs from the traditional Foundation's programs in making allowance for a face-to-face communication between an expert commission and applicants, as well as a free-form application. Program managers believe that this should help to select most promising projects. First round of selection took place in Ekaterinburg in December. Foreign representatives were invited by the British Council and the American Foundation for Civil Research and Development to take part at the expert commission. The quality of the proposals surpassed all expectations according to their estimate, with 3 to 4 projects being most likely to receive foreign funding. The Foundation itself plans to finance about 400 projects in 2004.

It follows from comparison of the START and SBIR Programs that the research-to-prototype stage is expected to be very short, within a 1 year, under the domestic pattern, whereupon the state will be financing a project within two years. Thus, there is a high risk of selecting unpromising projects for continued support, and no conditions for size and build-up rates of extrabudgetary (shared) funding have been well-defined so far.

Major business remains the basis of innovation development. It is the major business that makes «rules of the game», while small enterprises rather adjust themselves to the existing pattern. Research and development at industrial enterprises fall behind the world's average. Thirty one percent of industrial enterprises perform research and development in the house, while 15 % do it outside, according to a questionnaire conducted by the Institute for the Economy in Transition (IET) in September 2003<sup>28</sup>. However, structural changes need to be carried out: purchase of machinery and equipment (59 % of the recipients (enterprises)) remains predominant among innovation activities in the same way as before, and mechanic engineering, chemical and petrochemical industries remain innovation leaders.

The signs of new stage of corporate science development emerged in 2003. «TNK», «YUKOS», «LUKOIL» and «Norilsky Nickel» companies promoted their research and devel-

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<sup>27</sup> Refer to: *Ivanova N.* Organization and Evolution of National Innovation Systems. M.: IMEMO, 2001. P. 71.

<sup>28</sup> Russian bulletin of market polling. Industry. 137 questionnaire – October 2003. IET.



opment departments. Today, major financial industrial groups and monopolies engaged in resource extractive industries, power engineering and nuclear power industry intend to invest in research and development. For the time being, corporations choose to finance short-term application-oriented projects which can be paid off in 2 to 3 years. An average of 65 % of Russian organizations spend less than 1 % of their turnover on research and development, while the First World countries can afford 20 %.

Last year «YUKOS» opened an up-to-date new research center which is worth 18 ml US dollars. Ten million US dollars annually is planned to fund research and development at the center<sup>29</sup>. It should be noted that personnel was recruited not only among Russian researchers but also immigrants and foreign scientists. It was made possible because of the wages that meet international standards, 30 to 100 thousand US dollars annually.

In addition, research organizations and major corporations entered into cooperation. «Norilsky Nickel» and the Russian Academy of Sciences concluded an agreement on cooperation in hydrogen energy and fuel cells. At the first stage under the agreement, which is expected to last approximately three years, the Russian Academy of Sciences will be receiving up to 40 ml US dollars annually. About 20 academic institutions are planned to be involved in the program. This period should be enough to develop a marketable product. The initiative is quite perspective. It resembles in a way the implementation pattern of major innovation projects initiated by the government in 2002. However, in this case the government is neither a mediator nor a sponsor.

Implementation of twelve major innovation projects continued, which were intended to create conditions for a successful product commercialization, become «stories of success» and demonstrate profitability of investment in the Russian high technology sector for Russian and foreign investors. In 2003, 1,25 bln rubles was allocated in the budget for science and implementation of innovation projects, while in 2004 it grew up to 2 bln rubles. First results are expected to be figured late in 2004. The major aggregative index should be capitalization of high technology sector of the economy. In addition, selection efficiency of the innovation projects continued to be under consideration. The question of distinguishing between the innovation project and traditional modernization of production was considered in particular. There is no one opinion on this issue at government level because of lack of a well-defined concept of «innovation» and «innovation project».

A tax burden of 38 to 54 % vs. 34 %<sup>30</sup>, which is heavier than that at the primary industry, and customs walls remained the factors that hampered development of the high technology industry. At present, high technology products are not identified in the export structure, whereby export of products with a higher share of added value becomes unremunerative. In addition, active position of the state as investor is deterring the corporate sector from involvement (in particular, this arises problems of execution of the rights to intellectual property objects).

### *3.5.8. Shaping Innovation Infrastructure*

An implementation plan on innovation promotion and venture investment development for 2003 to 2005 was approved pursuant to the Government Decree (No. 1187 — p dated

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<sup>29</sup> Refer to *Pokrovsky V.* Five-Star Research Institute // *Nezavisimaya Gazeta*, 30.09.2003.

<sup>30</sup> *Expert*, 2003 . No. 15. P. 59.



21.08.2003). The Decree includes a list of all main measures to be implemented in the science sector, namely supporting the major innovation projects, developing small business, regional and sector-specific venture funds in partnership with the state, technology transfer centers, introducing a multi-stage system of personnel advanced training and retraining for innovation sector). The Decree reiterates in many ways the provisions of the «Concept of Venture Industry Development in Russia» developed in 2002 but not approved by the government.

Technology transfer departments became elements of innovation structure developed in 2003. The prototype of technology transfer departments existed in the USSR as patent departments and other structural units at research institutes and colleges. However, their task boiled down mainly to invention patentability assessment, patent applications and acquisition of licenses rather than commercialization, search for partners and product buyers. Such list of functions remains the same for the time being. Thus, the number of traded technologies remains fairly small regardless of a positive trend in patenting at this country.

Technology transfer departments are expected to be created at all leading public research organizations, and there are two concepts available for this purpose for the time being. The first one is to be implemented by the Ministry of Industry, Science and Technology. Six technology transfer departments were funded by the Ministry last year. Three million rubles was paid to every winner. The concept and object of technology transfer departments is to promote economic growth at the regions. Therefore, the model in use is so-called «technology transfer departments (mediators) » as independent legal entities which could be founded by several organizations at a time. It is expected that technology transfer departments will promote creation of technology incubators and companies will be able to receive initial funding on competition basis. The advantages of the model are that it has a positive impact on regional development and creates a neutral environment for interaction between research organizations and business enterprises. The weakness of the approach is possible conflicts between research and technology organizations.

Yet, no clear vision of the model, nor a development line of technology transfer departments were developed. There is no knowing whether the Ministry of Industry, Science and Technology will continue financing the created technology transfer departments. What will become the source of their stability and where initial financing will come from? Today, only a single-source financing is available, which results in an overdose of the Ministry's patronage over the departments.

The Ministry of Education and the American Foundation for Civil Research and Development almost simultaneously conducted competitions on creation of technology transfer departments at the leading universities of the country. Four winners were selected to be financed by the Ministry and the Foundation in the ratio 1:2. From 75 to 150 thousand US dollars is allocated for creation of each Center within 3 years.

In this case, the model of technology transfer departments differ from that taken as a basis by the Ministry of Industry, Science and Technology. The technology transfer departments that are set up at universities are not independent legal entities. They serve primarily their university's interests and carry a heavy educational and commercial load. Creation of technology transfer departments is expected to increase management efficiency in the innovation sector. The advantages of this model are its close integration with its university, immediate and easy access to final products and reinvesting in research and technology process. However, the

global practice shows that technology transfer departments do not have enough flexibility inside universities and respond poorly to market signals.

Two models of technology transfer departments are available, which is a positive fact. The majority of the First World's countries have no single pattern of technology transfer departments. Availability of various structures can encourage processes of technology commercialization to its maximum. Availability of independent mediators (structures) apart from technology transfer departments, which would not contemplate «regional development» but promote research commercialization, would also be appropriate. In this case the technologies could be employed more effectively and largely because the same invention can find application in various industries. Selecting and maintaining a database on customers interested in various innovations is the main feature of the new structures whereby the mediators will support universities and research organizations in search for the customers of their intellectual products irrespective of territorial location.

Innovation technology centers are the backbone elements of the national innovation system. At present, 52 innovation technology centers are operated in Russia, which incorporate over 1000 small enterprises. Innovation technology centers provide a set of services to integrated small enterprises: apart from premises leasing small enterprises receive technical, informational and consultancy assistance, as well as formal and informal guarantees in search for development funding. The majority of small enterprises proved highly effective within the framework of innovation technology centers: the taxes paid by developing enterprises offset public infrastructure investments. Last year, the average volume of products and services realized by the small enterprises integrated into innovation technology centers exceeded that of nonintegrated small enterprises, according to a survey conducted by order of the Foundation for Small Enterprises Promotion in High Technology Sector.

Science towns are one of the key elements of the National Research System apart from innovation technology centers. On January 14, 2003, the President Council for Science and High Technology held a meeting dedicated to development of science towns. The most effective utilization of the unique research and technology potential was considered at the meeting. The issue derived from the fact that «science» status failed to accelerate the expected innovation growth. Only Korolyov has a budget surplus among the science towns, while the others are running short of investment and innovation ideas. High technology production remained at a 20 % level, and enterprises and employees didn't grow in number in this sector. An audit conducted at two science towns, Obninsk and Dubna, revealed that a «science» status helped to cope with crisis, and yet no research and development incentives emerged<sup>31</sup>. The situation can be explained by the fact that budget financing is not targeted at innovation support. Funds are allocated for general development of science towns and utilized mostly in social sector and for municipal needs.

All in all, there are seven science towns in Russia. Four municipalities were given a «science town» status, namely Koltsovo (Novosibirsk Oblast), Michurinsk (Tambov Oblast) and Reutov and Fryasino (Moscow Oblast). The only civil virology center, APRC «Vector», in Russia is located at Koltsovo. The most dangerous infections are investigated at the center. Michurinsk is the first science town to specialize in agriculture. At present, over 10 % of scientific projects are introduced into agricultural sector of the country against over 50 % at the

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<sup>31</sup> Russian scientific newspaper, 23.07.2003. No. 27.



United States. Therefore, Michurinsk is considered a promising center in terms of food and biological security of the country. A lot was expected of public contracts and additional domestic and foreign funding of the projects at Koltsovo which obtained a science status in January. However, a four-hour workday was established and wages were cut half as much at the APRC «Vector» from November 1. This was caused by a new federal law on public unitary enterprises specifying a mandatory integration of associated companies into research centers, whereby commercialization of research and development was decreased in efficiency. In addition, entering small companies in the books is most likely to misbalance the 70:30 ratio which is to be met for research accreditation. The second reason is a substantial increase in utility rates. The science town status can not mitigate the arising problems.

In addition, an issue of transforming science towns into technology and commissioning zones was under consideration throughout the entire last year. It is stated at the Russian Federation's Medium-Term Socio-Economic Development Program that «creating of technology and commissioning zones under the law on special economic zones should be the key factor to promote development of high technology production and new economy enterprises». Special economic zones are expected to encourage economic development, including several types of incentives. For the time being, there is no legislation on special economic zones, nor any well-defined key concepts exist, like whether science towns represent technology and commissioning zone or such zone is the next step in its development. What are technological parks? Can they be a measuring unit for technology and commissioning zones? Those who oppose special economic zones also believe that this model is likely to lead to a mass tax evasion. Nevertheless, the Ministry of Industry, Science and Technology plans to create 5 to 6 technology and commissioning zones in 2004.

In spite of the fact that the problem of special economic zones remains to be finally resolved at government level, several regions initiated commissioning sites, zones, etc. A special commissioning zone is planned to be created at the Nizhegorodsk Oblast under the existing technological parks; a technology and commissioning zone was announced at the Novosibirsk Academic Institution; three research and technology and commissioning centers are scheduled by early 2004 in Siberia, at Novosibirsk, Krasnoyarsk and Tomsk. The residents at the Novosibirsk technology and commissioning center are expected to receive several allowances: simplified export-import registration procedure, relief from customs duties on imported and exported goods, licensing abolishment, reduced number of inspections by inspecting organizations. The resident status along with the corresponding aforementioned allowances will be granted by means of a special procedure whose mechanism still remains to be defined. Performance of a zone will be considered successful subject to creation of up to 500 new small and medium-size enterprises with the annual output of 3 to 4 bln US dollars within 2 to 3 years., The figures seem to be overestimated judging by the last year performance.

The concept of special economic zone is closely associated with that of technological park and hence leading university. The existing technological parks were mostly created under such universities. The concept of leading university itself has not yet been officially accepted, while it has been under consideration for about two years. The status of leading university should be granted to 15 to 20 federal higher education establishments according to the latest performance, and the similar quantity of such establishments will be classified as «leading college by technology», including those leading in particular research. The «leading» status will be granted for five years and financed from the budget. The Ministry of Education ex-

pects to select on competition basis about 40 leading universities in the country which will conduct comprehensive research, including the basic one, and commercialize their products, hence establish technology transfer departments. So far, there is no a clear-cut list of leading status criteria, and types of research at colleges remain to be considered. The issue of research institute status and accreditation of colleges as research organizations has not been settled yet, which interferes with their scientific work (thus, under the law colleges can not receive public research funds).

Technological parks are promising as a basis of special economic zones rather than science towns because the latter can not provide self-reproduction of scientific and technological personnel. Many of them specialized in a single research which may not necessarily comply with public priorities. In addition, commercial culture is poorly developed at science towns.

Finally, innovation development is impossible without updating the science resource base. Though it was planned to allocate no less than 5 % of the science budget funds to research equipment, item 06, according to «The Principles of the Russian Federation's Policy in Development of Science and Technology till 2010 and in Prospect», the funding accounted for 1,76 % in the 2003 budget.

The potential of small enterprises can be effectively employed in resolving this problem, many of which specialize in research instrument engineering. First precedent of simultaneous support for small business and strengthening of equipment base emerged in the first half of 2003: an agreement was concluded between the Foundation for Small Enterprises Promotion in High Technology Sector and the Siberian Unit of the Russian Academy of Sciences under which small enterprises supported by the Foundation will design research equipment for the institutes of the Siberian Unit of the Russian Academy of Sciences. Fifty percent is funded by the Foundation, 40 % by the Siberian Unit and 10 % by the institutes.

### *3.5.9. Developing Financing Mechanisms in Innovation Sector*

Venture financing continued to develop as promising form of support for enterprises at the inception stage and was recognized as an important research and development element in building up a «technological corridor». The last year was marked by several new trends, primarily an increase in investment of small enterprises in intellectual property, growth in Russian investments and gradual change in public attitude towards innovation business by replacing a rigid regulation with indirect measures.

Much is expected of a Program under the Venture Investment Fund which was set up with participation of the state and launched back in 2000. Regional and industrial venture funds which are co-financed by the Venture Investment Fund, can receive 10 % of equity (which is equal to 1 ml US dollars). Since the Fund's model was based on that of the Fund of Funds in Israel («Yozma» Fund) where 10 regional funds were created under the Fund of Funds, the similar performance is expected in this country.

Two funds are under formation for the time being. These are «Leading» Regional Venture Fund with a budget worth 11 ml US dollars and First Industry Venture Fund which is formed by joint stock co. «Corporation «Aerospace Equipment» », one of the major integrated structures of the Defense Industry incorporating over 30 developers and aircraft equipment manufacturers in Russia and CIS countries. Initial volume of the «Venture Fund for Aerospace and Defense Industry» will be worth 10 ml US dollars.



One of the main reasons for lack of progress in the development of venture funds in Russia is that the state is reluctant to take real risks. For reference, public share in Israel accounted for 40 % of the funds' equity. The second reason is the lack of a high motivation for investment in high-risk projects when it is safer to invest in extractive industries. However, new materials, computer technologies and power engineering are considered promising for venture investment. In general, the development of venture industry is restricted by a set of factors as follows.

- Lack of sources of funds at the «seeding» stage;
- Poor safety of intellectual property and a large number of dual-application technologies which should meet special conditions;
- Undeveloped innovation infrastructure and lack of small enterprises whose projects could be attractive for venture investors;
- Lack of incentives with a reasonable risk for making direct investments in high technology sector;
- Lack of legal forms in the existing legislation which could meet the needs of venture business;
- Complicated registration procedures of venture funds;
- Bureaucratization of public control over business and reporting, and excessive flow of documents;
- Undeveloped stock market and, as a consequence, poor liquidity of venture investment, as well as poor variety of the available «exit» strategies;
- Lack of skilled managers for venture funds.

Venture fairs are considered one of the effective mechanisms that can promote venture financing projects of the government. The 4<sup>th</sup> Venture Fair was held on a regular basis in Perm in October 2003. The fair's pattern was similar to that in the United States. Three basic tasks are generally expected to be fulfilled during such fairs: (1) investment potential assessment in high technology; (2) provision of intermediary services to manufactures and customers of high technology products; (3) advance training of the participants on application of various financial instruments.

About 20 ml US dollars was attracted to high technology sector over the three previous venture fairs. However, this is a conservative assessment, since it is difficult to obtain reliable data on the size of venture investment. A total investment request from the participants at the Fair 2003 was about 90 ml US dollars. However, the investment potential is ten times as much as the request, according to the estimates of the Ministry of Industry, Science and Technology. Domestic companies tend to grow in number among potential investors. Several Russian investment organizations obtained membership at the Russian Venture Investment Association last year.

At present, a new interdepartmental program on innovation system reform is under consideration, which is expected to be implemented within the nearest 3 to 4 years. A similar interdepartmental program initiated development of innovation and technology centers in 1997. It is expected that the Russian Academy of Sciences, the Ministry of Atomic Energy, the Ministry for Antitrust Policy and several business enterprises and agencies will take part in the new program along with the traditional Ministry of Industry, Science and Technology and the Ministry of Education. One of the objectives of the program is to continue building up small intellectual enterprises, approximately 500 to 800 units over a period between 2004 and 2006,

and promote innovation investment growth from 10 to 12 bln US dollars annually. The financing estimates are unlikely to be realistic since there was no significant investment inflow to the high technology sector, while the number of small intellectual enterprises remains unchanged. Only five cases of high technology investments at the project's inception stage, i. e. prior to growth, were registered between 2002 and 2003, which totaled 43 ml US dollars. In general, the venture capital pool accessible to Russian entrepreneurs totals 40 to 60 ml US dollars<sup>32</sup> for the time being.

The last year initiatives show that the state is just beginning to build up its attitude towards science and apprehend its role. Stereotypes and methods inherited from the Command and Administration System still have a strong impact on this sector of economy and thereby hamper organizational reforms in the science sector, including its relations with the industry and educational system.

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<sup>32</sup> Refer to: *Ammosov Y.*. Unstable Trends // *Expert*, 2003, No. 23.

## 3.6. Social sphere

### 3.6.1. Health service

As compared against the 1990s, certain improvements have occurred in the dynamic indicators of infant and maternity mortality, as well as of morbidity rate of some diseases, e. g. tuberculoses, venereal and/or infectious diseases. These developments, however, were taking place in the context of rather alarming overall morbidity/mortality trends during the past decade: in the period between 1990 – 2002, the total population morbidity rate showed about 12 (twelve) per cent increase, mortality – 45 (forty five) per cent. Which was caused not only by the notorious stress factors of the period in transition but by deficiencies of the national health service itself as well: significantly reduced respective prophylactic and educational activities among population, inefficient spending of the budget monies allocated for the health service. Population health condition as well as the state of the whole Russian health system itself can be best described by most serious problems to solve which does require serious changes in the state and society attitudes with regard to the existing population health protection methods.

Central to the problems of the Russian health system is the fact that the state declared guarantees of providing medical service to population as well as their respective mechanisms which were developed and formulated as far back as in the 30s of the past century, under contemporary conditions, already cannot not be leading to fair and efficient health care of the population within the affordable budget means.

Socialism has left to us exceptionally wide state obligations with regard to providing free medical servicing to the population. But the Soviet healthcare system was then targeted to mass use of relatively simple and rather inexpensive medical technologies. Progressive developments in the area of medical sciences and pharmaceuticals have considerably expanded our abilities in treating many diseases having thus stimulated demand of the population for higher quality medical services. However, the state is no longer capable of meeting such needs through providing free medical services to all our citizens either now or in any feasible future.

Similar to many other countries, we are now facing a clear-cut dilemma: greater financing of the health service due to still higher taxation or better targeted guarantees and more efficient use of the available resources? A specific peculiarity of our situation is the crying gap between the guarantees declared and their financial support, on the one hand, and the extent to which this gap is to be compensated by own spending of the country's population, on the other. Impossibility to provide the required medical servicing free to all and everybody is inevitably leading to lesser availability of most good quality medical services for broad masses of the population and a growing degree of paid medical services accompanied with expanding the so called «informal payments». And it is usually the poorer population strata that suffer most from such practice. Different social groups are highly unequal in the ability to get good-quality medical aid. Any references to insufficiency of the budget financing or to impracticability of the populistically declared rules for free medical servicing the population are nothing but attempts of healthcare officers to justify themselves for falling quality of medical services which citizens are expected to get with no additional payments. While at the same time the already available means are often spent very and very inefficiently – they are targeted to support unnecessarily excessive number of beds in stationary in-patient units to the obvious detriment of prophylactics and/or out-patients treatment.

An attempt was made in the early 1990s to reform the Russian health service system: there took place some control and management decentralization, compulsory medical insur-



ance system (CMI) was introduced, federal and territorial programs of state guarantees for population medical servicing were developed each year to be officially confirmed and/or approved. These changes were eventually aimed both at improving the economic stability of the field and greater efficiency of its resource potential through respective restructuring the system of healthcare servicing, including new and more advanced methods of financing medical offices. However, this reforming process turned out to be somehow incomplete which, quite unsurprisingly, led to rather ambiguous results.

The set up budget-insurance financing system is exceptionally cumbersome and, accordingly, very inefficient. The CMI system has at its disposal but 1/3<sup>rd</sup> of the state healthcare financing (instead of the needed 2/3rds at least). This is mainly because the RF subjects, local self-government bodies, prefer not to pay due premiums to the CMI system for non-employed population but rather, like in the good earlier times, to finance their local medical institutions themselves. In the result, these get financial support to cover spending on one and the same activity from two channels simultaneously: budget financing and CMI. The former source supports local medical institutions regardless the respective volumes and/or quality of the medical servicing, payment methods of the latter did tie up financing with the volume/quality of the medical servicing, yet their stimulative effects were to a large extent devalued by the simple fact that the CMI funds compensated but part of the required medical institutions' expenses. In fact, the existing eclectic combination of insurance and budget financing elements is not stimulating any higher efficiency in the use of the available resources but, on the contrary, rather results in simple reproduction of the traditional expenditure-intensive economic activities.

The insurance principles of population healthcare financing turned out to be practically totally neglected in the financing system really functioning under the «Compulsory Medical Insurance» name. As of now, the CMI system has already drained itself out and indeed needs either to be fully replaced or at least radically modernized.

Last year, the need in further developing medical insurance did become the subject of acute attention in the higher bodies of power, including even mentioning of this set of problems in the annual Address of the Russian President to the RF Federal Assembly and then, in March 2003, a special meeting of the RF State Council was devoted exclusively to this very area of activity. Following which the RF Government passed Resolution, # 158, dated 17, 03, 2003, «On Additional Financing the Expenditures as Connected with Targeted Medical Services to Non-Employed Pensioners in the Year of 2003». Accordingly, beginning from the May month of that year, a number of the so called «pilot regions» started practically testing the new system of compulsory medical insurance payments of the non-employed population combined with the RF Pension Fund's participation.

These steps were caused primarily by a steadily growing realization of the need in adequate modernizing of the CMI system, set up in the first half of the 1990s, which was then complemented by the respective activities of the RF Pension Fund which had offered a basically new approach for practical solving chronically degrading problems.

Lack of sufficiently precise and clear-cut rules to make due insurance payments for the country's non-employed population out of the respective local and regional budgets being the key problem of the existing CMI system, misbalance between the basic CMI program and the CMI accumulated financial funds but only still further aggravates the problem of overall disbalancing between the state healthcare financing and the cost of practical implementing the



federal program of state guarantees with regard to providing free medical services to RF citizens.

Methods and approaches to radically change the existing situation have been intensively dwelt on in the RF Government practically during all the recent years. In particular, considerable attention was devoted to detailed discussion of proposals to set up a compulsory medical and insurance system in which the federal budget shall also co-participate with regard to the respective payments for the non-employed population. Yet, no decisions followed, at that mainly because of the RF Finance Ministry's attitude. While outwardly supporting the practical need in medical insurance as well in modernizing the existing CMI system, this ministry, for such or other reasons, intentionally delayed taking any definite decisions in this area. Hence, the changes under discussion brought no any tangible positive results. Thus, the unbalanced CMI program, a rather eclectic combination of the medical budget and insurance financing principles, quite inefficient budget healthcare spending do not seem to be sufficient priority problems for the RF Finance Ministry if viewed from its own purely departmental interests. On the contrary, the CMI system modernization versions under discussion could mean for the Finance Ministry an additional expenditure item in the federal budget – state financing CMI payments for the country's non-employed population. Control over the targeted spending within the CMI system seems to the Finance Ministry less efficient than if it were done by the budget framework itself while practical participation of non-state insurers in the system is viewed rather as a prerequisite stimulating their getting richer at the expense of the state than for stimulating the country's medical healthcare system. Probably, that is exactly why the RF Finance Ministry took a long-time waiting attitude with regard to the said CMI reforming.

Beginning from the second half of the year 2002, the RF Pension Fund became much more active in insisting on the need to reform the existing CMI system. It was the Fund that initiated discussing these proposals at the March 2003 meetings of the RF State Council and the RF Government. The gist of the new Pension Fund, as proposed and RF Government approved mechanism, basically is this: the RF Pension Fund through its own funds makes the said additional payments to the CMI for the non-employed pensioners. In the year of 2003, the RF Pension Fund was legally permitted to spend something about 1.5 billion roubles on such stated goals.

The RF Pension Fund takes part in financing insurance payments made for those non-employed pensioners in the Russian Federation territories who have duly signed the respective agreements with the RF Pension Fund, the RF Finance Ministry and the Federal CMI Fund on financing such payments. The amount of the said insurance payments, as made by the authorized RF executive power bodies which have legally concluded such agreements, shall not be less than that of the RF Pension Fund. By the end of the year, the number of such pilot regions where this new mechanism had already been practically tested, reached the figure of 18 (eighteen).

The role of the RF Pension Fund in the financing mechanism suggested is by no means limited by allocation of the said funding. The Pension Fund demanded that the pilot regions coordinate with it the respective CMI territorial indicators, legally approve the medical and economic normatives to become the basis for medical aid provided to pensioners by medical institutions, use sufficiently uniform methods of financing various in-and-out-patient medical institutions as well as providing the Pension Fund with the right to make selective control over activities of the insurers and medical institutions within the respective CMI territorial

system. The RF Pension Fund also moved forward an initiative to regularly keep the said pensioners informed as regards the real costs of factual medical services provided to each of them by the end of the current year.

Indeed, this experiment is a significant step forward on the way to the CMI modernization progress which will, most probably, stimulate certain positive effects on the growth of its efficiency in the said pilot regions. Yet, the mechanisms being tested so far seem rather insufficient for solving the basic CMI problems. But this will undoubtedly require much more fundamental changes in the functions of both the insurers' and those insured which, in its turn, will require adoption of a new and, accordingly, a more modern and adequate law on compulsory medical insurance.

In the period from the years of 2002 to 2003, the respective bill was being developed in the RF Government under the undoubtedly dominant role of the RF Ministry of Economic Development. The resultant «On Compulsory Medical Insurance in the Russian Federation» draft law was duly considered at the RF Government meeting in the first reading on January 15, 2004, and was, on the whole, approved.

The most complicated in its preparation was how to overcome the problem of the lack of sufficiently precise and clear rules for paying the due compulsory medical insurance premiums for the non-employed population. The more so since making the RF subjects pay certain amounts of such premiums from their own budgets obviously contradicts our understanding of the principles of federalism. This would be viewed as an attempt of the federal bodies to impose on its subjects additional financial obligations which in fact should be covered through certain sources from the federal budget itself. Yet, in reality, such sources of the federal budget permit financing but only a lesser part of the said CMI premiums and by no means the whole amounts. Analysis of various versions or formats and finding the necessary compromises became the major factor of such a lengthy delay in preparing the new bill.

Finally, a certain mechanism of concluding agreements on insuring the country's non-employed population between the RF Finance Ministry, the RF Ministry of Health, the CMI Federal Fund, the RF Pension Fund, the executive bodies of the RF subjects and the CMI territorial funds has been developed. Its main contents shall consist of obligations of the parties in co-financing due payments for the non-employed population duly transferred to the respective CMI territorial funds and the federal budget, in its turn, shall provide the necessary funds for such co-financing.

Those RF subjects which have not concluded the said agreement shall independently determine the scheme of insuring the non-employed population as well as that for providing and paying for medical services as stipulated for in the respective CMI territorial program.

The bill, approved by the RF Government, also provides for the following changes in the CMI system:

- exclusion of local budgets as sources of financing CMI payments for the non-employed population; making such CMI payments only out of the budgets of the RF subjects;
- \* preserving insurance medical institutions as the only CMI insurers but complementing it with stricter standards and state control over their activities;
- giving insurants the right to chose their insurers;
- unification of mechanisms of price formation and payment for medical healthcare within the CMI system.



A significant role in the modernized CMI system is to be played by the RF Pension Fund which shall list all those insured in the CMI system, shall participate in the concluding multilateral agreements process, shall receive and duly check all the respective information necessary to keep personal accounts of those insured.

It is also planned to gradually concentrate in the CMI Federal Fund a greater part of the CMI monies due to proportional changes in the social taxation distributions between the federal and the territorial CMI funds thus making it easier for the Federal Fund to even up financial conditions of CMI system's practical implementation in different regions of the country.

Unfortunately, fully ignored were the widely discussed proposals to make it possible for those thus insured to voluntarily quit the CMI system should a respective agreement be concluded on voluntary medical insurance with partial use of the CMI premiums as payment of premiums for the said voluntary insurance.

It could be reasonably stated that, on the whole, this bill is offering quite acceptable solutions of the problems peculiar to the existing CMI system. Accordingly, formal adoption of the new law will undoubtedly stipulate transition to the «uniform payer system» for medical services provided to RF citizens at the expense of the state: concentration of the major budget means in the respective CMI funds in the form of premiums for the non-employed population as well as full-tariff-based payments for the services of medical institutions including all kinds of the respective healthcare. These all do stipulate creating the conditions necessary for a better balance of mutual responsibilities in the CMI system framework including also another step towards higher efficiency in the healthcare of the population.

One more step on the way to improving the state control/regulation over functioning of medical-prophylactic institutions was taken this past year. On May 6, 2003, the RF Government passed # 255 Resolution «On Development and Financing Measures as Connected with the State Guarantees in Providing Free Medical Services to Citizens of the Russian Federation Including Control over their Further Practical Implementation». Fully in accordance with this Resolution, the executive power bodies as well as the respective local self-government ones in the healthcare sphere have the right to set up and further detalize work and function tasks for the organizations under them. It is also to be stated that introduction of such work/function tasks does fully correspond to the Civil Code norms which formally regulate relations between organizations and their respective founders. At the same time, however, this Resolution gives the RF subjects' healthcare executive bodies the right to set up (as approved by the respective local self-government bodies in the field of healthcare servicing) tasks to the municipal healthcare systems including their structural municipal bodies. Yet, correspondence of the said norm to the local self-government legislation still remains somewhat disputable.

The said tasks to the medical institutions include volume indicators of their budget financed activities. In accordance with the set up budget- insurance model of healthcare financing, this, in fact, meant that business planning of virtually all budget-and/or CMI based functioning of medical institutions is to be done by the respective healthcare bodies. The territorial CMI funds shall be made participants of the task-setting commissions to be set up in each respective subject of the Russian Federation. Participation of medical insurance institutions whose main business is to buy medical services from healthcare organizations, in the planning of the respective medical services volumes is nowhere stipulated for at all.

This Resolution opens the way for planning volumes of medical services — not as indicative (framework) planning, although it has been often suggested by a number of experts — but in the framework of the so called «administrative planning». The national, as well as the local healthcare systems do need sufficiently accurate planning of the volumes of the different level medical services provided through the respective budget and/or insurance means. However, such planning is needed rather as indicative, the one targeting buyers of such or other medical services (legitimate healthcare and/or insurance bodies) as well as medical institutions when concluding agreements for concrete volumes of the healthcare services. Regulated should also be the procedures of the respective contractual relationships as to financial risks distribution. Meanwhile the Resolution introduces a system of obligatory tasks for medical institutions not even mentioning the procedure of concluding agreements with any medical institutions. Any somewhat literal application of this Resolution's norms shall, in fact, turn these agreements into nothing but a mere formality.

The very text of this Resolution is targeted towards restoring the administrative system of managing medical institutions at the regional level as well as at gradual turning of the CMI system into a passive financing source of part of medical institutions' expenses with regard to the tasks as directed by the respective higher executive bodies. However, such a scheme obviously contradicts the principles and the tasks of developing the healthcare insurance as clearly determined both in the presidential addresses and the respective key-note documents of the Government. So the Resolution under discussion definitely needs either to be fully revoked or at least significantly corrected with regard to task-setting for the medical institutions primarily so as concerns the right of the regional executive bodies to prepare such tasks including, additionally, their respective norms regulating the adopted procedure of combining the framework healthcare services volumes planning with concluding agreements between the medical healthcare services payers and the respective medical institutions.

### **3.6.2. Education**

The year of 2003 witnessed continued experimental testing of the new higher educational establishment admission rules including those with regard to financing of educational establishments. This in the context when problems of reforming the educational system still remained the subject of active public discussion.

Significantly expanded has become the scale of the «Uniform State Examination» experiment (USE), with the number of its RF subjects participants having increased from 5 (five) in the year of 2001 to 47 (forty seven) in the year of 2003 (see *Table 46*). Accordingly, the quantity of those who successfully passed both the USE entrance and graduation (high school) examinations increased from 30 000 (thirty thousand) in 2001 to almost 700 000 (seven hundred thousand) in 2003 and the number of the general educational establishments where the said USE was to be taken, grew from 2845 (two thousand and forty five) in 2001 to 18130 (eighteen thousand one hundred and thirty) in 2003, while the number of the state higher professional training establishments, including their branches accepting USE entrants, increased from 16 (sixteen) in 2001 to 464 (four hundred and sixty four) in 2003. Much greater has also become the number of the middle level professional training establishments accepting USE entrants: from 79 (seventy nine) in 2001 to 928 (nine hundred and twenty eight) in 2003. Authorization for 20 (twenty) more higher educational establishments and federal bodies was officially done in that same year.

**Indicators of the USE Experiment**

	2001	2002	2003	2004 (plan)
Number of RF subjects taking part in the USE experiment (units)	5	16	47	63
Number of students who have passed The USE examination (thous)	30	300	700	900
Number of the USE exam subjects (units)	8	9	12	12
Number of universities and/or branches Taking part in the USE experiment (units)	16	117	464	-
Number of technical schools taking part in the USE experiment (units)	0	79	928	-
Number of ministries and departments taking part in the USE experiment (units)	3	10	20	-

Source: Data of the RF Ministry of Education

In 2002/2003 academic school years, the experiment was closely followed with further development of the respective administrative and material-technical supply normative base:

- the respective new normative documents and regulative materials concerning both the contents and procedures for the USE examinations, the RF State Examination and Appeal Commissions have been thoroughly prepared; test and/or measuring materials for 12 (twelve) general education subjects have been developed;
- the USE examination technology has been improved;
- \*further actualization followed with setting up federal and/or regional data bases as to the respective federal level testing the USE results are well on the way;
- training of USE specialists (organizers, operators, members of subject commissions, etc) have been completed;
- \*schemes of the USE experiment, its regional programs, the respective normative, instructive and methodological materials, etc have been prepared in 47 RF subjects;
- \*defined and implemented have been the schemes for material-technical and financial provision of the RF subject, participants of the experiment, from the funds of the Federal Development of Education Program (FDEP) and the Federal «Development of Unified Educational Informational Environment (2001 – 2005)» Program;
- the necessary equipment and communication channels have been supplied to 47 (forty seven) RF subjects;
- work have been carried out with 464 higher educational establishments and 928 high schools participating in the experiment (defining the directions and specialities for acceptance according to the USE results, rules of acceptance, procedures of acceptance, the respective federal data bases, etc);
- work has been organized for informing the interested educational establishments – participants of the experiment and mass media means on preparation and carrying out of the experiment through the USE informational support portal ([www. ege. edu. ru](http://www.ege.edu.ru)).

Overall USE expenditures from the FDEP funds in 2003 comprised 586, 6 mln roubles; these included payments for preparing the respective examination tests, training of specialists, purchase of the necessary equipment, etc. Average costs per one experimental region in 2003 comprised 12,5 mln roubles (see *Table 47*).

*Table 47*

**Expenditures on Conducting the USE**

	2001	2002	2003	2004 (plan)
Общие затраты из ФПРО, млн руб.	65,5	365,1	586,6	866,4
Затраты в расчете на один экспериментальный регион, млн руб.	21,8	22,8	12,5	13,8

*Source:* Data of the RF Ministry of Education

Comparative analysis of the results for the period of 2001 – 2003, carried out by the RF Ministry of Education and then discussed at the meeting of the special USE Board on 14.10.2003, showed greater mobility of those entering higher educational establishments in the RF subjects participating in the USE experiment, higher competition rate, growing quantity of those rural school graduates who took the entrance examinations and those accepted; quite a number of school graduates entered various higher educational establishments not even leaving their native habitat.

According to the analysis data of study progress among first year students in a number of higher educational establishments taking part in the USE experiment, correlation between the USE and the first examination session results turned out to be higher than that between the results of the traditional entrance examinations and further study progress.

Members of the special RF Ministry of Education USE Board think that practical introduction of the USE public observers system in 2003 resulted in greater confidence of the society and better public control over the process of conducting the experiment.

According to the estimates of the RF Ministry of Education, on the whole, the first three years of the USE experiment:

- showed that the goals set up when starting the USE experiment, can very well be achieved;
- confirmed real possibility of combining the USE results and higher educational establishments entrance examinations;
- enabled solution of certain technical problems which were detected when using the respective USE measurement and controlling devices.

The indirect results of the USE experiment include Decision of the RF Ministry of Education, dated May 7, 2003, on the final abolition of the practice popularly known as «combined examinations», that is examinations which simultaneously are school finals and entrance examinations to higher educational establishments. Such a system worked earlier under condition that higher educational establishments concluded the respective agreements with certain secondary/high schools but was first abolished by Decision of the Collegium of the RF Ministry of Education on March 12, 2002, which was duly reflected in the respective Orders of the RF Minister of Education # 1932, dated 28.05.2002 and # 2398, dated 25.06.2002, but nevertheless remained active even throughout the year of 2003 for those higher educational establishments which had concluded the said two-year long agreements in 2001, i. e. before these Orders.

As to some of the problems which became manifest during the USE experiment, experts of the RF Ministry of Education think that their positive solution will most definitely require:



- more precise defining and further development of the USE normative documentation on both federal and regional levels;
- \* further improvement of the respective measurement and controlling materials;
- better USE organizational and/or technological procedures;
- \*analyzing different versions of making informational flows during the USE preparation and conducting stages;
- \*considerably wider sphere of higher educational establishments and secondary/high school representation during all the USE preparation and conducting stages.
- monitoring as connected with quality of school education in schools of the Russian Federation;
- further development of the respective public observers system.

It is not at all difficult to notice that, among others, no mention is made of the problem of financing the USE system after the experiment has been completed. This is explained by a simple fact that the situation with regard to the USE financial support from the federal budget is already quite tense and the RF Ministry of Education agrees to include a region into the USE experiment only provided there is a respective regional co-financing. The FDEP program which remains the major source of financing the USE experiment, shall stop such financing upon formal completion of the experiment in the year of 2005. It is also to be mentioned that conducting USE in all the RF regions on the regular basis will require about 800 (eight hundred) mln roubles annually (based on the level of specific expenditures in 2003 minus spending on purchase of the necessary equipment).

Another problem not to be ignored is the absence of a clear-cut and sufficiently efficient technology for taking in students according to the USE results. The explanation for this is quite simple: entrants who have sent their USE results to several higher educational establishments and turned out to be among the best (taken in) in not one but several higher educational establishments shall render the original documents but only to one of them, the rest having to wait a certain number of days after which they will be able to offer the vacancies to the «second wave» entrants who will find themselves in a rather similar situation, the more so since a number of them could be already taken in as students of probably less prestigious higher educational establishments. Hence the admission process could very well become a mess by the beginning of the academic year (which, among other significant factors, is quite possible particularly in view of the quality of our postal services and our traditional transport congestion in the summer time).

Still another but nevertheless potentially quite a serious problem is connected with making the city of Moscow also part of the USE experiment. Initially, the Moscow government agreed to conduct the USE experiment in the 2003 – 2004 academic year only in about half of its administrative districts (about 50 % of all Moscow secondary/high schools) having moved forward at that a number of additional conditions which put Moscow in a somewhat privileged position. Among these are: use of the uniform text in the Russian language and literature; conducting USE not in special places but in schools in the presence of the school teachers. That adopting a specific, different from others USE procedure even in one particular region is basically ruining the whole USE structure is obvious because it *de facto* makes end results practically immeasurable. Moreover, such an approach not only makes it impossible to take in students on any uniform basis but does not even permit to estimate the USE results as quality indicative for both the general educational establishments and the regional educational



systems. After that the Moscow Government rejected USE as compulsory even for part of schools having given the school-leavers the right to take it as they wish.

The year of 2003 saw continuation of the experiment with financing of certain educational establishments using the so called «government individual financial certificates» (GIFC). According to the admission campaign for the 2002/2003 academic year in 6 higher educational establishments – participants of the experiments, over 14,3 thousand (total number of entrants – 35 thousand) were taken in as first-year students, with 8,4 thousand (or 58 %) having been taken in on the GIFC basis.

Distribution of the budget funds and freshmen – participants of the experiments by the GIFC categories in the higher educational establishments is shown in *Table 48*, below.

*Table 48*

**Distribution of Freshmen and Budget Funds by the GIFC Categories  
in Higher Educational Establishments – Participants  
of the 2002 – 2003 Experiment (all forms of education, in %)**

GIFC category	Freshmen		GIFC-based budget funds	
	2002	2003	2002	2003
First	8	11,6	20	28
Second	39	27,5	49	38
Third	37,6	42,7	25	28
Fourth	10,8	12,5	5	5
Fifth	4,7	5,7	1	1

*Source:* Data of the SU-HSE

It is to be specially emphasized that the GIFC funds can also be used by higher educational establishments to cover such items of their current expenses as salaries and wages, etc. The rest of the expenditures are to be financed by the respective higher educational establishments fully in accordance with the existing budget system of financing. Planning of expenditures for the following years is made with account taken of the GIFC value as recounted according to the federal budget approved categories for the current year.

Special mention should also be made that in the year of 2003, the GIFC amount (all categories included) was much lesser as compared against the previous year (see *Table 49*). But then the amount of the first three GIFC categories was made larger for a number of specialties. This can be rather easily explained by a strong intention of the RF Ministry of Education to provide budget support for training region-priority specialists. The RF Ministry of Education Regulation # 2376, dated early July, 2003, «On Further Development of the Experiment with Regard to GIFC Financing of Certain Higher Professional Education Establishments», provides that the RF subjects shall jointly with the respective higher educational establishments – participants of the experiment, determine for the year of 2003 the list of specialties which, due to the lack of the population demand, are particularly significant for the region's social and economic development. This list sets higher financial support for the GIFC first, second and third categories. However, the whole number of persons for all the specialties in



the said list must not exceed 300 (three hundred) and should a student be transferred to a study speciality not included in the list the said higher level financing is not retained.

*Table 49*

**Category-Based GIFC Amounts in 2002 – 2003**

GIFC category	GIFC budget financing (roubles)		
	2002	2003	2003
	Set up GIFC* amount	Set up GIFC** amount	Higher GIFC*** amount
1 <sup>st</sup> category	14500	12500	17500
2 <sup>nd</sup> category	7500	7200	12200
3 <sup>rd</sup> category	3900	3000	8000
4 <sup>th</sup> category	2800	2000	2000
5 <sup>th</sup> category	1200	700	700

\* Approved by the Order of the Minister of Education on 25.03.2002, # 1013.

\*\* Approved by the Order of the Minister of Education on 26.03.2003, # 1193.

\*\*\* Approved by the Order of the Minister of Education on 3.06.2003, # 2376.

This experiment of GIFC-based higher educational establishments financing revealed a number of problems connected with practical introduction of new approaches to the current higher educational establishment budgeting. Among these problems are:

- instability of GIFC financing due to the current state of the federal budget;
- GIFC insufficiency whose amounts are lesser than training of specialists costs;
- absence of GIFC specialities differentiation even though it is quite obvious that costs to train a nuclear physicist do differ from such to train, say, an economist or a lawyer.

To overcome the shortcomings found during the experiment, The RF Ministry of Education have worked out a number of proposals concerning changes and a more precise/correct experiment's legal-normative base to its consequent GIFC transition at the second stage (2004 – 2005). The most significant of these include:

- \*changing the GIFC categories structure and transition to 3 (three) GIFC categories from initial 5 (five);
- \*setting up the top GIFC category for winners of the All-Russia school Olympiads as well as for members of the Russian selected teams which participated in international-class competitions in general educational subjects.
- \*changing correlation between the GIFC categories and the sum of the exam points received by the entrants with the lowest one (the 3<sup>rd</sup>) for school-leavers who got less than 60 GIFC points (it is to be noted that earlier the lowest 5th GIFC category level comprised minimally thirty five points);
- taking in fully paid students who got less than 60 (sixty) GIFC points;
- \*rejection of the demand to compulsorily admit (at the GIFC funding) at least 50 per cent of the total number of students admitted; setting up pilot admission values for obligatory GIFC-based admission of students to higher educational establishment;
- \*limited number of students studying socially significant for the region subjects with the said higher GIFC financing is determined proportionally to the population quantity of the respective RF region;

- \*introduction of the higher GIFC financing for specialities requiring better technical support of the educational process;
- \*the third GIFC category is set for persons fully in accordance with the RF legislation granted the right for the out-of-the-competition admission to higher educational establishments.

The new mechanism of the GIFC-based current financing of the higher educational establishments thus tested by the RF Ministry of Education, on the one hand, is targeted towards greater budget support of the students showing high academic achievements as well as those in need of a certain degree of social protection and, on the other hand, inevitably reflects the attitude directed to less rigid requirements as to taking in students on a free of charge basis. With all its positive elements, such an approach does compel higher educational establishments to expand paid admission of students to assure more stable and/or adequate financing.

Concluding, special mention, along with a number of other measures aimed at strengthening the legitimate bases of financing the municipal general educational establishments, should be made of the Federal Decree «On Introducing Changes and Amendments in Certain Legislative Acts of the Russian Federation with Regard to Financing the General Educational Establishments», # 123-FZ, dated July 7, 2003, signed the President of the Russian Federation. According to this document, financial provision of citizens' state guarantees for generally acceptable and free education in the municipal general education systems should be made through subventions to the local budgets in the amount necessary to practically implement the state general education standard. Such subventions are intended to cover the current costs on wages/salaries of employees of the municipal general education establishments, the expenditures on buying the needed training supplies, the technical educational aids, expendable materials (except for communal costs). In other words, all the required current budget expenses to support the respective educational process shall be financed at the respective regional level.

Thus, this law can be considered as quite a real step forward in the higher bodies of the vertical power levels concentration of financial resources process as well as in the greater responsibilities of the RF subjects for practical implementation of the federal authorities in the sphere of municipal level general educational services, taking place in the recent time.

### 3.7. Foreign economic activities

In 2003 the world economy was up 2.5% as compared with 2% in 2001 and 2002. In the US low interest rates (the lowest in recent 45 years), growing consumer expenditures and corporate profits created conditions for economic recovery. The annual US GDP in 2003 increased by 3.1% as compared with the previous year, which is the highest indicator since 2000. The annual US exports grew by 1.9%, imports – by 3.7%.

An important contribution to the world economy recovery was made by China where GDP in 2003 grew by 8.5% (the biggest increase in 6 recent years). Chinese foreign trade turnover expanded by 37.1% up to 851.21 billion US dollars – the highest growth rate since 1980. Exports amounted to 438.37 billion US dollars (up 34.6% as compared with the previous year), imports – to 412.8 billion US dollars (up 39.9%).

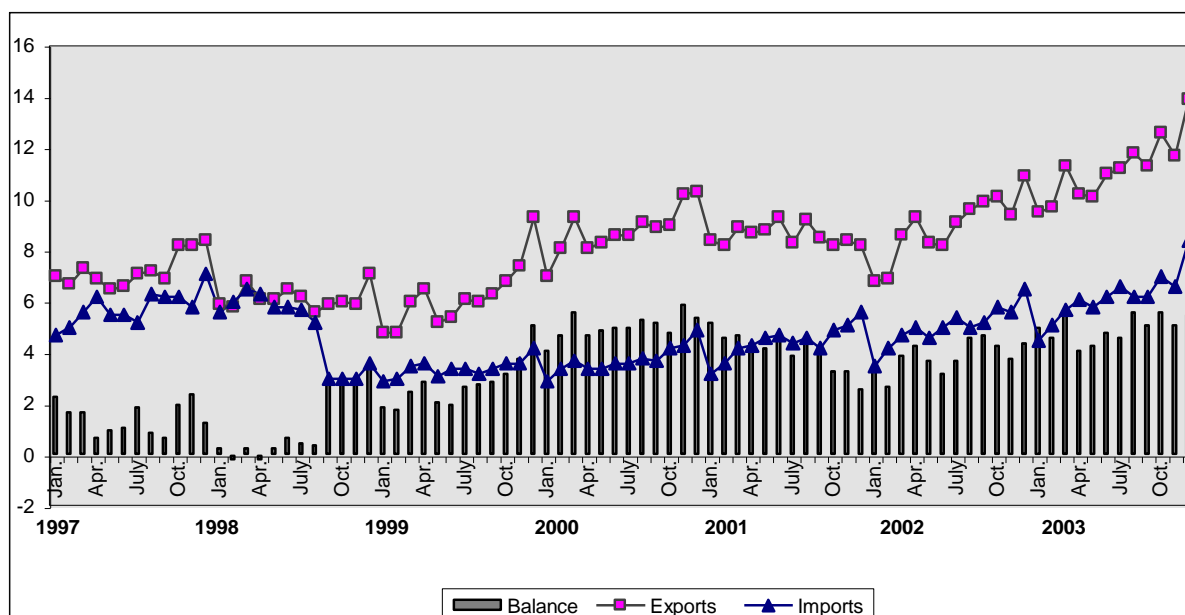
As to the Western Europe and Japan, they are on the verge of recession. In July-September 2003 the euro-zone GDP grew by 0.4% as compared with April-June, and the average annual growth rate is 0.3%. The EU (15) indicators are 0.4% and 0.6% respectively. Exports from euro-zone expanded by 2%, from the EU – by 1.8%; imports to the countries of monetary union fell by 0.1%, to the EU – grew by 0.1%.

2003 was one of the most successful of the 15 recent years for development of Russia's foreign economic activities. The country's foreign trade benefited from favourable situation on the world markets of its basic export commodities, strengthening of the RUR/USD real exchange rate, growth of domestic solvent demand. As a result, the foreign trade turnover in 2003 totaled 210.8 billion dollars – up 25.3% as compared with 2002 (data of the RF Central Bank). Russia's exports set a historic record – 135.4 billion dollars, which is 26.2% above the 2002 indicator (107.3 billion dollars).

Imports' increase was less remarkable – they grew by 23.9% (from 61.0 billion dollars in 2002 to 75.4 billion dollars in 2003).

Picture 55

Basic indicators of Russia's foreign trade (billion dollars)



Source: RF State Committee for Statistics.

The most noteworthy trend that shaped Russia's foreign economic development throughout most part of 2003 was a notable rise of export prices for fuel and energy products and some other raw commodities and materials. The non-precedent growth of exports based upon exceptionally favourable dynamics of the world prices for oil and other fuel and energy products.

Prices on the world oil market in 2003 remained basically high. In addition to larger demand the market situation was positively affected by relatively low oil stocks in developed countries, limitation of oil production by OPEC countries and some other factors.

In 2003 the average price for Urals and Brent oil was about 13% above the 2002 level.

*Table 50*

**Average annual world prices for selected commodities**

	1996	1997	1998	1999	2000	2001	2002	2003
Oil (Brent), USD / barrel	21.33	17.4	14.1	15.9	28.19	24.843	25.022	28.83
Natural gas, USD / 1 million BTU	-	1.9642	2.5469	2.1876	4.3442	3.9764	3.3857	5.461
Petrol, USD / gallon	0.71	0.615	0.511	0.529	0.887	0.7922	0.755	0.891
Copper, USD / ton	2574.9	2369.7	1775.3	1539.9	1863.9	1613.6	1592.9	1785.6
Aluminium, USD / ton	1590.2	1554.0	1413.5	1318.0	1550.0	1444.7	1350.7	1424.7
Nickel, USD / ton	8053.9	7312.4	5352.5	5239.5	8624.0	5966.0	6175.1	9580.8

*Source:* calculated on the basis of data of London Metal Exchange (Great Britain, London) and the World Oil Exchange (Great Britain, London).

Prices for Russian natural gas remained high. In 2003 the average contract price for it rose by 61.3% as compared with 2002.

The upper trend prevailed on the market of ferrous metals in 2003 largely due to the fast growth of demand for metals in China and Japan as well as to the general optimistic outlook for economic development in countries – basic consumers of metals.

The signs of world economy revival also fostered rise of prices on the world market of non-ferrous metals. Price for nickel grew most notably. By the end of 2003 it set the record for the recent 14 years – 14,900 dollars per ton. The cause of its rise is larger consumption of this metal, primarily by China.

As compared with 2002, the average price for nickel in 2003 was up 55.2%, the price for copper – 12.1%, the price for aluminium – 5.5%.

### *3.7.1. Foreign trade with countries outside the CIS*

In 2003 the turnover of Russia's foreign trade with countries outside the CIS grew by 24.5% as compared with 2002 – up to 174 billion dollars. Exports increased by 25.3% (up to 114 billion dollars), imports – by 23.0% (up to 60 billion dollars). The positive balance of trade with the non-CIS countries grew by 11.8 billion dollars (up to 54 billion dollars).

Favourable world market situation in 2003 fostered rise of contract prices for actually all basic items of Russia's export.



*Table 51*

**Average contract prices for basic items of Russia's export  
(supplies to the non-CIS countries, dollars per ton)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Crude oil	100.6	108.2	133.5	118.5	74.4	110.9	179.9	156.4	162.4	181.2
Petrochemicals	86.2	103.5	129.9	115.7	75.7	94.5	171.9	145.2	147.9	180.2
Natural gas (dollars per 1 thousand cubic meters)	72.8	80.1	84.2	88.6	72.2	55.31	85.91	105.21	91.4	112.3
Ammonia	113.8	129.5	125.6	113.0	83.1	53.0	97.5	81.7	72.4	118.5
Nitrogen fertilizers	80.9	119.8	128.0	90.3	58.3	36.8	57.9	61.8	60.6	76.0
Potash fertilizers	69.7	71.9	7.2	79.7	87.4	86.4	86.6	76.8	74.9	77.8
Round timber (dollars per 1 cubic meter)	53.0	58.0	59.4	57.5	46.9	43.5	43.4	45.6	44.8	47.8
Pulp	378.4	708.4	407.3	373.5	342.9	274.0	352.2	293.4	300.0	321.7
Newsprint	291.5	591.8	473.7	383.4	394.0	349.5	386.6	421.7	332.2	338.3
Cast iron	112.8	130.4	136.8	124.2	104.3	66.8	80.7	86.2	91.1	126.8
Ferroalloys	832.7	1090	1114	819.2	740.8	548.2	625.6	601.7	625.7	634.6
Copper	2042	2550	2143	2099	1655	1495	1675	1465.3	1371.4	1564.9
Nickel	5973	8057	7272	6733	5140	5761	8629	5730.9	6143.9	8584.0
Aluminium	1029	1519	1500	1401	1352	1157	1296	1176.3	1036.9	1050.0

Source: RF State Committee for Statistics, customs statistics.

The rise of export prices in 2003 was accompanied by the increase of exported goods' physical volumes. An important incentive for this increase was a notable strengthening of euro versus US dollar that raised competitiveness of Russian commodities as compared with the European ones.

*Table 52*

**Russia's export indicators**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Exports, total (billion dollars)	67.4	82.4	89.7	86.9	74.4	75.6	105.0	101.9	107.2	135.4
Including:										
Exports to non-CIS countries (billion dollars)	51.7	65.4	71.1	67.8	58.7	63.6	90.8	86.6	91.0	113.9
Growth rates (as % of the previous year)										
Physical volume index	...	...	100.1	101.8	99.7	109.4	110.2	104.2	115.0	109.5
Price index	...	...	108.6	98.1	84.2	92.1	128.2	93.8	86.0	113.4

Source: RF Central Bank.

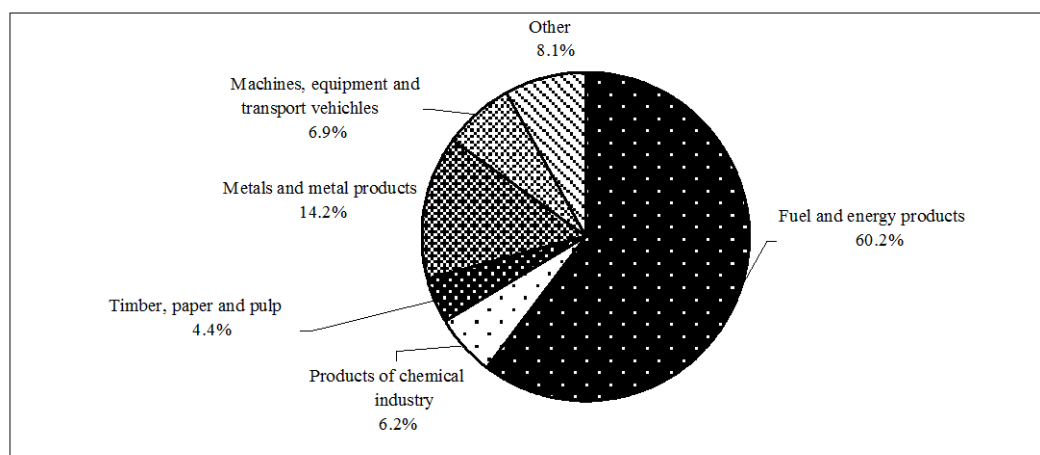
Quantitative indicators of Russian export grew in line with further enlargement of its fuel, energy and raw material component. According to the data of RF State Customs Committee the share of fuel and energy products in the commodity structure of export in January-November 2003 increased up to 60.2% (up 3.5 percent points as compared with January-November 2002).

The share of ferrous and non-ferrous metals and metal products equaled 14.2% (down 0.9 percent points), of timber, paper and pulp – 4.4% (down 0.5 percent points), of chemical industry products – 6.2% (down 0.3 percent points).

The share of products with high value added (machines, transport vehicles, textile goods and footwear, other finished goods) decreased. For instance, the share of machines, equipment and transport vehicles in the total exports fell by 0.8 percent points as compared with January-November 2002 down to 6.9%.

*Picture 56*

**Commodity structure of Russian export (January – November 2003)**



Source: RF State Customs Committee.

Further acceleration of Russian export's growth is constrained by the scale of external demand and cargo-carrying capacity of transportation network. One more serious hindrance to larger exports is the restriction of Russian commodities' access to foreign markets. At present 93 restrictive measures are targeted against them inflicting losses on domestic exporters to the total amount of about 2 billion dollars. The largest number of restrictions is imposed by the European Union. Besides, Russian economy may loose up to 150 million dollars due to the Union's expansion. This will result from elevation of import duties and application of anti-dumping procedures against Russian producers by countries that are going to join the EU.

In 2003 Russia's GDP grew by 7.3% as compared with 2002. Higher economic activities induced bigger aggregate domestic demand by both households (demand for consumer goods) and enterprises (demand for investment and intermediate products) that resulted in a noticeable increase of import supplies. Due to larger solvent consumer demand, more available and less costly consumer credit imports of expensive consumer goods grew notably.

Besides, in 2003 the real RUR/USD exchange rate was on the average 18.6% above the 2002 level also stimulating import. The real effective exchange rate of ruble (estimated in respect to the currency basket) strengthened by 6%.



The strengthening of euro versus dollar elevated the dollar value of commodities imported from Europe. At the same time it improved the competitiveness of Russian products and constrained growth of import's physical volumes. These two effects completely offset each other and euro exchange rate fluctuations did not noticeably influence the value of imports.

In 2003 the value of imports amounted to 74.8 billion dollars – 23.6% above the 2002 level.

*Table 53***Russia's import indicators**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Imports, total (billion dollars)	50.5	62.6	68.1	72.0	58.0	39.5	44.9	53.8	60.5	75.4
Including:										
Imports from non-CIS countries (billion dollars)	36.5	44.3	47.3	53.4	43.7	29.2	31.4	40.3	48.2	60.0
Growth rates (as % of the previous year)										
Physical volume index	...	...	98.1	121.1	89.0	84.4	129.2	129.1	117.6	119.2
Price index	...	...	100.2	94.8	92.3	82.1	86.7	94.3	93.4	98.7

Source: RF Central Bank.

According to the data of RF State Customs Committee the dominant place in commodity structure of Russia's import in January-November 2003 was occupied by machines, equipment and transport vehicles that accounted for 40.4% of its total value (up 2.2 percent points as compared with corresponding period 2002).

The share of chemical industry produce amounted to 18.5%, textile goods – to 4.3%, timber, paper and pulp – to 4.5%.

The share of food and agricultural products fell to 21.3% (down 2.8 percent points).

In 2003 imports grew at a lower rate as compared with exports. As a result the positive foreign trade balance amounted to 59.6 billion dollars – 27.9% above the 2002 level. Its growth was primarily favored by the rise of world prices for fuel and energy products and by the strengthening of euro versus US dollar. The export/import ratio amounted to 179.5%.

The principal Russia's trade partners in 2003 were the EU countries that accounted for 35.8% of the total foreign trade turnover (in 2002 – 37.2%). In value terms their contribution amounted to 48.3 billion dollars (119% of the 2002 indicator) including 12.8 billion dollars (122%) of trade turnover with Germany, 7.8 billion dollars (112%) – with Italy, 6.9 billion dollars (107%) – with the Netherlands, 4.5 billion dollars (140%) – with Finland, 4.4 billion dollars (126%) – with Great Britain, 4.1 billion dollars (130%) – with France.

Three countries accounted for almost 80% of Russia's trade turnover with APEC (Asian Pacific Economic Cooperation): China, the turnover with which amounted to 7.8 billion dollars (121% of the 2002 indicator), the United States – 5.4 billion dollars (107%) and Japan – 2.9 billion dollars (145%). The aggregate turnover with the APEC countries grew by 21.5% as compared with 2002 up to 21.6 billion dollars – 16.0% of Russia's total trade turnover.

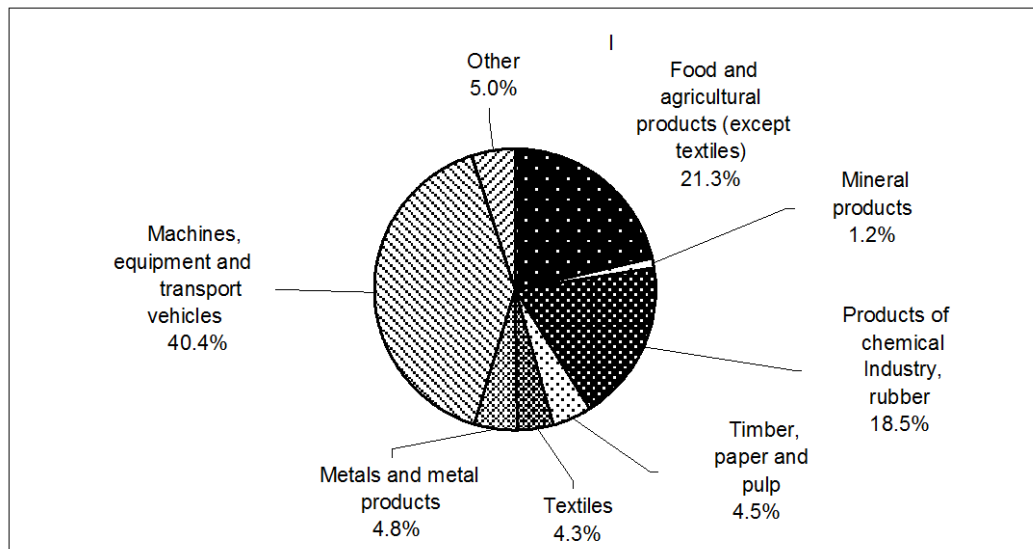
The turnover with countries of Central and Eastern Europe amounted to 17.3 billion dollars (126% of the corresponding 2002 indicator) including 4.5 billion dollars (128%) – with



Poland, 2.6 billion dollars (131%) – with Hungary, 1.9 billion dollars (123%) – with Slovakia, 1.9 billion dollars (132%) – with Czechia.

Picture 57

**Commodity structure of Russian import (January-November 2003)**



Source: RF State Customs Committee.

**3.7.2. Foreign trade with the CIS countries**

Russia's turnover with the CIS countries (estimated using the balance of payments methodology) in eleven months 2003 totaled 32.8 billion dollars – 28.4% growth as compared with the corresponding period 2002. Exports grew by 30.4% up to 19.13 billion dollars, imports – by 25.5% up to 13.67 billion dollars. The balance of trade with these countries was positive and amounted to 5.47 billion dollars (3.78 billion dollars in 11 months 2002).

The share of CIS countries in Russia's foreign trade turnover slightly enlarged up to 17.4% (16.9% in January-November 2002). Their share in exports amounted to 15.7%, in imports – to 20.4%.

Table 54

**Russia's foreign trade with the CIS countries**

	2000	2001	2002	2003 January- November
Trade turnover (billion dollars)	27.68	28.24	28.57	32.80
Exports (billion dollars)	14.25	15.20	16.25	19.13
Imports (billion dollars)	13.43	13.04	12.32	13.67
Balance (billion dollars)	0.82	2.16	3.93	5.47
Growth rates (%)	23.7	2.0	1.2	28.4*
CIS share in the total foreign trade turnover (%)	18.5	18.2	17.1	17.4

\* as percent of January-November 2002.

Source: RF Central Bank (balance of payments methodology).



Byelorussia, Ukraine and Kazakhstan remained Russia's principal trade partners among the CIS countries: their share in the total Russian exports to this group of countries amounted to 37.5%, 37.5% and 15.2%, in the total imports – to 37.6%, 32.3% and 20.4%, respectively.

*Table 55*

**Russia's foreign trade with the CIS countries  
in January-November 2003 (million dollars)**

	Turnover	Exports	Imports	As % of January-November 2002		
				Turnover	Exports	Imports
Azerbaijan	445.4	369.8	75.6	138.2	150.7	150.7
Armenia	182.3	114.6	67.7	141.4	150.6	150.6
Belarus	11 166.4	6 760.9	4 405.5	126.2	127.9	127.9
Georgia	196.9	125.4	71.5	137.7	152.9	152.9
Kazakhstan	5 272.1	2 867.1	2 404.9	133.5	131.6	131.6
Kyrgyzia	223.8	135.5	88.3	139.7	142.2	142.2
Moldova	616.9	264.4	352.4	127.0	110.1	110.1
Tajikistan	173.9	112.6	61.4	142.8	181.3	181.3
Turkmenia	228.5	203.7	24.8	149.2	164.9	164.9
Uzbekistan	890.5	448.3	442.2	124.9	113.3	113.3
Ukraine	10 724.3	6 845.4	3 879.0	131.4	129.2	129.2

Source: RF State Customs Committee.

### Export

In 2003 Russian export to the CIS countries grew at a higher rate (30.4%) than that to the non-CIS countries (25.4%). Still, its volume has not yet surpassed the 1996 indicator.

Although no radical changes have taken place, the commodity structure of Russia's export to countries of the Commonwealth in 2003 improved: the share of fuel and energy products in the total exports decreased (from 46.3% in 2002 down to 43.3%) while the share of machines and equipment (whose exports grew by 35.4%) amounted to 21.8%. Exports of coal increased 2.5 fold, exports of ferrous metals – by 43.1%.

Due to favourable situation on the world markets and larger production of steel in the world Russian exports of iron ore and concentrates grew by 48.9%. About 40% of their total volume was supplied to Ukraine.

In 11 months 2003 physical volume of exported crude oil increased by 18.2%, of coal – 2.5 fold. At the same time export supplies of natural gas fell by 13.0%. The overall growth of oil products' exports by 7.5% is mostly due to much bigger exports of fuel oil (up 2.4 fold). On the contrary, export supplies of diesel oil decreased by 14.4%.

Larger value of exports to the CIS countries is due to the growth of supplies of energy resources (up almost 22.3%) and machine building products (up 35.5%). One more cause is the rise of contract prices by 18% as compared with the same period 2002. For instance, prices for machines and equipment got higher by 27%, for chemical industry products – by 18.9%, for fuel and energy products – by 17.6%, for metals and metal products – by 14.7%.

At the same time Russia continues to grant preferential regimes to countries of the Commonwealth. For instance, in 2003 prices paid by them for crude oil were as low as about 70% of prices set in contracts with other countries, prices for iron ore – 65%, for timber – 85%, for cargo cars – 36%.

However, these preferences not always lower prices on domestic markets of the CIS countries: e.g. prices for Russian metals, oil products, timber and cars were there almost 1.5 fold above the world level.

*Table 56*

**Exports of selected products to the CIS countries**

	January - November 2003	January - November 2002	January-November 2003 as % of January-November 2002
Crude oil, thousand tons	20197.4	16996.6	118.8
Oil products, thousand tons	2091.9	1946.1	107.5
Including:			
Car petrol	505.9	427.1	118.5
Diesel oil	566.1	661.0	85.6
Fuel oil	178.2	74.4	2.4 fold
Natural gas, billion cubic meters	26.7	30.7	87.0
Coal, thousand tons	8538.0	3394.6	2.5 fold
Machines and equipment, million dollars	2457.0	1770.2	138.8
Iron ore and concentrates, thousand tons	6842.6	4596.1	148.9
Ferrous metals, million dollars	413.5	289.0	143.1
Nitrogen fertilizers, thousand tons	435.4	559.9	77.8
Synthetic rubber, thousand tons	56.5	33.4	169.2
Timber, thousand tons	804.2	508.2	158.3
Wheat and meslin, million dollars	161.2	691.5	23.3

*Source:* RF State Customs Committee.

### Import

Import deliveries from the CIS countries increased primarily due to their larger physical volumes. They grew faster than deliveries from countries outside the Commonwealth: 25.5% and 22.5%, respectively.

The commodity structure of import from the CIS countries is largely the same as that of import from industrially developed countries, but the share of machine building products in it is far below – only 12%.

Similarly to previous years in 2003 imports from the CIS countries largely consisted of food and agricultural products that accounted for 21.2% of aggregate deliveries from this region (in 11 months 2003 –19.6%).

The distinctive feature of the last months 2003 was a steady growth of imports of raw products, first of all coal and ferrous metals, deliveries of which increased by 21.5% and 87.1%, respectively. Imports from the CIS of steel pipes grew 2.0 fold, of passenger cars – by 67.5%, of cotton fabrics – by 34.0%. On the contrary, deliveries of rubber fell by 46.4%, of cotton fiber – by 9.7%, of oil products – by 9.6%.

Noteworthy trends in food import dynamics are larger purchases of frozen meat (up 31.8%), dried and condensed milk (up 2.2 fold) and tea (up 16.0%). Volumes of imported sunflower oil grew as well (by 61.0% in January-November 2003). Ukraine remains its principal supplier to Russia. (Exports of Russian sunflower oil, on the contrary, fell. One of its main importers is Kazakhstan).

The dynamics of average import contract prices differed by groups of commodities. As compared with 2002 prices for machine building products rose by 13.2%, for metals and metal products – by 3.7%. Meanwhile prices for foodstuffs fell by 31%, prices for chemical products – by 8.9%. Consequently, these were the CIS countries that provided for the increase of Rus-



sia's food imports in 2003 – they grew by 96% in physical terms while supplies from the non-CIS countries decreased by almost 8%.

At the same time prices for products imported from the CIS countries are above those paid for corresponding commodities from the non-CIS countries: for frozen meat they are higher 1.2 fold, for poultry meat – 2.1 fold, for milk products – 1.5 fold, for butter and sunflower oil – by 11%, for white sugar – 1.7 fold.

Cargo cars were traditionally imported from the CIS countries but since average contract prices for them got 3.2 fold higher than those quoted by other countries, the corresponding purchases fell by nearly one third.

Low competitiveness of commodities from the CIS constrained growth of their imports to Russia. Imports of machines and equipment therefrom remained at the same level while corresponding supplies from the non-CIS countries expanded by almost one fourth. Greater demand for high-quality products in Russia explains 5% decrease of purchases of textile, textile products and footwear from the CIS and their 40% growth from other countries.

*Table 57***Imports of selected products from the CIS**

	January – November 2003	January – November 2002	January-November 2003 as percent of January-November 2002
Machines, equipment and transport vehicles, million dollars	1347.5	1127.6	119.5
Passenger cars, thousand	17.6	10.5	167.6
Ferrous metals, million dollars	770.0	411.5	187.1
Ferrous metals (less cast iron, ferroalloys and scrap), million dollars	577.1	298.5	193.3
Steel pipes, thousand tons	632.5	310.4	2.0 fold
Coal, million tons	22.8	18.7	121.9
Oil products, thousand tons	6.6	7.3	90.4
Meat, fresh and frozen (less poultry meat), thousand tons	154.5	117.2	131.8
Condensed milk and cream, thousand tons	15.5	7.0	2.2 fold
Fish, fresh and frozen, thousand tons	23.2	27.1	85.6
Wheat and meslin, thousand tons	553.1	241.8	2.3 fold
Barley, thousand tons	42.5	1.8	23.6 fold
Sunflower oil, thousand tons	143.1	88.8	161.1
Alcoholic and non-alcoholic beverages, million dollars	373.1	271.6	137.4
Cotton fiber, non-carded, thousand tons	248.5	273.9	90.7
Cotton fabrics, thousand m <sup>2</sup>	23000	19325	119.0
Natural and synthetic rubber, thousand tons	1.5	2.8	53.6

Source: RF State Customs Committee.

## Trade relations with some CIS countries

### *Belarus*

The problem of debts for supplied gas again came to the forefront of Russian-Belarus relations. Debts accumulated by Belarus in 1999-2002 exceed 120 million dollars. In 2003 Russia sold there over 60% of planned annual supplies of gas at domestic price (28 dollars per 1 thousand cubic meters) but beginning from January 1, 2004 the new price will go up to 50 dollars. In its turn Belarus took the decision to double tariffs for transit of Russian gas to Western countries.

From January 1, 2004 "Gazprom" stopped deliveries to Belarus since no agreements have been reached on the price for gas and terms of transit in 2004.

In winter period Belarus consumes approximately 60 million cubic meters of natural gas daily. In January Russian companies supplied about 2 billion cubic meters of gas to Belarus at the average price 46.7 dollars per 1 thousand cubic meters. Independent exporters of natural gas "ITERA" and "TransNafta" in February extended contracts on supply of gas on terms close to those effective in January. The planned delivery volumes will be sufficient not to create problems for Belarus economy.

In July the RF State Customs Committee decided to toughen control over delivery of cargos by Belarus transporters. As early as in spring the Committee's Order № 202 of March 3, 2003 "On delivery under customs control of goods carried by Belarus transporters" came into force. It specified only 8 customs clearing points and warehouses for consignees from Central Russia. The tying of transporters to specified terminals will facilitate more thorough control over delivery of goods. It's known that Belarus companies are ready to transport cargoes at much lower prices as compared with ones quoted by Russian companies. For instance, delivery of a cargo from Finland by Russian transporters will cost 1000 dollars, by Belarus transporters – 700 dollars. Delivery of a cargo from Germany to Moscow by Belarus companies is cheaper by approximately one third. The Association of international transporters finds that the share of Belarus carriers in transportation of cargos from third countries to Russia is about 48%.

In 2003 Belarus introduced special tax regime for Russian beer aimed to restrict its import. According to the new rules beer will be sold only from customs warehouses specified by the tax bodies. In 2002 Russian exports of beer to Belarus grew 1.5 fold up to about 3.5 decalitres.

### *Ukraine*

The key problems of Russian-Ukrainian bilateral relations in 2003 were the restrictions on export of about 150 Ukrainian commodities to the Russian market. Ukraine finds that revenues from larger Russian exports may exceed losses from abolition of VAT on energy products supplied from Russia.

Wishing to guarantee future supplies of meat Ukraine advocated introduction of quotas for this product although import of beef and pork to Russia from the CIS is not subject to quoting. In 2002 Ukraine supplied about 115 thousand tons of beef to Russia and its share in the structure of corresponding imports reached 24%. On the domestic market Ukrainian beef is sold at prices close to prices of Russian producers. The planned size of quota for 2003 is



already 315 thousand tons. The almost 3 fold increase of import supplies can affect Russian producers.

In May 2003 Russia introduced a new antidumping duty on import of galvanized rolled metal from Ukraine. The duty will be effective for 2.5 years and its size is 24.3% of the customs value of supplied rolled iron and steel with zinc or aluminium-zinc plating. Earlier a temporary antidumping duty amounting of 31.8% was introduced in August 2002 and was effective for four months. From May 2000 till April 2001 the average dumping margin for Ukrainian galvanized rolled metal amounted to almost 50%.

In November 2003 the problem of constraining import of pipes from Ukraine got a new impetus. The summary 2003 quota set for Ukrainian producers amounted to 620 thousand tons of pipes including 135 thousand tons of large-diameter pipes. However, Ukraine delivered the quota volumes ahead of time and obtained the permission to supply additionally 120 thousand tons.

Up till now the annual demand for pipes by Russian companies grew at the rate of 7-8%. This growth was primarily due to activities of oil companies and "Gazprom" interested in the expansion of export and, consequently, in the development of transportation mains. But in 2002-2003 the Ukrainian dumping deprived Russian manufacturers of orders to the total amount of 710 thousand tons.

The only enterprise designed to produce pipes for gas mains in the former USSR (and currently in the CIS) is Khartsyz pipe plant situated in Donetsk oblast (Ukraine). Besides, the Ukrainian government actually subsidizes pipe producers by writing off their fines and penalties on overdue debts and by granting them tax privileges.

In view of the above, there is an urgent need to sign a new agreement with Ukraine on regulating export of pipes within the Common economic space and to fix in it the volume of Ukrainian supplies to Russia. Besides, in case more pipes of a certain type are supplied, it would be rational to cut imports of pipes of some other type without revising the overall Ukrainian quota. The situation for Russian manufacturers may change for the better in case they start to produce large-diameter pipes needed by "Gazprom".

### *3.7.3. Foreign trade regulation*

In March 2003 a meeting of customs officials of EvrAzES (Euro-Asian Economic Community integrating Belarus, Kazakhstan, Kyrgyzia, Tajikistan and Russia) took place. Among the key issues discussed at the meeting was the customs control over export and import of alcohol and tobacco products, ethyl spirits and intellectual property.

Besides, measures to further forming of a common customs territory were discussed and results of comparative analysis of draft Customs Codes of three countries (Kazakhstan, Kyrgyzia and Russia) were generalized.

At the meeting of EvrAzES Integration Committee in July 2003 the plan to create a Common Customs Space till 2008 was announced. It envisages a common customs territory and common or at least close customs duties on foreign borders of the Community. Besides, common customs duties will be applied to commodities from the third countries. A free trade regime is already in force in countries-members but only commodities produced in the Community are eligible for it. Besides, the Customs Union envisages forming of common administrative bodies and a common budget based on deductions from customs duties.

In August the RF Government approved the draft agreement on creation of Common Economic Space integrating Russia, Belarus, Kazakhstan and Ukraine. Heads of these states signed a declaration on founding this new organization of regional integration on February 23, 2003. These four countries account for 90% of the CIS total GDP, for 90% of mutual trade therein and for almost 80% of population. For the first time it's planned to form a super-national body for taking decisions on foreign trade regulation and tariffs. This project is of particular importance for Russia due to the membership of Ukraine with which there is a lot of disagreements on trade policy issues, e.g. those pertaining to import of Ukrainian pipes and sugar.

In November there was a meeting of officials of the RF State Customs Committee and the Agency for Customs Control of Republic Kazakhstan, where guidelines for unification of customs clearance and control, customs payments of the two countries were discussed with regard to further development of EvrAzES customs legislation.

On the first stage the member-states' rates of customs duties on imported commodities (except agricultural products) are to be coordinated and the corresponding legislations are to be unified. More complicated task is to be coped with on the second stage – the forming of customs union with common customs tariffs that will require abolition of protective and anti-dumping measures. The third stage envisages free transit of goods, services, labour and capital across borders and probably the introduction of a common currency.

In case of the draft's approval by all countries the work will begin on elaborating documents regulating specific cooperation issues.

A notable expansion of food imports resulted in a sensible increase of import competition on the domestic market and in growth of protectionist sentiments.

According to estimates of the RF Ministry of Agriculture only 11.45% of the Russian agricultural market is currently under customs and tariff protection while the corresponding world indicator amounts to 62%<sup>33</sup>.

An illustrative example of protecting domestic producers is the struggle for preservation of Russian motorcar industry. In 2003 the RF Government introduced 3 serious amendments into the customs legislation pertaining to import of cars. In summer it equalized import duties on used import cars (aged 3 to 7 years) for individuals and legal bodies.

The scale of import duties was also largely changed. While before July 25, 2003 there were only two rates of the duty (for low-capacity and more powerful engines), after this date 6 of them were set depending on the engine capacity. As a result the cost of customs clearing of medium-capacity cars almost doubled hindering import of used cars.

Beginning from January 1, 2004 customs rules regulating import of cars changed again. A single rate amounting to 48% of customs value is imposed on all cars manufactured not earlier than 3 years ago (except Russian-origin cars). The rate of customs duties and taxes for Russian cars of the same age is also single and equals 1 euro per 1 cubic centimeter of engine capacity. For cars manufactured more than 3 but less than 7 years ago the following customs duty rates are set (irrespective of the country of origin): for cars with engine capacity less than 1 thousand cm<sup>3</sup> – 0.85 euros per 1 cm<sup>3</sup> of engine capacity; for cars with engine capacity over 1 thousand cm<sup>3</sup> but less than 1.5 thousand cm<sup>3</sup> – 1 euro per 1 cm<sup>3</sup>; over 1.5 thousand cm<sup>3</sup> but less than 1.8 thousand 1 cm<sup>3</sup> – 1.5 euros per 1 cm<sup>3</sup>; over 1.8 thousand cm<sup>3</sup> but less than 2.3

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<sup>33</sup> For more detailed information on regulating foreign trade in food see Section "Agrifood sector".



thousand cm<sup>3</sup> – 1.75 euros per 1 cm<sup>3</sup>; over 2.3 thousand cm<sup>3</sup> but less than 3 thousand cm<sup>3</sup> – 2 euros per 1 cm<sup>3</sup>; over 3 thousand cm<sup>3</sup> – 2.25 euros per 1 cm<sup>3</sup>. For cars manufactured more than 7 years ago the following customs duty rates are set (irrespective of the country of origin): for cars with engine capacity less than 2.5 thousand cm<sup>3</sup> – 2 euros per 1 cm<sup>3</sup> of engine capacity; for cars with engine capacity over 2.5 thousand cm<sup>3</sup> – 3 euros per 1 cm<sup>3</sup>.

This alteration of import duties on cars corresponds with the concept of Russian motor-car industry development adopted in 2002. According to it already in 2005 import duties on cars manufactured more than 7 years ago will rise up to 35% of the customs value. The concept's authors find that this will help Russian plants to become more competitive and to attract foreign car producers to Russia. Beginning from 2010 import duties on passenger cars are expected to decrease by 5% annually.

In addition to the above mentioned, protective measures in foreign trade with the non-CIS countries included the introduction of temporary (January-September 2003) special duty on import of beet sugar products and liquid raw cane sugar (sugar syrup) and of import duties on aluminium tanks, tea in original packing and homogenized tobacco. Investigations are underway examining growing imports of sugar confectionery, products containing cocoa, liquid raw cane sugar (sugar syrup), wallpaper; investigations of larger imports of ball and roller cone bearings, crystalline silicon, galvanized rolled metal and fluorspar have been already completed.

Export duties were also corrected in order to replenish federal budget and to regulate export supplies in accordance with the world price situation and the need to protect domestic market.

New rates of export duties have been adopted for 46 tariff classification items including crude oil and some oil products; the resolution is taken on duty-free export of fertilizers (urea and ammonium nitrate); rates of export duties on iron ore and concentrates and some types of packing are corrected. Export duties on such items as caprolactum and newsprint are notably diminished.

In 2003 the work on adjusting customs legislation to WTO requirements continued.

The most important event in Russian foreign trade regulation was the adoption of RF Customs Code the work on which was going on for almost 4 years. Norms, provisions and definitions used in the Customs Code were adjusted to the effective RF legislative acts adopted in 1994-2003 and to WTO requirements. The principal goal of the new Customs Code is the regulation of customs operation in Russia, and that's why provisions on administrative offences and liability for breaking customs rules were excluded from the draft. From now on administrative offences are regulated only by the RF Code on administrative offences, violations of customs rules – by the Criminal Code. Norms pertaining to service in customs bodies were also excluded from the new Code since now this is the subject of RF Federal Law "On service in Russian Federation's customs bodies".

In accordance with the Kyoto convention the economic notions of some customs terms (e.g. processing, free storage, re-export and re-import) in the new Customs Code were revised. The document shortens the period specified for customs clearance and offers options for its simplifying and speeding up. The time needed for meeting customs formalities is reduced three fold. In particular, the period for drawing up cargo customs declaration can be cut to 3 days instead of 10. Besides, the Code envisages advance preparation of documents before the commodities' arrival to the customhouse. This will become possible due to the adoption of



advanced systems and technologies. The required formalities will be gone through while the cargo is still on its way to the border.

Besides, the Code specifies the application by customs bodies of methods for analyzing and managing of risks associated with customs clearance of excise commodities and commodities subject to high customs duties (e.g. consumer electronics, cars, foodstuffs, etc.). In accordance with the Code control will be primarily exercised over “budget-building” commodities.

One of the basic WTO requirements met in the new Customs Code is a more fair system of collecting customs fees the size of which should correspond with the real value of services rendered by customhouses. Until recently the customs fee in any case amounted to 0.15% of the commodity value and sometimes let customhouses get inadequately high receipts. According to the new Code the determination of fees for specific commodities lays within the competence of the government but their size should not exceed approximate expenditures of customs bodies on carrying out customs procedures.

One more principal novelty is the absence in the Code of numerous references to intra-departmental regulations of the RF State Customs Committee that let customs officers take decisions at their own discretion. The new Customs Code includes maximum number of direct action clauses. It contains no phrases “at the discretion of customs bodies”, although phrases “at the discretion of the Government” are in some cases retained therein. At the same time ample opportunities are left for intra-departmental law-making. 146 clauses transfer the taking of decisions on particular issues into the competence of RF State Customs Committee.

The Code specifies in detail relations of the RF Customs Committee with companies engaged in customs activities, e.g. customs brokers or expert organizations. Until now these relations were regulated by the Committee itself and as a result some companies had privileges over the rest.

After the Code’s elaboration clauses regulating customs control became more detailed. Now the Code contains the full list of its forms including new ones – for example control based on audit methods or detailed mechanisms for initiating expertise and examinations.

Besides, new chapters and sections were included in the Customs Code. For instance, now it contains a section on securing intellectual property rights by customs bodies – the issue always accentuated by WTO. In compliance with its provisions customs officers will have to keep a register of intellectual property objects and to apply to them a special regime of clearance and control that will help to reveal counterfeit products. The new Code also envisages stricter responsibility of customs bodies for their actions. So, the new Customs Code is supposed to notably diminish corruption loop-holes in the customs legislation.

The new Customs Code came into force on January 1, 2004.

In June 2003 the RF State Duma passed in the second reading the draft law “On special protective, antidumping and compensatory measures applied for commodity import”. It is to replace the effective law “On protecting the RF economic interests in commodity foreign trade” adopted in 1997 and contradicting WTO rules (in particular, it envisages application of legal term “substantial damage” not only in case of dumping but also in case of ousting domestic producers from the market by means of fair competition).

Moreover, the effective law does not differentiate measures of state intervention. According to the WTO fundamental document – the General Agreement on Tariffs and Trade – antidumping duties are used only after the case of dumping is confirmed by respective investi-



gation, while protective measures in the form of ordinary import duties are set only for creating more favourable conditions for residents.

The new law contains definitions so far not included in the Russian legislation. For instance, it explains what is “a similar commodity”, “dumping margin”, “compensatory measures”. Without their definition it was impossible to conduct objective antidumping investigations.

An investigation can be launched on the basis of an application filed by a Russian producer of competing commodity or by an association of Russian producers. The application should enclose proofs of damage caused to Russian producers.

The draft law presents a detailed procedure for such investigations. An essential novelty is the setting of time limits for conducting them. For instance, according to the draft the government has to take a decision on imposing or non-imposing of protective measures within 14 days after receiving the report on investigation results from the authorized agency (the Ministry for economic development and trade).

The draft law envisages 3 types of response to undesirable import. In case of sharply increasing physical volumes of a certain commodity’s import, special protective measures can be applied (special import duties and import quotas). The duration of special temporary duties introduced for the period of investigation should not exceed 200 days. In case the damage to Russian economy is proven the term of duties and quotas can be extended up to 4 years.

If a case of dumping is proven (export price of a commodity is lower than its domestic price) an antidumping duty is introduced. It is imposed in addition to the ordinary import duty. And finally, in case subsidizing of exporters by their governments is revealed, the so called compensatory duties can be introduced. They equal the estimated amount of subsidies. The maximum duration of antidumping and compensatory duties is 5 years.

As different from the effective legislation the new law contains primarily direct action provisions, so there should be more order and transparency in investigation procedures. It limits the time for conducting investigation and enumerates all documents needed for launching it. The provision requiring that an application should be signed by companies, all together producing over 51% of a certain commodity, was amended. Now in sectors with large share of small-scale production (for instance, agriculture) it’s enough to file an application signed by several companies.

At present the government rarely uses its right to protect domestic producers. About dozen investigations were carried out in 2003 and less than half of them resulted in the introduction of protective measures. After the law’s enforcement the number of investigations, and more importantly their positive results, is likely to grow.

In October 2003 the RF State Duma passed in the second reading the draft law “On fundamentals of state regulation of foreign trade” introduced by the RF Government. This is one more document required by WTO for joining the organization.

The main idea of the draft law is “the adjustment of effective foreign trade legislation to new legal and economic realities. When working out the draft law basic provisions of WTO general agreements on tariffs and trade and on trade in services as well as of WTO agreements on import licensing procedures have been taken into account”. The effective law despite its revision in 1999 does not comply with international norms and has too many contradicting provisions that cannot be applied in practice.

The draft law gives a clear definition of basic terms used in normative and legal acts and defines some terms that are new for Russian legislation (“zone of free trade”, “customs union”, “transit”). The RF Government is conferred the right to impose temporary export restrictions to prevent “critical deficiency” of food and other important products on the domestic market. Protective measures can also be applied for preserving balance of payments’ equilibrium and for preventing the threat of currency reserve’s decrease. The draft law contains a special reservation that not a single decision on export-import regulation can be taken by the RF Government without preliminary consultations with foreign trade operators. Besides, all such decisions have to be published prior to their adoption.

The law specifies a comprehensive list of cases when export and import licensing procedures are required. For the first time it contains provisions regulating trade in services. It’s also the first document stating that the sum of all payments except duties should not exceed the commodity value.

As compared with the effective legislation the authorities of Federation’s constituent members in regulating foreign trade are notably cut. After the law’s adoption regional administrations will be deprived of the right to render additional financial guarantees to foreign trade agents registered on their territory and to found insurance and mortgage funds for inviting foreign loans and credits.

In November 2003 the State Duma passed in the first reading amendments to Law “On customs tariff”. The currently effective law envisages tariff quotas on preferential import only for commodities that originate from developing countries benefiting from the national system of preferences or from countries that together with the Russian Federation form the Customs Union. Such a practice does not comply with the objectives of tariff quoting and makes it impossible to efficiently use the mechanism of state regulation of foreign economic activities.

The draft law proposes to supplement the Law “On customs tariff” with a provision stipulating the imposition of tariff quotas restricting commodity imports in volume or value terms. This amendment will help to more efficiently use mechanisms of customs and tariff regulation of import in order to control commodity flows and to support domestic agricultural producers. Besides, the draft law proposes to exclude the provision limiting size of import customs duties.

So, Russia is almost completely ready to join WTO and did its utmost for it. All the required laws are being examined by the State Duma. Yet, our opponents continue to keep to the opposite point of view. The stumbling stones remain the same: the problem of pricing energy products, the level of tariff protection and state support to agriculture, maximum accessibility of services’ market. Negotiations actually move in a circle. At each meeting opponents again ask the same questions as a year or five years ago.

Negotiations with countries of the European Union are the hardest. They set 6 requirements on energy issues: the final price for gas inside the country should completely cover costs of its production and transportation; “Gazprom” should not have a monopoly right on export of gas to Europe; Russia should ensure a free transit of Turkmenian gas through its gas mains; foreign companies should have the right to construct gas mains in Russia; export duty on gas supplies to Europe should be abolished; prices for transportation of gas to domestic consumers and to Europe should be equal.

Russian negotiators admit that some of these requirements may be justified since they comply with WTO rules. For instance, the existence of export duty really contradicts the Gen-



eral Agreement on Tariffs and Trade (GATT) – the fundamental document of the World Trade Organization. The only argument that Russia can present in its defense is possible losses of the federal budget in case of abolishing the duty. In its turn, the lack of free transit regulations for Turkmenian gas contradicts Clause 5 of GATT that requires to ensure equal access to national transportation systems to suppliers of commodities. However, gas mains are not directly mentioned therein. But it's also very difficult to prove that they are an exception.

Meeting of all the 6 above mentioned requirements would lead to an upsurge of domestic prices in Russia. Although Europeans do not directly insist on leveling off of domestic and export prices for gas, the fulfillment of their requirements would bring exactly this result that Russian side finds unacceptable.

At the same time not all is well in the World Trade Organization. In September 2003 Cancun (Mexico) hosted the fifth Ministerial conference of the organization. The negotiations should have defined principles of future WTO rules the discussion of which began in November 2001 in Doha (Qatar) at the conference of ministers of countries-members. The projected innovations concerned agriculture (reduction of state support to farmers, lowering and further abolition of export subsidies, lowering of tariffs for farm products), services and industrial goods (easier access to markets), antidumping procedures, electronic trade, procedures of settling disputes within WTO and principles of the world trade development (easier access to markets for the least developed countries, making modern medicaments available for them). The Doha round agenda also included four “Singapore issues”: regulation of investments, competition, transparency of government purchases and simplifying of trade procedures (including customs regime). These problems were discussed at the WTO ministerial conference in Singapore in December 1996. There were plans to adopt the new rules at conference in Cancun in September 2003 and to put them in force beginning from 2005.

Negotiations attended by representatives of 146 countries – members of WTO reached a deadlock already in a few days after the conference's start. Disagreements between developed and developing countries revealed on actually all the agenda issues, especially agricultural subsidies, trade barriers, tariffs and investments.

The principal requirement of developing countries to the United States and the European Union is the abolition of subsidies to farmers. In their turn, the US and the EU demanded to cut customs duties and to carry out large-scale economic and legal reforms in developing countries. After the latter refused to negotiate foreign investment issues, the summit was announced ended without signing any serious documents. The only agreement that was reached in Cancun was the decision to sell cheap patents on production of mass medicaments (those for curing AIDS, tuberculosis, malaria, etc.) in developing countries. Developed and developing countries blamed each other for the negotiations' failure.

The failure of WTO summit can cause great problems in the world economy. Due to lower growth rates and recession in developed countries the world trade grows slower and investments are far below the 2000 level. According to the World Bank's estimate, in case new WTO trade agreements were signed in Cancun, by 2015 144 million men could get from under the poverty line and the world GDP could grow additionally by 520 billion dollars.

### **3.8. The state of the Russian military economy and the trends of reform**

#### *3.8.1. Plans of military development in relation to the federal budget*

The beginning of 2003 was on the whole rather favorable for the RF military economy. The budget of the preceding year was administered satisfactory, while the budget for the next year was timely approved. The document determining the general plans of military development, "Basic Principles of the State Policies of the Russian Federation Related to Military Development for the Period until 2010," as it seemed, did not raise doubts as concerns its adequacy to the specific objectives set for year 2003. However, it needed concretizing. The necessity was primarily caused by the consequences of the tragedy in the theater center at Dubrovka in Moscow, delay in the political settlement of the Chechen problem, and the military actions of the USA and US allies in Iraq.

Therefore, in May of 2003, the RF President in his Address to the Federal Assembly named modernization of the RF military organization, i.e. rendering it adequate to the current requirements, including the transition to a professional army, reduction of the term of conscription, as well as creation of adequate social conditions for servicepersons among the major priorities of the state policy.

The meeting held in the RF Defense Ministry with participation of the RF President on October 2, 2003, was of great importance for the military development in the Russian Federation. At this meeting it was declared about the completion of major structural shifts and reductions, and about transition of the Armed Forces to the stage of systematic development. In the course of the meeting, the top officials of the Defense Ministry tried to convince the political leadership of the country and the populace that the most difficult stage of the military reform had been completed. However, the RF President, although not doubting directly so optimistic evaluation, pointed out in his final statement on that day that "we have not done everything yet we have agreed on" and indicated the existing problems in the military planning rendering it cost-intensive and inefficient.

Judging by mass media reports, many independent experts have in this connection paid attention to the insufficient economic substantiation of the plans of modernization of the RF Armed Forces made by the top officials of the RF Defense Ministry without explaining the meaning of the term "modernization." In fact, at the given level of the existing strength of the Armed Forces and objectives set for them, the budget expenditures for year 2003, and planned for year 2004 are not adequate to ensure the required combat preparedness of the Army and the Navy answering the available armaments and combat equipment, not to mention the introduction of new models of weaponry. Thus, the allocations for procurement of fuel and lubricants are sufficient only for fulfillment of only about 40 per cent of the flight training program. A similar situation exists in the Navy.

While characterizing the military and political situation, it may be noted that the military and military economic policy of Russia at the international level was rather successful. The Russian Federation did not take part in military conflicts, its relations with NATO and the majority of the countries in the world had stabilized, while the military and technical cooperation successfully developed. In 2003, the amount of revenues generated by the export of weaponry for the first time reached US \$ 5 billion.

However, the domestic military policy was not marked with success. The resistance of bandit formations in the Chechen Republic resulted in the fact that special military operations aimed to complete the liquidation of such formation acquired the chronic character. The set-



tlement of “siloviki” (armed and security service agencies) debts to the enterprises of the defense and industrial complex (DIC) was delayed – for instance, the debt of the Defense Ministry to such enterprises, although it decreased, still makes Rub. 2 billion. Defense procurement was not rational as concerns the balance between the nomenclature of models and amounts of respective purchases. At the same time, out of Rub. 109.8 billion allocated for purchase of weaponry in accordance with the state defense procurement program for year 2003, almost one fourth (Rub. 24 billion) were not utilized as on December 1. At one and half thousand enterprises still remaining in the composition of the RF DIC, the average wages and salaries are below the national average, while the average age of employees exceeds 50 years. The technological level of DIC enterprises is declining.

At the same time, the unresolved problem of price determination as concerns military production results in the fact that in 2003 losses borne by the RF Defense Ministry due to the rising prices of armaments and combat equipment, according to the assessment made by the experts of the RF Audit Chamber presented to the State Duma, made Rub. 50 to 55 billion.

The number of violations registered in the military organization remains rather high. The accumulated social problems have not been settled. The completion of the experiment concerning the transition of the 76<sup>th</sup> airborne division to the contract based recruitment system encountered significant difficulties. Only by spring the Defense Ministry top officials became aware of the fact that the level of money allowances set forth in the program of the experiment in 2002 and prolonged for 2003 was not sufficient. It should be reminded that at the end of 2002, the Defense Minister and the Chief of the General Staff signed the document setting the money allowance of the contracted serviceman at Rub. 4000 a month, while the national average wage made Rub. 5000 a month. Only after a significant delay there was taken the decision to increase the money allowance of contracted military personnel at a level exceeding the national average. At the same time, since the budget for 2003 contained the previous indicators of money allowance, it indicated that the budget was not fully adequate to the objectives of the military reform and economic realities in the country.

Certain financial problems (extra payments to the contracted military personnel of the 76<sup>th</sup> airborne division) were settled at the expense of the own resources of the Defense Ministry, some other (repayment of the debts accumulated over the past years) – at the expense of additional allocation of funds in the course of adjustment of the federal budget.

The reform of the recruitment system of the RF military organization has been twice (in April and July of 2003) discussed at the meetings of the Government. In both cases, the meetings were attended by IET representatives, since the Institute was among the developers of the respective federal targeted program (FTP). Many proposals put forward by the IET experts were taken into account in the final version of the program approved on August 25, 2003, however, the program on the whole more answered to the concept worked out by the Defense Ministry.

The regular financing of the state military organization in accordance with the law on the budget may be evaluated as a successful result of the RF Government actions.

The federal budget for year 2003 envisaged the military expenditures as follows (see *Table 58 – 61* and *Figures 58 – 60*; the numeration in figures corresponds to the table entries).

Table 58

**Military expenditures of the RF military organization in 2003 (plan)**

Item No.	Expenditures	Amount, Rub. million	Share in the expenditures of the federal budget, %	% of GDP
	"National Defense" section	344 525	14,69	2,64
1	<i>Military expenditures for the military organization included in the expenditures for "National defense," including:</i>	331 161	14,12	2,54
1.1	Development and maintenance of RF Armed Forces	325 564	13,88	2,49
1.2	Ensuring of mobilization and extra-military preparedness, including the expenditures for:	4 161	0,2	0,03
	Federal Railroad Troops Service	3 284	0,14	0,03
1.3	Preparation for and participation in collective security and peace making operations	1 436	0,06	0,01
	Expenditures for the military organization included in item "Law Enforcement and State Security"	244 794	10,44	1,88
2	<i>Military expenditures for the military organization included in item "Law Enforcement and State Security," including:</i>	90 547	3,86	0,69
2.1	Troops of RF Interior Ministry	18 490	0,79	0,14
2.2	State security agencies	47 992	2,05	0,37
2.3	Border guard service agencies	24 065	1,03	0,18
3	<i>Expenditures for the military organization in other items of the federal budget, including:</i>	6 320	0,27	0,05
3.1	Maintenance of the special construction service	1 028	0,04	0,01
3.2	Maintenance and equipment of Ministry for Emergency Situations (MES) troops, including targeted expenditure items:	5 292	0,2	0,04
3.2.1	Maintenance of personnel of troops (forces)	2 727	0,12	0,02
3.2.2	Combat training and material and technical maintenance of troops (forces)	1 344	0,06	0,01
3.2.3	Procurement of armaments and combat equipment (ACE), products of technical products (TP), and other stocks	1 059	0,05	0,01
3.2.4	Repairs of ACE, TP, and other stocks at enterprises	116	0,00	0,00
3.2.5	Insurance guarantees for servicemen	46	0,00	0,00
4	TOTAL: general military expenditures of the RF military organization	428 027	18,25	3,28

\* The estimated GDP in 2003 makes Rub. 13 050 000 million (the State Duma Defense Committee findings as concerns draft federal law No. 362797-3 of September 11, 2003, "On the federal budget for year 2004").

Figure 58

**Structure of expenditures of the RF military organization in 2003 (plan)**

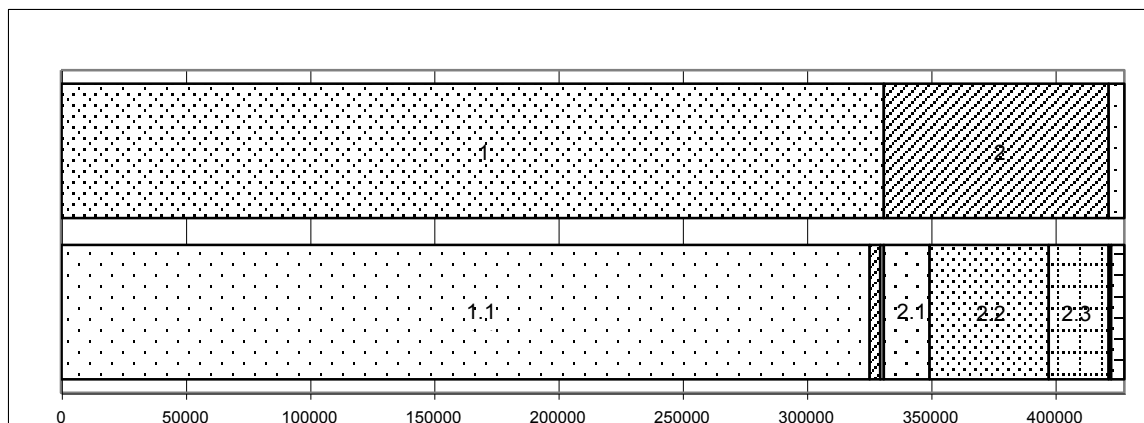




Table 59

**Military expenditures outside of the military organization (plan)**

Item No.	Expenditure	Amount, Rub. million	Share in the expenditures of the federal budget, %	% of GDP
<i>Expenditures included in "National Defense" section of the federal budget</i>				
1	Military program of the Atomic Energy Ministry	13 012	0,55	0,10
2	Russian Defense Sports and Technical Organization (RDSTO)	42	0,00	0,00
3	Ensuring of industries' activities for the national defense: Ministry of Industry, Science, and Technologies	353	0,02	0,00
<i>Expenditures included in other sections and subsections of the federal budget</i>				
4	Mobilization preparedness of the economy	500	0,02	0,00
5	Grants and subventions to Closed Administrative and Territorial Entities (CATE) budgets, including:	14 538	0,62	0,11
5.1	Grants to CATE budgets	7 955	0,34	
5.2	Grants and subsidies for the maintenance of Baikonur town infrastructure	564	0,02	0,06
5.3	Subventions to CATE budgets	6 019	0,26	0,00
6	Civil defense	67	0,00	0,05
7	TOTAL: general military expenditures outside the RF military organization	28 511	1,22	0,00

Figure 59

**Structure of military expenditures outside of the RF military organization in 2003 (plan)**

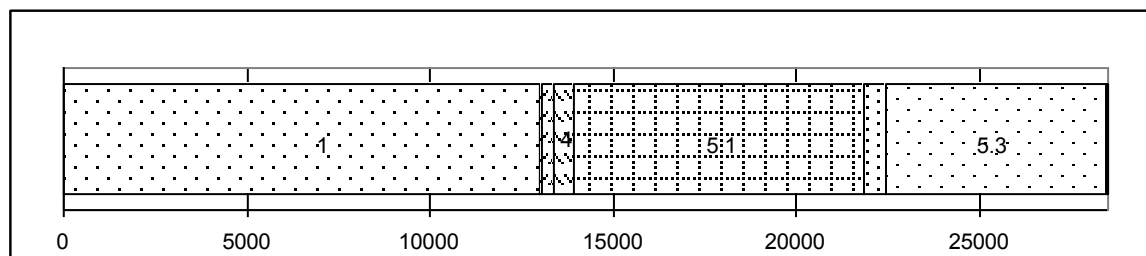


Table 60

**Expenditures related to past military activities (plan)**

Item No.	Expenditure	Amount, Rub. million	Share in the expenditures of the federal budget, %	% of GDP
	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
1	Military pensions	67 721	2,89	0,52
2	Pensions paid to servicemen of law enforcement agencies, including:	38 105	1,62	0,29
2.1	- paid via the Interior Ministry	26 700	1,14	0,20
2.2	- paid via the FSS	8 799	0,38	0,07
2.3	- paid via the Federal Tax Police Service	658	0,03	0,01
2.4	- paid via the Ministry of Justice	1 947	0,08	0,01
3	Utilization and liquidation of armaments	10 760	0,46	0,08
4	Conversion of the defense industry	250	0,01	0,00
5	Implementation of the military reform, including:	15 800	0,67	0,12
5.1	- via MES	582	0,02	0,00

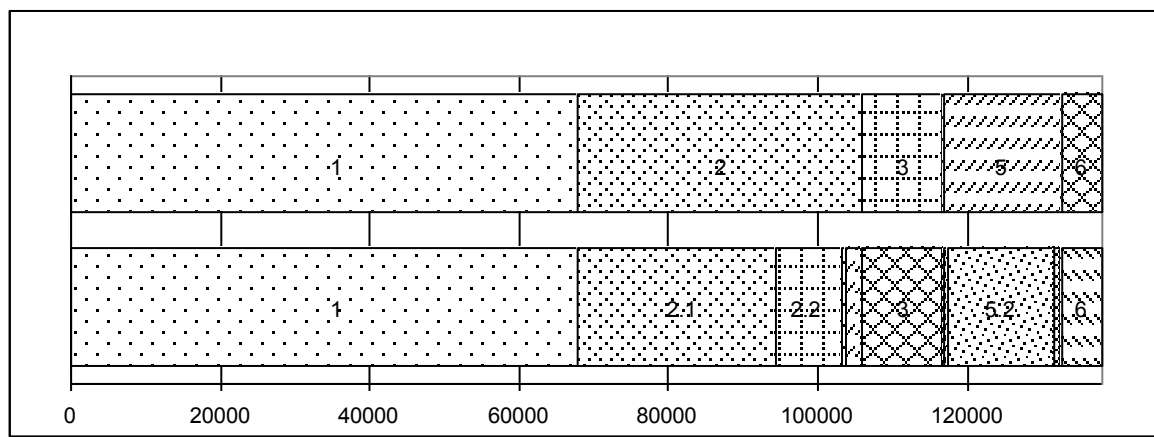


*Table 60 cont'd*

	2	3	4	5
5.2	- via the Defense Ministry	14 335	0,61	0,11
5.3	- via the Interior Ministry	670	0,03	0,01
5.4	- via the FBS	64	0,00	0,00
5.5	- via the FAGCI	149	0,01	0,00
6	Program "State Housing Certificates (1998 – 2002)" In the framework of FTP "Housing" for 2002 – 2010	5 435	0,23	0,04
7	TOTAL: Expenditures related to the past military activities of the RF	138 071	5,89	1,06

*Figure 60*

### Structure of expenditures related to past military activities (plan)



*Table 61*

### Aggregate indicators of military and military-related expenditures (plan)

Item No.	Expenditure	Amount, Rub. million	Share in the expenditures of the federal budget, %	% of GDP
1	General military expenditures (for the military organization and other related items) (the sum of line 4 of Table 51 and line 7 of Table 52)	456 538	19,46	3,50
2	The amount of total military expenditures and expenditures related to the past military activities of RF (the sum of line 1 of this Table and line 7 of Table 53)	594 609	25,35	4,56
3	Aggregate expenditures for national defense and law enforcement and national security (see Table 51)	589 319	25,12	4,52

*Note:* In accordance with the methodology and practices of accounting for military expenditures in the UN and NATO some of the expenditures indicated above, for instance, for civil defense or maintenance of public utilities (infrastructure) of the space vehicle launching site Baikonur, may be excluded from the category of military expenditures. However, due to their insignificance, it would not have changed the general picture of military expenditures. On the contrary, according to the UN standards, pensions paid to former servicepersons should have been included in the military expenditures.

However, from the point of view of civilian and public control, the transparency and reliability of expenditures are more important than the category they were included in.

#### 3.8.2. Execution of the federal budget in 2003

In 2003, the financing of military expenditures was carried out in accordance with the approved budget. The adjustment of military expenditures was made only in November, sim-



ultaneously with the general adjustment of the federal budget by federal law No. 150-FZ. At the same time, the general increase in the military expenditures was insignificant and made 2 to 4 per cent (the expenditures of the federal budget grew by 2.85 per cent), however, there were significantly raised expenditures for the federal border guard service (by 8.15 per cent) and implementation of the military reform (by 10.5 per cent). The budget expenditures for preparation for and participation in collective security and peace making operations, as well as pensions of servicepersons of the Defense Ministry were reduced by Rub. 541 million (60 per cent) and Rub. 5 billion 123 million (8 per cent) respectively. It may be assumed that initially overestimated amounts targeted for these budget expenditure items were partially a result of mistakes in planning and partially a result of objective circumstances.

The data on the execution of the federal budget for year 2003 presented in *Tables 62 – 64* were obtained from the monthly reports of the RF Federal Treasury and quarterly reports of the RF Government presented to the State Duma.

*Table 62*

**Military expenditures of the RF military organization in 2003 (Rub. million)**

Item No.	Expenditure	As targeted by the federal budget for year 2003, adjusted	Jan.	Feb.	March	April	May	June	July	August	Sep.	Oct.	Nov.	Dec.
2	3	4	5	6	7	8	9	10	11	12	13	14	15	
0	General military expenditures of the military organization	454 823	16 662	30 122	41 344	38 014	34 023	36 234	35 146	34 837	34 888	37 296	37 339	72 763
1	Military expenditures for national defense, including	354 907	13 018	24 831	34 701	30 355	27 440	27 714	29 792	27 924	27 146	29 909	29 086	53 774
1.1	Development and maintenance of RF Armed Forces	336 478	12 103	23 311	32 824	28 822	26 107	26 409	28 450	26 584	25 841	28 655	26 688	51 205
1.2	Ensuring of mobilization and extra-military preparedness	4 170	41	237	584	356	165	180	188	172	165	140	1 217	721

*Table 62 cont'd*

	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1.3	Preparation for and participation in collective security and peace making operations	895	47	38	60	61	63	20	33	65	15	9	22	30
2	Military expenditures included in the composition of expenditures for law enforcement and state security, including:	93 597	3 620	5 216	6 558	7 580	6 512	8 443	5 275	6 845	7 660	7 307	8 124	18 820
2.1	Troops of RF Interior Ministry	19 222	567	1 135	1 219	1 558	1 351	1 573	1 489	1 532	1 670	1 622	1 727	3 939
2.2	State security agencies	48 176	2 312	2 895	3 546	4 048	3 206	4 318	3 035	2 977	3 998	3 711	3 931	9 535
2.3	Border guard service agencies	26 199	742	1 187	1 793	1 974	1 955	2 551	751	2 336	1 992	1 973	2 466	5 346
3	Other expenditures for the military organization	6 320	24	74	85	80	71	78	78	68	82	81	130	170
3.1	Maintenance and equipment of Ministry for Emergency Situations (MES) troops	5 292	–	–	–	–	–	–	–	–	–	–	–	–
3.2	Federal special construction service	1 028	24	74	85	80	71	78	78	68	82	81	130	170



*Table 63*

**Military expenditures outside of the military organization (Rub. million)**

Item No.	Expenditure	As targeted by the FB for year 2003, adjusted	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
1	From the "National Defense" section of the federal budget	13 423	830	1 247	1 235	1 119	1 108	1 108	1 125	1 105	1 126	1 108	1 161	1 820
1.1	Military program of the Atomic Energy Ministry	13 012	813	1 220	1 214	1 090	1 084	1 084	1 084	1 1084	1 085	1 084	1 084	1 776
1.2	Ensuring of industries' activities for the national defense: Ministry of Industry, Science, and Technologies	353	14	25	19	26	21	21	38	19	39	21	74	41
1.3	Russian Defense Sports and Technical Organization (RDSTO)	59	3	3	3	3	3	93	3	3	3	3	3	3
2	Expenditures included in other sections and subsections of the federal budget	14 633	954	1 050	1 363	1 062	727	1 346	1 383	1 696	1 580	1 236	1 461	771
2.1	Mobilization preparedness of the economy	500	9	25	59	45	43	44	41	49	38	52	39	51
2.2	Civil defense	67	0	0	0	12	1	8	10	4	9	6	8	8
2.3	Grants and subventions to CATE budgets	14 066	945	1 025	1 304	1 005	683	1 295	1 332	1 642	1 533	1 178	1 414	711
	<b>TOTAL: general military expenditures outside the RF military organization</b>	<b>28 056</b>	<b>1 784</b>	<b>2 298</b>	<b>2 599</b>	<b>2 181</b>	<b>1 835</b>	<b>2 454</b>	<b>2 509</b>	<b>2 801</b>	<b>2 706</b>	<b>2 344</b>	<b>2 623</b>	<b>2 591</b>

*Table 64*

**Expenditures related to past military activities (Rub. million)**

Item No.	Expenditure	As targeted by the federal budget for year 2003, adjusted	Jan.	Feb.	March	April	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
1.1	Military pensions to the servicepersons of the Defense Ministry	62 598	4 601	4 803	4 974	6 821	3 215	5 122	4 849	4 956	4 927	4 898	5 564	5 542
1.2	Utilization and liquidation of armaments	10 760	347	643	650	728	706	1 112	1 332	1 091	844	610	1 077	1 620
1.3	Conversion of the defense industry	250	15	24	23	0	42	20	21	21	21	21	21	21
1.4	Implementation of the military reform	17 654	448	1 309	1 083	977	784	1 484	1 720	1 406	1 800	1 591	1 059	2 522
1.5	Financing of the State Housing Construction program included in the composition of expenditures for state investment	5 525	345*	345	345	345	345	345	345	345	345	345	345	345
	<b>TOTAL: Expenditures related to the past military activities of the RF</b>	<b>96 788</b>	<b>5 755</b>	<b>7 124</b>	<b>7 074</b>	<b>8 872</b>	<b>5 092</b>	<b>8 083</b>	<b>8 266</b>	<b>7 818</b>	<b>7 937</b>	<b>7 464</b>	<b>8 065</b>	<b>10 050</b>

\* In this line, there are presented the estimated monthly expenditures as per the semiannual report of the RF Government.

It should be noted that on the whole the expenditures for military purposes were conducted rather regularly, although there was observed a gap in the beginning of the year and a peak late in the year. Military expenditures of RF subjects made Rub. 1 billion 28 million in 2003, 56 per cent of these expenditures were for civil defense and 40 per cent were for mobilization preparedness of the economy.

As it was noted in the materials of the preceding annual IET publication, in the end of 2002 there were achieved significant shifts in the declassification of the federal budget for year 2003.

However, an analysis of the reporting data submitted to the RF State Duma revealed that the declassification of a considerable part of the military expenditures achieved in the course of passing of the draft budget through the RF Federal Assembly had no impact on the reporting. First, reports on the execution of declassified targeted items and types of expenditures remained secret (see, for instance, the data on expenditures for maintenance and equipment of MES troops in *Table 62*), although it infringes on the provisions of the Budget Code.

Second, there was observed the unpunctual preparation of documents confirming the legitimate nature of expenditures, and, therefore, delayed transfers of funds to the financial departments of armed and state security agencies (see *Table 65*). Not only the fact that the budget execution was unsatisfactory organized in the said agencies (especially as compared with the Ministry of Atomic Energy) draws attention, but also the simultaneous significant exceeding of the budget targets across a number of items, what is reflected by negative values in the Table below. The general picture of the administration of military budget expenditures would



not be complete without mentioning the misappropriation of Rub. 14 billion of federal budget funds on the part of the Defense Ministry revealed by the RF Audit Chamber.

Table 65

**The share of deficient financial resources in the total amount of financing of military and related expenditures of the federal budget for 2003**

Section (subsection) of expenditures	The share of deficient funds, %			
	3 months	6 months	9 months*	12 months
In the total expenditures	15,25	8,86	5,79	2,46
National defense, including:	21,66	11,54	5,99	-0,21
Development and maintenance of RF Armed Forces	22,39	11,74	5,62	-0,15
Military program of the Atomic Energy Ministry	0,19	0,00	0,00	-5,32
Mobilization and extra-military preparedness	17,53	26,06	33,09	-0,08
Collective security and peace making operations	54,58	36,64	62,62	48,17
Ensuring of industries' activities for the national defense	7,85	0,00	16,93	-0,96
Law enforcement and state security, including:	29,17	14,52	15,73	1,38
Troops of RF Interior Ministry	39,64	23,42	12,79	-0,83
State security agencies	31,36	13,64	15,73	1,38
Border guard service agencies	35,08	9,78	15,33	4,32
Military reform	16,77	0,28	7,10	8,34
Military pensions	1,86	6,47	12,84	3,71

\* As concerns the results of the 3<sup>rd</sup> quarter, there are presented the estimates of the actual execution relative to 9/12 of the amounts of the initial annual budget; the results of the year are evaluated relative to the budget targets as increased in November.

**3.8.3. Evaluation of military, economic, and other consequences of planned measures in the framework of the military reform**

The dubious character of the statement made at the meeting in the Defense Ministry with participation of the RF President held on October 2, 2003, that the military reform was completed has been already noted above.

The military reform, or, using the term modernization, which has become more popular since recently, as well as the military development, are complex phenomena. However, *the reform of the recruitment system of the RF military organization is the priority, especially for the society.* The issue of the military personnel, the question of whose hands would hold weapons of the 21<sup>st</sup> century, if the soldiers would be able to expertly use such weapons, if they would wish to selflessly defend their homeland are the questions requiring attention and settlement in the first turn.

The RF President, while indicating the “priority guidelines of military development” at the meeting of October 2, 2003, said that the most urgent task was to “improve the principles of recruitment.” The RF Defense Minister also paid attention to this issue, however, he did not stressed its priority. The Defense Minister report focused on the more active transition to the new system of recruitment on the contractual basis. This transition was defined as the implementation of the federal target program (FTP) “Transition to the recruitment of servicepersons serving on the contractual basis to a number of formation and military units” for 2004 till 2007, which was approved by the RF Government on August 25, 2003 (Resolution No. 523).

Item 4 of the RF Government Resolution approving the FTP is of special importance. According to this item, in the 4<sup>th</sup> quarter of 2003 there should be elaborated a draft federal law “setting forth the one year term of the military service by conscription since January 1, 2008.” This item was introduced in order to implement the requirements set by the RF President in

his address to the RF Federal Assembly and should concern not only the Defense Ministry, Interior Ministry, and FSS, but also “other federal executive agencies, where the military service is determined by the law.”

Judging by the FTP text, “a number of military units” transiting to the recruitment on the exclusively contractual (voluntary) basis, should be reduced to the military units of the Defense Ministry, Interior Ministry, and FSS (border troops), which were included in the category “of constant combat readiness.” According to the published definition of this category it includes “formations and military units, which in the time of peace and war should be able to carry out combat missions without taking measures for complementation from the mobilization resources.”

The report of S. B. Ivanov, the Defense Minister of the Russian Federation at the meeting mentioned above and the booklet “Urgent tasks of development of the RF Armed Forces” assess the FTP very positively. For instance, after stressing the necessity of “changes in the recruitment system, without which the maintenance of the required level of combat readiness of the RF Armed Forces will not be possible” it is noted that the “decisions taken recently by the RF Government radically change the situation existing in this sphere.”

In connection to such statements, IET has carried out a complex evaluation of expected military, economic, and social consequences of the implementation of the approved FTP. The key results of the research are as follows:

1. As concerns the key military objectives set for the RF military organization, the said FTP was worked out and approved as a program aimed to form elite military formations defined as military units of constant combat readiness in three armed agencies taking part in the settlement of problems arising in “hot spots”: the Defense Ministry, Interior Ministry, and FSS. Only these military units will transit to the exclusively voluntary principle of recruitment.

In the case it could be assumed that military threats to the Russian Federation are limited only to those emerging from the “hot spots,” there would be no doubt of the success of the FTP. However, it should be noted that the role played by force methods, for instance, in the Chechen Republic, is diminishing. Second, there are also other military threats. In the case it is assumed that there is also the possibility of emergence not only of “hot spots,” but also “hot” territories, water areas, and air and space areas, where military missions should be performed by different types and arms of the armed forces, it turns out that the ensuring of the national military security even in the narrow sense of recruitment to these forces is rather problematic. It should be also noted that these armed forces include a special category of military units on permanent combat alert, the importance of which is not less great than that of the military units of constant combat readiness. However, in the report of the Defense Minister there was no indication of the time, when the issues of the complementation of these military units on the exclusively contractual basis and of rendering them professional character could be settled.

2. The situation concerning the settlement of social problems seems even more vague. The society expected, first, a significant decrease in the terms of military service in the immediate future, and, second, changes in the objectives and conditions of conscription service.

The measures envisaged by the FTP do not explicitly indicate that these expectations will be met.

3. IET has evaluated the probable consequences of the FTP implementation in quantitative terms using imitation and analytical mathematical models. As concerns the methodology,



this approach is different from that used in the course of substantiation of the FTP by its developers. First, the evaluations were made not only within the period set by the program (2004 through 2007), but also outside this period, since the consequences (especially social, economic, and mobilization ones) of such programs, as a rule, become clear only in the long outlook. Second, the military units implementing the transition to the new recruitment system were evaluated not separately from other military units, but in the framework of the whole military organization.

As it turned out, simultaneously with the increase in the number of privates and non-commissioned officers serving on the contractual basis in formations and military units of constant combat readiness, in other formations and military units the decrease in the strength of such military personnel observed at the moment will continue. The decrease in the strength of the military personnel serving on the contractual basis in military units other than those of constant combat readiness results from lower money allowances they receive and inadequate housing conditions.

The key conclusions derived from the analysis of this part of calculations is as follows: in the case the pace of transition to the new system set by the FTP is maintained, *even by 2112 the total number of contracted servicepersons would not reach the values required by the RF military organization*. As the calculations demonstrate, in certain rather probable circumstances the number of contracted military personnel in the RF military organization may not increase at all, while the military units on permanent combat alert may lose a considerable part of specialists, what negatively affects their combat readiness. The same phenomenon may concern officers, since their money allowances remain at the same level.

4. The dynamics of future changes in the total number of drafted servicemen will also be negative. It is apparent that in the case the FTP is implemented in the designated years and after 2007, the strength of the military personnel serving on conscription terms will diminish only insignificantly. In this case, *the reduction of the term of service will result in a sharp increase in the number of conscripts*.

Such developments will either frustrate the transition, or require abolishment of the majority of current deferments of and exemptions from military service.

5. It should be noted that the *effective strength* of privates and non-commissioned officers *is diminishing*.

This indicator takes into account the heterogeneity of the total strength and different “weight” of soldiers in the general combat capability of a military unit. For instance, those serving for less than six months demonstrate lower combat efficiency (according to the assessments made by experts of the chief directorate of combat training it makes about 0.1 of the fighting capability of a “model” soldier), while the coefficient of those serving for one year makes about 0.3, and so on. The coefficient of combat efficiency exponentially reaches 1.0 for professional “model” soldiers (serving over 5 years) and is considered to be constant until such a soldier is 30 to 35 years old, later the coefficient is lowering due to the age factors. As concerns the calculation of efficient strength of mixed groups of servicemen, there the number of persons serving for a certain term should be summed up with the “weight” coefficient of this category.

As concerns this extremely important indicator, the variant envisaged by the FTP, which, no doubt, is useful from the military point of view for military units of constant combat readiness and, later, for other “model” military units, does not produce any significant in-



crease in the general combat capability of the RF military organization and after the transition to shorter terms of military service will result in reduced fighting efficiency.

6. Similarly, there will be no significant positive effect as concerns the mobilization human resources.

7. The social and economic consequences for the society calculated as the costs of drafting of the young people to the military organization borne by the society in the form of a "tax," as well as the costs of illegitimate draft dodging in comparison with the "revenues" of the society generated by the contracted military personnel are also not to the credit of the variant envisaged by the FTP.

The IET evaluations indicate the following:

1) the long term consequences of the FTP implementation may be negative both from the military and economic, and social and economic points of view;

2) *the task of a more active transition to the voluntary recruitment system* stated in the report of the Defense Minister at the meeting of October 2, 2003, is vital, however, it should be formulated differently. The Minister has identified the "more active transition of the Armed Forces to the contractual basis" with FTP and its implementation. However, proceeding from the mission of the RF military organization and the respective requirements set by the society, the problem should be formulated differently: *the real intensification should be a more rapid transition to the voluntary recruitment system outpacing and supplementing the schedule set by the FTP.*

It is only natural to put the question if there exists the potential required for the real intensification of the reform.

#### **3.8.4. Evaluation of future military expenditures, modernization trends, and potential to carry out planned measures**

An analysis of military expenditures set by the federal budget for year 2004 taking into account the dynamics of national economic development and military expenditures borne in the preceding years (see *Table 66* and *Figure 61*) permits on the whole to positively answer the question about the potential, although the growth in the respective expenditures demonstrate a clear downward trend. The statement of the top officials of the Defense Ministry about a 9 per cent increase in expenditures (as adjusted for inflation) included in the section "National defense" seems to be unrealistic.

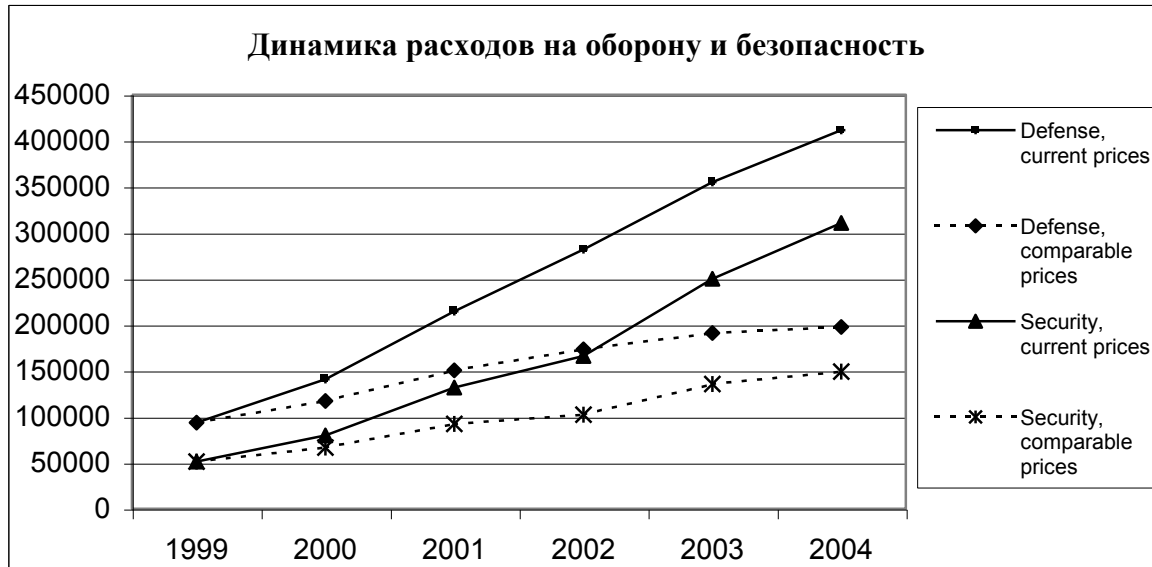
*Table 66*

#### **Expenditures for defense and security: the dynamics**

Sections of the federal budget / years	1999	2000	2001	2002	2003	2004
Expenditures in the "National defense" section (in current prices / in comparable prices of 1999*), Rub. million	93 702 93 702	140 852 117 181	214 688 150 598	281 970 173 504	354 907 190 987	411 473 197 474**
Increase in % of the preceding year	–	25,1	28,6	15,2	10,1	3,4
Increase in % of 1999	0	25,1	60,7	85,2	103,8	110,7
Expenditures in the "Law Enforcement and State Security" section (in current prices / in comparable prices of 1999), Rub. million	51 324 51 324	79 802 66 391	131 621 92 329	165 999 102 144	249 799 135 618	310 577 149 068**
Increase in % of the preceding year	–	29,4	39,2	10,6	32,8	9,9
Increase in % of 1999	0	29,4	79,9	99,0	164,2	190,4

\*Пересчет в сопоставимые цены проводился по ИПЦ.

\*\* CPI of 2004 is assumed to make 1.11 relative to the figures registered in 2003, it makes about 2 relative to the figures registered in 1999.

*Figure 61***Expenditures for defense and security: the dynamics**

Yet another answer is of even greater importance: the experience of the states having completed the transition to the voluntary system of recruitment indicates that the increase in the efficient strength of the military personnel serving on the contractual basis in comparison with the efficient strength of drafted servicemen is not an abstraction. It may be transformed in a respective reduction of the total complement of the military organization. For instance, in France the transition to the voluntary system of recruitment did not require an increase in military spending, since it was accompanied with a proportional reduction of the total strength of the military personnel and the respective reduction of expenditures for its maintenance.

Therefore, the recommendation to follow the French example in the modern Russia seems quite feasible.

As concerns the trends of development of the RF military economy and military development in the next years, they seem to be positive due to the fact that the Government has already started and plans to further intensify its efforts aimed to repay its debts to all citizens, including servicepersons.

The fact that the RF President indicated the problem of the military reform as a priority in his annual Address to the Federal Assembly (2003) is a pledge of its successful completion.

At the same time, this fact indicates the necessity to continue independent research concerning the feasible ways to intensify the military reform and the necessity of initiative on the part of the legislature and public. In particular, it concerns the following.

Judging by the draft federal budget for year 2004 and the documents annexed to the draft, the developers of the budget believed that 2004 would see the further economic growth in Russia occurring simultaneously with the ensuring and strengthening of its military and other types of security.

According to the draft budget, the revenues are targeted to make Rub. 2742.9 billion (17.9 per cent of GDP), and the expenditures are planned at Rub. 2659.4 billion (17.4 per cent of GDP). The budget surplus will be used to complement the special Stabilization Fund aimed

to parry the uncertainty of revenues, especially those related to oil exports. However, in the case revenues exceed the target level, as it occurred in 2003, the excessive amounts (exceeding the targets for the Stabilization Fund) could be used for intensification of the reform of the recruitment system. Such an item in the budget could be sufficient to reduce the outflow of contracted military personnel from the military units not included in the composition of military units of constant combat readiness.

The second circumstance to be taken into account both in the course of implementation of the federal budget for year 2004 and in the course of elaboration of the federal budget for year 2005: the explanatory note to the draft federal budget for 2004 does not contain any comprehensible substantiation of military expenditures, which could satisfy the public.

As concerns the budget revenues, the respective situation is not much better. For years, the Russian society has heard that the Russian defense industry with participation of representatives of the military organization successfully sells its products abroad thus bringing in the country "foreign exchange earnings." However, the revenue items of the federal budget contain no mentioning of such earnings, although the budget sets the expenditure targets for military and technical cooperation. The same situation exists with respect to utilization of armaments and military equipment: the federal budget indicates respective expenditures, but fails to show any related revenues. Much is also said about the economic efficiency of the use of the dual purpose technologies. This item is also absent in the revenue section of the federal budget. However, after the types of expenditures have been declassified, it became apparent that expenditures for military R & D are increasing. Therefore, there should have been visible also the growing role played by these expenditures in creation of dual purpose technologies and products.

Therefore, it is necessary to declassify the expenditures for military R & D. The success achieved with respect to declassification of military expenditures has been already noted above.

At the same time, even after the decision on declassification would be taken, the degree of transparency of RF military expenditures for domestic experts will be much less than for foreign military researchers. Russia annually furnishes foreign organization with the data not only related to aggregate expenditures of the Defense Ministry, but also on the distribution of funds among three components of the Armed Forces, what is not reflected in the budget. Therefore, it is recommended to include the information on the RF military expenditures presented to international organizations in the list of open supplements to the federal budget.

As concerns the purposes of detailed civil control over the RF military expenditures, the possibilities to obtain necessary information by further declassifying of the budget in the framework of the current budget classification have been exhausted. The matter is that a more thorough economic analysis is possible only by comparing financial indicators with actual indicators of military statistics (strength of personnel, quantity of armaments and military equipment, military objects, etc.). However, these data are absent even in the classified sections of the RF budget.

As concerns the practices of military budgeting in other countries, there financial and economic indicators are presented in their inseparable totality:

- expenditures for military personnel are supported with the information about its strength as broken down by key categories;



- expenditures for military procurement are substantiated by the information about planned purchases of concrete models of planes, tanks, missiles, etc.;
- expenditures for capital construction are substantiated by the information about airports, bases, residential housing, etc. being in the process of construction.

All this is planned and presented not separately, but in the budget and respective supplements.

As concerns the Russian planning practices, there are separately elaborated and approved, and, therefore, separately classified programs and plans. The state defense procurement program is also a separate act related to the budget, but not reflected in it. Even the data about the strength of the personnel of the RF military organization are still classified, although it is not the case in other countries' practices. Moreover, such information was published in order to substantiate budget expenditures in the early 1990s, but now it is classified. Therefore it would be feasible to improve the existing system of planning, programming, and budgeting on the whole. However, it is even more serious problem than the issue of declassifying of the federal budget in its present form.

The second problem is the declassification of reports concerning execution of the federal budget. The budgeting and reporting are carried out by different departments of the Finance Ministry. Probably it is a reason why one of the most important requirements set forth by the RF Budget Code: "Reporting on administration of the budget should be compiled in accordance with the same structure and budget classification as was used for approval of the budget" (item 2, Article 272) is not complied with.

It is necessary to comply with the requirement (to be introduced immediately, starting with the report for year 2003) that the structure of reporting on the execution of the budget should correspond to the structure of the budget itself so the reports fully reflected all budget indicators across all supplements to the federal budget taking into account the approved level of their transparency.

## Section 4. Institutional and Macroeconomic Challenges

### 4.1. Privatization and Management of Federal Property

The most significant innovations of the year 2003 were, firstly, the onset of a gradual implementation of the elements of the new Concept of Federal-Property Management (approved at the RF Government's meeting on February 6, 2003), and secondly, the definitely established (at least in theory) deadlines for privatizing the non-strategic entities that have remained state property (until the year 2008). These new developments may directly promote a certain quantitative acceleration in the privatization process in the year 2003. Primarily, this has to do with unloading of the remaining minority blocks of shares and corporatizing state unitary enterprises with subsequent sale of their stocks.

#### 4.1.1. Preliminary results of the year 2003

A Prognostic Plan (Program) of federal-property privatization for the year 2003 was approved by the Regulation of the RF Government No 1155-r of August 20, 2002 (with amendments as of October 9, 2002). The information concerning renewable sources of income is presented in *Table 1*. The forecasted income from privatization in the year 2003 was to amount, according to preliminary estimates, to 15-20 bln roubles, then (after some adjustments introduced by the government) - to about 51-54 bln roubles. This amount was to result, most probably, from the sale of several big blocks of shares – traditionally, the “Sviaz’invest”’s block of shares (and in different variants – from 25 % minus 2 shares, to 75 % minus 1 share), 23.76 % of the Magnitogorsk metallurgical combine’s shares, the “Rosgosstrakh”’s 26 % minus 1 share, 25.5 % of the “Sibir”’s airline’s shares, 21.78 % of the Central Telegraph’s shares, and some others. As a rule, 90-95 % of total privatization income is made up by 25 to 30 blocks.

Nevertheless, in contrast to the previous years, in the year 2003 no relatively big privatization transactions took place (the latter usually producing a dramatic increase in revenues from non-renewable sources). The last block of shares of the oil company “Lukoil” (7,6%) will not be sold before the year 2004, and for this purpose it is intended to list this company on the New York Stock Exchange.

The block of shares of the “Sviaz’invest” telecommunications holding company (25 % minus 2 shares, or another one), whose privatization has been intended over a number of years, will be sold, at earliest, in the year 2005, after the reorganization of the holding is completed, the completion of the tariff reform, and the solution of the problem of imposing social welfare responsibilities on the regional companies. Considering the growing attractiveness of the telecommunications stocks, there seems to be no sense in urgently selling out the holding’s securities. Although it would be unreasonable to discuss, at present, any precisely defined variants of the sale (as the “Slavneft”’s experience has shown, radical changes may be introduced on a daily basis), one of the existing proposals is worth mentioning – that of selling at auctions the blocks of shares of the holding’s regional companies (at least four interregional subsidiaries have been included in the 2004 list). If this variant is implemented, then it would be highly probable that the whole spectrum of problems once caused by the “double” privati-



zation of oil companies in the 1990s (at first, oil extracting companies, then holdings with residual state blocks of shares) will be reproduced again in this sector.

The sale of 23.76 % of the Magnitogorsk metallurgical combine's shares (in fact, this is the last remaining big asset in this sector owned by the state) is complicated not only by a very acute struggle going on between several large groups of metallurgy owners. Although the decision to hold an open auction has already been made, this enterprise will have first to be taken off the strategic list, which can only be settled at the presidential level.

In the year 2002, as is known, some grave conflict occurred involving various corporate groups that had to do with the privatization tenders that took place in coal mining, transportation (ports, etc.), and the oil industry (primarily, "Slavneft"). On the contrary, the year 2003 is characterized by fewer conflicts associated with the privatization process, at least as regards the biggest deals. This by no means implies that a certain degree of harmonization of the interests of the largest oil and metallurgy groups has been achieved; one can speak only of the assets-to-be-privatized (offered for bidding) having been exhausted as of the year 2003, which are of interest for the buildup of integrated groups in some sectors.

Accordingly, the real budget incomes (without the transactions that took place in the year 2002) from the sales of blocks of shares in the year 2003 must be quite low. It is unlikely that the income amount specified above, adjusted with regard to the incomes of the year 2002, will become higher than the initial figure – 15-20 bln roubles.

Table 1

**Changing incomes from privatization and use of federal property, bln roubles**

	1999*	2000	2001	2002	2003 (estimation)	2004 (forecast)
<b>1. Non-renewable sources</b>	<b>8 547.4</b>	<b>31 367.1</b>	<b>10 110.6</b>	<b>14 700.7</b>	<b>88 500</b>	-
1.1. Privatization (number of enterprises)	8 547.4	31 367.1 (320)	9 990.6 (170)	12 703.8	84 000**	35 000 – 40 000
1.2. Sale of FSUEs and military property	-	-	-	-	1 300	-
1.3. Sale of land and intangible assets	-	-	120.0	1 996.9	3 200	-
<b>2. Renewable sources</b>	<b>8 720.5</b>	<b>18 790.1</b>	<b>29 122.6</b>	<b>36 762.2</b>	<b>44 500</b>	<b>38 700</b>
2.1. Dividends (number of enterprises)	848.1 (600)	3 675.1 (1050)	6 478.0 (782)	10 402.3 (747)	12 000	12 500
2.2. Lease of property	2 191.4	3 427.2	4 896.1	7 657.9	8 800	8 700
2.3. Lease of land	-	-	3 917.0	4 400.0	8 000	-
2.4. Part of FSUEs' profits (number of enterprises)	-	-	209.6 (131)	914.2 (809)	2 500	3 200
2.4. JV "Vietsovetro"	5 675.0	11 687.3	13 621.9	13 388.8	13 200	14 300
<b>Total</b>	<b>17 261.9</b>	<b>50 157.2</b>	<b>39 233.2</b>	<b>51 462.9</b>	<b>133 000</b>	<b>73 000 – 80 000</b>

\* For the changes that took place during 1995-2002, see: Rossiiskaia ekonomika v 2002 godu. Tendentsii i perspektivy. (The Russian economy in the year 2002. Trends and prospects). M., IET, 2003, p. 367.

\*\* In fact, approximately 82 bln roubles, or 95 % of this amount, is represented by the incomes from the transactions of the year 2002 (58.7 bln roubles for 74.95 % of the "Slavneft"'s shares, and 775 bln roubles for 5.9 % of the "Lukoil"'s shares) received by the budget in 2003. Accordingly, the RF Ministry of Property Relations included these two transactions in both the reports of the year 2002 and the year 2003. It should also be noted that the proceeds of the sale of the "Lukoil"'s block of shares were transferred to the budget only on May 8, 2003, while the specific user of the income from the use of these proceeds during that period (amounting to tens of millions of USD) remains unknown. If these transactions are excluded, renewable sources were dominant both in the year 2002 and the year 2003.

Source: the RF Ministry of Property Relations, the authors' calculations.

In terms of budget revenues, the trends of the years 2001-2002 demonstrating the predominance of incomes from the use of state property have been retaining their significance.

According to the preliminary data of the RF Ministry of Property Relations, in January-September 2003, the bulk arrivals in the federal budget resulting from privatization and utilization of state property amounted to 118 bln roubles. The bulk arrivals from utilization of federal property amounted to 31.5 bln roubles, including 6.7 bln roubles from the lease of federal property; 9.3 bln roubles due to the dividends on shares in federal ownership; 13.1 bln roubles - from the RF's stake in the joint-stock company "Vietsovpetro", 60 bln roubles - in the form of land-rent payments (after delimitation); 2 bln roubles - in the form of transfers of a specified share of the profits gained by state unitary enterprises; 241 bln roubles - from the sales of property owned by state unitary enterprises (establishments) and military property; and 2.7 bln roubles - from the sales of land. The arrivals resulting from the sales of property and blocks of shares of joint-stock companies effected by the RFFP and the funds for property in the RF subjects amounted (in January-July 2003) to 83.6 bln roubles, though more than 90% of this sum was obtained from two transactions effected in the year 2002 with the money arriving later, in the year 2003 (the blocks of shares of "Lukoil" and "Slavneft").

Dividends on state-owned blocks of shares are considered by the Government as the most important renewable source of budget revenues. The trends demonstrated in the last few years testify to a significant increase in the corresponding payments (*Table 2*). In the year 1996, the dividends on state-owned blocks of shares were paid by just 35 open-end companies. While in the year 1998, 273 companies with a government stake transferred 574 mn roubles to the federal budget, and 747 companies transferred to it the amount of 10 400 mn roubles in the year 2002. It is clear that this growth has resulted from the intensification of the activity of the RF Ministry of Property Relations.

At the same time, the analysis of the aggregate increase in dividend payments effected by 95 compatible companies in the years 2001 and 2002 indicates that the increase in dividend payments amounted to 263% (with the dividends paid by "Sibneft" not taken into account, it amounted to 171%). In the year 2002, and for the first time in general, there was a sharp rise in dividend payments on the part of Russian corporations as a whole, and it did not relate either to a devaluation of the rouble or to any sharp change in the financial efficiency of enterprises (as after the 1998 crisis).<sup>1</sup> To a great extent, this growth was preconditioned by an increase in the dividends on common equities caused by a number of factors: the policy of corporate governance and capitalization growth, the pressure from sectoral holding companies (such as the RJ-SC UES in power engineering and "Sviаз'invest" in the sphere of communications), and a reduction in the dividend-tax rate.

In this respect, one could assume that the noticeable successes achieved by the RF Ministry of Property Relations as regards the rise in payment of dividends on the Federal Government's blocks of shares, which took place in the years 2000 to 2003, have resulted not only from the intensification of pressure on the issuers but also from the objective processes existing in Russia's corporate sector in the early 2000s. As far as the given source of government revenues is concerned, this factor will undoubtedly remain decisive in the future as well.

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<sup>1</sup> Danilov Iu. A. Osnovnye tendentsii dividendnoi politiki rossiiskikh predpriatii v 2002 godu. (Major trends in the dividend policy of Russian enterprises in the year 2002). A report given at the workshop "Institutional problems of the Russian economy", GU-High School of Economics, 2003.



On the contrary, the acquisition of some part of profits earned by state unitary enterprises could hardly be considered as a substantial and much promising source. The point is that the institute of state unitary enterprises is to be gradually eliminated in accordance with a special program, while the remaining state unitary enterprises will be, in the long run, converted into treasury structures satisfying the needs of the State.

The revenues from land-privatization are expected to amount to approximately 2.2 bln roubles in the year 2003. It is well known that the norms of land legislation (the Land Code adopted in 2001) envisage the cancellation of free-of-charge perpetual use of land plots under privatized enterprises from 1 January, 2004. The inconsistency of such an archaic construction as “perpetual use” is evident. On the one hand, the land plot cannot be taken from an enterprise, while on the other, it is not possible to sell this land. In this situation, the State could be sure of getting a relatively small income in the form of a tax on land plots. From the point of view of market turnover, there exists an actual situation when the object of real estate becomes inferior per se, with the land plot being a “deadened” component.

The problem is that both variants (purchase and lease) as they stand are rather burdensome for the entrepreneurs. Thus, in the year 2003, the pegging of the price of land lots to the annually indexed land-tax rates resulted, among other things, in a 3.2-fold increase in the redemption value of land plots. At the same time, regional authorities have introduced maximum correction factors.<sup>2</sup> In the “expensive” regions (first of all, Moscow), one of their excuses would be the fact of purchasing of land plots by enterprises. As a result, by September 2003, only about 5% of juridical persons had redeemed their land plots.

Also important is the psychological factor related to the fact that the privatization of many objects has already been basically completed, while a certain part of the property complex remains, objectively, a factor of instability, at least financially. Finally, it is rather hard to assume that a land plot could be claimed by anybody else but the owner of the enterprise. It was exactly on those grounds (also presuming that the land plots, in one way or another, had been priced in the course of privatization) that the Russian Union of Entrepreneurs and Industrialists (RUEI), for example, demanded that the land plots be gratuitously transferred into ownership.

In the summer of 2003, the Ministry of Economic Development and Trade (MEDT) put forward a demand to postpone the said cancellation by several years during which the entrepreneurs would be able to choose between the two forms of land use (redemption or lease). It should also be taken into consideration that the process of delimitation of state land ownership has just begun. By the beginning of the year 2003, out of 500,000 land plots to be delimited in this respect, the RF Ministry of Property Relations had received the data on only 110,000 land plots.

In September 2003, the alterations to the Land Code and other acts to the effect that the said period be extended till the year 2007, and the redemption price of land plots be reduced, were submitted to the Government. The new methodology for determining the redemption price of land plots envisages: 1) a basic rate in relation to the size of the population in a given settlement; 2) a 20-fold upward coefficient which would take into account the potential of

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<sup>2</sup> See: Finansy, 2003, No 18, p. 4. The cost of redemption of land plots under privatized enterprises is estimated as being between 30 bln USD (the Realtors' Guild) and 106 bln USD (the RUEI) or 1/4 of Russia's GDP. The MEDT, in the person of its First Deputy Minister A.V. Sharonov, gives the figure of 34.8 bln USD, considering it unbearable for Russian enterprises.



taxation, the area of the region and the size of its population; 3) the possibility for introduction of an up-to-20-fold downward coefficient; 4) the right to pay by installments over a period of five years. The amount of annual lease-payment should not exceed the land-tax amount; it shall be fixed for all the leasing period, while the latter should be no less than 10 years and no more than 49 years. In this case it becomes clear that redemption is preferable to leasing, bearing in mind the long-term conditions for the reproduction of corruption. Nevertheless, the corresponding projects in their full volume could be considered only by the newly elected State Duma in the year 2004.

#### *4.1.2. The new Concept of Federal-Property Management*

Certain positive results of the implementation of the Concept of State-Property Management, and those of the 1999 privatization, the adoption of new laws on privatization in the year 2001, as well as the law on unitary enterprises adopted in 2002, providing the executive authorities with a greater freedom of action in the field of de-nationalization, have laid foundation for a discussion, in the years 2002 and 2003, of some new initiatives pertaining to the management of the government sector.<sup>3</sup> The state policy in this sphere should be focused on the following problems: 1) classification of federal property, 2) upgrading the new mechanisms of management as regards the objects constituting this property; 3) optimization of the structure of federal property.

*Classification of state, and first of all, federal property* should be carried out through a categorial definition of those types of property which could be solely in federal ownership, in the ownership of the Federation's subjects, and in municipal ownership, so as to enable these owners to fulfill the public functions invested in them. In this respect, the draft law "On government and municipal property" developed by the RF Ministry of Property Relations and submitted to the Government in early 2003 represents a basic legal innovation. According to this draft law, the RF, subjects of the Russian Federation and municipalities could own property of the following three major categories: the property necessary for the bodies of state power of the RF, subjects of the Russian Federation and local self-government to exercise the authority invested in them by the RF Constitution, the federal laws and the laws of subjects of the Russian Federation as regards the exercise of this authority:

- the property necessary for the bodies of state power of the RF, subjects of the Russian Federation and local self-government to exercise the authority invested in them by the RF Constitution, the federal laws and the laws of subjects of the Russian Federation as regards the exercise of this authority;

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<sup>3</sup> The Materials of the All-Russian Conference of the RF Ministry of Property Relations, of 26-28 November 2002, "O realizatsii zadach v sphere imushchestvennykh otnoshenii" (On the solution of problems in the sphere of property relations); the materials of the RF Ministry of Property Relations relating to the meeting of the RF Government, of 6 February 2003, "O merakh po povysheniiu effektivnosti upravleniia federal'noi sobstvennost'iu i kriteriakh ee otsenki" (On the measures designed to improve the efficiency of management of federal property, and on the criteria of its assessment); the Materials relating to the meeting of the RF Government, of 27 November 2003, "O khode realizatsii reshenii Pravitel'stva RF po povysheniiu effektivnosti upravleniia federal'noi sobstvennost'iu, osnovnykh napravleniakh dividendnoi politiki" (On the progress of the implementation of the decisions of the RF Government on enhancing the efficiency of federal-property management, and on the main directions of the dividend policy).



- the property necessary for the maintenance of activity on the part of appropriate bodies, as well as government and municipal employees, as stipulated by the federal laws, the laws of subjects of the Russian Federation and other normative legal acts;
- other property which, in accordance with the federal laws, could not be alienated and withdrawn from state or municipal ownership (property withdrawn from public turnover).

Apart from the property of these three categories, federal ownership could also include property of strategic importance in accordance with the list approved by the RF President on its submission by the RF Government. The list of such property should not include the property classified as belonging to subjects of the Russian Federation or municipalities. Subjects of the Russian Federation also could own property needed by said subjects of the Russian Federation for the exercise of their authority.

*The organizational legal forms* of functioning of state and municipal property should be as follows: 1) treasury enterprises and institutions holding such property consolidated to them by the right of operative management; 2) transfer of property by concession; 3) inclusion of property in the authorized capital of open-end companies with more than 50% of shares owned by the RF, its subjects or municipalities. In this case, the authorized capital of an open-end company should not include property which, in accordance with federal legislation, cannot be withdrawn from state or municipal ownership (property excluded from public turnover). The state and municipal property not consolidated to state or municipal treasury enterprises constitutes, respectively, the state treasury of the RF and its subjects and the municipal treasury of municipalities.

Also worthy of attention is the problem of organization of accounting and control as regards the movement of state and municipal property; it is planned to be solved by compiling appropriate lists of property for each level of authority and by keeping registers. The final document reflecting the changes in the body of property which have occurred during the calendar year, should be *the annual report on the entry and withdrawal of state and municipal property*.

It is evident that the optimization of the structure of federal property represents a complex and many-sided process related to the medium-term program of socio-economic development of the country, the federal budget and the investment program. Therefore, it seems very logical that the RF Ministry of Property Relations has suggested that a program of management of federal property (assets) for 3 years be developed, so as to systematize the acquisition, withdrawal and use of federal property. The advantage of this approach rests in the proposal that the above Program should embrace every possible operation and procedure regarding property (creation of new objects, redemption, nationalization, privatization, transfer into ownership of regions and municipalities, participation in the activity, transfer by lease and concession, or to trusteeship) which are coordinated with the stages of property management.

It is of principal importance that starting from the date when this law enters into legal force, *no permission should be given to establish any unitary enterprises based on the right of economic jurisdiction*, and to include state and municipal property into the authorized (contributed) capital of commercial organizations (with the exception of open-end companies conforming to the above requirements) and in the authorized funds of non-profit organizations. Also starting from the date when this law enters into legal force, no laws defining the authori-

ty of federal, regional and municipal organs but not specifying the types of property necessary for its exercise, should ever be passed.

In the year 2004, the Government should authorize the procedure for keeping the registers of state and municipal property, the forms of the corresponding documents, the procedure for free-of-charge transfer of state and municipal property in the case of redistribution of authority among the organs of state power of all levels, as well as the procedure for alienation of the property consolidated to treasury enterprises and institutions. In the years 2004 and 2005, the list of strategically important property will be submitted for the approval of the President, while a number of draft laws defining the types of state and municipal property needed by the organs of power for the exercise of their authority, will be submitted to the legislative bodies of all levels.

The constituent documents created before the coming into legal force of the suggested law on unitary enterprises and based on the right of economic jurisdiction, as well as treasury enterprises and institutions, should be brought into line with the given law prior to 1 January 2008. In case the constituent documents of unitary enterprises based on the right of economic jurisdiction are not brought into line with this requirements on time, such enterprises will be subject to liquidation in accordance with the procedures envisaged by the law. As long as the constituent documents of unitary enterprises based on the right of economic jurisdiction are not brought into line with these requirements, the recording of the property of such enterprises will be conducted in accordance with the requirements of the law.

Thus, the draft law, de facto, determines, among other things, the time-horizon of privatization in its medium-term prospects. The state and municipal property not classified as such, should be subject to conversion or alienation in accordance with the procedures stipulated by the law on privatization, in the years 2005-2008. Beginning on 1 January 2009, the state and municipal property not included in the registers of state property of subjects of the Russian Federation and the registers of municipal property will not constitute federal property and shall be subject to sale in accordance with the procedures and within the time limits envisaged by the laws on privatization.

#### *4.1.3. The program of privatization up to the year 2008 and its limitations*

One of the elements of the new Concept of Federal-Property Management is the three-year-long program of privatization. The first such document (the Prognostic Plan (Program) of federal-property privatization for the year 2004) was approved by the Regulation of the RF Government No 1165-r of 15 August 2003. The following sequence of actions is suggested:

- the year 2003 - privatization of state-owned blocks of shares up to 2% of the authorized capital;
- the year 2004 - the State departs from all the joint-stock companies where the stake of the State is less than 25%;
- the year 2005 - the State departs from all the joint-stock companies where the stake of the State is between 25% and 50% (in particular, the departure from the capitals of companies relating to the power-engineering complex, the fishing industry, the external economy, machinery construction and cinematography);
- the year 2006 - discontinuation of state participation in the companies where the State owns more than 50% of shares, provided that these companies are not strategic (in particular, the civil-aviation companies whose activity does not relate to ensuring state security



and safety of flights, companies of the chemical and petro-chemical industries, and those engaged in the sphere of geology and certain branches of agriculture); among other things, the discontinuation will involve the selling of shares issued by joint-stock companies established in the process of transformation of federal state unitary enterprises (FSUE);

- by the year 2008 - the completion of privatization of the federal property not used for the fulfilment of state functions of the RF, the conclusive formation of the system of management of the state sector's property, the doubling of revenues from the use of property.

According to the estimates given by the RF Ministry of Property Relations, the implementation of this Program will require annual sales of shares of 4,000 joint-stock companies (including the reorganized FSUEs). In order to reorganize, as suggested, approximately 6,000 FSUEs by the year 2006, it should be necessary to simultaneously introduce alterations in the normative legal acts so as to remove the restrictions on privatization of more than 5,000 existing FSUEs. By the end of the year 2008, there should remain no more than 2,000 FSUEs and 500 various blocks of shares owned by the State. Thus, one can recognize that the above scenario for the conclusion of the property reform in Russia is indeed of a very radical nature.

The excessive ambitiousness of this Program, as we see it, relates to a number of circumstances.

1) The actual progress of privatization during the period when the 1997 Law on Privatization remained in force, is testimony to the fact that when the Law was relatively strictly observed, the organisational capabilities of the managerial organs as regards rapid reforming of the state sector were in serious conflict with the quantitative limitation - the scope of this reforming (*Table 2*). Thus, according to the official data, just 749 enterprises (organizations, objects) were privatized in the years 1998-2002.

Apart from the federal blocks of shares and FSUEs, there exists a large amount of unitary enterprises and economic unions where local authorities have a share in capital at the regional and municipal levels, the ratios between which still remain unclear.

2) Still lingering is the problem of residual blocks of shares which has been under discussion since the mid-1990s. During the past decade (starting from the conclusion of mass privatization in 1992-94), the number of minority interests owned by the State has been generally declining, though the rate of this decline is too insignificant for us to forecast a complete solution of the problem in the course of just three years.

The new law on privatization ("On privatization of state and municipal property" No 178-FZ of 21 December 2001, entered into legal force as of 26 April 2002) provides legal grounds for a mass reduction in the number of state-owned objects and offers the instruments to effect the disposal of relatively unattractive minority interests (in particular, it does not necessitate the evaluation of minority interests offered for sale and envisages the determination of the starting price in accordance with the nominal value of the shares). It is still too early to make any conclusion regarding the efficiency of the new methods of privatization legitimized by the new law on privatization. The demand for these mechanisms is still a matter of theory rather than practice.

Very typical in this respect is the conflict between the Ministry of Property Relations and the Russian Fund for Federal Property (RFFP) which became more intensive in the year 2003. It is well known that the plan of selling state-owned blocks of shares envisaged for the year 2002 had been implemented by the RFFP by 10% only, and all the unsold blocks of shares were automatically included in the program for the year 2003. A similar situation is

typical of the year 2003 as well. Formally, the phenomenon is explained by the inability of the RFFP to cope with the burden of the execution of the documents pertaining to transactions, but the real problem is the illiquidity of most of the blocks of shares. One of the recent (November 2003) initiatives of the Ministry of Property Relations was a proposal to increase the range of sellers of state property, which clearly could not suit the RFFP, an actual monopolist in this sphere. More radical measures are apparently necessary, and not just a mere revision of functions. Such steps could include, for example, an analysis of the feasibility of a legalized *reduction in the size of authorized capitals to the amount of the State's share in those joint-stock companies where the state-owned blocks of shares could not have been sold in the course of several attempts, and no further management of these blocks of shares promises any financial, managerial or strategic rewards whatsoever.*

3) The above Program indirectly envisages a nearly complete liquidation of the very institute of state unitary enterprises, which is totally justified from a conceptual point of view. Apart from a very limited number of FSUEs, all of them should be converted into treasury enterprises, or - via corporatization - into joint-stock enterprises to be subsequently privatized. The processes of reorganization (merger, liquidation, sale of shares, partial sale) must also involve the subsidiary enterprises of FSUEs. A strong stimulus for abandoning this organizational legal form should come from the provisions of the Law "On state and municipal unitary enterprises" No 161-FZ of 14 November 2002.

Nevertheless, it should be noted that this plan is by no means the first one as regards a drastic curbing of the State's presence in the economy - the RF Ministry of Property Relations has repeatedly planned a full-scale reduction in the number of SUEs. The first variants of this approach (the transformation of all SUEs into treasury enterprises and joint-stock companies) had been discussed as early as 1995-94. In the government program for the years 1997-2000, the issue dealt with was the completion of the program to transform SUEs into the joint-stock companies with 100% of shares being in federal property, by the beginning of 1999. The Program of medium-term (up to the year 2004) socio-economic development of the RF had envisaged that the above program be completed by the end of the year 2001, and then the number of FSUEs be reduced to 1,500-2,000 by the end of the year 2003.

The resistance of branch ministries is equally well known.<sup>4</sup> The problems encountered in this respect deal with both the current financial matters and the more fundamental ones which relate to the administrative reform. Thus, according to one official from the RF Ministry of Property Relations, everybody "clearly understands that the majority of ministries can exist only due to their FSUEs - the Ministry of Labor and Social Relations alone, for example, owns one and a half thousand of them. If they are taken away (and they represent financial pyramids which are difficult to control but "are feeding" the ministries), the Ministry of Labor and Social Relations will no longer be a ministry but will become an ordinary research insti-

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<sup>4</sup> For more details, see, for example, Radygin A., Simachev Iu. Mal'ginov G. et al. "Povyshenie effektivnosti biudzhethnogo finansirovaniia gosudarstvennykh uchrezhdenii i upravleniia gosudarstvennymi unitarnymi predpriiatiiami. (The enhancement of efficiency of budgetary financing of state institutions and that of the management of state unitary enterprises). Volume II. Problemy upravleniia i zadachi regulirovaniia v sektore gosudarstvennykh unitarnykh predpriatii. (The problems of management and the aims of regulation in the sector of state unitary enterprises). M., IEPP-CEPRA, 2003.



tute elaborating various codes. Like many others, it will simply have nobody and nothing to control".<sup>5</sup>

4) The orientation of the Ministry of Property Relations towards the greatest possible reduction in the number of unitary enterprises of all level, with the prospect of their transformation into open-end companies, will result in an increase of the burden shouldered by the organs of state administration, which will have to act within the norms of corporate law. In this respect, there will emerge a necessity to quantitatively increase the number of state representatives in the managerial bodies of joint-stock companies, and at the same time, it will be desirable to upgrade the level of their qualification as well as that of their material incentives.

5) The opposite direction of the possible transformation of unitary enterprises is the creation of treasury enterprises based on the property of the latter which would operate in accordance with the right of operative management. Nevertheless, the duty of the State to bear subsidiary liability for the obligations of these enterprises creates a potential possibility for increasing state expenses, as well as the burdens imposed on the budgetary system. Most likely, that is the reason why treasury enterprises have failed to become a common phenomenon in the state sector of the Russian economy. Similar problems have recently surfaced in relation with the expected reorganization of social services.

If the concept of not burdening the budget by any unscheduled liabilities becomes decisive in the further transformation of the state sector, there will inevitably emerge a question of whether it would be feasible to liquidate the organizational legal form of a unitary enterprise based on the right of economic jurisdiction - the form which, despite all its drawbacks, has at least one advantage over an enterprise based on the right of operative management (treasury enterprise): the State bears no liability for its obligations.

6) The orientation towards the speed of privatization, the desire to complete it, whatever the costs, by a certain date, could be very detrimental to the quality of the process. Despite the fact that the title of the Government's document mentions the prognostic plan (program) of privatization for the year 2004 and the main directions of privatization up to the year 2006, its text actually contains the lists of objects to be privatized only for the year 2004.

Thus, according to the estimates made by the RF Ministry of Property Relations, in the year 2004, the expected revenue of the Federal Budget from privatization is to amount to 35-40 billion roubles. The basic list of objects scheduled for privatization in the year 2004 includes 1063 federal state unitary enterprises and 719 blocks of shares of joint-stock companies. The largest privatization projects of the following year could be the sale of 7.6% of shares issued by the oil company "Lukoil", the sale of shares of the aviation holding company "MiG", of the Novorossiisk, St Petersburg, Vladivostok and some other sea ports, as well as of some airports. In the case of selling the shares of these sea ports, the State reserves the right to introduce a "golden share". At the same time, 123 federal state unitary enterprises and 215 blocks of shares are scheduled for the inclusion in the vertical integrated structures of the defense complex.

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<sup>5</sup> Kornysheva A. Minimushchestvo dressiruet unitarnye predpriatiia. (The Ministry of Property Relations is schooling unitary enterprises). Kommersant, 2003, 5 August.

It should be noted that the possibility of correction of such lists, as it took place in the year 2003, remains traditionally high.<sup>6</sup> There remain certain risks of the equity market being destabilized, and there is also a risk that state property would be sold cheaper than in the case of an orderly and prolonged privatization.

*Table 2*

**Principal objects of federal property and privatization program of the 2000s**

	1999*	2000	2001	2002	2003	2004 (forecast)
Total number of FSUEs' **	13 786	11 200	9394	9846	8820	-
FSUEs privatized during year:						
- Forecast	-	-	-	1652	435	1063
- Actual number	-	2	5	78	400	-
Joint-stock companies whose blocks of shares are owned by RF**	3611	3524	4407	4 222	4 035	-
Including by stakes in charter capital						
- 100 %	382	61	90	99	124	-
- 50-100 %	470	506	646	589	552	-
- 25-50 %	1601	1211	1401	1 382	1308	-
- under 25 %	863	1746	2270	2 152	2051	-
- golden share	580	-	750	958	640	-
Privatized federal blocks of shares during year:						
- Forecast	-	-	-	1126	435	719
- Actual number***	-	87	216	185	187	-

\* As of the end of each year. The year 1999 is taken as base, with regard to the adoption of the "Concept of State-Property Management and Privatization in the Russian Federation" (approved by the RF Government's Decree No 1024 of 9 September, 1999).

\*\*In the early 2000s, the total number of unitary enterprises was approximately 85,000, including about 20,000 state enterprises and about 65,000 municipal enterprises. In 1995, according to other estimates, the State owned at least 15,000 – 17,000 blocks of shares of various size, in 1999 – about 3,100 "consolidated" blocks, and 7,000 – 8,000 unsold (on the balances of regional property funds). In 1995, 1,004 joint-stock companies had golden shares. By late 2003, the State owned 855 blocks of shares of less than 2 %, the shares of 75 close joint-stock companies and stakes in 6 open joint-stock companies. In 148 joint-stock companies the State owned only the golden share.

\*\*\* The data on annual rates of privatization of blocks of shares cannot be interpreted correctly for several reasons: 1) absence of any regular information from the RF Ministry of Property Relations and the RFFP; 2) transfers of blocks from the RF Ministry of Property Relations to the RFFP and its affiliations for subsequent sale which never takes place (as a rule, only 10-20 % of transactions are completed); 3) a "counter process" of FSUEs' corporatization and other ways of increasing the number of blocks held by the state.

Source: the RF Ministry of Property Relations's data. New entries in the Register of the RF's property are being constantly made.

7) Another serious problem is the possibility of a relatively rapid elaboration of the criteria of efficiency as regards the use of state and municipal property in not-profit undertak-

<sup>6</sup> To a certain extent, it resembles the situation with cheque auctions during the period of mass privatization (1993-1994) when the main bulk of potential purchasers could not obtain sufficient information as to which assets were to become the object of marketing throughout the term of the voucher validity.



ings, because the corresponding functions of both the State and local authorities are rather numerous.

The subjection of the activity conducted by the enterprises of the state sector to the goal of satisfying certain social demands does not permit us to reduce the estimation of the efficiency of their activity to the mere value of direct revenues received by the State from one or other enterprise in the form of dividends or a share in profits; it is also necessary to take into consideration the indirect effects influencing the economy in general. At the same time, these effects are, as a rule, rather difficult to account and analyze in financial terms. Some serious problems could also emerge in the course of attempts to introduce a separate accounting of expenses and revenues for different directions of activity within a single object of federal property (as exemplified by the process of reformation of natural monopolies).

8) Finally, there have emerged some rather difficult problems as regards the provision of an adequate normative and legal base. It is evident that the suggested legal structure necessitates the adoption of numerous attendant regulatory and legal acts, thus resulting in the emergence of equally numerous problems. Thus, the actual cancellation of the right of economic jurisdiction would make it necessary to adopt a law on treasury enterprises, whereas the law on unitary enterprises already regulating this organizational legal form has been in effect for just slightly more than a year. Similarly, any speeding up of privatization could require the introduction of alterations in the less than two-year-old law "On privatization of state and municipal property" in order to revise the limitations imposed on this process. The question of legislation stability would therefore become purely rhetorical.

The Edict of the President of the RF No 1514 of 21 December 2001, which was issued in parallel with the adoption of the new law on privatization, contained an instruction to the effect that the RF Government should submit for approval, by 1 March 2002, the lists of strategic enterprises and strategic joint-stock companies. Nevertheless, so far nothing has been heard concerning any approval of any new list of strategic enterprises and joint-stock companies. It should also be mentioned that the text of the law reveals no mechanism for the President to consider the proposals submitted by the Government. Apparently, the Head of the State would have to rely on expert opinions of the structures directly subordinated to him. And yet, it is not quite clear whether it would be the Presidential Administration, the Security Council or some other organ.

Among all the new mechanisms of federal property management, the only relatively well-developed one is, in fact, the institute of state representatives in the managerial bodies of joint-stock companies. There is no legislation on concessions. There is no absolute clarity in the matter of prospects for the partial transformation of state-owned establishments (including non-profit organizations created on the basis of some types of social institutions) into other organizational legal forms. Serious problems can be expected in the course of the introduction into practice of the mechanism of trust management in respect to state-owned blocks of shares. The methods which came into practice in the 1990s are predominantly criticized, while all the mechanisms involved are far from being properly developed.

A rather distinctive problem is the matter of coordination of the draft-law "On state and municipal property" with the draft-laws "On the introduction of alterations and amendments in the Federal Law 'On the organization of legislative (representative) and executive organs of state authority of subjects of the Russian Federation'" and "On the general principles of organization of local self-government in the Russian Federation".



## 4.2. Trends and dynamics of mergers and takeovers. Unfolding reorganization processes.

Overall the trends noted in 2001-02 retained their significance in 2003, too: those were the ongoing processes of concentration of stock-holder capital, integration of enterprises and reorganization of already established business groups, dependence of strategic objectives of the reorganization on the level of a corporate group's institutional 'maturity'. The development of corporate governance standards was directly associated with these or those companies' reorganization and long-term strategies<sup>7</sup>.

The year 2003 also witnessed the remaining importance of the trend that was unfolding between 2001-02, that is, the search by the largest Russian groups of their place in the system of international economic relations. Some decline in the domestic expansion by the largest groups (which can be explained primarily by the process of optimization of their assets acquired in Russia) in 2003 was compensated by their growing interest in enterprises and other objects in the CIS, European countries, USA and a number of other regions (see *Table 3*). Nonetheless, the fundamental question, as to whether the current reorganization of large Russian businesses meets the goal of ensuring its international competitiveness, remains plumb-ing. At the same time, strategic options to a significant extent depend on motives and vision by actual owners of the groups of particularities of their international expansion – whether they are keen to ensure strategic development of a competitive group or to abandon the business and fix their profit. In 2003 the state articulated more clearly its vision of acceptable limits of international expansion by private groups (more precisely, of appropriateness of emergence of really multinational companies on their basis), which has had an increasingly growing impact on their actual owners (partners') strategies.

### 4.2.1 Dynamics of mergers and takeovers

Overall, the period between 2003- early 2004 witnessed the following substantial processes: first, in quantitative terms, one can speak of a considerable absolute rise in the number of transactions in this particular area (*Table 3*). This domestic trend appears quite corresponding to the global practice when certain stages of economic growth are traditionally accompanied by merger and takeover waves. At the same time, the noted processes in Russia take place against the background of a visible decline in the respective processes in the West (in this respect the results of 2003 appear especially moderate vis-à-vis the peak figures of 2001-02).

*Table 3* shows that in 2003 the overall volume of deals grew 7-fold vs. 1999 and 2-fold vs. 2002 (minus the TNK-BP deal). When compared with 1999, the total number of deals grew almost 4-fold, while the 2003 increment is at 30% greater than in 2002. between 2002-2003 the average value of a merger/takeover deal in Russia (without regard to the YUKOS-Sibneft and TNK-BP deals) soared by 47% - from USD 17 mn. to 25 mn., with as many as nearly two-thirds of them falling under the 'domestic deal' category. While in 1999 the number of takeovers of Russian companies by foreign ones was 3-fold greater than the opposite process and the volume of the former deals was 23-fold greater than the latter ones, the respective indices have proved to be roughly even in 2003: the number of takeovers of Russian

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<sup>7</sup> For greter details, see: radygin A., Shmeleva N. Sovremennye tendentsii konsolidatsii, integratsii i reorganizatsii krupnykh korporatsiy (grupp).- In: Ekonomika perekhodnogo perioda. Ocherki istorii politiki postkommunisticheskoy Rossii 1998-2002. M., Delo, 2003, Chapter 11, p. 414-441. Radygin A. Privatization, Ownership Redistribution, and Formation of the Institutional Basis for Economic Reforms. - In: The Economics of Russian Transition. The MIT Press, Cambridge, Massachusetts, 2003, Chapter 14, pp. 395-459.



companies by foreign ones was just 1.2 times greater than the opposite process and 2.5 times greater in terms of the volume of such deals<sup>8</sup>. It is impossible, of course, to assess the share of genuine foreign capital rather than the share of the repatriated Russian capital in these processes, that is why any analysis of this kind is conditional. However, the noted dynamics can indirectly testify both to the rise in Russian companies' expansion abroad and the trend top repatriation of earlier exported capital noted in the 2000s. From the of international expansion perspective, the main areas for Russian investing traditionally area the CIS and the central and Eastern European countries (42% and 21% of the overall volume of external investment in 2003, accordingly).

*Table 3***Completed merger and takeover transactions in Russia, 1999-2003.\***

	1999		2000		2001		2002		2003	
	Volume (USD mn.)	Number of deals	Volume (USD mn.)	Number of deals	Volume (USD mn.)	Number of deals	Volume (USD mn.)	Number of deals	Volume (USD mn.)	Number of deals
<b>Domestic mergers and takeovers</b>	1203,8	75	508,3	134	1899,3	199	2578,9	217	6668	308
<b>Takeover of Russian companies by foreign ones</b>	167,2	33	2111,9	60	1318,6	43	1825,8	41	2455	53
<b>Takeover of foreign companies by Russian ones</b>	6,9	11	105,7	17	463,6	25	504,4	33	975	45
<b>Mergers and takeovers, total</b>	1377,9	119	2725,9	211	3681,5	267	4909,1	291	10098	406

\*Deals complete by December 2, 2003, without regard to privatization transactions. For 2003- without regard to the TNK-BP and YUKOS-Sibneft deals. With account of the TNK-BP deal, the 2003 volume of deals should be adjusted by USD 7.7 bn. (or by the share of cash- USD 2.6 bn.). This methodology appears most accurate and complete while assessing the market for mergers and takeovers. While assessing the volume of the market, other research include both privatization deals and stock swaps (Thomson Financial). The Ernst&Young's assessment (only cash-based, including the BP-TNK and YUKOS-Sibneft deals) is: for 2000- USD 4 bn., 2001- 5 bn., 2002- 9 bn., 2003 99 months) – 12 bn. This result, less 3 bn. (the contribution of the failed YUKOS-Sibneft deal), coincides with the Dealogic's data, though both companies' data on the prior years appeared fairly different.

Source: Dialogic 2002-03; KPMG.

From the sectoral perspective, in 2003 the proportion of deals involving oil- and gas-producing companies and other mineral producers accounted for 63% in the total volume of merger and takeover deals. It is yet more notable, given that the mining sector's global significance is less than 5% (*Table 4*). Nevertheless, absolute values of such deals soared by 40% in the industrial output and by more than 100% in the sectors for communication, transport and utilities. Against such a background, highly developed worldwide, finance and insurance, real estate, chemicals and pharmaceuticals, and mass-media are still fairly unattractive to foreign investors in Russia. The proportion of merger and takeover deals across there particular sectors in Russia roughly accounts for 3% of the overall volume of such deals vs. some 42% reported worldwide.

According to the RF Ministry for Anti-Monopoly and Entrepreneurship, in 2003 the greatest activity in this particular realm was noted in the block of the fuel and energy subsec-

<sup>8</sup> This assessment is based on the data on mergers and takeovers presented by the corporate finance department of KPMG ("Analiz obschei situatsii na mirovom rynke sliyaniy I pogloscheniy", 2004) consequently adjusted and completed by the author's calculations based on the Dealogic's data.

tors, transportation, communication and the housing and utility complex, and it was still present on the markets for oil, petroleum derivatives and coal (47.1% of applications). As concerns the block of basic sectors of industry and construction, this trend is characteristic of the machine engineering and the military and industrial complex (35%), and the ferrous metallurgy (26%), while across the agri-food complex, forestry, chemicals and natural-resource complex over 2/3 of applications considered in 2003 fell on the agri-food complex.

*Table 4*

**Sectoral structure of merger and takeover deals, 1999-2003 гг., as %\***

Sectors	Russia			The world as a whole		
	1999	2000	2001	2002	2003	2003
Mining sectors	53	4	49	25	63	5
Industrial production	1	55	6	34	14	8
Telecommunication	2	14	9	7	11	12
Transport	0	0	4	1	4	4
Utilities	27	1	0	3	2	5
Food, light, wood-working	4	15	2	10	2	4
Finance and insurance	0	0	2	4	2	21
Chemicals and pharmaceuticals	4	5	20	1	1	12
Media an software	0	2	0	14	0	5
Others	9	5	8	1	2	25
Total	100	100	100	100	100	100

\* Deals complete by December 2, 2003, without account to privatization deals. For 2003- without the YUKOS-Sibneft deal.

Source: Dealogic 200-2003; KPMG.

It was the merger of TNK and BP's assets, the Interross Group – OMZ deal, and Alfa Group attempts to establish control over Megaphone cellular communication company that became especially notable among the respective deals in 2003. The YUKOS-Sibneft merger (friendly takeover) announced in 2003 could have become the largest transaction in the history of the national economy, however it is senseless to analyze a futile attempt. It is likely that the signing of the protocol on termination of business in February 2004 the period of uncertainty in relationship between the largest stockholders of the company came to an end, and from the perspective of applied significance, it will be the analysis of the 'divorce' technique after the de-facto complete takeover that will undoubtedly be worthwhile.

The USD 7.7 bn.-worth acquisition of Alfa Group and Access/Renova's (TNK) oil assets by BP Plc (UK) place this transaction on the 7<sup>th</sup> place worldwide in 2003 in terms of its value<sup>9</sup>. For the Russian market the merger between Russian and Ukrainian assets of TNK and BP appeared the largest one both in terms of the value of the deal and the volume of foreign investment. The newly established company whose capitalization accounts for nearly USD 16 bn. (as of the date of signing the agreement in June 2003) is the third biggest oil producer in Russia and holds the ninth line among private oil companies worldwide.

In August 2003 Alfa-Eco (member of Alfa Group), which is known for its aggressive policy on the market for corporate control, announced an acquisition of the blocking stake of the noted megaphone (through the acquisition of LV Finance that owned 25% of Megaphone's stock). Alfa Group's ownership of the blocking stake of Vypelkom raised speculations about a possible merger of the two operators that hold the 2<sup>nd</sup> and 3<sup>rd</sup> positions on the market for cellular communication. However, 2004 started with an investigation into Vym-

<sup>9</sup> Though the deal implied the acquisition of TNK's Russian assets, in legal terms, the deal does not concern Russia and investment in Russian economy. Thus the deal was made between the British company, that is, BP and TNK International registered in the offshore zone of the British Virgin Islands. In all likelihood, all the respective settlements were made via foreign offshore firms and banks. The newly established BP-TNK was also registered abroad, and the deal stricken between the two British companies required the EU Commission's approval.



pelkom's licenses and the start of prosecution basing on the fact of illegal entrepreneurship (initiated by the RF Ministry of Communication and supported by the General Prosecutor's office) most likely appeared a reaction to such assumptions. It should be noted that Vym-pelkom (as Yukos in 2002-2003) is traditionally considered the most transparent publicly traded company, while the presence of the listing with the New York Stock Exchange *a priori* excludes any legal or any other ambiguity concerning licensing and other aspects of the company's operations.

In late 2003 Silovye Mashiny holding and Obyedinennye Mashinostroitelnye Zavody group announced their merger into OMZ-Silovye Mashiny company with over USD 1 bn. in sales. It was envisaged that sales of energy equipment should account for up to 70% of the company's sales. According to some estimates, the merger should result in the creation of the largest producer of energy equipment and the second biggest (after AvtoVAZ) machine-engineering corporation in Russia. The uniqueness of the deal is associated to its sectoral origin: it is for the first time ever in Russia there happens a large-scale merger in the sector that so far has not showed high indicators of concentration and investment attractiveness<sup>10</sup>.

Though the transaction has been discussed for some 2 years, it was constrained by different stages of corporate development of its participants: while OMZ relatively early became a public company with a transparent structure, Silovye Mashiny at that time only entered the period of consolidation of its assets (which by an large was over only by September 2003). The merger process should take several stages in 2004. In January 2004 enterprises – members of the concern (Leningrad Metal –Working Plant, the Turbine Blade Plant, Elektrosila) were truned into the concern's sister companies, while their shareholders were granted with the right to sell their stock. Most of them decided to convert their stock into OAO Silovye Mashiny' securities at the set exchange rates.

Stockholders of Silovye mashiny should receive 50% in the OMZ stock, while OMZ should get 100% of the Silovye Mashiny stock. To ensure the transaction, OZ should hold an early shareholder meeting that should approve an additional stock issuance, and the stock will be designated to the exchange for the Silovye mashiny stock. According to Mr.K. Bendukidze, the fact that the company had become publicly traded has allowed OMZ to structure the deal with Silovye Mashiny not as a creation of a new company to which OMZ contributed with all its assets, but as a takeover of Silovye Mashiny (at least, by the form of the transaction). As a result, there should appear a large company with both listing and the accountability record, while de-facto OMZ is take over by Interross Group.

The principal stockholder of Silovye Mashiny should also own the largest stake (roughly as much as 35%) of the joint company, while Mr. Bendukidze's share should fall from 25.9% (the share in OMZ) to 12.95% in the newly created OMZ-Silovye Mashiny company. While the management of Silovye Mashiny should take control over operational issues, Mr. Bendukidze will become the Chairman of its Board. It was already in January 2004 that Mr. E. Yakovlev, Director General of Silovye Mashiny replaced Mr. Bendukidze as President of Atomstroyexport (one of key structures of the new company). An actual level of 'equality' of the parties in the course of the merger (which is emphasized in official statements) is likely to be

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<sup>10</sup> See: K. Bendukidze's interview.-Vedomosti, February 5, 2004, p. 5A; A. Vinkov. Okhota na mirny atom.- Expert, 2004, # 3, p. 20-23; [www.interros.ru](http://www.interros.ru)

assessed accurately only in the course of time needed for assessing of actual managerial and controlling capacity of the both sides in the new company<sup>11</sup>.

As for other notable transactions of the period between 2003-early 2004, one should refer to the stock swap between Novolipetsky Metallurgical Plant (NMP) and Metalloinvest holding: NMP stockholders exchange their 15.5% stake for the 59.8% (controlling) stock of Stoylensky Mining Plant, thus notably strengthening their mineral base. Basing on rough estimates of capitalization of the companies, the value of the deal accounts for nearly USD 600 mn. in market prices.

In summer 2003, SUAL group was likely to attempt to take over enterprises of VSMPO-Avisma group, that is, OAOAvisma (Bereznikovsky Titanium and Magnesium Plant) and Verkhnesaldinsky Metallurgical Production Amalgamation (that owes a 80% stock in Avisma). Purchasing shares resulted in 10-12% stakes in each company, but purchasing was consequently stopped by the mutual agreement of the parties in exchange for seats in their Boards and an agreement on 'production cooperation'.

SUAL group, in turn, has already experienced some attempts of potential corporate blackmail. More specifically, in 2002 SUAL-holding acquired 65% of stock in Nadvoitsky Aluminum Plant, while another 32% of the stock was acquired by Russky Aluminiy. It is fairly obvious that a joint management by of an enterprise by two competitors is hardly promising and bears the peril of a long intra-corporate confrontation. That is why in late 2002 the parties agreed that SUAL would buy the noted 32% stake. Though details of the deal were not made public, it can be easily assumed that Russky Aluminiy received a considerable premium for the refusal of the 'joint management'. An analogous situation occurred in 2003: Rusal bought a 14% stock of OAO metallurg at an auction held by RFFI, while 80% of the company's stock already belonged to SUAL group. From the managerial perspective (especially considering SUAL group as a whole), the stock package did not have any significance, that is why one can assume there should happen its reselling with a consequent premium.

In the light of the above, the saga on Surgutneftegas is especially illustrative. As of April 2003, the company's management (by some estimates) controlled 67.5% of its stock. Interestingly, most of the stock was listed on the balance sheet of the company's daughter companies: 36.7% of OAO belonged to Surgutneftegaz oil company (in which OAO owns 99% of stock), while the non-government pension fund Surgutneftegaz owned a 8.6% package. Whereas the Russian law does not consider such stock 'treasury' ones, it allows to vote with them. The alleged takeover attempt in April 2003 resulted (as the management's protective reaction) in the rise of the management's stake (up to nearly 75%) and the decision to transform Surgutneftegaz oil company from OAO into OOO. As a result, the largest shareholder of OAO Surgutnetegaz (i.e. its daughter oil company Surgutneftegaz) frees itself from FSC's control and from the obligation to disclose information mandatory for a publicly traded company.

To assess quantitative dynamics of mergers and takeovers in the conditions of the contemporary Russia regardless of stages of economic growth, one should take into account the impact of such factors as the post-privatization property redistribution and the expansion of

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<sup>11</sup> Yet in the very early 2000s one of the biggest Russian entrepreneurs noted in a private conversation that as soon as there emerged a real business interest in the machine-engineering sector (as well as other sectors that did not reach an adequate level of investment attractiveness at the time), Mr. Bendukidze would be 'eaten up' in a wink.



large groups. *The latter factor has grown less significant nonetheless.* The ‘contribution’ of the largest groups to the intensification of the domestic merger and takeover process in 2003 became less considerable due to both the intensification of reorganization processes within the groups and their growing expansion overseas. The major reason for the intensification of the note process became vigorous operations by economic agents of the second echelon, large- and medium-size companies that possess resources necessary for expansion of their business through taking over smaller-size firms.

#### 4.2.2. *Forms of integration and management models*

The period between 2002-2003 witnessed an increasingly obvious process of the further transformation of a number of the largest Russian groups: more specifically, they evolved from multi-sectoral holdings and conglomerates (de-facto analogues to the Korean chaebols) characteristic of the 1990s towards more manageable and better structured forms of corporate groups.

To the greatest extent that appears characteristic of the groups whose ‘nucleuses’ emerged yet between the 90s through the early 2000s and which have already passed through the stage of ‘primary’ reorganization in various forms, be that sales of non-profile assets (production), separation of specialized sub-holdings (along with consolidation of the respective assets), optimization of governance system (particularly for the sake of establishing a maximum stringent control by management, among others), and reaching a certain level of transparency and attaining the status of a publicly traded company.

In conjunction with this, it is necessary to consider some specifics of formation of large corporate groups in Russia *in the context of integration processes*. Formally, from the perspective of types of integration, the history of emergence of corporate groups there arose (in a certain proportion) both conglomerate and vertical and horizontal kinds of integration<sup>12</sup>.

It is widely known that the process of vertical integration (oil, gas, chemicals, metallurgy) ensures concentration of mining and processing production. It appears most characteristic of the sectors with a considerable number of technical property redistribution and enables one to maximize the given group’s proceeds thanks to control of the whole chain that produces value-added (particularly with the account of specifics of ‘optimization’ of taxes and financial flows within the group). The process of vertical integration has proved to be especially advantageous in Russia particularly due to the property redistribution process. An interception of control over supplier or consumer means the halt of a vertically integrated chain as a whole (in this respect coal mines and ore mining and processing plants represent most notable examples).

Among typical examples of the process there are major oil companies, the groups emerged in the non-ferrous metallurgy (Rusal, SUAL, UGMK), some holdings in the ferrous metallurgy (Severstal, Mechel). The rise in interest in electric companies’ stock in 2003 is associated primarily with vertically integrated groups’ (primarily with the metallurgic ‘nucleus’) to seize control over energy facilities in the frame of the process of RAO UES restructuring.

It should be noted though that even the most ‘advance’ vertically integrated companies do not at all strictly match the definition. First, many of them were conglomerates by their

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<sup>12</sup> see also: Radygin A.D., Entov R.M., Shmeleva N.A. *Poblemy sliyanij i pogloschenij v korporativnom sektore*. M., IEPP, 2002; Avdasheva S.B. *Khozyastvennyye svyazi v rossiyskoy promyshlennosti*. M., GU-VSHE, 2000; Matytsyn A.K. *Vertikalnaya integratsiya: teoria i praktika*. M., Novy vek, 2002

origin, and the transformation has not been complete as yet. In addition, in the early 2000s some groups based upon mining sectors (especially with account of the volume of export proceeds) showed their interest in profitable subsectors of the industrial sector, agri-food complex and trade that were not technologically associated with their profiles.

Finally, mining companies believe that conglomerate investment (investing in non-profile assets) bear an important advantage, that is, the possibility of price adjustment. For example, Norilsky Nickel acquired gold mines because the holding's principal business, which is production of platinoids, is dependent on considerable international price fluctuations, while such fluctuations for gold prices are not so considerable and they are in antiphase vis-à-vis prices for platinum<sup>13</sup>. In other words, as far as Russian groups that provisionally are called vertically integrated companies are concerned, *under current circumstances it would be more accurate to refer to mixed forms of integration that combine vertical and conglomerate forms.*

Another specific feature of most of the largest groups is their dependence on the sectoral 'nucleus'. This is the effect of two opposite processes. On the one hand, that is the transformation of the conglomerates with the banking origin of the 1990s into groups based on 1-2 enterprises in 1-2 sectors. On the other hand, that is an expansion of originally large monosectoral companies of the real sector into technologically close and other sectors.

Accordingly, *a classical conglomerate does not represent a typical phenomenon for the Russian practice of the 2000s-* on the contrary, it is the trend to lowering the level of diversification that appears more characteristic of that. The structures emerged in the frame of such groups as MDM, Mezhprombank, some groups in the mining sector are closest to this particular form of integration.

As concerns horizontal integration, it bears certain advantages, such as saving production and sales costs, and reduction in tax payments. Typical examples of this kind of integration include some machine-engineering holdings (for example, the a.m. Silovye Machinery), breweries, confectionery holdings, Evropeyskaya Podshipnikovaya Korporatsia, among others. The current level of capital concentration in concrete sectors primarily determines prospects for this type of integration in Russian economy.

In some sectors, this process is close to its scope (the non-ferrous and ferrous metallurgy, coal, oil). That is why horizontal integration processes are practically over<sup>14</sup> in the frame of the largest national groups that control the mining sectors. Notwithstanding, the 2003 TNK-BP deal can be considered as horizontal one, while new horizontal alliances are possible in the metallurgical sector. The respective prospects are promising in such sectors as food-processing, wood-working, in the agri-food complex, in certain segments of the machine-engineering sector, in the banking sector, MIC, and civil aviation<sup>15</sup>. Certain opportunities may

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<sup>13</sup> See: Ivanova A. Pogloschenia: za i protiv.-Finans, 2003, # 35, p.20

<sup>14</sup> According to some data, in the early 2000s 8 largest Russian groups already were in control of 85% of proceeds of 64 largest Russian private companies (Boone P., Rodionov D. Rent Seeking in Russia and CIS. Brunswick UBS Warburg, 2002). The 'investment activity' (i.e. merger and acquisition processes, as the RF Ministry for Anti-Monopoly Policy and Entrepreneurship puts it) on the markets for oil, petroleum derivatives, coal, ferrous and non-ferrous metallurgy) is still on a high level, nonetheless. At the same time, the largest mining groups are keen to get control particularly over non-profile processing sectors (housing and utilities, the agrarian sector, fishery, to name a few)

<sup>15</sup> For example, as of 2002, there were some 300 air companies in Russia, of which some operated just 1 plane. At the same time 4 largest air companies serviced up to 80% of passengers (Sliyania I pogloschenia.- Zhurnal dlya aktsionerov, 2002, #6, p. 13-16).



be also open in the process of privatizing generating capacities in the electricity sector, daughter companies of RAO Russian railways, and unitary enterprises. An expansion of a group's role through taking over regional enterprises of analogous profile is a characteristic process.

As *Table 5* shows, in quantitative terms, horizontal deals remained prevalent in 2003, while conglomerate mergers and takeovers accounted for 10-15% in the aggregate volume of deals and a 20-25% in the total amount of deals. Nevertheless, according to the RF MAP, as of early 2004, it is the processes of establishing multiprofile structures and vertical integration, including formation of large vertically integrated companies that appear most large-scale processes on commodity markets. Notably, the large vertically integrated companies are keen to establish control over the enterprises that ensure the whole technological cycle of production and consequent sales of produce. These processes determine the rise in the aggregate economic concentration.

*Table 5*

**Mergers and Takeovers by Their Kinds, January to September 2003, as %**

	<b>Conglomerate</b>	<b>Vertical</b>	<b>Horizontal</b>
Proportion in the aggregate volume of deals less the oil sector	10-15	20-25	65-70
Proportion in the aggregate volume of deals	20-25	25-30	50-55

Source: M&A Appraisal.

In addition, between 2002-03 the largest groups were increasingly demonstrating *diversification of governance models*<sup>16</sup>. Typically, there are three corporate governance models:

- financial (the possibility of a broad diversification of businesses, purely investment functions, non-interference with business units' production activity, approval major business units' budgets and investment programs, high return rates on invested capital serving as a main criterion of their matching the group's profile);
- operational (mono business, directive and functional management of operations);
- strategic planning and control variants (the existence of a business nucleus, non-interference with operational performance, functions of identification of a corporate strategy, subordination of financial operations to strategic goals, development of the business nucleus and other business units that ensure an aggregate synergy effect as a main criterion of matching the group's profile).

Most of large Russian groups evidently so far find themselves at the stage of emergence or growth, and only a very narrow circle of the largest groups that have already entered the stage of stabilization of their property and governance structure consciously arrived to opting for one model or another. While at the stage of the outset and growth of the largest groups (conglomerates) in the 1990s to early 2000s the head (governing) company of a group (holding) focused on establishment and maintenance of control as its major function, currently

<sup>16</sup> See: Chandler A.D. *Funktsii shtab-kvartiry v mnogoprofilnoy firme.*- Rossiysky zhurnal menegmenta, 2003, #1, p. 91-122; Goold M., Campbell A. *Strategies and Styles: The Role of the Center in Diversified Corporations.* Basil Blackwell, Oxford, 1987. On specifics of the noted processes in Russia, see, for example: Ovanesov A. *Rossiyskie holdingi vybirayut modeli pozitsionirovania;* Kuzmichev A. *Kazhdomy-svoe.-Upravlenie kompaniy,* 2003, #11, p. 4-9; Frumkin K. *Etapy korporativnoy burokratizatsii.*- Finansovaya Rossia, 2002, # 24, p.13; Butrin D. *Kompanii nabirayut ves. Professionalnye deliteli sobstvennosti.*-Kommersant, 2002, 3 December, p.20.



they gradually think over the central structure's (managing company in a broad sense) functions. This is related particularly to the need in optimization of the general governance system within the corporation to enhance economic efficiency and increase the value of the business. In this sense, in particular, the transition to single share was necessitated by the fact that otherwise it would be impossible to increase the holding's capitalization<sup>17</sup>. Without that 'holding is tables, chairs and financial flows', while its daughted companies' stock would remain costly assets (for minority holders inside the company are just owners, not investors).

Severstal Group, OMZ (in all likelihood, prior to its 2003 deal with Interross), and a number of the largest oil companies have opted for pure strategies of developing their *business-nucleuses*. The transformation of a number of mother (holding) structures into *mutual funds* appears characteristic of such groups as Alfa (that develops private equity funds), Interross ('private investment company'), Bazovy Element (managing company for private equity funds'), R. Abbramovich's group (Millhouse Capital), among others. While characteristic features of chabol-type structures are inner capital flows, enforced production ties, lack of transparency of business operations, and discrimination of minority stockholders, an efficient activity of a fund becomes possible under other conditions and constraints<sup>18</sup>. In particular, a notably different feature of the fund's operations becomes the need to take into account regulations effective for publicly traded companies set by international stock exchanges, which does not always enables its managers and large stockholders to pass fully comfortable for them rulings. At the same time, the financial governance model which was especially popular in the world in the 1960s to 1990s suggests closeness, personification and a high level of political connections.

As in the case of assessing forms of integration, the above classification appears fairly relative, nonetheless. As it was shown above, due to various reasons, some largest Russian groups in the 2000s arrived to the 'business nucleus' (strategic planning) model, however at the same time positioning themselves as mutual funds (financial model).

Equally, many largest groups retain elements of the *operational governance* model. On the one hand, indeed, there takes place the process of granting business units a considerable autonomy in the operational area and with respect to creating value. On the other hand, the problems of a rigid and regular governance control over the business units' management by the head structure is still there (especially at the stage of the group's growth).

As a result, regardless of the selected governance model within the group by today there have emerged *standards of organization of operational control* in the largest companies (groups). There are two characteristic features of the standards:

- an ultimate bureaucratization of their bottom and medium-rank links (detailed regulations, standartization and formalization in the decision making process, especially in the financial area, sophisticated conciliation procedures, etc.);
- making critically important decisions by principal partners (stockholders) and top management on-line, without any 'excessive' procedures.

Practices of 200-03 introduced just a sole substantial nuance to this system. While between the 1990s- early 2000s key decisions were made basing on the 'partnership' principle,

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<sup>17</sup> Tuzhilin A. Sozdanie v gruppe kompaniy systemy zaschity ot vrazhdebnykh deistviy konkurentov.-In: Rynok tsennykh bumag, 2001, # 11, p.21

<sup>18</sup> See: Interview with K. Bendukidze.-Vedomosti, 2004, 5 February, p. 5 A.



i.,e. within a circle of actual partners that fully controlled their business group, without paying attention to minority shareholders' stance, the appearance of actual external outsider shareholders, as a rule, foreigners, with a 3-4% stake, in some largest Russian companies creates objective conditions for the emergence of another strategic decision making mechanism. That is, a really 'corporate' mechanism, as the respective decisions have to be passed with account of such outsiders' opinion.

Obviously the partners themselves initiate the appearance of such stockholders, and they are not the mass privatization outcome, nor they are an intermediary result of a corporate takeover. In a certain sense, one can speak of *the appearance of a new type of outsiders in the national corporate governance system*. The development of this particular trend is immediately associated with Russian groups' reorganization and governance strategies.

#### **4.2.3. Mergers and takeovers in the context of government regulation. *The problem of hostile takeovers.***

General trends of merger and takeover dynamics are proved by the data on the dynamics of the respective applications submitted to the RF MAP (*Table 6*). The aggregate number of application submitted to the Ministry following Art. 17 and 18 of RSFSR law # 948-1 of March 22, 1991 'On competition and restricting monopolistic activity on commodity markets' has been rising recently. Interestingly, these applications increasingly concern Art. 18.

In 2002 the number of notifications that concerned Art. 18 (9,461) could be compared with the number of applications that referred to the same Article (10, 918). At the same time, according to RF MAP, in 2002-2003 nearly half of such deals (following Art. 18) was associated with an acquisition of stock (shares) in authorized capitals of economic agents operating on different commodity markets, thus not competing with each other. So Art. 18 was 'tuned' at an excessive rigidity in terms of the need of using the permissive order. As a result, a considerable part of economic agents are keen to avoid seeking conciliation with respect to Art. 17 and 18. The number of the respective breaches exposed only by the RF MAP totaled some 4,000 in 2000 and over 5,000 in 2001 (while in reality the number is much greater). The increment in such breaches has been dangerously high<sup>19</sup>. The problem of 'bureaucratization of the breaches' (as the head of MAP, Mr. I. Yuzhanov put it at his press-conference on December 25, 2003) in the areas of anti-monopoly law, i.e. the growing participation of civil servants in anti-competition agreements is equally pressing.

Analyzed separately, the structure of applications (notifications aside) shows that the main retained their significance (*Table 7*). Between 2002-03 the applications on stock acquisition (Art.18) accounted for over 70% of the structure of applications considered by MAP, while the respective share of applications on a merger or takeover did not exceed 5%. This does not mean at all that the MAP data contradict the aforementioned statistics on mergers and takeovers in Russia. On the contrary, though the MAP statistics does not allow to single out takeovers a separate item (as there is no such concept in the Russian law), it testifies to a growing magnitude of the noted process, especially considering that fairly large stock packages (starting from 20%) are on stake..

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<sup>19</sup> Simachev V.Yu. O sovershenstvovanii antimonopolnogo regulirovania primenitelno k integratsionnym protsesam v promyashlennosti. Mimeo, 2003

*Table 6*

**Dynamics of the number of considered notifications and applications  
that referred to Art. 17 and 18 of the law ‘On competition...’\***

	The number of notifications and applications		The proportional weight in the aggregate number of applications referring to Art. 17 and 18, as %	
	Ref. To Art. 17	Ref. To Art. 18	Ref. To Art. 17	Ref. To Art. 18
1998	2485	4417	36,0	64,0
1999	2936	7315	28,6	71,4
2000	3882	12092	24,3	75,7
2001 г.	4827	16165	23,0	77,0
2002	4371	19659	18,2	81,8

\*RF Law # 948-1 of March 22, 1991 ‘On competition and restricting monopolistic activity on commodity markets’ sets the government control over establishment, reorganization and liquidation of commercial entities and their amalgamations (Art. 17) and over compliance with the anti-monopoly law in the course of acquisition of stock (shares) in commercial structures’ authorized capital (Art. 18).

Source: the data of the RF MAP.

*Table 7*

**The structure of applications considered by MAP in 2002-03**

Types of applications	2002		2003	
	Quantity	proportion, as %	Quantity	proportion, as %
Stock (share) acquisition	7813	71,1	8880	71,0
Acquisition of major production means or non-material assets	1901	17,3	2144	17,1
Merger and takeover of commercial structures	500	4,6	539	4,3
Others	763	7	951	7,6
Total	10 977	100	12 514	100

Source: the RF MAP data, authors’ calculations

The problem is, the term ‘reorganization’ used in the Civil Code of RF (Art. 57) concerns only the legal aspects of enterprises’ activity in the part of the regulation of possible intermediate transformations of legal entities in the range between their creation and liquidation (though conceptually including the latter, for reorganization is also a way of both termination and appearance of new legal entities). The legally set forms of reorganization are limited with the following list: merger, takeover (interpreted as ‘joining’-*transl.*), division, separation, transformation, while the law does not specify any definition of reorganization themselves. It should also be noted that the forms of reorganization of a legal entity stipulated in the Civil Code of RF do not mirror the whole variety of economic forms of restructuring. At the same time, differing from each other by economic motivation and the resulting property structure, the economic forms of restructuring (for instance, the split of a company into independent or mother and daughter companies) often fall under the single form of reorganization of a legal entity<sup>20</sup>.

<sup>20</sup> See, for example: L’vov Yu.A., Rusinov V.M., Saulin A.D., Strakhova O.A. Upravlenie aktsionernym obschestvom v Rossii.M., Novosti, 2000



At the same time, there often happens the situation when being essentially a merger (joining), the transaction is documented as a purchase of stock and assets rather than following requirements to 'reorganization'. This is associated with the parties' eagerness, first, to avoid the procedures needed in the course of reorganization (the respective agreement, sequence of conversion, the transfer endorsement, calling the general shareholder meeting, seeking conciliation with MAP, etc.) and, second, to deprive creditors of the right to insist on an early fulfillment of obligations<sup>21</sup>. The last requirement in the list appears excessive, however its presence in the law forms a serious incentive to search for roundabouts while striking such deals. Another objective motive is to retain the existing company with a stock exchange, credit and 'accounting' (especially by international standards) record, while a merger would demand establishment of a new company. As *Table 7* shows, the number of applications on stock and assets procurement is roughly 20 times greater than those on merger and takeover. It should also be noted that application on reorganization (merger, takeover, etc.) usually are submitted in the course of enlargement of state unitary enterprises (SUE) in the frame of the sector's recently started reform.

In 2003 there appeared a whole series of optimistic assessments of the existing merger and takeover procedures according to which 'directors increasingly view the idea of amalgamating with other enterprises as one of kinds of business restructuring, one of arsenals of a qualitative improvement of its structure, and one of the means to attract investment'<sup>22</sup>. We believe the reality is still far from such estimates, and though being in presence, there are just very few positive shifts in this area.

Overall, according to the Economic safety Department of the Russian Chamber of Trade and Commerce, three- fourth of the takeovers currently underway are hostile, i.e. with account of the prevailing technique, they suggest buying stock using by means of blackmail, threats or graft, an illegal access to the register of stockholders<sup>23</sup>, etc. An evident economic motivation to use illegal takeover means is the comparison between costs under a 'hostile' (using the noted specific methods) and 'civilized' ways of takeover: given some USD 0.5 mn.-worth costs (roughly as much as the annual proceeds of the target company) for legal services, bribing of officials, judges and marshals, one may receive a USD 5 mn.-worth company.

The most renown examples of 2002-03 are: the struggle between Ilim Pulp and bazovy Element over the Kotlas and Bratsk paper and pulp plants, conflict between Evrazholding and mechel over Korshunovsky mimning and refinery plant, Alfa-Eco's attempts to take over Taganrog metallurgical Plant, conflicts around Krasnoyarsk coal company, Dalvostokugol, Nizhny Novgorod Margarine Plant, Moscow oil refinery, Ust-Ilymsk paper and pulp plant, Stupino Metallurgical Plant, Azot Chemical plant, among others.

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<sup>21</sup> See: Pleshanova O. Slitno I bezrazdelno. Kak obyedinyautsya rossiyskiye kompanii.- Kommersant, 6 February 2004

<sup>22</sup> Efimchuk I. Vzryv sliyaniy.-Finans, 2003, # 35, p.15

<sup>23</sup> Interview of Director of the Department, A. Makarychev.- Commersant, 2004, February 6, 2004. In 2002, of 1,870 takeovers 76% were hostile in the noted context. Clearly, by contrast to the classical definition of hostile takeover which is understood as a legal attempt to obtain control over the target company's economic operations or assets (through a tender offer or acquisition of a stake in the market) in the conditions of resistance on the part of its managers or key participants, in this case there are certain differences. According to some other estimates, in 2002 the proportion of *attempts* to arrange hostile takeovers in their overall number accounted for 85-90% (vs. 65-70% in 2001), however this share was lower (a. 55%), as long as the *actually conducted* takeovers are concerned.

Moreover, the problem of hostile takeovers by means of the so-called administrative resource has become so serious that it even demanded legislators' attention. Thus in May 2003 the State Duma held parliamentary hearings on legislative security of property rights, particularly under hostile takeovers.

The list of recommendations comprises, apart from other provisions, toughening of responsibility for adoption of the respective judicial rulings (which requires amendments to the law on the judicial system), introduction of minority shareholders' responsibility for filing a suit that initiates a hostile takeover, specification of procedures of conducting stockholders meetings and AO's registers (grounds for a transfer of the functions of conduct of the register from one registrar to another, prohibition of a withdrawal or arrest of registers), etc. nevertheless, even should the noted amendments be introduced, the problem would not be less pressing as long as there are economic (different costs of different methods of establishment of control) and institutional (system corruption) prerequisites.

In parallel with that on the threshold of 2002-03 the government re-galvanized its efforts to change the law in the area of mergers and takeovers in the frame of the anti-monopoly law as a whole.

It is known that at present merger and takeover deals of the companies whose aggregate assets are in excess of 200,000 Minimal Wages Rates (MWR) require a preliminary conciliation with the RF MAP. Equally, the same requirement is effective with respect to a deal that involves an acquisition of over 20% of a company stock. According to MAP, the envisaged innovations should allow to get 85% of such transactions out of the anti-monopoly agencies' control.

In late January 2004 the RF Government approved a bill<sup>24</sup> that suggests an increase up to Rb. 3 bn. (150-fold) threshold values of the balance-sheet value of aggregate assets of the companies whose merger requires a preliminary conciliation<sup>25</sup>. Transactions involving participants' assets ranging between Rb. 200 mn. to 3 bn. should imply the respective notification and an anti-monopoly's agency right to prohibit the deal within 3 months. As concerns transactions with the value up to 200 mn. Rb., they should involve submission of the respective notification, i.e. the threshold should be increased 20 times.

At the same time, the bill suggests to lift a number of limitations on the amount of the stake procured. In the event the share amounts to over 25%, the control should be exercised in full, up to 20% - there should not be any control, while between 20 to 25% - the control should be simplified. Should there be any increase in the stake of the already existing stockholder in a company's capital from 50% plus 1 share to 65% or over 75% plus 1 share, only a notification should be needed. The appropriateness of the preliminary approval of deals should be effective only for the cases when the change of the structure of the equity capital would result in shifts in the balance of forces on one or another commodity market. Thus the bill maintains *prevalence of the anti-monopoly approach in the area of the monitoring of economic concentration and property structure*, which notably limits the value of these innovations.

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<sup>24</sup> The change in threshold values is considered an intermediate measure to be effective until the adoption of a new federal law 'On development of competition on commodity markets'

<sup>25</sup> With reference to Materials for the Government Meeting of 22 January 2004 'On changing the procedures of the government control under merger and takeover of economic agents', materials posted on the RF MAP's official Homepage and on a Homepage on corporate governance ([www.lin.ru](http://www.lin.ru))



In addition, any monitoring of the respective deals, as a rule, encounters a typical property structure of large Russian companies that have already mastered the skill of avoiding the respective MAP's limitations by means of a group of formally independent stockholders or some other more sophisticated schemes.

According to the MAP experts, in order to enhance the openness of the national economy and to ensure repatriation of investment, the new law should suggest transition from the preliminary control to the notification regime for all the cases when a deal is made within the same group of individuals (providing the composition of the group would not change as a result of the deal). At the same time one should introduce by law the obligation of disclosure of information of actual beneficiaries participating in deals performed by offshore companies.

The latter mission also *goes far beyond the anti-monopoly regulation framework and, apart from new legal concepts, it requires a whole complex of measures.*

It is large Russian companies and groups that became main initiators of the transition towards the notification regime. The noted decisions most likely appeared a certain compromise to the RF MAP – likewise any agency that finds itself in the administrative reform process, the Ministry perceives the loss of a significant number of objects to exercise its licensing powers on them as the loss of its departmental dignity. As an asymmetric compensation, the anti-monopoly law reform schedule for 2004 may envisage both toughening of penalties for abusing the respective law and a modification of the RF MAP's functions (adding new, particularly supervising, along with liquidation of a number of existing ones).

Traditionally, protection of rights of various kinds of stockholders under mergers and takeovers occupies a significant part in the developed nations' law. Such a protection can be exercised in different directions:

- general regulation of merger and takeover regulations (according to specifics of forms as per the given national legal system);
- general mechanisms of protection of minority stockholders' rights under takeover (public offer, the right for decision making, 'fair price', etc.);
- protection of rights of minority shareholders that object to reorganization;
- conditions under which an entity that has set a certain threshold of control in the process of takeover has a right to complete the consolidation (cancellation of protective mechanisms, buying the remaining stock, etc.);
- requirements to information disclosure with respect to the merger or takeover process;
- ensuring transparency of the property structure and changes in that;
- provisions that regulate specifics of an issuance or conversion of securities;
- control on the part of regulatory agencies and self-regulating organizations;
- judicial practice of solving disputes that arise in the process of merger or takeover.

In Russia. One of nuances is that the monitoring of large deals on acquisition of the stock (and, accordingly, on a large participation in equity capital) with low efficiency is carried out for the sake of anti-monopoly regulation. At the same time, such a monitoring (transparency of participation systems) appears no less important to prevent causing harm to various groups of already existing stockholders. While the protection of various kinds of stockholders under takeover is fundamentally important, the minimal provisions of the national law that regulate this particular issue are stipulated only in Art. 75 and 80 of the law on AO. It is equally important that regulation of takeovers, as per Art. 80 of the law on AO, concerns solely OAOs with the number of stockholders- owners of equities outnumbering 1,000.

The decision can be only complex, which suggests the following innovations:

- it is necessary to set a legal definition of the single list of categories of entities whose rights should be guaranteed in the event the company is restructured (as an amendment to the Civil Code of RF or as a section of a special act on reorganization);
- it is equally necessary to develop and specify legal tools that should secure protection of minority stockholders' rights under takeover (public offer, the right for decision making, 'fair price', etc.);
- protection of rights of the minority shareholders who object to the reorganization;
- identification of the conditions under which the entity that has established a certain threshold of control in the process of takeover has a right to complete the consolidation regardless of managers and the minority shareholders' resistance (cancellation of protective mechanisms, acquisition of the remaining stock, etc.);
- introduction of a series of procedures with respect to conversion of equities shares) that should exclude the possibility of dilution, supplanting and other means of abusing the possibility for large participants to dictate conditions of the reorganization;
- development of the legal regulation of transactions that involve debt instruments (at present there exists a possibility of lowering the value of the deal on acquiring control through buying debt instruments while remaining 'incognito');
- development of standards (requirements) of information disclosure of the merger or takeover procedure;
- arranging for an optimal transparency level of the property structure and changes in that;
- promotion of improvement of the provisions that regulate specifics of securities issuance and conversion;
- changes in the law on registrar and depository activities aimed at protecting property rights for stock;
- further specification of principles of taxation of economic operations in the frame of reorganization (the RF law 'On the tax on operations involving securities') with account of concrete strategic tasks of government regulation and the existence of international experiences of encouraging/restricting the noted processes;
- ensuring coordination of the regulatory agencies' activities (consistency of departmental acts, a single control system, etc.);
- ensuring 'transparency' of judicial practices and responsibility of judicial ruling while solving disputes that arise in the course of mergers and takeovers.

#### **4.3. 2000-2004: Towards 'State Capitalism'?**

The trend to intensification of the state control in the economy (the corporate sector) noted yet in 2000-01<sup>26</sup> manifested itself more clearly by 2004.

##### **4.3.1. Expansion of the State and Building 'the Centers of Power': the First Steps**

It was already the year 2000 that witnessed a characteristic trend to extension of the state – owned structures and consolidation of the government-owned stakes under the aegis of holdings: the notable examples in this respect were: the start of the consolidation process of Rosneft's daughter companies, concerns Antey and Almaz in the MIC sector, alcohol holding

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<sup>26</sup> See: Russian Economy in 2000. M., IET, 2001; Russian Economy in 2001, M., IET, 2002



Rosspirtprom 989 enterprises), consolidation of all the structures dealing with production and sales of nuclear fuel into a single corporation, unification of all the nuclear power plants into a single energy generating company on the basis of Rosenergoatom, among others. Similarly, the 2000 shareholder meetings at RAO Gasprom, RAO UES, Aeroflot, and in a number of other big companies demonstrated that the federal center was keen to tighten its control through corporate structures (Boards of Directors).

Clearly, the strengthening of the government control by means of forming large holdings and expansion of the government representation in the existing companies is associated with a whole series of objective factors: the need in technological integration, creation of larger, from the perspective of international competitiveness, structures, a growing pressure on enterprises for the sake of increasing payments to the budget. One can suggest that the government followed its strategic task that had been implicitly formulated yet in 2000, that is, the maintenance (fostering), at least, one government-owned 'center of power' in every key sector, and such centers should be constructed out of fragments remained in the government ownership (SUE and stock packages).

At the same time, such a policy faces a whole range of objective constraints: 1) the efficiency of the current state property management system, including the problem of corruption and bureaucrats' 'rent'; 2) a limited number of state assets that enable to build actually controlled holdings; 3) the need in some case to make decision that investors attribute to the systemic risk area (for instance, deprivatization); 4) domestic and external political factors. This notwithstanding, decisions on a mechanical consolidation and merger of government assets seem most attractive and simplest (when compared, for instance, with such an alternative as trust).

It became evident by 2000 that the concept of mechanical building large government structures (basing on the remaining assets) could lead to rather negative consequences. The most illustrative example in this respect is Rosspirtprom holding where in addition to constant inner corporate scandals (between the mother and daughter structures) there arose evident problems related to managers' opportunist behavior. The 'fine-tuning' of the newly created structures required the government's involvement. In compliance with governmental order # 1512-p of October 29, 2002 On introduction of amendments to the Charter of the federal state unitary enterprise 'Rosspirtprom', the holding was deprived of the right to obtain credits by its own as well as to include in the shareholder meetings' agenda such issues as elections to the boards and executive bodies of the AO whose stock were assigned to the SUE's authorized capital, and to terminate the powers of management of its daughter companies. These powers now can be exercised only upon the government's consent and the latter will be recommending to the shareholder meetings of the noted AO's the amount of dividends and to make decisions on amending their charters and authorized capital. As concerns appointing general directors of branch structures, deputies to the Director General and Chief Accounting Officer of the holding itself, this will be coordinated with the RF Ministry of Agriculture. Prior to the noted measures, the holding had been limited with respect to placing additional issuances or conversion of its stock into obligations. The government cited the need in reducing the number of deliberate bankruptcies of enterprises of the alcoholic sector as the main being such a move.

As far as property relations are concerned, the state-owned Rosneft still lags far behind its private rivals. While the latter practically completed the processes of consolidation of their daughter companies and the transition to single share between the late 1990s- early 2000s, the



consolidation process in Rosneft was far from completion even in late 2003. One of the problems in this respect is the property structure in its daughter companies, where Rosneft owns 51% of single voting stock that accounts for only 38% of their authorized capital (in case of failure to pay dividends on privileged shares, Rosneft consequently would lose control, which already occurred in 1997). Rosneft's evident final goal is to get qualified control over its daughter companies with a consequent transition to single share. It is yet more a pressing task for the company, if one recalls its conflicts with minority stockholders in 2002-2003 concerning transfer pricing in the holding (which does not raise any legal enforcement agencies' concerns, nonetheless).

Equally, the concept of the MIC consolidation has rather a long record full of conflicts. Following the Federal Targeted Program approved in October 2001 'Reforming and development of the military-industrial complex', the institutional reform of MIC to be implemented between 2002-06 should result in establishing of 74 state-controlled large holdings and concerns on the basis of some 400 enterprises of the sector. The number of such holdings should have been reduced to 42 in 2002. By late 2003 in reality there existed 3 such integrated structures ('Sukhoi', 'Almaz-Antey' and 'Tactical Missile Arms') while another 2 concerns were at the final stage ('Avionika' on the basis of research and production center 'technocomplex', and 'Optical and electronic instrument-making and optical technologies'. According to a program approved by the RF Government in May 2002, by 2004 there should be 5 integrated structures in the aircraft industry, including two multi-profile holdings that should produce both military and civil product (the transition to single share of VASO, 'Ilyushin' and the Aviation Complex named after Ilyushin and creation of a holding OAO 'Ilyushin Corporation' with the 51% government participation in it; creation of the 'Tupolev Corporation'. It is envisaged to adjust the program in 2004, most likely, with the emphasis on further consolidation of the existing structures. More specifically, in February 2004 Vice Premier B. Aleshin stated the possibility of creating of a national aviation corporation that would unite all Russia's aircraft-building capacities, which also suggests consolidation of state-owned and private assets.

The self-assertion of the new power in the early 2000s was accompanied (perhaps, with the involvement an element of general government and/or private/ departmental economic financial interests) by tough actions by government (primarily tax) authorities against oil company LUKoil, TNK, OAO 'AvtoVAZ', RAO 'gasprom', RAO 'Norilsky Nickel', among others. However, such actions, particularly those undertaken in 2001 by the Federal Tax Police against LUKoil, by the Accounting Chamber against TNK and the Prosecutor General's Office against Sibneft and Norilsky Nickel, accompanied by searches and instituting legal proceedings resulted practically in nothing, 'with no evidence of *corpus delicti*'.

One can agree that development and *accomplishment* of the proceedings associated with tax crime appear one of the very few efficient means of the government influence on corporations and their principals (beneficiaries). There arise only three fundamental comments. First, it is necessary to promote the tax reform, i.e. elimination of objective economic causes for most of tax crimes. Second, one should ensure a legal purity of the enforcement means applied and the trustworthiness of facts needed to start legal proceedings. Third, and this is a key issue, actual final objectives of initiators of the *selective* proceedings against the *systemic* nature of the noted abuses of the law remain unclear.

The federal center has been increasingly active with interfering with property collisions in the regions via the presidential envoys in the federal *okrugs*. For example, having cited in-



efficiency of state property management in the Federation Subjects of the Ural federal *okrug* and poor profitability of 50% of state unitary enterprises there, in 2001 the presidential envoy proposed to substantially restrict the respective regional administrations' powers. In particular it was proposed to deprive the regional executive agencies of territorial functions of the Ministry for State Property, to tighten requirements to government representatives in AO, to introduce legal standards on withdrawing 'excessive' real estate out of their operative control and to introduce professional trust with respect to government stock packages and to substitute the representatives of regional administrations in the respective registers for representatives of the Ministry for State property.

For example, in 2001, to solve a conflict around AO Karabashsky Copper Refining Plant-ZAO Karabashmed, the office of the presidential envoy in the Ural region proposed to assign a part of stock to the federal government.

Equally illustrative appeared the situation in Bashkortostan in 2002-2003, which was associated with the re-election of the Republic's Head. In all likelihood, the transfer of the largest local holdings- Bashneft and Bashneftekhim under the federal government's ownership became a key condition for President Rakhimov's successful re-election. This testifies particularly to the federal center's eagerness to obtain control over 'family' regional groups that have not experienced such a persistent pressure from the center before.

In 2001-02 the federal executive power was increasingly- and regardless of motives- expanding its economic influence. This particular process was carried out in a number of mutually related areas:

- management reshuffles in the largest natural monopolies and strategic companies with the governmental participation (Gasprom, the Ministry of railroad Transportation, MIC, Minatom, daughter companies of Rosspirtprom, the State investment Corporation, among others.)<sup>27</sup>;
- the continuation of reorganization processes (primarily takeovers) of the existing and creation of new holding companies in the strategic sectors (the consolidation of regional communication monopolies into 7 inter-regional companies of Svyazinvest holding in the frame of 7 federal okrugs, etc.);
- the return of the earlier stripped-off (privatized, pledged) assets (ex-assets of Gasprom-enterprises of SIBUR, Itera group, etc., pledged stock of OAO Novorossiysk Sea Steamship and North-Western Steamship, etc.);
- putting single segments of the state property under the presidential Administration's control (yet back in 2000, an establishment of a federal public enterprise to manage Russia's overseas property, among others)<sup>28</sup>;

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<sup>27</sup> Management changes in RAO Gasprom (Mr. Vyakhirev's resignation in May 2001, the change of the financial management, institution of legal proceedings with respect to exceeding managerial commissions in January 2002, etc.) and the Ministry of railway Transportation (the institution of legal proceedings on ex-Minister N. Axenenko's exceeding his commissions and his subsequent resignation in January 2002). The personnel changes were likely to be sufficient in the frame of the gas sector 'restructuring'

<sup>28</sup> According to the Accounting Chamber of RF (as of January 2004) the state register contained only 3% of the federal overseas property worth a total of USD 21 mn. The RF Ministry of State Property believes that furthering the work on inventorying the federal objects overseas encounters the major obstacle, that is, the unavailability of the main mass of departmental information. Nonetheless, according to some estimates, yet in 1996 such objects made up 1, 500, in 1998- a. 2,5000 (with estimates of their aggregate value ranging between USD 3 to 400 bn.). The attempts to boost the profitability of their use faces the main challenge, that is, both the non-transparency of

- attempts to revise the provisions on assigning levels of ownership and the federal government's share in a company's capital (for instance, ALROSA);
- establishing control over major financial flows and their concentration in state-owned banks. The de-facto nationalization of the financial flows is used as a substitution for de-privatization of industrial assets. As Sberbank and Vneshtorgbank have an access to the greatest and cheapest financial resources, that is, the population's savings and the bank of Russia's funds, they can credit industrial enterprises intensively<sup>29</sup>. In this respect, the discussion on privatization of Vneshtorgbank in 2001-02 is especially illustrative;
- an intense political struggle of 2000-02 around reorganization of the largest natural monopolists (RAO UES Russia, Gazprom, and the Ministry of railway Transportation).

In 2003, the radical reform of RAO Gazprom was considered inappropriate on the highest level of the government, while in the MRT restructuring program framework that the government approved in summer 2001 and which was consequently approved by the legislature, there emerged OAO 'Russian Railways' (interestingly, such a project had existed back in 1993) to which economic management functions in the sector were assigned. Russian Railways currently comprises 987 enterprises of 2,046 earlier falling under the MRT's control, including 17 railways. With its authorized capital amounting to Rb. 1.5 trln., the company has become the biggest enterprise in Russia. It is envisaged that between 2004 through 2006 its daughter companies should be separated as its competitors, with their subsequent partial privatization. Accordingly, the actual effect from the noted measures (so far, the formal 'incorporation' of MRT) may become possible in the long run only.

The outcome of the first stage of the electricity sector reform (2001- early 2003) show that RAO UES Russia has become the most advanced monopolist in terms of the inner corporate transformation (namely, the creation of a network company and a system operator) and in preparation for a partial price liberalization (the creation of a trade system administrator). It was the management of the holding's head company that formed the major force in the course of arranging and implementing the first stage of the reform. The half-year delay with the adoption of the respective law has showed the complexity of mobilizing consensus on other issues of the reform agenda<sup>30</sup>.

The laws passed in March 2003 enable one to carry out a full-scale reform in the electricity sector, which includes: (1) vertical division of companies with their consequent horizontal consolidation and, possibly, privatization); (2) a regulated access to networks and the public property in the infrastructure segment; (3) price liberalization both on wholesale and retail markets; (4) the electricity stock trade mechanism and direct contracts to be concluded on the wholesale market; (5) regulated guaranteeing sales companies that undertake to provide their services upon client's request. One should acknowledge provisions of the already passed acts that concern an intensification of antitrust regulation in the electricity

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the current policy towards the use of the overseas property (which has fallen under the presidential Administration's purview since 2000) and the absence of legal regulation (for instance, the impossibility of a legal commercial use of the objects that enjoy diplomatic immunity).

<sup>29</sup> see: Grigoryev A. Dvenadtsat s polovinoi.-Kompania, 2002, 14 January, #1, p.21. In this respect it is interesting to draw an indirect analogy – with an opposite sign and under the new conditions- to the scheme of privatization of financial flows without privatizing the enterprise itself that has been popular since the early 1990s.

<sup>30</sup> see: Pogrebnyak E. O khode reformirovaniya elektroenergetiki: ot postanovleniy k zakonu. M., IKSI, 2003 (www.icss.ac.ru)



sector, division of account by types of operations, synchronizing the budget process and price regulation, combining an organized trade and direct contracts on the wholesale market. The identification of the reform deadlines and its substantial parameters falls under the government's purview. The uncertainty factors to be considered at the next stage of the reforms should be lowered upon the government making decisions in the following areas: wholesale market rules, price zone margins, undiscriminated access rules, procedures of guaranteeing suppliers' operations. Notably, property redistribution mechanisms remain among major uncertainty factors.

Most likely the problem of centralization of and control over major financial flows emerged yet in 2003, in the course of the pension reform, the failure of whose first stage was recognized particularly by high-rank officials of the Ministry of Finance and the Ministry of Economic Development and Trade<sup>31</sup>. The non-transparent 'selection' of Vneshekonombank as a manager of public funds, the so-called competition on selection of 55 private management companies, a loose and non-articulated information campaign for the population allow to suggest that the pension reform should have camouflaged an opposite mission, that is, to maximize resources that remained under the government control. According to the RF Ministry of Finance, the managing companies have succeeded to collect up to 1-1.5% of future pensioners' funds (i.e. not from more than 700,000 individuals) vs. 6-10% as it was envisaged at that stage. At the same time, as the market feels the shortage of long-term papers, the Ministry of Finance intends to issue in spring 2004 government bonds with the maturity to date between 10 to 30 years with the fixed yield rate of 10-11% and with a possibility of their early buyback. As it is not intended to have them circulate in the secondary market, there should not be any particular interest in the papers on the part of the private sector.

#### 4.3.2. *Trust managers in the private sector?*

The clear trend to the tightening of the government control through consolidation of economic structures in a certain sense is *ideologically* extrapolated onto *private companies*, too. This is associated with objective constraints for a direct government property expansion, among other reasons.

The establishment of the largest aluminum holding Rossiysky Alluminiy in 2000 was unlikely to be doable without the permission from 'the top'. The latter, however, suggests an a priori absolute transparency (not for the public, but for the state), including that with respect to actual owners (beneficiary owners).

In 2000-01 experts' attention focused on a large-scale process of formation of a conglomerate associated with operations by R. Abramovich, I. Makhmudov, M. Cherny, O. Deripaska, Evrazholding, MDM Group and others. The structure of the conglomerate did not appear particularly distinct, apparently due to the continuous expansion and some specific governance principles. Thus potential sub-holdings whose managers became partners, trusted managers or their former managers that had retained their stakes in the respective equity capital controlled considerable segments of the copper industry, ferrous metallurgy, coal, aluminum and automobile sectors.

With account of the aggregate role played by the noted structures in the national economy, one of the crucial questions became the problem of the level and economic and

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<sup>31</sup> See, for example, proceedings of the International pension Congress (Finans, 2003, #40, 15-21 December 2003)

political justification for the government support to the essentially unchecked expansion of the holding. Obviously, the already accomplished mergers and takeovers (at least, in the frame of sub-holdings) as well as the necessary financial resources (apparently including reinvestment from overseas) could be so significant that could not help becoming subject to the government's permission. Even being formally passive, the government's stance was a certain indicator for assessing its actual view on the further structural transformation of the economy. The collapse of the conglomerate in 2001 was most likely associated both with loosening political ties, the growing wave of *kompromat*, both domestically and from abroad, and with yet more serious conflicts caused by the 'partnership system'. The latter suggests focusing on current short-term gains and, accordingly, there arise problems of conciliation and implementation of a long-term investment strategy.

In the fuel and energy and the banking sectors alike, in all likelihood one can single the 'loyal' companies vis-à-vis other ones. While, for example, Gasprom and Rosneft can be directly considered pro-government (by the share property and their management's loyalty), YUKOS clearly illustrates the other pole (see below).

After the first steps on consolidation of government assets and demonstration of force against private companies, speaking of 2001-2002, one can argue there emerges an *alternative strategic approach* basing on the use of single private companies (groups) as the 'trusted' managers for the federal center in a specific region (for instance, Tyumen) or a sector (for instance, ferrous and non-ferrous metallurgy). The private groups also see their evident benefits that are associated already with the green light for expansion back-upped by the federal center's political support rather than with impunity of implementing trivial 'gray' schemes.

Not only the demonstrative distancing by the President from contacts with the largest financiers and industrialists at that period implied such an approach, but it just emphasized the possibility of replacing a 'trusted manager' if he breached the rules.

With the account of all the benefits of the status, that could not help but put the candidates to 'trusted managers' on their guard. Furthermore, a demonstrative government policy of 'equal distancing' of the large capital from the government (even on the surface) had a direct effect on reorganization processes in the largest private groups.

There first emerged an evident counter trend on the part of the private capital, that is, to secure 'equal distancing' by ensuring a maximum safe distance. That was made particularly by legally arranging an ownership of one's consolidate assets abroad: the creation of TNK International by Alfa Group and Renova, the registration of Millhouse Capital by Abramovich Group, the establishment of an overseas holding of SUAL Group were likely to become the first sign of Russian tycoons' eagerness to ensure the 'safe transparency'.

The protective methods became notably different in 2003. Thus, R. Abramovich opted for sales of a considerable part of his Russia assets (the 25% stake in Rusal, a stake in Aeroflot, in trade, pharmaceuticals, etc.) In 2004 there was a discussion (at least, the media speculated about that) on the sale of his stake in Sibneft to Total, though until the official cancellation of the deal with YUKOS the Russian oil giant was an official holder of the 92% stake in Sibneft.

At this stage, Alfa/Renova partners were likely to opt for an alliance with large Western companies (investors). The TNK/BNP merger and the creation of an international industrial group on the basis of SUAL's assets with the participation of the Fleming Family and Partners



in 1993 became a logic continuation of this particular strategy. As of January 2004, the share of the Fleming Family and Partners in SUAL International (registered at the British Virgin Islands and comprises assets of the participants in the group) reached 23%. That does not exclude further extension of the partners' number (through IPO or strategic deals), i.e. a 'multinationalization' of the aluminum holding.

Another 'line of defense' for the large groups in the early 2000s became ensuring an absolute access to the regional executive power resource (A. Khloponin in Krasnoyarsk krai, R. Abramovich in Chukotka, etc.).

As well, in 2002-04 single groups launched a transition from a direct and clear policy of privatization of the 'administrative resource' to an emphasized loyalty to the federal center and demonstration of big businesses' 'social responsibility'. Some companies concluded agreements on social partnership with regional administrations, while some other initiated an increase of the government share in or a transfer under the government control of their certain assets.

The period between 2003-04 witnessed the growing prevalence of the 'corporate social responsibility' issue (with all the abstractedness of this concept with respect to commercial structures) in the discussion on possible relationship between businesses and the state power. The polarity of the parties has manifested itself (perhaps, deliberately) in the most illuminating way, for instance, in prominent entrepreneurs' large purchases, that is, R. Abramovich's acquisition of Chelsea soccer club (in 2003, for a. USD 300 mn.) and R. Vexelberg's purchase of the Faberge collection from Forbs family (February 2004, a USD 100 mn.-worth deal) for its repatriation.

A whole range of large companies had to prove their loyalty in the frame of legal proceedings that formally fell under economic disputes but had a clear political resonance and as such caused a direct damage to the plaintiff company's reputation (Gasprom-NTV, LUKoil-TV6, among others).

Overall, it can be argued that the period between 2000-03 witnessed the process of division of companies into loyal (trusted and reliable) ones and all others, or into 'etatists' and 'cosmopolitans'. Nevertheless, as the practice has shown, there was a constant interchange between these two groups, and some occurrences of 2003 proved the vulnerability of the situation.

#### **4.3.3. The YUKOS Case.**

The 'property-in-exchange-for-freedom' method was first tested yet in 2002, though the arrest of the top managers of SIBUR in winter 2002 serves an example only by its form, as conceptually the stripping the enterprise off its assets 'in favor of a group of individuals' appeared quite evident. At this point, there is likely to arise another problem, that is, the conflict between the legal area (i.e. essentially legal possibilities for stripping off an enterprise of its assets) and methods of their return (the need in enforcement using various provisions of the Criminal Code of RF due to the absence of any legal perspective on the main issue). The analogous method (instituting criminal proceedings) has also proved to be necessary to ensure reshuffle in the Ministry of Railway Transportation. One can assume this particular method was proposed to the largest stockholders in YUKOS in 2004.

As it is known, the policy towards maintenance of pressure around the company's top managers has been there since June 2003 and reached its apotheosis in autumn 2003 when

Mikhail Khodorkovsky was arrested. That formed the major event of that time. The steps undertaken by General Prosecutor's office both give a rise to innumerable speculations and versions and, as it often happens, keep genuine motives away from the public's eyes.

Purely political versions associated with the start of the political (pre-election) struggle, conflicting parties within the presidential Administration and their financial sources (the remains of the 'family' and YUKOS-Sibneft vs. St. Petersburg *siloviki* – Rosneft), Mr. Khodorkovsky's political ambitions, etc. do not serve a likely explanation, though they might have formed an additional impetus to the solution that involved enforcement means<sup>32</sup>.

To withdraw disputable stock in other companies, that is, a deprivatization of 20% of OAO Apatit or re-assigning of 19% of stock of Enisseyneftegas to Rosneft requires far less forces involved and too strong judicial (providing the court of law's impartiality) perspectives.

Equally, it is hard to regard purely economic motives of property redistribution as dominating ones. The currently available *transparent legal* instruments appear insufficient to ensure a non-market seizure of a share in YUKOS, providing one abstracts from variants that imply personal threats: for instance, amending the trust agreement on establishment of the Special Trust Arrangement (a 50% stake in MENATEP Group) in favor of *other* beneficiaries, a 'voluntary' return of a part of assets to the government or to a subject it entrusts (similar to the MediaMost and SIBUR cases (though the latter is essentially was an absolutely justified case), etc.

In all likelihood, there are all but to little *legal* grounds for a nationalization (deprivatization) of YUKOS or a compulsory, however *legal* alienation of any stock of the company in favor of the government. At least, the arrest of a considerable stock (initially as much as 44.1%) cannot result in its alienation in favor of the state as a legally justified effect. First, some experts believe the arrest have no legal grounds, while its justification with Art. 115 of the Criminal Code of RF raises doubts. Second, there exists a clear possibility the offshore holdings, which are actual *owners* of the stock can bring the respective counter-claims to the British court of law.

As well, tax pretensions to the company that hypothetically can be 'off-set' for a considerable stake need to be grounded more seriously. At the same time, it is quite possible that *by their essence* such pretensions can be fairly grounded and significant. However, first, YUKOS was not alone practicing various tax schemes in 1998-2000 and second, most of 'tax optimization' schemes were perfectly legal in the frame of then existing legal environment. Accordingly, most of accusations in this case can be built only on an *assumption* that the company deliberately minimized tax payments using drawbacks of then existing tax law (or by creating loopholes by means of lobbyism in the Duma), which is recognized worldwide as a standard action by any large commercial company.

Back to the background of the conflict, the context of the case is likely to be more fundamental. The reorganization so vigorously pursued by the largest private groups (holdings) in the 2000s was in many ways ignited by a fundamental dilemma that had emerged by 2001: as 'partnerships' within each group de-facto emerged by that time, it became necessary to make the property and income structure legally clear or, at least, more legal. An obvious logical step became establishing off-shore holdings (to avoid an additional

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<sup>32</sup> As concerns the most exotic 'political' versions, one can refer, for instance to the following one: Mr. Khodorkovsky had planned to ensure in the new Duma the number of votes sufficient to block changes in the Constitution that would open for Mr. Putin an opportunity to be elected the RF President more than twice.



taxation in Russia), while the owners ('partners', beneficiaries) ensured control and protection of their assets through groups of complex legal structures. All the organizational schemes became formally consistent with the law, except for the constant breaching of the anti-monopoly law and transfer pricing). That determined a greater protection of the partners' property rights and a greater transparency with respect to actual owners of the Russian companies. In parallel with that, lowering the legal risk level allowed to make the problem of civilized (genuinely independent) economic institutions more applied.

Naturally, such motivations as an access to the capital market (issuance of ADR) or the pressure the Western banks exercise particularly on Russia in the framework of the global company against money laundering (through FATF, OECD, EU, the Wolfsberg principles, among others) appear insufficient to ensure a full transparency in the beneficiary ownership area. Apparently, there is some 'time' factor associated with a completion of the groups' reorganization (after privatization and consequent takeovers), building fully legal (protected) arrangements related to asset ownership and legal optimization of taxation of benefits. In other words, some period of time should pass upon which the risk of loosing the assets acquired (often by breaching the civil or criminal law) becomes minimum<sup>33</sup>.

The impossibility to show until a certain moment sources of the acquired property including facts of tax dodging also appears fundamentally important. The overwhelming majority of Russian group and companies have proved not be ready for that as yet, and YUKOS essentially pioneered the completion of this particular corporate development stage.

Clearly, taking the whole ownership scheme out of shadow (not speaking of tax and financial schemes) and creating fully legal arrangements for protection of one's assets means, first, lesser need in specific intimate relations with the bureaucracy that unfolded in the frame of the protective mechanism of the '90s that was based on using the 'administrative resource', that is, relations with federal and regional bureaucrats and judges, funding politicians' activity, etc.

Second, one can note a notable rise in the company's (its owners and beneficiaries') autonomy from the state and its law enforcement system. So far, there has not been a private company of such size and such level of legal protection of its owners as YUKOS (though the latter proved to be fairly illusive). Hence a pertinent question: *to what extent does a large independent company fits into the ideology of 'strong government' in its contemporary Russian variant?*

A qualitative change of the transparency level (even in the noted context) of course could not form a cause for specific enforcement action to Mr. Khodorkovsky's group. Possible specific reason should lie with the whole logic of YUKOS's development as a 'model' company in the 2000s.

The policy of promotion of an attractive corporate image and an artificial 'ballooning' of the company's capitalization may testify particularly to preparations for selling it or for a parity international merger. In any case, given other conditions being equal, many experts believe that the arrival of new, particularly foreign, co-owners in some Russian companies is just a matter of time, which is determined, first, by the national companies attaining a certain level of value matching their foreign analogues, and, second, by the existence of options with respect to investing the respective proceeds (for instance, in a soccer club in UK). There is an

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<sup>33</sup> To put it in the ultimately vulgar way, there still is too much illegally acquired property that needs to be 'laundered'.



opinion that yet in 2002 at the level of declarations YUKOS did not position itself as a Russian company.

The announced (and consequently suspended) in 2003 YUKOS-Sibneft merger (by its essence, the takeover of the latter) could put the newly established company onto the 4-6<sup>th</sup> place among the biggest international oil companies. Meanwhile, the mission of the newly created company, that, is, to grow into a 'global energy leader' would become hardly doable without transforming it into a multinational company. The negotiations on merger (sales of a considerable stake) between YUKOS and Exxon Mobil or Chevron Texaco that became known in late summer 2003 only intensify the realism of this particular version.

The level of influence and autonomy such a company can exercise (given its production and refinery basis is located in Russia and its de-facto control over Eastern Europe) is likely to become intolerable. In this respect it is worthwhile noting that despite his protocol positive comments, according to some sources, President Putin was informed on the merger of Russian assets of TNK and BP yet during his visit to UK (June 2003), while his actual stance was not positive. It is quite likely that the decision was made not to create such precedents in the future<sup>34</sup>.

If this version is correct, a blow at capitalization of YUKOS and Sibneft. The Russian authorities' actions (regardless of legal grounds, names, and prescription) were aimed at not only explaining to the owners of YUKOS what should not be done under any circumstances, but also at demonstrating to the world that one should not deal with such a 'filthy' company. The fall in capitalization, in turn, lowers the company owners' interest in sales of their stock (while one can organize as many such falls as needed)<sup>35</sup>.

The above was complemented by a general 'anti-oligarch' campaign launched in summer-autumn 2003 (primarily in the form of various 'public opinion' polls) which to a significant extent was focusing on the hysteria regarding 'the population's aversion to the privatization outcomes'. Clearly that was just a camouflage for other socio-economic objectives.

The above of course is just an attempt to build some acceptable version, however the first immediate lesson has already become clear: the company that had pioneered the most complete (compared with other) disclosure of its structure, stockholders and beneficiaries has also fallen the first prey to such a legalization. It is not excluded as well that the enforcement pressure policy may become typical, for the 2002-03 trends testify to the possibility of creation of large international groups on the basis of some metallurgical and chemical holdings that have practically completed their consolidation stage. Time will show if this assumption is accurate.

Some more general comments to conclude the above: it can be quite easily assumed that the company heads and owners committed illegal acts (in the tax area, using budget funds, stripping off assets and transfer prices at other stockholders' expense, etc.). Under any

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<sup>34</sup> By contrast, the sale of R. Abramovich's aluminum assets (the 25% stake in Russky Alluminiy) to O. Deripaska and the concentration in the hands of the latter of 75% of stock of the Russian biggest aluminum holding did not raise the government's negative reaction. In all likelihood, the government can easily ensure control over Mr. Deripaska's aluminum assets (apparently except for a quite 'non-transparent' from the perspective of ownership blocking 25% stake that formally remained under control of Millhouse Capital).

<sup>35</sup> A very peculiar version of the situation was that the General Prosecutor Office acts on the request of ExxonMobil or Chevron Texaco, respectively, on decreasing YUKOS's capitalization prior to a big transaction (as Mr. A. Shokhin speculated in his interview to Kommersant on October 18, 2003).



circumstances of the YUKOS case, one should not forget who, together with other business leaders and, particularly, RUIE who advocated 'generally recognized moral rules and standards', had been fostering 'special' relations with the federal and regional bureaucracy through all the years of the Russian reform: under all the stages of privatization, benefiting from the 1993-98 GKO pyramid, in the course of the 'loans-for-shares' auctions, under distribution of budgetary funds, in the credit and finance realm and in the banking sector, in the foreign trade area, while stripping off enterprises of their assets at other stockholders and creditors' expense and justifying that with rulings of the court of law, by unleashing the 'compromise wars', by means of 'submissions' to the prosecutor's office, etc.

In this case the prosecutor's office actions and the consequent trials are not only legal, but necessary. However, all that is correct, providing the enforcement is not selective. On the other hand, should owners and management of a company find themselves under the enforcement pressing for the crime that everyone committed during a certain period of time, the enforcement turns into arbitrariness.

Under any variants of its development such a situation provides any ground for optimism. If the government focus solely on YUKOS (regardless of whatever reasons for this), then, as noted above, enforcement does turn into arbitrariness on the part of the enforcement authorities.

Furthermore, the value of the whole set of measures under the aegis of the 2000-2003 judicial and legal reform is prejudiced. If the YUKOS case marks the beginning (and quite logical one – from the largest Russian companies to smaller ones, so that everybody beware), then there are no claims against the enforcement of the whole. However, in this case there arises the question of deprivatization as the government's general policy.

It is also important to emphasize the polarization of views on the 'YUKOS case' on the part of the Western official and business (investment) circles, and academic and media ones that represent 'public opinion' as a whole. The latter tend to interpret the case in the global context of an assault to democratic freedoms. By contrast, the business circles associated with Russia provide at least neutral, if not positive, comments on the Russian authorities' actions. This is not a surprise, if one recalls constant corporate scandals in the whole range of the developed economies and the consequent tightening of their law on companies and in the securities area.

The US companies were found guilty of abusing the financial accounting procedures, increasing the volume of their operations by means of 'circle deals', concealment of the company's actual financial state, abuses by top management, concealment of losses, etc. The Enron collapse in 2001-2002, along with the scandals around Worldcom, Citigroup, Tyco, Adelphia, and Arthur Andersen, among others, highlighted drawbacks in the legislative regulation of corporate governance, accounting systems and stock market, which ignited the adoption of the 2002 Sarbanes-Oxley Act. For instance, the Enron bankruptcy stroke a blow both at investors and the company's staff, for their pension savings had been invested in the company stock with no right of an early sale of those prior to the retirement. Once the company stock quotations plunged and it went bankrupt, the staff's pension assets practically evaporated. The 2003 scandal with Mr. Grasso's remuneration and his consequent resignation highlighted on the loose control over top managers.

December 2003 witnessed one of the greatest scandals in Europe's history, namely the Parmalat case. The alleged deficit (between EURO 9 to 13 bn.) was camouflaged by means of

obligations, a sophisticated system of false offshore funds and companies, fictitious transactions and banking accounts. As in the Enron case, it is affiliated banks that likewise played a considerable role in corporate schemes in Parmalat. The company's bankruptcy may well result in a crisis in the milk and dairy sector in EU and Brazil, where the company would buy the lion's share of raw produce.

In 2004 the German government instituted legal proceedings against the top management of Mannesmann for 'abusing stockholders' confidence' in the course of the sale of the company. The 2000s also witnessed constant scandals in Japanese companies and Korean *chabols*. More specifically, in the early 2004 the head of the 4<sup>th</sup> biggest Korean company, SKG, was detained on the allegation of stripping the company off its assets with a total of USD 200 mn. and failure to pay some USD 30 mn. in taxes. In 2003 the same person was under investigation due to allegation of falsifying the company financial accounting (by falsely increasing its profit at USD 1.2 bn.). In January 2004, Scandia, the Swedish insurance giant, disclosed an account on results of the investigation of its recently dismissed top managers who falsified the company's financial accounting, paid lofty bonuses to themselves and refurbished their apartments at the company's expense.

So the problem lies even not with the fact against such a backdrop the 'YUKOS case' may appear just negligible. Rather, *the above challenges compel business circles of the noted countries to project the need in toughening regulative measures applied to large companies onto other countries, too*<sup>36</sup>. At the same time, paradoxically, the exposure of the West to corporate schemes and the failures in the regulative area do not allow any longer the developed nations to classify Russia as a country with high corporate governance risks.

This situation is yet more illustrative, considering the fact that according to the 2003 results, YUKOS was ranked the second in terms of corporate governance among 20 publicly trade oil companies worldwide<sup>37</sup> (according to Energy Intelligence, USA). Notably, RAO Gasprom and Surgutneftegas were awarded with the 19<sup>th</sup> and 20<sup>th</sup> positions, respectively, given that despite its traditional closeness, the latter is considered one of the most efficient Russian oil companies.

Nevertheless, the YUKOS case also illuminated the overall vulnerability of the constructions known as 'the Russian corporate governance model'. According to some experts, the clinch in the situation of the YUKOS-Sibneft divorce between late 2003- early 2004 was directly associated with the absence of the real decision makers. Thus YUKOS's main problem in the conflict (regulation of problems with Sibneft) was that regardless of all its transparency, openness and adherence to the Western corporate governance standards, it was *the sole*

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<sup>36</sup> It should be noted though that the business circles in the US and elsewhere have not necessarily appeared particularly positive towards the Sarbanes-Oxley Act. That can be explained both by the general toughening of requirements to corporations and the rise in their respective costs and by doubts of efficiency of the measures stipulated therein, which appear mostly political by their nature.

<sup>37</sup> The rating was computed basing on performance of the companies where the government share accounted for less than 50% and using the following criteria: the number of directors; the division between the function of the company's head and its Chairman of the Board; independent directors; the share of directors' property in the company's capital; independent auditor(s); the Board Nominating and Remuneration Committees; the frequency of directors re-election. However, Energy Intelligence put an important remark: 'One may perfectly meet the corporate governance standards without following them; similarly, one can perfectly manage a company without satisfying the above six criteria'. Interestingly, following the Energy Intelligence methodology, in 2001 Enron would get 81.8% and hold the first place (Vedomosti, 2004, January 16).



*man's* company at that man was behind bars. At the same time, the current Sibneft's management (if one interpretes the situation basing on the generally available information) in their maneuvers were constrained by the sword of Damocles in the form of claims the RF Ministry of Taxes may raise against the company<sup>38</sup>.

Finally, the 2003-04 YUKOS case was likely to play its role in accentuating the government' stance in the debate on taxation of the mineral sector and industrial policy. Apparently, one of strategic effects of the YUKOS case can become very vague prospects for emergence of multinational corporations (see below) on the basis of large Russian groups in the mineral sector.

#### *4.3.4. 2003-2004: the continuation of the expansion and polarization of interests.*

The logic of the government expansion and toughening control over strategic sectors in 2003 was not limited by the YUKOS case, though in many cases there were clear intersections and side-effects.

First, one should note the *combination of the mission of reforming the system of state unitary enterprises (SUE) with the one of furthering building state-owned (vertically integrated) holdings*. In particular, it is envisaged to assign federal 123 SUE=s to the state-owned holdings.

While assessing the process of creation of holding structures on the whole, one can agree that a compulsory integration as dictated by the government can appear appropriate with respect to the fuel and energy complex, some other sectors (for nuclear power, communication, and MIC, among others), single unique production complexes (for instance, the national airspace company NPO 'Energia' Imeni Akademika S.P. Koroleva, aviation holdings spearheaded by their head design offices). That would enable to retain the governmental control (at least, formal one) over the largest natural monopolies and some strategic production complexes (sectors), to preclude a break-up of traditional economic ties and to maintain coordination in the frame of originally united production and technical complexes.

At the same time, there are well known objective defects (including those basing on international experiences) of such structures: additional costs for procedural issues and inspections and audit of the respective integrated companies, a complicated control over redistribution of resources (assets) and revenues, the trends to politicization and bureaucratization, etc. The Russian practices of the past decade also bore yet another two additional specific features:

- a constant reorganization of holding structures coupled with abuses of property rights, struggle for control, transfers of stock packages and CUE=s, etc. At the same time economic efficiency and rational governance considerations have not always prevailed in the decision making process. Formally, one should distinguish reasons underpinning reorganization of public (politics, lobbyism, concession of property by various means, budget, stripping off assets, corruption) from private (optimization of management, takeovers, sales of loss-making companies, getting rid of 'alien' shareholders, expansion, tax dodging, export of capital), though they often intersect;
- the use of state-owned holding companies to service narrow group interests of civil servants and private structures, withdrawal of financial resources (offshore holdings, transfer

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<sup>38</sup> YukosSibneft: ni mira, ni voyny.- Kommersant, 2004, 9 January

pricing, centers of profit outside formal public holdings, abusing the rights of stockholders of both the holding and its daughter companies, etc.), non-economic objectives (elections, financing certain political elites, etc.) and urgent decisions in the budget area. The above coupled with an intense corruption and the widespread of the rent-seeking behavior results in inefficiency of the state as an owner and, consequently, minimum revenues raised from the available assets.

From the corporate governance perspective, it is important to understand how the government's interests in holdings' corporate bodies are represented and how efficiently control functions are exercised. It is also important to note that the emergence of new structures of this particular type (in the course of privatization becomes possible primarily at the expense of the existing corporations, property relations and shareholders' rights. It is purely political decisions that often prevail in property redistribution processes in the existing holdings. The level of significance of this trend consequently will depend exclusively on pragmatism and the common sense of the executive power.

From the perspective of efficiency of general governance models, the current practice of 'constructing' public holdings leads to a conflict between attempts to apply an operational model (which is possible only under a mono production structure) to manage fairly diversified assets. By some estimates, the government appears utterly perverse in this respect in the MIC/Defense sector: it first encourages conversion and diversification of public enterprises there and ends up with a rigid centralization of management designed 'under a single export contract' thus strangling other areas outside the immediate cooperation under the given contract<sup>39</sup>.

Second, *nationalization (deprivatization, etc.) of some significant assets* may form an evident component of the public holdings restoration and control over strategic sectors.

Formally, Russia has no law on nationalization, despite numerous bills lately submitted to the Duma. The Constitution of RF admits the possibility of nationalization on the basis of not passed as yet federal law and provision of compensation to an owner for his assets, their value and other losses as per Art. 235 of the Civil Code of RF. Nonetheless, it should be noted that possibilities for nationalization are laid out in the existing legal base:

- recognition of the negligibility (illegal nature) of a privatization transaction and the return of the stock to the state (this particularly concerns investment tenders and other deals prior to 1997)<sup>40</sup>;
- indictment and arrest of private individual that provide confiscation of property and the consequent arrest of stock and other properties;
- seizure of a legal entity's assets and prohibition on managing actions by the company's management, with consequent purchase of stock in the event of a failure of their quotation;
- inspections of compliance with the environmental requirements and licensing agreements;
- takeovers exercised by a 'pro-government' private structure back-upped by government agencies and the court of law<sup>41</sup>;

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<sup>39</sup> Ovanesov A. Rossiyskie holdingi vybirayut modeli pozitsionirovaniya. -Upravlenie kompaniy, 2003, # 11, p. 5

<sup>40</sup> As concerns privatization deals, they are subject to the general period of limitation stipulated in Art. 181 of the Civil Code of RF to apply consequences of nullity of negligible deals, which accounts for 10 years.

<sup>41</sup> Peresmotr itogov privatizatsii v Rossii nachalsya. Bureau pravovoy informatsii, 20 November 2003



- debt restructuring processes, consolidation of debt and bankruptcy (having set some barriers to private takeovers, the 2002 law notably modified the functions the government agencies exercise);
- the rise in the number of unitary enterprises (after a debt-driven bankruptcy they are assigned to regional budgets);
- return or pledging stock packages to government agencies, their transfer to public holdings, etc.

To illustrate the above, it is worth considering the situation with ZAO Atompromstroyexport (ASE), a large general contractor on construction of nuclear power plants in India, China and Iran which, prior to its merger with Silovye Machiny was de-facto controlled by OMZ group<sup>42</sup>.

Back in summer 2003, the RF Minister of Nuclear Power Mr. A. Rumyantsev argued that it would be possible to partly privatize business at nuclear power plants (refrigerant ponds, turbines, engine rooms). In October 1993 Vice-Prime Minister V. Khristenko stated that NPP=s should at 100% remain the government property, and consequently the Ministry of Nuclear Power raised the issue of renewing the government control over ZAO. Its stockholders are OAO 'Atomenergoexport' (53.8%), federal SUE 'Zarubezhenergostroy' (44%), and OAO TVEL (2.2%), while OMZ controls roughly as much as 20% of stock in Atomenergoexport which, given the dispersion of the ZAO's equity capital, ensures an actual control over the mother and daughter companies. Restoring the government control (so far the discussion has not involved any practical implications) both prior to, and after the merger between OMZ and Silovye Machiny is possible by the two means as follows: either through redemption of ASE stock to have the 100% public enterprises under the Ministry of Nuclear Power, namely the federal SUE Zarubezhenergostroy and OAO Tvel, (should the redemption price be satisfactory for the Ministry), or to withdraw from the company the earlier granted contracts (which would require a revision of intergovernmental agreements).

This particular example, however, basically fits into the common international pattern: everybody is aware that in the history of nationalization programs implemented in the second half of the 20<sup>th</sup> century the fact of nationalization per se did not lead to a trial due to the recognition of the state's right to exercise such an action and most often the former owners of the nationalized assets filed suits in conjunction with the redemption price.

In Russia, the situation is somewhat different. While practically everyone is aware of 'non-transparency' of the privatization transactions of the 1990s (as well as contemporary ones), however, the noted loans-for-shares- auctions survived through numerous trials. So public (but not legal) claims can be raised against the formal inventors of the legal base of such auctions rather than its users. This can be proved by a contemporary example, namely, a dubious transparency of the 2002 sale of Slavneft.

At the same time, nearly any privatization transaction of 1992-2004 may suffer certain defects, which appears quite objective, if one considers the speed with which the respective law was developed and the privatization program was implemented. That does not always at all testify to the presence of a criminal component therein. Clearly, one should draw a line under the matter (for instance, by reducing the 10-yr limitation period on such deals) forever, except for the transactions that demonstrate a clear breach of the law by the respective authori-

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<sup>42</sup> Ibid.

ties (as a sign of corruption) and bear signs of crime. The list of such signs should be utterly clearly stipulated in a special act. Providing impartial enforcement, such decision could form a serious constrain to attempts of quasi-legal large-scale property redistribution.

Judging international experiences, it is equally clear that it is fairly hard to ensure a comprehensive implementation of this process. The bilateral restitution suggests the need in a compensation, which in turn suggests solving a whole complex of problems: the stance towards bona fide purchaser (after series of re-sales); search of funds to pay the compensation (which would require a special line in the budget and identification of a concrete amount of funds for the ongoing year); a special stock appraisal methodology; a special privatization cheque ('voucher') appraisal methodology; a special property complex (enterprise) appraisal methodology.

There also exist protective schemes that appear doable only to the largest companies, nonetheless, due to high costs involved. To cite an example in this respect, apparently the Norilsky Nickel restructuring in the early 2000s following the General Prosecutor Office's proposal to return to the state funds allegedly 'underpaid' in the course of the privatization of the company falls under the category of such protective measures.

Third, one should refer to re-activation in 2002 *of the debate on objectives and principles of potential industrial policy in Russia*, which in short implies two fundamental and inter-related matters: 1) more general alternatives of Russia's development in the longer run – the current *status quo*<sup>43</sup> or a refusal of the orientation of the national economy to mineral resources, toughening of taxation of its exports to balance profitability in the mineral and processing sectors; 2) an absolute government support to 'integrated business groups' (as RUIE conceives the concept) or 'limiting the all-mighty powers of the domestic financial and industrial groups'<sup>44</sup>.

However, in practice currently 'industrial policy' as a notion appears some mutating symbiosis of lobbyist efforts by the largest financial and industrial groups and ambitious declarations by political groupings. In some sense such a situation also mirrors the absence of relatively distinct ideas of the strategic place and role of the state in the contemporary Russian economy, though the eagerness to operative control remains constant.

In a broader context, the problem lies with the uncertainty of final objectives the government pursues: either it is keen to unleash a war against corruption and to ensure an efficient prevention of assets withdrawal in any form, or there continues a trivial property redistribution and pressure on competitors exercised in favor of pro-governments structures and/or in the frame of an elementary use of the 'administrative resource' by all the agents that have such an opportunity. Obviously, to ensure an actually efficient industrial policy, one needs a set of concrete measures in such areas as tax policy, economic concentration (in MAP's terms), se-

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<sup>43</sup> An utterly clearly stand was also articulated in an economic report of one of Russia's leading broker companies, Brunswick UBS Warburg (published on January 31, 2003): 'In the post-industrial world, the nation's prosperity is determined by the country's integration into the global economy through concentration on its comparative advantages. For Russia, it is exportation of minerals and energy-intensive commodities (in contrast to capital- and labor-intensive industrial goods) which constitutes such an advantage.'

<sup>44</sup> Mau V.A. Itogi 2002 goda I osobvennosti ekonomicheskoy politiki v vybornom godu. *Commersant*, 2003, # 15, p.20; Tremasov K. Promyshlennaya politika. Pochemu net investotsiy. *Vetsnik NAUFOR*, 2002, # 3, p.9, et al. O probleme oligarkhicheskogo kapitalizma v kontexte zatukhayuschikh tempov vosstanovitel'nogo rosta I zamedeniya strukturnykh reform. See also: Vystuplenie E.T. Gaidara na Sovete partii SPSA 22 December 2002 ([www.iet.ru](http://www.iet.ru))



curities market, enforcement, and Russia's foreign policy rather than some formal document of general nature.

In 2003, this debate was ractically reduced to a highly politicized discussion of the 'mineral rent'. The noted YUKOS case is also likely to play its role in accentuating certain stands in the discussion frame. While politicians and economists from all the camps debate amounts and mechanisms of the mineral rent withdrawal, the oil companies reacted fairly adequately to the unambiguous signals from the government. Thus, for instance, in late 2003 LUKoil declared it would no longer be using any schemes aimed at minimization of its tax obligations. According to some estimates, while facing the range of quite legal tax optimization options (3.5% of corporate profit tax by using the remaining legal loopholes, or saving a few percent while paying the 18-20% tax rate), most of oil companies currently are more inclined to opt for the latter<sup>45</sup>.

The passing of the new law 'On subsoil reserves' (with the respective draft scheduled for the consideration by the government in summer 2004) should appear an important indicator of the government's actual stand towards the mineral rent and the related matters. At this point, the most sensitive issues are the possibility for local administrations to take part in distribution of powers for subsoil reserves (which at present the Constitution of RF suggests), a search of an alternative to licenses (for instance, 'an exclusive right for using the subsoil site') which has to be acquired at an auction), conditions of granting the right for subsoil reserves, problems in the prospecting area<sup>46</sup>. As well, the introduction of a concession mechanism of the subsoil use that would suggest narrowing of chances for the private sector in this particular area also appears quite possible.

Another strategic effect from the YUKOS case apparently is fairly vague prospects for emergence of multinational corporations basing on large Russian groups that engaged in the mineral production. In a certain sense, one can argue that the problem of 'restricting the domestic financial and industrial groups' all-mightiness' is no longer in existence (while the key question as to whether such a solution is universal still retains its significance).

Fourthly, the available data allow to suggest that in 2003-2004 there happens *a further formation of some 'nucleus' of the state expansion and control* that comprises Gasprom in tandem with several loyal oil companies and some MIC components. Considering this, it becomes clear that any serious reform of RAO Gasprom is doomed to practically zero prospects.

Thus, as suggested by the Chairman of Board of RAO UES Russia A. Chubais in November 2003, by late 2003 RAO Gasprom should have become an indirect owner of some 10% of RAO UES Russia's stock, while allegedly holding roughly the same stake (10-12%) in the equity capital of Mosenergo. This clearly also gives the gas monopoly a chance to participate in privatization of united generating companies (UGC) in the Russian sector for electricity. So, an interesting collision may become quite possible. Thus, in the course of Slavneft's privatization in 2002 one of the reasons behind debarring the Chinese company, CPC, was the reference to a high share of the government participation in that, i.e. that helped create the precedent. In any case, a less probable Gasprom's participation in future transactions with UGCs' stock would mean strengthening the government control in the sector rather than privatization.

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<sup>45</sup> Ivanova S. Lgoty zakonny. No kompanii teper boyatsya ekonomit na nalogakh.- Vedomosti, 2003, December 24, p.1.

<sup>46</sup> See: Vedomosti, 2004, 5 February, p. A3-A4



Another possible avenue for the government expansion (basing on state-owned and loyal companies) are licenses and auctions in the oil sector. It is also hard to assume that the departmental and judicial revision of some licenses unleashed in 1993 (particularly, revoking of a license from YUKOS's affiliate Sakhneftegas on the largest in the region Talakan oil and gas deposit and its reassigning to Surgutneftegas) became possible at the level of a routine decision by the RF Ministry of Natural Resources or a regional court.

It is also important to note that in December 2003 Gasprom, Rosneft and Surgutneftegas entered into an agreement on establishment of a consortium to coordinate their activities with respect to bidding for license auctions and tenders and developing the eastern Siberian (where YUKOS's presence has long be especially notable until lately) deposits and Yakutia. With account of the governmental share in two of the three noted companies, it is easy to assume that the government is keen to strengthen its control over that particular area. Apparently the coordinated policy and operations obviously should form a counterbalance to the BP-TNK and Chinese oil companies' expansion in the region. In all likelihood LUKoil has also joined the alliance, as the company had concluded a strategic agreement with Gasprom on sales of its gas and stricken an agreement on exchange of assets with Rosneft.

In early 2004 there was made the first step to constrain BP-TNK's (more precisely, Russia-Petroleum, their daughter company) operations at Kovyktinsky gas- condensate deposit. More specifically, the problem of Gasprom joining Russia-Petroleum for this project has been practically solved, otherwise the company could loose its respective license and face problems with pipelines. In early 2004, Rosneft proposed to BP to cover the costs of operations in the frame of Sahalin- 5 project (some USD 5 bn. over 10 years) to retain its share in the project. Finally, Chevron Texaco and Exxon Mobil (who competed for a stake in YUKOS-Sibneft in 2003) in 2004 found their rights for developing 3 deposit blocks in Sakhalin-3 revoked. The project is likely to fall under the sphere of interests of a consortium led by Gasprom.

Yet another potential innovation is creation of a state-owned oil company (provisionally known as Gosneft). In addition to consolidation of all the assets in the sector that remained in the government's hands, should the company be established, it may well become a bridgehead for a further expansion of the government's direct participation in the sector. Interestingly, Gosneft (along with Rosneft, Surgutneftegas and Sibneft) was viewed as a candidate for managing a nationalized YUKOS's stock on behalf of the state.

Considering the ongoing events in the usual pattern, that is, in the context of the conflict between the 'old -Moscow' and 'St. Petersburg' groups, one has to reckon as follows: *the intensification of the conflict between their interests in 2003 also determined a greater polarization of the largest Russian business groups*: thus state-owned Gasprom, Rosneft, Transneft and private Surgutneftegas and LUKoil, and the Mezhprombank group have found themselves on the one side of the barricade, while Alfa/Renova group, YUKos, Sibneft, O. Deripaska's group, and MDM group – on the other.

Some largest Russian groups (Interross, OMZ, that consolidate certain assets between 2003-04) are not directly associated with the noted process of strengthening of the government control, and by their origin they are likely to gravitate towards the 'old-Moscow' group. However, according to some estimates, they are conceived as 'reliable' due to their 'appreciation of the state interests'. At the same time real owners in both cases well understand the fact that any deviation from the noted 'appreciation of the state interests' may result in fairly serious penalties. In the case of Interross those will be a revision of the procedures of acquisition of



Norilsky Nickel, while for OMZ- Atomstroyexport (this also directly concerns Interross after the establishment of OMZ-Silovye Machinery). For example, according to the RF Ministry of Natural Resources, in February 2004 the Ministry is to start examining compliance with environmental law at Norilsky Nickel's enterprises, which 'during 15 years have been among most serious atmosphere polluters both in Russia and throughout the Northern Eurasia'. In 2004, the RF MAP made a series of statements on the need for evaluating the gold-mining sector in terms of monopolization, which directly concerns Norilsky Nickel and Interross group as a whole.

There were different reasons that fueled aggravation of the situation: YUKOS establishing control over strategic deposits in eastern Siberia and negotiations with Western oil companies on sales of a huge stock; Alfa/Renova's interest in privatization of Svyzinvest holding and the federal unitary enterprise 'Rossiyskaya Teleradiotranslyatsionnaya Set'; the success of TNK and Sibneft in privatization of Slavneft (vs. Rosneft and Mezhprombank); control over Atomstroyexport by OMZ and MDM's eagerness to retain control over accounts of the RF Ministry of Nuclear Power; an attack at state-owned monopolists controlled by the St.Petersburg' group (demands for privatization of railways, the gas market liberalization, certain electricity sector restructuring schemes, including tariffs and the sector for housing and utilities, a free access to main-line export pipelines and property rights for the newly built pipelines), attempts to obtain control over the Sakhalin shelf, among others.

Clearly, from the strategic 'etatist' perspective, it is initiatives undertaken by representatives of the 'old-Moscow' group in the oil, telecom and electricity sectors that posed the greatest threat. YUKOS fell the first prey in this struggle, while the list of consequent probable candidates (ranked by the 'urgency' of the problem) allegedly is headed by O. Deripaska's group and Alfa/Renova<sup>47</sup>. In January 2004 the Accounting Chamber of RF announced the upcoming planned budget audit in Chukotka autonomous okrug and Sibneft's tax payments. Given that YUKOS and Sibneft practiced very similar taxation optimization schemes, one cannot exclude an application of the same 'tax' lever to Sibneft (filing tax claims with a consequent instituting bankruptcy procedure against the company)<sup>48</sup>.

One should note there exists a multipronged political context underlying the 2003 processes and decisions in question as well as their motivations, where the conflict between the two political groups only partly highlights on the situation.

First, the interpretation of the contemporary trends only in the format of the noted conflict excludes any other motives that property redistribution. However, such a narrowly focused approach clearly appears insufficient for explaining more complex (and resting upon other grounds than the material one) tendencies of strengthening of the role of the state in the 2000s.

Second, such an approach essentially implies the absence of President Putin's personal stance (the concrete contents of which does not matter at this juncture). Nonetheless, the YU-

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<sup>47</sup> For greater details, see: Sobyenin A., Novosiltseva M. V mode-kopya s shirokomi nakonechnikami.- Sliyania I poglosheniya, 2004, # 1, p. 34-41. In this context, one cannot help mentioning '5-7 individuals' that 'did not honor the law', 'consciously swindled and put themselves in better conditions than those who behaved' (from the presidential address to the RF Chamber of Commerce on December 23, 2003, Vedomosti, 2003, 24 December p.1)

<sup>48</sup> No doubt, there exists another hypothesis: some enforcement and other agencies' demarches towards single business groups may present just a political imitation of equal approach, while the real relationship between the groups and the government (represented by different branches of power) suggest a favorable regime.

KOS case provides a unambiguous evidence of the fact that he has his own view on the place of a large private company in the Russian state organization<sup>49</sup>. That is why RUIE and other business associations' advocacy arrangements of the company owners was so loose and fragmentary.

Thirdly, despite rather an efficient strengthening of the 'federal vertical of power', regional leaders (especially those that have succeeded in building their own financial and industrial groups, i.e. cities or regions) still retain a considerable resistance resource.

Finally, it would be inaccurate to reduce recent numerous decisions in the economic policy area only to mutual attacks launched by the two political groups. Many of them appeared unambiguously positive, regardless of whether they constituted a resistance tool, obedience to orders from the top, or merely based upon their initiators' common sense: in particular those are attempts to radically reform the SUE=s since 2003, measures on closing domestic offshore zones (upon coming into effect of amendments to Art. 25 of the Tax Code of RF as of January 1, 2004), measures of constraining tolling schemes, among others.

In the light of the above one should particularly single out the problem of transparency of Russian companies' property structure which appears closely associated with the beneficiary ownership problem.

For example, Prime Minister L/ Jospin of France in his address to the European Parliament on February 8, 2002, articulated the core of the challenge as follows: 'The war against capital laundering should be unleashed at the scale other than currently... We still observe funds created by nobody knows whom and companies registered by non-residents. Whatever legal status of such funds and companies be and wherever they were created, their purpose is always the same, that is, to conceal their genuine owners'<sup>50</sup>. The growing attention governments of the leading nations and international organizations demonstrate to the problem of 'beneficiary ownership' is associated primarily with such motives as laundering of criminal revenues, funding of terrorism, tax dodging, corruption, saving property from creditors, deals associated with related parties, assets withdrawal, manipulation of markets, insider transactions, avoidance of antitrust requirements, harboring civil servants' properties and incomes, hostile takeovers, etc<sup>51</sup>. Clearly, the motive may comprise both legal (boosting profits through legal tax 'optimization') and illicit (breaching national and international law) ones.

In the contemporary Russia, one of the prevailing incentives underlying the beneficiary owner's intention to conceal the information on real owners of this or that company's stock is protection of assets acquired relatively lately and not always on perfectly legal grounds (i.e. their protection from judicial, political, criminal, etc. risks, corporate blackmail, a threat of confiscation, recognition of privatization deals negligible, etc.). A real owner can be 'camouflaged' by means of a chain of offshore companies, trusts and funds, nominal holders and trust managers, contracted corporate groups and shareholders agreements, etc<sup>52</sup>.

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<sup>49</sup> See, for instance, President Putin's interview to European media during his visit to Italy and participation in the 2003 EU Summit

<sup>50</sup> Quoted from: Minaev S. Ogranichit', uzhestochit' i zapretit'. - *Commersant Vlast*, 2002, 19 February, p.22

<sup>51</sup> See, for example: *Behind the Corporate Veil. Using corporate entities for illicit purposes*. Paris, OECD, 2001

<sup>52</sup> Ex-officio, final (controlling) owners of numerous Russian companies are well known, but most of companies do not give official and accurate data on their real property structure and control. As a result, it is *just commonly recognized*, that, for instance, the owner of LUKoil is Mr. Alekperov, Norilsky Nickel- V. Potanin and M. Prolhorov, UGMK – I. Makhmudov, Sibneft – R. Abramovich (prior to the deal with YUKOS), SUAL- V. Vexelberg, TNK- M. Fridman, V. Vexelberg and others (prior to the deal with BP), Surgutneftegas – V. Bog-



Clearly, the concealment of actual owners thus is objectively determined, and as the practice shows, even the most severe law on disclosure of the respective information will not be honored without adequate prerequisites in companies themselves. At this point, only a comprehensive solution (apart from the rise of objective economic prerequisites of such a disclosure) can become possible, that is, adequate amendments to the corporate, tax, forex, anti-trust, banking law, as well as international cooperation, regulation of offshore businesses, etc.

There RF Government has made some statements that received a positive response on the part of the international investors community<sup>53</sup>. While addressing the US Chamber of Commerce and the RUIE Expert Institute conference, the RF Minister of Economic Development and Trade, Mr. G. Gref particularly declared that the government plans comprise a radical antitrust law reform, including property transparency issues. Mr. Gref emphasized that the Government was capable to provide guarantees that would urge businesses, at least, the key companies, to maximally disclose their property structure.

The existence of government guarantees indeed appears particularly important (especially in the context of the YUKOS case) and requires a complex set of measures. But practice shows that apparently the government has opted for already tested and far simpler for an immediate implementation 'enforcement' way. That was what the head of the Accounting Chamber of RF, Mr. S. Stepashin, utterly clearly stressed at the meeting with the British top managers of TNK-BP in early 2004<sup>54</sup>. On the one hand, the participants in the meeting discussed companies that invested in Russian economy and honor their tax obligations (which, as far as TNK-BP is concerned, might mean an indirect dissatisfaction with the deal itself and the existence of centers of profit outside Russia), and the Chamber's plans to evaluate the privatization outcomes over the past decade, on the other. The company's first reaction was the announcement of an 'optimization of the corporate structure', that is, consolidation of TNK, ONACO, Sidanco and Slavneft (50%).

Let us draw some conclusions. The 2000s witness the prevalence of the trends to intensification of the government property expansion, attempts to establish (extend) control over major financial flows in the economy and, speaking more broadly, *to ensure the dependence of businesses on the state institutions, despite decisions on deregulation, administrative reform, and plants to promote privatization further on.*

This policy may result in the unfolding of a 'state capitalism' model whose specifics would lie with the combination of the following elements:

- A considerable strengthening (extension) of standard elements of the government entrepreneurship, which is likely to be viewed as a component (very debatable, though) of ensuring Russia's national interests;
- Creation of favorable (or, at least, neutral) conditions for the functioning of a narrow circle of loyal, including private, companies that have earned the reputation of being 'etatist' and back-upped by the highly centralized and controlled by President government (including the legislature and judicial system);

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danov, NLMK- V. Lisin, Russky Aluminy – R. Abramoich and O. Deripaska, Basovy Element – O. Deripaska (Basic Element Holding Ltd.), OMZ- K. Bendukidze, Severstal- A. Mordashov, etc. The same situation is noted with respect to the largest private banks (Alfa-bank, MDM-bank, etc.)

<sup>53</sup> See, for example: Radygin A. raskrytie informatsii o benefitsiarnoy sobstvennosti.- In: materialy Kruglogo stola OECD o korporativnomu upravleniyu. M., 2-3 October 2003.

<sup>54</sup> See: Russky focus, 2004, #3, p.9

- Using ‘model’ (selective) repressive measures (administrative and criminal) against those powerful economic agents that do not fit into the intended model;
- Asymmetry of objectives and methods of enforcement. The initially set and often well-grounded objectives, such as, assets repatriation, transparency of property structures, return of centers of profit back to Russia, liquidation of certain tax schemes, among others, are implemented not by means of reforms in the respective areas. Rather one resorts to other enforcement means that formally have no relation to the above matters, including the use of the ‘property for freedom’ principle;
- The separation of the concept of Russia’s national interests from the principle of safety of private property.

At this juncture it is worthwhile noting that the concept of ‘state capitalism’ in its traditional form does not encompass the whole specificity of the Russian model under construction. The term first arose in the socio-democrat polemics of the early 20<sup>th</sup> century (the problem of sufficiency of nationalization to ensure the transition to socialism). As concerns the Western states, the term is used (including academic references) primarily to describe the classical government entrepreneurship which includes both the state property and other forms of the government participation in economic life. Traditionally, theoreticians of Marxism-Leninism in the USSR and abroad alike conceived state capitalism as a positive phenomenon and a material prerequisite of socialism and as one of socio-economic structures, as far as the transitional period from capitalism to socialism was concerned. In the 1940s, T. Cliff, the British Trozkist developed yet another version of state capitalism. He described the structure that had emerged in the USSR by the 1930s as an ultra-monopolist state capitalism where the state by itself plays the role of an aggregate capitalist<sup>55</sup>. After the socialist ideas collapsed and the USSR broke up, in the 1990s there arose numerous interpretations of the notion of ‘state capitalism’ already with respect to the noted processes. There also exist viewpoints that in principle reject the possibility of using the concept to describe the processes that take place in Russia in the 2000s<sup>56</sup>.

Perhaps it would be more accurate to describe the current structure in Russia as ‘bureaucratic capitalism’. It fundamentally differs from the so-called ‘oligarhic capitalism’ era. In the 1990s, the specific feature of the system of relations between big businesses and the government was the possibility for the largest financial and industrial groups to develop or impose key political decisions that bore, at the same time, undisputable commercial benefits.

The 2000s increasingly witness an opposite picture when the government emphatically demonstrates its growing ignorance of private businesses’ general interests by imposing its rules of the game and compelling to follow them by a broad spectrum of means. The YUKOS case has drawn the line under the era of oligarchs. Probability of repetition of such a scenario would require certain protective actions on the part of the existing private groups. Given a very low level of their resistance, this conflict cannot be over at once. That is why one should expect in the medium run the growing number of publicly announced lawsuits with respect to some privatization transactions, legal proceedings associated with illicitly acquired assets, seizures of stock packages (assets), etc.

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<sup>55</sup> Cliff T. Gosudarstvenny capitalism v Rossii, 1991

<sup>56</sup> see, for instance: Kopylov G. Gosudarstvenny capitalism.- 23 November 2003.- <http://www.lebed.com/2003/art350.htm>



However one cannot help considering the fact that the ‘crony state capitalism’ may logically result in the comeback to the 1990s. The problem is, the currently built system also implies the emergence of new potential ‘oligarkhs’, and it is quite likely that once consolidation (return) of assets has been over, financial flows of the largest natural monopolists and public holdings have been re-oriented and sectoral ‘centers of force’ and inter-sectoral pro-government alliances have been reinforced, their management would have green light to expand into the private sector and to build their own groups<sup>57</sup>.

It also becomes clear that it is very hard to accurately distinguish the policy of intensification of the state control and property expansion (which can be subject to factological analysis and may be interpreted in the context of the classical concept of state capitalism or, at least, an elementary establishment of order in the public assets) from fostering a crony capitalism basing on a close intersection of the governmental and single business structures’ interests. Due to the above, an extremely important question as to what the actual ultimate objectives of such an expansion are (either Russia’s strategic interests as the initiators of the expansion interpret them or a banal personal enrichment through property redistribution) remains unanswered.

As noted above, no one has articulated anywhere the state expansion policy. Moreover, it could not be made synchronically with statements on further progress towards competitive market economy. Nonetheless, with a great deal of probability one can argue that the trend to state capitalism has become clearer in 2003. Whether that can be explained by the pre-election fever, or, on the contrary, represents just the start of large-scale actions in 2004-08, will become clear already after the 2004 presidential elections. In any case, property rights, the judicial reform and the problem of efficient enforcement still form a highly urgent challenge.

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<sup>57</sup> ‘Any equally distanced old oligarkh will be counterbalanced by a new or ‘old new’ equally close large businessman. For it is not the system itself and crony relations between business and the government, when it is unclear where one ends and the other starts, but key civil servants that personify power and large businessmen that represent business that are changing. The model of alliance between the power and the capital, the privatized power and the ‘governmentalized’ capital so far has not gone anywhere. Such a model appears normal to the fine-tuned political system and the aligned political elite. The system is called state capitalism, and inside it both the elite is pro-governmental and the government remains a principal monopolist player on the market’ (Kolesnikov A. Posidim na dorozhky. — Ogonyok, 2003, #46, p.16—17)

#### 4.4. The Moscow housing market: results and forecasts<sup>58</sup>

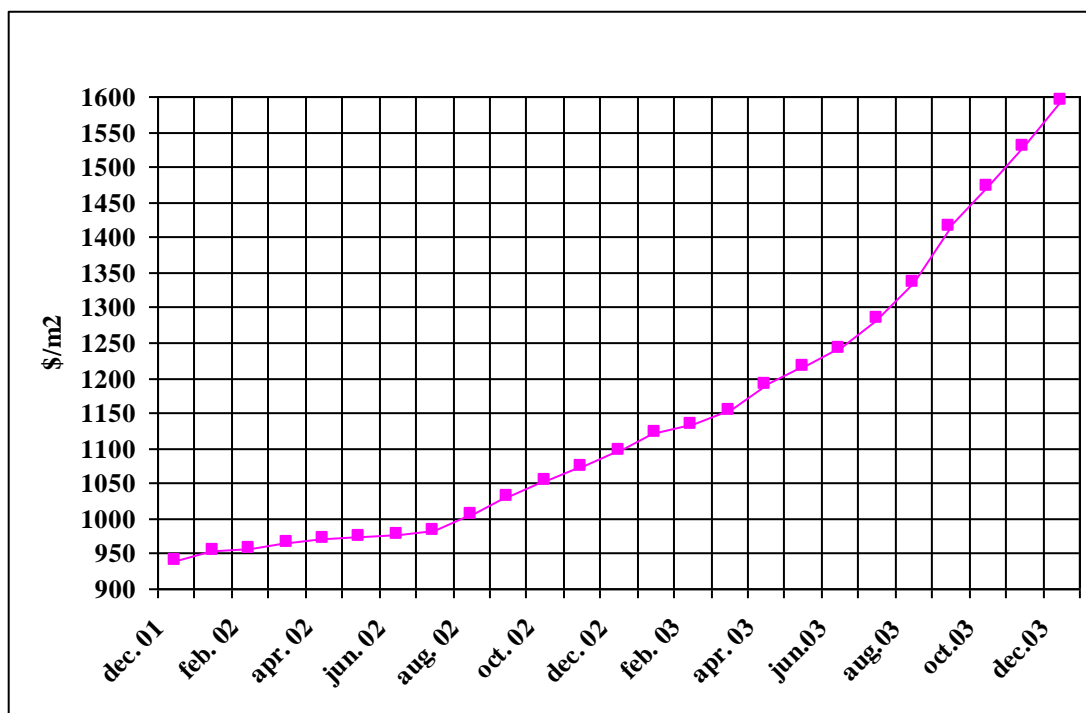
The results of the year 2003

The previous analysis of the Russian housing market<sup>59</sup> in respect to Moscow contained a forecast a concerning possible price-rise by 12-16%, which was mainly based on the transition from the stabilization, which became evident from the second half of the year 2002 to a new spiral of price growth. At the same time, the expressed views left room for a substantial widening of the range of fluctuation of world oil prices and some other circumstances of economic and political nature capable of radically changing the existing tendencies in the economy and of exerting a substantial influence on the real-estate market.

In reality, the behavior of housing prices in Moscow has exceeded all expectations. The development of the Moscow housing market in the year 2003 was characterized by a continuation of the price rise which had started as early as August 2002 (*Figure 1*).

*Figure 1*

**The average specific asking price of Moscow apartments in the years 2002–2003**



<sup>58</sup> The data used in this section were those produced by the monitoring of the Moscow housing market which was carried out by the companies “RMLS”, “MIEL’-Nedvizhimost”, “Kontakt-Nedvizhimost” and “BEST-Nedvizhimost”.

<sup>59</sup> See Bossiiskaia ekonomika v 2002 g. Tendentsii i perspektivy. (The Russian economy in the year 2002. Tendencies and prospects). Vyp. 24. M.: IEPP, 2003. P. 463–474.



As a result, by the end of the year 2003, the average specific price of Moscow apartments climbed to 1594 USD/sq. m. in comparison with 1096 USD/sq. m. in December 2002 (1241 USD / sq. m in June 2003) (*Table 8*). It should be noted that two years earlier, in December 2001, this price was 940 USD/sq. m. Thus, in December 2003, the index of housing prices in respect to December 2001 was 1.70. As for the year 2002 the price index was 1.17, the growth registered for the year 2003 amounted to 53 points.

*Table 8*

**The behavior of medium-level asking prices of housing in Moscow in 2001–2003.**

Average specific asking prices of housing, \$/sq. m			Indices of nominal cost of housing			Annual indices of actual cost of housing (IGS) <sup>60</sup>		
Dec. 2001	Dec. 2002	June 2003	Dec. 2003	Dec. 2002/ Dec. 2001	June 2003/ Dec. 2002	Dec. 2003/ Dec. 2002	2002	2003
940	1096	1241	1594	1.17	1.13	1.45	1.07	1.20

Given the complexity of the situation in the financial sphere, nominal dollar prices of housing should be converted into real prices (cleared of inflation of both the rouble and the dollar).

Changes in macroeconomic parameters are characterized by the following figures. According to the Goskomstat, inflation of the rouble amounted to 12% in the year 2003, and to 15.1% in the year 2002 (28.9% in two years). The average nominal exchange rate of the dollar in December 2003 was 29.44 roubles, while a year earlier it was 31.84 roubles. Thus, the index of devaluation of the rouble against the dollar amounted to 0.925 in the year 2003, and to 0.977 for the period of two years (in comparison with December 2001). Thus, the index of inflation of the dollar in Russia in the year 2003 was 1.21, and 1.32 for the period of two years. The purchasing ability of the dollar (in respect to the consumption basket), on the contrary, has decreased; its index for the year 2003 was 0.83, and for the period of two years it amounted to 0.76.

As a result, the actual cost of housing, with allowance made for the levels of rouble and dollar inflation (the IGS index), grew by 20% in the year 2003, while in comparison with December 2001 it increased by 28.8%. Bearing in mind that in the year 2002 this index amounted to 7%, it could be deduced that in the year 2003 the IGS index grew by more than 21 points.

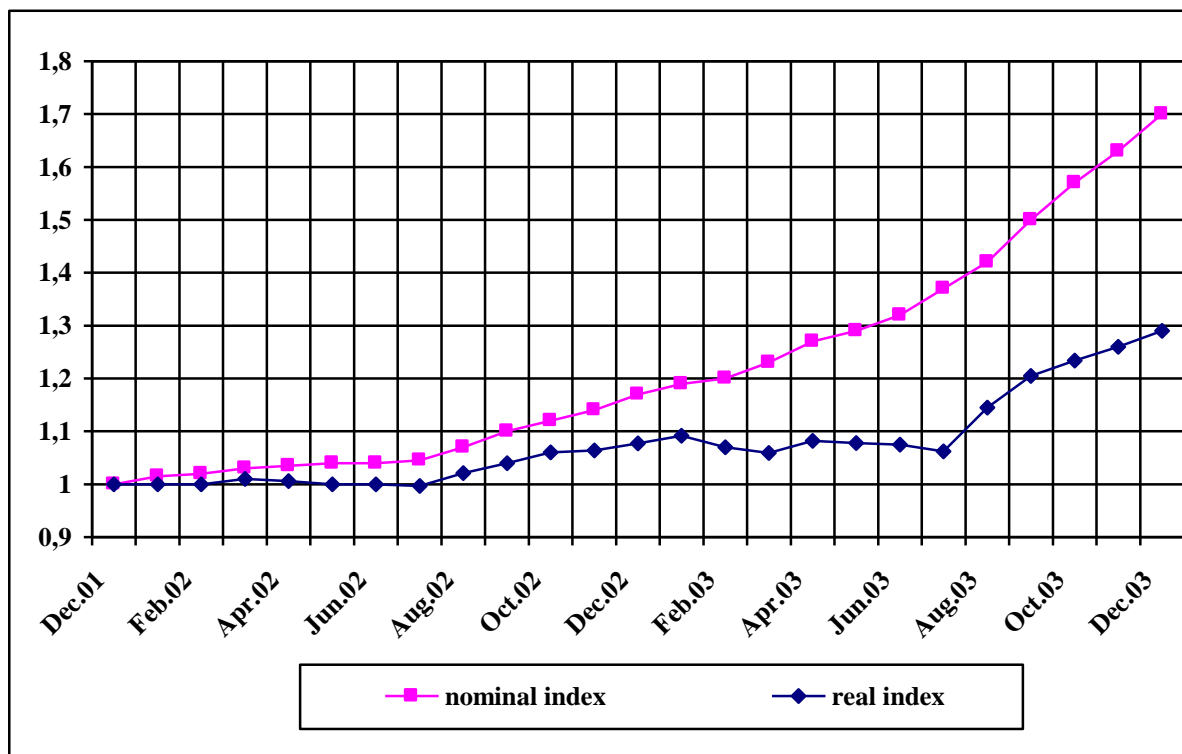
A more detailed monthly analysis of the behavior of nominal and actual indices of housing prices in Moscow throughout the period of two years (2002-2003) would present the following picture (*Figure 2*). If inflation of the rouble and the decline in the exchange rate of the dollar in Russia are not taken into account, the actual cost of housing in Moscow was stable in the first half of the year 2002, then it fluctuated to a certain extent in the latter half of the year 2002 and in the first half of the year 2003, and started to rapidly increase only in the last five months of the year 2003.

<sup>60</sup> The IGS index was computed by the following formula:  $IGS = I_{pr}/I_{cp} = I_{cd}/I_{id}$ , where  $I_{pr}$  - index of housing price in roubles,  $I_{cp}$  - index of consumer prices,  $I_{id} = I_{cp}/I_{rd}$  - index of inflation of the dollar in Russia (in respect to the behavior of consumer prices),  $I_{rd}$  - index of devaluation of the rouble against the dollar.



Figure 2

The behavior of nominal and actual indices of dollar prices of housing  
in Moscow in the years 2002–2003



An analysis of the factors which have determined the tendencies of change in housing prices

Thus, the average level of nominal dollar asking prices of housing in Moscow recorded in October 2002 exceeded the pre-crisis level (1030 USD/sq. m. in December 1997), while in September 2003 it exceeded the historical maximum of 1360 USD/sq. m., recorded in March 1993 and approached the unprecedented level of 1594 USD/sq. m. by the end of the year 2003. It should be noted that the socio-economic situation in the capital, the character and quality of the living-space fund, and the quality of new construction radically differ today from those of the initial period of market reform. And it should also be taken into consideration that in the previous period of development of the housing market, price stabilization was achieved in the years 1996-1997 at the level of 1000-1050 USD/sq. m., then “natural” for Moscow, whereas today Moscow clearly deserves something more impressive.

However, no stabilization has yet been achieved at the new level, and in order to forecast further development of the Moscow housing market one should consider the mechanisms for the realization of this regularity common for all cities, the factors determining the achieved level, and the future tendencies of the development of the housing market. These factors could be subdivided into *internal* and *external* in respect to the afore-said market.

First, let us consider the influence of the *external factors*. When the economy of a country functions in strict accordance with the principles of market economy, these principles would include the general economic situation expressed in the behavior of such indices as the



GDP, real income of the population and the retail-turnover. However, the specific character of the Russian economy in transition points to the fact that equally important in this respect is the price situation at the international oil market (because oil is the staple of Russian export), the currency-market tendencies and the current political situation in the country.

As is evident from the previous studies<sup>61</sup>, one of the important factors influencing the level of housing prices in Moscow in the years 2002-2003 was *the level of world oil prices*.

With allowance made for the two-to-three months time lag between the acquisition of the proceeds from a sale of oil and their return to the country (and their subsequent partial transfer to the real-estate market), the April rise in housing prices was determined by the February oil prices (which were at their maximum, climbing above 30 USD/barrel); the rise was by more than 3%. In May, housing prices were determined by the March oil prices (28.5 USD/barrel), and the rise declined to 2.2%. Given the April drop in oil prices to 22.6 USD/barrel, the rise in housing prices was limited to 2.1%. Thus, while the increase in oil prices directly influenced housing prices by pushing them up, the influence of the decline in oil prices was less pronounced, expressing itself only by a deceleration of the rise in housing prices.

There was no further reduction in oil prices because the US economy sharply increased the consumption of oil, while the Iraqi oil export, after all, did not reach any significant level, and oil prices in May and June grew to 24-25 USD / barrel. It should be pointed out that the volume of oil extraction in Russia, as well as that of its export, also grew considerably at this time. As a result, the rise in housing prices in Moscow significantly accelerated in July and August owing to the so-called "oil factor", and its share in their overall increase by 3.5-4.0% amounted, in our opinion, to 2-2.5%.

In July and August, oil prices continued to grow (to 28.7 USD/barrel), and therefore, the rise in housing prices caused by this factor in September and October could be estimated at the level of 2.5-3%. In September, oil prices declined by more than 10% (down to 25.6 USD/barrel), but in October they rose again practically to their August level (28.0 USD / barrel). Correspondingly, the rate of growth of housing prices in November amounted to approximately 2%, while in December they rose by 2.5%. In November and December, oil prices grew to 27-28 USD / barrel, and it could be suggested that in December 2003 - February 2004 the contribution of this factor would be 2.0-2.5% per month.

On the average, the rise in oil prices by 5 USD/barrel was sufficient to produce an estimated monthly growth of housing prices by 1.2% (see *Figure 3*).

Thus, the "oil factor" which has determined the rise in effective demand at the Moscow housing market, accounted for more than one half of the aggregate growth of housing prices in Moscow in the year 2003<sup>62</sup>.

In the past two years, another significant factor influencing the behavior of the real-estate market, namely, the *behavior of exchange rates* (first of all, the ratio between the rouble and the dollar) reappeared in full force.

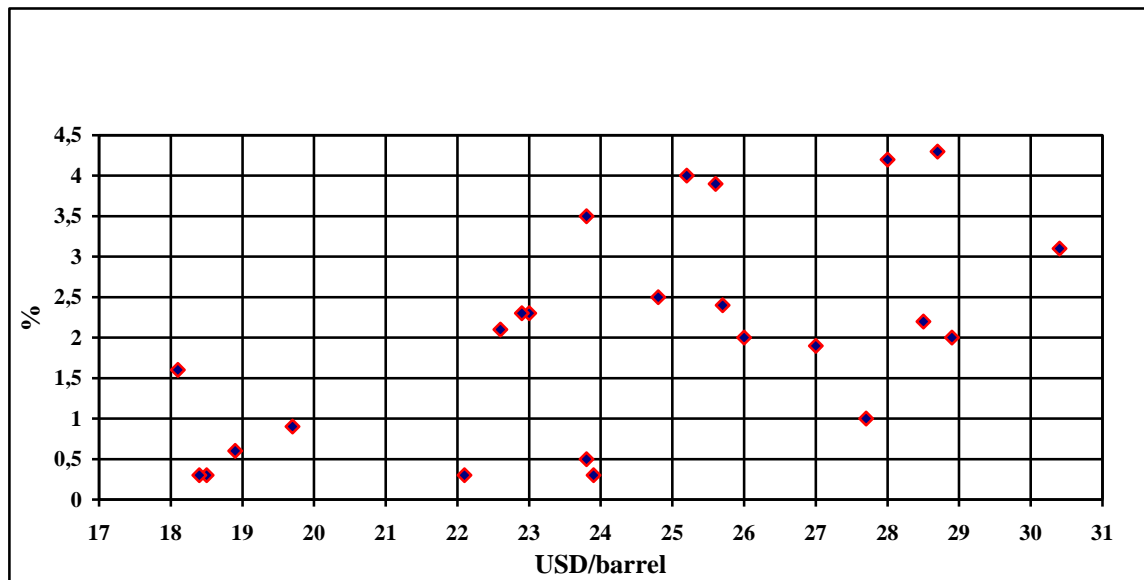
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<sup>61</sup> See G.M. Sternik. Prognoz razvitiia zhil'ia Moskvyy do 2005 goda. Otchet AEKSIP, aprel' 2003. (A forecast of the development of the Moscow housing market up to the year 2005. The AEKSIP report, April 2003). [www.realtymarket.org](http://www.realtymarket.org).

<sup>62</sup> Despite the low reliability of estimates, the influence exerted by the "oil factor" on the housing market could be given the first priority because, as it will be shown later, the gains produced by other factors are even less significant.

Figure 3

**Correlation between the monthly rate of growth of housing prices in Moscow  
and the world prices of “URALS” oil (with a time-lag of two months)  
in the years 2002–2003**



Because of the strong dollarization of the Russian economy produced by the years of market reform, which is especially pronounced as far as the nomination of the Moscow real-estate market is concerned, any serious changes at the world currency market exert considerable influence on the behavior of both the sellers and the buyers of housing, and result in the corresponding changes in prices and in the volume of sales. The fluctuations of the exchange rate of the euro against the dollar in the years 2002 and 2003, coupled with the decline of the dollar in respect to the rouble in the year 2003, caused by the new exchange-rate policy of the RF Central Bank aimed at strengthening the rouble, were the second factor contributing to the development of the situation at the real-estate market.

After consolidating itself at the level of approximately 90% of the rate of the dollar, the euro again began to rise in May and June of the year 2002, and surpassed the dollar by 8-10% in November-December; by May 2003, the euro outstripped the dollar by 22%. In February 2003, the RF Central Bank announced about the adoption of a policy of strengthening the rouble against the dollar as a means of combating inflation. In June and July 2003, the situation changed. The dollar regained some ground against the euro (up to the 1.09-1.12 ratio), and stopped to decline against the rouble. The population once again started to buy more dollars than to sell. From September 2003, the euro continued to rise against the dollar, while in Russia it gained ground against the rouble (while the dollar was becoming weaker against the rouble). By the end of December, the euro was worth approximately 37 roubles, while the dollar was worth approximately 29 roubles.

Under these conditions, savings-holders gradually began to diversify their assets by decreasing the share of the dollar component. As far as the real-estate market is concerned, this factor is especially important because of the excessive concentration of savings and a relatively high level of the population's adaptation to market conditions, which implies tracing-

any changes at the financial markets and responding to them. The commodities markets started to nominate prices of certain goods and services in euro; the onset of the long-awaited process of de-dollarization of the markets in favor of the national currency also dates back to that time. However, there have been no such changes as yet at the real estate market (apart from some isolated attempts<sup>63</sup>).

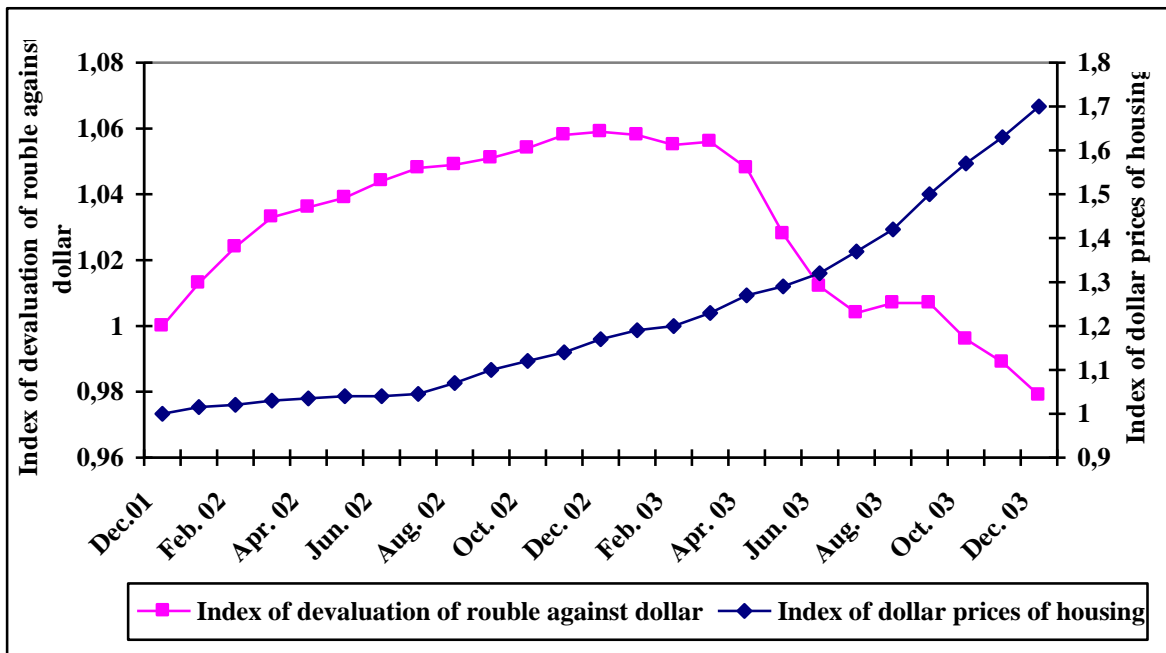
Given the absence of sufficient amounts of euro-in-cash at the banks and the unprofitability of converting dollar savings either into euro or into roubles, in the years 2002 and 2003, savings-holders converted their assets from the predominantly dollar form into the rouble one, but mostly into real estate. This stimulated the buyers' activity at the market and conduced to the rise in the volume of sales.

It is possible that the decline in the exchange rate of the dollar results in the growth of housing prices because of the desire of the sellers to preserve the value of their assets and the desire of the buyers to get rid of the weakening dollar as soon as possible (the "escape from the dollar").

The quantitative assessment of the influence exerted on the behavior of dollar prices of housing in Moscow by the changes in the exchange rate of the dollar presented in the diagrams (Figures 4 and 5) confirms this possibility only to a certain extent.

*Figure 4*

**The behavior of the rouble/dollar exchange rate and the behavior of dollar prices of housing in Moscow in the years 2002–2003**



On the basis of the above diagrams, it is possible to assume that in the case of negative rates of devaluation of the rouble against the dollar (the exchange rate of the dollar declines

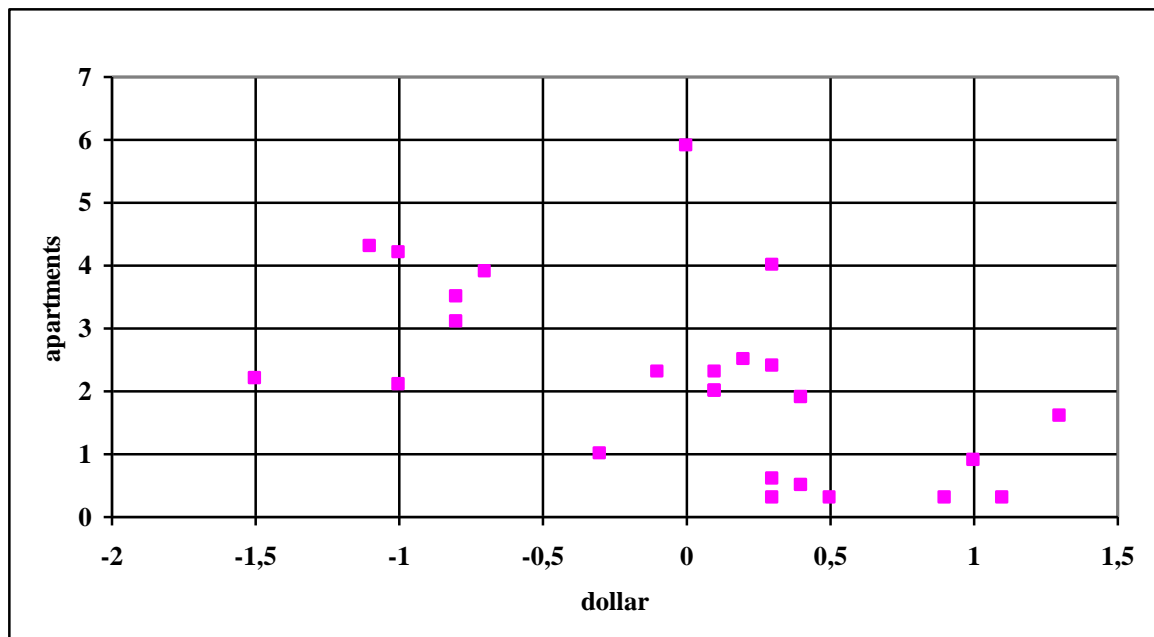
<sup>63</sup> Thus, the Department of Investment Programs in the Field of Construction (DIPFC) of the Government of Moscow has announced about the switching, from 1 February 2004, to the system of housing-valuation in roubles (at the exchange rate of 30 roubles for one dollar). Nevertheless, it is not clear whether other builders will follow suit, while the DIPFC itself controls just 15% of the market.

against the rouble), the rate of growth of housing prices accelerates when the rate of decline in the exchange rate of the dollar increases in proportion 2:1 (a 2%-rise in housing prices in the case of a 1%-decline in the exchange rate of the dollar).

At a positive rate of devaluation (the exchange rate of the dollar goes up), the rate of growth of housing prices practically does not increase when the exchange rate of the dollar rises.

Figure 5

**Correlation between the monthly rate of growth of housing prices in Moscow and the exchange rate of the dollar in the years 2002 and 2003.**



If these assumptions are accepted, then, given the rate of decline in the exchange rate of the dollar, which amounted to 7% in the year 2003 (approximately 0.5% per month), the contribution of this factor to the rise in housing prices would be 1% per month, or 14-15% for the whole year, which would amount to one-third of the total growth.

Thus, the influence exerted by the factor of the rouble's growth against the dollar on the rise in housing prices in Moscow in the year 2003 would amount to 14-15%, or to one-third of the annual increase in prices.

Another important factor which has contributed to the rise in housing prices in Moscow is the *influx of electoral funds to the real-estate market*. Experience indicates that the expenses incurred by the candidates for election to the Duma in the course of campaigning are caused, among other things, by considerable fees paid to PR technologists, advertisers, journalists, actors, organizers and participants of electoral shows, etc; these funds, in one way or another, would partly flow to the real-estate market. As a rule, the above-listed categories of payees, while already in possession of top-class dwellings, would "hide" their money in housing, using it as a reliable placement (much better than the declining dollar) and as an object for commercial investment (with the hope of selling it some time later with a profit).



According to mass media, the last elections to the State Duma were backed up by various campaign funds in the amount of up to 1 billion dollars. If only one half of this money finds its way to the real-estate market (including one quarter going to the Moscow market), effective demand would rise by 15-25%. Thus, in the course of the electoral campaign, this factor accounted for no less than 15% of increase in housing prices in Moscow in respect to the aggregate annual growth.

The least important of the factors external in respect to the market is apparently the factor of *the general economic situation in the country*. Despite the indisputable and stable growth of the GDP and the real income of the population, the rate of this growth is incomparable with the rates of increase in prices and turnover at the Moscow housing market and could not explain this increase. Nevertheless, economic growth and the inflow of investments accounted, in the year 2003, for up to 10% of the aggregate increase in housing prices by supporting the positive dynamics of the real-estate market and by safeguarding it from collapses and crises.

Let us consider now the influence of the *internal* factors of the Moscow real-estate market.

As far as this category of factors is concerned, one could single out the *decline in the volume of supply* of apartments at the secondary market, which, quite naturally, conduces to price-rising. It would be logical to assume that the main driving force behind this behavior of the sellers is the expectations of a further rise in prices substantiated by the weakening of the dollar in Russia.

Secondly, the situation at the Moscow housing market is influenced by the *record rise in supply at the primary market*. According to V. I. Resin who heads the Moscow construction complex, in the year 2003, the amount of housing put into operation was 4.5 million square meters, including more than 2.5 million square meters earmarked for commercial selling. At the same time, relatively cheap dwellings built of concrete panels are clearly underrepresented at the market. There exists a disbalance between the structure of demand and the structure of supply in respect to the price-quality relationship. Because of this, given the conditions of high effective demand guaranteed by various external factors, the rise in prices of new apartments is nearly synchronous with the rise in prices at the secondary market.

As far as the turnover of the primary market is concerned, the data at our disposal are rather contradictory, given the absence in Moscow of any available official statistics. Thus, realtors usually say that the volume of sales of apartments in new buildings has risen by 20-25%, while the head of the Moscow Registration Committee, H. A. Skvortsov, points to a sharp decline in the number of registrations of investment contracts. The head of the Department of Promising Designs of the DIPFG, Ye. Leonov, indicates that in the last two months of the year 2003 there was a decline in demand at the primary market<sup>64</sup>. Under these conditions, builders act cautiously, either freezing or reducing the prices by means of Christmas discounts and special offers.

Thirdly, a new factor dealing with the onset of development of mass mortgage should also be taken into consideration.

According to the Bank of Russia, by the beginning of the year 2003, credits on housing were advanced by 143 banks. In the year 2002, the volume of such credits increased nearly

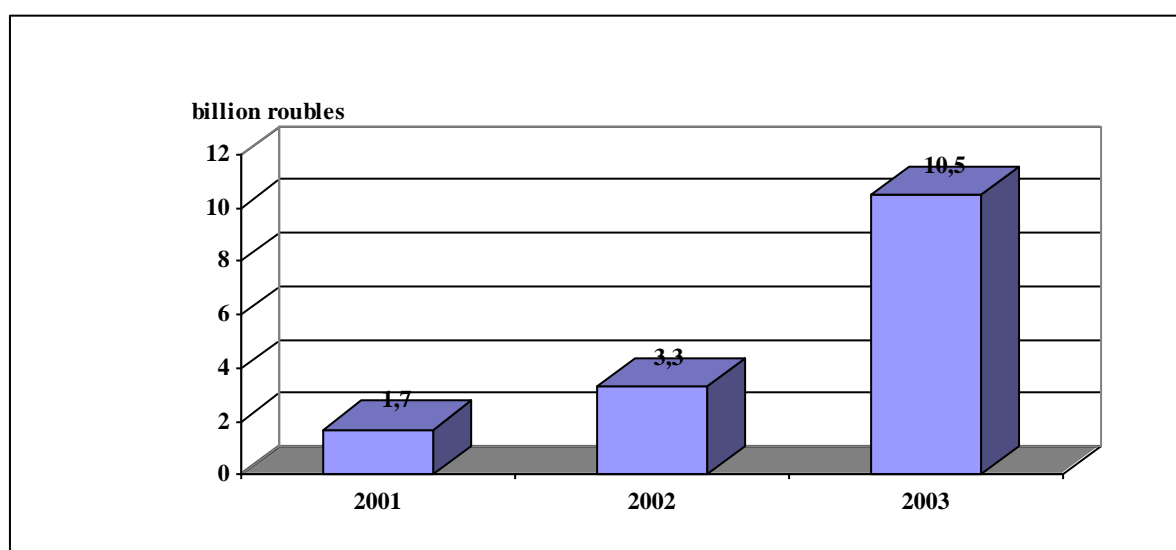
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<sup>64</sup> See V. Leonov. *Kogda upadut tseny na kvartiry*. (When will the prices of apartments fall down?) // "Nedvizhimost. Zhiloi fond" (supplement to the newspaper "Vesti"), December 2005, No 4.

two-fold - from 1.7 billion roubles to 3.3 billion roubles (*Figure 6*). The average amount of a credit rose from 430,000 roubles to 530,000 roubles, while the term remained at the level of 10 years. Sixty-eight percent of the aggregate mortgage portfolio was nominated in foreign currency. In the year 2003, the volume of mortgage crediting increased three-fold - up to 10.5 billion roubles.<sup>65</sup> Though mortgaging in Moscow is not in full swing as yet (partly because of sufficient effective demand), approximately 2,000 mortgage credits have already been advanced. Next year, this figure can increase two-to-fourfold, which would exert an additional influence on prices, pushing them upward.

*Figure 6*

**Changes in the volume of advanced mortgage credits in the years 2001-2003**



It is necessary to separately discuss the possible influence exerted on the primary market's prices by the beginning *upsurge in the cost of construction* caused both by the rise in production costs and by the heavier demands placed by the city authorities on the builders as well as by the onset of auction sales of land plots for housing construction. Apparently, the purchasers of licenses for construction on the corresponding land plots who agree to the extremely high prices have calculated their expenses so as to avoid the risk of excessively reducing the profitability of the project in face of the existing realization prices. In other words, at the present time, the factor of expenses is not responsible for selling prices of housing and practically does not influence their changes. But it could become decisive if effective demand at the market and the profitability of investment projects should decline.

Thus, the internal factors of the real-estate market are not pushing prices upward, but they also do not prevent their further growth.

<sup>65</sup> According to the real-estate agency "Laurel" (see Dychenko O. Zeiyonyi svet na "Ulitse ipoteki" (The "go-signal" in Mortgage Street) / Bankovskoe obozrenie, 2003 (spetsvypusk)) ([www.rusipoteka.ru](http://www.rusipoteka.ru)), Information service "Ipoteka" ([www.ipoteka.cosa.ru](http://www.ipoteka.cosa.ru)), [www.realty-inform.ru](http://www.realty-inform.ru).



### A forecast of the behavior of prices

In mid-December 2003, there was published a preliminary forecast concerning the behavior of prices at the Moscow housing market in the year 2004.<sup>66</sup> It was based on the above assessments of the influence exerted by various factors on the behavior of prices at the housing market, as well as on the forecasts for the year 2004 presented by economists, oil-market analysts, the RF Government and the RF Central Bank.

The first to be used was the forecast of oil prices, according to which their decline would begin early in the year, and by the early summer they would fall to 19-23 USD/barrel (the RF budget for the year 2004 is based on the assumption that the average annual price under the pessimistic/optimistic scenario would be 19.5/22.0 USD/barrel). During the second half of the year 2003, the forecasts of the behavior of oil prices were based on the assumption that the crisis in Iraq would soon be over, that the volume of oil extraction in this country would be restored and that the supply of the Iraqi oil to the world markets would grow. Nevertheless, the activization of armed resistance, which had not stopped with the arrest of the former Iraqi leader Saddam Hussein and a number of major figures from his entourage, as well as the vagueness of any prospects for a quick solution of the problem because of the presidential elections in the USA in November 2004 caused the oil-market analysts to revise their forecasts, and now they predict that oil prices would remain high at least until the end of the first half of the year.

If the estimates are correct in respect to the Moscow housing market, and even if the other important factors pushing the prices up are not taken into account (the presidential electoral campaign, the exchange rate of the dollar, and the general economic growth), it would mean a 3-4%-monthly rise in prices, or a 20-25%-rise for a half-year. If the decline in oil prices begins in the summer, our forecast for the year 2004 predicts a general annual rise in housing prices by 30-35%.

The situation in the sphere of currency exchange is more controversial. Some experts (for example, George Soros) predict that the devaluation of the dollar against the euro will continue till the end of the year to the level of 1.35-1.40, while other specialists (for example, V. V. Gerashchenko) predict that the dollar will start to gain strength against the euro in the nearest future and will gradually rise to the level of 1.10-1.15 by the end of the year. Under the second scenario, which involves a narrowing of the gap between the dollar and the euro, the euro sharply declines against the rouble and its attractiveness for the Russians decreases. In this case, the exchange rate of the dollar would decline by 5-6%, or to 26.5-27 roubles, by the end of the year, while the exchange rate of the euro will drop to 29-30 roubles. This would correspond to a contribution to the rise in housing prices in Moscow in the amount of 10-12%.

To a certain extent, the rate of the rise in housing prices would also be accelerated by the general growth of the GDP and the revenues of the population planned in the budget to be at the level of 5-6%, by the development of the mortgage system and, possibly, by the presidential electoral campaign in March 2004.

The volume of housing construction is planned to be kept at the level of 4.5 million sq. m., while the share of housing earmarked for resettlement of residents from the buildings to be

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<sup>66</sup> See G.M. Sternik, *Rynok zhil'ia Moskvy: predvaritel'nyi prognoz na 2004 god.* (The Moscow housing market: A preliminary forecast for the year 2004). Materials of the MAGB press-conference, 15.12.2003, [realtymarket.org](http://realtymarket.org).



destroyed into new dwellings, provided to persons on the waiting list and to some other categories of citizens free of charge or on the subsidy basis, must increase. Therefore, the volume of supply at the primary market will slightly decline, whereas effective demand will go up.

Thus, the general forecast of the rise in housing prices in Moscow in the year 2004 is close to the figures of the year 2003; that is, it is expected to be at the level of 40-45%. The above analysis shows that there will be no fundamental threats of either macroeconomic or microeconomic character to endanger the situation at the Moscow real-estate market in the foreseeable future.

This conclusion can provide the basis for the two following preliminary scenarios of the development of the Moscow housing market.

In our opinion, the first likely scenario will be a gradual and symptomatic (with “crawling-in”, as the technical terminology would put it) transition to stabilization in late 2004 and early 2005; in the year 2004, the price-rise will amount to 40-45%, while in the following two or three years it will amount to an “inflationary” 5-10%, or roughly correspond to the rate of inflation. We consider the probability of this scenario to be about 70-80%.

Nevertheless, the second scenario is also worth considering.

In our opinion, the possible threats to the market are to be looked for in the psychological sphere. It is common knowledge that the real-estate market is more exposed to the influence of irrational factors than any other market, and this influence cannot be always explained by the existence of any fundamental reasons. The real-estate market is a fluctuating socio-economic system, which is unlikely to remain at the point of equilibrium after having reached it. In the absence of strong stimulating factors, the transition to price-stabilization under the influence of the supply-demand situation could result in a more or less radical roll-back of prices (if not in their collapse). This already happened in the years 1995 and 1996, when no macroeconomic indicators were pointing to the impending decline in prices. However, the transition to stabilization has taken place in Moscow in accordance with the “fluctuating” (“rush”) scenario involving a 20-25%-rollback in prices. The same scenario can be expected in the years 2004 and 2005 as well. According to this scenario, in the year 2004, the rise in prices could amount to 40-45%, and during the next two or three years prices would roll back by 20-25%.

The mechanisms for realization of this scenario could be different. For example, the following chain of events is possible: a decline in the rate of sales of new housing - an extension of the schedule of sales in respect to those planned by the builders under conditions of growing demand - difficulties in serving the loans - an increase in the share of bad loans provided by the banks - banking crisis caused by the bad loans failure to complete the investment projects and to put the houses into operation - flight of the buyers from the primary market. In our opinion, the probability of this scenario is 20-30%.

It should be emphasized that within the boundaries of the year 2004, there would be practically no disagreement between these scenarios.

The experience accumulated during the past few years indicates that any of the above variants of stabilization would involve stratification of the market, the continuation of both the price-rise and the activity of the market in some segments, and a possible decline in other segments.

This conclusion would mean that the investors and the builders should strictly monitor and analyze the situation and tendencies at the market in respect to the selected territorial lo-



cation as well as the categories of housing under construction, and that there should be an adequate price policy aimed at guaranteeing the liquidity of the objects and at increasing the profitability of investment projects.

#### 4.5. Reform of the accounting system in Russia

The issue of switching Russian enterprises to the International Accounting Standards has been discussed for a long period of time. The necessity to reform the Russian system of accounting is absolutely clear because under the existing conditions it can no longer fulfill the major functions any such system is expected to implement, that is, to furnish reliable information on the financial standing of an enterprise to the external persons concerned in the matter, and to provide it for any internal purposes, as well as for the purposes of taxation.

Despite the fact that reforming of the accounting system in our country has been under way for quite a long time, only one thing has been accomplished as yet - the setting of the course of reforms specified in the Decree of the Government of the Russian Federation No 283 of 6 March 1998 "On the Approval of the Program for Reforming Accountancy in Accordance with the International Accounting Standards (IAS)". Such a direction of reform generally corresponds to the necessities put forward by the development of the country within the framework of market economy and encompasses all the contemporary approaches to solving the problems of accountancy which have emerged in international practice.

The reforming is gradual. The complex of measures and the deadlines for their implementation are defined both by the above document and by "The Measures for Realization in the Years 2001-2005 of the Program for Reforming Accountancy" approved by the Government of the Russian Federation<sup>67</sup>.

One should not underestimate the difficulties represented by the necessity to rapidly adopt a system of accountancy and reporting totally unfamiliar to the Russian accountant and, what is more, not based on the principles adopted in the past. Nevertheless, the gradual adoption of the new Accountancy Regulations (AR) partly corresponding to the IAS does not solve the main problem of reforming the accounting system, that is, the creation of a strict and understandable national system of accountancy subjects which would meet the requirements of a market economy. The adopted approach just creates new difficulties and further complicates accountancy legislation in Russia.

When analyzing the course of reforming the accounting system it should be kept in mind that in modern practice, as we see it in developed countries, there exists a complex of accountancy subjects based on strict principles, any violation of which would result in a distortion of the results of application of one or other accountancy subject. Such a system can operate only on condition that the approach to it is integrated. The basic principles must remain unchanged whatever changes might take place in respect to the conditions of functioning of enterprises and whatever alterations might be introduced in the regulations for accounting certain operations, and only then the gradual adaptation to the new accounting practices could be achieved.

However, while adopting the foreign standards of accounting and reporting, Russia ignores in its practice the very principles on which these standards are based. In the West, the accounting system, when being formed, has passed the way from formulating the principles (it is in the basic principles on which an accounting system is based that its objectives and tasks are expressed) to formulating the accountancy procedures. In our country, as a rule, the sequence of steps aimed at reforming one or other area of accountancy is reverse; certain new provisions would be developed and introduced to regulate the procedure for accounting in a partial accordance with the international standards, while the objective would be left outside

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<sup>67</sup> Letter of 13.04.2001 No KA-P13-06573.



of the framework of reform, because an indirect or partial recognition by Russian accountancy legislation of the basic principles of any foreign accounting system cannot guarantee their implementation.

Essentially, accountancy in Russia is not financial but tax accounting from a Western point of view, because financial reporting on the part of Russian enterprises serves as a basis for the imposition of the profits tax. At the same time, under market conditions, economic agents would need reliable financial information for decision-making. It is evident that if one and the same reporting serves both for the purposes of taxation and for those of the external users, the information it contains could not be classified as unbiased.

And that is not the only reason for mistrust in the reports composed in accordance with the Russian standards. Given the absence of any inviolable principles on which accountancy legislation could be based and a very chaotic manner in which the new AR are being adopted, the accountancy information could be rather easily manipulated.

Actually, at the present time, accounting formed on the basis of prevailing accountancy legislation is, quite frequently, of no interest for most of the users. In essence, what we have now, is accountancy for the purposes of taxation (and from the year 2002 - simply tax accounting), and managerial accounting for internal users, while accountancy for investors is composed in direct accordance with the IFRS (IAS) or US GAAP. Thus, there exist practically all the preconditions for introducing the foreign system of accounting disciplines.

#### *4.5.1. Financial accounting*

At the present stage of reform, there remain numerous problems in the sphere of reforming the accounting system in Russia. In practice, the issue of switching Russian enterprises to the IAS has turned to be more difficult than it seemed at the time the program for this transition was being developed. The discrepancy between the current measures taken in this sphere and the approved schedule also points to this fact. According to the Plan of measures aimed at implementing the program for reforming accountancy in accordance with the IAS (Supplement to the Government Decree No 28.3 of 6 March 1998), by the year 2000 there should have been developed a number of programs concerning the training and re-training of specialists in the field of accountancy as well as of the personnel of accountancy services; also completed by this date should have been the development of instructions, methodological directions and recommendations in respect to accountancy to be formed as individual provisions (standards). None of these tasks has been fulfilled as yet.

In accordance with the above program, reform should have been carried out along the following major lines:

- improvement of normative legal regulation;
- formation of a normative base (standards);
- methodological back-up (instructions, methodological directions, commentaries);
- manpower coverage (formation of accountancy as a profession, training and re-training of specialists in accountancy);
- international cooperation (accession to the corresponding international organizations and active participation in their work; interaction with the national organizations engaged in the development of accounting standards and in the regulation of the corresponding activity).

Later, we would discuss the problems of reforming the Russian system of accountancy in its major aspects.

It should also be necessary to focus on the two most salient events in accountancy reforming:

1) from the year 2004, Russian banks would switch to the International Accounting Standards<sup>68</sup>;

2) On 19 June 2003, there was issued IFRS 1 “The First-time Adoption of International Financial Reporting Standards”<sup>69</sup>.

IFRS 1 requires that enterprises should correspond to every standard in force at the time of the first application of the IFRS (there are certain exceptions from the rule prescribing complete correspondence that may be permitted in the spheres where the costs of meeting this requirement would exceed the benefits to be gained by the users of this accounting system). According to IFRS 1, the enterprises using the IFRS for the first time, should present an opening IFRS balance sheet for the date of transition<sup>70</sup> and to show how the switching to the IFRS have affected their financial position, financial performance and cash flows.

Thus, the International Accounting Standards Board (IASB) has, in fact, imposed a regulation on the procedure for switching the enterprises to the new principles of accounting and reporting. This regulation significantly differs from the one envisaged in the Russian Program for reforming accountancy in accordance with the International Accounting Standards, which would certainly produce some additional difficulties.

According to the Program, “the key element in reforming accountancy and financial reporting in correspondence with the international standards is the development of new and the clarification of the previously adopted provisions (standards) in respect to accountancy, and their introduction into practice” which contradicts the major requirement set forth by the International Accounting Standards Board, which necessitates the full correspondence between an enterprise's accounting and the existing international standards. According to the Board, switching to the IFRS should take place not through adapting a national policy to the international standards but through adopting the IFRS as a coherent system of accounting disciplines.

### *Switching of Russian enterprises to the International Financial Reporting Standards*

Experience indicates that Russian accountancy legislation existing at the present time does not correspond to the main requirements on the part of users of financial reporting. For a long period of time and for a number of objective reasons (closed planned economy) Russia did not have any need in furnishing the external user with reliable and neutral financial information, while its accountancy legislation was just a base for state control over the economy. The main user of accountancy information was the State in the person of branch departments

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<sup>68</sup> See below the section devoted to this event.

<sup>69</sup> On 1 April 2001, the reorganized International Accounting Standards Board (IASB) replaced the previous Board of the International Accounting Standards Committee (IASC). All the international accounting standards (IAS) adopted prior to this date remain in force. In the course of time they would be updated by the IASB to be added to the new IFRS. The term IFRS includes the previously adopted standards (IAS).

<sup>70</sup> The beginning of the earliest period for which an enterprise must submit the completely comparable information in the form of its first financial report composed in compliance with the requirements of the IFRS. For example, if an enterprise is intending to submit its first IFRS balance sheet for the period finishing on 31 December 2005, it should compose an opening balance sheet for 1 January 2004.



and ministries, as well as various state planning and statistics agencies. In this connection, the main responsibility imposed on the system of financial reporting was to expose any deviations from the models of economic behavior prescribed to organizations<sup>71</sup>.

Since the early 1990s, as a result of a number of reforms, some cardinal changes have taken place: the development of democratic institutions and market relations, the creation of a new tax system, the introduction of new property relations, etc. Market reforms in Russia and the inclusion of our country in the global economic space have created necessary preconditions for the reformation of the national accounting system in correspondence with the International Accounting Standards. Switching to the IFRS would create new opportunities both for the enterprises and for the State in general.

### The positive aspects

The consultants working on the Federal Securities Commission's project concerning the development of a strategy for switching Russian companies to financial reporting in correspondence with the international standards have conducted a survey of Russian companies carried out at the first stage of the said project. One of the questions put to them pertained to the goals pursued by the companies when preparing their international reporting. The result is shown in *Figure 7*.

*Figure 7*



\*information from the company's websites

Clearly leading among the stimuli to prepare a financial report in correspondence with the international standards was the wish to enhance the reputation of a company. In the second place was the wish to correspond to the new requirements of the market and to gain access to foreign stock markets.

Financial reports prepared in accordance with the international standards provide the user with complete, reliable and neutral information concerning the financial standing and cash

<sup>71</sup> Government Decree of 6 March 1998 No 283 "On the adoption of the Program for reforming accountancy in accordance with the International Accounting Standards".

flows of the corresponding enterprise which is guaranteed by the fundamental principles of the IFRS.

Given the absence of the users' trust in the data of any reports composed in accordance with the requirements of the Russian AR, international financial reporting becomes the indispensable means of communication not only for the enterprises that have foreign partners but also for all those who are eager to enjoy trust in the Russian business-community.

Actually, many countries do a lot to make their national accounting practice closer to the International Accounting Standards. First of all, this is true of the enterprises whose shares are quoted at the world's financial markets. Under these conditions, international financial accounting would imply the existence of a certain quantitative level of the development of management, including financial management, at the corresponding enterprise, the level which, in its turn, would bring about better terms of financing, longer terms of loans and lower interest rates.

Moreover, the presentation of reliable information is considered by the market to be a positive signal, and therefore it would result in a direct increase in value. It should be noted that this effect is not immediate to come. It is also worth mentioning that in the period of transformation of the Russian accounting system, one should expect a decline in the capitalization of domestic enterprises which results from the inadequacy of accountancy information in respect to the actual state of affairs at the present time and points to the switching to a new system of accounting and reporting that would provide the user with reliable and neutral information pertaining to the enterprise in question.

Thus, it is reasonable to believe that the switching to accounting and reporting in correspondence with the IFRS would enable Russian enterprises to gain the following advantages:

- enhancement of reputation and an increase in market capitalization in future;
- access to foreign capital markets and a decrease in the cost of debt capital;
- improvement of corporate management owing to the use of accountancy information in decision-making in the sphere of management.

All the above stimuli manifest themselves not only at the microlevel but also at the macrolevel. For the State as a whole, the advantages implied by the adoption of the IFRS by Russian companies are as follows:

- integration of the Russian economy in the system of global economic relationships;
- influx of investments strengthening the Russian economy;
- improvement of the quality of statistical data and the possibility to compare them.

As noted above, the IFRS are becoming a real instrument of international integration because many countries including the USA, Australia, Japan and the countries of the European Union are switching to the system of international standards. In this connection, the switching of Russian enterprises to the IFRS should be considered as a step bringing them closer to their partners abroad.

As also noted above, the Russian standards of accounting do not guarantee such important qualities of accountancy information as reliability, timeliness, and materiality which are integrated in the fundamental principles of the IFRS, and therefore the statistical information pertaining to Russian enterprises has major shortcomings making it less trustworthy. Moreover, the principles of comparability and consistency of the accounting procedures which are stipulated by the IFRS and which imply the presentation of report data in such a way that their comparison would be possible (for several reporting periods), and if the accounting pro-



cedures are changed these principles would require the data to be clarified and presented in comparable formats, thus making it possible to improve the quality of the corresponding statistical information and to compare it in respect to both domestic enterprises and foreign companies.

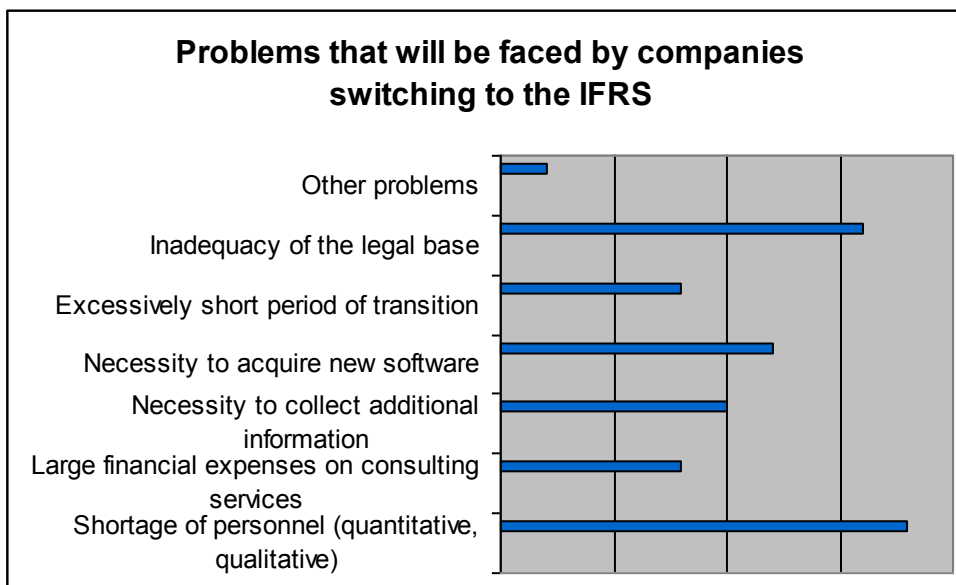
As far as the possibilities to manipulate the information are concerned, it should be necessary to keep in mind that any rules and regulations could be violated, but what really matters is the clarity of one or other violation and how great is the possibility that this violation would be exposed. If an enterprise formally does everything in compliance with the rules but, in fact, hides the real state of affairs, the methods adopted by the Russian accounting system would sometimes fail to expose the violations because from a formal point of view all the rules have been observed. At the same time, the international standards are oriented to the judgments based on the essence of an event or transaction. Therefore, the foreign accounting system is capable of revealing hidden information even in the case when, formally, all the procedures have been carried out correctly.

#### The negative aspects

The switching to the IFRS would create not only advantages for Russian enterprises and the State as a whole but also numerous problems to be solved immediately.

Figure 8 demonstrates the results of a survey conducted in the framework of the above-mentioned Federal Securities Commission's project.

Figure 8



Thus, it could be seen that the maximum concern on the part of enterprises is caused by shortage of personnel and inadequacy of the legal base.

Unfortunately, the results of the survey do not reflect one more serious problem dealing with the introduction of the IFRS in Russia - the absence of strict understanding of the basic principles integrated in the system of accountancy subjects in a modern market economy and also the lack of real preconditions for introducing these principles in Russian practice. In



many respects, this problem is the source of quite a number of legislative omissions and additional financial expenses on consultants.

One of the major components of the success in switching Russian enterprises to the International Financial Reporting Standards is, in our opinion, the human factor.

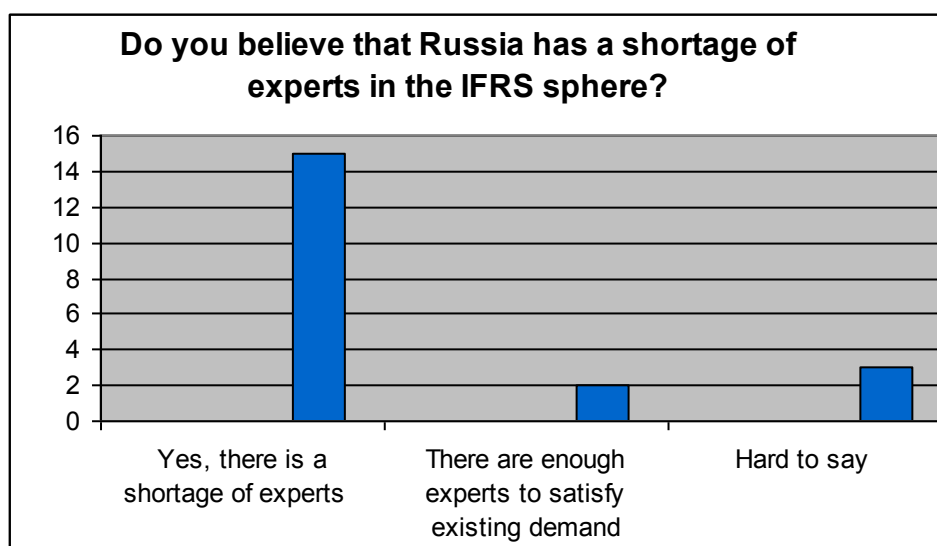
Financial accounting in contemporary foreign practice is organized in such a way that the key role in recognizing and assessing the events and operations belongs to the accountant. The system of accounting in foreign countries with developed market economies, as a rule, is based on a certain set of obligatory principles. At the same time, the concrete accounting procedures envisaged in the accounting standards and accountancy legislation could be changed or amended if some methods improved in comparison with the existing ones have been developed to reflect economic transactions, or if the circumstances have changed<sup>72</sup>. However, the principles would remain permanent and independent of any accounting procedures.

It is evident that all the instances emerging in business practice of every concrete enterprise could not be reflected in the standards especially under conditions of a constantly changing environment. In such cases, in order to reflect a financial event or a transaction in correspondence with the fundamental accounting principles, a qualified opinion of the accountant would be required.

One of such principles is the priority of economic substance over juridical form which would be a complete novelty for the majority of Russian accountants who are still working within a system based on the most rigid instructions from above and on the documentary verification of every transaction. Thus, at the time of switching to the IFRS, the mentality of practical workers is a problem as difficult as the one of a shortage of trained personnel.

*Figure 11* demonstrates how enterprises assess the situation in this sector of the labor market (the answers have been received within the framework of the Federal Securities Commission's project concerning the development of a strategy for switching Russian companies to financial reporting in correspondence with the international standards).

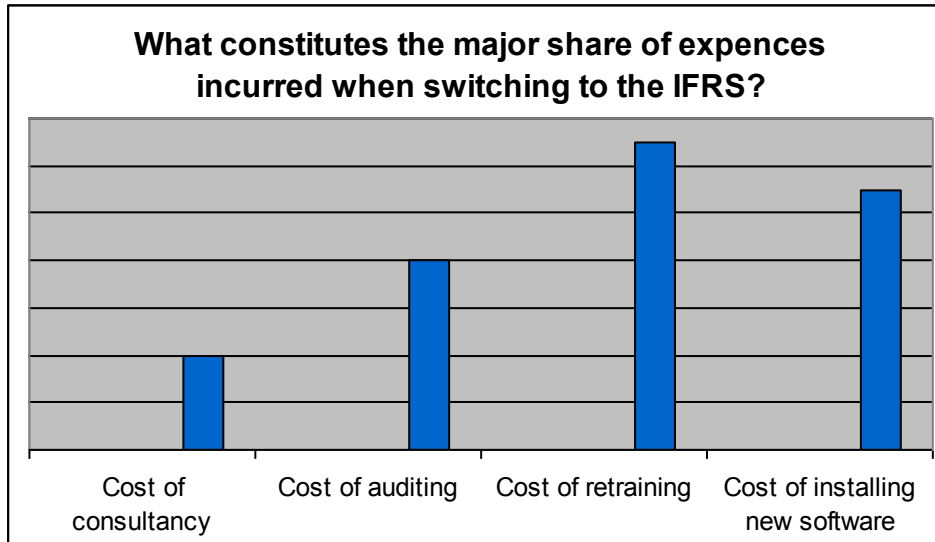
*Figure 9*



<sup>72</sup> Statement of Accounting Principles Board № 4, par. 138.

In many respects, the existing shortage of trained personnel also explains the structure of expenses incurred by Russian enterprises when switching to the IFRS (*Figure 10*). These results have also been obtained within the above project of the Federal Securities Commission.

*Figure 10*



It could be seen that the costs of retraining and the costs dealing with the shortage of specialists (the cost of services provided by consultants and auditors) outweigh the capital costs incurred by Russian enterprises when switching to the IFRS. Such a situation would result in a considerable rise in expenses on the development of methodological and practical recommendations concerning the international standards, especially at the initial stage of the transition.

Another key problem encountered in the course of switching Russian enterprises to the IFRS is the creation of a logical and noncontradictory legal base in respect to this sphere which would be in agreement with the rest of legislation. The solution of this problem mainly depends on how deeply the Government is interested in solving it and on the insistence of the business community thereof.

In the last few years, the RF Government, while implementing the Program for reforming accountancy in correspondence with the international accounting standards, issued a large number of AR partly corresponding to the IAS (IFRS). At the same time, the fundamental principles of the system of international standards, that is, understandability, relevance and reliability, have not been properly formulated in the AR as yet. And the principles of forming the reports, such as conservatism, completeness and the priority of economic substance over juridical form, are altogether left by AR 1/98 to discretion of an organization which shall specify them in its Accounting Policy (paragraph 7). As the Accounting Policy of an Organization reflects the specific features of accounting at a concrete enterprise, it is not possible to claim that the fundamental principles of the IFRS have been universally recognized by the Russian economy as a whole.

The legal status of the IFRS is still indefinite in Russia. There is no official Russian translation of the IFRS. In this situation, the leading Russian enterprises are forced to carry out two or even three types of accounting (financial - in accordance with the Russian standards,

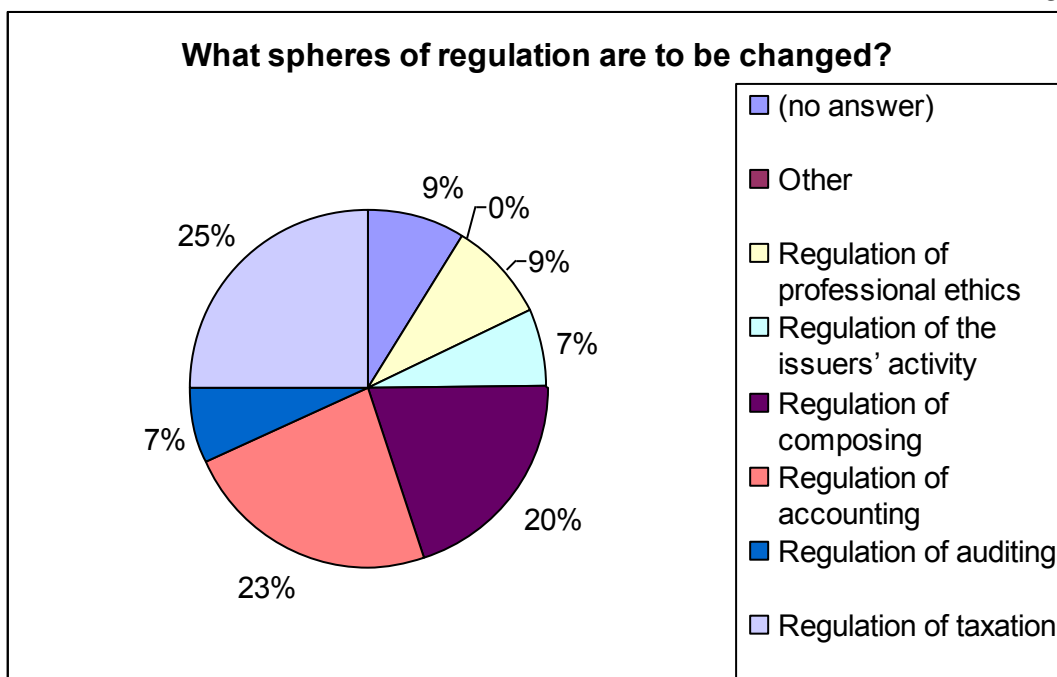
financial - in accordance with either the IFRS or the US GAAP, and tax accounting), which inevitably causes a rise in consultancy costs.

Bearing in mind all the afore-said problems, it would be urgently important, first of all, to conceptually determine the status of the IFRS in the Russian economy, i. e., to solve the problems pertaining to the possibility of IFRS financial statements instead of those prepared in accordance with the Russian standards, and to use them as a basis for calculating the corresponding tax liabilities, and also to accomplish the regulation of accounting in accordance with the international standards.

As the system of IFRS envisages the regulation of accounting on the basis of professional organizations and auditing firms, it would be necessary to adopt a law on self-regulatory organizations and a number of amendments to the Law "On Auditor's Activity" to be composed in accordance with the International Standards on Auditing and in order to accord relevant status to the auditing of reports prepared in correspondence with the IFRS.

It would be impossible to affirm that Russian enterprises have begun to switch to the IFRS unless a clear legal concept of their application is developed.

*Figure 11*



The data presented in *Figure 11* clearly demonstrate that there remain a lot of problems to be solved in respect to the regulation of the system of accounting disciplines in Russia.

Finally, it should be necessary to touch upon one more problem frequently encountered by Russian enterprises when switching to the IFRS. The case in point is the increase in expenses on the collection of information and on organizing the information flows within a company.

The expenses on the collection of information would grow because the financial reports prepared by companies in accordance with the IFRS differ from those prepared in correspondence with the Russian standards by a larger volume and a greater accuracy in revealing the fi-



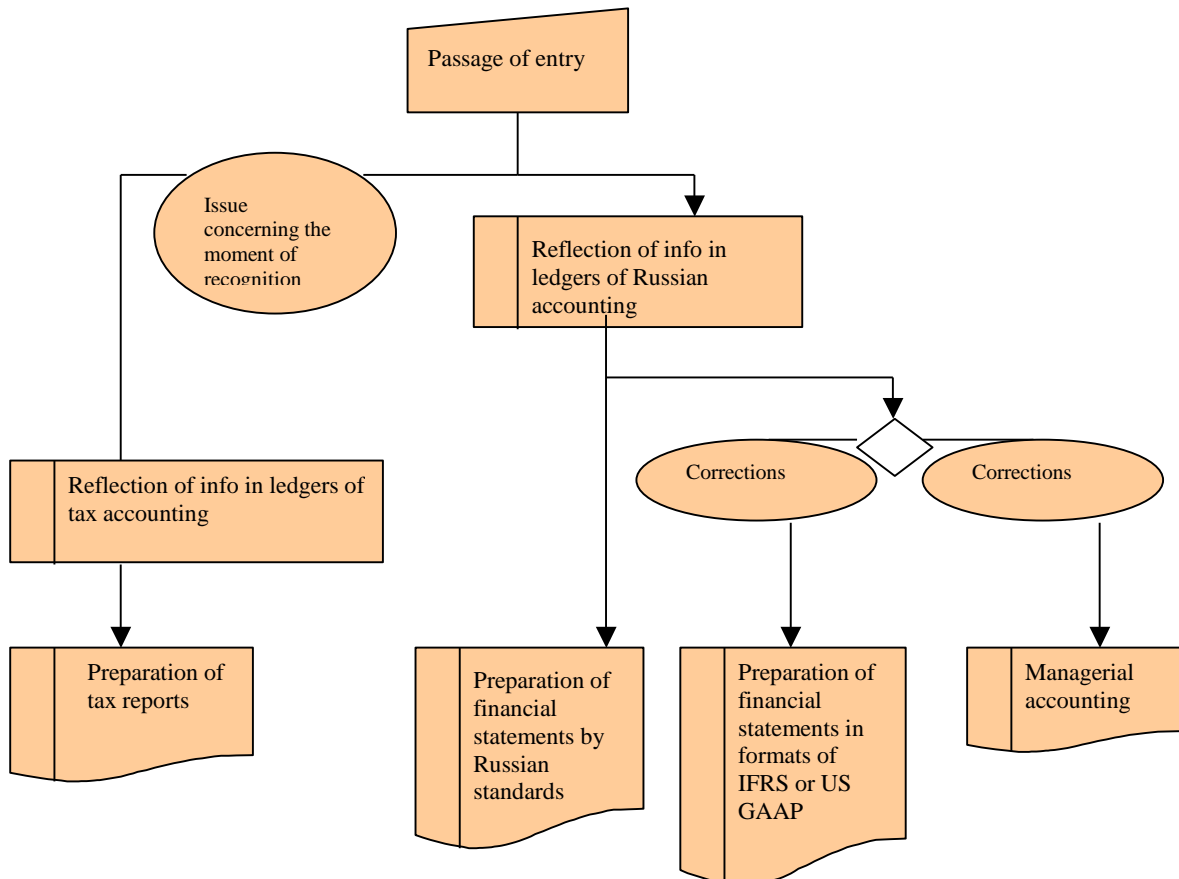
financial data concerning the corresponding enterprise. Accordingly, some additional expenses would be necessary in order to collect and verify the information pertaining to each of the departments and subsidiary enterprises. Also, it should be noted that in the first few years of the period of transition, the expenses would be especially high owing to the organization of a new system of communication among various subdivisions of the enterprise in question.

Another aspect of this problem is the organization, within the company, of an optimum information system that would make it possible to generate the data for the purposes of financial, managerial and tax accounting.

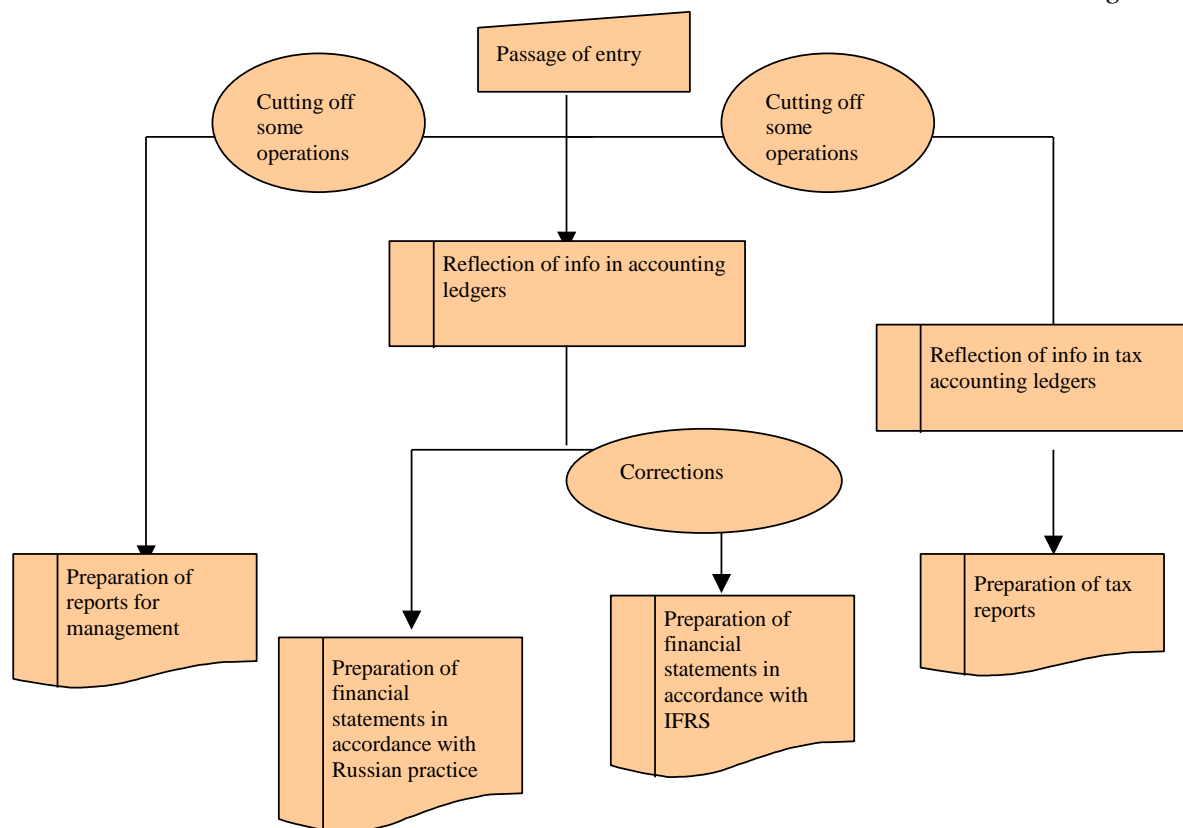
At the present time, the information flows in many a company are organized as shown in *Figure 12*. At the same time, it is possible to offer a more rational organization of the information flow within an enterprise (see *Figure 13*).

Such an organization is, firstly, more efficient because it discards the excessive data at the entry to each of the system's unit; secondly, it would permit to avoid considerable expenses when switching to the international standards because the discontinuation of financial accounting by the Russian standards and the abandonment of the corresponding ledgers would result only in the cancellation of corrections (see *Figure 13*) and would not require to replace or modify other ledgers; and thirdly, it is conceptually consistent with the modern organization of the system of accounting disciplines because it envisages a certain delimitation of financial, managerial and tax accounting.

*Figure 12*



*Figure 13*



## Conclusions

A complex approach to solving the problems which emerge in the course of switching Russian enterprises to the International Financial Reporting Standards is essential and indispensable. It is the only means to eliminate the whole complex of interrelated problems which nowadays makes it possible to affirm that the IFRS cannot be used efficiently in our country.

It would be necessary to guarantee the transition to the IFRS by providing it with legislative, financial and manpower-related support in order to ensure that this transition would take place within the framework of a well-defined concept.

The legislative support should particularly include the following measures:

- determination of the IFRS legal status in Russia;
- creation of a mechanism for regulating the use of the IFRS on the basis of professional organizations and big auditing firms. The role of the State would consist in guaranteeing the observance of legislation on joint-stock companies and the securities market.
- The manpower-related support should include the following:
- development and adoption of a concept in respect to the training of the IFRS experts in Russia, and, in particular, the development of a new or the adoption of the already existing system of certification composed in accordance with the IFRS, which is to be approved by the International Accounting Standards Board;



- development and introduction of a program of continuous education for accountants and IFRS auditors which would correspond to the requirements formulated by the International Federation of Accountants;
- development of programs of education for the Russian users of IFRS-based reports.
- In order to guarantee efficient switching of Russian enterprises to the IFRS, it would be essential to finance a number of measures aimed at supporting the process of transition, such as:
  - conduct of organizational works in respect to the development of a refined version of translation of the IFRS and the International Standards on Auditing;
  - creation of a self-regulatory organization of accountants and IFRS auditors;
  - development of methodological recommendations concerning the IFRS and of a complex of practical recommendations for various sectors of the economy;
  - organization of the process of education and certification of persons including the civil servants working with IFRS-based reports.

### *Switching of the banking sector to the International Financial Reporting Standards*

On 30 December 2001, the Central Bank issued the document “On the Strategy of the Development of the Banking Sector of the Russian Federation” specifying that from 1 January 2004, Russian banks would switch to the IFRS together with all the other sectors of the economy (point 7.2.3). On the eve of the year 2004, it had become clear that the Russian banking sector would be the first to carry the brunt of the full-scale switching to the new system of accounting and reporting.

Despite the fact that the switching of the banking sector to the IFRS is the *fait accompli*, there remain a lot of problems both technological and methodological which have not been solved as yet. That is why we may consider the results of this reform to be rather dubious.

#### The goals of transition

The Russian banking system desperately needs profound reorganization. At the present time, the funds of a large number of Russian banks are considerably inflated, and the banking sector includes many potential bankrupts functioning alongside healthy organizations. In this situation, the Central Bank considers the International Financial Reporting Standards to be an instrument of controlling the banking system and simultaneously increasing its transparency.

The main objectives of switching Russian banks to the IFRS are as follows:

- to generate complete, detailed, trustworthy and substantive information concerning the activity of credit organizations and their financial statuses;
- to use financial accounting and reporting for the purposes of managerial decision-making;
- to prevent negative results of business activity on the part of credit organizations and to reveal the internal reserves that could guarantee their financial stability.

Russian practice of accounting does not make it possible to accomplish these ends. It is out of the question to suggest that the information contained in the accounts which are prepared in accordance with the Russian standards can be comprehensive and reliable, because the very structure of the Russian system of accounting effectively prevents accountancy from acquiring these properties. The majority of the existing methodologies concerning managerial accounting, for example, the coefficient analysis, have come to Russia from the West, and

therefore they are oriented to the use of financial information obtained in accordance with the western principles of accounting. The revelation of the internal reserves of an enterprise is also a goal of managerial accounting. As far as the “control” function is concerned, the absence of trust in the existing system of accounting is widespread not only among the largest Russian enterprises and banks but also among the public authorities.

At first glance, the situation is as follows: the banks receive the instruments for analyzing the internal information and for adopting the up-to-date managerial decisions that would improve the efficiency of their work, while the State receives transparent and sufficiently detailed financial reports of the banks which would enable it to track down dishonest market participants. In reality, everything is much more difficult, because the international standards themselves would hamper the implementation of this scheme.

The international standards of financial reporting represent a system based on a number of very definite principles. If one of these principles is not observed, the result, most likely, would be distorted.

Within the IFRS framework, the function of control over the quality of information in the reports submitted by an enterprise is imposed on independent auditing organization, and indirectly - on the user, because every user has the right to cancel a deal with an enterprise whose reporting he does not trust. And any intervention on the part of state controlling bodies would inevitably result in a distortion of the qualitative characteristics and information contained in the financial reports of an enterprise (bank).

The international standards do not contain any prescriptions concerning concrete accounting procedures. Within the IFRS framework, substance prevails over form, while accounting in correspondence with the IFRS suggests active participation of the accountant in the recognition and assessment of the events and operations. However, it is evident that such standards do not guarantee that enterprises (banks) would treat the events and operations in a uniform manner. Only an expert auditor is capable of judging the correctness (i.e., the correspondence with the standards) of a recognition and assessment of the events and operations. IFRS-based reporting would only complicate the problem encountered by the state controlling bodies and, among other things, would impede the RF Central Bank's control over the banking system.

### The problems

The problems emerging in the process of switching the Russian banking sector to the International Financial Reporting Standards are practically similar to those resulting from reform of the accounting system in other sectors of the economy. They can be subdivided into two categories:

- technical problems;
- issues of the technical organization of accounting;
- issues of personnel training;
- misunderstanding of the fundamental principles of the foreign system of accounting disciplines.

These two categories are interrelated. Some technical problems, for example, those surfacing in the course of the transformation of reporting, result from the misunderstanding of the essence of the adopted international standards and nothing else.



Switching to the IFRS can be carried out through the use of two methods. Every enterprise (bank) would decide what method to apply: either to conduct accounting in accordance with the international standards (in the present circumstances it would mean parallel bookkeeping because the Russian system of accounting has not been discarded), or to transform reporting.

The first method is more expensive but it produces reliable results. Transformation is cheaper, but the data of financial reporting acquired by this method could be characterized as corresponding to the IFRS only at a stretch. This stretch has several reasons: it is necessary to take into consideration the degree of correspondence between the accounting policy of an enterprise (bank) and the fundamental principles of the IFRS, the existence of a large number of corrections essential for bringing the data of Russian accounting into line with the principles of the IFRS (the typical corrections are related to the accrual method, the substance over form principle and the market revaluation; while in the case of banks one of the corrections most important in respect to the final financial result is the creation of reserves in conformity with the international standards, the reserves that should be backed by loans and similar borrowings), and the level of training of the personnel carrying out the transformation. Bearing in mind the large volume of financial and economic activity it would be practically impossible to take into consideration all the corrections to be introduced in respect to the data of bookkeeping based on the Russian standards, even with the availability of well trained personnel and even if the accounting policy is close to the IFRS.

The shortage of trained personnel would create one more negative effect in the course of switching to the IFRS. The fact that specialists capable of expertly and responsibly carrying out accounting and preparing reports are not included in the staff of enterprises (banks) creates the following paradox: IFRS financial statements to be submitted by enterprises (banks) are composed by specialists of international auditing companies, and these very companies would audit them. Given this scheme of interaction between the financial institutions and the auditors, it is not difficult to inform the society on the positive results of functioning of a certain bank, while in reality this information would not have any solid base.

The main difference between accounting based on the IFRS and that based on the Russian standards consists in the procedure for the accrual of reserves on banks' assets. The amount of accrued reserves depends on the category of reliability of one or other borrower. Given the existing practice of interaction between the banks and the auditing companies, the category of reliability of a borrower is determined by the auditor. The lesser is the reliability, the larger is the reserve, and, accordingly, the smaller is the bank's capital. In the Russian situation, when the uncertainty at the financial market is rather strong and the accounts of enterprises could not be considered trustworthy, the reserves accrued in accordance with the IFRS would be relatively large. At the same time, given the existing practice of interaction, the bankers would always have a possibility to convince the auditing firm that in reality the borrower is more reliable than it might seem at a first glance.

### The expected results of reforming

Bearing in mind the present situation when the pathway toward switching Russian banks to the International Financial Reporting Standards is blocked by a multitude of unsolved problems, let us try to assess the expected results of this transition. There would be some positive



results, though not those expected by the Central Bank, and they would be slow to come even if all the numerous conditions are met in order to accomplish these ends.

The first rather obvious result consists in the fact that the switching of the Russian banking sector to the IFRS represents one more step on the road to introducing the international standards in the Russian economy as a whole.

In full measure, the result of the introduction of the system of international standards would manifest itself when this system of accounting disciplines would be obligatory for every market participant, without exception.

Firstly, accounting based on the IFRS implies a certain qualitative level of development already achieved by the systems of enterprise management, including financial management. Thus, the IFRS implies a relatively high level of development of a national economy in general and its banking sector in particular.

Secondly, the foreign system of accounting disciplines implies that the corresponding enterprise has already adopted the system of managerial accounting, the adequate utilization of which is possible only in the case of application of the international standards of accounting and reporting. In its turn, as far as the enterprises are concerned, the presence of managerial accounting and budgeting would mean more favorable terms of financing, including the longer terms of loans and the lower interest rates.

As regards the expectations of the Central Bank that the switching to the IFRS would increase the transparency of the Russian banking sector and would improve the efficiency of control, it is unlikely that they would become true. And the point in case is not limited to the fact that the IFRS are not fitted to ensure the State's control over enterprises' activity.

At the present time, approximately 200 Russian banks prepare their accounts in conformity with the international standards. It is less than 15% of all commercial banks, but they carry out more than 90% of all banking operations. Given this situation, the compulsory switching of the rest of the banks to the IFRS would not be able to significantly change the existing state of affairs. It is especially true bearing in mind the intention of the Central Bank to perform the switching not to the international standards but to the presentation of international financial reporting.

Unfortunately, the information on the number of banks simultaneously carrying out the two types of accounting (Russian and international) is not available. Nevertheless, a number of publications indicate that the majority of the leading commercial banks preparing their reporting in accordance with the IFRS transform the corresponding data by means of various methods. In some banks, these technologies actually produce the results very close to the requirements of the IFRS, while elsewhere the scheme of transformation has too many weak points to yield any results that could be considered trustworthy.

If the transition to the IFRS is conducted in accordance with the Central Bank's scenario, the transparency of the Russian banking sector would, most likely, remain unchanged.

The point is that there are too many conditions to be met in order to achieve a positive result. It is necessary to adequately organize the process of transition; to guarantee the correspondence between the international standards and accountancy as such and not only the accounting data; to solve the personnel problem; and to change the existing scheme of interaction between the banks and the auditing companies.

Would the switching of the Russian banking sector to the IFRS result in the transformation of the banking system?



The situation is close to that existing in the sphere of the struggle for transparency. And there is also one additional aspect: it is impossible to say with confidence how the switching to the IFRS would influence the capitalization of Russian banks. Everything depends on the way the transition would be organized and on the model of usage of the IFRS that would emerge in this country.

We have already discussed the issue concerning the reserves in respect to banks' assets. As far as the banks are concerned, this is the main component of changes in capital at the time of switching to the international standards. An important role would be played by the structure of assets, investments in particular, as well as by the structure of liabilities. It is these parameters that would determine the scope of corrections to the accrual method and to the substance over form principle. The structure of investments determines the size of the correction to market revaluation, because in accordance with the international standards, investments are valued in the accounts of an enterprise by the so-called "fair value"; for example, traded securities are valued by their market value and not by their acquisition prices. Accordingly, the amount of profit or loss resulting from changes in the value of traded securities also influences the amount of capital of an enterprise (bank).

What would happen with the capitalization of Russian banks if the international standards are introduced as a system? In the short term, the capitalization would inevitably decline. Firstly, the new authentic system of accounting would force the banks to get rid of "inflated" capital. Secondly, the reserves accrued in the course of financing the enterprises initially would be sufficiently high, for the level of Russia's economy in general and of its financial market in particular is not adequate as yet.

And there exists a significant factor of the potential rise in the capitalization of Russian banks: the market considers the presentation of reliable information to be a positive signal, and therefore it would result in a direct rise in value. This tendency is already starting to manifest itself in the Russian economy, and the analysts of investment companies directly link the increase in capitalization of some Russian companies to the fact that they submit to the market more information on their state of affairs.

#### *4.5.2. Tax accounting*

As far as reforming of tax accounting in Russia is concerned, attention should be given to the two events dating back to the year 2002 which are still widely discussed and continue to influence the situation. It is the putting into effect of Chapter 25 of the Tax Code of the Russian Federation "Profits tax on organizations" and the putting into effect of the Accounting Regulations "Financial accounting in respect to the profits tax" AR 18/02.

The effects of the adoption of these documents were actively discussed throughout the year 2003. For example, the Ministry for Taxes and Levies suggested to introduce some amendments to the Tax Code that would have reduced the gap between financial and tax accounting, and also it was suggested to abolish both Chapter 25 of the Tax Code and AR 18/02. Nevertheless, no steps in this direction have ever been taken, and the situation in the sphere of tax accounting is still determined by the two afore-mentioned documents.

According to the head of the Department of Profits Taxation of the RF Ministry for Taxes and Levies, K. Oganian, the said Ministry is planning to submit to the State Duma a number of draft amendments to Chapter 25 of the Tax Code which is to take place in the first six months of the year 2004. These draft amendments are aimed at narrowing the gap between

financial and tax accounting, and are primarily focused on the issue of treatment of production costs.

*Adoption of Chapter 25 of the Tax Code of the Russian Federation "The profits tax on organizations"*

With the adoption, from 1 January 2002, of Chapter 25 of the RF Tax Code "The profits tax on organizations", financial and tax accounting was separated, and a new procedure for the computation and payment of the profits tax by enterprises was established. Chapter 25 of the RF Tax Code has finally introduced tax accounting as mandatory for all Russian enterprises which are computing and paying the profits tax.

Tax accounting is defined in Article 313 of Chapter 25 of the RF Tax Code as "a system for generalizing the information needed for determining the tax base for the tax on the basis of primary documents grouped in accordance with the procedure envisaged by the present Code". The main principle of tax accounting consists in grouping the information contained in primary documents into analytical registers in accordance with the requirements of tax legislation, and not with those of accounting legislation, in order to form the tax base of the profits tax and to fill in a tax declaration.

The Tax Code contains no stipulations concerning any specific methodology of tax accounting. The taxpayer must decide on his own as to how to organize accounting procedures – either on the double-entry principle (in this case it is necessary to develop a working card of accounts with postings), or on the receipts-and-expenditures principle (in an analogy with enterprises which have adopted simplified accounting procedures), or in accordance with any other system.

On the whole, as defined in Chapter 25 of the RF Tax Code (Article 313), the system of tax accounting consists of three basic elements:

- 1) primary accounting documents;
- 2) analytical registers for tax accounting;
- 3) computation of the tax base.

The standards and rules for tax accounting are reflected in the accounting policy for the purposes of taxation, which is to be approved by an order or instruction of an organization's director.

Thus, at the beginning of the year 2002, enterprises had, first of all, to make a decision as to which system of tax registers was to be applied:

- to develop on their own a system of tax registers;
- to apply the registers recommended by the RF MTL;
- to make use of the proposals of other authors and specialized organizations concerning the application of other variants of tax registers.

The attempt to develop model analytical registers of tax accounting made by the RF Ministry for Taxes and Levies has demonstrated the complexity of the task of creating a tax accounting system. The system of financial accounting had been developing over a sufficiently long period of time. The creation of a tax accounting system will also require a lengthy period. The development of more than 50 analytical registers has not resulted in the creation of a well-coordinated and interrelated system of tax accounting. These registers are not sufficient for big companies, while being superfluous for small businesses.



In addition to the issue of tax accounting organization, Chapter 25 of the RF Tax Code has given rise to a number of important problems. Primarily, this has to do with some insufficiently elaborated provisions contained in this chapter of the law.

From 1 January, 1999, the parts of the RF Tax Code which are being put in effect have become laws of direct action. Now, neither the MTL, nor the Ministry of Finance have no right and cannot issue instructions so as to explain the procedure for the application of tax laws. This is a normal legislative practice adopted in the majority of developed countries. For this practice to be effectively applied, it would be necessary for the direct-action laws to be devoid of intrinsic controversy, and for their provisions and articles to be worded with the maximum clarity. In Russia, there exists another traditional practice, when the insufficiently elaborated provisions of legislation are additionally explained by numerous subordinate legal acts. This results in continual disputes between control agencies and taxpayers, because the explanations concerning some individual provisions of subordinate legal acts often contradict legislative principles and norms. Chapter 25 of the RF Tax Code represents no exception. Below there is a list of only some of the provisions the explanations for which may be regarded as disputable<sup>73</sup>.

1. The text of Chapter 25 of the RF Tax Code contains some notions for which there are no precise definitions. For example, the term “economically justified costs” used when defining substantiated costs in Article 252 requires an explanation within the context of the law itself.

If the procedure for recognizing costs is not regulated precisely, some situations of conflict may arise in connection with the explanation of this definition.

2. The law of direct action contains no clear definition of certain types of property and the conditions for the use of such property. Thus, in accordance with point 3 of Article 257 of the RF Tax Code, as intangible assets the following are categorized: “possession of know-how, a secret formula or process, the information concerning industrial, commercial or scientific experience”. However, in the Tax Code there are no definitions of these terms, and thus there exist the preconditions for a conflicting situation, which might arise in the event of a disagreement between the tax agencies and taxpayers concerning this issue.

3. Not quite clear is also the provision in accordance with which off-realization incomes are to include the income of previous years revealed during a reporting (fiscal) period (Article 250 of the RF Tax Code), while off-realization expenditures are to include the amounts of expenditures of previous years revealed during a reporting (fiscal) period (subpoint 1, point 2 of Article 265 of the RF Tax Code).

The reflection of the said incomes and expenditures within the composition of the off-realization ones during a current fiscal period can be possible only in the event when it is not possible to determine the period during which the error occurred. If the period during which the error occurred is known, it would be necessary to recalculate the tax liabilities for the period when the error occurred and to submit corrected declarations in accordance with Article 54 of the RF Tax Code. Besides, in Article 81 of the RF Tax Code it is stipulated that when the taxpayer discovers that his tax declaration which was submitted lacks certain information, or the information is incomplete, or there are certain errors which have resulted in an underes-

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<sup>73</sup> The materials “The organization of fiscal accounting in the Russian Federation” prepared by Cand. Econ. Sci. O.V.Popova and Cand. Econ. Sci. N.N.Salamatova.

timation of the amount of the tax due to be paid, the said taxpayer must make the necessary amendments to the declaration.

4. The legislators, when determining the procedure for accounting the expenditures on repairs of main assets, overlooked the procedure for the repair of the main assets received under contracts of use on the gratis basis, as well as the reflection in tax accounting of the expenditures on the repairs of other property (implements or property valued under 10,000 roubles, etc.).

5. Article 313 of the RF Tax Code stipulates the necessity for enterprises to adopt a document concerning their accounting policy for the purposes of taxation. It should be taken into consideration that Chapter 25 of the RF Tax Code does not specify the period when this document should be adopted and does not require that this policy documentation be submitted to tax agencies on the mandatory basis.

6. Many questions are raised by the procedure for the payment of the profit tax by budgetary organizations.

In accordance with Article 321 of the RF Tax Code, the tax base of budgetary organizations is determined as the difference between the received amount of income from realization of goods, works, or services, the amount of extra-realization incomes, and the amount of actual expenses associated with commercial activity. Thus, for budgetary organizations there exists a separate definition of the tax base, and at the same time they are also subject to the same procedure for the accounting of incomes and expenditures operations as that established for other enterprises. The definition of the tax base applicable to budgetary organizations in itself contains an element which is not quite clear: their incomes are not diminished by the amount of off-realization costs when computing the amount of taxable profit.

7. Large-scale disputes among specialists have been caused by the issue concerning the reflection, in tax accounting, of incomes and expenditures in the form of fines, penalties or other sanctions for non-fulfillment of contractual or debt obligations.

Despite the large amount of problems that have emerged due to the adoption of Chapter 25 of the RF Tax Code “The profits tax on organizations”, the new procedure for computing the profit tax has also yielded some positive results, among which the following should be noted:

1. Tax accounting is specified as a separate subject, and thus there have been created the preconditions for reforming the financial accounting in Russia in strict conformity with the International Financial Reporting Standards;

2. In the sphere of tax accounting:

- an open list of incomes and expenditures to be taken into account when determining the tax base has been established;
- a new mechanism for property depreciation is applied, in accordance with which the standard depreciation deductions have been increased, on the average, by 2.5 times;
- there has occurred a certain liberalization of the restrictions imposed on the inclusion in costs of certain types of expenditures.

Thus, Chapter 25 of the RF Tax Code “The profits tax on organizations” has laid a foundation for establishing in Russia a separate subject – that of tax accounting.



*Adoption of the Accountancy Regulations “Financial accounting in respect to the profits tax” (AR 18/02)*

The next step in reforming the tax accounting sphere in Russia has become the approval, by Order No 114n of 19 November 2002, of Accountancy Regulations (AR) 18/02, developed by the Ministry of Finance of the Russian Federation. The order was registered at the RF Ministry of Justice as of 31 December 2002, and all enterprises, with the exception of small businesses, must draw their financial statements in accordance with the requirements stipulated in AR 18/02, beginning with Quarter I of the year 2003.

In a situation when enterprises have not as yet solved the problem of organizing their tax accounting procedures, which has emerged owing to the adoption of Chapter 25 of the RF Tax Code, the necessity to change the newly formed technique of tax accounting in accordance with the requirements of AR 18/02 “Financial accounting in respect to the profits tax” has aroused the discontent of the accounting community.

AR 18/02 represents the translation of IAS 12 “Income taxes” and describes the mechanism for calculating the corrections to the actual expenditures associated with the profits tax in accordance with the financial accounting data. However, the AR’s text sometimes departs, in certain instances substantially, from that of IAS 12. Interestingly, the incorrect formulations, as a rule, refer to those notions which cannot be found in IAS 12.

The purposes of applying AR 18/02 “Financial accounting in respect to the profits tax” are stipulated in point 1 of the Regulation:

1. To reflect in financial accounting and reporting the interrelation between profit (or loss) determined in accordance with the normative acts concerning financial accounting, and the tax base for the profit tax determined in accordance with legislation on taxes and levies.

2. To reflect in financial accounting and reporting the difference between the tax on financial profit (or loss) recognized as such in financial accounting, and the tax on taxable profit formed within the context of financial accounting and reflected as such in the tax declaration concerning the profits tax.

3. To reflect in accounting: the amounts of the profits tax payable to the budget; the overpaid and/or collected in excess amounts of tax, due to be repaid to an organization; the amounts of offsetting the tax during a reporting period; and also the amounts that may influence the amount of the profits tax due in subsequent reporting periods, in accordance with legislation of the Russian Federation.

All these goals follow from the requirements for ensuring the completeness, understandability and reliability of reporting, as well as from observing the matching concept (an analogue to the principle of time-determination of the factors of economic activity – in Russian practice), which fully corresponds to the IFRS. It should be noted that among the goals of applying AR 18/02 by enterprises there is none that would simplify the procedure for accounting the profits tax by means of introducing the mechanism for obtaining the index of taxable profit on the basis of financial profit.

Thus, the following question arises: where are the roots of the erroneous opinion, which is fairly common in the Russian accounting community<sup>74</sup>, that by applying AR 18/02 it will be

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<sup>74</sup> In accordance with p. 7 of the Resolution of the Congress of Accountants and Auditors of Russia “Accounting, taxes and audit – 2002”, the accounting community, as represented, in the first place, by the members of the Institute of Professional Accountants of Russia, having noted the « unjustified complexity of the taxation rules », sup-380

possible to avoid the introduction, at an enterprise, of tax accounting separate from financial accounting? It is very difficult to find a definite answer to this question; one can only make some assumptions. There exists an opinion<sup>75</sup> that AR 18/02 was adopted by the Ministry of Finance not in order to make the reporting of Russian enterprises more correct from the point of view of reliability and timeliness of information to be reflected in accounting, but in order to “oust” tax accounting and thereby to provide support to financial accounting, which, having lost its fiscal functions (which used to be a priority), is now practically unrequited.

It is true that the present-day accounting reports formed on the basis of existing legislation on financial accounting is often of no interest to the majority of users. In effect, there exist financial accounting for the purposes of taxation (and from the year 2002 onward – simply tax accounting), managerial accounting – for internal users, while the reporting for investors is prepared directly in accordance with the IFRS (IAS) or US GAAP. Until an appropriate investment climate is created, there will appear no economic culture and no need for reliable reporting, and no financial accounting as such will be required.

One more argument in favor of the above-stated opinion concerning the goal of adopting AR 18/02 – the wording used in subpoint 2 of point 1 of the Provisions: “of the tax on taxable profit formed in financial accounting...”. This wording says nothing as to the inconvenience of tax accounting, the very phrase “tax accounting” is simply omitted. A substitution of notions takes place: for an accountant, it is of no crucial importance how the documents are called which represents the results of computation – financial accounting registers or tax accounting registers.

Despite the fact that the tax accounting procedure as suggested in Chapter 25 of the RF Tax Code is regarded by the Russian accounting community as being too complex<sup>76</sup>, AR 18/02 has not become commonly applied for deducing taxable profit from financial profit. The experience of the year 2003 has demonstrated that the text of this documents has so many limitations that its application in the present form will not make it possible not only to compute the tax base but also to achieve the expected goals in terms of accountancy. This has rather more to do with the actuality of economic activity which was not taken into account when elaborating AR 18/02 than with incorrect wording.

Below certain provisions are listed, which, according to our belief, represent obstacles to clear understanding and adequate application of the Regulations.

1. The wording used in Point 1 – “the tax on accounting profit” – is not quite correct. There exists no tax on financial profit, which, moreover, would differ from the actual profits tax. A more correct definition is applied only in Point 20 – “arbitrary expenditure (arbitrary income) on the profits tax”.

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ported « the decision of the Ministry of Finance of Russia concerning the introduction of an alternative mechanism for calculating the amount of taxable profit on the basis of financial accounting data envisaged by AR 18/02 “Financial accounting in respect to the profits tax”.

<sup>75</sup> See the paper by A.N.Kalanov, Head of the Department for specialized auditing projects AKG “Interekspertiza”, “A commentary to the Accountancy Regulations “Fiscal accounting in respect to the profits tax” AR 18/02, approved by Order of the Ministry of Finance of Russia No 114n of 19 November, 2002”, published in the journal “Finansovye i buhgalterskie konsultatsii” (Financial and Accounting Consultations) No 2 and No 3, 2003.

<sup>76</sup> In the Resolution of the Congress of Accountants and Auditors of Russia “Accounting, taxes and audit – 2002”, the Russian accounting community noted “the unjustified complicating of the taxation rules” due to the adoption of Chapter 25 of the RF Tax Code.



2. The wording “arbitrary income on the profits tax”. At first glance, all is correct: if there is arbitrary expenditure, there must also be arbitrary income. But what is understood as being the arbitrary income on the profits tax? This is the amount of loss (according to the accounting data) multiplied by the rate of the profit tax. Thus, it follows that a loss-making enterprise theoretically receives an income in the amount equal to this “arbitrary income on the profits tax”, due to the lack, in a period of loss, of the necessity to pay the tax.

3. The text of the AR, for objective reasons, contains only a short list of constant and temporary differences; however this list does not fully conform to reality.

In respect to constant differences, one important aspect should be noted, which is not taken into account in AR 18/02. According to Point 4 of the Regulations, constant differences are understood as incomes and expenditures which *are forming financial profit* (or loss) of a reporting period and are *excluded from the computation of the tax base* of the profit tax both for the reporting and for the subsequent period. At the same time, there may exist a situation when certain incomes (or expenditures) *form the tax base* but *are not reflected in the financial accounting data* of neither the period in question nor in subsequent periods. Such situations do occur, however rarely. In particular, they may include the instance of receiving incomes as a result of gratis services which are not subject to an entry in the financial accounting data on property rights: according to Point 8 of Article 250 of the RF Tax Code, such revenues are subject to inclusion in the tax base, however legislation on financial accounting does not envisage that they be reflected on the accounts.

If an organization gives no due regard to this circumstance, there will be no corresponding connection between the current profit tax and arbitrary expenditure (or income) on the profit tax as defined in point 21 of AR 18/02: there will occur either a discrepancy in financial reporting, or a distortion of the tax base in the tax declaration.

4. When AR 18/02 was being developed, one of the important aspects was missed, which has to do with the recognition, for the purposes of taxation, of a number of expenditures. Thus, in accordance with Chapter 25 of the RF Tax Code, for standardizing expenditures certain base indices are applied (proceeds, costs of payment for labor, etc.). In this instance, both the expenditures proper and the corresponding base indices fluctuate during a tax period (one year), representing different values as of the end of each reporting period. As a result, the precise value of a base index and, accordingly, of recognized expenditures will be known, in accordance with Point 3 of Article 318 of the RF Tax Code, only as of the end of a year, while all their values throughout the year will be intermediate and serve only for determining the amounts of advance tax payments. At the same time, AR 18/02 is to be applied also for preparing intermediate reports throughout a year, the result of which, in the event of “blind” compliance with the Regulations, will be certain distortions in financial accounting reports.

5. The definition of temporary differences is incorrect. Thus, according to these definitions, temporary differences decrease (or increase) the amount of the profits tax payable to the budget. However, the differences, as a rule, cannot change the amount of the profit tax payable to the budget – the profits tax is computed only once, with regard to all incomes and expenditures. For example, expenditures carried over to the future decrease the tax base and not the profits tax, while the profits tax is computed only once by the tax base adjusted by these expenditures. But this is not the most important point. What important is that only in comparison with the other provisions of AR 18/02 it would be possible to understand that the above



definitions *refer not to the profits tax* in principle, but to a certain virtual “profits tax” computed as multiplication of financial profit by the rate of tax.

6. According to Point 9 of AR 18/02, deferred profit tax is understood as the amount which influences the amount of the profits tax payable to the budget in the period that follows the reporting period, or in subsequent reporting periods. Thus, it was assumed that deferred profit tax is an index which aggregates temporary differences, both deductible and taxable. At the same time, the notion of deferred tax assets and liabilities is already defined as “components” of deferred profits tax, while they are computed entirely without applying this index – by means of applying temporary differences. Therefore, the introduction of the term “deferred profits tax” within the context of the final classification in AR 18/02 seems superfluous, because it is an intermediate one and does not play any role in either analytical or synthetical accounting.

And the most important comment: the requirement stipulated in Points 14 and 15 of AR 18/02 to calculate the amount of deferred assets and liabilities at the rate established as of the reporting date contradicts the requirements stipulated in the IFRS. Deferred assets and liabilities are deferred exactly because they are going to be recognized in the future, and therefore their amount depends upon future events. In this connection, in accordance with IAS 12 “Income taxes”, deferred tax assets and liabilities are to be evaluated by using the rates of tax which are intended to be applied in to the period wherein an asset in question is going to be realized, or the liability to redeemed.

The introduction of AR 18/02 “Financial accounting in respect to the profits tax” has produced the following positive results.

1. With the elimination of shortcomings concerning practical application of the Regulations, the latter would make it possible to reflect, both in accounting and reporting, the profits-tax amount payable to the budget, the amount of overpayment or over-taxing due to be returned to the corresponding organization, the amount of a tax setoff carried in the accounting period, and also the sums capable of influencing the amount of profits tax payable in the following accounting periods in accordance with legislation of the Russian Federation. This, in turn, would furnish more detailed information to be utilized by the user in order to determine the financial position and the future cash flows of the enterprise ;

2. The interrelation between financial accounting and tax accounting has been established;

3. The responsibility for improper accounting has been, in fact, legalized.

As the absence of reliable tax accounting (in one form or another) makes it impossible to completely satisfy the requirements for element-by-element accounting specified by AR 18/02, from the year 2003 violation of the established regulations for calculating the profits tax is bound to result, in many instances, also in the distortion of data of financial accounting (even if the terminal indicator, the amount of profits tax payable, is correctly determined). In this connection, it should be taken into consideration that from the year 2003, it is possible to respond to such instances by the imposition of fiscal sanctions in accordance with Article 120 of the RF Tax Code and by the imposition of administrative sanctions in accordance with Article 15.11 of the RF Digest of Administrative Regulations.

4. The base of the property tax has not been changed.



Despite the fact that deferred tax assets should be reflected in the balance sheet of an organization (Point 25 of AR 18/02), it would not influence the calculation of property tax because deferred tax assets are reflected in the balance sheet as a part of non-current assets.

## Conclusions

Thus, it is possible in Russia to carry out tax accounting in the form of a separate sphere of accounting, and it is also possible to introduce corrections in order to isolate taxable profit from book profit. The first possibility is provided for by Article 25 of the RF Tax Code, while the second - by Accountancy Regulations (AR) 18/02 drafted by the Ministry of Finance and enacted by Order No 114n of 18 November 2002.

The approaches specified in these documents do not contradict each other but for two exceptions:

1. The opportunity to use corrections does not eliminate the necessity to carry out tax accounting;
2. Corrections are used not for isolating taxable profit from book profit, but, on the contrary, for bringing the data of financial accounting into line with actual expenses dealing with the payment of profits tax.

The conclusion is evident: AR 18/02 should be used in correspondence with the goals specified in this document and not in order to simplify the accounting procedures. With the elimination of the afore-mentioned shortcomings, Chapter 25 of the RF Tax Code and AR 18/02 generally used in tandem (given the afore-noted reservations) would form a basis for the establishment in Russia of a system of accounting disciplines corresponding to the International Financial Reporting Standards. Chapter 25 of the RF Tax Code has separated tax accounting from financial accounting, while AR 18/02 has determined the relationship between these two categories.

Thus, the problems existing in Russian practice of tax accounting, in fact, could be subdivided into three interrelated groups:

1. Shortcomings of legislation;
2. Unresolved problems of the technical organization of tax accounting and financial accounting in respect to the correction of data in accordance with the requirements of Chapter 25 of the RF Tax Code and AR 18/02;
3. The absence of clear understanding of basic principles of the system of accounting disciplines in a modern market economy, and also the absence of any real precondition for the use of some of these principles in Russian practice. (For example, the category of users interested in financial reporting based on the Russian standards practically does not exist, which results in the absence of understanding of the necessity to reform the Russian system of accounting in order the reports would contain more reliable information.)

As regards the technical organization of tax accounting, it is possible to recommend, judging from foreign experience, to keep separate ledgers for financial and tax accounting. Any artificial narrowing of the gap between these categories would exert, when they are used in combination, a negative influence, first of all, on financial accounting. Disinclination to use all the variety of accountancy methods as well as the techniques for reflecting the facts of economic activity which are based on the systemic approach and the requirement to comprehen-

sively reflect the events and operations, would cast doubt on the veracity of output accounting information.

The system of tax accounting has already been emerged in Russia. This system is Russian accounting practice. It is necessary to create a completely new system of financial accounting as well as the stimuli for its development.

\* \* \*

It is of vital importance to reform the Russian accounting system. The necessity of reform is clearly demonstrated by the collapse of confidence in the information of the reports based on the Russian accountancy regulations. The majority of large enterprises and banks in Russia already prepare their reports in accordance with the American (US GAAP) or international (IFRS, IAS) standards.

The international standards are not a panacea against all the problems encountered by the users of reporting. Nevertheless, they represent a necessary and extremely important instrument not only for the transformation of Russia's economic system but for international economic integration as well. In order to completely utilize this potential, it is essential to develop corporate principles of management, as well as to develop managerial accounting and tax accounting as separate subjects. In other words, it is vital to approach the process of switching to the IFRS bearing in mind the priority of substance over form, and to accept the system of accounting disciplines as a whole.

A complex approach is called for in respect to reforming the system of financial accounting in our country. The task of creating an efficient and understandable system of accounting disciplines could not be accomplished by merely copying the accountancy procedures adopted in foreign practice. These procedures are inherently adapted to the economic conditions for which they have been developed. By adapting the international standards to Russian practice, the Russian authorities responsible for reform of accountancy do not improve the degree of their adequacy to the present-day conditions in our country but only distort the essence of approaches specified by the standards.

When adopting the International Financial Reporting Standards, it would be counterproductive to introduce them piecemeal and to treat them in accordance with the practice existing in our country. Only a systemic approach to the introduction of foreign practice in Russia could produce a positive result in creating an efficient system of accounting disciplines in our country.

## **Annex 3**

### **Economic Legislation Review in 2003<sup>1</sup>**

Over 2003, the State Duma of the Federal Assembly of the Russian Federation considered about 1000 draft laws, 100 of which were considered in order of priority, one half was initiated by the Government of the Russian Federation, while the other half was initiated by the President of the Russian Federation, members of the State Duma and various committees, members of the Council of Federations, regional Dumas, and other entities of legislative initiative.

The lower Chamber adopted about 150 Federal Laws over the period under review, most of which were initiated by the RF Government and the President of the Russian Federation. Special conciliation commissions drafted amendments to various Federal Laws.

Among the most relevant laws are new editions of Federal Laws «On Foreign Exchange Regulation and Control» and «On Citizenship of the Russian Federation», new Federal Laws «On General Principles of Local Self-Government» and «On Mortgage Securities», and a new Customs Code.

The present Annex contains key novations in the Russian legislation, some of which are analyzed in details in corresponding sections herein.

### **Tax Law Amendments**

In continuation of the tax reform, the RF Tax Code was updated in 2003 with three new chapters on corporate assets tax, namely the animal and aquatic objects tax and taxation regulations on implementation of production sharing agreements, as well as a redrafted chapter on a unified agricultural tax was adopted.

In addition, new regulations on tax registration were adopted with the view to improving procedures of state registration of legal entities and self-employed entrepreneurs.

Taxation regulations governing natural gas production are to be updated in 2004. Along with abolition of the natural gas excise, the existing ad valorem Mineral Tax rate was replaced with a specific tax on production of combustible natural gas at all types of gas fields to the amount of 107 rubles per 1000 cubic meters of gas, which is three times the ad valorem rate. However, the specific Mineral Tax rate on oil production is 347 rubles per ton since 2004.

The State Duma adopted a Law on introduction of Chapter 30, «Property Tax», as amended by the conciliation commission, into the Tax Code, which is to come into force on January 1, 2004 in order to replace the RF Law «On Corporate Assets Tax» of 13.12.1991 No. 2030-1.

Pursuant to the Federal Law, the corporate assets tax is to be introduced by laws of the constituent entities of the Russian Federation. In this case legislative ( representative ) bodies of the constituent entities of the Russian Federation are authorized to establish a tax rate at their own discretion within the limits specified at the RF Tax Code, as well as taxation procedure, terms of payment and reporting form. In introducing a tax, the laws of constituent entities of the Russian Federation also may provide for tax allowances as well as justification for their application.

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<sup>1</sup> The review was made with the use of the «Konsultant» legal system.

Recognized as taxpayers are Russian and foreign organizations which operate in the Russian Federation through permanent missions or own a real property on the territory of the Russian Federation, in continental shelf and exclusive economic area of the Russian Federation.

Recognized as objects of taxation are immovable and movable assets ( including assets assigned to a temporary possession, usage or trust management as part of joint activity ), accounted as fixed assets of an organization according to the established accounting procedure.

Not recognized as objects of taxation are ground areas and other objects of natural management ( bodies of water and other natural resources ), as well as assets owned by federal executive agencies on the basis of economic or day-to-day management in which military and/or equal services are legally envisaged, and utilized for the purposes of national defense, civil defense, security and law enforcement in the Russian Federation.

Intangible assets, raw materials, materials, fuel, semi-finished and finished products are excluded from the objects of taxation against the existing legislation.

Taxation base is determined as average annual value of assets recognized as objects of taxation.

The average annual value of assets recognized as objects of taxation over a fiscal period ( period under review ) is calculated as a quotient of the amount resulted from summation of written down value at first date of each month of the fiscal period ( period under review ) and first date of the month following the fiscal period ( period under review ) by the number of months in the fiscal period ( period under review ) increased by one.

The fiscal period is recognized as a calendar year, while periods under review are recognized as first quarter, half year and nine months of the calendar year. However, legislative ( representative ) bodies of constituent entities of the Russian Federation are entitled not to register periods under review in introducing the tax.

Differentiation of tax rates by category of assets and tax payers is delegated to the corresponding agencies of constituent entities of the Russian Federation. Most importantly, tax rates are not supposed to top 2,2% of the maximum rate as specified in the new chapter. The existing law specifies that the corporate property tax rate can not exceed 2% of the taxation base.

In addition, a list of tax exemptions and allowances was shortened against the existing law. Several organizations are exempted from taxation on assets utilized for the purpose of exercising the assigned duties.

The law provides for tax exemption on assets of scientific organizations under the Russian Academy of Science, Russian Academy of Medical Sciences, Russian Academy of Agricultural Sciences, Russian Academy of Education, Russian Academy of Architecture and Construction Sciences, and Russian Academy of Arts. However, this tax allowance will cease to be in force from January 1, 2006.

The new chapter contains a shorter list of tax allowances. In particular, tax allowance is applied to the assets of mobilization purpose, assets owned by religious organizations, All-Russian non-profit organizations of invalids, penitentiary system, enterprises with pharmaceutical production as core activity, space devices, cultural and historical monuments. In addition, assets of special orthopedic enterprises, colleges of lawyers and public research and technology centers are exempted from taxation.



Chapter 25.1 of the Tax Code «On Animal and Aquatic Objects Tax» was introduced under the Federal Law of 11.11.2003, No. 148-FZ.

Recognized as tax payers on animal objects, except for animal objects related to aquatic objects, are organizations and physical bodies, including self-employed entrepreneurs, subject to a license ( permit ) in accordance with applicable regulations on animal objects on the territory of the Russian Federation.

Recognized as tax payers on aquatic objects are organizations and physical bodies, including self-employed entrepreneurs subject to a license ( permit ) in accordance with applicable regulations on aquatic objects in inland waters, territorial waters, continental shelf of the Russian Federation and exclusive economic area of the Russian Federation, as well as the Caspian Sea, the Sea of Azov, the Caspian Sea, the Barents Sea and in the area of the Spits Bergen apx.

Recognized as taxable are animal objects and aquatic objects specified in special lists, which may be removed from their habitat subject to a license ( permit ) on animal objects and aquatic objects correspondingly.

Not recognized as taxable are animal objects and aquatic objects which are used for personal needs by representatives of aboriginal ethnic minorities inhabiting the northland of this country, Siberia and the Far East, as well as persons which do not represent ethnic minorities but are permanent residents in the areas of their traditional habitat and traditional economic activity with hunting and fishing representing their living base. Limits on animal objects as well as limits and quotas on harvesting ( fishing ) of aquatic objects for personal needs are established by local executive authorities on approval by the federal authorities.

The chapter specifies tax rates in terms of rubles per each taxable object.

The chapter provides for certain tax allowances. In particular, Russian fishery organizations ( that form industrial fishery towns and settlements ) will pay only 15% of the aquatic objects tax. In addition, a zero tax rate for each animal and aquatic object is established, provided that such objects are used on approval of an authorized executive agency for the purposes of healthcare, elimination of danger to life or survey of supplies and industrial expertise.

The tax on animal objects is payable upon receipt of a license ( permit ).

The tax on aquatic objects is payable on the basis of non-recurrent or regular contributions. The amount of a non-recurrent contribution is determined as a share of the assessed amount of tax which equals 10%. The non-recurrent contribution is payable upon receipt of a license ( permit ). The remaining amount, which is determined as a difference between the assessed amount and non-recurrent amount, is payable in equal shares as regular contributions throughout the entire period of license ( permit ) on aquatic objects on a monthly basis not later than on the 20<sup>th</sup> date.

The total amount collected from the tax on animal objects is carried to budget revenues of the constituent entities of the Russian Federation.

New chapter 26.4 on «Taxation Regulations in Implementation of Production Sharing Agreements» specifies special taxation regulations applicable in implementation of agreements concluded pursuant to the Federal Law of 30.12.1995 No. 225-FZ «On Production Sharing Agreements» and meets the conditions as follows.

1) Agreements are concluded upon a tender on utilization of natural resources under conditions other than product sharing and according to the procedure and conditions specified

in the Federal Law «On Production Sharing Agreements», and when such auction is invalidated;

2) Government's share of the total production accounts for not less than 32% in agreements with the use of a «direct» production sharing scheme specified in the Federal Law «On Production Sharing Agreements»;

3) Agreements provide for growth in the government's share in profit production in case of improved investment efficiency for investor in implementing the agreement. Investment efficiency is measured according to the terms of the agreement.

Special tax regulations are applied within the entire period of agreement and provide for replacement of a group of taxes and duties specified in the legislation of the Russian Federation on taxes and duties by sharing of the manufactured production in accordance with the terms of agreement, except for taxes and duties payable as provided for in Chapter 26.4 the RF Tax Code.

Taxation base is determined for each particular agreement.

The mineral tax rate is applied with a 0,5 ratio in implementation of agreements on production sharing.

The amount of corporate profit tax is determined according to Chapter 25 of the RF Tax Code with due regard to the specifics provided for in the given Chapter. The profit generated by a tax payer from implementation of the agreement is recognized as a taxation object. The earnings generated from implementation of the agreement less expenses is recognized as a profit.

The value added tax is payable in implementation of agreements according to Chapter 21 of the RF Tax Code with due regard to the specifics provided for in the given Chapter.

Redrafted is Chapter 26.1 of the Tax Code which specifies taxation regulations for agricultural manufactures ( unified agricultural tax ).

Under a new regulation which is to come into force on January 1, 2004, transition from the unified agricultural tax back to the general taxation regulation will be performed by farming enterprises and self-employed entrepreneurs on a voluntary basis on the condition that a share of proceeds from manufactured agricultural production and/ or produced fish, including primary treatment products manufactured from in-house agricultural raw materials and/ or produced fish, accounts for not less than 70% of the total proceeds from realization of goods ( works, services ). There are limits introduced to prevent some taxpayers from transition to the unified agricultural tax. Such transition can not take place if the aforementioned persons manufacture excisable goods or pay unified tax on imputed earnings, as well as for organizations having affiliates and representative offices.

The unified agricultural tax for organizations replaces corporate profits tax, value added tax ( except for the value added tax payable during export of goods to the customs territory of the Russian Federation ), corporate property tax and unified social tax.

Taxation objects, taxation base and tax rate are changed.

Recognized as objects of taxation are earnings less expenses. Objects of taxation under the existing legislation are recognized as agricultural land in ownership, in hand and/ or on lease.

The new Chapter specifies that the taxation base is recognized as a monetary value of earnings less expenses. The taxation base was recognized under the previous regulations as agricultural area equal to cadastral values and recognized as object of taxation.



The tax rate is 6%. The tax rate used to be determined by legislative ( representative ) bodies of constituent entities of the Russian Federation in terms of rubles and kopeks on the basis of one hectare comparable to cadastral values of the agricultural land located at their territories.

Recognized as fiscal period is calendar year ( previously a quarter ) with regard to agricultural seasonality, and half year as period under review.

Agricultural manufacturers which intend to change over to the unified agricultural tax, shall apply to a tax department located at their domiciliary within a period between October 20 and December 20 of the year preceding the year from which agricultural manufacturers change over to the unified agricultural tax.

Unlike the existing regulation, the redrafted Chapter 26.1 does not specify that the given tax is introduced under the law of constituent entities of the Russian Federation.

Corresponding amendments are made to other laws, especially the Budget Code is amended by regulations establishing the procedure of allocation of the unified agricultural tax to budgets at other levels.

The Federal Law of July 7, 2003, No.117-FZ "On Amendments to the Second Part of the RF Tax Code and Other Laws of the Russian Federation, as well as Invalidation of Various Laws ( Provisions of Law ) of the Russian Federation" established that the base rate of value added tax is to be established at 18% from January 1, 2004. Other provisions of the tax law regulating VAT rates and their application remain inalterable. In addition, the law introduced the changes as follows:

- 1) in defining hydrocarbon material and its classification as follows:
  - 1) dewatered, desalted and stabilized oil;
  - 2) gas condensate from all types of hydrocarbon deposits, separated, dewatered, separated form light fractions and other foreign bodies;
  - 3) combustible natural gas ( dissolved gas or solution of dissolved gas and gas from gas cap ) from all types of hydrocarbon deposits, produced from oil wells ( oil-well gas );
  - 4) combustible natural gas from all types of hydrocarbon deposits, except for oil-well gas;
- 2) abolition of the unified rate of Mineral Tax 16,5% in production of all types of hydrocarbon material and its replacement with:
  - a. 16,5% rate in oil production from 2007, and growth in specific rate of Mineral Tax in oil production being in force till 2007, from 340 to 357 rubles per ton;
  - a. establishment of 17,5% rate in gas condensate production from all types of hydrocarbon deposits, separated, dewatered, separated form light fractions and other foreign bodies;
  - b. establishment of 107 rubles per 1000 cubic meters of gas in production of combustible natural gas from all types of hydrocarbon deposits;
- 3) abolition of gas excise.

New regulations on registration with tax authorities and extrabudgetary funds from January 1, 2004 were introduced. The Federal Law of 23.12.2003, No. 185-FZ «On amendments to laws of the Russian Federation on improvement of procedures of public registration of legal entities and self-employed entrepreneurs» introduced a «single window» concept for registration of all tax payers. The amendments are intended to simplify the procedure of registration of legal entities and self-employed entrepreneurs. The “one window” concept makes it possi-



ble to get a public registration, registration with tax authorities and extrabudgetary funds ( Pension Fund, Federal Compulsory Medical Insurance Fund and Social Insurance Fund ), as well as obtain a Goskomstat Code on the basis of a single submission of the required documents to tax authorities. Previously, entrepreneurs had to submit four sets of documents to different agencies for public registration, which made such registration time-consuming. The newly introduced procedure allows legal entities/ self-employed entrepreneurs to get registered with tax authorities within 5 days and obtain a registration certificate on the 6<sup>th</sup> day from the date of submission of all documents required for public and tax registration. Agencies under the RF Ministry of Taxation will pass the data on a legal entity/ self-employed entrepreneur to corresponding extrabudgetary funds and statistical offices upon registration with the United State Register of Enterprises and Organizations. Legal entities/ self-employed entrepreneurs can open bank accounts on presentation of a registration certificate.

### **Law on Foreign Exchange Regulation and Control**

On November 21, 2003, the State Duma of the Federal Assembly of the Russian Federation adopted a new Federal Law No. 173-FZ «On Foreign Exchange Regulation and Control», which is intended to implement the unified public foreign exchange policy and stabilize the national currency and internal market.

The new Federal Law includes recently approved measures on liberalization of foreign exchange regulation and introduces some innovations into it.

The Law specifies the concept of national currency, currency of the Russian Federation, residents and non-residents, and authorized banks. In addition, concepts of external and internal securities, special account and exchange markets are introduced in the Law. Amendments are made to the concept of foreign exchange assets by unfilling precious metals and jewels from the list of foreign exchange assets. Foreign exchange assets are nothing but foreign exchange and external securities.

The new Law specifies that foreign exchange transactions are not classified into current foreign exchange transactions and foreign exchange transaction related to capital movement, as was the case in the previous Law. Foreign exchange transactions are classified by composition of participants: transactions between residents, transactions between residents and non-residents, and transactions between non-residents.

The Law consolidates the principles of foreign regulation and control. Among the basic principles are:

- priority of economic measures in implementation of public policy on foreign exchange regulation;
- exception of unreasonable interference by the government and government agencies with foreign exchange transactions of residents and non-residents;
- unity of foreign and domestic foreign exchange policies of the Russian Federation;
- unity of the system of foreign exchange regulation and control;
- public protection of rights and economic interests of residents and non-residents during foreign exchange transactions.

The Law develops the concept of foreign exchange legislation which includes the Federal Law itself and corresponding federal regulations. Foreign exchange regulation agencies, which are the RF Central Bank and the RF Government under the new Law, are entitled to



issue regulatory documents with regard to foreign exchange regulation subject to the cases provided for in the Federal Law.

It is specified that in case foreign exchange regulatory agencies have issued no regulations regarding foreign exchange transactions and usage of accounts, then foreign exchange transactions can be conducted and accounts can be opened and used without restriction.

Foreign exchange regulatory agencies are not authorized to establish individual authorization requirements for residents and non-residents.

No restrictions are specified for foreign exchange transactions between residents and non-residents, except for foreign exchange transactions related to capital movement which are regulated by the RF Government and the RF Central Bank, as well as trading in foreign exchange and checks denominated in foreign exchange in the internal market. Such foreign exchange transactions are restricted in order to prevent a substantial reduction in foreign exchange and gold reserves of the country, jumpiness of the national currency, and to sustain foreign balance of the Russian Federation.

The Law contains an absolute list of measures enabling the RF Government and the RF Central Bank to regulate foreign exchange transactions related to capital movement, among which are:

- requirement for reservation of a part of the foreign exchange transaction's amount for a certain period;
- requirement for opening a special account;
- requirement for opening an account with authorized bank.

It should be noted that the RF Government and the RF Central Bank will be regulating foreign exchange transactions related to capital movement till the 1<sup>st</sup> of January 2007.

The new Law allows physical bodies – residents and non-residents – to make transactions with external securities without restriction to the maximum amount of \$150 thousand US dollars within a calendar year, while in the previous law it was \$75 thousand US dollars.

The Federal Law contains a regulation prohibiting foreign exchange transactions between residents. However, the Law specifies a list of foreign exchange transactions which can be conducted between residents. These are trading in foreign exchange and checks denominated in foreign exchange. Such transactions only can be conducted through authorized banks. No personal identification is required in this case, except for the cases specified under the federal laws. Personal identification data can be entered by request of a physical body in documents compiled during his/ her transactions with foreign exchange and checks ( including travelers checks ) which are denominated in foreign exchange.

Under the Law the residents are unrestricted to open foreign exchange accounts with the banks located on the territories of foreign countries, members of the Organization for Economic Cooperation and Development ( OECD ), or Financial Action Task Force on Money Laundering ( FATF ). However, the residents are obliged to notify tax authorities located at their domiciles about such accounts not later than within a month upon the date of account. With regard to other cases, the residents may open accounts with banks in other countries according to the procedure established by the RF Central Bank which may require a preliminary registration of the account to open.

Residents are subject to a compulsory sale of 30% of their foreign exchange earnings. The RF Central Bank is entitled to establish a share of foreign exchange earnings other than

the established one but not exceeding 30%. It should be noted that the regulation on compulsory sale of 30% of foreign exchange earnings will be in effect till January 1, 2007.

Foreign exchange control is governed by the RF Government, foreign exchange control agencies ( the RF Central Bank, federal executive agency, RF Government commissioner ) and foreign exchange agents ( authorized banks accountable to the RF Central Bank, as well as professional participants of the securities market other than authorized banks, including registrars accountable to federal executive agencies on securities market, and local federal executive agencies performing foreign exchange control ). The Law regulates rights and duties of foreign exchange control agencies and their personnel, as well as residents and non-residents.

## **Customs Regulations**

A new Customs Code of the Russian Federation is to come into force on January 1, 2004.

Under the Constitution of the Russian Federation, customs regulation is conducted by the Russian Federation and intended to establish the procedure and regulations which allow a legal entity or physical body to realize the right to transition of goods and transport means through the customs frontier of the Russian Federation. General customs governance is conducted by the RF Government according to the legislation of the country.

The regulations, provisions and terminology of the Customs Code comply with the regulations of the Russian Federation and universally accepted norms and regulations of the World Trade Organization. Unlike the previous Customs Code, the new one provides for a better protection of rights and legitimate interests of foreign trade participants.

The document contains provisions on the customs, basic principles of transition of goods and transport means, customs procedures, customs clearance and regulations, customs duties, customs control and customs agencies. In particular, customs regimes are classified into four groups: basic, economic, closing and special ones.

The basic customs regimes include: production for internal use; export; international customs transit.

Economic customs regimes include: processing on customs territory; processing for internal use; processing beyond customs territory; temporal import; customs warehouse; free customs zone ( free warehouse ).

Closing customs regimes include: re-import; re-export; disposal; abandonment to the government.

Special customs regimes include: temporal export; duty-free trade; transition of supplies; other special customs regimes.

Special customs regimes include: transition of transport means; transition of goods by legal entities; transition of goods by international post services; transition of goods by specific categories of foreigners; transition of goods by pipelines and power transmission lines.

The Customs Code provides a well-defined list of customs documents required for customs clearance. Customs clearance is simplified. The period of customs clearance is reduced from 10 to 3 days.

Citizens going abroad are exempted from customs duties on transfer of all goods, except for transport means, totaling up to 65 thousand rubles worth. Transport means as well as other goods being worth more than 65 thousand rubles but not more than 650 thousand rubles are subject to unified duty rates with respect to the amount in excess. The rate of duties is deter-



mined by the RF Government on the basis of the average duty rates applicable to the categories of goods and transport means that are most often transferred by citizens over the customs frontier.

Customs duties, taxes or their unified rate can be fully exempted within the limits established by the RF Government. The RF Government is also entitled to establish quantitative or value restrictions on import of particular categories of goods by citizens.

The new Customs Code contains a simplified procedure of application for a transit customs regime: transit goods are exempted from taxes and duties and are not subject to unrated regulation. In addition, customs clearance duties are reduced in size, license and permit fees are abolished, size of fees depends on expenses of customs agencies.

Conditions of licenses and permits issued prior to January 1, 2004 for processing on customs territory, processing under customs control, processing beyond customs territory, and temporal import ( export ), remain valid till the expiry date of these licenses unless the conditions run counter to the requirements established by the new Customs Code. Issued duty-free store licenses will cease to be in force from January 1, 2004. In respect to goods being under free warehouse customs regime till January 1, 2004, the free warehouse regime can be applicable from the date of the Customs Code till the expiry date of licenses issued prior to January 1, 2004, but not later than the expiry date of investment projects.

## **Local Self-Government Development**

The Federal Law of 1995 «On General Principles of Local Self-Government in The Russian Federation» accepted various definitions of functions and authorities of self-government and neither contained well-defined criteria that could distinguish them from public functions nor established a clear-cut distinction of authorities, including fiscal ones, between municipalities of various types and territorial levels. The regulations of constituent entities of the Russian Federation are restrained from distinguishing these authorities by uncertainty of regulations on territorial principles.

The new Federal Law «On General Principles of Local Self-Government in the Russian Federation» of 06.10.2003, No. 131-FZ establishes general legal, territorial, organizational and economic principles of local self-government in the Russian Federation, as well as state guarantees of its implementation. The major part of the provisions will come into force on January 1, 2006.

The Law provides for several basic types of municipalities: urban and rural settlements, municipal regions, urban districts and intra-urban territories at federal level.

The new Law provides a detailed regulation of the principles and limits of public involvement in local self-government. The fact that executive and control authorities of federal and local government agencies over municipalities and local self-government agencies are restricted by the limits established by the RF Constitution, laws and regulations, can be considered a guarantee of independence of local self-government.

However, the Law specifies a list of cases which may cause a temporal delegation of authorities of local self-government agencies to public authorities, in particular:

- 1) if a municipal representative body and local administration is absent and/ or can not be formed under the law due to a natural disaster, catastrophe or other emergency condition;
- 2) in the event of decisions, actions ( no actions ) of local self-government agencies that have resulted in arrears and/or budget arrears of municipalities, as determined according to the

procedure established in the RF Budget Code, exceed 30% of budget revenues of municipalities in the financial year under review, and/ or budget arrears of municipalities exceed 40% of budget allocations in the financial year under review, provided that liabilities of the federal budget and budgets of constituent entities of the Russian Federation to budgets of the foregoing municipalities are fulfilled;

3) if local self-government agencies, in executing certain public authorities delegated by allocation of subventions to local budgets, have committed a non-purpose utilization of budget funds or violation of the Constitution of the Russian Federation, the Federal Law, other regulations, as disclosed by a corresponding court.

Concurrently, the Law specifies the competence of municipal agencies and regulates their economic activity.

Solution of issues of local character ( regulation of local public self-government; utilization of territory; social assistance; medical service and education; municipal housing economy, road network; municipal housing ) come within the competence of municipalities. In addition. local self-government agencies govern municipal property, draw up and administrate local budgets, establish local taxes and provide protection of public order.

The Law provides for a two-tier structure of local self-government. The territory of a constituent entity of the Russian Federation ( except for underpopulated territories ) is delimited between settlements. Territories of all settlements, except for territories of urban districts, as well as territories emerging within municipal regions on underpopulated territories. An urban settlement can comprise a town or a settlement with adjacent territory, as well as rustic units which are not municipalities. A rustic unit with population less than 1000 people is generally embodied in urban or rural settlement. The Law provides detailed provisions regulating formation and structure of local self-government bodies, their authorities and responsibilities.

Generally, the structure of local self-government bodies is required to comprise a representative body of municipality, chief of municipality and local administration (executive-administrative body ). The chief of municipality can not simultaneously occupy positions of chief of representative body of municipality and head of local administration. Term of office of a deputy, member of elective agency of local self-government, elected official of local self-government is limited by five years.

The Law provides for characteristics of local self-government in federal cities of Moscow and St. Petersburg where local self-government is exercised by local self-government bodies on intraurban territories.

Maintenance expenditures of local self-government bodies are financed solely by the budgets of corresponding municipalities. The size criterion of a settlement's representative body, including urban district, is the number of residents on the corresponding territory. The minimum figure varies between 7 and 35 deputies. Utilization of local budgets and municipal asset management is monitored by special local self-government bodies, control and accounting chambers, auditing commissions, etc. The Law provides for public hearings, meetings, conferences and polling as new forms of local self-government.



## **Improving Legal Relations on Citizenship**

The Federal Law «On Citizenship of the Russian Federation» of 31.05.2002, No. 62-FZ tightened the rules for acquiring Russian citizenship since July 1, 2002 almost for all categories of applicants against the previous Law 1991.

Under the new rules, most categories of applicants for Russian citizenship may obtain it subject to more than a five-year period of residence in Russia on the basis of residence permit. The simplified procedure categories were reduced. A serious problem is how to grant the Russian Federation citizenship to the former USSR citizens which constitute the majority of applicants for Russian citizenship. Such individuals are registered at their domiciles in Russia, they considered themselves Russian citizens but lost some social guarantees under the new rules.

In order to eliminate negative consequences of the Law, a few draft laws aimed at improving regulations in this sphere were developed and submitted to the State Duma. The Duma adopted at three readings a draft law «On Amendments to the Federal Law «On Citizenship of the Russian Federation» submitted by the President of the Russian Federation.

A Federal Law of 11.11.2003 No. 151-FZ, «On Amendments to the Federal Law «On Citizenship of the Russian Federation» came into force on December 14, 2003, which provides for simplified rules for acquiring Russian citizenship.

Under the previous edition of the Law, the Russian citizenship only could be granted regardless of a residence period to adult persons which are rendered outstanding public services to the Russian Federation or have at least one disabled parent ( citizen of the Russian Federation ), as well as former USSR citizens which resided and still reside in the former Soviet Union's republics without citizenship and remain stateless persons.

The adopted amendments enlarge considerably the list of persons entitled to the Russian citizenship regardless of the required residence period.

- citizens of the former the Soviet Union's republics which graduated from secondary technical schools or institutions of higher education in Russia after July 1, 2002;
- citizens of the former Soviet Union's republics which do contractual military service at the Armed Forces of the Russian Federation, other forces, military bodies or departments for not less than 3 years;
- disabled foreign citizens and stateless persons which came to the Russian Federation from the former Soviet Union's republics and were registered at their domicile in the Russian Federation up to and including July 1, 2002;
- persons which have at least one disabled parent, citizen of the Russian Federation, residing on the territory of the Russian Federation.

Among the conditions which may reduce the required residence period from 5 to 1 year are birthplace on the territory of the Russian Federation of Soviet Socialist Republics and former USSR citizenship; not less than 3 years of matrimony with a Russian citizen; in case a disabled person has an adult able-bodied son or daughter being Russian citizens.

Most relevant privileges on acquiring the Russian citizenship are granted to those who were citizens of the former USSR, came to the Russian Federation from the former Soviet Union's republics and were registered at their domicile in the Russian Federation up to and including July 1, 2002, or obtained a part-time residence permit in the Russian Federation. In order to obtain Russian citizenship, they are not obliged to reside on the territory of Russia for

the period established, declare means of living and prove proficiency in the Russian language. The only restriction is that they have to apply for Russian citizenship before January 1, 2006.

In addition, WWII veterans, former USSR citizens, residing on the territory of the Russian Federation, are not obliged to renounce their foreign citizenship, if any.

Regulations that secure the general citizenship procedure were updated too. The Law is supplemented with an annex specifying that a period of residence for those who came to the Russian Federation prior to July 1, 2002 and have no residence permit will be assessed from the date of registration at the domicile.

## **Annex 4.**

### **Economic programs of political parties**

Speaking of Russian political parties' programs, one should note their eclecticism. However this specific feature can be noted not only in the Russian politics. For example, while pursuing rather a right-center policy, including lowering social expenditures and privatization, among other things, it was only in the 1990s that the British laborists excluded from their Charter the famous 4th Article that had been there since 1918. The Article proclaimed their eagerness to secure for workers of physical and intellectual labor their labor output in full and its most just distribution on the basis of public ownership on means of production. That, however, due to a number of reasons, provided no grounds to consider Mr. Blair's party either leftist, nor communist<sup>1</sup>.

Nonetheless let us try to assess economic programs the major Russian political parties put forward in their recent Duma campaign.

The United Russia's program provides too little answers to the question of its political substance, though it appears essentially right-centrist<sup>2</sup>. In particular, it reads: 'We wish to build in Russia a just society based upon the government social policy, in which a high level of social protection is secured and equal starting opportunities are created for everyone... Our priorities are: fostering conditions in which most of the population will be able to solve their socio-economic problems by their own; social partnership; an efficient system of social guarantees, redistribution of benefits in favor of those who are really needy, a targeted social assistance, formation of a single system of social insurance and health protection'. As concerns economic priorities, the program refers to 'assisting to development of high-tech science and industry branches; enhancing the quality of public property management; a rational taxation of natural resources; improving the business environment in the country, structural reforms and development of the financial market; debureaucratization of the economy, development of medium-size and small businesses; uniform competition procedures between participants in the economic life'.

However, another document, 'the Pre-lection Program of Political Party 'United Russia' shows an absolutely different stance. 'By contrast with the 'reformers' of the 80s and 90s who failed to achieve the major goal, that is, the rise in the majority of Russians' welfare, we accept only such reforms that ensure the welfare. One should abandon the market romanticism in favor of the government pragmatism where the main thing is result. The major condition for achieving this particular goal is sustained economic growth at a high pace, 8% annually on average', the Program Preamble goes.

The party put forward 'centrism' as its slogan, which was used vigorously in its election campaign. Interestingly, the party opposed itself both to the communists and the rightists. Centrism is interpreted as realism, responsibility, etc., which undoubtedly did not add too much to its portrait. In its economic section (p. 2.2.1) the Program set the task of overcoming the mineral-based nature of the national economy and argues that '...the current favorable situation in the foreign trade area allows to transfer a part of revenues from the mineral sector to processing industries. We are going, by means of a flexible tax policy, to withdraw super-profits in the oil and gas complex and to spend them on developing infrastructure and high

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<sup>1</sup> K stoletiyu angliyskykh laboristov// Sovremennyya Evropa. 2002. # 4

<sup>2</sup> Cited from [www.edin.ru](http://www.edin.ru)



tech. By regulating export tariffs, we plan to change the structure of export in favor of machine-engineering produce and high-tech sectors. The description of 'the public policy aimed at support and development of high-tech, innovation sectors' leaves a very broad room for speculations as to what that all means. As concerns MIC (p.2.3.2) the program argues about 'a full state control, electricity sector – control over tariffs (p.2.2.4), while for agriculture it suggests relatively modern vehicles, that is, to develop preferential credit system, exchanges, among others.

The Program set the task (p. 2.4.1.) of 'increasing social payments to the level not lower than the subsistence one', which de-facto implies a requirement to increase them in many times. The Program proudly reckons that the party initiated 'the adoption of an act that increases the minimum salary rate up to 600 Rb. a month starting from October 1, 2003, while the first grade rate grew up to 450 Rb.'<sup>3</sup> The Program stresses retaining numerous subsidies in the sector for housing and utilities, as well as that United Russia allegedly 'blocked the transition to the 100% level of payments for the services in question, while for the needy the level was lowered by 30-50%'.

In parallel, the program sets the task of debureaucratization of the economy, while very general contours of the health care, education and pension system reform raise no objections.

Though the document argues that the lowered tax rates are the UR's merit, the party does not raise basic right-centrists claims, namely, lowering the public social obligations, furthering tax cuts, and privatization of public property.

Overall, it can be argued that the party's program documents contain deliberately broad statements, though their rhetoric implies a lot of attacks on the rightists.

The CPRF program adopted in 1995 leaves an impression of a substantially earlier drafted document. In addition to digressions to, and declarations of the past<sup>4</sup>, it contains a 'program-minimum', though no 'program-maximum' (clearly, following the bolshevick traditions, the latter is a secret).

The minimum program particularly emphasizes the 'unacceptability of private property for land and natural wealth, their sale and purchase, along with implementation of the 'the land belongs to the people and those who develop it' principle, 'restoring the government control over production and incomes'; 'implementation of urgent public regulation measures to stop the production decline', 'returning to the Russian citizens the guaranteed socio-economic rights for labor, rest, housing, free education and health care, secured old age'; 'toughening repressive measures with respect to those who are involved in property theft, cor-

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<sup>3</sup> As Mr. Putin estimated in his TV address on December 18, 2003, the subsistence minimum accounted for 2,121 Rb.

<sup>4</sup> For instance, '...Imposition of capitalism coupled with exploitation of man by man generated an intense class disunity of the society. Its one pole was formed by the class of 'strategic owners' formed by the ruling regime. Its basis is formed by the banking and speculative capital which economically is closely associated with the West. Likewise, the mineral-export capital has a comprador nature. At the same time, the national capital that is oriented on the renewal of the domestic economy finds itself in a poor, uncompetitive state. The opposite pole is formed by a huge mass of people of labor suppressed by the impoverishment, threat of unemployment, fear of uncertainty of tomorrow. The proletarianization of most of our compatriots is coupled by the social stratification of the lower classes. In their search of means of subsistence the yesterday's workers, employees, specialists join the petty bourgeoisie lines. Absolute impoverishment of most of people of labor is aggravating. The stratum of de-classed elements is growing ([www.kprf.ru/about/program/html](http://www.kprf.ru/about/program/html))



ruption, speculation, gangsterism, selling out the country's natural resources, material and spiritual wealth'.

Despite Mr. Zuganov's repeated statements about support to small and medium-size businesses during the campaign, his addresses were very peculiar. Thus commenting on Mr. Khodorkovsky's arrest, he claimed that '... here is Mr. Chubais is being infuriated about the situation with YUKOS, but it was he who has sowed these dragon's teeth, and now they are sprouting. Basically, the enforcement agencies should have get hold of Chubais first'. In Mr. Zuganov's view, privatization that the current head of RAO UES Russia led in the 1990s was 'both illicit and criminal' and it was that which paved the way to the current situation of a new property redistribution. The remedy lies with 'the people's will realized through a referendum, which should result in regaining the public control over Russia's natural wealth'. Though not degrading to Mr. Zhirinovskiy's level, Mr. Zuganov nevertheless also addressed some plumbing problems in his peculiar fashion: 'Whatd difference does it make for the Russians if a part of the national wealth previously belonged to Berezovsky, and now it has been re-assigned to Abramovich'<sup>5</sup>.

The political program by LDPR is relatively far from the ritual spells 'We are for poor, we are for the Russians'. More specifically, '...in its activity, LDPR is guided by liberalism and democracy. LDPR understands liberalism as a genuine, not supposed freedom. This is primarily protection of civic rights and individual freedom for people of any nationality that populate the Russian state. Democracy, as it is understood by LDPR, suggests the democratic structure of the state in the form of the presidential republic, democratic nature of all branches of power, that is, legislature, executive and judicial ones'<sup>6</sup>. The party proclaims quite dirigist slogans in the economic area: 'First, the state should control economic processes in the country. Second, a powerful public sector of the economy should be restored. Thirdly, due to climatic conditions when the production costs in the country are always higher than overseas, the government should support national producers in their competition against foreign partners'.

LDPR proposes specific measures that all but not new and represent a classical set of populist ideas, that is, 'to stop any free aid to other countries, including those in the CIS', 'to supply military produce in larger quantities to the world market', 'to liquidate the organized crime and to legalize the 'shadow economy', 'to introduce foreign trade monopoly for minerals and energy sources, sales of alcohol, tobacco and sugar', 'to hold a general economic amnesty', 'to write ff all the debts accumulated by agrarian and industrial enterprises, 'to drastically cut down tariffs for electricity and transport', etc. Interestingly, however the party does not cite any tax increases, while the solution to privatization lies with 'the need to develop a law on nationalization of enterprises and other economic structures that cannot function efficiently in the private sector and to tighten control over privatized enterprises.

The program put forward by block 'Rodina'<sup>7</sup> represents, in some sense, an unabridged CPRF program. It proclaims 'the annual increment in GDP by not less than 10% ,providing the government pursues a targeted economic policy that suggests structural reconstruction and modernization of the economy on the modern technological basis, a drastic boost of investment and innovation activities' as its fundamental purpose. It can be achieved by means of 'the system of the state economic policy measures, including the use of government guarantees

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<sup>5</sup> [http://www.vibory-info.ru/index.php?action=show\\_news&id=137](http://www.vibory-info.ru/index.php?action=show_news&id=137)

<sup>6</sup> [http://www.ldpr.ru/programm\\_ldpr.htm](http://www.ldpr.ru/programm_ldpr.htm)

<sup>7</sup> <http://www.rodina-nps.ru/programma/show/?id=3>

under attraction of credits to finance promising economy modernization projects, unfolding the system of banks of development, implementation of targeted investment programs of structural reconstruction of the economy, re-orientation of the monetary policy towards provision of credits the production sphere, and stop of the illegal capital exportation. At the same time, holding inflation within pre-set limits necessitates a radical enhancement of the control over prices for energy sources and natural monopolists' services and curbing their rise by limiting it with consumer prices growth rates and real incomes of most of the population'.

It is proposed to increase the federal budget 'in 1.5 times minimum' 'only thanks to the natural rent'. Rodina drafted a bill on introducing an additional tax on subsoil users and claims that it is aimed at 'returning to the state the right for withdrawal of the natural rent in favor of the whole society'. The block estimates the value of the rent at the level of USD 50 bn. annually.

The owner is to be made 'responsible before the society for efficient use of property as well as for the effects, including social and economic, from his entrepreneurial activities'.

To ensure such a responsibility, it is proposed 'to retain the public (people's) ownership over natural resources, major energy, transportation, information and social infrastructure systems, basic enterprises of the defense complex, financial sphere as well as those involved in the production of alcohol, narcotic and other dangerous for the man's health substances'; to use 'mixed (with the governmental participation) property forms and government regulation in highly monopolized spheres of the economy'.

The program confirms the safety of legally acquired property, however at the same time it is suggested to 'conduct investigation of all suspicious transactions associated with privatization of public property with the abolition through judicial procedures of illicit acts and collecting the underpaid in the course of privatization funds to the revenue part of the state budget'.

The block proclaims a classical set of populist measures, but, by contrast with CPRF, they are much more intellectual and articulated, and deploy the 19<sup>th</sup> century terminology, not to mention their volume is much greater than the one by CPRF. They comprise using preferential credits to abroad spectrum of enterprises, government guarantees for commercial companies, maintenance of budget deficit, debt amnesty, repayment of the population's deposits with Sberbank as of 1991, limiting the capital outflow, protectionist, anti-import measures, refusal of land sales, etc. At the same time, Rodina promises 'to ensure a substantial lifting of the tax burden on labor and production, primarily by lowering the social tax and VAT rates and exclusion from the taxable base of costs for investment, research and development in the area of new technologies, creation of new jobs'. As concerns social challenges (health care, education, pension system) Rodina just mentions which new costs should be planned.

According to the pre-election program by the Union of Rightists Forces (SPS)<sup>8</sup>, the party advocates 'the way towards fostering democracy and market, forming an open political system and innovational economy, knowledge-based economy, i.e. towards democratic market'. The party proclaimed rightist, liberal values, as far as basic economic parameters are concerned: the need for a professional army, reforming the social sector, including health care, education and research, the sector for housing and utilities, as well as the administrative and banking

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<sup>8</sup> <http://www.sps.ru/?id=63261>



reforms, furthering the judicial, tax, pension reforms, drastic changes in the migration policy, solidifying guarantees of personal safety and private property protection.

In the educational, health care areas and the pension system (though without addressing the research area) SPS proponent the principles of fixing and limiting the governmental responsibility for delivery of free services. In addition, the party proposed further tax cuts: more specifically it was proposed to cut VAT down to 15%; to reduce the list of goods (works, services) whose sales is exempted from VAT taxation to the list of 'standard' exemptions practiced worldwide coupled with the cancellation of other benefits; maintenance of the flat personal income tax rate; increase in tax rebates for education and medical costs; harmonization of taxation of public and private pension and insurance plans (provision of rebates on contributions to private specialized organizations); lowering the effective social tax rate and lifting the restrictions on access to the regressive tax rate; lowering the presumptive tax rate, among others.

As concerns the mineral resources tax, SPS likewise proposed to increase its rate in the carbohydrate minerals area coupled with an introduction of the 3-year statute of limitation on privatization transactions and fixing a dual approach to consideration of abuses of law in the course of implementation of those; a termless application of legal penalties for the revealed and proved in the court of law breaches of law by officials and their counterparts, and securing an absolute principle of property inviolability.

SPS, by and large, has proved to be the only party that declared a unambiguous and tolerant attitude towards privatization, though that task was not directly articulated.

The program presented by the Russian democratic party 'Yabloko', the structure formed in 1994 on the basis of the block of the same name, proved to be more sophisticated. At the time most of public organizations had already positioned themselves in the political spectrum, while Yabloko still finds itself at the interfaces between the liberal and the social-democratic movements. That is clearly declared in its 2001 democratic manifest: 'The new democratic course that RDP Yabloko declares is based upon the revision of vulgar approaches to the past and a clear apprehension of tasks of the future. The course is based upon the contemporary liberal and social ideology'<sup>9</sup>. With a perfect understanding of what that implies, one cannot help but noting Yabloko's conscious camouflaging their own stand. The documents also refers to 'the European economic model' but, again, fails to provide any specific guidance as to which institutions they have in mind. Likewise, Yabloko's program documents appear immanently contradictory: while advocating guarantees for private property, protection of economic freedom, liquidation of bureaucratic barriers to entrepreneurs, protection of medium size and small businesses, creation of favorable conditions for any investment, a vigorous resistance to monopolists and supporting competitive environment on the one hand, the party tends to call for non-formalized expansion of government obligations, on the other ('to raise the minimum wages to the actual subsistence level'); 'decreasing by three times the number of Russians living below the poverty line'; 'to liquidate the USSR foreign debt'<sup>10</sup>. The declaration does not say anything of lowering the tax burden, which just intensifies the concerns raised by the references to the European experiences regarding sources of funding such ambitious projects, that is, raising taxes; of the need for further privatization of government property; of cutting down public expenditures. The same can be noticed in the party's previ-

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<sup>9</sup> The Democratic Manifest of Yabloko party. <http://www.yabloko.ru/Union/Program/manifest-2001-proj.html>

<sup>10</sup> Op.ed

ous program documents, namely the 1995 political declaration, the 1999 pre-election program, among others.

It is worthwhile noting that Yabloko's attitude towards privatization is not just neutral. Rather the party is very negative to that. Thus, according to a statement made during the Duma campaign, G. Yavlinsky 'carries out computations of a single tax to be levied on all those who participated in privatization deals. Its essence is as follows: the net profit over 9 years less the amount paid during privatization is subjected to the 25% tax<sup>11</sup>.' Mr. Yavlinsky also argued that there should be introduced an occupational ban for those who had conducted privatization.

In conclusion, the attitude to current urgent challenges by major political parties that participated in the 2003 electoral campaign can be presented in the table form.

Issue	United Russia	CPRF	LDPR	«Rodina»	SPS	«Yabloko»
Budget policy	Responsible	N/a	Condemns the financial stabilization policy	Condemns the financial stabilization policy	Responsible	Contradictory
Increase in social obligations of the state	In proportion as GDP grows	yes	yes	yes	In proportion as GDP grows	yes
Tax policy	N/a	Not articulated as a whole	Lowering	Increase of some with decrease of others	Lowering	Lowering
Including taxation of the mineral sector	Increase with some reservations	Increase	Increase	Increase	Increase with some reservations	Increase with some reservations
Including personal income tax and the SST collection system (the 2000 reform)	yes	No	yes	No	yes	yes
Nationalization of large enterprises	No	yes	Yes, with reservations	Yes, with reservations	No	No
Privatization	No stand	No	No stand	No	Yes	No, with reservations
Government regulation of the economy	Strengthening for large companies, loosening for others	Strengthening	Strengthening for strategic sectors, loosening for others	Strengthening	Loosening	Loosening
Accession to WTO	Yes, with reservations	No	No позиции	Yes, with reservations	Yes	Yes
Economic aid to the CIS	No stand	Yes	No	Yes	No stand	No
Attitude to the 1990s reforms	negative	negative	negative	negative	Positive	Negative, with reservations
Professional army	Deadline for the completion of transition is not identified, not earlier than 2008	negative	negative	negative	Yes	Yes

<sup>11</sup> <http://taimyr.yabloko.ru/elections/index.phtml?f=1&ff=1>

## **RUSSIAN ECONOMY IN 2003**

### **Trends and Outlooks**

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