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The present monograph comprises a detailed review of major trends in the Russian economy in 2005. It consists of four major sections highlighting on single aspects of development of Russia's economy: social and political background; monetary and credit and budgetary spheres; the real sector; institutional and macroeconomic challenges. The work is based on a great mass of statistical data that allowed original computations and numerous illustrations in the form of figures and charts.

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Section 1. The Socio-Political Background

1.1. Economic Policy in 2005: Identifying Priorities

1.1.1. Main Outcomes

Russia's economico-political situation in 2005 largely continued the logic and tendencies of the prior year. Its main peculiarities became maintenance of fairly high rates of economic growth, along with a growing role of the state in the nation's economic life.

Main characteristics of 2005 are as follows:

First, the ongoing favorable economic dynamics against the backdrop of high prices for Russia's main exports (see *Table 1*).

Russia's economic growth has reached values greater than forecasted at the threshold of the year and accounted for 6.4% of GDP vis-à-vis the expected 5.9%. That occurred despite of the presence of two factors that are capable to exert an adverse influence on the process of growth – that is, the continuous appreciation of the national currency and intensification of the state intervention with economic life. While generating problems for the monetary authorities, the inflow of oil dollars at the same time helped solve the nation's budget challenges, such as an early repayment of its foreign debt and its fall to an unprecedented low level, followed by granting Russia with high sovereign ratings by the leading rating agencies. It is not less important that the growth rates of Russia's economy were greater than those of the most developed countries, as well as most post-communist nations (see *Table 2*).

Second, in its policy the RF Government continued to maintain elements of different approaches to attaining high economic growth rates:

- on the one hand, the Government improved general economic conditions by pursuing the administrative, tax and budget reforms, monetization of benefits, etc.;
- on the other hand, it favored the concept of shaping mechanisms of the private-public partnership (PPP), which suggested emergence of fundamentally new instruments of economic policy that ensure the government's immediate contribution to design and implementation of specific economic projects (special economic zones, investment fund, concession laws).

The noted approaches bear no insurmountable conflicts. In the absence of opportunities for a full-scale liberalization of an economy, creation of special economic zones can *in principle* be viewed as a way of a partial liberalization. Analogously, the concession law can be regarded as an alternative to more pro-market instruments, such as lease and privatization, in the event political factors require from private managers to solve some socio-economic tasks. The conflict emerges only when the second approach is viewed as an independent one and it is applied in the situation when political conditions *allow* implementation of measures of the first approach.

Third, the year of 2005 saw a continuous debate over a medium-term socio-economic policy program and government operational priorities. Two fundamentally critical decisions in this regard were made in the second half 2005. In September new priorities were set and, consequently, the Government became focused on social, rather than plainly economic, landmarks as their core operational priorities. In December, following after nearly two-year debates, the Government eventually became capable of formulating its medium-term action plan.

Fourth, the country's economico-political life found itself increasingly dependent on the progress of its fuel and energy sector and conditions of exportation of its output, and that happened against the background of high prices for main Russian exports. Strictly speaking, this tendency does not allow unambiguous interpretation. On the one hand, the dependence of the budget on the inflow of oil dollars has undoubtedly grown along with the expansion of the magnitude of the use of these funds on the budget investment and social objectives. On the other hand, however, the dependence has remained relatively insignificant compared with what it could have become otherwise, given extremely high prices for the FES output, which can be attributed to the existences of the Stabilization Fund and the current fairly conservative budgetary policy.

Besides, one should not ignore such an aspect of the growing dependence on the state of affairs in the foreign trade area as a considerable amount of the nation's foreign debt. While the sovereign debt continued to shrink, in absolute terms the aggregate debt has remained quite huge. Capitalizing on extremely good Russia's macroeconomic performance indicators and encouraged by low interest rates on international financial markets, the national private commercial organizations (financial and non-financial alike) borrowed vigorously overseas. Such a debt in principle does not form a negative factor per se, as, given other conditions being equal, it testifies to investment activity in the country and proves to be a natural phenomenon under economic growth. However, the question as to what degree the current economic growth by itself is natural and whether or not it is a visible proof of overheating of the economy (as some analysts and heads of the "economic bloc" of the RF Government argue¹ from time to time) has remained unanswered. If the indeed is there, it bears a risk for entrepreneurs, as they would face results of massive and systematic mistakes while computing their investment and credit risks². That in turn can endanger well-being of a number of Russian industry branches and financial institutions that service them. In such a context, a rise of the debt can become an alarming indicator.

Finally, 2005 showed that the oil and gas aspect of Russia's economy cannot be reduced just to problems of intensification of the dependence of the budget on mineral export. It has become evident over the past 12 months that oil became the most important instrument of Russia's social policy, while gas – some *summum argumentum* in its foreign policy. The decisions on building a Baltic gas pipeline and the "gas confrontation" with Ukraine became critical events of the past year that will echo in the long run.

Fifth, in 2005 for the first time over the past 6–7 years the government faced mass manifestation of social discontent. The monetization of benefits in early 2005 faced the population's strong resistance, with pensioners taking the lead. The government had to retreat and revise considerably the volumes of intended social payments and compensations, which implied the rise of new significant budget obligations. However, it is not the budget problems that are the most critical ones in the circumstances.

The political crisis around monetization exposed two serious problems that can further have a substantial impact on development of the socio-economic processes in the medium term.

On the one hand, the crisis exposed a poor efficiency of the mechanism of designing and making important decisions under the existing automatic support of the government

¹ See Mr. A. Kudrin's interview to Interfax agency (http://www1.minfin.ru/off_inf/1361.htm) and Mr. G. Gref's account at the RF Government entitled «Osnovnye parametry prognoza sotsialno-ekonomicheskogo razvitiya na 2006-2008 gg.» (http://www.economy.gov.ru/wps/portal/!ut/p/.cmd/cp/.c/6_0_69/.ce/7_0_2ES/.p/5_0_1BV/.pm/H?helpMode=Detail_default.jsp&documentId=1118924266938).

² См. Rothbard Murray N. America's Great Depression, Kansas City: S heed and Ward, 1972, pp. 8–9 (<http://www.mises.org/rothbard/agd.pdf>).

by the parliamentary majority, because the guaranteed rubber-stamping of any bill lowers the quality of MPs' law making, for they do not consider themselves responsible for the decisions made. At this point, the problem is not just that the ministries de-facto substituted the legislature's work, but that the former carried out that work in a "non-parliamentary" way – that is, secretly, with no public discussions and maximum possible account of the existing interests, orientation towards consensus, etc. In other words, we see a substantial bias from the UN principles of good governance³.

On the other hand, for the first time ever in the Post-communist Russia's history there was built a precedent of the government revising its decision under the pressure of the public at large. The latter, of course, is not dangerous by itself (if the decision is wrong, it should be revised), but in the context of the possibility to make unpopular decisions in the future and, more specifically, such decisions that can affect interests of far more influential interests groups than urban pensioners that protested against the monetization.

Sixth, 2005 became a year of the continuation of the crisis of functioning of government institutions, primarily the administrative, legal and law enforcement systems. As a result, Russia continued sliding down along major international quality of governance ratings. In the rating of economic freedom it plunged from the 114th to 112th position (the level of Indonesia and Cameroon); in the Transparency International's rating of corruption it likewise sank from the 90th to 126th position and joined the group formed by Niger, Albania, and Sierra Leone⁴. The country also found itself in a similar situation, so far as the WEF's competitiveness rating is concerned – here it fell from the 70th to 75th position, thus lagging behind not only all the developed nations, but most post-communist ones, including China in particular⁵.

Seventh, investment activity in the country was growing, regardless a loose institutional environment. More specifically, foreign investors displayed a greater activity, with FDI soaring 1.5 times and their volume for the first time ever being greater than into other post-communist country and accounting for USD 13.1 bln. The respective index in terms of share of GDP has still been relatively low, of course- a meager 2.4%, however it proved to be greater than in Ukraine). However, domestic investors still remained conservative or prefer investing from overseas, i.e. in the form of foreign investment. This cautious approach can partly be attributed to the "Problem of 2008", i.e. business is keen to know not only the name of the future RF President, but a real mechanism that will be activated to have that figure appear. In conjunction with this it is worthwhile noting an actual stagnation of investment activity in the FES subsectors, despite an extremely favorable situation with prices and a drastic investment boom in the countries that produce oil in similar natural and climatic conditions (Canada, for instance).

These challenges are becoming critical in the conditions of completion of the transformational crisis and entering the path of modern economic growth.

³ See: <http://www.unescap.org/huset/gg/governance.htm>.

⁴ Practically all the oil-producing countries demonstrated a similar tendency, except for the institutionally mature Norway.

⁵ The credibility of such ratings should not be overestimated, though. They usually bear a great deal of subjectivity and fund themselves very much dependent on the level of informational openness of a given country (which is why it is not a surprise that Russia was placed below not only China, but sometimes even Belarus. However, no matter the quality of such rating is, it cannot be denied that Russia has not advanced in fighting corruption and boosting competitiveness.

Table 1

Main Indicators of Russia's Socio-Economic Development in 2001–2005

Показатели	2001	2002	2003	2004	2005
Annual GDP increment, as %	5.1	4.7	7.3	7.4	6.4
Annual increment of industrial output, as %	4.9	3.7	7	6.1/8.3*	4.0*
Annual increment in investment in capital assets, as %	8.7	2.6	12.5	10.9	10.5
Foreign direct investment, as USD bn.	3.98	4	6.78	9.42	13.1
Stabilization Fund Rb. bn.	-	-	-	522.3	1237
Inflation (CPI)	18.6	15.1	12	11.7	10.9
Surplus of the federal budget, as % of GDP	2.9	1.4	1.7	4.4	7.4
Foreign reserves, as USD bln	36.6	47.8	76.9	124.5	182.24
Balance of foreign trade, as USD bn.	48.1	46.3	59.9	85.8	120.2
Balance of payments by current operations, as % of GDP	11.1	8.4	8.2	10.3	12.2
RTS index (as of end-December)	260	359	567.3	607.57	1125.6

* The dynamics of industrial production is given by kinds of economic activity.

Source: Rosstat, The RF Ministry of Finance.

Table 2

**The Dynamics of GDP in Russia and a Number of Other Countries
(Increment as % to the Prior Year)**

Countries	2001	2002	2003	2004	2005*
<i>Russia</i>	5,1	4,7	7,3	7,2	7
Great Britain	2,1	1,7	2,1	3,1	1,7
Germany	0,8	0,2	-0,1	1,6	3,0
Italy	1,8	0,4	0,3	1,2	
USA	0,8	1,9	3,0	4,4	3,5
France	2,1	1,2	0,5	4,4	1,6
Japan	0,4	-0,3	2,5	3,7	3,0
Ukraine	9,2	5,2	9,4	12,1	2,8
Belarus	4,7	5	7	11	8,7
Armenia	9,6	15,1	13,9	10	11,6
Georgia	5,2	5,4	11,6	7,7	7,7
Kazakhstan	13,5	9,8	9,3	9,4	8,8
Poland	1	1,4	3,8	5,3	3
Czech Republic	2,6	1,5	3,7	4,6	5,1
Hungary	3,8	3,5	2,9	4,6	4,4

* January-September to the respective period of the prior year.

Source: Rosstat, United Nations Statistics Division.

1.1.2. Economic Growth: Debates and Politics

Growth and National Priorities

Like in the previous years, in 2005 policy-makers and economists focused on problems of economic growth, while the problem of doubling Russia's GDP discontinued to be

a central one, albeit it remained in the government agenda. No one, of course, refused to tackle the problem – both President Putin and Prime Minister Fradkov raised the issue periodically and there equally periodically was a discussion on the possibility to resolve the problem within a decade. The discussion, however, was increasingly shifted to problems of quality of growth, its mechanisms and structural priorities. It is quite natural, for figures of economic growth by themselves cannot ensure the much-needed strategic result – that is, a socio-economic breakthrough towards the modern post-industrial society.

With the discussion in place, its cause lay in personal relationship between different political groups in the executive branch, rather than with the challengeable identification of concrete figures. Through the end of 2005 Mr. Fradkov insisted on a search of instruments that would ensure to solve the “problem of doubling GDP”, as for him that was the most critical political landmark and the core of his accounting to President Putin. The main reason for the refusal of the official adjudication of the government medium term program of socio-economic development until end-2005 was the absence of a clear understanding of mechanisms of the doubling of GDP. Since the crisis 1992 Russia has not seen a situation when the Government would be operating for a year without an action plan, while by the very end 2005 the program had already been non-existent for nearly 2 years. Mr. Fradkov, however, had every reason to believe that the absence of a program due to political reasons for him would be better than a program with no clear answer to the question as to how GDP would be doubled. The RF Ministry of Economic Development and Trade that was responsible for the program design in turn did not want to assume a full political responsibility for economic growth. That was quite logical, as economic growth in Russia nowadays is directly dependent on the state of political and law enforcement institutions, rather than economic ones.

Economic growth is a very complex phenomenon that appears resulting in relation to numerous economic, political and social factors. It would be incorrect to seek solutions to the task of “doubling GDP” only in the economic sphere. Furthermore, it can be argued that today we are living under the “declining productivity” of its economic factors, with political and legal ones, i.e. the state of public administration, judicial, law enforcement and political systems, parliamentary institutions, and a state’s ability to ensure law enforcement coming to the forefront. It is not surprising, after all, because to be competitive, business has to enjoy an opportunity to utilize public goods provided by the state, of which ensuring contract enforcement is the most critical one. Once the judicial and law enforcement systems fail to guarantee that, entrepreneurs have to incur all the costs associated with contract enforcement, which results in greater costs and lower competitiveness.

The entrepreneurs’ personal safety poses an equally critical challenges. Back in the early 1920s, on the onset of the so-called New Economic Policy, in response to the question if he was happy with a new Bolshevik decree on safety of bank deposits, a *nepman* commented, ‘Safety of deposits? And what about depositors?’⁶. The question retains its actuality these days, too – suffice it to recall that modern economic growth in England started resulting from the “Glorious Revolution” of 1688–89, after passing the famous “Bill of Rights” that guaranteed personal safety and safety of property.

Finally, the year 2005 saw an increasingly greater widespread of an obvious fact that the country needed not an economic growth per se, not the nation needed it at any cost. There are several things one should take into consideration while developing an adequate economic growth policy: first high growth rates are needed in the long run and not just for

⁶ Chlenov S. Ekonomicheskaya politika I revolyutsionnaya zakonnost’// Narodnoye khozyastvo. 1921. No. 8–9. p. 27.

triumphal reports in a 2–3 year perspective. Second, high growth rates are sound only when they are coupled with necessary structural shifts, such as, primarily, diversification of the economy, (at least) partial shaking off the dependence on the fuel and energy sector, and an accelerated emergence of post-industrial sectors of the economy. More than that, at certain stages the progressive structural shifts may be coupled with a decline of growth rates. Third, it has to be a real growth, which should not be falsified in favor of a given political situation and for the sake of pleasing political leaders. Fourth, there is some danger of orientation of the government policy immediately towards tasks of economic growth, while bypassing a separate discussion on problems of the quality of an economic policy. Problem is, growth can be ensured by both a natural investment and saving activity and by shaping a “mobilization economy” of the Soviet type, which is based on “compulsory savings” and tightening of belts.

That is why the 2005 discussion centered on the structure, quality and institutions of economic growth. The discussion was fueled by designing and debating strategic priorities of Russia’s socio-economic policy.

During the whole period of the country’s post-communist development the public at large and various interests groups demanded from the government a clear vision of long-term priorities of Russia’s socio-economic development. The demands as a rule implied a list of industries the government should be bound to stimulate by means of budgetary or tax measures, support them and protect from competition from overseas. However, such decisions were impossible to make due to a number of political (current) and economic (strategic) nature.

Politically, it was impossible to identify the priorities, because of the social struggle of the revolutionary transformation of the 1990s. That was the time of a strong social conflict, absence of consensus on basic values and landmarks of the state and nation’s development. These problems are being overcome today, and there arises a fundamental possibility for development of some set of strategic landmarks.

So far as the economic perspective is concerned, the difficulty with setting priorities can be attributed to a wrong setting of the task. It proceeded from the concept of priorities traditional for the industrial society⁷. However in the modern world, with its greater dynamism of production and needs, a setting by the state of industrial or other sectoral priorities appears plainly impossible – development of the post-industrial system appears far less predictable than that of the industrial one. As evidenced by the most developed nations’ experiences, the specific peculiarity of modern development has become investment in development of human capital.

They create conditions of a sustained and dynamic growth and constant adjustment of the socio-economic structure to new, earlier unpredictable, twists of the scientific-technical progress.

The political leadership and government experts in Russia vigorously discussed the problem of the priority role played by human capital over nearly two years. These problems were also mirrored in the presidential addresses to the Federal Assembly. Finally, in September 2005 Mr. Putin suggested them in the form of the so-called “national projects, which de-facto became national priorities of Russia’s development. Those are education, health care, housing (introduction of mortgage), and solving social problems in the countryside.

⁷ More on challenges of post-industrial development see: Mau V. Postindustrialnaya Rosia v postindustrialnom mire: problemy dogonyaushego razvitiya//Voprosy ekonomiki. 2002. No. 7.

This list of priorities de-facto means the rise of a new stage in Russia's economic and political life. This stage is no longer associated with the mission of overcoming the communist legacy. Rather, it is based on a positive agenda – that is, the need to solve new challenges that reflect realities of the modern world.

Indeed, over past 15 years Russia has passed through two stages of its development⁸. During the first stage that covered mostly the 1990s, the mission was to overcome a full-scale macroeconomic crisis and create basic economic and political institutions, without which the modern society cannot function – namely, private property, monetary and tax and fiscal system, federative relations. These were highlighted primarily by the Constitution of RF and the Civil Code. During the second stage (roughly between 2000 and 2003) the emphasis was made on shaping the bulk of economic institutions, such as the tax and land law, lowering administrative barriers for business (deregulation), bankruptcy law, transformation of natural monopolists, among others. Such decisions, however, reestablished what the nations with more or less modern structure of society not distorted by the communist experiment had long enjoyed by then.

The “national priorities”, however, appear different by their substance. The shaping of a modern efficient system of human development poses an urgent challenge for all the most developed nations worldwide. The post-industrial challenges with their demographic problems have led to the crisis of the traditional “welfare state” and many nations currently face the challenge of a radical transformation of their social sphere⁹. In other words, Russia does not face the problem of the crisis of the Soviet social system. Rather, it is a far more serious a challenge, which is why the search for and creation of a new model of social policy falls to the sphere which is common for all the developed nations¹⁰, rather than to the catching-up development.

Each national priority implies two groups of actions. Those are on the one hand, allocating additional budgetary resources to raise labor compensations of employees in the respective sectors and population groups, while on the other – implementation of structural reforms in the sectors. The two groups appear inseparable from each other. Addressing one task while ignoring the other would be politically perilous and economically inefficient, however, the risk the situation would emerge in such a way is fairly substantial.

Raising teachers and medical doctors' salaries, investing in equipment and other similar financial measures form a prerequisite, rather than a sufficient condition, of remedying a number of plumbing problems. The quality of educational and medical services is not associated solely with the labor compensations level and, accordingly, attraction of qualified cadres to the social sphere, but enhancement of efficiency of functioning of the respective system. That is why it would be undesirable, if the social sector reform ended up with an increase of budget expenditures, i. e. if the first step were the last one.

Furthermore, without structural reforms, a rise of financing may even entail adverse effects. Higher salaries would result not in the rejuvenation of the cadres, but their preser-

⁸ For analysis of stages of the post-communist development see: Rossiyskaya ekonomika v 2004 gody: Tendentsii in perspektivy. Issue 26. M.: IEPP, 2005 p. 14–16.

⁹ See: Gaidar E. *Dolgoye vremya*. M.: Delo, 2005. Chapters 12 and 13.

¹⁰ Strictly speaking, the search for a most efficient remedy to contemporary social challenges forms a major factor of solving the very task of catching-up development. Such an approach is in the mainstream of A. Gershenkron's ideas. He regarded backwardness as a factor of an accelerated development. (See: Gershenkron A. *Economic Backwardness in Historical Perspective* // A. Gershenkron *Economic Backwardness in Historical Perspective*: Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962). The substance of the approach is that the more backward countries can allow themselves not to replicate the path of the advanced ones, but to utilize already existing technologies and institutions. Speaking of the current situation, it can be suggested that Russia's ability to find the most efficient institutions of boosting its human capital (in the conditions of a general crisis in this sphere) would give the country considerable comparable advantages, so far as solution to the task of reducing its economic backwardness from the most advanced countries is concerned.

vation, i.e. maintenance of the medical doctors and teachers that have long lost their qualifications and even for a 100-fold salary rise would not be able to do their job better. The rise in expenditures on equipment will turn into kick-back-based procurements of the unneeded one, while given the current level of monopolization of the market for construction services, the boost of the funding for housing construction will result just in sky-rocketing prices for it and rapid enrichment of a handful of local monopolist entrepreneurs.

So, money constitutes only the first, but not the most critical, step to regalanizing of the noted sectors – in parallel with that, it is necessary to vigorously pursue the structural reform of the social sphere and reform budgetary organizations, in particular.

Implementation of the national projects demands a fierce resistance to budget populism. While declaring them the priorities, President Putin emphasized the imperativeness of maintaining hard budget constraints, a balanced budget and preclusion from strengthening of the country's dependence on the state of affairs on the overseas markets. This can be ensured with the help of two inter-related conditions. First, the balanced budget formed under rather a conservative forecast of the world oil prices; and, second, setting a relatively short time horizon for specific projects (some 2 years) – i.e. the projects should become oriented to a period during which it can be assumed, with a great degree of probability, that financial revenues necessary for its implementation would most likely be there.

However, after the priorities *were announced* the public opinion decided President spoke of areas of spending of resources accumulated in the Stabilization Fund. The fall of 2005 even saw claims to immediately use them. President Putin, however, reckoned the opposite, and the Stabilization Fund is growing, rather than shrinking. It is quite another matter, a part of future expenditures on the national project, indeed, will appear in the budget, due to softer conditions of the formation of the Stabilization Fund (primarily, because of a greater so-called “cutting price”).

Mechanisms of Securing Economic Growth

Mechanisms that are to secure high rates of economic growth continued to be in the heart of the 2005 economico-political discussion. Their group comprised:

- Improvement of institutional conditions of economic development;
- A more active role of the state in the country's economic life;
- Shaping mechanisms of the public-private partnership; and
- Securing macroeconomic stability and prevention from populism in the monetary and budget policy.

The discussion unfolded between advocates of two approaches to consolidation of economic growth – namely, dirigist and institutional (or, accordingly, etatist and liberal ones). At the 9th International Economic Forum in St. Petersburg, there was a round table on the issue. The session was moderated by Minister G. Gref and included Mr. Putin's presentation, among others¹¹.

The respective polarization first manifested itself yet in 2004, with two other options (development of financial-industrial groups and resolute liberalization) losing their political urgency¹².

The intensity of the debate between proponents of the dirigist and institutional approaches has formally faded away, and in 2005 they began to some degree complement

¹¹ See: Vestnik Mezhpaparlamentskoy assamblei gosudarstv – uchastnikov Sodruzhestva nezavisimyykh gosudarstv. SPb., 2005. № 3, p. 45–63.

¹² For the comparative analysis of the four models, see: Rossiyskaya ekonomika v 2002 godu: Tendentsii i prespektivy. Issue 24. M.: IEPP, 2005. p 18–20.

each other. The state's immediate participation in the economy started being getting more transparent and institutionalized forms (for instance, creation of the investment fund), which replaced non-systemic attempts to intervene in the economic life by making individual decisions on individual enterprises or industries. While in 2004 sectoral strategies were viewed as a direct alternative to the institutional reforms, now they have formed the last separate section in the medium-term program the government approved of on December 29, 2005. In all fairness, however, the basis of the program is made by sections about institutional reforms.

In 2005, the work continued on improvement of the economic and social legislation: more specifically, individual natural monopolist sectors (except for the gas one) and the respective law on the whole (the work began on the bill "On goods and services of the general economic significance and pricing for them"¹³, which is likely to replace the currently effective federal statute "On natural monopolies"); the administrative reform, reduction on the volume of economic activities subject to licensing; important statutes on concession agreements and special economic zones were passed; and public procurement procedures were tightened, to ensure their maximum transparency¹⁴. From the legal perspective (and with account of the "YUKOS case"), an important event became the introduction of an amendment to the Civil Code, in compliance with which the statute of limitation on privatization transactions was reduced from 10 to 3 years. Thus, there occurred a de-facto legitimization of results of the mass privatization of the 1990s, which can form an important factor that will contribute to a greater investment activity of the national business.

However, there was no radical progress in the institutional sphere in 2005. This can be explained by a number of factors. First, a certain break was needed after a series of radical decisions of the prior two years, when the administrative and municipal reforms were launched, followed by a subsequent substantial transformation of the public administration system. The reform implementation provided ambiguous outcomes and participants in the political processes needed time to adapt to the new rules of the game. Similarly, time was needed to fix the outcomes, given, as noted above, some of them were equivocal. The transition to the three-tier structure of executive power (Ministry – Service – Agency) triggered a serious mess and resulted in a far lower degree of manageability that that of the first years of Mr. Putin's tenure. It was only by late 2005 when the trend to a more efficient interaction between the new government bodies began to emerge. However, while reproducing the classical scheme of the division of powers under which Ministry carries out quasi-parliamentary functions, Service – quasi-judicial and police functions, and Agency – economic activity, the three kinds of government bodies have failed to acquire their specific function and objectives. It is particularly because of the confusion with objectives that collisions may arise, with carrying out their quasi-judicial function, the federal Service are directly centered on ensuring some socio-economic results, which is a typical feature of political bodies (for instance, parliament), but cannot fall to the purview of

¹³ Information of the bill is available on: <http://www.fstrf.ru/discussion>.

¹⁴ See, for example, federal laws "On introducing amendments to the Federal Law 'On licensing individual kinds of activity'; the Federal Law "On protection of rights of legal entities and self-employed individuals in the course of the conduct of the state control (supervision) (No. 80-FZ of July 2, 2005); "On concession agreements" (No.115-FZ of July 21, 2005); "On special economic zones in the Russian Federation" (No.116-FZ of July 22, 2005); "On introducing amendments to some legal statutes due to the adoption of the Federal Law "On special economic zones in the Russian Federation" (No. 117-FZ of July 22, 2005); "On placing orders on delivery of goods, services and works for the state and municipal needs" (No. 94-FZ of July 21, 2005); "On introducing amendments to Art. 18 of the Federal Law "On licensing of individual kinds of activity" (No. 200-FZ of December 31, 2005); "On special economic zone in Kaliningrad oblast and introducing amendments to some legal statutes of the Russian Federation (No.16-FZ of January 10, 2006); Resolution of the RF Government "On approval of provisions on licensing in the sphere of foreign trade with goods and formation and conduct of the federal bank of issued licenses" (No.364 of June 9, 2005).

the court of law. Departmental “reports on performance and main directions of activity” give various sorts of examples of this kind, which reflects that certain directions of the administrative reform have been incomplete so far.

As concerns the municipal reform, which had formed a very urgent matter yet in 2004, it was postponed until 2009.

Second, the government was under shock from the street manifestations against the monetization in January 2005. The concerns about their repetition became one of the critical factors in the decision making in the economico-political area – in the event of a smallest hesitation in this regard the government preferred to refrain from adopting of already designed decisions. The shock and its effect on the government underlay its refusal of a consistent implementation of the municipal reform.

Third, already matured and ready for the launch, a number of important reforms faced deficiencies of the current law enforcement practice, without which economic measures per se cannot ensure the desired effect.

The last problem is among the formidable challenges that face the modern Russia’s economic policy. The country has found itself in a peculiar situation that can be characterized as the “decline of productivity” of economic institutions (the economic law). Today, the law enforcement practice and the state of the public administration, judicial and law enforcement systems in particular form the biggest obstacles on the way to improvement of the economic law and giving boost to the efficiency of the functioning of socio-economic processes. This primarily concerns such areas as the antitrust regulation, taxation, and the customs policy.

In 2005, the government was working vigorously on a new antitrust law that will allow to enhance the efficiency of the noted sphere of regulation. This is one of the hottest matters, as the monopolist nature of a number of sectors in the national economy not just formed the major cause of its low competitiveness, but inhibit implementation of urgently needed reforms in a number of sectors (development of mortgage, for instance). The Federal Anti-Monopoly Service (FAS) designed a bill which to a significant degree is based upon the EU standards and thus solving an important problem of synchronization of the Russian law with the European. However, the law was harshly criticized – and not only representatives of monopolists or liberal economists¹⁵. The problem is, implementation of an antitrust law is impossible without a vigorous contribution of an army of authorized civil servants and an efficient judicial system. In other words, the FAS’s bill suggests in introducing the European antitrust regulation procedures in the conditions of the Russian law enforcement system, which in practice will fully discredit the law.

Similar problems arise in the course of the discussion on furthering the tax reform efforts. In 2005, the Government vigorously debated the problem of a further decrease of tax rates and the VAT rate from 18 to 13% in particular. Interestingly, the latter idea was opposed primarily by representatives of liberal circles within the Government and expert community. Their reasoning was not limited just by concerns of stability of the budget – they also cited inefficiency of the tax administration system. Whenever businesses perceive the tax service’s operations as an explicitly unfriendly activity, rather than partnership, when a tax inspection may result in penalties that exceed all the incomes the enterprise can generate over a year, the level of the tax rate no longer matters, so far as development of a business strategy is concerned. Numerous representatives of the busi-

¹⁵ See: V. Novikov, K. Yanovsky, S. Luzan. Rossiyskoye antimonopolnoye regulirovanie I zadachi promyshlennoy politiki: pozitivnyi i normativnyi analiz. Nauchnye trudy, IEPP, 2004; and Vliyaniye rossiyskogo antimonopolnogo zakonodatelstava na ekonomicheskoye razvitiye//Voprosy ekonomiki, No. 9, 2003; O prave sobstvennosti na vneshnie efekty//Voprosy ekonomiki, No. 1, 2004.

ness community that took part in the discussion reckoned this; even President Putin himself accentuated that 'tax administrations have no right to terrorize business'¹⁶. These words are also worth conceiving as a forewarning about some dangers associated with the application to the federal agencies of result-oriented performance which in the case of law enforcement agencies implies setting concrete targeted results.

The Government undertook some steps to improve the effective VAT levying procedures in the part of its refunding in the event of export operations and investing¹⁷, though such measures will unlikely to be able to secure a breakthrough qualitative advancement in the tax administration area.

Similar problems arose with regard to the mineral extraction tax (MET), which by its essence is a royalty the state collects for the use of its property. Perhaps the state as the owner of subsoil reserves could generate more cash, had it computed MET basing on the difference between natural conditions on different sites where minerals are produced. It is equally evident, however, that a differentiation of MET rates could fuel corruption in agencies that would make the respective decisions on each given site or deposit. That is why the non-optimal, but non-corruption mechanism is perhaps more preferable than a more flexible and therefore potentially more efficient but provoking corruption one.

Nevertheless, despite the aforementioned challenges associated with the weakness of administrative and political institutions, the substance of 2005 was not their improvement, but the rise of their intervention in the economic life. In other words, they were developing extensively, rather than intensively¹⁸.

The processes manifested themselves primarily in the intensification of the government's participation in property of the largest companies. The past two years have demonstrated that the state was keen to solidify its positions as an owner in the strategic (traditional per se) sectors of the economy, getting rid, at the same time, of its property in other sectors. The state made a vivid demonstration that it was ready to use alternative approaches to get control over property. Those were through the court of law and purchasing earlier privatized assets. The first option was visualized in the case of YUKOS. The well-orchestrated operations of the tax agency and the general attorney's office secured the transfer of the private company's best assets into the hands of a public one. The other option was exemplified by the purchase of the USD 13 bn. –worth oil company Sibneft from its owner. Notably, there is no evidence the state did not pay for the company a price greater than the market one. In a similar fashion the state acquired a control block of OAO "AvtoVAZ" (purchased by Rosoboronexport), Guta-bank and Promstroybank (purchased by Vneshtorgbank), among others. In addition, Mr. Putin spelled out an initiative of forming a closed list of industries or objects that should be under "a preferable control of the domestic capital and the state-owned one, in particular"¹⁹.

However, it would be incorrect to interpret the YUKOS case as a less costly for the state. The "best buy" triggered a far more negative reaction among investors and citizens

¹⁶ Poslanie Prezidenta Rossiyskoy Federatsii Federalnomu Sobraniyu. M., 2005. P. 21.

¹⁷ See the Federal Law "On introducing amendments to Art. 21 of Section Two of the Tax Code of RF and recognizing invalid individual provisions of legal statutes of RF on taxes and levies" (No. 119-FZ of July 22, 2005). The law provides for measures on reducing the derivation of taxpayers' funds, simplification of the procedures of computation of tax payments, stimulation of investment activity, an supporting exporters. The VAT refunding on export supplies will be carried on against notification, effective as of January 1, 2007.

¹⁸ Ten years ago, Yegor Gaidar commented on a similar case, "Territorial expansion constitutes the exchange of space for time – expanding the physical boundaries of a state at the expense of the regress in time and comeback to archaic forms of governance (nearly feudal-absolutist). This is a clear way towards the death of the country. The same can be attributed to the economic sphere itself" (Gaidar Ye.T. Gosudarstvo i evolutsia. M. Eurasia. 1995).

¹⁹ Poslanie Prezidenta Rossiyskoy Federatsii Federalnomu Sobraniyu. M., 2005. p. 22–23.

than the costly acquisition of Sibneft. Given reputation losses of the government and the country on the whole, the price of YUKOS may eventually become very high.

So, an important outcome of 2005 became the demonstration of, first, the government's intention to expand its presence in a number of strategic industries and, second, a certain kind of its "flexibility", so far as ways and means of solving the task are concerned. The major point is that private owners of a number of big firms (who, as a rule, had participated vigorously in the loans-for-shares auctions of 1995–96) apparently well digested the combined YUKOS-Sibneft lesson and are keen to timely demonstrate their readiness to sell their assets once offered a price that matches the currently favorable market situation. There grows a sort of quasi-development business – not being sure of the public opinion of their property, entrepreneurs are keen to sell as soon as possible their assets to the state for cash.

In parallel with that, in 2005 in the framework of the administrative reform the government worked on contracting its presence in small enterprises and institutions many of which were subject either to privatization, or re-assignment to lower tiers of government. Thus, the country has made another critical step towards the use of an economic model based on control of "commanding heights". The model was inherent in the Bolshevik concept for market capitalism and the New Economic Policy of the early 1920s.

To accelerate the process, in 2005 the government made decisions that introduced fundamentally new economic policy instruments, which were designed specifically to fuel economic growth. Those are the law on special economic zones (the framework legislation and the one on Kaliningrad oblast)²⁰, on concessions, and investment fund. The respective statutes were enacted in the second half 2005, and an intense work on developing the respective by-law acts is under way. All these measure have a common feature – that is, they suggest exceptions from general economic procedures and the government exerting a directional influence on economic agents.

Despite a mighty pressure in favor of such measures during the first 15 post-communist years, the government had beet trying to avoid practicing them. At this point, its skepticism was based on two inter-related reasons.

On the one hand, it had to secure a basic stability (macroeconomic and political), shape a sound tax and budgetary systems, without which any directional measure cannot be efficient per se. Suffice it to take a look at the record of production sharing agreements (PSA) that the country started using yet in the mid-90s and which were useless until the basic stability was secured.

On the other hand, such instruments bear greater risk of corruption, which is why a state with a loose administrative resource and nascent institutions will most certainly find them inefficient. Only when the state has reestablished itself and adequate resources have been accumulated in its budget may one try to embark on directional economic impact measures.

In summer 2005, the federal law on special economic zones (SEZ) was enacted. In compliance with the law, there is a possibility to form special zones of two types – that is, industrial-production and technical-developing ones. The government is ready to grant tax and administrative benefits within such zones. The new law has some specifics that distinguish it from the previous attempts to create special zones in the post-communist Russia and constrain the opportunity to abuse the mechanism. First, individual decision (and, accordingly, negotiations with regional authorities and businesses concerned) on a mecha-

²⁰ There also is a law that prolongs the effect of an economic zone in Magadan oblast. The role of the document is minimum, however, for it prolongs the effect of the current special tax and customs regime in the region just for another year.

nism of the zone is excluded, as the law introduces universal conditions of functioning of CEZ. Second, there is the procedure of a tender-based selection of the SEZ site, providing regional and municipal authorities are bound to express their material interest in its establishment – that is, to allocate financial resources to develop the respective infrastructure. Third, the law abolished the effect of all other economic zones whose establishment had been lobbied over the 1990s and which produced no positive effect (except for those in Kaliningrad and Magadan oblasts). Fourth, from now on the zones have become oriented towards attraction of investment in new technologies, diversification of the economy, rather than solving the problem of inter-regional inequality and overcoming the depressive state of a given region. That is why in today's Russia special economic zones will be established in the regions and on the sites wherein there is no special need in them – they will be established in investment-friendly areas where authorities pursue a sound policy and CEZ can provide just some additional incentive for the investors in doubt. In other words, CEZ should form some complementary vehicle for a given economic policy, rather than its core component.

In November 2005, the Government received over 70 proposals on establishment of SEZ, from which it selected two industrial-production zones (in Lipetsk oblast and Tatarstan) and 4 technical and introductory ones (in the outskirts of Moscow, St. Petersburg, town of Dubna, Tomsk).

Finally, in the very end of 2005 the new Federal Law on the Special Economic Zone in Kaliningrad oblast was passed. The Law introduced all substantial modifications to the current mechanisms by shifting the center of gravity from import benefits to stimulation of production²¹.

In 2005, the Federal Law “On concession agreements” was passed. It will allow extended forms of property management by the state and municipal entities. The statute allows concedents to vary ways of payment for the property they receive from the government bodies and municipalities (fixed payment, a share of product, or a proportion of revenues), set terms of the re-assignment of the concessioner's property to the concedent and set conditions before the latter with regard to the used property in an explicit form, without using a similar by the contents rental agreement with the condition of improvement of the rented property stipulated therein.

The Federal Law “On concession agreements”, as a rule, is understood as a legal form of the private-public partnership (PPP). The ambiguous nature of such agreements is worth a special attention. On the one hand, in many instances PPP allows either a saving of budget funds, or a greater socio-economic outcome. On the other hand, however, there arises a certain contradiction between the principles of the already implemented monetization of benefits and concept for PPP. While the former suggests tackling social tasks by direct subsidizing targeted groups, PPP suggests getting business involved into receiving socio-economic benefits in kind, by means of complementing a rental agreement with extra charges.

The establishment of the Investment Fund also constituted an important decision. It is intended to form the Fund in the frame of the federal budget (of an annual and three-year projection) in the times of high prices for fuel and energy resources²². The resources of the Fund are per se the money that otherwise would be forwarded to the Stabilization Fund. Given an outstanding pressure to use the oil Dollars for the sake of the “people's

²¹ For greater details, see: Mau V. kaliningradskaya oblast: okraina Rossii ili tsentr Evropy?//Profil. 2005. No. 15. Mau V. nakazat' za udvoenie?//Vedomosti. 2005. 2 August.

²² “Ob investitsionnom fonde Rossiyskoy Federatsii”. RF Government Resolution № 694 of November 23, 2005.

economy”, the Government had to develop a compromise decision by allocating a part of the funds on boosting public investment. This, of course, makes the national economy somewhat greater exposed macroeconomically to effects from an unfavorable shift of oil prices, however, the decision is not fatal, should two conditions be abided by. First, the size of the Investment Fund should remain moderate vis-à-vis that of the Stabilization Fund, and, second, should its resources be spent efficiently indeed, i.e., should they result in a greater labor productivity rate and favorable structural shifts (decline of the national economy’s dependence on mineral exports). One thing should be made clear of: once oil prices plunge, resources of the Stabilization Fund should be spent to honor the government’s obligations under investment projects first, and only then can they be used to ensure damped cuts in other budget expenditure items.

It is suggested to utilize the governmental support primarily for the sake of implementation of projects centered on development of the national-scale infrastructure, creation and development of elements of the Russian innovation system, as well as securing institutional transformations. These three avenues are indeed critical, so far as the nation’s entering the path of sustained development is concerned.

Speaking of conditions of selection of projects, it is critical to ensure an equal access for economic agents to procedures of granting the government support, as well as the make-out of proposed projects. The “equal access” is, of course, the most delicate issue, given today’s realities, and the first projects will show to what degree it will have been secured.

It is suggested to select projects by employing qualitative and quantitative criteria. It is the former criteria on which the major burden will lay in the course of formation of the array of potential investment projects. At this point, satisfaction of the following requirements matters: the existence of a commercial organization that will take part in investment (or else there would be no PPP); to what extent the task matches the Government’s socio-economic development priorities and sectoral strategies; the presence of positive social effects; justification for the impossibility to implement the project without governmental participation; the estimated costs of the project being not lower than Rb. 5 bn.; and the presence of a positive conclusion of an investment consultant. The last point is particularly important, for the consultant should be well known, enjoy a stable international reputation which he will not ever risk to ruin (they should not be over-idealized, though – suffice it to recall the fall of Atrhur Andersen LLP). Anyway, the consultant selection criteria proposed by the Government indeed are extremely strict and raise some concern that there would eventually emerge a very narrow circle of firms that will dictate their conditions to clients.

Given a notable expansion of the activity of the state budget, keeping and strengthening of the role played by the Stabilization Fund has become an extraordinary important factor of securing sustained growth rates in the short- and longer-run. The Fund is usually viewed as a pool of spare resources that would enable one to maintain the existing level of budget expenditures in the event the foreign economic situation darkens, or as a financial reserve for “future generations”. Meanwhile, its major function today is to preclude a structural adjustment of the country’s economy to high oil and gas prices, curb its growing dependence on the FES industries, while so far as politics is concerned, – to help Russia not to repeat the destiny of the USSR.

The year 2005 saw repetitious attempts to use the resources of the Fund for the sake of investment financing. Such attempts appeared quite natural in the light of today’s extremely favorable price situation for Russian exports. There were four groups of such proposals put forward in 2005:

First, to forward the resources, in the form of capital investment, to the production sphere, on large-scale investment projects and primarily into infrastructure sectors. It is impossible not to note grave problems that may arise en route. It appears extremely risky to drag the country into oil-dollar-based investment projects, as such steps can generate unfavorable macroeconomic and structural consequences. On the one hand, public investment will help further appreciation of the Ruble and thus suppress advancement of most of the economy that is not associated with public investment. On the other hand, the possibility for an efficient use of these funds appears doubtful. The modern institutional system in Russia does not allow a rational utilization of budget funds, so far as investment projects are concerned.

Second, to use windfall tax revenues on lowering taxes or providing guarantees to private investors. An indisputable advantage of such an approach is that the choice of the direction of investment should be made by businesses, rather than bureaucracy, i.e. the investment vector is not set resulting from a bureaucratic bargaining, but remains open for any sectors or entrepreneurs. If we know that we will have such rich pools of budget revenues, it would be better to lower VAT and the corporate profit tax. That should concern everybody and not just those close to a given decision maker. Some doubts are present here too, nonetheless. The situation with taxes is non-symmetric, i.e. if prices fall, the government will not be able to raise taxes for the sake of the balanced budget. There also are doubts that our institutions allow an efficient and stable provision of state guarantees, which has been proved by the negative record of the 1990s.

Third, to use the cheap funds of the Stabilization Fund to drastically cut down the foreign debt. The undisputable plus of such an approach is maintaining favorable macroeconomic conditions (taming appreciation of the Ruble) and preclusion the economy from "adjusting" to a temporary and unstable state of affairs on the market(s). However, the equally undoubted minus is the inability to efficiently control the resources (the situation when such resources shrink, because of inflation, is very unpleasant).

Fourth, last year there appeared suggestions to use resources of the Stabilization Fund to reinforce the national pension system, which can fall short of funds in a few years, due to the post-industrial demographic transition. Thus, the accumulated oil-dollars could be invested in long securities and, indeed, spent on servicing the future generations' interests.

Should the current prices for Russian exports be maintained, requirements to utilize resources of the Stabilization Fund will undoubtedly only intensify. In such circumstances one needs to undertake, at least, two additional steps: first, to set an "untouchable level" of the Fund in shares of GDP equivalent, rather than in an absolute value; and, second, to sharply intensify the work on increasing the efficiency of budget expenditures and introduction of result-oriented budgeting, which forms the mission of the governmental commission chaired by Mr. A. Zhukov.

1.1.3. Models of Russia's Socio-Economic Development over a Long-Term Perspective

The economico-political processes of 2005 have led us to the possibility to assess long-term scenarios of its development. The current state of the country's institutions and contradictory socio-economic and political development tendencies of Russian society allow a conditional identification of three qualitative paths facing the country now:

- 1) European path: it suggests diversification of the economy, with political institutions of the modern Western society present therein;

- 2) Mexican path: the market economy dominated by the oil sector, albeit considerably diversified;
- 3) Nigerian – Venezuelan: the oil-based economy, with a poor diversification of it and loose political institutions.

The names of the models are tentative – under any scenario it is going to be the Russian model anyway, regardless of the degree of its successes or failures. Notwithstanding this, such names allow identification of some essential development peculiarities and specificity of the final state, which are worth being taken into account, while pursuing the current economic policy.

The European (Australian) Model

While analyzing this model, it is appropriate to carefully examine the development record of Estonia, Poland, and Australia. Estonia is a post-Soviet country that initially had been dependent on supplies of cheap minerals but promptly managed to get rid of the dependency. It has completed the structural reconstruction of its economy and at present has found itself in the closest proximity to the average European level in terms of development level and state of institutions. Poland still faces grave macroeconomic challenges, however, it has ensured rather a rapid unfolding of European economic and political institutions. Such a background was coupled with fast economic growth rates, which let Poland to pioneer with overcoming the pre-crisis level, despite a severe production slump that had battered the country at the onset of reforms. Finally, Australia is a country abundant with mineral resources, which, nonetheless, has managed to secure diversification of its economy and absorb a considerable immigrants²³ inflow.

So far as long-term prospects for Russia are concerned, such a path means advancing along the following avenues:

High or moderate growth rates (in terms of GDP and GDP per capita in particular) that ensure Russia's convergence, in terms of level of development, with the leading nations, as well as the existence of an actual convergence in terms of rates and levels of socio-economic development.

Substantial level of foreign investment diversified by sectors. The overcoming of the situation in which the bulk of foreign investment flows in subs-sectors of the fuel and energy complex.

Under such a scenario the proportion of the latter remains great, but it declines in the domestic production. Thus, the Australian model of production diversification at the expense of resources accumulated from mineral export is implemented.

Depending on the price situation for the FES produce, the balance of payments on current operations is either close to zero, or it grows passive, which is explained by a great activity of foreign investors.

The Ruble continues to appreciate, which is compensated by a growing labor productivity, thanks to a high investment activity of the domestic and overseas capital.

The government pursues a conservative budgetary policy, with budgetary drag on the economy being limited; the share of the budget in GDP remains at the level lower than that in the most developed countries.

Under such a scenario, a gradual formation of a single economic space with EU, lifting tariff and non-tariff barriers and creation of a common market become possible.

²³ On the Australian record of post-industrial development of the mineral economy and its applicability for Russia, see: Brich A. Put Rossii k protsvetaniyu v postindustrialnom mire//Voprosy ekonomiki. 2003. No. 5.

In the course of reform implementation the emphasis is made on the state of political institutions and enhancement of efficiency of the social sphere (educational and health care reform). It is the sectors where the key to the progress along the European way will lie.

This is the least inertia-driven model, the realization of which necessitates a proactive public policy on institutional building, restructuring of the whole budgetary sector of the economy, and enhancement of the efficiency of budgetary expenditures.

Mexican Model

This particular model suggests securing high growth rates through fostering the development of the fuel and energy sector and its supplying/consuming industries. This path is characterized by fairly high growth rates, while with oil prices being steadily high, economic growth rates and investment activity may substantially overrun those under the European model. Volumes of foreign direct investment also appear high, albeit they concentrate primarily in FEC, as well as in some other industries.

The scenario suggests a moderate progress with diversification of the economy, as investors would be keen to focus on FEC. The share of the latter remains dominating in exports and high in the DP structure. The pace of diversification is low, with the competitiveness of a number of industries of domestic production declining, as they find themselves affected by the Dutch disease.

Export remains primarily mineral based, while the rise in it of the share of sectors other than oil and gas ones – that is, metallurgy, chemicals and petrochemicals, and other environmentally unsafe kinds of production, and agriculture, – is quite possible.

The trade balance appears steadily active, while the balance of payments on current operations is close to zero or even passive. This should not generate serious problems, unless there is a drastic change in the role FEC plays in the international economy.

Such a scenario suggests a high probability of a considerable intensification of the role of the state in the economy, which would manifest itself, at least, in two areas:

First, investment activity. The government would be investing in infrastructure, both the general one and the FEC produce transportation one, create institutions to support private investment, and, perhaps, directly invest in the sectors of the economy that appear relatively unattractive to the private business. The principle of the private – public partnership as a method of combining the government and business's operations would become critical under such a scenario.

Second, more active measures on protection of the domestic producer from competition from overseas. The fall in the competitiveness rate of the domestic production would contribute to solidification of the stance of proponents of protectionism, and sooner or later the government would inevitably take that path. Individual sectors of the national economy (first of all, agriculture and food stuffs, some machine-engineering industries) will be closed for foreign rivals, which in turn would result in a further decline of competitiveness of those sectors.

The government's economic activity would face objective constraints of the politico-administrative nature. Their efficiency will be challenged by the degree of the country's ability to considerably improve the quality of government institutions, including administrative and judicial ones.

Under such a scenario, it is most likely that the political regime would unfold as a "one-and-a-half-party-democracy", i.e. the democratic regime will survive, albeit under a considerable strengthening of the role of a political group (and, accordingly, a political

party) that permanently wins elections and stay in power. Such a model can secure a fairly successful economic development, as evidenced the post-war development of Italy and Japan, despite some costs of its realization (a high level of corruption and organized crime).

It should be noted, however, that the domination of FEC would form a negative factor, so far as the one-and-a-half-party-democracy is concerned, thus corrupting the responsibility for and quality of decisions made.

Finally, such a scenario suggests a probability of no significant reforms in the social sphere. The existing financial resources would allow status quo in the area, with no serious social protest, however, the social sphere would remain in the neo-Soviet shape and fail to form an engine for a socio-economic breakthrough.

So far as prospects for the nation's socio-economic development are concerned, this model suffers from two very serious constraints.

First, it appears very vulnerable to external and internal shocks. The steadiness of its functioning is associated with the existence of a favorable for Russia situation in the foreign trade area. A downfall in oil prices for any long period of time will give a rise to a hard, perhaps, even systemic crisis. The degree of its intensity will depend primarily on the length of time during which world prices for the FES produce will be remaining low. The longer the oil boom will last, the more the economy (and, primarily, the domestic production) will depend on the infusion of "cheap money" and, accordingly, the growing cheap imports. Thus, there will be a high risk of repeating the scenario of the USSR-type development, under which the country had adjusted to a favorable situation in the foreign trade area and once it changed, the country found itself in a severe crisis.

Second, the implementation of the model in question will block the opportunity to use the scenario of breakthrough into the post-industrial system and catching up the gap between Russia and the most developed nations. As shown above, the key condition of realization of the post-industrial breakthrough scenario is a drastic modernization of sectors of the social sphere. A systemic crisis of the noted sectors in all the developed countries mean that the country that earlier than the others will find the way of their efficient reforming will give them odds in development of a modern socio-economic structure.

Meanwhile, at this point, yet another twist is possible. Should oil prices remain high over a long time (roughly coinciding with the period of this forecast), the economic progress by itself will be pushing towards healthier political institutions, further democratization and overcoming corruption.

Thus, the Mexican model may contribute to a relatively stable economic development, at a moderate or high rate, without carrying out substantial structural transformations in the economy, politics, and social sphere. Thus, there arise conditions of ensuring the current macroeconomic stability in the absence of shocks external to the system. However, the system faces serious problems – that is its vulnerability to shocks and a low probability of realization of the scenario of post-industrial breakthrough.

The Nigerian Model

This scenario suggests the development of a country abundant with mineral resources and provided a favorable state of foreign trade. The scenario also suggests preservation of the economic and social situation, with mechanism of inertia-driven development prevailing in the economy.

Under this particular model growth rates are fully dependant on the state of affairs on the world market for FEC resources that form a source of forex – denominated revenues

designated for solving all other tasks of the country's social, economic and political development. It can be suggested that, given other conditions being equal, growth rates in the medium term should decline, even providing permanently high export prices, for with the mineral-based economy (and the inflow of oil dollars) solidifying, the quality of the economic policy and, accordingly, the general level of efficiency of the economy will be declining.

Such a scenario suggests a probability of solidification of two tendencies in the policy area as a whole and particularly in the economic policy area.

First, intensification of authoritarian trends. The FEC resources can be easily centralized and concentrated in someone's hands, which will create the basis for the authoritarian regime. The existence of huge financial resources not associated with the rise of labor productivity enables one to build a system of power that is not interested in the taxpayers' opinions.

Second, the strengthening of populist trends in the economic policy area. The available financial resources allows to buy political support through budgetary infusions and bizarre economic experiments.

In such circumstances, it is public investment that forms the critical factor of maintenance of high, or, at least, moderate economic growth rates. Foreign investors treat the country with a great deal of skepticism and are keen to invest nearly exclusively in the EC sectors and some other industries associated with them.

As a result, there occurs a rapid deterioration of the balance of payments on current operations, along with a gradual degradation of the financial and monetary policies, and the transition to the policy of budget deficit. Budget deficit (as a source of public investment) forms an important factor of promotion of economic growth, which, however, deteriorates the general economic situation in the country. As a result, there unfolds a classical model of macroeconomic populism, which has been well studied into and exemplified by numerous Latin American countries' development record. Their experiences exposed an extreme danger of such a policy, even if it is applied to the industrial phase of development of production forces. Practically all the countries that followed the recipe failed to accomplish the mission of bridging the gap between them and the most developed states, while some even ended up with yet a greater backwardness from them (Argentina, for instance). In the countries in question, a short period of economic growth (not occurred everywhere, though) was followed by a hard economic and political crisis. The exit from the populist model has always been very painful and in most cases – by means of military coup d'état²⁴.

So, the Nigerian scenario suggests a steady reproduction of political instability, which can become possible both in relatively constitutional framework (Venezuela) and through a direct violation of the effective law.

A natural outcome from such a development becomes the further intensification of the crisis of political and legal institutions exemplified, in particular, by a high level of corruption in the public administration area and the judicial system, as well as degradation of sectors of the social sphere. The latter is funded mostly according to the "residual principle", with a strong component of populism in the decision-making process.

²⁴ For the detailed analysis of the populist economic policy, see: Dornbusch R., Edwards S. (eds). *The Macroeconomics of Populism in Latin America*. Chicago and London: The University of Chicago Press, 1991.

1.1.4. *Tendencies and Challenges of Socio-Economic Development*

Further development of Russia and its economic policy will find themselves under effect of three groups of factors. Each factor is long-term and appears associated with fundamental challenges of implementation of political and economic processes. The groups of factors are: the past revolutionary transformation and its long-term impact on the socio-economic processes, challenges facing the post-industrial society and the state of affairs with regard to prices for main Russian exports.

This is first of all the **post-revolutionary stabilization**. By contrast with the late 90s, over past 5 years Russia has enjoyed a high degree of macroeconomic and political stability. The comprehensive revolution Russia has passed through in the course of the systemic post-communist transformation is over now and basic government institutions have been reestablished²⁵. Meanwhile, it should be emphasized that we speak just of some consolidation of elites, rather than mobilization of a stable national consensus on basic values. Stabilization of a society on the way out of a revolution is a temporary an unstable phenomenon that generally is ensured on the level of its elite and which can be interpreted as a post-revolutionary *consolidation*. Mobilization of a national consensus requires a far longer time, perhaps, decades. The absence of the consensus for long leads to the situation in which in the aftermath of the completion of a full-scale revolution a long time (for decades) periods of a relative stability would be followed by drastic political twists and vice versa.

Reproduction of instability is directly associated with the nature of the political regime that usually emerges post-revolution. Its critical feature is that the government has to maneuver constantly between social groupings with substantially different socio-economic interests. As a result, there emerges rather a peculiar system wherein the stability itself is secured by fluctuations of the government in search of establishing new coalitions.

Thus, despite an evident political consolidation of the elite, one ought to speak of a long period of post-revolutionary instability. This instability is, of course, of a different kind than that of the revolutionary era, for now the country for some time would be seeing stability and order, with substantial political fluctuations and explosions would occur periodically, albeit the mere fact of their probability increases the general level of political uncertainty and creates an unfavorable background of the country's socio-economic development.

Another long-term factor of Russia's socio-economic development is formed challenges of the post-industrial society. The country's further development will be taking place in the same world and in the presence of the same fundamental challenges, the inability to handle which has entailed the revolutionary explosion in a not-so-distant past. At this point, it extremely important to appreciate the following: the fact of the completion of a revolution by itself does not guarantee conditions more favorable for a country's socio-economic development. While throwing away some institutional constraints on the path of socio-economic progress, revolution can easily replace them with others, equally inhibitive ones. That is why it is important to ensure that the emerging institutional system would become adequate to objective challenges of a given era, or speaking in Marxist terms, peculiarities of a given stage of technological progress.

Russia per se will have to solve the problem of catching-up development in the conditions and under challenges of the post-industrial era, the mechanism of resolving which appears substantially different from that of the industrial era.

²⁵ For greater details, see: Starodubovskaya I., Mau V. *Velikie revolyutsii. Ot Kromvelya do Putina*. 2nd izd. M.: Vagrius, 2004.

It should not be forgotten that Russia faces not only (and not even to any degree) the task of securing growth, but, first and foremost, the need in pursuance of an intense structural transformation. Meanwhile, the most developed nations' record evidences that the period of structural reform is often accompanied by a slowdown of growth rates and sometimes even an external stagnation (as it was noted in a number of Western economies in the 1970s). Partly this can be attributed to the traditional statistics' failure to fix new sectors (services, in particular), while partly – to the necessity to accumulate resources for a new technological breakthrough²⁶. The above, of course, should not be perceived as an apologia of stagnation, however, one should take into account that with no structural shifts economic growth can easily be ensured by state administrative means, but such a growth does not make the country richer and its economy more efficient. It is the problem wherein one of the forms of manifestation of political crisis lies.

Below we try to outline elements of the economic policy aimed at solving post-industrial development challenges:

First, refusal of attempts to identify long-term sectoral (industrial) priorities on which the government could focus and concentrate resources. Such an approach would mean preservation of the emerging proportions, while an attempt to implement them would result in a situation in which the group of priorities would be formed by the sectors with the greatest lobbyist capacity.

Rather, it is far more important to design a strategy of permanent adjustment of the structure, which implies that the government is ready to be flexible in defending by political (and foreign policy in particular) means all of those who have proved to be successful in the global competition.

Second, moving to the forefront is the mission of securing flexibility of the system and its ability to adjust, and its economic agents' ability to promptly and adequately react to present and future challenges. The ability to adapt to current realities is substituting for concentration of resources as a key landmark of the public policy, and the solution to this particular task appears inseparable from the mission of securing a efficient system of protection of property rights.

Third, a limited possibility for making long-term forecasts and the importance of the system's maximal adjustment capacity allows a hypothesis of imperativeness for a catching-up nation in the modern world to have a lower budgetary burden on the economy vis-a-vis the most developed nations of the world.

Fourth, investment in human capital should form a priority for both the state and a private entrepreneur. This primarily concerns such spheres as education and health care. Apart from its humanitarian aspect, the latter sphere can generate a considerable multiplying effect. Roughly, it is worth noting that in the circumstances the health care sector can play a role similar to that of the railroad construction once did in industrialization of the late 19th century.

Fifth, securing a sufficient level of the economy's openness. The foreign trade policy should center on fostering the development of new, highly technological sectors, as well as an intense processing of traditional exports. It is the post-industrial breakthrough, rather than a primitive protection of "domestic producers", at which negotiations on accession to WTO should be aimed.

Finally, ***the situation with prices for energy resources*** forms a serious long-term factor of Russia's socio-economic development. Traditionally, the view is high prices for

²⁶ Melyantsev V. Informatsionnaya revolyutsia, globalizatsia i paradoxy sovremnnogo ekonomicheskogo rosta v razvitykh i razvivayuschikhsya stranakh. M.: ISAA MGU, 2000. P. 14.

them appear extremely favorable for a nation. However, the situation is far less unambiguous. Keeping oil prices for energy resources high for long does not increase predictability of their future dynamics, but can bear a series of adverse consequences, so far as the stability of the country's economico-political advancement is concerned. This is associated with the degradation of its tax and budgetary systems for which high revenues not generated by a growing labor productivity rate results in a substantial fall in efficiency of decisions made²⁷.

The above allows singling out the short-run major socio-economic development challenges and, accordingly, priority economic policy avenues, as follows:

1. Implementation of the priorities related to development of human capital, as accentuated in 2005.
2. Progress in the administrative reform area, which comprises the budgetary sector reform, introduction of mechanisms of performance-oriented management, along with specification of boundaries of an efficient application of the method, specification of management peculiarities of various kinds of bodies of executive power (federal ministries, agencies, and services), the fact of the difference between which was omitted by the 2005 Concept for Administrative Reform in Russian Federation for 2005–2006 and the 2004 Concept for the Budgeting Reform in Russian Federation for 2004–2006. So far the noted documents have referred to “ministry”, “agency” and “service” as synonyms to the term “the federal bodies of executive power”.
3. Securing the macroeconomic stability, which suggests a further pursuance of the conservative budgetary policy and solidification of the Stabilization Fund.
4. Completion of the tax reform and enhancement of the quality of tax administration. Improvement of the tax law cannot be an infinite process, and today Russia has found itself in the situation when stability in this particular area appears more important than its refining.
5. Implementation of the pension reform to give a boost to efficiency of the pensioning system and insurance elements in it. Preclusion the pension system from collapsing, due to a high degree of probability of an emergence of the shortage of funds therein by 2010. The working out the matter of using resources of the Stabilization Fund for the pension system.
6. Increase of efficiency of the judicial and law enforcement systems.
7. Military reform and, particularly, further expansion of the contract-based service and the conscription reform. It is the transition to the one-year conscription, along with cancellation of many respites from the military service scheduled for 2008 that should become the most critical socio-political move.
8. Risks of populism due to the forthcoming elections – that is, the 2007 parliamentary and 2008 presidential ones. The monetization of benefits has substantially weakened the government's desire to implement reforms that are associated with risk of losing popularity, which becomes particularly true in the period of 1.5 years prior to elections. All that will seriously inhibit opportunities for implementation of institutional reforms, however the objective need in them will remain the same. As a result, the country will see further aggravation of institutional challenges, which Russia will have to cope with anyway, albeit at greater costs, especially if the situation in the foreign trade area will have deteriorated by then.

²⁷ On negative effects of an economy's dependence on the natural rent, see: Gylfason Th.; Zoega G. *Natural Resources and Economic Growth: the Role of Investment*. London: CEPR, 2001. In addition, a plentiful inflow of free funds usually results in a greater growth rate of budget expenditures vs. revenues, no matter how big budget revenues are (Mau V.A. *Uroki Ispan'skoy imperii, ili Lovushki resursnogo izobilija//Ekonomiceskaya istoria. Ezhegonik. 2005. M.: ROSSPEN, 2005).*

The closer the elections will be, the greater budgetary populism will be observed in the country. Given the present configuration of the Cabinet, it is unlikely to pose a serious threat, however the loosening of the budgetary policy against the background of a great inflow of oil dollars appears practically inescapable and one should expect the growth of investment and social budgetary allocations.

9. Accession to WTO, which now has reached its final stage, forms an indisputable priority for the country. In parallel with that, one can forecast some lower intensity of relations with EU in the part of shaping the Common European Zone in the foreseeable future. Russia's contacts with EU will concern certain specific spheres and, primarily, energy safety.
10. Russia's chairmanship in G-8 in 2006 can form an important factor of its fundamental positioning in the contemporary world. The format of G-8 by itself is not an instrument of implementation of a collective strategy – it can, however, help solve certain political challenges a nation faces these days. Notably, political and public circles in some G-8 countries have been questioning Russia's participation and current chairmanship in the Group, which mirrored both current political contradictions therein and objective problems associated with the current Russia's self-identification, including processes of consolidation of the post-communist power under economic growth. The year 2006 may form a new stage on the way of Russia's organic joining in the group of the most developed nations, which is the community it belongs per se.
11. Political and economic risks associated with a downfall in oil prices continue to grow. The nation's political and economic dependence on oil dollars is growing with every new year of the favorable situation on the foreign trade arena. This, however, does not mean that the prices hit a new level and will not ever slide down. Downfall in oil prices can lead to the an inadequate reaction of the elite that have (increasingly) grown accustomed to an extraordinarily favorable budgetary situation. This can entail both the budgetary and political crises, which are so typical of a post-revolutionary development.

To cushion the possible crisis, it is imperative to promptly develop an action plan, which should comprise various monetary, budgetary, tax policy measures, changes in the foreign trade regulation, and other decisions that would allow softening the blow, or else. there would arise a great risk of an uncontrolled chain of events. Besides, the oil prices downfall and the authorities' reaction to it will test the maturity of Russia's political elite and the country's commitment to the sound economic policy.

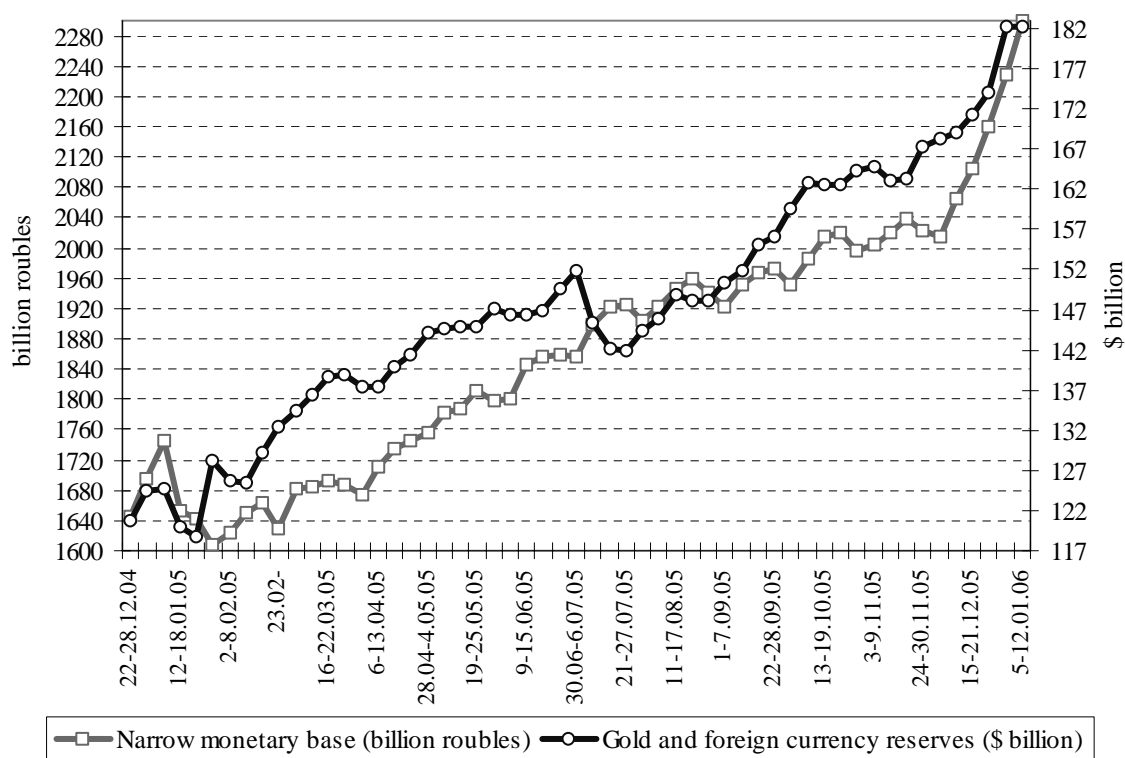
Section 2. Monetary and budgetary spheres

2.1. Monetary Policy

The major development in the RF's monetary sphere that occurred in the year 2005 was rapid growth of prices during the first half-year. In the second half-year, inflation was slowing down and, as seen by the results of January through December, became lower than in the same period of the year 2004.

2.1.1. The Money Market

In 2005, a considerable growth of the RF's gold and foreign currency reserves was observed (*Fig. 1*). The record prices of the major Russian export commodities, and primarily of oil prices, served as the main growth factor. A reduction in the reserves' volume (by monthly results) was seen only in July and was caused by the early repayment of the external government debt to the Paris Club in the amount of more than 15 billion USD. By the year's end, the volume of gold and foreign currency reserves reached an absolute record high of 182.24 15 billion USD.



Source: RF Central Bank.

Fig. 1. Changes in Monetary Base and Gold and Foreign Currency Reserves of RF in Years 2004–2005

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

During Q I 05, the monetary base (in a broad sense¹) decreased by 130.2 billion roubles, to 2.26 trillion roubles (5.5 %). The broad monetary base volume as of 1 January 2005 was 2.39 trillion roubles. In the same period of the year it increased by 1.2 %. The cash-in-circulation volume, including the cash balances of credit institutions, as of 1 April, was 1.58 trillion roubles (– 5.4% as compared to 1 January), the correspondent accounts of credit institutions with the Bank of Russia – 326.9 billion roubles (– 33 %), mandatory reserves – 133,4 billion roubles (+ 9.6 %), banks' deposits with the Bank of Russia – 149.8 billion roubles (+ 63.9 %), the value of the Bank of Russia's bonds held by credit institutions – 60.6 billion roubles (growth by 5.2 times), the RF Central Bank's liabilities against securities buyback – 2.1 billion roubles (– 16 %), while the reserves on operations in foreign currencies deposited with the Bank of Russia – 4.2 billion roubles (– 10.6 %). The fall, in last year's first quarter, of the cash-in-circulation volume (– 5.4 %), with a simultaneous increase in mandatory reserves (+ 9.6 %), resulted in a reduction of the narrow monetary base (cash + mandatory reserves)² by 0.4 % (*Fig. 1*). At the same time, the gold and foreign currency reserves of the RF CB also grew in January through March (by 11.6 %) and amounted, as of 1 April, to 137.4 billion USD. At the same time, liquidity sterilization was occurring in the Stabilization Fund, whose volume as of 1 April amounted to 768.5 billion roubles (growth by 246.2 billion roubles in the first quarter).

In Q II 05 the monetary base (in a broad sense) decreased by 52.7 billion roubles to 2,31 trillion roubles (by 2.3 %). The volume of the broad monetary base as of 1 April 2005 was 2.26 trillion roubles. In the same period of the previous year, it decreased by 0.9%. The cash-in-circulation volume, including the cash balances of credit institutions, as of 1 July amounted 1.76 trillion roubles (growth by 11.2% against the amount as of 1 April), the correspondent accounts of credit institutions with the Bank of Russia – 282.7 billion roubles (– 13.5 %), mandatory reserves – 137.2 billion roubles (+ 2.8 %), banks' deposits with the Bank of Russia – 34.4 billion roubles (–77 %), the value of the Bank of Russia's bonds held by credit institutions – 93.2 billion roubles (+ 53.8 %), the RF Central Bank's liabilities against securities buyback – 0 roubles (– 2.1 billion roubles against the amount as of 1 April of the same year), while the reserves on operations in foreign currencies deposited with the Bank of Russia – 5.7 billion roubles (+ 35.7 %). The growth, in the second quarter of last year, of the cash-in-circulation volume (+ 11.2 %), with a simultaneous increase in mandatory reserves (+ 2.8 %), resulted in broadening of the narrow monetary base (cash + mandatory reserves) by 10.2 % (*Fig. 1*). At the same time, the gold and foreign currency reserves of the RF CB grew in April through June (+ 10.3 %) amounted, as of 1 July, to 151.6 billion USD.

In Q III 05 the monetary base (in a broad sense) grew by 236.2 billion roubles to 2.55 trillion roubles (+ 10.2 %). The volume of the broad monetary base as of 1 July 2005 amounted to 2.31 trillion roubles. In the same period of the previous year it decreased by 4.8 %. The cash-in-circulation volume, including the cash balances of credit institutions, as of 1 October became 1.86 trillion roubles (+ 5.7 % against the amount as of 1 July), the correspondent accounts of credit institutions with the Bank of Russia – 380.4 billion roubles (+ 34.6 %), mandatory reserves – 150 billion roubles (+ 9.3 %), banks' deposits with the Bank of Russia – 64.4 billion roubles (+ 87.2 %), the value of the Bank of Russia's

¹ The RF's monetary base in a broad sense, in addition to the cash-in-circulation issued by the Bank of Russia, and the residuals on the accounts of mandatory reserves of the funds in the national currency attracted by credit institutions and deposited with the Bank of Russia, includes the funds in corresponding accounts with credit institutions and bank deposits placed with the Bank of Russia.

² It should be remembered that the monetary base in a narrow sense is fully controlled by the RF Central Bank, which cannot be said in respect to the monetary base in a broad sense.

bonds held by credit institutions – 87 billion roubles (– 6.7 %), the RF Central Bank's liabilities against securities buyback – 0 roubles (no change), while the reserves on operations in foreign currencies deposited with the Bank of Russia – 7.4 billion roubles (+ 29.8 %). The growth, in the third quarter of last year, of the cash-in-circulation volume (+ 5.7 %), with a simultaneous increase in mandatory reserves (+ 9.3 %), resulted in broadening of the narrow monetary base (cash + mandatory reserves) by 6% (*Fig. 2*). At the same time, the gold and foreign currency reserves of the RF CB grew in July through September (+ 5.3 %), having amounted, as of 1 October, to 159.6 billion USD. At the same time, liquidity sterilization took place in the Stabilization Fund, whose volume as of 1 October amounted to 960.7 billion roubles (+ 342.8 billion roubles in Q III).

And finally, in Q IV 05 the monetary base (in a broad sense) grew by 375.2 billion roubles to 2.91 trillion roubles (+ 14.8 %), its volume, as of 1 October 2005, amounting to 2.54 trillion roubles. The cash-in-circulation volume, including the cash balances of credit institutions, as of 1 January 2006 amounted to 2,2 trillion roubles (+ 18.3 % against the amount, as of 1 October), the correspondent accounts of credit institutions with the Bank of Russia – to 508.6 billion roubles (+35,8%), mandatory reserves – to 161.4 billion roubles (+ 7.6 %), banks' deposits with the Bank of Russia – to 7.2 billion roubles (88.8 %), the value of the Bank of Russia's bonds held by credit institutions – to 32.8 billion roubles (62.3 %), the RF Central Bank's liabilities against securities buyback – 0 roubles (no changes, as compared to the amount as of 1 October of the same year), while the reserves on operations in foreign currencies deposited with the Bank of Russia – to 8.8 billion roubles (+ 18.9 %).

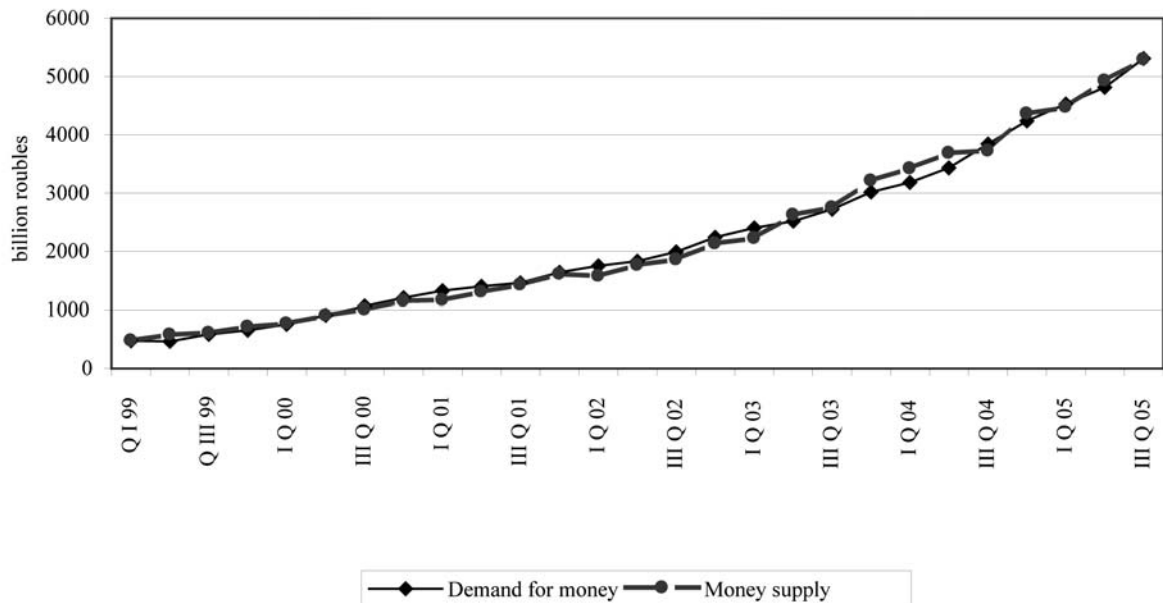
The growth, in Q IV 05, of the cash-in-circulation volume (+ 18.3 %), with a simultaneous increase in mandatory reserves (+ 7.6 %), resulted in broadening of the narrow monetary base (cash + mandatory reserves) by 9,6% (*Fig. 1*). At the same time, the gold and foreign currency reserves of the RF CB also grew in Q IV 05, by 14.2 %, having amounted, as of 1 January 2006, to 182.2 billion USD. A substantial part of the liquidity inflow into the country was accumulated in the RF Stabilization Fund, whose volume, as of 1 January 2006, amounted to 1.237 trillion roubles (+ 510.5 billion roubles as compared to 1 October 2005).

Thus, the results of the year 2005 demonstrated a less impressive growth in money supply than that observed in the year 2004. At the same time, during last year the revenues in foreign currencies were being actively sterilized in the Stabilization Fund, the volume of which, as seen by the results of the period of January through December, exceeded 1.23 trillion roubles. In order to assess the successfulness of the efforts of the monetary and financial authorities in terms of money supply sterilization, below we analyze its excess value.

For this purpose, we assess the demand for money equation of the type

$$\frac{M_t}{GDP_t} = a_0 + a_1 Y_t + a_2 \Delta p_t + a_3 t + \varepsilon_t, \text{ where } M_t - \text{money supply M2, } GDP_t - \text{nominal GDP}$$

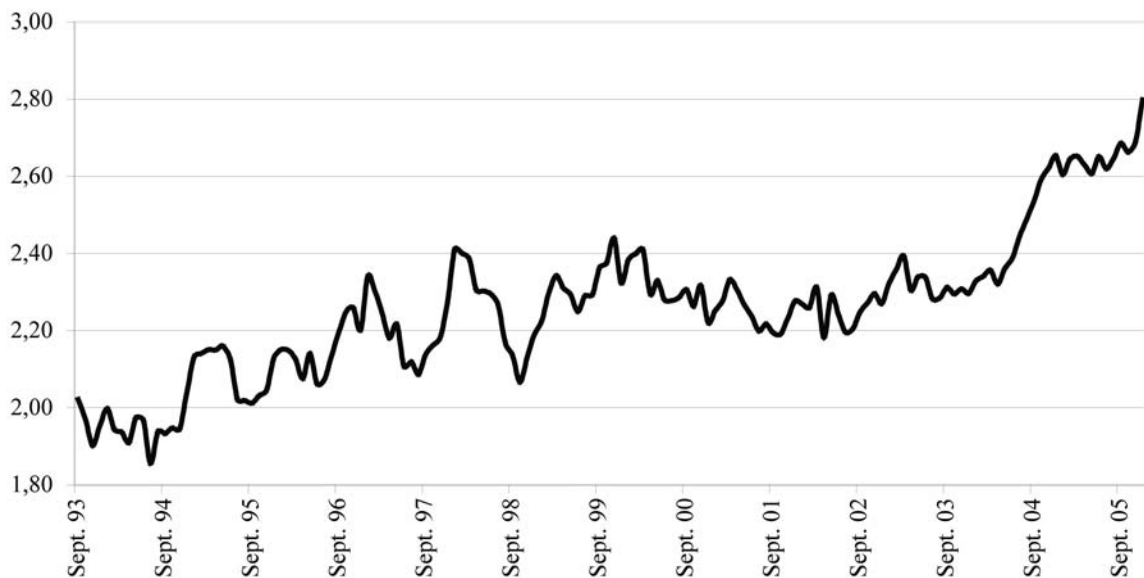
value, Y_t – GDP volume (in the 1995 prices), Δp_t – consumer price index, t – time. The assessment was based on the quarterly data of the years 1999–2005. The resulting residual values can be interpreted as excess of money supply. *Fig. 2* shows the curves of actual money supply and estimated demand for money.



Source: RF Central Bank; the authors' calculations.

Fig. 2. Dynamics of Demand for Money and Money Supply (Money Aggregate M_2) in Q I 99 – III Q 05

It can be noticed that throughout almost the whole of the year 2004, money supply was higher than demand for money. In all probability, this was one of the major factors responsible for the high inflation rate observed in the first half-year of 2005.



Source: RF Central Bank; the authors' calculations.

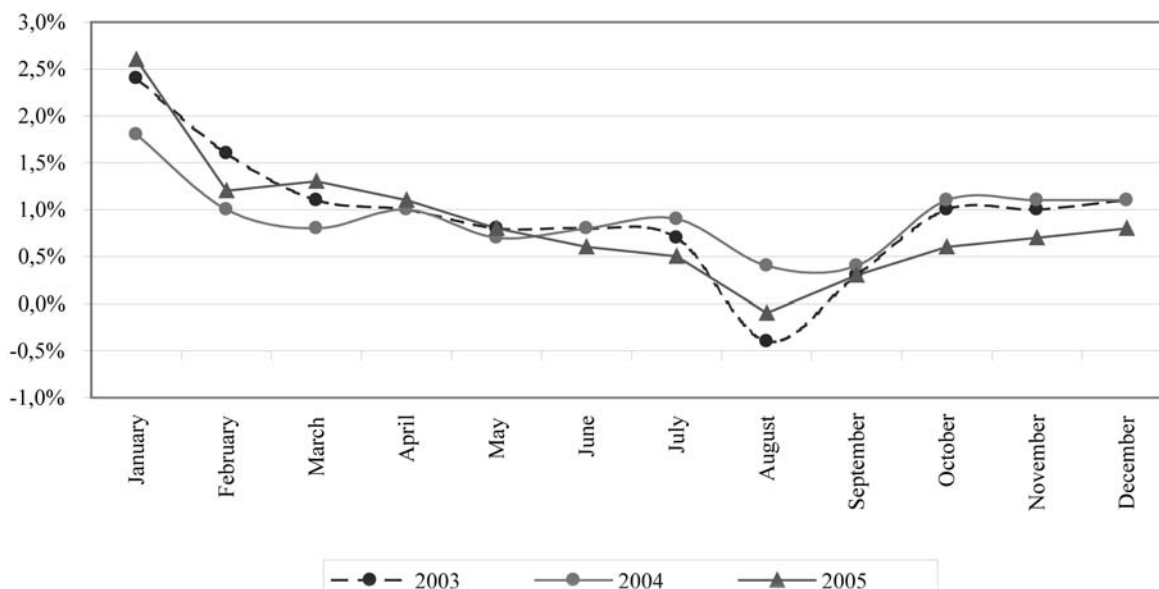
Fig. 3. Money Multiplier in RF in 1993–2005

It should also be noted that, despite the increased money supply, the money multiplier in the RF remains at a low level (*Fig. 3*). Thus, this index in Bulgaria (calculated by the IFS data base) in G II 05 amounted to 3.15, in Estonia – to 3.83, in Hungary – to 5.07, in Latvia – to 2.96, in Lithuania – to 3.24, and in Slovakia – to 5.87. Against this background, the index value of 2.8, achieved by late 2005, appears very insignificant, reflecting the underdeveloped status of this country’s banking sphere.

Thus, on the basis of the above analysis of the situation on the RF money market, it becomes possible to conclude that the high inflation rate seen in early 2005 was an objective phenomenon; one of its causative factors was the excess of money supply over the demand for money in 2004. Now we are going to discuss the inflation processes in more detail and make an attempt at determining also the non-monetary factors that were responsible for the development of these processes in the RF.

2.1.2. Inflation Processes

Early 2005 saw dramatic acceleration in the rate of inflation, as compared to the year 2004 (*Fig. 4*). As a result, already by the results of the first half-year, it became clear that the government’s 2005 target plan for keeping the annual inflation rate at the level of 8.5% was going to fail, because in the period of January through June CPI growth, as compared to December 2004, amounted to 7.8 %. It should be noted that in the spring of 2005 the target value was increased to 10 %. However, this target was also doomed to fail: according to the results of the year 2005, the inflation rate in the RF was as high as 10.9 %. So, we are going to take a closer look at the way the inflation rate was behaving throughout the year.



Source: Rosstat.

Fig. 4. Dynamics of CPI in RF in 2003–2005

The value of the consumer price index in the first quarter of last year amounted to 5.3 % (against 3.5 % in Q I 04 r. (*Fig. 5*)). In the group of food commodities the prices grew by 4.9 % (against 3.8% in January – March 2004). As seen by the results of the first quarter,

the highest growth rate was demonstrated by fruits and vegetables (+ 24 %), meat and poultry (+ 6.9 %), and fish and seafoods (+ 6.3 %). A downward trend was demonstrated by the prices of granulated sugar (– 0.8 %), grouts and legumes (– 1.2 %). Thus, judging by the results of the first three months of 2005, the prices of food commodities grew largely because of the increased, almost by one-quarter, prices of fruits and vegetables (against + 10.1% in January – March 2004). As before, CPI growth was mainly being contributed to by the growing prices of commercial services provided to the population – by 12.6 % (against 6.4 % in Q I 04). At the same time, every month during the first quarter was continual decline in the growth rate of the prices of commercial services. While in January 2005 the highest upsurge was demonstrated by the prices of housing and utilities services (+ 19.4 %), in February their growth rate went down to + 4%, and in March – to + 1.9 %. Nevertheless, in the first three months of the year 2005 it were the prices of housing and utilities services that demonstrated the most noticeable growth (+ 26.5 % against 13.1 % in the previous year), as well as the prices of pre-school education services (+ 16.7 % against + 8.4 % in the same period of the year 2004). As for non-food commodities, in the first quarter their prices went up, on the average, by 1.1 % (in Q I 04 their growth amounted to + 1.4 %). A continuing downward trend in the prices of motor petrol should also be noted (–1.6 %). At the same time, motor petrol became cheaper only in January – February, while in March its prices went up by 0.3 %. The increase of the base consumer price index³ in Q I 05 amounted to 2.4 % (against 2.4 % in the same period of the year 2004). Thus, the main reason of the inflation surge in early 2005 was the dramatic growth in the tariffs on commercial public services. Simultaneously, in January through March the prices of fruits and vegetables were also demonstrating a rather substantial growth rate.

By the results of the first half-year of 2005, the value of the consumer price index amounted to 8 % (against 6.1 % in the first half-year of 2004. (*Fig. 4*)). In the group of food commodities the prices grew by 8.6 % (against 6% in January through June 2004). In this connection, the greatest contribution to the growth of prices in this group of commodities was made by fruits and vegetables, their prices having increased by almost 1.5 times. The prices of commercial services were also contributing to the overall CPI growth by increasing by 15.4 % (against 11 % in the first half-year in 2004). In May – June the growth rate of their prices became stabilized at the monthly level of 0.8–0.9 %. In the first six months of 2005 the highest growth rate, as in the first quarter, was demonstrated by the prices of housing and utilities services (29.1 %, against 18.6 % in 2004), as well as by the prices of pre-school education services (21.9 %, against 12.5 % in the same period of the year 2004). As for non-food commodities, in the first half-year they became more expensive, on the average, by 2.4 % (against 3.4 % in the first half-year of 2004). The increase of the base consumer price index in the first half-year of 2005 amounted to 4.4 % (against 4.3 % in the same period of the year 2004). Thus, the main cause of the impressive inflation rate in the first half-year of last year became the dramatic growth, early in the year, of the tariffs levied on commercial services to the population, as well as the growing prices of fruits and vegetables.

The value of the consumer price index in the first 9 months of the year 2005 amounted to 8.6% (against 8% в January – September 2004 г. (*Fig. 1*)). Thus, in the second half-year the growth rate became slower, as compared to that in the year 2004. In the group of food commodities the prices grew by 7.1 % (against 7.2 % in January through

³ The base consumer price index reflects the inflation level on the consumer market less the seasonal factor (prices of vegetable and fruit products) and the administrative factor (tariffs on regulated services, etc.); it is calculated by the RF Statistics Service (Rosstat).

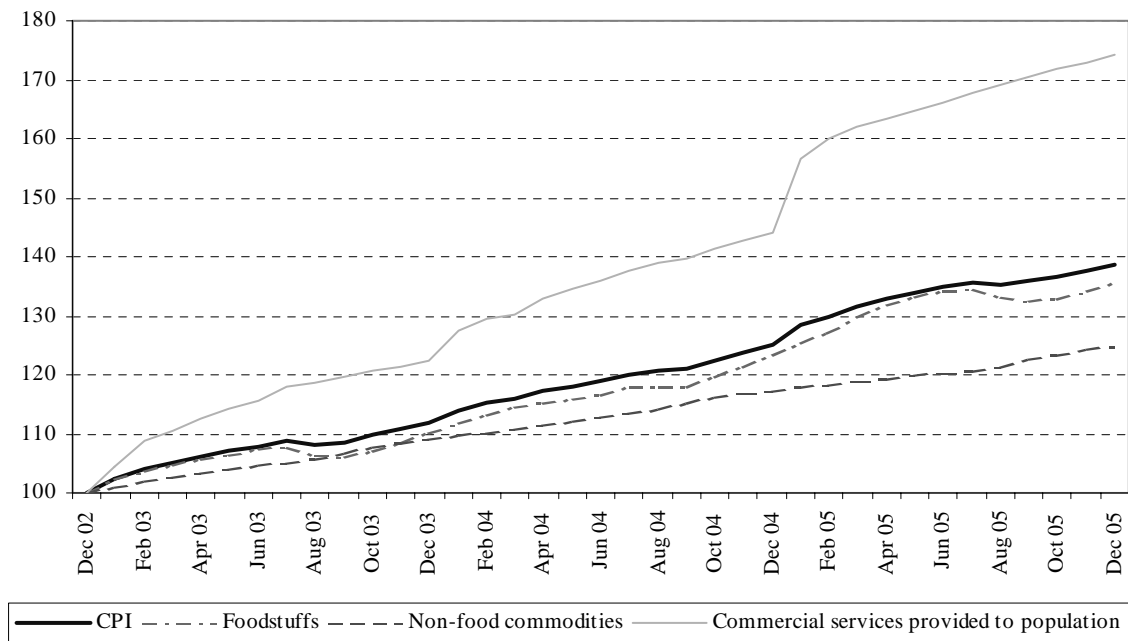
September 2004). As seen by the results of the period of January through September, the growth of food prices was mainly contributed to by the increasing prices of meat, poultry and fish. CPI growth, as before, was to a considerable degree driven by the prices of commercial services provided to the population, which increased by 18.5 % (against 14.3 % in January – September 2004). In the first 9 months of the year 2005, the highest growth rate was displayed by the housing and utilities services (31.2 % against 21.8 % in 2004), as well as by the prices of pre-school education services (27 % against 19.7 % in the same period of the year 2004). As for non-food commodities, in the first 9 months of the year their prices went up on the average by 4.5 % (against 5.5 % in the first 9 months of the year 2004). In the period of January through September, the growth rate of the prices of motor petrol was the highest (15.1 %). It is noteworthy that September, when the prices of motor petrol went up by as much as 7.9%, was the month that accounted for more than a half of its total price growth. Besides, in January through September, the prices of construction materials also demonstrated a substantial increase (+ 7.5 %, against + 6.6 % in the same period of the year 2004). The increase of the base consumer price index since the beginning of the year 2005 amounted to 6.3 % (against 6.8 % in the same period of the year 2004). Thus, the main causes of the marked inflation rate, as shown by the results of the first 9 months of the year 2005, were the growing prices of the housing and utilities services and motor petrol.

And finally, CPI as demonstrated by the year's results amounted to 10.9 %. The rate of inflation in the year 2005 was found to be lower than that in 2004, although still much higher than the initial value forecasted by the government. In the group of food commodities, prices grew by 9.6 % (against 12.3 % in 2004). Judging by the results of the period of January through December, the growing prices of food commodities were mainly the result of the increased prices of meat and poultry, fruits and vegetables, fish and seafood, milk and dairies, as well as butter. The greatest contribution to the overall annual CPI growth was made by the prices of commercial services provided to the population, which went up by 21 % (against 17.7 % in 2004). During the 12 months of 2005, the highest growth rate was displayed by the prices of housing and utilities services (32.7 % against 23.5 % in the previous year), as well as by the prices of pre-school education services (32.1 % against 21.6 % in the same period of the year 2004). As for non-food commodities, the 12 months of the year their prices went up on the average by 6.4 % (against 7.4 % in the 12 months of 2004). In January through December the prices of motor petrol displayed the highest growth rate (+ 15.8 %). The increase of the base consumer price index since the beginning of the year 2005 amounted to 8.3 % (against 10.5 % in the same period of 2004). Thus, the main causes of the dramatic inflation rate, as seen by the results of the year 2005, were the growing prices of commercial services provided to the population and of motor petrol.

Now let us turn to the factors that have been producing the greatest impact on the inflation rate in recent years. Since 1999, the Russian economy was characterized by a stable downward trend in the annual values of the consumer price index. It resulted from the moderately rigid monetary policy pursued after the 1998 financial crisis, as well as the sustained surplus of the federal budget. However, from the year 2003 onward, the decline in the inflation rate has been seen no more, and annual CPI growth became stabilized at the level of approx. 12 %.

In order to analyze the existing obstacles to decreasing the rate of consumer price growth, we are going to investigate the main inflation components observed during that period. In *Fig. 5*, the changes in the values of the three main CPI components are shown: the growth rates of the prices of foodstuffs, the prices of non-food commodities, and the

prices of commercial services provided to the population in the years 2003–2005. It can be noticed that throughout that period, the prices of commercial services provided to the population were going up much more rapidly than those of all the other commodities within the consumer’s basket. From early 2003 through December 2005, consumer prices increased, on the average, by 38.7 %, while the prices of commercial services provided to the population – by 74.2 %, or almost twofold.



Source: Rosstat; the authors’ calculations.

Fig. 5. Growth Rate of Consumer Prices in Years 2002–2005 (01.01.2003 = 100)

As seen from the data in *Table 1*, one of the most important components of inflation in 2003–2005 was the rise in the tariffs levied on the housing and utilities services, which between January 2003 and December 2005 more than doubled. Next, in terms of their contribution to the overall inflation rate, there were the increasing prices of the basic passenger transport services (by 55.4 %). The prices of meat and poultry were also rapidly going up (by 55.5%), as well as those of bread and other bakery products (by 56.7 %).

An analysis of the dynamics of the prices and tariffs on the services and goods produced by natural monopolies (electric power, gas, cargo shipment) in 2002–2005 has demonstrated that, during the period under consideration, the highest growth rates were displayed by the gas tariffs and the prices of cargo shipment. The electric power tariffs, by their growth rates, were only slightly ahead of the CPI growth rate.

Thus, the main non-monetary factors that influence the inflation rate are, as before, the rapid rise in the prices of commercial services provided to the population and motor petrol. In such a situation, an efficient anti-inflation measure could be the imposition of restrictions on the growth of tariffs on the services provided by natural monopolies, as well as the creation of a domestic exchange for oil and oil products.

Table 1

**Main Growth Factors of Consumer Prices in 2003–2005
(Growth Coefficient), as %**

	2003	2004	2005	January 2003 – December 2005
CPI	12.0	11.7	10.9	38.7
<u>Foodstuffs</u>	10.2	12.3	9.6	35.6
Bread & bakery products	30.4	16.7	3.0	56.7
Grouts and legumes	17.0	11.6	0.2	30.8
Pasta products	14.0	14.6	1.9	33.1
Milk & dairies	13.1	12.8	10.5	41.0
Meat & poultry	8.9	19.6	18.6	54.5
Fish & seafood	9.9	11.5	12.7	38.1
<u>Non-food commodities</u>	9.2	7.4	6.4	24.8
Motor petrol	16.8	31.3	15.8	77.6
<u>Commercial services to population</u>	22.3	17.7	21.0	74.2
Housing & utilities services	28.7	23.5	32.7	110.9
Passenger transport services	13.7	18.0	15.8	55.4
Services of cultural organizations	21.8	19.9	17.7	71.9
Pre-school education services	15.1	21.6	32.1	84.9

Source: Rosstat; the IET's calculations.

It should also be noted that the failure to achieve the target inflation value set for the year 2005 (8–10 %) will, in all probability, result in growing inflation expectations. Coupled with the slowdown in GDP growth in real terms, this may result in a rather serious fall in the growth rate of the demand for money in the year 2006. Therefore, while the current level of money supply growth is maintained, further inflation growth may occur. It should be borne in mind that in 2006 the government is planning to bring down the inflation rate to 8 %, which may well prove impossible in view of the aforesaid circumstances.

By way of rounding up, we are going to compare the rates of consumer price growth in the RF and other CIS countries (*Table 2*). It can be observed that the majority of countries within the CIS have been far more successful than Russia in their efforts to cope with inflation.

Table 2

Indices of Consumer Price Growth in CIS in 2000–2005, as %

	2000	2001	2002	2003	2004	2005 ⁴
Azerbaijan	2	2	3	2	7	5.1
Armenia	1	3	1	5	7	-2.6
Belarus	169	61	43	28	18	6.2
Georgia	4	5	6	5	6	4.4
Kazakhstan	13	8	6	6	7	6.9
Kyrgyzstan	19	7	2	3	4	4.6
Moldova	31	10	5	12	12	8.7
Russia	20	19	15	12	12	10.9
Tajikistan	24	37	10	17	7	5.9
Ukraine	28	12	1	5	9	9.4

Source: CIS Interstate Statistical Committee.

Consequently, one cannot say that the rapid consumer price growth in the RF is the legacy of the inflation that was characteristic of the 1990s. Obviously, it represents a rather

⁴ With regard to all these countries, except the RF, the data are presented for January–February 2005, and with regard to the RF – for the year 2005 as a whole.

serious problem, the causes of which may be both the growing money supply resulting from the necessity to maintain a stable rouble's exchange rate, the high degree of monopolization on the markets, the rapidly growing prices of commercial services provided to the population, and other potential factors that have not yet been clarified.

As for forecasting the rate of consumer price growth in 2006, it should be noted that in a situation of international oil prices staying at a high level, thus generating an inflow of foreign currency into this country, it would be practically impossible to try to bring down the high inflation rate (see the section "Long-term problems of monetary policy"). According to our estimations, if the average annual price of Brent crude stays at the level of \$ 40-50 per 1 barrel, the growth rate of money supply will be around 25–30 % per annum, which means that the annual inflation rate can be expected at the level of 9.5–10.5 %.

2.1.3. State of Balance of Payments

Russia's steady balance-of-payments situation in 2005 as in years before was due largely to record volumes and prices on Russia's main exports, first and foremost its energy sector. With soaring world oil prices, value of Russia's exports swell by a third. Russia's official gold and foreign currency reserves rose accordingly. 2005 was also remarkable in that for the first time in Russia's modern history more capital came into the country than left it.

According to Central Bank's initial estimates on the balance-of-payments for 2005, current account surplus stood at \$86.6 bn, a 47.8% growth on the year before (*please see Table 1*). Trading surplus in particular rose by 40.1% (from \$85.8 billion in 2004 to \$120.2 bn in 2005), with growth in exports at 33.9% (from \$183.2 bn in 2004 to \$245.3 bn in 2005) though imports also grew by 28.4% (from \$97.4 bn in 2004 to \$125.1 bn in 2005). Products from the oil and gas segment of the economy took up more than two thirds (61%) of total exports, an increase from its 57% share in 2004 (*see Figure 1*). Just as in the years before, status of Russia's current account depends largely on its trade component, which in its turn is mostly determined by changes on prices for Russia's main exports. A quick look at Figure 2 demonstrates that the correlation between the country's trade account and the world's energy prices observed in 2004 continued in 2005 as well.

Deficit in services account as compared with 2004 rose by 9% to \$14.6 bn. In 2005 Russia exported services worth of \$24.3 bn, \$4 bn than a year before which constituted a 19.7% increase. At the same time, value of services imported also grew by 15.4% on the year before and stood at \$38.9 bn for 2005.

Labor costs in 2005 continued to decline and were –\$1.6 bn. In 2004 that figure was –\$0.6 bn.

Russia's investment income component in the balance of payments in 2005 as compared to its 2004 levels rose by 32% to \$16.5 bn. Investment income receipts rose from \$9.2 bn to \$16.5 bn, with most of that growth stemming from banks (from \$0.9 bn on 2004 to \$1.7 bn by 2005) and non-financial enterprises (from \$5.1 bn in 2004 to \$9 bn in 2005). Similarly rising figures for investment income payments at the non-financial sector (from \$15 bn in 2004 to \$25.1 bn in 2005) have contributed to larger overall income payments (from \$21.7 bn in 2004 to \$32.7 bn in 2005).

Unilateral current transfers in 2005 changed insignificantly, and for 2005 the figure was estimated at \$1 bn.

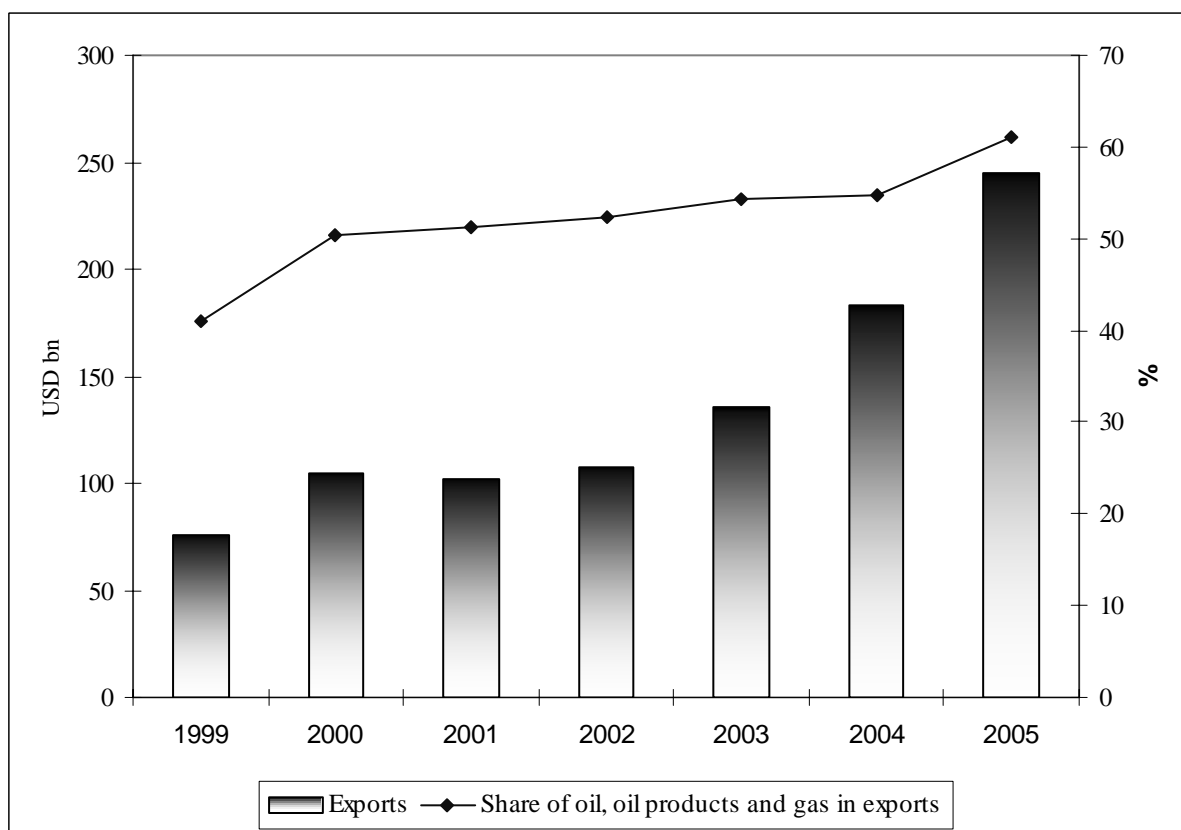


Fig. 6. Share of Energy Sector in Exports

Table 3

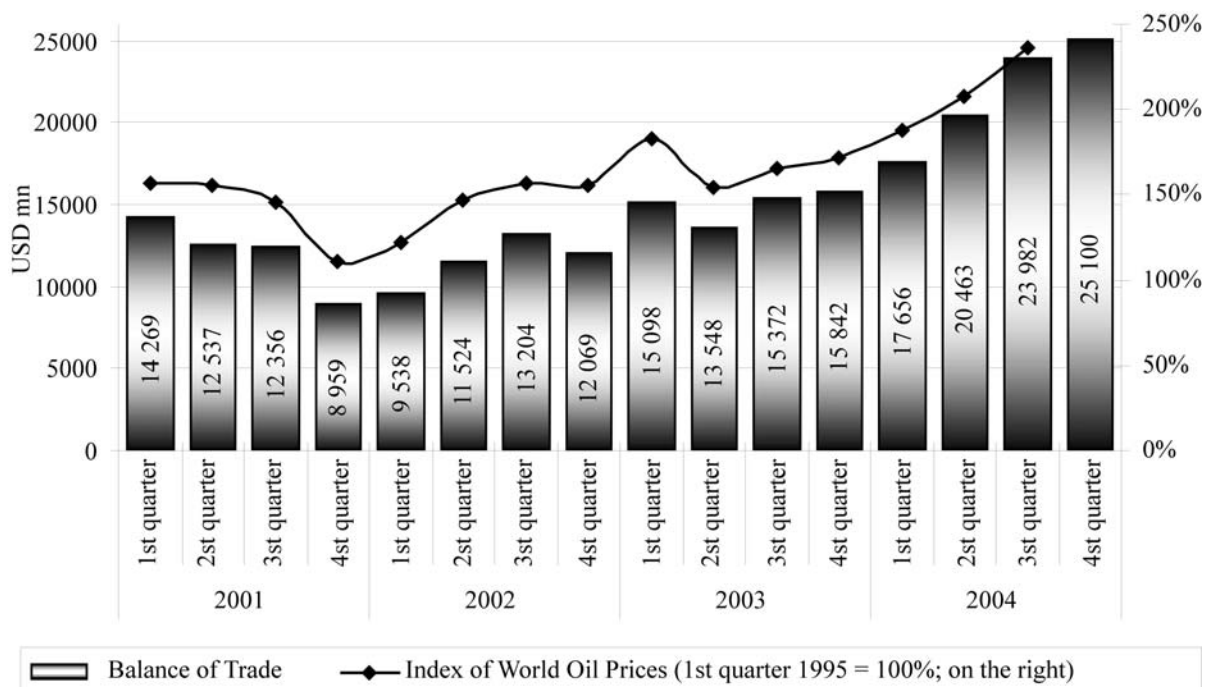
**Major Components of the Russia's Balance of Payments
for 2003–2005 (in \$bn)**

Components	2003				2004				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4 ⁵
Current Account Transactions	11.4	8.1	7.3	8.6	12.5	13.4	14.9	17.8	21.4	21.5	20	23.7
Capital Account Transactions ⁶	-2.4	1.5	-6.7	6.7	-3	-7.9	-8.1	12.8	-3.9	-0.5	-10.7	0.7
Gold and Foreign Currency Reserves	-7.6	-8.1	2.6	-13.3	-6.8	-5	6.5	-26.9	-14.4	-18	-8.1	-21
Net Errors & Omissions	-1.5	-1.6	-3.2	-1.9	-2.8	-0.4	-0.3	-3.6	-3.1	-3	-1.2	-3.4

Source: Bank of Russia.

⁵ Estimates.

⁶ Minus changes in gold and foreign currency reserves.



Source: Bank of Russia, IFS, Authors' Own Calculations.

Fig. 7. Russian Balance of Trade and Index of World Oil Prices for 2001–2004

Russia's capital account deficit (excluding foreign reserves changes) in 2005 rose 2.3 times (from \$6.3 bn to \$14.4 bn) on the year before.

Capital transfers in the amount of \$12.2 bn resulting from writing off Soviet era debts to a number of countries such as Iraq and Syria were largely responsible for this growing deficit. Encouragingly when such official capital transfers are excluded from the analysis, the picture is a lot more positive and it becomes clear that capital no longer flees Russia like it used to. In 12 months of 2005 capital account deficit shrank from \$4.6 bn to \$2.1 bn.

Growth of Russia's liabilities to foreigners in 2005 stood at \$58.7 bn, down from 34.1 bn in 2004, i.e. a 72.1% reduction.

Though in 2005 Russian government external liabilities declined by \$21.3bn, just as the year before it was still a net borrower to non-residents. The reduction on external liabilities resulted mainly from early repayments of Russia's sovereign debt to IMF and the Paris Club in the amount of over \$18 bn. Russia's regional governments were able to reduce their external obligations in the amount of \$.1 bn. Russian banks on the other hand engaged in attracting more foreign capital, hence raising their external obligations to the tune of \$18 million, a 2.5 times increase on 2004. Non-residents investments in the real sector were \$29.1 bn in 2004 and rose to \$59.1 bn by 2005.

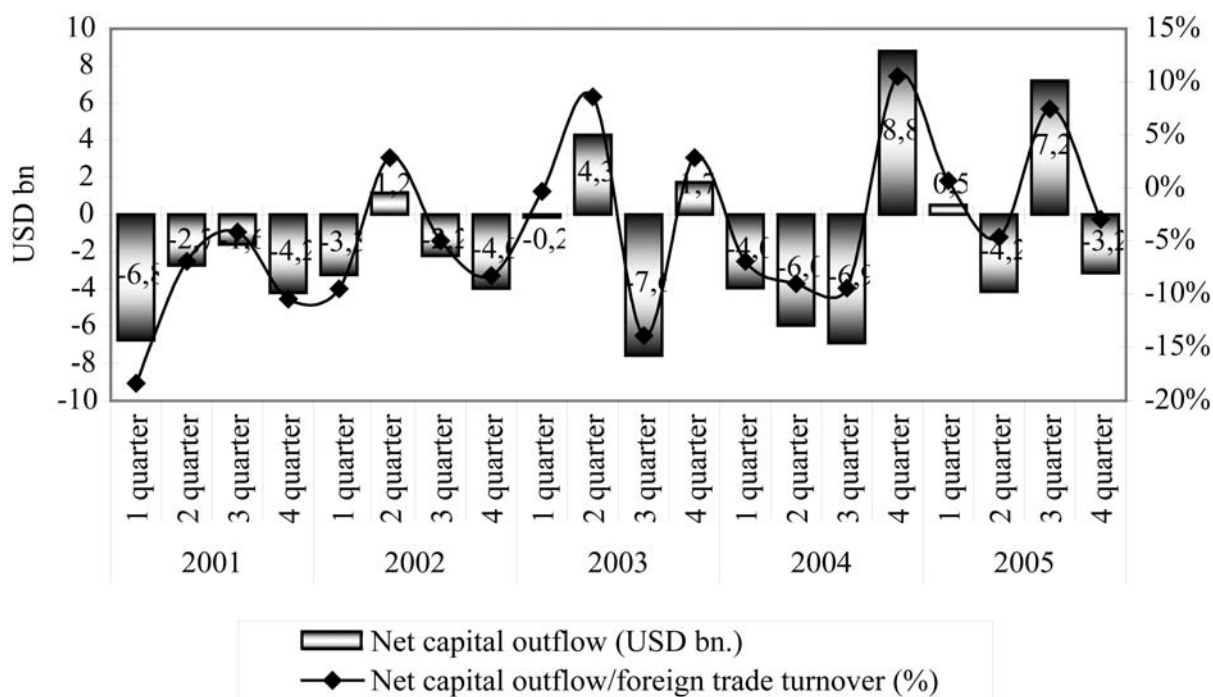
Russian residents' holdings of foreign assets also increased in 2005 by \$60.8 bn (up from \$38.7 bn in 2004). Lion share of the increase occurred in the private sector.

Foreign assets held by Russia's federal government declined by \$10.7 bn. Though foreign assets held by the regulators of the country's monetary base increased by \$ 5.5 bn. For country's private banks the increase was \$12.7 bn.

Assets taken out of country in 2005 by non-financial sector and households were estimated at \$53.3 bn, a 58.6% increase on the year before. The decline in the amount of cash held in foreign currencies (\$1.9 bn) is particularly sizable when taken against significant increases in the direct and portfolio investments (\$18.2 bn) as well as in trade credits

and advances. Value of export earnings not received timely, imported goods paid for under import contracts but not delivered and asset transfers on non-existing contracts virtually has not changed from 2004 and was estimated at \$25.8 bn by the end of 2005.

As mentioned earlier, for the first time in Russia's modern history in 2005 the country saw a net inflow of capital at \$400 million. An impressive turn-around, if compared to just a year ago when the situation was reverse and the deficit stood at 8.1 bn (see Fig. 3).



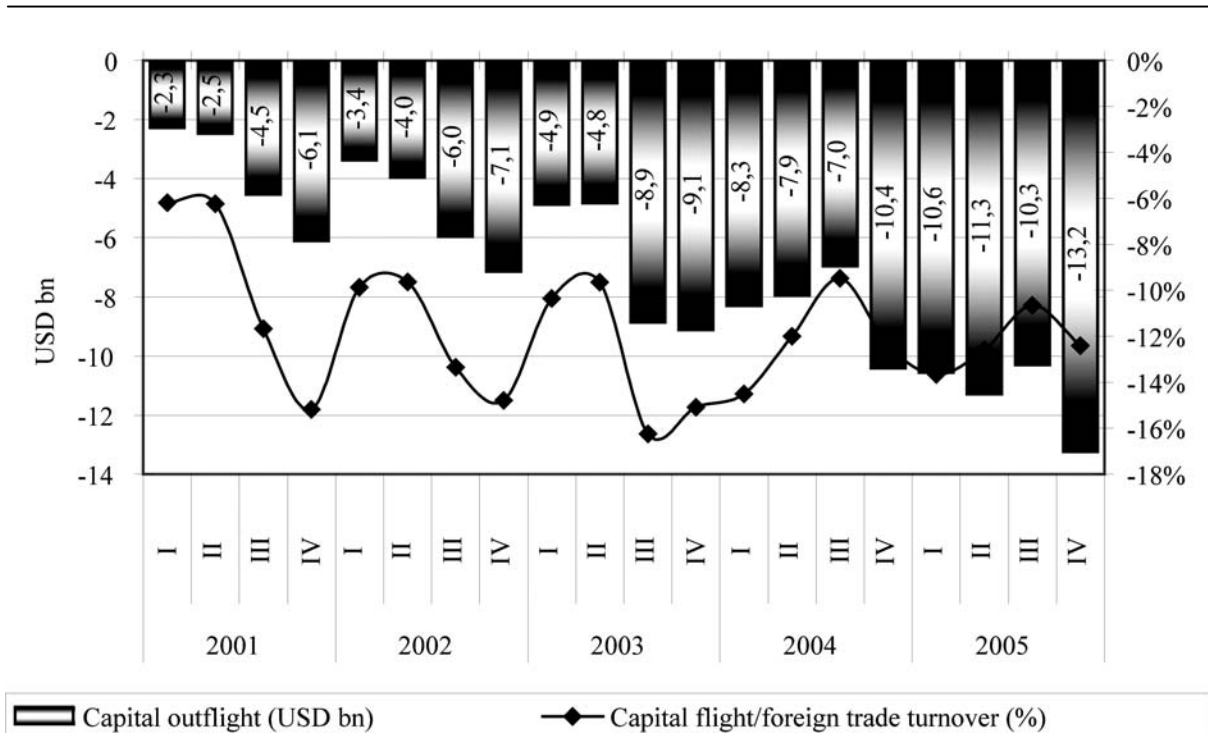
Source: Bank of Russia, IET.

Fig. 8. Net Capital Flows Dynamics for 2001–2005

It has to be noted that on quarterly basis capital flows varied significantly. In the 2nd and 4th quarters, there was a net outflow of capital from the non-financial sector in the amount of \$4.2 and \$3.2 bn respectively. 1st quarter saw a small inflow of capital at \$0.5 bn. It was the 3rd quarter with its massive \$7.2 bn of net capital inflow that determined the outcome for the year as a whole. These capital inflows resulted mainly from Russian firms' and banks' active pursuit of financing from abroad as well as foreigners' enthusiasm for lending money to Russian firms in the face of the country's sounder macroeconomic fundamentals.

Unfortunately though, non-official outflows, "capital flight" (see Fig. 4) continued to grow in 2005 and in absolute terms according to these authors' calculations⁷ were \$45 bn, a \$6.4 bn increase over 2004.

⁷ Here we used the IMF's capital flight formula which is a sum of all "trade credits and advances", "export earnings not received timely, value of imported goods paid for under import contracts but not delivered" and "net errors and omissions".



Source: Bank of Russia, IET.

Fig. 9. Capital Flight Dynamics for 2001–2005

Moreover capital flight remained on the increase in the country’s external trade turnover and from 12% in 2004 rose to 12.3% in 2005.

Taken against these data that show the capital still leaving the country on a large scale, the capital flow situation is not so unequivocally positive. Overall, one can conclude that in the face of favorable macroeconomic setting there is a net inflow of capital into the country, but the persistent nature of risks associated with the country feeds the continuing capital flight.

An important observation that has to be noted from this analysis of the country’s 2005 balance of payments is that energy exports have contributed over a half of total trade earnings and that share is growing. This certainly demonstrates the economy’s dependence on this one sector. Luckily for Russia, any downward revisions to the world oil prices in the near future are unlikely. With growth in export earnings ahead of imports, the balance of payments situation is expected to remain stable. Granted that net capital inflows grow and capital flight moderates, stability in the balance of payments could be sustained not only due to current account surpluses but also through capital transactions and growing gold and foreign currency reserves.

2.1.4. Basic Measures to be Implemented by CBR in the Sphere of Monetary Policy

The Bank of Russia, from 15 March 2005, established the following structure of the bi-currency basket for purposes of implementing the exchange-rate policy: the euro – 20 % and the USD – 80 %; from 16 May, the euro’s share was increased to 30 %, from 1 August to 35 %, and from 2 December to 40%. It should be remembered that from 1 February the Bank of Russia has begun to apply, as an operational target for its exchange-rate, the value of a foreign-currency basket where the euro’s share is 10 %, while that of

the USD is 90 %. The changed structure of the basket is aimed at decreasing the rouble's exchange rate's volatility in respect to the currencies of Russia's major partners in trade.

In March 2005, representatives of the RF Bank declared that, while preserving the same cutoff price level as before, for purposes of creating a stabilization fund, the operations of money supply sterilization will be dominating over refinancing operations. However, if the cutoff price is increased, the Central Bank would be able to make a more extensive use of the existing possibilities of refinancing the banks.

From 1 June 2005, the changes to the Provisions of the Bank of Russia "On the mandatory reserves of credit institutions" came into force, which envisaged that credit institutions were to assume, toward their responsibilities relating to the equalization of the mandatory reserves against the residuals listed not only on the correspondent account of the head office of a credit institution, but also those on the correspondent subaccounts of its subsidiaries opened at the Bank of Russia. This measure is in a certain sense equivalent to the lowering of the requirements to mandatory reserves, which may result in growth of the money multiplier and money supply level in the national economy.

In May, representatives of the Central Bank announces that it was probable for the Bank of Russia to begin the refinancing of banks against the pledge of non-standard assets, which might be represented by the obligations of issuers without appropriate credit rating or market quotations. This measure is quite compatible with the Bank's latest measures designed to make easier the refinancing of commercial banks. The obligations of the Agency for Mortgage Loans against Housing and the Moscow Mortgage Agency have already been placed on the mortgage list. However, bankers felt that these measures alone were not sufficient. It is planned that the financing against the mortgage of non-standard assets will be regulated by separate guidelines. If the Bank's plans come true, this measure can be estimated as positive, because an easier procedure for refinancing will be a safeguard against crises similar to that which happened in the summer of 2004.

In May, the RF president signed the Law on the Central Bank, thereby establishing the special procedure for the issuing of short-term bonds of the Bank of Russia. Previously, the Government had made is mandatory for the Bank to register the prospectus for a loan emission with the Federal Securities Market Commission and the RF Ministry of Justice. However, under the new Law the issuing of bonds by the Bank of Russia will be effectuated without State registration of an issue, without an issue's prospectus, and without State registration of the report on the results of a bond issue. Besides, the decision concerning an issue of bonds will be made by the Board of Directors of the Bank of Russia. As of now, the yields to maturity of the Central Bank's bonds is much lower that the average market yield value. These securities will be of interest only for those banks that conduct repo operations with the Central Bank, because such securities can be accepted as a pledge. Generally speaking, this instrument can be regarded as one of those to be applied for money supply sterilization.

In 2005, the Board of Directors of the Bank of Russia decided to issue into circulation the 1997 five-thousand-rouble note of the Bank of Russia. According to the Bank's representatives, the issuing into circulation of the five-thousand-rouble note has been necessitated by the needs of the cash turnover and the growing average wage level in this country. It is planned to issue into circulation the five-thousand-rouble note in 2006.

On 16 November, the Bank of Russia submitted to the State Duma a new version of *The Main Directions of Monetary Policy in the Year 2006*. It should be reminded that in mid-October last year the State Duma's Committee on Budget and Taxes had already considered the draft of *The Main Directions of the State's Unified Monetary Policy in the Year 2006*. However, according to the Committee's members, the experience of imple-

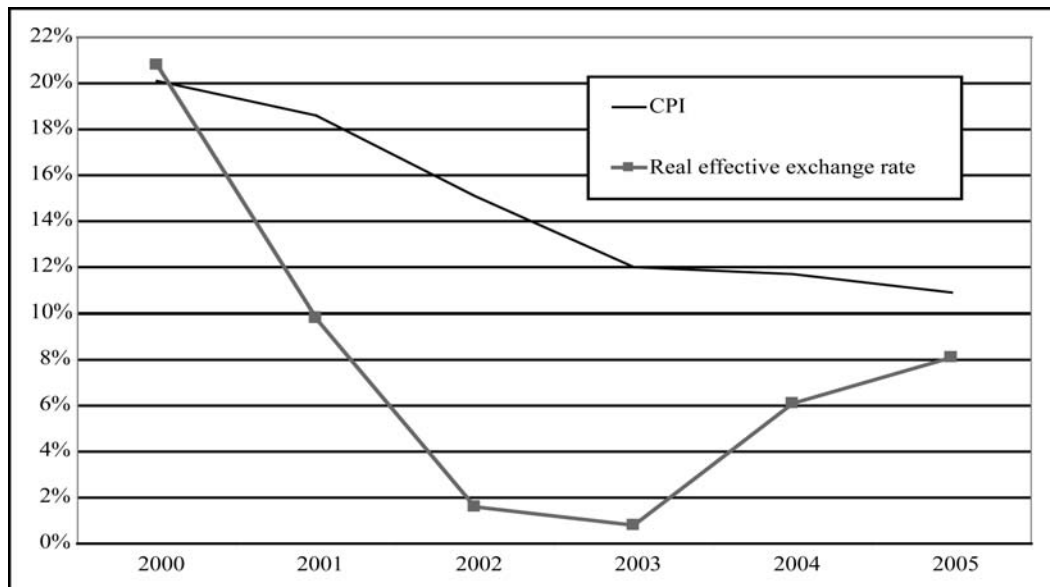
menting the monetary policy has shown that there exist marked discrepancies between the inflation rate's forecasted and actual indices, largely due to the underestimation of the future price of one barrel of oil. In this connection, the newly developed draft document of *The Main Directions* now incorporates a version of calculations based on the forecasted price of "URALS" amounting to \$ 60 per barrel.

In late 2005, the information was released that from the year 2006 the published information concerning the gold and foreign currency reserves of the RF is to be based on estimations of gold at the quotations established by the Bank of Russia. Previously, for these purposes an arbitrary price had been applied, equal to 300 USD per 1 troy ounce. According to the Bank's representatives, this change in the procedure of statistical recording has been associated with the need to make the information being published compatible with a current market situation. It should be remembered that throughout the year 2005 the price of gold was higher than 400 USD per 1 troy ounce.

2.1.5. Long-Term Problems of Monetary and Exchange-Rate Policies

Russia's monetary and exchange-rate policies after the 1998 crisis have given rise to many discussions. We believe that throughout the post-crisis years these policies were sufficiently well-balanced and created the necessary conditions for economic growth in this country. Nevertheless, the currently rather high inflation rate, which is contributing to the continual and sufficiently rapid strengthening of the rouble, as well as resulting in the understanding of the high dependence of the situations in the monetary sphere and on the foreign-currency market on the state of foreign markets, require that the issues of long-term financial policy be discussed further.

Fig. 1 demonstrates the joint dynamics of the consumer price index and the rouble's real effective exchange rate. As is seen from the chart, since the year 2003 the rate of the strengthening of the rouble's real exchange rate has been accelerating. During the same period, the growth rate of CPI became stabilized at the level of 11–12% per annum.



Source: Rosstat, Bank of Russia.

Fig. 10. Annual Growth Rates of the Consumer Price Index and the Rouble's Real Effective Exchange Rate (2005 – Data on First 10 Months)

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

During the transition into a period of high international oil prices, a high positive balance of payments, coupled with capital inflow, result in an overall positive current balance and a high equilibrium value of the real exchange rate, thus generating a trend toward the rouble's real exchange rate being strengthened due either to growing domestic prices, or to a strengthening nominal exchange rate.

And vice versa – during the transition toward low international oil prices the current balance of payments becomes negative because of a negative balance of trade and capital outflow, and the equilibrium value of the real exchange rate decreases, thus resulting in a weakening real exchange rate of the rouble.

When analyzing these situations, it should be noted that, despite the seemingly symmetrical situations occurring when oil prices go down and when they go up, if one considers the costs of inflation and the fluctuations of the exchange rate being borne by the population and by the real sector, the monetary and exchange-rate policies must be fundamentally different.

Given specific preconditions, it can be demonstrated that the rational policy in this sphere for Russia in a situation when the prices of energy carriers on the world market are high will be that of maintaining a moderate rate (or suppressing the rate) of the growth of the rouble's real exchange rate in face of a sufficiently low inflation rate. This policy will be in fact reduced to a one-sided targeting of the inflation rate, that is, to the setting of an upper margin (preferably, to be further decreased every year) for the annual rate of price growth. The behavior of the RF Central Bank (RF CB) on the currency market is determined by the existing opportunities for sterilizing the issue of money arising from the need to maintain the rouble's nominal exchange rate at a certain level necessary for ensuring the desired growth rate of the rouble's real exchange rate in a situation of a continuing actual inflation.

When the prices of energy carriers go down, the rational policy appears to be that of a gradual but relatively rapid decline in the rouble's real exchange rate to the level that can ensure the equilibrium of the current account.

Certainly, highly important in both cases is the state of the balance of capital transactions, which, in the case of Russia, is heavily dependent on the situation in the sphere of foreign trade.

Now let us discuss separately the situations characterized by low and high prices of energy carriers.

When the foreign economic situation is favorable. This case corresponds to the situation currently existing in Russia, when the rouble is displaying a tendency of strengthening toward a level that can ensure an equilibrium balance of payments, while the RF Central Bank is opposing this process by its interventions on the currency market, and, as a result, is increasing both foreign currency reserves and money supply. In absence of any efficient mechanisms for sterilizing the CB's interventions, the resulting inflation represents an obstacle to providing an adequate solution to the problem of slowing down the strengthening of the rouble's real exchange rate's strengthening. The current account equilibrium could have been achieved through strengthening the rouble's nominal ex-

change rate, if the CB had not been making its interventions, or had been making them in smaller volumes than are necessary for maintaining a stable nominal exchange rate. In such a case, resulting from inflation, the real strengthening of the rouble would have been achieved at a lower level than the actual current values of the real exchange rate, because it would have been influenced by the changes in the rouble's nominal exchange rate and would have corresponded to lower degree of monetization of the positive balance of foreign trade.

However, we believe that, irrespective of the actual results of such a policy, from the point of view of the rouble's real exchange rate being suppressed, such an approach could have had negative consequences because of the rouble's nominal exchange rate's strong response to external shocks. The application of the rouble's nominal exchange rate as an instrument for ensuring the national economy's adjustment to new economic conditions has been made difficult by its excessively sensitive response to any external changes (the flyover effect), as well as by the possibility of speculation attacks on the roubles by the participants of the currency market. As a result, with a floating exchange rate, the changing foreign trade conditions may result in instant dramatic changes in relative prices and the competitive capacities of domestic enterprises, these changes being greater than necessary for establishing an equilibrium. And if the RF Central Bank suppresses the changes in the rouble's nominal exchange rate through currency interventions, the movement of the rouble's real exchange rate towards an equilibrium can be made slow and gradual.

In this connection, we depart from the assumption that the keeping, at present, of the rouble's real exchange rate at a lower level than would be necessary for an equilibrium balance of trade is contributive to stable economic growth. At an equilibrium exchange rate of the national currency, a substantial number of production entities may presently lose their competitive capacity. As a result, the national economy's specialization will be increasingly focused on the extraction and primary procession of raw materials, which can hardly be considered a reasonable strategy under conditions of a highly changeable situation on the international raw-materials markets and their limited economic reserves. Besides, the rouble's lowered real exchange rate is quite compatible with the existing ratios of labor productivity in the RF and developed economies.

Thus, in view of the necessity to maintain the rouble's real exchange rate at a relatively low level of acceleration in a situation of a positive balance of foreign trade, the policy being currently pursued by the RF CB and the RF Ministry of Finance would appear, on the whole, to be quite reasonable. However, in the last two years, as the prices of energy carriers have been extremely high, the financial authorities have been suffering from the lack of adequate financial instruments for sterilizing the excessive money supply resulting from the RF CB's currency interventions. As a consequence, the inflation rate, that in recent years has never been below 11.5 %–12 %, is contributing to the rouble's accelerated strengthening.

In actual practice, sterilization is achieved by means of applying two instruments: budget surplus (in the form of money accumulation on the accounts of state administrative bodies, and the creation of the Stabilization Fund) and the accumulation of commercial banks' excessive reserves on the accounts with the RF CB⁸. These instruments need to be further developed. Thus, it is necessary to consider the possibility of creating, either within the Stabilization Fund's framework, or outside of it (but based on the same principles), a

⁸ The calculations performed by the IET have pointed to the fact that when the amounts of money placed on the accounts of state administrative bodies and the excessive reserves of commercial banks are being changed, there occurs a coordination between the accumulation of reserves and the increased residuals on the accounts of state administrative bodies and commercial banks. Also, as far as the current interventions are concerned, two-thirds of their total volume is sterilized.

Fund on whose accounts the formation of funded pensions for Russian citizens will be ensured in a situation of a highly favorable foreign trade situation. The process of accumulation, by banks, of excessive reserves, which at present involves mainly those banks that are controlled by the State (The RF Sberbank, the RF Bank for Foreign Trade), is, most probably, being favored by the monetary authorities. At the same time, there exists the probability that the interest rates established for commercial banks' deposits with the RF CB may be increased.

The increasing of the norms for mandatory reserves formation (MRF) in the nearest future, obviously, cannot be regarded as an instrument for suppressing the growth of money supply. This can be explained by the considerable differentiation, in their financial status, between various Russian banks, in a situation when the market for interbank credits, as well as the mechanisms for the refinancing of commercial banks by the RF Central Bank, are underdeveloped. Under such conditions, the toughening of MRF norms may increase the risks of liquidity crises. So, before it can become possible to apply MRF norms as an instrument for managing money aggregates, measures will have to be taken that will be aimed at developing the mechanisms of granting loans to the banks which are in need of liquid funds.

An important instrument for sterilizing currency interventions may become bonds issued by the Bank of Russia. The efficiency of such bonds when applied as a sterilization instrument may be limited due to the practical difficulties associated with the need to prevent non-residents from investing in them, which may, in its turn, result in an increased inflow of foreign currency into the country, to be reflected in the status of the capital transactions account of the balance of payments. And if the investments by residents are allowed (through appropriate banks), the effect resulting from the transactions of sale, by the Bank of Russia, of these bonds, expressed in decreasing money supply, will depend on the intensity of the additional capital inflow, which will increase the requirements for the RF CB's currency interventions and, consequently, the need for sterilization.

The measures designed to limit the flow of foreign capital into the bonds issued by the Bank of Russia can be, e. g., as follows:

- sufficiently strict control over the attraction of foreign credits by banks desiring to purchase the bonds of the Bank of Russia;
- a ban on the attraction of foreign credits by banks where the State's share is more than 50%;
- the imposition of limits on the share of foreign liabilities for commercial banks;
- the introduction of requirements for reserves on short-term foreign investments flowing into this country, etc.

As an instrument designed to reduce the necessity for sterilizing the RF CB's operations on the currency market, we can point to the abolition of the requirement for mandatory repatriation of proceeds denominated in foreign currencies. There is no doubt that the introduction of such a measure can be possible only on condition of creating an efficient system of tax control over the operations of Russian companies being handled through their foreign accounts.

When implementing a monetary policy, it is necessary to take into account the fact that sterilized interventions, while not influencing directly the monetary base and inflation rate, still entail certain consequences that must not be overlooked.

Within the impact produced on the exchange rate, the monetary policy and the real sector by the sales of foreign currencies carried out by the RF Central Bank on the currency market, two components can be distinguished.

Firstly, the sale of foreign currencies on the market in the event of demand being higher than supply results in a given foreign currency's exchange rate declining or failing to rise within a short-term interval. If the RF CB's goal is to prevent the strengthening of the rouble's nominal exchange rate, the intervention's results would be, on the one hand, signals being sent to the market participants as to the character of a current monetary policy. On the other hand, the dynamics of the exchange rate in this case will not be dependent on the actions of the market participants or the values of the fundamental variables characterizing the long-term and short-term equilibrium on the currency market and the other markets; instead, it will be fully determined by the actions of the RF Central Bank. This effect has no influence on the long-term equilibrium – regular purchases of foreign currency in a situation of excessive supply during a long period results in the accumulation of reserves and gradual strengthening of the rouble's real exchange rate, depending on the existing potential for intervention sterilization.

Secondly, interventions, including the sterilized ones, may influence the exchange rate, the financial and the real sectors through the changes in the long-term equilibrium in the national economy. Such interventions may occur both as a result of asset redistribution between economic agents (changes in the volumes of foreign currencies, the monetary base or securities in the agents' portfolios), and also resulting from shifts in the monetary and exchange-rate policies or from signals that such shifts are actually taking place, the information concerning them becoming open when interventions are carried out. Accordingly, in the existing literature on this subject⁹, two channels for the influence of interventions on the equilibrium in the national economy are distinguished: the portfolio channel and the information (or signalling) channel.

It should be noted that the main influence of a non-sterilized intervention, in addition to a short-term impact on the exchange rate, is expressed in the changes in money supply, which in itself will result in a changing equilibrium in the national economy. If an intervention is sterilized, and the monetary base is not increased, the impact of interventions on the equilibrium is not obvious and requires an additional theoretic and empirical analysis.

The portfolio channel (portfolio balance) for the impact of sterilized interventions. The impact of interventions on the equilibrium in the national economy through the portfolio channel may be briefly described as follows. When foreign currency is purchased by the RF Central Bank, and the intervention is sterilized through a sale of securities on the domestic financial markets, there occurs a redistribution of domestic and foreign assets between the portfolios of economic agents. In the event of incomplete replaceability of domestic and foreign assets, the changes in their ratios in a portfolio, as a result of a sterilized intervention, will produce a shift in the equilibrium on the financial markets. This, in its turn, may cause changes in interest rates and, as a consequence, changes in the exchange rate.

The informational channel (or signalling channel) for the impact of interventions. The hypothesis as to the RF CB's interventions influencing the equilibrium in the national economy also through the signalling channel states that the interventions of the RF Central Bank on the currency market may give one a notion of the future monetary and exchange-rate policies. The character of the interventions' impact through this channel depends on the degree of openness of the interventions and their informational content. The idea of the impact of interventions occurring through the signalling channel implied that the RF Central Bank can influence the exchange rate through providing the market with a new important and reliable information concerning the intended exchange-rate and monetary

⁹ For an overview, see, e. g., (Sarno, Taylor, 2001).

policies of the state authorities. Strictly speaking, the interventions may indeed influence the exchange rate, because economic agents change their expectations in respect to the future exchange rate by responding to the interventional activities of the RF CB.

When the foreign economic situation is unfavorable. We believe that in a deteriorating situation in the sphere of foreign trade, the responses of the financial authorities must be asymmetrical in respect to the policy that is pursued when the situation is, on the contrary, improving. When the trade conditions are improving, it is not feasible to apply the nominal exchange rate for achieving an equilibrium of the trade balance, firstly, because it is not desirable to maintain an artificially lowered real exchange rate of the rouble, and secondly, because of the excessively powerful responses of the nominal exchange rate to external shocks.

When the trade conditions for Russia are becoming worse, a dramatic fall in the nominal exchange rate does have some positive aspects from the point of view of economics, which primarily are reflected in the increased competitive capacity of domestic production resulting from the rouble's lowered exchange rate. However, the depreciation of the national currency can also have its negative consequences, in terms of accelerated inflation resulting from increasing prices of foreign commodities; lowering well-being of the population, whose savings are denominated in the national currency; the emergence of negative expectations on the part of both domestic and foreign investors, which may provoke further growth in the demand for foreign currencies, the dollarization of the national economy and capital outflow from this country. Besides, it should be taken into consideration that dramatic depreciation may prove impossible because it is fraught with high risks for the careers of the top government officials responsible for the implementation of such measures.

Given all the aforesaid considerations, it can be concluded that, in a worsening situation in the sphere of foreign trade, the rational policy (with some political restrictions) would be that aimed at lowering the rouble's nominal exchange rate, possible with a "fly-over", thereby creating reserves for its later growth in course of the next cycle of price growth. The political implementability of such a scenario may be ensured by complying with the principles of gradual and predictable depreciation rate (possibly, with the announcement of a new prospective exchange rate value) with the help of currency interventions supportive to the rouble's exchange rate, to be carried out by the RF Central Bank with gradually shortening time intervals.

2.2 State Budget

2.2.1. General Structure of the Budget of the Russian Federation for 2005

A general analysis of the 2005 Russian State Budget will immediately point out one observation – extremely high revenues with somewhat lower level of expenditures as a percentage of GDP as compared with the year before (please see *Table 1*). Both the Russian federal and the consolidated budgets have continued to grow throughout 2005 and not only outperformed corresponding figures from 2004 but also reached record levels for the past 8 years. According to the actual budget figures for 2005, state revenue stood at 23.7% of GDP, 3.3 percentage points higher than the corresponding figure for 2004. Revenues for the consolidated budget were 35.1% of GDP in 2005, a 2.8 percentage points increase on 2004. State expenditures in 2005 on the other hand have not undergone any significant increases and from 16.1% of the GDP in 2004 moved up only to 16.2

in 2005. Expenditures for the consolidated budget have actually gone down from 27.8% of the GDP in 2004 to 27.4% in 2005.

Revenues in the budgets of Russia's local governments have in general been somewhat lower than in 2004. In 2005 consolidated revenues of local governments stood at 13.8% of GDP, down from 14.3% in 2004. Expenditure lines in the local government budgets as a share of GDP however have declined even further by a .5 percentage point on the year before (from 14.1 % of GDP in 2004 to 13.6% in 2005). The combination of increasing state budget revenues and a steady level of expenditures has generated surpluses of a size unprecedented in the budget history of the post Soviet Russia. Surplus in the consolidated budget was a whopping 7.7% of GDP with an equally impressive 7.4% of the GDP for the federal budget. Though a recent makeover of the tax code has made it somewhat difficult to track changes and make direct comparisons with the past when it comes to the tax base of budget revenue, a higher volume of tax-based proceeds into the consolidated budget of the Russian Federation in 2005 suggests that tax revenue in 2005 as a percentage of GDP has increased from previous years. Please see a more detailed structure of tax-based revenues below.

Table 4

Actual Revenues and Expenditures for the Consolidated, Federal and Subnational Budgets (as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
Federal Budget								
Tax-based Revenue:	8.8	10.7	13.2	16.2	18.6	18.0	18.8	
Unified Social Tax Revenue	–	–	–	–	3.1	2.7	2.6	1.23
Expenditures	11.3	12.9	15.4	17.6	20.1	19.4	20.4	23.7
Deficit (-)/Surplus (+)	14.5	14.0	13.1	14.7	18.7	17.7	16.1	16.2
	-3.2	-1.1	2.4	2.9	1.4	1.7	4.4	7.4
Territorial Budgets								
Tax-based revenue	11.5	10.4	10.2	9.6	10.0	10.0	10.6	
Revenue	14.8	13.6	14.4	14.3	14.9	14.5	14.3	13.8
Expenditures	15.2	13.6	14.0	14.3	15.3	14.9	14.1	13.6
Deficit (-)/Surplus (+)	-0.3	0.0	0.5	0.0	-0.4	-0.4	0.2	0.3
Consolidated Budget								
Tax-based Revenue	20.3	21.1	23.4	25.8	28.6	28.0	29.4	
Revenue	24.5	25.2	28.5	29.3	32.1	31.1	32.3	35.1
Expenditures	28.1	26.3	25.6	26.4	31.1	29.7	27.8	27.4
Deficit (-)/Surplus (+)	-3.6	-1.1	2.8	2.9	1.0	1.4	4.5	7.7

Source: Ministry of Finance, Russian Federation; Calculations: IET.

Higher prices for oil and other major export items (mostly natural resources) were certainly the main reason for an increase in the budget revenues in 2005. Since the actual revenues have exceeded forecasted figures, the Law on Federal Budget of the Russian Federation had to be edited in July and November of 2005. According to these changes, state budget revenues were reported to be 4979.76 billion Rubles (up from 3326.04 billion Rubles forecasted in the first draft of the Law), while the expenditures had to be revised upward from 3047.93 billion Rubles to 3539.45 billion Rubles).

2.2.2. Analysis of Tax Proceeds to the State Budget of the Russian Federation

Pursuant to the Order No. 114 issued by the Ministry of Finance on October 14, 2004 “On Guidelines for Application of Definitions in the Budget of the Russian Federation”, all categories of revenues and expenditures were redefined for all types of state budgets. These changes make it somewhat difficult to compare the 2005 budget with budgets from previous years on certain categories of revenues or expenditures.

One such change for instance that came into effect on January 1, 2005 increased the Natural Resource Extraction Tax (NRET) from R347 per ton of oil to R419 per ton of oil. Other changes in the Tax Code also increased the non-taxable price of oil from \$8 a barrel to \$9 a barrel. In addition, the ruble/dollar exchange rate used in calculation of the NRET was revised from 31.5 Rubles to 29 Rubles for \$1, reflecting a ruble’s appreciation against the dollar. Thus the current formula for determining the NRET is as follows:

$$NRET = t_{NRET} \times \frac{(P - P^*)}{P \times ER_{off}}$$

Where:

t_{NRET} – is the NRET current rate at 419 Rubles per ton of oil;

P – is the current price of oil on world markets;

P^* – is the non-taxable price of oil;

ER_{off} – is the official dollar exchange rate (currently 29 rubles for 1US dollar).

Table 5

Main Types of Tax Proceeds to the Budget of the Russian Federation (as a percentage of GDP)

	1999	2000	2001	2002	2003	2004	2005
Profits Tax	4.6	5.4	5.7	4.2	4.0	5.2	6.2
Income Tax	2.5	2.4	2.8	3.3	3.4	3.4	3.3
VAT	8.8	6.2	7.1	6.9	6.6	6.4	6.8
Excise Taxes	2.2	2.3	2.7	2.4	2.6	1.5	1.2
NRET*	1.2	1.6	1.6	2.5	2.5	3.0	4.2
External Trade Tax	1.8	3.1	3.6	3.0	3.4	5.1	7.5
Unified Social Tax				3.1	2.7	2.7	1.2

Source: Ministry of Finance, Russian Federation.

*Until 2001, the NRET was a sum of oil excise tax, natural resource use tax and contributions towards mineral base recovery (MBR).

Table 2 demonstrates that in 2005 changes in proceeds over 2004 from different types of taxes were not uniform. Profits tax collected from enterprises as a share of GDP for instance has grown significantly by a whole percentage point to 6.2%, thus continuing a 3-year trend of growth of tax revenue in that sector. Growth in income tax revenue was partly due to a growth of the tax base. In other words, according to the Russian State Statistical Agency, bottom lines in Russian businesses’ balance sheets (summed revenues minus losses) have grown in the period from January to November of 2005 by 35.2% as compared with a similar period in 2004. The infamous “Yukos Affair” has also played its role in deterring other companies from using existing loopholes in the tax code to minimize their payments of tax dues.

Individual income tax proceeds in 2005 were somewhat lower than in 2004 and stood at 3.3% of GDP, down from 3.4% of GDP in 2004. Proceeds from UST on the other hand have been more pronounced from 2.7% of GDP in 2004 down to 1.2% of GDP). Curiously though, according to the Statistical Agency official data, in 2005 real individual income grew by 8.8%, with the real wages and salaries alone rising by 9.7%, both ahead of the overall GDP growth by 2.2% and 3.3% respectively. This data suggests that in real terms individual income tax rates and the unified tax rates were lower in 2005 than in 2004, with a decrease in the unified tax rate particularly notable.

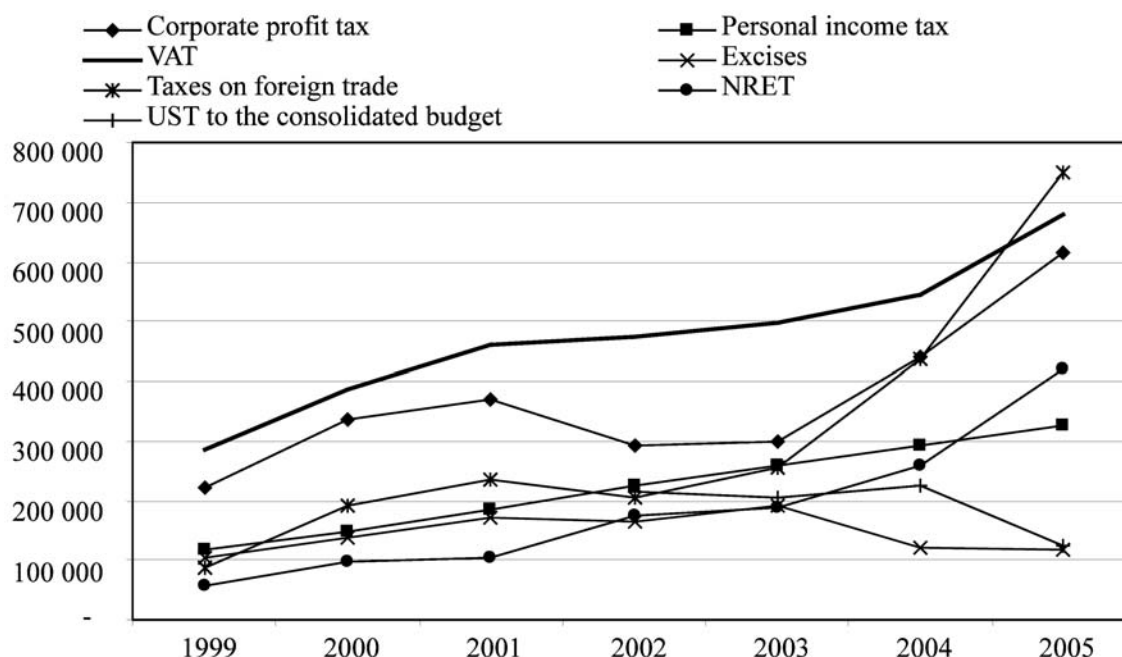
Proceeds from the value added tax remain the largest contributor to the budget of the Russian Federation. In 2004, VAT proceeds to the federal budget constituted 6.4% of the GDP. In 2005 that share grew to R1.48 trillion, or 6.8% of the GDP even though rebates on VAT have also grown to 2.1% of the GDP in 2005 from 1.9% of GDP a year earlier. Excise tax proceeds in 2005 brought in an amount worth of 1.2% of the GDP to the federal budget, .3 percentage points less than a corresponding figure for 2004.

Predictably, budget revenues from natural resource extraction taxes demonstrated considerable growth in 2005. Thus in 2005 this tax generated R908 billion to the consolidated budget of the Russian Federation, an amount worth of 4.2% of GDP, up from 3% of the GDP in 2004. An auspicious environment for energy, minerals and other major Russian exports, as well as certain changes to the tax code, like the already mentioned changes in the formula for NRET, were certainly the causes for an increase in proceeds from the natural resource extraction tax.

Taxes levied on external trade activities in 2005 have also brought in higher revenue and constituted 7.5% of the GDP, a considerable increase over the 2004 level of 5.1% of the GDP. High oil prices again are responsible for the increase in revenues from this tax.

Graph 1 depicts the changes in tax revenues on different types of taxes in real terms in the period from 1999 to 2005¹⁰. As can be easily deduced from the graph, most of the growth in revenue in real terms was generated from 5 categories of taxes: external trade tax, VAT, profits tax, NRET and to a lesser degree the income tax. On the other hand proceeds from the excise tax and the federal unified social security tax have decreased in real terms in 2005. In general, changes in revenue in real terms collected from different types of taxes correspond to the changes in their nominal share in the GDP.

¹⁰ A chained consumer price index with 1999 as a base level was used as a deflator in these calculations.



Source: Ministry of Finance, Russian Federation.

Fig. 11. Changes in Major Tax Proceeds in Real Terms in 1999–2005 (mln rubles)

In conclusion of this chapter it is necessary to review the changes in the amount of taxes owed, penalties and other sanctions imposed by the budget authorities of the Russian Federation.

Table 6

Back Taxes, Tax Penalties and Sanctions in the Budget System of the Russian Federation 2002–2005 (as a percentage of GDP)

	2002	2003	2004	2005
TOTAL	4.82	3.93	5.24	3.48
<i>Including:</i>				
In the Federal Budget	4.12	3.30	4.70	3.03
<i>Including:</i>				
Profits Tax	0.81	0.54	1.36	0.84
VAT	2.23	1.84	2.45	1.44
Payments for Usage of Natural Resources	0.19	0.16	0.33	0.25
<i>Including:</i>				
NRET	0.01	0.02	0.17	0.14
Other Federal Taxes and Fees	0.89	0.76	0.55	0.50
Back payments on Regional Taxes and Fees	0.42	0.35	0.30	0.25
Back Payments on Local Taxes and Fees	0.28	0.25	0.21	0.16

Source: Federal Tax Service, Reporting Form 4-NM.

Graph 3 demonstrates that in 2005 there was a significant reduction in volume of back taxes, tax penalties and sanctions. From 5.24% of the GDP in 2004 the figure went down to 3.48% of the GDP in 2005. Taxes owed to the federal budget have also decreased from 4.7% of the GDP in 2004 to 3.03% of the GDP by 2005. Most of the reduction resulted from the decrease in the taxes owed on the profits tax (from 1.36% of the GDP in 2004

down to .84% of the GDP for 2005) and on VAT (from 2.45% of the GDP in 2004 down to 1.44% of the GDP for 2005). Taxes owed on other types of duties have not undergone any significant reductions. In general however when compared with 4 previous years 2005 was notable for its lowest level of taxes owed to the budget, something that could have stemmed from a better collection efforts on part of tax authorities or higher discipline on part of taxpayers.

2.2.3. State Budget Expenditures

Reforms and changes that were introduced to the budget definitions in January of 2005 make line-by-line comparisons with previous years impossible. Therefore in this paper data up to 2004 shall be depicted separately and then analyzed with the actual budget realization in 2005. Please see *Table 7* for the key characteristics of the expenditures part of the Russian State budgets of all levels in the period from 2002 to 2004.

Table 7

**Expenditures in the Federal, Territorial and Consolidated Budgets
in 2002–2004 (as a percentage of GDP)**

	2002			2003			2004		
	Federal Budget	Territorial Budgets	Consolidated Budgets	Federal Budget	Territorial Budgets	Consolidated Budgets	Federal Budget	Territorial Budgets	Consolidated Budgets
1	2	3	4	5	6	7	8	9	10
Federal and Local Affairs	0.5	0.8	1.4	0.5	0.9	1.4	0.5	0.8	1.3
Judicial Branch	0.2	0	0.2	0.2	0	0.2	0.2	0.0	0.2
International Affairs	0.3	0	0.3	0.2	0	0.2	0.3	0.0	0.3
National Defense	2.7	–	2.7	2.7	0	2.7	2.6	0.0	2.6
Internal Security and Law Enforcement	1.7	0.5	2.2	1.9	0.4	2.3	1.9	0.4	2.3
Research and Development	0.3	0	0.3	0.3	0	0.3	0.3	0.0	0.3
Manufacturing, Energy and Construction Sectors	1	1.3	2.3	0.5	2	2.5	0.5	1.9	2.3
Agrarian Sector and Fisheries	0.3	0.3	0.5	0.2	0.3	0.5	0.2	0.3	0.5
Transportation, Roads, IT and Communications	0.1	0.4	0.5	0	0.3	0.3	0.0	0.2	0.3
Housing and Utilities	0	2.3	2.3	0	1.9	1.9	0.0	1.7	1.7
Education	0.7	3	3.8	0.8	2.8	3.6	0.7	2.8	3.5
Art, Cinema and Cultural Affairs	0.1	0.4	0.5	0.1	0.3	0.5	0.1	0.3	0.4

	1	2	3	4	5	6	7	8	9	10
Mass Media		0.1	0.1	0.2	0.1	0.1	0.2	0.1	0.1	0.1
Healthcare		0.3	2.1	2.4	0.3	1.9	2.2	0.3	1.9	2.2
Social Policy		4.4 [*]	1.3	5.7 [*]	1	1.4	2.4	0.9	1.5	2.4
Sovereign Debt Service		2	0.1	2.2	1.7	0.1	1.8	1.2	0.2	1.4
Financial Assistance to Lower Level Budgets		2.7	0	–	6.0 ^{**}	0	3.2 ^{**}	5.4	0.0	3.0
Military Reform		0.1	0	0.1	0.1	0	0.1	0.0	0.0	0.0
Roads		0.4	0.4	0.7	0.3	0.5	0.8	0.3	0.2	0.5
Earmarked Budget Funds		0.1	1.4	1.6	0.1	1.1	1.2	0.1	1.0	1.1
Total Expenditures		18.7	15.3	31.1	17.7	14.9	29.7	16.1	14.1	27.8

Source: Ministry of Finance, Russian Federation.

^{*} Including PF transfers for financing base level pensions from the centralized federal ESN proceeds.

^{**} Starting in 2003, this article of spending also includes transfers to state non-budget foundations.

Table 8

**Expenditures of the Federal, Consolidated and Territorial Budgets
in 2005 (as a percentage of GDP)**

	Federal Budget	Territorial Budgets	Consolidated Budgets
State Affairs	3.5	2.3	1.2
Including state and municipal debt servicing	1.1	1.0	0.1
National Defense	2.7	2.7	0.0
Law Enforcement and Internal Security	2.7	2.1	0.6
National Economy	3.5	1.2	2.4
Housing and Utilities	2.2	0.03	2.2
Environment	0.1	0.02	0.1
Education	3.7	0.8	2.9
Art, Cinema, Cultural Affairs and Mass Media	0.7	0.2	0.5
Healthcare and Athletics	2.6	0.4	2.1
Social Policy	2.4	0.8	1.6
Interbudgetary Transfers	3.5	5.8	0.1
Total Expenditures	27.4	16.2	13.6

Source: Ministry of Finance, Russian Federation.

For a description of major budget expenditures for Russia's federal, consolidated and territorial budgets in 2005 in accordance with changes introduced in January 2005, please consult *Table 8*.

When comparing data from 2004 and 2005 it becomes evident that share of expenditures in the consolidated budget of the Russian Federation, as a percentage of GDP was somewhat lower for 2005 than in 2004. Thus in 2005 the figure constituted 27.4% of the GDP down from 27.8% of the GDP in 2004. Expenditures in the Russia's federal and terri-

torial budgets in 2005 were 16.2% and 13.6% of the GDP respectively versus 16.1% and 14.1% of the GDP in 2004. In other words, in 2005, a modest growth of expenditures in the federal and consolidated budgets over the previous year has coincided with a decrease in expenditures in the territorial budgets.

An analysis of the major expenditures of the consolidated budget in 2005 will demonstrate that a lion share of the resources has gone into 4 categories of spending: Education (3.7% of the GDP), Interbudgetary Transfers, State Matters¹¹ and National Economy¹² (3.5% of the GDP each). Spending on national defense, security and internal law enforcement constituted 2.7% of the GDP, on healthcare 2.6% of the GDP, social policy took up 2.4% of the GDP and housing 2.2 % of the GDP.

In spite of the aforementioned changes to the budget classification that came into effect for the 2004 and 2005 budgets, some lines of the consolidated budget of the Russian Federation can still be directly compared with budgets from previous years. Budget spending on housing and utilities is one such instance. In 2005 that figures stood at 1.31% of the GDP against 1.66% of the GDP in 2004. Spending on education¹³ in 2005 remained on the same level at 3.16% of the GDP. Expenditures on healthcare and “athletic promotion and awareness” programs have increased from 1.8% of the GDP in 2004 to 2.2% of the GDP for 2005. Direct comparisons on other categories of spending are not feasible due to the aforementioned changes in budget classifications.

2.2.4. 2006 Federal Budget

In august of 2005, the Russian cabinet presented a draft Law on Federal Budget of the Russian Federation. A final version of the Law was passed in November of 2005. Further in the text we supply a commentary on certain aspects of the revenue, expenditures as well as sources for financing the budget deficit.

Please see *Table 9* for a description of revenues to the federal budget in 2005 and 2006.

A look at the table demonstrates that forecasted revenues for 2006 federal budget in absolute terms were much higher than figures that had been forecasted for 2005. However 2006 forecasts were still lower than actual revenues collected in 2005. Even revised 2005 forecasts of R4,979,765.5 million do not alter the picture of growth of revenue in absolute terms. In relative (to GDP) terms however, 2006 revenue forecasts at 20.7% of the GDP were 3 percentage points lower than actual revenues collected in 2005, though still above the initially forecasted number for that year. A drop in revenue in 2006 over the previous year has been spawned by a change in certain macroeconomic environment (1.84% of the GDP), tax reform (0.35% of the GDP) as well as other factors (1.17% of the GDP).

Among changes in the macroeconomic environment it is necessary to point out a 2006 forecast for a falling price of Urals crude. This change accounted for 1.83% reduction in the forecasted budget revenue. On the other hand upward changes in amounts of extraction and export of natural gas, taxable profits, excise tax base, dollar depreciation as well as some changes in imports composition have all increased the forecasted 2006 budget revenue by 0.36%.

¹¹ This budget article includes spending on the following subcategories: «head of state post-related expenditures», «expenses pertaining to work of highest state officials», «legislative expenditures, judicial branch expenses, «state and municipal debt servicing», etc.

¹² This budget article covers spending on the following subcategories: «General Economy », «Fuel and Energy», «Transportation», «Communications and IT», «Forestry», «Water Resources», «Agrarian Sector and Fisheries», «Applied Economic Research » etc.

¹³ Includes spending on primary, secondary, higher and tertiary education as well as professional training and re-training expenses.

Table 9

Major Revenues to the Federal Budget of the Russian Federation in 2005 and 2006

	2005 (official forecasts)		2005 r. (actual)		2006 r. (official forecasts)	
	MIn Rubles	% of GDP	MIn Rubles	% of GDP	MIn Rubles	% of GDP
Total Revenue	3 326 041.1 ¹⁴	17.8	5 125 092.0	23.7	5 046 137.5	20.7
<i>Including:</i>						
Tax-based revenue¹⁵	3 151 745.6	16.8	4 801 229.5	22.2	4 830 748.5	19.8
<i>Including</i>						
Profits tax	259 003.3	1.38	337 591.8	1.74	344 838.1	1.41
VAT	1 120 751.3	5.99	1 472 210.2	6.80	1 634 342.6	6.70
Excise Taxes	84 805.7	0.45	107 192.1	0.49	110 186.5	0.45
Custom Duties	867 969.0	4.64	1 622 844.9	7.49	1 607 843.3	6.59
NRET	464 934.1	2.48	854 522.3	3.94	731 570.3	3.00
UNIFIED SOCIAL TAX to the Federal Budget	266 500.0	1.42	267 513.2	1.23	302 090.2	1.24
Non-tax Revenue	174 295.5	1.0	323 862.5	1.5	215 389.0	0.9

Source: Ministry of Finance, Russian Federation.

Reforms of the tax system that have led to a decrease in budget revenues have mainly to do with a change in the calculation of VAT for capital investments as well as an accelerated depreciation rate of 10% for capital assets. Some loss of revenue should be offset by other changes in the tax system, such as a termination of a zero tax rate for import services provided by the Russian rail freight forwarding companies, excise tax indexation as well as an increase in the tax rate for extraction of natural gas under the NRET.

Finally, a decrease in the forecasted revenue for 2006 budget over the previous year, had been a result of a considerable tax contribution made by Yukos in the first half of 2005. When 2005 and 2006 budget forecasts are brought under leveled conditions, according to the draft version of the budget, 2006 revenues should have risen in nominal terms by R318.5 billion, though relative to GDP 2006 revenues would be lower than 2005 figures by 1.81%.

To ease the process of comparison this paper used a different classification of tax and non-tax budget revenues from those employed in previous IET works. As demonstrated in Table 6, 2006 tax revenues to the federal budget in absolute terms were above forecasts made in the 2005 Law on Budget as well as actual figures for that year. As to the non-tax sources of revenue 2006 figures though still above 2005 forecast but below actual revenues collected in that year. Also, 2006 tax revenues though above corresponding values for 2005 turned out to be lower than forecasts made at the end of that year. 2006 non-tax revenue in the meantime turned out to be lower than figures both forecasted and actually collected in 2005.

Table 9 also provides data on other types of taxes, which bring significant contributions to the overall budget revenue. In 2005 revenue from these taxes was higher than forecasts both for 2005 and 2006. Figures forecasted in the budget law for 2006 are also higher than corresponding figures in the 2005 budget law, with the exception of UST,

¹⁴ In accordance with changes made to the Law on Federal Budget of the Russian Federation for 2005, federal budget revenues were raised to R4,979,756.5 mln, or 23.7% of the GDP.

¹⁵ For the purposes of this research, the term "tax-based revenue" includes the following: "profits and income tax", "social security taxes", "domestic goods and services consumption taxes", "taxes on goods imported to the Russian Federation", "taxes on usage of natural resources", "state duties" and taxes on external economic activities". All other revenue articles are grouped in the "non-tax based revenue" category.

whose share of the GDP for 2006 was forecasted to be at 1.24%, down from a 2005 level of 1.42% of the GDP. In 2006 some decrease in revenue is expected from lower NRET and customs proceeds as a result of falling prices for Russian crude.

Table 10

Major Expenditures in the Federal Budget of the Russian Federation in 2005 and 2006

	2005 (official forecasts)		2005 r. (actual figures)		2006 r. (official forecasts)	
	Mln. Rubles	% of GDP	Mln. Rubles	% of GDP	Mln. Rubles	% of GDP
Total Expenditures	3 047 929.3 ¹⁶	16.3	3 512 182.9	16.2	4 270 114.7	17.5
<i>including:</i>						
Interest expenditures	244 150.4	1.3	208 367.1	0.9	198 482.2	0.8
Non-Interest Expenditures including expenditures finances by UNIFIED SOCIAL TAX	2 803 778.9	15.0	3 303 815.8	15.7	4 071 632.5	16.7

Source: Ministry of Finance, Russian Federation.

From *Table 10*, which compares data on budgetary expenditures in 2005 and 2006, it is clear that in 2006 federal government spending is expected to considerably exceed 2005 levels both in absolute and relative to GDP terms. In forecasts for 2005, for instance, government spending was expected to reach 16.3% of the GDP. In reality 2005 spending turned out a little shy of that forecasts and amounted to 16.2% of the GDP. For 2006 on the other hand, government spending is forecasted to reach a 17.5% of the GDP. The increase is expected to result from a rise in non-interest spending (up to 16.7% from 15% forecasted and 15.7% actually spent in 2005). Interest expenditures in 2006 on the other hand are expected to decrease down to 0.8% from 1.3% forecasted and 0.9% actually spent in 2005.

Table 11 compares different types of government spending in 2005 and 2006 accounting for various changes introduced in that year.

Table 11

Federal Budget Expenditures in 2005 and 2006

	2005 (official forecasts)		2005 (actual)		2006 (official forecasts)	
	Mln. Rubles	% of GDP	Mln. Rubles	% of GDP	Mln. Rubles	% of GDP
1	2	3	4	5	6	7
State Affairs	491 327.72	2.62	499 291.7	2.30	638 885.61	2.62
<i>Including</i> State and Municipal Debt Servicing	244 150.36	1.30	208 367.1	0.96	198 482.24	0.81
National Defense	549 680.46	2.94	581 131.9	2.68	666 026.63	2.73
Law Enforcement and National Security	442 552.33	2.36	450 096.5	2.08	541 634.56	2.22
National Economy	253 507.21	1.35	248 472.5	1.15	339 333.97	1.39
Housing and Utilities	10 098.48	0.05	6 905.5	0.03	38 883.16	0.16
Environment	4 782.34	0.03	4 746.6	0.02	6 334.26	0.03
Education	162 947.72	0.87	162 080.1	0.75	201 588.66	0.83
Arts, Cinema and Mass Media	46 149.09	0.25	47 448.8	0.22	51 248.09	0.21

¹⁶ In accordance with changes made to the Law on Federal Budget of the Russian Federation for 2005, federal expenditures were raised to R3,539,450.6 mln, or 16.8% of the GDP.

	1	2	3	4	5	6	7
Healthcare and Athletics		87 876.45	0.47	88 166.3	0.41	149 098.67	0.61
Social Policy		177 476.02	0.95	178 254.1	0.82	205 253.27	0.84
Interbudgetary Transfers		1 169 871.24	6.25	1 245 589.2	5.75	1 431 827.82	5.87
Total Expenditures		3 396 268.74	18.14	3 512 182.98	16.21	4 270 114.72	17.51

In general, federal budget expenditures between 2005 (both forecasted and actual) and 2006 has changed little in relation to GDP for some categories of spending. Categories spending on which has changed significantly are as follows: “federal and municipal debt service” (down from 1.3% forecasted and 0.96% actually spent in 2005 to 0.81% of the GDP for 2006), “housing” (up from 0.05% forecasted and 0.03% actually spent in 2005 to 0.16% of the GDP for 2006), “inter-budget transfers” (down from 6.25% in 2005 to 5.87% of the GDP for 2006). Among categories that continue to command highest share of government spending one has to note the following: “general state matters”, national defense, national economy and inter-budget transfers. The sum of spending on these categories amounted to 14.83% of the GDP in 2006 as compared to 15.52% forecasted and 13.96% actually spent in 2005.

Table 12

Federal Budget Surplus in 2006

	2005 (official forecasts)		2005 r. (actual)		2006 r. (official forecasts)	
	Mln Rubles	% of GDP	Mln Rubles	% of GDP	Mln Rubles	% of GDP
Deficit (-)/Surplus (+) of the Federal Budget	278 111.8	1.5	1 612 909.8	7.44	776 022.78	3.18

Source: Ministry of Finance, Russian Federation.

A sizeable increase of budget revenues coupled with an insignificant increase in spending resulted in higher forecasts for 2006 federal budget surplus (please see *Table 12*). While in 2005 the budget forecasts called for a surplus of 1.5% of the GDP, in 2006 that figure rose to 3.18% of the GDP. It is interesting to note that actual budget surplus in 2005 at 7.44% of the GDP shot well above the forecasts all due to extremely high prices for crude and other major Russian exports that stayed high throughout the year.

Government debt obligations in 2006 are expected to be financed from the following sources: domestic sale of government bonds, resources from the Federal Stabilization Fund as well as funds raised through sale of government properties.

Thus issuance of government bonds on the internal market is expected to raise R238.2 billion, with only R68.4 billion worth of government bonds being repaid which leaves the net government bond issuance for 2006 at R169.8 billion. Since 2006 budget does not call for any significant reductions in the amount of government debt, re-financing will be the method for debt servicing. In addition, planned sale of government assets and land in 2006 are expected to attract R31 billion and R8 billion accordingly.

Among external sources of financing for 2006 budget there are no non-targeted loans from other sovereign states or international monetary organizations. Bundled loans on the other hand are expected to bring in \$1.1 billion in 2006. Most of the currently active projects lead by international lending organizations are expected to expire within the 2006-2008 period thus following the Russian government’s policy at ending the practice of attracting new bundled IMF loans.

The 2006 Law on Budget also calls for repaying \$8.5 billion worth of sovereign external debt. In addition, in 2006 the government also plans to repay \$2.8 billion of its foreign currency nominated debt. \$710 million will be repaid on Russia's debt to the IBRD, while \$51.8 million will be paid back to the EBRD.

The Budget Law for 2006 was devised on the basis of economic growth forecasts made by the Ministry of Economic Development and Trade of the Russian Federation. These forecasts called for two possible scenarios of Russia's economic development in 2006. Thus according to the first scenario, general inertia, falling competitiveness of Russia's economy and lack of any noteworthy positive developments in the investment climate – all put a hold on realization of any new government programs, strategies, etc. A major element in such scenario is a sharp deterioration in demand for Russian Urals crude with its price dropping down to \$28 a barrel and remaining at that level for some time. In that case, revenue from crude exports was to fall by 22% even with its volume growing by 9% and crude extraction by 5.3%. Also according to this scenario, GDP growth slows down from 5.9% in 2005 down to 4–4.6%, which lifts the GDP from its base of 2004 by 20% during the 2005–2008 period.

The second scenario is based on more optimistic premises of deepening institutional reform, solid growth in key economic industries set against favorable world markets environment for Russia's major exports. It was this scenario on the basis of which the calculations for the 2006 budget and the forecasts down to 2008 were made. According to this model, a decrease in the price for the Urals crude was to be more gradual from \$48 a barrel in 2005 to \$40 in 2006 and further down to \$35–36 a barrel in later years. In addition according to this scenario domestically instituted reforms in the tax code encouraging business expansion as well as an increase in the investment-gearred government spending, including a creation of an investment fund were to spur economic growth further. In this model, the Russian GDP was to continue expanding at 5.9–6% in 2005–2008 and growing by 25.8% by the end of that period.

In an effort to provide an independent evaluation of forecasts laid as the basis of budget calculations, the IET staff has designed its own scenarios of possible economic development of the Russian economy. These scenarios were based on structural econometric models of the Russian economy. The following were used as exogenous factors for building the model: price for Brent crude, index of capital investments, changes in the real income per capita as well as changes in the M2 monetary base.

Three different scenarios of possible economic development were designed on the basis of this model. Under one such scenario dubbed as "inert ional" the price of Brent crude in 2006 is to decrease gradually to \$40 a barrel thus making for a year-round average price of \$43 a barrel for Brent and \$40 a barrel for Urals. This particular is scenario, in other words, replicates the second model designed by the Ministry of Economic Development and Trade and was used as the basis for the 2006 budget forecasts.

Another scenario developed by the IET staff and dubbed as "likely" is based on the commonly shared expectations that crude oil prices will stay at or above \$55 a barrel throughout 2006.

A third "negative" scenario presumes that oil prices plummet to an annual average of \$30 for a barrel of Brent and \$28 for a barrel of Urals while the dollar strengthens sharply against other leading currencies. This set of events is very similar to a first model developed by the Russian Ministry of Economic Development and Trade.

Table 13 presents expected budget revenue and expenditures corresponding to each of these three possible scenarios of economic development.

Table 13

Major Budget Characteristics as Forecasted by the IET Models of Possible Economic Development for 2006

Budget Characteristic	2006 (official forecasts)	2006 (inertia)	2006 (likely)	2006 (negative)
Budget revenues (as % of GDP)	20.7	20.3	28.2	17.7
Budget revenues (Rb.bn)	5046	5026	7080	4350
Budget expenditures (as % of GDP)	17.5	17.3	17.0	17.4
Budget expenditures (Rb.bn)	4270	4270	4270	4270
Surplus (as % of GDP)	3.2	3.0	11.2	0.3

Source: Ministry of Finance, Russian Federation. Calculations IET.

According to the table calculations, revenues expected under the “inertia” model align very closely to Ministry figures used for determining the 2006 budget law, as both the IET and the official calculations were based on very similar premises.

Other two scenarios developed by the IET produced revenue calculations very different from those used in the budget. For instance under the “negative” scenario, federal budget revenue may decrease to 17.7% of the GDP, while in the official forecasts that figure stands at 20.7% of the GDP. Federal budget expenditures in the meantime are forecasted at more or less the same level of 17.4% of the GDP in the IET model and 17.5% under the official forecasts. A combination of sharply decreasing revenue and constant expenditures would diminish the budget surplus to an almost negligible 0.3% of the GDP as opposed to a sizable 3.2% of the GDP expected in the 2006 budget law. In other words the “negative” scenario would not have a truly ruinous effect on the Russian economy but could seriously undermine its stability.

Calculations under the “likely” model on the other hand produced results under which the budget revenue at 28.2% of the GDP was significantly higher than officially anticipated figure of 20.7% of the GDP while budgetary spending of 17% of the GDP was somewhat lower than the official version of 17.5%. In the case of expanding revenue and slowing expenditures, budget surplus understandably skyrockets to a record 11.2% of the GDP.

The following are conclusions that were made in the course of this survey of revenues and expenditures in the federal budget of the Russian Federation for 2006.

First of all, an anticipated increase in the absolute value of revenue collected may not automatically translate into higher revenue in relation to the GDP as compared with previous years. A forecasted decrease in the price of Urals crude, as was cited earlier, would be the major reason behind falling revenue. However, given the current conditions in the markets for crude oil, it appears safe to assume that actual 2006 revenue will exceed its budget projections.

Secondly, budget expenditures in 2006 are expected to rise both in absolute and relative to the GDP terms. With some minor changes in expenditures on debt servicing, interbudgetary transfers and housing, overall government spending on various programs has remained virtually unchanged. Given the government’s priority at taming the inflation, a policy of steady spending in the face of growing revenue is, in our opinion, a justifiable course of action.

Thirdly, a more rapid rate of growth in revenue over spending has produced a significant increase in the budget surplus. This allows the government to continue its policy of increasing domestic debt while reducing its external obligations.

Interestingly the IET calculations in all three of our models though not identical but still are analogous to the figures used in the budget. Revenue and expenditure results arrived at in the “negative” and “inertia” scenarios in particular, are quite similar to the official numbers. Considerably higher revenues in the face of lower spending and a resulting record budget surplus obtained in the “likely” scenario- were certainly influenced mostly by expectations of steadily high oil prices and demonstrate the Russia’s economy extreme dependence on its oil and gas sector.

Finally, on the basis of data presented in this paper, the 2006 budget of the Russian Federation can be characterized as fairly conservative, as there are no significant adjustments have been introduced to the structure of the budget since the budget of the previous year.

2.3. Interbudgetary Relations and Subnational Finance

The current system of interbudgetary relations underwent no radical changes in 2005. The structure of tax revenues and tax powers assigned to different tiers of power basically remained unchanged vs. the prior year, except for some minor modifications. The federal level retained already familiar from the previous years channels of financial support of regional budgets – that is, interbudgetary transfers in the form of subsidies to ensure equalization of budget sufficiency, subventions and subsidies from the Fund of Compensations, interbudgetary transfers from the Fund for Regional Development, Fund for Reforming Regional Finance and other kinds of interbudgetary transfers distributed on the basis of earlier approved principles¹⁷. Given the growing revenues to the federal budget in real terms, the financial state of subnational budgets, with account of the federal financial assistance can be characterized as a stable one.

However, the sum of decisions made and/or put into effect in 2005 allows conclusion that Russia has seen a gradual emergence and maturity of the national model of corporate federalism. Its distinctive feature is a considerable degree of centralization of a number of critical powers and financial resources in the hands of the federal center. The federal government enjoys broad powers, introduces universal law on all critical matters and secures the uniformity of the tax system throughout the federation. The Federal Republic of Germany perfectly exemplifies such a system. However, under the German democracy subnational authorities enjoy the possibility for exerting a substantial influence on the shaping of the federal center’s policy through the party system and the Bundesrat. By contrast, the Russian way of centralization of powers and financial resources in the hands of the federal center is complemented by the administrative and political control over subnational authorities.

The year of 2005 saw the completion of building the system – the law on the actual cancellation of governor elections came into effect and a number of them were elected-appointed according to the new procedure; the federal center unilaterally made a number of decisions on the “monetization” of benefits, the administrative reform and holding the national projects, while subnational authorities were given the role of “marshals” of individual measures that the federal center planned, funded and controlled.

¹⁷ See: issues of “Russian Economy: Trends and Outlooks” No. 21–26. M., IET.

Because of the domination of the federal center, the Russian model of interbudgetary relations is growing increasingly unitary, which can partly be attributed to the nascent party system, which in the noted Germany incorporates subnational interests into a single national policy. By contrast, in the Russian system the federal center is responsible for the economic and political development strategy, while subnational authorities chiefly exercise organizational and executive powers. As concerns the municipal level of power which the federal center believes should reflect local interests and help foster democracy bottom-up, its has been so far in the nascent state.

The above proves that the process of reforming the interbudgetary relations launched in 1997–98 has clearly slowed down over recent years. However, in contrast to other areas of the economy, this particular sphere still sees reform efforts aimed at a more efficient and transparent system of financial relations between different tiers of power. More specifically, in 2005 the government tried to abandon “unfounded federal mandates”; amendments to the Budget and Tax Codes were enacted¹⁸; the Concept for and methodology of reforming the interbudgetary relations in the Russian Federation and Subjects of the Russian Federation for 2006 and medium-term perspective. The progress in the interbudgetary relations area, however, is somewhat derailed by the Russian model of federalism.

In any case, as evidenced by the recent practice, the reform of principles of distribution of the federal financial assistance has remain on the agenda, as the current system appears insufficiently transparent, which does not allow assessment of its efficiency and provides grounds to suggest the possibility for creation with its help negative incentives for budgetary policies pursued by regional and local authorities.

2.3.1. Main Trends of Development of Relations between Budgets of Different Levels

Evaluation of main trends of 2005 in the area of relations between budgets of different tires suggests consideration of the structure of revenues and expenditures of the consolidated budget of the Russian Federation and its dynamics over recent years. *Table 14* represents data that characterize the proportion of tax revenues, as well as revenues and expenditures of budgets of Subjects of the Federation in the latter’s consolidated budget.

Table 14

The Proportion of Some Indexes of Budgets of the Subjects of the Federation in the Consolidated Budget of the Russian Federation in 1992–2004 (as %)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Tax revenues	44.2	53.1	53.4	47.6	49.5	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9
Revenues*	44.1	53.1	52.9	47.6	49.5	53.1	54.0	48.9	45.4	40.1	37.4	37.6	34.1	33.8
Expenditures	34.0	40.3	37.7	43.4	45.4	48.1	54.1	51.9	54.4	54.2	49.3	50.0	50.8	49.5

*Less financial aid from the federal budget (except for the balance of outstanding loans from the federal budget) and revenues to the targeted budget funds.

Source: the RF Ministry of Finance, authors’ calculations.

The data in *Table 14* evidence that starting from 1999 there has been a trend to centralization of revenues in the federal budget. During the period in question, the proportion of tax revenues to budgets of Subjects of the Federation in Russia’s consolidated budget

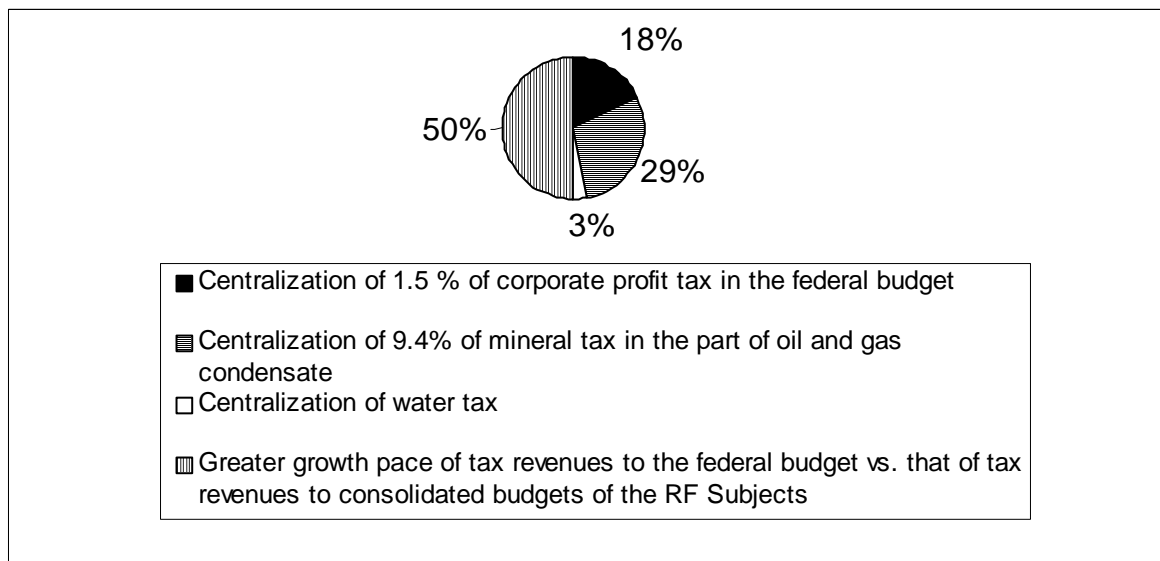
¹⁸ See: Rossiyskaya Ekonomika. Tendentsii i Prespektivy. Vypusk 26. M.: IEPP, 2005.

slid from 56.6% in 1998 to 30.9% in 2005, while the proportion of all budget revenues of the Subjects in Russia's consolidated budget plunged from 54% to 33.8%, accordingly. It should be noted that 2005 saw a drastic fall in the share of the Subjects' tax revenues in the nation's consolidated budget – by 5.2 percent points vs. 2004.

The causes for such a fall were:

- 1) centralization of taxes in the federal budget, and
- 2) a greater pace of growth of taxes and payments due primarily to the federal budget.

Fig. 12 presents the contribution different factors have made to the fall in the proportion of the Subjects' budget tax revenues in Russia's consolidated budget in 2005 vs. 2004.



Source: the RF Ministry of Finance, authors' calculations.

Fig. 12. Contribution of Various Factors to Decline in Proportion of Tax Revenues of Budgets of the RF Subjects in Russia's 2005 Consolidated Budget vs. the 2004 Consolidated Budget

The decline in the proportion of tax revenues to budgets of the RF Subjects in Russia's consolidated budget was fueled to significant extent by a greater growth rate of tax revenues to the federal budget compared with the rise in tax revenues of consolidated budgets of Subjects of the Federation. Thus, given that in 2005 all the revenues to consolidated budget of RF showed a 50% rise in nominal terms vs. 2004, the growth rate of customs duties accounted for 90% and that of mineral tax – 78%, respectively.

The centralization of taxes in the federal budget also contributed to the decline in the proportion of the RF Subjects' revenues in the nation's consolidated budget – in 2005, 1.5% of the corporate profit tax and 9.4% of the mineral tax in the part of oil and gas condensate, and water tax were centralized into the federal budget. From the perspective of subnational finance, the most significant effect was secured by the centralization of the mineral tax, which, however, did not embrace all regions, but those wherein oil and gas condensate are produced. In 2005, there were 39 such regions in Russia, while roughly as much as 95% of losses of the regional budgets resulting from the centralization of the mineral tax fell on 14 regions whose budgetary sufficiency level was greater than the average

nation one¹⁹. Thus, it can be concluded that the centralization of 9.4% of the mineral tax in the part of oil and gas condensate ensured a considerable equalization effect. By contrast, the centralization of two other taxes – that is, 1.5% of corporate profit tax and water tax concerned all the RF Subjects, albeit the respective equalization effect proved to be less significant. The regions not entitled to subsidies from the Federal Fund for Support of Regions suffered losses whose aggregate share accounted for some 40% of losses from the centralization of the water tax and some 70% of losses from the centralization of 1.5% of the corporate profit tax. Both measures, nonetheless, have had a certain equalization effect on the RF Subjects' budgetary sufficiency level. However, given a great dispersion of tax sources in the territory of Russian Federation, it can be suggested that in the current conditions centralization of practically each and every tax and levy will result in equalization of the level of the RF Subjects' budgetary sufficiency. With fixing tax sources with levels of the budgetary system, the degree of evenness of distribution of a given tax base should not form a sole criterion, for keeping subnational authorities keen to boost regions' tax capacity appears an equally important challenge. In conjunction with this, we believe there is no explicit need in centralization of the corporate profit tax and water tax.

In parallel with the above processes, the proportion of the RF Subjects' expenditures in the consolidated budget of the Russian Federation fell from 50.8% to 49.5%. Such a decline is most likely to be attributed to the following reasons: the federal budget expenditures were growing at a pace greater than that of the RF Subjects, while the decline in expenditures of the subnational budgets was driven by the lowering of the single social tax rate. Interestingly, by the end of 2005 revenues to the RF consolidated budget grew from 32.2% of GDP in 2004 to 35.1% (at 2.8 p.p.), while the growth in revenues to the federal budget accounted for 3.3 p.p. of GDP. The RF Subjects' revenues fell to 13.8% of GDP from 14.3% of GDP reported in 2004. To a significant extent (at some 0.26% of GDP) the decline was caused by the centralization of the mineral tax. It was the factor that generated decline in the proportion of tax revenues to consolidated budgets of the RF Subjects in tax revenues of Russia's consolidated budget. In parallel with the decline in tax revenues in 2005, there occurred, as noted above, the decline in the aggregate final revenues to regional budgets from 13.8% of GDP from 14.3% in 2004, which was caused by the contraction in interbudgetary transfers to regional budgets at 0.15% of GDP.

The above data allow conclusion on a considerable centralization of financial resources in the federal budget vis-avis the RF Subjects' budgets. While tax revenues grew on the whole, the growth turned to be favorable mostly to the federal budget. By the same token, the federal financial assistance to regions computed in the share of GDP equivalent shrank under an insignificant decline in the share of regional budget expenditures in the consolidated budget of RF. All this testifies to a greater vertical imbalance in distribution of revenue sources and fixing expenditure obligations between the federal and regional levels of power.

Whilst considering the state of tax revenues to the consolidated regional budgets in 2005, one should note that like before, more than a half of tax revenues are secured by revenues from the two taxes – that is, personal income tax (34% of tax revenues to regional budgets) and corporate profit tax (46%). More than this, the proportion of revenues from these taxes in tax revenues to regional budgets in 2005 displayed a drastic rise vs. 2004 (from 69% to 80%), thanks chiefly to the growth in corporate profit tax. Interestingly,

¹⁹ Orenburg, Tomsk, Samara, Astrakhan, Sverdlovsk, Perm, Tyumen oblasts, Khanty-Mansy, Yamalo-Nenetsky autonomous okrugs, Republic of Tatarstan, Republic of Bashkortostan, Republic of Komi, Nenetsky autonomous okrug, and Krasnoyarsky krai.

in 2005 revenues from personal income tax in the share of GDP equivalent slightly lowered (a. 3.3% of GDP), while those from corporate income tax grew drastically (from 3.9% of GDP to 4.4% of GDP). Revenues from excise taxes dropped insignificantly (down to 0.7% of GDP), while those from payments for the use of natural resources fell considerably (to 0.26% of GDP vs. 0.9% of GDP in 2004), and taxes on small business grew from 0.3% of GDP up to 0.33% of GDP.

The above phenomena continues the process of centralization of tax revenues in the federal budget launched back in 2003. As a reminder, the year of 2003 saw coming into effect such decisions as a complete abolition of the road users tax and transition to a complete collection of revenues from tobacco excise taxes into the federal budget. The tendency intensified in 2004, with the abolition of the sales tax and a whole range of levies revenues from which had been subject to collection to the RF Subjects' budgets, and the growth in the federal proportion of the mineral tax. In 2005, the government continued to centralize the mineral (oil and gas condensate) tax (9.4 p.p.), as well as the water tax and 1.5 p.p. of the corporate profit tax.

While in 2004 the tax centralization moves were fully compensated for by such measures in the area of interbudgetary redistribution of tax revenues as a full reassignment of the federal part of tax revenues under special regimes of taxation of small businesses to the RF Subjects' budgets, of the federal proportion of liqueur excises along with a simultaneous reforming of procedures of their payments, and of 1 p.p. of the federal rate of the corporate profit tax, in 2005, as shown above, the centralization measures failed to be compensated either by an equal reassignment to regions of other taxes and levies, or an increase of financial assistance from the federal budget.

As a result, the RF Subjects' tax revenues dropped by 0.3 p.p. of GDP vs. the prior year. That occurred primarily thanks to the centralization of 9.4% of the mineral tax in the part of oil and gas condensate (0.26% of GDP) and lowering the personal income tax (0.16% of GDP). A considerable rise in revenues to the regions' consolidated budgets in 2005 was noted only with regard to the corporate income tax (by 0.46 p.p. of GDP), as well as property taxes (0.29 p.p. of GDP). The rise in revenues from the corporate income tax was fueled exclusively by the growing tax base, regardless of the declining regional share of the corporate income tax. It can be suggested that the expansion of the tax base of the corporate income tax has been under positive influence of the decrease of the basic VAT rate from 20% to 18% in 2004. According to some hypotheses, the growth in revenues from the corporate income tax since 2004 can be attributed to the taxpayers' greater discipline, which was caused by the federal authorities' steps against YUKOS. Given such a rapid growth of the tax base and taxpayers' discipline, it can be suggested that despite the mobility and a considerably uneven dispersion of corporate profit tax across the RF territory, its role in budgets of the RF Subjects will be growing.

Meanwhile, the analysis of the indicator of tax revenues per capita to the RF Subjects' consolidated budget shows that the inter-regional diversity of it decreased in 2005 – thus, the value of the respective Gini coefficient accounted for 0.51 vs. 0.57 reported in 2004. The decrease of the interregional unevenness of tax revenues per capita to the RF Subjects' consolidated budgets took place chiefly due to centralization of unevenly distributed taxes – that is, the mineral and corporate profit taxes, – as well as because of the growth in the proportion of relatively evenly distributed between regions property taxes in the RF Subjects' consolidated budgets (from 6.1% in 2004 to 8.5% in 2005).

In 2005, of all the RF Subjects 14²⁰ reported fall in their revenues in real terms, while in 2004 only four Subjects had found themselves in such a situation, which partly proves the above thesis of the centralization of a number of taxes in the federal budget in 2005 falling short of being compensated for with decentralization of other taxes and levies or an equal increase of the financial assistance from the federal center. The maximum fall in absolute terms was registered in Khanty-Mnasy AO, Chechen Republic, Republic of Mordovia, Chukotka AO, and Evenk AO. The drop in revenues in Khanty-Mansy AO is explained by the fact that the region suffered the greatest losses from the centralization of the mineral tax in the part of oil and gas condensate. In Chechen Republic, the federal center cut its financial assistance and centralized the mineral tax which resulted in a similar situation, however, yet another factor was that the proportion of corporate profit tax revenues from which in the total volume of revenues to budgets of other regions demonstrated the most rapid growth in 2005 accounted for the meager 1.8% in the Republic's budget. The fall in revenues to the Republic of Mordovia's budget can be attributed to the fact that the peak of the additional collection of tax payments from the taxpayers – oil traders and brokers registered in this particular Subject of the Federation, which used to grant considerable tax benefits, fell on 2004. The peak was passed in 2005, and the proportion of corporate profit tax in tax revenues to the regional budget slid from 78% in 2004 to 61%, while the Republic's consolidated budget revenues plunged by 16%. Similarly, revenues to the budget of Chukotka AO sunk – the proportion of corporate profit tax in the regional budget revenues fell from 57% in 2004 to 42% in 2005. As concerns Taymyrsky and Evenk autonomous okrugs, the fall in their respective revenues can be attributed to modified tax powers under which proceeds from their corporate tax revenues have begun to be collected to the budget of Krasnoyarsk krai.

In parallel with that, a maximum increment in tax revenues in absolute terms was noted in the city of Moscow, Tyumen oblast, Moscow oblast, St. Petersburg and in Samara oblast, i.e. in the regions with a high budgetary sufficiency (the city of Moscow, Tyumen oblast, St. Petersburg and Samara oblast) and those where the proportion of the corporate profit tax in the structure of tax revenues is high (the city of Moscow, Tyumen and Samara oblasts).

The analysis of the dynamics of tax revenues per capita evidences that the maximum positive increment in tax revenues per capita in real terms was registered in such regions as Tyumen oblast, Novgorod oblast, Koryaksky AO, Stavropol krai and Novosibirsk oblast. The success of Tyumen oblast is easily explained by high oil prices, as well as a considerable proportion of the corporate profit tax in the revenue structure of the oblast's consolidated budget (63%). In contrast, a considerable rise in the average per capita revenues in real terms in Novgorod, oblast, Stavropol krai, Novosibirsk oblast and Koryaksky AO cannot be explained by the above phenomena. The budgetary sufficiency level in these particular regions is below the average nationwide level, while the share of the corporate profit tax in their consolidated budgets fluctuates between 3% in Koryaksky AO to 23% in Novgorod oblast, i.e., again, below the average level. The rise in revenues in the least budgetary sufficient of the noted regions (Koryaksky AO and Stavropol krai) can be attributed primarily to a greater volume of financial assistance out of the federal budget, while a similar phenomenon in Novgorod and Novosibirsk oblasts was fueled by an accelerated rise in revenues to their consolidated budgets from personal income tax, corporate

²⁰ Bryansk oblast, Republic of Kalmykia, Karachayevo-Cherkesskaya Republic, Chechen Republic, Republic of Mordovia, Komi-Permyatsky AO, Khanty-Mansy AO, Republic of Buryatia, Aginsky Buryatsky AO, Taymyrsky (Dolgano-Nenetsky AO), Ust-Ordynsky Buryatsky AO, Evenk AO, Jewish AO, Chukotka AO.

profit tax, taxes on small businesses, and property taxes. In both oblasts it was corporate profit tax that displayed the greatest growth rate – its growth in real terms vs. its respective index of 2004 accounted for 85% in Novgorod and 35% in Novosibirsk oblasts.

Thus, the above provides grounds to reckon that all the regions experienced a growth in revenues, except for the aforementioned 14 ones. Given a drastic growth of the federal budget revenues, this proves the existence of a certain centralization of tax revenues, as well as a growing vertical imbalance of the budgetary system. Meanwhile, the unevenness of distribution of tax revenues in 2005 has declined for the first time over recent years, which can be explained by the assignment to the federal budget of taxes with unevenly distributed base. Despite the re-assignment of 1.5% of corporate profit tax to the federal budget, the role this particular tax plays in the subnational finance grew in 2005, which can be proved by the fact that the coefficient of the correlation between the dynamics of revenues to consolidated budgets of the RF Subjects and the ones of payments on corporate profit tax made up 75% in 2005.

The year 2005 became the second straight year of an aggregate surplus of the RF Subjects' consolidated budgets, with the respective index accounting for 0.26% of GDP, which is at 0.06% of GDP more than in 2004. The surplus resulted in a 0.48 p.p. of GDP growth in balances of budget funds as of the end of the reported period.

The group of sources of financing the regions resort to in 2005 comprises issuing state and municipal securities, attracting credits on behalf of the RF Subjects and municipal entities, and privatization of the government and municipal property. Notably enough, like in the period of 2003-05, the country as a whole displayed a negative balance of such a source of financing of budgetary deficit as federal budgetary loans and budgetary credits (since 2005 – budgetary credits only), i.e. between 2003 and 2005 across the country as a whole the Subjects of the Federation repaid loans and credits at a volume greater than that of newly received loans and credits. This can be conceived as a radical change of the negative trend in existence prior to 2003²¹.

The analysis of quantitative characteristics of the financial assistance to the RF Subjects' budgets from the federal budget (see *Table 2*) shows that, despite a considerable increase of tax revenues to the federal budget, the volume of federal financial resources transferred for free to the subnational budgets demonstrated a insignificant growth in nominal terms. In 2005, it roughly accounted for Rb. 487 bn., or 2.25% of GDP (vs. 2.39% of GDP in 2004). However, in real terms the financial assistance to regional budgets displayed a 9.5% growth vs. 2004, while revenues to the federal budget over the period in question grew by 35%.

In 2005, the federal budget expenditures on financial assistance to the RF Subjects and municipal entities underwent certain modifications vis-à-vis a number of prior years. Thus, the tendency to lowering the financing from FFFSR was in place, with the respective support declining from 1.14% of GDP in 2001 to 0.88% of GDP in 2005. Given that the methodology of formation of the Fund is one of the most transparent ones this tendency cannot be viewed as a positive one. The volumes of financing from the Fund for Financing Social Expenditures displayed a drastic rise – from 0.04% of GDP in 2004 to 0.12% of GDP in 2005. The main cause for such a rise became the monetization of benefits (with subsi-

²¹ In 2005, new amendments to the Budget Code of RF came into effect. In compliance with the new version of the Code, which does not provide for such a kind of financial assistance as budgetary loans, there has been set a strict requirement to the RF Subjects' budgets to return budgetary credits within a given budgetary year. The failure to do so entails repayment of the remaining part of the credit, including interest, penalties and fines by means of subsidies from the Federal Fund for Support of Subjects of the Russian Federation, as well as deductions from the federal taxes and levies, the taxes provided for by special tax regimes (except for local taxes) due for collection to the budget of the RF Subject.

dies on a partial compensation for expenditures on measures of social support of veterans and laborers of the Home Front during the Great Patriotic War accounting for a considerable part of the Fund's expenditures). Likewise, subsidies on provision of measures on maintenance of balanced regional budgets grew considerably – from 0.11% of GDP up to 0.24% of GDP. This particular kind of financial assistance has become in 2005 a principal instrument the federal center used to smooth down negative shocks that regional budgets faced at the time, as well as to equalize the vertical imbalance of the budgetary system. The vigorous use of this particular mechanism of financing aggravated the problem of soft budget constraints in 2005. The funding from the Federal Fund for Development of Regions shrank considerably, as since 2005 the Fund has begun to comprise only funds of the “Reduction of differences in socio-economic development of regions of the Russian Federation” program. As concerns positive outcomes of the 2005 development of interbudgetary relations, suffice it to note a considerable reduction in mutual settlements, which had been among the most non-transparent instruments of interbudgetary relations. Their volume plunged from 0.12% of GDP in 2004 to 0.01% of GDP in 2005.

In 2004–05 the government attempted to enhance the transparency of interbudgetary relations. Thus, in 2005, for the first time ever, resources of the FFFSR and the Fund for Compensations were allocated according to a methodology approved by the governmental Resolution. Likewise formalized became the procedures of formation and use of the Fund for Co-Financing of Social Expenditures, Fund for Reforming Regional Finance, and a part of subsidies on supporting measures on ensuring balanced budgets of the RF Subjects. Despite the accomplished reforms, particular characteristics of this kind of federal budgetary expenditures still are considerable amounts of funds distributed following the interbudgetary regulation procedures, but without any methodological and financial and economic justification. The proportion of financial assistance allocated on a formalized basis in the overall volume of transferred resources has been under 60%. Even given that, as far as the noted funds are concerned, it was only three Funds with respect to which procedures of formation and distribution were approved – namely: FFFSR, the Fund for Compensations and the Fund for Reforming Regional Finance.

Characteristic feature of the period of 2003-05 has become revision of the budget law and an increase of the originally pre-set amounts of financial assistance to regions at Rb. 67 bn. over the period in question. It should be noted that such modifications have lately become fairly routine, which questions the efficiency of the accomplished reform of allocation of financial assistance to regions.

To exemplify the existing procedures and principles of allocation of the additional financial assistance, suffice it to refer to the following decisions:

- 1) During 2005 the Fund for Compensations was increased from Rb. 33.4 bn. up to 35/8 bn., or at 7%;
- 2) The Fund for Co-Financing of Social Expenditures – from Rb. 23 bn. to 25.3 bn., or at 10%;
- 3) Subsidies to balance regional budgets were increased from Rb. 19.5 bn. to 52 bn., or at 167%.

Table 15

**Financial Assistance from the Federal Budget to Consolidated Budgets
of the RF Subjects between 1992 and 2006 (as % of GDP)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006*
1. Financial assistance to budgets of other levels	2.3	2.5	1.6	1.18	1.43	1.79	2.2	1.94	1.70	1.65	1.52
1.1. Federal targeted programs, as well as subsidies to the RF Subjects on support of agriculture, water-economic measures, support of small businesses, and children's health and rehabilitation										0.05	0.15
1.2. Fund for Co-Financing of Social Expenditures							0.15	0.11	0.04	0.12	0.11
1.3. Fund for Financial Support of Regions, including:	1.04	1.22	1.12	0.99	0.96	1.14	1.36	1.30	1.05	0.88	0.94
<i>Subsidies on equalization of budgetary sufficiency</i>	0.68	0.86	1.00	0.99	0.96	1.14	1.36	1.30	1.05	0.88	0.94
<i>State support of the "Northern Supply"</i>					0.06	0.08	0.08	0.07	–	–	–
<i>Transfers at the expense of VAT</i>	0.36	0.36	0.12	–	–	–	–	–	–	–	–
1.4. Subsidies and subventions including:	0.09	0.13	0.10	0.06	0.15	0.54	0.28	0.29	0.27	0.36	0.21
<i>Subsidies and subventions to closed territorial-administrative entities and the town of Baykonur</i>					0.11	0.12	0.11	0.11	0.09	0.07	0.07
<i>Subsidies to budgets to support measures on securing their balancing</i>									0.11	0.24	0.10
1.5. Resources of the Fund for Reforming Regional Finance						0.00	0.01	0.01	0.01	0.00	0.01
1.6 Other free and irrevocable transfers (subsidies and subventions)							0.01	0.01	0.01	0.01	0.08
1.7. Fund for Financing of Development of Regions					0.03	0.05	0.10	0.10	0.15	0.01**	0.01
1.8. Funds allocated by mutual settlements	0.81	0.43	0.36	0.14	0.28	0.05	0.20	0.14	0.12	0.01	
1.9. Loans and budget credits less repayment due to other levels of government	0.23	0.64	–0.03	–0.10	–0.08	0.02	0.09	–0.01	–0.02	–0.03	
2. Fund for Compensations						0.37	0.38	0.36	0.34	0.17	0.3
3. Other interbudgetary transfers				0.18	0.11	0.4	0.45	0.54	0.35	0.33	0.34
<i>of which:</i>											
–state support of the road sector				0.18	0.11	0.27	0.27	0.31	0.22	0.13	0.15
All the funds disbursed to other levels of government	2.3	2.5	1.60	1.36	1.54	2.56	3.03	2.84	2.39	2.25	2.17

* In compliance with the 2006 budget law.

** Since 2005 the Fund for Regional development comprises only resources of the program "Reducing disparity in socio-economic development between regions of Russian Federation".

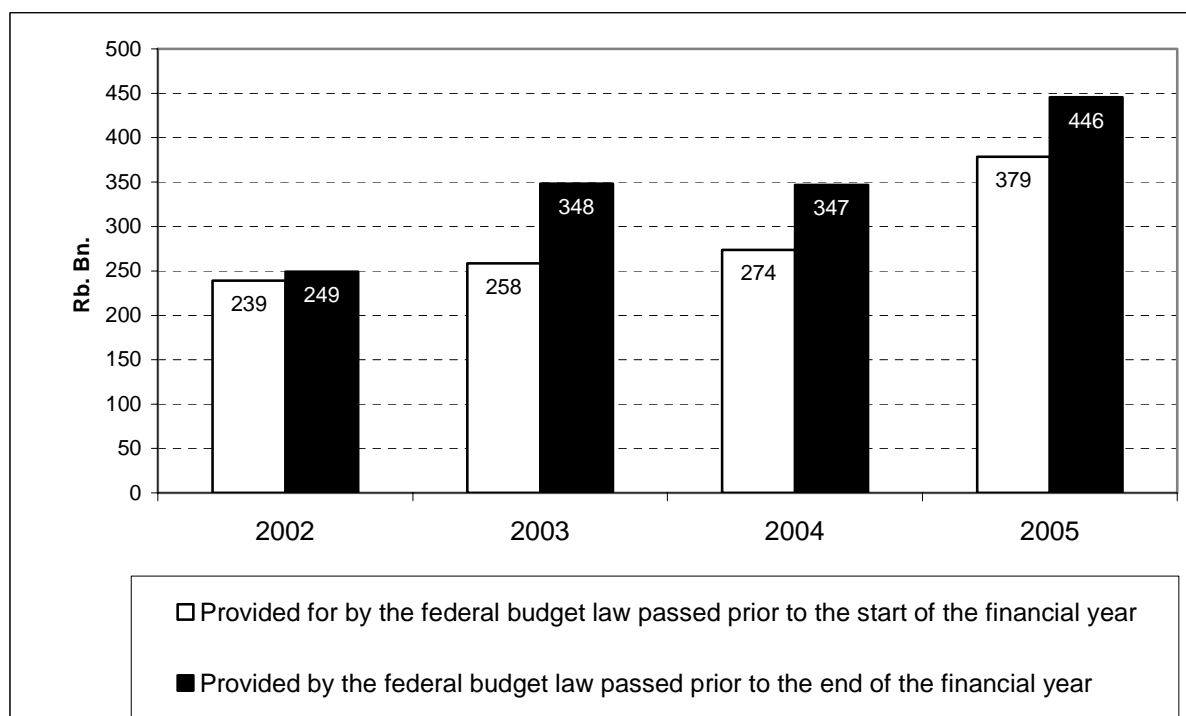
*** Since 2005 r. – only budgetary credits.

2.3.2. The Problem of Soft Budget Constraints for Regional Governments

The two previous annual reviews on the Russian economy and its trends and outlooks emphasized that the volume of financial resources allocated in the form of financial assistance to budgets of the RF Subjects recently was considerably in excess of the volume of financing that was initially provided for by the law on the federal budget of the respective year and of which regional authorities were duly notified. Thus, we believe that in 2003 the allocation of an additional financial assistance to regions through various channels was made in conjunction with the eagerness to secure favorable for the federal center outcomes of the parliamentary elections of December 2003.

This practice continued in 2005. Numerous statutes on amending the law on the federal budget²² were passed during the year. They implied distribution of additional federal budget revenues, particularly for the sake of boosting expenditures on various financial assistance issues.

Fig. 2 presents the data that characterize the difference between the volume of financial assistance to the regions, as originally set in the law on the federal budget passed by the Parliament and signed by the President right prior to the start of the financial year, and the volume of financial assistance, as fixed by the law on the federal budget effective as of end-financial year, i.e. with account of amendments introduced in the law during the year.



Source: Various drafts of the federal budget law on 2002, 2003, 2004, 2005.

Fig. 13. Excess of the Amount of Financial Assistance to Regions as per the Federal Budget Law Passed Prior to the End of the Financial Year over the Amount of Financial Assistance as per the Federal Budget Law Passed prior to the Start of the Financial Year

²² See the federal statute "On introducing amendments to the federal law "On the 2005 federal budget" passed by the State Duma on June 17, 2005; federal statute on introducing amendments to the federal law "On the 2006 federal budget" No. 141 FZ of November 4, 2005.

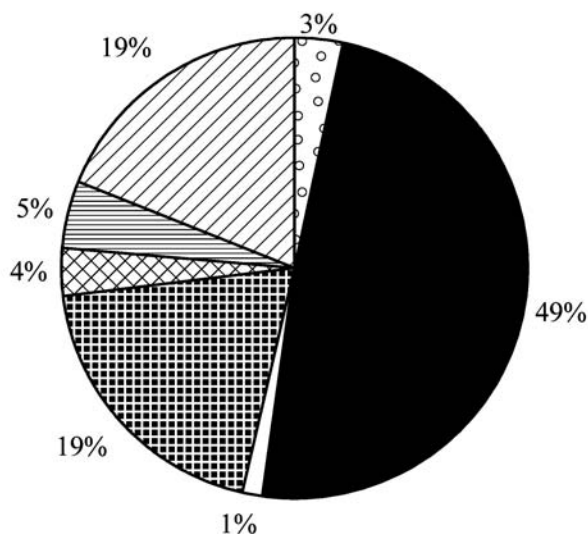
The data in the Figure above demonstrate that the volume of financial resources assigned as additional ones to the volume stipulated in an original draft of the budget law grew dramatically in 2003–05. While the 2002 federal budget law enacted in end-2002 provide for just a 4.2% rise of funds to be distributed between the RF Subjects' budgets vis-à-vis the original intent at the start of the year, in 2003 the respective index ultimately made up 34.8%, in 2004 – 26.7%, and in 2005 – 17.7%.

Underlying such increases may be several causes, of which some appear characteristic of the whole period of 2003–05, while the others are episodic.

The universal causes for the emergence of soft budget constraints lie with the following peculiarities of Russia's economic and political situation:

- 1) an insufficient quality of financial planning – at the beginning of the year policy makers fail to accurately assess both the federal budget revenue indicators and the regions' need in financial resources;
- 2) because of the “corporate spirit” of the Russian federalism, the federal center bears a considerable drag of political responsibility for some regions' socio-economic state. That is why the federal authorities would deliberately leave at their disposal a considerable volume of financial resources, for the sake of their distribution over a given financial year between the regions, which, due to economic and/or political reasons, are in need for additional funding;
- 3) the planning of revenue and expenditure indices of the federal budget was made proceeding from a conservative forecast of the situation in the foreign trade area, while a favorable situation in the world market for minerals would entail a great inflow of additional revenues, which would partly be assigned between regions in the form of financial assistance.

In addition to the above causes, there exist a number of episodic factors that determined a considerable excess of the actually allocated volume of financial assistance in late 2004 over the planned one. To evaluate the reasons, one needs to identify main sources of the excess of the actual volume of interbudgetary transfers over the planned one. In 2005, the noted excess accounted for Rb. 66.9 bn. *Fig. 14* presents the contribution of various kinds of financial assistance to the excess of the volume of interbudgetary transfers to regions as of end-2005 over the respective index as of the beginning of the year.



- ▣ Federal Fund for Co-Financing of Social Expenditures
- Subsidies for supporting measures on provision of balanced budgets of the RF Subjects
- Subsidies to closed administrative-territorial entities
- ▤ Subsidies for compensation for losses from maintenance of the housing and communal objects and those of socio-cultural sphere delegated under the mandate of the municipal self-governance bodies
- ▨ Fund for Compensations
- ▧ Subsidies to Tatarstan
- ▩ Other interbudgetary transfers

Source: federal statute No. 173-FZ of December 23, 2004 "On the 2005 federal budget" and federal statute No. 141-FZ of November 4, 2005 "On introducing amendments to the federal statute 'On the 2005 federal budget'".

Fig. 14. Contribution of various Kinds of Financial Support to the Excess of the Volume of Interbudgetary Transfers to Regions as of End-2005 over the Respective Index of the Beginning of 2005

The data presented by *Fig. 14* evidences that:

- nearly half of the unplanned in the beginning of the year financial assistance falls on subsidies on support of measures on securing the balancing of the RF Subjects' budgets;
- 19% falls on subsidies to the RF Subjects on compensating for losses from maintenance of housing and communal objects and objects of the socio-cultural sphere delegated under mandate of local self-governance bodies;
- 5% – on the Fund for Compensations (additional funding was assigned to regions to exercise the federal powers with respect to the state registration of acts of civil status);
- 3% – on the Fund for Co-Financing of Social Expenditures (the excess of the actual volume of funding over those planned at the beginning of the year occurred due to an inaccurate assessment of the volume of subsidies to residents on housing payments).

In 2005 over 80% of unplanned in the beginning of the year interbudgetary transfers was assigned using above financial mechanisms.

The main causes for the rise of additional interbudgetary transfers in 2005 became:

- 1) liquidation of unfounded federal mandates (aka “monetization of benefits”), the part of the burden on which was paid upon regional budgets. As the process of preparation of the reform at the federal level was not synchronized with the local budgeting processes, there arose the need in increasing the subnational governments’ expenditures. Most regions found themselves unprepared for such an increase, which resulted in the social tension, which the federal center was compelled to mitigate by means of boosting interbudgetary transfers. That formed the cause for a dramatic rise of subsidies on supporting measures on securing the balancing of the RF Subjects’ budgets.
- 2) Lack of harmonization between the administrative reform and the budgeting resulted in the situation in which, following the division of property into the federal, regional and municipal ones, a number of the housing and communal, and socio-cultural objects were re-assigned to regional and local self-governance authorities without any financial provision. As the law has failed to strictly stipulate the property assignment procedures, in practice regions and municipalities often refuse to accept thus assigned property. This results in certain social problems, as the property comprises colleges, schools, kindergartens, departmental housing facilities, etc. To eliminate social tension, the federal center has had to transfer to regions earlier unplanned subsidies on compensation for losses from maintenance of housing and communal objects and objects of the socio-cultural sphere delegated under mandate of local self-governance bodies.
- 3) Plainly political reasons: thus an increase of the volume of the subsidy on implementation of measures under the federal targeted program entitled “Socio-economic development of the Republic of Tatarstan until 2006” was likely to be attributed to the celebration of the thousandth anniversary of the city of Kazan and a special status of the region in question.

Regardless of reasons, the current situation exerts the most adverse influence on incentives for regional authorities to pursue an efficient budgetary policy. The situation in which the federal authorities do not abide by already declared principles in the course of allocation of financial resources and grant financially challenged regions with an extra help, or, as in the case of Tatarstan, they practice unequal approaches to different regions is known in the literature as *soft budget constraints*. As evidenced by international experiences, soft budget constraints for subnational authorities generate a whole series of adverse economic effects, such as an excess of an efficient level of budgetary expenditures, as well as more general effects (the rise of obstacles to growth in private investment and a growing number of inefficient investment projects that bear greater risks).

In reality this means that in the situation in which regional authorities have all the grounds to expect financial assistance in addition to its originally announced volume there may arise several sorts of adverse effects. First, the regional authorities now can assume greater risks while implementing both budget programs and borrowing programs. Second, the probability of receipt of an extra funding enables them to assume additional obligations in the form of accounts payable and not to attempt to increase efficiency of budgetary expenditures in the region. Third, given their past experiences and being aware of a tentative list of indicators basing on which the federal government will distribute an additional financial assistance between regions, the regional authorities can influence values of the respective indicators (for instance, levels of accounts payable in their region, wage arrears in the public sector, the budgetary institutions’ debt on communal payments, etc.). As a result, the seemingly favorable for the local population decision on allocation of an extra financial assistance can generate negative effects both for the population in a given region and the country as a whole (so far as the state of its public finance is concerned). The

probability of the rise of such effects is growing if the receipt of an additional financial assistance occurs periodically.

The factor that fosters the emergence and presence of the Russian subnational authorities' soft budget constraints is increase in the aggregate volume of financial assistance, as per the federal budget law. However, there exists yet another factor – that is, the continuously great volume of financial resources announced yet on the eve of the start of the new financial year. However, the decision-making powers with regard to a specific methodology of their distribution are delegated to the federal government that rules the respective decisions during the financial year. The regional authorities consequently have no information of how these or those funds will be distributed, which creates incentives for the rise of soft budget constraints, as well as encourages regional authorities to seek additional financial assistance.

Thus, in 2005, the federal budget law failed to distribute between regions over 26% of resources to be spent on subsidies on getting regional budgets balanced – the Rb. 38.417 bn.-worth subsidies allocated to the RF Subjects' budgets for the sake of getting them balanced were distributed according to Annex 16 to the federal budget law. Plus, procedures of allocation and amounts of subsidies designated for the same purpose and totaled Rb. 13.639 bn. were to be identified by the RF government.

Creation of reserves along with the failure to strictly set procedures of their utilization at the start of the financial year can also affect the regional authorities' fiscal behavior (in the form of an attempt to receive from the federal center yet unallocated financial resources, instead of seeking optimization of their own financial resources), as well as the control over distribution and consumption of the resources in question.

The practice has survived through 2005. As evidence by the data of *Fig. 15*, the proportion and volume of subsidies on getting regional budgets balanced have been considerable between 2004 and 2006. The proportion of the funds roughly accounts for j of the overall volume of the respective subsidies. The situation has been particularly bad in 2005, with 72%, rather than the usual 24–26%, of subsidies being allocated de-facto at the discretion of the government. Basing on the earlier designed methodology, at the beginning of the year the budget law read that just as much as Rb. 14.5 bn., or 28% of the total volume of subsidies on stabilization of regional budgets as per the federal budget law as of end-2005 was to be distributed between regions. This means that the government planned and actually implemented the rest of the volume of financing through the end of 2005. Plus, given that in 2004 the volume of subsidies on support of measures on stabilization of the RF Subjects' budgets had remained unchanged during the year, in 2005 the government made decisions that boosted the volume of financing considerably.

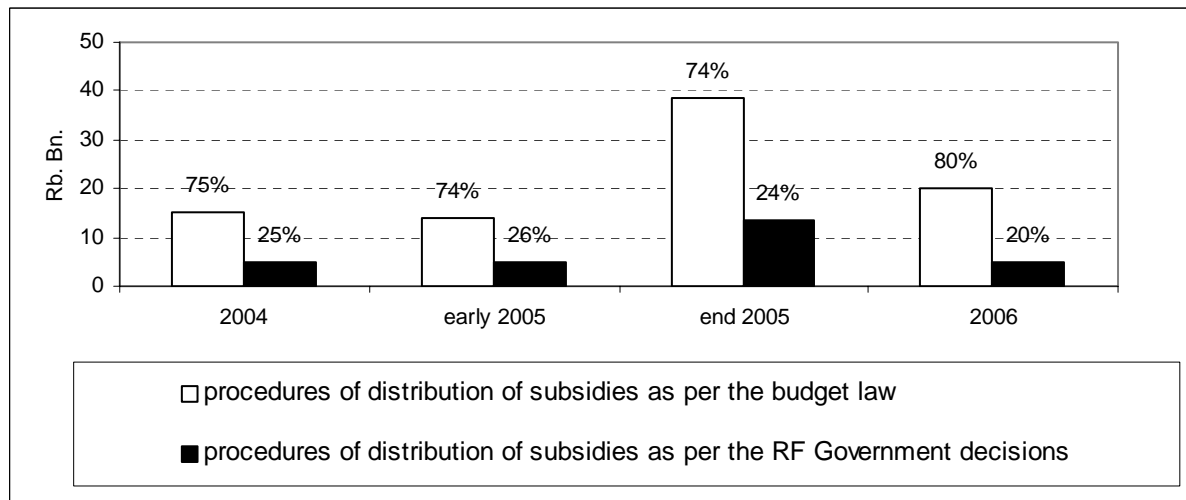


Fig. 15. The Dynamics of the Volume of and proportion of Subsidies on Stabilization of Regional Budgets Allocated Proceeding from the Methodology of Distribution of the Given Funds and at the Discretion of the Government (as Rb. Bn.)

Subsidies to Budgets of Subjects of the Russian Federation on Supporting Measures on Provision of Stabilization of Budgets of Subjects of the Russian Federation

Whereas subsidies to budgets of subjects of the Russian Federation on supporting measures on provision of stabilization of budgets of Subjects of the Russian Federation have become in 2005 a critical mechanism that secured “flexibility” of the federal budget in the part of interbudgetary transfers, it is appropriate to provide a detailed depiction of the effect the instrument of financial assistance to regions has on the subnational authorities’ fiscal behavior.

The methodology of distribution of subsidies to budgets of the RF Subjects on supporting measures on provision of stabilization of budgets of the RF Subjects was approved by the government Resolution of November 4, 2004. According to the methodology, the said subsidies are assigned in three stages.

At the first stage, the subsidies are assigned for the sake of a partial compensation for the decrease in the volume of resources of the Federal Fund for Financial Support of Subjects of the Russian Federation according to the following formula:

$$S1_i = S1_{rf} * D_i / D_{rf},$$

where

$S1_i$ is the amount of the subsidy to a given Subject of the Federation assigned at the first stage;

$S1_{rf}$ – the amount of subsidies assigned to all the Subjects of the Federation assigned at the first stage (the amount of the subsidies to be assigned at the first stage accounted for 20% of the initially planned volume of subsidies allocated according to the said methodology, or Rb. 2 bn.²³);

²³ As a reminder, a part of subsidies to Subjects of RF on supporting measures on securing stabilization of their budgets is allocated following the government decision, rather than an earlier approved methodology.

D_i – difference between the volume of funds assigned to the Subject of RF out of the Federal Fund for Financial Support of Subjects of the Russian Federation, as per the federal statute “On the 2004 Federal Budget” and the volume of funds provided for the Subject of RF from the Federal Fund for Financial Support of Subjects of the Russian Federation for 2005 (only positive values are accounted for computation);

D_{rf} – the difference between the volume of funds assigned to all the Subjects of the Federation from the Federal Fund for Financial Support of Subjects of the Russian Federation, as per the federal statute “On the 2004 Federal Budget” and the volume of funds provided for the Subject of RF from the Federal Fund for Financial Support of Subjects of the Russian Federation for 2005 (only positive values are accounted for computation).

Meanwhile, the right for the subsidy assigned at the first stage is granted only to the Subjects of the Federation that succeeded to match two conditions:

- 1) the share of the fall in the volume of subsidies out of FFFSR for a given region in the revenues of the consolidated budget of the RF Subject²⁴ has been over 3% over eight months of 2004;
- 2) the share of subsidies from FFFSR in the revenues of the consolidated budget of the RF Subject exceeded 10% over eight months of 2004.

While 14 regions²⁵ have succeeded to match the first criterion, of which only Astrakhan and Tomsk oblast failed to meet the other one and, accordingly, they failed to receive subsidies at the first stage.

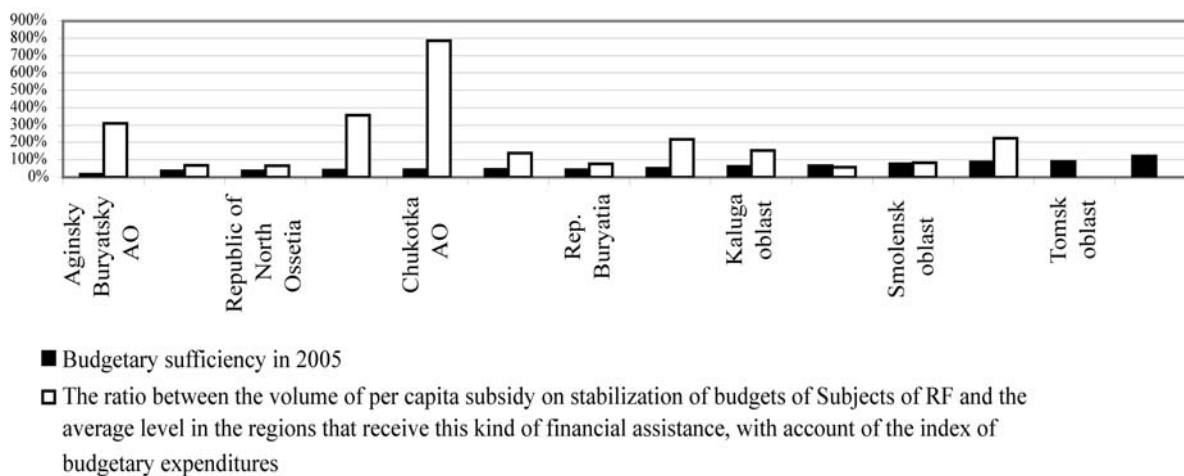


Fig. 16. Correlation between Subsidies on Stabilization of Budgets of Subjects of RF Allocated on the First Stage from Budgetary Sufficiency of Subjects of RF

Thus, the subsidies on stabilization of regional budgets assigned at the first stage partially duplicate those from FFFSR. However, by contrast with the latter, their earmarking is based upon an actual data on consolidated budgets of the RF Subjects, which discourages regional authorities to employ their own fiscal efforts to get budgets balanced. The

²⁴ Without regard to resources of the Fund for Compensations, subventions on implementation of development programs for cities as R&D centers, subventions to the city of Moscow on exercising federal powers, disposal of nuclear wastes, and forward transfers.

²⁵ Kaluga, Smolensk, Tomsk, Astrakhan, Chita and Sakhalin oblasts, Republics of Kalmykia, North Ossetia-Alania and Buryatia, Khabarovsk krai, Aginsky Buryatsky, Koryaksky and Chukotka autonomous okrugs, and Jewish autonomous oblast.

hypothesis of the duplication by the noted subsidies of those assigned from FFFSR can be proved by the following considerations:

The two regions (Astrakhan and Tomsk oblasts) which failed to receive the stabilization subsidies despite a “considerable (in the frame of the methodology) fall in subsidies out of FFFSR, had enjoyed a high level of budgetary sufficiency (123% and 89%, respectively, with the 2006 projected value of the indicator of Tomsk oblast accounting for 107%). The other regions had a low level of budgetary sufficiency – 58% on average. There is a certain correlation between the size of stabilization subsidies and budgetary sufficiency highlighted by *Fig. 16*.

The data of *Fig. 5* evidences that there exists a certain negative correlation between the size of the per capita subsidy on stabilization of the RF Subjects’ budgets assigned at the first stage and with account of the index of budgetary expenditures and the region’s budgetary sufficiency. Our computations show that the correlation coefficient between these two indices accounts for –40.2%. It could be greater, if in the course of allocation of subsidies one employed a computation tax capacity of a region, rather than actual data on its revenues. The correlation coefficient in that case would make up – 90.1%. Hence, subsidies on stabilization of regional budgets allocated at the first stage appear to be a mere duplication of those from FFFSR, thus creating negative fiscal incentives for regional authorities.

At the second stage, Rb. 3-bn. – worth subsidy is distributed for the sake of a partial compensation for revenues and increasing expenditures of the RF Subjects’ budgets due to a partial centralization of the tax on minerals in the form of oil and gas condensate, centralization of water tax and 1.5 points of the corporate profit tax rate in the federal budget and according to the following formula:

$$S2_i = S2_{rf} * (O1_i + O2_i + O3_i - H_i) / (O1_{rf} + O2_{rf} + O3_{rf} - H_{rf}),$$

where

$S2_i$ – the size of the subsidy to i -Subject of the Federation allocated at the second stage;

$S2_{rf}$ – the size of the subsidy to all Subjects of the Federation allocated at the second stage;

$O1_i$ – the size of centralization of 9.4% of the tax on minerals in the form of oil and gas condensate for i -Subject of the Federation;

$O2_i$ – the size of centralization of the water tax for i -Subject of the Federation;

$O3_i$ – the size of centralization of 1.5% p. of corporate profit tax in the federal budget for i -Subject of the Federation;

H_i – the size of savings on expenditures due to the lowering of the uniform social tax for i -Subject of the Federation;

$O1_{rf}, O2_{rf}, O3_{rf}$ – the aggregate size of centralization of the tax on minerals in the form of oil and gas condensate, centralization of water tax and centralization of 1.5 points of the corporate profit tax rate in the federal budget across all the Subjects of the Federation;

H_{rf} – the aggregate size of the economy on expenditures due to the lowering of the uniform social tax for i -Subject of the Federation.

The right for the subsidy distributed at the second stage is granted only to those Subjects of the Federation for which the level of the computation budgetary sufficiency after distribution of FFFSR appeared under 110% for 2005.

For 44 Subjects, the amount of saving on expenditures due to the lowering of the uniform social tax exceeded losses from the centralization of the noted taxes, therefore at the second stage these regions failed to receive subsidies on stabilization of their budgets. Of the remaining 45 regions for which a negative budgetary effect from the centralization of the taxes exceeded the amount of saving from the lowering of the UST rate, 14 Subjects did not receive subsidies on stabilization of their budgets, because the level of their budgetary sufficiency had become over 100%²⁶. So, at the second stage the noted subsidies were allocated to 31 regions, with the aggregate amount of negative changes in the budget stabilization across these regions amount to over Rb. 11.7 bn. So, thanks to the subsidies, at the second stage it became possible to remedy only 25.6% of the imbalance of regional budgets caused by modifications in the tax law.

Given that, the question arises as to what effect the federal center was going to ensure by allocating this very volume of funds according to the noted formula. Clearly, it did not set a task of compensating for 100% of all the withdrawn revenues, otherwise it would have appropriated a far greater volume of funds, without linking them to a degree of budgetary sufficiency. If the federal center was after equalization of the budgetary sufficiency of the RF Subjects, it is unclear what was the reason for allocating the subsidies to regions whose budgetary sufficiency was above the average nationwide level²⁷. Those highly sufficient regions received 33% of the budget stabilization subsidies allocated at the second stage.

To prove the hypothesis that the subsidies on stabilization of regional budgets allocated at the second stage were bearing no equalization effect, *Fig. 6* highlights on the correlation of the subsidies on stabilization of budgets of the RF Subjects allocated at the second stage and the RF Subjects' budgetary sufficiency.

The data presented on *Fig. 17* show that there is no significant negative correlation between the amount of the per capita subsidy on balancing the RF Subjects' budgets with account of the budgetary expenditures index and the region's budgetary sufficiency. Our computations show that the coefficient of the correlation between these two indices accounts for -17.2%.

At the third stage, the Rb. 5-bln. – worth subsidy is assigned for the sake of a partial compensation for the re-assignment of main powers with regard to the preschool education, general education, primary and secondary vocational training. The assignment follows the formula:

$$S3_i = S3_{rf} * H_i / H_{rf},$$

where

$S3_i$ – the size of the subsidy to the subject of RF assigned at the second stage;

$S3_{rf}$ – the size of the subsidies to all the RF Subjects assigned at the third stage;

H_i – the amount of the increase in expenditures of budgets of all the RF Subjects, due to the re-assignment of main mandates on provision of the preschool education, general education, primary and secondary vocational training.

²⁶ Lipetsk oblast, city of Moscow, Republic of Komi, Vologda oblast, Murmansk oblast, St. Petersburg. Nenetsky autonomous okrug, Republic of Tatarstan, perm oblast, Samara oblast, Tyumen oblast, Khanty-Mansy autonomous okrug, Yamalo-nenetsky autonomous okrug, Krasnoyarsk krai.

²⁷ Yaroslavl oblast, Leningrad oblast, Republic of Bashkortostan, Udmurt Republic, Orenburg oblast, Sverdlovsk oblast in 2005 received no subsidies on stabilization of the level of their budget sufficiency out of FFFSR, but they received subsidies on stabilization of budgets of RF Subjects.

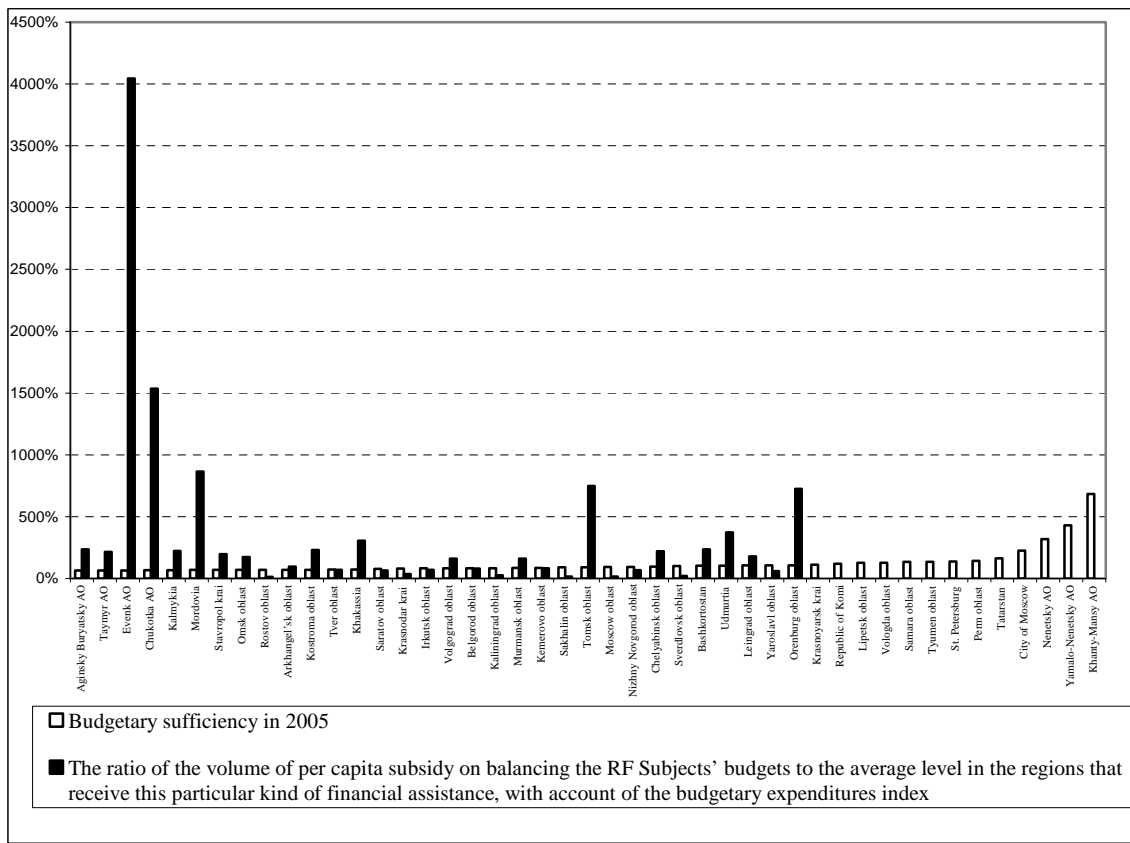


Fig. 17. Correlation between Subsidies on Balancing of Budgets of the RF Subjects Assigned at the Second Stage and the Budgetary Sufficiency of the RF Subjects

Meanwhile, only the Subjects of the Russian Federation for which the level of computation budgetary sufficiency after the distribution of FFSR for 2005 was under 110% became eligible for the subsidy.

The distinctive feature of all the three stages of allocation of subsidies on getting the RF Subjects' budgets balanced became an attempt to combine compensational and equalizing features of interbudgetary transfers. Setting a few objectives for a form of interbudgetary support can result in the situation in which none of them would be efficiently achieved, as it happens now. As a result, a full compensation for the decrease of revenues and increase in expenditures of regional budgets has become unavailable, on the one hand, while negative fiscal incentive for regional authorities have arisen, on the other hand, as the methodology is chiefly based on reporting, rather than computation, indicators.

The shortage of compensational mechanisms laid into the methodology of distribution of subsidies to budgets of the RF Subjects on supporting measures on securing stabilization of their budgets essentially has necessitated a wide-scale revision of the total volume of subsidies on getting the RF Subjects' budgets balanced in favor of their increase.

Table 16 presents the data on the degree of compensation for unbalanced budgets of the RF Subjects by means of subsidies on supporting measures on securing stabilization of the RF Subjects' budgets.

Table 16

**Compensation for Imbalance of Budgets of Subjects of RF by means
of Allocation of Subsidies on Supporting the Measures
on Provision of the Balancing of Budgets of Subjects
of the Russian Federation**

Factors that generate imbalances of budgets of the RF Subjects in 2005, as per the Methodology	Changes in the balances (as Rb. bn.)	Subsidies, as provided for by the Methodology at the start of the year	
		Rb. bn.	As % of the change in the balance
1. Declines in the volumes of funds of the Federal Fund for Financial Support of Subjects of Russian Federation	5.53	2.0	37.7%
2. Decline in revenues and increase in expenditures of budgets of the RF Subjects due to a partial centralization of the tax on minerals in the part of oil and gas condensate, centralization of the water tax and centralization of the 1.5 p. of the corporate profit tax rate in the federal budget	11.72	3.0	25.6%
3. Re-assignment to the RF Subjects of main powers with regard to provision of the preschool and general education, and primary and secondary vocational training	21.33	5.0	23.4%
Total	38.58	10	25.9%

Source: the RF Ministry of Finance.

As noted above, subsidies to budgets to the RF Subjects on supporting measures on provision of their stabilization have formed a major source of soft budget constraints in 2005. Instead of originally set for 2005 by the Methodology of distribution of subsidies to budgets of the RF Subjects for the noted purpose amount of Rb. 10 bn. or 19 bn. as per the 2005 budget law, the government ultimately disbursed over Rb. 52 bn. for the said purpose.

By the degree of the destructiveness of their impact on the subnational authorities' fiscal behavior these subsidies can be conditionally broken into four groups. There are two factors underlying such a breakdown – that is, when the decision on allocation of the subsidy was made (in the beginning of the financial year, or already in the course of execution of the budget) and on which grounds the funds were allocated (whether it was done on the basis of the government decision, or proceeding from the earlier approved methodology) (*Table 17*).

The data of the Table above show that the subsidies in question allocated in 2005 can be divided into four categories:

- 1) Category A1. This category is mostly formed by subsidies allocated according to the Methodology. Their negative impact on the subnational authorities' fiscal behavior was noted above;
- 2) Category A2. In addition to the negative effects inherent in the subsidies of category A1, this particular kind of financial assistance fuels the subnational authorities' desire

- to solve all the problems they face at the expense of the federal budget funds, rather than by their own fiscal efforts, as the volume of the subsidies is not pre-set;
- 3) Category B1. Given the absence of clearly articulated procedures of their distribution, this kind of subsidies, on the one hands, encourages the RfFSubjects to receive these financial resources, while, on the other hand, the federal government now has a possibility to re-assign the funds over the financial year at their discretion, which can also imply negative effects, such as political bargaining, lobbying regional and private interests, among others;
 - 4) Category B2 appears the most “noxious”, as far as the impact on the subfederal authorities’ fiscal behavior is concerned. In this particular case the volume of the subsidies and procedures of their allocation are not known beforehand and form a subject of political bargaining.

Table 17

Classification of Subsidies on Supporting Measures on Provision of Balanced Budgets of the RF Subjects allocated to the RF Subjects in 2005

	The procedures of distribution of subsidies is stipulated in the 2005 budget (A)	The procedures of distribution of subsidies are regulated by the government (B)
As provided by the federal budget law passed prior to the beginning of the 2005 financial year (1)	Rb. 14.5 bn.	Rb. 5.0 bn.
Additional subsidies, as per the budget law passed prior to the end-2005 (2)	Rb 23.9 bn.	Rb 8.6 bn.

At the end of the day, the amount of Rb. 38.4 bn. in subsidies on supporting measures on getting the 2005 RF Subjects’ balanced was earmarked by late 2005²⁸. Almost all the RF Subjects have received this kind of financial assistance, except for seven regions with a high degree of budgetary sufficiency – Lipetsk, Samara and Tyumen oblasts, the city of St. Petersburg, Nenetsky, Khanty-Mansy and Yamalo-Nenetsky autonomous okrugs. However, we failed to identify any significant correlation between the level of budgetary sufficiency and the volume of the subsidies and the extent to which the RF Subjects’ budgets were balanced. Thus, 13 regions whose budgetary sufficiency was greater than the average nationwide level received the subsidies – suffice it to refer to the city of Moscow: with its level of budgetary sufficiency being 2.2 times greater than the average nationwide one, it received Rb. 115 mn. in subsidies.

However, should one broke down the regions into three groups by the degree of their budgetary sufficiency, as follows:

- 1) the budgetary sufficiency is greater than the average nationwide one (the regions receive no subsidies from FFFSR);
- 2) the budgetary sufficiency accounts for 60–100% (the regions receive the FFFSR subsidies only on the second stage of equalization);
- 3) the budgetary sufficiency under 60% (the regions receive the FFFSR subsidies both on the first and second stages of equalization);

²⁸ See Annex 16 to the Federal Law “In the 2005 federal budget” (the version of Federal Law “On introducing amendments to the federal law ‘On the 2005 federal budget’ No. 141-FZ of November 4, 2005.

- 4) one can note a certain correlation between the level of budgetary sufficiency and the amount of the subsidies in question (see *Table 18*).

Table 18

The Grouping of Regions That Receive Subsidies on Supporting Measures on Provision of Balanced Budgets of the RF Subjects, due to the Budgetary Sufficiency Level

Budgetary sufficiency level	Number of regions that receive the subsidies in question	The share of the subsidies in question earmarked to the given group of the RF Subjects in the total volume of subsidies on getting the RF Subjects' budgets balanced	The average per capita subsidy on getting the RF Subjects' budgets balanced (as Rb.)
Over 100%	13	25.3%	271.5
60–100%	25	29.7%	235.3
Under 60%	43	45.0%	402.8

The data of *Table 18* make it evident that the average per capita subsidy in regions with a low degree of budgetary sufficiency appears 1.5–1.7 times greater than the respective index of all other regions of RF. A relatively high level of the subsidies that falls on highly sufficient regions is most likely to be caused by merely political reasons. Thus, the allocation of nearly 6% of the subsidies in question to Krasnoyarsk krai apparently was caused by the federal center's desire to promote its consolidation with Taymyr and Evenk autonomous okrugs. Should political component be excluded from the procedures of allocation of the subsidies in question, there would occur a considerable redistribution of the respective funds in favor of regions with a low degree of budgetary sufficiency. Hence, the question arises, as to whether the subsidies are needed. It is a very urgent problem for the today's interbudgetary relations system, for, on the one hand, this kind of financial assistance bears a number of features that discourage the regional and federal authorities' fiscal behavior, while it is growing increasingly significant in the structure of interbudgetary transfers, on the other hand. The latter can be proved both by a drastic rise in the volume of the subsidies over 2005 and by the fact that the role played by this particular kind of financial assistance to the regions in the Concept for and methodology of formation of interbudgetary relations in Russian Federation and its Subject for 2006 and the medium term becomes increasingly significant.

According to the Concept, the year 2006 should see the implementation of Federal Law of October 6, 2003 No. 131-FZ "On general fundamentals of organization of local self-governance in Russian Federation", which will require from the RF Subjects to assign additional funds to ensure the interbudgetary equalization between municipal entities and from the latter - to exercise the powers they are supposed to be granted, as per the Law. Because of that, the volume of subsidies on supporting measures on getting the RF Subjects' budgets balanced should grow 2.8 times²⁹ vs. 2005 and reach Rb. 55319.7 mn. The allocation of the funds will be carried out with account of implementation of Federal Law of October 6, 2003, No. 131-FZ "On general fundamentals of organization of local self-governance

²⁹ Meaning the volume of subsidies on getting the RF Subjects' budgets balanced, as per the federal law on federal budget enacted in early 2005 – Rb. 19.5 bn.

in Russian Federation” and modifications of the tax law, which should result in reduction of the tax bases of the RF Subjects’ budgets.

Though the local self-governance reform was extended (put off) until 2009 and the volume of the subsidies in question in 2006 should account for some Rb. 25 bn., while the Concept was revised, there arises a serious danger that the federal center would be keen to “put out” all consequent drastic hikes of the vertical budget imbalances by means of such an inefficient financial instrument as the noted subsidies.

2.3.3. Methodology of Allocation of Subsidies from the Federal Fund for Co-Financing of Social Expenditures between Subjects of the Russian Federation for 2006

On August 9, 2005, the Task Force for improvement of interbudgetary relations in Russian Federation adjudicated a methodology of distribution of subsidies from the Federal Fund for Co-Financing of Social Expenditures between the RF Subjects in 2006.

According to the methodology, in 2006 the RF Subjects are going to receive subsidies from the Fund to support measures of social support to be provided to four categories of citizens:

- 1) rehabilitated individuals and those recognized as victims of the political repressions;
- 2) laborers of the Home Front;
- 3) veterans of labor;
- 4) citizens that have children.

The subsidies to the RF Subjects with regard to the two first categories of citizens rests upon two indicators – the number of citizens falling under the respective category and residing in the territory of a given Subject of RF, and the size of the cash allowance set by the federal center per one recipient (Rb. 227.9 a month for victims of the political repressions and 206.7 a month- for laborers of the Home Front).

As concerns the other two categories, the amount of subsidies is to be computed according to a more sophisticated formula, with account of the differentiation of the price scale and the level of budgetary sufficiency of the region (on which the level of co-financing depends).

To compute subsidies to veterans of labor, the methodology implies the budgetary expenditures index from the formula of subsidy allocation from FFFSR, while as far as citizens with children are concerned – the average weighted (by the number of residents in the respective cities and *rayons*) rayon coefficient to wages and salaries, which is set by the federal acts in the cities (rayons) of the Subject of RF.

Given the above, the level of the co-financing of expenditures from the federal budget with respect to the both categories of citizens is found according to the formula:

$$\text{a) if } BS_i < 1: \quad L_i = 1 - BS_i \times (0,6 / BS_{\min}),$$

where L_i – level of the co-financing from the federal budget;

BS_i – level of the computation budgetary sufficiency of the subject of RF after distribution of subsidies from the Federal Fund for Co-Financing of Social Expenditures of the Russian Federation;

BS_{\min} – minimal level of budgetary sufficiency of the subject of RF after distribution of subsidies from the Federal Fund for Co-Financing of Social Expenditures of the Russian Federation;

$$\begin{aligned} \text{b) if } 1 < BS_i < 1,2: \quad & L_i = 0,1 / BS_i, \\ \text{c) if } BS_i > 1,2: \quad & L_i = 0,05 / BS_i. \end{aligned}$$

Like in the case of the subsidies on stabilization of regional finance, it is evident that the government is keen to simultaneously ensure both the stabilization (compensational) and equalization effects by means of a sole instrument. However, the above formula does not quite allow for equalization of the level of the regions' socio-economic development.

Fig. 18 presents a correlation between budgetary sufficiency and the level of co-financing of social expenditures in 2006, given that the minimum level of budgetary sufficiency accounted for 64%.

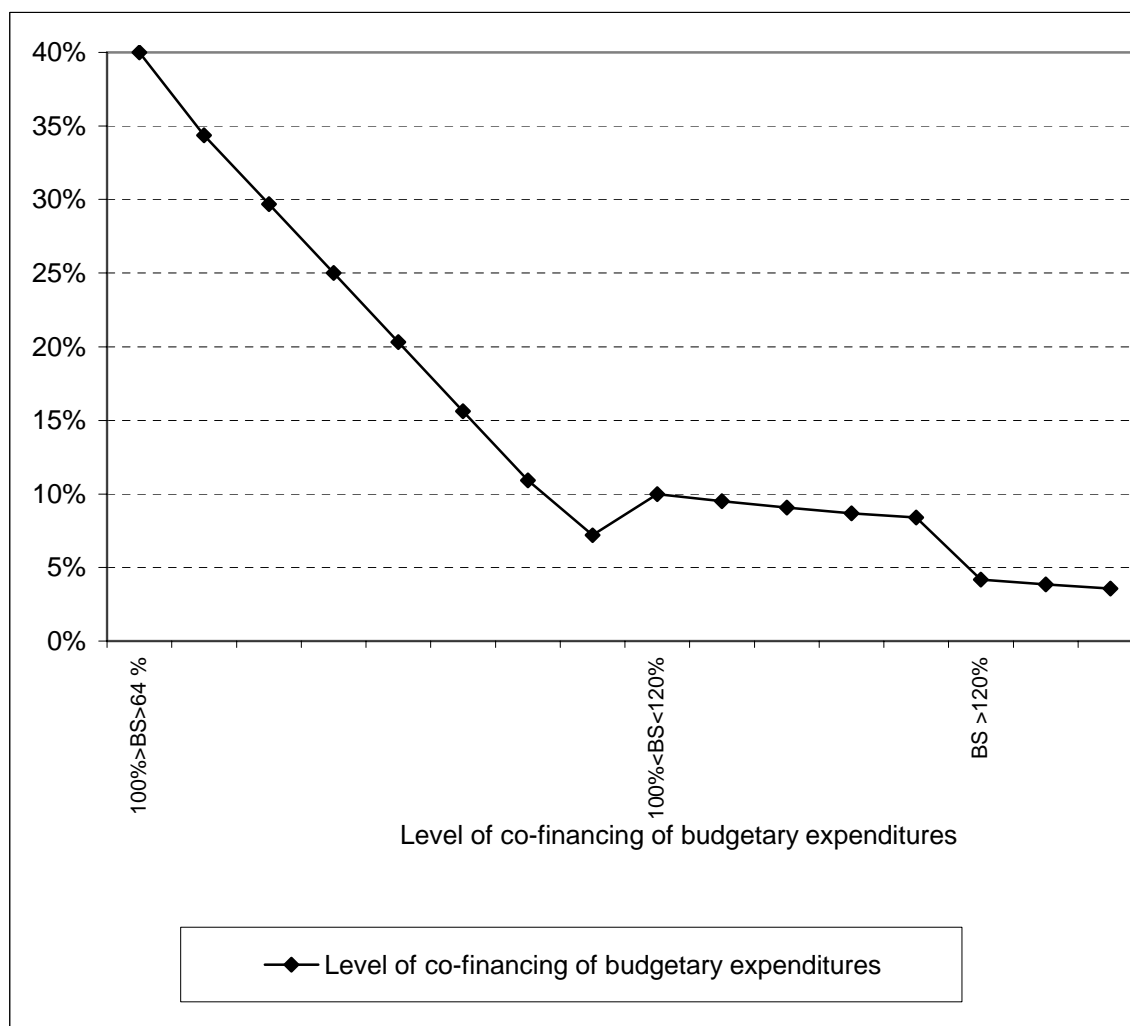


Fig. 18. Correlation between the Level of Co-Financing of Social Expenditures in 2006 and the Level of Budgetary Sufficiency

As evidenced by the data in *Fig. 18*, under the level of budgetary sufficiency being between 64 and 100% the values of the level of co-financing of social expenditures diminishes due to the level of budgetary sufficiency. However, the formula of computation of the level of co-financing of social expenditures exposes two considerable distortions under the transition from one schedule of budgetary sufficiency to the other:

- 1) The region with the budgetary sufficiency level of 99% is granted with a 7.2% level of co-financing of its social expenditures, while the region with the 100% budgetary sufficiency level somehow enjoys a 10% level of co-financing of social expenditures;

- 2) The regions with a 119% budgetary sufficiency level would receive a 8.4% level of co-financing of its budgetary expenditures, while the one with a 120% level of budgetary sufficiency would be granted only with a 4.1 level of co-financing of its social expenditures.

It seems more efficient:

- 1) not to divide *I'gotniks* (individuals eligible for benefits – *Transl.*) into federal and regional ones and secure the “monetization” of benefits at the expense of subventions to regions out of the federal budget;
- 2) Allocation of financial resources across all the above categories of citizens should be made with account of the regional price scale;
- 3) Provision of subsidies and subventions out of the federal budget should not be dependent on a given region’s level of budgetary sufficiency. If, however, by some reason such a dependence emerges, it may not exert an adverse influence on the subnational authorities’ fiscal behavior – the region that has enjoyed a greater budgetary sufficiency level prior to the receipt of the financing from the federal budget should retain its advantage after receiving it, too.

2.3.4. Methodology of Allocation of Subventions from the Federal Fund for Compensations between Subjects of the Russian Federation on Payments for Housing and Communal Services to Individual Categories of Citizens and on Provision of measures of Social Support to Individuals Awarded with the “Honorary Blood Donor of the USSR” and “Honorary Blood Donor of Russia” signs for 2006

Like the above methodology, this particular one was approved at the same meeting of the same Task Force on August 9, 2005.

The computation of subsidies to the RF Subjects on payments for the housing and communal services for single categories of citizens rests upon three indicators: 1) the number of citizens eligible for benefits with respect to payments for the housing and communal services in a given Subject of RF; 2) the federal social housing standard employed for computation of interbudgetary transfers is 18 square meters per person; 3) the federal standard of the costs of the provision of the housing and communal services per 1 square meter of the overall living area per month for 2006 set by the Resolution of the RF government with respect to a given Subject of RF (this indicator takes into account the interregional price differentiation with regard to costs of the housing and communal services.

The subsidies to Subjects of RF on provision of measures of social support to individuals awarded with the “Honorary blood donor of the USSR” and “Honorary Blood Donor of Russia” are computed basing on two indicators: 1) the number of citizens awarded with the noted signs in a given Subject of RF, and 2) the amount of the annual cash allowance to such citizens, which was set for 2006 at the level of Rb. 6, 420.

As far as the computation of the subsidies on social support of blood donors is concerned, it appears imperative to consider the inter-regional price differentiation. As the donors are in need primarily of additional foodstuffs, to account the inter-regional price level differentiation, it would be rational to employ the price index for foodstuffs.

2.3.5. Application of a New Methodology of Allocation of Subsidies on equalization of Budgetary Sufficiency of Subjects of the Russian Federation

In compliance with the new budget law, the new Methodology of allocation of resources of the Federal Fund for Financial Support of Regions has become effective as of January 1, 2005. The Methodology was designed and consequently approved with the RF

government Resolution of November 22, 2004, No. 670. In the 2004 review of the Russian economy³⁰, we provided a detail description of the new Methodology and highlighted on its pluses and minuses. The present section specifies the allocation of subsidies from FFFSR for 2006, as well as some recommendations with regard to strengthening their equalizing features, which are necessary to ensure a full refusal of the subsidies on supporting measures on getting the RF Subjects' budgets balanced in favor of an increase of subsidies from FFFSR.

In 2006, 65 regions should receive subsidies from FFFSR, which is at 4 regions less than in 2005. This modification was caused by the following reasons:

- 1) The 2006 subsidies to Koryaksky, Ust-Ordynsky Buryatsky and Aginsky Buryatsky okrugs will not be separated from the subsidies to the oblasts in which the okrugs belong. That is why they are not formally specified in the methodology of allocation of subsidies from FFFSR;
- 2) Chelyabinsk and Tomsk oblast will no longer receive subsidies from FFFSR in 2006, as their budgetary sufficiency level has exceeded the average nationwide level;
- 3) The Republic of Udmurtia will receive the FFFSR subsidies in 2006, as its budgetary sufficiency rate has proved to be below the average nationwide level.

Fig. 19 represents the dynamics of the disparity between the RF Subjects in terms of the budgetary sufficiency level over 2001–2006.

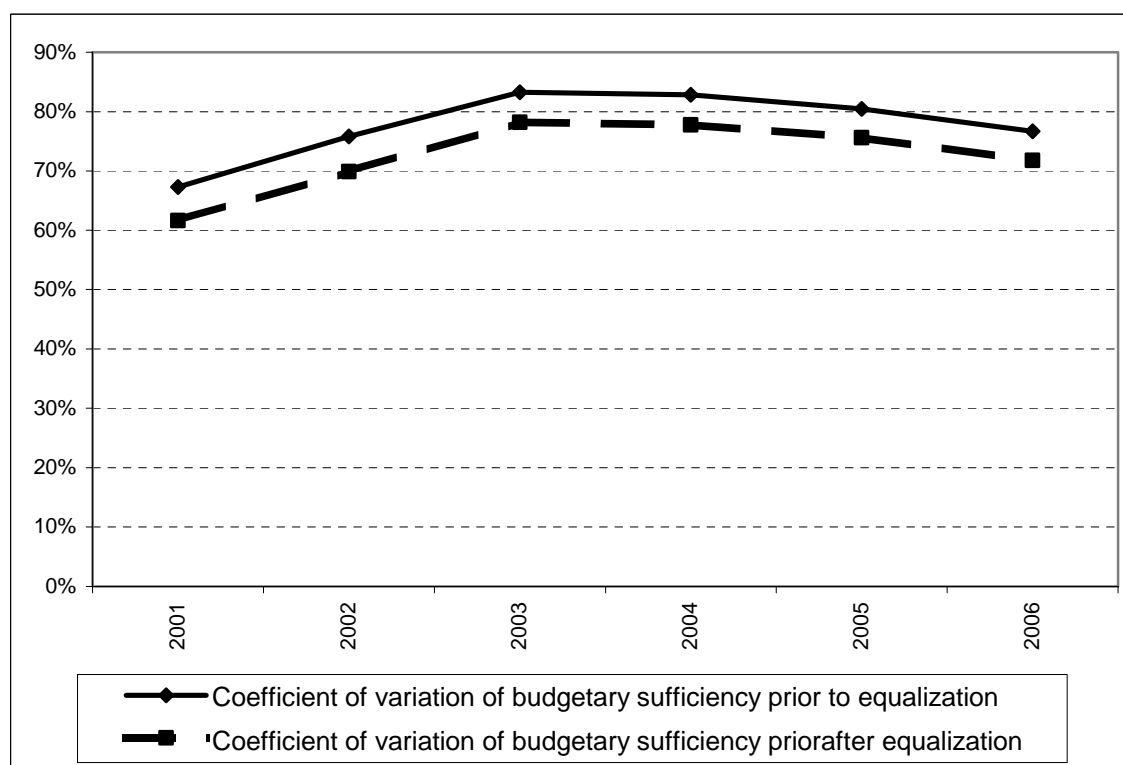


Fig. 19. The Dynamics of Disparity of the Level of Budgetary Sufficiency of the RF Subjects between 2001 and 2006

³⁰ See: Russian Economy: Trends and Outlooks. Issue 26. M., IET, 2005.

As evidenced by *Fig. 19*, the coefficient of variation of budgetary sufficiency prior to equalization has grown from 67% in 2001 up to 83% in 2004, while the coefficient of variation of budgetary sufficiency after equalization has grown from 62 to 78%, respectively. This testifies to the fact that despite all the federal center's efforts to equalize budgetary sufficiency of the RF Subjects in 2001–04, the disparity in question was growing, anyway. The year of 2005 saw for the first time over the period in question the disparity and computation budgetary sufficiency of the RF Subjects significantly decline. The decline continued in 2006 as well, however, it is hard to judge if it occurred because of a change in the formula of allocation of subsidies from FFFSR. For instance, a considerable equalization effect in 2006 became possible, because the budgetary sufficiency of Koryaksky, Ust-Orynsky Buryatsky and Nenetsky autonomous okrugs was not computed separately, as it had been noted over the prior years. Rather, it found itself incorporated into the respective indices of the oblasts in which the okrugs in question belong. The equalization effect proved to be the strongest one under the consolidation in the framework of allocation of subsidies from FFFSR of Nenetsky autonomous okrug, whose budgetary sufficiency is considerably greater than the average nationwide one, and Arkhangelsk oblast that appear subsidies from the perspective of the Methodology of allocation of subsidies from FFFSR. As a result, the latter's budgetary sufficiency grew from 56.4% in 2005 up to 70.5% in 2006 and the Oblast received at Rb. 810 mn. less in the 2006 subsidies vs. 2005.

The 2006 volume of FFFSR grew by 8.3% in real terms vis-à-vis 2005. Meanwhile, 18 regions will receive smaller amounts of subsidies from FFFSR in 2006 vs. 2005. The regions are: Belgorod, Kaluga, Kursk, Orel, Ryazan, Tula, Tomsk, Magadan, Amur, Omsk, Novosibirsk, Arkhangelsk, Kemerovo, Kurgan and Chelyabinsk oblasts, Republic of Khakassia, Altay krai and Primorsky krai. Interestingly, the decrease in subsidies from FFFSR in real terms does not appear associated in any way with their level of budgetary sufficiency.

The FFFSR volume appears clearly insufficient to enable the subfederal authorities, providing they undertake the same tax efforts, to enjoy an equal opportunity to provide the same level of comparable public goods to their citizens. As well, the minimum level of budgetary sufficiency after the FFFSR subsidies are allocated remains extremely low. *Fig. 20* presents the dynamics of the level of the minimum budgetary sufficiency after allocation of subsidies from FFFSR.

As the data of *Fig. 20* shows, the 2005–06 minimum budgetary sufficiency of the RF Subjects accounted for 64%, which is an intolerably low level that necessitates employment of additional transfer mechanisms to ensure equalization the vertical and horizontal budgetary imbalances. In other words, one can reckon that an insufficient volume of FFFSR and a low degree of equalization of budgetary sufficiency levels indirectly necessitate employment of subsidies on supporting measures on getting the RF Subjects' balanced, soft budget constraints and the whole set of the aforementioned negative phenomena.

A modification of the formula of allocation of the FFSR subsidies might reedy the problem, provided such a modification has to meet a few requirements:

- 1) to increase progressiveness of the equalization;
- 2) to keep the regional authorities' keen to boost their budgetary sufficiency by themselves, i.e. regions with a greater budgetary sufficiency prior to equalization should keep on enjoying a certain advantage post-equalization, too;
- 3) the modification should affect as little parameters in the equalization formula as possible, to keep the continuity with the previous formula, but the pattern of computations should not grow more sophisticated.

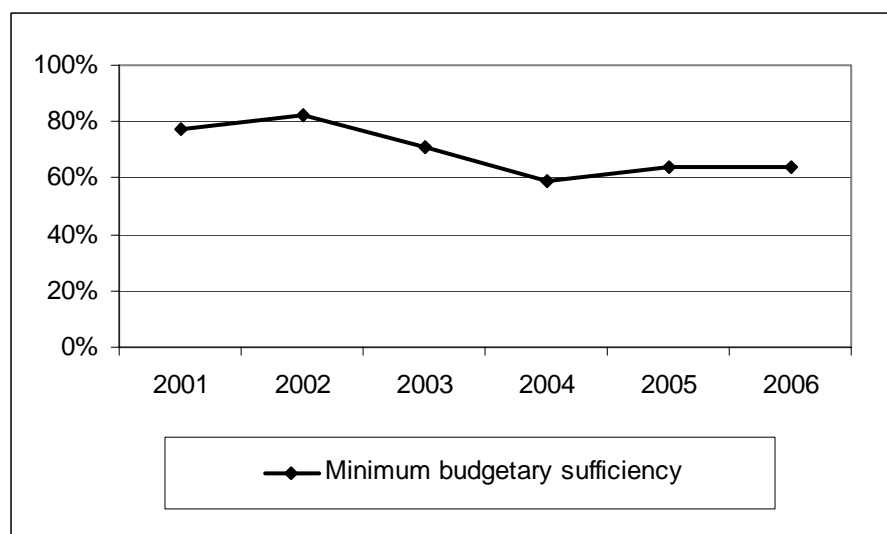


Fig. 20. The Dynamics of Minimum Budgetary Sufficiency of the RF Subjects over 2001–2006

With that in mind, one of indisputable merits of provision of interbudgetary transfers is their predictability and stability in time. If the methodology of allocation of the FFSR subsidies is frequently modified, there will be no stability. Rather, a revision of the current methodology of allocation of subsidies from FFSR is appropriate in the medium-term perspective.

2.3.6. *The Impact of the New System of Elections of heads of Subjects of RF on Interbudgetary Relations*

The IET review “Russian Economy in 2004: Trends and Outlooks” contains an analysis of the impact of the new system of election of heads of the RF Subjects on organization of interbudgetary relations and fiscal federalism on the whole. The year 2005 allows to conclude some interim outcomes of the introduction of the new system of federalism in Russia. Our forecast that the decision of an actual abolition of appointment by election of heads of executive power of the RF Subjects would affect the state of interbudgetary relations and subnational finance in the medium-term perspective has been quite accurate.

All the interim outcomes can be divided into three groups:

1. **Immediate political modifications resulting from the introduction of the new system of election of heads of the RF Subjects.** On 15 December 2004 the national media published amendments to the federal statute “On general fundamentals of organization of legislative (representative), executive bodies of state power of Subjects of the Russian Federation”. The statute contained a decision on an actual cancellation of appointment by election of heads of the executive power of the RF Subjects. According to the new election arrangements, direct elections of heads of the executive power in regions are cancelled and replaced by appointment of an individual who pretends for the post by the legislative body of the Subject of the Federation, with the RF President proposing a candidature.

Originally it could be suggested that the federal center would not be employ the new arrangement too often, to reserve it as a certain strategic administrative resource which should not be misused for the sake of political stability in the country. However, in 2005 the federal center has used this instrument vigorously:

- overall, 44 governors in 43 regions were appointed according to the new procedure (in Tyumen oblast, the governor was appointed twice, as Mr. S. Sobyenin was appointed the Head of the presidential Administration);
- as many as 7 governors have failed to be re-appointed for the new term;
- finally, 1 governor was dismissed.

There exist two major reasons for “electing” governors nearly in a half of the RF Subjects according to the new arrangement. First, some 80% of the newly appointed governors were heads of the executive power of the respective subjects that had been elected prior to the political reform and they raised the “matter of confidence” before the RF President. Confidence was granted to them and they continued to exercise their duties, but already as appointed, rather than elected, governors. This trend can be recognized as tentatively positive, for a high proportion of governors adjudicated by the federal center increases stability of the regional political system. Second, a relatively great number of governors who have failed to be re-appointed or who were dismissed can be attributed to the specificity of the President’s cadres policy – appointments are made by cadres packages. This allows assumption that in the future the federal center will be pursuing a sound cadres policy in the regions, avoiding mess, but not feeling awkward to dismiss disobedient or notoriously inefficient regional heads.

We suggested that the noted decisions with regard to modification of the election arrangement of heads of the executive power in the RF Subject appeared consequent upon the experiment with the introduction of the institution of presidential envoys in the federal okrugs, whose positive outcomes had been fairly modest vis-à-vis original expectations. However, the suggestion has been inaccurate so far, for 2005 saw no change in the envoys’ status, despite an obvious need for such modifications. First of all, the new status of the supreme authorities of the RF Subjects is determined by a greater level of legitimacy compared with the presidential envoys, for the former are appointed de-facto by the RF President and the respective legislature, while the latter only by the RF President. Whereas the granting of the supreme regional authorities with powers is made by the RF President’s initiative, they essentially become his representatives in the regions. This inevitably generates a legal dualism and parallelism and duplication of their and the envoys’ powers. It means that a substantial adjustment of the envoys institution in the federal okrugs will be required over time, otherwise the envoys would soon turn into “halved” representatives. In all likelihood, they would be given a role of supervisors over governors’ actions.

The new governor election arrangement does not appear a self-sufficient measure and it will require new steps to intensify control over activities of the heads of the executive power of the RF Subjects. A consistent implementation of these measures will lead to an eventual emergence of the Russian national model of federalism discussed above. The system can be conditionally labeled as a corporate-commanding federalism. To ensure its more or less efficient functioning, it will greatly necessitate a system of the federal center’s control over the governor’s economic activity, as it is the federal center that holds politically responsible for the socio-economic situation in the territories under the new election arrangement.

2. Attempts to create a methodology of assessment of governors’ activities in 2005. The year 2005 proved our assumptions³¹ that in the event of a modification of the governor elections procedures the federal center would be compelled to search for new instruments that would be based upon enforcement and hierarchic control over the inter-budgetary regulation mechanism. During the year the presidential Administration, the Task

³¹ See: “Russian Economy in 2004. Trends and Outlooks.” Issue 26. M., IET, 2005.

Force led Mr. D. Kozak, by the presidential envoy in the Southern federal okrug, the RF Ministry of Finance, and some other government bodies have been attempting to formulate criteria of assessment of governors' activities and a methodology of monitoring of their meeting the criteria. It has become possible now to single out three interim outputs of the work:

1. The RF Ministry of Finance has designed Procedures of carrying out the monitoring of the RF Subjects' compliance with requirements of the Budget Code of RF³². The distinctive feature of the order became an attempt to assess the RF Subjects' compliance with requirements of the Budget Code and the quality of management of their budgets on the basis of biases from the pre-set by the federal center parameters. While as far as the control over compliance with the Budget Code requirements is concerned, such criteria are evident and the need in control over them does not raise any doubts, the suggested procedures with regard to assessment of the quality of management of the RF Subject's budget appears fairly disputable.

According to the noted Order, the respective monitoring is to be carried out every quarter by the Department of Interbudgetary Relations along two avenues – that is, compliance with requirements of the Budget Code of RF and conditions of the quality of management of the RF Subjects' budgets.

Compliance with requirements of the Budget Code of RF comprises meeting the following criteria:

BC1 – the marginal amount of the public debt of a given RF Subject may not exceed the volume of revenues of the budget of the RF Subject, without regard to financial assistance from budgets of other levels of the budgetary system of RF;

BC2 – the marginal amount of deficit of the budget of the RF Subject without account to proceeds from sales of property may not exceed 15% of the volume of revenues of the RF Subject's budget, without regard to financial assistance from the federal budget³³;

BC3 – the maximum ratio of current expenditures of the RF Subject's budget to the volume of its budget revenues (the current expenditures of the RF Subject's budget may not exceed the volume of its budget revenues);

BC4 – the marginal volume of expenditures on servicing the public debt may not exceed 15% of the volume of expenditures of the RF Subject's budget;

BC5 – conditions of labor compensations payable to civil servants in the RF Subject (for the RF Subjects that receive subsidies on equalization of the level of budgetary sufficiency the amount of labor compensations payable to civil servants may not exceed amounts of labor compensations set for the respective categories of civil servants of the federal level).

Conditions of the quality of management of budgets of the RF Subjects are assessed by 11 parameters:

QM1 – execution of the budget by revenues (without account of free receipts from other budgets of the budgetary system) as per cent of the originally approved value shall exceed 95%.

The following three criteria are related to a given region's accounts payable and partly duplicate each other:

CM2 – accounts payable with regard to wages and salaries payments to budget employees. The criterion is computed according to the formula:

$$QM2_i = A_i * 12 / B_i,$$

³² See : The RF Minfin Order № 98 of 11 May 2005.

³³ See: Art. 92 of the Budget Code of RF.

Where

QM2_i – the value of the indicator by the RF Subject;

A_i – accounts payable on salaries and wages payments by the RF Subject, as of the end of the reporting period;

B_i – the annual volume of expenditures on paying salaries and wages from the budget of the RF Subject approved by its budget statute.

The value of QM1 may not exceed 1;

QM3 – accounts payable on taxes on labor compensations; it is computed by analogue to QM 2 and partly duplicates it, as the region that experiences problems with wage debts is most likely to be as well in an unfavorable situation with regard to taxes on wages;

QM4 – accounts payable on payments for communal services by budget institutions; it is computed by analogue to the previous two kinds of accounts payable;

QM5 – the set level of the population's payments for housing and communal services shall equal or exceed 95%;

QM6 – the actual level of the population's payments for housing and communal services shall equal or exceed 85%;

QM7 – the maximum affordable share of the citizens' own expenses on payments for housing and communal services in the household's aggregate income. Strangely, according to the methodology, the value of K7 shall be equal to or exceed 21%, while the Housing Code requires that the maximum affordable share of citizens' own expenses on housing and communal services in the household's aggregate income may not exceed 22%, while regional authorities can lower the value at their discretion. We believe QM7 not only mismatch requirements of the RF law, but fails to characterize the quality of management of the RF Subjects' budgets. This criterion can be excluded from the methodology without affecting its comprehensiveness;

QM8 – the electricity tariff for industry to the electricity tariff for the population (across the region) ratio shall not exceed 1.35;

QM9 – the heating power tariff for industry to the heating power tariff for the population (across the region) ratio shall not exceed 1.35;

QM10 – the level of repayment of subsidies due to the population for housing and communal services payments shall be over 90%;

QM11 – the amount of outstanding (unregulated) debt on debt obligations of the RF Subject shall be absent. The formulation of this criterion can be questioned, for it is not just the fact of the presence of an outstanding debt, but its volume that matters. According to the current procedures regions that have an outstanding debt of 1 Rb. and 1 bn. Rb. will be recognized as equal abusers of the QM11 requirement.

While in the first case economic and social consequences of such an outstanding debt do not require the federal center's interference, the other case demands for an immediate and full-scale action of all the tiers of government. This can be proved by the data on outstanding accounts payable of the RF Subject as of January 1, 2005³⁴. According to the data, the outstanding accounts payable of Tver oblast was Rb. 1,000, while that of Kamchatka oblast – Rb. 3.58 bn. Despite the fact that in the first case that was a "regrettable confusion" and a "budgetary catastrophe" in the other case, both regions are recognized as abusers of the aforementioned procedures. In conjunction with this, the current formulation of the QM11 criterion appears poorly informative, as far as managerial decision-making on the federal level is concerned.

³⁴ Source: the RF Ministry of Finance.

The year 2005 saw the first attempt to conduct a monitoring, according to the MinFin procedures (*Table 19*).

Table 19

Results of the Monitoring of the Compliance by the RF Subjects with Requirements of the Budget Code of RF and the Quality of management of Budgets of the RF Subjects, as of January 1, 2005

Criteria of monitoring	Compliance with the Budget Code (BC)					The score of quality of management of budgets of the RF Subjects (QM)											Total
	1	2	3	4	5	1	2	3	4	5	6	7	8	9	10	11	
The number of the Subjects with the respective abuses	5	2	6	0	58	18	0	3	9	67	80	19	57	35	28	43	88
Abuses, total	71					359											430

Source: The RF Ministry of Finance.

As evidenced by the data of *Table 19*, the greatest number of abuses (83%) falls on the mismatch between the Subjects' performance and criteria of assessment of the quality of their budgetary management. As concerns abuses of the Budget Code requirements, the only considerable one is an excess of the amount of labor compensations due to civil servants in the RF Subjects that receive subsidies on equalization of their budgetary sufficiency level and amounts of labor compensations set for the respective categories of the federal-level civil servants – 13% of the total number of abuses.

The most widespread abuses fall on the quality of management of the RF Subjects' budgets:

- the actual level of the populations' payments for the housing and communal services in 80 regions is under 85% – 19% of abuses;
- the set level of the populations' payments for the housing and communal services is under 95% in 67 regions – 16% of abuses;
- the electricity tariff for the industrial sector to electricity tariff for the population (across a given region) ratio is over 1.35 in 57 regions – 13% of abuses.

Overall, regions have had 5 abuses of the set requirements on average. The only region that had none was the Republic of Khakassia, while other regions had between one to ten abuses. Hence, the question is, how should one apply the results? Does they mean that all Russian governors, except for that of Khakassia, should be replaced? Or should one undertake any measures to improve the situations in the regions with the number of abuses over the average nationwide one? Obviously, in the absence of an assessment of the degree to which a given criterion has been abused, assessment of significance of the criterion and ambiguity of the selection of the criteria, the RF MinFin's procedures of monitoring of the RF Subjects' financial state is poorly applicable.

2. In late 2005, the RF MinFin conducted a comparative evaluation of performance by 9 Subjects of RF by 13 blocs:

- 1) Economy.
- 2) Debt burden.
- 3) Compliance with the Budget Code.
- 4) Management of the expenditure mandate.
- 5) Financial policy and relations with lower-tier budgets.
- 6) Budgeting and expenditure management reform.
- 7) Result-oriented budgeting.

- 8) Administrative reform.
- 9) Th public sector reform.
- 10) Improvement of the investment system.
- 11) Creation of conditions of the tax base development.
- 12) Improvement of the debt policy.
- 13) Improvement of interbudgetary relations.

Each bloc comprises several indicators, with every indicator being given a certain weight. The sum of all weights in a given bloc shows the significance of the bloc.

Without a detailed analysis of the quality of the methodology, it is possible to note a systemic defect of practically any methodology the federal center creates to evaluate the subfederal authorities' performance. The mission of the latter is to deliver a certain set of necessary public goods at a certain cost in the form of taxes for the sake of maximization of the public function of usefulness of citizens in the territory. By contrast, all the methodologies the federal center designs will take into account, intentionally or incidentally, its interests in regions.

Thus, the avenues the federal center selected as priority ones have become critical or its assessment of subfederal authorities. For example, the federal center is keen on the regions' debt policies, as it affects the aggregate volume of the public debt and stability of regional finance. That is why the weight of the two blocs that concern the debt policy accounts for 24%. The federal center considers it important to have regions honor the Budget Code requirements, pursue result-oriented budgeting, be less dependent on the federal financial assistance, etc. Hence, the 41% weight of the budgetary policy. By contrast, the indicators that have no immediate relation to the RF MinFin's operations in regional terms – that is, economic growth, local employment rate, investment, etc. – are either absent in the methodology, or their weight is little (the “Economy” bloc weighs a meager 3%).

2. The third attempt to design criteria of assessment of governors' performance and a methodology of matching the criteria became proposals by the task Force led by Mr. D. Kozak, the presidential envoy in the Southern Federal okrug. The Task Force has submitted to the presidential Administration a bill that contained strict criteria of assessment of the governors' performance. The bill is aimed at tightening control over governors' activities and provides for restriction of powers exercised by heads of subsidize regions. Thus, along with submission of the budget bill to the regional parliament, the governor will have to provide projections of the dynamics of the region's development by 30 criteria and report on the performance by the end of the year. Basing on that, President and his envoys will make a decision to keep, or dismiss him. In addition, should the regional budget for two straight years be formed at more than a half by transfers from the federal center, the Federal Treasury will assume control over its expenditures. Given the above conditions, the share of transfers from the federal budget accounts for 80%, or the region has accumulated a debt before the federal center that would exceed 30% of its own revenues, it is proposed to introduce a temporary financial administration, like it has been done now in Chechnya. Governors may refuse the introduction of the external management, but they will consequently have to refuse federal subsidies as well. Plus, they will be prohibited to establish any off-budget funds, which currently constitute a legal from of extraction of money from local businesses. The governors should be assessed according to the following criteria: 1. The annual rate of change in GRP. 2. The volume of GRP per capita. 3. To what degree the regional budget is subsidized. 4. The volume of investment in fixed assets per local resident. 5. The rate of change in the volume of collection to the federal budget of taxes

and levies per local resident. 6. The rate of change in areas of land in the agricultural turnover. 7. The rate of change of the volume of collection of revenues from the use of the region's property. 8. The rate of change of the length of general-use blacktop roads with of inter-municipal significance. 9. The rate of change in the proportion of loss-making public unitary enterprises owned by the region. 10. The volume of the outstanding debt of the region's budget to the revenue volume ratio. 11. The pace of change of real monetary incomes of local residents. 12. The correlation between the local residents' average pre capita incomes and the subsistence level. 13. The pace of change of the size of budget employees' salaries funded from the regional budget. 14. The housing area average per capita. 15. The level of unemployment. 16. The number of jobs created. 17. The decline rate of wage arrears. 18. The migration increment (loss). 19. The pace of change in the volume of small businesses' output. 20. The retail trade turnover. 21. The pace of change in the number of economic partnerships and companies, and self-employed individuals. 22. The average life expectancy rate. 23. The birth and mortality rates. 24. The natural rise (decline) of the populace. 25. The mortality at birth rate. 26. The average length of the local residents' stay at stationary therapeutic and rehabilitation institutions. 27. The correlation between the number of senior citizens provided with all kinds of in-house social services and the number of those in need for such services. 28. The proportional weight of children aged 7 to 15 educated at the general education institutions in the total number of children of this particular age category. 29. The proportional weight of students at general education institutions and those of primary and secondary vocational training that study in the "second shift". 30. The annual crime decline rate in the sphere of public administration committed by local civil servants.

Despite quite a broad array of criteria of assessment of the governors' performance, this methodology also suffers from certain drawbacks that take their roots in a universal approach to regions. Thus, for example, in a region with a low crime rate in the sphere of public administration will find it hard to ensure a high rate of decline in the index, while its possible insignificant rise may also become absolutely non-representative, as far as cadres decisions on the region's leadership are concerned. As concerns regions that enjoy certain favorable indicators, it will be hard to ensure their further rise. Rather, the indicators would fluctuate around a certain level, the change of which would require an improvement of the situation nationwide. Hence, the application of the suggested criteria may result in unjust scores to regions.

In conclusion, it is possible to suggest that:

1. The abolition of elections of heads of the RF Subjects has challenged the federal center with a hard task of formalization of the process of assessment of the governors' performance.
2. All the currently available methodologies suffer from certain defects. Their common defect is that they describe an etalon of the governor's behavior from the perspective of the federal center, rather than local residents. Time will show how significant this defect is.
3. The question remains unanswered as to whether it is possible to realize even an ideal methodology, as it is associated with two hardly resolvable problems:
 - a) the problem of informational distortion. The governor enjoys considerable possibilities to distort information on the basis of which the federal center will assess his performance. There arises the need in creation of a data collection system independent of heads of the RF Subjects.

- b) The problem of political choice between the governor's loyalty and his political weight, on the one hand, and the degree to which his performance meets the federal center's criteria, on the other. Hence, an inevitable question as to what if a politically and/or loyal to the federal center governor failed to match the criteria, what would the federal center do? Will it change its assessment criteria, grant the region with additional financial resources to make it match the criteria, or would it keep its eyes shut, or, would it take the risk of political instability and dismiss the governor? This is the most difficult question in today's Russia.

Consolidation of regions. Yet another significant political result of 2005 that affected interbudgetary relations and subnational finance became an intensifying process of consolidation of regions. In the aftermath of the consolidation of Komi-Permyatsky autonomous okrug and Perm oblast in 2003 the 2005 consolidation processes embraced Krasnoyarsk krai, Taymyr and Evenk autonomous okrugs; kamchatka oblast and Koryaksky autonomous okrug; as well, discussions on consolidation of some other regions have been under way.

There exist several reasons in favor of enlargement of Russian regions:

1. a consolidation will result in a lower economic polarization. For instance, should Krasnoyarsk krai (whose budgetary sufficiency is greater than the average nationwide one) "merge" with two autonomous okrugs whose budgetary sufficiency level is lower than nationwide, there would appear a single region with the budgetary sufficiency still greater than the average one nationwide. This would enable the federal center to spend far less resources on equalization of budget sufficiency and socio-economic development levels of regions;
2. the consolidation of regions will result in diversification of their economies and regional budgets being less vulnerable to non-economic shocks. A greater sustainability of regional budgets and the regional economy on the whole would enable the federal center not to spend financial resources on stabilization of the regional finance, which appears extremely important in the light of the absence in today's Russia of efficient transfer instruments of stabilization of regional budget revenues;
3. Consolidation of regions would allow abandonment from the non-rational administrative-territorial division of the country by the national principle. The division had been caused by the national policy of the USSR and it did not provide for independent sub-federal bodies of powers that would be able to most efficiently satisfy the need of citizens residing within a given territory in public goods and services. Furthermore, such a division of the country appears extremely dangerous from the perspective of political stability;
4. Larger administrative-territorial entities will enjoy economies of scale, at least, with respect to administrative costs;
5. Larger and richer regions, as a rule, secure a greater degree of financial independence for local self-governance³⁵. In any case, they have far greater opportunities for that and they are more keen to establish bodies of power within the closest local citizens' reach.

Meanwhile, in Russia the consolidation of regions can bear quite evident drawbacks associated with the fact that the process is artificially promoted by the federal center. To highlight on this, suffice it to cite a few facts that prove that such a consolidation is extremely desirable for the federal center and it is ready to pay the respective costs:

³⁵ See: Paying for Cities. The Search for Sustainable Municipal Revenues, Institute for Public Economics. Western Studies in Economic Policy No. 9, 2003.

1. In 2005, Krasnoyarsk krai received Rb. 2.2 bn. in subsidies to get its budget balanced, while there was no clear evidence of deterioration of its financial situation that year.
2. In 2006, the Krai should receive the respective subsidies worth a total Rb. 140 mn., while Art. 44 of the 2006 federal budget law reads that its budget will receive a 2bn. worth subsidy.
3. It would be logical, while allocating certain financial resources to Krasnoyarsk krai to avoid possible budget imbalances, because of its consolidation with two autonomous okrugs, to discontinue allocating subsidies on equalization of the okrugs' budget sufficiency levels³⁶. That has not happened in 2006, and Taymyr and Evenk autonomous okrugs have received Rb. 1.8 and 1.2 bn., respectively, in subsidies from FFFSR.
4. In 2005, President Putin signed Decree № 1227 of October 21, 2005 "On measures on socio-economic development of Kamchatka oblast and Koryak autonomous okrug" and Decree № 412 of April 12, 2005, "On measures on socio-economic development of Krasnoyarsk krai, Taymyr (Dolgano-Nenetsky) autonomous okrug and Evenk autonomous okrug". In compliance with the Decrees, it is planned:
 - for Kamchatka oblast and Koryaksky autonomous okrug:*
 - to provide the government support to construction of local heating and electricity plants of small capacity in the village of Tilichki and urban-type settlement Palana (to be put in operation in 2006), in the village of Manily, village of Tigil and settlement Ossora (to be placed in operation in 2008), as well as to formation of the infrastructure to ensure the supply of local coal;
 - to provide the government support to carrying out emergency works on restoration of electricity networks in settlements of Koryaksky autonomous okrug;
 - to construct a highway Milkovo-Klyuchi-Ust-Kamchatsk;
 - to construct runways and an airport in the urban-type settlement Palana;
 - to complete the reconstruction of a sea station in the city of Petropavlovsk-Kamchatsky;
 - to supply the public unitary enterprise "Koryaksky aviapredpriatie" with aircraft for the purpose of organization of air passenger transportation in remote and hardly accessible localities using local air ways;
 - to provide the government support with respect to procurement of automobile transportation vehicles of increased cross-country ability for the purpose of developing an inter-settlement ground transportation system;
 - to reinforce the seismic characteristics of objects of the social sphere in Kamchatka oblast;
 - to remove citizens from the tumbledown housing fund;
 - for Krasnoyarsk krai, Taymyr and Evenk autonomous okrugs:*
 - to provide assistance to implementation in 2005–09 of an investment project on development of Vankor oil and gas deposit;
 - to provide the government support to ensure the start of operation of Boguchanskyaya hydroelectric power station in 2010 and preparation of the reservoir zone for its flooding;
 - to implement in 2005–10 a complex of measures on development of the transportation and social infrastructure of Krasnoyarsk krai, Taymyr (Dolgano-Nenetsky) autonomous okrug and Evenk autonomous okrug by providing for:

³⁶ For example, as noted above, the 2006 computations of budget sufficiency of Arkhangelsk oblast included Nenetsky autonomous okrug and the 2006 funding of the Oblast from FFFSR was cut down drastically.

- reconstruction of runways of Emelyanovo airport (the city of Krasnoyarsk) (to be placed in operation in 2006) and Khatanga airport (settlement of Khatanga (to be placed in operation in 2007));
- construction of the first stage of the detour around the city of Krasnoyarsk with a bridge passage across Yenisei (to be put in operation in 2009);
- construction of the first stage of the highway Kansk-Aban-Boguchany (208th–220th kilometer) (to be put in operation in 2006);
- moving in 2005–10 from the Far-North areas and areas equaled to them the residents of Taymyr (Dolgano-Nenetsky) autonomous okrug, Evenk autonomous okrug and Krasnoyarsk krai to whom housing subsidies are to be provided first of all.

According to the noted Decrees, the RF Government is bound to allocate, as per the set procedures, resources to finance the noted measures in the course of formation of the 2006 federal budget and those of next years.

Basing on the above data, it is possible to conclude that the federal center vigorously intervenes with the process of consolidation of regions. This may entail certain unfavorable economic effects. It would be desirable to have a “bottom-up” consolidation instead, with citizens of Subjects of the Federation deciding that an administration of a consolidated administrative-territorial entity will better satisfy their needs. Once the process of consolidation is subsidized by the federal center, there arises eagerness to consolidation for consolidation, to attract the federal center’s financial resources.

2.4. Financial Markets in Russia

2.4.1. National Debt Market

In 2005, the internal debt of the Russian Federation grew in volume by nearly 12.5% from Rb 756.8 billion up to Rb 851,2 billion (in terms of GDP, the national debt reduced from 4.45% to 3.93% of the GDP).

Over the period between Q1, Q2 and Q3 of 2005, the external debt of the Russian Federation (government authorities and monetary control authorities) reduced from \$105.6 billion to \$81.4 billion US dollars (according to the data of the Central Bank of Russia). Thus the absolute value of the external debt of the Russian Federation reduced by 22.9%. Two Eurobonds issues were redeemed in March and July 2005. At the same time, the private sector increased its debt to non-residents from \$108.9 billion to \$146,9 billion US dollars (+34.9%) over the same period. Thus the external debt of the Russian Federation grew from \$214.5 billion to \$248,3 billion US dollars in total within nine months in 2005.

Internal Debt

In 2005, a substantial reduction in average weighted yield of the traded issues was noted in the ruble government debt market. The average weighted yield reduced to reach 6.49% p. a. as opposed to 7.18% p. a. early in 2005, according to the data at closing on December 23, 2005. In some periods, especially in the first half of the year, the reduction in yield was accompanied by high volatility within the range of 6.41% an 8.02% p. a., while it changed within 6.29% and 7.55% p. a. in the second half of the year. A special emphasis should be placed on the fact that in 2005 the parameters of investment activity remained almost the same as those in 2004. The total trading volume of GKO/ OFZ bonds was about Rb 345,06 billion in 2005 as opposed to Rb 350.8 billion in 2004 .

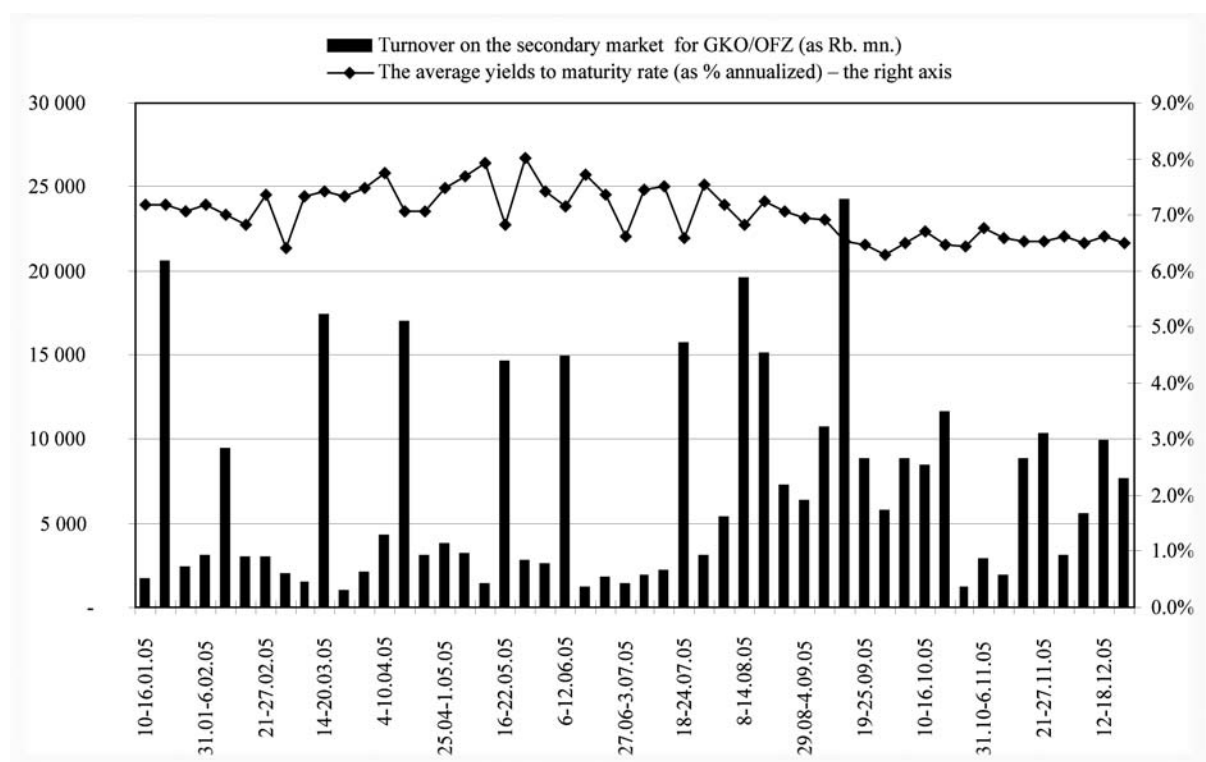
Table 20

Russian Federation's Internal Debt Structure (Rb, billion)

Type of securities	As of 01.01.2005	As of 01.01.2006
GKO	0.02	0.02
OFZ— PK	0.001	0.001
OFZ – PD	43.31	123.64
OFZ – FK	171.22	131.13
OFZ – AD	542.24	596.33
ORVZ 1992	0.03	0.03
OGSZ	0.0002	–
Total	756.82	851.15

Source : the Ministry of Finance of Russia.

In spite of small decrease in the total trading volume, the average weekly parameters grew to Rb 6.9 billion in 2005 as opposed to Rb 6.74 billion in 2004. The maximum weekly trading volume reached nearly Rb 24,2 billion in 2005 (as opposed to nearly Rb 35,87 billion in 2004), while the minimum was nearly Rb 1 billion (as opposed to nearly Rb 350 million in 2004). Thus, in 2005, the maximum trading volume parameter fell considerably against the growth in the minimal weekly trading volume parameter in the market of government bonds denominated in rubles.



Source : Finmarket Asset Management Company, estimates made by the authors.

Fig. 21. Market Movements for GKO/ OFZ bonds in 2005

In analyzing the annual market movement, it should be noted that market quotations periodically moved up and down throughout the year. The yield of the government bonds fell slightly early in the year. The level of liquidity in the banking sector was high enough to

be able to support the market. In addition, Standard & Poor's, one of the leading credit rating agencies, upgraded the sovereign credit rating of Russia up to the investment rating, which, according to comments, was governed by a favorable situation with external liquidity and state finances. Furthermore, early repayment of \$3.3 billion US dollars as part of the Russian debt due to the IMF also stimulated investment demand for Russian bonds. However, still high level of political risks discouraged buying of these bonds in substantial volumes. The market was slightly effected by a statement made by the Ministry of Finance of Russia regarding a domestic borrowing program for 2005 which provides for some growth in securities offer as opposed to the figures reported in 2004 (net borrowing to the amount of nearly Rb 125 billion as opposed to Rb 96 billion in the previous year). The situation deteriorated in February. First, investment activity still remained low as evidenced by a 1.7 fall in trading volumes in the secondary market as compared to the average monthly figures in. The market was adversely affected by the outcomes of the negotiations between Russia and the representatives of the Paris Club of Creditors. Not only did they refuse to discount the debt which was anticipated to be repaid early, but also demanded a premium for early repayment of its part.

In the period between March and May, the market was dominated by a slow upward trend in yield which gave way to correction sometimes. It is late in May that the average weighted weekly yield reached its highest peak in 2005, 8.02% p. a. In March, the market liquidity still remained at an acceptable level, which prevented quotations from significant fall. The situation with liquidity slightly deteriorated as early as at the end of the month, when trading participants needed additional funds to pay taxes. In April, market quotations of most of issues showed an upward correction resulted in some reduction in yield. The market was positively effected excessive banking liquidity denominated in rubles, relatively stable foreign exchange of the Ruble, and favorable market situation in the sector of Russian bonds due to expectations of Russia's early repayment of its debt to the Paris Club of Creditors. The market positively responded to the statement of the representative of the Central Bank of Russia saying that the monetary authorities are ready to allow the Ruble to gain more than it was planned (8% per year) in order to attain the target inflation rates of 8.5% to 10%. Expectations of high inflation rates, as well as volumes of primary placements of government and non-government bonds restrained the demand for second market securities. In May, price fluctuations were insignificant, while quotations fell slightly in general. Favorable market situation with Russian Eurobonds which grew steadily throughout the entire month, was the only positive factor which supported the internal debt market. In May, on the contrary, the market was further affected by adverse factors. It should be noted that growing expectations of devaluation and inflation in the market, as well as significant deterioration of the situation with liquidity in the banking sector (MIBOR (Moscow Interbank Offer Rates) grew from 2% to 8% p. a. per month on average) constrained the investors' demand for bonds.

The period between June and late in September 2005 is the second one to be focused on in terms of price movement of Russian government bonds. The average weighted market yield, as well as its volatility, reduced significantly from the maximum annual figure late in May to 6.29% p. a. late in September. While the growth in yield was always followed by fall in the period between June and July, as seen in *Fig. 21*, quotations were falling almost evenly throughout the period between August and September.

In June, investors were adversely affected by the factors similar to those in the previous month, namely losing ruble exchange rate against other currencies in the domestic market, declining liquidity in the banking sector due to tax payments, and considerably large volumes of primary placements, as well as growing inflation expectations caused by

actual inflation rate that exceeded the estimated one in the budget. Under the lack of attractiveness in the secondary market, investors focused on primary actions, where premiums were anticipated. In June, long-term bonds started to grow in price, while prices of short-term securities varied within a great range. However, investment activity remained poor due to a holiday season. Liquidity was limited, official data on inflation rates evidenced inflation growth in the economy, which inevitably reflected on investors expecting higher rates of inflation. However, the adverse factors that affected the market were limited under a very low level of investment activity.

In August, the yield continued to fall. In spite of the fact that it is typical of the Russian financial market to fall to the lowest levels in all segments in August, the monthly trading volume reached its maximum peaks in the previous 2005 period. Such a significant improvement in the market situation resulted from general growth in the demand for the instruments denominated in rubles under the conditions when the Ruble is gaining vs. the US dollar, early repayment of a part of the Russian Federation's debt due to the Paris Club of Creditors, as well as Fitch upgraded sovereign credit rating on Russia. In September, the news was more positive in general. Early in the month, Moody's published a statement that it anticipated to revise Russia's sovereign credit rating for upgrading. The experts of the agency noted that the Russian Federation continued to improve its creditworthiness not only by building up its gold and foreign exchange reserves and revenues generated from raw materials price rise, but also prudent financial management and active debt service management. A combination of substantial amount of rubles in the market and high oil prices resulted in growing interest in government bonds and falling yield of a series of issues to their hysterical minimum levels, while the demand exceeded several times the offer in primary market.

Throughout the Q4 of 2005, quotations of the bonds denominated in rubles consolidated at the levels attained. Investors refrained from further purchases, since the yields rate attained by the end of September was not attractive enough for active purchases. This was reasonable given other market factors: growth of inflationary expectations and unstable foreign exchange market interfered with the growth. Moody's upgrade of the Russian sovereign credit rating one step up to Baa2 was a fundamentally important event for the market, but it did not come as a surprise for investors and thus had no actual significant impact on the market. Other rating agencies, however, were in no haste to upgrade Russian credit rating. According to the statement made by Standard & Poor's, the government of the Russian Federation takes no advantage of high oil prices to implement structural reforms: "In relative terms the situation with reforms is more like getting worse, and this is the main reason for the Russian credit rating remaining at the current level".

In November, the demand for government bonds was stable, but not heavy enough. In spite of the gaining US dollar and extremely unfavorable situation with cash liquidity, investors restrained from active sales. At the same time, the demand in the primary market was poor, and the bonds were placed with premium to the second market. It should be noted, however, that the government managed to take under control the initially unfavorable situation with inflation which had a certain effect on the market of debts denominated in rubles. This was attained by way of artificial "freezing" of motor gasoline prices and regulating rates of the municipal housing economy (public utilities). Upward trend in government bonds quotations remained weak throughout the last month of 2005. Domestic news remained positive in general thus supporting the demand for the assets denominated in rubles. The macroeconomic statistics testified of fall of inflation rates and growth, even faster than it was anticipated, in economic rates in the Russian Federation. The fact that Standard & Poor's upgraded the Russian Federation's sovereign credit rating from BBB-

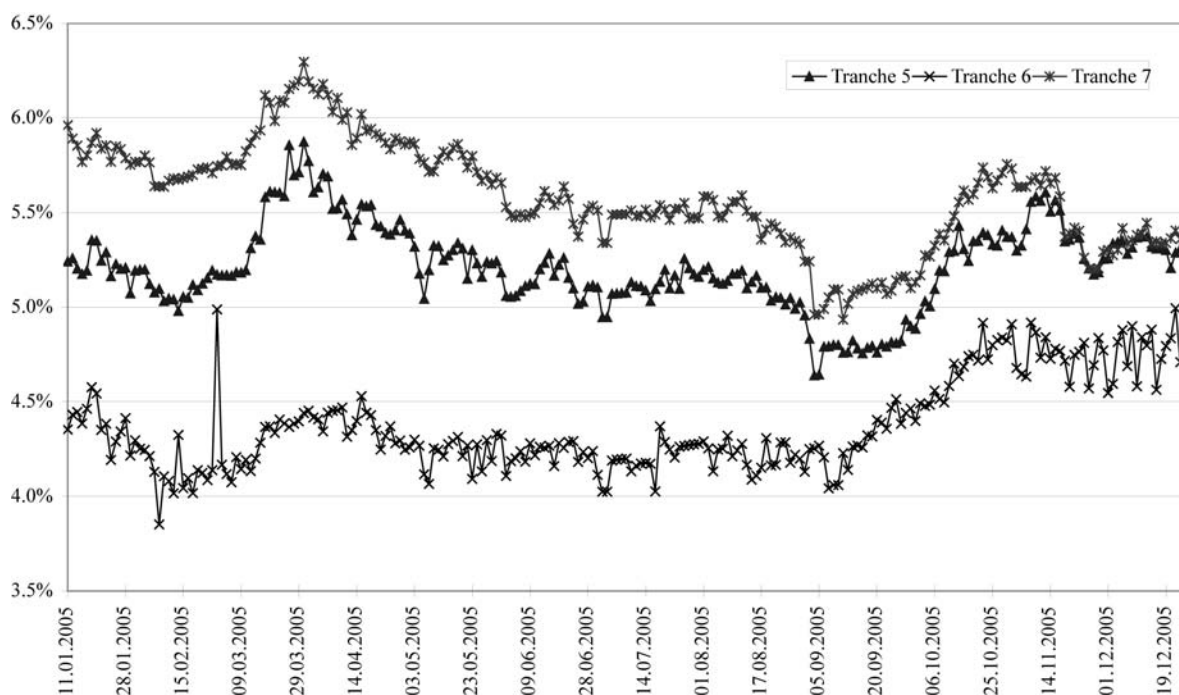
to BBB also provided a certain support to quotations. In December, however, a share of funds of the government debt market was spent on corporate bonds, whose primary offering was good enough in December. Hence the average weighted yield fell insignificantly to amount to 6.5% p. in the market of debt denominated in rubles under the influence of the foregoing factors by the end of 2005.

During 2005, the Ministry of Finance of Russia held successfully 20 auctions on placement of GKO/ OFZ bonds to the amount of nearly Rb 165.7 billion, which is slightly smaller than that in 2004. The actual volume of placement amounted to Rb 116.6 billion. The yield at the average weighted price varied from 6.22% to 8.85% p. a. at the auctions. As of December 30, 2005, the volume of GKO/ OFZ bonds market amounted to Rb 721.57 billion at par value and Rb 724.62 billion at market value. Duration of the GKO/ OFZ market portfolio was 1892.63 days.

External Debt

According to the outcomes in 2005, there was an upward trend for some bonds and downward trend for the others in the market of bonds denominated in foreign currency. In particular, as of the end of December, 2005, the yield of the fifth tranche MinFin Bonds amounted to 5.27% p. a. (as opposed to 5.24% early in the year) and the sixth tranche 6 MinFin Bonds – 4.71% p. a. (as opposed to 4.35% early in the year). During the year, however, the yield of RUS-30 and RUS-28 bonds varied within the range between 6.77% and 7.35% to 5.50% and 6.08% p. a., yield to maturity of RUS-07 bond amounted to nearly 5.0% p. a. (as opposed to 4.72% early in the year), while RUS-18 bonds were traded at prices corresponding to the yield of 5.67% p. a. (as opposed to 7.21% early in the year).

Several most significant positive factors regarding the movement in the Eurobonds market can be highlighted. The first one is extremely favorable conditions in the world oil and metal markets, as well as stable macroeconomic situation in the country. The second factor is the early repayment of a share of the Russia's sovereign debt (\$15 billion US dollars) due to the Paris Club of Creditors. The third factor: it is essential that Standard & Poor's upgraded the Russia's credit rating up to BBB, as well as Fitch upgraded the Russia's sovereign credit rating to BBB. The key adverse factor for the market throughout the year was the movement of the yield of the US Treasury Bonds which was influenced by periodical increases of the discount rate by the US Federal Reserve System, as well as the growth in inflationary processes in the US economy.

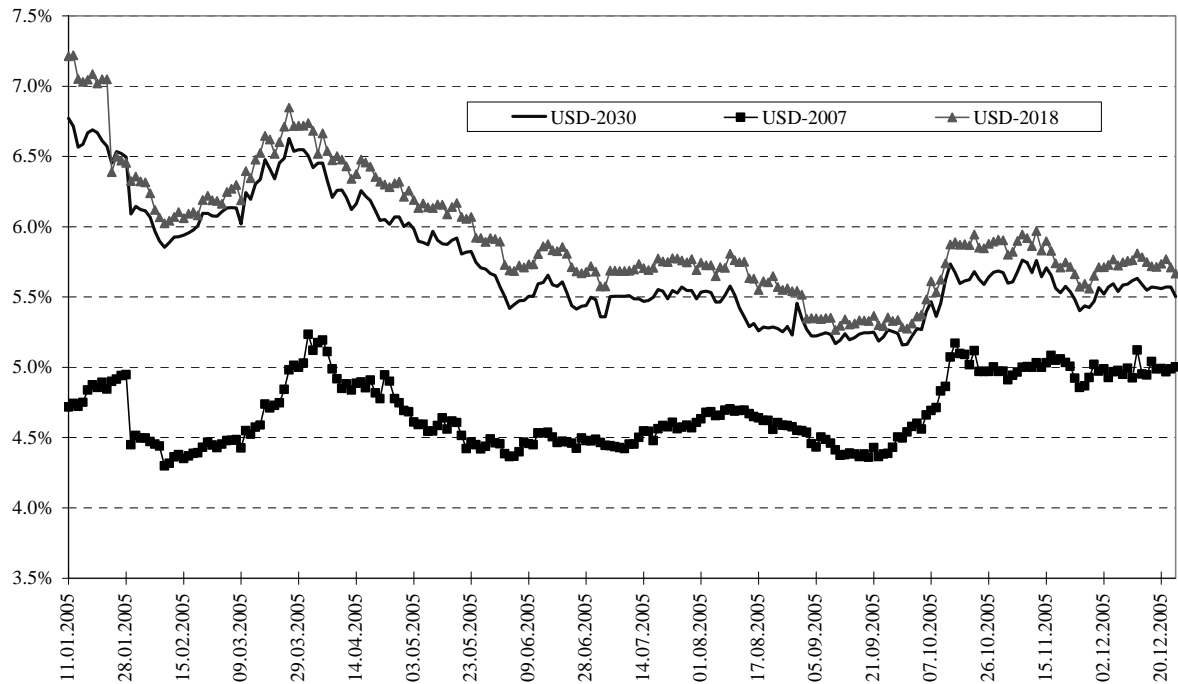


Source : Finmarket Asset Management Company.

Fig. 22. MinFin Bonds Yield to Maturity in 2005

Several periods in the movement of quotations should be highlighted. Quotations grew throughout the first month and the first half of the second month of 2005, but since the mid February the upward movement gave way to downfall, as a result the yield of most series reached the maximum annual peaks by the end of March. In January, the market situation was fairly favorable. Quotations of Eurobonds grew as the yield of the US Treasury Bonds declined. The news on the likelihood of early repayment of a share of the Russia's debt due to the Paris Club of Creditors was essential for the market. However, the negotiations between the parties held in January resulted in disagreement on this issue, mainly because of the amount of the discount which Russia would expect for the early repayment. The news on that Lehman Brothers investment bank was considering an option of accepting the Russian Federation's Eurobonds into the listing of bonds traded under its index, which is taken into account in developing strategies by major foreign funds, was fairly positive. In February, prices ceased to grow, and quotations changed insignificantly. The market was supported by rising world oil prices, while their stabilization and even fall was caused by the decision of the Paris Club of Creditors which not only refused to discount the debt but also demanded a premium to be paid for early repayment.

The world debt market was influenced by several developments, in particular, investment activity in the market of Russian Eurobonds at the end of February, as well as a February statement of the head of the US Federal Reserve System A. Greenspan, who stressed the need to further increase the basic interest rate. As early as in March, a 2.75% increase in the discount rate of the US Federal Reserve System provoked active sales of Russian Eurobonds, which resulted in substantial growth in yield. Increasing inflationary expectations on the ground of official statistics should be highlighted among the domestic factors that led to aggravation of the market conditions in March. Consumer prices grew by 5.3% by the end of Q1 as opposed to 10% of the annual forecast.



Source : Finmarket Asset Management Company.

Fig. 23. Russian Eurobonds Yield to Maturity due 2030, 2018 and 2007, in 2005

The fall of quotations that took place throughout the entire March, stopped in April to give way to an upward trend which lasted till the beginning of September. The favorable market conditions over the period under review were governed by a series of external and internal factors. First, the market participants were watching carefully the negotiations on early repayment of a share of the Russia's debt due to the Paris Club of Creditors. As a result, the information available on certain developments concerning this issue and subsequently the fact of an agreement on the likelihood to repay \$15 billion US dollars at par value supported the interest of investors in Russian bonds denominated in foreign currency. Second, in spite of the fact that an increase in the discount rate by the US Federal Reserve was initially a negative factor for the debt market, it had no significant adverse impact on prices in the period between April and August. The level of interest rate over this period was gradually increased up to 3.5%, but any increase was expectable, i.e. included in prices long before the relevant decisions were made. In addition, while the comments made by the US Federal Reserve System in April – June regarding its intention to further gradually increase interest rates, the US monetary authorities noted the likelihood of recession in the US economy and that it could be possible to pause the interest rate increase after publication of negative macroeconomic statistics and a hurricane in the Gulf of Mexico in August. As a result, the US market responded by price rise, which automatically improved the market conditions in the Russian Eurobond market as well. It should be noted that the Russian market became less dependant on price movement of the US debt securities throughout the period between April and August 2005. So, Russian Eurobonds grew as the yield of US Treasury Bonds declined, while they showed no clear movement or declined insignificantly as the later fell.

Third, investors also felt optimistic as they anticipated the Russian sovereign rating to be upgraded. In April, Fitch published comments which were favorable Russia by giving a high credit to Russia due to high oil prices. In June, Moody's upgraded credit rating on Gazprom and some other Russian companies, whose rating was higher than that of the Russian Federation, which was interpreted by investors as the likelihood of upcoming upgrade for Russia, and consequently had a positive effect on quotations.

There were several negative factors which should be highlighted in this period, namely General Motors and Ford were downgraded to junk status, which resulted in mass sales of corporate bonds in the United States and could be considered a potential threat to the debt markets. However, these events had no serious effect on the movement of the Russian segment of Eurobonds. In July, the debt markets were effected by China's transition to a floating exchange rate of its national currency Yuan within a corridor instead of pursuing the fixed exchange rate policy. The US market responded by a downward trend, because any significant gain of Asian countries' currencies is likely to lessen their demand for US debt instruments.

In September, the movement of quotations of various instruments was quite different. While during the month the yield of MinFin Bonds consolidated with a weak upward trend, the yield of Eurobonds continued to fall. The market was supported by high oil prices in the world market, as well as a statement of President Putin who highlighted "a good positive strengthening of the economy" and provided a forecast of at least 5.9% for the GDP on the basis of the outcomes of 2005. At the same time, the investment demand for Russian bonds denominated in foreign currency was adversely affected by yield growth of the US debt securities after a new increase of 3.75% p. a. in the interest rate, as well as growing inflationary expectations in the United States.

The Russian market of bonds denominated in foreign currency was falling throughout the October and first half of November, which was governed mainly by the movement in the US government debt market which traditionally serves as a guidance for other developed and emerging markets. Most evident were risks of accelerating inflation in the United States, as well as planned increase in the US interest rate of up to 4.25% p. a. by the end of the year. In November, Russian securities were affected by a growth in the USD exchange rate both in the external and internal markets. On the one hand, the growth in USD exchange rate obviously was caused by a new increase in the interest rate of up to 4% p. a., as well as concern of government about growing inflation processes. Under a stable economic growth it meant that the US Federal Reserve System were very likely to further pursue the course aimed at increasing the value of borrowings. The similar effect was produced by an OECD statement which contained recommendations to keep on increasing the interest rate. Under a stable interest rate in the European community, such steps of the US Federal Reserve System promoted attractiveness of USD assets in terms of investment, which, on the one hand, stimulated the demand for US bonds and could have a favorable effect on the markets of other countries, but, on the other hand, could result in outflow of funds from emerging markets in a medium-term period, and thus a decline. Eventually, however, the former effect was found to be prevailing, which caused correction movement in the US market, and subsequently the Russian market, which continued until the end of November to result in some decline in the yield of traded instruments.

In December, quotations changed in opposite directions with a prevailing weak upward trend. The market was stabilized by mainly the news from the United States, where the interest rate reached the anticipated 4.25% p. a., while the comments made by the US Federal Reserve System evidenced some changes in the official position of the US monetary authorities. In particular, it followed from the document that any further increase in the

interest rate would depend largely on the nature of published macroeconomic statistics. Favorable US statistical data, which evidenced reduction in the inflation risk, had an additional positive effect on prices. There are several internal factors that should be highlighted, namely favorable statistical data on economy of the Russian Federation and, in particular, the readiness of the Russian government to early repay additional \$12 billion US dollars to the Paris Club of Creditors in 2006. As a result, quotations of some series of Eurobonds declined by year end, while other series of bonds showed the yield equal to average annual figures or less at closing on December 23.

2.4.2. The Market for Subfederal and Municipal Borrowings

The Dynamics of Market Development

According to the 2005 results, the consolidated regional budget was executed with surplus of Rb 57.1 bn, i.e. 1.6% of its expenditure part, or 0.26% of GDP. Budgets of the Federation's Subjects were executed with a surplus of a. Rb 53.8 bn (2.3% of the expenditure part), while the municipal entities' budgets – with a surplus of Rb 9.4 bn (0.8% of the expenditure part).

In 2004, the consolidated regional budget was executed with a surplus of Rb 31.9 bn, i.e. 1.1% of its expenditure part, or 0.19% of GDP. The budgets of the Federation's Subjects were executed with a surplus of nerally Rb 28.7 bn (1.6% of the expenditure part), the municipal entities' budgets – with a surplus of Rb 2.2 bn (0.2% of the expenditure part). Meanwhile, the 2003 and 2002 consolidated regional budgets were executed with a deficit (*Table 21*).

Table 21

The Territorial Budgets' Surplus (Deficit) to Budgetary Expenditures (%) Ratio

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
2005	1.6	2.3	-0.8
2004	1.1	1.6	0.2
2003	-2.6	-2.3	-3.2
2002	-2.7	-3.0	-2.8

Source: Author's calculations basing on the data of the Ministry of Finance of the RF.

As of January 1, 2006, the consolidated budget in was executed with surplus33 Sub-jects. An aggregate volume of the budget surplus in the regions made up Rb 1050.7 bn., or 5.4% of the amount of the revenue part of their budgets. The median value of the budget surplus made up 2.6% of the revenue part of the budget.

The greatest surplus to level of consolidated budget revenues ratio was reported by Tyumen oblast – 25.1%, Yamal-Nenetsky autonomous okrug – 8.3%, Khanty-Mansy autonomous okrug – 6.6%, Chechen Republic – 6.4%, Perm oblast – 5.1%. More than a half– that is, 59.3% of the aggregate surplus of the regional budget was secured by three Subjects of the Federation: Tyumen oblast 34.3%, or Rb 36.0 bn, Moscow – 18.6%, or Rb 19.5 bn and Khanty-Mansy autonomous okrug – 11.8%, or Rb 12.4 bn. The surplus of the consolidated budget of Yamal-Nenetsky autonomous okrug amounted to Rb 6.7 bn. A considerable level of surplus noted in budgets of the oil-producing regions can be explained primarily by a notable increase of export prices for energy sources.

In 2005, as many as 54 RF Subjects executed their consolidated budgets with deficit³⁷, the aggregate volume of which made up Rb 48.0 bn, or 2.9% of the revenue part of the budgets in question.

The median value of the budget surplus made up 2.0% to revenues of the respective budget. The highest deficit to budget revenues ratio was noted in the Republic of Sakha (Yakutia) – 18.3% and Republic of Kalmykia – 11.3%.

Roughly as much as 50.3% of the aggregate deficit fell on 5 Federation's Subjects: the Republic of Sakha (Yakutia) – 26.5% ,or Rb 12.74 bn, Krasnoyarsk krai – 9.9%, or Rb 4.75 bn, Lipetsk oblast – 5.4%, or Rb 2.6 bn, Khabarovsk krai – 4.3%, or Rb 2.06 bn, Moscow oblast – 4.2% ,or Rb 2.01 bn (*Table 24*).

Change in the structure of the accumulated debt

In 2005, the value of the accumulated debt of the consolidated regional budget soared up to Rb 20163.43 mn., or by 0.09% GDP. The rise of the debt was fueled by the growth of the domestic debt (i.e. the debt denominated in rubles). The foreign debt of the consolidated regional budgets decreased by Rb 2168.8 mn., while the domestic debt grew by Rb 22332.2 mn (*Table 22*).

Table 22

Net Borrowings of Regional and Local Budgets (as % to GDP)

Year	1995	1996	1997	January– August 1998	January– December 1998	1999	2000	2001	2002	2003	2004	2005
Borrowings of subfederal and local government including:												
Repayable loans from the budgets of other levels	0.38	0.87	1.43	0.71	0.33	0.15	-0.29	-0.04	0.47	0.37	0.26	0.09
Subfederal (municipal) bonds	н.д.	0.16	0.22	0.08	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09
Other borrowings	0.31	0.48	0.55	0.58	0.43	0.31	0.01	-0.02	0.19	0.6	...	0.03
Reduction in balances of the budget accounts	...	0.03	-0.18	0.09	0.02	-0.19	-0.30	-0.05	-0.04	-0.18	-0.62	-0.48
Financing of deficit using borrowings and cutting the balances of the budget accounts	0.38	0.9	1.25	0.8	0.35	-0.04	-0.59	-0.09	0.38	0.19	-0.36	-0.38

Source: Author's calculations, basing on the data of the Ministry of Finance of the RF.

³⁷ In the 2005 report on execution of the budgets of the Russian Federation's Subjects for published by the Ministry of Finance of Russia (Federal treasury) the data on Evenk autonomous okrug and Taymyr (Dolgano-Nenetsk) autonomous okrug are not singled out as separate items.

The structure of borrowings

The 2005 total volume of borrowings of the consolidated regional budget amounted to Rb 227153.92 mn, of which the external borrowings accounted for Rb 1 403.8 mn. The biggest domestic borrowers became Moscow – Rb 131.1 mn and Bashkortostan – Rb 1, 272.8 mn.

The aggregate volume of domestic borrowings made by regions and municipalities made up Rb 225750.08 mn. The list of the biggest borrowers on the domestic market was topped by: Moscow oblast – Rb 39.1 bn, followed by Novosibirsk oblast – Rb 26.0 bn, Moscow – Rb 21.4 bn, Krasnoyarsk krai – Rb 11.1 bn, Saint-Petersburg – Rb 9.8 bn, Nizhny Novgorod oblast – Rb 9.7 bn, Khabarovsk krai – Rb 8.9 bn. When compared to 2004 the volume of borrowings in nominal terms decreased by Rb 31.9 bn or by 20.9% in real terms. The contraction of regions and municipalities' borrowings can be explained by a healthier state of their budgets, which enabled many of them to repay the accumulated loans from current budget revenues.

In the total volume of domestic borrowings of the consolidated regional budget the securities issuance accounted for 36.0%, loans from the federal budget – 1.2%, other borrowings (primarily banking credits) – 62.59%. It should be noted that according to the data of the Ministry of Finance of Russia, budgetary loans practically discontinued to play a significant part in the financing of municipal budgets deficits. They contracted for a year in the structure of municipalities' borrowings from 46.4% practically to 0. Meanwhile, the role of banking credits and papers rose. Thus, the share of papers in the volume of municipal administrations' borrowings increased 2.6 times, from 4.0 to 10.2%, while the share of other borrowings grew from 49.6 to 89.8%.

The continuous trend towards growth of securitization of the regions' debt was still there: the share of papers in the Federation's Subjects' borrowings in 2005 increased vis-à-vis the prior year by 4.5 percentage points – from 41.0 to 45.5%. Thus, over the last 2 years the level of securitization of the market for regional borrowings increased by more than one-third, while the market for domestic municipal borrowings – by more than 4 times (*Table 23*).

Table 23

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

	2005			2004			2003		
	Consolidated Regional Budget	Regional Budgets	Municipal Budgets	Consolidated Regional Budget	Regional Budgets	Municipal Budgets	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
Securities issuance	36.0	45.5	10.2	32.5	41.0	4.0	26.9	33.8	2.5
Budgetary loans	1.2	1.6	0.03	3.0	4.0	46.4	7.9	10.6	48.9
Other borrowings	62.9	52.9	89.8	64.5	55.1	49.6	65.3	55.6	48.6

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

The largest value of net borrowings to budget revenues ratio was demonstrated by: Astrakhan oblast – 8.2%, Khabarovsk krai – 7.9%, Moscow oblast – 6.5%, Kostroma oblast – 6.3%, Kamchatka oblast – 5.7%, Belgorod oblast – 5.3% (*Table 24*).

The largest net borrowers became: Moscow oblast – Rb 11.3 bn, Khabarovsk krai – Rb 3.2 bn, Krasnoyarsk krai – Rb 2.3 bn, Nizhny Novgorod oblast – Rb 1.7 bn, Saratov oblast – Rb 1.7 bn.

The following regions have succeeded in cutting down the accumulated debt to the greatest extent: Moscow – Rb 12.6 bn, Saint-Petersburg – Rb 1.5 bn, Chukotka autonomous okrug – Rb 992 million, Rostov oblast – Rb 758 million, Ulyanovsk oblast – Rb 641 million.

Table 24

**Execution of the RF Subjects' Consolidated Budgets
in 2005 (%)**

	Budget revenues, (thou. rub.)	Budget surplus (deficit) (thou. rub.)	Surplus (deficit) to revenues ratio	Attracted borrowings to revenues ratio	Net borrowing to revenues ratio	Interest expenditures to revenues ratio	Net borrowings to surplus (deficit) ratio
1	2	3	4	5	6	7	8
Central Federal okrug							
Belgorod obl.	29 798 847.24	-1 059 256.98	-3.55	7.27	5.32	1.95	-149.64
Bryansk obl.	18 637 546.07	-652 508.82	-3.50	10.62	4.41	6.21	-125.85
Vladimir obl.	20 289 765.93	539 481.72	2.66	0.50	-0.91	1.41	-34.25
Voronezh obl.	29 648 020.67	739 110.79	2.49	8.38	-0.43	8.82	-17.43
Ivanovo obl.	23 709 266.03	-315 138.14	-1.33	7.47	3.62	3.86	-272.30
Kaluga obl.	18 542 143.22	-348 719.97	-1.88	3.81	1.08	2.72	-57.54
Kostroma obl.	10 703 331.42	-689 094.19	-6.44	17.76	6.31	11.44	-98.05
Kursk obl.	17 364 372.92	418 685.07	2.41	0.58	-0.68	1.26	-28.32
Lipetsk obl.	28 330 844.25	-2 596 769.99	-9.17	1.06	1.06	0.00	-11.55
Moscow obl.	174284 317.12	-2 007 935.29	-1.15	22.42	6.47	15.94	-561.79
Oryol obl.	11 881 015.96	-95 519.96	-0.80	0.03	-0.12	0.15	14.67
Ryazan obl.	17 740 286.26	-644 916.05	-3.64	6.45	3.63	2.82	-99.79
Smolensk obl.	14 624 830.31	391 517.12	2.68	2.57	-1.39	3.97	-51.99
Tambov obl.	16 786 396.54	86 859.93	0.52	1.55	0.08	1.47	16.07
Tver obl.	18 542 143.22	-348 719.97	-1.88	3.81	1.08	2.72	-57.54
Tula obl.	25 649 733.16	239 447.99	0.93	21.71	-0.45	22.16	-48.05
Yaroslav obl.	30 289 315.33	-395 580.93	-1.31	9.24	1.92	7.32	-147.17
Moscow	523 763 314.80	19 517 527.17	3.73	4.11	-2.40	6.52	-64.53
Total	1 029 527 650.1	13 196 040.06	1.28	3.58	0.34	7.67	26.31
North-Western Federal okrug							
Republic of Karelia	17 866 888.79	974 160.59	5.45	5.00	-0.44	5.44	-8.05
Komi Republic	34 241 139.93	220 025.49	0.64	3.16	2.59	0.57	403.26
Arkhangelsk obl.	27 416 063.26	-1 722 086.02	-6.28	1.88	-1.54	3.42	24.57
Vologda obl.	32 822 517.04	-19 367.33	-0.06	1.53	-0.26	1.79	434.90
Kaliningrad obl.	19 347 710.51	-1 145 324.53	-5.92	5.29	-0.06	5.35	0.98
Leningrad obl.	33 365 908.44	-20 427.77	-0.06	8.11	2.14	5.97	-3 487.89
Murmansk obl.	23 726 314.68	551 852.40	2.33	4.22	0.17	4.05	7.51
Novgorod obl.	15 032 256.94	529 129.20	3.52	0.17	-0.28	0.45	-8.09
Pskov obl.	12 500 112.56	6 451 156.55	51.61	5.67	-2.36	8.04	-4.58
St. -Petersburg	143 245 334.75	-610 750.42	-0.43	6.88	-1.02	7.90	239.19
Nenetsky autonomous okrug	6 132 412.82	-662 962.51	-10.81	0.00	0.00	0.00	0.00
Total	365 696 659.74	279 381.79	0.08	1.88	-0.21	5.21	-270.22

Section 2.
Monetary and budgetary spheres

1	2	3	4	5	6	7	8
Southern Federal okrug							
Republic of Adygeya	6 261 626.05	1 342 591.37	21.44	3.25	-0.57	3.83	-2.68
Republic of Dagestan	32 170 224.32	-548 100.11	-1.70	0.00	-0.08	0.08	4.60
Republic of Ingou-shetia	6 773 784.54	-289 766.72	-4.28	0.00	0.00	0.00	0.00
Kabardino-Balkar Republic	10 770 466.49	-541 194.21	-5.02	22.06	3.60	18.46	-71.63
Republic of Kalmykia	4 875 687.38	-105 254.38	-2.16	4.14	4.11	0.04	-190.26
Karachai-Chircassian Republic	6 404 227.75	3 199 566.90	49.96	26.45	-0.18	26.63	-0.36
Republic of North Ossetia -Alania	12 761 232.22	1 524 406.11	11.95	5.38	3.31	2.07	27.70
Chechen Republic	20 929 668.63	-8 627.63	-0.04	0.00	0.00	0.00	0.00
Krasnodar krai	76 861 809.11	-746 385.01	-0.97	0.53	-0.15	0.68	15.34
Stavropol krai	38 282 639.99	-500 251.78	-1.31	2.72	1.37	1.35	-104.98
Astrakhan obl.	13 801 959.57	759 572.42	5.50	22.39	8.19	14.20	148.90
Volgograd obl.	34 326 922.59	72 086.11	0.21	9.79	1.84	7.95	876.80
Rostov obl.	68 372 055.92	-27 469.10	-0.04	0.11	-1.11	1.22	2 758.79
Total	332 592 304.57	-125 772.63	-0.04	3.41	0.71	3.24	-1 870.93
Volga Federal okrug							
Republic of Bashkortostan	69 339 694.21	-569 667.08	-0.82	1.85	-0.03	1.88	3.69
Republic of Mary-El	10 449 407.42	-153 154.81	-1.47	3.90	0.47	3.43	-32.13
Republic of Mordovia	22 115 964.76	-677 839.16	-3.06	0.00	-0.60	0.60	19.73
Republic of Tatarstan	109 074 903.58	-811 912.67	-0.74	5.44	1.19	4.25	-159.31
Udmurt Republic	28 437 879.47	-987 375.44	-3.47	5.97	2.94	3.03	-84.67
Republic of Chuvashia	19 857 833.86	2 758 159.84	13.89	7.99	3.27	4.72	23.53
Kirov obl.	48 800 527.07	-19 176.65	-0.04	19.96	3.52	16.44	-8 948.72
Nizhny Novgorod obl.	24 037 095.83	-424 422.80	-1.77	5.58	3.36	2.22	-190.28
Orenburg obl.	66 787 840.97	3 116 824.16	4.67	6.21	2.21	4.00	47.36
Penza obl.	36 362 965.68	-1 147 503.49	-3.16	0.60	-0.50	1.10	15.90
Perm obl.	19 041 044.49	668 127.51	3.51	8.82	0.63	8.18	18.01
Samara obl.	60 863 054.33	54 608.17	0.09	0.30	-0.08	0.38	-85.74
Saratov obl.	34 961 574.06	243 977.72	0.70	9.42	4.78	4.64	684.84
Ulyanovsk obl.	17 882 979.16	2 842 977.63	15.90	0.75	-3.59	4.34	-22.56
Komi-Permyatsky autonomous okrug	3 739 542.58	36 041 258.65	963.79	0.64	-0.24	0.89	-0.03
Total	571 752 307.47	-449 385.11	-0.08	4.00	1.33	4.21	-1 687.65
Ural Federal okrug							
Kurgan obl.	16 010 092.77	12 424 218.38	77.60	0.59	-0.35	0.94	-0.46
Sverdlovsk oblast	80 456 112.12	6 714 466.30	8.35	0.81	0.00	0.81	-0.06
Tyumen oblast	143 747 556.72	-232 161.80	-0.16	0.03	-0.25	0.27	152.13
Chelyabinsk oblast	63 038 860.59	118 763.17	0.19	0.01	-0.15	0.17	-81.98
Khanty-Mansy autonomous okrug	189 430 325.90	1 097 514.31	0.58	0.40	-0.19	0.59	-32.88
Yamal-Nenetsky autonomous okrug	81 224 713.26	-4 753 688.07	-5.85	2.41	-0.01	2.41	0.09
Total	573 907 661.35	-747 503.40	-0.13	0.59	-0.15	0.76	117.22

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	1	2	3	4	5	6	7	8
Siberian Federal okrug								
Republic of Altai	7 829 171.46	578 333.61	7.39	5.53	0.72	4.81	9.73	
Republic of Buryatia	20 363 837.59	-447 707.87	-2.20	12.15	1.07	11.09	-48.50	
Republic of Tuva	9 761 282.53	-1 074 205.89	-11.00	0.00	-0.29	0.29	2.68	
Republic of Khakassia	8 991 398.88	-2 059 017.85	-22.90	0.41	-0.06	0.47	0.26	
Altai krai	41 473 013.99	-138 485.45	-0.33	4.72	-0.33	5.06	99.86	
Krasnoyarsk krai	90 367 875.40	-67 702.48	-0.07	12.28	2.57	9.71	-3 435.50	
Irkutsk obl.	54 236 003.38	-569 977.04	-1.05	8.75	3.24	5.51	-307.86	
Kemerovo obl.	72 196 077.74	-210 675.09	-0.29	0.53	-0.66	1.18	224.59	
Novosibirsk oblast	51 942 823.30	138 961.59	0.27	50.06	1.50	48.56	559.38	
Omsk obl.	49 567 495.72	-293 343.03	-0.59	7.81	-1.39	9.19	234.19	
Tomsk obl.	25 576 122.91	-15 372.33	-0.06	14.72	0.35	14.37	-585.80	
Chita obl.	23 394 157.97	-12 743 534.66	-54.47	3.17	1.87	1.30	-3.43	
Aginsky Buryatsky autonomous okrug	3 011 760.13	371 315.07	12.33	0.53	0.00	0.53	0.00	
Ust-Ordynsky Buryatsky autonomous okrug	3 234 026.34	-891 383.32	-27.56	0.02	0.02	0.00	-0.06	
Total	461 945 047.35	-1 617 738.97	-0.35	9.78	0.94	11.08	-267.40	
Far Eastern Federal okrug								
Republic of Sakha (Yakutia)	69 480 303.81	-47 875.04	-0.07	6.67	2.02	4.64	-2 936.33	
Primorsky krai	41 660 325.20	-573.38	0.00	1.63	-0.77	2.40	56 269.97	
Khabarovsk krai	40 128 724.81	-1 887.98	0.00	22.30	7.86	14.44	-167 57.21	
Amur oblast	25 676 885.92	-902 574.26	-3.52	4.42	-0.86	5.28	24.49	
Kamchatka oblast	16 293 961.91	-663 104.62	-4.07	18.61	5.72	12.89	-140.51	
Magadan obl.	12 386 243.35	-2 607.01	-0.02	2.23	1.16	1.07	-5 495.63	
Sakhalin oblast	20 594 340.72	209 680.45	1.02	8.27	0.18	8.08	18.15	
Jewish Autonomous obl.	4 275 051.95	32 712.57	0.77	1.08	-0.51	1.58	-66.26	
Koryaksky autonomous okrug	4 615 760.68	-37 120.26	-0.80	17.77	3.94	13.83	-490.15	
Chukotka autonomous okrug	16 405 049.33	-761 028.22	-4.64	0.00	-6.05	6.05	130.35	
Total	251 516 647.66	-97 251.83	-0.04	7.23	1.71	6.75	-4 420.83	
Total federal okrugs	3 622 522 716.23	57 132 014.22	1.58	6.27	0.56	5.71	35.29	

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

Domestic bonded loans

In 2005, 25 Federation's Subjects and 13 municipal entities registered bonded loans (vis-à-vis 24 regional and 10 municipal loans in 2004). In 2005, the total volume of placed bonds made up Rb 81.2 bn vis-à-vis Rb 79.4 bn in 2004, thus decreasing for a year from 0.47 to 0.37% GDP (Table 25).

Despite the fact that the growth of the volume of issuance of regions and municipalities' securities was lagging behind inflation rates, the volume of the market for subfederal bonds had grown for the first eleven months of 2005 in real terms by 11.8%, from Rb 128.2 to Rb 158.9 bn. In parallel with that, the volume of monthly secondary exchange-traded turnover of subfederal and municipal bonds, after reaching its maximum in September 2005 (Rb 70.7 bn vis-à-vis Rb 37.0 bn in December 2004) began to decline and amounted to Rb 55.6 bn in November 2005.

Table 25

Volume of Issuance of Subfederal and Municipal Papers (as % to GDP)

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47	0.37
Repayment	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19	0.28
Net financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09

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

In 2005, the Ministry of Finance of the RF registered issue prospectuses by: Moscow, St.- Petersburg, Republic of Chuvashia, Volgograd obl., Tomsk obl., Komi Republic, Leningrad, Irkutsk obl., Moscow obl., Khabarovsk krai, Republic of Sakha (Yakutia), Novosibirsk obl., Yaroslavl obl., Krasnoyarsk krai, Republic of Bashkortostan, Republic of Karelia, Lipetsk obl., Nizhny Novgorod obl., Voronezh obl., Belgorod obl., Tver obl., Kostroma obl., Samara obl., Kabardino-Balkar Republic, Kirov obl., Udmurt Republic, Ekaterinburg, Yuzhno-Sakhalinsk, Krasnoyarsk, Novosibirsk, Novocheboksarsk, Volgograd, Cheboksary, Kazan, Angarsk, Klin and Odintsovo districts of Moscow oblast, city of Shumerlya, and Vurnar district of Republic of Chuvashia .

The largest issuers of the securities became: Moscow, (for Rb 21.2 bn or 26.2% of the volume of total issuance of the territories), Moscow obl. – Rb 18.7 bn (23.0%), St.- Petersburg – Rb 9.8 bn, or 12.1%, Novosibirsk obl. – Rb 4.1 bn, or 5.1%. Thus, the share of the four largest issuers accounted for 66.3% of the total volume of issuance of placed regional and municipal bonds.

As well, large volumes of issuance was placed by: Krasnoyarsk krai – Rb 2.6 bn, Irkutsk oblast – Rb 2.6 bn, Nizhny Novgorod oblast – Rb 2.5 bn, Republic of Sakha (Yakutia), Republic of Tatarstan, Belgorod obl. and Samara obl. – Rb 2.0 bn each (*Table 26*).

Table 26

Placement of Subfederal Papers in 2005

Federation's Subject	Volume of Issuance (thou. rub.)	Issuer's Share in the Total Volume of Issuance, (%)	Volume of Issuance to Domestic Borrowings Ratio, (%)
1	2	3	4
Central Federal okrug			
Belgorod oblast	2 000 000.0	2.5	92.4
Voronezh oblast	500 000.0	0.6	20.1
Tver oblast	800 000.0	1.0	45.1
Kostroma oblast	793 840.0	1.0	41.8
Lipetsk oblast	300 000.0	0.4	100.0
Moscow oblast	18 665 784.0	23.0	47.8
Yaroslavl oblast	1 342 470.0	1.7	48.0
Moscow	21 242 274.0	26.2	99.2
North-Western Federal okrug			
Republic of Karelia	350 000.0	0.4	39.2
Komi Republic	950 000.0	1.2	87.7
Leningrad oblast	300 000.0	0.4	11.1
St.- Petersburg	9 849 248.7	12.1	100.0
Southern Federal okrug			
Kabardino-Balkar Republic	500 000.0	0.6	21.0
Volgograd oblast	1 294 331.7	1.6	38.5

1	2	3	4
Volga Federal okrug			
Republic of Tatarstan	2 000 000.0	2.5	33.7
Udmurt Republic	1 000 000.0	1.2	58.9
Chuvash Republic	875 130.0	1.1	55.2
Nizhny Novgorod oblast	2 500 000.0	3.1	25.7
Kirov oblast	400 000.0	0.5	29.8
Samara oblast	2 000 000.0	2.5	48.2
Ural Federal okrug			
Sverdlovsk oblast	120 000.0	0.1	18.5
Siberian Federal okrug			
Krasnoyarsk krai	2 600 000.0	3.2	23.4
Irkutsk oblast	2 550 000.0	3.1	53.7
Novosibirsk oblast	4 127 000.0	5.1	15.9
Tomsk oblast	1 059 028.3	1.3	28.1
Far Eastern Federal okrug			
Republic of Sakha (Yakutia)	2 000 000.0	2.5	43.2
Primorsky krai	1 433.0	...	0.2
Khabarovsk krai	1 000 000.0	1.2	11.2
Sakhalin oblast	100 000.0	0.1	5.9
Total	81 220 539.8	100.0	36.0

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

As of today, it was mostly the largest issuers that demonstrated a high level of securitization: Moscow – 99.2% and St.– Petersburg – 100%. Lipetsk oblast conducts borrowings exclusively in the form of securities issuance. The level of securitization of the Belgorod oblast borrowings made up 92.4% and that of Komi Republic – 87.7%.

In 2005, the total volume of net borrowings on the market for subfederal and municipal papers made up Rb 20.9 bn, thus demonstrating a more than two-fold fall vis-à-vis 2004 (Table 27).

Table 27

**Volumes of Net Borrowings on the Market for Domestic Subfederal
Municipal Papers, thou. rubles**

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
1	2	3	4
2005			
Net borrowings	20 887 596	16 939 894	3 947 703
Attraction of funds	81 220 540	75 016 756	6 203 783
Repayment of the principal debt body	60 332 944	58 076 863	2 256 081
2004			
Net borrowings	47 880 300	44 470 128	3 410 172
Attraction of funds	79 436 708	74 995 965	4 440 743
Repayment of the principal debt body	31 556 408	30 525 837	1 030 571
2003			
Net borrowings	41 908 199	40 043 511	1 864 688
Attraction of funds	61 712 635	59 012 901	2 699 734

1	2	3	4
Repayment of the principal debt body	19 804 436	18 969 390	835 046
2002			
Net borrowings	17 696 530	17 153 760	542 770
Attraction of funds	29 141 777	28 169 158	972 619
Repayment of the principal debt body	11 445 247	11 015 398	429 849
2001			
Net borrowings	6 601 447	6 667 592	-66 145
Attraction of funds	15 123 785	14 226 931	896 854
Repayment of the principal debt body	8 522 338	7 559 339	962 999
2000			
Net borrowings	-1 877 328	-2 286 175	408 847
Attraction of funds	13 042 220	10 090 208	2 952 012
Repayment of the principal debt body	14 919 548	12 376 383	2 543 165

Source: Ministry of Finance of the RF.

The majority of regions that issue debt securities on a regular basis continued their issuance in 2005. Since 1999, the yearly bond issuance has been conducted by Moscow, St. Petersburg, Chuvash Republic, Volgograd obl. Since 2000, – Toms oblast. and Komi Republic, Ekaterinburg. Since 2001 they were also joined by Irkutsk oblast (*Table 28*).

Table 28

Issuance of Subfederal and Municipal Papers in 1999–2005

Issuer Federation's Subjects	Issuer 1999	Issuer 2000	Issuer 2001	Issuer 2002	Issuer 2003	Issuer 2004	Issuer 2005
1	2	3	4	5	6	7	8
Moscow	*	*	*	*	*	*	*
St. - Petersburg	*	*	*	*	*	*	*
Chuvash Republic	*	*	*	*	*	*	*
Volgograd oblast	*	*	*	*	*	*	*
Tomsk oblast		*	*	*	*	*	*
Komi Republic		*	*	*	*	*	*
Irkutsk oblast			*	*	*	*	*
Moscow oblast				*	*	*	*
Khabarovsk krai				*	*	*	*
Republic of Sakha				*	*	*	*
Novosibirsk oblast	*				*	*	*
Yaroslavl oblast					*	*	*
Krasnoyarsk krai					*	*	*
Republic of Bashkortostan			*	*		*	*
Republic of Karelia						*	*
Lipetsk oblast						*	*
Nizhny Novgorod oblast						*	*
Voronezh oblast						*	*
Belgorod oblast				*	*		*
Tver oblast				*	*		*
Kostroma oblast				*	*		*
Samara oblast					*		*
Kabardino-Balkar Republic		*					*

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	1	2	3	4	5	6	7	8
Kirov oblast								*
Udmurt Republic								*
Leningrad oblast				*	*	*	*	
Republic of Mary-El			*			*	*	
Yamal-Nenetsky autonomous okrug						*	*	
Krasnodar krai							*	
Kaluga oblast							*	
Bryansk oblast							*	
Khanty-Mansy autonomous okrug					*	*		
Murmansk oblast					*	*		
Tambov oblast						*		
Republic of Mordovia					*			
Sakhalin oblast					*			
Kursk oblast					*			
Stavropol krai				*				
Primorsky krai			*					
Municipalities								
Ekaterinburg			*	*	*	*	*	*
Yuzhno-Sakhalinsk						*	*	*
Krasnoyarsk						*	*	*
Novosibirsk						*	*	*
Novocheboksarsk		*		*			*	*
Volgograd		*	*	*	*	*		*
Cheboksary		*						*
Kazan								*
Klin district of Moscow oblast								*
Angarsk								*
Odintsovo district of Moscow oblast								*
Vurnar district of Chuvash Republic								*
Shumerlya-city of Chuvash Republic								*
Ufa					*	*	*	
Tomsk						*	*	
Barnaul							*	
Perm							*	
Noginsk district of Moscow oblast							*	
Nizhny Novgorod					*			
Kostroma		*	*					
Arkhangelsk		*						
Dzerzhinsky		*						

Source: Ministry of Finance of the RF.

Solvency of Territorial Governments

Credit rating

A considerable contraction in the accumulated sovereign debt to GDP ratio (driven by high economic growth rates in Russia, early repayment of foreign debt by the federal government, and a real appreciation of the ruble exchange rate), as well as a boost in the volumes of stabilization fund and foreign reserves over the last few years have ensured a steady rise in the country's credit rating. In 2005, Standard&Poor's raised Russia's sovereign rating by two degrees, up to level "BBB"; while Fitch also granted the country with the "BBB" level – by and Moody' – to the "Baa2" level–s. In parallel with that, there continued the process of raising of credit ratings of territorial governments. In 2005, the international credit rating of the city of Moscow was growing together with the sovereign rating of the Russian Federation. It hit the "BBB" level according to Standard&Poor's and Fitch, and "Baa2" – according to the Moody's.

The Moody's also estimated St. - Petersburg to be at the level of the sovereign credit rating. Though the Fitch agency granted St. - Petersburg with a level by one degree lower than the sovereign ("BBB–") rating, the agency's credit rating level made it possible for the city bonds to be upgraded from the category "speculative" to the "investment" one: the investment credit rating granted by the two international rating agencies opens the way for a broad array of institutional players' investing in the city's papers.

Thus, of the three international rating agencies only the Standard&Poor's considered that the risk level on St. Petersburg bonds was too high to grant them with investment rating (*Table 29*).

Table 29

International Credit Rating of the Standard&Poor's as of Beginning of 2006

Issuer name	In Foreign Currency/Forecast	In National Currency/Forecast
1	2	3
Sovereign Ratings		
Russian Federation	"BBB"/Stable	"BBB+"/Stable
Ratings of Local and Regional Administrations		
Balashikha district	"B–"/Positive	
Bashkortostan	"BB–"/Positive	"BB–"/Positive
Vologda oblast	"B+"/Stable	
Klin district	"B–"/Stable	
Krasnodar krai	"B+"/Positive	"B+"/Positive
Leningrad oblast	"B+"/Positive	
Moscow	"BBB"/Stable	
Moscow oblast	"B–"/Positive	
Samara oblast	"BB–"/Stable	
St. -Petersburg	"BB+"/Positive	"BB+"/Positive
Sverdlovsk oblast	"BB–"/Stable	"BB–"/Stable
Stavropol krai	"B"/Positive	"B"/Positive
Surgut	"BB–"/Stable	
Tatarstan	"B"/Positive	"B"/Positive

1	2	3
Ufa	"B"/Stable	"B"/Stable
Khanty-Mansy autonomous okrug	"BB+"/Positive	
Yamal-Nenetsy autonomous okrug	"BB-"/Positive	

Source: Standard&Poor's.

The outstanding debt restructuring problems

The process of the outstanding debt restructuring was gaining its momentum against the background of improvement of the budgetary situation in most of the Russian Federation's Subjects. According to the RF Ministry of Finance, as of October 2005, the volume of outstanding (non-restructured) debt, decreased by more than twice (by Rb 14.8 bn in nominal terms) vis-à-vis October 2004 – from Rb 29.0 to Rb 14.2 bn, amounting to 0.39% of the revenue part of the consolidated regional budget, or 0.07% GDP.

Of the problems associated with outstanding debt are particularly plumbing in the following regions: Kamchatka oblast – Rb 3.6 bn, or 22.0% of the revenue part of the local budget, Orel oblast – Rb 1.8 bn, or 15.2%, St. Petersburg – Rb 1.1 bn, or 0.8%, Republic of North Ossetia-Alania – Rb 0.6 bn, or 4.9% (*Table 30*).

Table 30

Outstanding Non-Restructured Bonded Debt of the Federation's Subjects

Federal Okrug	Volume of Outstanding Non-Restructured Debt, Thous rubles ³⁸	Outstanding Non-Restructured Debt to Budget Revenues Ratio, % ³⁹
1	2	3
Central Federal okrug		
Belgorod oblast	128 891	0.43
Bryansk oblast	39	...
Vladimir oblast	9 921	0.05
Kursk oblast	77 982	0.45
Moscow oblast	7 346	...
Orel oblast	1 807 900	15.22
Tambov oblast	1 297	0.01
Tver oblast	1	...
Yaroslavl oblast	717 606	2.37
Moscow	23	...
North-Western Federal okrug		
Republic of Karelia	12 680	0.07
Arkhangelsk oblast	61 375	0.22
Kaliningrad oblast	35 868	0.19
Novgorod oblast	8 793	0.06
Pskov oblast	418 999	3.35
St.-Petersburg	1 127 979	0.79
Southern Federal okrug		
Republic of Adygeya	35 700	0.57

³⁸ As of October 1, 2005 data.

³⁹ The ratio of restructured outstanding bonded debt as of October a 1, 2005 to the revenues of regional (non-consolidated) budget for 2005.

1	2	3
Kabardino-Balkar Republic	184 742	1.72
Republic of North Ossetia-Alania	627 940	4.92
Krasnodar krai	362 918	0.47
Volgograd oblast	268 971	0.78
Volga Federal okrug		
Republic of Bashkortostan	12 432	0.02
Udmurt Republic	655 556	2.31
Chuvash Republic	14 450	0.07
Kirov oblast	65 520	0.13
Nizhny Novgorod oblast	2 190	0.01
Orenburg oblast	246 151	0.37
Samara oblast	326 170	0.54
Saratov oblast	1 170	...
Ulyanovsk oblast	177 245	0.99
Ural Federal okrug		
Kurgan oblast	8 4781	0.53
Sverdlovsk oblast	2 318	...
Tyumen oblast	2 214 414	1.54
Siberian Federal okrug		
Republic of Tuva	100 435	1.03
Krasnoyarsk krai	10 2 68	0.01
Novosibirsk oblast	326 296	0.63
Taymyrsky (Dolgano-Nenetsky) autonomous okrug	21 840	no data
Evenk autonomous okrug	8 930	no data
Far Eastern Federal okrug		
Primorsky krai	398 050	0.96
Kamchatka oblast	3 582 261	21.99
Magadan oblast	16 850	0.14
Jewish autonomous oblast	254	0.01
Chukotka autonomous okrug	35 970	0.22
Total	14 200 521	0.68

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

2.4.3. Stock Market

According to the outcomes in the Russian Stock Market in 2005, it grew significantly and the RTS index almost doubled. Such a rapid growth of the Russian Stock Market was produced by several key factors, namely fairly favorable conditions in the world markets of oil and metals, which allowed the revenues of the budget system of the Russian Federation to significantly exceed the estimates, the same is true with regard to the Stabilization Fund of the Russian Federation. The macroeconomic situation was also favorable, – according to the outcomes of 2005, the Russian economy grew at the rate of 106.4% to overpass the initial forecast – except for inflation which went beyond the forecasted range throughout the entire 2005, which had an adverse affect on investment behavior. Nevertheless, the Russian government managed, by freezing prices of gasoline and regulating the rates of services provided by natural monopolies, to restrain significant growth of prices which by year end amounted to 10.9% as opposed to a 10% forecast for the year.

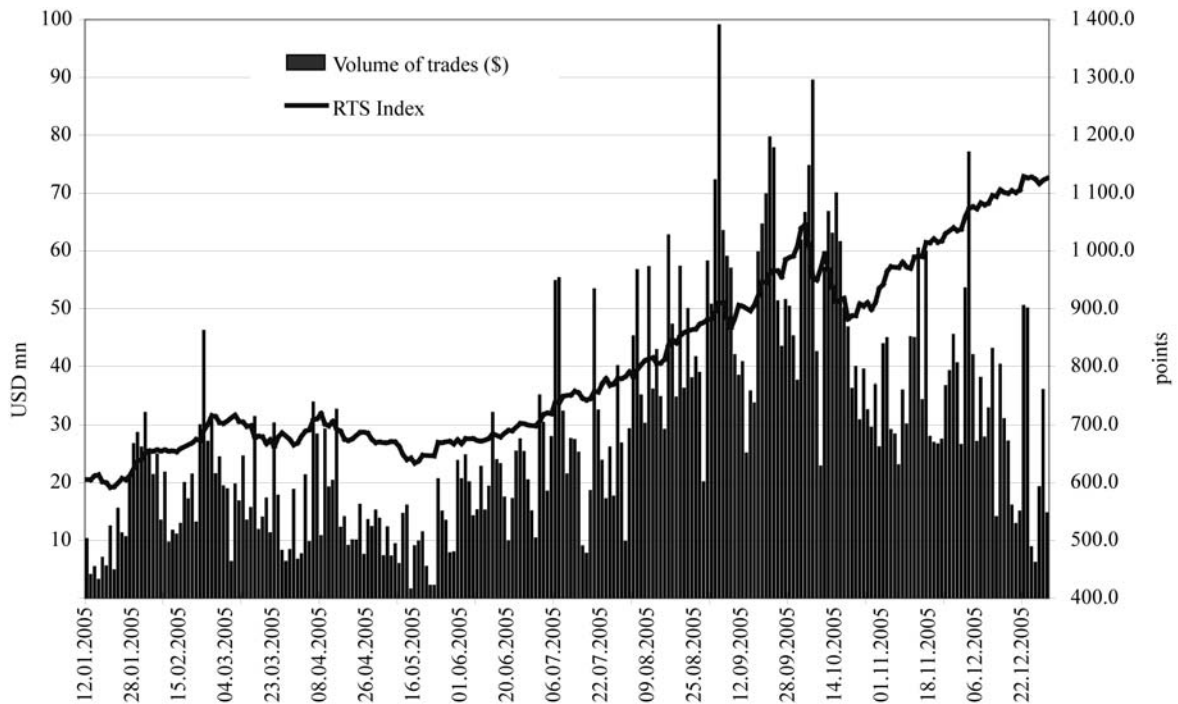
Internal corporate news played a significant role as well. So, according to the outcomes of Q1, Q2 and Q3 of 2005, financial performance results of most companies involved in the raw materials, telecommunication and some other sectors were considerably beyond those of 2004, which made such companies more attractive in terms of investment. In addition, Gazprom became one of the key newsmakers in 2005. In 2005, the Russian government increased its share in gas monopoly by purchasing a block of shares for cash, thereby completing acquisition of Sibneft oil company. However, it is the liberalization of Gazprom's shares that was the key event that marked the previous year, which had a significant influence on the upward movement of the market throughout the entire second half of 2005.

In the past 2005, the Russian RTS Stock Market grew by 518.03 points from 607.57 to 1125.6 points, which accounts for 85.26% of the index value at closing on January 11, 2005. Thus, in 2005, the stock market demonstrated a fairly impressive growth as opposed to 2004 when the RTS index grew by mere 28.3 points (by 4.78%) in terms of absolute value. The minimum growth of the RTS index in the last year – 590.62 points – was recorded on January January 21, while the historical maximum – 1139.04 points – was attained on December 23. Regarding investment activity in 2005, it grew as opposed to the previous year of 2004. In particular, the trading turnover in the classic stock market in the RTS amounted to nearly \$7.9 billion US dollars in 2005, which was far beyond the corresponding figure of 2004 (nearly \$5.7 billion US dollars). Hence the trading volume grew by nearly 38.5% in 2005 as opposed to the corresponding parameter in 2004. In addition, in 2005, 51.6 thousand transactions were entered into as opposed to 48.8 thousand transactions in the previous year, which also testifies in favor of a higher investment activity. The average annual trading volume on shares listed for the RTS index trading in 2005 amounted to \$30.86 million US dollars, which exceeds by 43% the corresponding parameter of 2004 (\$21.15 million US dollars) .

Several distinctive periods can be highlighted in the market movement. In the period between January and the beginning of April the market grew insignificantly from 607 to 719 points under the RTS index, which was followed by a short-term correction until the mid May, when the RTS index rolled back to reach 633.69 points. As illustrated in *Fig. 24*, the movement of the RTS index was accompanied by a relatively low trading volume during that period.

For example, while the monthly trading volume in the classic RTS market averaged \$960 million US dollars in the period between July and December, it remained at the level below \$500 million US dollars throughout the period between January and June. In January, quotations moved in random – for example, while the market fell in the beginning of the month, the fall eventually gave way to growth due to a series of favorable factors, namely high financial performance results of LUKOIL over nine months in 2004; information on a framework agreement between Russia and the Paris Club of Creditors on early repayment of approximately \$45 billion US dollars within a period of three years; the decision of Lehman Brothers investment bank to include Russian bonds in the listing of securities traded under its index; high oil prices in the world market; as well as Standard & Poor's upgrade of the sovereign rating of the Russian Federation up to the investment level on January 31, 2005 . Early in February, the market was at the stage of consolidation, which was governed by technical factors after the upgrade of the sovereign rating. By the end of the month, however, the market movement was dominated by bullish trend. The market was supported by favorable news from the telecom sector in which the government refused to change the structure of acquired Svyazinvest and, in particular, to separate Rostelecom from it. In addition, Standard & Poor's upgraded the long-term rating for Ros-

telecom, which also was a favorable news for investors. An emphasis should be made of a statement made by President Putin on the need to streamline the tax audit system, which, when implemented, should reduce tax risks for companies and consequently increase their market value. In addition to the internal factors, Russian shares were supported by further growth in oil prices and bullish trends in many world stock markets as well.



Source : the RTS Stock Exchange.

Fig. 24. The RTS Stock Exchange and Trading Volume in 2005

Then, the market was corrected during the first two decades of March, which was followed by a new growth. The fall was mainly caused by uncertainty about merger of Rosneft and Gazprom, as well as reduced activity of nonresidents on the threshold of an increase in the US interest rates. The market only was supported by a statement of President Putin on the need to reduce the term of limitation from 10 to 3 years for transactions лет, as well as still high oil prices in the world market. Neither did the deteriorated market conditions in the developed stock markets support any growth in the Russian stock market. Early in April the market started to grow upon the news on the likelihood that Gazprom shares would be allowed for trades without any restrictions, as well as the date of a merger of Gazprom and Rosneft were confirmed. Share of the telecom sector were found to be in great demand after the news on a draft resolution on privatization of Svyazinvest had been submitted to the Government and deleted from the list of strategic enterprises. High oil prices provided additional support to the market. However, this market trend had be changed under the pressure of negative news by the end of the month. The news that was first to cause quotations to fall concerned tax claims against TNK to the amount of Rb 22 billion for 2001. Later on, the President of LUKOIL V. Alekperov also stated that tax claims might just as well be laid against his company for the period between 2002 and 2003. Finally, another tax-related statement was made by Deputy Ministry of Finance S. Shatalov on that tax claims would be laid not only against YUKOS but also other companies. There were external fac-

tors that increased the likelihood that the monetary policy would be tightened, which consequently would result in cash outflow from emerging markets. These factors were growing inflation risks in the United States.

In the first half of May, the market continued to fall which was partially due to uncertainty about the issues of merger of Gazprom and Rosneft and privatization of Svyazinvest, as well as a court verdict was about to be announced in respect of the managers of YUKOS. A combination of all these factors and the period of closing of the registers of many large companies stimulated sales or, at least, restrained the market from active transactions. In the middle of the month, however, the market trend was changed due to a statement of the gas monopoly's representatives on that the government interest in the company would be increased without Rosneft, and the required block of shares would be redeemed by cash at the market value.

It is this news that caused the downward trend of the Russian shares to slow down in mid – May, which gave way to a sharp boost for the entire range of securities to continue until the beginning of October and make the RTS index to grow up to 1045.02 points – the highest ever in the history of the RTS trading system. In spite of the fact that early in June the market was dominated by some weak negative trends – namely the comments made by a Deputy General Prosecutor of the Russian Federation on the likelihood that criminal case would be initiated against some of the tycoons; uncertainty about privatization of Svyazinvest, as well as interest rates were very likely to be further increased in the United States – the market continued to grow in the second decade of the month. The growth was promoted by the news on transfer of 100% Rosneft shares in favor of Rosneftegaz by the Federal Agency for Federal Property Management (Rosimuszhestvo), which was indicative of the fact that the government began to implement its plan on taking control over the gas monopoly and liberalizing transactions with shares. Growth rates in the Russian stock market was further promoted by a very good information on financial performance results of Norilsky Nickel in 2004, as well as a statement made by A. Chubais, who said that the reform in the electric power sector had reached its final stage. In addition, an emphasis should be placed on favorable conditions in the world oil and metal markets, as well as upward trends in the stock markets of the most developed countries, and developing ones as well.

In the period between July and August, the market continued to grow steadily as supported by growing investment activity. While in July the trading volume in the RTS Stock Market amounted to nearly \$680 million US dollars, it increased up to \$998 million US dollars as early as in August.

The growth in July was influenced by several key factors:

- the Russian Federation started early repayment of its debt due to the Paris Club of Creditors;
- a statement made by ConocoPhillips that it would increase by 20% its share in LUKOIL by the end of 2006;
- successful IPO of a major Russian independent gas producer, Novatek company, during which 19% of the authorized capital were placed in the form of GDR (global depositary receipts). As a result, the IPO was ranked No. 2 by the amount of borrowed funds in the list of Russian corporations.

A special emphasis should be placed upon the new terrorist acts that took place in London on July 7, which forced the stock markets at developed countries to fall, but the Russian stock market only responded by a short-term price fall within a day. The growth in the Russian market in August was effected by several key factors, namely high prices of oil and metals; improved liquidity in the banking sector; the new agreement between the Ministry of Economic Development and Trade and the RF Ministry of Internal Affairs on a

draft ordinance concerning privatization of Svyazinvest; Fitch's upgrade of the Russia's credit rating up to BBB, as well as the similar upgrade on the credit rating of Sberbank of Russia. In the middle of the month, the market was supported by several good news, namely on good financial performance results gained by Gazprom in exports; transition by of Polyus company into a separate gold mining under Norilsk Nickel; high dividends allocation by Sibneft; as well as favorable financial performance results of Sberbank of Russia. At the end of the month, the stock market experienced active growth which was heavily supported by the investors from developed western countries. Not only the shares issued by the companies operating in the oil and gas sector that were in great demand, but also securities issued by Sberbank of Russia, which had a direct relationship with early repayment of a share of the Russia's debt due to the Paris Club of Creditors. Record-breaking high oil prices had a significant effect on the market as well, in August. On the contrary, the situation in world stock markets was not as much insignificant.

In September, the Russian stock market continued to grow rapidly showing record-breaking trading volumes which amounted to nearly \$1,3 billion US dollars at the end of the month. This development was promoted by several factors, namely an excellent financial reports made by LUKOIL in the first half of 2005 in accordance to the International Financial Reporting Standards; an agreement entered into between Rosneft and a syndicate of international banks (\$7,5 billion US dollars) on payment for the Gazprom shares purchased by the government; as well as Rosneft's IPO plans. The good news flow was further enriched with new good news by the end of the month, namely V. Christenko announced that a decision had been made to liberalize the Gazprom share market till year end; documents were signed on selling of 72.6% of Sibneft shares to Gazprom at a value of \$13,1 billion US dollars, which came to be very close to the market value of the company at that time. The likelihood of correction was reduced by still high oil prices in the world market as well as favorable conditions in stock markets in most countries.

In October, after the market reached its historical peak, the market experienced logical correction after a non-stop growth for almost six months, when the level of trading activity was even higher than in September. The correction was caused by falling world prices of oil and stock markets. Some internal factors should be noted as well, namely news on new searches at YUKOS office; statement of a representative of the RF Ministry of Internal Affairs on criminal investigation with regard to a number of major Russian companies and banks in respect of criminal income laundry. Even positive factors such as a discussion by the RF Government on VAT reduction to 13%, and high valuation (\$50 billion US dollars) of Rosneft by Deloitte&Touche audit company, failed to support share prices of Russian issuers. Some negative news came from abroad: there was a new concern about another increase in the US interest rates and inflation growth.

However, the correction lasted for a short period of time to gave way to resumed active purchases as early as at the end of October and early November. The market broke one historical record after another, which was governed by a series of factors. Early in November, the situation developed more or less quietly due to lack of significant internal news and falling world oil prices. The demand for Russian shares resumed to grow shortly after a rise of the prices of oil futures contracts. The market responded upwardly to the news on growth (almost by 50% to Rb 87 billion) of the retained profit of Surgutneftegaz, as well as a statement made by L. Reiman, the Ministry of Communications and Information technologies, that Svyazinvest would be privatized concurrently with adoption of legal regulation documents on protection of special users' rights. It is, however, obvious that adoption of a law on liberalization of the Gazprom shares market at first reading was the most significant factor for the market. Neither unstable situation in the world oil market, nor dete-

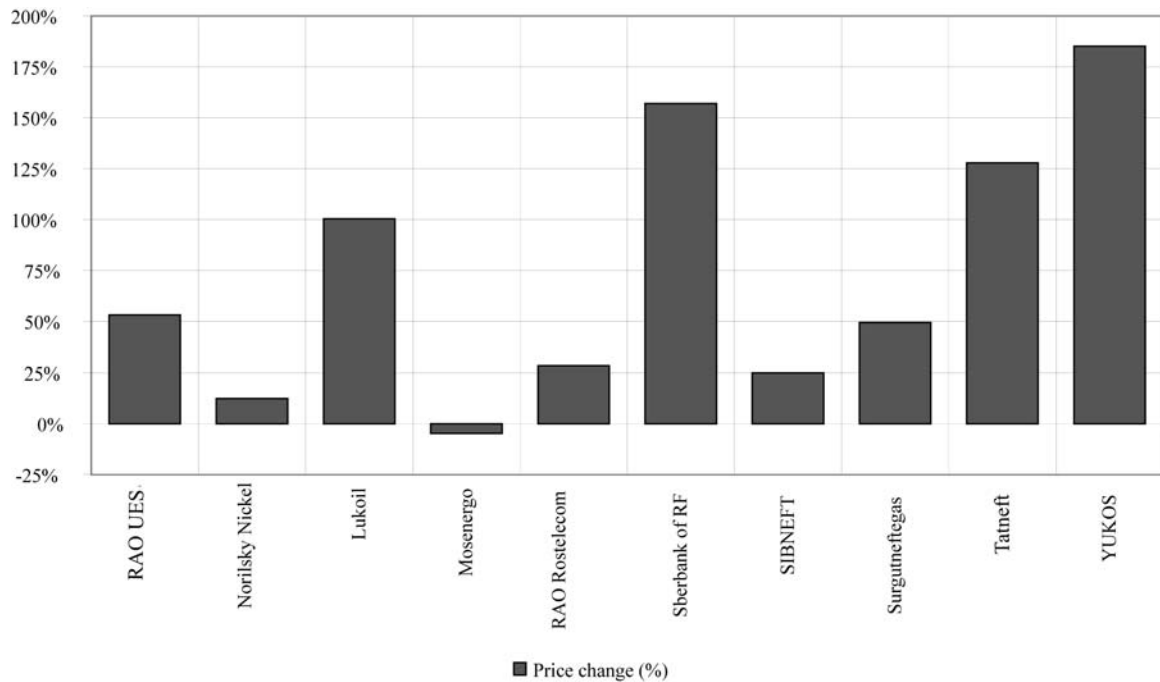
deteriorating liquidity in the banking sector could have any significant adverse effect on the prices of Russian shares at the end of November.

Throughout the entire last month of 2005, the market experienced no significant movements: share prices continued to grow to allow the market to break the psychological 1000 points. Trading activity was relatively high, which, on the one hand, was governed by that investors were waiting for the outcomes of a meeting at the US Federal Reserve System in the United States, and, on the other hand, deteriorating liquidity in the banking sector. It should be noted, however, that the US interest rate was finally raised, but it was not a surprise for investors, so this development had already been taken into account in the prices in emerging markets. Nevertheless, the market did not fall due to support by the news on a 7% growth of the GDP of the Russian Federation in Q3, which was found to be far beyond the forecast, as well as that Standard & Poor's upgraded the Russia's sovereign credit rating up to BBB. As a result, the RTS index hit a new historical maximum of 1128.51 points at closing on December 22, 2005, while it grew beyond to 1139.04 points on December 23 as well.

Unlike the previous year, 2004, which became the year of relatively stable share prices, in 2005, most liquid Russian shares grew significantly in value (*Fig. 25*). Last year, for example, returns on investments in OJSC YUKOS were most profitable, with the yield being 185.07% (as opposed to -93.82% in 2004). Such high growth rates were caused mainly by technical factors after a drastic and long fall throughout the entire year of 2004 rather than improved situation in the company itself. The second to YUKOS were shares of OJSC Sberbank of Russia, which gained 156.92% (as opposed to 83.46% in 2004) to its value during the year. Relatively high growth rates were demonstrated by the shares issued by OJSC Tatneft and OJSC LUKOIL, which gained in value by 127.87% and 100.34% respectively in 2005 as opposed to 32.31% and 24.39% in 2004. The shares issued by RAO "UES of Russia" (53.07% as opposed to -1.72% in 2004), OJSC Surgutneftegaz (49.23% as opposed to 21.95% in 2004), OJSC Rostelecom» (28.18% as opposed to -13.72% in 2004), OJSC Sibneft (24.92% as opposed to 4.11% in 2004) and OJSC «GMK Norilsky Nickel (12.36% as opposed to -18.67% in 2004) showed much less growth rates. OJSC Mosenergo was the sole company among the blue chips, whose shares lost in value in 2005, - 4.76% as opposed to 117.52% in 2004.

In 2005, Vozrozhdeniye Bank, OJSC Uraltrubstal, OJSC Sinarsk Trubny Zavod (Sinarsk Ripe and Tube Mill) were among the "second echelon" companies whose shares gained maximum values, 677.78%, 444.26%, and 383.33% respectively. However, trading activity with regard to the above listed companies remained low. For example, 28 transactions were entered into on the shares of Vozrozhdeniye Bank, 107 transactions on the shares of OJSC Uraltrubstal, and 40 transactions on the shares of OJSC Sinarsk Trubny Zavod (Sinarsk Ripe and Tube Mill).

The shares of OJSC LUKOIL were ranked No. 1 by trading turnover to account for 29.55% of the total trading volume in the RTS in 2005, as opposed to 21.2% in 2004. The shares of RAO "UES of Russia" were ranked No. 2 to account for nearly 20.39% in 2005, as opposed to 25.86% in 2004. The shares of Norilsky Nickel were ranked No. 3 among the blue chips to account for 9.7% of the total trading volume in the RTS in 2005, as opposed to 10.55% in 2004. Transactions on the preferred shares of OJSC Transneft accounted for 6.04%, but the shares were not ranked high by trading volume in the RTS. Finally, the shares of Sberbank of Russia were ranked No. 5 to account for 5.6% in 2005. Hence, in 2005, transactions on the shares of the five abovementioned issuers accounted for nearly 71.28% of the total trading volume in the RTS, which exceeded the corresponding parameter of 2004 (nearly 72.44%).



Data source : the RTS Stock Exchange .

Fig. 25. Blue Chips Price Movement in 2005

According to the data as of December 30, 2005, the top-five list of companies by capitalization was as follows: LUKOIL – \$50.5 billion US dollars (as opposed to \$26.01 billion US dollars in 2004), Surgutneftegaz – \$38.5 billion US dollars (as opposed to \$26.65 billion US dollars in 2004), Sberbank of Russia – \$24.89 billion US dollars (as opposed to \$9,33 billion in 2004), Sibneft – \$17.99 billion US dollars (as opposed to \$14,22 billion US dollars in 2004), и RAO “UES of Russia” – \$17.32 billion US dollars (as opposed to \$11.70 billion US dollars in 2004). Hence, the lineup of companies in 2005 differed from that in 2004. For example, LUKOIL was ranked No. 1 in 2005, while it was ranked second to Surgutneftegaz in 2004. In addition, Sberbank of Russia was ranked No. 3 by capitalization in 2005 by forcing Sibneft to give up its No. 3 scored in 2004. It should be noted that the three most capitalized companies of Russia belonged to the oil and gas sector⁴⁰, as well as in the previous year. Such a stable position of primary industry companies was governed by an extremely favorable conditions in the primary commodity markets in 2005 Sberbank of Russia had the highest capitalization among the companies that do not belong the primary commodity market, as well as in the previous year.

Futures Contracts Market

In December 2005, the FORTS market (Futures and Options on the RTS) celebrated its 4.5 anniversary since the commencement of transactions at this segment of the financial market in Russia. Since the trading turnover in the Russian futures market has increasingly been growing, the year of 2005 was not an exclusion. For example, the turnover of futures and options contracts in the futures market totaled nearly Rb 711,54 billion in the previous year, as opposed to Rb 336,37 billion in 2004. In other words, the turnover of the

⁴⁰ Capitalization of OJSC Gazprom is taken into account in this review.

futures contracts (FORTS) market in 2005 doubled the corresponding figures attained in the previous year. Participants of the market entered into nearly 1.96 million transactions to amount to 54.87 million contracts (nearly 1.5 million transactions and 41.5 million contracts in 2004). Hence the foregoing data testify that investment activity in this segment of the stock market was found to be much higher than in the previous year, 2004. In 2005, the average daily volume of open positions on standard contracts was Rb 18 billion, 1.63 million contracts, to grow 2.5 times as denominated in rubles and 1,9 times in contracts as compared to 2004. During 2005 the volume of open positions reached maximum volumes to the amount of Rb 30.93 billion (on December 12) and 2.43 million contracts (on September 12).

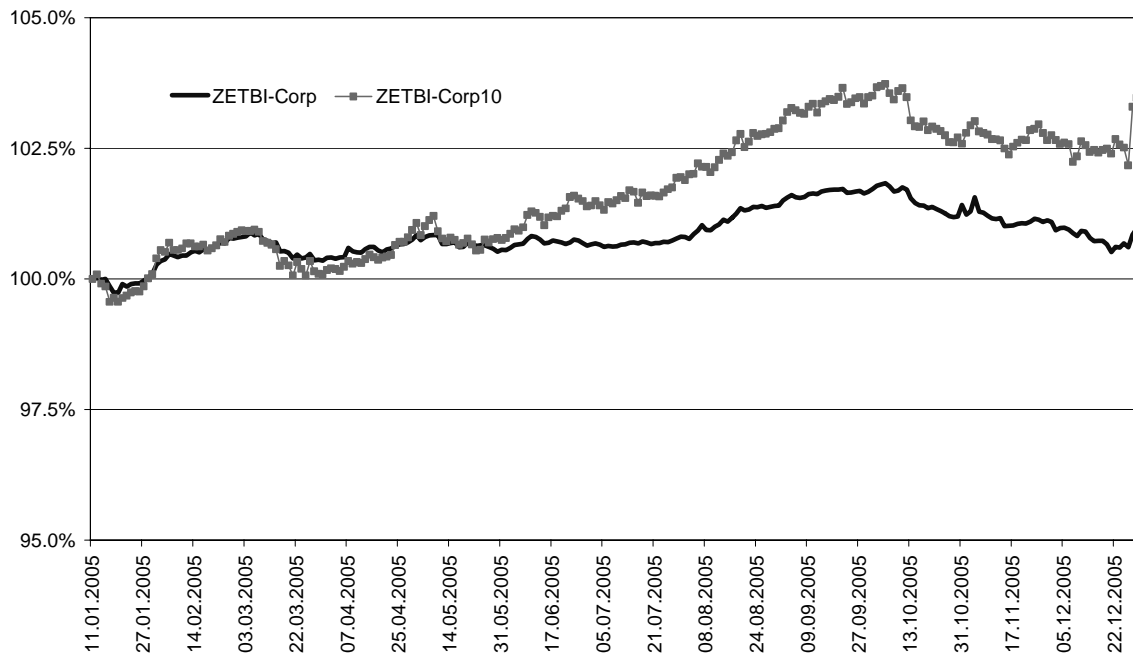
A share of futures transactions was biggest in the segment of futures contracts in 2005, like in the previous year, to account for nearly 89% (as opposed to 91.95% in 2004) of the total trading volume or Rb 630,53 billion (as opposed to Rb 309.3 billion in 2004), while the value of option transactions amounted to mere Rb 81.01 billion (as opposed to Rb 27.06 billion in 2004). Hence a share of options transactions increased considerably by trading volume in the last year as opposed to that in 2004. Futures contracts on the market value of the shares of RAO "UES of Russia" still remained most attractive for investors in 2005. In spite that, their share reduced significantly in the total trading volume from 54% in 2004 to 27.37% (Rb 188 billion) in 2005. Futures on market value of the shares of OJSC Gazprom were ranked No. 2, like in the previous year: in 2005, transactions on this instrument accounted for nearly 21.62% (Rb 148.5 billion) as opposed to 19.6% (Rb 66 billion) in 2004. Transactions on NK LUKOIL futures accounted to 17.59% (Rb 120.8 billion) in 2005 as opposed to 12.8% (Rb 43 billion) in the previous year. In 2005, a few new instruments emerged in the market. One-month option contracts on the shares of OJSC Gazprom, OJSC Rostelecom, RAO "UES of Russia" and OJSC LUKOIL were launched on March 5. The futures contract on Moscow three-year bonds denominated in rubles was launched on June 1, which is currently the sole interest rate derivative in Russia. Futures contract on the basic index of the Russian stock market – the RTS index – were launched on August 3, 2005, and options on this contract were launched on September 15. Finally, futures contracts on the common share of OJSC Sberbank of Russia were launched on October 10, after which a full set of derivatives was formed for all blue chips of the Russian stock market. Hence, for the time being, FORTS participants can enter into transactions on 10 futures and 6 option contracts.

Corporate Bonds Market

In 2005, the market of corporate and regional bonds was stable in general. However, the corporate bonds market grew insignificantly in 2005 as compared with the stock market. This is evidenced by the movement of corporate bonds indices assessed by Zenit Bank on the basis of market prices of bonds traded in the MICEX⁴¹ (Moscow Interbank Currency Exchange). In 2005, the ZETBI-Corp index grew by 1.06 points (0.96%) from 110.59 to 111.65 points. However, the ZETBI-Corp10 index, which is assessed on the basis of quotations of most liquid corporate bonds, grew by mere 3.99 points (3.46%) from 115.13 to 119.12 points in the preceding year of 2005.

There were several periods that could be distinguished by upward and downward trends of market quotations in the corporate bonds market, which in general corresponded to the similar period of ups and downs in the stock market. However, the corporate bonds market demonstrated much higher volatility than the stock market.

⁴¹ The ZETBI-Corp and ZETBI-Corp10 indices have been assessed by Zenit Bank since 03.01.2002 .



Source : Zenit Bank.

*Fig. 26. Corporate Bonds Price Index Movement in 2005
(January 5, 2005 = 100%)*

Throughout a period between January and February 2005, quotations of corporate and regional bonds remained the same. In January, investment activity slowed down drastically due to holidays, while most liquid series of bonds demonstrated an upward trend in the beginning of the month. External environment for the bond markets remained quiet enough. In January, the yield of the benchmark of the world bond market – the US Ten-Year Treasury Bonds – varied insignificantly within a small range. The market was supported by a favorable situation in the Russian Eurobonds market. The news that Standard & Poor’s upgraded the sovereign credit rating of the Russian Federation up to the investment level was most significant in the second half of the month. In general, quotations changed under the impact of the factors that affected the both markets of government bonds denominated in rubles and foreign currency. In February, investors resumed their activity, and series of most liquid bonds showed growth. There were some external factors that are worth noticing, namely a slow growth of the US securities as a result of an 2.5% p. a. increase in the interest rate in the United States, as well as comments made by the US Federal Reserve System that it would continue to raise the interest rate in the future. Liquidity in the banking sector remained fairly low, which in combination with gaining ruble foreign exchange rate in the forex market supported prices.

In March, investment activity continued to grow in the market, which, however, was accompanied by falling quotations. In general, the external environment remained moderately negative: the US market continued to fall because of negative statistical data on inflation, and the foreign exchange reserves in Japan were likely to be diversified, which might result in sales of US assets. The internal forex market had an additional impact on the

prices of corporate bonds. It is the relatively high level of liquidity that restrained quotations from falling.

Then, in the period between April and September, the market of corporate and regional bonds was growing continuously. Trading activity increased significantly in April: the total trading volume in April amounted to nearly Rb 206 billion to exceed by 16.6% the corresponding parameter in March. The growth was partially caused by a significant improvement in the foreign economic situation and, in particular, the growth in the US market of government bonds. The outcomes of a meeting at the US Federal Reserve System showed that the US Government was ready to gradually increase the interest rates, which had a positive effect on market quotations. There were some internal factors that had an effect of positive movement of the market, namely a decline in the USD/ RUR exchange rate and still high level of liquidity in the banking sector.

In spite of an insignificant correction that took place as early as in May, the market continued to grow. In the beginning of the month, the US debt market remained stable, even after the news on a 0.25% increase in the interest rates, but the yield of government bonds increased shortly after the news on that the credit rating of General Motors and Ford had been downgraded to junk status. At the same time, however, the growth in the Russian Eurobonds, due to an agreement on early debt repayment between Russia and the Paris Club of Creditors, supported to a certain extent the market of corporate and regional bonds. With regard to internal factors, these were mostly negative, since a combination of deteriorated situation with liquidity and the USD gaining against the RUR stimulated sales of the instruments denominated in rubles.

In June, prices of most liquid series moved up and down, but the general trend was upward. The yield of the US Ten-Year Maturity Bonds varied in the range of 4.01–3.94% with the highest monthly peak being 4.13%. This was partially governed by a new increase in the interest rate in the United States and comments made by the US Federal Reserve System that the interest rates were very likely to be increased in the future. During the month, however, investors focused on the world forex market, where the USD lost drastically against the Euro, by an average of 4%, which was reflected in the internal forex market as well – the USD gained 2% against RUR in June. Such a violent fluctuations in the foreign exchange rate was an evidence of increasing foreign exchange risks for the investors that were interested in the instruments denominated in rubles, which couldn't but have an effect on quotations. There were some internal economic factors that are worth mentioning, namely high inflationary expectations caused by the revision of annual target figures (up to 10%), and deteriorated situation with liquidity.

During the entire Q3 of 2005, the market showed a sustained growth on most series. In July, investment activity slowed down as compared to June, and quotations of most liquid series grew moderately. The movement was governed by interaction of negative (growth of the US Treasury Bonds due to the information on the US GDP, which was found to be better than the forecast figures, thus increasing the likelihood of the interest rates to be raised, and the US dollar gained against the Russian Ruble in the first half of the month) and positive factors (stabilization of liquidity). In August, trading activity developed much better as compared to that in July. Quotations of most liquid series of bonds grew considerably due to several factors, namely the yield of US bonds reduced; Fitch upgraded the Russian's sovereign credit rating; early repayment by Russia of a share of its debt due to the Paris Club of Creditors; positive situation with liquidity; and the Russian Ruble gained against the US dollar. In September, again investment activity grew considerably on the market of corporate and regional bonds due to a drastic growth of quotations of most liquid series of bonds. The foreign economic environment slightly improved: the yield in the

US debt market grew up as a result of a new increase in the US interests rates, as well as threats concerning the impending Rita hurricane in the United States. The market was slightly supported by growth in quotations of the Russian Eurobonds due to the anticipated upgrade of the sovereign credit rating of the Russian Federation by Moody's after it was entered into the list of countries whose rating is to be revised. Not only did the excess of ruble liquidity support the secondary market, but also promote a successful placement of a series of issues in the primary market as well. The RUR/ USD exchange rate moved up and down, thus having no significant effect on investment activity.

In October, the upward trend that had been lasting for nearly six month gave way to downward trends in price movement. The fall of quotations was caused, first of all, by continuing increase in the yield of the US Treasury Bonds, as well as subsequent deterioration of the situation in the Russian Eurobond market. Further fall in the corporate and regional debt market was restricted by a fairly good liquidity in the banking sector as well as lack of explicit upward or downward trends in the RUR/ USD exchange rate. In November, the foreign economic situation slightly improved, but the US dollar gained against the Russian Ruble in the foreign exchange market following its rise in the world Forex Market. Additional problems with liquidity resulted in a slow fall of the quotations of most liquid series of bonds in November. In December, however, the market quotations became stable. The internal debt market regained on the price rise in the Russian Eurobonds after a decline in the yield of the US Tresury bonds. Investors considered positively the comments made by representatives of the US Federal Reserve System, due to completion of a cycle of interest rate rise. However, the growth was restrained by adverse affects of internal economic factors, i.e. still unstable situation with liquidity, and the Russian Ruble lost some points in favor of the US dollar.

In 2005, issuers became much more active in the primary market, though their behavior differed largely during the year. For example, the maximum volume of placements of corporate and regional bonds in the primary market was recorded in December to amount to nearly Rb 75,1 billion (as opposed to nearly Rb 27.93 billion in 2004), while the minimum one amounted to Rb 9.05 billion in August (as opposed to Rb 4.81 billion in 2004), let alone zero activity in the primary market in January 2004. The total volume of placement of corporate bonds amounted to nearly Rb 313 billion for the entire year of 2005 as opposed to Rb 194.87 billion in 2004. Hence one may find a substantial increase in primary offering in the market of corporate and regional debt.

Factors that Have an Effect on the Movements in the Russian Stock Market

In 2005, the Russian Stock Market was governed by a series of factors which conventionally can be broken down into the groups as follows :

- Internal politica situation;
- Relations with international financial organizations;
- Situation in the international financial markets;
- Situation in the world raw material markets (especially oil).

Each of the foregoing groups of factors had a different effect on the movement of different segements of the Russian financial market during the year of 2005. In spite of the fact that most of these factors have already been mentioned in the analysis of differnet segments of the Russian financial market, it is appropriate to focus on them несколько более подробно.

Internal political situation. While the year of 2004 was marked by the Russian business society as the year of tighter pressure on the Russian businesses by the Gov-

ernment and subsequent increase in political risks, in 2005 the situation improved to some extent. There were some negative factors in the previous year that are worth mentioning, namely termination of the court case against the YUKOS management, who were sentenced different terms of imprisonment; tax service authorities continued to exert pressure on the disgraced company; and tax claims were laid against several companies (TNK, LUKOIL and some other companies) as a result of tax audits of their performance for the recent years.

However, all these negative events took place mostly during the first half of the year, while the second half of it was found to be quiet enough. Furthermore, the Russian Government took a series of measures which had a direct or indirect effect on investment activity. For example, the government settled the issue of uncertainty about increasing its share in the gas monopoly, i.e. the government purchased a block of shares for cash. Finally, in December, amendments were made to the law of gas supply, whereby allowing the Gazprom shares market to be liberalized.

In spite of some reduction of political risks which resulted in a substantial growth in the Russian stock market, some steps of the Russian Government aimed at increasing its role in the economic life of this country cause certain concern. For example, that the Government strengthened its participation in the oil and gas sector after Gazprom purchased Sibneft at the value comparable to its market value, shortly after the YUKOS's main production asset – Yuganskneftegaz – had been sold with a considerable discount, is indicative of the fact that the Russian Government applied methods that are not supposed to be applied in a true market economy. All these steps, however, were taken against the background of huge revenues the country generated from export of energy sources and metals which could have been utilized to enhance structural and economic reforms and improve investment environment in Russia.

Relations with international financial organizations. Relations between Russia and international financial organizations developed successfully enough throughout the entire year, which depended largely upon a favorable macroeconomic situation in the country available over the last two years, and effective management of the external debt of Russia. For example, on 31 January 2005, Standard & Poor's upgraded the Russia's sovereign credit rating denominated in foreign currency from BB+ to BBB-. In August, Fitch upgraded the Russia's sovereign credit rating one step up, c BBB- to BBB. In October, another agency, – Moody's – upgraded the Russia's sovereign credit rating one step up to Baa2. As early as in December, Standard & Poor's again upgraded the Russia's sovereign credit rating from BBB- to BBB .

Another important event for the Russian bond market was a statement made by Lehman Brothers investment bank on that Fitch's credit ratings would be considered equal to those of Moody's and Standard&Poor's in entering securities into the listing of bonds traded under its index, thereby the Russian securities were listed for trading under the Lehman US Credit/Aggregate index, benchmark for the US funds with a total value of about \$1.5 to 2 trillion US dollars .

In 2005, Russia followed the previously approved schedule to observe its debt commitments in full. In addition, last year, Russia managed to successfully repay a share of its external debt. In February, for example, Russian effected an early repayment of \$3.3 billion US dollars as part of the debt due to the IMF, as well as repaid nearly 1.6 billion Euro as part of the principal and accrued interests due to the member-countries of the Paris Club of Creditors. Besides, during the first half of 2005, Russia conducted negotiations with the Paris Club of Creditors on early repayment of a share of its debt due to the latter. In spite of that the creditors rejected to discount the debt and demand a premium at the initial stage

of the negotiations, later on Russia managed to attain an interim agreement on repayment of \$15 billion US dollars at par value in the period between July and August 2005 .

Situation in the international financial markets. The year of 2005 was characterized by a substantial improvement of the situation in the world stock markets. In particular, the US stock market indices demonstrated a mixed behavior in 2005. For example, while the Dow Jones fell by 11.93 points (–0.11%), the Nasdaq Composite gained 53.17 points (2.47%) by end-2005. A special emphasis should be placed on that volatility of the US stock market was generally comparable with that in the Russian stock market, which was mainly caused by reduced volatility of the latter. In 2005, the US stock market was mainly affected by extremely high oil prices which restrained the US economy growth and encouraged inflation to grow. While the economic growth rates caused no concern, the threat of growing inflation stimulated the federal authorities to revise the monetary policy's priorities, which resulted in multiple growth of the interest rate in the United States which reached 4.25% p. a. by year end. However, though the increase in the US interest rate had some short-term effect on the market during the year, the decisions of the US Federal Reserve System always were predictable by investors. Hence the effect of such increase was, at least partially, reflected in prices prior to a new increase. The statistical data on the US labor market and imbalance in trade were another essential factor which had a substantial effect on investors' behavior. All these factors together with the policy pursued by the US Federal Reserve System, had an effect on foreign exchange rates in the world Forex market and consequently made USD assets more attractive, or less. Finally, as before, financial performance results of US corporations were affected by the aforementioned factors, as well as the behavior of those who participated in the US stock market.

With regard to stock markets of other countries, in particular, the European stock indices grew at much faster rates than their US counterparts in general in 2005. The situation in developing countries was even better, whose stock markets' growth measured more than a dozen of per cent per year in 2005. As a result, the Morgan Stanley's aggregate stock market index in developing countries grew by nearly 30%.

In general, the developed markets had a greater effect on the Russian stock market either when there was no essential internal news, or oil prices were stable. On the contrary, when there were enough internal news available in the market from the both corporate and public sectors, this news has a greater effect than world markets' fluctuations. It is the policy of the US Federal Reserve System that was the sole factor considered by investors from any country, which could have a medium-term effect on market liquidity in these countries due to outflow of major US funds and institutional investors from these countries.

Situation in the world oil market. In 2005, the world oil market grew at very fast rates to become one of the key factors that allowed the Russian stock market to recover and grow reaching its historical peaks. It should suffice to mention, for example, that while prices varied around \$45 US dollars per barrel as early as in the beginning of the year, oil prices hit \$70 US dollars per barrel, even beyond, in the United States in the second half of the month.

During the year of 2005, a sharp rise in oil prices was affected by several traditional factors, which investors normally focus on, the data on oil and oil products stock in the United States, weather conditions on the territory of the country, level of activity of major funds conducting operations in the oil market, as well as OPEC countries position concerning the market conditions, as well as a series of factors which were specific with regard to the previous year.

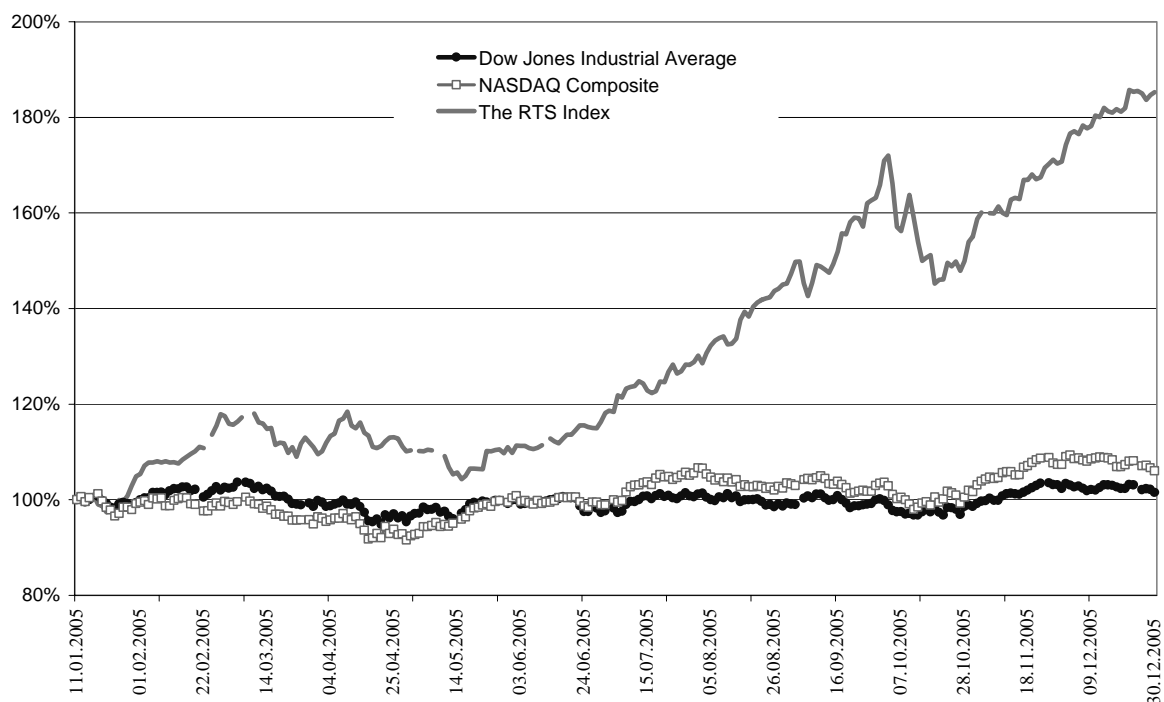


Fig. 27. Dow Jones and NASDAQ in 2005 (December 31, 2004 = 100%)

For example, in February, the market growth was driven by a forecast made by the International Energy Agency, in which production growth rates of independent producers were revised to slow down. Statements made by major investments companies and banks, such as Goldman Sachs, also had an impact on price movement: in April, experts made an analytical report, in which they forecasted that Brent oil would cost around \$105 US dollars per barrel by end 2007.

In July, oil prices depended largely on weather conditions in the Gulf of Mexico. Two hurricanes, Synda and Dennis, interfered with oil production to a certain extent – up to 12% of shelf-based oil platforms had to be shut down, while gas production and refining used to drop down to 8% in some of those days. As early as in August, the Hurricane Katrina, which caused substantial damages in the United States and a drastic fall in oil production in the Gulf of Mexico, resulted in a new rise oil prices. Furthermore, the aftermaths of these acts of God were far more devastated than it was predicted. As result, the head of the International Energy Agency expressed his concern about the possibility of a large-scale energy crisis caused by the Hurricane Katrina, if the aftermaths would have an adverse affect on oil product manufacturing, especially on the threshold of another impending tropical hurricane, Rita, which was approaching towards the United States in September. Late in the year, prices dropped slightly to lower levels as compared to the maximum peaks reached in August. However, these levels still remained high enough.

Hence, the situation in the world oil market was extremely favorable for Russia during the entire year of 2005. Oil companies did the best they could to increase oil production and export by any possible means, and consequently increase their net profit. Given the situation, investors found shares of Russian companies quite attractive, thereby keeping up fairly high prices. It should be noted, however, that high oil prices may have a potential negative affect on the world market movement. This may be caused by, firstly, possible restriction of growth rates of the world economy, which may result in substantial redistribu-

tion of funds between the markets in different countries, especially through outflow of funds from emerging markets. Secondly, the year of 2005 demonstrated that high oil prices are unable to boost inflation substantially in countries – net importers – most of which are leaders in the world economy (above all in the United States). Tightening of the monetary policy in the United States and other countries above all may have an adverse affect on emerging markets.

Corporate News

Some of the Russian corporations improved significantly their positions after having been assigned long-term credit ratings or revised for upgrade.

For example, early in February, OJSC Rostelecom announced that Standard & Poor's, the international credit rating agency, decided to upgrade its long-term credit rating from B to B+, Outlook Stable. Standard & Poor's reported that the upgrade reflected a reduction of company's financial risks of the company, strengthened market positions, as well as improved financial performance. According to Standard & Poor's, OJSC Rostelecom enhanced its creditworthiness through efficient measures taken by management in order to reduce company's costs and retain leading market positions. The "Outlook Stable" reflects anticipation that the company would further improve its capital structure, as well as increase its idle cash in the short-and long-term periods.

On April 26, 2005, Moody's Investors Service, the international credit rating agency, upgraded the basic rating of OJSC LUKOIL from Ba2 to Ba1. At the same time, Moody's upgraded the OJSC LUKOIL's rating of the issuer on unsecured borrowings from Ba3 to Ba2. По всем рейтингам прогноз стабильный. According to Moody's, the upgrade mainly reflected LUKOIL's very good financial performance results and, in particular, a substantial growth in operational efficiency, growth in EBITDA (Earnings before Interest, Taxation, Depreciation and Amortization) over the first 9 months in 2004, improved structure of company's credit portfolio, as well as enhanced corporate management, especially after ConocoPhillips purchased a 7.6 per cent interest in LUKOIL in September 2004 and further increased its interest up to 10% in January 2005.

On August 4, 2005, Fitch Ratings, the international credit rating agency, upgraded the long-term rating of Sberbank of Russia from the status BBB- to BBB shortly after the Russia's sovereign long-term rating denominated in foreign currency was upgraded. The Outlook for Sberbank of Russia remained Stable. At the same time, the short-term rating of the bank was confirmed F3, and support rating 2. The priority unsecured Eurobonds, 1 billion US dollars with maturity in 2006, issued by Sberbank of Russia were upgraded from BBB- to «BBB». The subordinated debentures, 1 billion US dollars with maturity in 2015, of the bank was upgraded from BB+ to BBB-.

On 10 August, 2005, Standard & Poor's, the international credit agency, announced an upgrade of the long-term credit rating of GMK Norilsky Nickel from BB to BB+. The national scale credit rating was upgraded from ruAA to ruAA+, Outlook Stable. According to the report made by Standard & Poor's, "The assigned rating reflects the leading position of GMK Norilsky Nickel in the world market of nickel, palladium, platinum and copper, a unique resource base and stable financial situation of the company. While the situation with the business environment in Russia is the key constraint for upgrading credit ratings of Russian companies, GMK Norilsky Nickel has demonstrated high financial and operational performance results, and positioned itself as one of the straightest corporate borrowers in this country". The Outlook Stable includes Standard & Poor's assessment of the gold-mining assets on allocation program considered by Norilsky Nickel, which is, accord-

ing to the rating agency, unlikely to have a significant effect on diversification of the group and result in a considerable cash outflow.

Finally, on December 21, 2005, Fitch Ratings, the credit rating agency, announced an upgrade of the credit rating of the company. Norilsky Nickel был assigned BBB-long-term credit rating denominated in foreign currency; Outlook Stable. Hence, at present, Norilsky Nickel is the first and the sole Russian company which has ever been assigned an international rating with the investment status.

In the period between October and December 2005, most companies published their financial performance statements for 2005. The following companies should be mentioned.

On August 2, 2005, OJSC Rostelecom disclosed the results of its performance in the first half of 2005. For example, its earnings totaled Rb 19 501.4 million in the first half of 2005 to grow by 8.3% year on year. The EBITDA increased by 5.6% year on year to Rb 7 735.5 million. Profitability amounted to 39.7% in the first half of 2005, according to EBITDA. As a result, net profit net profit in the first half of 2005 amounted to Rb 5 661.0 million to increase by 28.2% year on year.

On September 20, 2005, LUKOIL published its consolidated financial statement for the first half of 2005 prepared in accordance with the US generally accepted accounting principles (US GAAP). According to the results disclosed for in the first half of 2005, net profit of the company amounted to \$2 590 million US dollars to grow by 52.7% year on year. The EBITDA parameter reached \$4 298 million US dollars to grow 45% year on year. Sales revenues grew up to \$24 049 million US dollars to increase by 66.1% year on year. In addition, total tax expenses exceeded \$7 billion US dollars to double the level of 2004. Cost per unit of oil production grew by 6.3% year on year to \$2.69 US dollars per barrel.

In October, OJSC Sibneft published its financial performance statement for the first half of 2005. According to the financial statement prepared in compliance with the US GAAP on October 4, 2005, net profit of Sibneft grew by 44% to \$1.42 billion US dollars as compared to \$988 million US dollars in the corresponding period of 2004. The company's profit growth was governed by the growth in prices of oil and oil products in the both international and internal markets, in spite of growth of electric power costs, transport costs, taxes and export duties. The revenue of the company increased by 43% year on year to \$5.73 billion US dollars. The EBITDA parameter in the first half of 2005 amounted to \$1.94 billion US dollars, which grew by 29% as compared to \$1.50 billion US dollars in 2004. As of 30 June, 2005, the value of credit portfolio of Sibneft group amounted to был равен \$1.50 billion US dollars.

On November 16, 2005, a meeting was held in Sberbank of Russia, in which the Principle Deputy Chairwoman of the Board of Sberbank of Russia A.K. Alioshkina made a report summarizing performance of the bank over the period of 9 months in 2005 and making a forecast for 2005. According to the presented data on the foregoing period, net-assets of Sberbank of Russia grew by 20% to Rb 2.4 trillion. Balance-sheet profit amounted to Rb 63.3 billion, which was by 20% above the corresponding parameter over the entire year of 2004. Net profit totaled Rb 48.3 billion, which was by 11% above the corresponding parameter over the entire year of 2004. Net worth grew by 38% to Rb 239.3 billion. Return on assets and capital increased up to 3.0% and 29.5% respectively. High financial performance data resulted in heavy demand for the shares issued by Sberbank of Russia in the market: within 9 months of the current year, common shares of the bank grew more than 1.9 times in value to \$960 US dollars per share, while preferred shares grew more than 2.7 times to \$13.6 US dollars (the RTS index grew by more than 1.6 times

over that period). As a result, market capitalization of the bank increased from \$9.7 billion to \$18.9 billion US dollars.

On November 25, 2005, OJSC Gazprom published its non-audited interim consolidated financial statement for the first half of 2005 prepared in accordance with the International Financial Reporting Standards. Within six months of 2005, sales proceeds (less excise, VAT and customs duties) increased 30%, or by Rb 139 759 million, year on year, to Rb 611 233 million. Operating expenses over the same period grew by 15 %, or by Rb 53 106 million, year on year to Rb 402 178 million. Return on investments of the OJSC Gazprom's shareholders totaled Rb 152810 million in the first half of 2005, which grew or 66%, or by Rb 60552 million, year on year.

In 2005, several Russian companies continued to purchase new assets, including foreign ones, as well as establish long-term relations allowing them to expand and enhance efficiency of their business. In addition, some of these companies implemented business reorganization and restructuring.

For example, late in March, an information emerged that LUKOIL-Finlandia (a company incorporated in LUKOIL Group) had entered into a share purchase agreement with Finnish companies Oy Teboil Ab and Suomen Petrooli Oy. As a result, the former gained a sole control over these two companies. The value of the transaction was \$160 million US dollars. The transaction was approved by the European Commission. The core business of Oy Teboil Ab and Suomen Petrooli Oy is to manage a network embracing 289 gas filling stations and 132 D-points (free standing ground based reservoirs and diesel filling stations), wholesale selling of oil products, as well as lubricant production and sale. By having entered into this transaction, LUKOIL managed to enter the Finnish market of ultimate oil product consumption. The company intends to generate additional profit by supplying to Finland pollution-safe low-sulfur diesel fuel EN-590 which is produced by a new hydro-cracking unit, Perm Oil Refinery. The capacity of Oy Teboil Ab and Suomen Petrooli Oy in the Finnish furnace oil market will also allow LUKOIL to expect additional export of fuel oil and gas-oil produced by Russian Oil Refinery companies.

On April 15, 2005, the Board of Directors of GMK Norilsky Nickel made a decision to approve an action program which provides for allocation of Russian gold-mining assets consolidated under CJSC Polyus and its subsidiaries, as well as a 20% interest held by the company in Gold Fields Limited. The reorganization was expected to result in establishment of a new large independent gold-mining company which would have a potential of further growth and substantial assets in Russia. A preliminary stage of reorganization became consolidation of all gold-mining assets of the Company (including a 20% interest in Gold Fields Limited) under CJSC Polyus. The reorganization of GMK Norilsky Nickel was consulted by Deutsche Bank AG London (financial advisor) and Debevoise & Plimpton LLP (legal advisor). In the context of the reorganization, the management of GMK Norilsky Nickel made a decision to increase the authorized capital of CJSC Polyus by closed subscription to additional common nominal uncertified shares. Additional issuance of CJSC Polyus's shares provided for placement of common uncertified shares at nominal value of Rb 400 each to the amount of 126 shares at a value of Rb 290609959 per share. The revenues generated from placement of shares were planned to allocate to CJSC Polyus for consolidation of a 20% block of shares of Gold Fields Limited, South-African gold-mining company in compliance with a decision made by the Board of Directors of GMK Norilsky Nickel on allocation of gold-mining assets .

In July 2005, LUKOIL and ConocoPhillips established a joint venture, OOO Narian-marneftegaz, intended to develop hydrocarbons at Timano-Pechiorsky oil & gas-bearing area in the North European Russia. ConocoPhillips holds 30% of economic share in the

joint venture. The value of purchase of the foregoing share amounted to about \$500 million US dollars. The joint venture will be managed by LUKOIL and ConocoPhillips on a basis of parity. Top oil production volume of the joint venture is expected to reach nearly 200 000 barrels daily. To be delivered to international markets, oil will be shipped to oil tankers through a LUKOIL's terminal located at Varandei town on the coast of the Barents Sea (Nenets Autonomous Area). In 2007, LUKOIL plans to implement a project on increase of the current capacity of the terminal up to 240 000 barrels daily which ConocoPhillips participating in designing and financing of the project. The joint venture was established as part of a large-scale strategic alliance entered into between ConocoPhillips and LUKOIL on September 29, 2004, under which ConocoPhillips purchased more than 11% common shares of LUKOIL.

Shortly after that, in October 2005, LUKOIL, entered through its 100% subsidiary LUKOIL Finance Limited (Gibraltar) into a loan agreement at a value of \$2 billion US dollars with a six-month maturity in order to purchase a controlling interest of Nelson Resources Limited. This is an unsecured loan extended at Libor + 0.5% p. a. Citigroup is the sole arranger, book runner and creditor on this loan. The warrantor is represented by OJSC LUKOIL. Within six months, LUKOIL refinances the loan by syndicated loans. Nelson Resources Limited takes part in the projects on hydrocarbons production in the Western Region of the Republic of Kazakhstan, Akibekmola, Kozhasai, Karakuduk, Sevenuye Buzchi and Arman fields. Nelson Resources Limited is a cooperator in most of the projects. In addition, the company is a party of an option agreement in respect of two geological exploration blocks in the Kazhakh sector of the Caspian Sea, namely Yuzhny Zhambai and Yuzhnoye Zaburuniye. Proved and undiscovered deposits of hydrocarbons at Nelson Resources Limited составляют 269.6 million barrels.

On October 21, 2005, 72.663% of OJSC Sibneft shares were transferred to by affiliated companies of Millhouse Capital to Gazprom Finance B.V. (100% subsidiary of OJSC Gazprom) in accordance with the terms and conditions of a share purchase agreement entered into September 28, 2005. To purchase Sibneft's shares, Gazprom borrowed \$13.079 billion US dollars from a consortium of international banks. The consortium comprised Dresdner Kleinwort Wasserstein (DrKW), ABN AMRO, Citigroup, Credit Suisse First Boston (CSFB), Goldman Sachs and Morgan Stanley. Prior to that, Gazprom purchased a 3.016% interest in Sibneft from JS Gazprombank (CJSC). Hence Gazprom gains control over a 75.679% interest in OJSC Sibneft.

In addition, OJSC Gazprom received an expert report prepared by the London branch of Doutche Bank AG in respect of a purchase value of 72.663% shares of OJSC Sibneft, \$13.079 billion US dollars, by Gazprom Finance B.V., the affiliated company of OJSC Gazprom. Doutche Bank conducted an expertise to come to a decision that a premium of 13.079 billion US dollars for 72.663% shares of OJSC Sibneft is reasonable for OJSC Gazprom from the financial point of view. The final amount was therefore reduced against the initial amount of 13.091 billion US dollars as a result of additional negotiations between the purchaser and the sellers.

In addition, in December 2005, Gazprom also purchased 22.43% of interest in OJSC Silovyye Mashiny on the basis of a decision made by the Board of Directors on October 4, 2005. The value of the transaction was \$101.4 million US dollars with the upper level of the market value of \$107 million US dollars as determined by KPMG, an independent appraiser and approved by the Board of Directors. Hence, considering the interest held by OJSC Lenenergo in OJSC Silovyye Mashiny, holding company RAO "UES of Russia" accumulated a blocking package (25% + 1 share) of shares of the concern.

Last year, domestic companies pursued quite an active policy aimed at additional borrowing, including foreign financial markets, as well as strengthened their position in the world capital markets.

For example, on January 24, 2005, Sibneft announced a change in the proportion of its own shares as per American Depository Receipt (ADR). Since January 24, 2005, one ADR became equal to 5 Sibneft common shares. Prior to that, one ADR was equal to 10 common shares of the company. Hence, the number of ADR doubled, and their holders received one additional ADR per share held. The company took this measure to increase liquidity of its shares traded in international markets. At present, Sibneft ADRs included in the first-level listing are traded in the Frankfurt and Berlin Stock Exchanges.

At the end of January 2005, GMK Norilsky Nickel reported the results of the bids made by its shareholders in connection with purchase by the company of its outstanding shares in accordance with a decision of the Board of Directors of GMK Norilsky Nickel dated December 2, 2004. On December 3, 2004, GMK Norilsky Nickel announced that it intended to purchase up to 12 500 000 its shares (5.8% of the authorized capital of the company) to the amount of up to Rb 21 billion at Rb 1 680 per share. A total of 372 bids were made by the shareholders to CJSC National Registration Company in connection with selling of the shares they held, of which 207 bids were made by shareholders represented by legal entities and 165 ones by those represented by physical bodies. Number of the shares specified in the applications made by the shareholders totaled 59761360, of which 57965450 shares related to the shareholders representing legal entities and 1 795 910 shares related to those represented by physical bodies. Since the total amount of shares which were offered for sale to the company was 59761360 with an excess of 12 500 000 shares, the final number of shares to be purchased by the company from a shareholder was determined in a pro rata basis.

During 2005, OJSC Gazprom placed successfully several issues of bonds. For example, on February 3, 2005, it placed A3 series of three-year maturity bonds denominated in rubles to the amount of Rb 10 billion, at par value of Rb 1000. The coupon rate, payable every 180 day, was determined at 4% of the par value. The placement was determined to the amount of 100.69% of the nominal value by an auction held in the MICEX (Moscow Interbank Currency Exchange), which corresponds to effective yield to maturity of 8% p. a. Investors made applications to the amount of Rb 15.88 billion. Later on, in summer 2005 (on August 11), OJSC Gazprom placed A6 series of four-year maturity bonds denominated in rubles to the amount of Rb 5 billion, at par value of Rb 1000. The coupon rate, payable every 182 day, was determined at 6.95% p. a. by an auction held in the MICEX. Investors made 158 bids to the amount of more than Rb 12 billion. Forty five bids were accepted during the auction. The securities were placed with a record-breaking low yield as compared to that corporate bonds placed for the similar periods. Finally, on October 12, 2005, OJSC Gazprom placed A5 series of three-year maturity bonds denominated in rubles to the amount of 5 billion at par value of Rb 1000. The coupon rate, payable every 182 day, was determined 7.58% p. a. by an auction held in the Moscow Interbank Currency Exchange. Investors made 120 bids to the amount over Rb 9 billion. Seventy three bids were accepted at the auction. The funds borrowed during the placement were planned to finance the investments required for maintaining current production facilities, implementing new promising projects, as well as refinancing a short-term debt and optimizing the debt portfolio structure.

On October 21, 2005 RAO "UES of Russia" redeemed its second series of interest bearing bonds in time and in full to the amount of Rb 3 billion, as well as paid a total of Rb 225.63 million of the yield for the sixth coupon period. The coupon yield totaled Rb 75.21

payable per bond at par value of Rb 1000. Trast investment bank is the paying agent and underwriter of the issue. The bonds had six coupons payable at an interest of 15% p. a. The previous five coupons with a total volume of Rb 1.12 billion were also paid in time and in full. As of October 22, 2003, RAO "UES of Russia" made its annual offer which provided for early retirement of bonds at 102.36% of the par value (Rb 1023.6 per share), but none of the investors executed this right. The decision on issuance of bonds to the amount of Rb 3 billion was made at a meeting of the Board of Directors of RAO "UES of Russia" on June 21, 2002. The bonds were placed on October 22, 2002 in the MICEX. The report of the outcomes of the placement was registered with the Federal Financial Markets Service on November 19, 2002. The maturity of the securities is 1095 days. The funds borrowed through the placement of RAO "UES of Russia" bonds were intended to finance the day to day operations.

It is well known that a sound dividend policy is one of the means to improve attractiveness of shares, which should be aimed at improving wellbeing of the shareholders.

For example, a general meeting of the shareholders of OJSC Gazprom was held on June 24, 2005, which approved the annual statement and balance sheet of OJSC Gazprom for the year of 2004, including an asset and liabilities report of the Company. Decisions on profit allocation according to the results of the financial year were made as well, including annual dividend payout. In particular, the meeting approved the size of dividends – Rb 1.19 per share – on the basis of performance results of OJSC Gazprom in 2004. This was the biggest size of dividends that has ever been paid in the history of the company. The amount of allocated dividends totaled Rb 28 171.5 million or 17.5% of net profit as a result of performance in 2004. The final date of dividend payout was set on 31 December 2005. Those decisions were made in line with the recommendations given by the Board of Directors.

On June 25, 2005, OJSC Rostelecom announced the results of its annual general meeting of shareholders which was held on June 25, 2005. The meeting approved annual statement, annual balance sheet, including the asset and liabilities account of OJSC Rostelecom, allocation of profit and assets and losses according to the results of the financial year reported on (2004). The meeting approved size of dividends, namely Rb 2.9738 per preferred share, and Rb 1.4593 per common share. The amount of dividends on preferred and common shares totaled Rb 722.1 million and Rb 1 063.4 million respectively, which accounted for 10.0% and 14.7% respectively against the total amount of net profit in accordance with the Russian Accounting Standards (RAS).

In July 2005, the balance was stroke of the annual general meeting of the shareholders of RAO "UES of Russia", which was held on June 29, 2005. The company's dividend policy was described on the basis of the performance results attained in 2004. It was decided to allocate dividends for 2004 as follows: common shares – Rb 0.0559 per share, which is equal to Rb 2294230816.18; preferred shares – Rb 0.2233 per share, which is equal to Rb 463380239.58.

An extraordinary meeting of the OJSC NGK Slavneft shareholders, which was held on September 20, 2005, approved dividend payout on the basis of the company's performance within the first half of 2005. The size of dividends totaled Rb 7 654 323 180 or Rb 1.61 per each common share at par value of 0.1 kopeks.

Section 3. The real sector

3.1. Macrostructure of Production

3.1.1. Trends and Factors of Changing Final Demand

Influence of internal and external demand on the GNP dynamics and structure

In the period of 1999–2005, the Russian economy could be defined as dynamically developing in practically all kinds of economic activities. This economic growth was taking place in the context of quite favourable foreign economic situation and internal social and political stability (*Table 1*). Specific for the functioning and structural changes was the internal market expansion in terms of dynamic growth of both the consumer and investment demand. Greater business activity rested on outstripping growth of investments with regard to the dynamics of end-consumption, having thus exerted most significant influence on the nature of structural shifts in the GDP produced and employed. With 57.5 % GDP increase during the last seven years, the actual household end-consumption grew by 65.0 % and fixed capital investments – by 90.1 %. Both development specifics and transformational shifts in the internal market were significantly influenced by positive dynamics of commodities and services production. In 2005, as compared against 1998, output of industrial production went up by 62.8 %, agriculture – by 28.9 %. Growth of commodity production is supported through the servicing market infrastructure sufficiently developed during the reforms period. The commercial transport turnover, as compared against 1998, grew by 41.7 %, the communications services – by 296.8 %, the retail trading – by 68.5 %.

Table 1

**Indices of the Basic Macroeconomic Indicators
in 1999–2005, in % as against the Preceding Year**

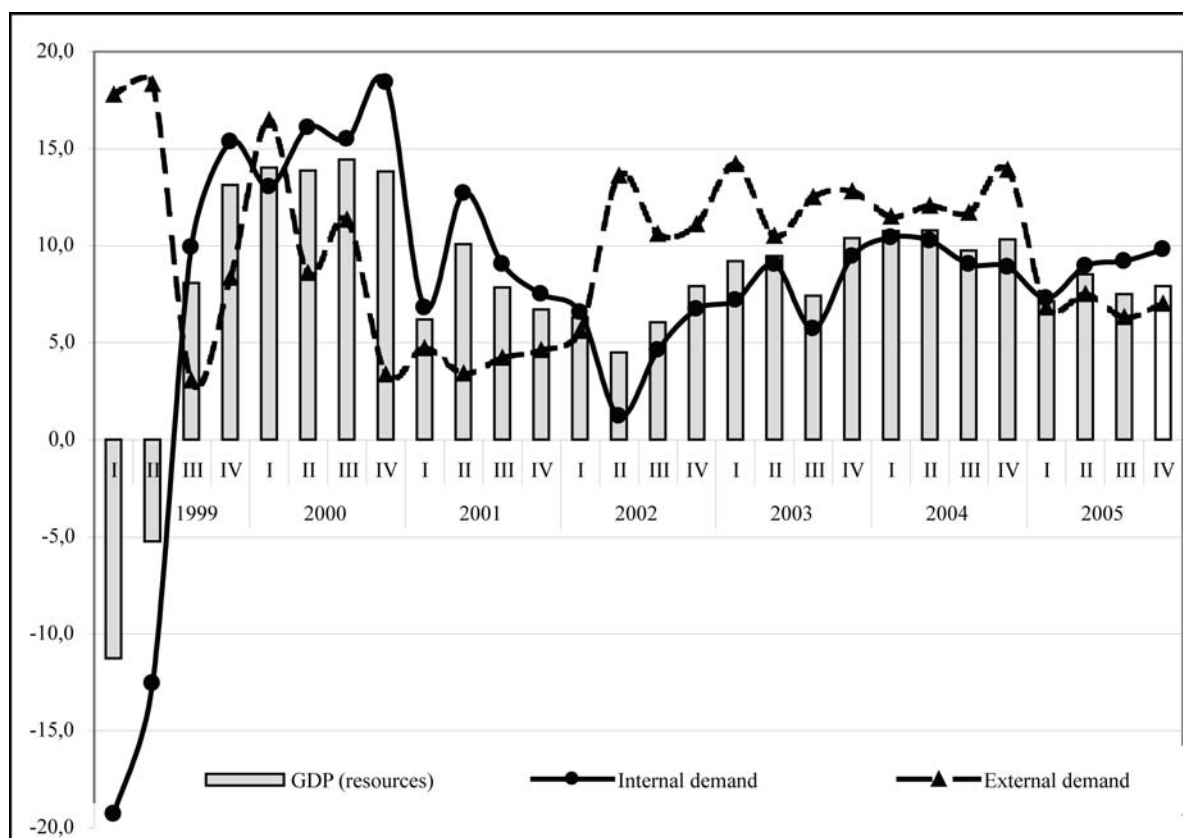
	1999	2000	2001	2002	2003	2004	2005
Gross domestic product	106.4	110.0	105.1	104.7	107.3	107.2	106.4
Actual household end consumption	97.1	107.3	109.5	108.5	107.5	111.6	111.1
Fixed capital investments	105.3	117.4	108.7	102.6	112.5	110.9	110.5
Volume of industrial production	111.0	111.9	104.9	103.7	107.0	106.1/ 108.3*	104.0*
Agricultural production	104.1	107.7	107.5	101.7	101.5	101.6	102.0
Transport turnover	105.8	104.8	103.2	105.6	107.4	106.4	102.6
Communications	133.1	113.8	119.1	115.6	127.5	129.0	115.7
Retail trade	93.9	108.8	110.7	109.1	108.4	112.5	112.0
Paid services for population	107.0	105.0	102.8	100.4	105.1	108.4	107.5
Foreign trade	86.7	129.7	105.4	108.1	124.6	130.6	133.2
Real monetary incomes	87.7	112.0	108.7	111.1	114.9	109.9	108.8
Real wages	78.0	120.9	119.9	116.2	110.9	110.6	109.7
Real pensions	60.6	128.0	121.4	116.3	104.5	105.5	109.3
Average annual quantity of those employed in the national economy	100.5	100.6	100.6	101.0	99.2	101.8	100.8
Number of unemployed (by the end of the year)	102	77	90.0	98.0	106.0	96.1	94.0

* The dynamics of industrial production is given by kinds of economic activity.

Source: Rosstat.

A positive factor of stable economic development in the recent years was simultaneous expansion of both the internal and external markets. While the dynamics of external demand was formed exceptionally through favourable situation on the world markets of fuel and raw materials, expansion of the internal market was mainly determined by the cu-

mulative effect of greater national business activities and systematic growth of the population's solvent demand in the context of its stably growing monetary earnings.



Source: Rosstat.

Fig. 1. Growth rates of internal and external demand for 1999–2005, in % as against the respective quarter of the preceding year

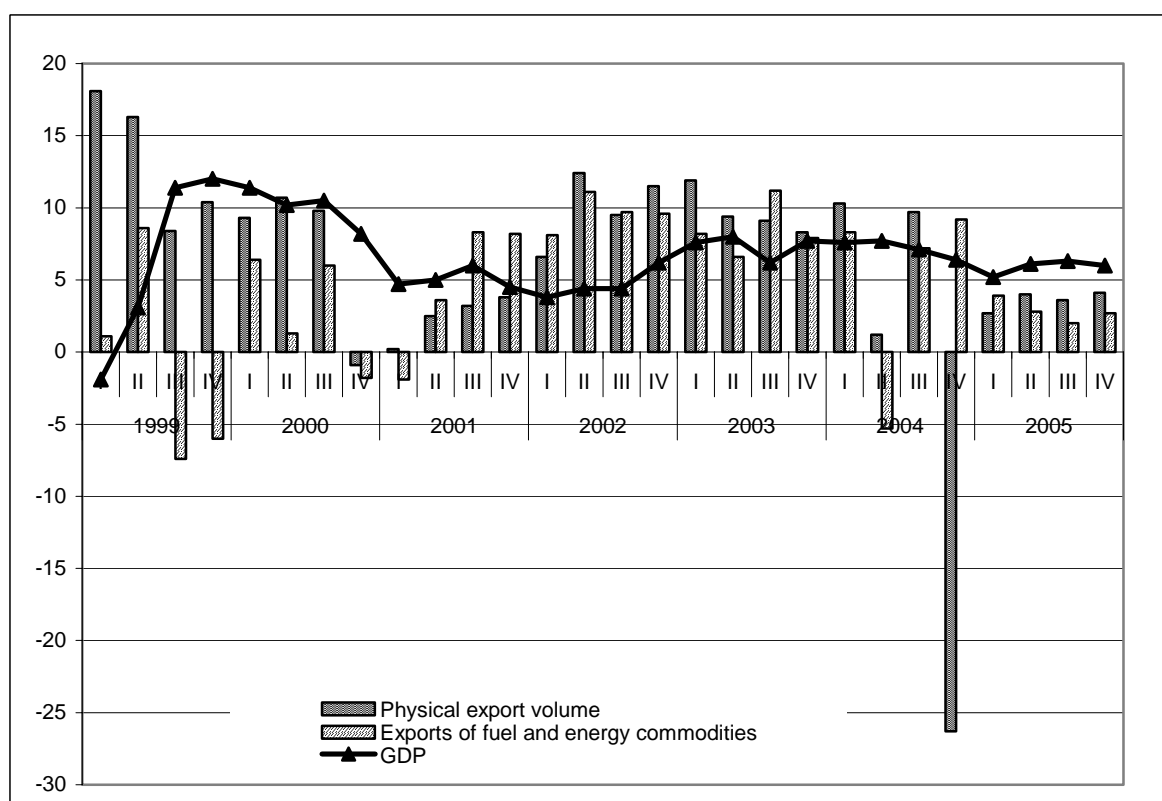
As can be seen from Fig. 1, the internal and external demand ratio during 1999–2005 experienced rather significant transformations.

Active substitution of imports, from the end of 1999 to the first half of 2001, was a major for successful overcoming negative consequences of the August 1998 financial crisis. In the context where the national business is being more and more guide lined to fill in niches on the domestic market, dominating influence on the economic situation was exerted by dynamic growth of manufacturing, construction industries and infrastructure. High economic growth rates of extractive industries, manifest from the second quarter of 1999, were to a certain extent caused by greater demand for Russia's traditional export commodities as well as intensive growth of the world market prices on hydrocarbons. Nevertheless, it was primarily the internal demand that accounted for almost 75 % of the GDP growth in that particular period.

Greater impacts of external factors on the Russian economic development were being registered beginning from the second half of 2001 up to quarter IV of 2002, and was taking place in the context of restrained internal demand dynamics as well as somewhat unfavourable price shifts on the world commodity and raw materials markets. Besides, it was exactly in this period that the Russian rouble devaluation effect was practically stopped. One of the results being that expansion of the external demand and production in

the export-oriented sectors was unable to compensate for shrinking demand on the internal market during the second half of 2001–2002 but resulted, in the long run, in slower growth rates down to the minimum, at least for the last five years, level. The average annual GDP growth rates in 2001–2002 comprised 104.5 %. As regards the economic sectors, this approximately similar GDP growth was determined by expanding internal and external demand, even with rather significant yearly and quarterly changes in the respective growth rates.

The 2003–2005 period registered gradual improvement in the terms of Russia’s trade with foreign countries due to both the outstripping price growth on exported commodities and the expanding demand for the basic Russian export trading positions. In 2005, the relative weight of exports in the sumtotal resources reached 36.8 % as against 30.5 % in the pre-crisis 1997. However, even with such exceptionally favourable foreign economic situation, beginning from the second quarter of 2004, gradual slow down of the export growth rates in terms of physical volume was observed. As compared against the year of 2003, these went down by 1 p.p. with regard to the physical export volumes and as concerns fuel and energy commodities – by 1.8 p.p. (see Fig. 2 below). In 2005, slow down of the growth rates was taking place more aggressively and also provoked by somewhat sluggish physical exports dynamics of oil and oil products. Resulting, finally, in obviously weaker influence of external demand on the GDP dynamics.



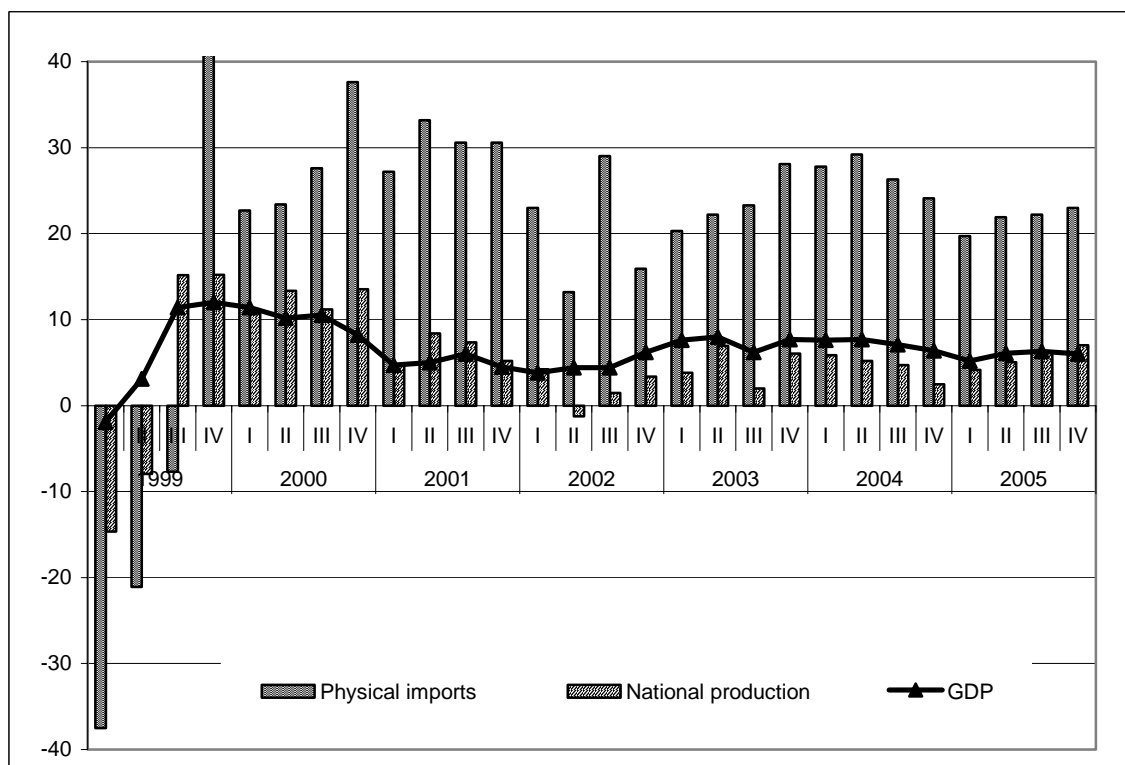
Source: Rosstat.

Fig. 2. Changing GDP Growth Rates, All Exports and Fuel-Energy commodities in 1999–2005 in % as against the Respective Quarter of the Preceding Year

Of principle importance for the Russian economy are both the level of external demand for the mineral and raw materials products and the way foreign economic activity profits are used in practice. In 2005, the VAT share of extractive industries in the industry on the whole reached 33.7 % as against 25.2 % in 2002–2003 and 20 % in 2000. With dynamic growth of prices on hydrocarbons and metals, the export share of mineral raw materials and primary manufacture products in the incomes structure from foreign economic activity comprised 78.4 % in 2005 having thus increased by 4.1 p.p. as compared against the previous year. In 2005, as shown in the resultant finance balance of industrial production, the share of extractive branches comprised 40.2 % as against 38.3 % in 2004 and 33.9 % in 2003. Due to underdeveloped structure of inter-branch redistribution of resources, greater concentration of incomes in the export oriented sector of industry exerted pressure on the internal market.

Beginning from the IV quarter of 2003, expansion of internal demand was already exerting dominating influence on both the structure and dynamics of economic growth. In 2004, growth of internal demand reached 10.3 % as against 7.8 % in 2003 and 4.6 % in 2002. In 2005, restored was the outstripping internal demand growth trend as compared against the external one (8.1 % growth in the 1st half of 2005 and 9.5 % in the 2nd as compared against the respective periods of the previous year). Contribution of internal demand to the 2005 GDP growth is estimated at the level of almost 80 % which corresponds to the 2000 indicators – the year of the best economic dynamics during the last seven years.

Positive internal demand dynamics in 2000–2005 was determined by both growing volumes of internal production and further expansion of the scale of imports. It is also noteworthy that sudden upsurge in the activities of the national business caused by the devaluation of the rouble, on the whole did not last too long. Worse competitive context (much due to stronger rouble), including lesser competitive resources, as well as lower activities in modernizing and reconstruction of production resulted in gradual slowing down of the respective economic growth rates. In 2002, growth of the national production fell down to its minimum level for the last seven years comprising 1.9 %. Saturation of internal market under this situation was determined by the fact that the growth rates of physical imports remained at the level of 117.8 % (*Fig. 3*). Hence, the share of Russia's own commodity production in forming internal market resources in 2002 decreased almost by 6.6 p.p. as compared against the most favourable 2000. In the period from IV quarter of 2002 to II quarter of 2004, the internal market showed greater growth rates of imports even though under sufficiently unstable dynamics of the national production. The average annual growth rates of own production commodities during this period comprised approximately 4.5 % and those pertaining to the physical imports – 20.5 %. Outstripping growth rates of imports as against the respective internal production, were quite typical for the economic growth of the recent years.



Source: Rosstat.

Fig. 3. Changing Growth Rates of Imports, the National Commodity Production and GDP in 1999–2005, in % as against the Respective Quarter of the Preceding Year

Most significant influence on the structure of internal demand was exerted by the respective consumer and investment ratio. Sharp upsurge of investing in the fixed capital in the 2nd half of 1999 – 1st half of 2001 somewhat stimulated development of the national production, including formation of potential sufficient to control and regulate the changing situation in the consumer sectors of economy. Gradual consumer demand growth, as based on the growth of population's real incomes and dynamic production development of food products, textile and clothing manufacture, retail trade, stimulated restoring of the household end consumption in 2000 up to the level of the pre-crisis year of 1997. Greater share of the national commodity production was registered in the retail trade resources structure but this process was interrupted in 2002 when sharp slow down of growth rate in practically almost all manufacturing industries opened the market for more intensive imports.

The consumption level of the population determined faster growth rates of consumer goods imports and under longer trend of outstripping growth of investments with regard to dynamics of machine building – import of machinery and equipment. In 2003–2005, import exerted stronger influence on dynamics and structure of both end and intermediate demand on the internal markets. Growth of imports in 2005 comprised 28.5 % as against 24.6 % in 2004 and 13.4 % in 2002. Shaping of this trend was supported by growing profits of business from foreign economic activities and by greater efficiency of imports in the context of gradually stronger rouble.

Restoring trend towards greater role of internal demand practically did not change the situation. Although 2005 was characterized with gradual growth of internal production

rates from 4.6 % in the 1st quarter up to 6.3 % in the 3rd and 7.0 % in the 4th quarters, this did not result in any greater influence on the structure of sources forming internal demand resources. Correlation between imported and own, domestic goods remained at approximately the 2004 level. Dominating influence on the 2005 imports structure was exerted by intensive growth of physical volumes of imported investment commodities and quite moderate growth rates of intermediary demand goods. The share of imported machinery and equipment in the overall volume of imports in 2005 comprised 43.5 % as against 41.6 % in 2004 and 37.3 % in 2003.

The turnover structure of retail trade in 2005 also registered further growth in the import share of consumer goods. In view of the slowing down growth rates in consumer industries, as initiated by the permanent crisis in the textile, clothing and footwear productions, the share of domestic inedible commodities in the respective retail trade went down to 44.4 % in 2005 as against 46.4 % in 2004 and 50.0 % in 2001–2002. The dynamics of food imports was restrained by rather strong competitive positions of the Russian producers so the imports share in the overall volume of commodity food resources somehow stabilized at the level of 34 %. Hence, the general competitive positions of Russian producers who are, on the one hand, positively influenced by growth of production and, on the other, experience negative effect of stronger rouble as well as changing correlation between internal prices and imports practically returned to the 1997 pre-crisis level. Which did significantly aggravate competition between domestic and imported commodities having thus shifted the gravity center towards different non-price factors.

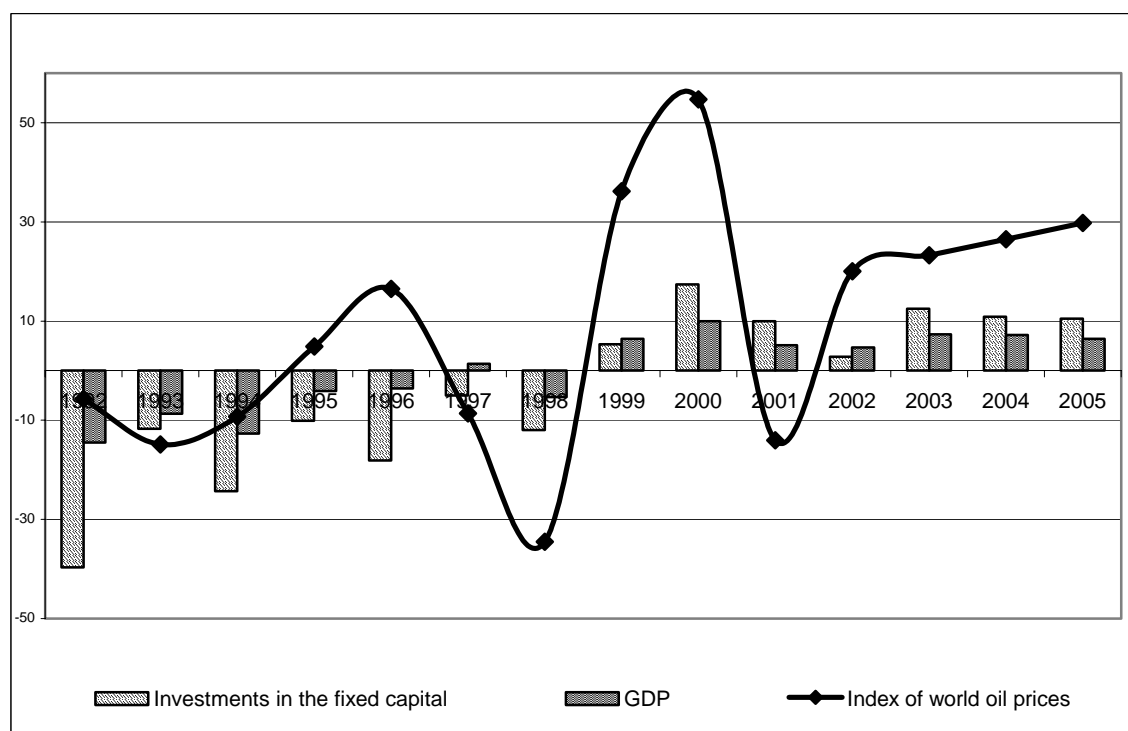
Dynamics and share of gross saving and gross accumulation in GDP

According to the comparative by-factor analysis of GDP dynamics, the investment sphere was the one that reacted to the changing volumes and incomes from exports most sharply. Upsurge of investment activity in the 1999–2000 and 2003–2005 periods coincided with dynamic growth of incomes from commodity exports while the respective slowing down of investment rates in 2001–2002 was caused by reduced demand on the foreign market and flabby dynamics on the world markets of oil and metals. Due to lower incomes from exports and moderate investment behaviour in 2001–2002 the average annual GDP growth comprised 4.9 % as against 11.0 % in 2000 while investments in the fixed capital 5.6 % as against 17.4 %, respectively. In 2003–2005, growing incomes from foreign economic activities definitely stimulated business operations. The respective growth rates increased from 108.1 % in 2002 and 130.6 % in 2004 up to 133.2 % in 2005. The average monthly foreign economic trade balance in 2005 comprised about \$10 bln as against \$6–7 bln in 2003–2004, averagely. The GDP growth rates in 2005 comprised 6.4 % while those of investments in the fixed capital–10.5 % as against similar indicators for the 1999–2004 period (in average) – at the level of 7.2 % and 10.9 %, respectively (*Fig. 4*).

Exceptionally favourable combination of domestic business activities and the price situation on the world markets of raw materials stipulated quite intensive growth in the gross saving scales. The share of the latter during the recent seven years was within the 31.1 %–38.7 % GDP range as against 24.0 % in the 1997 pre-crisis year. In 2005, under the influence of growing export incomes, on the one hand, and lower household expenditures, on the other, the gross domestic saving comprised 35.1 % GDP as against 33.7 % in 2004 and 31.8 % in 2003.

The phenomenon of Russian economy is that growing export incomes along with greater credit and investment attractiveness have been leading to significant increase in the centralized withdrawal of capital into the respective reserve funds. As beginning from

January 1, 2004, the RF Stabilization Fund started to be being formed for the purpose of lowering risks, as connected with unfavorable foreign economic situation, and as an instrument to adequately sterilize excessive money supply in circulation at the expense of additional budget incomes from high oil prices. In 2004, it comprised 4.4 % GDP and in 2005—almost 6 % GDP, i.e. 1.3 trillion roubles. In the context of higher levels of “available monies” in the Stabilization Fund, the recent two years saw stronger orientation towards more efficient solving of the state’s external debts on the one hand, and fulfillment of the adopted social programs, on the other.

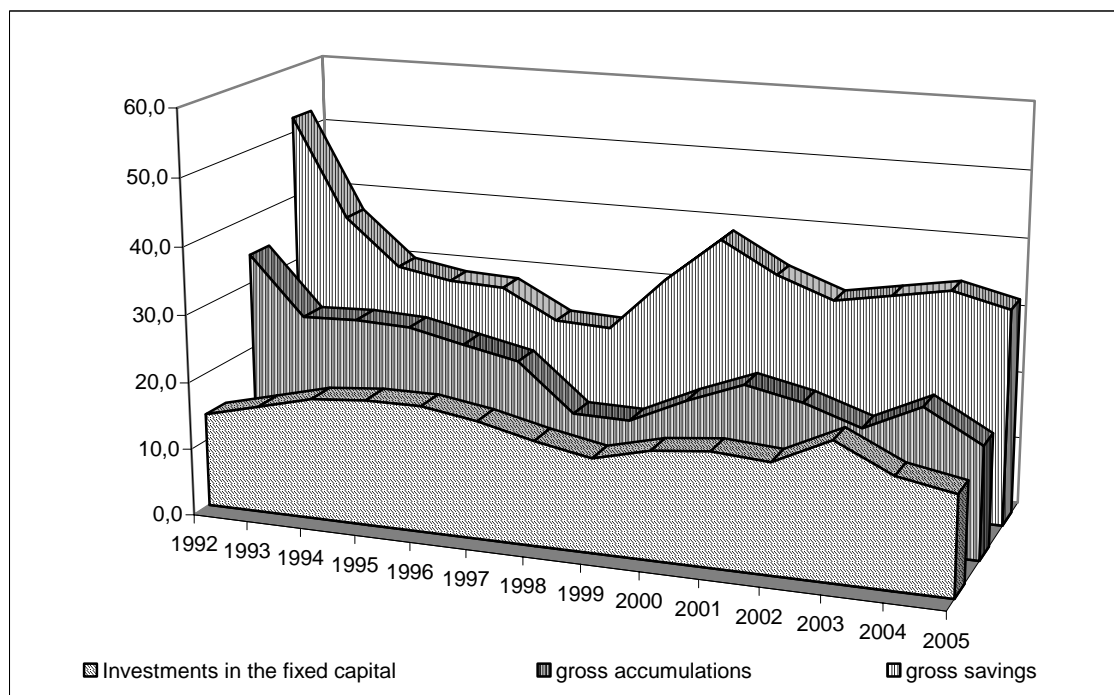


Source: Rosstat.

Fig. 4. Changes of the GDP Investments Growth Rates in the Fixed Assets and the World Oil Prices in 1992–2005 (in % as against the Preceding Year)

Analysis of operational accounts with such capital does graphically illustrate growing gross saving asymmetry, gross accumulation resources and investments in the fixed capital in the context of gradually weakening loads on economic operations with the rest of the world. Despite the growing volumes of the gross domestic saving, the investment sphere was not involved. The investment share in the fixed GDP capital in 1999–2005 remained averagely at the 15.9 % level which was 1.5 p.p. below the 1997 pre-crisis level (see Fig. 5 below). The policy of withdrawing potential capital into the reserve funds did limit abilities to modernize production thus eventually increasing its dependence on the foreign economic situation. Insufficient investments in the real sector under the existing age, technological and branch structure of the fixed capital exerted negative impacts on the economic growth structure. Which resulted in the 6.4 % GDP growth in 2005 as compared against 7.2 % in the preceding year. The overall influence of internal factors regulating the level of business activity, turned out to be rather insufficient to compensate for weaker external demand on the economic growth rates.

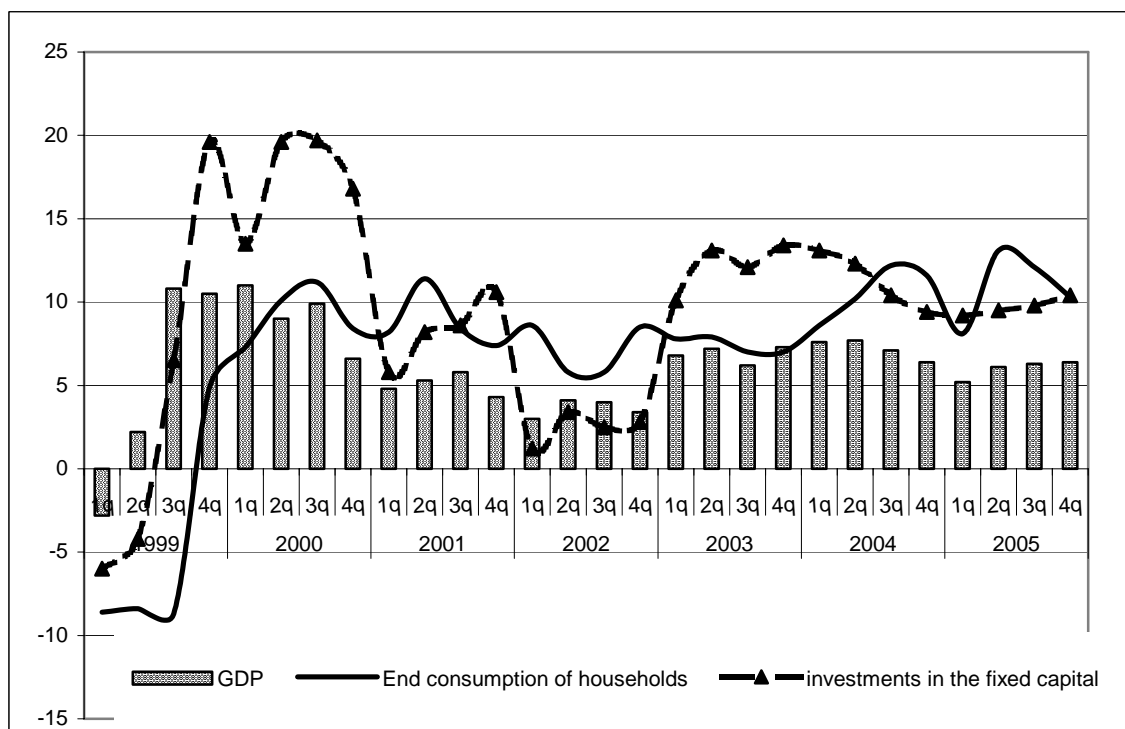
Underdeveloped financial markets could not ensure adequate inter-branch flow of incomes and exporters' accumulations into the sectors serving the internal demand sectors. It is also noteworthy that the impact area of growing incomes from the respective foreign economic activities was rather rigidly limited by the functional branch priorities pertaining to the export-oriented industries.



Source: Rosstat.

Fig. 5. Share of Gross Savings and Investments in the Fixed GDP Capital in 1992–2005 in (%)

As shown by the practical experience of the recent years, it is the investment demand – end consumption ratio that most sensitively reacts to the changes in export incomes and determines specific features of the internal market functioning. Sharp fluctuations in the investment expenses on fixed capital reproduction are compensated through smoothly changing dynamics of end consumption. It is noteworthy here that weaker influence of the investment component was observed beginning from the 2nd quarter of 2004 (see *Fig. 6*).



Source: Rosstat.

Fig. 6. Changing Dynamics of GNP by the End Demand Components in 1999–2005 (in % as against the Respective Quarter of the Preceding Year)

End consumption of households and changing parameters of the population's level of life

Positive dynamics of the end consumption was a major factor influencing internal market development in 2000–2005. Real earnings of the population, real wages and real size of pensions showed a trend towards stable growth. Growing scale of the end consumption was taking place in the context of sufficiently stable correlation between consumption of households and volume of social transfers received from state bodies and non-commercial organizations. In the 2005 structure of GDP use as compared against the previous year, the share of expenditures on end consumption comprised 64.9 % and went down by 1.4 p.p. as compared against the previous year (see Table 2).

In 2001, the end consumption of households returned to its pre-crisis level and then went up by 46.3 % during the following four years. In 2005, growth of the population's real earnings comprised 8.8 % as against 9.9 % in 2004, real wages – 9.7 % as against 10.6 % and real size of pensions – 9.3 % as against 5.5 %. Greater earnings of the population were accompanied with state reduction in the level of poverty. The share of citizens with monetary earnings below the cost of living level went down to 21.9 mln men which comprised 15.8 % of the total population as against 24.9 mln men (17.3 %) in 2004 and 34.6 mln men (24.2 %) in 2002.

Structural shifts in forming monetary earnings of the population were accompanied with changes in distribution of the population with regard to the size of average per capita incomes. In 2005, when the average per capita incomes grew by 123.0 % as compared against the previous year and the nominal wages by 123.6 %, the share of population with

average per capita incomes above 7000 roubles went up by 10.5 p.p., in the 5000–7000 roubles range – by 0.8 p.p. and in the below 5000 roubles brackets – went down by more than 11.3 p.p. However, this did not serve to weaken the social and economic differentiation of the population by earnings. It is estimated that the ratio of funding which defines correlation between average values of the lowest and highest earnings pertaining to the corresponding decile population groups, comprised in 2005 14.8 times as against 14.3 times in 2003 and 14.0 times in 2001–2002. The Jini ratio, describing concentration of incomes, increased up to 0.404 as against 0.400 in 2003 and 0.398 in 2002–2000.

Table 2

Structure of GDP Use in 1998–2004, in % as against the Result

	1998	1999	2000	2001	2002	2003	2004	2005*
Gross domestic product	100	100	100	100	100	100.0	100	100
Expenditures on end consumption including:	76.2	68.1	61.3	65.8	68.9	68.1	66.3	64.9
households	55.6	52.3	45.1	48.3	50.0	49.4	48.6	47.9
state bodies	18.7	14.6	15.1	16.4	17.7	17.6	16.7	16.3
Gross accumulation including:	14.9	14.8	18.7	21.9	20.1	20.8	21.1	21.2
gross accumulation of fixed capital	16.5	14.4	16.9	18.9	17.9	18.4	18.6	18.5
Net export of goods and services	6.8	17.0	20.0	12.7	10.8	11.3	12.6	13.9

* Preliminary data.

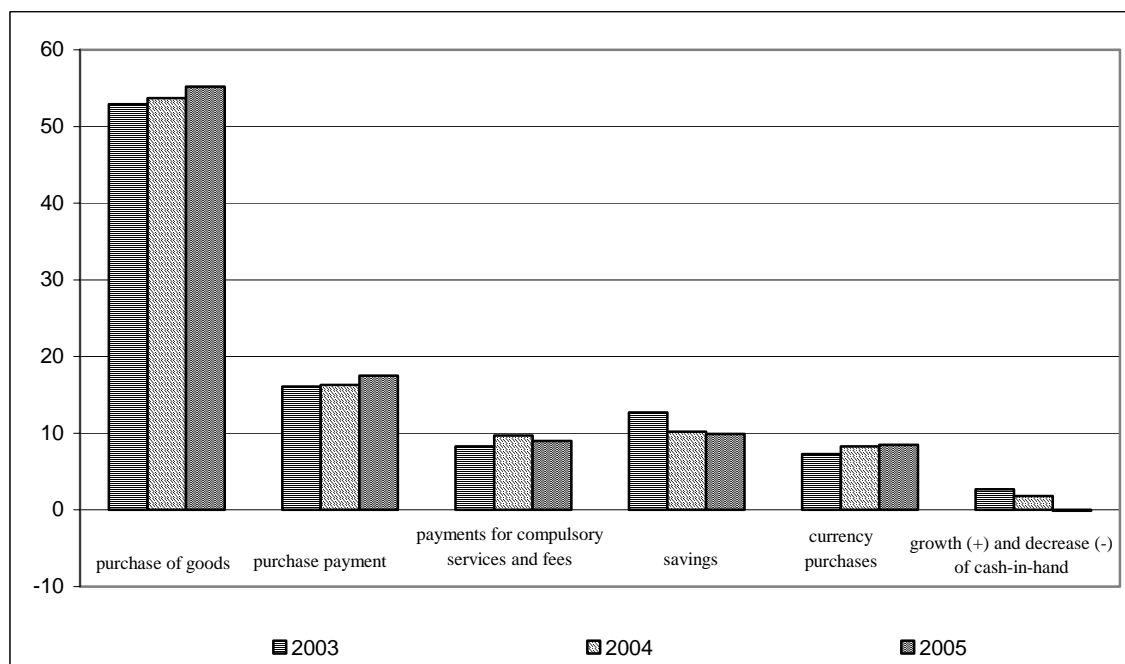
Source: Rosstat.

Specific features in incomes distribution did determine peculiarities in the dynamics of current expenses and the level of savings in the household sector as well. Higher purchasing power of the population's incomes resulted in remaining high growth rates of the retail trade turnover: in 2005, it grew by 12.0 %. Changes in the structure of consumer expenditures were determined, for the last seven years, by higher relative weight of expenditures on nonfoods and services accompanied with lesser share of such expenditures on foods. Growth of sales of foods comprised 10.6 % while those of nonfoods – 13.4 %. Changing consumer behaviour was to a certain extent explained by structural price shifts in the basic commodity groups. With consumer prices growth by 10.9 % in 2005, prices on foods in the beginning of the year grew by 9.6 % and on nonfoods by 6.4 %. It is also noteworthy that under the present level of incomes, gradual shifting of the assortment sale structure of foods towards more expensive foods and nonfoods – towards better quality imported goods were statistically registered. Changing demand structure of the population and greater sales share of durable nonfoods and household stimulated more active development of consumer crediting. Volume of credits to physical persons grew 1.82 times from the beginning of the year. In 2005, the share of credits to physical persons comprised 18.9 % of the total crediting given by the respective crediting organizations as against 14.4 % in 2004 and 9.8 % in 2003. It is to be noted that the share of sales through trading companies was stably increasing in 2003–2005.

The dynamics of consumer demand was significantly influenced in 2005 by greater share of expenditures on payment for services. In 2005, the market of paid services to the population was taking shape in the context of higher indices of prices and tariffs by 21.0 % as compared against 17.7 % in the preceding year. Of the services, statistically registered, most dynamic in 2005 was growth of prices and tariffs in the housing and communal services (132.7 %) and the transport sector (115.8 %). Accordingly, the housing and commu-

nal services took the first place in the structure of paid services having comprised over a quarter of the total paid services. This became a factor for almost 1.2 p.p. greater expenditures on services in the monetary incomes structure as compared against 2004. Besides, dynamic growth of household motorization as well as increasing house building on the population's own money initiated active development of the corresponding services markets. Over half of personal services accounted for the total share of services in technical repair and servicing transport vehicles, technical devices and equipment (23.4 %), house building and repair (28.8 %). Dynamic growth of the market of services in technical servicing and repair transport vehicles as combined with expanding sales of cars and growing demand of the population for combustive and lubricating materials also exerted significant influence on the structure of current consumer expenditures of the population. It is to be noted here that 15.8 % growth of prices on petrol in 2005 also significantly influenced the dynamics and structure of expenditures, particularly so in view of the fact that in 2004 such growth of prices on petrol comprised 31.3 %.

The expenditure structure of the population was also influenced by increased inflationary expectations of the population which were traditionally manifested in greater expenditures on buying foreign currency and faster rates of acquiring nonfood consumer goods. This upsurge of consumer activity caused reduction of the cash-in-hand volume. Due to faster growth rates of prices and tariffs for services as compared against 2004, the share of consumer expenditures in the structure of spending monetary earnings in 2005 went up to 70.9 % as compared against 69.8 % in the preceding year (see *Fig. 7*). It is to be noted here that lesser inclination to saving was registered only during the first half of 2005. Faster growth rates of real earnings of the population in the second half of the year manifested a trend towards returning to the inclination to save. A factor restraining active use of savings on current consumption, was high investing activity of the population in house building. In 2005, the volume of living space build by the population on their own money and/or through credits received grew by 6.8 % as against 5.9 % in the preceding year. However, the influence of this factor on the way the population spends their earnings depends not only on the level of earnings and prices on housing but on the general economic situation and the investment climate as well.



Source: Rosstat.

Fig. 7. Structure of Consumption of Monetary Earnings by the Population In 2003–2005, in % as against the Total

3.1.2. Specific features of GDP Formation by Incomes

Dynamically growing incomes of the population is a specific feature pertaining to the restorative period of the Russian economy in 1999–2005. Supporting the internal market dynamics was based on the growth of real wages and followed with incomes redistribution from enterprises to the population. In 2005, the share of payment for wage earners in the GDP comprised approximately 43.2 % remaining above the respective indicators in 1999–2000 (see Table 3).

Table 3

Structure of GDP Formation by Incomes in 1999–2005, in %

	1999	2000	2001	2002	2003	2004	2005*
Gross domestic product	100	100	100	100	100	100	100
including:							
payment of wage earners (including the hidden ones)	40.1	40.2	43.0	46.8	47.1	45.4	43.2
Net taxes on production and imports	15.7	17.1	15.7	17.0	15.9	17.2	19.3
Gross profits in the economy and gross mixed incomes	44.2	42.7	41.3	36.2	37.0	37.4	37.4

* Preliminary data.

Source: Rosstat.

It is noteworthy that greater payment of wage earners in the structure of incomes was taking place in the context of remaining high differentiation in the average wages area by

branches of economy and industry. Dynamic growth of wages in the infrastructure branches, the finance-credit sector and management bodies was accompanied with smoothly decreasing wages paid in the commodity production sector as compared against the respective average level for the economy as a whole. In industry, the said differentiation degree of wages was determined by greater gap in the rates in the export oriented manufacturing branches. The nominal wages paid in the extractive sector, was 2.2 times higher than the average level in the economy as a whole, including in the extraction of fuel and energy fossils – 2.5 times. In the manufacturing branches, respective wages comprised 101.1 % regarding the average for the economy as a whole and 40.2 % with regard to the respective indicator in the extractive branches. 2.3 times exceeding the average indicator of wages for the economy was registered in productions connected with processing and transporting fuel and energy fossils. In education and health care the average wages comprised 64–68 % regarding the average level for the economy as a whole, in transport – 130 % and in finance – 241 %. Specific features of remuneration for labor by kinds of economic activities exerted significant influence on forming the structure of incomes and expenditures, the consumer demand of the population as well as on the nature of employment and distribution of labor resources in the economy.

In the structure of employed population, 92.1 % work for a wage and only 7.9 % account for those who do not work for a wage: employers using hired labor in their own enterprises on a permanent basis, self-employed people. Accordingly, this determined certain peculiarities in forming the incomes structure of the population and the GDP (see *Table 4*). Over 64.5 % of incomes and 42 % of the GDP accounted for the share of wage earners. The transformational shifts in the business environment stimulated higher activities in the small business sphere and quantity of those employed in it reached 11.3 % of the overall quantity of those employed in the economy as a whole. In the structure of monetary earnings of the population, the share of incomes from entrepreneurship and property in 2005 went up to 20.5 % which exceeded the 2004 level by 0.5 p.p. and by 3.4 p.p. that of 2002.

Table 4

Structure of Monetary Incomes of the Population in 1999–2005, %

	1999	2000	2001	2002	2003	2004	2005*
Monetary earnings – total	100	100	100	100	100	100	100
Wages, including hidden ones	66.5	62.8	64.6	65.8	63.9	64.9	64.5
Incomes from entrepreneurship	12.4	15.4	12.6	11.9	12.0	11.7	11.5
Incomes from property	7.1	6.8	5.7	5.2	7.8	8.3	9.0
Social payments	13.1	13.8	15.2	15.2	14.1	12.9	13.0
Other incomes	0.9	1.2	1.9	1.9	2.2	2.2	2.0

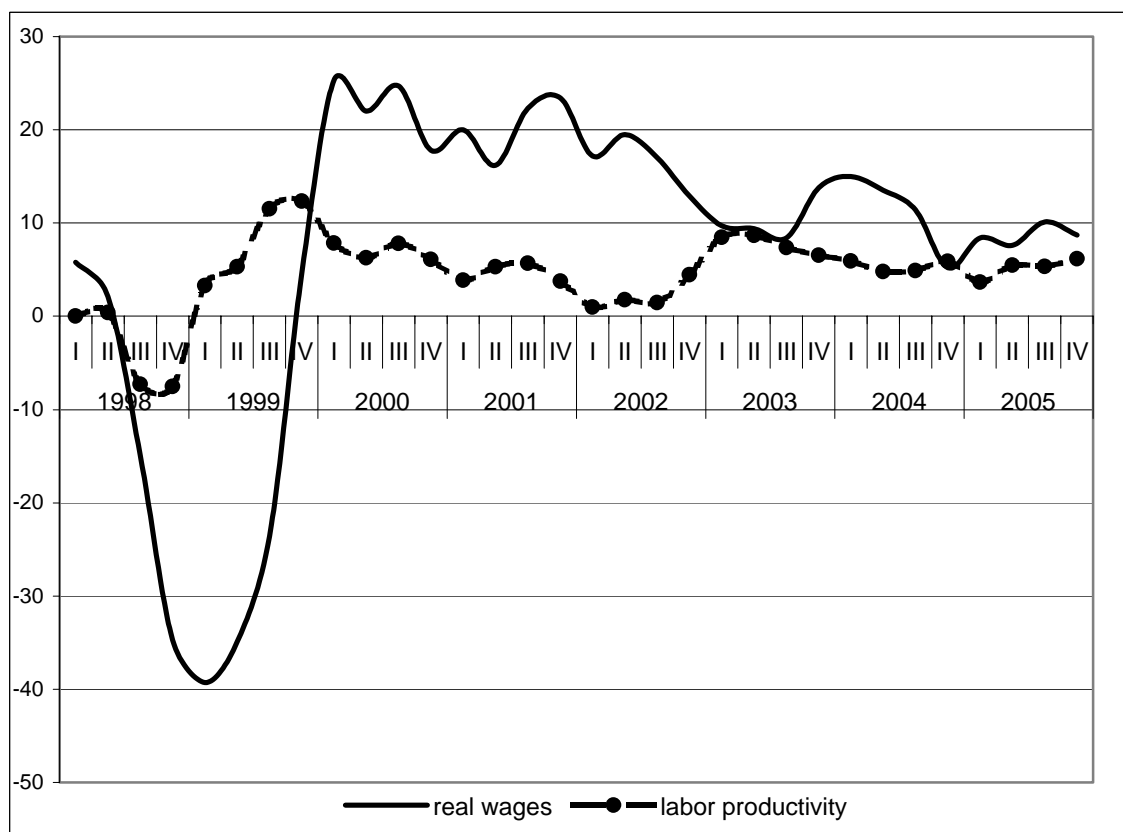
* Preliminary data.

Source: Rosstat.

Both the level and share of wages in the GDP structure exerted dominating influence on the social parameters. With the economic growth back, significant changes were registered on the labor market. The 1999–2005 period was characterized by a trend towards greater demand for labor. In 2005, the average annual number of those employed in the economy comprised 68.2 mln men as against 65.8 mln men in 2003 and 63.8 mln men in 1998. It is to be noted here that changing demand for labor was also determined by shifting employment from the commodity production sector to activities directly connected with market services. Shaping this trend at early stages of restoring economic growth exerted powerful positive influence on the quality of life and gave impetus to faster growth rates of

the service sector development. However, in the context of slower rates of industrial production and faster imports thus provoking a trend towards reducing the average annual quantity of the respective production personnel. The recent three years registered reduction of employment practically in all industrial branches, with most intensive decreases in the number of jobs taking place in the manufacturing industries. However, the existing efficiency in using labor and fixed capital both in the investment and consumer segments stimulated a gap in the growth rates in the manufacturing and extractive branches what, in the long run, was determining formation of the trend towards slower economic growth rates.

Low efficiency in using factors of production but one of the reasons decreasing competitive advantages of Russian commodities. Negative impacts on the qualitative indicators in the respective economic dynamics were exerted by greater gap between rates of labor productivity and those of wages, in favour of the latter (see Fig. 8). In the 2000–2005 period, real wages increased 2.25 times while the productivity of labor grew 1.42 times. Such order of growth of wages was accompanied with lowering gross profits in the GDP structure from 42.7 % in 2000 down to 37.4 % in 2005.



Source: Rosstat.

Fig. 8. Dynamics of Labor Productivity and Real Wages in 1998–2005 (in % vs. the Respective Quarter of the Preceding Year)

In 2003, rates of labor productivity and wages were drawing together in the context of faster rates of production. However, influence of this process on changing efficiency indicators of enterprises and/or organizations was exceptionally weak and unstable. Maintain-

ing a positive internal market dynamics through growing wages and earnings of the population was accompanied with redistribution of incomes from enterprises to the population which, in the long run, resulted in higher production costs and lower profitability of production. In 2004–2005, dynamics of wages 1.04 times exceeded the growth of the labor productivity. However, possibilities for further increase of expenditures on wages were rather limited by changes in the competitive environment on commodity markets taking place due to strengthening of the rouble and higher pressures exerted by imports. Hence, in 2005, the share of wages in the GDP went down by 2 p.p. as compared against 2004.

Since the dominant part of population's incomes is formed through wages, problems of employment and jobs placement acquired priority significance. The total number of unemployed, as calculated by the IOL methodology, went down to 8.9 mln men (13.2 % of economically active population) in 1998, down to 6.2 mln men in 2003 (8.6 %) and down to 5.6 mln men (7.5 %) in 2005 (see Fig. 9). The ratio of tension (number of unemployed citizens officially registered in the respective employment services as per one vacancy) went down to 2.7 men as against 2.7 men as per the end of 2004. Simultaneously with changing demand for the labor force, registered was also a trend towards higher efficiency in using working time. In 2005, *de facto* length of work time increased in economy as a whole and in industry. As compared against 2004, quantity of those working part time and having forced administrative leaves went down almost by 1/5. Changing motivation to labor was accompanied with a trend towards shorter leaves fully in accordance with the respective active legislation and on own initiative of those employed.



Source: Rosstat.

Fig. 9. Changing Growth Rates of the GDP, Real Wages and Relative Share of Unemployed in 1998–2005 (in % vs. the Respective Period of the Preceding Year)

According to analysis of changes in the share of gross profits and business incomes in the GRD, average profitability of the Russian economy has an upward trend of development. The resultant financial balance of organizations in the basic branches of economy in 2005 grew 1.38 times as compared against the similar period of the preceding year.

Analysis of profit formation by sectors of economy shows that the resultant balance was formed in approximately equal shares through production of commodities and services. However, there are sectors within sectors which exert dominant influence on the process of forming and using profits in the national economy.

Industry maintained its leading positions both in the growth dynamics of financial activity results and in the branch structure of profits formation by kinds of economic activity. Faster financial results growth in industry was initiated by greater profits in the extractive branches. The resultant finance balance in the fuel and energy fossils sector increased 1.85 times in January – November, 2005 as compared against the similar period of 2004. Due to growing production costs caused by increasing expenditures on labor, internal prices on energy carriers and tariffs on transport, the situation in the manufacturing branches was less favourable. The resultant financial balance in the manufacturing branches increased 1.77 times. Both the value and dynamics of dynamics in the extractive branches also determined the nature of using enterprises' own monies on investing, production and social aims. Comparing dynamics and structure of education against using the GDP showed that, in 2005, support was continued of a limited number of export oriented branches in the extractive industry, primary processing of raw materials and branches of infrastructure in the context of faster growth of internal demand as compared against the external market development dynamics. Growth of profits in the exporting sector exerted the most significant influence on the connecting infrastructure branches – transport, communication, trade but practically did not affect branches which are mostly internal market-oriented.

3.1.3. Dynamics and Structure of GDP Production

Development of the services sector

Russian economy development in 2005 was formed under the influence of the following most significant factors:

- greater effect of internal demand;
- outstripping growth of the manufacturing industries as compared against the extractive industries;
- outstripping growth of investments in the fixed capital with regard to the GDP dynamics and end demand;
- greater growth rates of imports of the end consumption commodities than the internal production rates;
- intensive growth of the services sector;
- outstripping growth of wages as compared against the labor productivity; preservation of high consumer demand and inclination of the population towards saving;
- faster price growth rates industrial production producers and tariffs on services.

The 1999–2005 economic development was characterized by simultaneous increase business activities in production of commodities and services. Specific features of the Russian economy was defined by stably high share of commodity production and sufficiently strong influence of growth in the industry and construction on the growth rates in the economy as a whole. In 2005, the share of commodity production in the GDP com-

prised 37.3 % 73.9 % of which accounted for industrial production and 13.4 % for construction. The outstripping growth of commodity production was maintained through the infrastructure of the services market developed during the reforms years. The growing business activity indicators in the services sector closely correlates with the business activity level and structural changes in the economy as a whole. The dominant influence on the services market was exerted by faster growth rates in transport, communication, trade, commercial sphere of functioning on the real estate market and operations.

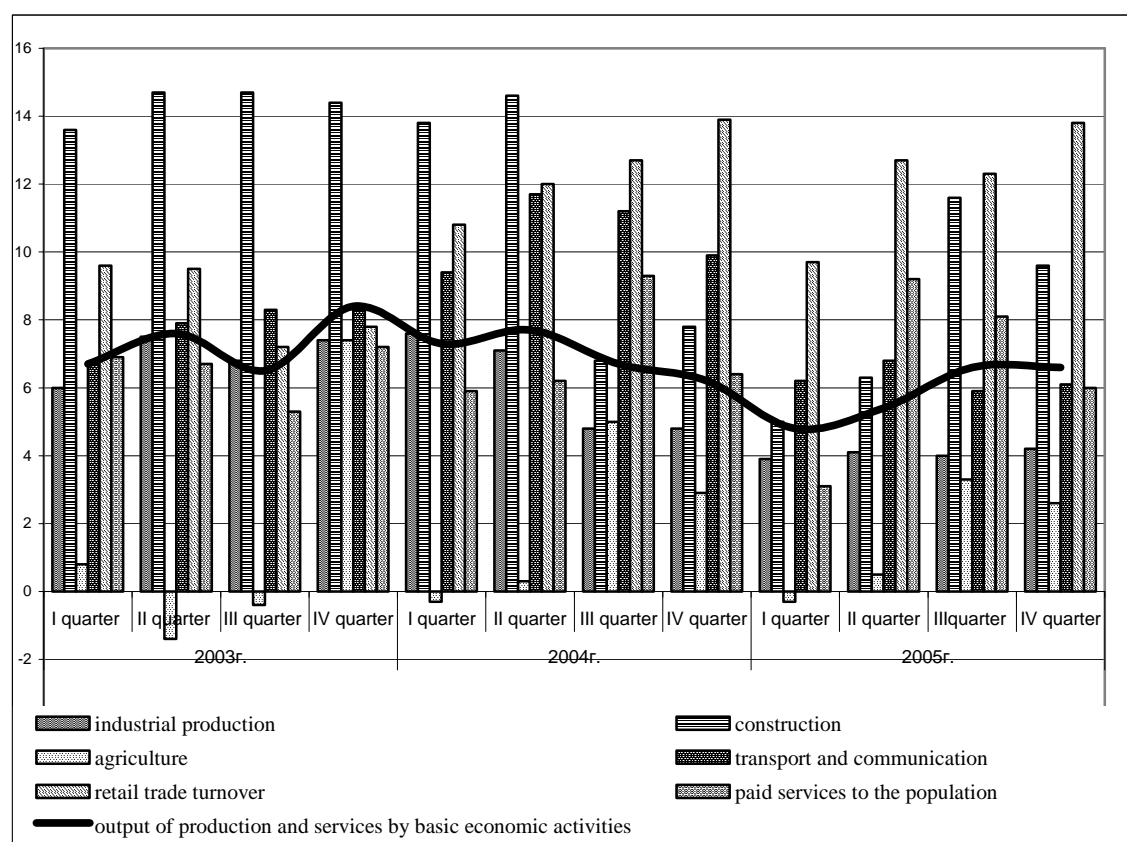
In 2003, faster output growth rates in the basic economic industries of up to 7.3 % as against 3.5 % for the 2001–2002 period in average, were initiated through restoring of the investment demand. Dynamic increase in the volume of work in construction (in the period from early 2003 to quarter 11, 2004) was maintained through faster industrial output due to outstripping production growth of the major commodities and constructive materials. Beginning from quarter 11, 2004, weaker investment activity was registered in the economy which was accompanied with slowing down of industrial growth and work in construction in the context of dynamic scale expansion of the foreign economic activity. Beginning from the second half of 2004, the leading positions in forming both the structure and dynamics of the economic growth belonged to trade and connected branches of the market infrastructure – transport, communication, informational servicing, finance and credit organizations.

Stably increasing share of trade in the structure of the national economy was a phenomenon in the Russian economy. Development of trade was accompanied with intensive development of the industry's material and technical basis and changes in the structure of services provided. Greater role of organized trade in the commodity turnover structure initiated intensive growth of trade space, storage areas, servicing. Trade was making growing demand for equipment, informational, communication and transport services. The share of trade in the 2005 GDP comprised 20.7 % which corresponded to the average indicator for the last five years. It is to be noted here that dynamic structural shifts were quite specific for development of this branch of economy. Favourable changes of demand on the world market determined the outstripping growth and higher relative weight of the foreign trade in the trade turnover structure. At the same time, attention should be paid to the fact that a specific feature of the Russian economy was almost twofold exceeding volumes of wholesale trade with regard to retail trade turnover. Along with higher business activity, intensive growth of wholesale trade was maintained due to expanding internal market demand for material and technical resources.

Greater volumes of trade both inside the country and on the international level were accompanied with the scaled growth of transport activities. Commercial transport turnover of goods in 2005 grew by 2.6 % while that of industrial output increased by 4.0 %. The greatest contribution in the growth of demand for transport services was made by export oriented productions. Growth of commodity transporting through pipelines comprised 2.3 % as compared against 2004. As to volume rates of transporting the major cargoes by rail, the leading positions remained with oil and oil products, ferrous and non ferrous metals, chemical and mineral fertilizers and wood products.

In the context of stably high business activity level, the changing structure of transport services was determined by the overall economic situation as well as by the practical solution of coordination problems in the transport infrastructure. More intensive cargo motor transporting was accompanied with greater share of investment spending on development of the main road system and automobile transport. The state of Russia's transport system is not a direct obstacle to economic growth but its inefficiency is leading to higher transporting costs and loss of profits from the respective transit traffic.

One of the problems directly pertaining to the modern economy structure continued to be higher requirements to coordinated development of different services. Communication remained the most perspective and rapidly development activity. In 2005, volume of communication services grew almost by 15.7 %. The share of new communication operators accounts for nearly 3/5 of the total volume and over half of communication services provided to the population. Most spread among other types of electric communication was the telephone one which produces 3/4 of all profits received from this services of this business, including 40 % from mobile electric communication. As per October 1, 2005, the total number of the cellular communication comprised about 110.3 mln having thus grown by 39.0 mln or by 54.6 % as compared against the beginning of the year (see Fig. 10).



Source: Rosstat.

Fig. 10. Changing Production Rates by Types of Activity for 2003–2005 (in % vs. the Respective Period of the Preceding Year)

Industry: rates and structure of production

In the context of restrained dynamics of demand for capital goods and greater influence of imports on the internal market, volumes of output in industry were characterized by gradual slow down in the growth rates and lesser contribution to the economic growth. The industrial growth index in 2005 comprised 104.0 % as against 108.3 % in 2004 (Table 5). In 2003–2005, structural shifts in industry were determined by outstripping development of the manufacturing branches. In 2005, growing production output in the manufacturing branches comprised 5.7 % as against 1.1 % in the extractive branches.

When analyzing development trends in extracting minerals, consideration should be taken of such factors of influence as reduction of efficient reserve capacities, low rates of development and putting into operation new fields, limitations on the part of the transport and export expeditionary infrastructure. Underexploitation of the growth potential in the extractive branches was also determined by somewhat restrained rates of minerals processing in metallurgy, petrochemistry and timber productions. In view of the already existing fixed capital assets structure, further increase in the capacity loads was accompanied with greater capital output ratio of production and less efficient use of labor and finance resources. This determined significant influence of output dynamics in the export oriented branches on the structure of industrial production and demand on the internal market.

It is to be noted here that most significant influence on the dynamics of extractive branches in 2005 was exerted by slow down in the rates of fuel-energy minerals extraction. The production index of such in 2005 went down to 101.8 % as compared against 107.7 % in the preceding year and of metal ores – down to 96.8 % as against 108.5 %. Observed under conditions of greater tax load in oil companies was weaker motivation for building up out extraction and exports. Accordingly, this resulted in slowing oil production rates down to 102.2 % and exports – by approximately 2.0 % as compared against 2004.

Table 5

**Indices of Industrial Production by Types of Economic Activities
in 2002–2005, in % vs. the Preceding Year**

	2002	2003	2004	2005
Industry – total	103.1	108.9	108.3	104.0
Extraction of minerals	106.8	108.7	106.8	101.3
Extraction of fuel-energy minerals	108.9	111.2	107.7	101.8
Manufacturing productions	101.1	110.3	110.5	105.7
Production and distribution of electrical energy, gas and water	104.8	103.3	101.3	101.2

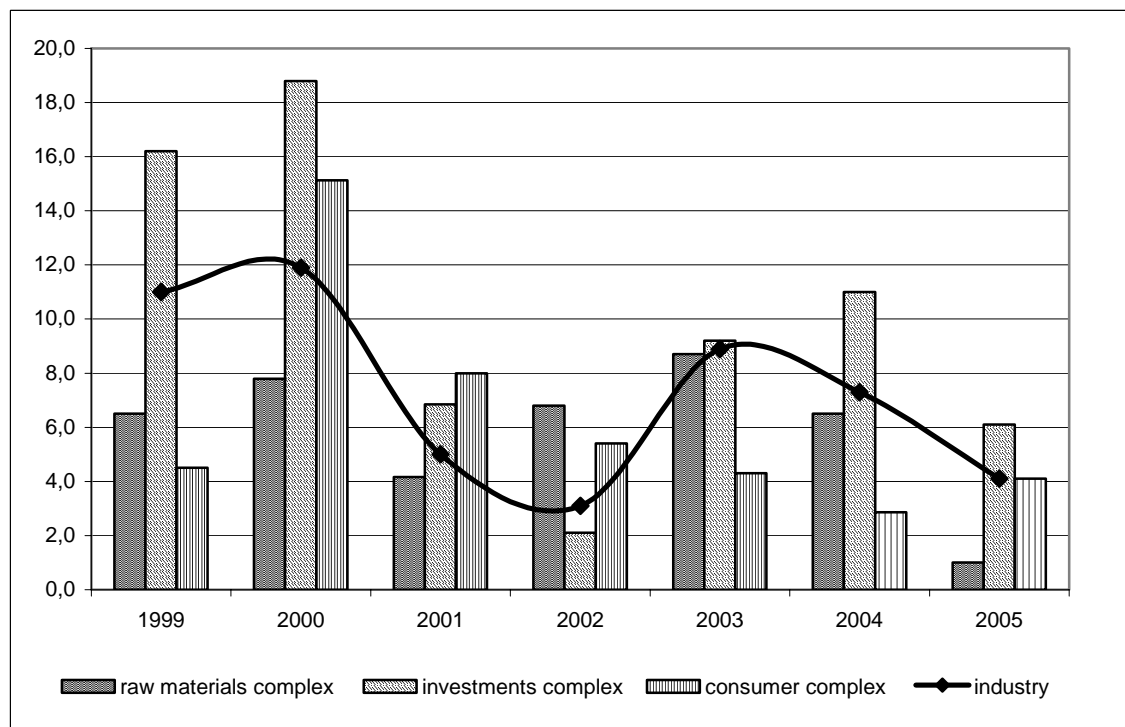
Source: Rosstat.

Dynamics of the manufacturing productions is quite significantly differentiated by types of economic activities with the greatest influence exerted by correlation between the production rates of capital and consumer goods.

Functioning of the capital goods market in the structure of the national economy branches in the recent years, according to the respective analysis of its dynamics, points to a rather significant dependence of the level of business activity and profits of the economy on foreign economic activity. Positive dynamics of investments in the fixed capital was registered beginning from the 3rd quarter, 1999, and was maintained through scaled expanding the output of domestic capital goods as well as by greater role of machinery and equipment imports in the reproduction structure of investments. In the context of frontal production rise, branches of economy and production started to show growing demand for both domestic and imported machinery and equipment as connected with more active involvement of competitive capacities in production as well as their modernization and reconstruction. Additional impulse was given by stable growth of economy determined by expanding external market demand, on the one hand, and greater internal market capacity, on the other.

Under the average annual growth rates of industry, in the period of 1999–2005, at the level of 107.3 %, the investment complex – 108.6 % and consumer – 106.2 %, this indicator comprised 105.9 % for the raw material sector. Though correlation of the growth rates for industries was subjected to rather significant fluctuations during the said period, it on

the whole does illustrate gradual turning from growth as oriented towards using the traditional natural – raw materials factors to forming the investment development of resources system (Fig. 11).



Source: Rosstat.

Fig. 11. Growth Rates of Production by Complexes
in 1999–2005, in % vs. the Previous Year

One of the factors which determined the structural peculiarities of economic development in 2004–2005, was a stable outstripping price growth of industrial commodity producers with regard to the index of consumer prices. In 2005, with about 110.9 % inflation on the consumer market, the price growth of industrial commodity producers comprised 13.3 %.

The dynamics of prices does significantly differentiate by the extractive and manufacturing productions (Table 6). With growth of prices for commodities in the extractive sector by 31.0 %, in production and gas and water distribution by 12.6 %, freight service tariffs – by 16.6 %, the price index of producers in the manufacturing branches comprised 8.1 %. In 2005, changes in the price proportions in industry were initiated through intensive growth of prices on fuels. Faster price growth on fuel and energy commodities was taking place in the context of changing price structure on energy resources. In 2005, index on oil prices comprised 140.9 % as against 166.2 % in 2004, on gas – 118.6 % as against 211.5 % and on electrical energy – 111.9 % as against 111,0 %. In 2005, the tariff for electrical energy provided to consumers, exceeded the average price on gas 2.8 times while in 2004 this correlation comprised 3.1 times and in 2003 – 5.8 times. The restrained price policy of domestic producers of end demand commodities was quite significantly influenced by changes in the competitive environment and stronger pressure of imports in the strengthening of the rouble context.

Table 6

**Indices of Producer Prices by Certain Types of Economic Activity in 1999–2005,
December vs. December of the Preceding Year, in %**

	1999	2000	2001	2002	2003	2004	2005
Industry	170.7	131.9	108.3	117.7	112.5	128.8	113.4
Extraction of minerals	225.2	149.1	104	125.8	101.8	164.7	131.0
Manufacturing productions	167.6	124.8	106.3	113.2	115.8	121.5	108.1
Production and distribution of electrical energy, gas and water	117.7	141.6	127.4	126	114.5	112.5	112.6
Tariffs on freight services	118.2	151.5	138.6	118.3	123.5	109.3	116.6

Source: Rosstat.

Significantly greater profitability of extractive productions was determined due to favourable combination of situational price factors on the world market of fuel and natural – raw materials resources. Besides, with the existing correlation between internal and world prices, most part of revenues due to greater rouble value of production but sold for foreign currency, also become profits. Similar was also the internal market trend toward outstripping growth of prices on minerals extraction as compared against the dynamics of prices on manufactured goods. Hence, much greater share of the export oriented productions in the total profits of the economy.

Growth of revenues in the export sector exerted the most significant influence on the connected infrastructure branches – transport, communication, trade practically not involving internal market oriented branches. The situation was less favourable in the internal market oriented manufacturing productions. With high level of material costs, greater prices on raw materials became a factor restraining growth rates of profits and resulted in lesser profitability of production.

Major trends in capital goods production

Restrained dynamics of capital goods output with regard to the rates of industrial growth during the last seven years was registered only in 2002 when production growth in the investment branches went down to its minimum level and comprised 2.1 % as against 6.9 % in 2001 and 18.8 % in 2000. However, the situation radically changed already in 2003. Like in the 2000–2001 period, the investment complex reacted to faster growth rates of production and profits in the export oriented sector by intensive production growth of the capital goods. Output of production in machine building in 2003 grew by 9.2 % as against 1.9 % in 2002 and in building materials production – by 6.4 % as against 3.0 %. An additional factor of growth in machine building was improvement of conditions for trade in domestically made high tech products on foreign markets. In 2004, growth of production in the investment complex comprised 11.0 % thus exceeding the level of the previous year by 1.8 p.p. As to the growth rates of production, machine building preserved its leading positions in industry. At the same time, however, it is to be noted that output of production in individual branches of machine building is subjected to rather significant fluctuations.

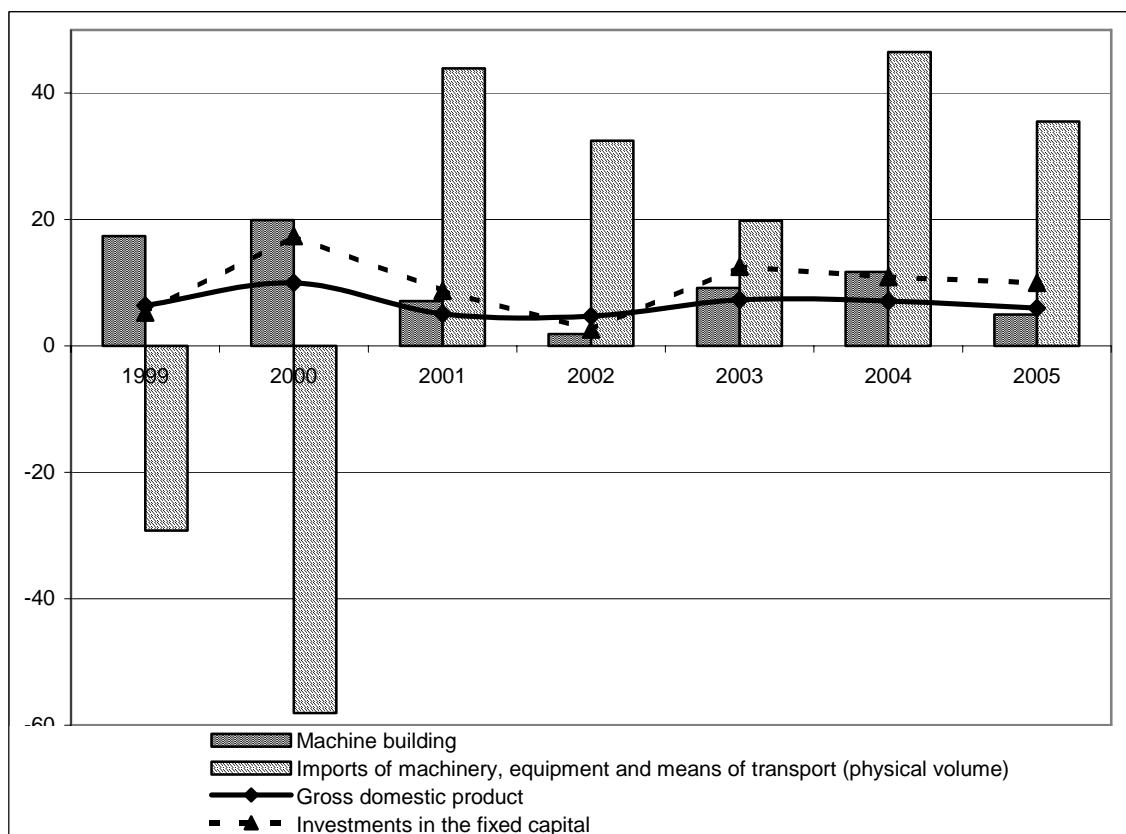
In 2005, production growth in electrical appliances, electronic and optic devices comprised 20.7 %, transport means and equipment – 6.0 %, that in the context of stable output of machines and equipment. Stable dynamics output of machines and equipment was maintained mainly due to expanding demand for production of lifting and shifting, railway, energy and agricultural machine building, instrument making, communication means. Besides, stably expanding demand for equipment to be used in the consumer branches

remained during all the last years. Greater output of commodities made by licenses of foreign companies with imported component parts can be marked out among factors positively influencing the dynamics of production. Outstripping growth of production output by enterprises with participation of foreign capital does somewhat change competitive conditions. In motorcar construction, in particular, one of the reasons for lesser output of Russian cars as well as reorientation of demand towards production of foreign producers, under dynamic growth of population's earnings, was a more flexible price and sales policies conducted by dealers of the respective foreign companies.

Negative factors which were exerting influence on the dynamics of machine building in 1999–2005, include sporadic cases of overproduction crisis in motorcar construction as well as instability of the investment demand for domestic machinery in the fuel industry in the context of growing incomes from exports and scaled expansion of imports of machinery and equipment.

Analysis of specific features pertaining to formation of capital goods market, is of principle importance since the dominant influence on the GDP structural shifts during the recent years was exerted by outstripping growth of investments in the fixed capital as compared against the dynamics of the end consumption. Significant influence on both the dynamics and the nature of machine building development was also continuously exerted by outstripping growth rates of imports with regard to the respective domestic production. This is connected with the fact that non-competitiveness of quite many kinds of machinery and equipment as compared against the import "price – quality" analogues as well as lack of adequate capacities for the output of modern machinery and equipment significantly limit market for the domestic machine building. In 2005, growth of imported machinery and equipment comprised (according to the respective preliminary data) 38.5 % (*Fig. 12*).

The state of investment machine building appears to be the main technological factor which limits possible solution of significant problems of new technology based reconstruction and modernization of production. Preservation of a prolonged trend towards recession of production in the machine tool industry and low rates of the fixed capital renewal in the machine building proper determines servicing of the investment process on the basis of traditionally standard technologies. Although in 1999–2005, growth of investments in machine building comprised approximately 42.8 % with regard to the 1998 level, this did not exert any significant influence on the respective technical and economic parameters of the fixed capital in the branch and industry as a whole. With the average renewal norm of the fixed funding in the branch during the last three years being at the level of 0.9 % and in the industry – at the level of 1.8 %, registered in the structure of machinery fleet was lower share of equipment with the service time less than 10 years. A peculiarity of the branch is also high intensity of employees movement. In the period of 1998–2005, quantity of the respective industrial personnel went down almost by 8.9 %, the industry desperately lacks skilled specialists.



Source: Rosstat.

Fig. 12. Changes of Growth Rates in Machine Building and Imports of Machinery and Equipment in 1999–2005 (in % vs. the Preceding Year)

Output dynamics of consumer goods

The consumer goods producing complex was unable to maintain sufficiently high growth rates during long time which fact is to a considerable extent connected with absence of serious qualitative changes in the technology and structure of production. The growth index of the consumer complex in 2005 comprised 4.3 % as against 2.9 % in 2004 (maximum level for the last seven years). The greatest influence on the structure of consumer goods production was exerted by the falling production trend (registered since 2002) in the textile and clothing manufacture branches – about 3 % annually. In 2005, the consumer complex maintained a prolonged trend towards reduction of investment activities.

The textile and clothing manufacture productions are part of the manufacturing sector characterized by critical indicators of the basic funds deterioration. The retirement ratio of the basic funds due to wear exceeds the indicator of funds renewal more than 4 times over. The textile and clothing manufacture productions experience absolute decrease in the fixed capital volume. The crisis of production resulted in sharp reduction of the demand for labor force. During the last three years, the average annual strength of the industrial and production personnel in the light industry reduced by more than 12 %. Low attractiveness of the branch is also determined by the existing level of payment for labor. Payment in the branch comprised approximately 40–45 % of the average overall level for the branch.

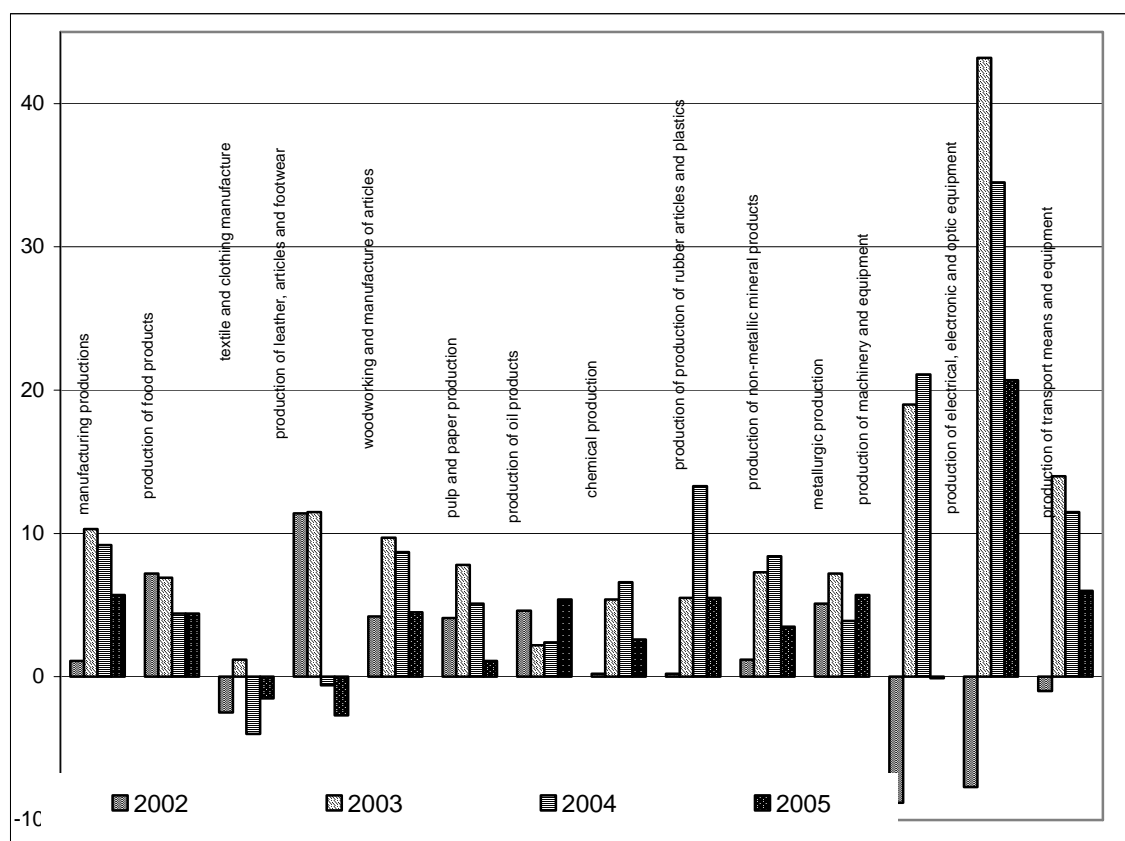
Inconsistency between the material and technical basis and the skill level, on the one hand, and the market criteria, on the other, determined both by lower competitiveness of domestic light industry products with regard to imports and, under the existing currency rates, by expanding niches for foreign goods. Beginning from the 3rd quarter, 1999, registered were trends towards pushing domestic commodities out.

Faster output growth of home appliances and/or house arrangement articles are also among the factors weakening negative impacts of the production rates of textile, clothing manufacturing and footwear on forming the market resources of domestic nonfood products. The dynamics of furniture and construction materials output does correlate with intensive growth of housing construction and high business activity on the real estate market. Significant influence on functioning of these productions as well as on increasing their competitiveness was exerted by introduction of new technologies and scaled output of assembly productions on the basis of imported component parts.

Production dynamics of food products in 1999–2005 was characterized by gradual slowing down of growth rates. Preservation of the food industry positions on the Russian market was maintained through intensive investments flow in the fixed capital and creation of new jobs. Accordingly, investments in the fixed capital of the food industry in the 2001–2003 period grew almost by one third. With the renewal of machinery and equipment ration increase of up to 4.2 % in 2004 as against 2.4 % in 1998, the funds deterioration degree in this period went down more than by 10 p.p. having thus comprised 35.7 %. This potential, however, turned out to be insufficient for maintaining a stable growth trend of production, labor productivity and efficiency. Growth of production in the food industry in 2005 comprised 4.4 % as against 5.1 % in 2003 and 6.5 % in 2002 while the relative weight in the structure of industry comprised up to 13.2 % as against 14.2 %, respectively. Registered was also slowing down of development rates in the food productions with regard to the retail trade turnover dynamics. In the context of greater investment support, the share of investments in the food productions in 2005 went up by 0.8 p.p. with the growth rates of the food productions maintained at the level of 4.4 %.

Output of intermediate demand commodities

Beginning from 2002, the dynamics of productions which form the market of intermediary demand commodities remained within the range of positive values. Functioning of the metallurgic, chemical and woodworking industries was determined by the level of both internal and external demand. For example, in 2005 as compared against 2004, faster rates in production of coke and oil products comprised 3.0 p.p., in metallurgy – 1.8 %, slow down of rates in timber processing and production of finished wood articles – by 8.0 p.p. and chemical production – by 4 p.p. (*Fig. 13*).



Source: Rosstat.

Fig. 13. Changing Production Rates by Major Activities in the Manufacturing Productions in 2002–2005 (in % vs. the Preceding Year)

Metallurgy

The market of metallurgy production is highly competitive being different in cyclic demand and more dynamic changeability of prices and incomes as compared against other industrial branches. Such highly cyclic production can to a certain extent be explained by the fact that demand for metallurgy production depends not only on the general economic situation but on the state, development level and demand on the part of the basic branches consuming building materials, machine building and construction in particular. A serious problem in functioning of the metallurgy complex was the traditionally existing territorial structure of enterprises placing which results in disproportions in supplying raw and attendant materials which is directly connected with additional transport expenses.

As to the technological level, Russia's metallurgy is definitely inferior to the industrially developed countries. The existing structure of production capacities does not allow for greater depth of redistribution nor to solve the problem of lowering the relative expenditures of material and fuel energy resources and higher productivity of labor. Besides, due to specific features of demand for production, observed in the metallurgy complex are excessive production capacities practically for all trade groups. Negative impacts of this factor were further aggravated through a rather high level of constant expenditures on maintaining the production personnel as well as additional expenditures on wages. In the

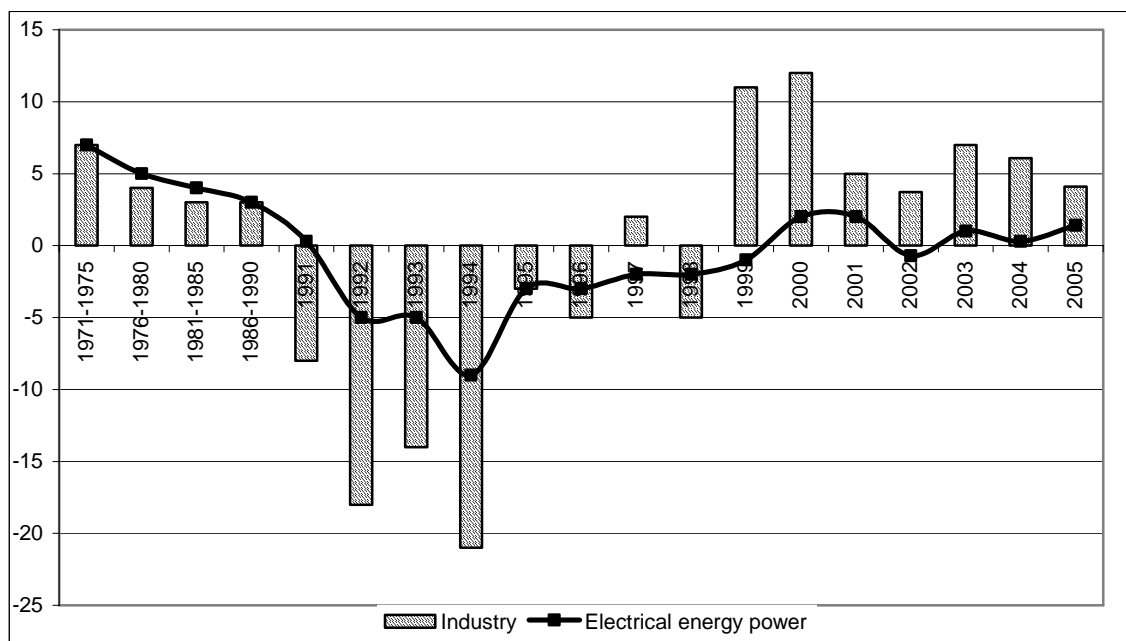
context of the existing internal solvent demand, stronger export orientation turned out to be the most significant source of monetary receipts. Yet, these implied risks determined by changes in the situation on the world markets as well as anti dumping measures on the part of importing countries.

The specific features in the industry during the last two years were determined by dynamic growth of investing in the fixed capital. In 2005, the share of investments in the fixed capital of the metallurgy production grew by 2.1 p.p. as compared against the preceding year and comprised 5.4 %. Faster rates of production renewal as well as more active withdrawal of obsolete equipment, even though having somewhat resulted in slower production growth with regard to 2003, nevertheless did determine preconditions for both future development of the branch and diversification of production. In the course of the recent years, correlation of the internal consumption and the general volume of production has been demonstrating trend towards growth which is determined by growth of production in the basic consuming branches. The greatest growth of production was registered in the pipe plants which can be explained by growing orders from the oil and gas sector as connected with exploitation of new fields and renewal of the respective production funds. According to the analysis of resources for the ready rolled ferrous metal, the share of its consumption on the internal market increased by 8.4 p.p. as compared against 1998. In 2005, growth of the metallurgy production and ready metallic articles output comprised 5.7 % as compared against 3.9 % in 2004. Significant influence on the dynamics of metallurgy development was exerted by expanding internal demand for metal production on the part of machine building and construction. A peculiarity of 2005 development was outstripping growth of ready metallic articles (122.5 %) as compared against the metallurgy production (102.2 %).

Electrical power industry

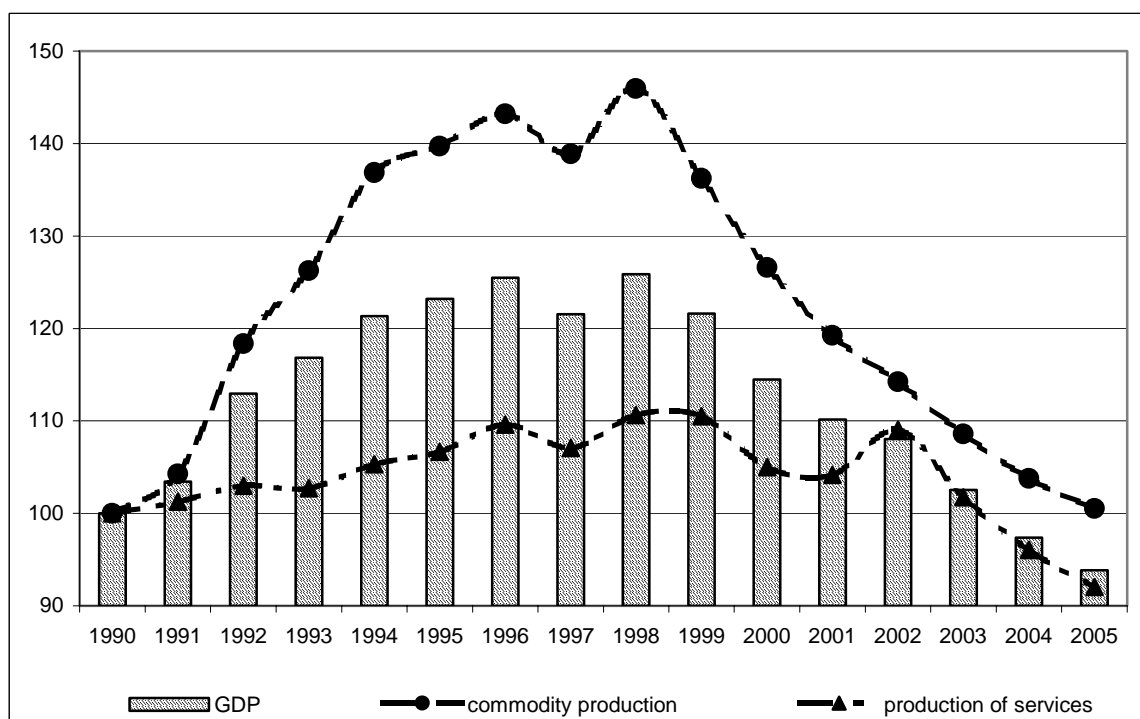
The structural parameters of the Russian economy, as retrospectively formed, are characteristic of high inertance and leave a certain imprint on forming interrelationships of the power industry in the system of branches in the modern national economy (*Pic. 14*). Recession of production in the electrical power industry was less deep as compared against other industries and economy as a whole. Compared with the pre-reform level, electrical power consumption went down by 14.0 %. Analyzing functioning of the Russian economy for the last decade shows that weakening rates of recession were accompanied with stronger energy constituent in the system of factors exerting influence on the GDP dynamics. In 2005, the share of electrical power in the Russian economy comprised 2.7 % GDP, 5.2 % investments in the fixed capital, 1.4 % those employed in the national economy.

Fluctuations of demand for electrical energy during the recent decade closely correlate with the transformational shifts in the national economy. As the crisis phenomena were being recovered and the economic activity vitalized, the trend towards expanding demand for electrical energy was also on the rise. Comparative analysis of the development dynamics of the Russian economy clearly shows that with almost 40 % reduction in the GDP production in the period of 1992–1998 and production in industry by almost 50 %, the output of electrical energy went down by 18 %. This resulted in over 40 % electro capacity growth of the GDP and industry. Typical for the 2002–2005 post devaluation growth period was forming a stable trend towards lower electrical capacity: growth of electrical energy production comprised 10.3 % with the GDP increase by 48.0 % and industrial production – by 46.7 % (*Fig. 15*).



Source: Rosstat.

Fig. 14. Changing Growth Rates in Industry and Electrical Energy Power for the Period of 1971–2005 (in % vs. the Preceding Period)

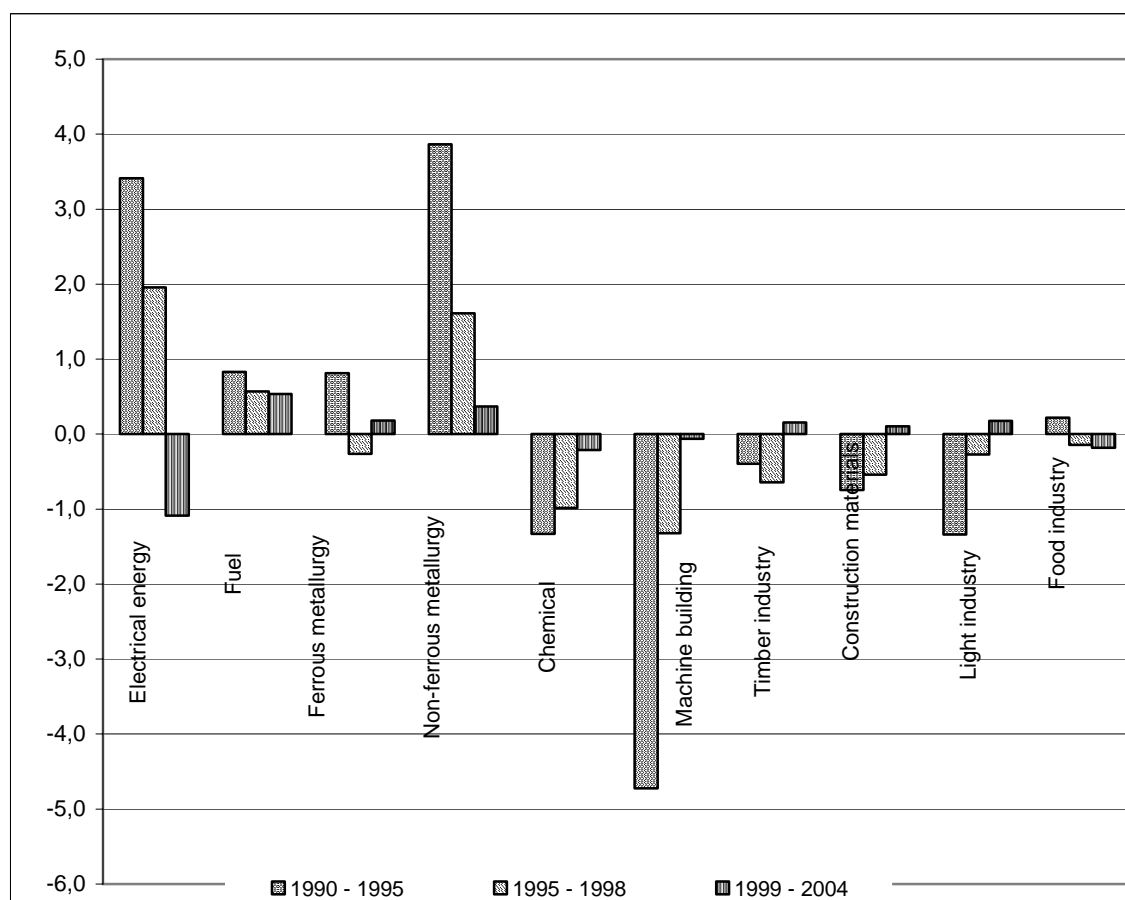


Source: Rosstat.

Fig. 15. Electrical Energy Capacity in the Period of 1990–2005, in % (1990 = 100)

Changes in the electrical energy capacity of the national economy were determined by two opposite trends. On the one hand, greater share of a less electrical energy capacity sector of services in the GDP structure was conducive to reduction of electrical energy capacity and, on the other, with absence of radical technical and technological shifts in the production of commodities sector, did provoke growth of electrical energy consumption. Thus, in 1990, the share of servicing industries accounted for about a quarter of electrical energy consumed in the economy but in 2005, their relative weight went up to 40 %. Forming the new segments of the servicing market, in particular dynamic development of modern communications systems, data processing, financial credit and insurance companies was accompanied with cardinal changes in the material and technical basis, creation of new jobs and higher productivity of labor. Besides, significant influence on the dynamics of electrical energy capacity in the servicing sector was also exerted by the growing consumer demand for electrical energy as determined by greater demand for domestic electrical appliances as well as intensive construction of new modern housing. Changing technologies of servicing on the basis of a higher level of electrical supply to the labor in the servicing sector became factors which actually determined increasing efficiency in using the potential formed during the reform years.

Dynamics of the relative electrical energy capacity in commodity production is determined by the specific features of the production structure. For Russia on the whole, the share of industry accounts for over half of the electrical energy produced and 85 % of electrical energy consumed in the commodity production sector. Dynamics of electrical energy capacity in industrial production is determined, on the one hand, by increasing of the share of electro- and energy consuming industries in the metallurgy and chemical and forest productions and, on the other hand, can be understood as reflecting low efficiency in using the available resources and restructuring of production. Analysis of consumption structure of electrical energy by industries shows that 36.6 % of the energy consumed fall at the share of metallurgy productions and 33.0 % – at the fuel and energy complex. Accordingly, both the dynamics and efficiency in using electrical energy in these two complexes determines a dominant influence on the electrical energy capacity level in industry as a whole (*Fig. 16*).



Source: Rosstat.

Fig. 16. Changes in the Structure of Electricity Consumption by Industries in 1999–2004 (in % over the Respective Period)

A comparative analysis of the reproduction parameters of the fixed capital, the level of using production capacity and the structure of electrical energy consumption by branches of industry shows that quite typical for the recent decade was gradually decreasing relative norms of electrical energy consumption on production of the respective product (Table 7).

Table 7

Consumption of Electricity for Production of Certain Products and Works, kWt per Ton

	1999	2000	2001	2002	2003	2004
Oil production, including gas condensate	100.2	98.6	102.1	96.0	94.8	97.4
Coal production	30.0	26.8	25.4	26.4	22.7	
Oil procession, including gas condensate	47.5	49.9	50.2	48.4	47.43	46.8
Electric steel	750.2	714.1	711.3	690.3	671.9	640.8
Finished ferrous metals rolling	154.5	151.7	150.4	148.9	150.1	144.6
Synthetic rubber	3067	2971	3193	3118	2865	2749

Source: Rosstat.

In the electrical energy industry itself, however, which is characterized by high wear level of equipment and obsolete technologies, registered was greater relative norms of fuel consumption on production of electrical energy and its consumption for its own needs. Prolonged trend towards reduction of investments in electrical energy production resulted in changes in both the qualitative and the quantitative parameters of the fixed capital in the industry. As compared against the pre-reform level, volume of investing in the electrical energy production went down almost three times over, volumes of new and/or replacing equipment commissioned, in particular as to the generating capacities, – approximately 3 times, for electrical networks – almost 5 times. The ratio of fixed funds renewal in the electrical energy production went down from 4.0 % in 1990 to 1.3 % in 2004. The process of the generating equipment's physical ageing is swelling. By the year of 2004, the capacity resource had already been exhausted in almost 17 % of Russia's electrical power stations. A significant part of such obsolescent equipment with less than 30 % output – input ratio is still in practical operation. Approximately one quarter of the equipment in the respective electrical energy substations have reached their wearlife limit. With the existing technical and economic parameters of the fixed capital, systematic decrease in intensity of using the generating capacities is observed. A significant part of equipment in the electrical energy industry can not be used in production because of its physical and moral wear and tear. High deterioration level of the fixed capital in the electrical energy industry can be considered to be one of the reasons for quite low loads of the respective equipment as well as a factor limiting possibilities for further growth of production. Impossibility of timely replacement of the respective elements in the fixed capital results in longer duration of using inefficient machinery and equipment. In many cases the fixed assets are liquidated only when it becomes practically impossible to use them because of their complete physical wear. Ageing of the fixed assets brings about greater probability of their destruction due to man-caused catastrophes and natural disasters. In 2004, deterioration of the fixed capital in the industry grew up to 57.8 % as against 40.6 % in 1990. Worsening parameters of the fixed capital reproduction in electrical energy is particularly striking if compared against similar indicators in the fuel and non ferrous metals branches which account for about 2/5 electrical energy consumption in the industry. Combination of high wear and loading levels does show critical loads on the respective equipment. In the context when the growth of demand trend for electrical energy is obvious low renewal norms for the fixed capital as well as the existing dynamics of annual capacity introduction create certain dangers of possible deficit thus directly limiting the growth rates of the national economy.

Dynamics of the fixed capital reproduction in the industry depends on the state of the power machine building, the electro technical industry and the power construction complex. Yet, insufficient volumes and irrational structure of machinery and equipment output do obstacle normalizing the reproduction process of the fixed capital. The obsolete material and technical basis of the energy and electrical power machine building as well as low investment activity in machine building proper were factors restraining a stable economic growth trend and maintaining a sufficiently high investment demand.

The policy of energy saving includes problems of price and tariff regulation, changes in the methods to calculate depreciation with regard to energy saving equipment, revision of the existing norms, rules and regulations towards tougher requirements with regard to energy saving; setting up standards for energy consumption and power waste as well as compulsory certification of electrical power consuming appliances and mass consumption equipment. Widely spread in many countries were programs of managing demand for electrical power. Such programs suppose that electrical power companies shall directly participate in stimulating energy saving and regulating the energy consumption regimes.

They also include regulating the regimes of consumers' appliances as well as assistance in improving the respective technological processes connected with significant use of electrical power and modernizing or replacement of consumers' equipment, using privileged and stimulating tariffs.

Oil and Gas Sector

The oil and gas sector remains the principal sector of Russia's economy. It plays the leading role in the formation of the state budget revenues and secures the positive trade balance of the country. World oil prices determined the state of Russia's oil and gas sector in 2005. Due to the fact that nearly 75 per cent of Russia's oil is exported in crude or refined form, the level of world oil prices represent major factor determining revenues and financial state of Russia's oil industry.

World oil prices in 2005 were at a very high level, which exceeded \$50 per barrel. In the second half of 2005 oil prices reached their historical maximum in the nominal terms. The price of Brent in 2005 exceeded the average level of the previous five years by 87.5 per cent. This situation resulted from the high rate of the world economic growth. In particular, the US and Chinese economies' growth and the low level of spare production capacities available in the oil industry did not allow increasing quickly the oil production in order to satisfy the growing oil demand. OPEC countries refused supporting world oil prices at the previously set price range of \$22–28 per barrel. OPEC carried out policy of moderate increase of the oil production within the limits of the available production capacities.

OPEC members announced increase in the oil production quota by 500 thousand barrel per day at the March (2005) OPEC conference. From July 1, 2005 aggregate production quota of OPEC countries went up by another 500 thousand barrels per day and reached 28 million barrels per day. However, these measures did not influence in any way the oil price dynamics. At the September (2005) OPEC conference the members of this organization declared their intension, if there was to be a need, to put into operation spare oil production capacities in the amount of 2 million barrels per day during three months starting with October 1, 2005. However, in reality only Saudi Arabia had considerable spare oil production capacities. Limited demand on heavy sulphur oil to a certain extent hampered oil production growth in the OPEC countries.

Reduction of growth rates in the oil production in Russia and oil production decrease in the Gulf of Mexico resulting from hurricanes considerably influenced oil production dynamics. Problems remained in the sphere of freight transportation and refining. This was due to limited available capacities, which led to high transportation costs and oil refining. Geopolitical risks such as instability in Iraq and possible problems in Nigeria and Venezuela maintained high degree of uncertainty on the world oil market.

As a result, average price of Brent in 2005 came to \$54.4 per barrel. Average price of Urals in 2005 came to \$50.8 per barrel. Average price of OPEC oil basket during the whole year exceeded the upper price limit set by this organization and on average constituted \$50.6 per barrel in 2005. Average price of Russian Urals on the world (European) market was at 47.3 per cent higher in 2005 than the level of the previous year (see *Table 8*).

The development of the oil and gas sector in Russia in the year 2005 was characterized by continuing growth of the oil production, increase of petroleum products output and increase in natural gas production. This tendency started in 2003–2004. The oil production including gas condensate in 2005 exceeded the 1991 level and reached 470 million tones. At the same time, growth rates of the oil extraction plunged. Oil extraction growth including gas condensate in 2005 in comparison with the previous year amounted to only 2.2 per

cent where as in 2002–2004 the oil extraction growth constituted 8.9–11 per cent annually. If we analyze the oil production dynamics in Russia during a longer period of time, we notice that oil output in 2005 was by 17.5 per cent below the pre crisis maximum level, which was achieved in 1987 when oil production amounted to 569.4 million tones and by 56 per cent above the minimum oil production level of 1996 when the oil production plunged to 301.3 million tones. The volume of preliminary petroleum refining increased by 6.2 per cent in 2005. Investment in the oil and gas sector significantly decreased: installation of the new oil wells went down by 28 per cent in 2005 in comparison with the previous year. The natural gas production growth continued in 2005 although at a lower rate. In 2005 it amounted to 0.5 per cent (see *Table 9*).

Table 8

World Oil Prices in 2000–2005, US\$ per Barrel

	Price of Brent, Great Britain	Price of Urals, Russia	Price of OPEC Oil Basket
2000	28.50	26.63	27.60
2001	24.44	22.97	23.12
2002	25.02	23.73	24.34
2003	28.83	27.04	28.13
2004	38.21	34.45	36.05
2005 1 st quarter	47.50	43.10	43.66
2005 2 nd quarter	51.59	48.44	49.54
2005 3 rd quarter	61.54	57.34	56.28
2005 4 th quarter	56.90	54.10	52.86
2005	54.38	50.75	50.64

Source: OECD International Energy Agency, OPEC.

Table 9

**Production of Crude Oil, Petroleum Products and Natural Gas in 2000–2005
in Percent to the Previous Year**

	2000	2001	2002	2003	2004	2005
Crude oil including gas condensate	106.0	107.7	109.0	111.0	108.9	102.2
Preliminary petroleum refining	102.7	103.2	103.3	102.7	102.6	106.2
Motor oil	103.6	100.6	104.9	101.2	103.8	104.8
Diesel oil	104.9	102.0	104.7	102.0	102.7	108.5
Fuel oil	98.3	104.2	107.1	100.3	97.8	105.8
Natural gas, billion cubic m.	98.5	99.2	101.9	103.4	101.6	100.5

Source: Russian Statistical Agency.

LUKOIL, TNK-BP, Rosneft and Surgutneftegas extracted the highest volumes of crude oil in 2005. Major part of Rosneft oil extraction was done by Yuganskneftegas, which was separated from YUKOS and attached to Rosneft in the end of 2004. YUKOS oil production went down sharply. In 2005 YUKOS' oil production (without Yuganskneftegas) went down by 24.5 per cent in comparison with the previous year. The share of the company on Russia's oil market fell down to 5.1 per cent. At the same time, the share of Gazprom on Russia's oil market sharply increased resulting from acquiring Sibneft. Gazprom's share in Russia's oil production went up from 2.6 per cent in 2004 to 9.7 per cent in 2005. As a result, the share of state companies (Rosneft and Gazprom including Sibneft) on Russia's oil

market increased to 25.6 per cent in 2005. Production sharing operators produced 0.6 per cent of Russian oil in 2005. The share of other producers who number about 150 small oil-producing companies accounts to 4.3 per cent of oil production in the country (*Table 10*).

Gazprom dominated gas production. Its share in the all-Russia gas production amounted to 85.4 per cent. At the same time, oil companies increased gas production too. However, the share of oil companies in gas production remains low. Surgutneftegas, Rosneft and TNK-BP remain the largest gas producers among the oil companies.

Table 10

The Structure of Oil and Gas Production in 2005*

	Oil production mill. tones	Share in the overall produc- tion in %	Gas production billion cubic m	Share in the overall produc- tion in %
Russia, total	470.0	100.0	640.6	100.0
LUKOIL	88.3	18.8	5.7	0.9
TNK-BP Holding	75.3	16.0	8.7	1.4
including:				
Tuymen NK	54.0	11.5	6.5	1.0
SIDANKO	21.3	4.5	2.3	0.4
Rosneft	74.4	15.8	13.0	2.0
Surgutneftegas	63.9	13.6	14.4	2.2
Gazprom+Sibneft	45.8	9.7	549.2	85.7
including:				
Gazprom	12.8	2.7	547.2	85.4
Sibneft	33.0	7.0	2.0	0.3
Tatneft	25.3	5.4	0.7	0.1
Slavneft	24.2	5.1	1.0	0.2
YUKOS	23.9	5.1	2.0	0.3
RussNeft	13.9	3.0	1.1	0.2
Bashneft	11.9	2.5	0.4	0.1
Other producers	23.1	4.9	44.4	6.9
For information:				
Public companies,				
total:				
Rosneft+Gazprom+	120.2	25.6	562.2	87.8
Sibneft				
including:				
Yuganskneftegas	51.2	10.9	1.4	0.2

* According to organizational structure as of 31.12.2005.

Source: Minpromenergo of Russia, authors' estimates.

In 2005 there was a significant domestic price growth on oil and oil products due to the world oil price growth. Producers' prices on crude oil, motor oil, diesel oil and fuel oil in 2005 reached maximum indices for the whole reform period. In October 2005 average domestic price of oil (producers' price) in dollar terms reached 201 dollars per ton. Average price of motor oil reached 386.6 dollars per ton, which equals the maximum price level of oil and motor oil for the whole reform period (*Table 11*). In September 2005 under the government's pressure major oil companies took an obligation to stabilize domestic sales price of motor oil. As a result, in October-December 2005 consumer prices of motor oil stabilized.

Domestic prices of natural gas also continued growing. Producers' prices on natural gas in 2005 significantly exceeded pre devaluation level and in December 2005 constituted 11.5 dollars per a thousand cubic meters. Average purchase price of natural gas in industry, which both included gas production costs and transportation costs and trade allowance reached 49.9 dollars per a thousand cubic meters in December 2005.

Table 11

**Domestic Prices of Oil, Oil Products and Natural Gas in Dollar Terms in 2000–2005
(Average Producers' Prices, US\$/t)**

	Oil	Motor oil	Diesel oil	Fuel oil	Gas, US\$/thous. cub. m
December 2000	54.9	199.3	185.0	79.7	3.1
December 2001	49.9	151.5	158.5	47.1	4.8
December 2002	60.7	168.8	153.8	66.1	5.9
December 2003	70.1	236.9	214.3	66.0	4.4
December 2004	123.5	333.1	364.3	69.4	10.5
March 2005	120.7	287.2	347.5	75.4	12.1
June 2005	150.4	316.4	347.4	117.8	11.9
September 2005	194.9	379.1	439.9	168.5	12.3
October 2005	201.0	386.6	455.6	178.1	13.1
November 2005	190.4	362.2	437.2	161.3	11.4
December 2005	167.2	318.2	417.0	142.7	11.5

Source: Calculated on Russian Statistical Agency data.

Oil export in natural terms went down by 1.9 per cent in January-November 2005 in comparison with the corresponding period of the previous year. Export of oil products went up by 16.4 per cent (*Table 12*). The share of export in the fuel oil output in January-November 2005 constituted 69 per cent, diesel oil–56.9 per cent, motor oil–18.6 per cent (for comparison: in 1999 the share of export in the motor oil output constituted only 7.2 per cent, in 2004–14 per cent). Contrary to several previous years, which were characterized by significant growth of petroleum products imports, 2005 posted reduction in petroleum products imports. In January-November 2005 import of petroleum products went down by 71 per cent in comparison with corresponding period of the previous year. At the same time, import of motor oil went down by 98 per cent in comparison with the previous year and the share of import of petrol constituted only 0.03 per cent (for comparison: in the first six months of 1998, i.e. before the ruble devaluation unit weighted of import in petrol production constituted 8.7 per cent, in 2004 – 1.7 per cent).

In comparison with the previous year, gas export growth rates decreased, which was stipulated by gas supplies to CIS countries (gas supplies to these countries in January-November 2005 decreased by 13 per cent).

Table 12

**Export of Oil, Petroleum Products and Natural Gas from Russia
in % to the Previous Year**

	2002	2003	2004	2005 (11 months)
Oil, total	113.9	117.8	115.0	98.1
including:				
non-CIS countries	109.9	118.9	116.3	98.5
To CIS countries	137.3	112.4	108.3	96.0
Petroleum products, total	118.5	103.6	105.5	116.4
including:				
non-CIS countries	119.1	102.6	104.9	117.6
To CIS countries	102.8	132.3	117.9	92.9
Gas, total	102.4	102.0	105.5	103.1

Source: Russian Statistical Agency.

Analysis of production and export of oil and petroleum products illustrates (Table 13) that practically all additionally produced in 2005 oil was exported in the form of petroleum products. Net export of oil and petroleum products in 2005 reached 345.3 million tones, i.e. increased by 10.7 million tones in comparison with the previous year (by 3.2 per cent). In other words as in 2000–2004 precisely growth of export volumes determined increase in the oil production in 2005. As a result, unit weight of net oil export and petroleum products export in the oil production reached 73.5 per cent volume. At the same time, net oil export constituted 53.2 per cent of its production volume. Unit weight of net export in gas production in 2005 constituted 31.3 per cent.

Table 13

**Ratio of Production, Consumption and Export
of the Energy Resources in 2000–2005**

	2000	2001	2002	2003	2004	2005 (estimate)
1	2	3	4	5	6	7
Oil, mill. t						
Production	323.2	348.1	379.6	421.4	458.8	470.0
Export, total	144.5	159.7	187.5	223.5	257.4	252.5
Export to non-CIS countries	127.6	137.1	154.8	186.4	217.3	214.0
Export to CIS countries	16.9	22.7	32.7	37.1	40.1	38.5
Net export	138.7	154.7	181.3	213.4	253.2	249.9
Domestic consumption	123.0	122.9	123.5	129.8	124.2	124.7
Net export in % to production	42.9	44.4	47.8	50.6	55.2	53.2
Petroleum products, mill. t						
Export, total	61.9	70.8	75.0	78.4	82.1	95.6
Export to non-CIS countries	58.4	68.3	72.5	74.9	78.0	91.7
Export to CIS countries	3.5	2.5	2.6	3.5	4.1	3.9
Net export	61.5	70.5	74.8	78.2	81.4	95.4
Oil and petroleum products, mill. t						
Net export of oil and petroleum products	200.2	225.2	256.1	291.6	334.6	345.3
Net export of oil and petroleum products in % to oil output	61.9	64.7	67.5	69.2	72.9	73.5

	1	2	3	4	5	6	7
Natural gas, bill. cubic m							
Production		584.2	581.5	594.5	620.3	634.0	636.0
Export, total		193.8	180.9	185.5	189.3	200.4	206.6
Export to non-CIS countries		133.8	131.9	134.2	142.0	145.3	158.8
Export to CIS countries		60.0	48.9	51.3	47.3	55.1	47.8
Net export		189.7	176.8	178.3	180.5	193.5	199.0
Domestic consumption		394.5	404.7	416.2	439.8	440.5	437.0
Net export in % to production		32.5	30.4	30.0	29.1	30.5	31.3

Source: Russian Statistical Agency, Minpromenergo of Russia, Federal Customs Service, authors' estimates.

Export of crude oil, which constituted nearly three quarters of the overall export of oil and petroleum products, dominated in the structure of the oil export with certain increase of the share of petroleum products. Fuel oil and diesel oil constituted major share in the export of petroleum products. Fuel oil is used in Europe as raw material for further refining. Major part of the energy resources (85 per cent of oil, 96 per cent of petroleum products and 77 per cent of gas) was exported outside of CIS.

Analysis of the dynamics of the Russian oil export over a long period of time demonstrates that aggregate net oil and petroleum products export in 2005 reached its historical maximum and by 53.7 mill. t (by 18.4 per cent) exceeded the 1988 level, which was characterized by the maximum oil export volumes (291.6 mill. t). At the same time, the share of petroleum products in the oil export grew. Its unit weight increased from 18.2 per cent in 1990 up to 27.6 per cent in 2005 (*Table 14*). Resulting from a sharp reduction in domestic oil consumption (according to our estimates, it decreased from 269.9 mill. t in 1990 down to 124.7 mill. t in 2005, i.e. by half), unit weight of export of oil and petroleum products in the oil production for this period increased from 47.7 per cent to 73.5 per cent. In contrast to export of oil and petroleum products, the net gas export and its share in gas production over last years do not exceed the level of late 1990-s, although unit weight of the net gas export in its production volume remains somewhat above pre reform period (31.3 per cent in 2005 against 28 per cent in 1990).

Table 14

Structure of the Net Export of Oil and Petroleum Products

	2002		2003		2004		2005 (estimate)	
	mill. t	%	mill. t	%	mill. t	%	mill. t	%
Oil and petroleum products	256.1	100.0	291.6	100.0	334.6	100.0	345.3	100.0
Oil	181.3	70.8	213.4	73.2	253.2	75.7	249.9	72.4
Petroleum products	74.8	29.2	78.2	26.8	81.4	24.3	95.4	27.6

Sources: Russian Statistical Agency, Federal Customs Service, International Energy Agency, authors' estimates.

These data demonstrates strengthening of the export orientation of the oil and gas sector in comparison with the pre reform period. However, one should bare in mind that this fact is connected not only with the increase of absolute export volumes but with a significant decline in domestic oil and gas consumption, which resulted from the market-oriented reforms, which took place in the Russian economy.

High levels of world oil prices predetermined significant revenue growth in the oil sector. Aggregate earnings obtained from the oil export and main petroleum products export (motor oil, diesel oil and fuel oil) in January-November 2005 reached 101.7 billion dol-

lars, which is a record level for the whole reform period (*Table 15*). For comparison, one can note that the minimum level of earnings from the oil export was recorded during the 1998 fall of the world oil prices, when oil export earnings constituted only 14 billion dollars.

The share of fuel and energy products in Russian export in January-October 2005 reached 63.5 per cent (in January-October 2004 this index constituted 57.6 per cent). Unit weight of crude oil in Russian export in January-November 2005 constituted 34.8 per cent (in 2004–32.5 per cent).

Table 15
Earnings from the Oil and Petroleum Products Export in 2000–2005, bill. Dollars

	2000	2001	2002	2003	2004	2005 (11 months)
Earnings from the oil and main petroleum products export	34.9	33.4	38.7	51.1	74.6	101.7

Source: calculated on Russian Statistical Agency data.

Passed year was characterized by a significant growth of tax burden in the oil and gas sector. In 2005 the new rates of severance tax on oil and natural gas were introduced. Also amended formula for calculating coefficient characterizing the dynamics of the world oil prices was introduced, which was applied to the base tax rate. From the beginning of 2005, the base severance tax rate for oil was set at 419 rubles per ton (i.e. increased by 20.7 per cent in comparison with 2004) and coefficient, which characterizes the dynamics of the world oil prices, is determined by the formula $K_{\omega} = (\omega - 9) \times P / 261$, where ω is an average for the fiscal period level of the oil prices of Urals in US\$ per barrel, P is an average for a fiscal period index of the US\$-ruble exchange rate set by the Central Bank of the Russian Federation (*Table 16*). Severance tax rate for the natural gas was raised beginning with 2005 up to 135 rubles per a thousand cubic meters (by 26.2 per cent in comparison with 2004).

Table 16
Severance Tax Rate on Oil Production in 2002–2005

	2002–2003	2004	2005
Base severance tax rate, rubles/t	340	347	419
Coefficient, which characterizes dynamics of the world oil prices (K_{ω})		$(\omega - 8) \times P / 252$	$(\omega - 9) \times P / 261$

Sources: Federal Law No. 33–FZ of 07.05.2004, Federal Law No. 126–FZ of 08.08.2001.

Increase of the base severance tax rate on oil production and amendment of the formula for calculating adjustment coefficient led to a noticeable increase of real rate of severance tax in 2005. Severance tax rate significantly depends on the world oil price level after the introduction of the adjustment coefficient. According to the formula, at an average dollar exchange rate of 28.28 rubles per US\$ coefficient K_{ω} grows from 0 at the price of Urals at 9 US\$ per barrel up to 5.5 at the price of Urals at 60 US\$ per barrel (*Table 17*). Calculations demonstrate that the increase of base severance tax rate, which took place in 2005, and amendment of the formula for calculating the adjustment coefficient led to an increase of the real severance tax rate at the price on Urals of 50 US\$ per barrel from 7.9 US\$ per barrel under the 2004 tax system to 9.0 US\$ per barrel under the 2005 tax system or by 13.9 per cent. As a result, at the price of 50 US\$ per barrel the share of the severance tax in the price of oil increased from 15.8 per cent under the 2004 tax system up to 18 per cent under the 2005 tax system.

Table 17

Severance Tax Rate on the Oil Production Under the 2005 Tax System, Rubles/t

	Price of Urals, US\$/b				
	20	30	40	50	60
Severance tax base rate	419	419	419	419	419
Coefficient K_{U}	1.1924	2.2764	3.3604	4.4444	5.5284
Severance tax real rate	500	954	1408	1862	2316
Increase of severance tax real rate in comparison with the 2004 tax system, in %	7.1	11.3	13.0	13.9	14.4

Source: Table 16, authors' estimates.

In 2005 there was a more progressive scale for calculating marginal rate of the crude oil export rate set by the Federal Law No. 33-FZ of 07.05.2004 "On Introducing Amendments in Article 3 of the Law of the Russian Federation 'On Customs Tariff' and in Article 5 of the federal Law 'On Introducing Amendments and Additions in the Second Part of the Tax Code of the Russian Federation and Also Declare Invalid Several Legal Acts of the Russian Federation'" and enact it in august 2004. This scale is designed to withdraw super profit obtained from oil exports in the circumstances of high world oil prices (Table 11).

Table 18

Export Duty Rate on Oil in 2002–2005

World price on Urals	Rate of duty, US\$/t	
	2002–31 July 2004	1 August 2004–2005
To 15 US\$/t	0	0
From 15 to 20 US\$/t	$0.35 \times (\text{U} - 15) \times 7.3$	$0.35 \times (\text{U} - 15) \times 7.3$
From 20 to 25 US\$/t		$12.78 + 0.45 \times (\text{U} - 20) \times 7.3$
Above 25 US\$/t	$25.53 + 0.4 \times (\text{U} - 25) \times 7.3$	$29.2 + 0.65 \times (\text{U} - 25) \times 7.3$

Source: Federal Law No. 33-FZ of 07.05.2004, Federal Law No. 126-FZ of 08.08.2001.

Introduced changes allowed significantly increasing the efficiency of the tax system. According to our calculations made with the help of an IET model of financial flows of the oil sector¹ tax payments of the sector went from US\$ 48.8 in 2004 up to (preliminary estimate) US\$ 88.4 in 2005. That growth of tax payments was determined both by the growth of proper taxes and a significant growth of the world oil prices and increase of output and export volumes. As a result, the share of taxes in the oil sector revenues, according to our estimates, increased from 45.4 per cent in 2004 to 59.5 per cent in 2005. The share of taxes in the net profit equals to gross earnings minus capital and operational costs increased from 81 per cent in 2004 to 91 per cent in 2005. Correspondingly, the share of enterprises in the net profit shrank from 19 down to 9 per cent.

Consolidated results of tax payments of the oil sector are illustrated in Table 19. According to this data, the tax payments of the oil sector increased from US\$15.0 in 2000 up to US\$88.4, according to preliminary estimate, in 2005. In this connection, growth of tax payments was determined both by the taxation reform and significant growth of the oil production and oil and petroleum products exports and increase in the world oil prices.

¹ Under the oil sector we understand both oil producing and petroleum refining branches of industry and part of trade and sales, which is engaged in the export of crude oil and petroleum products and in the marketing of petroleum products on the domestic market.

Table 19

Tax Payments of the Oil Sector in 2000–2005

Taxes, bill. dollars	2000	2001	2002	2003	2004	2005*
Profit tax	6.17	4.63	4.05	5.42	7.24	6.51
Severance tax	2.51	3.21	7.92	10.51	16.24	29.58
Export duty	3.92	5.60	5.45	8.65	19.15	44.17
VAT	7.06	8.92	9.21	11.77	15.21	21.09
VAT to suppliers	6.53	8.33	9.14	11.45	14.23	18.93
VAT to pay	0.53	0.59	0.07	0.33	0.98	2.15
Excises	0.45	2.19	2.11	2.22	3.51	4.22
Other taxes	1.46	1.65	1.81	1.94	1.68	1.78
Total taxes	15.04	17.88	21.42	29.06	48.80	88.41

* Preliminary estimate.

Source: authors' estimates.

The role of the severance tax and export duties sharply increased in the structure of tax payments made by the oil sector: unit weight of the severance tax in the tax structure increased from 17–18 per cent in 2000–2002² up to 33–37 per cent in 2002–2005; unit weight of the export duties increased to 39–50 per cent in 2004–2005. At the same time, there was a decline in the profit tax, reduction of unit weight of excises and other taxes. On the whole, unit weight of special taxes increased from 46 per cent in 2000 up to 80–88 per cent in 2004–2005.

In *Table 20* we illustrate main indicators of the tax burden in the oil sector in 2000–2005. According to our estimates, the share of taxes in the oil sector earnings increased over that period from 28.3 per cent in 2000 up to 59.5 per cent in 2005, and the share of taxes in the net earnings—from 57 to 91 per cent. As a result, the share of companies in the net earnings shrank from 43 per cent in 2000 down to 9 per cent in 2005. Thus, financial resources remaining at the disposal of companies in 2005 constituted 6 per cent of the returns.

Table 20

Main Indicators of the Tax Burden on the Oil Sector in 2000–2005

	2000	2001	2002	2003	2004	2005*
Earnings, bill. dollars	53.23	54.26	60.12	77.68	107.52	148.58
Net profits, bill. dollars	26.35	23.96	25.29	36.35	60.40	97.60
Taxes, bill. dollars	15.04	17.88	21.42	29.06	48.80	88.41
Special taxes, bill. dollars.	6.88	11.00	15.48	21.37	38.90	77.97
Net profits per a ton of extracted crude oil, dollars/t	81.54	68.82	66.62	86.25	131.64	208.10
Taxes per a ton of extracted crude oil, dollars/t	46.54	51.35	56.42	68.96	106.37	188.50
Net profits, in % to earnings	50	44	42	47	56	66
Taxes, in % to earnings	28.3	32.9	35.6	37.4	45.4	59.5
Taxes, in % to net profits	57	75	85	80	81	91
Net profits left at the disposal of enterprises	21	11	6	9	11	6
Net profits, which remains at the disposal of enterprises, in % to net earnings	43	25	15	20	19	9

* Preliminary estimate.

Source: authors' estimates.

² The severance tax was introduced in 2002. Prior to 2002 oil companies paid for the use of the subsoil resources, allocations for the restoration of the raw materials base and excise on oil.

As a result of the taxation reform, the progressiveness of the tax system significantly improved. *Tables 21 and 22* illustrate results of the model calculations of the tax burden on the oil sector in circumstances of different world oil prices for the 2002 tax system and for the 2005 tax system. In order to secure comparativeness, calculations were carried out under the 2005 tax system in both cases. As can be seen from the given data, the progressiveness of the 2005 tax system is significantly higher than the 2002 tax system. Under the 2005 tax system with the growth both of the world oil prices and of the production profitability the share of taxes in the net returns increases from 56 per cent under the price of Urals at US\$12 per barrel up to 91 per cent under the price of Urals of US\$50 per barrel, and under the 2002 tax system – correspondingly from 56 per cent up to 76 per cent.

Table 21

Indices of Tax Burden on the Oil Sector Under the 2002 Tax System

	Price of Urals, US\$/barrel					
	12	17	22	30	40	50
Earnings, billion dollars	83.13	91.86	100.58	114.54	131.99	149.44
Net profit, billion dollars	32.16	40.89	49.61	63.57	81.02	98.47
Taxes, billion dollars	18.03	23.05	30.58	43.11	59.05	75.03
Taxes on a ton of extracted crude oil, dollars/t	38.44	49.14	65.20	91.92	125.92	159.99
Net profit, in percent to earnings	39	45	49	56	61	66
Taxes, in percent to earnings	22	25	30	38	45	50
Taxes, in percent to net profit	56	56	62	68	73	76
Net profit left at enterprises' disposal, in percent to earnings	17	19	19	18	17	16
Net profit left at enterprises' disposal, in percent to net earnings	44	44	38	32	27	24

Source: authors' estimates.

Table 22

Indices of the Tax Burden on the Oil Sector Under the 2005 Tax System

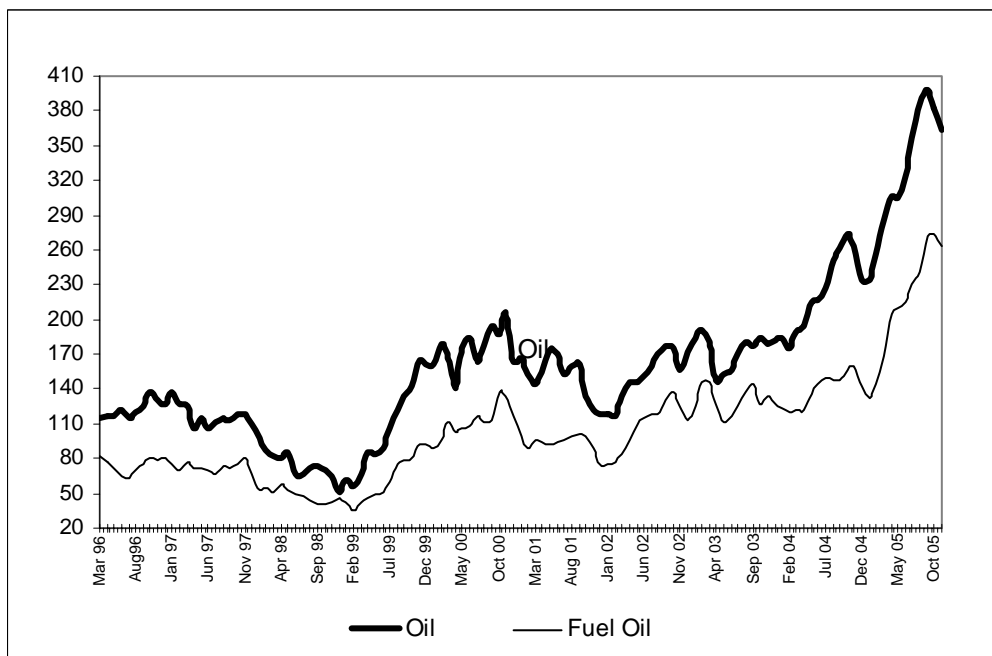
	Price of Urals, dollars/barrel					
	12	17	22	30	40	50
Earnings, billion dollars	83.13	91.86	100.58	114.54	131.99	149.44
Net profit, billion dollars	32.16	40.89	49.61	63.57	81.02	98.47
Taxes, billion dollars	18.10	23.61	31.82	47.57	68.51	89.46
Taxes on a ton of extracted crude oil, dollars/ton	38.58	50.34	67.86	101.43	146.08	190.74
Net profit, in per cent to earnings	39	45	49	56	61	66
Taxes, in per cent to earnings	22	26	32	42	52	60
Taxes, in per cent to net profit	56	58	64	75	85	91
Net profit left at enterprises' disposal, in per cent to earnings	17	19	18	14	9	6
Net profit left at enterprises' disposal, in per cent to net earnings	44	42	36	25	15	9

Source: authors' estimates.

Thereby, the taxation reform carried out in the oil and gas sector over the last years in Russia allowed to improve the budget efficiency of the tax system, to overcome its regres-

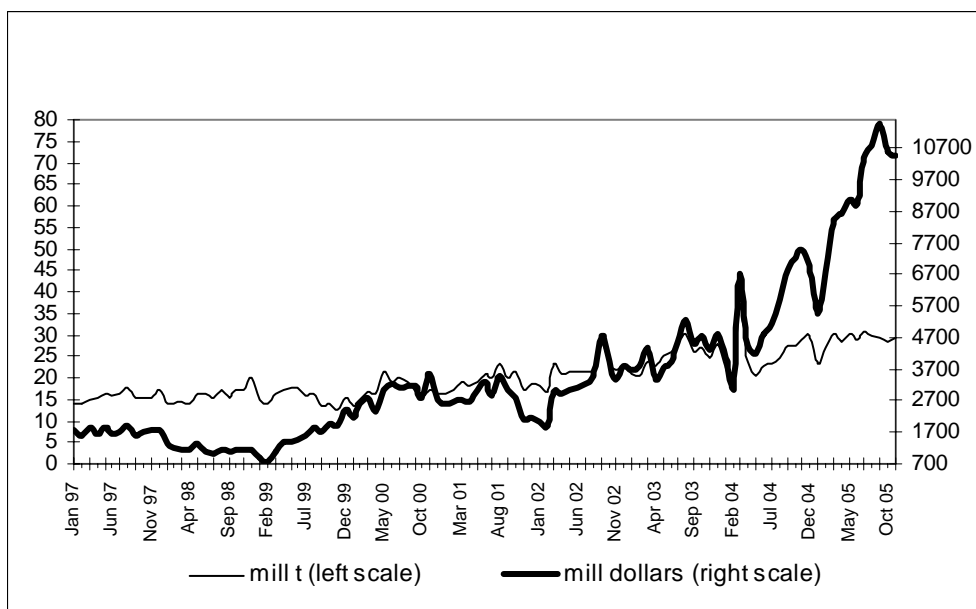
sive nature, neutralize negative fiscal consequences of the transfer pricing, secure transparency of tax rates and make Russian taxation system compatible with the world one.

Dynamics of certain development indices of the oil and gas sector is given in Fig. 17–20.



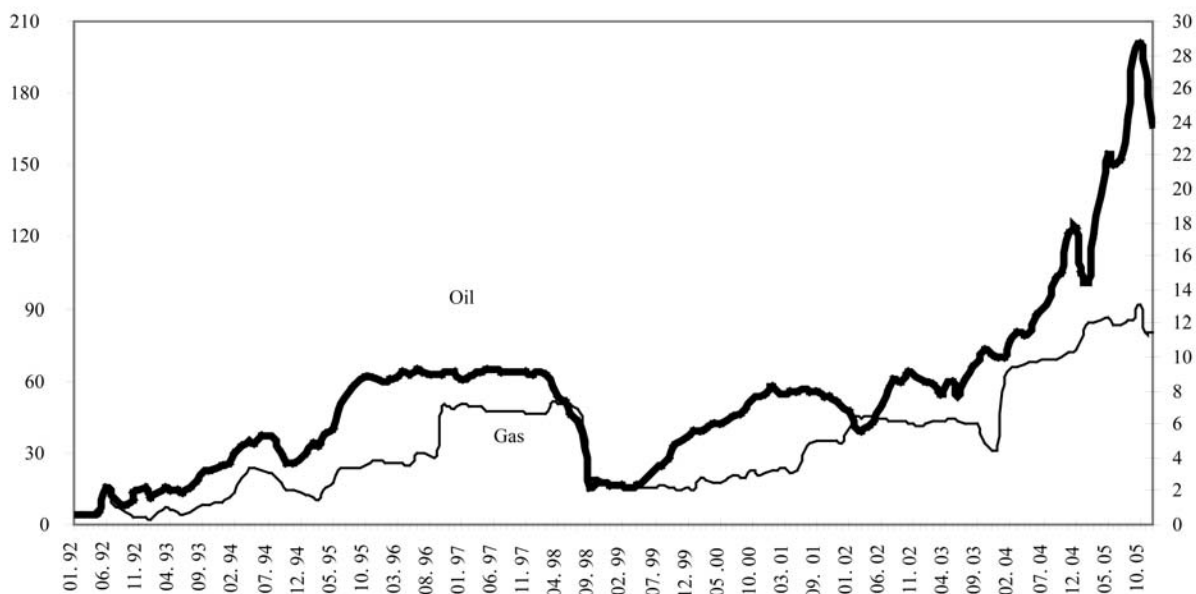
Source: estimated on Russian Statistical Agency data.

Fig. 17. Average export price of oil and of fuel oil in 1996–2005, dollars/t



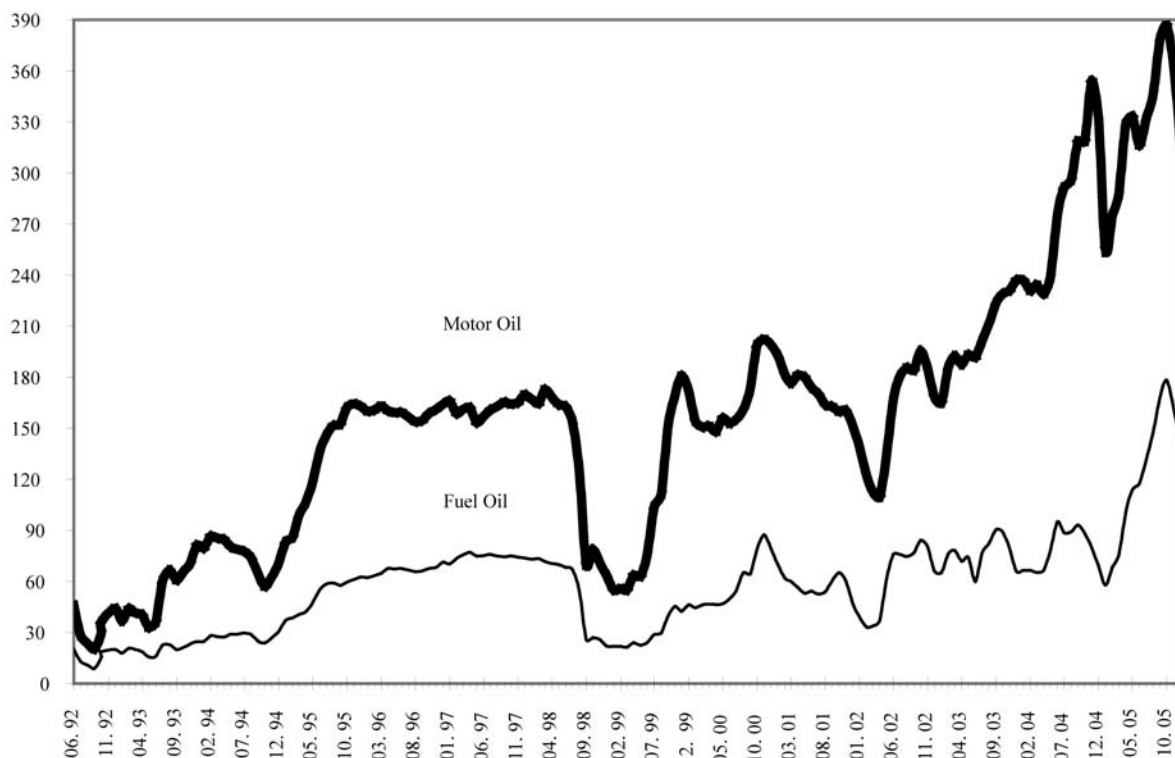
Source: estimated on Russian Statistical Agency data.

Fig. 18. Export of oil and petroleum products in natural and monetary terms in 1997–2005



Source: estimated on Russian Statistical Agency data.

Fig. 19. Average Producers' Prices on Oil and Gas in Dollar Terms in 1992–2005, Dollars/t, Dollars/Thousand Cubic Meters



Source: estimated on Russian Statistical Agency data.

Fig. 20. Average Producers' Prices on Motor Oil and Fuel Oil in Dollar Terms in 1992–2005, Dollars/t

3.2. The IET Business Surveys³

3.2.1. The 2005 Dynamics of Demand for Industrial Output

The 2005 dynamics of the main indicator of Russian industrial sector – that is, effective demand – displayed a number of particularities.

First, the end of 2004 did not prove to be as negative as in the prior years. It was in the 3rd quarter 2004 that growth rates of sales of industrial produce were the lowest ones. The intensity of the growth in the demand was consequently growing and the start of the new year was not particularly gloomy for Russian enterprises.

Second, it was expected that January 2005 would substantially worsen the companies' positions. The first long winter holidays in new Russia's history resulted in a drastic decline in business activity, with the noted intensity indicator plunged (by the data not cleared off from seasonality) down to – 26% (by balance), which, however, became comparable with the prior year's results. Once cleared off from seasonality, the balance became positive, while exclusion of random fluctuations made increased its value up to 5 balance per cent. The 2004 average annual value of the balance of change of effective demand was the same (after it was cleared off from seasonal and random components).

Third, an intense rise of sales of industrial production started in February already. The demand growth rates reached 12 balance points, or became greater than results of the respective months between 2001 and 2004. Once cleared off from seasonality, the intensity of the balance growth rates became unparalleled save October 2000. In February, sales were growing in all the industries, except ferrous metallurgy and forestry complex. The champion became the industry of building materials (+16%), followed by food processing (+15%) and machine engineering (+13%). In March, the surveys registered the further solidification of the positive trends in the demand dynamics and the intensity (balance) of the demand growth prior to clearing off from seasonality hit +25%. It became an ever record-breaking value for the period between 1993–2005. Once seasonality was excluded, the value made up +11%, albeit still a breath-taking one. The greatest growth rates of the demand were reported in June 1999 (+17%). Let us note that then, in a few months post-default and given a rapid depreciation of the Ruble and the intense import substitution, it was much simpler to boost sales than today, when everyone speaks of the pressure on the domestic producers on the part of the appreciating Ruble and growing imports. The growth in cash sales continued in April, too, albeit a bit less intensively (see *Fig. 21*). The growth rate of the effective demand slowed down by 10 points vis-à-vis March, but it remained fairly high – it was just thrice that a greater rise of sales was registered since early 2004. The monthly dynamics of the demand between February through April 2005 became inferior just to the one reported in 2000. Seasonality excluded, it fell only by 4 points, while less the random component, it displayed that the previous, greatest for the period 2001–05, growth rates of sales were still there.

³ This section is based on business surveys IET holds monthly on heads of industrial enterprises since September 1992. The surveys are nationwide, with the size of the panel of a. 1,200 enterprises at which over 15% of industrial employees work. The panel is biased towards large enterprises. The questionnaire return rate is a. 65–70%.

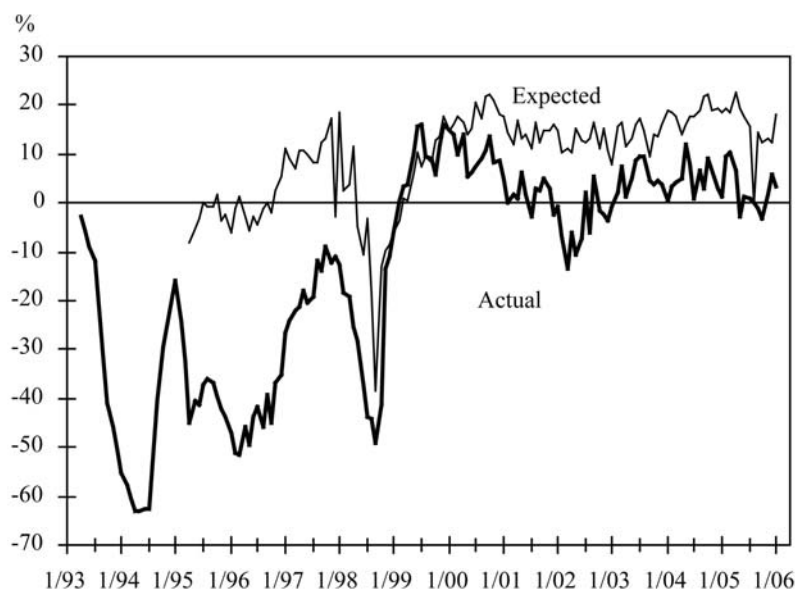


Fig.21. Change in Effective Demand, Seasonality Excluded (Balance =% growth – % fall)

Fourth, in the middle of the 2nd quarter Russian industrial sector faced serious problems with sales. As it should be expected, the May data (not cleared from seasonality) showed an absolute fall in demand for industrial output. The balance plunged by 23 p.p. down to –8, which became unique phenomenon not reported since 2002. The demand was growing only in the industry of building materials, while other sectors reported either a fall in, or the same volumes of sales. Seasonality excluded, the fall rates in demand across the industrial sector as a whole became just smaller and reached –3%. June did not help much Russian enterprises – while the effective demand began to grow, but at a very low pace that was down vis-à-vis its respective indices of the 2 prior years. Furthermore, the fall in the effective demand continued in June in the sector for machine engineering, forestry, and light industry. Cleared from seasonality, the picture became yet gloomier- the June growth rates of sales by the industrial sector as a whole proved to be the worst ones since July 2004. Until June enterprises had cherished hopes for high growth rates of sales of their output. Forecasts of the change in demand had remained at a fairly high (optimistic) level. All the sectors hoped for a rise in sales, but the non-ferrous metallurgy wherein the balance of forecasts from the beginning of the year had dropped from 29 to 1 p.p.

The volumes of sales in July did not enable Russian industrial sector to “take off” as well. After a relatively small growth in demand in June, which, nonetheless, enabled enterprises to restore the growth in their output, sales discontinued to grow in July. The balance of growth of demand became negative both by original data and after seasonality was excluded. However, its small absolute values in May-July (the balance of change in demand after seasonality was cleared off found itself within the range between –3...+1) allow the conclusion that the demand for Russian corporations’ industrial output did not grow across the industrial sector on the whole, nor it fell further on. In July, enterprises lost their hopes for high sales rates and the forecasts of changes in demand underwent a drastic drop. Cleared from seasonality, the data proved to be the worst ones over the past 1.5 years. The drop in optimism with respect to forecasts of sales was noted in all the industries except for the light one.

August proved the enterprises' negative forecasts – according to their own assessments, sales growth rates remained zero. As a result, the demand for domestic industrial produce was being stagnant for three straight months already. It was the light, food-processing and fuel sectors that reported the greatest problems with sales. The absence of growth in sales compelled enterprises to fundamentally lower their forecasts of demand. After the adjustment for seasonality the balance of their forecasts lost 17 p.p. and became negative for the first time since early 1999 – at the time, under the post-default recovery the share of enterprises that expected a fall in their sales was greater than those that predicted their rise. In August 2005, however, the excess proved to be minimum, with the bulk of enterprises hoping for keeping the previously reported volumes of sales.

September, however, did not bring the long-awaited revival to the Russian industrial sector. The survey results mirrored the ongoing absence of a rise in effective demand for industrial output. Thus, the volumes of its sales remained unchanged for straight 5 months. Cleared of from seasonality, the balance of the change on demand (growth-fall) was at that time within the range between – 2 and +1, which gives enough grounds to conclude that the volume of demand for domestic production had stabilized. However, in September forecasts of sales discontinued to lose their optimism. The balance of forecasts (after the adjustment for seasonality) grew by 9 p.p. The rise in optimism of sales forecasts was registered in all the industries, with the light and food-processing sectors being the most optimistic ones.

However, the September optimistic mood failed to be realized in October. That contradicted the customs of forecasts being most often matched in the first month after the moment they were actually made. The situation with the sales of industrial production continued to worsen in October. The demand for it began to contract already – the share of responses of the fall in sales exceeded the proportion of reports of their growth. Such a situation has not been registered in October since 1998, even in the hardest in this regard 2002. Adjusted for seasonality, the conclusion was accurate – the demand growth rates reported for October 2005 proved to be the worst ones since August 2002. An absolute fall in sales was reported by the fuel, chemicals, petrochemicals, machine-building and food-processing sectors. Real problems with sales compelled enterprises to revise their forecasts in favor of their decline and they once again began to lose optimism. The balance of expected changes not cleared off from seasonality became negative for the first time since end- 2002 and the forecasts of decline in sales began prevalent among enterprises. On the sectoral level, such a situation was registered in the fuel, metallurgical and light industries. The adjustment for seasonality corrected the forecasts to the better, however, the worsening of expectations vs. September was still there.

The absolute contraction in demand for domestic industrial output ceased in November 2005, however, it was too premature to contemplate a start of a rise in sales across the industrial sector as a whole. The initial data demonstrated a minimum contraction in demand (balance –1%), while seasonally adjusted, it showed zero balance, which, because of exclusion of random fluctuations ultimately became negative (–2%). However, the November results became the best vis-à-vis the 3–4 prior months. As concerns the sectoral level, it was only forestry, wood-working and food-processing industries that reported a stable (free from seasonality) rise in demand, while either sectors reported either a fall in sales, or a slowdown of their growth.

The effective demand for industrial output finally began to climb up as late as December 2005, and the rise was fairly intense. Russian industrial sector has not for long demonstrated such impressive performance at the end of the year, save yet higher growth rates registered 5 years ago. Once adjusted for seasonality, the balance of change of this

critical indicator soared by 6 p.p. at once and hit +9%, which became the best value for the past 9 months. The rise of the indicator in December was driven by the metallurgical sector and those for chemicals, petrochemicals, and food processing.

3.2.2. Enterprises' Assessments of Effective Demand in 2005

The assessments of effective demand on the scale "above norm- normal -below norm" proved the aggravation of problems with sales in Russia's industrial sector in 2005. Given that in 2004 responses "normal" dominated the enterprises' responses for 10 months, in 2005 the situation changed for the worse – the domination of the enterprises satisfied with the demand was noted only in 5 months out of 12 (see Fig.22).

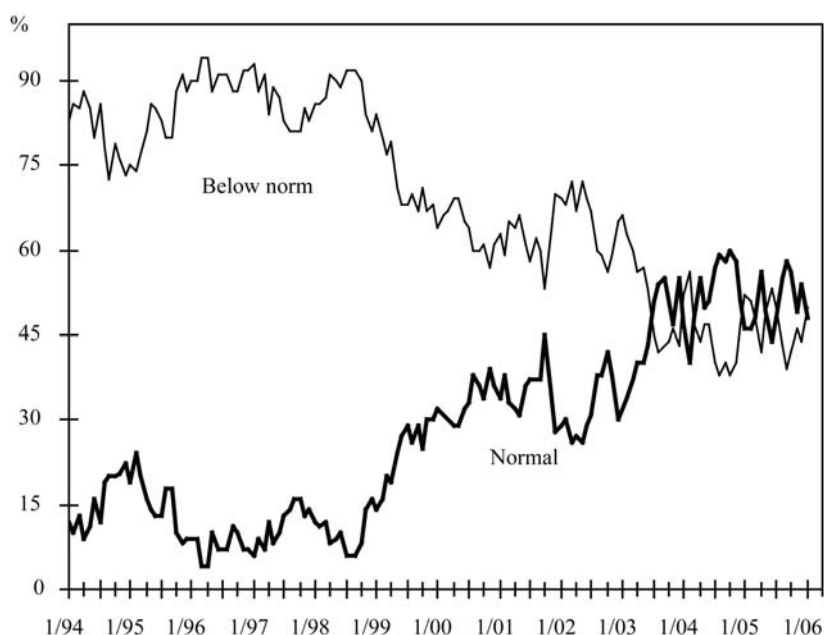


Fig. 22. The Dynamics of Main Assessments of Effective Demand

As a result, the difference between assessments of the 2005 results became slightly worse, albeit remained positive, i.e. the domestic producers still satisfied with the demand for their output prevailed over those who were displeased with it (see Table 23).

At the sectoral level, the situation in most cases likewise changed for the worse. The difference between "normal" and "below norm" assessments dropped for all the industries, except the non-ferrous metallurgy and industry of building materials (see Table 24). In the latter case the correlation between the assessments underwent a fundamental change – it became positive and greater by the value. The cause for such a "transition" is obvious – the current nationwide construction boom (primarily in the housing sector) fueled great volumes of demand for the construction industry. Consequently the difference between the assessments grew by 16 points- o far the best sectoral record. However, it was the non-ferrous metallurgy that found itself in far and away the most privileged position. Only as many as 13% after 24% in 2004) enterprises on average considered the demand for their output insufficient in 2005, while their satisfaction rate hit 78%. Albeit not the best result ever recorder, as shown by the table below, but still impressive, especially as long as the general background is concerned. The cause for it is evident – a very favorable state of af-

fairs on the world market for non-ferrous metals. By contrast, the fuel sector that has not less favorite position on the world market lowered its forecasts of the demand, which is likely to be attributed to a wrong pricing policy domestically wherein a substantial part of its output is sold. After the situation improved in the industry of building materials, there remained just two industries still unsatisfied with the demand – that is, machine engineering and light ones. Both saw their assessments worsened- and quite considerably.

Table 23

**The Dynamics of Main Assessments of Volumes of Effective Demand
(as % to the Number of Those Who Responded)**

	«Norma»	«Below norm»	Difference of assessments
1993	37	55	-18
1994	14	82	-67
1995	14	84	-69
1996	8	91	-83
1997	12	85	-74
1998	10	88	-78
1999	25	72	-48
2000	33	64	-30
2001	35	62	-27
2002	32	65	-33
2003	45	51	-6
2004	53	45	8
2005	51	47	4

Table 24

**Main Assessments of Volumes of Effective Demand in 2004 and 2005,
by Industries (as % to the Number of Those Who Responded,
the Average Annual Data)**

	«Normal»		«Below norm »		Difference in assessments	
	2004	2005	2004	2005	2004	2005
Fuel	83	70	14	30	69	40
Ferrous metallurgy	71	70	23	28	48	42
Non-ferrous metal- lurgy	76	78	24	13	52	65
Chemicals and pet- rochemicals	65	59	33	39	32	20
Machine engineering	45	42	53	56	-8	-14
Forestry complex	62	59	36	39	26	20
Construction industry	47	55	50	42	-3	13
Light	39	35	57	63	-18	-28
Food	59	59	38	39	21	20

Most non-public enterprises (AOs) maintained in 2005 their skill to adjust to the current market conditions, despite the overall aggravation of problems with sales. As shown

by the survey results, the answers “normal” once again dominated in this category of enterprises, so far as assessment of the effective demand is concerned (Fig. 23). However, the final result for 2005 proved to be down vs. the 2004 one – the average annual prevalence rate dropped from 12 to 7 p.p. The situation has not changed over the year in question in the public sector, with the same 11 p.p. domination of the “below norm” answers. Notably enough, in 2005 this sector only once (in September) happened to demonstrate the prevalence of satisfaction with the demand, while in 2004 such a situation was noted four times. The gap between the public sector’s assessments and those made by the private one became narrower, but the former has failed to reach satisfaction with effective demand and most of its enterprises have ultimately failed to adapt to the current market conditions. More than that, with sales problem clearly intensifying and industrial growth decelerating, they demonstrated independence from these processes, which can hardly be conceived as a success in reforming the industrial sector.

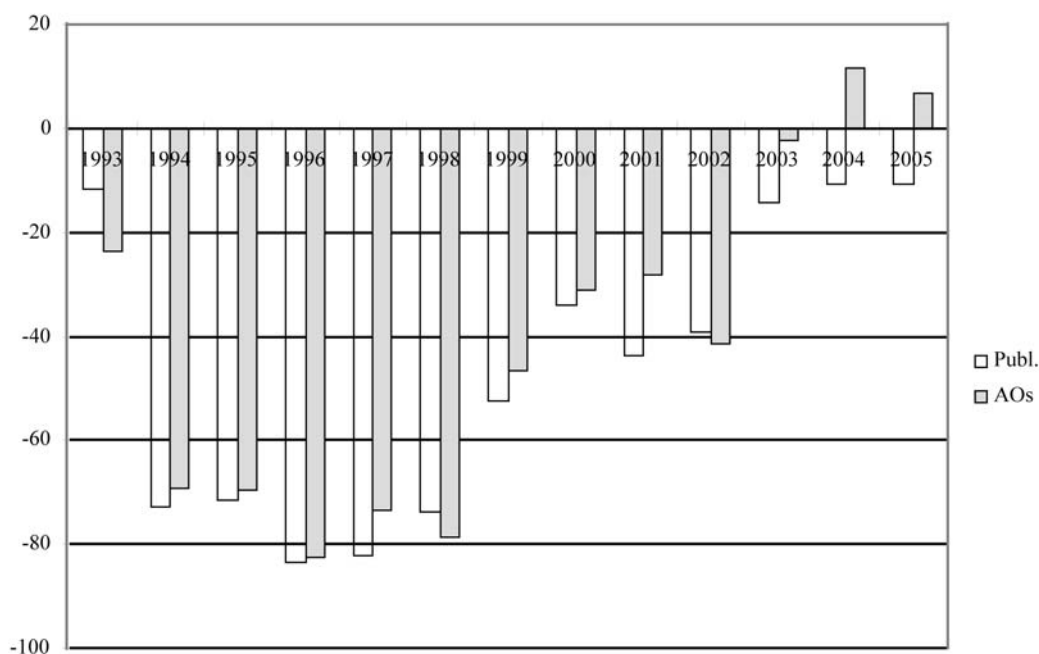


Fig.23. The Average Difference between Main Assessments of Demand by property Forms

The gap between the level of adoption to Russian market conditions between enterprises of different sizes was still in place in 2005. As before, leaders in this regard are huge enterprises with the number of employees over 2,000 (see Fig.24) – in April and September 2005, the proportion of “normal” assessments of the demand in the group was 60% and it was at 24 p.p. over the proportion of responses “below norm”. The average annual excess made up 12 p.p., but failed to overrun the 18 p.p. difference reported in 2004. As concerns the group of medium-sized enterprises, in 2005, on average dominating were assessments “below norm”, while the excess remained unchanged (–9 p.p.). This result is the best over the whole period of monitoring. However, in late 2005 these enterprises managed to reach the level of satisfaction with the demand – between August to December the proportion of assessments “normal” was steadily over the one of assessments “below norm”. Our surveys first registered such a situation in 2003, but it had been lasting for just three months then and the value of the excess was small (+3 ...+6 p.p.). By end–2–5

the excess rate had already reached 10 p.p. and is likely to grow further on. The group of small-size enterprises (with the number of employees under 500) demonstrates the lowest level of adjustment to the Russian market. As in the past years, they likewise find themselves in the negative segment and too far from the transition to the positive one – the 2005 gap between the proportion of responses “normal” and those “below norm” accounted for –27 p.p. and proved to be worse than in the prior year. The best value in 2005 was registered in September and made up –11 p.p., while the 2005 maximum value in the group of medium-sized enterprises was 10 p.p. and that in the group of large enterprises was 24 p.p.

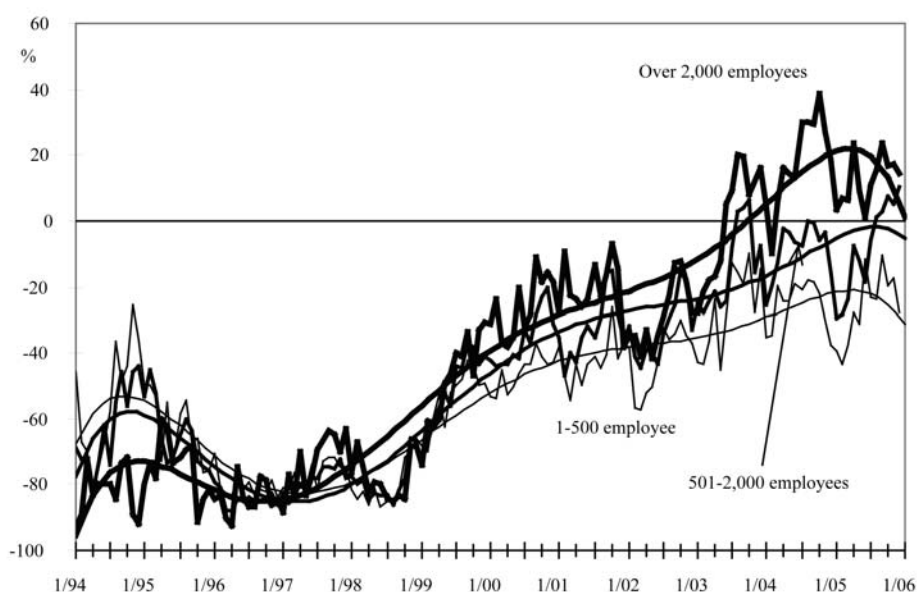


Fig.24. Difference between Main Assessments of Effective Demand by Enterprises' Sizes ('Normal' – "below Norm")

In 2005, Russian enterprises reported their existing production capacities were sufficient to secure the match between their output and normal, in their view, volumes of demand. However, the surplus of the capacities was minimum. This can be concluded on the basis of analysis of the dynamics of balances of assessments of capacities computed for two main assessments of the demand ("normal" and "below norm"). After 2004, when the average balance of assessments for normal demand for the first time became negative, the value of the indicator once again bounced back to the positive zone, albeit with its absolute value being minimum. Thus, in last 2 years the national industrial sector was balancing on the verge of a minimum possible match between demand and production capacities (see *Fig.25*).

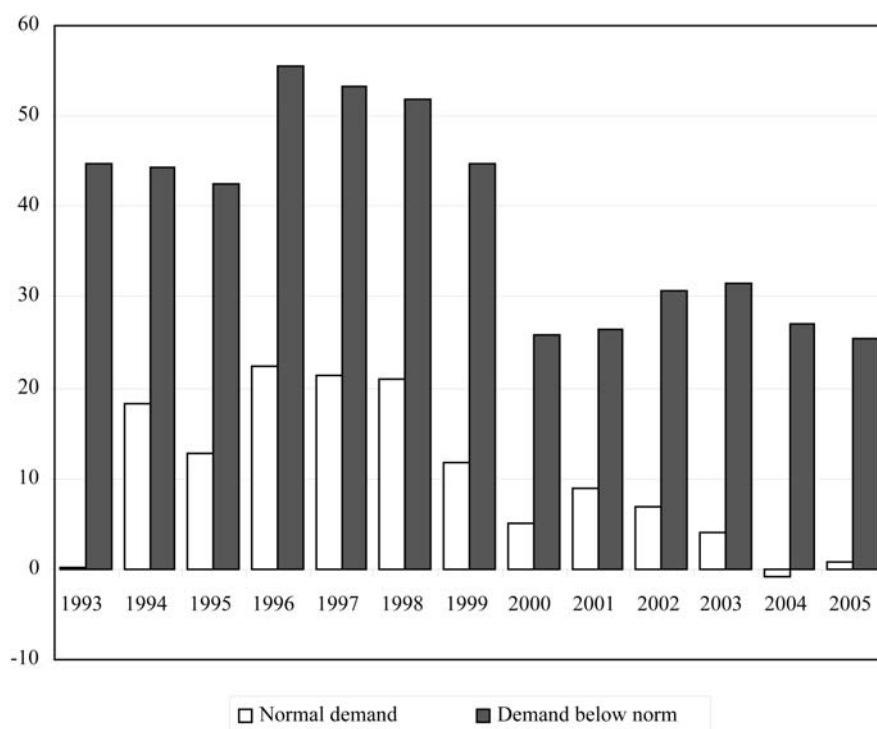


Fig. 25. Average Annual Balances of capacity Assessments for Different Assessments of Demand

The excess in capacities in 2005 was associated with lower growth rates of demand, rather than the growth in their placement into operation, albeit the enterprises' investment activity has also contributed to the expansion of production capabilities of the industrial sector. In early 2005, as many as nearly 1/3 of Russian enterprises considered the 2004 actual level of capital investment to be sufficient due to expected changes in effective demand. This index (31%) appeared the best one over the whole period of its monitoring. In the first post-default years, investments satisfied demand just at 15% (see Table 25).

Table 25

Assessment of Sufficiency of Capital Investment in Conjunction with Expected Demand (as % to the Number of Those Who Responded)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
More than enough	1	1	1	1	1	1	2	1	4
Sufficient	16	13	15	15	21	22	20	29	31
Insufficient	83	86	84	84	78	77	78	70	65

3.2.3. Constraints to Industrial Growth in 2005

While the 2005 dynamics of effective demand tended to be negative, rather than positive, and resulted in worse market positions of most Russian companies, the survey data witnessed that the changes in output did not appear to have similar tendencies (see Fig. 26).

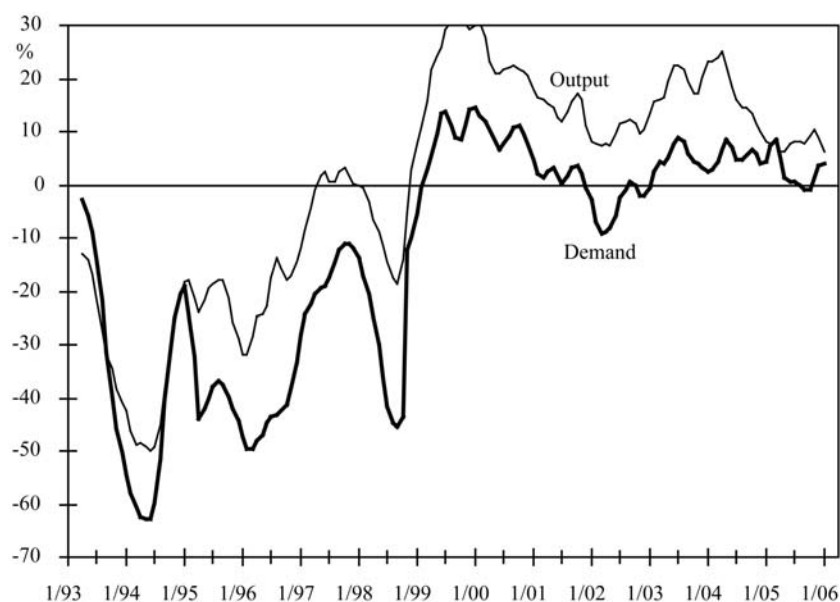


Fig. 26. Changes in Demand and Output Cleared from Seasonal and random Fluctuations (Balance=% of growth- % of Decline)

A rapid growth at the beginning of the year enabled enterprises to boost the production intensity without the risk of outpacing demand. In March, the balance of the change in output grew up to +47%, which appeared an absolute record-breaking value over the whole period of monitoring this indicator. Once cleared from seasonality, it plunged to +24%, however, it retained certain advantages: the survey evidence that output has not grown at such a pace since 2000. The intensity of the growth in output fell to +15% ...+19% in the 2nd and 3rd quarters (by the balance), followed by a growing intensity of the production activity.

The quarterly monitoring of obstacles to growth in output (see *Fig. 27*) displays emergence of new trends in the structure of the factors that inhibit the advancement of the national industrial sector, however, one can reckon that the old defects aggravated, while new ones emerged.

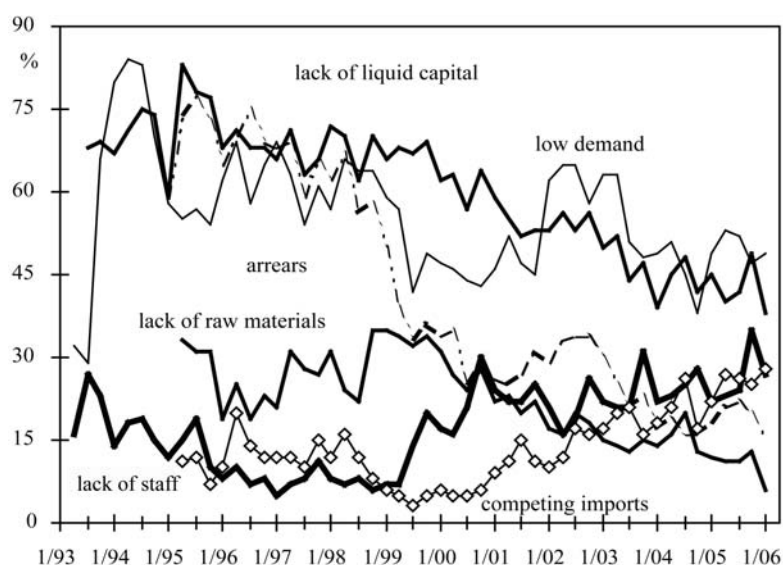


Fig. 27. Obstacles to Growth in Output

First, the enterprises began to more frequently cite insufficient domestic demand as an obstacle to growth in output. While in late 2004 only 38% of them referred to this factor, which can be considered a historic minimum, as early as in the 2nd and 3rd quarters the respective frequency grew up to 52–53% and it once gain formed the most widespread obstacle to growth in output. In 2005, it was an obstacle for 50% of enterprises on average. The same situation was also noted in all the industries – a low demand became the most frequently cited obstacle to growth in output and as such it inhibited production expansion at a range between 43% of enterprises in the sector for chemicals and petrochemicals up to 52% of metallurgical companies (see *Table 26*). On the sectoral level the inhibiting impact of demand dropped over the year only in the sector for chemical and petrochemicals (from 52% to 43%) and remained practically unchanged in the industry of construction materials (49 after 50%). In other sectors, the frequency of the obstacle grew largely by 5–9 p.p., while it was only metallurgy where the respective references rose by 21 p.p. at once (from 31 up to 52%). Let us note that the numbers of enterprises in different sectors that cited this obstacle in 2005 have converged, while the standard bias dropped to 3.21 after 7.67 reported in 2004. The maximum value of this particular indicator was registered in 1999 when it accounted for 14.64. At the time, the reference to demand as an obstacle to growth in output had been in the range between 22 (the forestry complex) and 65% (the construction industry).

Second, low sales were followed by lack of liquid assets. By the 4th quarter the frequency of its citing had grown up to 49%, thus showing a drastic rise at 7 p.p. after the 3rd quarter. The results proved to be the worst on over the past 9 quarters. However, as in early 2005 liquid assets inhibited rise in output not so frequently (they were still under the impact of successful results of sales of end-2004), the 2005 result proved to be just at 1 p.p. worse than that of 2004⁴. The outspread of this obstacle in 2005 across industries varied very considerably – with the standard bias being 10.21, from 27% in metallurgy to 52%

⁴ Given that, completion of liquid assets is the most popular way of using borrowed capital. In 2005, 70% of enterprises reported that they used borrowed resources for that particular purpose, while 36% of them spent borrowed capital on production rearmament, and 24% – to expand their production.

in machine engineering. The change also varied seriously vis-à-vis 2004. In machine engineering and forestry complex it formed an obstacle to a greater number of enterprises, while metallurgy saw no fundamental change, and its inhibiting influence dropped by 4–9 p.p. in other industries.

Table 26

Frequency of Citing the Domestic Demand as an Obstacle to growth of Output in Industry Branches (as % to the Number of Those Who Responded, the Average Annual Data)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Industrial sector on the whole	56	64	61	63	51	45	47	62	58	46	50
Metallurgy	64	66	57	63	38	35	64	81	61	31	52
Chemicals and petrochemicals	50	71	69	63	51	47	46	65	54	52	43
Machine engineering	62	63	62	66	59	54	51	60	62	49	51
Forestry complex	49	70	55	45	22	26	32	39	29	38	47
Construction industry	55	67	66	73	65	45	44	59	53	50	49
Light	54	58	49	53	42	40	37	53	47	39	48
Food	52	51	62	62	56	52	41	46	49	40	45
Standard bias	5.80	7.00	6.72	9.13	14.64	9.54	10.39	13.75	11.14	7.67	3.21

Third, in 2005 the third most often cited obstacles became 2 factors that differ in popularity in the respective literature – that is, lack of qualified staff and competing imports. While the former impede the boost of output at 26% of enterprises (2 p.p. up vs. 2004), while the latter – at 25% (5p.p. up). Let us consider the lack of stuff, as competition with imports will be considered in a greater detail below.

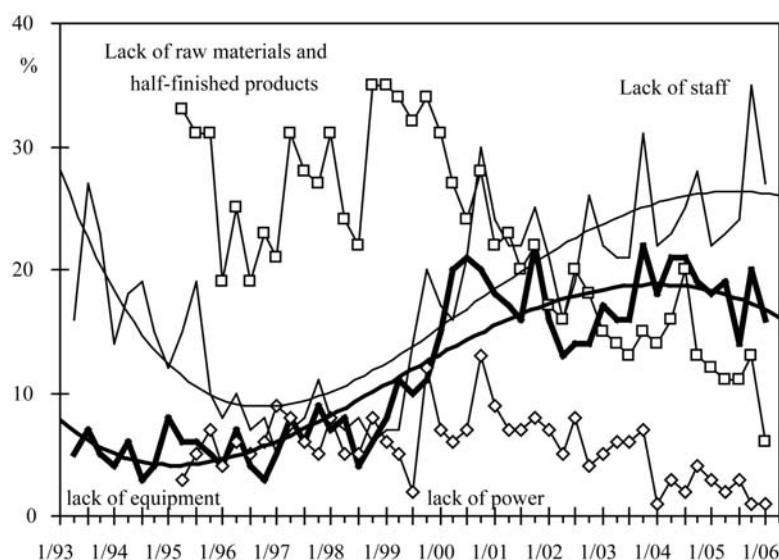


Fig. 28. Resource-Based Obstacles to Production Growth

As concerns other resource-based obstacles, lack of staff has long and steadily been on the top o the list (see Fig. 28). In the past 5 years it has overrun by frequency of

referring to it once such a very widespread factor as the lack of raw materials and other material resources, while since 1999 (when its value slid to absolute minimum) the number of references to it were growing constantly and reached its absolute maximum by late 2005. It was machine engineering that cited the lack of staff most often in 2005 (35% of enterprises). In this particular industry branch lack of staff has traditionally held the third position, following insufficient demand and lack of liquid assets. Competing imports in machine building in 2005 lagged behind lack of staff by 11 p.p., being even inferior by referring to them to insufficient export demand. It is worthwhile noting that in the sector for machine engineering the lack of staff has always (except for 1998) constrained output at a greater number of enterprises than competing imports did (see *Table 27*).

Table 27

**Obstacles Facing Machine-Engineering Enterprises' Attempts to Boost Output
(as % to the Number of Those Who Responded, Average Annual Data)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
None	0	0	1	0	0	1	1	1	1	3	3
Domestic effective demand	62	63	62	66	59	54	51	60	62	49	51
Low export demand	12	13	20	20	21	22	23	25	29	28	25
Competing imports	6	11	10	11	5	6	10	16	21	22	24
Consumers' non-payments	75	74	72	69	44	37	32	39	30	19	21
Lack of liquid assets	78	73	72	71	69	65	60	63	56	50	52
Shortage of qualified staff	19	12	12	9	17	29	33	30	30	34	35
Lack of equipment	5	3	4	3	5	15	19	16	18	21	17
Lack of raw materials	20	26	27	26	29	26	22	17	12	11	10
Lack of electricity	6	6	5	6	4	7	7	4	5	2	2
Others	9	7	8	5	5	4	7	5	7	6	4

The shortage of staff in Russian industrial sector is still combined with an excessive employment. The quarterly monitoring of assessments of the current number of staff in conjunction with expected changes in demand show that in 2005 some 12% of enterprises reported more than sufficient number of personnel. However, this value has declined over recent years and by late 2005 it reached its minimum ever observed over the whole period of monitoring of the indicator in question (1996–2005). By contrast, the proportion of enterprises with a normal quantity of staff reached its maximum (74%) in 2005. The best results by the latter indicator were reported by the fuel (91% of enterprises with an adequate number of staff), metallurgical (86%) and food-processing (85%) industries. The other, relatively close, pole is formed by machine engineering (86%) and light (67%) industries. In 2005, some 14% of enterprises on average assessed the number of their staff as being insufficient (vs. 15% in 2004). As a result, the average annual balance became negative, which testifies to the shortage of employees in the national industrial sector and particularly so far as demand is concerned. Such a situation was last time registered in 2000-01, i.e. right in the aftermath of the default and in the period of an intense and quite unexpected rise in demand and output. In 2005, the national enterprises' position was different – demand was growing, albeit not as intensively as before and it was hardly unexpected. So, the enterprises' problems with staff reported in 2005 testify to the formation of indeed long-term negative tendencies with respect to staff problems in the sector. The cause for then lies in an intense staff migration to other sectors (primarily those for services and

trade), which is driven by low salaries and the absence of an inflow of new staff from universities and secondary special educational institutions.

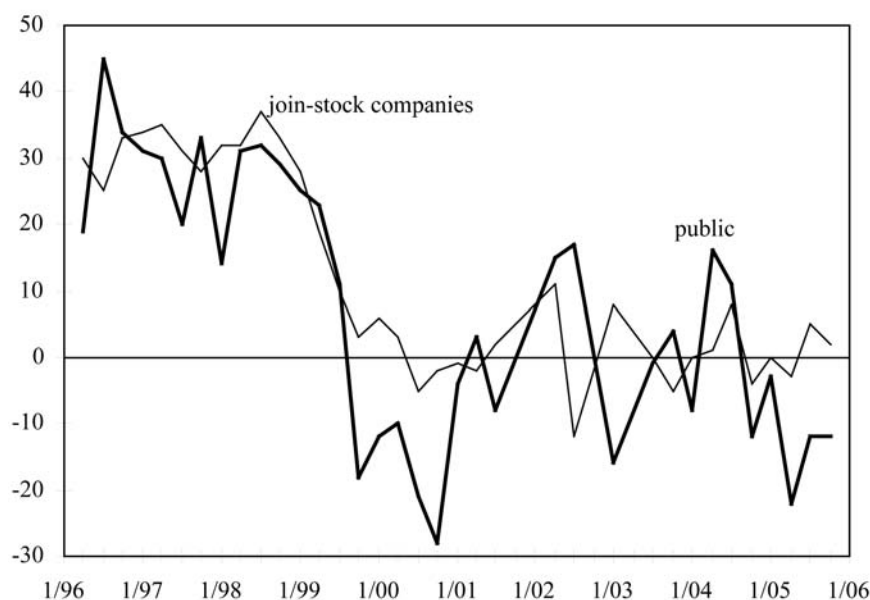


Fig. 29. Balances of Assessments of Staff Due to the property Form
(Balance=More than Enough –Less than Enough)

In 2005, public enterprises saw the situation with staffing drastically complicating (see *Fig. 29*). The average annual balance of assessments fell to -13% , which became the worst result over the past five years. Analogous problems with staff (with the balance accounting for -18%) emerged in the sector in 2000, but at the time they were explained by an intense post-default rise of sales and output. Given that the non-public sector of the national industrial sector did not experience substantial biases of the actual number of employees from the desired one, it can be argued that public industrial enterprises have begun being defeated by non-public ones on the labor market. This became evident after the 1998 default (see *Fig. 29*). Until 1998 employment assessments balances had displayed the existence of roughly similar problems in the public and non-public sectors, wherein the staff was excessive to a roughly equal extent. However, with the start of the post-default growth public enterprises sensed serious staff shortages – in the 4th quarter 2000, 39% of enterprises reported they lacked workers to fulfill orders. Join-stock companies proved to be better prepared for the rise in output and finished 2000 with zero balance. It was in the 3rd quarter 2002 that non-public enterprises reported the greatest staff shortages (22%). The 2002 annual balance of employment assessments for the non-public sector in industry proved to be extremely high ($+8\%$) vs. other post-default years. The 2001 balance was -1% (a small shortage of staff), while in 2002–05 it steadily was being $+1\%$ (a small excess of staff). Notably enough, given the specificity of the national market and a low mobility of labor resources, enterprises clearly prefer excessive staff to its shortage.

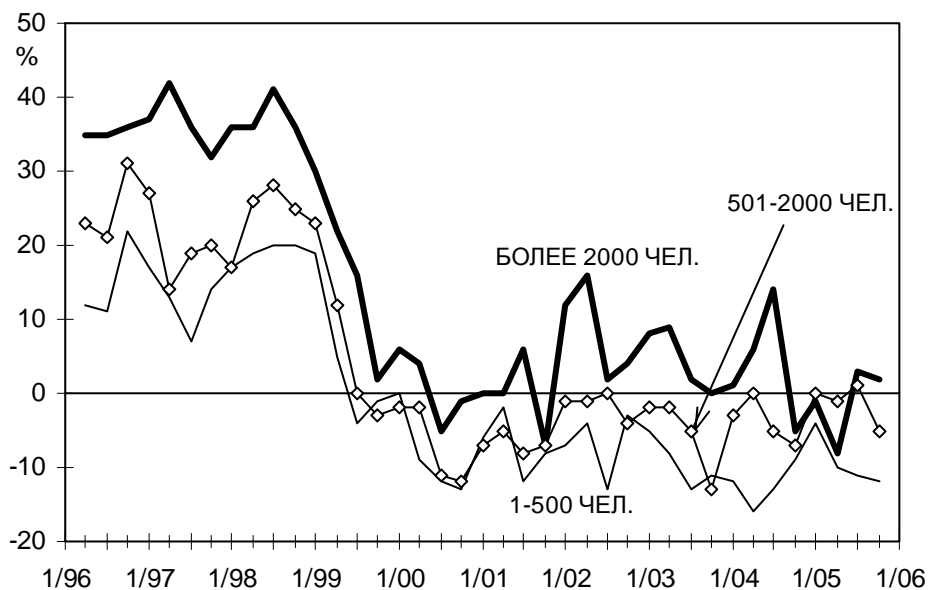


Fig. 30. Balances of Staff Assessments due to the Size of an Enterprise
(Balance=More – Less than Enough)

The excess of workforce was no longer in existence at large enterprises in 2005. The survey results show that until recently large producers had kept a greater surplus of staff than small- and medium-sized ones (see Fig.30). Post-default and through the end-2004 the balance of their assessments more often was positive than negative and sometimes it would reach great values (+ 14%...+16%). The “reserve” had exhausted by the 4th quarter 2004, thanks to fairly good demand and production indicators, as well as the staff migration to sectors with greater salaries paid. The flagship industrial enterprises consequently ran into staff shortages in early 2005. However, the decline in business activity at the end of the year allowed them to get rid of the problem in question and return to a small surplus of workforce. The group of medium-sized enterprises likewise reported negative balance. This particular sector of the national industry had to operate in the conditions of staff shortages already since mid-1999, which is why the 2005 result (–1%) looks as a successful one, rather than displays an aggravation of the challenge. Until 2005 the annual balance of assessments in this group would slide to –6...–7%. The greatest problems with staff persisted in the group of small enterprises (with the number of employees under 500). Their 2005 annual balance made up –9%, albeit it can also be viewed as an improvement of the situation, for in 2004 it had been –13% and –10% – in 2003.

Fourth, the year of 2005 saw the discontinuation of progress with payments and settlements in the national industrial sector. According to enterprises’ assessments, last year, the inhibiting impact of non-payments on rise in output grew up to 20% on average vs. 17% reported in 2004. The later result still is the best one from the start of an extended monitoring of impediments in 1995. Pre-default, the non-payments affected up to 77% of enterprises (in 1995) and at best would slide to 59%. Right after August 1998 the situation with settlements began to improve and as early as in the 3rd quarter 1999 non-payments formed an impediment just to 30% of Russian industrial enterprises (with the 1999 average annual result being 39%). The inhibiting effect of non-payments has been on decline over the next years, with 2002 being an exception – that year, problems with sales and slow-

down in the rise in output triggered an expansion of non-payment practices up to 32%. In 2004, the frequency of citing non-payments was steadily low and fluctuated between 16 to 19% from quarter to quarter.

Table 28

**Frequency of Referring to Non-Payments as an Obstacle to Rise in Output
in Industries (as % to the Number of Those Who Responded,
Average Annual Data)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Metallurgy	60	51	52	54	25	11	21	23	11	6	11
Chemicals and petro-chemicals	67	72	70	59	44	23	27	27	41	19	16
Machine engineering	75	74	72	69	44	37	32	39	30	19	21
Forestry complex	52	68	67	48	22	17	17	19	7	6	15
Construction industry	77	69	71	61	48	39	24	26	32	27	20
Light	74	63	55	49	25	19	14	15	18	15	19
Food processing	68	62	63	48	31	22	14	13	15	13	16
Standard bias	9.15	7.74	8.14	8.03	11.04	10.40	6.78	8.62	12.49	7.70	3.52

In 2005, it was metallurgical enterprises that experienced minimum problems with non-payments (see Table 28). Only 11% of the sector on average believed non-payments inhibited their production growth. Interestingly, in 2004 the respective result was even better. Analogous situation was noted in the forestry complex wherein the frequency of citing non-payments grew from 6% in the prior year to 15% in 2005. The most affected by non-payments output in 2005 was reported by machine engineering and industry of building materials. However, if the former sector referred to them more often than in the prior year (21% vs. 19%, respectively), the latter reported their decline from 27 to 20%. The construction industry that back-ups the construction boom as consequently reported a minimum inhibiting impact of non-payments.

3.2.4. The Dynamics of Competition Relationship in Russia's Industrial Sector in 2005

The year of 2005 became a period of a drastic intensification of competition within the national industrial sector, as well as with Far-and Near-Abroad producers. The aggregate competition indices IET computes twice a year demonstrated the greatest rise since the start of monitoring of this particular indicator in 1995. The aggregate competition index grew by 0.39 p. and hit an unprecedented 3.65 (see Table 7).

In 2002, driven by the domestic competition the indicator rose as high as 3.25 maximum. By contrast, in 2005, the competition on the Russian industrial enterprises' sales markets was largely steered by their rivalry with Near- and Far Abroad counterparts. The indices of these directions of competition showed a 0.45 p. growth each over the year. Our surveys have not ever registered such a drastic rise. By contrast, in 2004, enterprises assessed competition as weakening in all the areas and particularly with the Near-Abroad producers.

The competition between national producers themselves has remained the strongest one (see Fig. 31). In 2005, the level of the domestic competition for the first time ever over-ran the level "moderate" and fixed itself on a new one. The competition with Far-Abroad producers also intensified drastically, with its 2005 values of its index being over the pre-

default peak. In other words, today Russian producers' goods compete with imports with an unparalleled intensity.

Table 29

Values of Annual Indices of Competition with Different Producers

	Russian	Near Abroad	Far Abroad	Aggregate index
1995	3.39	2.65	2.79	2.94
1996	3.46	2.82	3.01	3.10
1997	3.55	2.81	3.02	3.13
1998	3.52	2.79	3.09	3.13
1999	3.61	2.73	2.87	3.07
2000	3.60	2.70	2.80	3.03
2001	3.73	2.89	2.90	3.17
2002	3.87	2.93	2.96	3.25
2003	3.95	2.92	3.08	3.32
2004	3.94	2.82	3.03	3.27
2005	4.20	3.27	3.48	3.65

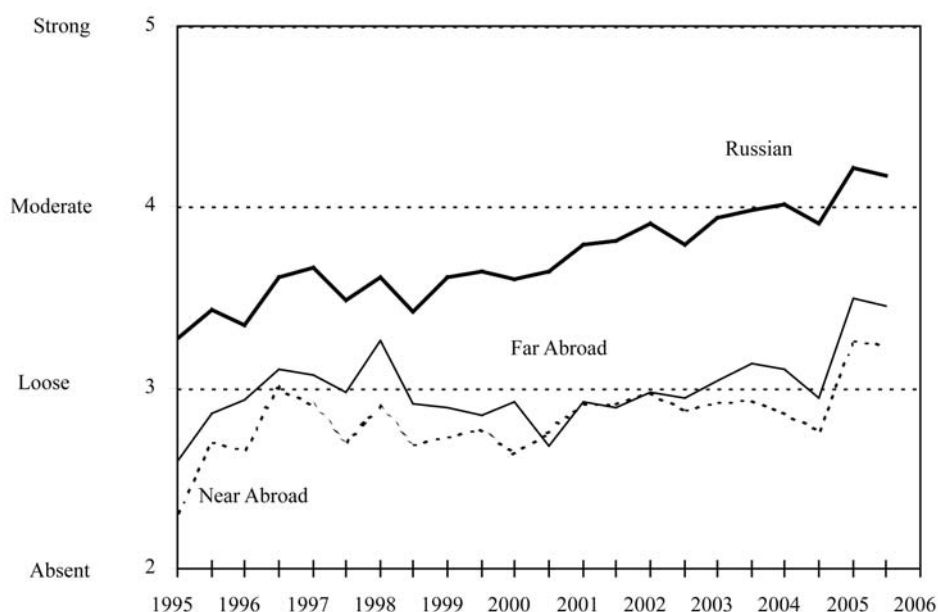


Fig. 31. The Dynamics of the Competition Level with Different Producers Across the Industrial Sector as a Whole

The domestic competition intensified in all the industry branches (except or the light one) and in each of them it reached its historic maximum values. Interestingly, industry-specific competition indexes display no strong difference from each other (as it used to be before) – enterprises in all sectors experience a similar and fairly strong competition pressure on the part of other Russian producers. It was just the light industry wherein the surveys failed to register any growth in the domestic competition – its respective index slid

(albeit insignificantly) to its 2003 level (see *Fig.32*). This particular industry branch reported a considerable growth in competition in 2002, but it has been stable and found itself on a relatively high level (evidently above the mark “moderate”) ever since. In 2002, the light industry saw its competition with imports intensify – at the time, its index grew by 0.77 points and for the first time ever after the default it overrun the level “loose”. It slightly bounced back shortly afterwards, however, ultimately remained above that mark. The next time the competition with imports from Far Abroad rose rapidly was in the first half 2005 – at the time, it nearly climbed up to the “moderate” mark and the level of intensity of the domestic competition. It slid back again, however, at the end of the year.

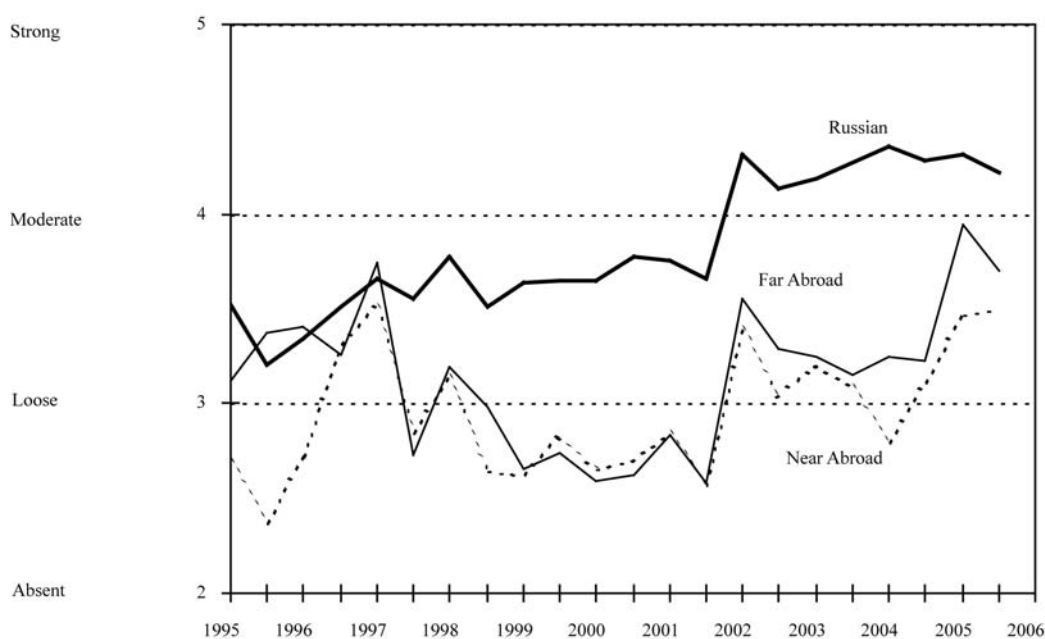


Fig. 32. The Dynamics of Competition with Different Producers in the Light Industry

The food-processing industry reported in 2005 a minimum growth in the domestic competition (see *Fig. 33*). In the 2nd half 2005 its competition index reached its historical peak and became slightly greater than its respective values of 2002 and 1996. The domestic competition level in the industry has been the most stable and the greatest one (very rarely sinking below the mark “moderate”) over the past decade. In the industry, the competition with imports begins to approach the pre-default level, with the last index value already being over the April 1998 competition intensity assessment (the last one prior to the default), however, it still is 0.40 down compared with the peak values of the index registered in 1996–97. Nevertheless, an absolute level of competition with Far-Abroad imports in the sector is still very low. Since early 1998 it has never overshoot the mark “loose”, while in 2002 it slid nearly to the level “absent”. Indeed, imports are not a threat to the domestic food-processing sector.

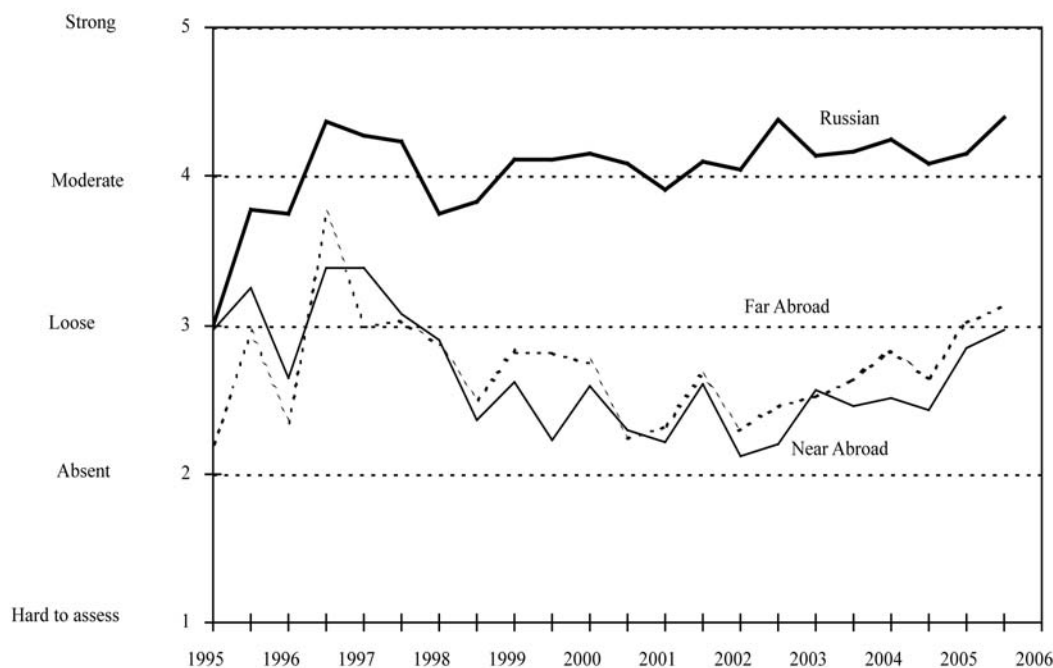


Fig. 33. The Dynamics of Competition with Different Producers in the Food-Processing Industry

The decade of monitoring of factors that intensify competition on the Russian industrial enterprises' sales markets demonstrated interesting results that appeared quite correspondent to the traditional statistical available data (see Table 30). First, enterprises referred to contraction in the volume of domestic demand and rising volumes of import. In 2005, these factors were cited by 40% of enterprises each and more frequently than before. The contribution of the domestic demand to formation of competition has been falling from 81% reported in 1996 and reached its minimum (31%) in 2004. The impact of import was minimum in 1999 and it was growing since 2001, reaching its maximum in 2005. Second, enterprises quite often cited in 2005 such a factor of formation of competition as other Russian producers' penetrating their sales markets. In 2003–04 this particular factor topped the respective list and even supplanted the traditional import, while prior to the default references to it were as or even more frequent than those to import. Unlike the aforementioned factors it has not undergone such intense fluctuations from year to year. Third, it seems that the price competition between Russian producers is fading and gives room to other, more civilized, methods of struggle for consumer. However, import prices begin to exercise their pressure on Russian producers' price policies. In 2005 they began troubling some of Russian producers, which was more often than Russian competitors' prices and, most importantly, the pre-default import prices. The better quality of imports also contributes to intensification of competition on the sales markets for Russian goods, particularly in the machine engineering (26% of enterprises referring to this factor). Enterprises in other sectors are far less afraid of import, which is grounded and easy explainable in the case of the food-processing industry (with just 3% of enterprises being concerned of that), but not in the light industry (11%).

Table 30

Frequency of Citing the Factors That Intensify Competition on the Russian Industrial Enterprises' Sales Markets, as %

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Contraction of the domestic effective demand	81	81	76	64	48	53	53	37	31	40
Growth in import volumes	31	23	28	8	9	14	23	30	30	40
Better quality of imports	7	9	11	7	14	10	18	20	26	24
Low prices for imports	17	14	18	5	9	12	12	24	16	26
Possibility to advertise the produce	4	2	4	3	6	4	5	8	4	6
Price containment by Russian rivals	14	15	15	20	23	23	26	31	24	22
Russian producers' penetration to the sales markets	18	25	25	26	34	36	44	42	45	35
Activity by the Federal Anti-Trust Committee and the RF Government	8	9	4	6	3	5	6	4	3	6
Trade and intermediate organizations' activity	9	13	16	24	22	18	15	15	16	12
Others	11	6	6	6	9	7	5	2	2	7

Note. In 1998 the question was posed in March.

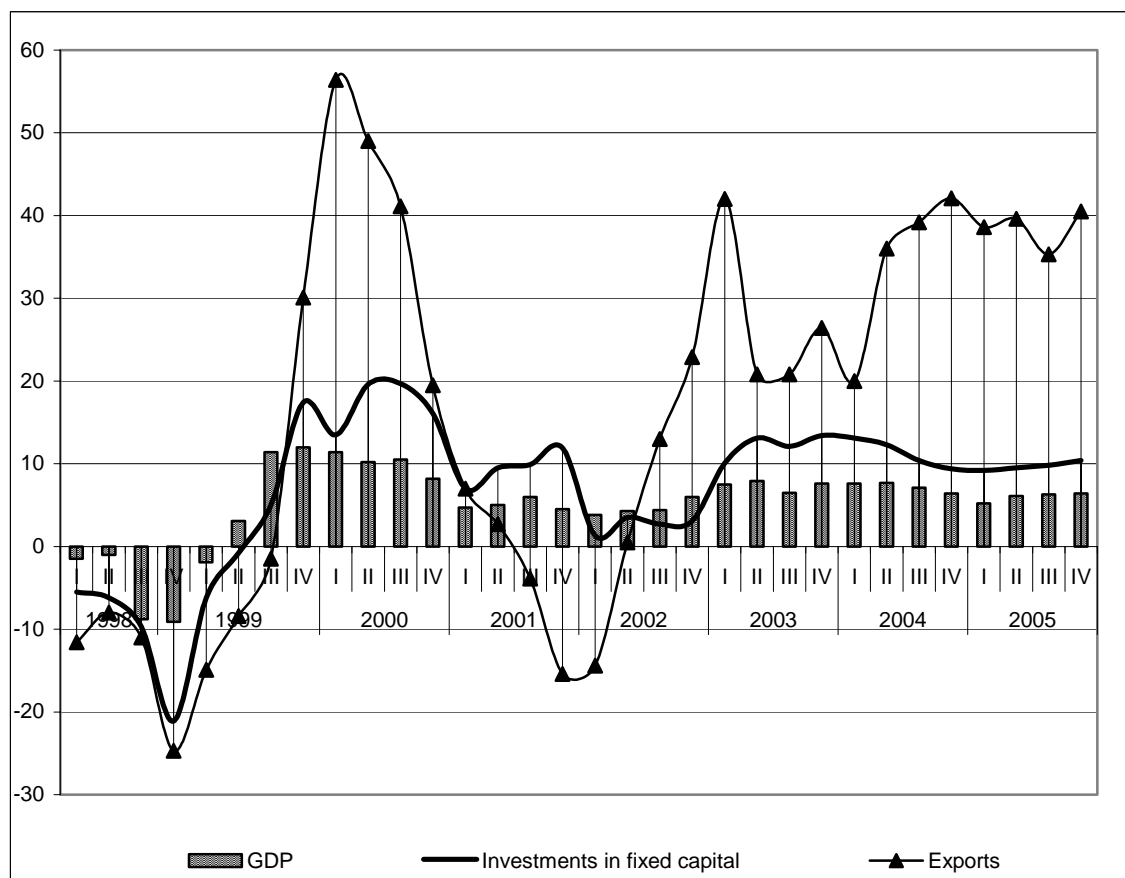
3.3. Investment Processes in the Real Sector of the Economy

3.3.1. Domestic Investment in Fixed Assets

One of the specific features characterizing the development of the Russian economy in 1999 through 2005 is the outpacing rates of growth in investments in fixed assets as compared with the GDP dynamics and the output of products of base sectors of the economy.

The stable positive dynamics of production has changed the situation observed in the investment sector. The post-crisis recovery of economic growth has initially based on the mobilization of internal resources and use of competitive capacities. The expansion of investment demand has been registered since 1999 and supported by exceptionally favorable changes in the price situation on world markets of hydrocarbon raw materials and metals (see Fig. 34), on the one hand, and by an active policy pursued by the Russian businesses, which was aimed at the filling of the niches existing on the domestic market with Russia-made goods, on the other hand.

The growth in the profitability of production and increasing business earnings have determined the expansion of the demand for capital goods. Due to the fact that manufacturers were oriented towards the implementation of an active modernization and reconstruction of production, the export sector and manufacturing industries have begun to increase demand for machinery and equipment. As concerns the technological structure of investments, since 2000 there has been observed a growth in the share of expenditures for machinery and equipment (see Table 31).



Source: Rosstat.

Fig. 34. Rates of growth in GDP and Investments in Fixed Capital in 1998 through 2005, in per cent of the Figures Registered in the Respective Period of the Preceding Year

Table 31

Technological Structure of Investments in Fixed Assets in 1992 through 2005, in per cent of the Total

	1992	1995	2000	2001	2002	2003	2004	2005*
Investments in fixed assets, total including:	100	100	100	100	100	100	100	100
Construction and installation works	58.0	63.9	46.8	47.4	47.9	49.6	48.4	48.6
Equipment, tools, fixtures	20.5	21.9	34.3	32.9	35.6	35.0	34.7	35.7
Other capital works and expenditures	21.5	14.2	18.9	19.7	16.5	15.4	16.9	15.7

* Preliminary data.

Source: Rosstat.

An exceptionally high growth in investment demand observed in the year 2000, which was caused by a dynamic increase in the proceeds of extractive industries has been replaced by rather weak dynamics of 2001 through 2002 observed at the backdrop of contracting domestic demand and falling profitability of production resulting from the changes in relative prices registered on the domestic and external markets. The recovery of the

outpacing rates of growth in investments in fixed assets as compared with the GDP dynamics has been observed since the early 2003 and was accompanied by a growth in prices on the world markets of fuel and energy resources, as well as the raw materials markets. In 2005, the amount of investments in fixed capital increased by 10.5 per cent in comparison with the figures registered in the preceding year and made 3431.0 billion rubles.

In spite of the positive impact the proceeds of the economy derived from the external economic activities had on the rates of economic growth, their influence on the dynamics of investment activities was limited by the trend towards a decline in the level of transformation of the gross national savings in investment expenditures. Under the impact of the disproportions in the movement of fixed capital, investment expenditures, and the dynamics of domestic mechanical engineering existing in the Russian economy, the domestic market was influenced by the dynamic growth in import of machinery and equipment. In the period from 2000 till 2005, in which investments in fixed assets increased by 80.8 per cent, the increase in production in mechanical engineering made 68.0 per cent, whereas the scale of import of machinery, equipment, and vehicles grew 3.6 times.

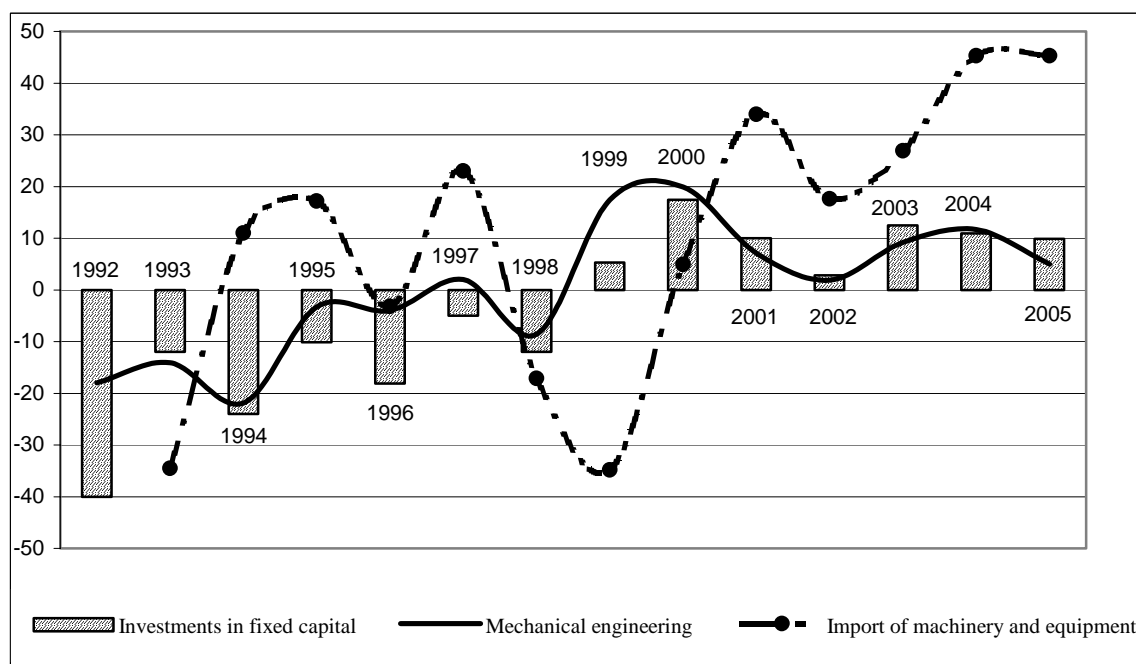
The decline in the share of imports in the overall consumption of mechanical engineering products was observed for a short time only (in the period from the 4th quarter of 1998 till the 3rd quarter of 1999). The dynamics of output of capital goods across branches of mechanical engineering reflected the immediate reaction of Russian businesses to the shifts in the business situation on the domestic market. As concerned the output of investment goods, in this sphere the branches engaged in the production of equipment for oil and chemical industries, as well as the branches of mechanical engineering traditionally oriented towards the domestic market – railroad and metallurgical mechanical engineering – established themselves as the leaders. The intensive development of infrastructure industries had given an impetus to the increase in the volumes of production of road-building machinery and hoisting and conveying equipment.

However, as the products of domestic mechanical engineering have been losing their competitive advantages with respect to similar imported products in the price / quality ratio terms, the situation on the market of capital goods changed dramatically. The surge in demand for imported machinery and equipment was registered in the year 2000 and since that time the trend towards outpacing rates of growth in the import of machinery and equipment in comparison with the rates of development of domestic mechanical engineering has become stable and corresponded with the dynamics of investment activities. In 2005, the amount of investments for purchase of imported equipment made 213.3 billion rubles, or 20.6 per cent of the total amount of investment in machinery, equipment, and vehicles.

The growth in proceeds derived by the economy at large, household savings, and the enhancing activity of the banking sector have positively affected the nature of development and permitted to overcome the trend towards the deceleration of the rates of investment activities, which formed in 2001 and 2002. The principally new factor of economic growth was the shift from the financing of investments in fixed assets at the expense of own funds of enterprises and organizations to the expanding participation of borrowed funds. It was a graphic illustration of the qualitative changes occurring in the mechanism of investment development oriented towards the rationalization of flows of investment resources. In 2005, the share of borrowed funds amounted to 52.3 per cent of the total amount of investments in fixed assets, what corresponded to the figures registered in 2000, when there was observed the peak of investment demand in the whole period of recovery growth.

In contradistinction to the situation of 2004, in the structure of investment resources there was observed a 2.2 p. p. growth in the share of budgetary funds in the financing of

investment expenditures initiated by the increase in investments at the expense of the federal budgetary funds. In 2005, the share of banks in the crediting of investments made 6.5 per cent decreasing by 1.4 p. p. in comparison with the figures registered in the preceding year. At the background of moderate behavior of the banking sector, there persisted the trend towards increasing participation of insurance and investment companies, industrial and trade enterprises, as well as foreign capital in the financing of investment activities.



Source: Rosstat.

Fig. 35. Rates of Growth in Investments in Fixed Capital, Production and Import of Capital Goods in 1992 through 2005, in per cent of the Figures Registered in the Preceding Year

Among the factors positively affecting the dynamics of credits and attraction of borrowings from other organizations there may be specifically mentioned the dedollarization of household savings. The decline in the amounts of foreign exchange denominated cash on hand disposed of by households and the scale of conversion of this cash in rubles was accompanied by the increasing amounts of deposits with banking structures. Given the average level of profitability existing in the economy, the low real costs of credit resources determined the growth in the number of enterprises making borrowings in the sectors of the economy oriented towards the domestic markets.

In spite of the observed deceleration of the rates of economic development, foreign investors are still interested in the Russian market. By the end of 2005, the amount of accumulated foreign capital made US \$ 111.8 billion, whereas the share of foreign investments in the total amount of investments made in the national economy remained at about the average level registered in 2003 and 2004. No doubt that the lack of confidence in the Russian institutions introduced to protect property rights results in higher risks associated with provision of borrowings for foreign banks. However, the stable growth of proceeds derived from the export of oil and natural gas, as well as the assignment of the investment grade rating to Russia completely justifies the retention of high rates of investment in Rus-

sia for the international banking business from the viewpoint of the geographical diversification of activities. Although the dynamics of foreign investments made in the Russia's economy in 2005 were at about the level registered in the preceding year, foreign direct investments increased by 38.8 per cent and their share in the total amount of foreign investments grew from 23.3 per cent to 24.4 per cent. The trend towards the growth in the amount of foreign direct investments reflects the reaction of foreign investors to the improvement of the components of the investment climate existing in Russia and the implementation of reforms. As concerns foreign investors, since recently they have preferred to invest in industry. Trade and public catering alongside with the general commercial activities relating to market servicing remain the next most attractive objects for investments.

Table 32

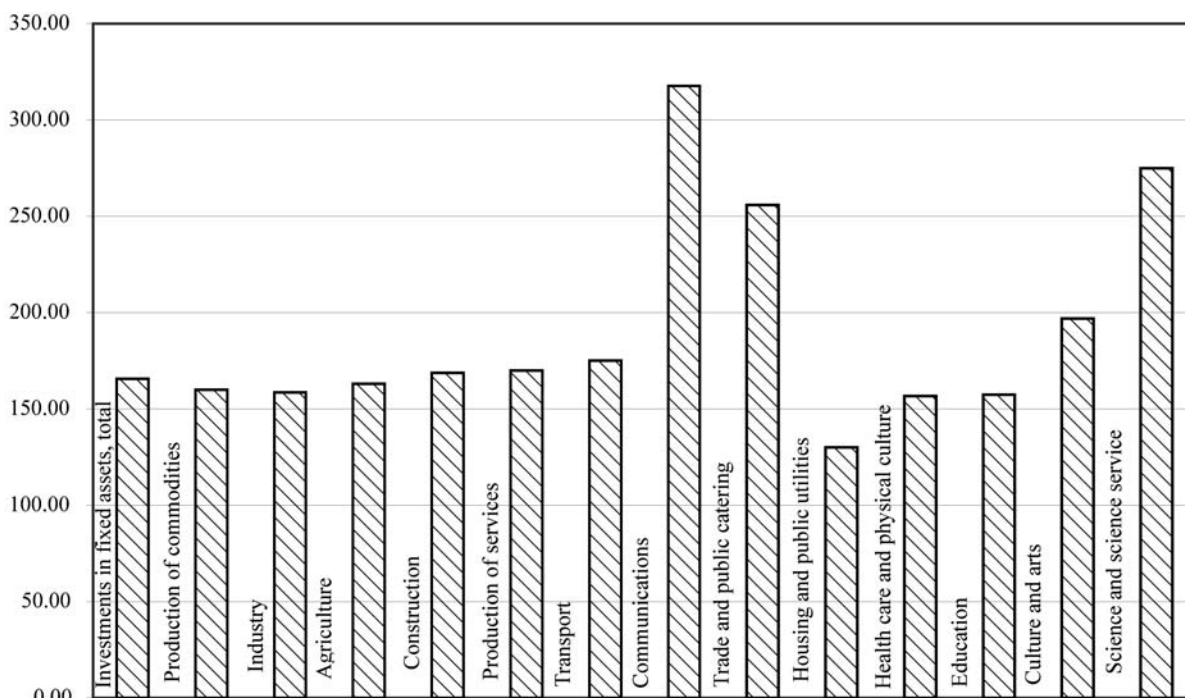
Structure of Investments in Fixed Assets as broken down by the Sources of Financing, in per cent of the Total

	2000	2001	2002	2003	2004	2005
Investments in fixed assets, total	100	100	100	100	100	100
Including investments as broken down by the sources of financing::						
<i>Own funds</i>	47.7	49.4	48.0	46.2	46.8	47.7
of which:						
profits	23.4	24.0	20.5	17.2	18.3	22.4
<i>Borrowed funds</i>	52.5	50.6	52.0	53.8	52.6	52.3
of which:						
Bank credits	2.9	4.4	4.8	5.2	7.3	6.5
Including credits extended by foreign banks	0.6	0.9	0.5	0.8	1.3	1.0
Borrowings from other organizations	7.2	4.9	6.0	8.6	7.3	7.3
Budgetary resources:	22.0	20.4	19.6	18.8	17.4	20.1
from the federal budget	6.0	5.8	6.0	6.5	5.1	6.7
from budgets of RF subjects and local budgets	16.0	14.6	13.6	11.5	11.3	12.4
Foreign investments in the total amount of investments in fixed assets	4.7	4.5	4.1	4.7	5.0	4.8

Source: Rosstat.

In the period from 2000 till 2005, investments in the sector of services increased from 54.7 per cent to 56.8 per cent of the total amount of investments in the national economy, whereas the specific weight of the sector of goods declined from 45.3 per cent to 43.2 per cent over the same time. Redistribution of investment flows in the sector of services was accompanied by an increase in the share of infrastructure branches. In the period from 1999 till 2005, on the average the share of transport, communications, and trade accounted for one fifth of the total amount of investments in fixed assets as compared with 12 per cent registered in the period from 1992 till 1996. Over the years of reforms, the share of transport in the structure of investments in the real sector of the economy has increased almost two times. In 2005, the share of transport in investments increased up to 22.1 per cent as compared with 20.3 per cent observed in 2004. While in 1992 the share of investments in communications made less than 0.6 per cent of the total amount of investments in the national economy, in year 2000 this figure made 2.6 per cent, whereas in 2003 and 2005 this indicator was registered to be at 4.8 per cent and 6.7 per cent respectively. The enhancing investment activity in infrastructure branches and the growing de-

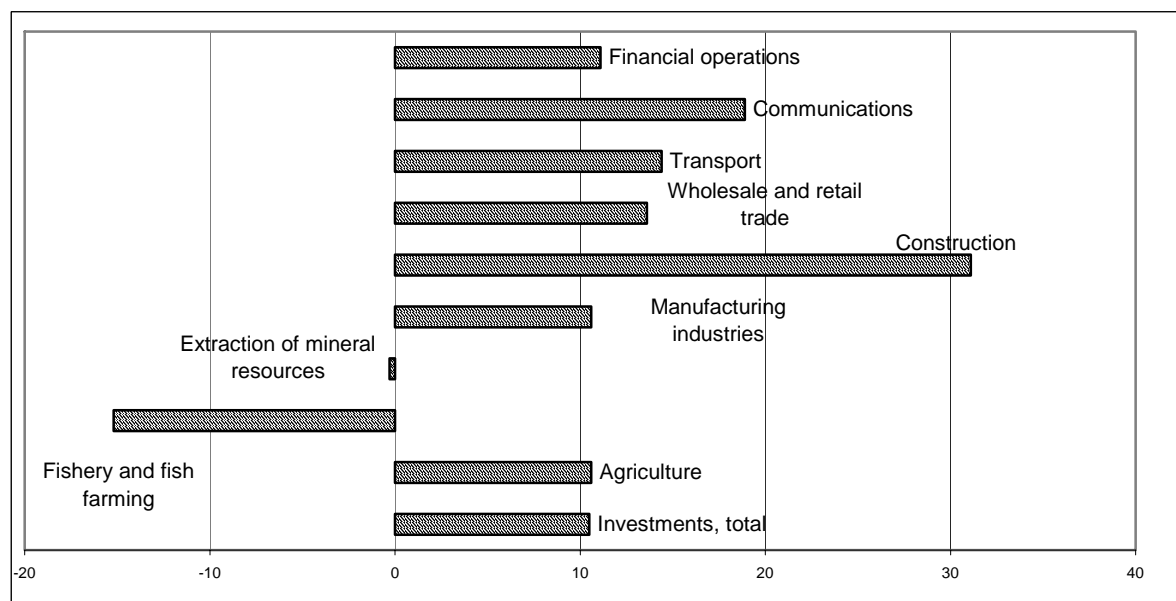
mand for services of these branches are indicators of the economic potential of growth, moreover taking into account the fact that the investment policies pursued in this sector are mainly oriented towards the settlement of problems expected to be encountered in the future.



Source: Rosstat.

Fig. 36. Dynamics of Growth in Investments in Fixed Assets as broken down by the Sectors and Branches of the Economy in the Period from 2000 till 2005, in per cent of the Figures Registered in 1999

In 2005, the dynamics of investment demand were determined by the aggregate impact of factors of changes in the sectoral, technological, and reproduction structures of the national economy. The redistribution of investment flows was accompanied by the increase in the share of the service sector. The share of investments in transport and communications in the total amount of investments in fixed assets made in 2005 made 28.8 per cent growing by 3.8 p. p. in comparison with the figures registered in the respective period of the preceding year. The structure of investments in transport was determined by the outpacing rates of growth in investments in railroad transport (119.8 per cent) in comparison with the respective figures characterizing investments in pipeline transport (106.4 per cent). It should be mentioned that in 2005 at the backdrop of steadily increasing demand for services provided by trade there was observed the enhancement of investment activity in this sector of activities up to 113.1 per cent as compared with 108.1 registered in 2004.



Source: Rosstat.

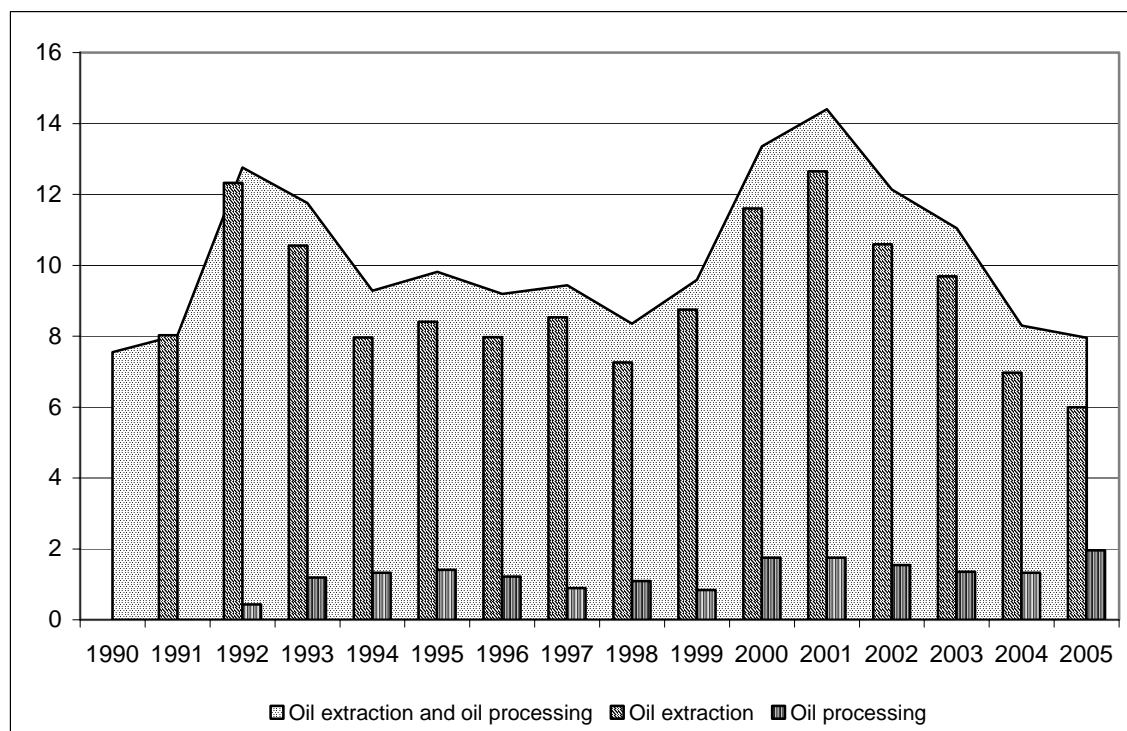
Fig. 37. Changes in the Rates of Growth in Investments in Fixed Assets as broken down by the Types of Economic Activities in 2005, in per cent of the Figures Registered in the Preceding Year

In 2005, the share of investments in fixed assets in the industries manufacturing goods persisted at about the same level, as registered in the preceding year. This fact was determined by the rather moderate growth of investments made in industry. It should be noted that in comparison with the figures observed in 2004, there was registered a decline in the rates of enhancement of investment activity in the export oriented extractive sector, whereas the share of manufacturing industries oriented towards the domestic market grew. In 2005, the share of manufacturing industries in the structure of investments in fixed assets in the sphere of industry made 43.3 per cent, whereas these indicators characterizing investments in extractive industries and production and redistribution of electrical power, natural gas, and water were registered to be at 37.4 per cent and 19.27 per cent respectively. The increment in investments in manufacturing industries made 10.9 per cent in 2005.

An analysis of business activity in industry observed in industry in the period from 2000 till 2005 reveals that fuel and energy industries have had the most significant impact on the dynamics and structure of investments. The share of fuel industries in the amount of investments in fixed assets made in 2000 through 2005 was on the average at 18.7 per cent. In 2005, the share of extraction of fuel and energy mineral resources accounted for 13.2 per cent (15.2 per cent in 2004) of the total amount of investments and 1.8 per cent of the amount of production of fuel products. However, in absolute terms the investments in extractive industries declined by 2.6 per cent and made Rub. 362.7 million.

In 1999 through 2001, the favorable external and internal business situation determined the growth in the amounts of investments in oil extraction 2.3 times, whereas these indicators characterizing the amounts of investments in oil processing and natural gas industry increased 2.1 times, while the total amount of investments in industry grew 1.58 times and in the economy at large – 1.36 times. However, as the situation changed in the period from 2002 till 2005, in the oil sector there was registered an average annual decline

in the amounts of investments at the level of about 9.0 per cent. In 2004, the amount of investments in oil extraction declined by 20.3 per cent. Although in early 2005 the growth of investments in oil extraction increased by almost one third in comparison with the figures registered in the 1st quarter of 2004, these developments failed to help overcome the negative effects of low rates of enhancement of investment activity observed in the preceding year. The proportions of the distribution of investments between the extractive and processing industries of the oil complex changed in the direction of growing share of oil extraction.



Source: Rosstat.

Fig. 38. Share of Investments in Fixed Assets of Oil Extraction and Oil Processing Industries in 1990 through 2005, in per cent of the Total Amount of Investments Made in the Economy

In accordance with the data presented by “Gazprom” OAO, the dynamics of extraction of natural gas were significantly affected by the absolute decline in the amounts of investments by 1.7 per cent in comparison with the figures registered in January through August of 2004. In the same period, there was registered even more pronounced dip in the share of investments made in extraction of natural gas initiated by the shift in priorities of investment activity in favor of the development of the pipeline network. As a result, in 2005 the increase in investments in production and distribution of gaseous fuels made 17.4 per cent.

The increase in the share of investments made in manufacturing industries observed in 2005 was caused by higher rates of growth in investments in the metallurgical production by 24.5 per cent in comparison with the figures registered in 2004, whereas investments in the production of coke, chemicals, pulp and paper products, as well as food

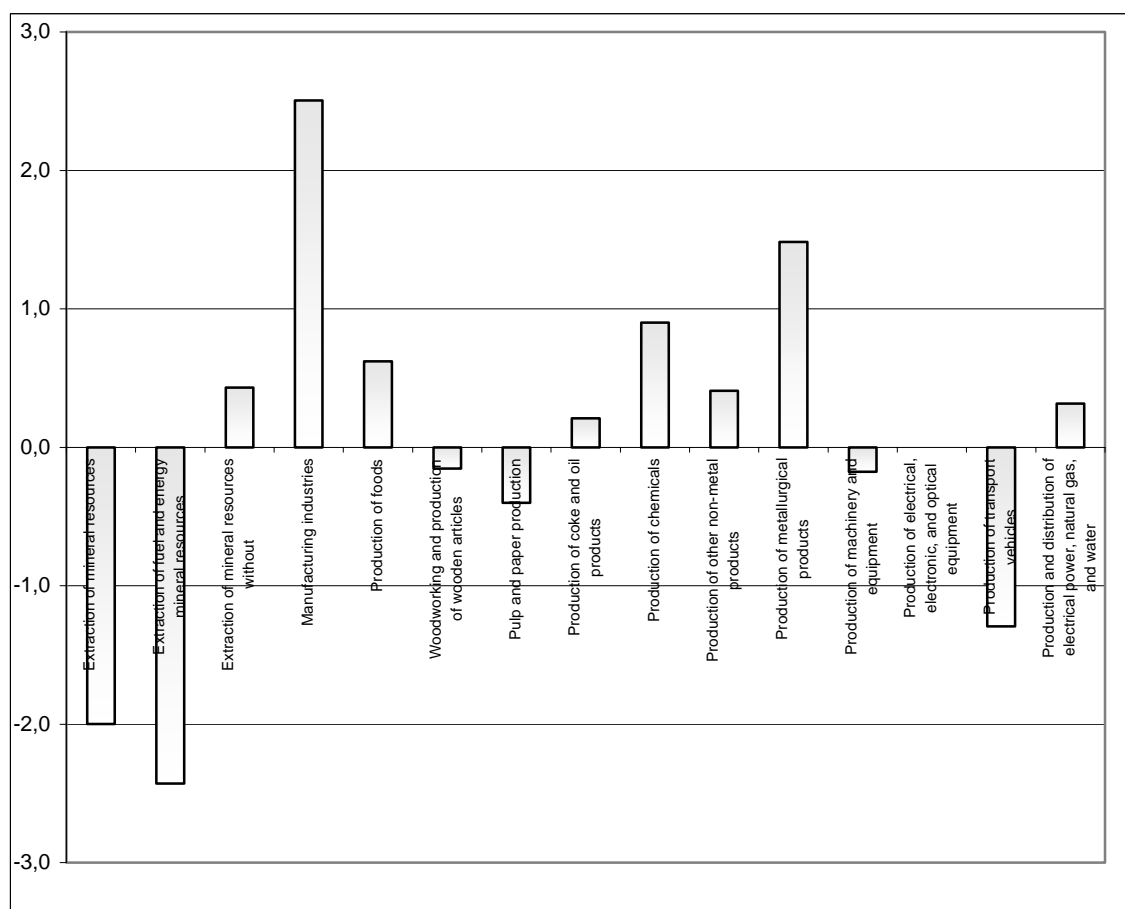
products grew by 94.8 per cent, 37.5 per cent, 13.5 per cent, and 7.5 per cent respectively.

While the investment activity in production of foods was determined by the growing demand on the domestic market, in metallurgy the main factor affecting production remained the increasing demand for metallurgy products and metal articles on foreign markets. It should be noted that in metallurgy there was observed the simultaneous growth in investment in both extractive and processing industries. As concerned fuel and energy industries, one of the most urgent problems remained the more pronounced trend towards a decline in investments in oil processing. It should be noted that at the backdrop of high world prices of hydrocarbons, the low rates of transformation and diversification of growing proceeds derived from exports into investments in reconstruction and modernization of facilities involved in the extraction and processing had a negative impact on the indicators characterizing economic growth. The increase in the rates of growth in investments in production of coke and oil turned out to be insufficient as concerned the change in the role played by these types of production in the structure of Russian industry.

In 2005, the share of industries manufacturing capital goods accounted for about 6/0 per cent of the total amount of investments in industry. In the framework of the given age, technological, and reproduction structure of fixed assets, a factor decelerating the general rates of economic growth was the low rates of investments in these industries. The decline in the amounts of investments in production of transport vehicles, machinery, and equipment had a negative impact on the nature of economic growth in 2005. The lack of a definite strategy of development of mechanical engineering branches and targeted support of individual productions resulted in imbalances on the market of investment goods and deteriorating competitive power. In the framework of the given structure of domestic production of investment goods, imports retained their role as one of the major sources of renewal of fixed capital, reconstruction, and modernization of production.

The effective growth of the Russian economy significantly depended on the intensity of changes in the structure of investments in favor of the industries oriented towards the domestic market. The implementation of such shifts envisages coordination of decisions taken in the spheres of budgetary, tax, tariff, customs, and monetary policies. The processes of transformation of the structure of the economy and enhancement of investment attractiveness of manufacturing branches of industry in particular depend on the equalization of conditions of efficiency of the utilization of investment resources at the expense of redistribution of fiscal burden between the raw materials and the non-raw materials sectors of the economy. In the case the traditionally high concentration of proceeds within the export oriented oil and raw materials sectors persists and taking into account the lack of mechanisms of inter-sectoral flow of capitals, it may be hardly expected that the rates of investment would increase and radical changes would occur in the nature of the reproduction of fixed capital.

Among the factors able to positively affect investment activity in the short term and medium term outlook there were noted the following: cheaper prices of imported machinery and equipment caused by the real appreciation of ruble; growing real disposable household incomes; and respective changes in the legal framework. The creation of special economic zones in the territory of the Russian Federation and the introduction of tax and customs privileges stipulated by law, establishment of an adequate infrastructure, and non-burdensome administrative controls should facilitate the attraction of investments in enterprises of the manufacturing sector and innovative sectors of the economy.



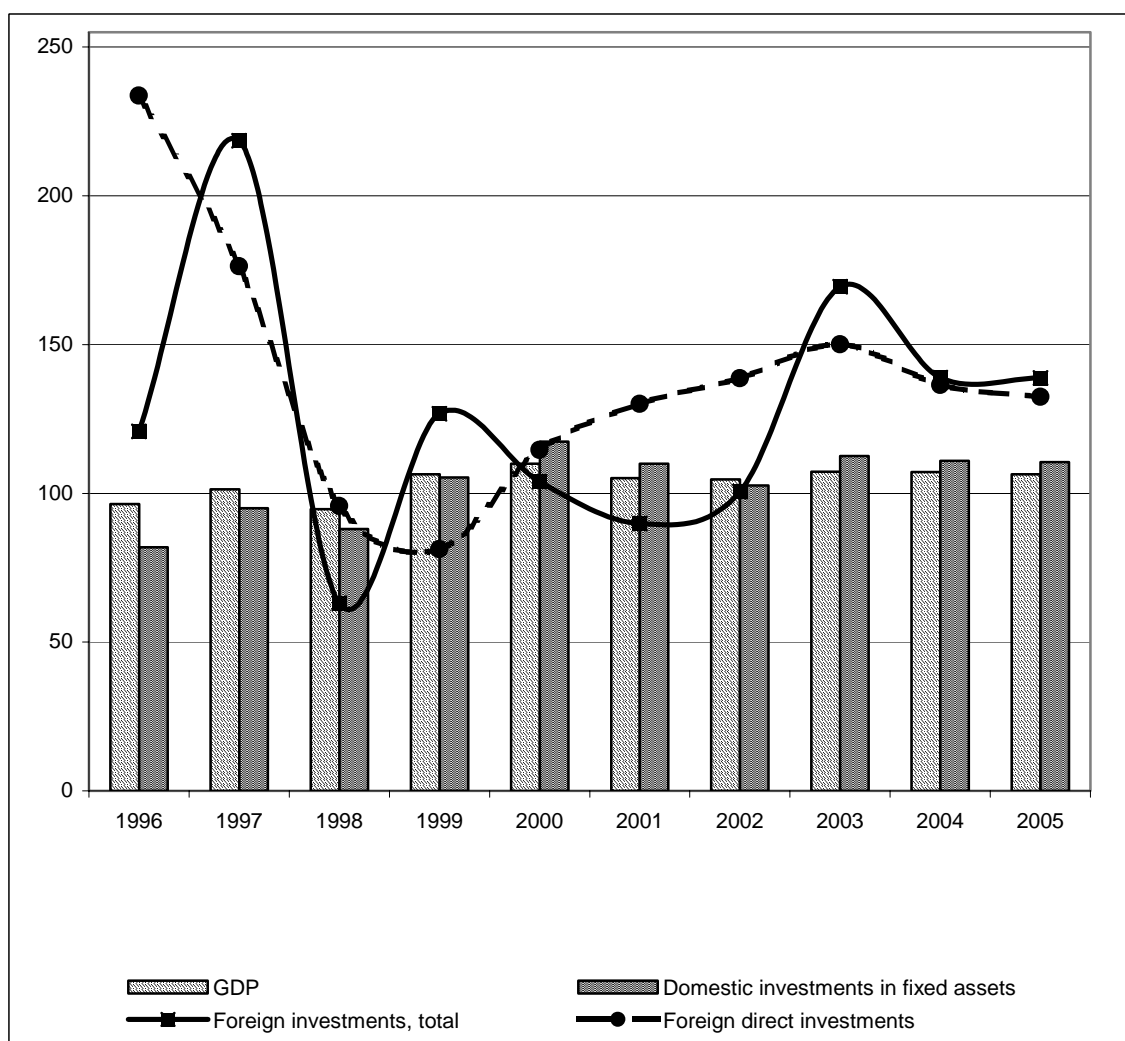
Source: Rosstat.

Fig. 39. Changes in the Structure of Investments in Fixed Assets as broken down by the Types of Economic Activities in January through September of 2005, in per cent of the Figures Registered in the Respective Period of 2004

3.3.2. Flows of Foreign Investments in the Russian Economy

In the process of formation of a market economy and active involvement of Russia in the system of the global economy, there has been increasing the interest of foreign capital in the receptive and promising Russian market. The moderate dynamics of foreign investments in the Russian economy observed in the post-crisis period of 1999 through 2002 was replaced with a trend towards the outpacing rates of growth in foreign direct investments with respect to the rates of expansion of the scale of the domestic capital and GDP dynamics in 2003 through 2005. The share of foreign investments in the total amount of investments in fixed assets made in the Russian economy increased from 4.7 per cent registered in year 2000 to 5.9 per cent in 2004, whereas in 2005 in accordance with preliminary estimates it made 5.3 per cent. No doubt, the investment attractiveness of the Russian economy was positively affected by the fact that in 2003 and 2004 foreign rating agencies (Fitch, Standard & Poor's, and Moody's) raised Russia's sovereign credit rating to investment grade. However, in 2005 there was observed a decline in the flow of foreign investments in the Russian economy, even in spite of the fact that three leading rating agencies had raised Russia's investment rating. In August of 2005, agency Fitch and in

October agency Moody's raised Russia's rating one notch over the minimal "investment" grade. Evidence of the growing confidence of foreign investors making direct investments in the Russian economy was the position Russia had in the Foreign Direct Investment Confidence Index published in November of 2005 by the global management consulting firm A. T. Kearney: last year Russia was for the first time ever ranked as the 6th most attractive market globally (in 2004 it was ranked 11th, in 2003 – 8th, in 2002 – 17th, in 2001 – 32nd)⁵.



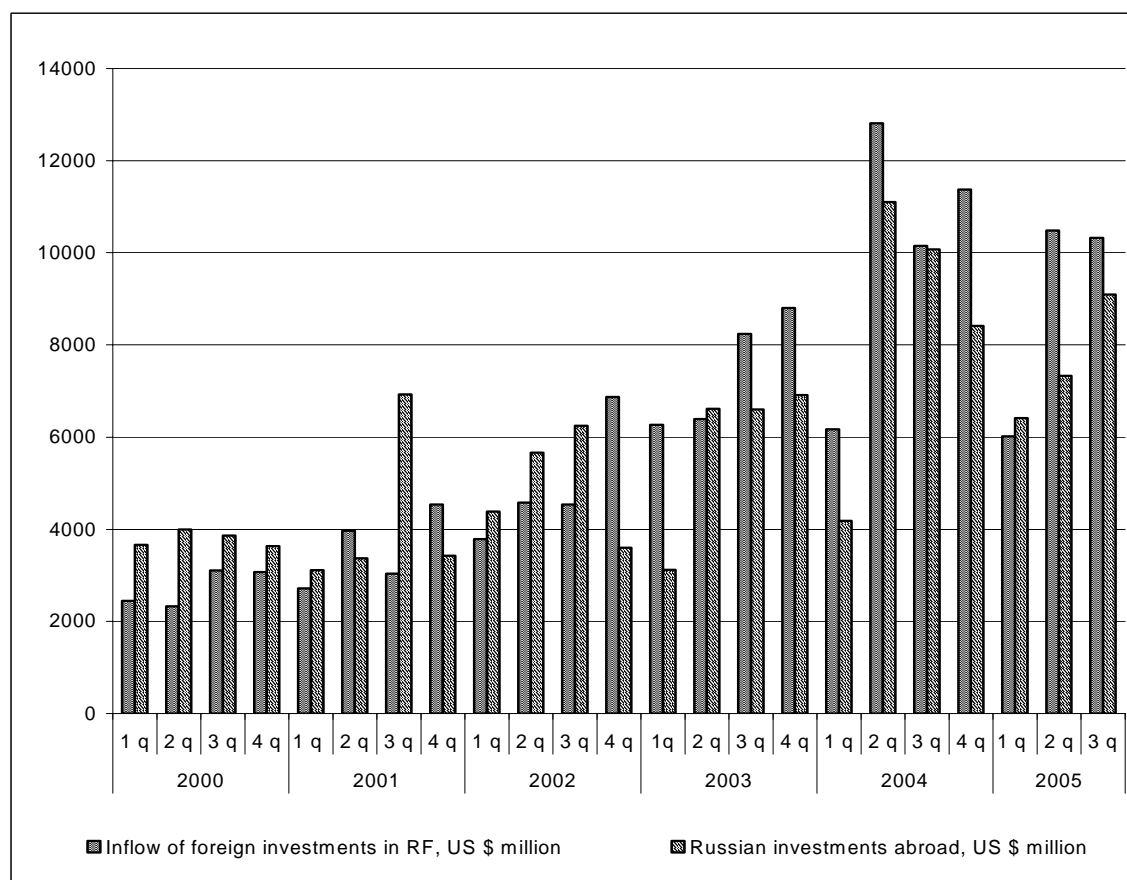
Source: Rosstat.

Fig. 40. Indices of GDP Volumes, Investments in Fixed Assets, and Foreign Direct Investments in 1996 through 2005, in per cent of the Figures Registered in the Preceding Year

Over the last three years, in Russia there persisted a trend towards the excess of foreign investment inflowing in the Russian economy over the investments taken from Russia abroad. In January through September of 2005, the investments in the Russian economy

⁵ The rating characterizes investment attractiveness of countries of the world by reflecting not the current amounts of foreign direct investments, but only moods and intentions of investors.

exceeded the amount of investments exported from the country by US \$ 4 billion, whereas in 2004 this indicator was registered to be at US \$ 6.74 billion.



Source: Rosstat.

Fig. 41. Foreign Investments in Russia and Russia's investments abroad in 2000 through 2005, US \$ billion

As concerns the changes in the structure of foreign investments, the specific feature here was the persistence of the trend towards an increase in the share of direct investments formed in 2003. In 2005, the growth in foreign direct investments made 38.9 per cent, and the share of such investments in the total amount of foreign investments increased to 24.4 per cent as compared with 23.3 per cent registered a year ago. The total amount of foreign investments made in the non-financial sector of the Russian economy amounted to US \$ 53.65 billion growing by 32.4 per cent. In contradistinction to the developments observed in the preceding year, the positive dynamics of growth in portfolio investments have recovered, whereas the rates of increase in "other" investments have become more moderate⁶.

⁶ Investments not defined as direct or portfolio investments are indicated as "other investments" and include all operations not associated with direct and portfolio investments. "Other investments" are classified by the types of respective financial instruments: loans and borrowings; trade credits, credits granted not by direct investors, for instance, by international financial organizations: World Bank, International Monetary Fund, International Bank of Reconstruction and Development, European Bank of Reconstruction and Development, the credits extended by foreign governments against guarantees of the Government of the Russian Federation, etc.

The opposing dynamics of changes in the ratio between direct and “other” investments had resulted in changes in the structure of foreign investments in Russian industry.

Table 33

Amount of Foreign Investments Made in the Non-Financial Sector of the Russian Economy

	US \$ mil.				In % of the figures registered in the preceding year			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
2001	14 258	3 980	451	9 827	130.1	89.9	71.5	153.9
2002	19 780	4 002	472	15 306	138.7	100.6	104.7	155.8
2003	29 699	6 781	401	22 517	150.1	169.4	85.0	147.1
2004	40 509	9 420	333	30 756	136.4	138.9	83.0	136.6
2005	53651	13072	453	40126	132.4	138.8	136.6	130.3

Source: Rosstat.

In 2005, there persisted the trend towards the concentration of foreign investments in two spheres of the Russian economy: in industry (45.3 per cent of the total amount of foreign investments) and the sphere of trade (38.1 per cent, see *Table 34*). At the same time, it should be noted that the dynamics and changes in the shares of investments in industry are increasingly affected by the enhancement of investment attractiveness of new segments of the market of services. For instance, the share of investments in communications as one of the most dynamically developing types of economic activities increased from 3.4 per cent registered in 2004 to 6.1 per cent in 2005.

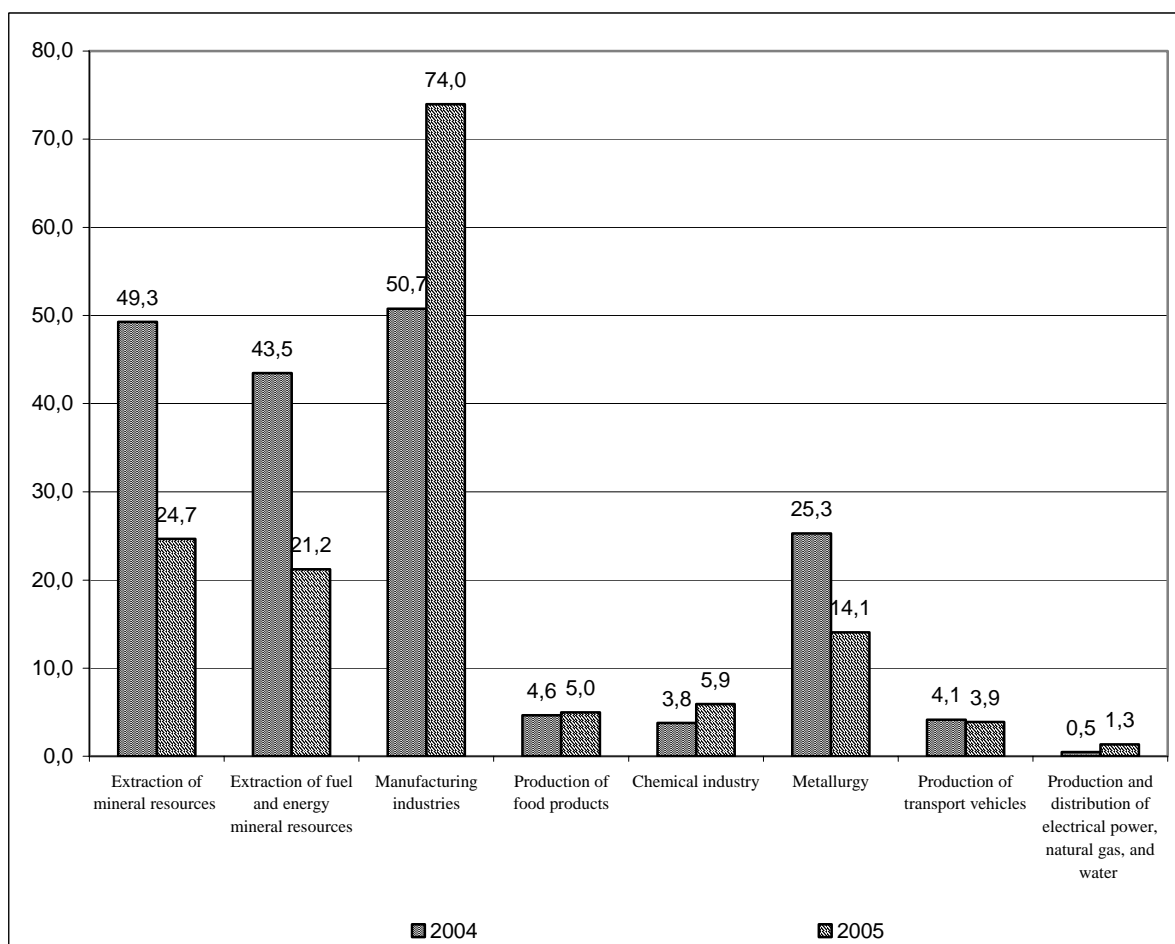
The decline in the share of investments in industry in the total amount of foreign investments inflowing in the country was accompanied by cardinal transformational shifts in the ratio between the extractive and manufacturing industries. While the amount of investments in the extraction of fuel and energy mineral resources decreased from US \$ 8766 million in 2004 to US \$ 5165 million in 2005, investments in manufacturing industries grew 1.76 times and made US \$ 17987 million. In 2005, there was registered an increase in the activity of foreign investors with respect to the production of food products, chemicals, transport vehicles, and equipment. At the backdrop of stabilization observed with respect to the foreign direct investments in extractive industries, there was registered almost threefold drop in the scale of “other” investments made in this sphere, what completely accounts for the changes in the dynamics of investments in the extraction of mineral resources. As concerns the manufacturing industries, there was registered the simultaneous growth in both direct foreign investments (US \$ 6028 million in 2005 as compared with US \$ 2911 million in 2004), and “other” investments (US \$ 11837 million as compared with US \$ 7196 million respectively). The largest share of “other” investments was observed in the metallurgical and chemical industries, as well as production of transport vehicles. As it seems these developments were related to the increasing amounts of tied credits against goods.

Table 34

The Sectoral Structure of Foreign Investments Made in the Russian Economy as broken down by the Types of Activities in 2003 through 2005, in per cent

	US \$ mil.			In % of the total		
	2003	2004	2005	2003	2004	2005
Industry	12 330	20 170	24318	41.5	49.8	45.3
Transport and communications	1 083	2 033	3840	3.6	5.0	7.2
Wholesale and retail trade; repairs of motor vehicles, motorcycles, household appliances, and personal demand items	10 516	13 037	20461	35.4	32.2	37.2
Real estate operations, renting and rendering of services	3 403	2 572	2602	11.5	6.3	3.4
Financial operations	640	1 001	1823	2.2	2.5	4.8
Other sectors	1 727	1 697	381	5.8	4.2	1.2

Source: Rosstat.



Source: Rosstat.

Fig. 42. Sectoral Structure of Foreign Investments in Industry in 2004 through 2005, in per cent of the Total Amount of Investments in Industry

As concerns the dynamics of foreign investments as broken down by Russia's regions, large financial and industrial centers have retained their leading positions. It should be noted that in 2005 there was observed that investments shifted from peripheral regions to central regions. The bulk of foreign investments had been traditionally made in Moscow and the Moscow oblast. In 2005, the amount of investments flowing in Moscow increased 1.64 times and exceeded US \$ 25.2 billion, whereas the amount of investments made in the Moscow oblast grew 1.5 times and made US \$ 2.7 billion. In 2005, Moscow accounted for 47.0 per cent of the total amount of foreign investments as compared with 37.9 per cent registered in 2004, whereas the respective figures for the Moscow oblast made 5.1 per cent and 4.5 per cent respectively. The investment attractiveness of the North West federal okrug had increased. The inflow of investments in St. Petersburg grew 1.44 times making US \$ 1.4 billion, whereas the amount of investments made in the Leningrad oblast increased 2.2 times in comparison with the levels observed in the preceding year and made US \$ 351.2 million. Oil and natural gas producing regions retained their investment attractiveness: the Sakhalin (US \$ 4861.6 million), Tyumen (US \$ 3433.3 million), and Arkhangelsk (US \$ 642.3 million) oblasts, as well as the territories with high concentration of metallurgical production facilities – the Krasnoyarsk krai (US \$ 660.7 million) and the Vologda oblast (US \$ 450.9 million). The scale of investments in the traditional centers of mechanical engineering (the Sverdlovsk oblast – US \$ 1093.8 million and Samara oblast – US \$ 922.6 million) had increased. This year, the Omsk oblast demonstrated the most intensive dynamics – the amount of investments in this region grew 4.75 times in comparison with the figures registered in 2004 and made US \$ 5145.8 million, or 9.6 per cent of the total amount of foreign investments (in 2004 the respective indicator was observed to be at 2.7 per cent).

Table 35

Structure and Rates of Growth in Foreign Investments Made in the Russian Economy as broken down by Federal Okrugs

	Structure, in % of the total		Rates of growth, 2005 as compared with 2004
	2004	2005	
Russian Federation	100	100	132.4
Central federal okrug	47.6	53.9	150.1
North West federal okrug	7.1	6.5	120.9
Southern federal okrug	1.8	1.7	143.4
Privolzhski federal okrug	5.9	4.1	90.0
Ural federal okrug	17.4	10.0	76.3
Siberian federal okrug	7.8	12.6	215.3
Far East federal okrug	12.5	11.1	117.0

Source: Rosstat.

As concerns the geographical structure of foreign investments made in the Russian economy in 2005, Luxemburg (25.7 per cent of the total amount of foreign investments made in the Russian economy), the Netherlands (16.6 per cent), and Great Britain (16.0 per cent) were registered as the major investing countries. As at the end of 2005, the amount of accumulated foreign capital made US \$ 111.8 billion, what was by 36.3 per cent above the figures registered in the beginning of 2005. In terms of accumulated capital, Luxemburg, Cyprus, and the Netherlands retained their leading positions, whereas Cyprus

(28.0 per cent) and the Netherlands (32.4 per cent) remained leaders in terms of the amounts of accumulated foreign direct investments.

Table 36

Structure of Accumulated Foreign Investments as broken down by Major Investing Countries in 2005, US \$ mil.

	Accumulated		Including			Invested	
	total	in % of the total	direct	portfolio	other	2004	2005
Investments, total	111835	100	49751	1903	60181	40509	53651
Of which, from major investing countries	99214	88.7	43492	1640	54082	35088	46389
Including:							
Luxemburg	20984	18.8	451	1	20532	8431	13841
Cyprus	19279	17.2	13915	883	4481	5473	5115
Netherlands	18909	16.9	16125	31	2753	5107	8898
Great Britain	12752	11.4	2044	144	10564	6988	8588
Germany	9726	8.7	2714	29	6983	1733	3010
USA	6844	6.1	4361	404	2079	1850	1554
France	3918	3.5	905	0.0	3013	2332	1428
Virgin Islands (Brit.)	2463	2.2	1200	61	1202	805	1211
Switzerland	2364	2.1	1128	85	1151	1558	2014
Bahama Islands	1975	1.8	649	2	1324	n/a	730

Source: Rosstat.

The changes in the dynamics of foreign investments made in the Russian economy were accompanied by certain shifts in sectoral priorities. The increase of investments from the Netherlands 1.74 times in comparison with the figures registered in 2004 occurred as the backdrop of an intensive growth in investments in manufacturing industries, whereas the amount of investments in the extraction of mineral resources grew insignificantly from US \$ 3296 million to US \$ 3799 million in 2004. Investors from Great Britain increased their presence in manufacturing industries: the amounts of respective investments grew 1.67 times in comparison with the figures observed in the preceding year.

Table 37

Inflow of Foreign Investments as broken down by Investing Countries and Types of Activities in 2004 through 2005

	Invested, US \$ mil.		In % of the total by the type of activity	
	2004	2005	2004	2005
1	2	3	4	5
Extraction of mineral resources	9934	6003	100	100
including:				
Netherlands	3296	3799	33.2	63.3
Luxemburg	3814	413	38.4	6.9
Cyprus	1294		13.0	
Manufacturing industries	10236	17987	100	100
including:				
Netherlands	n/a	4179	n/a	23.2
Great Britain	1794	3175	17.6	17.7

	1	2	3	4	5
Cyprus		1690	1608	16.5	8.9
Germany		n/a	1528	n/a	8.5
Chemical production		n/a	1440	100	100
including:					
Switzerland		n/a	437	n/a	30.4
Great Britain		n/a	239	n/a	16.6
Germany		n/a	213	n/a	14.8
Metallurgical production and production of finished metal products		5102	3420	n/a	100
including:					
Great Britain		1386	650	n/a	19.0
Netherlands		n/a	450	n/a	13.2
France		n/a	399	n/a	11.7
Cyprus		1175	348	n/a	10.2
Wholesale and retail trade; repairs of motor vehicles, motorcycles, household appliances, and personal demand items		13037	20461	100	100
including:					
Luxemburg		2988	12009	22.9	58.7
Great Britain		3729	3315	28.6	16.2
Cyprus			1841		9.0
Transport and communications		2033	3840	100	100
including:					
Luxemburg		784	1215	38.6	31.6
Great Britain		481	1135	23.7	29.6
Netherlands		n/a	492	n/a	12.8
Of which communications		n/a	3287	100	100
including:					
Great Britain		419	1134	30.4	34.5
Luxemburg		784	1123	56.9	34.2
Netherlands		n/a	377	n/a	11.5

Source: Rosstat.

The most active cooperation with foreign companies and firms in the framework of the largest investment projects implemented in the territory of Russia was observed in oil and natural gas production, aircraft and motor industries, the agri-industrial complex, and food industry, as well as in the sphere of communications.

As concerns the factors positively affecting the investment attractiveness of the Russian economy, potential investors rank first the significant capacities of the Russian sales markets of both consumer and industrial goods, high rates of economic growth, and the gradual decrease in the rates of inflation. According to investors' evaluations, the situation in Russia is rather favorable with respect to such indicators as profitability of investment projects and the conditions of conduct of business. In the world community, there is gradually forming a positive image of Russia. Among the major competitive advantages of Russia, there may be listed the following: skilled work force, high rates of growth of the economy, high scientific capacity, and significant reserves of natural resources. Several structural reforms are implemented in order to improve the investment climate in the country. Special attention is paid to the reform of state administration aimed at the reduction of the excessive interference of the state in the economy.

3.4. Russian Agrifood Sector: Basic Trends in 2005

3.4.1. Dynamics and Factors of Growth

No important changes have taken place in the dynamics of Russian agrifood sector in 2005 – the average growth rates remained quite low (*Fig. 43* and *44*). The pre-reform production volumes in agriculture and food industry have been restored by approximately 74%. Annual output indicators for basic livestock products are falling (*Fig. 45*) while crop production displays some growth that is still not sufficient to change the situation radically (*Fig. 46*). The export-import balance for agricultural and food products continues to worsen, first of all due to growing imports.

In addition to intra-sector factors, growth was strongly hindered by macroeconomic trends. The strengthening of ruble by 3–5% impaired the competitiveness of domestic products on the home market and the competitiveness of exported products on the world markets. The rising prices for fuels and oils lower profitability of grain production and *ceteris paribus* induce contraction of areas planted in grain crops being one of the foundations of Russian agriculture.

At the same time structural shifts are taking place that enable us to speak of positive developments in the sector. As mentioned earlier⁷, the process of sharp differentiation of producers is underway – some of them are actively developing, modernizing production and involving investments while others become more and more marginal and go bankrupt. The latter segment of the agrifood sector pulls the average efficiency and growth indicators down.

Producers' differentiation proceeds in line with further shaping of regions with intensive farm production. Just 7 regions – Moscow, Leningrad and Novosibirsk oblasts, Krasnodar and Altay krais, Tatarstan and Bashkortostan republics – currently produce one third of the country's milk output. In 2005 milk production in these regions grew by an average 0.6% while the total national indicator fell by 3%. According to data of the Federal Service of State Statistics, 1/5 of domestic whole milk products is produced in 3 regions – Moscow, Saint Petersburg and Krasnodar kray. The concentration is all the more noteworthy as in the Soviet economy production of milk was dispersed all over the country and in the last decade of Soviet period milk cattle inventories demonstrated the biggest increase in Magadan and Murmansk oblasts, in Kamchatka and Sakhalin. In other words, zones of intensive production of some agricultural products are forming. These regions have better average indicators of productivity and profitability; although their growth rates may be not impressively high, it's quite explainable given relatively large production volumes.

The sector structure of agriculture is shaping as well: some sectors prove their competitive advantages on international and domestic markets while others are shrinking at a higher or lower pace. For instance, the output of sunflower seeds, vegetables and potatoes is growing and is now above the Soviet period level. Production of grain is primarily constrained by domestic demand limitations and vague perspectives on the world market.

Despite generally poor performance of the livestock sector, some segments therein demonstrate very high growth. For instance, the annual growth rates in poultry meat production amounted to 17%. The intensive production of pork is growing as well.

The situation in food industry is similar. Output of some products (e.g. vegetable oils and white sugar) has already surpassed the pre-reform level. Production volumes of some products have been nearly restored – e.g. sausages, pastas, margarine and some other

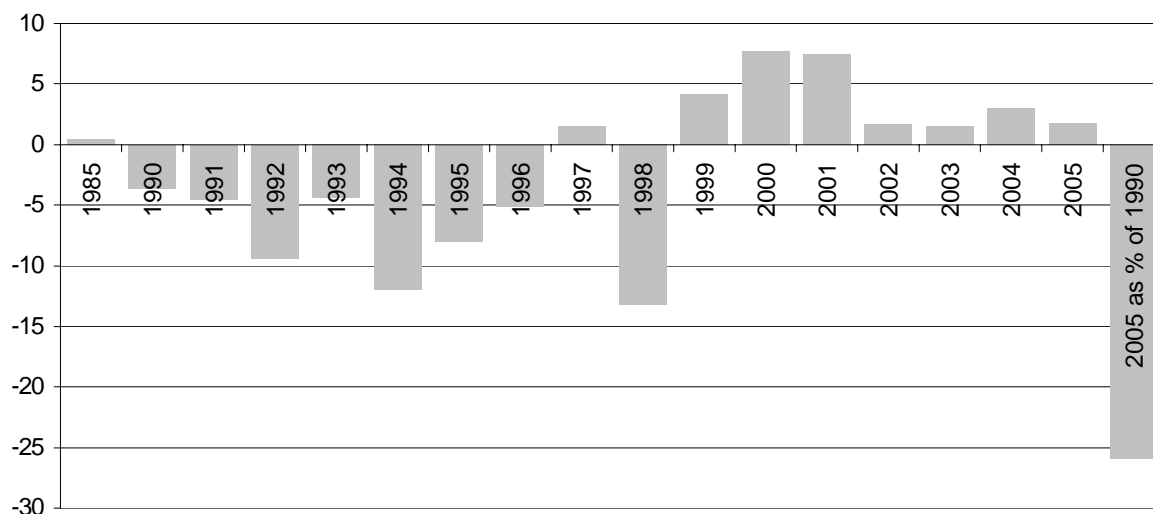
⁷ «Russian economy in 2003. Trends and prospects». No. 25. Moscow, IET, 2004.

products. Production of meat and milk products is constrained by population's purchasing power but is still growing (*Table 38*).

Real personal incomes increased by 8.8%, retail food turnover – by 10.6%. Faster growth of retail turnover as compared with real personal incomes is most likely due to accelerated growth of incomes in the three lower quintile income groups (e.g. real pensions were up 9.6%, Gini coefficient reduced from 0.408 to 0.404, ratio of incomes in the top and the bottom income groups – from 15.1 to 14.7) where the elasticity of demand for food is the highest. This fact can also be one of the explanations of speedy rise of prices for meat being one of the most income elastic products. The structure of meat consumption is optimizing. In Russia the share of beef in the overall meat consumption is very high. In 2005 sales of poultry grew faster than total meat sales (by 10.3% versus 5%). At the same time, the demand for cheese and fruits (products that are largely consumed by higher income groups) expanded even more – by 10% and 11.4% respectively.

A positive development factor was a certain improvement in rural social sphere. For the first time wages in agriculture grew faster than in mining or manufacturing (November 2005/ November 2004). Wages earned in farm production still constitute the basis of rural residents' well being. Employment in rural areas was up 1.6 percent points as compared with 2004. Although the shifts are not yet large, it's the trend that is important.

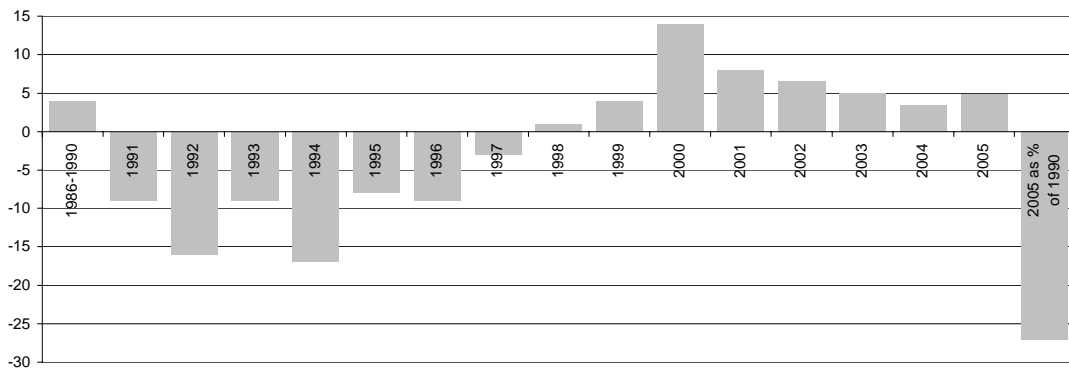
All these positive processes are going on in spite of an actual withdrawal of federal authorities from agrifood sector regulation. Budget support of the sector is in fact transferred to the regional level while measures still implemented at the federal level are largely non-efficient.



Source: Federal Service of State Statistics.

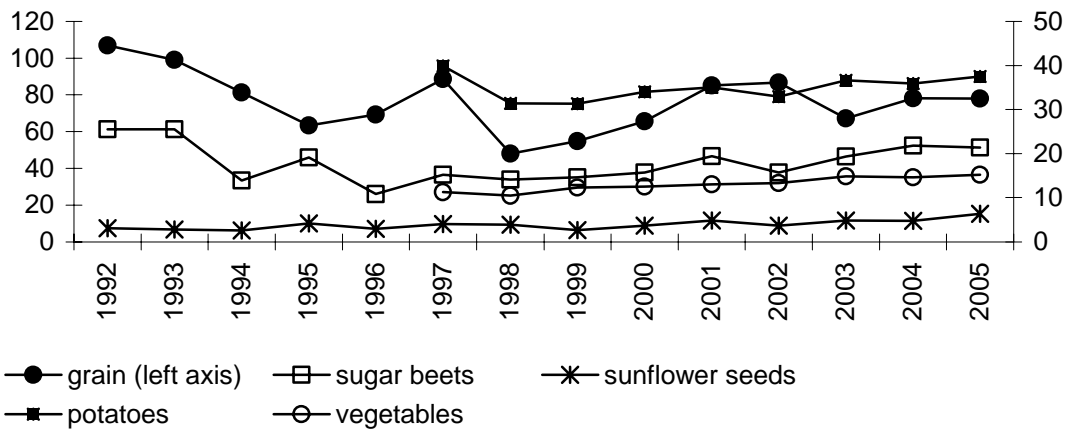
Fig. 43. Russian Agriculture: Percent Change of Annual Output in 1985–2005

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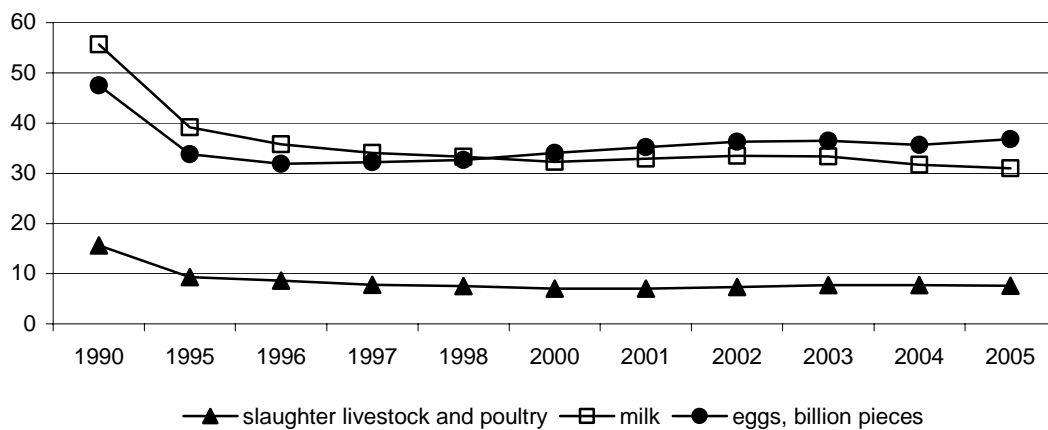
Source: Federal Service of State Statistics.

Fig. 44. Russian Food Industry: Percent Change of Annual Output in 1986–2005



Source: Federal Service of State Statistics.

Fig. 45. Gross Output of Basic Farm Crops (million tons)



Source: Federal Service of State Statistics.

Fig. 46. Gross Output of Basic Livestock Products (million tons)

Table 38

Production of Basic Food Products

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 I-XI
Meat, thous. t.	6484	2370	1900	1510	1315	1113	1193	1284	1456	1677	1698	1827
Sausages, thous. t.	2283	1293	1296	1147	1087	948	1052	1224	1468	1700	1832	1957
Butter, thous. t.	833	421	323	292	276	262	267	271	279	285	271	277
Whole milk products in milk equivalent, million t.	20.8	5.6	5.3	5.2	5.6	5.6	6.2	6.7	7.7	8.5	8.7	9.5
Vegetable oils, thous. t.	1159	802	879	687	782	881	1375	1281	1197	1598	1867	2206
Granulated sugar, thous. t.	3758	3155	3294	3778	4745	6808	6077	6590	6165	5841	4852	5588
Flour, million tons, thous. t.	20.7	14	11.8	12.2	12	12.7	12.1	12	10.9	11.2	10.8	10.2
Cereal products, thous. t.	2854	1418	988	992	1085	899	932	994	951	890	893	926
Pastas,	1038	603	444	453	554	707	704	764	821	874	950	982
Margarine products, thous. t.	808	198	200	222	239	379	462	515	536	542	561	630

Source: Social and economic situation in Russia (respective years).

Table 39

**Production of Agricultural Inputs: Machinery (Thousand Pieces)
and Mineral Fertilizers (Million Tons)**

	1990	1995	2000	2001	2002	2003	2004	2005
Tractors	214	21.2	19.2	14.2	9.2	8.1	8.7	5.5
Tractor ploughs	85.7	4	2.8	3.1	2.3	1	1.2	1.8
Tractor seeders	51.1	1.6	5.2	6.4	5.3	4.2	5.7	6.5
Tractor cultivators	101	2	4.7	5.6	5.6	6.2	6.7	8.6
Grain harvesters	65.7	6.2	5.2	9.1	7.5	5.4	7.9	7.5
Mineral fertilizers	16.0	9.6	12.2	13.0	13.6	14.1	15.7	16.6

Source: Social and economic situation in Russia (respective years).

3.4.2. Financial Performance of Russian Agriculture

The process of bankrupting farm producers has started: while in 2004 3455 bankruptcy proceedings against agricultural entities were initiated, by early November 2005 6210 bankruptcy cases were under examination. It had a positive effect on the sector's average financial performance (Table 40). The share of profitable farms increased while the total credit indebtedness fell. By the beginning of 2005 77% of farms had overdue debts, by August – only 70.7%.

It's customary to think that the crucial factor of improving agriculture's financial performance is the implementation of farm debts' restructuring program that continued in 2005. According to data of the RF Ministry of Agriculture, by the 1st of October about 12 thousand farms (almost half of their total number) signed debt restructuring agreements. The amount of restructured debts of farms that signed the agreements totaled 81.7 billion rubles (including 43.4 billion rubles of fines and penalties of which 28.2 billion rubles were written off). Given that the credit indebtedness of farms reduced by only 22 billion rubles.

This proves the assertion not once made in our earlier surveys that the restructuring of debts of some marginal producers results in an almost proportional marginalization of pre-marginal producers and does not notably improve the sector's average performance.

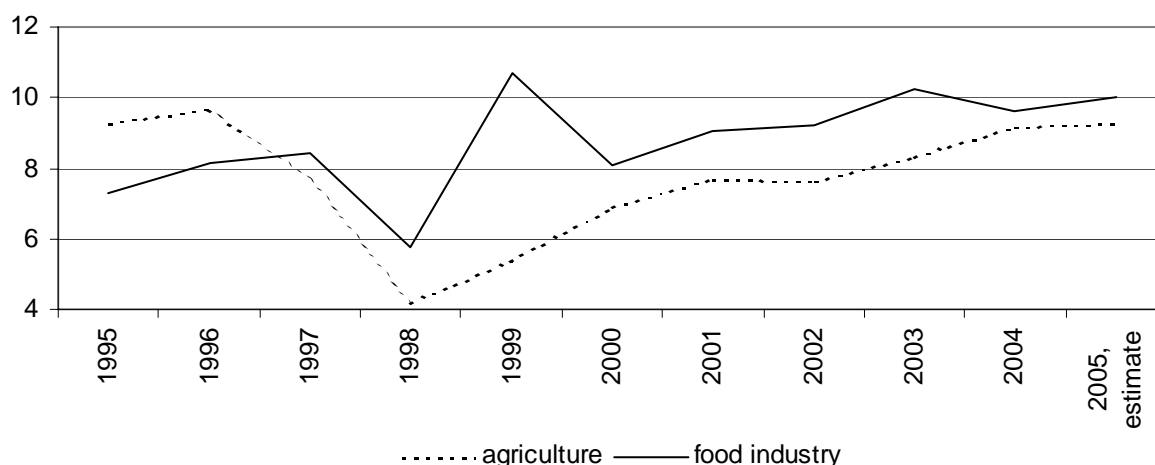
To all appearance, the improvement of the sector's financial performance in general is due to the increase of efficiency in the upper producer groups, their higher attractiveness for investors. In 2005 investments in fixed capital expanded by 16.8% (9 months 2005 versus 9 months 2004). Beginning from 2002 the amount of foreign investments grows not only in food industry but also in primary agricultural production. Although in 2005 foreign investments in agriculture are likely to be somewhat below the 2004 level, they still constitute 3% of the total foreign investments in Russian economy.

Table 40

Financial Performance of Corporate Farms

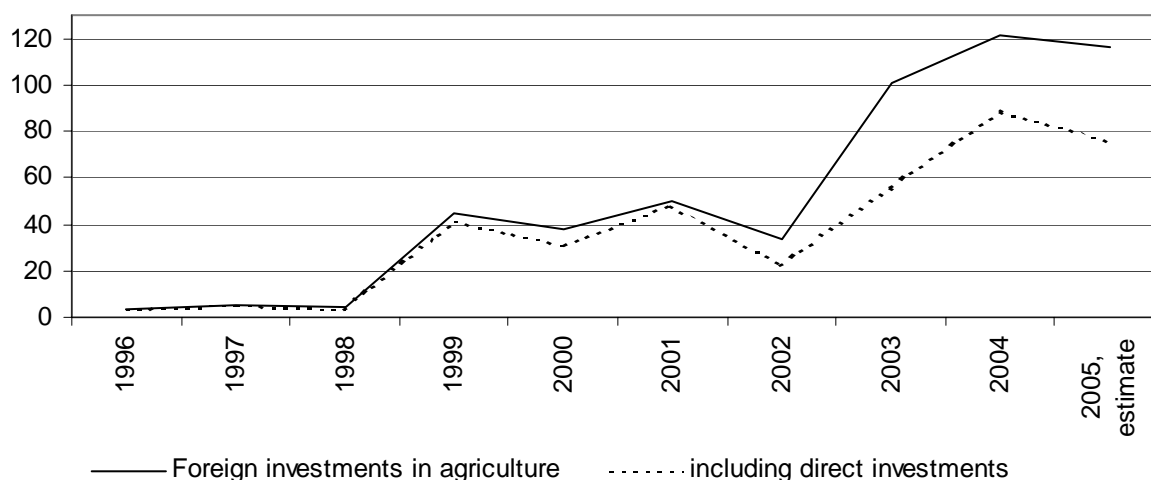
	2000	2001	2002	2003	2004	I-IX, 2005
Aggregate profitability (including subsidies and compensations), %	6.7	9.2	0.2	3	6.4	n.a.
Financial balance (profit less loss), billion rubles	16.1	25.6	-1	2.2	34.7	32.3
Share of profitable farms, %	47	44	42	49	62.2	66.1
Number of farms having overdue debts, thousand	23.9	23.0	21.8	18.9	16.5	13.5
Overdue credit indebtedness, billion rubles	144.1	162.9	162.3	149.9	113.9	91.3

Source: Federal Service of State Statistics, www.gks.ru.



Source: Federal Service of State Statistics, www.gks.ru.

Fig. 47. Investments in Agrifood Sector's Fixed Capital, Billion Rubles (Constant 1995 Prices)



Source: Federal Service of State Statistics, www.gks.ru.

Fig. 48. Foreign investments in Russian Agriculture, Million US Dollars

3.4.3. Novelty of Domestic Agrifood Policies

Shifting of Farm Sector Regulation to the Regional Level

Radical changes have taken place in the mechanism of budget allocations to agriculture. In compliance with Federal Law No. 95 of July 4, 2003 and Federal Law No. 199 of December 29, 2004 the subsidizing of agriculture was transferred to the competence of Federation's members. These laws delineate farm sector regulation competences only for 2005 but the draft budget law for 2006 also bases on their provisions. The granting to regions of exclusive powers to regulate agriculture will have the most destructive effect on the sector. First of all, regions-donors able to finance support to agriculture on their territories are primarily located in the climatic zones that are the least fit for farming. The shifting of farm budget support's gravity center from the federal to regional level leads to encouraging of agricultural production in these regions implying non-efficient public resource utilization.

The share of farm sector in the economy of regions, having the highest budget capabilities to finance it, is generally low. It's objectively conditioned by the fact that these regions are located in areas with the worst natural conditions for agricultural production. Picture 7 shows the distribution of Russian regions by their budget capabilities⁸ and the role of farm sector in the economy⁹. It's obvious that the correlation between these two indicators is clearly negative.

According to these indicators all Russian regions can be divided in 4 groups. Since the area of regions in Figure 49 stretches from the left upper corner to the right lower corner, groups 1 and 3 are more numerous than the two remaining.

⁸ Index of budget capabilities: $Find = EXPind + TRANSFind$; $EXPind = \frac{EXP_{2002-2004}}{N_{2002-2004}}$, where $EXP_{2002-2004}$ – average expenditures of regional budget in 2002–2004, $N_{2002-2004}$ – region's population in 2002–2004; $TRANSFind = \frac{TRANSF_{2002-2004}}{EXP_{2002-2004}}$, where $TRANSF_{2002-2004}$ – average transfers to the region's budget from the federal budget in 2002–2004.

⁹ Index of farm sector's role in the economy: $AGRind = \frac{AGR_{2002-2003}}{GDP_{2002-2003}}$, where $AGR_{2002-2003}$ – average gross agricultural output, $GDP_{2002-2003}$ – average gross regional product in 2002–2003.

In 2005 after the transfer of farm support competence from the federal level, agricultural production started to shift towards non-agrarian regions with high budget capabilities (*Table 41*). The regionalization of support has not affected the geographic location of grain growing since regional subsidies are primarily allotted to livestock production. The role of high-income non-agrarian regions in the total Russian meat output notably grew – in 2005 their share in the total production of livestock and poultry for slaughter increased by 3.4% as compared with the average share in 2002–2004.

The presented results show only the general trend – a serious shift of production could not occur in just one year. But even this minor shift resulted in a certain loss of the sector's efficiency and one should understand that as time goes both the shift and the efficiency loss will become greater.

Second, for already many years regional support results in “trade wars” between regions, attempts to oust neighbors from the market by means of direct subsidies to local producers, bans on agricultural and food products' transit, etc. And all this took place despite high share of federal funds. The transfer of agricultural financing authority to regions will support the trend. In other words, this decision of the RF Government brings in the domestic market all the negative effects of protectionism on the world agricultural markets that the WTO Agreement on Agriculture strives to eliminate (meanwhile Russia wants to join this organization with its anti-protectionism principles).

The need to preserve at least some functions in subsidizing of agriculture in order to prevent the above mentioned negative effects made the Ministry of Agriculture change the system of subsidizing by partially transforming subsidies into inter-budget transfers to the agrifood sector. Beginning from 2006 subsidizing of pedigree stockbreeding and elite seed breeding, subsidizing of interest rate on credits, support to insurance and even supply of seeds to northern regions are financed only in the form of inter-budget transfers. First, it makes the farm budget non-transparent – less than one half of subsidies to agriculture is financed under the sub-title “Agriculture” of the functional expenditures' classification while the rest is included into the title “Inter-budget transfers”. Second, this type of subsidizing can seriously distort regional agricultural policies. Since federal transfers are granted on the co-financing terms, all regions will start to implement the named programs in order not to lose federal transfers (i.e. each region will have a program of supporting, for instance, production of flax and hemp). The efficiency of respective federal programs as well as of spending regional budget funds on their co-financing will be extremely low. Besides, regions will become short of funds for implementing their own programs that are often more efficient than the federal ones and are more adjusted to regional priorities of agricultural development.

So, the principal problem of agricultural budget is the provisions of Federal Law No. 95. In case they are not abandoned, it will be impossible to implement normal agrifood policies.

Failure to Implement Result-Based Budgeting

The RF Ministry of agriculture has worked out a strategy of agrifood sector development for 2006–2010 coordinated with the principal ministries. But when preparing the draft 2006 budget this strategy hasn't been taken into account. Similar to previous years, there is no cohesion between agrifood policies proclaimed by the Government and budget allocations to their implementation.

According to the elaborated strategy, subsidizing of agriculture is to be financed under the Federal special program “Program of improving the efficiency and development of agriculture's resource potential” incorporating sub-programs of developing livestock production, encouraging grain export, staff education and training, support of small-scale en-

trepreneurship, information services and improvement of soil fertility. But none of the above mentioned items was explicitly included in the draft budget. The budget contains some subsidies to be granted under the program but in other classification sections and not in full. So, the principles of special program budgeting of agrifood sector still remain on paper. There is no cohesion between programs of the Ministry of Agriculture and actual budget expenditures, and thus it's impossible to estimate the efficiency of selected programs and the implementation of strategy at large.

Besides, the strategy itself is inconsistent, the lack of a complex approach to the sector's regulation also prevents from speaking about special program budgeting.

National Project "Development of the Agrifood Sector"

National project "Development of the agrifood sector" became one of the four national priority projects for the coming 2 years the decision about which was taken at the end of 2005.

In the current situation a National project is an attempt to lay down long-term fundamentals of economic development for the period of high budget revenues implying special state financing of the most urgent programs in the national economy. It's obvious that such programs should not be confined to a mere additional funding of programs already being implemented but should rather provide for the solution of some problems that earlier lacked money but can ensure a breakthrough in a certain field. However, a deeper examination shows that all measures proposed in the framework of the National project for the agrifood sector in some way have already been included in the country's recent agricultural policies. So, the message behind adopting the project in its current version is that the present farm policy is absolutely efficient but is short of funds. To our mind, the basic deficiency of the current agricultural policy is not the lack of money but rather its improper use not once stressed in our previous publications.

The project consists of 3 basic components each comprising a set of envisaged measures:

- Accelerated development of livestock production:
 - Subsidizing of 2/3 of interest rate on credits for the term up to 8 years (technical re-equipment);
 - State support of livestock leasing; Abolition of custom duties on technological equipment.
- Facilitation of small-scale farming:
 - Subsidizing of interest on credits to household and individual private farms and their cooperatives to the amount of 100% of Central Bank's discount rate;
 - Concept of developing agricultural supply and consumer cooperatives for small-scale farms.
 - Inviting of young specialists to agriculture (based on providing them with dwellings).

The project's term is 2 years; its funding during this period will amount to 30 billion rubles. It's quite a large sum – in 2006 funds allocated to the National project will account for 20% of the total federal expenditures on agriculture.

The system of subsidizing interest rate on credits to agriculture is implemented in Russia from 2000 and proved to bring good results. Several years ago long-term credits also became eligible for this program. The inclusion of this measure in the National project in general does not raise any doubt. However, slightly over 3 billion rubles per annum are envisaged for this purpose (*Table 42*) although the corresponding 2006 Budget indicator is about 13 billion rubles. In other words, this item of the National project does not seriously influence the level of state support in this field. At the same time, the National project envisages subsidizing of large and long-term (up to 8 years) credits although its own term is only 2 years. This means that investors joining the National project on these terms get

involved in very risky investment projects since there is no certainty about continuation of interest rate subsidizing after the National project's term is over. There is a danger that regional authorities will use "administrative resource" to make large agribusiness companies participate in such projects, and the potential risk will become quite real for them.

The program of developing livestock production envisages rather large investments in import of pedigree livestock. There are plans to buy 100 thousand heads of livestock and to lease them to agricultural producers. (By the way, this is in fact an official admission of the domestic selection's complete failure). One should clearly understand that import of highly productive breeds from abroad *per se* does not guarantee high animal productivity in Russia since the latter is pre-conditioned by compliance with certain technological standards, reconstruction of premises, skilled management. Many Russian regions have already funded import of pedigree livestock from regional budgets but these efforts proved to be non-efficient. Certainly, there are private businesses that are capable to meet all the requirements but the prescribed implementation scheme leaves no hope for success of this particular project component. Indeed, it starts with allocating 8 billion rubles to limited liability company "Rosagroleasing" for the enlargement of its authorized capital. This state corporation is supposed to buy pedigree stock that will be distributed between agricultural producers on preferential terms. Life shows that our agrarian bureaucratic system knows no other way of distribution than the one by so called limits that are set for regions, districts and agricultural producers. This means that pedigree livestock will be supplied not to the farms (or not always to the farms) that are capable to use it properly. "Rosagroleasing" is not interested in the efficient use of received funds: the corporation gets allocations not specifically for leasing operations but for the enlargement of its authorized capital conditioned by conducting of leasing operations. The scope of these operations is expectedly not fixed in the documents.

Purchase of 100 thousand heads of pedigree livestock is proclaimed. It's quite a large number for the respective world market. Experts say that the available supply is shorter. This means that in order to implement the project livestock with worse quality parameters will be bought. Besides, an *a priori* announcement of such a sizeable purchase will inevitably result in higher world prices. In other words, not the best livestock will be bought at overstated prices.

Credits to small producers are to be supported by subsidizing of interest rate that will amount to 100% of the RF Central Bank's discount rate (95% will be funded from the federal budget and 5% – from budgets of the Federation's members). Such a subsidy actually means a negative interest on bank credits. Agricultural producers could enjoy similar super-beneficial credit terms in 1992 (then individual private farmers got credits at 8% per annum while average bank interests were as high as 120%). This resulted in an intense criminalization of the sector, mass abuses, dissipation of resources and finally – in the bankruptcy of Agroprombank. The advocates of this measure proceed from good intention to provide small producers access to bank credit but disregard the fact that there are no barriers to prompt creation of small entities just in order to receive such a beneficial credit. To get the status of a household farm it's enough to buy a house in a village and to till 0.01 ha for planting potatoes.

Similar to its first part, the second part of the National project is also inconsistent. It envisages support to cooperatives marketing milk from households. The authorities still think that rural residents can earn money for decent living by selling milk of 1–2 cows. What's the logic then? On the one hand, we assist development of large-scale production by importing highly productive pedigree livestock for large commodity corporate farms and by facilitating their modernization, and, on the other hand, we support old women with

their tiny milking business. But these are competing sectors. Supporting milk collecting cooperatives we create competitors for large commodity enterprises that will buy imported highly productive dairy cattle. Rural population urgently needs help in the form of providing alternative income sources (the more so in case the first part of the project succeeds – then rural employment will further fall since handling of productive cows at farms with advanced technology requires 3–4 less workers than today) but why should it be solely household milk production?

What are the expected results of all the named measures? 130 thousand stalls are to be created. Let's suppose that half of them will be created in dairy cattle production and the sector will attain the European level of 8 thousand liters of milk produced per cow annually. Even given this super good performance milk output will increase by slightly over 0.5 million tons per annum while currently the gross domestic output of milk exceeds 30 million tons. The outcome of all the planned measures will be the growth of milk output by 4.5% and meat output – by 7% within 2 years. Let's suppose that the profitability of milk production will become incredibly high – 30%. So, the profit from additionally produced milk will be about 5 billion rubles. Even in case milk production will get only one fourth of the National project's funds, the efficiency of their use will be below 100%. The situation for meat is similar.

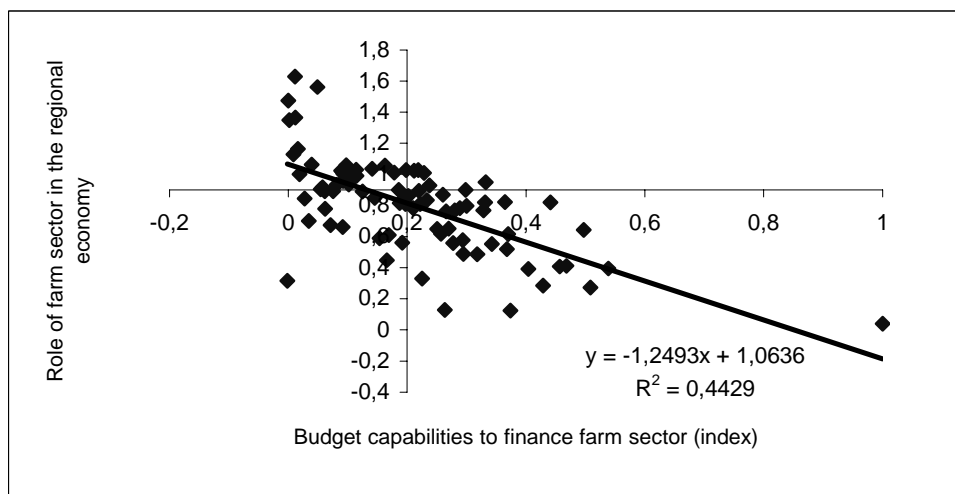
There is one more problem that can have long-term negative effects. The major measure targeted at the development of cooperatives in the framework of the National project is the enlargement of "Rosselkhozbank's" (Russian Agricultural Bank's) authorized capital by 9.4 billion rubles within 2 years. "Rosagroleasing's" authorized capital is also to be enlarged by 8 billion rubles in order to implement such measures as import of pedigree animals and renovation of fixed capital in livestock production. So, the implementation of the National project is largely (56% of the envisaged expenditures) confined to the transfer of budget funds to state corporations-monopolists. The intended monopolization of input and financial markets in agriculture hinders their normal development and affects farm producers' access to these resources.

So, in its present version the proposed National project has very low economic efficiency. To say nothing of the project's objective – it is too non-ambitious and does not go beyond tactical tasks of the sector to be recognized as a national priority for the beginning of XXI century.

Subsidizing of Prices for Fuels and Oils

Farm producers' complaints about growth of prices for fuels and oils could not be ignored in the agricultural policies (*Fig. 53*). The decision was taken to start direct subsidizing of prices for fuels and oils used by farm producers beginning from 2006. 5 billion rubles (about 10% of the federal agricultural budget) are allocated in the budget for partial compensation of their cost. The principal danger of this measure is that no mechanism of control over the use of subsidized fuels and oils is envisaged to prevent their outflow to parallel markets. Similar measure in the West European countries is combined with either distribution of subsidized fuel per hectare of cultivated area or with its colouring. Besides, in Europe this subsidy actually implies an abolition for farmers of very high excise on fuel (about 70%) that coupled with control over use of this fuel exclusively in agriculture results in lower cost of this input. In Russia excise on fuel is not an essential factor of price growth. Since prices for fuel for farm producers tend to rise during periods of mass agricultural works (*Picture 11* illustrates the trend – in 2005 prices for fuels and oils surged in April and October) the main problem is not the price for fuel *per se* but the peak demand for it. Peak demand for fuels and oils coincides with simultaneous sale of farms' output resulting in

seasonal drop of prices for agricultural products. The outcome is price disparity affecting agriculture. Thus the problem should be solved not by subsidizing prices for fuels and oils (the subsidy will eventually outflow to the fuel and energy complex) but by enabling farm producers to extend the sale of their output throughout the marketing year, to get credit on the security of this output and consequently to buy the necessary inputs more evenly during a year.



Source: calculated using data of the RF Ministry of finance and the Federal Service of State Statistics.

Fig. 49. Distribution of Regions by Budget Capabilities and the Role of Farm Sector in the Economy

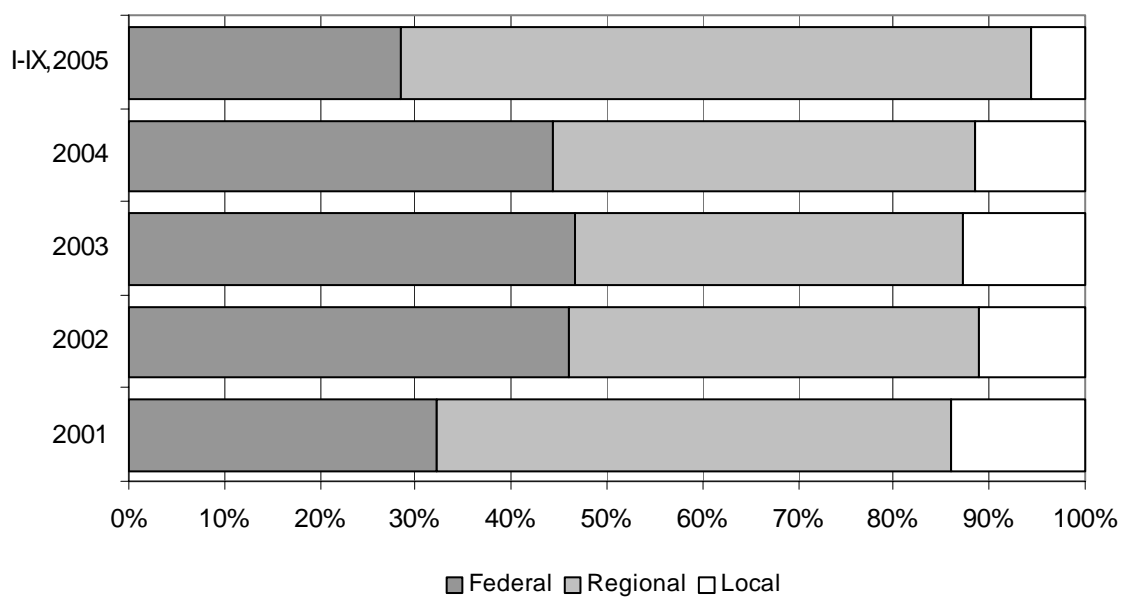
Table 41

The Changing Role of High-Income non-Agrarian Regions in the Total Russian Output of Selected Agricultural Products¹⁰

Group 1. High incomes ($Find > 0.9$), low share of farm sector ($AGRind < 0.2$) Grain: -0.5% Meat: +3,4% Milk: 0%	Group 2. High incomes ($Find > 0.9$), high share of farm sector ($AGRind > 0.2$)
Group 4. Low incomes ($Find < 0.9$), low share of farm sector ($AGRind < 0.2$)	Group 3. Low incomes ($Find < 0.9$), high share of farm sector ($AGRind > 0.2$) Grain: -0,06% Meat: -3,6% Milk: 0%

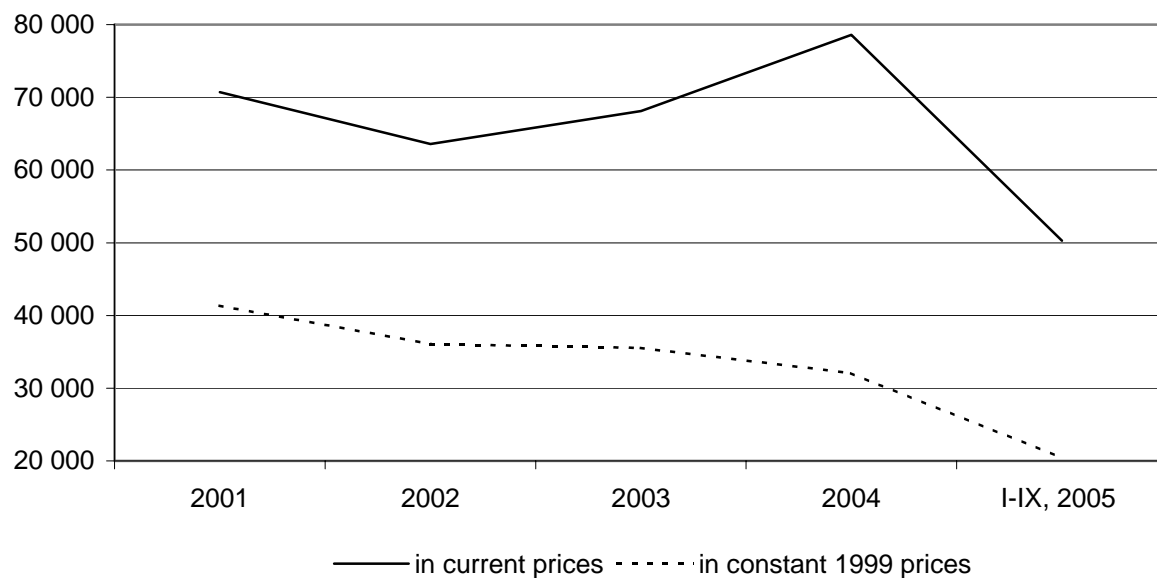
Source: calculated using data of the Federal Service of State Statistics.

¹⁰ The share of N group in the output of a selected product was calculated by formula: $Share = Y_{for N group} / (Q_i / Q_{RF})$, where Q_i – output of this product in i-region, Q_{RF} – total output of this product in Russia.



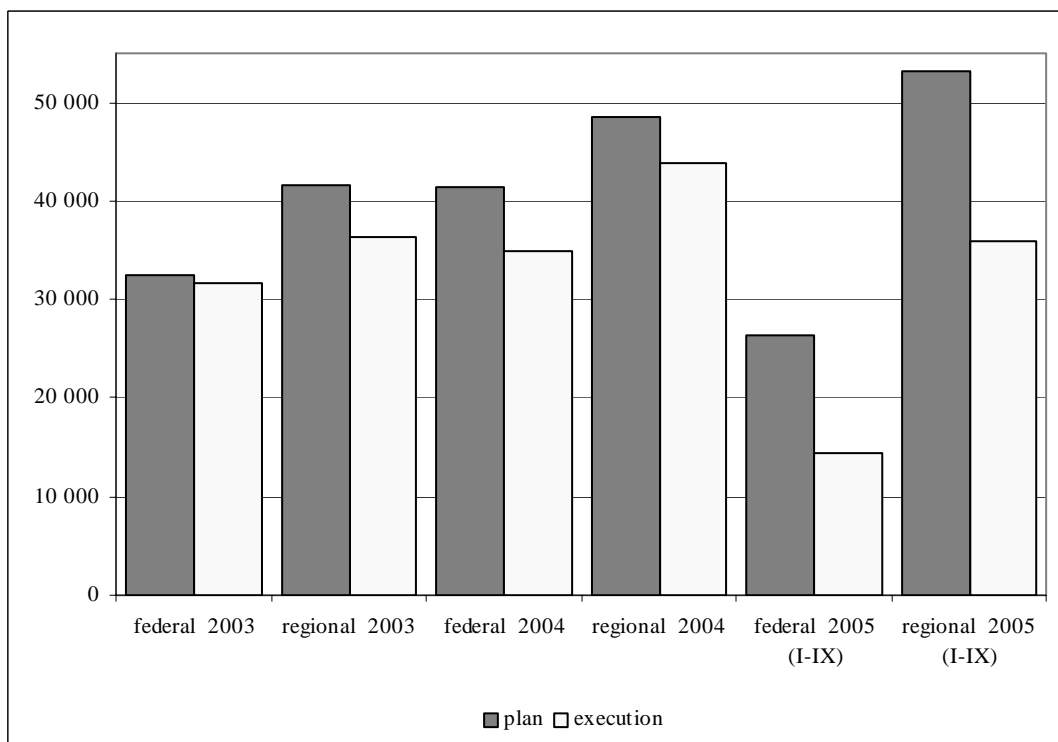
Source: RF Ministry of Finance.

Fig. 50. Structure of Consolidated Budget Expenditures on Agriculture



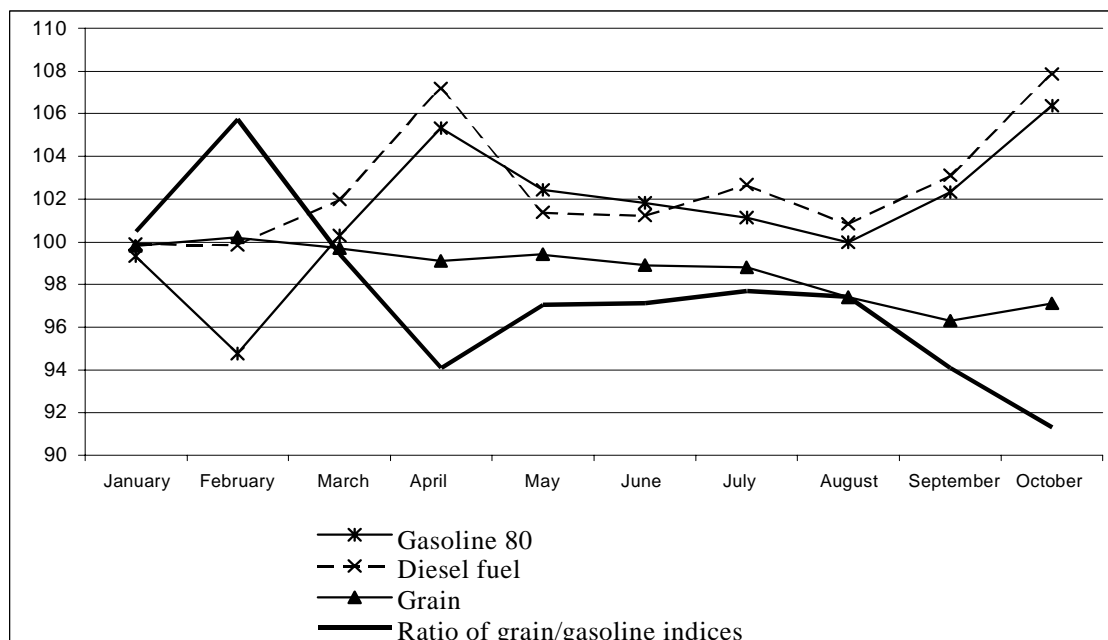
Source: RF Ministry of Finance.

Fig. 51. Consolidated Budget Expenditures on Agriculture, Million Rubles



Source: RF Ministry of Finance.

Fig. 52. Execution of Agricultural Budget in 2003–2005 by Federal and Regional Budgets (Million Rubles)



Source: RF Ministry of Agriculture www.mcx.ru, Federal Service of State Statistics www.gks.ru.

Fig. 53. Prices for Agricultural Products, Gasoline and Diesel Fuel in 2005, as % of the Previous Month

Table 42

**Financing of the National Project “Development of the Agrifood Sector”,
Billion Rubles**

	2006	2007	Total
<i>Accelerated development of livestock sector</i>			
Subsidizing of interest rate	3.45	3.18	6.63
Enlargement of “Rosagroleasing’s” authorized capital	4	4	8
<i>Development of small-scale farming</i>			
Subsidizing of interest rate	2.9	3.67	6.57
Enlargement of “Rosagroleasing’s” authorized capital	3.7	5.7	9.4
Organizational, methodological, informational support and monitoring	0.15	0.15	0.3
TOTAL	14.2	16.7	30.9

Source: RF Ministry of Agriculture.

3.4.4. Trends on Selected Agrifood Markets: Market of Meat

In the two last years prices for meat grow at rates exceeding those of consumer price index and of prices for food products at large (Table 43). Since in spring 2002 import quotas on meat were introduced (tariff quotas on beef and pork and volume quotas on poultry), one could suppose that the growth was due to this tool of meat market regulation.

Indeed, according to theory when domestic production substitution indices are not high enough, the introduction of import constraints *ceteris paribus* results in higher prices.

After the introduction of quotas domestic meat production displays different trends. Production of poultry continues to grow at a rather high rate – 15–20% per annum. However, this growth started before the enforcement of quotas on import of poultry. At the same time production of beef and pork reduces. Overall, within the past three years production of meat in agriculture steadily declines.

However, this decline does not imply a low coefficient of substitution in the meat sector. Actually the introduction of quotas have not curbed the import of meat products to Russia (Fig. 54). They were applied to import of fresh, chilled and frozen meat from the non-CIS countries. Meat and meat products from the CIS are not subject to quotas. As a result the structure of meat import shifted towards larger supplies from the CIS countries (Fig. 55) and bigger share of meat products (Fig. 56).

Larger imports from the CIS contributed to the growth of prices since average contract prices for meat imported from these countries are higher than those for meat from the non-CIS countries (Fig. 57). At the same time prices for meat products from the CIS are lower due to qualitative differences.

Prices were also affected by sharp fluctuations of import supplies of meat to the domestic market due to quotas. Quotas are distributed at the beginning of a year and uncertainty makes suppliers limit their deliveries (Fig. 54). This decrease of supplies to the domestic market can cause elevation of prices that is later reflected in the annual price index.

However, the principal factor of domestic meat price rise was surely the surge of prices for beef on the world markets (due to a series of world cattle epizooties and consequent cattle slaughter as well as lowering of export subsidies in the EU) (Fig. 58).

So, quotas have failed to reach their main goal – protection of domestic producers from competition with import. They entailed large expenditures on their administration,

contributed to the growth of domestic prices, entailed irregularity of supplies and are fraught with corruption. That's why their abolition should be welcomed.

At the same time the abolition of quotas is unlikely to have a direct effect on the lowering of meat prices. First, the world prices are expected to continue growing (Picture 16). Due to the spreading epidemic of bird flu, prices for poultry are likely to follow the upward trend of prices for beef. Second, liberalization of the EU and US markets, reduction of export subsidies already stipulated in the Framework agreement on agriculture of WTO Doha Round will also support growth of the world prices for meat. Third, as mentioned above, one more factor of price growth was the redistribution of meat supplies resulting from the introduction of quotas: the share of non-CIS countries reduced while that of CIS countries was up. However, Picture 13 shows that beginning from 2004 this factor is no more decisive and consequently in case of quotas' abolition won't entail lowering of prices.

Finally, from 2002 to September 2005 real personal incomes in Russia grew by approximately 140% while prices for meat within the same period – by 150%. Gini coefficient is gradually reducing. Meat in Russia is a very income elastic commodity. In this situation the demand for meat and meat products in the nearest future is likely to expand *ceteris paribus* preventing domestic price from falling.

Changes in the Ukrainian regulation of foreign trade in meat may also become an important factor influencing Russian meat sector. In 2005 Ukraine lowered import duty on meat. Import tariff on fresh, chilled and frozen beef as well as on many kinds on pork currently equals 10% of the customs value but not less than 0.6 euro per kilogram. One can compare it with 2002 rates: then the tariff on fresh and chilled beef amounted to 30% ad valorem but not less than 0.5 euro per kilogram, on frozen beef – 30% ad valorem but not less than 1 euro per kilogram, on pork – 10% ad valorem but not less than 1 euro per kilogram.

Ukraine is a net exporter of beef, veal and pork. Actually the only foreign sales market for the Ukrainian beef and pork is Russia (*Fig. 60 and 61*). While in 1995 Russia accounted for about 80% of the country's meat export, by 2004 its share grew up to 99.9%. Ukraine exports fresh, chilled and frozen beef as well as products out of beef (frozen beef being the largest item in this group of commodities).

Frozen beef from Ukraine is competitive on the Russian market due to its low price and low cost of transporting meat to the European part of Russia; not a minor factor is the absence of quotas on import of Ukrainian meat.

It's quite logical that lower prices for the Ukrainian beef are compensated by its inferior quality. There is few meat cattle in Ukraine and its number decreases in recent years. According to data of USDA in 2005 meat breeds accounted for only 0.7% of the total cattle inventories in this country.

As to the share of Ukraine on the Russian market of imported beef, in 2002–2003 Ukrainian frozen beef accounted for 1/3 of the total Russia's imports of this product. In 2004 this share fell to 16% primarily due to shorter supplies from Ukraine (the total volume of Russian beef imports didn't change). The share of Ukrainian pork on the Russian market does not exceed 2%.

The lowering of customs duties has already resulted in larger imports of meat to Ukraine. This can seriously influence the Russian market since domestic meat processors may start purchasing meat through Ukraine. As a result re-import of meat from Ukraine will grow while prices on the domestic market will fall.

Despite its inefficiency, the quota mechanism of regulating meat import is supposed to be preserved in 2006 although with some amendments. The volume quota on import of poultry meat will be replaced by tariff one and import duties on out-of-quota import of pork

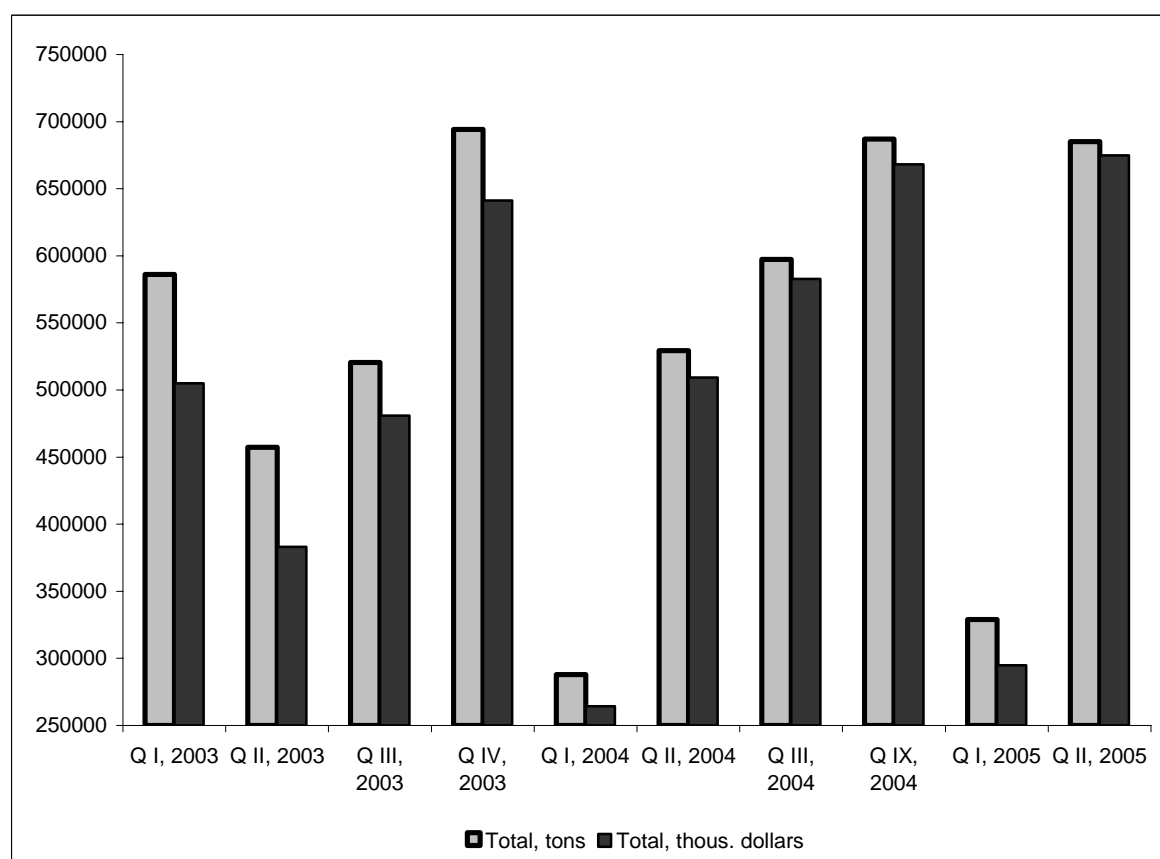
and beef will be reduced. The terms of poultry import were altered in compliance with agreement between Russia and the US in the framework of WTO accession negotiating process.

Table 43

Price Indices, as % of December Previous Year

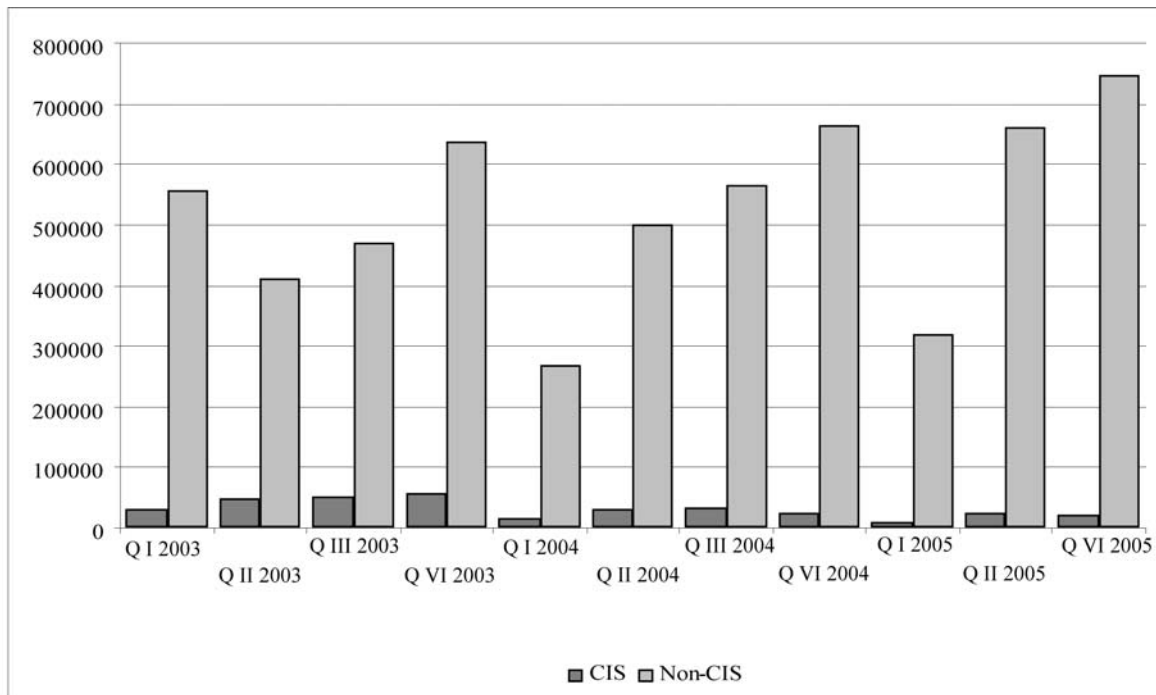
	2002	2003	2004	2005	2005/2001
Consumer price index	115.1	112.0	111.7	110.9	159.7
Food products	111.0	110.2	112.3	109.6	150.6
Red and poultry meat	102.7	106.8	119.6	118.6	155.6

Source: Federal Service of State Statistics.



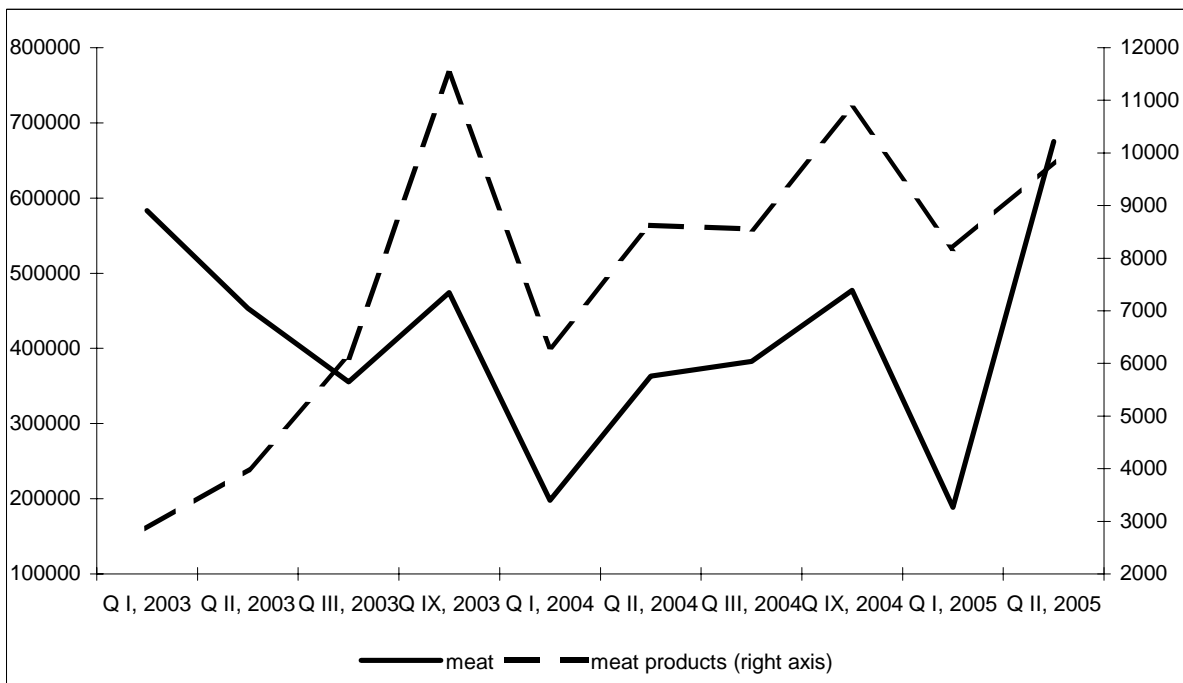
Source: Customs Statistics of RF foreign trade.

Fig. 54. Import of Beef, Pork, Poultry and Meat Products



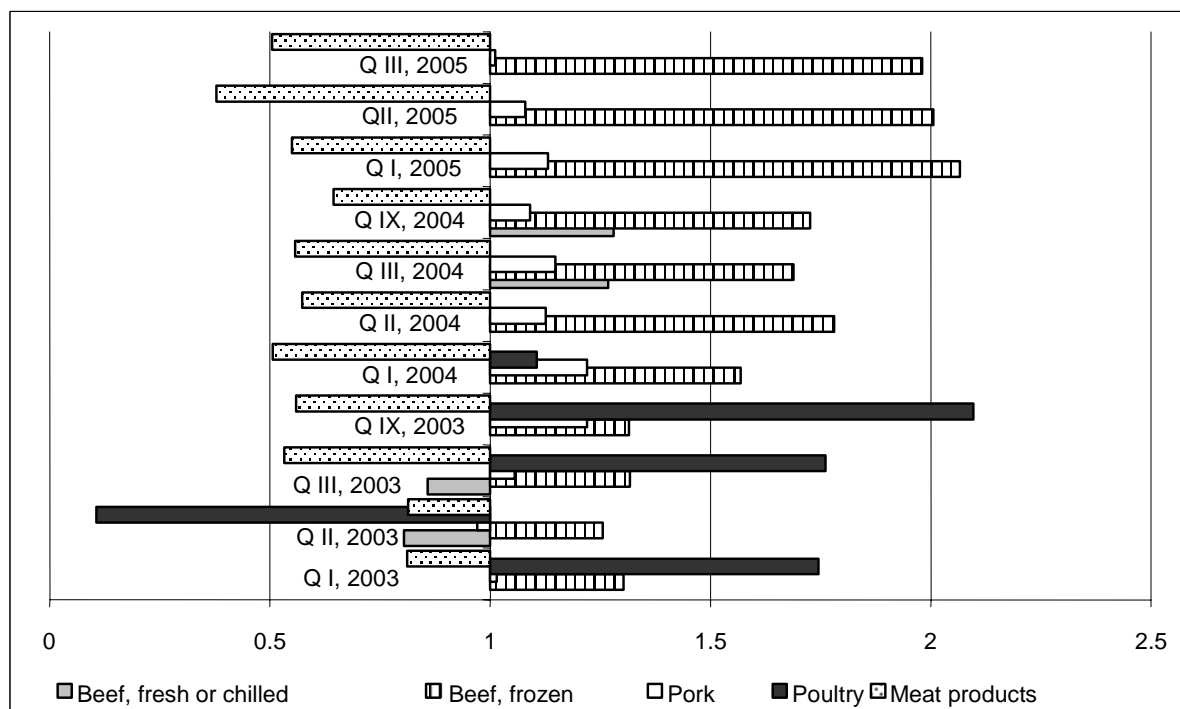
Source: Customs Statistics of RF foreign trade.

Fig. 55. Import of Meat and Meat Products From the CIS and non-CIS Countries, Tons



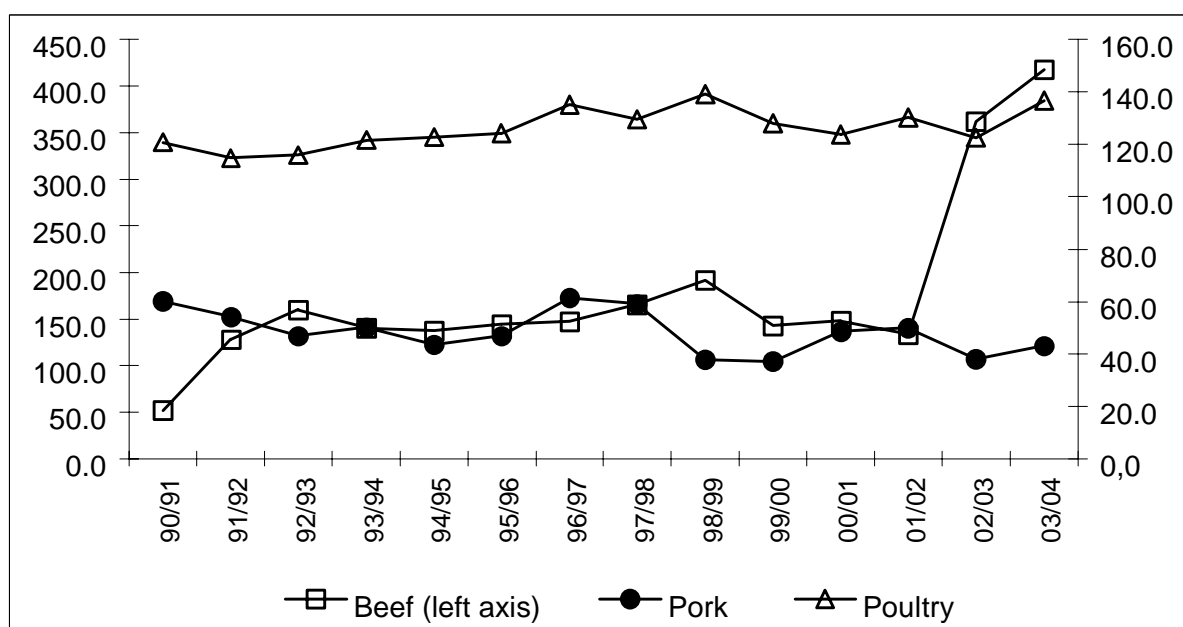
Source: Customs Statistics of RF foreign trade.

Fig. 56. Import of Fresh, Chilled and Frozen Meat (Red and Poultry Meat) and Meat Products, Tons



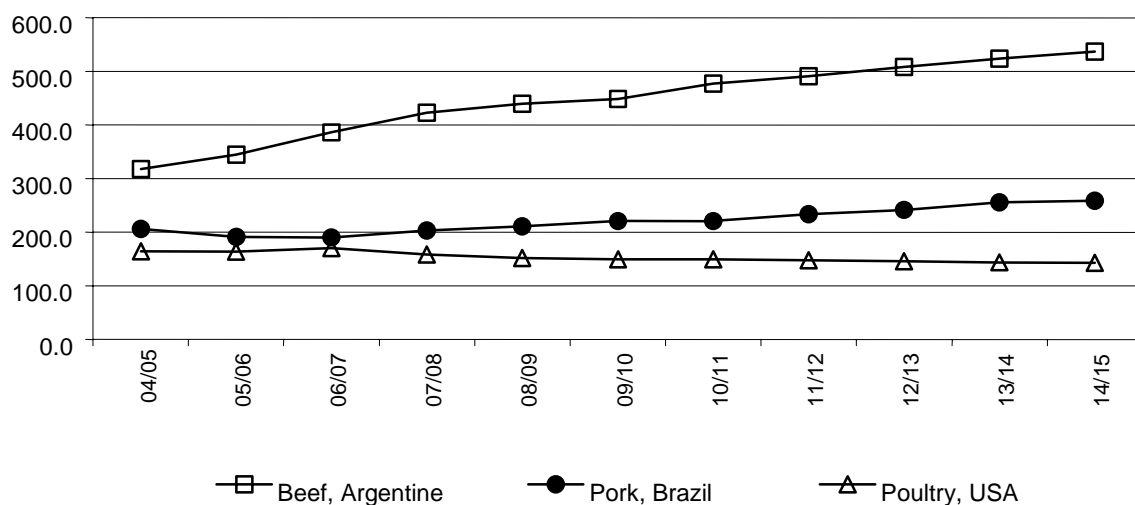
Source: Customs Statistics of RF foreign trade.

Fig. 57. Ratio of Average Contract Prices for Meat Imported from the CIS and non-CIS Countries



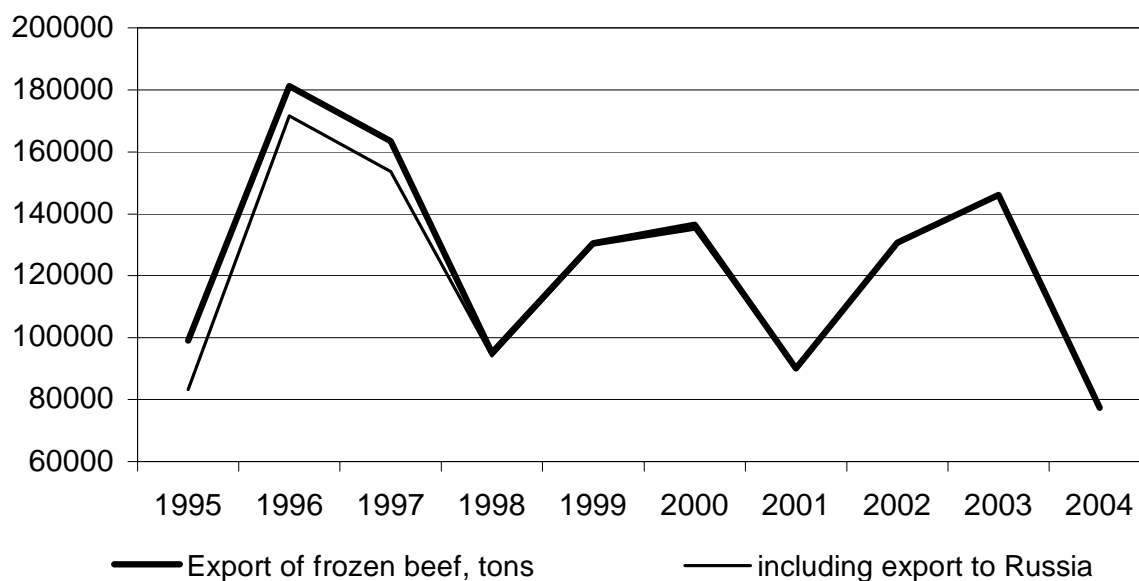
Source: <http://www.oecd.org/dataoecd/55/44/32980897.xls>

Fig. 58. World Prices for Meat, dollars per 100 kg



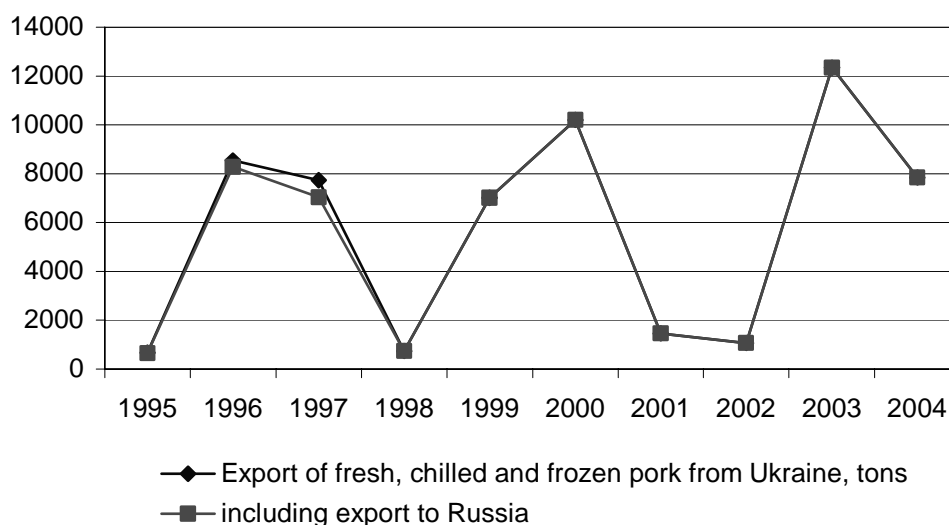
Source: <http://www.oecd.org/dataoecd/55/44/32980897.xls>

Fig. 59. Forecasted Prices for Selected Kinds of Meat in Countries – Major Suppliers of These Commodities to the World Market (National Currencies of the Respective Countries Per 100 Kg)



Source: data of USDA (www.usda.gov).

Fig. 60. Export of Frozen Beef From Ukraine in 1995–2004, Tons



Source: data of USDA (www.usda.gov).

Fig. 61. Export of Pork From Ukraine in 1995–2004, Tons

3.4.5. Foreign Trade in Agricultural and Food Products

Exports of Agricultural and Food Products Grow Faster than Respective Imports

In 2005 food exports grew faster than food imports: in January-November export indicators were 40% above the respective 2004 indicators while imports expanded at a far lower rate – 13%. Nevertheless, Russia still retains its traditional status of net importer of food and the modulus of agrifood trade balance continues to grow.

Growth was observed in sale of almost all major items of Russian agrifood export: fish, wheat, flour and flour products, sunflower oil, milk products, chocolate products (*Table 44*). The oil and fat industry increases export supplies of products with higher value added (vegetable oils and mayonnaise) while reducing exports of raw products (sunflower seeds).

Imports of food increased primarily due to larger purchase of meat and raw sugar (*Table 45*). Import supplies of meat exceed the established quotas. Probably, their growth is caused by an upsurge of out-of-quota meat imports after the lowering of respective customs tariffs in the middle of 2005. Import of raw sugar is likely to accelerate by the year end since beginning from January 2006 it will be subject to much higher duty (248.64 dollars per ton) as compared with the one effective in 2005 (January-September – 164 dollars per ton, October-December – 140 dollars per ton). According to the mechanism of raw sugar import regulation, the size of duty depends on the average price at the New York Board of Trade during the last three months. Sugar futures started to rise there in the middle of 2005 determining high level of Russian import duty by the beginning of 2006. That's why traders will try to increase sugar imports before the enforcement of higher duty.

Restoration of Grain Export

Russian grain export started to gradually restore after the sharp drop in 2004 (*Fig. 63* and *64*). Smaller export supplies were then due to poor grain crop in 2003 coupled with temporary restrictions on export of rye, wheat and their mix in 2004. The estimated total

2005 crop is not a record one but is still rather good (78 million tons). The growing supply on the home market shaped quite low domestic prices. The world production of grain grows as well and the world prices also demonstrate a downward trend (Table 9), competition becomes stronger complicating Russian grain export. Grain market interventions are supposed to raise domestic prices but no compensations to exporters are envisaged. In 2006 tariffs for transportation and port services will be elevated. This will further aggravate terms of the Russian grain export. In other words, the domestic policies regulating grain sector create new problems instead of offsetting the worsening situation on the world market.

Growing Export of Farm Machinery

Russia gets deeper and deeper involved in the world trade in farm machinery. In January-October 2005 it exported almost twice more farm machines than in the corresponding period 2004. The major part of these exports goes to Kazakhstan (50.9%), Ukraine (19.3%) and Uzbekistan (10.6%). Imports of farm machinery grew as well – by 65%. The first place in the structure of imports belongs to Germany (24.4%), the second – to the US (15.8%)¹¹.

The upward trend in the Russian export of farm machinery shaped back in 2000 (Fig. 65 and 66). After the 1998 crisis agricultural production started to grow in almost all the CIS countries entailing higher demand for farm machinery and consequently – larger Russian exports to members of the Commonwealth.

In recent years Russia became a net exporter of grain harvesters. In 2005 exports of this machinery increased at record rates. Growth in domestic agricultural machine-building started after the 1998 crisis but soon faded away. That's why one should keep in mind that the growing Russian export may to some extent be a re-export to the CIS countries since agency institutions for many trade items (including farm machinery) are located in Russia. Besides, exports may include supplies of used farm machinery to the CIS.

Two factors constitute specific causes of growing imports of farm machinery to Russia. First, in recent years many regional administrations started centralized purchases of imported machinery at the budget account. This machinery is often subsidized or used, i.e. enters the domestic market at initially lower prices and then is distributed between regional farm producers at prices even below the initial ones. Second, an important form of servicing agricultural producers – customer farming (when specialized companies having a set of farm machinery do basic agricultural works for farms) – is currently developing in the country. This service is partially provided by foreign companies, first of all the Turkish ones. Such companies bring their machinery to the Russia's customs territory on temporary import terms and thus do not pay respective taxes.

In order to curb import of used farm machinery at low prices federal authorities introduced a special tariff (in the form of "x euros per cubic centimeter of engine capacity or kW of engine power") on import of used tractors and harvesters. For harvesters this restriction became effective from October 2005. Import of used tractors was curtailed in 2004 and in 2005 the specific tariff was raised. In 2006 import of new grain and silage harvesters will also be additionally (in addition to ad valorem tariff) constrained by the introduced specific duty. This will prevent importers from declaring lower commodity value at the border.

¹¹ Data of "Soyuzagromach".

Prospective Provisions of WTO Doha Round Agricultural Agreement and Their Implications for Russia (the Market Access Aspect)

As stated by the head of Trade negotiations department in the RF Ministry of economic development and trade Maxim Medvedkov, Russia can become a WTO member in 2006. One of the key WTO agreements that Russia will have to join is the Agricultural Agreement signed in the course of GATT Uruguay Round in 1994. However, in 2001 a new round of multilateral negotiations on trade in agricultural commodities (“the millennium round”) began. In December 2005 a WTO Ministerial Conference was held in Hong Kong where countries-members of the organization specified provisions of the new agricultural agreement establishing rules for further liberalization of trade in agricultural and food commodities in the world. While we negotiate with WTO members the terms of our entering the prior agreement, a new one with more rigid provisions may come into force. We need to contemplate the prospective provisions of this new agreement to accordingly adjust our negotiation position. This can have the strongest effect on one of the three parts of Agricultural Agreement – market access, i.e. protective measures against import.

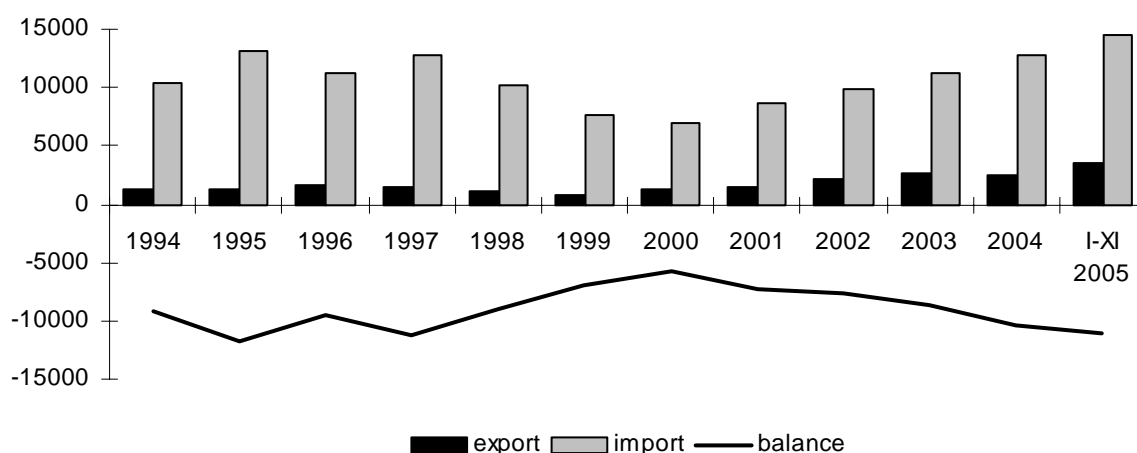
The new Agreement establishes tiered (or banded) approach as the basic principle for lowering import tariffs suggesting that higher tariffs will be cut more than lower ones. This approach is supposed to overcome the unfairness of 1994 Agricultural Agreement according to which countries-members had to reduce the level of tariff protection by the same rate meaning that the difference in access to their domestic markets persisted although at a lower level. Percent lowering of tariffs will be effected by groups of commodities. Overall four groups of commodities are defined depending on the rate of tariffs on their import. A certain percent of lowering is set for each group (*Table 47*). For developing countries tariff lowering requirements will be softer than for developed countries. The maximum admissible rates of tariffs, or tariff peaks, will be set between 75% and 100% (150% for developing countries).

The Framework Agreement introduces the notion of a sensitive commodity, i.e. commodity essential for a country’s economy and eligible for special protection. The list of commodities that a country can designate as sensitive ones should be coordinated with other WTO members. Tariffs thereon are not subject to the common reduction formula but are to be regulated specially. However, a special regime in respect to these commodities does not release countries from the commitment to expand their imports as compared with the former volumes. This expansion can be facilitated by the mechanism of preferential tariff quotas. The limit for sensitive products is set as follows: their number should not exceed a certain share in the total number of tariff lines (the existing proposals vary from 1% to 15%).

Developing countries will benefit from privileged terms for reducing their tariff support – a special regime. In addition to softer requirements – lower rates of tariff reduction and tariff quota enlargement, longer implementation period – they are granted an opportunity to designate a range of special products, i.e. products essential from the point of view of food security, rural poverty and rural development. A developing country is authorized to include at least 20% of all tariff lines from the group of agricultural and food products in the list of special products. Developing countries will also benefit from special safeguard mechanisms the rules for implementing which are still being debated in WTO.

What are the possible outcomes of further world agricultural trade liberalization for the Russian agrifood sector? Russia joins WTO with the status of developed country. In 2004 the average weighted import tariff for agricultural and food products was about 16%. The bulk of Russian imports of these products (about 80%) is subject to ad valorem duties that do not exceed 20%. Tariff peaks in Russia do not exceed 100% and are observed in import of such commodities as out-of-quota meat (equaling 60% for pork and 40% – for

beef), sugar (90% in ad valorem equivalent) and ethyl alcohol (100%). So, Russia has a rather liberal regime of customs and tariff regulation as compared with other countries. In the EU bound tariff averages 20.5%, in the US – 11.9%. But relatively low averages combine with very high tariff dispersion (a lot of high tariffs and a lot of relatively low tariffs). For instance, the maximum tariff on import of food products in the US reaches 378.7%, in the EU – 218.5%¹². That's why when joining the Doha Round agricultural agreement Russia can enjoy more beneficial terms as compared with other countries: having lower initial tariff it will be required to reduce it by a lower percent. But according to WTO rules subject to reduction are bound (i.e. maximum possible in a country) and not the effective tariffs. Russia's position in WTO is as follows: higher bound import tariffs as compared with the effective ones. But under the new agricultural agreement this position may entail larger tariff reduction requirements. As a result bound tariff after its reduction may be even far below the effective one (for more details see the IET survey of October 2005)¹³. One has to keep this in mind when elaborating Russia's strategy at WTO accession negotiations.



* - less trade with Byelorussia.
Source: Customs statistics of RF foreign trade.

Fig. 62. Foreign Trade in Agricultural and Food Products, Million US dollars*

Table 44

**Export of Basic Agricultural and Food Products from Russia in 2000–2005,
Thousand Tons***

	2000	2001	2002	2003	2004	I-IX 2005	I-IX 2005/I-IX 2004, %
Frozen fish	290.6	324.1	292.8	255.0	142.5	158.6	121
Wheat and wheat/rye mix	419.0	1635.7	10259.3	7587.9	4671.3	6841.8	2.5 fold
Wheat flour	165.7	n.a.	122.8	288.6	134.3	135.6	154
Sunflower oil	194.8	115.3	74.2	84.1	145.1	187.8	174
Sunflower seeds	1114.9	n.a.	86.8	292.1	124.4	59.3	48
Bread and bakery products	34.3	36.9	38.6	52.6	64.4	53.4	117
Milk and cream, condensed	73.7	45.6	35.0	11.3	35.4	29.1	116
Chocolate products	25.7	35.1	35.1	42.2	54.2	45.6	137

* - less trade with Byelorussia.
Source: Customs Statistics of RF foreign trade.

¹² Data of IPC.

¹³ For more details see: *Economico-politicheskaya situatsia v Rossii*. October 2005. M: IEI, November 2005.

Table 45

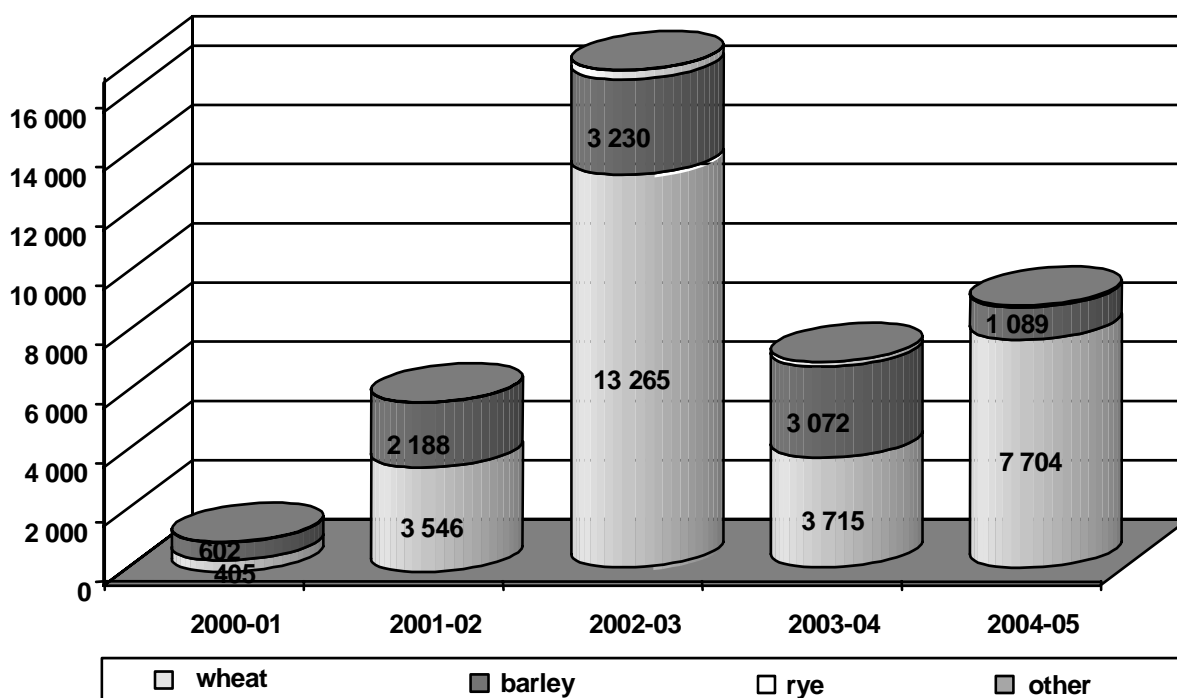
**Import of Basic Agricultural and Food Products to Russia in 2000–2005,
Thousand Tons***

	2000	2001	2002	2003	2004	I-IX 2005/I-IX 2004**
Beef	282.3	459.2	504.6	507.8	510.9	133.3
Pork	212.9	369.6	602.0	535.2	455.2	
Poultry meat	687.2	1383.3	1375.2	1190.0	1101.3	123.0
Butter	45.4	81.4	94.1	114.0	70.3	88.2
Sunflower oil	149.5	182.8	175.7	200.8	160.4	80.9
Wheat and wheat/rye mix	2631.3	916.2	264.8	640.7	1364.1	41.1
Raw sugar	4546.6	5410.4	4441.0	4112.0	2582.9	130.7
White sugar	271.4	143.1	163.2	151.1	200.1	96.9
Citrus fruits	472.2	562.1	701.3	781.1	858.4	110.6
Coffee	20.3	21.6	25.7	32.0	29.4	135.5
Tea	158.3	154.4	165.3	168.9	172.1	105.1

* - less trade with Byelorussia.

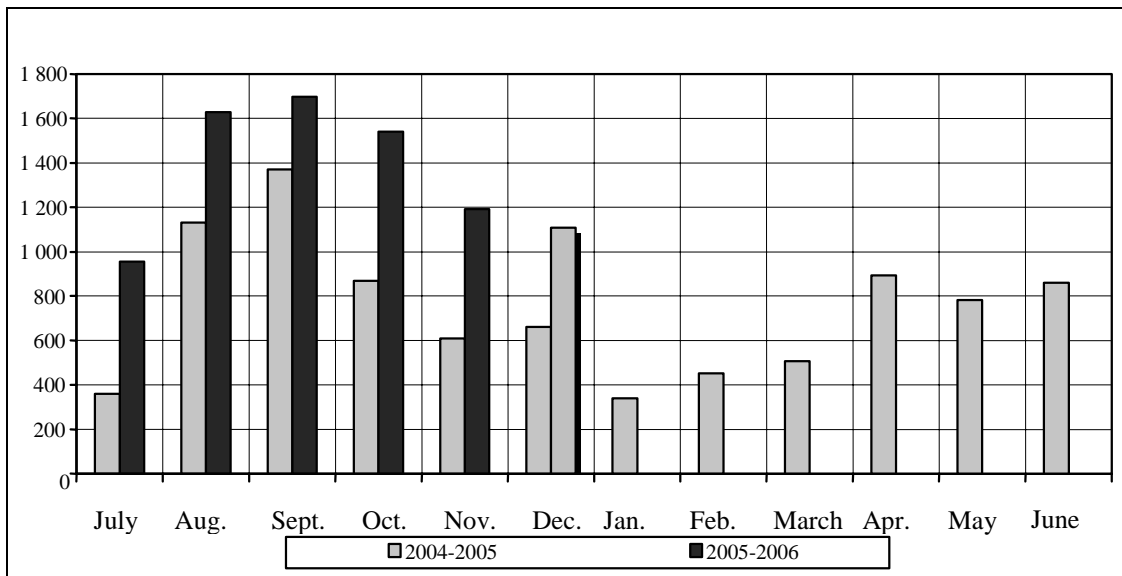
** - including trade with Byelorussia.

Source: Customs Statistics of RF foreign trade, data of the Federal Service of State Statistics.



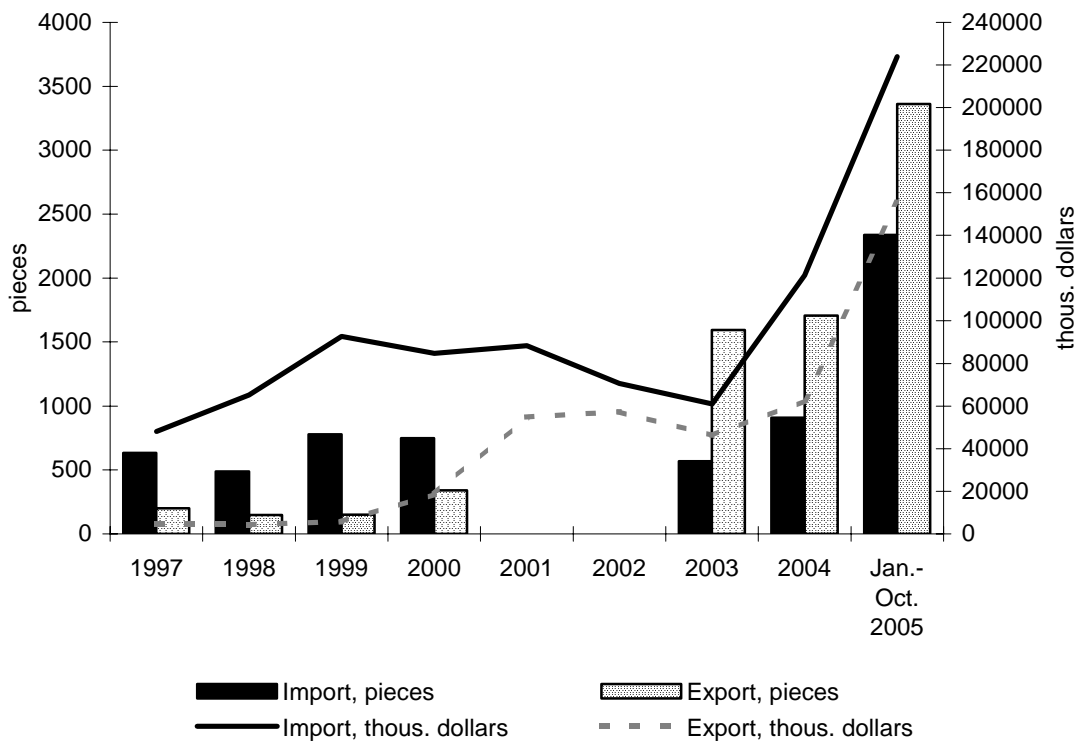
Source: WJ Inter Agro.

Fig. 63. Russia: Export of Grain, Thous. Tons



December – estimate of WJ Inter Agro.
Source: WJ Inter Agro.

Fig. 64. Grain Export from Russia in 2004–05 and 2005–06 MY, Thous. Tons



* - less trade with Byelorussia.

Source: RF State Customs Committee, Center of Economic Situation Studies of the RF Government, Soyuzagromach.

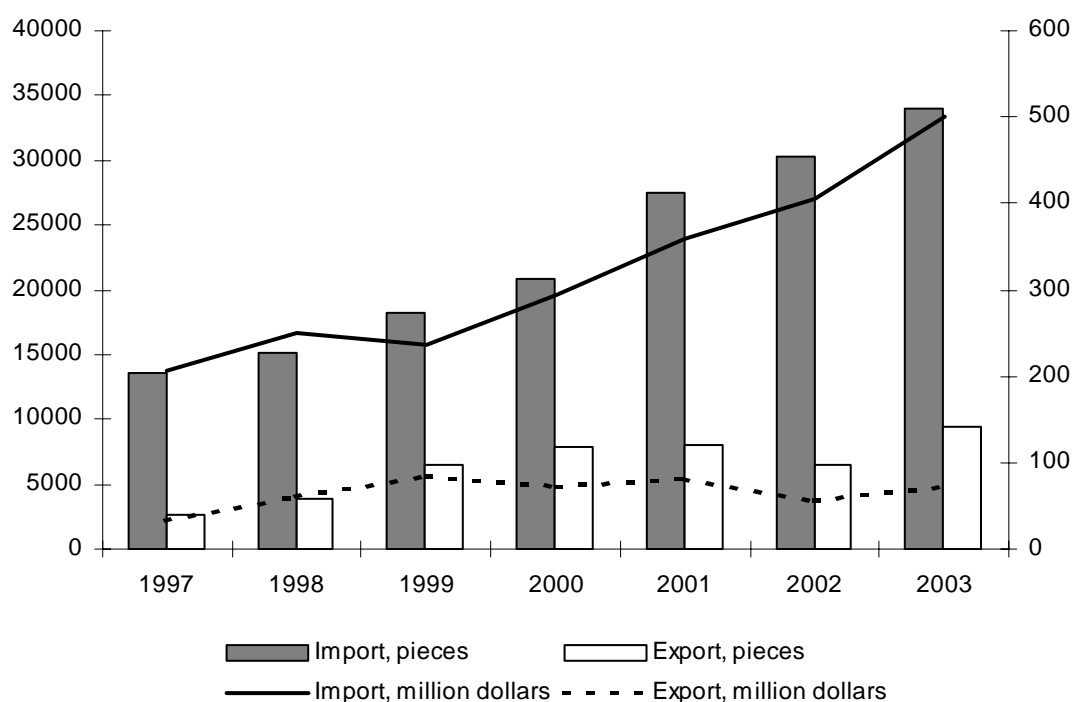
Fig. 65. Russia: Import and Export of Grain Harvesters*

Table 46

World Wheat Supply and Utilization Balance, Million Tons

	2003/2004	2004/2005	2005/2006
Production	555	626	611
Consumption	589	609	620
Trade	105	113	110
Ending stocks	132	149	140

Source: http://www.fas.usda.gov/grain/highlights/2005/12-05/4Q_Wheat_ITR05.pdf.



Source: Federal Service of State Statistics.

Fig. 66. Russia: Import and Export of Tractors

Table 47

**Proposals of WTO Members on Lowering Tariffs by Groups of Commodities
(for Developed Countries)**

	Borders of groups	Percent lowering within a group
Group 1	0% – 20/30%	20–65
Group 2	20/30% – 40/60%	30–75
Group 3	40/60% – 60/90%	35–85
Group 4	> 60/90%	42–90

Source: Doha Work Programme. Draft Ministerial Declaration. December 18, 2005. WT/MIN(05)/W/3/Rev.2. WTO.

3.5. The Situation in the Sphere of Research and Development

3.5.1. Strategic Targets for the Sphere of Science and Innovations

During the past year, the government's activity, among other things, was focused on the conceptual documents that were to determine the development in science and innovations in the medium term. The primary role there belongs to the RF Strategy for Developing the Sphere of Science and Innovations in the Period until the year 2010 (hereinafter – the Strategy), which is being continually improved by the RF Ministry of Education and Science, as well as to the Ministry's Report "On improving the efficiency of the activity in the public sector of science" and to "The Program for modernizing the structure, functions and mechanisms of financing to the Russian Academy of Sciences (RAS) and other academies". The Draft Strategy became the basic document for preparing the sections on science and innovations incorporated in "The Program for the Socio-Economic Development of the Russian Federation in the Medium Term".

The Strategy having not been adopted by the year's end, the timeline for its completion was extended to March 1, 2006¹⁴. In the course of last year it was remodeled several times, to become better structured; however, some basic points, which can hardly be judged as acceptable, remained unchanged. Thus, the formal definition of the national innovational system (NIS) as such, as well as of its constituent components, initially was not quite correctly worded, and still remains so. The notions of a NIS and the sphere of science, or, as it is referred to in the Strategy, the "knowledge generation" sector, are artificially separated. The universally accepted (including in the OECD countries) definition of a NIS implies that it should incorporate science as one of its key components. As for the Strategy, its approach to this definition is quite unique. However, when this approach, based on separate treatment of science and a NIS, is applied, the concept of an innovation system becomes meaningless, while science and innovations are being promoted by measures that have little coordination between them. It is quite characteristic that in August 2005 the Chairman of the RF Government approved "The main directions for the Russian Federation's policy in the sphere of developing the innovation system in the period until the year 2010" (No. 2473p-P7 of 5 August 2005), based on the classic definition of a NIS. However, no changes in the Strategy followed.

Another "methodology" problem is associated with the lack of clarity as to which exactly sector of research and development is being addressed by the Strategy. Sometimes it is specified that it is the public sector; however, it is defined in terms pertaining to the statistics of science. The public sector should be precisely determined, alongside the same criteria which are applied to the public sector in the national economy. In this case, the public sector should also incorporate public institutions, state unitary enterprises (SUEs), those economic societies where a block of shares (or a stake) in excess of more than 50% of the charter capital is held by economic societies belonging to the public sector. If the public sector in science is thus defined, its limits become much broader. In terms of personnel number, the public sector in science encompasses more than 80% of its total cadres, more than 86% of the fixed assets owned by research organizations, more than 83.5% in the total value of land, and more than 98% in the total volume of financing allocated to science in the consolidated budget. This is the evidence of the disproportional development of Russia's NIS, as well as of the fact that its entrepreneurial sector is almost invisible, while receiving, in effect, no direct support from the State. By way of comparison,

¹⁴ For an analysis of the Strategy's initial version, see in: Rossiiskaia ekonomika v 2004 godu. Tendentsii i perspektivy. Vypusk 26. (The Russian economy in the year 2004. Trends and prospects. Issue 26). M.: IET, 2005, p. 337–338.

the statistics concerning industrially developed countries can be cited, demonstrating that the State's share in the funding provided to research and development work (RDW) may be as high as 50% of the total expenditure on RDW received from all sources, while the public sector's share in the implementation of RDW is no more than 20%.

The changed approach to defining the public sector in science may entail a change in priorities, as well as in the very content of the priority goals to be established within the Strategy's framework and in the set of main instruments to be applied in the government policy.

The Strategy has formulated the basic systemic problem and, accordingly, the tasks that will be involved in providing the necessary solution to it. The main systemic problem is seen in the fact that "the rates of development and the structure of the Russian research and development sector satisfy neither the requirements of the national defense system nor the growing demand for state-of-the-art technologies displayed by several segments of the entrepreneurial sector". This interpretation of the existing problem seems to be narrow and not quite correct. First of all, the role of fundamental science and humanities is thus ignored, because these branches cannot be entirely orientated toward the market alone. At the same time, the list of basic measures to be implemented includes those designed to promote accelerated development of fundamental science as a primary goal. Thus, there exists an obvious contradiction. Secondly, when the problem is formulated in such a way, it may become easily reduced to the necessity to ensure growth only in the sphere of defense-oriented RDW. In this connection it is typical that the description of the currently existing situation, which is then reproduced in the Strategy, contains no evidence that science, indeed, does not satisfy the existing requirements in terms of national defense. Instead, it is only stated that science is poorly supplied with resources, and the national economy is not responsive to emerging innovations.

On the whole, the Strategy's main goal still remains unclear. One assumption may be that this goal is to establish, in the country, an innovative national economy through developing a national innovational system. If this assumption is true, the participation of a variety of departments in achieving this goal will be both necessary and justified. In fact, it is in this direction that current development is oriented: the innovation policy is no more the prerogative of the RF Ministry of Education and Science alone. Its practical implementation has also become part of the activities being pursued by the Ministry of Economic Development and Trade, the RF Ministry for Communications and Informatization, and the RF Ministry of Industry and Power Engineering.

If one takes it into consideration that the national innovational system incorporates the research and development sector, it would be more appropriate to recognize, as its major problem, the lack of proper balance in this system, the undeveloped status or sheer absence of some of its important components, including those responsible for the openness of Russian business to innovations.

The Strategy has put forth the main indices to be applied in the assessment of whether the formulated goals are actually being achieved. Among the six target indices pertaining to the Strategy's implementation, three appear to be rather doubtful. Regrettably, it is one and the same set of indices that has been replicated in the other conceptual documents concerning science and innovative development. The basic problem associated with the indices is that a purely statistical approach is applied, with all the limitations imposed by the standard system for the collection of statistical data on science and innovations that has been established in this country. Thus, the target index for the growth in the number of small businesses in the innovation sphere has been set in the amount of up to 30,000 by the year 2011. In this connection, the baseline, or the currently registered

number of such enterprises, is set as being approx. 22,000. However, this is not true. The latter figure is taken from the section of statistical records "Science and science servicing", but it does not reflect the actual situation in the innovation sphere. Meanwhile, more than 30,000 small innovative businesses have so far been established in this country. This has been clearly demonstrated by the computations prepared by the State Fund for the Promotion of Small-Size Forms of Enterprises in the Sphere of Science and Technology, which provides support to small-scale innovational entrepreneurship and therefore has accumulated true figures concerning the existing situation in the small-size business sphere.

The second aspect, which is fraught with problems because of the specific indices being applied, is the orientation toward increasing the patenting activity in the country. In view of the existing system of patent protection and the habitual commercialization of the results of research and development, growth in the number of patents cannot be set as a target. Most of the developments are being applied in the form of know-how, not patents. Patenting in Russia serves primarily the purpose of establishing priorities, similar to publications in scientific periodicals. The point is that a Russian patent does not ensure international protection, while making accessible the information concerning an invention's significant parameters. Therefore it is not by chance that only 35% of the total number of patents are actually in effect, as stated by the Russian Agency for Patents and Trademarks, while their support ceases, on the average, within 4–5 years.

Due to all these reasons, the orientation toward growth in the number of patents will result in a situation resembling that of the Soviet era. Then, the growing number of inventor's certificates was important for winning in socialist competition and thus being allocated additional budget funding. However, if the goal is to develop an innovation-based economy, it becomes more reasonable to use the licensing indices, or other indices that demonstrate *the use* of inventions.

And finally, an important problem is represented by Russian science's imbalanced cadres, the loss of succession, and young people's low interest in a career in science. The Strategy plans to assess the improvement in the cadre situation and the inflow of young cadres into science by the percentage of personnel aged below 39 years in fundamental research. In fact, this percentage is already growing every year, which, however, is not the proof of an improving cadre situation in science. The share of young scientists under 30 years is increasing, while that of those aged between 30 and 39 is declining, and thus the generation gap is becoming more pronounced. The well-being index in science will become the growing percentage of the middle generation – the scientists aged 30–39. This will mean that young people not only come into the sphere of science, but stay there.

The Strategy has been under discussion for more than a year, during which time, in addition to "The fundamental principles of the Russian Federation's policy in the sphere of developing science and technology in the period until the year 2010 and beyond", approved in 2002, "The Main Directions for the Russian Federation's policy in the sphere of developing the innovation sphere in the period until the year 2010" were adopted. The latter document provides some solutions to the problems formulated in the Strategy, and therefore it must once again be further developed – in order to catch-up with the developments. Within this context the Strategy's timelines – also until 2010 appears to be too short. More feasible would have been the mapping of a Strategy for innovational development of the national economy during 10–15 years, including the development of science and innovation activity.

3.5.2. Reform in the Public Sector of Science

During the past year, much attention at the government level was being paid to further remodeling of the strategic approaches to reforming the public sector of science. The RF Ministry of Education and Science prepared a detailed report concerning this issue, entitled "On improving the activity efficiency in the public sector of science". The organizational structure's reforming will inevitably impinge on property interests, and therefore it has more opponents than proponents.

The report offers a list of the basic problems existing in the public sector of science. Its content is not always based upon factual data, quite often representing unsubstantiated statements. The main problem specified is the lack of efficiency in the public sector of science. In this connection, its efficiency is assessed mainly on the basis of patenting statistics, while the low-key patenting at the state research institutions is by no means an evidence of their unsatisfactory operation, especially in a situation of uncertain status of the rights to intellectual property created at the expense of budget funding. The academic sector's inefficiency is being proved by comparing the growing budget funding of fundamental research to the almost unchanging quotability index. This is not quite correct, either, because the quotability index is the characteristic of past results, which does not respond instantly to the growth in budget funding seen in the past two or three years only. It is possible indeed to assess the results of science, including expert's estimations, but so far such data have not been systemized. Thus, for example, according to the expert's estimations performed by the Russian Foundation for Basic Research (RFBR), quality research is being done by only 50–70% of scientists, whereas the others either have no desire to get involved in this activity, or simply have no competitive capacity.

It is impossible, on the basis of the data presented in the Report, to get any understanding of the degree to which the non-public sector of science is more efficient than the public one, and, consequently, the degree to which the public sector ought to be reformed. The notion of efficiency as such must be appropriately coordinated with the main goals set for the public sector, whereas the Report does not introduce the notion of the ratio of "mission" to "the efficiency of its implementation. The Report's best-developed aspect deals with the mechanisms to be applied in institutional transformations. By way of generalization, the essence of the suggested changes can be put as follows:

- The institutes that work in the applied sphere are to be privatized, including as part of "in-house" science; the system of State Research Centers (SRS) must be fundamentally reorganized.
- The academic sector must improve the efficiency of its activity through self-reforming.
- Science must be strengthened at higher educational establishments, including through the creation of *national and innovative universities*; also, all types of integration must be implemented in order to ensure closer ties between science and education.

In the RF Strategy for Developing the Sphere of Science and Innovations in the Period until the year 2010 the main targets for transforming the organizational-legal structure of the public sector of science (*Table 48*).

From this table, it follows that one-half of all state institutions, and almost all state unitary enterprises, are to be reorganized by the year 2010 into other organizational-legal forms.

Table 48

Dynamics of Organizational-Legal Structure of Public Sector of Science

Percentage in total number of organizations in public sector of science	2005	2008	2010
State unitary enterprises	48.0%	2.4%	1.3%
State institutions	50.0%	28.6%	25.0%
State autonomous institutions	0%	11.9%	21.9%
State autonomous not-for-profit organizations	0%	9.5%	15.6%
Joint-stock companies where more than 50% of shares is federal property	2.0%	47.6%	36.3%
Total	100%	100%	100%
<i>Number of organizations (as reference)</i>	<i>2600</i>	<i>2100</i>	<i>1600</i>

Source: The RF Strategy for Developing the Sphere of Science and Innovations in the Period until the year 2010. The RF Ministry of Education and Science, December 2005, p. 130.

Reforming of the System of State Scientific Centers (SSCs)

The status of a State Scientific Center (SSC) was granted to research institutes with unique and large-scale experimenting bases, engaged in a complete innovation cycle, from fundamental research to pilot production. Their research themes were, in fact, covering the whole spectrum of priority areas in the development of science and technologies (Table 49). Presently, 58 State Scientific Centers are operating in this country, with the total staff of 80,000.

The organizations that had been granted the status of a SSC were developing along different lines, and some of the research centers, indeed, became leaders in their branches, while others were existing only due to the special support on the part of the State. The analysis of the SSC system, based on the results of a series of qualification tests, has demonstrated that all the SSCs can be subdivided into two unequal clusters: the most successfully developing organizations (approx. 30% of all SSCs) and the others, whose indices are much lower. Many SSC have no stable relations with industry and have not found their own niches in the branch system of the national economy. Thus, for example, the capacities of four metallurgic SSCs are not being made use of by metallurgy. Ninety-five percent of this industry has been privatized, and biggest companies have created their own research divisions.

At the same time, the government policy toward SSCs has always been equalization-oriented: the state funding under the support program for SSCs was distributed in the same proportions that had been established during the period when the SSC had been initially created, and no redistribution of funds in favor of more efficient organizations has been done since. No target indices or parameters for the SSCs performance have ever been established, either. In 2004 the SSC status of all the existing Centers was once again prolonged for two more years, but in 2005 the funding under the support program for SSCs was discontinued totally, without any exception being made for any of the Centers. The situation was somewhat softened, however, by the fact that for many of the SSCs' directors it was the status itself that was important, and not the additional budget funding associated with it. The status of a SSC implies tax exemptions (in respect to the taxes on property and land), which are more important than additional funding. Thus, in 2003 tax exemptions made it possible for the SSCs to retain approx. 3 billion roubles, billion roubles while only 1 billion roubles was allocated under the support program for the SSCs in that

year¹⁵. From the year 2006 onward the SSCs will be no more enjoying exemption from the land tax, and their situation therefore will become critical. So, it will be necessary either to adjust the terms of the support being provided to the SSCs, or to change their organizational-legal forms (at present, most of the SSCs have the organizational-legal form of a federal state unitary enterprise (FSUE)).

Table 49

**Areas of SSCs' Scientific and Science-and-Technology Activity,
and Their Coordination with Priority Areas of Scientific and Technological
Progress (STP) (Non-Military)**

Areas of SSCs' activity*	STP priority area**	Number of SSCs developing a specific priority area
Machine-building, motor-vehicle industry	New transport technologies	11
Shipbuilding, navigation and acoustics		
Biotechnologies, virology		
Medico-biologic problems	Live system technologies	10
Plant selection		
Chemistry and new materials	New materials and chemical technologies	8
Informatics, production of instruments and appliances, robot technologies	Industrial technologies	8
Metallurgy		
Construction		
Oceanology, meteorology, water supply and hydrogeology	Ecology and rational wildlife management	5
Opto- and photoelectronics	Informational and telecommunications technologies, electronics	4
Nuclear physics, nuclear power engineering	Energy-saving technologies	3
Electrotechnologies, power engineering		
Mixed-branch fundamental research	–	9
Total		58

* – According to the Classification of the Association of SSCs.

** – According to the list of priority areas in the development of science, technologies and machinery of the Russian Federation, approved by the President of the Russian Federation as of 30 March 2002, Pr-577.

Source: Association of State Scientific Centers of Russia.

The program for improving the efficiency of the public sector of science envisages exactly this – the possibility to change the organizational-legal form of a SSC. In a situation where new organizational-legal forms (of an autonomous institution or a state autonomous not-for-profit organization) have not yet been introduced, it has been suggested that the reforming of the SSC be started within the framework of the already existing organizational-legal forms. It is planned to preserve, in the form of a state institution, only the most viable ones among the SSCs, while to transform the others into joint-stock companies. However, if the respective branches are no more in need of the services provided by the SSCs, their reorganization into joint-stock companies will result in their effective liquidation.

¹⁵ Mazurenko S. Znaniia u nas iest'. Nado prevratit' ikh v den'gi. (We do have knowledge. It must be turned into money.) // Izvestiia, 1 April 2005, p. 16.

tion. The provision in existing legislation to the effect that the new joint-stock companies should not alter their core activity will only make more agonizing the last few years of their existence. The experience of privatization in recent years has demonstrated that the result of such transformations is a dramatic reduction in the number of design bureaus and the so-called “in-house” science – i.e., the organizations capable of technically developing and implementing in industry the products of those centers for fundamental and applied studies that represent the core object of the ongoing reform. Thus, the new wave of privatization may still further undermine the existing relationships between science and business.

It therefore appears that the reforming of SSCs should be started only after the new organizational-legal forms have been introduced. The prospect of such transformation may seem more appealing to the SSCs if the principles of budget funding are also changed. In particular, for the participation in the tenders for the budget funding of applied research, an additional requirement may also be introduced – that of providing parity-based funding from off-budget sources. In this case, the form of a state institution, while still ensuring a safe status in terms of guaranteed budget funding, will, nevertheless, become disadvantageous in terms of economics.

The list of measures designed to improve the level of the SSCs’ activity does not include one important component – the determining of the spectrum of functions to be performed by those Centers which will keep their special status. At the same time, it is not considered feasible, alongside the improvements in the system of SSCs, to create “national laboratories” oriented toward the development of specific strategic areas of research. It is planned to create, by the year 2008, at least 5–7 national laboratories. In this connection it is not clear why indeed one status should be replaced by the other. One explanation may be that the number of national laboratories will be restricted due to the limited capacities of budget funding being provided to big centers for applied studies. Then it would be logical to transform some of the successfully operating SSCs into national laboratories.

It would be feasible to introduce the special status (of a SSC or a national laboratory) only if it is to be granted to those institutes which have been assigned, by the State, to perform certain specific functions – those of expert’s assessment, forecasting, etc. In such a case, appropriate targeted funding from the state budget will be necessary, either within the framework of a special program, or as part of the funding allocated within the framework of federal target programs.

Modernization of the Academic Sector of Science

The modernization of the academic sector of science was actually carried out in the year 2005 by the Presidium of the RAS, while the plans of reforming had been developed in cooperation with the RF Ministry of Education and Science, the latter being the leader. In particular, the document entitled “The Program for modernizing the structure, functions and mechanisms of financing the Russian Academy of Sciences (RAS) and other academies”¹⁶ has resulted from a compromise achieved between the Ministry and the RAS.

In this document a set of measures is envisaged, which are designed to improve the efficiency of the academic sector of science. These measures include the rating of academic research organizations based on a set of quantitative indices, the support for the best institutes by means of allocating additional budget funding, the creation of a special system for managing the property not being made use of in current research, as well as additional pension benefits to scientists. The program is clearly oriented toward concen-

¹⁶ The Program was approved by the Interdepartmental Commission for Science-and-Innovation Policy, Protocol No. 4/04 of 11 October 2005.

trating, within the RAS system, the cadres, property and funding being available in the public sector of science. It consolidates the RAS' leading role in carrying out and coordinating all fundamental research in the public sector. In particular, it is planned to incorporate into the RAS system a number of research organizations belonging to branch academies of sciences, as well as other research organizations engaged in fundamental research. The Program states that it is necessary to increase budget funding allocated to fundamental research in absolute and relative terms so as to achieve, in the year 2008, the level of 58% of the total federal budget expenditures on non-military science¹⁷. This is a very ambitious goal. Even in prosperous countries this item of expenditure amounts to a lesser figure in relative terms¹⁸. It does to appear feasible to increase such expenditures, while the system for commercializing the results of research remains underdeveloped. The goal must be that of optimizing the allocation of budget funds throughout all states of the innovation cycle. So far, a rather disproportional structure has emerged in Russia, where the areas of applied research, technology design, designing proper, as well as marketing, are underdeveloped, while fundamental research is far from being so.

The practical implementation of the measures envisaged in the program had begun in two directions – the creation of a branch-based system of remuneration of labor in the RAS and the modernization of the system of departmental research institutions. The experience accumulated so far has demonstrated that any self-reforming, as a rule, is purely decorative. The first practical steps have confirmed this conclusion: the RAS' CEOs began to merge some of its subordinated institutes without any clearing or reduction of the existing "dead weight". Simultaneously, the introduction of the branch-based system of remuneration of labor was started. This will involve an assessment of the institutes in accordance with a number of criteria, with the planned result of 25% of budget-funded jobs being cut within the next three years, with a simultaneous creation of off-budget positions instead. The total number of job losses in the academic sector is not to exceed 10%. It is planned that the scientists employed at budget-funded jobs will be doing fundamental research, while those at off-budget jobs – innovation-oriented projects. Resulting from these changes, as well as the growing expenditures on non-military science, which are to be achieved until the year 2010, the average monthly salary of a scientist in the academic sector is expected to increase to 30,000 roubles. This figure (30,000 roubles) represents a certain mean value, which is to be reached gradually. Only 50% of this amount will be guaranteed, while the rest is to be provided by a variety of incentive payments (bonuses for urgency, important fundamental research, tutoring of post-graduate students, secrecy, etc.).

Is it really necessary to reduce the number of scientific cadres in academic organizations, and what criteria are to be applied when doing so? The answer to the first question is "Yes", because it is a well-known fact that many institutes are burdened with the so-called "dead weight", whose presence can hardly be justified even by the assumption that there should be "an appropriate environment" for young scientists to develop their abilities in. It would be more difficult to determine precisely the true scope of the existing "dead weight". Some selective assessments have demonstrated that the RAS is planning its job cuts very sparingly. The sociological survey in the academic sector of science, conducted in 2005

¹⁷ It appears that the Program, most probably, implies increasing budget funding of fundamental research in particular within the RAS system, because, as seen by the results of the year 2005 reported by the RF Ministry of Education and Science, approximately 67.5% of the total federal budget expenditures allocated to non-military science was spent on the financing of fundamental research.

¹⁸ For example, in the USA the share of budget allocations to fundamental research within the total federal expenditure on science amounts to 37.2%. Source: Science & Engineering Indicators – 2004. NSB: Washington, DC, 2004, vol.2, pp.A4-8, A4-12.

on the order of the Center for Strategic Research under the RF Government, has shown that the percentage of the research staff at the academic institutes who work in a well-motivated and productive way amounts to only 22–25%. Another 16–18% (approximately) are being drawn toward the former group¹⁹. That is, the Academy's active potential is constituted by approximately 40% of its actual research staff. Some additional data have been collected at the institutes of the Siberian Department of the RAS (SD RAS) concerning the activity of the research staff in generating scientific publications. These have demonstrated that the number of scientists who have produced no scientific papers to be published varied between 20% and 25% of the total research staff²⁰. At the same time, according to some comparative estimations, the research at the Siberian Department of the RAS is more active than the average level of activity in the RAS system. Thus, the volume of off-budget funds attracted by the institutes of the SD RAS is equal to 50% of the department's total volume of funding. This figure is higher than that observed in the RAS' other departments.

As for the criteria to be applied for determining viable research groups, the experience of the SD RAS can also be useful. Since 1998, in the assessment of the results achieved by the subordinated institutes, there has been applied a specific rating system. The rating builds upon a set of indices, including the number of published works, with due regard to the impact factor, the index of scientific references to each work, the patenting index, the volume of attracted off-budget resources, the amount of grants, the share of young scientists and postgraduates, the number of defended dissertations. The comparison of indices is done with consideration for the specificity of each area of research, and additional funding from the centralized fund is allocated to the best institutes.

The ratings, however, have their own limitations: they do not create incentives for better performance for scientists and research groups with "medium" potential. Therefore we believe that assessments still must be based upon scientific expert's estimations, and not upon rating by formal indices. The ratings can be applied as a one-time measure, within the framework of a large-scale inventory of research organizations. The central role, however, must be played by an individual approach to research laboratories, because this is the only way that can ensure that the truly best scientists remain in the sphere of science.

While the procedures for job cuts are being elaborated, the problems associated with normative-legal regulation may arise. The existing legislative base in respect to research staff does not establish any indices for assessing the results of their work that could serve as a justification for a dismissal. The attestations are held in a rather formal manner, based on characteristics signed by heads of laboratories, as stipulated in the provisions adopted in 1985. Under current legislation it is, in effect, impossible to dismiss a researcher who is punctual about his or her working hours but is totally unproductive.

On the whole, the project for a transition to the branch-based system of remuneration of labor, suggested by the RAS, gives rise to some questions and doubts. The very distinction - between those scientists who are engaged in fundamental research and all the others - appears to be an artificial and harsh imposition upon the natural course of research activity. Its possible consequence may be the growth of social tension in research groups and organizations, which is by no means a good incentive for better performance.

¹⁹ A. Belanovskii. Otsenka sosloiannia Rossiiskoi akademii nauk. Kratkii otchiot. (An assessment of the status of the Russian Academy of Sciences. A brief report. <http://www.polit.ru/dossie/2005/12/15/ran.html>

²⁰ http://www.sciencrf.ru/client/news.aspx?ob_no=1378

Moreover, will the increased salaries, as planned, really improve the level of fundamental research – without changing all the other conditions for the work of the research staff?

It is quite typical that the increasing of salaries and mergers of organizations are being done without any relation to the organizational reforming of the RSA itself, which is to be started only as late as Q 2 07. It is intended to increase salaries at the expense of the funding allocated to the renewal of equipment and appliances, which is to be “frozen” for three years²¹. The main argument in favor of such a decision is that if salaries are not increased, there will be no personnel to operate the new equipment. However, the opposite argument appears no less valid – that if equipment is outdated, science will have no competitive capacity, and besides, it will be difficult to attract off-budget sources, to submit publications to the leading scientific journals, etc. According to the data presented by Chief Academic Secretary of the Presidium of the RAS Valerii Kostiuik²², 57% of equipment in the institutes subordinated to the RAS is already more than ten years old, while the share of new equipment is only 14%. Thus, the approach based on the principle “first – increased salaries, and then – purchases of new equipment” may result in a still further deterioration of the cadres in the sphere of science.

The problem associated with the increasing of salaries and a simultaneous subdivision of scientists into two categories – those whose salaries are funded from the budget, and those whose salaries are funded from off-budget sources, appears even more complex if once scrutinizes all the details of this process. For example, if scientists receive grants from state research funds, will this type of financing be recorded as that requiring a switchover to an off-budget salary, or not? In which way must be treated the budget funding received within the framework of tenders held by various departments (e. g., the Ministry of Education and Science, or the Ministry of Economic Development and Trade) ? The work performed under such projects may well incorporate some elements of fundamental research, and so, in order to categorize it as the additional funding “allowed” as a supplement to a budget-funded salary, it will be necessary to investigate each specific case. So far, the situation has remained unclear. For example, according to one competent opinion, the grants from research funds must now serve a different purpose – instead of being a source of supplementary material support to scientists, they are now to provide for the research process proper (purchases of equipment, supplies, costs of expeditions and business trips)²³. If such an approach is applied, it will no more be a problem to categorize this type of additional funding. However, will it indeed be possible in the present situation, when salaries are being increased only very gradually, to eliminate entirely the material support to scientists in the form of grants?

Reform of the public sector of science is closely associated with property issues. In particular, this has to do with the regulation of rights and terms for leasing premises. State unitary enterprises (including SSCs) and the RAS have the right to lease their premises. However, it is not possible to assess the effect of the use of property, because no reliable data are available. As far as the RAS is concerned, even the information concerning the size of its property complex is closed to public. This lack of transparency in terms of information is possible due to the special status of state academies, which are both state institutions and self-governing organizations. One can speak only in indirect terms, pointing to insufficiently effective use of academic property, because the problem associated with the need to redistribute unoccupied premises between the academic institutes has so far re-

²¹ Interviu s akademikom S. Aldoshinym. (An interview with Academician S. Aldoshin.) // Poisk, No 42, 21 October 2005, p.5.

²² Novye Izvestiia, 23 May 2005.

²³ Interviu s vitse-presidentom RAN akademikom A. Nekipelovym. (An interview with Vice-President of the RAS Academician A. Nekipelov.) // Poisk, No 39, 30 September 2005, p.5.

mained unsolved. Some of them lease out their premises, while others are forced to lease premises from other organizations.

In developed countries, the economic activity at state research centers is taken care of by asset managers (often represented by private companies), which are obliged to direct the proceeds from the use of property to the support of an institution's core activity. This type of asset management organization is one of very common forms of public-private partnership. It is in the asset managers' interests to ensure efficient use of property, because their income depends on it. As for the RAS, the possibility of creating a centralized asset manager was also discussed, however it found no enthusiasm on the part of its Presidium.

On the whole, so far the Academy has kept all its assets, and the number of its personnel has also remained almost unchanged. This is a clear indication that any modernization implemented by the Academy itself has only been limited to "conserving" the existing status quo. No external influences have produced any serious effect on the academic sector of science – in particular, the academic institutes have not been devoid of their basic source of support, in contrast to the treatment being practiced by the Ministry of Education and Science in respect to SSCs.

The Integration of Science and Education

Science existing within the framework of higher educational establishments (HEEs), as well as its specificity, has hardly ever been mentioned while discussing the problems of organizational reforming. The incentives for HEEs to expand their research activity are created in the course of reforming the educational system. At the same, serious legal issues are faced by science based on HEEs – issues that are not limited just to the sphere of education.

The currently practiced approaches to reforming have demonstrated priority given to the integration inside a HEE, that is, the creation of incentives for them to expand their research and innovation activities. It is this internal integration that is envisaged in the currently being developed concepts of an "innovative HEE" and a "national university".

The "innovative" status is to be granted only to those HEEs, which, among other things, are involved in active and productive research. In 2006, the first ten 10 HEEs will be selected, and in 2007 – another twenty. Each of the HEEs, which will be granted the status of an innovative one, will receive a state grant in the amount of 500 million roubles. The funding is intended for the development of new curricula, renewal of the material base of research and educational activity, attraction of quality faculty personnel, as well as of promising young students, as well as faculty personnel and students from foreign countries. In this connection, the volume of a HEE's own off-budget funds to be invested in the program of its development will constitute no less than a half of the size of budget allocation. The first tender will be held among the most resource-intensive HEEs in the fields of natural sciences, technologies and engineering, medicine, and agricultural sciences. It would be reasonable to pick out universities within each group, because research and education have their specificity depending on a particular field.

The criteria for selecting HEEs must differ from those being applied by the Ministry of Education and Science in its ratings, because, according to specialists, the existing ratings do not adequately reflect the actual quality of HEEs' performance. Besides, it is planned that the selection itself of HEEs will be done by a Commission independent of the Ministry of Education and Science, so as to make as objective as possible the experts' estimation of the applications being submitted.

It follows from the list of criteria submitted for discussion that innovative universities must conduct research at a high level, combining it with state-of-the-art teaching technologies. Regrettably, the resource-based estimation indices (the number of infrastructure elements, types of infrastructure, the ratio of RDW volume to the number of staff, etc.) are given preference to, as before. At the same time, one of the estimation indices for HEEs, universally accepted throughout the globe, is the employment of their alumni. Russian HEEs do not monitor the information concerning their alumni, nor do they estimate the percentage of their alumni seeking employment in foreign countries. Despite the active work aimed at determining the necessary set of criteria, no distinct notion as to what “an innovative HEE” actually is, has emerged so far.

While implementing this initiative, it would be feasible not to forget all the other HEEs, providing them with the chance, in future, also to become “innovative”. For this to be achieved, the selection of innovative HEEs must not be a one-time act – such tenders should become regular.

The Ministry of Education and Science is also planning to provide special support to “national universities”. The concept of a “national university” underwent significant changes during the past year. In late 2004, national universities were understood as this country’s leading HEEs, and it was planned accordingly that about 100 universities will become “national” and receive the budget funding appropriate to their new status²⁴. In 2005, however, after a nation-wide project designed to develop the sphere of education was initiated, the notion of a “national university” was radically transformed.

Now a “national university” is a mega-university, created through merging several HEEs within a region. In the 2006 budget, 3 billion roubles is allocated to the creation of “national universities”. It is planned that national universities are to appear in Krasnoyarsk and Rostov-on-Don. However, other HEEs also hope to be granted support in the future, and so merger-oriented activity has been on the rise in some regions (e. g., in Archangel, in Ekaterinburg). The new concept of a “national university” envisages that they are to become a form of public-private partnership: private businesses will provide additional financing to educational activity, participate in the tutoring and program development, as well as in determining a HEE’s policy through their representative in the board of trustees.

In Krasnoyarsk, it is planned to merge seven HEEs, having simultaneously cut the number of students from 80,000 to 40,000²⁵. This may result in negative social consequences, because for many of the region’s young people it will become problematic to get an education, and for faculty members – to find employment. It seems that no serious assessment of such a merger’s outcome has been done so far.

Beside developing HEE-based science through a system of innovative and national universities, it has been envisaged in the Strategy of the Russian Federation that in the sphere of science development and innovations until the year 2010 there should be created incentives for integrating science and education within the framework of an interaction between HEEs and academic organizations, as well as other research centers throughout the country. The integration of science and education is declared to be one of the two key tasks associated with the development of science and innovations; this is also stated in the Program for Socio-Economic Development of the Russian Federation in the medium term (2006–2008). However, the development of this type of integration has been suppressed by a number of the existing normative-legal problems and the absence of tar-

²⁴ For more details, see: Rossiiskaia ekonomika v 2004 godu. Tendentsii i perspektivy. Vypusk 26. (The Russian economy in the year 2004. Trends and prospects. Issue 26). M.: IET, 2005, p.345.

²⁵ Poisk, No. 48, 02.12.2005, c.4.

geted and systemic support to such an integration. There are no definitions in legislation of either the forms of integration traditionally existing in Russia (a basic chair, a problem-oriented laboratory), or the progressive forms (a research university). No in-depth integration can be possible in the existing legal space, and therefore the costs of knowledge transfer become much higher²⁶. The existing remuneration system is not conducive to the integration of science and education, either. The professional and legal status of researchers is different from that of professors and other faculty staff. When the faculty personnel undergo an attestation, the fact of their conducting any research is by no means a basic criterion, and the requirements concerning research are very low²⁷. Furthermore, the basic salary level of the faculty staff at HEEs is several times higher than that of the staff of research departments, while the volume of lectures to be delivered is much greater than that established in foreign countries. All this results in the incentives for research being diminished in Russian HEEs.

Against this background, one positive trend has undoubtedly been represented by an attempt to revive the once successful "Integration" Program through providing support to Scientific-Educational Centers (SEC). Last year, the Ministry of Education and Science held a tender for the creation of 20 SECs, each of which was to be based on the cooperation between at least two organizations. The Centers are to receive 6 million roubles each for two years, which is not enough for any serious renewal of the equipment base. However, this is by all means better than those financial conditions that were envisaged in the "Integration" Program.

The Academy of Sciences has been attempting to find solutions to the integration issue and the need to augment the cadre potential through creating academic universities. This trend, which first emerged in 2004, is successfully developing. In 2005 the Academic Physico-Technological University in St. Petersburg was granted a state license to educational activity, and now is able to educate specialists within the framework of Master's and Postgraduate Programs. The education has been organized in accordance with similar programs at another academic HEE – the Pushchino State University. The number of students at an academic HEE is no more than 250, and such universities, in effect, satisfy the existing requirements of the academic sector of science. Their further development will depend on their ability to receive adequate funding through the Ministry of Education and Science.

When discussing the issue of science and education being integrated, one cannot overlook the issues relating the status of the research institutes (RI) attached to HEEs. The normative-legal substantiation for their activity has never been clearly stated, and so far those RI that have not become structural subdivisions of HEEs are functioning, in effect, outside the existing legal space. From the year 2006 onward, it is intended that an approach similar to that applied last year to SSC (the discontinuation of targeted funding within the framework of a thematic plan) will also be applied to the RI at HEEs. The thematic plan represents a form of basic support to a RI. It is especially important early in a year, when the portfolio of projects based on contracts has not yet been formed. Thematic plans so far have been covering only 20–25% of the HEEs' real needs; however, even this small-scale funding enabled them to maintain a permanent research staff. The simple solution of merely attaching all RIs to HEEs will not necessarily be promoting the growth of the latter's

²⁶ Thus, e. g., if the existing norms are strictly complied with, a HEE, when teaching its students on the basis of laboratories of academic institutes (or basic chair), must pay rent and taxes.

²⁷ Thus, in accordance with the new criteria for assessing the performance of a HEE's faculty, they must conduct research in a volume equal to 18,000 roubles per 1 person per annum. This is three times as high as the previous criterion; however, this new minimum can be easily reached by a purely symbolic participation in a grant or a small-scale commercial contract.

research capacities; on the contrary, it may result in an overall deterioration of the research base in the HEE sector. As a matter of fact, commercial education services represent the most profitable activity for a HEE, the resulting income being much higher than that of research activity. According to the data provided by the Committee on Education and Science at the RF State Duma, the earnings on research contracts of all the state HEEs in Russia in one year amounted to only 3.5% of their total earnings from commercial education services.

3.5.3. Modification of Fundamentals of Public Funding of Research and Development

In 2005, a new budget classification was introduced. Its structure makes it somewhat more difficult to analyze the expenditures on non-military fundamental research. While previously there existed the separate budget section 06, "Fundamental research and promotion of scientific-technological progress", where the amount of funding to be allocated to fundamental and applied research was clearly determined, after the switchover to the new budget classification the expenditures on science are scattered throughout nine directions of the expenditure's functional structure. As for the expenditures on fundamental research, they all are contained in the Section "General State Issues", while the expenditures on applied research are distributed between all the nine items, and in some subsections it is difficult to distinguish them from the expenditures on military fundamental research and development. As a result, the budget does not contain, in an evident form, any data concerning the funding to non-military RDW, and so recalculation is necessarily based on indirect data.

The structure of funding to science in the year 2005 remained almost the same as before: budget funding still constituted 60 % of the overall expenditures on science. Accelerated growth was demonstrated by budget funding to fundamental research, which was compatible with the program documents where priority support to fundamental science was declared. At the same time, the departmental structure of expenditures has remained nearly entirely unchanged: about 40 % of budget allocations to fundamental research went to the Russian Academy of Sciences, 6 % – to the Russian Academy of Medical Sciences, and 5.2 % – to HEEs. According to preliminary estimations, state funding to HEE-based science in 2005 was reduced, amounting to 4.3 % of total budget expenditures on science, against 6.1 % in 2004. Thus, despite the declared rise in the funding to fundamental research at HEEs, which is necessary, in particular, for a more efficient integration of science and education, its volume has remained negligible, as compared to the funding of the academic sector.

In the Explanatory Memorandum for the 2006 Budget it has been specified that among the total expenditures on fundamental research, only 14.6 % will be distributed on a tender basis. Probably, this 14.6 % also includes the funding of fundamental research through state research funds – the RFBR and the Russian Fund for Humanitarian Studies (RFHS). In such a case, only 7.6 % of the funding allocated to fundamental research at academic organizations and HEEs will be distributed on a tender basis.

Budget expenditures on applied research cannot be estimated from the point of view of their distributing among priority areas in science and technologies. It is practically impossible to establish the correlations between the nine priority directions for the development of science, technologies and machinery, approved by the RF President, and the directions of the functional structure of budget expenditures (general state issues, national defense, national security and law-enforcement activity, etc.). At the same time, it is the information concerning the funding for the priority areas in science and technologies that

is important for making an appropriate estimation of the degree of changes in the state policy in the sphere of science.

The year 2005 marked the transition to a large-scale application of tender mechanisms in the funding of projects through the agencies of the Ministry of Education and Science. While in 2004 only 23 % of funding was distributed on a tender basis, in 2005 this figure grew to 73 %. Applied research was implemented predominantly through the mechanism of Federal Target Programs. In the sphere of science, the core program is the Federal Target Scientific-Technologic Program (FTSTP) "Research and development in the priority directions for the development of science and technology in the years 2002–2006". Its scale had been to a substantial degree increased by merging it with several other programs (for example, the program "Integration of Science and Education", the program of support to SSCs, that of support to leading academic schools, and some others)²⁸. As a result, the FTSTP's budget in 2005 amounted to 7.4 billion roubles and became the largest (second only to the Federal Space Program of Russia) in terms of expenditures on research and development. Within the new FTSTP framework, the projects submitted to tenders have also become bigger, both from the point of view of their volumes of financing and their duration. While previously the average volume of financing to a project was 800,000–900,000 roubles, in 2005 the average amount of expenditures on fundamental research projects was already about 3 million roubles, and of that on projects in research and development – 10–20 million roubles.

It might seem that effect of the growth in project volume could have been only positive: in the majority of developed countries, the available funds are focused on a limited number of priorities, and resulting are full-scale projects, to be implemented over a rather long period of time. At the same time, the first practical results have demonstrated that the Russian version of contesting produced a worsened situation.

The emergence of a limited number of large-scale projects, while there still exists a huge public sector of science where all the organizations rely on budget support, will mean a dramatic fall in the number of state organizations entitled to budget funding. In face of lack of sufficient funding from other sources, this creates incentives for lobbying²⁹ and results in the monopolization of budget funding by a small group of organizations. The situation may still further be aggravated by the existing procedure for selecting applications. When projects are being selected for the allocation of funding, no attention is paid to such indices as the number of publications, the index of scientific references to each work, the number and size of previously received grants, the contracts concluded by an organization, and so on. The main criterion is the content of the application itself, and to a certain degree – the status of the applicant team and its director. In some instances the future implementers of a project are known even before a tender is started, while the lists of winners demonstrate that there exists a well-established circle of organizations – implementers of projects. As estimated by the Auditing-Consulting Company FBK (ACC FBK), which has analyzed the data on the organizations – winners of tenders for RDW in the sphere of eco-

²⁸ Decree of the RF Government "On making amendments to the Federal Target Scientific-Technologic Program "Research and Development in Priority Areas of the Development of Science and Technology" for the years 2002–2006, No 540, of 12 October 2004.

²⁹ The discussion in the media of the specific features of the contest-based selection of projects within the FTSTP's framework and the estimated scope of corruption in the sphere of science and technologies has been very active. See, for example, N. Sotnikova. Retsidivy imitatsii. (Imitation's relapses) // Poisk, No. 8, 25 February 2005, p. 4; M. Gelfand. Remontirovat' – nie znachit lomat'. (To repair does not mean to break) // Poisk, No. 12, 25 March 2005, p. 4; Ye. Morgunova. Vperiod, k ruinam? Gosudarstvo khochet izbavit'sia ot otraslevoi nauki. (To move forward, toward ruins? The State wants to get rid of branch science.) // Poisk, No. 25, 24 June 2005, p. 4; Ye. Pis'mennaiia. Otkati, togda pokatit. (Roll it away, and then it will start to roll on.) // Newsweek, No. 57, 25–31 July 2005, p. 17–20.

nomics, 10.3 % of all organizations received 31.8 % of the total volume of funding³⁰. As for the leading organization (the State University – Higher School of Economics), it received 25 % of all budget funding allocated through the tenders.

There also exists another problem. Presently, the funding of large-scale applied projects is executed without estimating the prospects for the theme's further development, which must include preliminary patenting and marketing research, the mapping out of potential markets for product sale, and the existence of established contacts with the companies – consumers of RDW results. All this contributes to the risk of inefficient spending. Also, it has almost never happened so that during a project's implementation its intermediate results are assessed, and, in the event of their being negative, the funding is discontinued. So far, procedures have been developed for monitoring the implementation of projects within the FTSTP's framework. This may to a certain extent neutralize the currently existing limitations of funding based on quasi-tenders. It also appears feasible to alter the principles for allocating budget funding through tenders. For example, in the first phase some small-scale funding can be allocated to several competing groups, and then the best project be chosen for further support.

3.5.4. Overseas Funding to Russian Science

During last year, several new divisions (or representative offices) of foreign funds were opened in Russia, in particular that of the Helmholtz Association (Helmholtz Gemeinschaft) and Fraunhofer Gesellschaft (associated institutes for applied research in Germany and elsewhere in Europe). The representative offices are established for purposes of developing closer contacts with Russian scientists and organizations, thus promoting cooperation in the sphere of research and development. Russia represents Europe's important strategic partner, being at the same time a country with prominent schools for fundamental research and a market for high-tech products with a potentially high capacity.

Besides, a number of foreign representative offices have recently expanded their Russia-oriented programs: the German Research Council (Deutsche Forschungsgemeinschaft) (DFG) has announced a joint tender with the Russian Fund for Humanitarian Studies, the German Academic Exchange Service (DAAD), in partnership with Russian agencies, has initiated a new program for postgraduates and young researchers in the sphere of humanities and social studies. This program is co-financed by the Russian party, and so the DAAD is discussing the possibility to implement supplementary projects (in particular, in the field of medical science), to be funded from additional resources.

The IET's poll, conducted in 2005 among 19 foreign organizations and funds that provide funding for Russian science³¹, has demonstrated that most of the organization that have been actively cooperating with Russia plan to continue this activity. Only about 20% of the funds that participated in the poll were either planning to round up their operation in Russia by a certain date (on the average – by 2007–2010), or had already stopped implementing their projects in the sphere of science and technologies. The limited timelines for their operation in Russia can be explained by the fact that in a few years Russia will become a full-fledged partner in international programs, and no special initiatives oriented to Russian science will be needed any longer.

³⁰ The study was based on openly available data, published in the newspaper "Konkursnye torgi". The sample incorporated 945 works performed by 386 organizations. Of these, 86.6% were state organizations. Source: Ekonomicheskie issledovaniia i ekonomicheskie reformy. Analiticheskii doklad. (Economic studies and economic reforms. An analytical report.). M.: FBK, 2005.

³¹ I. Dezhina. Vklad mezhdunarodnykh organizatsii i fondov v reformirovaniie nauki v Rossii. (The contribution of international organizations and funds to the reforming of science in Russia). M.: IET, Nauchnye trudy (Scientific Works) No. 91R, 2005.

At the same time, the funds intending to continue their operation in Russia have put forth a number of arguments in favor of this decision. The most frequently mentioned reason is the benefits of cooperating with Russian scientists and scientific organizations, some of which have powerful potential. Besides, this cooperation is also rather profitable in terms of economics, because the average salaries of researchers in Russia are lower than those of their counterparts in foreign countries. When providing the funding for joint studies, foreign partners spend on RDW much less than what they would have been paying in their own countries. Also, there exist common interests in the sphere of global research in the spheres of economics, environment protection, power engineering, etc.

The second reason the growing commercial interest displayed by Western partners, their desire to gain access to certain hi-tech products.

The third reason is the need to promote mobility, prevent "brain drain", participate in reforming. The situation in Russian science, while having indeed improved, is still far from being stable and favorable.

However, this positive trend of international cooperation growth may be reversed if legislation is changed. Early in 2006, the Federal Law "On making amendments to some legislative acts of the Russian Federation" (No. 18-FZ of 10 January 2006) came into force, which at the stage of its development had already stirred a negative response in the "third sector", with a simultaneous large-scale response in foreign countries.

The preparation of amendments to be made to existing legislation was started, resulting from the RF President's declaration that it was unacceptable for political parties and movements to receive financing from abroad through various not-for-profit organizations. Therefore the main goal was to keep the domestic political situation in Russia safe from any foreign influence. Indeed, several funds – foreign-funded Russian ones, as well as foreign proper with representative offices in Russia - have declared "the development of democracy in Russia" to be their principal target. Thus, in the 2006 budget of the US State Department, the allocation of \$ 85 million to the programs for promoting democracy and economic reform in Russia has been envisaged. The main bulk of these monies is being distributed through various programs and funds.

Some of the funds that are providing financing to science and education in Russia have at the same time declared, as their goal, the support to democratic values. Many such organizations receive their funding from government sources. Therefore, even the purely "scientific" and "innovational" funds have found themselves to be the target of the new Law.

The new Law has expanded the list of reasons for the refusal of registration of not-for-profit organizations, as well as strengthened state control over the financial and economic activity of such organizations. Foreign funds will be obliged to re-register, and may be faced with a refusal for reasons such as their activity presenting a threat to "the national integrity and uniqueness, cultural heritage and national interests of the Russian Federation". The notions of "uniqueness" and national interests are not defined in detail, and when interpreted broadly may serve as the grounds for a refusal of registration of almost any organization. Now, foreign non-governmental organizations must also inform the registration agency concerning any transfers of monies to the Russian territory, while the physical persons – recipients of grants – inform the same agency about any monies received from any foreign not-for-profit organizations. The recently introduced measures may create serious obstacles for the operation of foreign funds in Russia, because numerous bureaucratic barriers are bound to appear. This may induce the funds to curb their activity in Russia and to move on to countries with more favorable institutional regimes.

3.5.5. Solutions to the Cadre Problems Faced by Science

Among the cadre problems faced by Russian science, there are the changing demographic structures (the overall ageing of personnel, the continually decreasing number of “the medium generation” of scientists, the outflow of young cadres from the sphere of science, the ongoing “brain drain” (mostly of young scientists), the absence of “counterflow”, and the very small number of scientists returning to Russia.

The highest annual rate of decline in numbers is seen in respect to the research cadres aged between 30 and 49 years; that is, the gap between the young people coming into the sphere of science and the older generations is continually growing. Thus, the problem of succession in science is becoming more acute. The most negative situation can be observed among top-qualification personnel in academic research organizations. So, one-third of the Doctors of Sciences working at the Siberian Department of the RAS are aged over 65 years. As for young people, only 8% of those who have completed their post-graduate studies do indeed defend their dissertations (the national average index being 20%)³².

The stratification of research cadres in 2005 was becoming more auspicious, and this phenomenon was in part contributed to by the emerging system of budget funding based on quasi-tenders. Those institutes that were capable of creating their own channels for a continual flow of budget funding by means of contests and tenders, succeeded in their material status being greatly improved, and even began to reduce the degree of their participation in foreign contracts, which require harder work and stricter rules for reporting and bearing responsibility than that established for the participation in domestic government programs. A positive aspect of the concentration of funding has become the opportunity for institutes to purchase new equipment, and some institutes practicing modern management approaches have been able to fundamentally renew their material base and equipment. At the same time, even prosperous institutes admit the existence of the problem associated with an outflow of the young from the sphere of science. This had been confirmed by the results of a survey, demonstrating that high salaries do not guarantee a solution to the cadre problems. At Russian research institutes there still exist factors responsible for young people being ousted from science. They are the poor quality of research organization, very vague prospects of career growth, the generally unattractive public image of a Russian scientist, and housing problems. At the same time, the growing rates of enrollment into postgraduate courses does not mean that there exists a growth potential for science: according to the data of the RF Ministry of Education and Science, no more than 10% of the alumni actually stay in the sphere of science.

The “brain drain” problem does not disappear either: there is an continual outflow of research cadres to those countries where the situations in science and in the national economy in general are properly balanced. The trend of young people emigrating from strong and competitive research centers has become more evident. Young people, as a rule, work at such centers for 5–6 years, make necessary connections, and then 20 – 60% of them go to work abroad. Gradually, there have begun to emerge a clearer picture of those areas of research where the demand for specialists is highest in the West. These are microbiology, medical research, computer technologies, chemistry and physics. Young Russian scientists specializing in these areas are finding ever more jobs at centers owned by big companies in foreign countries.

The number of state initiatives addressing the cadre policy, including those formalized as decrees, edicts and other normative-legal acts, has exceeded the number of

³² Poisk, No. 7, 18.02.2005, p.3.

measures aimed at other aspects of the national research complex. However, the measures being implemented are primarily oriented toward establishing additional payments, bonuses to scientists and research administrators, support for the leading research schools, as well as increasing the size of stipends, grants and bonuses to young researchers and postgraduates. The cadre policy was continued in the same vein in 2005. During the year, two RF President's edicts were issued³³, which established the size of grants to be paid to young Candidates and Doctors of Sciences be increased, as well as the volume of funding to their research projects. To further develop these measures, a Government's Decree was issued, which determined the procedure for allocating grants to young scientists, as well as to the leading research schools³⁴.

As demonstrated by recent years' experience, any limiting of the cadre policy to the issues of increasing salaries, including those of young personnel, can never result in a better balanced structure of the science sphere in terms of cadres. Besides, the support in the form of grants has its own limitations: firstly, it encompasses a short period (2 years, at most), and therefore the situation faced by the young remains unstable. Secondly, only a very limited number of young researchers can hope to receive such grants. At present, in view of the available data concerning the research cadres aged under 35 years, it appears that state support is being provided to no more than 5% of young researchers. As planned by the Ministry of Education and Science, it is expected that the basic monthly salary of a young scientist by the year 2008 will be increased to 15,000–20,000 roubles. Considering the perpetual inflation, this means that science in terms of salary level will remain disadvantageous, as compared to other spheres of economic activity. Thus, the measures that have been implemented so far do not address the in-depth causes of the cadre problems currently faced by the sphere of science.

3.5.6. *Private Companies In the National Innovational System*

Big business in all developed countries represents the main source for the funding of research and development, and its role is expected to grow still further in the historic perspective. In Russia, big businesses are also beginning to more actively invest in innovative activity; however, no data is available on the size of funding provided by the business sector to RDW. With rare exceptions, companies do not show their expenditures on RDW in their annual reports. This behavior has partly been due to the provisions of the Tax Code (Part II, Articles 262 and 270), which were not conducive for companies to invest in RDW and, moreover, created incentives for concealing the true costs of RDW. According to Item 2 of Article 262 of the Tax Code, in the wording adopted prior to the enactment of Federal Law No. 58-FZ, of 6 June 2005, a taxpayer's expenditures on RDW being carried out for purposes of creating new technologies or improving the existing ones, in the event they have failed to produce a positive yield, were to be included in the other expenditures on an even basis throughout the period of three years in the amount not exceeding 70 % of the actual expenditures. Investments in RDW are always associated with risks, and it is not always possible to accurately predict their result. Therefore, the introduction of such a norm, in effect, implies that a company's innovative activity will entail losses. In the Tax Code's

³³ Edict of the RF President, No. 120, of 3 February 2005, "On additional measures designed to strengthen state support to young Russian scientists – Candidates of Sciences and their Academic Supervisors"; Edict of the RF President No. 121 of 3 February 2005 "On making amendments to Edict of the RF President No. 424 of 27 March 1996 "On some measures designed to strengthen state support to science and higher educational establishments of the Russian Federation".

³⁴ Decree of the RF Government, No. 260, of 27 April 2005, "On measures designed to ensure state support to young Russian scientists – Candidates of Sciences and their Academic Supervisors, young Russian scientists – Doctors of Sciences and the leading academic schools of the Russian Federation".

new version such expenditures are to be written off in full, and hopefully, the information concerning RDW in the business sector will become more open.

Some selective data on several companies have made it possible to conclude that the funding of science by the business sector is on the whole growing, and that the “in-house” research is developing further. The actual situation is somewhat better than any assumptions based on the official statistics published by the Goskomstat. Thus, the expenditures on RDW of four companies (“Gazprom”, AvtoVAZ, “Severstal” and GMK “Norilskii Nikel”) in 2004 amounted to more than 4 billion roubles, which, by way of comparison, is higher than the state funding allocated in the 2006 budget to the support of HEE-based science. The company “Russkii Aliuminii” in the last four years spent several million USD on RDW and renewal of technologies; the company “Silovye mashiny” annually spends about \$ 30 million on RDW.

At the same time, Russian business is very heterogeneous, and only some companies have adequate potential for the funding of RDW. According to a survey conducted by the Central Economics and Mathematics Institute (CEMI RAS), 20% of domestic companies are experiencing financial grave difficulties, 45% – medium-level difficulties, the situation in 30% is satisfactory, and in only 5% is good. At the same time, according to the IET’s polls, the majority of companies fund their innovative activity from their own resources (71 %) and bank loans (12 %) ³⁵.

Among the companies that spend their money on research, the expenditures on “in-house” RDW are higher than the outsourcing level (i. e., orders placed with outside organizations, including state research institutes and HEEs). A growing number of companies create their own research divisions or buy the former branch institutes (“Russkii Aliuminii”, “Silovye mashiny”, “Norilskii Nikel”) ³⁶. However, outsourcing is growing at a higher rate than “in-house” research, although its share in private companies’ total expenditures on RDW remains modest.

As for the relations between companies and outsider research organizations, they are associated with some problems. Firstly, business and science, so to say, “speak different languages”, and a special intermediary institution is needed for them to interact successfully (technological brokers, consulting services, centers for technologies transfer). At present, the shortage of such intermediaries is felt most strongly, while the institutes have not yet learned to adequately promote their projects. Secondly, it is very difficult at the existing institutes, with their outdated material base, to make the transition from the development of a pilot model to serial industrial production. However, the availability of a single pilot model is not always viewed by business companies as a reliable proof of an invention to be capable of successfully working at an industrial scale. Thirdly, research institutes, especially state institutes, have a habit of working under economic agreements concerning RDW, to be completed by the submission of a scientific report. Only few research organizations are actually capable of successful cooperation with businesses. Fourthly, many companies prefer, when placing orders for RDW, to take advantage of their long-standing connections, cooperating in this framework not with institutes but with smaller teams of individual scientists. This selective outsourcing is quite understandable, because it is a well-known fact that research organizations are far from being homogeneous, and therefore it is more convenient for businesses to sign contracts with efficient groups of researchers, instead of dealing with the bureaucratic structure of a whole institute. However,

³⁵ According to the Goskomstat’s data, the share of enterprises’ own funds in the total expenditures on innovations amounts to 88.3 %. Source: *Innovatsiis v tsifrah: 2004. (Innovation in figures: 2004.)*. M: TsISN, 2005, p. 94.

³⁶ I. Imamutdinov, D. Medovikov. *Za bortom Noieva kovchega. (Overboard Noah’s Ark.) // Ekspert*, No. 1–2, 16 January 2006.

in view of the existing gaps in the normative-legal regulation of the rights to the results of technologic studies, in case of such outsourcing the institutes quite often lose their intellectual property. As for companies, including big ones, they have, so far, in their patenting activity been lagging behind the leading Russian universities. For example, "LUKoil", including all its subsidiaries, holds no more than 300 patents³⁷.

On the whole, it is competition that provides companies with incentives for investing in RDW, and so this activity is being most prominently displayed by those operating on the international market. Another important factor is represented by antimonopoly legislation, which is still weak in Russia and does not create any obstacles for big companies. Also very important are other institutional signals that serve as incentives for investments in RDW. These are, e. g., various forms of private-public partnerships. The partnerships can be effectuated through the joint funding of a company's RDW, which it fully or in part contracts out to other research organizations, or through the funding of RDW being carried out by a research institute on an order placed by an industrial company. The degree of participation, by a company, in the funding of large-scale joint projects depends on the specific type of work being funded. When fundamental research is co-funded, the State's share, as shown by mean indices recorded in foreign countries, amounts to approx. 75 %; when applied studies are funded, it amounts to 50 %, and when development activity is funded – to 25%. This issue was not elaborated within the framework of Russian mega-projects, which today are regarded as nearly the only existing type of private-public partnership. The themes addressed by mega-projects demonstrate that they are aimed at providing solutions to some specific technological problems, and are not oriented to large-scale goals. It has so far been difficult to make any final conclusions as to the results of the implementation of such mega-projects, because the first among them are to be completed only in 2006. According to experts' estimations, about one-half of the funded projects will be successful.

Thus, while noting the overall positive trend of the entrepreneurial sector's growing participation in the support of science, it should be admitted that the expenditure on RDW remain modest enough, especially in science-intensive branches. Russia still has no high-tech corporations capable of addressing large-scale technological tasks.

3.5.7. The Problem Associated with the Intellectual Property Rights Created at the Expense of Budget Funding

One of the problems that prevent smooth transferring of knowledge from the sphere of science into the market consists in the vague and controversial nature of legislation on the rights to intellectual property. This has provided incentives for organizations to commercialize the results of their research and development through a variety of "gray" schemes, as well as by selling know-how, instead of patenting and registering it as part of their assets. Thus, resulting from the fact that the intellectual property involved in the economic turnover is for most part not registered at the patenting agency, the level of its capitalization in Russian in the past 13 years had amounted, according to the Russian Agency for Patents and Trademarks, to no more than 2 %.

At the end of last year, one important step was made toward improving the normative-legal regulation of intellectual property created at the expense of budget funding. On 17 November, Decree of the RF Government "On the procedure for disposing of the rights to the results of activity in the sphere of science and technology" (No. 685). By this Decree, the provision was approved concerning the consolidation and transfer to economic

³⁷ Poisk, No. 18–19, 13 May 05, p. 3.

subjects of the rights to the results of their activity in the sphere of science and technology funded from the federal budget; as well as the changes to be introduced to Decree of the RF Government, of 2 September 1999, No. 982, "On the use of the results of the activity in the sphere of science and technology".

Decree No 685 has outlined in general the potential mechanism for the distribution and consolidation of rights. It is stated that, in the event of government contracts being concluded, the rights to the results of the activity in the sphere of science and technology may be consolidated to the Russian Federation – if these results, by virtue of a law, have been withdrawn from turnover, or restricted in their turnover, or the funding for these results to be developed until the phase of industrial application (including the production of a pilot batch) is to be provided by the Russian Federation. The rights to the results may also be owned jointly by the Russian Federation and the performer of the work – if these results are necessary for the execution of state functions relating to national defense and national security, or to the protection of the population's health. In other cases, the rights to the results of the activity in the sphere of science and technology are consolidated to the performer on the conditions determined in a government contract. In this connection, it is assumed that, in the event of the rights being transferred to the performer, the latter is to pay to the federal budget compensation payments from the monies received as a result of the assignment and use of the rights to the results of the activity in the sphere of science and technology, achieved at the expense of the funding from the federal budget (Item 3).

The Decree has not yet granted to the direct authors of inventions the right to dispose of the intellectual property fully and at their own discretion. A number of aspects here need to be further specified: firstly, the conditions on which the rights are to be consolidated to the performer of the work; secondly, the criteria for determining the range of those types of work in respect to which it is the State who is to undertake the development of their results until the phase of industrial application; thirdly, the procedure for determining the size of the compensation payments, the feasibility of which is, in principle, far from being obvious. At the same time, there is no doubt that a certain movement has occurred toward adapting here the liberal approach. The adoption of this document has rounded up the two-year period of uncertainty, during which state agencies were unable to coordinate the general principles and approaches to the distribution of the rights to intellectual property.

3.5.8. Shaping a New Innovative Infrastructure

Among the infrastructure-oriented projects in the innovation sphere, the focus of attention in 2005 was placed on the creation of the technology implementation zones, which represent one of the two types of special economic zones (SEZ)³⁸, as well as the organization of technoparks, including those specializing in the sphere of information and communications technologies (ICT-parks).

Despite certain similarities, SEZs and technoparks represent different instruments for promoting innovative activity. Firstly, technoparks, in contrast to SEZs, may be created without active participation of the State. Secondly, technoparks may have as their purpose the promotion of primarily small- and medium-size innovational businesses, whereas for SEZ this task can never be the core one. Thirdly, the mechanisms applied for promoting the interaction between science and business are also different. A SEZ always implies certain privileges and preferences, whereas for a technopark this is not necessary. In the event of a technopark being registered as a resident on the territory of a SEZ, the privileges

³⁸ RF Federal Law No. 116-FZ of 22 July 2005 "On special economic zones in the Russian Federation".

are enjoyed by the technopark, not its lessees. This cannot provide solutions to the problems involved in the commercialization of the results of the activity of small-size science-intensive businesses.

The selection of the first few SEZs was completed in December 2005. According to the established Law, the land on which a SE is to be created cannot be owned by either individuals of juridical persons (with the exception of infrastructure objects). This approach is stimulating in terms of the territories' development. At the same time, it becomes obvious when analyzing the list of criteria for selecting a SEZ project³⁹ that the better developed a region is, and the higher is its preparedness to invest its own funds in the zone's creation, the greater is its chance to be granted the desired status.

To the tender for the creation of technology implementation zones, 28 applications were submitted, with the resulting selection of 4 winner projects (*Table 50*). These were Zelenograd (micro- and nanoelectronics), Dubna (information technologies and technologies based on nuclear physics), St. Petersburg (information technologies and analytical equipment) and Tomsk (biotechnologies and new materials). All these areas represent frontier research, with some powerful, competitive achievements. Thus, the choice of such projects has reflected the desire to support "strong" territories and promising areas of scientific and technological research and thus to produce "success stories".

Table 50

Characteristics of Technology Implementation Zones

Region	Area of specialization	Zone's total area, in ha	Total costs of creating infrastructure, billion roubles	Share of budget funding, %	Expected revenues of budgets of all levels from zone's activity in the period of 2006–2025, billion roubles
Zelenograd	micro- and nanoelectronics	155	5.0	50	40
Dubna	information technologies and technologies based on nuclear physics	187	2.5	70	42*
Tomsk	biotechnologies and new materials	197	1.9	70	70–90
St. Petersburg	information technologies and analytical equipment	200	1.5	51	25*

* – In 2006–2018.

Source: Data provided by the federal Agency for Administering Special Economic Zones.

Despite the wide spectrum of criteria applied in the selection of projects, several months prior to the deadline for the applications to be submitted the representatives of both the executive and the legislative authorities were quite often and with assurance referring to the 4–5 potential winners in the tender for creating the technology implementation zones; among these, Moscow Oblast, St. Petersburg and Tomsk were always mentioned. This is a clear evidence that there already existed a general idea as to which territories are most promising in terms of investment. Thus, it was a competition of

³⁹ Decree of the RF Government No. 563 of 13 September 2005 "On approving the Provision concerning the conducting of a tender for the selection of applications for the creation of special economic zones".

territories are most promising in terms of investment. Thus, it was a competition of teams, not projects.

The zones are to begin operating in 2007, while the first results will be available for estimation in another two or three years. In 2006, beside the funding from the federal budget to the construction of appropriate infrastructure, each technology implementation zone will receive additional budget funding in the amount of 100 million roubles from the Fund for promoting small-size forms of enterprises in the sphere of science and technology. In particular, the Fund's resources are to be spent on preparing the cadres needed for innovative business. Such cooperation appears to be promising, because it can promote the development of small-size innovative businesses in the SEZs.

The elaboration of privileged tax regimes in the zones is considered to be the most important task. It is also intended to make the zones' residents exempt from all local taxes. The experience of the past years has shown that the introduction of privileges almost always resulted in tax evasion. Therefore it would be more reasonable first to test the indirect regulation mechanism on limited territories, instead of simultaneously introducing in all over the country.

The concepts of zones and technoparks having many similarities, the Ministry of Economic Development and Trade, after having selected the winners in the tender, suggested that it would provide the funding for five technoparks, to be picked out among those applied for by RF subjects. The Ministry has already demonstrated its obvious preferences toward Novosibirsk (information technologies and biotechnologies), Tiumen (prospecting and extraction of hydrocarbons), Kazan (chemistry and petrochemistry), Sarov (medical information and environmental technologies) and Obninsk (information and communications, biotechnologies). Technoparks will be operating without being granted the tax and custom preferences envisaged for a SEZ, but will be receiving state funding for the creation of necessary infrastructure (communications, roads, office buildings). It has not become clear yet whether special measures designed to support innovative businesses are to be implemented on the territories of these technoparks.

In addition to the idea of creating technoparks in accordance with the SEZ model, during last year the Ministry for Communications and Informatization was actively developing the government program for the creation of ICT-parks. The total volume of funding under this program until the year 2010 is to amount to approx. 123 billion roubles. About 20 billion roubles will be allocated in the federal budget to the creation of ICT-parks. It is also planned to attract resources from regional budgets and international credit institutions. In particular, the RF Government has already made the decision to attract a loan from the IBRD in the amount of \$ 20 million. It is intended to build at least four ICT – technoparks: in Moscow Oblast (Dubna), St. Petersburg, Nizhnii Novgorod and Novosibirsk. Indeed, these regions are leaders in the development of software and other ICT products. Moscow accounts for 32% of all companies of this specialization, St. Petersburg – 19%, Novosibirsk – 8%, Nizhnii Novgorod – 4%, and Tomsk – 3%⁴⁰. It is planned to create, in each of the technoparks, no less than 10,000 new jobs.

And it is in this connection that the first problem arises. No one yet knows where to find the 10,000 software specialists needed for each ICT park. This problem has already been faced by Novosibirsk, where one of the parks is being created. Today it employs 2,000 software specialists, and the inflow of more cadres can be achieved only by increasing the number of students at the HEEs specializing in this area. However, the results will not be soon to come.

⁴⁰ Source: CNews Analytics, Fort Ross, 2004 http://cnews.ru/.reviews/index.shtml?184141_short

All the software companies currently operating on Russia's territory employ only a little over 40,000 specialists. By now, the domestic companies have already reached the upper threshold in the inflow of new employees: the number of specialists graduating every year remains unchanged, as well as the approaches toward preparing such specialists. This gives rise to both qualified cadre deficit and to the deficit of any cadres in this field (including, e. g., the growing requirements for those specializing in ICT management). Thus, in 2004, 14,120 vacancies were registered on the Russian ICT market. As seen by the results of the year 2005, this index grew by almost 55% and amounted to 21,850. The number of applications for jobs during the same period grew from only 9,593 to 16,849⁴¹. By way of comparison, in early 2005 in India the number of personnel employed at 13 technoparks was more than 450,000⁴².

The second problem is associated with the lack of confidence, on the part of the ICT community, in the idea of creating ICT parks being meaningful in terms of the prospects for developing such business in this country. According to the results of a survey conducted among the directors of ICT companies, they believe that priority measures, to be implemented by way of government support, are to reduce taxation through a wider application of simplified taxation schemes, or through introducing a presumptive tax on each working place of a company's software specialists, and to support the education of appropriate cadres. Also important is the lifting of barriers in the way of software exports. ICT parks, as a support instrument, were placed at the very bottom of the list⁴³. The opponents of such parks believe that this is an instrument for providing support only to selected entities, based on a territorial principle, instead of supporting the best ones. This factor will be further enhanced in the Russian national economy, where low mobility of workforce is a typical feature. Also, the number of companies included in a technopark will be much smaller than even their overall number in a given region. Consequently, the creation of parks and zones, as an instrument, will be justified only if the goal is to develop backward territories, in order to attract there an inflow of capable workforce.

The third problem is represented by the fact that the projects for new technoparks to be created are being developed without any in-depth analysis of the previous experience of successes and failures. The question as to whether technoparks are really an efficient component of the Russian innovative infrastructure has never been seriously investigated. No reliable data are available on the number of technoparks where successful operation has already been achieved, and how this has been achieved. So far, the network of technoparks in Russia has been developing in absence of any clearly defined rules for their organization and functioning, which has diminished the yield of the majority of them far below the potential capacity of this form of economic activity organization. Many of the previously created technoparks have already ceased their innovative activity, having exhausted the initial funding allocated either from budget sources or in the form of a grant from a foreign organization. Russian technoparks are very small, if one compares the area they occupy to that occupied by an average-sized technopark in a foreign country, which is equal to approx. 10 ha. From the point of view of their organization, Russian technoparks in a majority of cases entirely depend on their basis HEE or research center, being a component of its organizational structure. As a result, technoparks have only limited opportunities for attracting private investments. The emerging picture, on the whole, cannot be described as being very optimistic: in a vast majority of cases technoparks represent projects for the

⁴¹ C. NEWS. 2005, No. 9, p. 52.

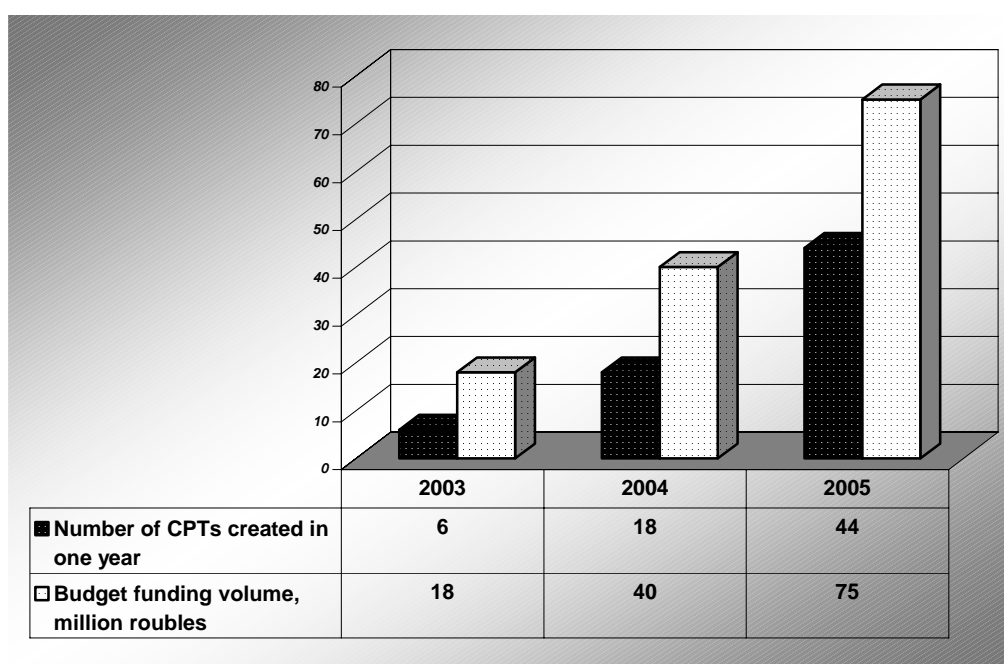
⁴² S. Shalmanov. IT v Rossii. Neurozhai umov. (IT in Russia. Bad harvest of minds) // C. NEWS. July 2005, p. 26–30.

⁴³ www.allmedia.ru, 2.12.2005.

exploitation of real estate, because their main function consists in appropriately equipping premises for their subsequent lease. Therefore, it is important to determine those fundamentally new elements that are to be introduced by the ICT park model, for how long and on what conditions the funding from state and regional sources is to be provided, and what an optimal scheme (or schemes) for managing a technopark will look like.

The problem of insufficient reliance on previous experience can also be clearly visualized, if one takes by way of example another type of infrastructure – the Centers for Promoting Technologies (CPT).

The annual number of newly established CPTs is growing, with simultaneous cuts in state expenditures on one such Center (*Fig. 62*). While in 2003 the budget support to the creation of one CPT amounted to 3 million roubles, in 2005 it went down to only 1.7 million roubles.



Source: Data provided by the Federal Agency for Science and Innovations.

Fig. 62. Centers for Promoting Technologies Created with State Participation

Guaranteed funding from the federal budget is allocated to a CPT for one year only, under the Item “Financing of RDW”, which makes more difficult the infrastructure-forming activity. In later years, few Centers still enjoyed such support. Thus, among the first six CPTs established in 2003, further funding from the budget in the form of subventions was provided to only one Center. The new performance-based budgeting system is promoting such an approach still further, because the Ministry of Education and Science must report only the number of infrastructure objects having been created, and not the number of those operating efficiently. However, for such structures to be able to survive and further develop, longer state support is necessary. It would also be feasible to allocate funding to CPTs in the form of subventions or investments.

The existing normative-legal base is not conducive to the development of CPTs, either. Thus, budget-funded organizations, in accordance with the Federal Law “On the Federal Budget for the year 2005” (No. 173-FZ of 23 December 2004) have no right to establish small businesses even at the expense of off-budget sources. This makes it nearly impossible to realize this form of RDW commercialization through the mechanism of CPTs.

In 2005, CPTs were also created with the support of the RAS, within the framework of the TACIS Project "Science and commercialization of technologies". Late in the year, on the basis of a tender, seven pilot projects designed to establish centers for the commercialization of the results of scientific research were selected, as well as seven so-called "associated project centers". The latter are to be given some modest financial support, as compared to pilot centers, for personnel training, informational support, exchange of experience with the commercialization centers, access to educational and methodological materials, and aid in the development of adequate connections, including with the European networks for technology transfer.

Today, as estimated by experts, only about 10% of the created CPTs are developing quite rapidly. The growth in their activity is being suppressed not only by the lack of financing, but also by a range of other problems, existing both in the spheres of science and business and within the CPTs proper. In particular, not every CPT visualizes the goal of its activity in the creation of an inflow of off-budget funding to the university or research organization to which it is attached, or in the promotion of small-size innovative businesses. Sometimes the idea of a CPT is perceived in a narrow-minded fashion (as an updated patenting department, as a department for supplementary training, etc.). Besides, with very few exceptions, the existing HEEs and RIs have no efficient management systems. In their turn, the entrepreneurs in the business sector are not inclined toward placing orders for RDW, or supporting small businesses by subcontracting them to carry out some of the orders received by the former. On the whole, in sphere of research and development, supply is still much higher than demand. According to the Russian network for transferring technologies, which encompasses some 30 commercialization centers, the number of companies' requests for technologies is by 20–30 times lower than the number of those available. In the European networks, the average ratio of requests to supply 1 : 4.

Thus, in addition to investigating the past mistakes, it is also important to assess the scope of the actually functioning infrastructure, including that developing without any active support on the part of the State.

One more type of infrastructure, which in 2005 received active state support, was represented by Scientific Cities. In 2005, as many as three territorial formations were granted this status – Petergof, Pushchino and Biisk⁴⁴. Scientific Cities receive targeted budget funding in the form of subventions, which are not taken into account when inter-budgetary transfers from the federal budget and the budgets of RF subjects are being distributed. The amount of budget funding to be allocated to Scientific Cities is determined on the basis of a city's population (or the number of recipients of budget-funded services). The support to Scientific Cities represents the funding predominantly of their social infrastructure, irrespective of the established goal for their development. At present, the funding mechanism is neutral in respect to the goal of a Scientific City's innovative development. It is believed that the support to Scientific Cities must be coordinated with the programs for their innovative development, which ultimately is to result in growing competitive capacities of the national economy.

As of the end of the year 2005, ten urban entities had the status of a Scientific City. However, those who had been granted it only recently were in an unequal position by comparison with those granted it in earlier years: while prior to 2005 this status was granted for

⁴⁴ RF Government's Decree of 23 July 2005 No. 449 (Petergof), RF Government's Decree of 27 October 2005 No. 642 (Pushchino), RF Government's Decree of 21 November 2005, No. 688 (Biisk).

the period of 25 years, from the year 2005, under new legislation on Scientific Cities⁴⁵, municipal formations may be granted it only for a period specially established by the RF Government. In fact, all the new Scientific Cities were granted this status for 5 years. Now Scientific Cities are to a greater degree than before depend on priority areas in the development of science and technology, and they can be deprived of this status in the event of the themes they are exploring having been taken off the list of state priorities. Since the list of priority areas is revised approximately every five years, this explains the specific length of the period established for the status of a Scientific City. These changes predetermine later uneven development of Scientific Cities and are not contributing to the integration of their programs for the development of science and technologies with their socio-economic development programs. It is not improbable that further development of those urban entities, which in fact represent Scientific Cities, will take the form of a SEZ.

The territories being developed as Scientific Cities, in effect, are duplicated by technology implementation zones, as well as by technoparks. The most interesting case is represented by Dubna, which has the status of a Scientific City, that of a technology implementation zones, coupled with the prospects of an ICT park to be created. Simultaneous development of several types of infrastructure-oriented projects is, undoubtedly, a factor that promoted the optimization of the emerging national innovations. However, along what lines will the goals of each infrastructure type are to be coordinated, if they all are concentrated in one territory? Can it happen so that the establishment of a single ICT park within a SEZ will result in unequal competitive environments?

3.5.9. New Programs and Venture Funds for Financing Innovation

The only state fund that supports the development of innovative activity has remained, in effect, the Fund for Supporting Small-Size Forms of Enterprises in the Sphere of Science and Technology (hereinafter – the Support Fund). This Fund is continually developing new promising initiatives (small-size businesses, start-up companies (the START Program), the interaction between small-size and big businesses (the TEMP Program), the training program for innovative management, etc.). However, a fund with an annual budget of about \$ 30 million cannot actually change the existing situation on a country-wide scale in any fundamental way – it can only demonstrate the success of certain instruments and approaches being applied. Regrettably, the Fund's experience is only very sparingly used by other state agencies. It is the Fund's joint initiatives with other organizations that are mostly being developed (at present – with the RAS, previously – with the RFBR).

The support for small-scale innovative business activity is of importance for the national economic development and results in high yields. This has been demonstrated not only by foreign experience, but also by the recent domestic developments. For example, in Zelenograd, where small-sized businesses are supported through a variety of infrastructure types, they generate 40% of tax revenues in the local budget⁴⁶. However, this is an exception, and small-sized businesses elsewhere in the country has so far been existing without any special support. It is noteworthy that even in the RF Strategy for Developing the Sphere of Science and Innovations in the Period until the year 2010 small-sized businesses have not been specified, among the Strategy's beneficiaries, as an independent economic agent. The overall economic environment has not yet become sufficiently favor-

⁴⁵ RF Government's Decree "On approving the Procedure for considering the proposals concerning the granting to a municipal formation of the status of a Scientific City of the Russian Federation, and concerning the termination of such a status", No. 681, of 25 November 2004.

⁴⁶ Poisk, No. 49, 9 December 2005, p. 4.

able for the development of small-scale innovative business activity, either. Thus, beginner (or start-up) companies have practically no chances to get a bank loan, because it is difficult for them to produce a pledged security (in the form of immovables, equipment or commodity turnover) for the loan's redemption, or to produce reliable proof that their business activity is profitable. In this situation, the START Program⁴⁷, supported by the Fund and continued in the year 2005, is of paramount importance.

It is typical that the most active participants in this program were universities – their staff submitted 36% of all applications for the creation of small-sized companies, whereas the scientists in the academic sector submitted only 13% of applications, SSC – 1.4%, and other organizations – 18%. The remaining 33% of applications were submitted by the personnel of the already existing small-sized companies. The generalized two-year data concerning the Program's implementation are shown in *Table 51*.

Table 51

Indices of Tender Activity and Funding for Projects under Program START

	2004	2005
Number of applications	2764	1674
Number of contracts concluded	538	421
Level of tender, applications / project	5	4
Total volume of financing, \$ million	13.0	12.0
Volume of financing during first phase, per project, \$ thousand	24.0	28.5

Source: Data provided by the Fund for Supporting Small-Size Forms of Enterprises in the Sphere of Science and Technology.

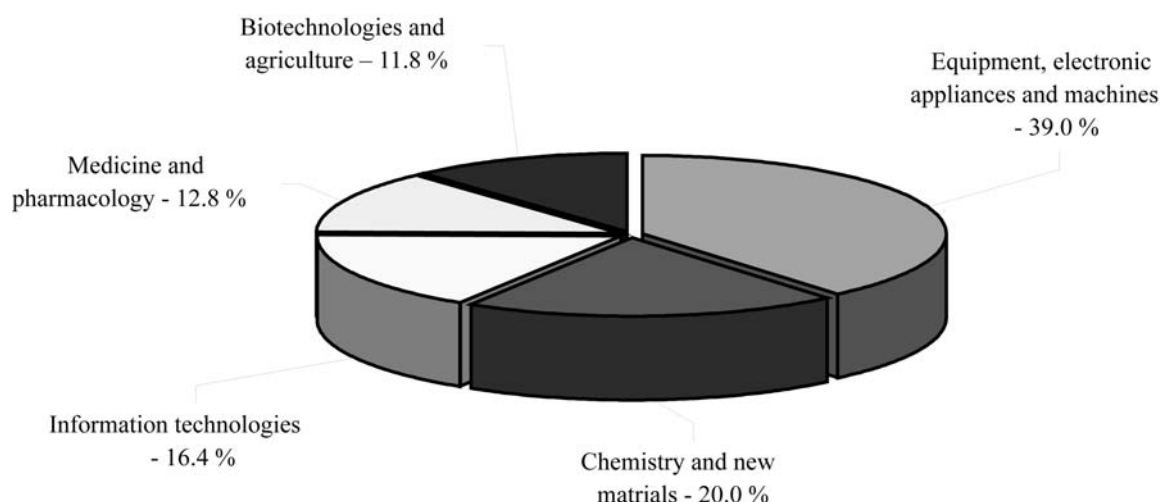
The distribution of applications in different areas of activity has demonstrated that the potential of innovative development is focused mainly in the field of electronics, equipment, chemistry and new materials, and information technologies (*Fig. 63*).

The year 2005 saw the completion of the first phase in the Program's implementation, and more than 10% of the start-up companies moved on to the second phase, when in order to continue the work it will be necessary to find an off-budget source of funding⁴⁸. This index is quite satisfactory, considering all the difficulties associated with the search for additional financing for a small-sized science-intensive business.

In 2005 the Support Fund began the implementation of a new program aimed at improving the qualification level of cadres in the sphere of innovative activity. The title of the program in PUSC (or partnership of universities with companies), and it is intended for the training of qualified teams capable of commercializing the available developments. It is planned that universities will be training appropriate cadres (economists, managers, market researchers, etc.) in order to eliminate the existing gaps in the educations of those involved in small-scale innovative business activity. The initiative is a timely one; however, the Support Fund will have to find solutions to a number of problems it is faced with. Thus, in accordance with its Charter, the Support Fund cannot provide direct funding to educational activity. Therefore, one possible variant would be for the Ministry of Education and Science to get involved in this initiative and to provide the funding for the remuneration of the tutors preparing the cadres for small-sized businesses.

⁴⁷ For the description and analysis of the development of the START Program, see: M. Rossiiskaia ekonomika v 2003 godu. Tendentsii i perspektivy. Vypusk 25. (The Russian economy in the year 2003. Trends and prospects. Issue 25) M.: IET, p. 269–270; M. Rossiiskaia ekonomika v 2004 godu. Tendentsii i perspektivy. Vypusk 26. (The Russian economy in the year 2004. Trends and prospects. Issue 26). M.: IET, p. 367–368.

⁴⁸ The data of the Support Fund as of the end of the year 2005.



Source: Data provided by the Fund for Supporting Small-Size Forms of Enterprises in the Sphere of Science and Technology.

Fig. 63. Distribution of Applications under Program START, by Areas of Activity of Small-Sized Companies

The year 2005 was also marked by a revival in the government activity aimed at the creation of venture funds. Such initiatives were put forth by the Ministry of Economic Development and Trade, the Ministry for Communications and Informatization, as well as regional authorities.

The Ministry of Economic Development and Trade launched a program for the establishment of 6–7 regional public-private funds for supporting the development of venture investments in small-sized businesses and the activity in the sphere of science and technology, in the amount of \$ 10–50 million each. It is intended that 25 % of a fund's resources will be transferred from the federal budget, 25 % – from a regional budget, and 50 % – from private investors. These are planned as closed share funds, with the payback period of 5–7 years. Presently, four such funds are being created – in Moscow, in Tatarstan, in Perm Oblast and in Tomsk Oblast. In Tatarstan and Moscow, the budgets of the new funds will amount to 800 million roubles each, of which 200 million roubles will be allocated by the region, 200 million roubles – by the Federal budget, and 400 million roubles – provided by private investors, which may include both Russian and foreign companies.

Despite the promising prospects for this initiative, there still exist some problems associated with the organizational-legal form chosen for these funds. The funds registered as closed mutual funds are subject to a high degree of regulation by the Federal Service for Financial Markets (FSFM), their asset manager must comply with very strict requirements in respect to its own capital, while the investors have practically no influence on the choice of investment objects made by the asset manager. Therefore, this form is not suitable for investing in small-sized high-risk companies of high-tech orientation. It is common international practice for venture funds to be registered as partnerships and thus obtain the necessary freedom and flexibility. A much better form in Russia, as believed by the business community, would be simple partnerships, where contracts between investors and managers can be made on flexible terms, and which are free from excessive regulation.

The Ministry for Communications and Informatization has initiated the establishment of the Russian Investment Fund for Technologies and Innovations. It is planned that its charter capital will amount to approximately \$ 100 million, the State's share being substan-

tial at the initial stage. As the fund's concept was being further developed, the initially planned State's share was greatly changed. At first, it was to be 51–75 %, then – 75 %, and by December 2005, during the first year of its operation, the State's share went up to 80 %, with its subsequent gradual diminishment, until complete withdrawal by the end of the fifth year. This fund will be focusing on investing in IT projects. As estimated by the Ministry for Communications and Informatization, the volume of investments in the Russian IT industry will not exceed \$ 80 million per annum, the total amount needed being \$ 450–600 million per annum. Therefore, the new venture fund is to become a catalyst for investments in IT. At the same time, it represents a political instrument, demonstrating the state's devotion to the development of high-tech industries.

At the regional level, one should mention the activity of the Government of Moscow Oblast, which has initiated the Fund for Supporting Venture Investments in Small-Size Businesses in the Sphere of Science and Technology. The Oblast Government is transferring 50 million roubles to the Fund.

An analysis of foreign experience has demonstrated that promoting the growth of high-tech sectors is usually more successful through the participation in venture funds than through allocating direct government investments. Direct investments are more often influenced by political motives, are prone to lobbying and therefore are not efficient enough. Therefore initiatives aimed at creating venture funds represent a positive trend. This trend is additionally important because venture business in Russia is still too passive: the volume of venture investments in 2005 amounted to \$ 62–65 million, and virtually all the transactions were effectuated with developed well-established companies, whose products had earned a good reputation on the market. All the companies are specializing in the sphere of informational and communications technologies and electronics⁴⁹. The main reason for the low activity in the sphere of providing support to start-up businesses is not the absence of interesting projects, but the cautious approach of investors who are far from being sure in the stability of their economic situation. Under such conditions the participation of the State is a guarantee of the unchangeability of the rules being applied by a venture fund. At the same time, the share of state participation in venture funds in foreign countries is much less significant. There, venture investments are ensured primarily by pension funds, banks and insurance companies.

Meanwhile, many companies are of the opinion that the State must not be present in the business sphere in any form, its function being reduced to establishing transparent general economic rules. A number of companies have chosen to create internal captive venture funds, which provide financing to small companies, whose core activity is close to that of the former. If the commercial effect of a development becomes evident, small companies are taken over by corporations. This strategy is already being practiced by the company "Aerokosmicheskoe Oborudovanie" ["Aerocosmic Equipment"] and the AFK "Sistema". It should be noted that their venture funds are not registered as share funds.

Lately, some attempts have been made at the government level to formulate the goals and tasks for the development of science and innovations in the medium term, to find appropriate instruments for promoting stable relations between the participants in an innovation scheme that would ensure the development of science, as well as practical implementation of the results of scientific research. In this connection, foreign experience

⁴⁹ Yu. Ammosov. Igra na povysheniie. // Ekspert, No. 3, 23 January 2006.

has been actively studied and adapted, which is an evidence of a growing openness of the national innovational system.

However, quite often the results of reform-oriented efforts are found to be less impressive than expected. This can be due to a number of reasons:

1. So far, government policy has remained at the stage of developing strategies that are not substantiated by appropriate tactics. Intentions are not always backed by a detailed plan of action. Moreover, even conceptual approaches in some areas are being modified too often. This can be said primarily about the concepts of national, innovative and research universities, reform in the public sector of science, as well as of the new initiatives for simultaneous creation of technoparks, zones, clusters and Scientific Cities.

2. Some practical initiatives are of a fragmentary character and do not take into account the broader economic context and the already accumulated experience. One illustration can be provided by the approaches to solving the cadre problems in the sphere of science and the integration of science and education.

3. Another problem is associated with underdeveloped and incomplete legislation which determines the functioning of the sphere of science and technology, primarily in respect to the issues of intellectual property, the development of small business, the development of venture business, and the integration of science and education.

4. An important gap is represented by the lack of variety in measures designed to promote innovative activity in the business sector. This results in the demand for innovations in the national economy being rather low, as well as in the absence of well-established connections between science, small business and big enterprises.

3.6. The Sociocultural Sphere

3.6.1. Health Care

After the institutional stagnation in the health care sector in the past decade in 2005 for the first time it underwent a nationwide reform of one of its subsystems – that is, provision of targeted categories of the population (the so-called *l'gotniks*) with medicines

The New Mechanism of Provision of L'gotniks with Medicines

In compliance with Federal Law No. 122 of August 22, 2004 (hereinafter referred to as Law-122), since January 1, 2005, *l'gotniks* were divided into federal and regional ones. The former group comprises those handicapped and participated in WW II, veterans of the War; family members of died (descended) veterans of the War; residents of the blocked Leningrad; individuals affected by nuclear radiation, disabled children, among others. They are eligible for the state social assistance and monthly allowance payable from the federal budget. The total number of the federal *l'gotniks* entitled for the said allowance since 2005 initially was estimated at the level of 14.4 mln., however it grew over the year up to 16.4 mln., or at 14%.

In 2005, the number of just disabled grew by 700,000. This process started yet in the 1990s and continued through 2005, despite of the reorganization since January 1, 2005, of the government system of medico-social expertise, whose organizations make decisions regarding recognition of disablement of an individual. The system became completely federal, with 88 newly established federal state institutions of medico-social expertise in regions and 1,667 their branches in cities and districts. However, these transformations failed to impact the substance and effectiveness of their operations – the branches usually “sympathize with people” and satisfy their disablement applications.

By late 2005 individuals entitled for various social benefits outnumbered 51 mln., of which 35 mln. are regional *l'gotniks* (15 mln. veterans of labor, 8 mln. pensioners and 12 mln. of needy families with children. The financial provision of their benefits falls under the competence of budgets of RF Subjects.

A number of the federal *l'gotniks'* in-kind benefits (free urban and suburban transport rides, housing and communal services, private telephone rates, denture services, etc.) are subject to monetary compensation. Plus, there appeared a new mechanism of provision of medicines, sanatorium and rehabilitation treatment and transportation to the place of such treatment. These services formed the so-called package of social services whose designed value was set at the level of Rb. 450 a month, including Rb. 350 to cover the costs of provision of medicines. The number of individuals eligible for free medicines rose up to 14.7 mln. by late 2005.

The right for free sanatorium and resort treatment was granted to a part of federal *l'gotniks* whose number initially was estimated at the level of 960,000, however by the end of the year the number of satisfied applications for this particular service rose up to 1,069,000. The average daily cost of this kind of treatment nearly for all the categories of *l'gotniks*, except for those with spinal problems was set at the level of Rb. 575.

The federal budget expenditures on monthly annual payments substituting for cancelled public transport rides, etc. accounted for Rb. 11.63 bln., while those on financing provision of *l'gotniks* with medicines – Rb. 50.8 bln., on sanatorium and rehabilitation treatment and transportation to and from the respective location – Rb. 12.1 bln. The aggregate federal budget expenditures on execution of Law 122 in the part of provision of measures of public social support to individual categories of citizens in 2005 accounted for Rb. 208.6 bln. (vs. 45.4 bln. reported in 2004). The Subjects' budgets allocated Rb. 92 bln. (vs. 69 bln. in 2004) on "their" *l'gotniks*.

Prior to the enactment of Law 122, the provision of *l'gotniks* with medicines had fallen within the RF Subjects' mandate and was carried out thanks to subsidies out of the federal budget, with every region organizing the provision on its own. The aggregate volume of the respective spending in 2004 made up Rb. 7.09 bln. Those funds proved to be insufficient to match the essential needs of the noted categories in medicines, with even actually issued prescriptions not being satisfied in full with medicines (the respective rate was 63%). In the 2005 federal budget the amount of spending on covering the costs of medicines for *l'gotniks* became 6.4-fold greater.

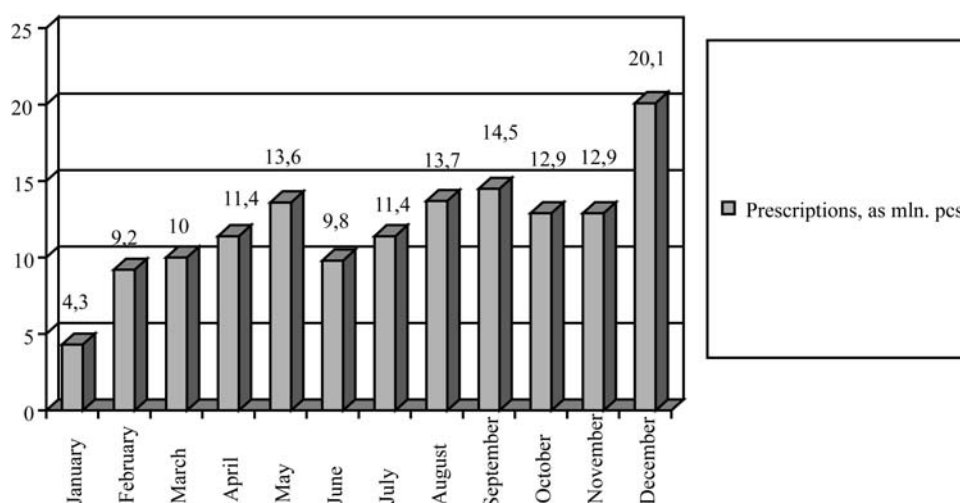
In the past, a part of the *l'gotniks* received medicines for free, while the other part with a 50% rebate. Since 2005, they all became eligible for a free provision of medicines. The list of the respective medicines was extended substantially – given that by early 2005 it comprised 362 international non-patented names and 1,986 trademarks, in the end of the year their number reached 500 and 2,346, respectively.

The mechanisms of financing the provision of medicines underwent fundamental modifications. The RF Subjects retained the right to select a pharmacy network through which medicines were to be provided to the *l'gotniks* in form of the demand for the necessary medicines. The prescriptions were produced by medical doctors at both public and municipal medico-therapeutic institutions, while supplies of medicines were given in the hands of distributor companies selected by the Federal Service or supervision in the field of health care and social development (*aka* Roszdravnadzor). For each Subject of RF there were selected a company that was to provide the *l'gotniks* with medicines and the list of producers (importers) of medicines included in the noted list. Upon negotiations with companies keen to be on the list the local administrations set marginal rates at which the companies were bound to deliver medicines to the authorized distributor companies. The

latter undertook the obligation to supply the medicines to regions upon their request with no down payment. The payments for supplies were made *post-factum* by territorial Compulsory Medical Insurance (CMI) funds out of targeted funds earmarked for them from the Federal CMI Fund. The RF Subjects were debarred from the selection of suppliers and price setting.

This particular scheme of provision *the l'gotniks* with medicines held federal authorities responsible for paying for the whole volume of prescribed medicines over which they had no control. The arrangement bore evident risks of the rise of the need in further growth of the respective costs from the federal budget, or social tension due to the impossibility to supply the prescribed medicines in necessary quantities.

Once introduced, the new mechanism triggered a rapid rise in prescriptions that reached its maximum in May, followed by a seasonal fall, then growth in August and September, and stabilization in October and November. Finally, December 2005 saw a record-breaking rise in the volume of prescriptions (see Fig. 64).



Source: Minzdravsotsrazvitia RF.

Fig. 64. The Dynamics of Prescriptions on Complementary Provision of certain Categories of Citizens with Medicines

In early 2005, because of a poor design of details of the mechanism, a number of regions faced problems with supplies of the requested medicines. A part of *the l'gotniks* for some time remained with no medicines, as they were receiving them according to the previous system of provision. By mid-February they received 6.6 mln. prescriptions, of which 88% were satisfied. However, the population's reaction to those problems was incomparable to that to other components of the reform of benefits and primarily to the cancellation of free public transport rides. The RF Ministry for Health care and Social Development and Roszdravnadzor were at pains to fine-tune the mechanism and they gradually solved the problem.

By late 2005 the overall number of prescriptions issued for *the l'gotniks* accounted for 145.2 mln., of which 138.1 mln., or 95%, were satisfied. Today, it can be argued that the new system of provision of *the l'gotniks* medicines entered the mode of relatively stable functioning, at least, the delays with provision of much-needed medicines and discontent with the new system have become far less visible.

In all, in 2005 the regions were supplied medicines worth a total of Rb. 44.8 bln., of which they consequently provided *the l'gotniks* with 33.5 bln.– worth medicines. However, as of late November nearly 40% of volumes of supplies of medicines had not been paid for, i.e. provided in the form of commodity credit. This fairly high rate proves that suppliers and distributors alike are keen to participate in the new arrangement and testifies to the fact that prices at which supplies are carried out include a fairly considerable costs compensation component associated with the commodity credits.

It should be noted that suppliers and distributors generally keep the price agreements on medicines for *the l'gotniks*, with prices for 312 brands even declining over the year. In actual fact, Minsotszdrav's regulation concerned price caps with regard to medicines delivered by suppliers and distributors, while marginal sales rates, as before, being set by the Subjects themselves.

In October, the RF Government adopted its Resolution of 10/17/2005 "On improving the state regulation of prices for medicines". It was decided that the list of medicines for *the l'gotniks* became subject to Minsotszdrav's approval. Prices for all the medicines included in the list are regulated by means of state registration of marginal sales prices for both overseas and domestic producers. As well, marginal sales increments to the prices would now be set at the federal level. The registered marginal producer prices would be included in a public register conducted by Roszdravnadzor.

The indicator of an annual aggregate price rise for all medicines including those subject to retail trade and procurements for *the l'gotniks* and stationary medical institutions made up 15%, while the retail prices for medicines grew by 40%. The comparison of these data compels to assume that both suppliers and distributors introduce extremely high assessments of risks to retail prices, albeit such risks diminish substantially once they are incorporated into the new system.

The main superficial challenges associated with the introduction of the new mechanisms became long lines formed by the *the l'gotniks* anxious to get their prescriptions, growing pressure on doctors, for now the lion's share of their office time is spent on paperwork related to producing *the l'gotniks'* prescriptions. Despite the noted considerable extension of the list of the medicines, in some locations there arise problems with their insufficient list to ensure an efficient treatment of certain categories of patients.

The major (and still latent) defect of the recently introduced mechanism became the absence of clearly set forms of regulation of volumes of consumption of medicines. Prior to the reform the volumes of the prescriptions of medicines were pre-set by volumes of their procurements with the use of allocated targeted funds. The health care administrative agencies let every medical institution and, accordingly, each local therapist know of the volume of medicines of different brands they could prescribe to their patient over a given month. Under the new mechanism, doctors were granted with the right to set on their own the volume of prescribed medicines, with no limits being preset "from the top". The refusal of employment of other instruments from the arsenal of pharmaceutical management methods was quite conscious. The Ministry leadership explained that by the desire to exhaust the delayed *l'gotniks'* demand for the much-needed medicines and in an experimental way find its actual volume. In reality, in all likelihood the equally significant factors became the lack of overseas experiences and a short time for mastering and comprehensive introduction of them.

Indirect constraints in this regard were a pre-set limit of the number of medicines listed in one prescription, relatively long time required to fill it out, and capacity of doctors that do it. In the first year of introduction of the new system the funds reserved in the budget proved to be sufficient to ensure satisfaction of *the l'gotniks'* actual demand, and

the noted indirect constraints were likely to play their part in this respect. This can be proved by numerous facts of long queues in polyclinics for prescriptions for *the l'gotniks*, a long waiting time, which undoubtedly affected the volume of the demand. However, such means of constraining demand potentially is ineffective and implies high social costs for consumers. Should the policy of refusal of planning volumes of prescribing of medicines be practiced further on, there will arise serious risks of growth in the gap between the size of the demand and its satisfaction. The need to introduce regulation of the volume and costs of prescribed medicines will arise inevitably, however, a panicky reaction would doom one to favor traditional, rough-and-tough methods of limitation of volumes of prescribed medicines over developing methods of soft regulation of offer and demand.

In compliance with Law 122, *the l'gotniks* were granted with the right to decide on their own between the receipt of the services included in the set of social services and cash compensation worth the value of the set. The choice was to be made until October 1, 2005. For reference, the annual value of the provision with medicines in the composition of the set of social services is Rb. 4,200. The actual average costs of medicines delivered per capita accounted for Rb. 2,698, so for many *l'gotniks* the choice in favor of cash appeared quite grounded. The number of those who have opted for cash proved to be extremely great and accounted for 54%, including: disabled veterans of WW II – 34%, war veterans – 43%, veterans of other military actions – 87%, disabled – 30%, disabled children – 61%, individuals suffered from nuclear radiation – 45%. Let us note that most of those who objectively are in need for a relatively greater volume of medicines refused to receive the set – either they underestimate their need in the medicines and overestimate the possibility to buy those on their own from retail vendors, or they value too much time and other costs associated with obtaining the respective prescriptions. Such a behavioral pattern testifies to the fact that being fairly technological from the managerial perspective, the recently introduced scheme of provision of medicines entailed effects that appear fairly doubtful from the perspective of the state of health of the targeted categories of the population in favor of which the scheme had been introduced.

The said choice – that is, cash vs. the in-kind set, and its results also cause a serious economic challenge – namely, the problem of unfavorable selection, which is a classical problem in the insurance sphere. Those who retain the provision of medicines experience a far greater need in them than those who opted for cash. No one among *the l'gotniks* that receive very costly medicines (such as hemophiliacs whose treatment costs some USD 10,000) proved to be keen to receive cash, instead of free medicines, which is quite natural. As well, those who are seriously ill and/or afraid of deterioration of their state and, consequently, a growing need in medicines have also remained in the program. However, the size of the average cost of the social package payable to all of those who refused from it was computed proceeding from the costs for provision of medicines to most *l'gotniks*. Should less than half of them with a higher need in medicines remain in the program, the respective costs for the provision of them with medicines would be greater than the cost of the package multiplied by the number of those who have remained in the program. That is why during the year one will need either to allocate additional funding to secure the provision of medicines to those who remained in the system, or there will arise the noted necessity to introduce limitations on the volume of prescriptions of medicines.

In mid-2005, the top officials of Minsotszdravrazvitia announced a new idea of establishment of a system of voluntary medicinal insurance. Participants in it were promised 50–70% discounts in the event of purchase of medicines, should they contribute 70 Rb. a month. Quite naturally, the initiative stirred quite a moderate reaction of insurers that operate in the area of voluntary medical insurance and who are well aware of the noted problem

of unfavorable selection. To make such programs viable, one has either to use sophisticated and hardly fine-tuned methods of computation of insurance tariffs, or their transformation into complementary insurance programs. The initiative was abandoned by the end of 2005.

New Government Policy Priorities

The autumn of 2005 saw notable turbulence of the country's political life, which focused on matters of organization of the health care system on the whole. By the time the one-year idle phase of the program implementation had been over. Just a reminder, in his 2004 Address to the Federal Assembly, President Putin accentuated the health care reform objectives. The Government postponed them and focused on the campaign on monetization of benefits. The discussion of the reform concept and the respective bills was discontinued, and the impression was that scared by the growing social tension due to mistakes in the design and implementation of Law-122 in the part of monetization of transport benefits, the federal agencies decided to restrain from any action associated with even a minimum risk of triggering a negative reaction of the population or professional groups.

Nonetheless, the country's political leadership is obviously well aware of the intensity of problems in the health care sector and the need for, at least, their mitigation. At his meeting with the Cabinet, heads of the Federal Assembly and members of the Presidium of the State Council on 5 September 2005 President Putin declared the task of fulfillment of four priority national projects – “Modern health care”, “Education”, “Affordable housing”, and “Development of Agriculture”, with health care as the top priority.

The respective national project planned for 2005–07 is clearly costly, and its evident mission is by means of giving boost to the public funding of the sector to mitigate the intensity of a number of its critical problems and to demonstrate to the population the care of the state of this particular sphere.

Within the project, priority was given to development of the primary medical assistance and provision of the population with highly technological medical assistance. The former priority avenue provides for a transition to new forms of labor compensations for general therapists and pediatricians (an increase of their monthly salary by 10,000 Rb. on average), nurses (at 5,000 Rb. on average), expansion of training of such doctors, equipping municipal medical organizations with diagnostic equipment, equipping ambulance stations with means of communication, cars, procurement of vaccines against hepatitis B, roseola, flu,, and population immunization (37 mln. people annually), prevention and treatment of AIDS- and hepatitis B and C- infected citizens, and clinical examination of various groups of the population. The latter priority avenue implies construction of 15 new federal medical centers and increase in the volume of the free delivery of the so-called highly-technological medical assistance by federal medical organization from 60,000 patients treated in 2004 up to 250,000 in 2008.

The project implies allocation out of the federal budget of Rb. 581. bln. in 2006 and another 87.7 bln. in 2007. As a result, in 2006 the cost of the project “Modern health care” will account for 43% of the total of Rb. 134.5 bln. provided for implementation of all the our national projects.

The selection of the primary and highly-technological medical assistance as priorities of the project “Modern health care” appears well grounded. Technologically, the primary link of provision of medical assistance plays a critical role in the counteraction of a national health care system to unfavorable trends in the population's state of health and sickness rate of non-infection and infection diseases, and it secures the rise in efficiency of opera-

tions of the medical assistance system on the whole. However, the level of labor compensations of employees in the sector and the material base of the primary link appears extremely low vis-a-vis other links of the system which is why the focus on development of the primary medical assistance is justified.

The state of affairs with the availability of highly-technological medical assistance is also extremely hard. According to some estimates, the volume of such assistance delivered at the expense of the federal funding, i.e. formally free for patients accounts for 10% of the actual need. Should the volume more than quadruple over next three years, it would undoubtedly increase the degree of actual availability of this kind assistance.

It should be noted that prior to adoption of this particular project, while discussing the need to boost expenditures in health care, Minzdravsotsrazvitia RF accentuated primarily proposals on building new federal medical centers that might attract additional revenues to the sector by delivering internationally competitive medical services and attracting patients from overseas. This particular task has not been articulated in the adopted national project and the hierarchy of priorities became different, which undoubtedly mirrors positive shifts in the Ministry's future policy.

Nonetheless, it is intended to allocate Rb. 32 bln. to build the 15 medical centers. Overall, the structure of planned expenditures on the project implementation in 2006–07 appears as follows; the transition to new forms of labor compensation – 21%, procurement of medicines – 14%, equipment purchases – 26%, capital construction and equipment to the centers – 22%, payments for delivery of highly-technological assistance – 11%, misc. – 6%. Thus, 73% of expenditures on the project are somehow associated with centralized procurements of medicines, equipment, services, and works.

This highlights high the associated risks of corruption. To ensure control over implementation of the national projects, by his decree of 21 October 2005 President established the Council for implementation of the priority national projects. At present it is hard to judge to what degree its operations will help lower the said risks, however, the mere fact of its creation testifies to the top political leadership's anxiety to ensure actual effectiveness of the project and not only a due PR-effect.

In its genuine form, in addition to the boost of funding of the health care sector, the national project provided for limited measures on increase of the efficacy of its functioning. It was suggested to accomplish the transition to new forms of labor compensations for doctors and nurses of the primary link by introducing a performance-based system of material incentives, rather than an automatic rise of salaries. That, however, remained only on paper. Plus, promptly designing a universal nationwide performance-based methodology of stimulation of doctors in a country with a great diversity of conditions of their operations and the population's state of health is nearly a mission impossible for a single ministry. As a result, the Government ruled that the respective funds would be allocated to regions not in the form of interbudgetary transfers, but in the form of subventions out of the Federal CMI Fund to regional ones, with their consequent earmarking to health care institutions, providing they have concluded agreements with the territorial CMI fund on carrying out a government assignment to deliver complementary medical assistance. The institutions in turn enter into complementary agreements to individual contracts with general therapists and their nurses. It is recommended to incorporate in such agreements conduct of clinical examinations, prescription of medicines to *the l'gotniks*, conduct of immunization of local residents, etc. Thus, the rise in the primary link personnel's salaries has been linked to the growth in the volume of their assignments, however, in all likelihood the identification of the volumes and control over actual performance will be formal.

It is provided for a modification of procedures of funding federal medical organizations that deliver highly-specialized medical assistance, which will imply transition from the estimate-based funding of their maintenance to their financing on the basis of governmental assignments. This will become effective starting from April 2006. It is also suggested to develop and introduce a system of patients waiting-lists with regard to the possibility to receive such an assistance, which should enhance transparency and fairness of procedures of sending patients from regions to the federal clinics for the sake of receiving such an assistance.

Unfortunately, with this institutional innovation, their list in the project framework is closed. Meanwhile, the challenges that the national health care system is currently facing lie not only with insufficient resources to boost its availability and improve the quality of medical assistance. Rather, those are the substitution for the public funding with private, with the formal keeping of the guarantees, a considerable inequity with respect to availability of medical assistance, low efficiency of the system, and the absence of incentives to its increase. These challenges require a comprehensive reform of the system of state guarantees of provision of medical assistance, the CMI system, and restructuring of the medical services system.

Debates Around Reforms

The introduction of the new system of provision of medicines and the adopted national project do not exhaust the Russian health care reform agenda. It was clearly articulated in the Presidential Address of May 26, 2004 as specification of guarantees of free assistance in the form of standards of medical services, restructuring of the budget institutions network, including modification of their status and transition from the estimate-based principle of their operations to payments for an actually delivered volume and quality of medical assistance in accordance with principles of voluntary medical insurance, and creation of incentives of development of voluntary medical insurance. To get the mission accomplished, Minzdravsotsrazvitiya developed federal bills on state guarantees of medical assistance and compulsory medical insurance, and the draft health care restructuring program. However, the Ministry has abandoned the task of coordination of the bills with other ministries and from the autumn of 2004 shifted its focus on the monetization of benefits and reforming the provision of medicines to *the l'gotniks*.

Meanwhile, the declared avenues of the suggested health care reform have been harshly criticized by a part of the medical community and mass media. The Cabinet meeting decided to put off the discussion on the health care reform till the end of the year. In his 2005 Address, President Putin repeated his concern of the state of the national health care system, however, he stated that the problems of its modernization should be tackled with a great caution and there should not be reorganization for the sake of reorganization.

On October 11, 2005, in Penza, the Presidium of the State Council debated measures on enhancement of availability and quality of medical assistance. Its Task Force had prepared a report in which articulated the urgency of solving the problems and the need in acceleration of development and enactment of federal statutes "On health care in Russian Federation", "On state guarantees of medical assistance", "On compulsory medical insurance", "On insuring professional responsibility of medical staff", "On autonomous institutions". While addressing the meeting, President Putin also articulated that there was not time left to enact the basic statutes in the area and the Government and Federal Assembly should pass them as soon as possible.

Finally, on October 17, 2005, the Cabinet at its meeting discussed the concept for development of health care and approved main avenues of its development over 2006–2010, as follows:

- Modernization of the system of compulsory medical insurance;
- Legislative fixing of state guarantees of provision of medical assistance to the population;
- Transformation of a part of medical institutions into new organizational-legal forms (autonomous institutions);
- Improvement of the system of provision of medical assistance;
- Ensuring the access of citizens to efficient, safe and qualitative medicines, shaping a comprehensive program of provision of individual categories of citizens with medicines;
- Improvement of the state of health of children and women by enhancing the accessibility and quality of medical assistance;
- Attraction of additional financial sources for the health care sector, etc.

While both the President and the Cabinet repetitiously accentuated the need in reforms in the sector and adoption of new laws, there have not been any real changes. Statutes themselves mean too little, when a systematic, consistent efforts at all the levels of power and society are required to modify the system. It is unlikely the much-needed changes will be launched in 2006.

For nearly a decade the country has discussed conceptual options of the health care reform, with the only practical change to date – that is, the introduction of the new system of provision *the l'gotniks* with medicines. Where does the obstacle to repetitiously declared governmental intents lie?

First, it should be noted that like in other social sectors, the health care financing system is full of institutional traps:

- Any revision of the existing guarantees is associated with huge budget and political costs – the recent monetization clearly demonstrated that it is impossible to change social guarantees without considerable price the government will have to pay for the cancellation of old guarantees;
- The long-standing informal practices of receipt of and payment for social services have formed a block to the division of responsibility between the government and the population for social services delivery and increase of the efficiency of the use of the respective public funding – the practices appear efficient for their subjects, both services suppliers and most consumers of theirs, for should payments be legalized, the latter would pay a greater price for them. That is why the costs needed to limit the practices are huge;
- Modification of the current public funding mechanisms requires huge administrative costs, as demonstrated by the recent campaign on monetization of benefits.

So, the costs of reform implementation in the health care and other social sectors are very huge, while practically all the subjects within the sector find the balance between costs and benefits under status quo being better, or, at least, not worse than in the event of its modification. This forms a major stumbling block on the path of reforms.

Another block is the absence in the society of a sufficiently broad consensus with regard to objectives and substance of much-needed transformations. Most interestingly, the critics attack a phantom, rather than actual substance of reforms (see *Table 52*). This mirrors, first, a high degree of mistrust in government's actions and, second, the existence of a profound conflict in the society – that is, the gap between demands for fairness and effi-

ciency expressed by the population, regional authorities and sectoral communities on the one hand, and those – by the Government, on the other.

Table 52

Health Care Reform: Reality and Phantom

What actually proposed:	What is criticized:
<ul style="list-style-type: none"> • Specification of state guarantees of free medical assistance (standards) • The network restructuring • New forms of public institutions 	<ul style="list-style-type: none"> • Liquidation of free medical assistance • Closure of much-needed for the people institutions • Malicious intent of privatization

Since 1997 the much-needed healthcare reform guidelines recognized efficiency requirements as the reform priority, while the population, sectoral communities, and regional bureaucracy valued fairness the most. In the eyes of the population the proclaimed reform does not restore fairness in terms of accessibility of free medical services, while reformers silence the main reasons for the insufficiency of funds to honor the public guarantees—namely, the reforms of the 1990s and corruption. The sectoral communities believe that the reform does not solve the problem of their labor compensations, which are unfairly low, and perceive it as a threat to the maintenance of informal practices of receipt of fair labor compensations. Regional bureaucracy does not support the reform, because they believe it fixes an unfair distribution of funds and responsibility between the federal center and regions. Notably, the ideas of fairness of the above groups appear conflicting, however, it is critical that they differ from the declared reform avenues wherein the priority is granted to the demand of efficiency of the sectors’ functioning and use of public funds allocated for the sector.

It should also be stated that the federal center does not appear united in its stance towards the reform, for departmental ideas of efficiency being diverse. The MinFin, Ministry of Economic Development and Trade, Minzdrav and presidential Administration have failed to mobilize a stable consensus on the substance of the proposed transformations over the past eight years.

The experiences with conduct of monetization show that the room for a possible compromise between the noted multi-vector requirements to efficiency is too narrow and it is hard to reach it. That is where the key obstacle to the success in reform lies.

Processes that will help get interests in the reform consolidated will be a continuous rise if inequality in terms of accessibility of medical assistance that also forms a factor of accumulation of protest potential and the apprehension of the inevitability of the national catastrophe, should there be no drastic transformations in the health care system, for without its qualitative modification there will be no chance to reverse current negative demographic trends in the country.

3.6.2. Education

The past year saw a notable activity of the state in developing and implementing both strategic and ongoing measures in the area of support and development of the educational sphere.

It should be noted that the Government has displayed a notable activity with regard to development of strategic documents in the educational area that should form priorities and objectives in support and control of development of education as a critical resource of the new, or knowledge-based, economy. Thus, in December 2004 the Cabinet adjudicated

Priority Avenues of Development of Education that include: development of a modern system of continuous vocational training (extension of additional vocational training, public accrediting); improvement of the quality of vocational training (categories of universities, the level of employers' participation in modification of educational standards); securing the investment attractiveness of the educational sphere (expansion of organizational and legal forms, public institutions); enhancement of accessibility of a qualitative general education (pre-schooling, the structure of educational standards, individual training programs (ITP) in profile training); transition to the per-capita principles of funding, and shaping an efficient market for educational services. The core project and programming vehicle of implementation of the basic reform guidelines is the Federal Program of Development of Education for the period between 2006-10 that was included in the list of federal targeted programs the Cabinet approved on 11 September 2006. In addition, to ensure implementation of the noted directions there was developed and consequently adjudicated by the Government set of measures aimed at development of the educational system in RF until 2010 (The Government assignment of 25 May 2005, No. AZH-P-44-2534).

However, the intensity of yet unsolved socioeconomic challenges facing the educational sphere, the absence of envisaged effect from budgetary resources spent on implementation of the previous targeted programs and the need for ensuring breakthrough results in the most urgent matters compelled some experts to raise before the Cabinet the idea of implementation of one of priority projects in the educational area. According to its authors, it should provide a strong impetus to the development of the whole system of Russian education.

The National Project in the Educational Sphere

On September 5, 2005 President Putin announced the initiative on launching the four national projects and "Development of Education" in particular. Like the others, it is envisaged for the term of 2 years (2006–07) and focus on the state support to universities and schools that vigorously introduce innovational educational programs, as well as a program on support of the best teachers, informatization of education, support of gifted youth, design of a system of vocational training in the army, upbringing of the secondary school students, among others (see *Table 53*).

Table 53

Components of the Priority National Project on development of Education

No	Avenue of action	Action magnitude (indicators)
1.	State support to universities and schools that vigorously introduce innovational educational programs	30 universities (some 2,5%) 6,000 secondary schools (slightly under 10%)
2.	Annual bonuses to the best schoolteachers	Rb. 100,000 for the best 10,000 schoolteachers
3.	Support of active users of informational educational technologies	20,000 secondary schools (some 30%) and 100 universities (less than 10%)
4.	Establishment of new universities in the Southern and Siberian federal okrugs, and business school for management training	2 universities in the noted okrugs and 2 business schools in Moscow region and St.Petersburg
5.	Supported of the gifted youth	5,000 grants worth Rb. 60,000 each
6.	Development of the vocational training system in the Army	Not less than 100 educational and vocational training centers
7.	Support of teachers in the form of bonus for out-of-class guidance of students, including those in the primary school	Additional monthly bonuses payable to 900,000 schoolteachers

The volume of support on the first avenue should amount to some Rb. 1 mln. for a secondary school and between 500 mln. to 1 bln. for a university. They will be able to spend the funds on staff training and recruitment, modernization of their material base, including software, repair and maintenance works, and development of methodological and tutorial materials. In the case of universities, it is suggested to employ such criteria as: the existence of a strategic program, public management bodies (such as board of trustees, etc.), level of extrabudgetary resources, quality of training according to an employers' independent rating, transition to new mechanisms of financing and new organizational and legal forms, and participation in international projects.

The second direction provides for employment of tender-based procedures designed in collaboration with regions and direct annual grants worth a total of 100,000 each for the best 10,000 schoolteachers.

The third avenue provides for organization of development of a federal portal for distance learning, support of active users of information technologies through equipping schools and universities with modern computerized means and securing access to the Internet for 20,000 schools. The development of the portal, design of 100 distance-learning programs and procurement of equipment worth a total of Rb. 0.2 bln. should ensure the launch of the educational portal in the second half 2007. The support of active users of information technologies will be carried out along two avenues; that is, Rb. 2.0 bln. will be spent on organization of computerized facilities in 100 universities and 2,500 schools, while another Rb. 0.8 bln. will be earmarked on connecting 20,000 schools to the Internet.

On the basis of concentration of the existing universities and research centers' resources the fourth avenue should provide for establishment of two new national universities (with 25–30,000 students, of which 20% should be overseas ones) in the Southern and Siberian federal okrugs, and the launch in Moscow oblast and St. Petersburg of two business schools (with up to 1,000 students) for the purpose of training managerial cadres for large investment projects, promoting entrepreneurial activity and modern management technologies. It is planned to earmark in 2006–08 a total of Rb. 9 bln. for all the stages of establishment of new universities – from the feasibility study to organization of the housing and social-household infrastructure for faculty and students, including Rb. 3 bln. for a university and 1.5 bln. for a business school.

To support young inventors and researchers, talented and initiative young individuals who will have excelled in studies, entrepreneurial and other publicly significant areas, the project's fifth avenue provides for setting 5,000 individual grants of Rb. 60,000 each, as well as organization of competitions, summer schools, stipendiums, grants, development and conduct of data bases of talented young individuals aged 12 to 20. The project also provides for organization of a public movement entitled "Russia of Talents".

The sixth avenue provides for creating conditions for conscript military staff to receive in specially created training centers civil diplomas of primary vocational training, while for draftees (not less than 5,000 of them) – conditions for pre-university training. It is provided to allocate some Rb. 5 mln. for each training center. According to the RF Ministry of Education, these measures should improve attractiveness of the army and transform it into an educational and vocational vehicle and ensure a greater accessibility of education to certain strata of the population.

Given a particular importance of the pedagogical function of the secondary school, the seventh avenue provides for introduction of monthly cash bonuses for 900,000 schoolteachers that deal with out-of-class guidance and primary-school teachers.

The volume of financial resources that have to be earmarked from the 2006 federal budget on implementation of the national educational project should account for Rb. 30.8 bln.

According to the designers of the project, the systematic nature of changes in this particular area, which are generated by the implementation of the national project, will depend on implementation of the best practices, organization of training, a vigorous introduction into selection procedures of civil society organizations and potential initiators of changes (other than red tape), intensification of feedback in the educational sphere through the launch of evaluation and monitoring systems.

The national project *prima facie* is a successful complement to the aforementioned strategic documents, as it suggests a direct boost of funding of education, rather than organizational transformations. It is a common knowledge that the main obstacle to improvement of the quality of education lies in teachers' low salaries – this kind of job is clearly unattractive to talented young individuals. However the question remains as whether they would be eligible for the noted bonuses beyond the project timeframe, as well as whether the bonuses would be taken into account in the course of formation of a new system of labor compensations in the budget sphere. It is unclear if these measures ultimately form elements that would become an organically inseparable components of a new sectoral labor compensations system for budget employees under which a teacher's salary would depend on the quality of his performance, including the out-of-class one, and his ability to adequately communicate with students, rather than the number of hours spent in the classroom. Plus, the selectivity of support of teachers, schools and universities will clearly conflict with the declared mission of equalization of *accessibility* of qualitative education. While teachers perceive the competition for bonuses as an incentive to professional growth, the educational institutions will view a single financial support as a factor that solidifies the inequality between them.

The poorly designed new system of labor compensations of employees in the educational sphere which was created with a genuine intention to increase the teachers and university faculty's eagerness to provide high quality tuition actually devalues the tender-based stimulation of the best of them. The system provokes corruption and abruptly leaves winners unmotivated on receiving the bonus – the probability of a second award is low, while the regular salary does not ensure normal living standards. Teachers surveys show that they prefer a regular increment (for long service, etc.) to a huge, but single bonus.

There exist risks associated with the rise of teachers' status, for the shortage of teachers of different profiles cannot be solved within a three- year period (even in such cities, as Moscow). The shortage of teachers is often coupled with their low qualification, particularly lack of expertise with regard to new sources, such as the Internet.

As concerns specific measures of the project, there are two that raise questions at most – that is, creation of new universities and business schools (as because of the earlier conducted policy, there are much fewer faculty remaining in the system), and introduction of primary vocational training in the Army, especially in conjunction with the recently declared transition to one-year conscription, for a "standard" primary vocation training requires at minimum a three-year curriculum.

It should be noted that progress in funding the educational sphere will mostly be determined by a degree of employers and big and small businesses' commitment. While addressing an enlarged Collegium of the RF Ministry of Education and Science, the newly elected President of the Russian Union of Industrialists and Entrepreneurs Mr. A. Shokhin stated that the national business community was ready to participate in the process with much gusto, however, expected the government to create attractive conditions, for instance, in the form of tax benefits. In other words, the business community's vigorous con-

tribution to the national project and modernization of education as a whole will have a substantial impact on the sector, only provided there will be a transition from sponsorship to partnership, for instance, in the form of introduction of new organizational and legal forms of educational institutions and banks extending educational loans at beneficial rates, and the state compensating for the respective benefits. Meanwhile, these matters remain beyond the national project framework.

To oversee implementation of the national project, there have been established some fifteen various structures whose sole mission will be to control financial flows in their frame. This raises a serious question as to if the control units are efficient enough not to inhibit the work on the project. In December 2005, the RF Minister of Science and Education established a Board on Education whose mission will be to ensure coordination of reforms in the educational sphere and primarily the national project. The Board was built according to the territorial principle, with a manager from each federal okrug and heads of a number of regional educational agencies being co-opted into it.

Changes in the System of Labor Compensations to Employees in the System of General Education

The RF Ministry of Education vigorously proposes the idea of transition to the sectoral system of labor compensations. Clearly, a universal nationwide system is impossible due both to legal and practical reasons. Specialists of the Department of Economic Affairs and Finance of the Ministry designed a general concept and granted regions with the right to form regional sectoral labor compensations systems.

The Ministry's concept differentiates labor compensations due to teachers' level of education, service record, and position. Thus, the maximum (1.5) coefficient was set for those with the higher profile education, while minimum one (1.0) – for those with secondary complete general education (technical staff). Due to the factor, there was set both the basic size of salary – that is, Rb. 3,975 and 2,560 as the highest and lowest rates. According to the Ministry scale, teachers are divided into 5 groups with account of the length of their service, with inter-record coefficients set for each of them. The coefficients vary within the range between 1 to 1.2.

The greatest coefficient was set for young specialists with the length of service between 2 to 5 years, followed by teachers with the record between 5 to 10 years (1.17), and those with the record between 10 to 15 years (1.15), and those with the greatest record (1.14). Finally, there follows the category of starting teachers with the length of service of up to 2 years.

The Ministry's stance is that it gives preference to young teachers over individuals of the pension and pre-pension age, albeit ultimately the differentiation is insignificant. Besides, one should take into account the fact that the greater is a teacher's length of service, the higher, a rule, his qualification category is and payments for it compensate for a modest value of inter-record coefficients.

The differentiation between labor compensations to educational staff of the 1st and 2nd group, due to their position, is not considerable (20%). Thus, the first group comprises teachers, vocational tutors, speech therapists, defectologists, and mentors, while psychologists, social pedagogues, instructors of physical culture, and pedagogues of complementary education find themselves lower at the scale of labor compensations. According to the hierarchy, the maximum salary, which is Rb. 8,780 is paid to a representative of the first group, a university graduate with the record of service of 15 years and more, while

the minimum one – a representative of the second group, with the secondary vocational education and the length of service up to two years.

As far as labor compensations to heads of educational institutions are concerned, the Ministry suggests to take into account the number of students, level of technical equipment, presence of structural divisions, and other volume- related indicators. With account of these factors, salaries of heads and principals fluctuate within the range of Rb. 7,900 to 14,150. In addition, experts of the Department of Economic Affairs and Finance of the Ministry of Education suggest a system of increasing coefficients that vary between 1.15 to 1.5 for pedagogical and top administrative staff, due to the type of educational institution. In this hierarchy priority is given to teachers of Russian that are employed at educational institutions with a non-Russian language of tuition located in the countryside and urban-type settlements. The Ministry concept emphasizes a special role of an off-tariff fund that should account for not less than 40% of the general labor compensations fund (this index currently does not exceed 20%).

Thus, given that according to the currently effective Uniform Tariff Grid the average teacher's salary is Rb. 2, 296.8 principal's 2.666.2, in the frame of the sectoral system they should make out Rb. 5.860 and 10.370, accordingly. This requires another Rb.172.6 bln. in additional funding.

The regional system of teachers' labor compensations can be exemplified by an arrangement already employed in Tyumen oblast. Since January 1, 2005, the local teachers were broken down into four groups, due to the complexity of subjects. The first group comprises teachers of Russian and foreign languages, literature, mathematics, and providing tuition in the first form of primary school. The second group is formed by teachers of history, social science, geography, physics, chemistry, and teachers of 2nd – 4th forms of primary school. The third group covers teachers of law, economics, and technology, while the fourth one – astronomy, physical culture, fine arts, music, technical drawing and basic survival skills (BSS). The oblast authorities introduced a basic salary rate payable in full to teachers falling under the 4th group, while the others enjoy an increasing coefficient, which makes up for the 3rd group – 1.05, 2nd – 1.1, and 1st one – 1.15. Principals are also paid for with account of complexity of their duties – for instance, the more pupils are at a given school, the higher its principal's salary is. In addition, the educational staff are eligible for compensations for state wards (including honors) of the USSR and RF, scientific degrees (PhD – Rb. 3,000, Dr. – 3,600). The oblast also introduced increasing coefficients for qualification categories, out-of-class education, etc.

The Universal State Examination: the 2005 Results

The experiment on introduction of USE takes place in the framework of implementation of the Concept of Modernization of Russian Education through 2010. It is guided by resolutions of the RF Government : of February 16, 2001, No.119 "On organization of the experiment on introduction of the universal state examination", of April 5, 2002, No. 222 "On participation of educational institution of the secondary vocational training in the experiment on introduction of the universal state examination", of November 29, 2003 No.725 "On extension over 2004 of the term of conduct of the experiment on introduction of the universal state examination", of March 2, 2005, No.108 "On conducting in 2005 the uniform state examination".

The data that highlight on the scale and volume of the experiment over the past five years are given in *Table 54* below:

Table 54

Indicators of the Experiment on Conduct of the Universal State Examination

Year	Number						
	RF Subjects participating in the experiment	Subjects on which USE is held	Graduates that passed USE	Persons/exam.	Universities and their branches participating in the experiment	Secondary special educat. instit. taking part in the experiment	Ministries and agencies
2001	5	8	30 000	48 524	16	-	3
2002	16	9	298 921	435 146	123	79	10
2003	47	12	654 115	1 226 734	464	928	20
2004	64	13	820 338	1 746 447	946	1525	29
2005	78	13	853 495	1 893 544	1 543	1 765	15 ⁵⁰
2006 (projected)	80	13	1 000 000	2 000 000	2 000	2 000	

In 2005, of 78 Russian regions the exam was for the first time held in 14 ones. Almost all the “old” regions have expanded their participation in the experiment, with 32 of them (41%) conducting USE practically by all the basic subjects, another 35 (44.9%) by 3 to 7 subjects, and 11 regions (14.1%) – by 1–2 subjects.

At the stage of the state (final) attestation, USE was conducted by 12 subjects – that is, mathematics, physics, chemistry, biology, geography, Russian history, social science, literature, Russian, English, German and French. At the stage of enrollment examinations to universities and special secondary educational institutions, USE was held by 13 subjects (including informatics).

In 63 Russian regions, universities and special secondary educational institutions ran enrollment examination in the form of and basing on USE materials by 100% of their respective profile specialties, while in another 14 regions that participated in the experiment for the first time they were conducted by 50% of specialties.

According to the pre-set objectives, the work in 2005 was organized by the following avenues:

- Improvement of legal acts and instructive documents;
- Continuation of testing of several technological models of organization and conduct of USE: the basic one – in 69 Subjects of RF, automated informational system “Examination” – in 9, and computerized system – in 5 ones;
- The launch of the testing of the technology of organization and conduct of USE in yadly accessible and remote areas of RF – in rayons of the Republic of Sakha (Yakutia), Khabarovsk krai, Magadan, Tomsk and Chita oblasts, and the area of Yugra in Khanty-Mansy autonomous okrug;
- Development of 465 original variants of control measurement materials by 13 subjects;
- Development of an infrastructure consisting of the federal and 77 regional data processing centers, including the possibility for universities and secondary special educational institutions to verify the USE scores by using the Federal Evidence Base;

⁵⁰ With account of the contraction in the number of ministries and agencies of the RF Government in the course of the ongoing administrative reform.

- Continuation of the testing of the automated system of informational back-up of the universal competition-based admission to universities and secondary special educational institutions;
- Training at the federal level of specialists that ensure the conduct of USE (organizers, operators, it-staff, members of examination boards, etc);
- Interaction with 1,543 universities and 1,765 secondary special educational institutions to secure their participation in the examination (design of admission procedures, those of organization of enrollment and admission basing on USE results, interaction with the Federal Evidence Base of USE results, monitoring of education, etc.).

In the frame of organization of USE, education management bodies of Subjects of the Federation have worked vigorously with boards of university rectors and principals of secondary special educational institutions, which considerably boosted participation of professional educational institutions in the experiment. With the number of universities and secondary special educational institutions growing, potential enrollees displayed a greater motivation for being attested in the form and by materials of USE. Because of that, as well as due to focus on enhancement of teachers' qualification, the number of unsatisfactory marks fell by all subjects – from 12.6% in 2004 to 10.6% in 2005 on average, while the number of excellent ones grew on average from 12.4% to 14.2%. That resulted in a 1% growth of the average score by each subject vs. 2004.

In 2005, roughly as many as 55,000 enrollees were admitted to 1,543 university (including their branches), which was 2.2 times more than in 2004. Interestingly, 697 universities and their branches in 35 Russian regions mostly practiced admission on the basis of USE results.

Overall, according to VTSIOM data (as of June 2005) nationwide 40% of surveyed citizens expressed their positive attitude towards the cancellation of admission examinations to universities and secondary special educational institutions and replacement of those by USE results, while another 26% was reported to have negative attitude in this regard. At this point, it should be noted that absolutely positive and absolutely negative assessment rates of USE have fallen, which speaks in favor of the lesser intensity of polarization of opinions of USE.

In the frame of monitoring of USE in 45 regions there were held surveys of head administrators in the educational sphere (814 of them) and methodologists (696). The survey results showed that with the length of time of participation in the experiment growing, the proportion of top educational administrators that employ the USE results to control the quality of education and consider it possible to use them while attesting schools and their pedagogical cadres was growing too. It should be stressed that an "immediate" use of the USE results for the sake of attesting institutions of general education and teachers is non-correct and may cause negative effects.

Meanwhile, the organization and conduct of USE in 2005 exposed the following drawbacks:

- In some control and measurement materials (CMM) there were errors and inaccuracies – the overall number of comments on CMM reported to the Federal Institute for Pedagogical Measurements of Rosobrnadzor made up 37, or twice as low as in 2004; of which 20 were rejected by members of the Federal Commission on Subjects, 7- did not entail changes in the graduates' score, while 10 comments (on mathematics, Russian and physics) entailed the correction of the final score for 1.4% of the overall number of those who had passed USE by these subjects. Today, the work is under way to

develop CMM evaluation patterns with attraction of highly qualified experts from regions;

- Individual cases of deliberate breaches of the procedure of holding the experiment by its participants were exposed (the use of cribs, cell phones);
- Delays with the issuance of the certificates of USE results in some localities;
- In some universities and secondary special educational institutions there were exposed cases of admission procedures that appeared conflicting with the respective federal regulation, including, in particular:
 - an unjustified introduction of additional admission examinations for those who enrolled to universities on the basis of the USE results;
 - some universities failed to fully adhere to the pre-set list of subjects while developing their admission procedures to specialties the admission to which was USE-based;
 - while enrollee were submitting their documents to universities, some admission commission required a compulsory submission of original educational certificates, as well as results of USE;
 - results of graduate examinations of universities' special training courses (which are not financed from the federal budget), university competitions and early examinations were treated as enrollment examinations.

While discussing the results of the 2005 USE experiment, numerous regions and university presidents councils raised the problem of the need in organization and conduct of USE "in one wave". This, on the one hand, would allow to save a certain part of financial and human resources, while on the other hand, there are groups of enrollees that objectively fail to pass USE in June (those demobilized from the army service, foreign citizens, mostly those from the CIS, offspring of Russian citizens that reside overseas, etc.). Should such a decision be made, these risks could be minimized by means of certain organizational and technological measures, for instance, reserving some days in July. It should be noted that the proportion of graduates of the past years, as well those from institutions of primary, secondary and professional education that take part in the "school" wave grows from year to year. It is appropriate to work out in 2006-07 standard legal models of modernization of technological provision of holding USE in "one wave", with an ultimate goal to complete the respective transition by 2008.

The transfer of the Secondary and Primary Vocational Training Institutions under Control of Subjects of the Russian Federation

In compliance with Article 26.3 of Federal Law of July 4, 2003, No.95-FZ, since January 1, 2005, the delivery of secondary and primary vocational training has been delegated to government bodies of the RF Subjects. The number of such institutions in Russia totals 6,439, of which in the first quarter 2005 2,536 ones had already been passed under the Subjects' purview, including 191 secondary vocational training institutions. The federal level has kept under its control 251 PVTIs and 1,011 SVTIs.

Until today, while being regional by their essence, such institutions were maintained and managed by the federal center (via educational agencies of the RF Subjects). That is why the purpose of the transfer is to get the educational institutions that satisfy local needs of regional labor markets closer to their immediate consumers represented by enterprises, organizations and agencies.

According to the original design, the transfer of the educational institutions under the RF Subjects' mandate should result in an emergence of regional PVTI and SVTI systems

and their optimization, which suggests their restructuring and integration that are necessitated by the unfolding hard demographic situation. In the circumstances, a fall in the number of school graduates from the 9th and 11th forms has become notable, and it promises to intensify drastically in the future. In addition, it is necessary to increase the efficiency of utilization of property that is under the noted agencies' operative control.

The RF Subjects received under their mandate the funding (from the federal budget), buildings and facilities that previously had been the federal center's property. In parallel with that, RF Government Resolution of January 24, 2001, No.64-p approved the List of federal public educational institutions due for the transfer in 2005 under control of Rosobrazovanie from other federal bodies of executive power (531 SVTIs and 1 PVTI). Plus, another 129 federal public educational institutions currently controlled by sectoral ministries (agencies) are also planned to be transferred under the RF Subjects' mandate. The overall number of SVTIs and PVTIs subject to transfer from the federal agencies to regions is presented in *Table 55*.

Table 55

The Number of Federal Educational Institutions Transferred under Control of Subjects of the Federation

Ministry (agency)	Number of transferred educational institutions
Rosobrazovanie	2,536 PVTI и 191 SVTI
Rosenergo	10 SVTI
Rossport	3 SVTI
Rosselkhoz	57 SVTI
Minsotszdravrazvitia Rossii	2 SVTI
Minekonomrazvitia Rossii	8 SVTI
Rosstry	23 SVTI
The RF Ministry of Natural Resources	3 PVTI
Total:	2,833 educational institutions, including 2,539 PVTI and 294 SVTI

Source: the data of the RF Ministry of Education and Science.

It should be noted that the transfer of educational institutions under regional control has been underway for quite a while – initiated by a number of Subjects of the Federation back in 1993, it further continued in 1997 when four regions – St. Petersburg, Nizhny and Veliky Novgorod, and Samara Oblast on their own initiative took local professional college on their balance sheets. Since then the regions saw a modification of the list of specialties by one-third, they created councils for staff policy, and the proportion of jobless with primary professional education went down considerably. Principals of professional colleges received the second higher education in the area of social management.

We believe that the most efficient solution to the set tasks is to develop regional programs of provision of functioning of various kinds of vocational training institutions. Such programs have already been developed and efficiently practiced in Samara and Yaroslavl oblasts, and the city of Moscow. Such regional programs in turn should be complemented and further specified by development programs of a specific educational institution.

Many regions report positive trends associated with the functioning of educational institutions transferred to them. Thus, in Murmansk oblast the volume of financing of primary vocational education institutions from the oblast budget grew by 27% vs. that from the federal budget – salaries to schoolteachers were raised by 20%, while it is intended to raise students' stipendiums by 100 Rb. since April 1, 2005. In Yaroslavl oblast, the financing of secondary vocational training institutions grew by 25% vs. that from the federal

budget – students' stipendium is Rb. 140, orphans have the right for a free use of public transport, and boarding costs were raised up to 15 Rb. per capita (vs. the average 9 Rb. nationwide). It is planned to raise teachers' salaries by 20% in the second half 2005.

In compliance with RF Government Resolution of December 3, 2004 No. 1565-p, education management bodies of Subjects of the Federation, in collaboration with territorial branches of the Russian Property Agency, regional property management committees and heads of the transferred educational institutions are completing – and in some regions have already completed – the work on registration of the free assignment of the federal property (including land sites that are in the permanent, termless use) to the state property of Subjects of the Federation and its exclusion from the federal property register.

However, in some regions these processes were connected with a number of certain complexities related primarily to the absence of necessary funds in the regional budgets.

The adoption of federal statutes of July 4, 2003, No. 95-FZ and October 6, 2003, No. 131-FZ, has considerably extended powers of the RF Subjects and local self-governance bodies with regard to setting both the level of labor compensations for budget employees and their conditions. Regions and territories now enjoy the possibility for opting on their own for labor compensations systems in the subordinated institutions and setting procedures of their application.

Overall, the transfer of educational institutions of primary and secondary vocational training under the regional control allows:

- development of social partnership and emergence of close relations between educational institutions and employers in the part of identification of volumes and structure of training, as well as re-training and qualification upgrading of working cadres, both youngsters that receive such education for the first time and jobless adults;
- boosting the quality of education by means of transition of the educational institution from the multi- to mono-profile training on the basis of direct contracts with corporations, as well as the operative management of educational institutions, and shorter term of the actual passage of budget funds;
- improvement of legal, as well as methodological, back-up of the regional budget institutions' functioning.

3.7. Foreign Trade

3.7.1. Foreign Trade Turnover

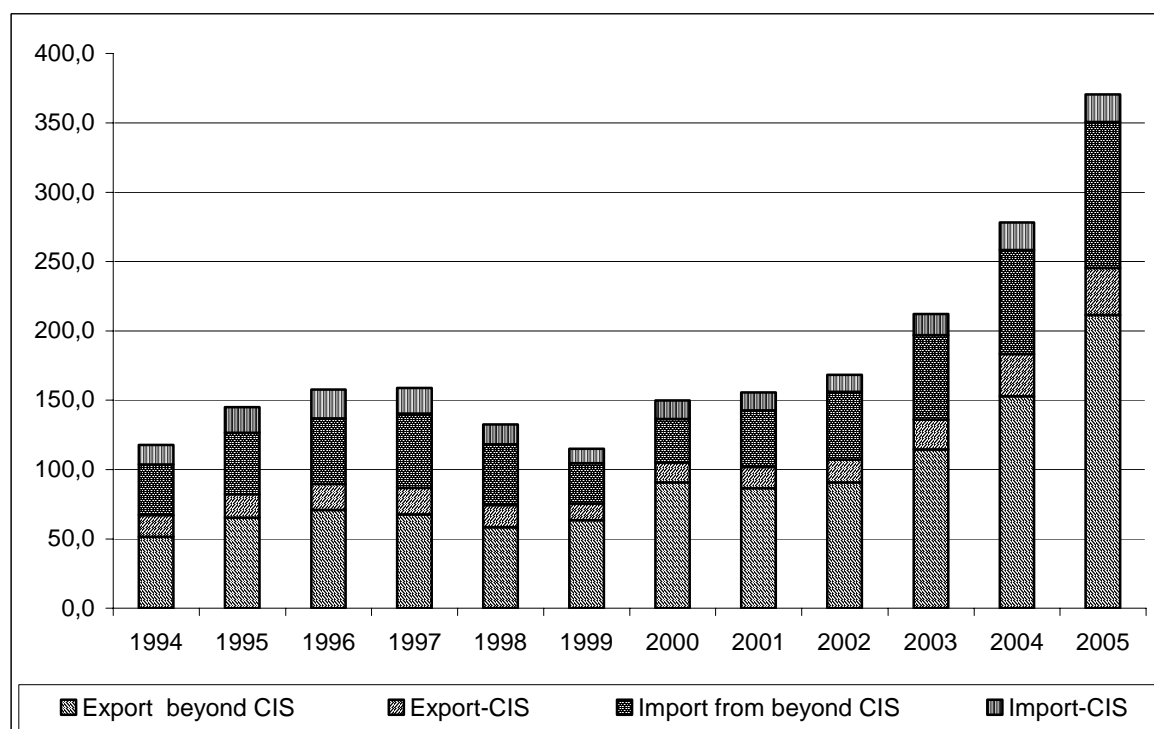
According to WTO projections⁵¹, the pace of growth rate of the world trade in 2005 dropped considerably vs. 2004. The deceleration rate in 2005 accounts for nearly 30%. It is envisaged that the global export of goods should grow by just 6.5% vs. the record-breaking 9% in 2004. For reference, in 2003 the respective index accounted for 5%.

While the members of OECD demonstrated growth in trade in the 2nd quarter 2005, the first half of the year saw the growth rates of volume of trade decline, which has had a particularly notable effect on the Asian markets and the US import volumes.

Against such a background the oil prices have broken the 20-year record, which battered consumer and business activity in oil-consuming economies. It is envisaged that a further price rise for energy sources will further be affecting consumers' and businesses' costs.

⁵¹ <http://www.wto.org>, Wto news, 27 October 2005.

By contrast, the indicators that characterize Russia's foreign trade were growing through the year of 2005 and broke the 15-year record values. Russia's foreign trade turnover computed by the balance-of-payments methodology made up USD 370.4 bln. in 2005, thus considerably over the respective index of the past years.



Source: the Central Bank of RF.

Fig.65. Russia's Foreign Trade Turnover

Russia's foreign trade turnover grew by 33.2% vs. 2004, with its growth rates with non-CIS being greater than with those with the CIS countries. In 2005, it sky-rocketed up to USD 314.98 bln., or at 36.7% more than the 2004 indicator. Russia's trade turnover with the CIS nations grew by 10.6% and accounted for USD 55.4 bln.

According to preliminary data, Russia collected revenues from foreign trade equivalent of 7.8% of GDP, or at 2.5% more than in 2004. It was export duties, primarily oil export duties, that contributed at most to the rise. As noted above, the major factor behind such a growth was the price rise for energy sources and, accordingly, the rise in basic prices used to compute the duties. Another cause became the revision of the procedures of computation oil export duties that became effective as of August 2004. More specifically, with the market price within the range between 20 to 25 USD/barrel, the duty rate was increased from 35 to 45% of the price increment over the margin of 20 USD, while with the oil prices over 25 USD/barrel, the respective increase became from 45% to 65%.

In 2005, the nation's positive foreign trade balance made up USD 120.2 bln., which became far greater a figure vs. 2004 (85.8 bln.), which became possible primarily due to the price situation.

3.7.2. The State of Affairs on the World Markets

The rise in the value volumes of Russia's foreign trade in 2005 was fueled by a considerable boost in export supplies, thanks to a favorable state of affairs on the world market for energy sources, in particular and a notable rise in imports that was driven by the growing domestic demand.

The global commodity markets in 2005 proved to be far more favorable for Russian exporters than in 2004. According to the bank of Russia, international prices, with account of the structure of Russia's export by the totality of traded commodities that included some 70% of its value, grew by 34.9%. In 2005, the average price for rals was 50.4 USD/barrel, which was at 45.6% higher than in 004. The European prices for natural gas soared at 48%, mazut – 52.3%, diesel fuel – 42.7%, gasoline – 26.3%. Overall, during the period in question the prices for energy sources grew by 43.9% on average, those for non-energy commodities – at 10%, including prices for frous metals – at 14%, non-ferrous metals – 10.6%.

The price dynamics for non-ferrous metals are usually driven by the correlation between industrial output and demand. In 2005 the main cause for the price hike noted over recent years was still the same – that is, China continued to boost the demand for them. However, the developed economies likewise pushed the demand up. Even the disastrous hurricanes in the US should have a positive effect in this regard, for it is envisaged that the country should use a lot of metal to restore the ruined facilities.

Against such a background prices for some ferrous metals demonstrated an unprecedented rise in 2005. More specifically, copper quotations grew by 33% and hit their historical maximum of USD 4,600/t. Interestingly, the first half year was relatively calm – it was suggested that after the price hike occurred in early summer 2005, when copper was traded at USD 3,700/t., there should occur a change of the trend, due to the rise in the copper production.

The stock of metal was indeed growing over the summer, but since the autumn the demand for metals grew drastically, due to China's procurements and the noted hurricanes. At that point, it became clear that the copper output was insufficient and its stock was extremely small. For instance, at LME, which is the biggest copper trading venue, its stock accounted for some 60,000 t., – the quantity the world industry consumes within less than three days. That resulted in a further price rise for copper.

The aluminum market likewise saw a considerable price rise. By late 2005 the prices had grown up to USD 2.270/t., or at 20% more than in early 2005. The stock of aluminum at LME is fairly great, some 500,000 t., but it fell by 180,000 t. over the year. The market was also keeping its watchful eye on China, for it attempts to boost its aluminum production. It was loss-making in early 2005, plus, prices for bauxites and alumina were on the rise, while electricity shortages compelled the government to shut down ten small plants there.

The prices on the market for nickel grew by 6.8% over the year. In early 2005 they were rising because of China's greater demand. However, it ultimately became clear that the demand was not that great, while prices were too high. Plus, the news that Canada was building new nickel plants also affected the market. It is envisaged that offer of nickel should exceed the respective demand in the upcoming years.

Table 56

Average World Prices

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Brent, USD/barrel	21.33	17.4	14.1	15.9	28.19	24.843	25.022	28.83	37.4	52.85
Natural gas, USD/1 mln.BTE	-	1.9642	2.5469	2.1876	4.3442	3.9764	3.3857	5.461	5.993	8.870
Gas, USD/gallon	0.71	0.615	0.511	0.529	0.887	0.7922	0.755	0.891	1.197	1.508
Copper, USD/t.	2574.9	2369.7	1775.3	1539.9	1863.9	1613.6	1592.9	1785.6	2808.2	3605.7
Aluminum, USD/t.	1590.2	1554.0	1413.5	1318.0	1550.0	1444.7	1350.7	1424.7	1693.2	1871.0
Nickel, USD/t.	8053.9	7312.4	5352.5	5239.5	8624.0	5966.0	6175.1	9580.8	13756.8	14692.3

Source: Computed basing on the LME data, International Oil Exchange London) data.

3.7.3. Export

An extremely favorable state of affairs on the world market boosted Russia's exports that hit record-breaking values in 2005. Its value volume accounted for USD 245.3 bln., or at 33.9% more than in 2004. The rise was steered mostly by the growth in export supplies to the non-CIS countries (at 38%). Exports to the CIS countries was worth a total of USD 33.9 bln., or at 12.1% more than in 2004.

Table 57

The Dynamics of Russian Exports

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Export, as USD bln.	89.7	86.9	74.4	75.6	105.0	101.9	107.2	135.4	183.2	245.3
Including: Far Abroad	71.1	67.8	58.7	63.6	90.8	86.6	91.0	113.9	152.9	211.6
Growth rates, as % to the prior year										
Index of physical volume	100.1	101.8	99.7	109.4	110.2	104.2	115.0	109.5	111.1	103.4
Price index	108.6	98.1	84.2	92.1	128.2	93.8	86.0	113.4	120.5	131.3

Source: The RF Central Bank, there ministry of Economic Development and Trade.

Under a very high 2005 price index one can note a far more moderate growth rates of export in its physical equivalent. While in 2004 Russia's export grew by 11.1% in physical equivalent, in 2005 the rise accounted for meager 3.4%. This can be explained primarily by declining physical volumes of oil export.

In 2005, Russia exported 233.1 mln. t. of oil, or at 2.7% down vs. 2004, while the 2005 oil export proceeds grew by 43.98% and totaled USD 79.2 bln. Russia supplied 214.4 mln. t. of oil worth a total of USD 73.8 to non-CIS countries, while to the CIS ones – 18.7 mln. t. (USD 5.4 bln.), with the physical volume of exported crude oil to Far-Abroad countries falling by 1.4% vs. 2004.

By contrast, the 2005 dynamics of physical volumes of export of gas, oil products and metals retained positive. The natural gas supplies grew by 3.6% vs. 2004, while petroleum derivatives – 18.7%, including: gasoline – 49.0%, diesel fuel – 12.9%, mazut – 18.8%. In 2005, Russia collected at 45.4% (up to USD 30.4 bln.) more receipts from export gas supplies vs. 2004, while proceeds form export of oil products grew 1.8 times (up to USD 33.7 bln.) vs. the prior year.

In 2005, the specific weight of fuel and energy commodities accounted for 66.8% of the total export to the noted countries (vs. 59.9% reported in 2004). The growth rate of the value volume of the group of goods in question accounted for 153.1%, due to high international prices for minerals and fuel (primarily oil).

Table 58

**Value Volumes of Russia's Export of Oil, Petroleum Derivatives and Gas
(as USD mln.) and Their Proportion in the Aggregate Volume
of Russian Export (as %)**

	Oil		Oil products		Gas	
	USD mln.	%	USD mln	%	USD mln.	%
1992	6662	12,4	2202	4.1	6389	11.9
1993	8061	13,5	3061	5.1	6964	11.7
1994	8948	13,3	3398	5.0	7939	11.8
1995	12297	15,2	4108	5.1	13381	16.5
1996	15578	17,6	7442	8.4	14683	16.6
1997	14346	16,2	7145	8.1	16420	18.6
1998	10254	13,7	4262	5.7	...	...
1999	14101	18,8	4713	6.3	...	...
2000	25284	24,5	10938	10.6	16644	16.1
2001	24576	24,6	9402	9.4	18303	18.3
2002	28950	27,1	11227	10.5	15897	14.9
2003	38816	29,1	14064	10.5	19981	15.0
2004	55024	30,3	18998	10.5	20918	11.5
2005	79216,4	34,5	33650	13.6	30424.2	12.9

Source: the Rosstat, FTS data.

Metals and metal articles still formed the second by significance commodity group of Russian exports. Its share accounted for 14.5% (down 3.1 p.p. vs. 2004), while its export value volume grew by 13.2%.

Export of non-ferrous metal products grew by 20.2% vs. 2004 and reached USD 14.3 bln, of which export to Far-Abroad countries accounted for USD 13.6 bln. (a 20.4% rise vs. the prior year) and to the CIS countries – USD 0.7 bln. (+16.7%), with 80% of the aggregate volume of export supplies falling on aluminum, copper, and nickel.

In 2005, export supplies of nickel from Russia grew by 6% vs. 2004, those of aluminum and its alloys – by 9.6%, and aluminum products – 1.3%. The structure of export supplies of the copper industry in 2005 shifted towards a greater share of export of finished copper goods. While export of refined copper plunged by 8%, the one of finished goods demonstrated a 4.7% growth.

In 2005, the value volume of export of chemicals grew by 25.3%, timber and paper and pulp products – by 18.0%. The specific weight of these groups in the aggregate volume of export to Far-Abroad countries slid just insignificantly vs. 2004 and accounted for 5.5 and 3.4%, respectively. The physical volume of potash fertilizers grew by 15.9%, nitrogen fertilizers – 10.9%, ammonia – 4.1%, caoutchouc – 3.6%, round timber – 15.5%, sawed materials – 14.8%, cellulose – 5.1%, plywood – 3.7%, commercial paper – 3.6%.

The real appreciation of Ruble in 2005 has had an adverse effect on profitability of export transactions, primarily in the manufacturing sector. The share of machinery and equipment in Russia's exports to Far- Abroad made up 3.6% in 2005, or 1.9 p.p. down vs. 2004. The value volume of the supplies in question accounted for USD 12.35 bln., or just at

0.7% more than in 2004. The machinery export to the Far-Abroad countries made up roughly as much as USD 7.6 bln. and to the CIS countries – USD 4.75 bln.

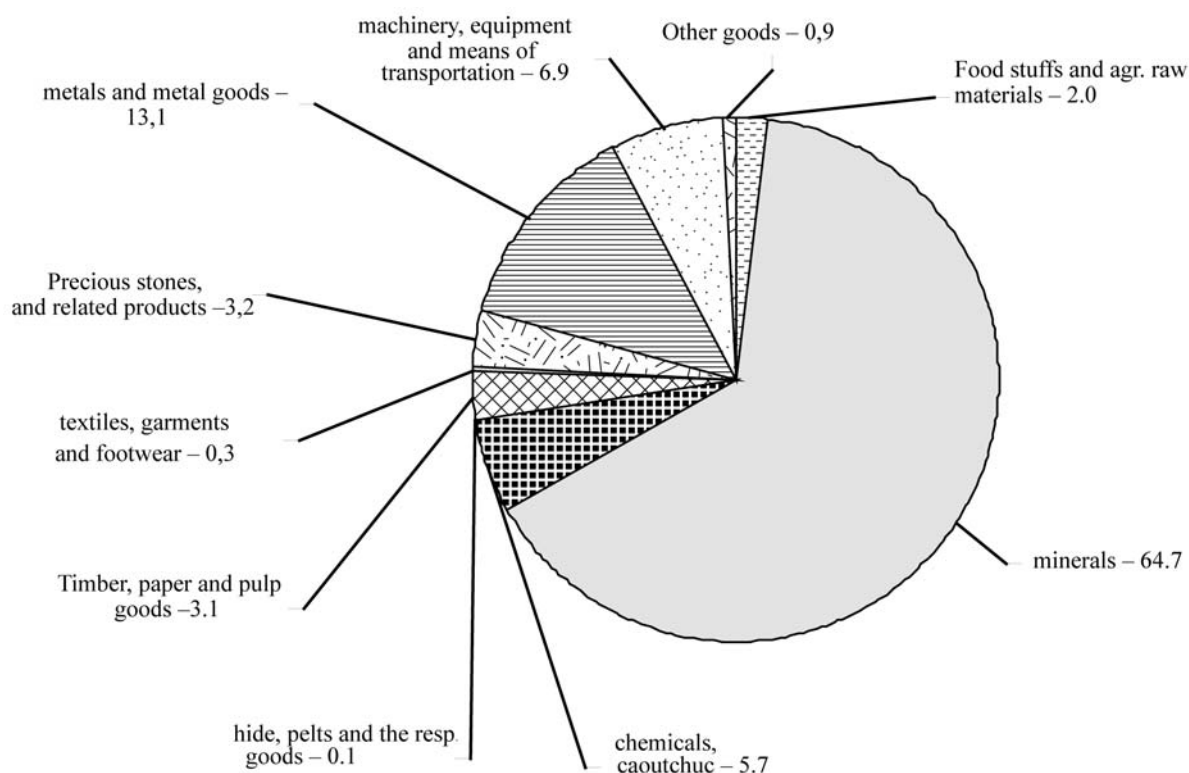
In 2005, Russia exported arms worth a total of USD 6.126 bln., thus breaking the record value over past decade. Rosoboronexport secured 85% of Russia's export of arms, with the remaining 15% being shared by Sukhoy, MIG, and Salyut. The Russian military exporters have shifted their focus towards technical servicing of Russian military craft overseas, establishment of service depots and technical centers, and joint ventures that will cope with this kind of work.

Export of Russian weaponry began its rise in 1998, and since then the volumes of supplies have more than doubled. That occurred against the general decline on the global market for arms – according to US sources, the volume of concluded contracts in the area of arms trade plunged from USD 42.1 bln. in 2000 to 37 bln. in 2004.

As concerns the goods structure of Russia's exports to the CIS countries in 2005, the share of production of the national fuel and energy complex accounted for 40.5% of the aggregate export to the noted countries (against 45.1% reported in 2004), machinery and equipment – 21.1% (21.0%), metals and metal goods – 11.9% (9.8%).

The value volume of fuel and energy commodities grew by 10.7% vs. 2004, machine-engineering products – 23.9%, chemicals – 20.9%, metals and metal goods – 49.8%.

Thus, in 2005 Russia has failed to improve the goods structure of its export and reverse its domination by minerals.



Source: FTS RF.

Fig.66. The Goods Structure of Russia's Export

High international prices boosted contractual prices for practically all the main assortment of Russian exports. In 2005, the average contractual prices for oil grew by 47.9%

vs. 2004, with those for Far-Abroad counterparts – at 48.5% (USD 344.3/barrel – up at USD 47.3/barrel). The greatest level of contractual prices for oil in 2005 was registered in September, while the lowest – in January.

The contractual prices for the basic assortment of ferrous and non-ferrous metals grew as well: export prices for raw aluminum grew by 12.5% vs. 2004, copper – 31%, nickel – 11.8%, while those for aluminum goods – 12.5%, and copper ones – at 78.5%.

Table 59

**Average Contractual Prices for Main Russian Exports
(Supplies to Far Abroad, as USD/t.)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Crude oil	133.5	118.5	74.4	110.9	179.9	156.4	162.4	181.2	231.9	344.3
Oil products	129.9	115.7	75.7	94.5	171.9	145.2	147.9	180.2	230.3	340.6
Natural gas Thos. Cub. m.	84.2	88.6	72.2	55.31	85.91	105.21	91.4	112.3	113.6	154.7
Ammonia	125.6	113.0	83.1	53.0	97.5	81.7	72.4	118.5	158.3	176.2
Nitrogen fertilizers	128.0	90.3	58.3	36.8	57.9	61.8	60.6	76.0	103.1	139.1
Potash fertilizers	7.2	79.7	87.4	86.4	86.6	76.8	74.9	77.8	94.3	133.9
Round timber, cub.m.	59.4	57.5	46.9	43.5	43.4	45.6	44.8	47.8	56.2	59.6
Cellulose	407.3	373.5	342.9	274.0	352.2	293.4	300.0	321.7	371.9	386.1
Commercial paper	473.7	383.4	394.0	349.5	386.6	421.7	332.2	338.3	387.9	455.3
Cast iron	136.8	124.2	104.3	66.8	80.7	86.2	91.1	126.8	242.7	274.4
Ferrous alloys	1114	819.2	740.8	548.2	625.6	601.7	625.7	634.6	1097.8	1582.5
Copper	2143	2099	1655	1495	1675	1465.3	1371.4	1564.9	2587.6	3389.8
Nickel	7272	6733	5140	5761	8629	5730.9	6143.9	8584.0	12660.0	14242.5
Aluminum	1500	1401	1352	1157	1296	1176.3	1036.9	1050.0	1162.1	1299.2

Source: FTS data.

The 2005 export quota (the proportion of export in output) grew by petroleum derivatives, natural gas, coal, raw timber, flat rolling, cellulose, passenger cars and trucks, while it dropped by oil, mineral fertilizers, plywood, and commercial paper.

Table 60

The Share of Export in the Output of Critical Goods (as %)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Crude oil	41.5	41.7	41.6	45.2	44.2	44.8	46.5	49.7	53.1	56.1	54.0
Petroleum derivatives	25.8	32.4	34.7	32.9	33.6	36.3	35.5	40.8	40.9	42.1	46.7
Natural gas	32.2	33.1	35.2	34.5	34.6	33.2	31.2	31.2	32.7	33.9	34.2
Coal	17.1	15.8	14.5	15.7	16.7	25.7	22.2	23.8	29.3	35.1	35.3
Mineral fertilizers	83.9	85.9	80.6	86.5	83.2	82.9	81.8	78.1	76.1	78.5	74.5
Raw timber	22.3	23.2	29.3	34.1	40.1	42.4	53.4	51.0	46.1	49.6	60.1
Cellulose	74.8	85.7	82.8	77.6	79.1	82.4	83.7	85.1	82.9	77.5	79.7
Commercial paper	71.1	72.2	70.1	74.6	70.6	69.0	67.4	68.6	66.0	65.6	61.2
Iron and steel flat rolling	53.1	59.7	58.6	63.5	60.6	55.3	43.0	50.5	47.1	46.1	48.4
Passenger cars	16.7	10.4	4.9	8.3	7.3	12.2	10.1	12.3	11.7	11.8	12.5
Trucks	25.4	17.4	10.7	9.6	8.3	7.0	12.3	20.8	19.3	23.0	22.8

Source: Rosstat, FTS.

3.7.4. Import

In 2005, Russian import peaked its maximum over the past 15 years. During the year Russia imported goods worth a total of USD 125.1 bln., or at 28.5% more than in 2004, with the share of non-CIS countries accounting for 82.6% (vs. 79.6% reported in the prior year).

Table 61

Russian Import (as USD bln.)										
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Import, total	68.1	72.0	58.0	39.5	44.9	53.8	60.5	76.1	97.4	125.1
Including:										
Far Abroad	47.3	53.4	43.7	29.2	31.4	40.3	48.2	60.1	76.4	103.3
	Growth rates, as % to the prior year									
Index of physical volume	98.1	121.1	89.0	84.4	129.2	129.1	117.6	119.2	120.8	122.2
Price index	100.2	94.8	92.3	82.1	86.7	94.3	93.4	98.7	103.1	105.9

Source: The Centrak Bank, The RF Ministry of Economic Development and Trade.

High growth rates of Russian import are fueled by an increasingly expanding domestic demand under real appreciation of Ruble. According to preliminary assessments of the RF Ministry of Economic Development and Trade, the Ruble appreciation rate against Euro in December 2005 could make up 0.4–0.6% and roughly as much as 1%– vis-à-vis USD, and the appreciation of real effective rate could account for 0.4–0.5%. In all, in 2005 (December 2004 through December 2005) the real appreciation of Ruble to USD made up roughly 3.7–3.8%, to Euro – 19.3–19.5%, the one of real effective rate – 11% or even slightly more.

The expansion of the domestic demand is generated by rapidly growing real disposable incomes of the population. Since September 2005 the growth rates of this particular indicator were steadily in excess of those reported in 2004. In 2005 as a whole their rise accounted for 108.8%, while for 2004 – 109.9%.

The growth in physical volumes of imports became possible thanks to the rise in supplies from Far-Abroad countries against the fall of those from the CIS countries. Thus, between January through September 2005 the index of physical volume of import supplies from Far-Abroad countries made up 131.4%, while from the CIS countries – 92.8%. The rise of import from the CIS countries was determined by the price component. The price index for imports from the CIS countries accounted for 117.9%, while that for imports from Far-Abroad countries made up just 103.2%.

Import expanded by most of assortment items. It was import of machine-engineering goods that demonstrated the most rapid dynamics. The specific weight of this particular kind of production in the 2005 structure of Russian imports hit 44.4%, or at 2.8 p.p. greater than in 2004. The rise in the overall volumes of import of machinery and equipment was fueled by the ongoing trend to the registered import of household equipment and consumer radioelectronics, which intensified to the maximum degree since September 2005. Given that between January through August 2005 import supplies of these items soared by 25.3% in value equivalent vs. 2004, between September through December 2005 the respective index was 3.2 times. As a result, in 2005 as a whole, Russia imported household electric devices and consumer radioelectronics worth a total of USD 4.2 bln., or 1.2 times more than in 2004.

It should be particularly noted that according to the RF Customs' statistics, the officially registered import supplies of cellular phones demonstrated a 20-fold rise by value. Their specific weight in the aggregate value volume of imported household electric devices and consumer radioelectronics was 36.4% vs. 3.9% reported in 2004. Russia's 2005 official import of cellular phones made up 15.5 mln. units, or 6 times more than in 2004. Import supplies of color TVs grew by 2.1 times in value equivalent (those with liquid crystal and plasma screens – 2.6 times), and VR- equipment, household refrigerators and freezers – 1.7 times.

The year of 2005 saw the rise of contractual prices for many imports.

Table 7

Increment rates of Average Weighted Contractual Import Prices (as %)

Goods	Increment rate (%)
Fresh and deep-frozen meat	4.9
Poultry	6.7
Fresh and deep-frozen fish	24.8
Cream butter	12.0
Sunflower seed oil	11.0
Raw sugar	23.0
Refined sugar	12.5
Pipes	34.7
Trucks	15.5
Coal	30.8
Oil products	11.7
Synthetic and natural caoutchouc	18.5

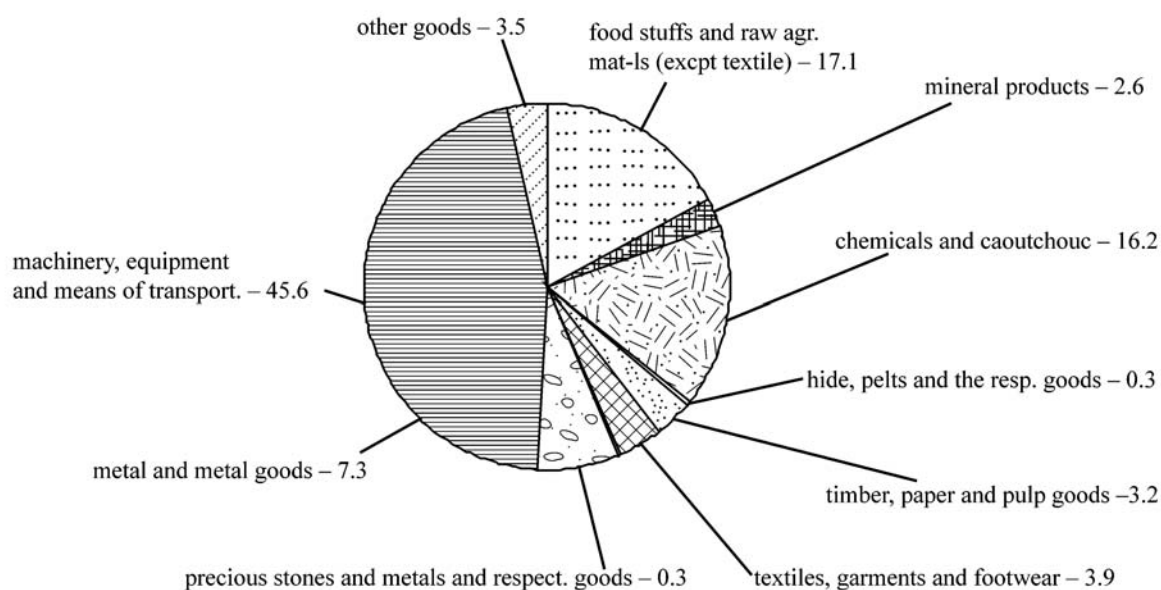
Source: FTS data.

Overall, in the structure of imports from Far Abroad the share of machinery and equipment accounted for 48.2% (vs. 45.6% in 2004) chemicals – 17.9% (17.7%), food stuffs and raw materials for their production – 17.0% (17.9%).

In 2005 vs. 2004 Russia increased importation from the Far-Abroad countries (in physical volumes) of fresh and deep-frozen meat by 36.9%, poultry – 19.7%, deep-frozen fish – 16.3%, citrus plants – 6.8%, coffee – 35.4%, raw sugar – 12.1%, medicines – 17.7%, insecticides and herbicides – 14.5%, synthetic and natural caoutchouc – 17.0%, passenger cars – 46.9%.

In 2005, Russia imported liquors, wine, and soft drinks worth a total of USD 1.507 bln., or at 33% more than in the prior year. Such a rise became possible thanks to a 2-fold boost in supplies of the Ukrainian vodkas. The situation should change this year, however, for in 2006 the regional excise warehouse regime should be abolished and Ukrainian producers will no longer enjoy their advantages vis-à-vis their Russian rivals. Thus, the share of import of liquors should fall.

As concerns imports from the CIS countries, there was a growth in physical volumes of import of tea (at 35.7%) citrus plants – 3-fold, pipes – 7.3%, passenger cars – 53.4%. Import of ferrous metals grew at 27.7% (by value).



Source: FTS RF.

Fig. 67. Commodity Structure of Russian Import (as %)

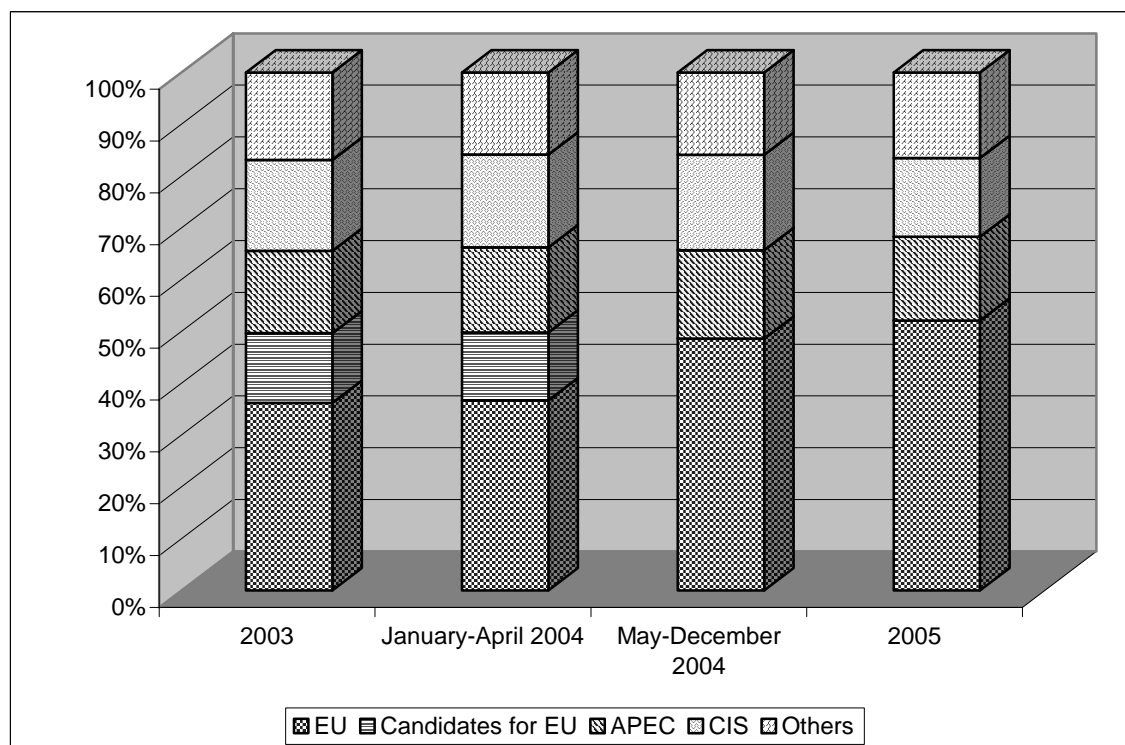
3.7.5. Geographic Structure of Foreign Trade

As far as the geographic structure of Russia's foreign trade is concerned, its largest economic partner is EU with 52.1% share of Russia's foreign trade turnover falling on it in 2005. The CIS countries' share accounted for 15.2% (in 2004 – 18.3%), EurAsEC nations' one – 7.8% (10.3%, APEC countries' – 16.2 (16.8%).

Among Russia's major trade partners in far Abroad in 2005 were Germany (the mutual turnover was USD 33.0 bln. – 138.2% up vs. 2004), the Netherlands – 26.5 bln. (159.4%), Italy – 23.5 bln. (153.5%), China – 20.3 bln. (136.7%), Turkey – 12.6 bln. (145.2%), Poland – 11.4 bln. (141.9%), Switzerland – 11.3 bln. (143.3%), USA – 10.9 bln. (110.8%), Finland – 10.7 bln. (131.4% up).

The decline in the share of the mutual trade between Russia and the CIS countries and those of EurAsEC in particular continued due to a temporary fall in their volume of mutual trade between Russia and Belarus which was driven by the transition to the country-of-origin principle of VAT collection effective as of January 1, 2005. Thus, in 2005 the trade turnover between the two countries fell by 10.7% vs. the respective index of 2004. Interestingly, Russia's import from Belarus plunged by 11.9%, while its export to Belarus slid by 10%.

In addition, the volume of Russia's import from Kazakhstan fell by 6.4%, which resulted from the fall in the physical volume of oil importation that was caused by technical complexities of the transition to the country-of-origin principle. There also occurred a 3% drop of imports from Kyrgystan caused both by political unrest in the latter and a two-month delay with the beginning of supplies of Kyrgyz electricity to Russia vis-à-vis the prior year.



Source: FTS RF.

Fig. 68. Geographic Structure of Russia's Foreign Trade

3.7.6. Regulation of Foreign Trade

The year 2005 saw discussions on tariff regulation procedures and adjustment of export and import customs duties on a number of goods.

Because of fluctuations of international oil prices, the export duties on oil and petroleum derivatives were subject to numerous revisions.

The Government issued a. 40 resolutions aimed at adjustment of import customs duties mostly towards their lowering.

Notwithstanding a considerable rise of importation of machinery and equipment into Russia, the government will be keen to encourage extension of import supplies of this particular group of goods in the future and it is going to cancel all the import duties on industrial equipment, which is not produced domestically. That would enable Russian enterprises to conduct technical rearmament whose major challenge is a considerable deterioration of fixed assets and insufficient efficiency of production capacities. Today, the domestic machine engineering is incapable of match modern requirements.

Originally, there were 1,200 kinds of equipment the import duties on which accounted for 5 to 15%. The Government has continuously lowered import duties over the past two years. In 2004, Russia canceled the duties on over 200 items, while in 2005 the process took yet a greater pace.

Since May 12, 2005, in compliance with the RF Government's Resolution of April 7, 2005, No. 196) the previous 5% import duty are no longer levied on individual kinds of technological equipment, including bearing conveyors, industrial robots, some elevating equipment.

Table 63

Export Duty Rates on Oil and Oil Products in 2004-2005 (as USD./t)

	Oil	Oil products	
2004			
January	31.2		28.1
Since February 1	33.9		30.5
Since April 1	35.2		31.7
Since June 1	41.6		37.5
Since August 1	69.9		45.4
Since October 1	87.9		
Since November 20			57.0
Since December 1	101.0		
2005		light	black
February 1	83.0		
March 16		68.2	36.7
April 1	102.6		
April 24		81.4	43.8
June 1	136.2		
June 27		104.1	56.0
August 1	140		
August 23		106.6	57.4
October 1	179.9		
October 29		133.5	71.9
December 1	179.6		

Source: Resolutions of the RF Government.

Effective as of the same date, the Government introduced a tax-free import regime for some kinds of packing equipment (the earlier rate was 10%) and equipment or production of paper and pulp items (5%) (RF Government's Resolution of April 7, 2005, No. 202).

Since May 14, 2005, the Government temporarily, for 9 months, lowered import customs rates on individual kinds of equipment: from 15 to 5% – on converters; from 10 to 5% – on bridge cranes on stationary feet; some kinds of lathes and grinders; cutting units, hydraulic presses; transformers with capacity over 10,000 kVA; from 5 to 2.5% – on centrifugal fans, single-shaft compressors, air-clearing equipment, equipment for rolling mills, sorting or separating equipment; individual kinds of fuel jets, industrial furnace, measuring devices (RF Government's Resolution of April 11, 2005, No. 203).

Since May 14, 2005, the Government introduced a temporary (for 9 months) duty free regime for importation of offset presses, instead of the earlier effective 5% duty (RF Government's Resolution of April 11, 2005, No. 208).

Since July 1, 2005, the Government lowered from 10 to 5% of their customs value duty rates on some kinds of equipment for filling and capping bottles, jars, other capacities, and packing equipment; wheeled self-propelled hoist engines; and digitally programmed units (RF Government's Resolution of May 26, 2005, No. 330).

Since August 21, 2005, the Government introduced a temporary (for 9 months) duty-free regime or importation of some sorts of technological equipment for the light and textile industries, including: bearing units used in the textile industry, printing paint-spraying machines, equipment for production and processing of yarn, equipment for processing of hide and leather; equipment for shoe production and repair; extruders; electronic machinery and devices for testing textile materials. The regime was introduced to substitute for the earlier existed 5% duty rate from the customs value of the goods in question. As well, the same regime became effective with regard to individual sorts of equipment on which

the customs rate had been 10% – that is some industrial sewing and knitting machinery (RF Government's Resolution of June 16, 2005, No. 380).

Since September 24, 2005, the Government introduced for 9 months a duty-free import regime with regard to certain kinds of technological equipment for the furniture and wood-working industries, including wood-processing units; disk saws, and drillers, to substitute for the previous duty of 5% from their customs value (RF Government's Resolution of August 16, 2005, No. 527).

In November 2005 the Interdepartmental Commission on Protection Measures in Foreign Trade recommended the Government to cancel import duties by 630 items of technological equipment whose analogues were not produced domestically. The list comprised equipment for oil refining and agriculture, as well as machine engineering, automobile and light industries. The measure is to be effective for 9 months during which the national producers were suggested to run technological re-equipping. It was suggested to compensate for the respective losses of budget revenues with improvement of the customs administration. The respective Government resolution should become effective as of February 1, 2006.

In December 2005 the Interdepartmental Commission ruled to cancel import duties on another 175 items of technological equipment whose analogues were not produced in Russia. The RF Ministry of Economic Development is going to submit to the Government a draft resolution on cancellation of duties on another 700 items of technological equipment.

The means of customs and tariff regulation helped to increase the degree of tariff protection of a number of critical sub-sectors of the agrarian and food sectors.

Since April 10, 2005 the RF Government introduced a new import customs duty rate on rice and flour-grinding and the respective groats products. The new rate, effective for 9 months, became 0.07 Euro/kg and substituted the previous one of 10% of the customs value of the goods, but not less than Euro 0.03/kg ((RF Government's Resolution of March 3, 2005, No. 115).

Since July 15, 2005, the Government increased from 5 to 10% import customs duty rates on dried figs, pineapples and mango. As concerns adipose and butter, as well as vegetable oil and grease in primary packing with the net mass not more than 1 kg., the previous ad-valorem 15% duty rates were transformed into 15% combined rates, but not less than Euro 0.12/kg. In parallel with that, the Government lowered duty rates (from 15 to 10%) on canned (with sugar) pineapples, tropical fruits and their mixes (RF Government's Resolution of June 29, 2005, No. 403).

Since July 3, 2005, the Government increased customs import duty rates for 9 months with regard to individual kinds of native and modified starch up to 20%, but not less than Euro 0.06/kg. The previous rates were 10% (for items of group 1108 TA FTA) or 5% (for those falling under group 3505 TA FTA) (RF Government's Resolution of May 31, 2005, No. 344).

In 2005, the government undertook important steps to boost investment attractiveness of the domestic automobile-making industry.

Since April 15, 2005, the bulk of automobile components (chassis, parts of the body, shock-absorbers, mufflers) imported for the purpose of industrial assembly of motorized transport vehicles falling under groups 8701 – 8705 TA FTA) became subject to the decrease of the duty rates from the previous 5 – 20% to 0 – 5%, effective for 9 months. The duty rate of 5% was set on two items – that is, electric accumulators and automobile seats, that of 3% – on car windows and mirrors, locks, fixing fittings and accessories, starters and starters-generators, wire kits for ignition plugs, and automobile speedometers. Other

automobile components are subject to duty-free importation (RF Government's Resolution of March 29, 2005, No. 166).

On the Government's request, the RF Ministry of Economic Development and Trade, Ministry of Finance and Ministry for Industry and Energy have designed a document that defined the concept of "industrial assembly" and procedures of its application with regard to importation of automobile components. The industrial assembly of motorized transportation vehicles is defined as a system of their serial production on the basis of technological processes that ensures an enterprise's annual production capacity of not less than 25,000 units under the two-shift operational mode, including: body welding, painting and assembly; mounting of: the cabin equipment; power aggregate, control mechanism, front and rear suspension brackets, electric equipment, suspension brackets elements, a compulsory conduct of tests of finished vehicles. The importation into the territory of RF of automobile components that the national TA FTA classifies as those for "industrial assembly of motorized transportation vehicles" is carried out on the basis of an agreement to be concluded between the RF ministry of Economic Development and Trade and a Russian legal entity which specifies the list, quantity and value of the said components under the "supplier's warehouse" terms, as well as the timetable of reaching the projected capacity (order of the RF Ministry of Economic development and Trade No. 73, Ministry of Industry and Energy No. 81, MinFin No. 58h of April 15, 2005).

The customs duty rate with respect to automobile components imported for the purpose of industrial assembly approved by Government's Resolution No. 166 for the term of 9 months have become constant effective as of 15 January 2006 (RF Government's Resolution of December 13, 2005, No. 757).

To protect domestic producers' interest, Russia conducted investigations that resulted in undertaking particular protective measures.

Between July 7, 2005 and July 6, 2006, Russia has introduced an antidumping duty on channels originated from Ukraine. The duty rate on the said produce manufactured by OAO "metallurgical plant 'Azovstal'" was set at the level of 12.3% of its customs value, and the 17.4% rate is applied to channels produced by other Ukrainian metallurgical plants. These rates are collected in addition to the import customs rate introduced by the RF Customs Committee with regard to this particular product ((RF Government's Resolution of May 24, 2005, No. 324, letter of the FCS of July 29, 2005 No. 06-48/26013).

Since August 14, 2005 the RF Government introduced for the term of 4 months a preliminary compensational duty on rods for reinforcement of ferroconcrete constructions the whose country of origin is Ukraine. The duty rate is 21% of the customs value of the product ((RF Government's Resolution of August 11, 2005, No. 504).

Since 16 October 2005 Russia introduced an antidumping duty on three-phase asynchronous electric motors with the capacity of not less than 0.37kWatt and not more than 7.5 kWatt with the height of rotation axle of 80, 100 and 120 mm originated from Ukraine. The duty rate was set as follows: 13.8% on produce of Kharkov electrotechnical plant "Ukrelectromash" and 59.3% on other Ukrainian plants' production (RF Government's Resolution of September 10, 2005, No. 558).

Since November 19, 2005 Russia introduced special duties on a series of confectionery goods imported from Ukraine. More specifically, the starch molasses became subject to the duty of 6.0 Euro/kg, while duty rates on stuffed or unstuffed sweets, caramel and analogous sweets vary from 20% of the respective customs duty rate (but not less than 0.25 Euro/kg) to 6.0 Euro/kg.

The confectionery war between Russia and Ukraine dates back to 2000. At the time, on the request of Russian producers, the RF Ministry of Economic Development and Trade

launched an antidumping investigation which in early 2002 resulted in introduction of a 21% special customs duty. The import supplies of Ukrainian sweets plunged nearly 5-fold – from 72,000 t. in 2007 to 15.600 t. in 2003.

However, keen to keep the Russian market, the Ukrainian producers went a compass. Having realized that the duty had been imposed only on sugar products without cocoa, they began to add half-percent of that into caramel and export the sweets as chocolate products that were exempted from the duty. Export of Ukrainian caramel consequently began growing rapidly and once the effect of the customs duties came to an end in 2004, the Ukrainian producers were holding one-fourth of Russia's confectionery market.

In 2004, the national confectionery association once again appealed to the Commission with a request to reintroduce the duties on imported caramel, particularly that with cocoa. The consequent investigation resulted in the reintroduction of the special duties.

As concerns prohibitive measures against Russian exports, as of October 1, 2005 there were 105 of them in force (as of January 1, 2005 there had been 125 of those), including: 49 cases of introduction of antidumping duties, 11 quota restrictions, 4 pricing restrictions, 10 administrative measures, 1 – restricted assortment, 1 ban on import, 1 additional tax, 2 tariff quotas, 9 technical barriers, 1 phytosanitary measure, 1 excise tax, as well as 10 measures that broke normal competition conditions, and 1 special foreign trade regulation. There also were 7 antidumping and 5 special protective investigations.

As of October 1, 2005, as many as 20 nations, as well as EU, practice protectionist measures against Russian goods. The losses from these actions are estimated at the level of some USD 2 bln. (vs. USD 2.5 bln. reported in 2004).

3.7.7. On Progress with Negotiations on Russia's Accession to WTO

Between 13 and 18 December 2005 Hong Kong hosted the 6th WTO Ministerial Conference. The Conference focused on measures on further liberalization of international trade in the frame of the Doha Round.

It was initially planned that the Doha Round would be basically complete in Hong Kong, however, it became clear as early as in mid 2005 that the disagreement between developed and developing nations was too grate to mobilize consensus by the end of the year. The stumbling block became the problem of subsidies that numerous developed countries grant to their agrarian producers. Most developing countries believe that is what makes their agrarian products noncompetitive on the global and local markets.

The Conference passed a declaration that provided for cancellation of agricultural subsidies by late 2013. The choice of the year as a deadline for cancellation of the subsidies testified to the EU delegation's victory, for it was able to defend its stance. The EU representatives repeatedly argued that their were not ready for radical reforms of their agriculture until 2013, while most other nations were insisting on the EU' cancellation of the subsidies by 2010.

Among other critical provisions of the Declaration was cancellation of all export subsidies for cotton producers by 2006 and provision of duty-free importation of 97% of goods from the least developed countries.

The Declaration, however, failed to suggest any concrete way to tackle two other critical items in the Doha Round agenda – that is, lowering tariffs for industrial produce and liberalization of the services sector. According to the final text of the Declaration, the WTO members should manage to conciliate the remaining matters until April 30, 2006.

Prior to the start of the Conference Russia had completed its negotiations on accession to WTO with 51 out of 58 member nations. At the conference, Russia signed protocols

on completion of negotiations with the Philippines, Nicaragua and Paraguay, as well as a preliminary protocol- with Canada who had proved to be a very tough counterpart.

In January 2006, in Davos, Russia signed agreements on joining WTO with Brazil and Switzerland.

Thus, according to the RF Government, to ensure Russia's accession to WTO, the country needs to reach agreement with just three counterparts – that is, the US, Columbia, and Australia. As concerns Australia, the respective documents should be signed shortly, as there are only technical issues to agree upon.

The main unresolved problem at the Russian-Colombian negotiations has remained the size of sugar duties. The Russian side has forwarded the Colombian counterparts a package of the respective suggestions and the final agreement is a matter of a few weeks.

By contrast, so far Russia's has failed to handle its most complex counterpart – that is, the USA. There are four unresolved problems that complicate the negotiation process: namely, matters of protection of intellectual property, the level of duties on aircraft, veterinary and phytosanitary standards, and access to the market for financial service as the most painful problem.

Protection of intellectual property is a very sensitive issue for the US whose producers of audio and video goods claim that they loose billions of dollars because of Russian pirates. Last year, the even attempted to exclude Russia from the General Preferences System under which Russian exports to the US are tax exempt. Russia boasts serious progress in the area. Its legal enforcement agencies vigorously pursued and shut down pirates' facilities. Over the first ten months of 2005 they brought 3,860 actions, including 2,227 of those falling under Art. 146 of the Criminal Code of RF (infringement of copyright and associated rights), of which 2,122 implied great and extremely great damage. However, the US insists on changing the predominant judicial practice of mostly conditional sentences, rather than real ones.

Clearly, the solution of the problem meets first of all Russia's interests, for it batters both the country's economic potential and its international reputation That is why regardless of Russia's accession to WTO, the country will keep improving its legal base, solidify cooperation between ministries and agencies with associations of copyright owners and international organizations as well as shaping public opinion with regard to counterfeit products.

Another hot issue that complicates the bilateral negotiations is the US side's persistent pressure in favor of cancellation of import duties on the US aircraft. Today, 60% of Russian air carriers' purchases falls on foreign aircraft, primarily produced by Boeing. They pay the duty of 20% of the customs value of the aircraft, which is not a barrier to the US producers to enter Russian market. Meanwhile, Russia admits the possibility for lowering customs duties on imported aircraft upon a transitional period after joining WTO, but not a complete refusal of them. Besides, this requirement falls under the so-called "WTO-plus" category, i.e. forms an extra requirement that toughens standard conditions of the accession. Russia repeatedly argued that she was not going to assume additional obligations while joining the Organization.

The problem of opening in RF branches of foreign banks and insurance companies is an equally complex issue. Today, Russia limits the foreigners' share in banking capital and in the event of sale of a big stake in a bank one needs to seek the bank of Russia's approval. Besides, in compliance with the law, foreign credit institutions may not open branches in the RF territory, but they must to establish daughter banks completely subject to the RF law.

After the bilateral meetings Russia will have to conduct a series of multilateral negotiations on its accession to WTO.

While signing the protocols, the Russian side assumes obligations formed basing on Directives on holding negotiations on granting access to the national market to foreign goods. The Directives were approved by the RF Government and provide for maintenance of the level of the tariff protection of Russian market at the moment of her joining WTO at the currently effective level. As concerns number of "volatile-to-import" goods (agricultural products, automobiles and aircraft), there exists a possibility for keeping a greater level of protection than today and the employment of the tariff quoting mechanism. The Government also reserved the possibility to employ combined customs duty rates that should preclude one from lowering the customs value while registering export-import transactions with the customs.

To ensure the Russian producers' adaptation to an expanded access of foreign goods to the national market, the Government provided for a transitional period that can vary due to the level of volatility of a given sector to import.

In 2005, the task Force on Russia's accession to WTO held four meetings. At them, the group brainstormed over the third version of its final report on the problem. By now the work on adaptation of Russian legal base to WTO requirements practically has been complete and the group keep reviewing departmental acts and regional law to test their compatibility with the WTO requirements.

3.8. Military Economy and Security of Russia

3.8.1. Military Policy and Military-Economic Activity in 2005

The 2005 year that has just come to a close continued a new exceptional period in Russia's military organization that, in as early as 2003, the President of the Russian Federation called modernization.

From the very beginning of the year it has been clear that the struggle for and against real modernization will continue, as it did in the previous year⁵². The central apparatus of power agencies, modified and reduced within the 2004 administrative reform framework, started to operate in accordance with goals of modernization and got formally involved in the budget reform. However, management organs' structure was not clearly defined and started to once again expand and branch out, while military expenditures started to grow, although in disagreement with principles of goal-oriented budgeting. Deadlines for development of appropriate documents were not enforced, and completeness of presentation did not correspond to the demands for transparency in military economy, which is a necessary condition for reforms.

Execution of the 2005 budget and development of military expenditures chapters of the 2006 draft largely did not correspond to military expenditures categorization, standardized by the UN. The level of classification of military expenditures increased even more. The list of classified items and categories of expenditures grew considerably larger than allowed by the norms, established by the Law on State Secrets. Thus, in order to avoid raising payments of military personnel's monetary allowances and military veterans' pensions, even the cost of rations was concealed. The 2004 promises of military personnel's salaries indexation were not kept; the indexation was postponed until 2006 and was to constitute 15 per cent, while the 2004–2005 inflation exceeded 20 per cent. Moreover,

⁵² See «Russian Economy in 2004. Trends and Perspectives.» Moscow, IET, 2005.

although contract personnel's monetary allowances were increased, housing waiting lists were reduced, allocations were made to savings-mortgage system and to other traditional housing solutions, nevertheless, socio-economic problems of the RF military organization persist.

These problems have an impact on the law and order within the RF military organization. The Council of Europe Commissioner for Human Rights, the Plenipotentiary Ombudsman of the RF for Human Rights, as well as the Chief Military Prosecutor and heads of the Accounting Chamber have officially testified to that fact in their reports. In particular, according to these reports, "the number of cases of draft discharges in exchange for bribes has increased, leading to general deterioration of moral climate in the society, as well as to drafting of young people mostly from indigent families. As a result, the cultural and educational levels of conscripts continue to decline, often barring them from effectively mastering complex military professions". The same relates to unregulated relations, forced labor unrelated to military service, which results in "military service turning into a hotbed of violence, cruelty and legal nihilism". According to the Chief Military Prosecutor of the RF⁵³ summary of the results of the year, "more than a thousand of servicemen were prosecuted last year for encroachments on weaponry, equipment, property and budgetary items."

Let us consider in more detail the interim results of the army modernization in three main blocks.

The first block of problems is the transition to a voluntary army recruitment principle of the state's military organization.

It was confirmed in 2005 that although the federal special-purpose program (FSP) of transition to a voluntary recruitment principle, adopted by the RF Government in 2003, represents a step forward, nevertheless, it encompasses only a few military units of permanent readiness of the Armed forces of the Ministry of Defense, the Interior troops of the Ministry of the Interior and the Border troops of the FSB. FSP does not include any plans to recruit "contract" sergeants.

General transition to a voluntary recruitment principle is realized differently by different agencies. Thus, the FSB completely abandoned the draft in 2005 and is transitioning to exclusively contractual recruitment for the Border troops. The Ministry of the Interior was planning to staff its 46th separate brigade, stationed in Chechnya, with contract recruits only by the end of 2005, and by August, the percentage of "contract" personnel reached 80 per cent.⁵⁴ However, full transition of the Interior troops, announced in the President's 2003 Address, is already being rejected. The Ministry of Defense and Main Organizational and Operative Directorate of the General Staff, responsible for this project, are most strongly opposed to all regular troops' transition to a contractual system, even in a distant perspective.

However, appearance in the Russian Federation of military units and even formations, fully and exclusively staffed on a voluntary contractual basis, is an enormous achievement.

As for problems, occurring in the process of FSP realization, and mentioned by the Minister of Defense⁵⁵, including:

⁵³ "Zakon – fundament gosudarstva (The Law is Foundation of State)," by V. Ustinov in *Rossiiskaya Gazeta*, February 6, 2006 (No. 23).

⁵⁴ "46-ya: pyat' let v Chechne (The 46th Division: Five years in Chechnya)," by V. Cherkasov and A. Kozachenko in *Krasnaya Zvezda*, October 26, 2005 (No. 198).

⁵⁵ *Krasnaya zvezda*. 2005. the 11 of November (No. 208).

- reaching and maintaining full recruitment quotas due to “attractive conditions of contractual military service”;
- introducing necessary corrections in the FSP budget (16 billion 671,7 million rubles were apportioned in 2005, while FSP budget stipulated 19 billion 913,1 million rubles taking into account inflation; 22 billion 306,9 million were apportioned in 2006, when 23 billion 153,8 million required).

These issues were very predictable. These were the same issues discussed at the RF Government meeting before FSP was confirmed. But all warnings have been ignored.

In particular, when doing feasibility studies of the FSP, the Institute for the Economy in Transition developed recommendations, based on opinion polls conducted by VTsIOM, on a system of incentives that could make military service appealing. These incentives included raising monetary allowance (MA) of even private contractual personnel by 10–20 per cent above a national average wage with additional considerable bonuses for participation in military operations. However, the Ministry of Defense assigned priority to bonuses for other personnel, those serving in organs of central administration.

Therefore, as present monetary allowances of contractual personnel do not exceed a national average wage, instead of an expected intensive inflow of contractual recruits, everywhere but in Chechnya we witness an outflow of personnel recruited earlier, mostly from units not included in the list of permanent readiness. However, even in Chechnya service incentives are being pinched. According to publications⁵⁶, more than 1.3 thousand contractual servicemen quit the 42nd Division, with additional 400 not returning from leave. As it was discovered, they were not receiving appropriate forms of allowance while in service. Furthermore, even the “elite” 76th Division is not doing well, according to the Division Chief of Staff’s testimony⁵⁷. Allowance norms are such that contractual personnel are sometimes forced to purchase their own items of clothing and equipment, including skis for winter operations. Providing contractual servicemen with housing is also a problem. In these conditions, the following data on this division is not surprising: 58 per cent of servicemen have incomplete secondary or secondary general education; more than 90 per cent come from working, peasant and other blue-collar families.

Corrections to FSP and indexation of expenditures were stipulated at its confirmation. However, the Ministry of Defense did not perform these steps in the process of budget development and spent additionally allocated resources on other needs.

The situation with upcoming reduction of the draft service term is even worse. The Resolution of the RF Government, as well as the President’s Address state the term of “up to 1 year,” interpreted as 12 months, instead of the service term of 6 months, sufficient for mastering the basics of military skills and training for contractual service. These provisions can not be acceptable to young people failing to enter into a college and being drafted. These young people will actually finish their college education 2 years later than other people of their age. There is also no clarity in realizing the promise of “spending the first 6 months acquiring military skills in educational sub-units.” There are not enough military units and available slots to educate all draftees. Therefore, young people will be sent to educational sub-units in other military units, where they will face the “grandfathers.” Even those enlisted men who pass through educational military units, in the second half-year of their service will find themselves not in permanent readiness units, but in units old-fashionably called “linear”. Officially, the Russian Federation does not have any military

⁵⁶ *Voенно-promyshlennyi kurier (Military-Industrial Courier)*, June 20–26, 2005 (No. 26).

⁵⁷ “Kontraktnaya divisiya uje suschestvuet, a kriteriev otsenki truda voennyh professionalov eschew net (Contact Division Already Exists, but Criteria for Compensating Military Professionals Do Not,” by V. Udmantsev in *Voенно-promyshlennyi kurier (Military-Industrial Courier)*, August 17–23, 2005 (No. 30). 2005.

units of such name. At present, these are “categories” of military formations and units in the Armed forces of the RF: of permanent readiness, of reduced effectives (types “A” and “B”), cadre and newly formed.

Possibly due to this ambiguity the Ministry of Defense did not keep the deadline of the 4th quarter of 2003 of presenting a bill on reducing draft terms and service appointment. In stead, the society is being agitated by bills on elimination of military departments in colleges, elimination of draft deferments, etc. Moreover, “feeding grounds” for activities of structures, parasitizing on illegal deferments and draft releases, are being preserved. According to latest estimates by a political scientist G. Satarov, this year’s “profits” in this “business” exceeded US\$ 350 million. This is why these structures’ concealed lobbying efforts against the reform are currently the main factor hindering the Armed forces transformation to a contractual service.

The delay in transition could have some extremely negative consequences, especially considering the upcoming demographic collapse. After 2007 the number of young men annually entering the age of 18 will be cut in half. These conditions will show that the growth rate of numbers of contractual personnel, specified in FSP, accompanied by reduction of the draft service term, are incompatible with the Ministry of Defense and other “*siloviki*” structures’ desire to maintain current strengths of the Armed forces. They will either have to draft almost everybody or to draft some people but for an extended, not reduced service term. As for drafting college graduates, which is being debated, this draft would not be feasible. As a reminder, in the tsar’s army people of higher education only served for 6 months.

Looming processes are dangerous from a military point of view, as they simultaneously lead to a draft’s negative impact on the economy as well as to a social explosion.

A rational solution would be, first of all, to accelerate the transition and have it completed in regular forces by 2008. However, the Ministry of Defense’s leadership rejects this idea, citing lack of fund. The Institute for the Economy in Transition experts performed calculations of means required for forced transition and found that the numbers constitute single digits of percentage of the RF general military spending. In the last year along, the Ministry of Defense received supplementary funds in the amounts several times larger than would be required to speed up the transition to a contractual service system. The 2006 budget supplement is larger than what would be required to speed up the transition to a new recruitment system. However, these means are either being spent elsewhere, or, according to the Chief Military Prosecutor’s Office and the Accounting Chamber’s data, being simply stolen.

However, there is another circumstance that the Ministry of Defense refuses to admit. When it comes to fighting efficiency, the number of enlisted men in a group made up of contractual servicemen is equal to one and a half of a group made up of drafted conscripts, serving the current term of 2 years. This means that the current numbers of the military organization could be cut in almost 1.5 times without inflicting any damage to the country’s defense capabilities. That includes not only privates, seamen, sergeants and sergeant-majors, but also, what more importantly, more costly officers. This could produce no additional expenses but savings, or provide for more rational spending on increased monetary allowances, housing and equipping junior servicemen with more effective weaponry.

The second block of problems includes issues of equipping Russian Armed forces with modern weaponry.

Some undeniable successes should be noted in solving the second block of problems in 2005. These achievements include renewal of strategic missile complexes of the

RF (Topol-M), the basis of nuclear forces of deterrence, as well as equipping the newest anti-submarine missile cruiser with Bulava complex with a unified ballistic missile, which promises future economic effects of unification. They also include development of a high-precision cruise missile with a non-nuclear warhead that will allow to transition from talks of non-nuclear forces of deterrence to actual deployment of such forces, particularly, for deterrence purposes. Finally, development of non-lethal weaponry, although at present equipping special forces only, is extremely important considering the fact that these weapons are essential in armed operations in highly-populated areas.

However, flaws were also discovered last year in exploitation of weaponry and military equipment, mostly due to specific technical reasons, as well as a human factor of inadequate personnel training stemming from lack of financing for combat training.

A number of measures were implemented to solve the above-mentioned problem. Federal Service on Defense Order was established; a system of a "single procurer" in the Ministry of Defense was set up; the Russian Government Commission on Military-Industrial Issues (VPK) commenced its activities, and restructuring of the Defense Industrial Complex (OPK) continues. However, the OPK "fences" oneself off from other enterprises of the RF, while its subsidiaries grow larger and transform into a monopolistic group. These occurrences might be stemming from existing to this day opinion that domestic OPK is the force behind any progress, and investments into the OPK will save Russian economy. Although, while this premise was not correct before⁵⁸, it is now losing its validity even more, especially in the case of un-scrutinized (by the public) investments.

Available positive practices are unfortunately discounted. In particular, we could cite works of the Defense Advanced Research Projects Agency (DAPRA) in the United States. The Agency directs research and development projects, mostly in the areas of national defense, without forgetting commercial applications of scientific and technical advances. In Russian history, similar and often broader functions were carried out by the Expert-Technical Committee of the Commission on Military-Industrial Issues (VPK) under the Cabinet of Ministers of the USSR. Joint efforts of coordinating bodies like DARPA and VPK ensured goal-oriented research of dual (civil and military) research, and, more importantly, practical applications of scientific and technical advances in various economic sectors for a range of purposes.

Unfortunately, the function of coordination of research and development in critical areas of scientific and technical progress has yet to be assigned to any agency. As a result, the Russian military organization and the so-called OPK and separate innovation firms located under its canopy, although not under its authority, are alienated from the civil society. Rather modest government spending on scientific and technical progress is dispersed with extremely low returns. According to the General Prosecutor of the RF's evaluation of the 2005 results⁵⁹, establishment of two new management structures, led by Deputies to the Minister of Defense, is yet to produce any positive results. "The unified body of military procurement has been inactive for a long time. More than a billion rubles earmarked for repairs, procurement and development of new weaponry were unused." The situation with spent funds is also obscure. The second structure, Center for Orders and Deliveries "commenced its activities with gross violations".

⁵⁸ "Chernyi khleb voennogo biznesa (The Black Bread of Military Business)," by V. Shlykov in *Otechestvennye zapiski*, No. 2(11), 2003, pages 459–472.

⁵⁹ "Zakon – fundament gosudarstva (The Law is Foundation of State)," by V. Ustinov in *Rossiiskaya Gazeta*, February 6, 2006 (No. 23).

The Ministry of Defense should deal with issues of weaponry and military equipment unification with products of household applications, as the Ministry of Defense is unable to place large, serial, profitable orders.

Another very important aspect concerns the intellectual property rights. It would be impossible to expect innovations influx until intellectual property rights of researchers and developers, together with procurers, are not legitimized. This issue has been discussed for a long time⁶⁰, however, an appropriate solution was unfortunately never found.

The state's innovation policy is no less important. As practically all innovations are of dual purpose, an opportunity for unification of different branches of industry arises, with larger production quantities and lower production costs. As a reminder, doubling production in modern machine-building sector usually reduces production costs by 15–20 per cent. This means that a reasonable innovation policy could increase the level of the country's defense capabilities without additional costs. A military-technical policy that would naturally incorporate innovations of dual-purpose into military construction plans would be beneficial to Russia.

Therefore, neither the state armament program, not the state defense order could be confirmed until their projects are supported not only by traditional military-technical reasons, but also by unified substantiations of rational civil applications of technologies and main weaponry and military equipment components.

The third block of problems of the army modernization is a budget reform and a civil society's oversight of power structures' activities.

At the beginning of 1992 the new Russian state's military-political leadership concluded that guaranteeing military security of the country within the framework of the CIS Joint Armed Forces was impossible, and decided to establish its own new military organization and a new system of military construction administration, both based on advanced international experience and domestic traditions. In particular, the following proposals were made⁶¹, based on the U.S. and other states' practices:

1) The principles of program-oriented planning, including "planning, programming and budgeting" (PPRB) known both inside and outside of Russia, were to establish the basis of a new system of administration;

2) Military budget to be considered a main instrument of administration;

3) Military expenditures to be categorized in accordance with the UN norms of international reporting, but to include more detailed break-down of expenditures for domestic purposes and to include mandatory budget substantiation.

At the same time, Main Administration for the Military Budget and Finance (GUVBiF) was established on the basis of the Central Financing Administration of the Ministry of Defense of the USSR. The Ministry of Defense, and therefore, the Main Administration within it, were entrusted with developing a military budget bill by the end of 1992. The Armed forces' structure and strengths were to be confirmed simultaneously with budget confirmation.

However, when planning its spending in the 1990s, the Ministry of Defense and a large number of other government bodies with troops under their authorities followed the traditional path. In reality, in Russia with market economy, the military economy has long

⁶⁰ "O problemah effektivnogo ispol'zovaniya intellektual'nogo potentsiala OPK (Issues of effective utilization of OPK's intellectual potential," by V.O. Rubanov in Aktual'nye problemy reformirovaniya oboronno-promyshlennogo kompleksa Rossii (Urgent Problems of Reforming Russian Defense-Industrial Complex.) Proceedings of a round-table at the Institute for International Economics and Political Studies, Russian Academy of Science. Moscow, Epicon, 2002, pages 130–139.

⁶¹ Declaration by the Presidium of the Supreme Council of the Russian Federation on "Priorities of Military Policy of the Russian Federation" of April 1, 1992.

been maintaining and continues to maintain in some degree a “Gosplan” type mechanism. In this mechanism, goals and budget are not as important as programs and plans that must be implemented “at any cost”.

Moreover, Russian Ministry of Defense, much like Soviet Ministry of Defense, regardless of the Law on State Secrets, continues to believe that largest part of military spending must be classified, as it “reflects” programs and plans constituting state secrets, hidden from the majority of Russian public.

It was not until after 1999 that the military security of the Russian Federation started to improve.

Serious hopes for successes in long-term military construction that appeared in 2005 provide us with an opportunity to address the issue of optimal administration. It will not be the return to the conceptions of 1992, although there are many similar key parameters, including the general number of military personnel of less than 1 million, exclusively voluntary recruitment of regular troops, and the priority assigned to increasing fighting capabilities on the basis of fully fledged combat training and XXI century weaponry and military equipment.

General approaches and methodology also showed some newness. In recent years, planning, programming and budgeting (PPRB) was developing in two directions. First, it involved the control stage, including control not only over budget execution, but also over achieving strategic goals. The second direction demanded a stricter and more precise formalization of the system of strategic goals, tactical tasks required for reaching the goals, as well as clear (calculated) indices that would confirm degrees of reaching these goals.

International standards related to financial classification were developed. An international standard of the Classification of the Functions of Government (COFOG), compiled by the Organization for International Economic Co-operation and Development and adopted by the UN in 2000 as part of the 1993 UN System of National Accounts, was deemed appropriate for use as a basis of functional budget classification of the Russian Federation. Furthermore, the use of COFOG was supported by the International Monetary Fund. The IMF included it in its “Government Finance Statistics Manual”.

However, the fact that another international standard has been adopted for military expenditures was not considered. Therefore, when realizing the Russian Government Resolution No. 249 of May 22, 2004 that adopted the concept of budget process reforms in the RF and “provided for alignment of budget classification of the Russian Federation with international standards”, it is necessary to be guided by all standards. Applied to military expenditures, this should be interpreted as the UN’s standardized form, adopted by the UN General Assembly as early as December 12, 1980 (the UN General Assembly Resolution 35/142 B). As a result of such incomplete work, classification of military expenditures became senseless and public control over military spending unrealizable.

3.8.2. Military Expenditures in the 2005 Federal Budget.

In connection with the transition to a new budget classification, the RF military expenditures in the 2005 federal budget were formally consolidated in the chapter “National Defense”. This chapter included spending on implementation of international military-technical co-operation programs and mobilization preparation of the economy. In addition, two new sections were introduced in this section – “Research and Development in the field of National Defense” and “Other Issues in the field of National Defense. The chapter “Armed Forces of the Russian Federation” included expenditures on railway troops and

special construction administration that had been returned under the authority of the Ministry of Defense.

However, as a result of selective adoption of some of COFOG's recommendations and rejection of other, for example, related to civil defense, some military spending continue to be realized within the chapter "National Defense and Law-Enforcement". Moreover, in 2005 some of power agencies' expenditures were scattered under chapters "Education", "Culture, Cinematography and Mass Media" and "Public Health and Sports", therefore partially classifying expenditures in these sections. Therefore, these changes in budget classification should be considered in comparing military and military-related spending in the 2005 federal budget with spending in previous years.

In February 2005 first amendments were introduced to the federal budget's chapter "National Defense," including increases in military personnel's monetary allowances. These raises coupled with increased fuel prices led to two other amendments in June and October. As a result, expenditures in the chapter "National Defense" grew by 8.9 per cent with general budget expenditures increase by 16.1 per cent. Moreover, 52.5 per cent of that increase included increases in military personnel's monetary allowances (an increase of 22.4 per cent), and 18.6 per cent included expenditures on fuel and lubricant materials (an increase of 25 per cent).

In the end, the 2005 federal budget's chapter "National Defense" (see *Table 64*) showed 578.4 billion rubles, which is 2.75 per cent of the GDP or 16.3 per cent of all federal budget expenditures. Despite the fact that the total increase in this section's expenditures reached 17.5 per cent compared to 2004, expenditures in the largest chapter "Armed Forces of the Russian Federation" reduced by 7.2 per cent, which should be considered to as one of the results of changes in budget classification leading to reassignment of some expenditures to other sections. Thus, the analysis of distribution of federal budget allocations along types of expenditures in functional classification shows that no less than 52.5 billion rubles (0.25 per cent of GDP or 1.5 per cent of all federal budget expenditures) in the chapters "Education", "Culture, Cinematography and Mass Media" and "Public Health and Sports", are appropriated to military and military-related expenses.

For comparison, 455.3 billion rubles (constituting 2.17 per cent of the GDP or 12.9 per cent of the federal budget expenditures) were allocated in chapter "National Defense and Law-Enforcement Activities", with real general increase of expenditures under that item amounted to 21.9 per cent compared to the previous year. Due to the fact that approximately 2/3 of the expenditures under that item do not belong to the military category, main portion of the increase was obviously allocated to judicial system, while real financing for interior troops and border patrol agencies inexperienced only an insignificant growth (see *Table 65*). A significant increase of 22.5 per cent was seen in financing in chapter "Emergency Management and Civil Defense", considering that its military aspect – civil defense expenditures – decreased by 16 per cent, probably as a result of already mentioned transfer of certain expenditures under other chapters of the federal budget. The dynamic of expenditures on defense and security in corresponding chapters of the federal budget in current and 1999 prices is shown in *Fig. 69*.

Table 64

**Direct Military Expenditures in the Federal Budget
Section "National Defense"**

№	Chapter and item	2005, million of rubles/ same in 2004 prices	2005 changes compared to 2004, million rubles/ increase, %	Share of expenditures, % / changes compared to 2004	
				2005 federal budget	GDP
1	National Defense	<u>578 351</u> <u>517 772</u>	<u>90 396</u> <u>17.46</u>	<u>16.34</u> <u>0.90</u>	<u>2.65</u> <u>0.10</u>
1.1	Armed Forces of the Russian Federation	<u>420 813</u> 376 735	<u>-27 064</u> -7.18	<u>11.89</u> -2.70	<u>2.00</u> -0.50
1.2	Mobilization and non-military preparation	<u>3 665</u> 3 281	<u>-1 415</u> -43.15	<u>0.10</u> -0.07	<u>0.02</u> -0.01
1.3	Mobilization preparation of economy	<u>3 500</u> 3 133	<u>2 033</u> 64.89	<u>0.10</u> 0.06	<u>0.02</u> 0.01
1.4	Collective security & peace-keeping	<u>60</u> 54	<u>-157</u> -293.06	<u>0.00</u> -0.01	<u>0.00</u> -
1.5	Nuclear weapons complex	<u>8 693</u> 7 783	<u>-10 544</u> -135.48	<u>0.25</u> -0.42	<u>0.04</u> -0.07
1.6	Realization of international obligations in the military-technical cooperation sphere	<u>6 231</u> 5 475	<u>-4 973</u> -90.84	<u>0.17</u> -0.20	<u>0.03</u> -0.04
1.7	R&D, field of national defense	<u>89 402</u> 80 038	-	<u>2.53</u> -	<u>0.43</u> -
1.8	Other issues, field of national defense	<u>46 103</u> 41 474	-	<u>1.30</u> -	<u>0.22</u> -

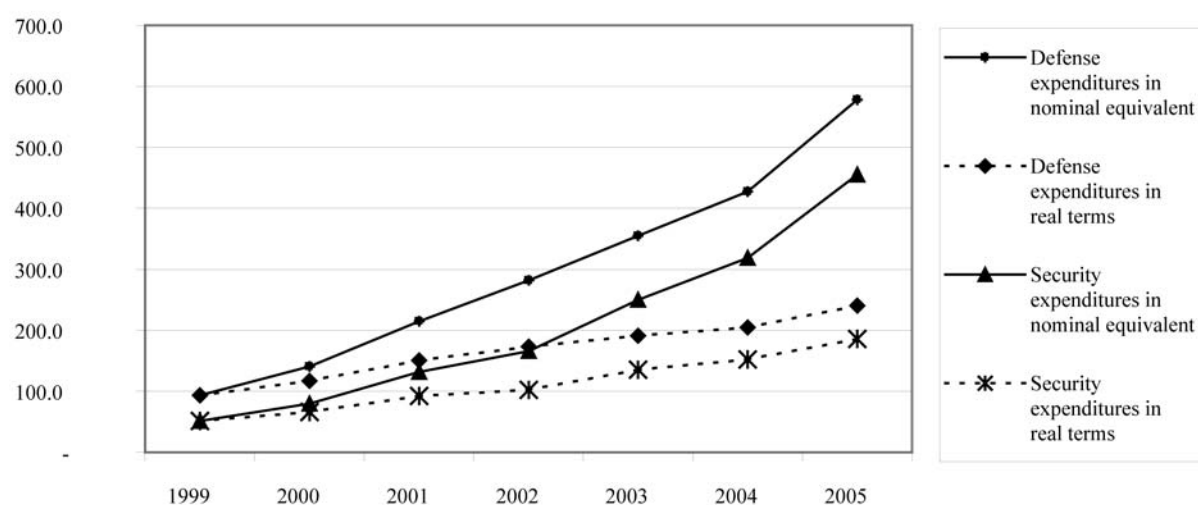
Source: Calculations by The Institute for the Economy in Transition, based on data of the Federal Law No. 141-FZ of April 11, 2005.

Table 65

**Direct and Indirect Military Expenditures in the Federal Budget,
Other Sections**

№	Chapter and item	2005, million of rubles/ same in 2004 prices	2005 changes compared to 2004, million rubles/ increase, %	Share of expenditures, % / changes compared to 2004	
				2005 federal budget	GDP
2	Military expenditures in chapter "National Defense and Law-Enforcement Activities"				
2.1	Interior troops	<u>26 960</u> 24 136	<u>789</u> 3.27	<u>0.76</u> -0.08	<u>0.13</u> -0.02
2.2	Security services	<u>67 557</u> 60 481	<u>6 910</u> 11.42	<u>1.91</u> -0.03	<u>0.32</u> -0.01
2.3	Border patrol agencies	<u>36 047</u> 32 271	<u>1 000</u> 3.10	<u>1.02</u> -0.11	<u>0.17</u> -0.02
2.4	Personnel, combat training, procurement and repair for civil defense troops of Ministry of Emergency Situations	<u>6 439</u> 5 764	<u>-932</u> -16.17	<u>0.18</u> -0.06	<u>0.03</u> -0.01

Source: Calculations by The Institute for the Economy in Transition, based on data of the Federal Law No. 141-FZ of April 11, 2005.



Source: Calculations by The Institute for the Economy in Transition.

Fig. 69. The Dynamic of Allocations for Defense and Security, Billion of Rubles

The analysis of indirect military expenditures, related to past military activities (see Table 66), in the federal budget shows that in 2005 the Ministry of Defense's budget experienced a 2.4 per cent decrease in real term spending on pensions, while housing expenditures for retiring personnel increased by almost 1.5 times.

Table 66

Indirect military expenditures, related to past military activities

№	Sections and subsections	2005, million of rubles/ same in 2004 prices	2005 changes compared to 2004, million rubles/ increase, %	Share of expenditures, % / changes compared to 2004	
				2005 federal budget	GDP
3.1	Pensions	<u>72 687</u> 65 074	<u>-1 532</u> -2.35	<u>2.05</u> -0.35	<u>0.35</u> -0.07
3.2	Subprogram on "State Housing Vouchers" for 2004–2010	<u>14 045</u> 12 574	<u>5 370</u> 42.71	<u>0.40</u> 0.14	<u>0.07</u> 0.02

Source: Calculations by The Institute for the Economy in Transition, based on data of the Federal Law No.141-FZ of April 11, 2005.

At a first glance, military expenditures (see Table 67) in absolute and comparative aspects did not experience significant growth, especially in comparison with expenditures on security and law-enforcement activities. However, it is important to remember that 2004 and 2005 budgets' structures could be compared only partially. Certain "hidden" military expenditures reaching, as it was pointed out earlier, up to 0.25 per cent of the GDP or 1.5 per cent of all expenditures in the federal budget, should also be kept in mind.

Table 67

Total Military and Military-Related Expenditures

№	Expenditures	Billion rubles	Share of expenditures, % / changes compared to 2004	
			2005 federal budget	GDP
1	General direct military expenditures	715 354	<u>20.21</u> 0.62	<u>3.41</u> 0.04
2	Total direct and indirect military expenditures, related to current and past military activities	802 086	<u>22.66</u> 0.27	<u>3.82</u> -0.02
3	Total expenditures in the fields of national defense, security and law-enforcement activities	1 033 661	<u>29.20</u> 2.26	<u>4.92</u> 0.30
4	Total direct and indirect federal expenditures related to current and past military, law-enforcement and national defense activities	1 171 283	<u>33.09</u> 1.69	<u>5.58</u> 0.19

Source: Calculations by The Institute for the Economy in Transition.

Unfortunately, the 2005 federal budget maintains traditional excessive classification of certain expenditures. Thus, 41 per cent of expenditures in chapter "National Defense" and 33 per cent of all Ministry of Defense's expenditures are classified. In general, 11.3 per cent of all federal budget expenditures were classified, compared to 9.7 per cent in 2004. Along these lines, starting in 2005, general transparency of the federal budget was seriously reduced due to the already mentioned "scatter" of certain power agencies' expenditures in different chapters, often only indirectly related to defense and security.

There were no grounds for these renovations; moreover, there were no grounds for classifying these expenditures, as proved by the practice of annual Ministry of Defense reporting to the UN and the Organization for Security and Co-operation in Europe. For example, on May 25 2005, the data, presented in *Table 68*, was reported to the UN in a form of a document on standardized international reporting of military spending. In the original document, expenditures in chapters "Strategic Forces" (1) and "Military Assistance" (2) were left blank, and therefore are absent from *Table 68*. The content of the document conforms to the initial federal budget, adopted in December 2004 or in force until June 2005, discounting the already mentioned 37.6 billion rubles of the MOD's expenditures concealed in "peaceful" chapters. The document shows that the truly classified is the data on spending on missiles and nuclear weapons, as well as, strangely enough, expenditures on active service personnel of the MOD. Corresponding expenditures of the Interior troops of the Ministry of the Interior, border troops and civil defense troops are disclosed.

Data on execution of military and related expenditures, compiled on the basis on the Federal Treasury reports on execution of the consolidated budget, is provided in *Table 69* and *Fig. 70*. It clearly shows that the characteristic January downfall and the December surge in spending also occurred in 2005, considering the positive nature of the budget, adopted in advance and executed through the Treasury.

Table 68

Military Expenditures of the Russian Federation in 2005, Million Rubles

Articles	Forces									
	Land Forces	Navy	Air Force	Other Armed Forces	Central structures of rear provision and administration		Militarized Forces	Unassigned funds	General Military Expenditures	Civil Defense
					Provision	Administration				
1	2	3	4	5	6	7	8	9	10	11
1. Operational expenditures	1 19 986	32 370	25 879	35 658	53 545	7 267	32 080	76 447	383 232	3 814
<i>1.1. Personnel</i>	73 404	23 413	19 627	25 489	–	6 239	16 653	66 552	231 377	1 759
1.1.1. Conscripts	–	–	–	–	–	–	314	–	314	12
1.1.2. Other military personnel, including reserve	42 553	13 640	14 127	20 278	–	4 45	15 451	66 552	177 066	1 468
1.1.3. Civilian personnel	30 851	9 773	5 500	5 211	–	1 774	888	–	53 997	279
<i>1.2. Operation and maintenance</i>	46 582	8 957	6 252	10 169	53 545	1 028	15 427	9 895	151 855	2 055
1.2.1. Funds for current operations	33 251	7 391	5 051	7 699	29 467	694	6 328	–	89 881	687
1.2.2. Service & repairs	5 005	814	807	1 454	397	66	2 759	9 895	21 197	693
1.2.3. Purchased services	7 071	699	353	626	23 681	236	5 804	–	3 8 470	447
1.2.4. Rent	–	–	–	–	–	–	35	–	35	–
1.2.5. Other	1 255	53	41	390	–	32	501	–	2 272	228
2. Procurement & Construction	51 431	27 098	23 307	40 962	1 901	2 011	9 426	1 005	157 141	1249
<i>2.1. Procurement</i>	39 112	23 412	19 556	92 997	1 469	356	5 027	–	121 929	977
2.1.1. Aircrafts & engines	–	904	11 225	–	–	–	725	–	12 854	822
2.1.2. Missiles, including non-nuclear warheads	–	–	–	–	–	–	–	–	–	–
2.1.3. Nuclear warheads and bombs	–	–	–	–	–	–	–	–	–	–
2.1.4. Ships & boats	–	12 360	–	–	–	–	1 314	–	13 674	–
2.1.5. Armored vehicles	3 824	–	–	–	–	–	220	–	4 044	–
2.1.6. Artillery	1 748	99	–	–	–	–	3	–	1 850	–
2.1.7. Other battle facilities & weapons	13 795	6 401	4 682	16 424	960	250	712	–	43 424	–
2.1.8. Ammunition	3 838	480	408	–	–	–	63	–	4 789	3
2.1.9. Electronic equipment & communications	4 066	2 289	3 054	14 579	75	106	1 074	–	25 243	46
2.1.10. Non-armored vehicles	4 907	91	–	85	–	–	763	–	5 846	–
2.1.11. Other	6 934	788	187	1 709	434	–	151	–	10 203	107
<i>2.2. Construction</i>	12 319	3 686	3 751	7 965	432	1 655	4 399	1 005	35 212	272
2.2.1. Air bases, airfields	–	1	525	6	–	–	–	–	532	–
2.2.2. Missile locations	–	–	–	1 885	–	–	–	–	1 885	–
2.2.3. Naval bases & structures	–	797	–	–	–	–	–	–	797	–
2.2.4. Electronic complexes, etc.	–	–	8	70	–	–	–	–	78	–
2.2.5. Personnel premises	2 670	1 420	2 036	2 410	87	230	2 609	367	11 829	90
2.2.6. Medical facilities	287	232	71	329	276	11	261	–	1 467	–
2.2.7. Educational facilities	117	184	83	56	–	47	–	–	487	–
2.2.8. Storage, depositories, etc.	353	160	41	131	50	10	–	–	745	5

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	1	2	3	4	5	6	7	8	9	10	11
2.2.9. Administrative facilities		53	373	420	477	5	711	4	–	2 043	13
2.2.10. Fortification structures		–	–	10	–	–	–	–	–	10	–
2.2.11. Shelters		–	–	–	–	–	–	–	–	–	–
2.2.12. Land		–	–	–	–	–	–	–	–	–	–
2.2.13. Other		8 839	509	567	2 601	14	646	1 525	638	15 339	163
3. Research & Development		2 906	14 142	6 300	11 876	4 418	9 657	114	–	49 413	19
3.1. Fundamental & applied research		2 712	13 840	6 085	8 961	3 707	8 786	–	–	44 091	19
3.2. Development, testing & evaluation		194	302	215	2 915	711	571	114	–	5 322	–
4. Total (1+2+3)		174 323	73 610	55 486	88 496	59 864	18 935	41 621	77 452	589 787	5 082

Source: Objective information on military issues, including transparency of military expenditures: the UN Secretary General Report/the UN № A/60/ 159 of July 25, 2005, pages 133–134.

Table 69

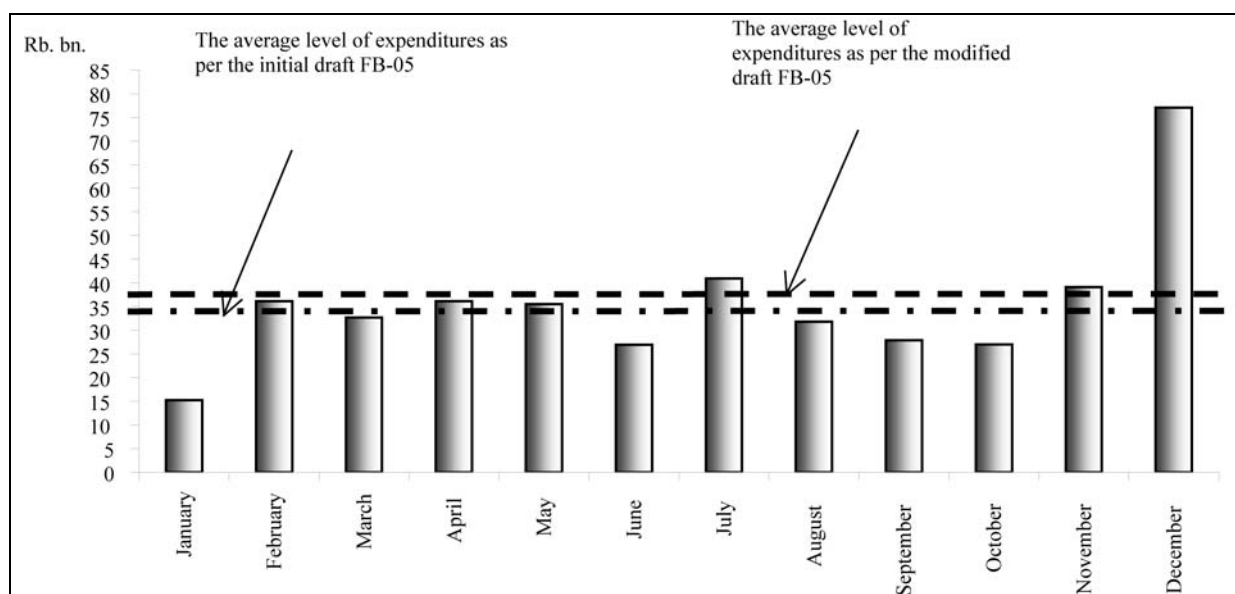
**Monthly Spending on Military and Related Expenditures in the Federal Budget,
in Billion of Rubles**

No№	Expenditures	FB-2005 Initial	FB-2005 Corrected	January	February	March	April	May	June	July	August	September	October	November	December	Surplus (deficit)
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
1.	National Defense	531.1	1578.3	18.6	45.0	53.5	47.5	44.4	35.5	51.1	41.7	35.2	37.5	49.4	121.6	(2.8)
1.1	Armed Forces of RF	388.0	420.8	15.2	36.1	32.7	36.1	35.5	26.9	40.9	31.8	27.9	27.0	39.1	76.9	(5.5)
1.2	Mobilization & training (outside forces)	1.9	3.7	0*	≈0	0.1	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.4	1.7	0.5
1.3	Mobilization preparation of economy	3.5	3.5	0*	0.05	0.1	0.2	0.2	0.2	0.2	0.4	0.2	0.3	0.5	1.0	0.01
1.4	Collective security & peace-keeping	0.061	0.06	≈0	0.01	0.01	0.01	≈0	≈0	≈0	≈0	≈0	≈0	0*	≈0	0.03
1.5	Nuclear weapons complex	8.7	8.7	1.7	1.6	0.1	1.0	0.4	0.3	0.8	0.9	0.02	0.8	0.8	0.1	–
1.6	Realization of international obligations in military-technical cooperation	6.2	6.1	0.8	–	0.5	0.8	0.04	0.09	0.9	0.05	0.02	0.9	0.06	0.6	1.3
1.7	R&D in field of national defense	79.2	89.4	0.2	5.4	10.6	7.4	4.5	5.2	4.5	4.5	4.3	4.8	4.8	32.9	0.2
1.8	Other issues in field of national defense	43.5	46.1	0.7	1.8	9.5	1.8	3.6	2.6	3.5	3.9	2.5	3.6	3.7	8.3	0.7
2.	National Defense & Law Enforcement	398.9	455.3	19.8	28.1	33.2	36.9	30.9	34.6	37.1	34.6	38.5	36.7	45.2	74.7	5.2
2.1	Interior troops	23.9	26.9	0.8	1.6	1.9	2.2	2.1	2.5	2.0	2.4	2.2	2.2	2.9	4.3	(0.03)
2.2	Security services	62.3	67.6	3.3	4.3	4.1	6.2	4.6	4.5	5.8	5.2	5.6	5.5	5.8	11.0	1.6
2.3	Border troops	31.7	36.0	1.4	1.8	2.6	2.8	2.9	2.9	3.1	3.1	2.7	2.9	3.7	5.9	0.1

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Emergency management & civil defense	2.4	22.1	23.1	0.9	1.5	1.4	2.6	1.6	1.4	3.4	0.9	1.9	2.4	1.9	3.1	0.1
R&D in fields of national defense & law enforcement	2.5	2.7	2.8	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.5	0.01
Other issues in fields of national defense and law enforcement	2.6	19.1	21.9	0.2	0.5	1.3	1.2	0.9	1.2	1.6	2.1	1.4	1.9	2.4	6.9	0.2

*Russian Treasury's report on consolidated budget shows a negative amount.

Source: Calculations by The Institute for the Economy in Transition, based on data of the Treasury of the RF.



Source: Calculations by The Institute for the Economy in Transition, based on data of the Treasury of the RF.

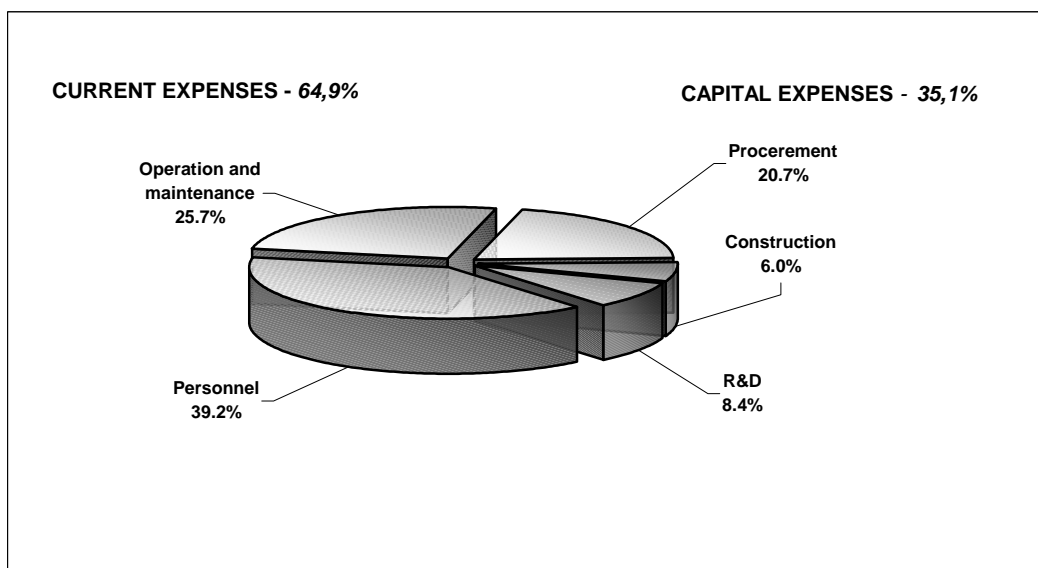
Fig. 70. Execution of Expenditures on Building and Maintenance of the Armed Forces of the Russian Federation in 2005

Judging by the military leadership's statements, in 2005 the priority was given to the realization of the state weapons program that intended to develop approximately 300 of new and modernized weapons samples. It was publicly announced that the leadership made a decision in favor of technical equipment, having increased allocations to weapons program instead of increasing compensations for food rations⁶² and indexation of monetary allowances of military personnel and salaries of civilian employees.

An intended increase in 2005 allocations to weapons program up to 40 per cent (according to the UN data, the increase amounted to 35 per cent, see Fig. 71) is considered to be a success and the evidence of functional quality of the Armed forces. Moreover, the goal for 2011 is to reach 50 per cent, and in a more distant perspective, up to 70 per cent by 2016. These increases are justified by the necessity to come closer to "world practices", based on the Russian Security Council's recommendations of 2000. However, the

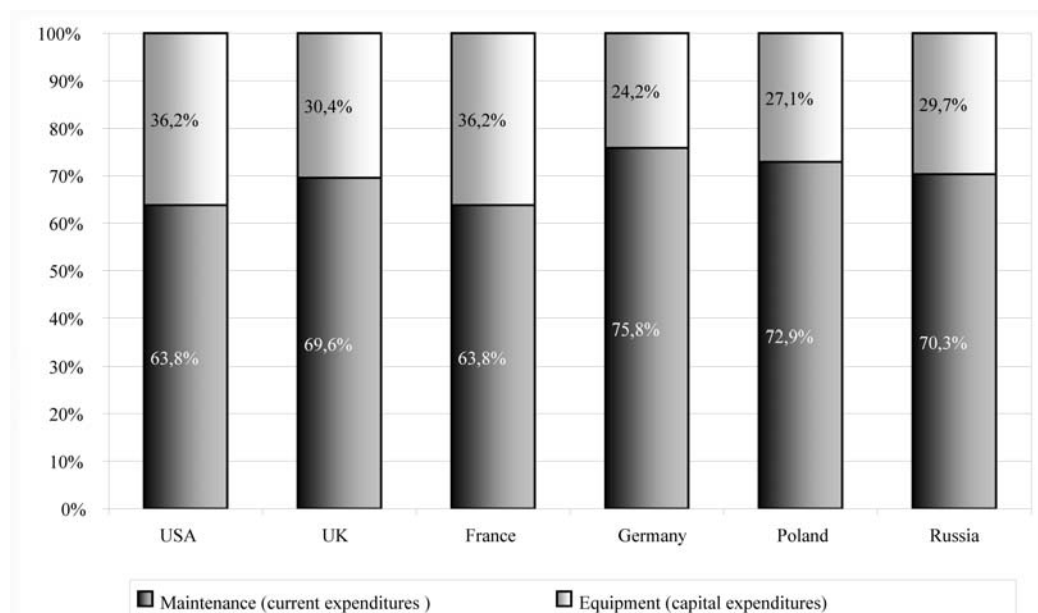
⁶² Voenno-promyshlennyi kurier (Military-Industrial Courier), 2005. No. 4.

analysis of modern structure of military spending of a number of Western countries shows that this premise is radically wrong (see Fig. 72). Current international maximum of capital expenditures in countries reporting their military spending to the UN reaches 45 per cent in Sweden and Switzerland. However, this level of expenditures is provided for by their specific defense expenditures not exceeding respectively 1.8 and 1.1 per cent of the GDP.



Source: Calculations by The Institute for the Economy in Transition, based on the UN data.

Fig. 71. Structure of Russian Military Expenditures in 2005



Source: Calculations by The Institute for the Economy in Transition, based on data provided in "Objective Information on Military Issues, Including Transparency of Military Expenditures," the UN, 2004–2005.

Fig. 72. Structure of expenditures on maintenance and equipment of armed forces of other countries in 2004

Judging by actually achieved level of financing of military expenditures, when for several years only of necessary combat training has been financed, the amounts of monetary compensative for food rations are kept at 1/3 of real costs, and only of conscripts are provided with uniforms, the maximum capacity of Russian Armed Forces can not exceed 500-600 servicemen, that is 50 per cent of the existing number. It is obvious that the former number will allow for a real opportunity to not only realize military weapons program, but to simultaneously or preferably in the first place, provide adequate conditions for military and civilian personnel, to enhance military service appeal and improve the image of the Armed forces. Furthermore, combat training will not be hindered by lack of fuel, and a real opportunity to achieve adequate fighting capabilities of the Armed forces will be created.

There is no doubt that vital qualitative improvement in financing of defense expenditures can be obtained as a result of the carried-out administrative reform and a transition to a goal-oriented budgeting. However it is advisable to consider the current absence of the practice of public debate on MOD's budget requests and on the following reinforcement of that request by the highest authority. Thus, there is no answer to the question whether 300 new weapon samples is a lot or a little, to be given to taxpayers.

3.8.3. Urgent Problems of Russia's Military Economy in the Current Period

The achievements results in the area of modernization of the army and military economy, discussed above, provide for certain conclusions and trends of development.

Firstly, modernization of the state military organization either faces concealed counteraction of a number of officials, as it did in previous years, or is being hampered by their low levels of execution and competence. It is also possible that certain criminal structures counteracting any transformations that could infringe on their "business", based on flaws of the acquisition system of the RF military organization, as well as failure of financial and economic safeguards of the country's security and army modernization, have a negative effect. The existing system of state management of modernization is yet to be effective.

An attempt to solve the problem by promoting the Minister of Defense ranking to deputy Chairman of the Russian Government might strengthen coordination of "power" departments' economic activity to a certain extent. However, this appointment of a "civilian" minister does not imply an increase in civilian and public control of the state's military organization.

Secondly, despite obvious achievements that include establishment of a number of military units and formations staffed exclusively with contractual recruits; gradual phasing out of drafted conscripts' involvement in military operations in the Northern Caucuses, the general problem of transition to a modern system of recruitment is not being solved well. Transition to a contractual system is going slowly and is even accompanied by outflow of "contractual recruits", who have signed contracts earlier.

Consequences of delays in regular army transition to a contractual system and in preparation for a reduced military service could be extremely negative both for the country's defense capability as well as for the society. After 2008, when the country will face a sharp decline in numbers of young men of draft age, the situation will be fraught with a social explosion.

Transition to a contractual system must be livened. The service term should come to 6 months, and its purpose should only be the preparation of military-trained "human resource." It is imperative to find opportunities to combine military training with college edu-

cation. A rational solution to the problem might be related to an increased role of the ROSTO (DOSAAF)⁶³.

Thirdly, equipping the RF military organization with latest weaponry and military equipment is proving difficult due to small order quantities and artificial separation of military knowledge, technologies and products from their possible civilian applications with a curtain of secrecy.

A solution to this problem is in obligatory alignment of state armament program and other program within the framework of military construction with programs of innovative development of civilian economy.

It would be expedient to introduce positive practices of DARPA-type foreign institutions in relations with business.

Fourthly, modernization of budget planning system in “power” agencies should be carried out on the basis of international standards, and it is imperative to include the UN standard of categorization of military expenditures.

It is no less important to reconsider the system of strategic goals of the Russian Government related to the section on National Security and to tie it with the correction of the budget categorization. Representatives’ of the civil society participation in formulation of strategic goals, and correspondingly, of the spending structure, should also be considered obligatory.

⁶³ Russian Defense Sports/Technical Organization (Voluntary Society for Assistance to the Army, Air Force and Navy).

Section 4. Institutional and Macroeconomic Challenges

4.1. Contradictory institutional background

The year of 2005 demonstrated several positive trends which explicitly or otherwise permit to make conclusions, though quite formally so far, on certain favorable shifts already appearing in the Russian economy. Among them were: significant capitalization growth of the leading Russian companies which exceeded all forecasts of the stock market dynamics; lower share of foreign trading space to deal in Russian securities; euphoria of initial public offering (IPO); some reviving (after the *de facto* 2003–2004 moratorium) in the sphere of the corporate management innovations at the company level; further development of the legalization of capital process; lower activity on the market of “uncivilized” hostile absorptions; positive (for the first time since 1994) capital account balance, etc.

In the recent years, some of the above phenomena really encountered with objective economic prerequisites, others were influenced by such or other situational, political and psychological factors. Thus, irrepressible growth of the Russian stock market in the context of slower growth rates, governmentalization and strengthening of its raw materials orientation these all make us consider the risks of the “soap bubble” effect. According to the available estimations, influence of the liquidity factor as well as of the situation in the global financial markets on the growth of the Russian stock market is at present much more significant as compared against the internal macroeconomic situation which also tells on the objective possibilities for regulating the national market (see section 4.6).

The positive capital account balance was determined in 2005 through intensive borrowing of the state companies used in order to pay for the private assets take over, yet, since in view of the obligations already accumulated, their further any significant growth seems hardly possible, therefore, already in 2006, the most probable result will be net flow out in the capital account. Renewal of the private sector initiatives in the sphere of corporate management (see section 4.5) lies mainly in the quantitative innovations sphere (volumes of information revealed, boards of directors composition) which is respectively connected with the IPO procedures and the regulator requirements. Involvement of the qualitative aspects (risk minimization, violating the rights of minority shareholders, dividend policies, relationships with daughter companies, beneficiary owners, etc.), on the contrary, still remains minimal.

In 2003–2005, at least 65 public corporate conflicts were registered in Russia for the sum (if estimated by assets involved) of more than 4 bln US dollars.

Nevertheless, the year of 2005 was typical for lower number of business deals which can be referred to the hostile take over category. The dynamics of official appeals as concerns the said corporate conflicts, for instance, to the Moscow government (other data are usually unavailable) were as follows: 2002 – 460 cases, 2003 – 151 cases, 2004 – 177 cases, 2005 – 97 cases. This is connected not only with tougher administrative control on the part of the state and regional authorities which, using the slogans of struggling against hostile take over, but only put up additional barriers putting obstacles to entering the regional property complex. In 2004–2005, according to the available estimations, political authorization for the process of acquiring such or the significant assets becomes a necessary condition for successful conclusion of such deals (see section 4.7).

At the legislative level, however, regulating the whole complex of questions as connected with the hostile take overs, is still in its early stages. Quite indicative in this sense are such innovations which were under way in 2005. The scaled changes in the corporate legislation (prepared by the RF Ministry of economic development) – Development Con-

cept of the Corporate Legislation for the Period of up to 2008 – were discussed in the Government in February 2006 although a number of quite radical and useful innovations (introducing the notion of “corporate disputes”, their full dependence on the respective arbitration courts, group claims in the interests of shareholders, harder recognition of non-validity securities’ emission, etc) may very well remain no more than just wishful thinking.

The only noteworthy decision adopted in the end of 2004 and outside the framework of the Concept’s practical implementation, were amendments to the “On Joint Stock Societies” Federal Law aimed against corporate blackmail of minority shareholders and providing the majority shareholder – owner of 95 % and more shares with the unconditional right to redeem the rest. The procedure of forcing minority shareholders out after a certain threshold of control has been reached, is accepted in the legislation on companies in many countries; in terms of Russia, its role can also include ensuring favorable legal possibilities for transforming many pseudo open joint stock societies into the closed ones. Nevertheless, in the context of the growing state activity on the market of corporate take overs this innovation may be also quite useful for 100 % share capital consolidation in the existing and future state companies while the wide range of measure, as provided for in the Concept and intended to protect the rights of property and interests of all respective parties, will be but limiting possibilities for expansion. In this sense, practical implementation of the Concept’s innovations can be viewed as a certain indicator of how much the state itself is actually interested in the absence of strict enough rules of the game in the sphere of property relationships.

Notwithstanding the formal progress in the sphere of privatization in 2003–2005 (with regard to the quantity of packages of shares for sale and the decision on transforming unitary enterprises), the real situation is quite close to critical. At least 50 % of deals are annually put off due to the absence of demand while the quality of managing the state property differs but little from that at the level of the 90s. In all probability, the situation in this sphere is directly connected with the modification of views with regard to the role of the state sector in the economy of Russia (see sections 4.2 and 4.3).

On the one hand, creation of at least an *impression* that privatization has been completed as a component of the institutional reforms – practical implementation of the federal packages of shares as well as transforming the state management sector – is one of the 2006–2008 practical tasks. Efficiency of the process both for the state and the enterprises concerned is deemed, in this particular case, as secondary with regard to possible political dividends.

On the other hand, rapidly accelerating property expansion of the state, whether the general economic strategy, a trivial property redistribution in favor of clans close to the mighty of the world or resistance of those ministries interested, is objectively taking out of the privatization process its most significant or profitable assets still remaining in the state ownership. As G.O. Gref, the minister of RF economic development and trade, said in 2005, “... liquid enterprises are not given to us for privatization. One hundred and fifty reasons are found to leave them in the state ownership. They agree to include in the privatization plan only what can be called “trash”. But this is not interesting for the market so we sell and resell such enterprises 4–5 times. So more and more enterprises are put on sale but fewer and fewer of them are sold... Moreover, with the time, the ration of those put for sale and those enterprises really sold will only be falling”¹. Complexity of the RF Ministry of Economic Development and Trade’s situation, as the body directly responsible for the privatization program since 2004, is obvious although the situation itself seems to be even more

¹ *Merges and Take Overs*, 2005, No. 11, p. 8; *Kommersant*, 2005, August 5.

contradictory: getting rid of the unsold “non-liquids” nevertheless does remain a priority although, in the context of the present situation with raw materials and the respective budget incomes, it is no less difficult to find arguments in favor of selling new and highly profitable assets. This is the more problematic due to the lack of sufficiently coherent ideas as concerns the directions in which the incomes accumulated in the federal budget are to be spent.

The legalization of capital processes which have already begun, are determined not only by adaptation of the big business to the “after YUKOS” situation but by more applied motives as well. In 2005, on the one hand, more evident became deals as caused by some majority shareholders (partners) leaving business (selling their shares). This is connected not only with reorientation of interests towards new spheres of investing or departing from the operative management/control but also with a sort of a certain defensive strategy – transforming property (at that displaced abroad) into liquidity obviously makes it quite hard to nationalize. On the other hand, there is a definite trend towards further expansion of the largest companies’ shareholding basis through selling part of the shares by the largest shareholders on the open market (through the IPO, inclusive). Legalizing the respective finance is accompanied with legalization of the shares remaining under control (in ownership) in the respective companies.

The late 90s – early 2000s were characterized by the situation when relatively developed economic legislation was already formed in the country with enforcement being its most critical sphere. In the middle of 2000s, the accents, in all probability, changed: although weak points in the Russian enforcement system do remain quite acute² a certain shift is taking place within the economic legislation framework (as well as its interpretations) significantly increasing the uncertainty degree of possible consequences of such or other economic decisions for business as regards reciprocal actions of the state, on the one hand, and obviously tougher regime of interrelations between the state and private business, on the other hand. Problems of Russia’s law enforcement system, as complemented with the trend towards returning to more tough legislative norms, do significantly expand the risk zone in the property rights sphere.

One of the most significant elements for favorable institutional environment – overall stability of the existing property structures and rules of appropriating long term investments for the whole period of functioning – still “does not work”. Before the early 2000s, it was primarily connected with the quality level of the institutes of state governing as well as with the regulative activity of the state – vulnerability of the property rights, the tax sphere, licensing, natural monopolies tariffs, administrative barriers, corruption, gaps in different areas of the law, inefficient law enforcement, etc. In the middle of the first 2000 decade, risks brought about into the entrepreneurship (its legal kinds and forms, indeed) by the respective institutes and regulative activities of the state, were not less significant yet there appeared a new and much more significant factor – the state is ever more and more vividly restoring its direct interference in the national economy.

It was even as far back as in 2003–2004 that discussion of the state’s property expansion problems and, in a broader sense, the state capitalism, as factors significant for the overall economic development of Russia caused, in a number of cases, quite a strong rejection of some researchers even though the said processes started their initial devel-

² Typical evaluations of the judiciary system’s state basically vary in the range from “inefficient and corrupt” to “market of judicial services” and “catastrophic”. This is not infrequently confirmed by top functionaries in different branches of the Russian power bodies. In particular, V. Zorkin, Chairman of the RF Constitutional Court (2004) spoke about system corruption, D. Kozak, Representative of the RF President in the Southern region (2005) who had earlier been responsible for the judicial system reform, spoke about the catastrophic and threatening situation in the judicial system.

opment beginning from the year of 2000. In our opinion, the year of 2005 became the turning point – at the present time, it makes sense to speak *not just about simple expansion of the state's direct presence in the national economy but rather about a stable trend towards dominant position of the state in a number of leading industries* of the Russian economy. Possible consequences of the property expansion of the state and of the state (pro-state) companies can be quite negative both for large private companies (groups) and the national economy as a whole.

4.2. Policy in the Sphere of Property Relations

Limitations and dynamics. The crucial milestone in this sphere was the year 1999, which manifested the onset of the realization, with certain later modifications of the specific approaches, of the Concept for the Management of State Property and Privatization, adopted by the Government's decision in 1999. The next Concept was approved at the RF Government's meeting on 6 February 2003; however, unlike the 1999 Concept, it has never acquired the status of an official document³. In 2005, the RF Ministry of Economic Development, in its report to the RF Government, emphasized the necessity to develop "a new model for managing the remaining state property, to be based on the principles of strict correspondence of the composition of state property to the functions of the State, and on guarantees of an efficient property use, while maintaining the state expenditures on management at an optimum level"⁴.

At the same time, the problems pertaining to the privatization and management of federal property have become, by now, of a chronic nature. The whole period of 1999–2005 was characterized by the following major limitations:

- the demand for most of the objects being privatized (first of all, the minority blocks of shares) was extremely low, mainly due to the already achieved level of concentration of corporate property (or of corporate control) and to the high costs of acquiring the residual property, whereas the number of the remaining unsold objects, being carried forward from year to year, was constantly on the rise⁵;
- the high probability of repeated adjustments in the lists of blocks of shares and unitary enterprises, caused by both objective and subjective factors;
- the existence of a serious conflict between the organizational capacities of the managerial bodies responsible for undertaking a rapid reforming of the public sector, and the qualitative limitations imposed on this reforming by its own scale;
- the absence of any clear ideas (either conceptual and formalized in established norms) concerning "a new model for managing the remaining state property";
- the demand for new mechanisms for the realization of unattractive minority blocks of shares (public offer, sales without publishing the price, the determination of a starting price by the nominal value of shares being sold, etc.) did not display any significant growth;
- the resistance of branch ministries – first of all, with regard to the reforming of state unitary enterprises (SUEs) (for financial and administrative reasons);

³ For more details, see: Radygin A., Mal'ginov G. Privatizatsiia i upravlenie federal'nym imushchestvom / Rossiiskaia ekonomika v 2003 godu. Tendentsii i perspektivy. M., IEPP, 2004, p. 327–339 (The privatization and management of federal property / The Russian economy in the year 2003. Trends and prospects. M., IET. 2004. P. 327–339).

⁴ The data used hereinafter are taken from the report "On the measures aimed at increasing the efficiency of federal property management". The materials prepared for the meeting of the RF Government on 17 March 2005; The report on the privatization of federal property in the year 2005. Moscow, FAFPM, 2006.

⁵ The amount of 62% of the blocks of shares earmarked for privatization in the year 2005 was less than the "blocking" one; of this amount, 48% were blocks of shares smaller than 5% of charter capital. In a considerable percentage of joint-stock companies, the controlling block of shares had already become property of one person or a group of affiliated persons.

- a dramatic reduction in the number of unitary enterprises of all levels, with prospects for their reorganization into open-end joint-stock companies (OJSC) considerably increased the burden imposed on state administration bodies, which were far from being efficient in their role of state representatives, even without this additional load;
- the creation, on the basis of the property owned by state unitary enterprises, of a noticeable sector of treasury enterprises, functioning on the basis of the right of operative management, entails increased financial risks being borne by the State, because of the subsidiary responsibility for the obligations of these enterprises;
- the non-transparency and weakness of unbiased control on the part of the State over the realization of privatization procedures in respect to unitary enterprises frequently results in a situation when, at the stage of selling, only an empty “juridical shell” is present, devoid of any assets (or the bankruptcy procedure is used as a tool for spontaneous privatization);
- the still acute problem associated with the need to formalize the solid property rights of enterprises to land plots (the excessive cost of redemption and lease; the methods for the cadastre assessment and determination of market prices, administrative barriers, the restrictive regional policy, etc);
- the existence of general, rather difficult, problems pertaining to the normative-legal backing, including for the division of property between the RF, subjects of the Federation, and municipalities;
- the measures implemented in the course of the administrative reform undertaken in the year 2004⁶ predetermined the necessity of a relatively long period of adaptation, both during the process of reorganization and thereafter, with the result that in the years 2004–5 the State’s activity in the sphere of state property management was characterized, to a great extent, by inertia and spontaneity;
- the growing complexity of the administrative structure in this sphere aggravated both the coordination problems and the departmental conflicts (the creation of the FAFPM and its subordination to the RF Ministry of Economic Development, with vesting the latter with the norm-creating functions in the sphere of privatization, while preserving the Russian Fund for Federal Property (RFFP), although the latter, by now, has reduced its functions to those of a seller).

As regards federal state unitary enterprises (FSUEs), the reforming of this sector is also hindered by the following problems, whose applied character is more explicit (the data are for the year 2005):

- the negative value of the book cost of an enterprise’s assets, which can prevent it from either being reorganized into a joint-stock company, or privatized by being sold at a tender as a property complex, because the normative price becomes a negative value as a result of calculations;
- the actual financial and economic crisis faced by the enterprises included in the privatization program (765 FSUEs had losses, or no net profit, as is seen by the results of the year 2004);
- no economic activity is being carried out (74 FSUEs);
- failure of the director of an enterprise to implement the established rules concerning the preparation to privatization (information, timelines, etc.);
- the absence of both the documents recording the industrial statistics and the documents consolidating the right to federal property objects, including land plots (all FSUEs);

⁶ Edict of the RF President, No. 314, of 09.03.2004, “On the System and Structure of Federal Executive Authorities”.

- ongoing court proceedings concerning the issues of ownership;
- the absence of money resources necessary for the enterprises to be able to formalize the appropriate documents as to their right of ownership and the documents of technical inventory (200 FSUEs);
- the implementation of insolvency proceedings (146 FSUEs);
- multiple instances when either the reorganization of an enterprise, by way of merging subsidiaries with a parent enterprise, has not been completed, or an enterprise is undergoing the procedure of its liquidation (15 and 68 FSUEs, respectively).

It should be noted that already in the first three-year Prognostic Plan (Program) for the Privatization of Federal Property and in the Main Directions of Federal Property Privatization up to the Year 2006 (approved by Regulation of the RF Government, No. 1165-r, of 15 August 2003), the following algorithm of actions has been envisaged: the year 2003 – the privatization of state-owned blocks of shares, amounting to up to 2 % of charter capital; the year 2004 – the withdrawal of the State from all joint-stock companies where the share of the State is less than 25 %; the year 2005 – the withdrawal of the State from all joint-stock companies where the share of the State is between 25 % and 50 %; the year 2006 – the discontinuation of State participation in the non-strategic companies where the share of the State exceeds 50 %; the year 2008 – the completion of the privatization of the federal property which is not being used in the implementation of RF state functions. In accordance with this scenario, by the end of the year 2008, the State will be keeping in its ownership no more than 2,000 FSUEs and 500 various blocks of shares.

Certain alterations have already been introduced in the Prognostic Plan (Program) for the Privatization of Federal Property for the Year 2005 and for the Period up to the Year 2007⁷:

- the extension of the prospects for the privatization of federal property into the year 2007;
- the completion, in the year 2005, of the privatization of the federally-owned blocks of shares in joint-stock companies amounting to less than 25% of charter capital;
- the alteration of the branch-based structure of federal property being privatized;
- and the introduction of the notion of a “prospective financial plan” in the planning of federal property privatization.

The Prognostic Plan (Program) for the Privatization of Federal Property for the Year 2006 and the Main Directions of the Privatization of Federal Property in the Years 2006-2008 (approved by Regulation of the RF Government, No. 1306-r, of 25 August 2005) is even more cautious in terms of quantitative indicators. According to this document, the major goals of the state policy in the sphere of federal property privatization are as follows: the privatization of the state property which is not being used for ensuring the implementation of the state functions (or powers) of the Russian Federation; the guaranteeing of a step-by-step reduction in the number of federal state unitary enterprises; an increased rate of federal property privatization; and the formation of the federal budget's revenues. In 2006, it is planned to offer for privatization those blocks of shares whose amount does not exceed 50% of the charter capital of the joint-stock companies, except for the blocks of shares in the joint-stock companies included in the lists of strategic companies or the companies participating in the formation of integrated structures (in the framework of the realization of the Federal Target Program “The Reforming and Development of the Military-Industrial Complex (the Years 2002–2006)”, and for those blocks of shares which will be

⁷ The draft plan for the years 2005–7 was considered at the RF Government's meeting on 29 June 2004; the Prognostic Plan for the Year 2005 was approved by Regulation of the RF Government, No. 1124-r, of 26 August 2004.

sold in compliance with the needs of forming the revenue side of the federal budget in the year 2006 and for the period up to the year 2008, in accordance with the prospective financial plan.

Nevertheless, the unrealistic nature of the established timelines is still evident, even after all the adjustments are taken into account, as the practice of the years 2004–5 has already proved (*Table 1*). The quantitative parameters of privatization calculated for the year 2006 have become more balanced; but, just as in the previous years, it is very likely that insufficiently justified (from the economic and organizational points of view) upward adjustments of purely administrative nature will be introduced once again.

Table 1

Major Objects in Federal Ownership and Privatization Program of 2000s

	1999*	2000	2001	2002	2003	2004	2005	2006
Total number of FSUEs**	13 786	11 200	9394	9846	9275	8820	8293	-
Number of FSUEs privatized during one year:								
- Forecasts	-	-	-	1652	970	1374	1245	885
- Actual number***	-	2	5	102	571	517	741	-
Joint-stock companies whose blocks of shares are owned by RF**	3611	3524	4407	4 222	4 035	3905	3524	-
Including by share in charter capital								
- 100 %	382	61	90	99	124	273	413	-
- 50-100 %	470	506	646	589	552	499	474	-
- 25-50 %	1601	1211	1401	1 382	1308	1183	1093	-
- less than 25 %	863	1746	2270	2 152	2051	1950	1544	-
- "golden share"	580	-	750	958	640	284	259	-
Federal blocks of shares sold during year:								
- Forecasts	-	-	-	1126	1965	1702		383
- Actual number***	-	87	125	112	630	565	566	-

* As of the end of each year. The year 1999 is taken as the baseline, due to the adoption of "The Concept for the Managing of State Property and Privatization in the Russian Federation" (approved by Decree of the RF Government, No 1024, of 9 September 1999).

** Without taking into consideration the special right – the "golden share". In the early 2000s, the total number of unitary enterprises was about 85,000, including approximately 20,000 state enterprises and approximately 65,000 municipal enterprises. In 1995, the State owned no less than 15,000–17,000 blocks of shares of various sizes, while in 1999 – approximately 3,100 "consolidated" blocks of shares and 7,000–8,000 unsold blocks of shares (registered as part of the fixed assets of regional property funds). In 1995, 1,004 joint companies had a "golden share".

*** The actual data concerning the annual privatization of blocks of shares and FSUEs cannot accurately be interpreted for a number of reasons: 1) the absence of any regular information from the RF FAFPM and the RFFP; 2) as a rule, between 10% and 50% of transactions actually take place each year, while the unsold blocks of shares are "carried forward" to the next year; 3) the ongoing "counter-process" of FSUEs being privatized, as well as other methods for increasing the number of blocks of shares owned by the State; 4) the reorganization processes going on in the electronic industry and in the sphere of communications, the inclusion of the property complexes, owned by a number of FSUEs, into the charter capital of state holdings, and the formation of integrated structures in the military-industrial complex, in the railway sector, etc. As regards FSUEs, the data

on their privatization are rather imprecise, because the official data on privatization also cover a number of FSUEs, in respect to which only a *preliminary decision* has been taken, and also those FSUEs which have passed only the stage of being reorganized into joint-stock companies. At the same time, the very number of FSUEs may increase (as a result of separation, creation of new enterprises, etc). In January 2005, the Ministry of Economic Development proposed to additionally include 42 FSUEs and 63 open-end joint-stock companies in the privatization plan for the year 2005; in March 2005, the proposed numbers were 547 and 947, respectively.

Source: data of the RF Ministry of Economic Development and the FAFPM.

One of the typical trends observed in 2004–5 was *the growing attention toward the liquidation of the institution of FSUEs*, predetermined both by some external factors (criticism aimed at the Ministry of Economic Development and the FAFPM; failures in the realization of residual blocks of shares) and by this sector's overall economic and financial inefficiency (clearly demonstrated by the comparison of various types of income from the use of federal property). Nevertheless, out of the 1,245 FSUEs earmarked for reorganization in the year 2005, only 22 FSUEs underwent the procedure of reorganization into joint-stock companies in the first six months of 2005 and actually became ready for privatization. By the year's results, certain decisions were taken in regard to 405 of FSUEs (741 enterprises, including the 39 enterprises sold at auctions as property complexes, and 702 reorganized into corporations). Accordingly, an absolute majority of these enterprises will embark on actual reorganization no earlier than in the year 2006, at best.

Despite the apparent discrepancy between the current practice of reforming the sector and the declared targets (as a minimum, to reduce the number of FSUEs to 1,000 only, and as a maximum, to liquidate this form altogether by the year 2008), the decision to gradually liquidate this organizational and legal form has been, undoubtedly, a positive development. This has been admitted by the FAFPM itself: "Practice shows that the preservation of enterprises in the form of FSUEs only results in the conservation and aggravation of their existing problems". During the period when "the extremely inefficient form of a state enterprise "based on the right of economic management" was in existence, many FSUEs became not only incapable of performing their state functions, but also lost their property potential and intellectual potential⁸.

The emphasis on reorganizing the FSUE sector has directly influenced the results of privatization. The specific feature of the year 2005 was the *absence of any major privatization transactions*. Naturally, it was caused by a whole range of factors of both objective and subjective character – apart from the reorientation of departmental efforts toward the FSUE sector, it was the generally favorable situation with budget revenues, the fact that the existing law on privatization provided for the possibility of a flexible approach to the realization of transactions in accordance with the market situation, the presence of competing interests (both departmental and private) with regard to a number of the most interesting objects, etc. Initially, the list of the major objects earmarked for privatization included the FSUE "Rosspirtprom" and the sale of its shares (200 enterprises, 80% of the Russian market), the "Domodedovo Airlines" (25% of shares), the Novorossiisk and Tuapse cargo sea ports (approximately 20% of shares), the "Rosgosstrakh" (25% plus one share), etc. However, for the year 2005, the following major transactions are worth mentioning: with the shares in the OJSC "Polief" (100% of shares – 3.38 billion roubles); with the shares in the OJSC "Galogen" (50.8% of shares – 830 million roubles); with the shares in the OJSC "Morskoi Port "Sankt Peterburg" (20% of shares – 0.8 billion roubles); and with the shares in the OJSC "Slava" (37.6% of shares – 657 million roubles).

⁸ The official statement (press-release) of the RF Federal Agency for Federal Property concerning the results of privatization and the management of federal property in 2005, of 23 January 2006.

The year 2005 witnessed the continuation of the practice of selling shares owned by the RF in one lot with shares owned by subjects of the RF. As an example, one may point out the consolidated sale of the federally-owned block of shares in the OJSC 'Morskoi Port "Sankt-Peterburg"' (the said block of shares was not big enough for the Russian Federation to make any managerial decisions, or even to block the decisions made by other shareholders). The sale of the federal block of shares in the OJSC 'Morskoi Port "Sankt-Peterburg"' was carried out in one lot with the shares owned by the city of St. Petersburg. Thus, a joint block of shares, in the amount of 48.79% of the charter capital of the said company, was put up for auction.

The sale of the block of shares in the telecommunications holding "Sviazinvest" had been on the agenda for a number of years, therefore the inclusion of this object in the list of entities earmarked for privatization in the year 2005 by no means implied that the final decision had been actually adopted. Firstly, any further privatization will be directly dependent on the completion of the reorganization processes going on inside the holding, on the tariff reform, on certain solutions being found to the problems associated with the social burden imposed on regional companies and the necessity to provide communication services to the power structures in the amount of more than 600 thousand telephone numbers, while the amount of arrears of payments due to the holding is very significant – about 600 million of roubles as of 1 July 2005). Secondly, bearing in mind the growing attractiveness of telecommunication shares, any prompt sale of the holding's securities would make little sense. Nevertheless, there also exists an opposite trend. According to the RF Ministry of Economic Development, despite the fact that the holding owns the controlling and blocking blocks of shares in the regional operators of wire communications, they are no longer being managed as efficiently as before. Thirdly, any specific sale option will have to be properly elaborated in detail.

As is known, as early as 1995 the State intended to put up, for a commercial auction with investment terms, 49% of the holding's shares. In 1997, 25% plus one share was acquired by the off-shore company "Mustcom Limited" (1.87 billion USD, G. Soros' interests), which was later, in May 2005, bought by a number of companies representing the interests of L. Blavatnik. In 2001–3, the standard procedure was to offer for privatization the amount of 25% minus 2 shares. In 2004, a number of sale scenarios were discussed, including the sale, at an auction, of some blocks of shares in the holding's regional companies (at least 4 interregional subsidiaries were included in the 2004 list). In 2004, the FAFPM was considering 3 major sales scenarios: 25%, 50%, and 75% minus one share. Nevertheless, a simultaneous sale of the subsidiaries' blocks of shares (with all the resulting consequences typical of the "double" privatization of the oil sector in the 1990s) cannot be ruled out, either. The terms of selling the holding will also depend on the number of bidders, on their relations with the authorities, and on the intensity of their competition (by the end of 2005, the ranks of potential bidders included the Joint-Stock Financial Corporations "Sistema", "Telekominvest", and "Alpha-group", as well as L. Blavatnik's companies).

From the point of view of the RF Ministry of Economic Development, the most rational scenario will be the simultaneous privatization of the whole state-owned block of shares (75% minus one share), which was being discussed in 2005 concurrently with the preparation of the President's edict concerning the exclusion of the holding from the list of strategic objects. At the same time, in the course of the year 2005, the terms of sale were continually discussed with the power agencies. In October 2005, major alterations were introduced in the draft edict on the initiative of the President's state-legal board, which envisaged the necessity to legislatively formalize the guarantees to be secured to the power agencies before the inclusion of the holding in the program of privatization. This means

that, most likely, the holding will not be privatized in the year 2006, either. In late 2005, the head of the holding, V. Yashin, announced that the sale of the state-owned block of shares would be possible either before 1 July 2006 or as late as after the 2008 presidential election.

In general, the history of the privatization of the holding "Sviazinvest" (and of the plans for its privatization) deserves a separate study, because it clearly reflects almost all the specific features of the Russian privatization in the period after the mass-privatization phase was completed: the "Oligarch War" of 1997, the non-transparency of the sales of the first blocks of shares, the active use of the administrative resource both in 1997 and 2005, the risks of "double" privatization (of the holding and its subsidiaries) typical of the oil sector in the 1990s, a wide range of social and regional problems, the limitations of strategic nature (national security) and the involvement of the power agencies, the problems associated with the reorganization of the corporate structure, the hidden struggle going on between various power-holding and financial groups in the 2000s, and a number of other features.

Budget revenue. From the point of view of budget revenue, the positive trends of the years 2001–4, resulting from the increase in the share of revenues from the use of state property (i.e., renewable revenues), were equally significant in the year 2005 as well (see *Table 2*).

In 2005, the expected budget revenue from privatization was to amount to no less than 42.7 billion roubles (with taking into account a number of blocks of shares in those large enterprises which were included in the list of strategic enterprises in the autumn of 2005). In fact, the revenue from privatization in 2005 amounted to approximately 13 billion roubles (if the receipts from the 2004 transaction with the shares in the Magnitogorsk Metallurgical Combine are not taken into account).

Moreover, starting from the year 2003, a stable trend towards an absolute decrease in the privatization receipts proper has been observed: in 2004 – by one third on the results of 2003, in 2005 – by nearly two-fold on the results of 2004. On the whole, in the period of 2003–5, the receipts from privatization declined nearly three-fold in absolute terms. The benchmark for the year 2006 is set at 31 billion roubles (or slightly lower than the actual results of the year 2005), but it will be possible to achieve this value only through implementing one or two major privatization projects (those involving "Sviazinvest", "Aeroflot", "Rosneft" or some other projects, which is still rather doubtful). In the summer of 2005, the prognostic plan for the year 2006 was extended, to include several major assets (34% of shares in the "KamAZ", 100% of shares in the "SG-Trans", 86% of shares in the corporation "Iliushin", 70% of shares in the All-Russian Exhibition Center, 100% of shares in the Russian Bank for Development (RBD), and some other assets). However, already in early 2006 the plan regarding the block of shares in the "KamAZ" was changed (it is now being claimed by the FSUE "Rosoboroneksport"). The sale of shares in "SG-Trans" will now require special authorization by the RF Government. The inclusion of "Iliushin"'s shares in the privatization plan is unlikely to result in the actual privatization of this asset, while the blocks of shares in the All-Russian Exhibition Center and the RBD were already excluded from the list in August 2005.

On the contrary, after the year 2000, the renewable sources of the federal budget's revenue related to property management have been clearly demonstrating a trend towards their dominance. According to the FAFPM, the aggregate federal budget receipts from privatization and the use of state property in the year 2005 amounted to 97 billion roubles (preliminary data). The receipts from the use of federal property accounted for more than a half of the aggregate revenue, or to 53 billion roubles, including 14.2 billion roubles from

the leasing out of federal property, 16.6 billion roubles in dividends from shares in federal ownership, 17.5 billion roubles from the RF's participation in the "Vietsovetpetro", 2.4 billion roubles allocated as a part of the profit of federal state unitary enterprises, and 522 million roubles from the realization of property owned by state unitary enterprises (or establishments) and military property. During the period of 2000–5, *the annual revenue from renewable sources increased by three times*. Nevertheless, the amount built in the 2006 federal budget is practically identical to that of the actual receipts of the year 2005.

Table 2

**The Dynamics of Revenues from Privatization and Usage of Federal Property,
in Millions of Roubles**

	1999*	2000	2001	2002	2003	2004	2005	2006 forecasts
1. Non-renewable sources, total	8 547,4	31 367,1	10 110,6	14 700,7	95 237,3	65 777	34 882	31 600
1.1. Privatization (number of enterprises)	8 547.4	31 367.1 (320)	9 990.6 (170)	12 703.8	90 660**	61 856.8	29 079.2**	31 000
1.2. Realization of FSUEs' property and military property	-	-	-	-	585	662.7	522	600
1.3. Sales of land and intangible assets	-	-	120.0	1 996.9	3 992.3	3 257.5	5 280.8	N.d.
2. Renewable sources, total	8 720.5	18 790.1	29 122.6	36 762.2	41 143.2	53 710.3	54 404	53 052
2.1. Dividends (number of enterprises)	848.1 (600)	3 675.1 (1 050)	6 478.0 (782)	10 402.3 (747)	12 395.2	17 222.0 (319)	18 610	20 500
2.2. Lease of property	2 191.4	3 427.2	4 896.1	7 657.9	9 573.9	11 928.8	14 170	16 700
2.3. Lease of land	-	-	3 917.0	4 400.0	197.3***	901.7	1 748	2 000
2.4. Part of FSUEs' profit (number of enterprises)	-	-	209.6 (131)	914.2 (809)	2 387.6	2 538.1	2 386	2 500
2.4. SJV "Vietsovetpetro"	5 675.0	11 687.3	13 621.9	13 388.8	16 200	17 199.5	17 490	11 352
Total	17 261.9	50 157.2	39 233.2	51 462.9	136 380.8	119 487.2	89 286	84 652

* For the dynamics during 1995–2002, see: Rossiiskaia ekonomika v 2002 godu. Tendentsii i perspektivy. (The Russian economy in the year 2002. Trends and prospects). M. IEPP. 2003. P. 367.

** The receipts from the 2002 sale of 74.95% of shares in the JSC "Slavneft", in the amount of 59,161.95 million roubles, are included in the revenue of the year 2003 (i.e., more than 60% of the received revenue). The receipts from the 2004 sale of 17.8% of shares in the JSC "Magnitogorskii Metallurgicheskii Kombinat", in the amount of 21,928.2 million roubles, are included in the revenue of the year 2005 – i.e., more than 60% of the received revenue).

*** The rent payment for land in federal ownership, after the delimitation. In the following years, the line "Rent payments and the receipts from the sale of the right to conclude lease contracts in respect to land in federal ownership".

Source: The RF Ministry of Economic Development, the RF Federal Agency for Federal Property Management (FAFPM), the Federal Law "On the 2006 Federal Budget", the authors' calculations.

On the one hand, a reduction in this group of revenues in the medium-term perspective should be considered as an objective process, predetermined by the plans for the withdrawal of the State from most of the joint-stock companies and for the liquidation of the FSUE sector, as declared by the government. On the other hand, the real timelines for any considerable reduction in the size of the mixed sector will, undoubtedly, be set beyond the medium-term perspective (i.e., 2006–8), and therefore the preservation of the 2005 level of revenues from renewable sources, even for the year 2006, can be considered as an actual admission of the presence of a management crisis in the mixed sector.

At the same time, it should be noted that the major renewable sources will not only retain their importance in the year 2006, but will also ensure, due to the global situation in respect to the prices of mined material, a significant growth in budget revenues (with all

other conditions being equal – for example, if the “special” role of the “Gazprom” and “Rosneft” in the activities of the Russian authorities is not taken into consideration, etc.).

Thus, dividends on state-owned blocks of shares are considered by the government to be the most important renewable source of budget revenues. The dynamic changes observed during recent years are indicative of a considerable growth in the payments of this type, which have been ranking first among the renewable assets since the year 2000 (see Table 2). As is shown by the data of the years 2004–5, approximately 75% of the dividend payments to the federal budget were accounted for by 5 companies – “Gazprom” (about 50% of all receipts came from this source of revenues), “Transneft”, “Vneshtorgbank”, “Rosneft”, and “LUKoil” (before its last block of shares was sold in 2004). The share of 15 largest payers accounts for 84% of the total amount of dividend receipts. As in the previous years, “Gazprom” still remains the largest payer of dividends on state-owned blocks of shares. On 28 October 2005, the company made the transfer of 10 billion 37 million and 600 thousand roubles to the Federal Treasury on the results of the year 2004, which amounted to 60.6% of all the dividend payments transferred to the federal budget.

The privatization of the majority of the aforesaid enterprises and banks is not planned for the nearest future; on the contrary, the experience of the years 2004–5 clearly demonstrates a growing property expansion within the state structures (see Section 4.3), and, correspondingly, an extension of the dividend base.

It is worth noting in this respect that, given the existing concentration of dividend payments, the mass-scale work with enterprises, which was declared to be one of the characteristic components of the administrative approach being practiced in the 2000s, is losing its former significance. On the one hand, the number of such enterprises displays an objective decline (see Table 1) – in 2000–04 it diminished by three times. On the other hand, if a company is capable of paying dividends, the receipts from the sale of its block of shares are likely to be larger than the expected dividend incomings; it is also important that in this case the issue of the various administrative costs related to dividend payments will no more be relevant.

The necessary measures to be implemented. As is shown by the experience accumulated since the year 2000, the medium-term strategic task, to be faced by the State in the sphere under consideration, should be the final settlement of those three issues that have constantly been on the agenda for the past ten years, with no tangible solution ever found:

- the formation of a very precisely elaborated list of strategic objects (or enterprises, or stakes), which are to remain in state ownership in the medium-term perspective, to be selected on the basis of a certain number of *justified, transparent, and legislatively consolidated* criteria relating to state security and the actual state needs, provided that the State will be able to efficiently manage them, from the quantitative point of view;
- the elaboration and normative-legal formalization of a transparent management model, to be applied to the aforesaid strategic objects (at the same time, the whole bulk of property, which is temporarily to remain in state ownership under various control regimes, is not to be taken into account in this model);
- the optimization of the existing methods of privatization, and the accelerated “deliverance” of the State from any non-liquid assets, without taking into consideration the “budget targets” for the extraction of non-renewable revenues.

The available proposals and innovations, that have been put forth by the State⁹, are quite justified (especially if we abstract them away from the problems associated with the general institutional background of the suggested transformations (corruption, private interests, rent-oriented behavior, the expansion of the public sector, etc.):

- the simplification of the procedure for the privatization of some of the SUEs and MUEs, by abolishing the mandatory reorganization of enterprises into joint-stock companies (selling without reorganization, as a property complex per one buyer);
- the modernization of the privatization infrastructure, and of the sales system in general;
- the simplification of the procedure for selling single shares in joint-stock companies (with taking into account the fact that the evaluation costs and the cost of organizing the tender can exceed the proceeds from the shares being sold);
- the introduction of competition-based schemes for choosing the sellers (the discontinuation of the monopolistic status of the Russian Fund for Federal Property as a specialized state establishment);
- the abolition of “the normative price” institution in the privatization procedure (or of the lower threshold of the possible value of the initial price of a piece of federal property, currently to be set by the FAFPM);
- the simplification of the procedure for the creation of an open-end joint-stock company during the process of privatization (the possibility to abstain from the issuance and registration of a securities issue prospectus during privatization, the possibility to create a provisional board of directors composed of state representatives, which will function until the moment of sale);
- the elimination of a number of limitations currently imposed on the privatization of strategic enterprises, and the revision of other legislative limitations on privatization;
- the vesting of the FAFPM with the right to control the transactions carried out by the enterprises, the right to dismiss their managers, etc.

In our opinion, some more radical innovations are also worth considering – for example, a reduction of the size of charter capital by the amount of the State’s stake in those joint-stock companies where several successive attempts at realizing the state-owned block of shares have failed, while any prospects of further management of such blocks are not promising from the point of view of financial, managerial, or strategic benefits. However, this step will require serious legislative backing. A positive incentive for potential purchasers can be created, for example, by the consolidation of the residual state-owned and municipal (or state-owned and private) blocks of shares for their simultaneous sale.

Another novelty introduced in the year 2005 – the idea of an auction sale of the shares issued by some large companies – was found to be rather controversial¹⁰. In September 2005, the government made public its plans for the initial public offering, at the London Stock Exchange, of at least three state-owned blocks of shares: in “Rosneft” (no more than 49%, with taking into account that 10–12% could be used for covering a certain part of the 22-billion debt, and another 7–8% – for exchange with minority shareholders of the company’s subsidiaries in the course of a switchover to a single share), “KamAZ” (34.01%), and the OJSC “Dalnevostochnoe Morskoe Parokhodstvo” (“The Far-Eastern Maritime Steamship Company”) (19.8%).

⁹ O merakh po povysheniiu effektivnosti upravleniia federal’noi sobstvennost’iu. Materialy k zasedaniiu Pravitel’stva RF 17 marta 2005 g. (On the measures designed to improve the efficiency of federal property management. Materials prepared for the RF Government’s meeting on 17 March 2005). M. 2005.

¹⁰ See: Gosudarstvo vyvodit aktivy v London. (The State transfers its assets to London) / “Kommersant”. 2005. 14 September.

As regards the internal market, certain experience has already been accumulated in this respect. An analysis of the sales, though a public offering, of predominantly non-controlling blocks of shares (the data of the year 2004) has indicated that 47% of the blocks of shares offered for sale (out of 525) did not find any buyers. At the same time, 62% of the blocks of shares sold in this way were realized at the minimum price achievable under this method – the cutoff price amounting to 50% of the initial price announced at a failed auction. The number of objects sold at the maximum achievable price (the price of an offer, which is equal to the initial price announced at a failed auction) amounted to 17%. In the nomenclature of the RF Ministry of Economic Development and the FAFPM, the said method of privatization falls into the category of “secondary” methods (with regard to auctions and special auctions), aimed at realizing sticky assets by lowering their price in the course of a sale. This method is intrinsically self-contradictory, because public offering, as a rule, is used in respect of quickest assets.

As regards the placement of shares on foreign markets, the aforesaid method was used only once (the IPO of 5.9% of shares in “LUKoil” in December 2002). This transaction was considered to be rather successful (although the monies in payment for the block of shares in “LUKoil”, sold on 4 December 2002, were transferred to the budget only as late as 8 May 2003, and the identity of the receiver of the income from the use of the said monies during this interval (presumably amounting to tens of millions of dollars) remains unknown. This method, if applied at a greater scale, will bring some noticeable benefits, alongside certain indisputable limitations.

For one thing, according to the existing estimates, the placement of a non-controlling block of shares on foreign markets under favorable market conditions can increase the State’s revenues by 20–50% (the market price plus a bonus of 5–10%), while an internal sale by means of an auction can be carried out at a discount of 20–40%, depending on the size of the block of shares and on the size of the company itself. After this, the sale of the controlling block of shares can be carried out, in its turn, its price established by a truly market-based evaluation in the process of the IPO. For another thing, the possibilities of such an offering are limited by a broad range of various factors:

- the high costs of the procedure for the placement of a block of shares (the costs of obtaining the listing in the amount of 1–2 million USD; the commissions paid to the banks-underwriters, totaling 2–5% of the amount offered; the need for the approval of the company’s shareholders);
- the necessity to achieve a much higher level of transparency of the companies in question (thus far, neither “Rosneft”, nor “KamAZ” can be placed in the category of transparent companies);
- legislative restrictions (previously, under the 1997 Law on Privatization, a block of shares could be transferred only to an entirely state-owned company, which was the initiator of the offering (the case of “LUKoil”), whereas after the adoption of the 2001 Law on Privatization, a block of shares can be transferred only to a company included in the list of strategic open-end joint-stock companies, which requires the implementation of a number of bureaucratic and corporate procedures);
- the absence of the practice of privatization sales with the usage of ADR or GDR instruments, which, however, is envisaged in privatization legislation;
- market fluctuations, which can influence the price of offering and considerably delay the sale;
- the existence, inside the RF, of certain property interests, which may hinder the implementation of these transactions.

By early February 2006, it were some of the afore-listed restrictions that became the decisive factors. The offering of shares in “Rosneft”, initially planned for the end of 2006, is likely to be indefinitely postponed because of a disruption of the negotiations with the investment banks that were the initiators of the offering, which may, however, be referred to as a purely formal reason. In October 2005, instead of being offered on the London Stock Exchange, “KamAZ” and its three subsidiaries were included, by a regulation issued by the RF Government, in the list of strategic enterprises; according to the data as of February 2006, 34.01% of shares in “KamAZ” can be transferred to the FSUE “Rosoboroneksport”, which has submitted a request to this effect to the FAFPM. As regards the OJSC “Dal’nevostochnoe Morskoe Parokhodstvo”, no decisions as to either the possible time-lines, or the conditions of an IPO, have been made as yet, even tentatively.

In November 2005, the idea of an IPO for some of the large state-owned enterprises and banks (including “Rosneft”, “Sviazinvest”, and Vneshtorbank) was put forward in the framework of the anti-inflation set of measures proposed by the RF Central Bank, the RF Ministry of Economic Development, and the RF Ministry of Finance. As the existing RF legislation does authorize the implementation of an IPO in the process of privatization of state-owned blocks of shares on foreign stock exchanges, it will be necessary to introduce some alterations in the Law on Privatization, if IPOs are to be organized on Russian trading floors. The entry of state-owned enterprises onto the financial market for the purpose of carrying out an IPO can be facilitated by lifting the ban on the State’s share in charter capital being reduced in the process of emission (nevertheless, each of those decisions can, apparently, be made on a strictly individual basis, and, as such, will require a rather complex coordination procedure). An intermediate solution can be provided by the Ministry of Economic Development’s proposal to carry out the privatization of some shares in “Rosneft” by selling them to the population via the retail chain of the RF Savings Bank; however, this proposal still remains a declaration of intentions only.

Although no clear idea has emerged so far concerning the principles on which the organization of such sales to juridical and physical persons can be based, their potential positive effect (primarily in terms of increasing the liquidity of the Russian stock market) can be very substantial.

Equally important has become the issue relating to the possibility *to buy out the land plots* on which the privatized enterprises are located. The alienation of such land plots must be carried out in accordance with the RF Land Code and Federal Law, No. 178-FZ, of 21.12.2001, “On the Privatization of State and Municipal Property”; these documents have determined the declarative character of the procedure for the privatization of land plots.

As is known, the norms adopted in land legislation (the 2001 Land Code) envisaged that any uncompensated in-perpetuity use of land plots occupied by privatized enterprises was to be discontinued as from 1 January 2004. The unsoundness of such an archaic term as “in-perpetuity use” is evident. On the one hand, a land plot could not be seized from an enterprise, while on the other, the enterprise had no right to sell it. In this situation, the State was entitled to a certain small income in the form of the tax imposed on land plots. From the point of view of market turnover, there existed, in fact, a defective real-estate object, where a land plot represented a “deadened” component.

The case in point is that both solutions, as they currently exist (the purchase and the lease), are very disadvantageous for entrepreneurs. As early as the summer of 2003, the RF Ministry of Economic Development demanded that the deadline be postponed by several years, so as to give the entrepreneurs enough time to make their choice between purchase and lease, as the most adequate form of land use. It should also be taken into consideration that the process of the delimitation of State ownership in land is far from being

over. In December 2003, the RF President signed a law (concerning the introduction of alterations in the Law “On Introduction into Operation of the Land Code of the Russian Federation”), thereby moving the timeline for the mandatory reformatization of the right of use of land plots occupied by privatized enterprises into the right of ownership or lease from 1 January 2004 to 1 January 2006. As regards the methods of payment for land plots, no definite decision was made in 2004–5, while the discussion of the projects in question was going on.

In 2005, the RF Federal Agency for Federal Property and its territorial agencies received 4.4 thousand applications for the privatization of land plots and adopted 2.8 thousand decisions on the privatization of land plots; 2.2 thousand purchase contracts were concluded with regard to 2.2 thousand land plots with the total area of 7.6 thousand hectares. The target figures, for the year 2005, concerning the income from the privatization of land plots amounted to 6 billion roubles; the federal budget’s actual revenue from the privatization of land plots amounted to 5.2 billion roubles, which exceeded the results of the year 2004 by 62%. At the same time, this process was hampered by a number of factors, which were as follows:

- the absence of the State cadastre for the recording of land plots being purchased. The conducting of land tenure work and the state cadastre recording of land plots are time consuming and so expensive that the associated costs are frequently equal to the costs of purchasing the plot;
- the absence of any rights to real-estate objects that are properly formalized in accordance with existing legislation;
- the obstruction of the privatization process by regional and local authorities;
- legislation contains a number of unjustified limitations to the privatization of land plots;
- there still exists some uncertainty as regards the issue of the redemption price of land plots.

However, some positive developments did take place in the year 2005. On 24 March 2005, the Plenum of the RF Supreme Court of Arbitration adopted the Decree “On Some Issues Concerning the Application of Land Legislation”, which limited the powers of authorities of different levels (first of all, the case in point is Moscow) to obstruct the sales, on easy terms, of land plots occupied by privatized objects. In May 2005, the RF President signed the Federal Law “On the Introduction of Alterations in Article 5 of the Federal Law “On the Privatization of State and Municipal Property”, which eliminated the considerable contradictions formerly existing between the RF Land Code and the Law “On the Privatization of State and Municipal Property”. In accordance with the adopted alterations, the ban on the participation in the privatization of those joint-stock companies, where the State’s or a municipal formation’s share in the charter capital exceeds 25%, must not be extended to owners of the real-estate objects, the construction of which has been properly authorized and which are located on plots of land owned by the State or municipal formations, in instances when the said owners are purchasing the said plots from the State or municipal formations. In other words, a considerable number of joint-stock companies with the State’s share exceeding 25% have also been granted the right to purchase or lease land plots, which was previously denied to them. At the very end of 2005, the immensity of the problem once again made it necessary to shift the deadline for the reformatization of rights to land: by Federal Law, No. 192-FZ, of 27.12.2005, “On the Introduction of Alterations in Article 3 of the Federal Law “On Introduction into Operation of the Land Code of the Russian Federation” this deadline was shifted to 1 January 2008.

4. 3. Public Sector: Size, Regulatory Innovations, Factors behind the Dynamics

4.3.1. Size, Components and Major Characteristics of the Public Sector

The general quantitative characteristics of the public sector starting from year 2003 can be found in the annual Estimated Plans of Privatization of Federal Property subject to the approval of RF Government Resolutions. These documents present the data on the number of unitary enterprises being in the federal property (FSUE) and joint stock companies, in capitals of which the Russian Federation has its share. Below, the quantitative dynamics of entities of the said organizational and legal forms as broken down by each of the public sector's sub-sectors observed over the recent years will be discussed in more detail.

Federal State-Owned Unitary Enterprises

Below, there is presented the dynamics and sectoral structure of FSUE in 2003 through 2005 (see *Table 3*).

Table 3

Federal State-Owned Unitary Enterprises: Dynamics and Sectoral Structure in 2003 through 2005

Sector	As on June 1, 2003		As on June 1, 2004		As on June 1, 2005		In % of units as on June 1, 2003
	units	%	units	%	units	%	
Nonproductive sphere	4357	44.2	4069	44.1	3617	43.6	83.0
Industry, including:	2224	22.6	2064	22.4	1870	22.55	84.1
mechanical engineering	908	9.2	827	8.95	734	8.85	80.8
light industry	193	2.0	193	2.1	194	2.3	100.5
industry of construction materials	81	0.8	80	0.9	68	0.8	84.0
food industry	60	0.6	61	0.65	55	0.7	91.7
metallurgy	49	0.5	37	0.4	34	0.4	69.4
chemical industry	46	0.5	43	0.5	39	0.5	84.8
other industries	887	9.0	823	8.9	746	9.0	84.1
Agriculture	1329	13.5	1237	13.4	1111	13.4	83.6
Construction	1035	10.5	978	10.6	903	10.9	87.2
Transport and communications	851	8.6	809	8.8	725	8.75	85.2
Forestry	64	0.6	65	0.7	67	0.8	104.7
Total	9860	100.0	9222	100.0	8293	100.0	84.1

Source: Estimated plan (program) of federal property for year 2004 and principal strategy of privatization of federal property until year 2006, Estimated plan (program) of federal property for year 2005, Estimated plan (program) of federal property for year 2006 and principal strategy of privatization of federal property in years 2006 through 2008; the author's calculations.

As it may be seen from *Table 3*, the total number of FSUE has declined by 1567 units, or by almost 16 per cent¹¹ over two years (in the period from June 1, 2003 till June 1, 2005). It should be mentioned that in the period from June 1, 2004 till June 1, 2005, the decline in the number of unitary enterprises in absolute terms (by 929 units) was almost

¹¹ Hereinafter, there is analyzed the dynamics of units of every organizational and legal form proceeding from their number as on certain date, but not the turnover thereof (i.e. the number of enterprises created and liquidated over the respective period).

two times above the respective indicator observed in the period from June 1, 2004, till June 1, 2003 (by 638 units).

As concerns the sectoral structure of unitary enterprises being in the federal property, over the period under analysis there were observed no significant changes, which amounted to less than one per cent. About half of all FSUE (43 per cent to 44 per cent) belong to the nonproductive sphere defined as the totality of all sectors of the economy with the exception of industry, agriculture, forestry, construction, and transport and communications, whereas 22.5 per cent of FSUE belong to the sector of industry, 13.5 per cent – to agriculture, 10 per cent to 11 per cent of FSUE are registered in construction, and less than 9 per cent – in transport and communications sphere. Among the industrial FSUE enterprises of mechanical engineering and light industry have the most significant specific weights – about 9 per cent and more than 2 per cent respectively.

The most significant (in absolute terms) decline in the number of unitary enterprises observed in the period between June 1, 2003, and June 1, 2005, was observed in the sectors of nonproductive sphere (by 740 units), agriculture (by 218 units), and mechanical engineering (by 174 units). In the case the number of unitary enterprises registered as on June 1, 2005, is compared as the percentage of the respective indicator observed on June 1, 2003, it may be noted that the most significant decline was observed in metallurgy (by more than 30 per cent) and mechanical engineering (by more than 19 per cent). At the same time, in light industry and forestry the number of FSUE did not decline, but even increased somewhat.

Joint Stock Companies, Shares in which are in Federal Ownership

The quantitative dynamics and the sectoral structure of economic agents of this organizational and legal form in 2003 through 2005 are presented below (see *Table 4*).

As it may be seen from *Table 4*, the total number of joint stock companies, shares of which are in federal ownership declined by 10 per cent in the period between June 1, 2003, and June 1, 2005. It should be noted that in the period between June 1, 2004, and June 1, 2005, the decline in the number of the said joint stock companies in absolute terms (by 122 units) was almost two times below the change in the respective indicator registered in the period between June 1, 2004, and June 1, 2003 (by 300 units).

In contradistinction to the sector of unitary enterprises, in the sectoral structure of joint stock companies, in which the state had its shares there were observed significant shifts, primarily in the period between June 1, 2004 and June 1, 2005, whereas the sectoral structure registered as on June 1, 2004, practically did not differ from that observed as on June 1, 2003.

The most important shift in the sectoral structure of joint stock companies, shares of which were in federal ownership was the increase in the specific weight of enterprises in industry (from 32 per cent as on June 1, 2004, to 55 per cent as on June 1, 2005), transport and communications (from 9 per cent to 12 per cent), agriculture (from 1 per cent to 6 per cent), and forestry (from 0.4 per cent to 1.2 per cent). At the same time, the share of joint stock companies belonging to the sectors of the nonproductive sphere declined (from 45.6 per cent as registered on June 1, 2004, to 18 per cent as observed on June 1, 2005), and construction (from 11.7 per cent to 7.6 per cent).

Table 4

**Dynamics and Sectoral Structure of Joint Stock Companies, Shares in which
are in Federal Ownership or Subject to the “Golden Share” Special Right
in 2003 through 2005**

Sector	As on June 1, 2003		As on June 1, 2004		As on June 1, 2005		In % of units as on June 1, 2003
	units	%	units	%	units	%	
Nonproductive sphere	1918	45.6	1781	45.6	685	18.1	35.7
Industry, including:	1350	32.1	1253	32.1	2078	54.9	153.9
mechanical engineering	225	5.4	209	5.4	187	4.95	83.1
food industry	43	1.0	40	1.0	54	1.4	125.6
metallurgy	34	0.8	32	0.8	28	0.75	82.4
industry of construction mate- rials	21	0.5	20	0.5	19	0.5	90.5
chemical industry	19	0.4	18	0.5	46	1.2	242.1
light industry	16	0.4	15	0.4	9	0.2	56.3
other industries	992	23.6	919	23.5	1735	45.9	174.9
Construction	492	11.7	457	11.7	287	7.6	58.3
Transport and communications							
	383	9.1	356	9.1	459	12.1	119.8
Agriculture	46	1.1	43	1.1	229	6.1	497.8
Forestry	16	0.4	15	0.4	45	1.2	281.3
Total	4205	100.0	3905	100.0	3783	100.0	90.0

Source: Estimated plan (program) of federal property for year 2004 and principal strategy of privatization of federal property until year 2006, Estimated plan (program) of federal property for year 2005, Estimated plan (program) of federal property for year 2006 and principal strategy of privatization of federal property in years 2006 through 2008; the author’s calculations.

It should be stressed that the increase in the specific weight of industrial joint stock companies, where the state had its shares, occurred primarily under the impact of the data pertaining to the specially singled out group of “other industries” in the sector of industry, which include industries other than those directly indicated in the Table (metallurgy, mechanical engineering, chemical industry, light industry, food industry, and the industry of construction materials). Exactly this group demonstrates the record increase in its contribution both in relative (from 23.5 per cent to almost 46 per cent), and in absolute terms (by 816 units). As concerns other industries, the absolute number of joint stock companies, shares in capital of which were in federal ownership, increased much less: in agriculture – by 186 units, in transport and communications – by 103 units, in forestry – by 30 units, in chemical industry – by 28 units, in food industry – by 14 units although the rates of growth in the number of FSUE in agriculture, forestry, and chemical industry registered in the period between June 1, 2003, and June 1, 2005, exceeded those observed in the group of “other industries”.

It should be also noted that in the period from June 1, 2004, till June 1, 2005, the most significant decline in the number of joint stock companies with shares in federal ownership in real terms was observed in the sectors belonging to the nonproductive sphere (by 1096 units) and in construction (by 170 units).

It may be suggested that the factors behind the said changes in the sectoral structure of joint stock companies, shares of which were in federal ownership, were, on the one hand, the implementation of privatization procedures (the sales of blocks of shares owned by the state and conversion of unitary enterprises into joint stock companies), and, on the other hand, changes in classification of joint stock companies as belonging to a certain industry and respective changes in the ratios between thereof.

Another important feature of the sub-sector of the joint stock companies, shares in which were in federal ownership, was the distribution of joint stock companies on the basis of the sizes of their shares owned by the state.

Table 5

Dynamics of Joint Stock Companies, in Capitals of which Participated the State, in 1999 through 2005 (including those Subject to the “Golden Share” Special Right)

Date	Number of joint stock companies											
	Total		Up to 25 %		25 % to 50 %		50 % to 100 %		100 %		“golden share”	
	units	%	units	%	units	%	units	%	units	%	to-tal	no shares
1999	3316/ 3896*	100	863	26.0	1601	48.3	470	14.2	382	11.5	580**	
January 1, 2001	3524***	100	1746	49.55	1211	34.4	506	14.35	61	1.7	...	...
January 1, 2002	4407****	100	2270	51.5	1401	31.8	646	14.65	90	2.05	750**	
January 1, 2003	4222	100	2152	51.0	1382	32.7	589	13.95	99	2.35	1076	118
June 1, 2003	4205	100	2148	51.1	1339	31.8	600	14.3	118	2.8	...	...
October 1, 2003	4035	100	2051	50.8	1308	32.4	552	13.7	124	3.1	640	148
January 1, 2004	3704	100	1769	47.75	1235	33.35	540	14.6	160	4.3	591	251
June 1, 2004	3905	100	1950	49.9	1183	30.3	499	12.8	273	7.0	...	...
March 1, 2005	4075/ 3791#	100	1697	44.8	1154	30.4	487	12.85	453	11.95	...	284
June 1, 2005	3783/ 3524**	100	1544	43.8	1093	31.0	474	13.5	413	11.7	...	259

* – in the text of the Concept of management of state-owned property and privatization approved in 1999 there are mentioned 3896 joint stock companies, in the capitals of which participated the RF. The figure of 3316 units is a computed value, which is the sum of the number of blocks of shares (stocks) of different sizes indicated in the text of the Concept;

** – the total number of joint stock companies subject to the “golden share” special right without singling out those, where the state has no blocks of shares;

*** – joint stock companies with the exception of 48 blocks of shares in foreign companies;

**** – open joint stock companies with the exception of shares in 75 closed joint stock companies and the shares in authorized capitals of limited liabilities companies transferred in accordance with Resolution of the RF Government No. 454 r of April 2, 2002, “On the cessation of state participation in the authorized capitals of crediting organizations” or obtained under the procedures of inheritance, the deeds of gift, or on other basis;

– 3791 units is the computed number of joint stock companies, shares in which are in the ownership of the RF with the exception of 284 joint stock companies subject to the “golden share” special right (but where the state has no blocks of shares). The specific weight of joint stock companies with different shares of the state in their capitals is calculated proceeding from this value for the purposes of comparability with the data pertaining to preceding dates.

Memorandum: in the materials prepared for a meeting of the RF Government of March 17, 2005, “On the measures aimed to the enhancement of the efficiency of management of federal property” by the RF Ministry of Economic Development and Trade it was indicated that as on January 1, 2005, in federal ownership there were 3767 joint stock companies with the exception of aforementioned 284 joint stock companies subject to the “golden share” special right, and shares in the authorized capitals of 24 limited liability companies transferred in the federal ownership in accordance with Resolution of the RF Government No. 454 r of April 2, 2002, “On the cessation of state participation in the authorized capitals of crediting organizations”, at the same time, in another source (V. Nazarov) it is said that in the register of federal property there were registered 3930 joint stock companies, shares in which were in federal property or subject to the use of the “golden share” special right with respect to the management thereof (562 joint stock companies);

– 3524 units is the computed number of joint stock companies, shares in which are in the ownership of the RF with the exception of 259 joint stock companies subject to the “golden share” special right (but where the state has no blocks of shares). The specific weight of joint stock companies with different shares of the state in their capitals is calculated proceeding from this value for the purposes of comparability with the data pertaining to preceding dates.

Source: the data presented on the departmental web site www.mgi.ru; Braverman A. A. O merakh po povysheniyu effektivnosti upravleniya federalnoy sobstvennostyu i kriteriyakh eye otsenki (On the measures aimed to the enhancement of the efficiency of management of federal property and criteria of its appraisal) // Vestnik Minimushchestva Rossii, 2003, No. 1, p.p. 13–14; Predpriyatiya s gosudarstvennym uchastiyem. Institutsionalno-pravovye aspekty i ekonomicheskaya effektivnost (Enterprises with state participation. Institutional and legal aspects and economic efficiency). “Nauchnye doklady: nezavisimiy ekonomicheskiy analiz,” No. 155. M.: Moskovskiy obshchestvennyi nauchnyi fond; Assotsiatsiya issledovateley ekonomiki obshchestvennogo sektora, 2004, p. 47; Program of privatization of federal property for year 2004 (Estimated plan (program) of federal property for year 2004 and principal strategy of privatization of federal property until year 2006) // Vestnik Minimushchestva Rossii, 2003, No. 3, p.p. 4–5; Klyuchevye problemy povysheniya effektivnosti upravleniya federalnoi sobstvennostyu i osnovnye napravleniya dividendnoi politiki Rossiyskoi Federatsii (Key problems of enhancement of the economic efficiency of management of federal property and principal strategies of the dividend policies of the Russian Federation) // Vestnik Minimushchestva Rossii, 2003, No. 4, p. 8; Estimated plan (program) of federal property for year 2005; Nazarov V. L. Administrativnaya reforma i upravleniye gosudarstvennym imushchestvom (Administrative reform and management of state property) // Upravleniye sobstvennostyu, 2005, No. 1, p. 3; Materialy k zasedaniyu Pravitelstva RF 17 marta 2005 g. “O merakh po povysheniyu effektivnosti upravleniya federalnoi sobstvennostyu” (Materials prepared for a meeting of the RF Government of March 17, 2005, “On the measures aimed to the enhancement of the efficiency of management of federal property”); Estimated plan (program) of federal property for year 2005, Estimated plan (program) of federal property for year 2006 and principal strategy of privatization of federal property in years 2006 through 2008; the author’s calculations.

As it may be deduced from *Table 5*, two periods may be singled out as concerns the dynamics of numbers of such joint stock companies: 1) 2000 and 2001, when there was observed a growth in the number of joint stock companies, shares in which were in federal ownership, and 2) 2002 through 2004, when the number of such joint stock companies declined. Thus, only in 2001 the number of such joint stock companies increased by one forth (or by 883 units) and reached 4407 units, what was the absolute maximum in the whole period under observation. In the next years, there was revealed a trend towards a decline in the number of joint stock companies, shares in which were in federal ownership. Over 2002, the number of such entities decreased by 4.2 per cent (or by 185 units), in 2003 – by 12.3 per cent (or by 518 units).

The dynamics of the total number of joint stock companies, shares in which were in federal ownership, is a result of impact of two vectors: on the one hand, it may increase in the result of conversion of FSUE into joint stock companies or a number of other actions, which may result in the appearance of blocks of shares (stocks) in federal ownership; on the other hand, the sales of such blocks of shares in the course of implementation of privatization procedures naturally results in the decline of their number being in ownership of the Russian Federation.

As concerns the practical aspects of this issue, a significant increase in the number of joint stock companies, where blocks of shares are in federal ownership, observed in 2000 and 2001 reflects rather the success of inventory of the federal property carried out after the approval of the Concept of 1999 than the real growth in the number of respective joint stock companies, since the number of FSUE converted into joint stock companies began to grow significantly only in 2003 and 2004.

In the case the structure of the totality of joint stock companies, where blocks of shares are in federal ownership, from the standpoint of how the shares belonging to the state could ensure that the Russian Federation, as the owner, had the adequate degree of control over such companies, there may be noted the following. In 2001 through 2003, the

specific weight of joint stock companies, where more than 50 per cent of shares were in federal ownership (including all companies, where this share made 100 per cent), made from 16 per cent to 17 per cent and by early 2004 somewhat increased making about 19 per cent. At the same time, there was registered a certain decrease in the specific weight of blocks of shares making up to 25 per cent of authorized capitals of joint stock companies and blocking shareholdings (from 25 per cent to 50 per cent), which made about half and one third of all federally owned blocks of shares respectively.

There should be specifically noted the shifts observed in 2004, when there occurred a decline in the share of federal blocks of shares of all sizes with the exception of blocks of shares amounting to 100 per cent. As a result, as on June 1, 2005, the structure of the totality of federal blocks of shares looked as follows: minority ownerships up to 25 per cent of capital amounted to less than 44 per cent of all joint stock companies, in which the state had shares, whereas the blocking shareholdings (from 25 per cent to 50 per cent of capital) made 31 per cent; in about one fourth of all joint stock companies the state could exercise majority or total control, and it should be noted that the share of the latter (with 100 per cent share of state-owned capitals) was just slightly below the share of the joint stock companies, where the state being the majority shareholder had less than 100 per cent of shares.

Upon comparing the structure of federal blocks of shares formed by the middle of 2005 as broken down by the size of the shares the state had in the authorized capitals of joint stock companies with the respective structure the RF Property Ministry expected to be formed after the implementation of the privatization program for year 2003¹², it should be noted that these structures differed considerably.

There was observed a clear bias in favor of the specific weight of blocks of shares, which did not ensure that the state had the adequate degree of control over joint stock companies. Thus, it had been planned to reduce the share of minority blocks of shares to 36 per cent (in reality it made 43.8 per cent), blocking shareholdings – to 22 per cent (in reality it made 31 per cent). On the contrary, the share of full blocks of shares should have reached 30 per cent (in reality it made less than 12 per cent). Only the expected share of controlling blocks of shares (12 per cent) was approximately commensurable with the figures registered in the middle of 2005 (13.5 per cent).

Even more ambiguous results are demonstrated in the course of comparison of the structure of the totality of the federal blocks of shares as in March of 2005 and in 1999 (basing on the data presented by the Concept). There is registered a significant (1.7 times) increase in the share of blocks of shares making up to 25 per cent of authorized capitals of joint stock companies, mainly due to the decline in the specific weight of blocking shareholdings (from 25 per cent to 50 per cent). The share of the blocks of shares making 50 per cent to 100 per cent of capitals has also decreased, but only by 1.5 p. p. At the same time, the share of joint stock companies, where all capitals were owned by the state remained practically unchanged (about 12 per cent). However, it should be noted that the data pertaining to 1999 may be incomplete.

Nevertheless, it may be noted that as on June 1, 2005, the number of registered federal blocks of shares making below 25 per cent of capitals of joint stock companies (1544 units) was 1.8 times above the respective indicators observed in 1999, with the maximum registered in the beginning of 2002 (2270 units), later there was observed a gradual de-

¹² In total, it was expected that in the federal ownership there will be 3613 blocks of shares. See: Braverman A. A. O merakh po povysheniyu effektivnosti upravleniya federalnoy sobstvennostyu i kriteriyakh eye otsenki (On the measures aimed to the enhancement of the efficiency of management of federal property and criteria of its appraisal) // Vestnik Minimushchestva Rossii, 2003, No. 1, p. 29.

cline in the number of such joint stock companies. In 2005, the number of federal blocks of shares in the group from 25 per cent to 50 per cent (1093 units) was by almost 32 per cent below than in 1999 (1601 units). It should be noted that in early 2002 (1401 units) it was above the figure registered a year ago (1211 units), later there was also observed a gradual decline in the value of this indicator. In 2005, the number of federal blocks of shares sized from 50 per cent to 100 per cent of capitals of joint stock companies (474 units) was approximately at the level registered in 1999 (470 units); however, it should be noted that it fluctuated within a rather wide band over the period under observation making 646 units in early 2002 and 600 units as on June 1, 2003; later there was observed a decline in the value of this indicator. As concerns the number of joint stock companies, where 100 per cent of shares were in federal ownership, in 2005 it was by about 8 per cent above the figures registered in 1999. The minimal value of this indicator was observed in the beginning of 2001 (61 units). Later, it gradually increased and it should be noted that it grew 2.8 times over 2004 (by almost 300 units).

The largest scales of the use of the “golden share” special right were registered in the beginning of 2003, when alongside 958 joint stock companies, where this right was applied simultaneously with the presence of federal blocks of shares, there also existed 118 such joint stock companies, in which there were no state shareholdings (for comparison: in 1999 there were 580 joint stock companies subject to the application of this instrument, while in the beginning of 2002 there were registered 750 such entities). In 2003 and 2004, as the process of sales of federal blocks of shares intensified, the total number of such joint stock companies declined (in the beginning of 2004 there remained 591 units); however at the same time there was increasing the number of companies, where the presence of the state was reduced exclusively to the “golden share” special right: 284 units as on March 1, 2005, what was 2.4 times above the figures registered in the beginning of 2003. The specific weight of joint stock companies, with respect to which only the special right was applied, in the total number of joint stock companies subject to the “golden share” rule also increased: in early 2003 such companies made about 11 per cent, while in the beginning of 2004 their number was already above 42 per cent.

4.3.2. Major Changes in the Regulatory and Legal Framework

Last year, the improvement of the regulatory and legal framework pertaining to the process of management of FSUE and blocks of shares in joint stock companies being in federal ownership continued.

As concerns the sub-sector of **unitary enterprises**, the major regulatory and legal innovations in this sphere were the new model FSUE charter and the employment contract with the head thereof. Over the period passed since the autumn of 1999, the date of approval of the Concept of management of state-owned property and privatization in the RF, it has been already third version of the said documents, which form the basis of the process of management of unitary enterprises. The first two versions are dated February of 2000 (it was somewhat amended later), and December of 2003.

The new employment contract with the head thereof was approved by Order of the Ministry of Economic Development and Trade No. 49 of March 2, 2005. In general, it followed the provisions of the preceding version of this document approved by Resolution of the RF Property Ministry No. 6946 r of December 11, 2003. A significant innovation in the document was the provision envisaging the full financial responsibility to be borne by the head of the enterprise in the case there arise direct damages added in the section “Responsibility of the head of enterprise”. Other amendments were of purely technical nature

(for instance, the removal of the indication of the minimal 3 year term of the employment contract, whereas the previous norm stipulating the 5 year maximal term was retained).

Somewhat later, by Order of the Ministry of Economic Development and Trade No. 205 of August 25, 2005, there was approved the new Model FSUE charter. Similarly to the Model employment contract, it differed little from its preceding version, the Model FSUE charter approved by Resolution of the RF Property Ministry No. 6945 r of December 11, 2003. Among the amendments made to the charter there may be mentioned changes in the formulations determining the goals enterprises should attain (in this version, concrete goals following from the stipulations of the law on unitary enterprises, to which profits are subordinate, are indicated in individual subparagraphs) and utilization of profits (as concerns utilization of profits, the new version of the charter sets as priorities the defrayal of expenses borne by the enterprise, formation of revenues of the federal budget¹³, and other goals), as well as the introduction of the previously absent regulation envisaging that proceeds from lease of fixed assets of the enterprise should be transferred to the federal budget under the respective procedures. In the section "Responsibilities of the enterprise" there was set as the priority the previously absent norm envisaging the approval, under the respective procedures, the operating program of the enterprise (earlier, only the approved targets of economic performance efficiency had been mentioned in this context). The procedures governing the approval of the operational programs of unitary enterprises and official evaluation of performance of the heads of enterprises was not changed.

The effect of the approval of the new normative acts regulating operations of unitary enterprises should not be overestimated. As it was noted at the meeting of the Russian Government held on March 17, 2005, by the head of the Ministry of Economic Development and Trade, the adoption of a special law on unitary enterprises containing provisions hindering their economic activities, which took place at the end of 2002, had failed to create the expected incentives for reduction of this sub-sector. Heads of SUE had managed to adapt for the requirements of the law pertaining to the coordination of their actions with the authorities¹⁴.

As concerns the sub-sector of **joint stock companies, in the capitals of which the state had its shares**, the most important innovation was Order of the Federal Property Management Agency No. 228 of July 26, 2005, which approved the following standard documents, which entered into force since August 1:

- Model form of directives to representatives of interests of the RF at Boards of Directors of open joint stock companies, shares in which are in federal ownership;
- Model form of directives to representatives of the state at the general meetings of shareholders of such open joint stock companies;
- Model form of designations of authority of the representatives of the state concerning the representation of interests of the Russian Federation at general meetings of shareholders of open joint stock companies, shares in which are in federal ownership;
- Model form of decisions taken by the single owner of open joint stock companies, 100 per cent of shares in which are in federal ownership;
- Model form of decision taken by the single owner of open joint stock companies, 100 per cent of shares in which are in federal ownership, with respect to increases of the authorized capital by the placement of additional shares;

¹³ Earlier, there has been no indication of a portion of the enterprise profits as a source of replenishing of the federal budget.

¹⁴ Frumkin K. Privatizatsiya na bumage (Privatization on paper) // Izvestiya, March 18, 2005.

- Recommendations pertaining to the formation of the position the state should have on the issue of approval of the annual report of open joint stock companies, shares in which are in federal ownership;
- Recommendations pertaining to the formation of the position, the state should have on the issue of approval of the transactions, in the conduct of which there is interest, and large transactions on the part of open joint stock companies, shares in which are in federal ownership;
- Form of the passport of the meeting of the managerial body of open joint stock companies, shares in which are in federal ownership.

The formulations, used in the **Model form of directives**, envisage the responsibility of the representative of the state to vote in a certain way (for or against) draft decisions (variants: ensure the election to the Board of Directors (including the Chairperson thereof), audit commission, etc. of certain persons or withdrawal of the issue from the agenda with the indication of the reason for such withdrawal). As concerns other issues on the agenda of the meeting, the representative of the state must vote in accordance with the legislation currently in force and in interests of the state, whereas in the case of introduction of additional issues not entered on the official agenda approved by the Federal Property Management Agency, the state representative should vote “against” the adoption of any decisions concerning such issues. The representative of the state must ensure the presentation of a copy of the records of such a meeting to the Federal Property Management Agency within two weeks after the date, on which such a meeting was held.

The Directives should be documented by a letter of a deputy head of the Federal Property Management Agency and registered in accordance with the procedures set for this agency by the records management instruction. The Directives should be supplemented with a passport of the meeting of the managerial body of the open joint stock company, shares in which are in federal ownership, made in the accordance with the form approved by the said Order. The Directives should be also supplemented with an explanatory note signed by the head of a Federal Property Management Agency department containing the justification of the proposed draft decisions for each issue on the agenda of the meeting and respective positions of the sectoral federal executive authority (if any). It is prohibited to use in the Directives formulations other than those indicated in the Model form.

The Model form of the **designation of authority of the representative of the state** should indicate the number of shares owned by the state and their share in authorized capitals. The designation of authority should be issued as a document without the right of delegation to another person, have the validity term not exceeding 7 days since the date preceding the date, on which the meeting of the general meeting of shareholders, and it should be valid in the case there is held the second general meeting of shareholders on condition that the agenda thereof remains the same.

The Model form of decisions taken by the single owner of open joint stock companies, 100 per cent of shares in which are in federal ownership has its specifics, since in this case it should be documented as a resolution of the Federal Property Management Agency. In this case, the Model form should directly indicate the issues, which should be approved on the mandatory basis: 1) annual report; 2) annual accounting statement, including the profit and loss statement; 3) distribution of profits, including the funds earmarked for the payment of dividends; 4) election of the Board of Directors, including the representative of the state; 5) election of the audit commission, including the representative of the state; 6) appointment of the General Manager; 7) approval of the auditor.

In order to determine the position the Federal Property Management Agency should have on the issues included in the agenda of the general meeting of shareholders of an open joint stock company, 100 per cent of shares in which are in federal ownership, there should be presented the following materials: 1) copies of records of the meetings held by the Board of Directors, at which there were discussed the issues pertaining to the preparation for the general meeting of shareholders; 2) annual report of the joint stock company documented in accordance with the Recommendations approved by this Order; 3) accounting balance sheet with all supplements for the reporting year approved by the head of the enterprise and stamped by the respective tax authority; 4) audit report based on the inspection of the economic and financial operations carried out by the joint stock company in the respective year made by the auditor of the joint stock company; 5) audit report based on the inspection of the economic and financial operations carried out by the joint stock company in the respective year made by the audit commission; 6) recommendations of the Board of Directors concerning the distribution of profits, including the size of dividends on shares in the joint stock company and the procedures governing the payment thereof based on the results of the respective financial year documented by a report on the proceedings of the meeting of the Board of Directors; 7) information about the candidate (candidates) for members of the executive bodies of the joint stock company, audit commission; 8) report on the proceedings of the contest commission as concerns the selection of the auditor for the respective year; 9) other documents required in order to take decisions on individual issues in accordance with the legislation currently in force and this Order.

The Model form of decision taken by the single owner of open joint stock companies, 100 per cent of shares in which are in federal ownership, with respect to increases of the authorized capital by the placement of additional shares should indicate the total number of shares resulting from the issue of additional shares; the amount of increase in the size of the authorized capital; the offering price of one registered ordinary uncertified share of the additional issue at face value; the dates of the start¹⁵ and completion¹⁶ of the placement of shares, which in the case of the placement with respect to the single shareholder – the Russian Federation – on the terms of closed subscription should be paid for in the full amount. There should be also approved amendments made in the charter of the joint stock company in connection with the changes in the number of shares¹⁷.

The decision taken by the single owner of open joint stock companies, 100 per cent of shares in which are in federal ownership, with respect to increases of the authorized capital by the placement of additional shares should be also documented in the form of a resolution issued by the Federal Property Management Agency. In order to determine the position the Agency should have on this issue of the agenda of the general meeting of shareholders there should be presented: 1) copy of the records of the meeting held by the Board of Directors, at which there was discussed the matter of increase in the authorized capital by the placement of additional shares; 2) other documents required in order to take

¹⁵ The date of the start of placement of an issue of securities is defined as the next day after the receipt of the notification of the state registration of the securities issue.

¹⁶ In a relevant case, there may be also indicated that "the end date of the placement of an issue of securities is the date of granting of the ownership rights with respect to a number of shares (number of shares in words) of the full name of the organization, the shares of which are transferred in payment of the authorized capital; however not later than one year since the date of the state registration of the additional issue of securities".

¹⁷ In the cases, where the charter of the organization does not contain the indication of the required number, the face value, categories (types) of shares, which the company has the right to place in addition to the already placed shares (authorized shares), and the rights pertaining to these shares.

decisions on individual issues in accordance with the legislation currently in force and this Order.

In the case the additional shares are paid for in a form other than money (securities, things or property rights, or other rights, which can be evaluated in money), the respective resolution should envisage the list of properties eligible for the use as the payment for the shares. In this case, in order to determine the position the Federal Property Management Agency should have on this issue there should be presented a statement on the results of the expert evaluation of the report concerning the evaluation of the respective properties prepared by the Department for the registration, evaluation, and control of the use of property of the Federal Property Management Agency. In the relevant cases there should be also indicated that the “placed additional shares may be paid for in kind”.

Recommendations pertaining to the formation of the position the state should have on the issue of approval of the annual report of open joint stock companies, shares in which are in federal ownership, should consist of the following sections: 1) general information about the joint stock company; 2) characteristic of the managerial and supervisory bodies of the open joint stock company (general meeting of shareholders, Board of Directors, executive body, audit commission); 3) position the enterprise has in its sector; 4) priority strategies; 5) report of the Board of Directors (Supervisory Board) on the results of development of the enterprise with respect to its priority strategies; 6) information on large transactions conducted by the joint stock company and the transactions, in the conduct of which there is interest; 7) report on the payment of dividends; 8) description of the major risk factors relating to the operations of the enterprise; 9) prospects of development of the enterprise.

Recommendations pertaining to the formation of the position, the state should have on the issue of approval of the transactions, in the conduct of which there is interest, and large transactions on the part of open joint stock companies, shares in which are in federal ownership, indicate that the following materials should be analyzed for these purposes: 1) copies of documents confirming that there are persons interested in the transaction in accordance with the legislation currently in force certified under the established procedures (in the case of the transaction, in the conduct of which there is interest); 2) copy of the accounting balance sheet of the open joint stock company, shares in which are in federal ownership, as on the last reporting date certified in accordance with the established procedures; 3) copy of the charter of the respective open joint stock company certified by its head; 4) report on the evaluation of the market value of the assets planned for the transaction prepared in the accordance with the RF legislation on evaluation activities not later than 3 months prior to the date of presentation thereof (if required); 5) statement on the results of the expert evaluation of the report concerning the evaluation of the respective properties prepared by the Department for the registration, evaluation, and control of the use of property of the Federal Property Management Agency (if required); 6) draft contract pertaining to the transaction (with the exception of contracts concluded in the course of a competitive tender) and detailed description of all terms of the transaction; 7) information about the forecast of the impact the transaction may have on the performance efficiency of the open joint stock company as concerns its production and financial indicators; 8) written opinion on the feasibility of the transaction prepared by the federal executive authority charged with coordination and regulation of the activities carried out in the respective sector (sphere of administration) (if any).

The **passport of the meeting of the managerial body of open joint stock companies, shares in which are in federal ownership**, should contain the following information: 1) the date, on which the respective meeting took place; 2) number of stocks in fed-

eral ownership and their share in the authorized capital (with a separate indication of voting shares); 3) values of a number of economic indicators (proceeds, net profits, net assets) registered in the reporting and the preceding financial years; 4) estimated amount of dividends, including in terms of their share in net profits (with a separate indication of dividends due on the federal block of shares); 5) composition of the Board of Directors (with a separate indication of the actual and estimated number of persons representing interests of the state); 6) package of required documents (annual report, statement of the audit commission, audit report, and report on the proceedings of the contest commission as concerns the selection of the auditor).

An important development, which may have a significant influence on the development of companies, in capitals of which the state has its share, was the introduction of amendments to the current law on privatization, which removed the prohibition on purchase of land by joint stock companies, in which the share of the state and municipalities exceeds 25 per cent. This provision will permit such large companies as Gazprom, RAO UES of Russia, Sberbank RF, and others to buy the land, on which their fixed assets are situated. This circumstance should facilitate the enhancement of investment attractiveness of companies in terms of the growth in their capitalization and ability to attract external borrowings (primarily credit borrowings).

4.3.3. Major Factors Affecting the Development of the Public Sector

In the practical aspect, the period including 2004 and 2005 was characterized by the fact that the issues pertaining to the management of unitary enterprises and companies, in capitals of which the state had its shares, turned out to be interweaved in the context of the administrative reform and its consequences.

First, there should be noted the contention concerning the List of strategic enterprises and joint stock companies. By the beginning of 2005, the RF Ministry of Economic Development and Trade had prepared and submitted to the RF Government a draft Presidential Decree "On amendments to the List of strategic enterprises and strategic joint stock companies".

In accordance with this document, it was proposed to exclude 252 organizations from the List, including 43 federal state-owned unitary enterprises and 209 open joint stock companies. In particular, it was envisaged to exclude from the List 8 blocks of shares in joint stock companies owned by the state and 9 FSUE operating in the sector of civil aviation, 23 open joint stock companies being sea and river ports and shares in 39 joint stock companies engaged in sea and river transport operations, as well as 47 open joint stock companies, the activities of which related to gasification and maintenance of gas networks in the respective subjects of the Russian Federation¹⁸.

Therefore, more than half of the strategic joint stock companies proposed to be removed from the List of strategic enterprises operated in the sphere of transport and infrastructure. The RF Ministry of Economic Development and Trade justified this approach by the necessity to attract extra-budgetary financing in the types of activities characterized by high capital intensity and long terms of the recoupment of capital investments under the conditions, where investment demand exceeded budgetary capacities of the state and own sources of the respective enterprises, what contributed in the growing disproportions between the increasing demand for transport services and the capacities to meet this de-

¹⁸ Materialy k zasedaniyu Pravitelstva RF 17 marta 2005 g. "O merakh po povysheniyu effektivnosti upravleniya federalnoi sobstvennostyu" (Materials prepared for a meeting of the RF Government of March 17, 2005, "On the measures aimed to the enhancement of the efficiency of management of federal property"), the RF Ministry of Economic Development and Trade, Rossiyskaya biznes-gazeta, March 22, 2005.

mand. In the same context, there was pointed out that private capitals took part in operations in the sphere of construction and maintenance of airports, ports servicing river transport, presence of private capitals on the energy market, and privatization of the majority of companies engaged in the extraction of energy resources.

Among the possible results of privatization, the document indicated the enhanced competitive power of infrastructure objects, reduction of transport costs, increase in the speed of passenger and cargo flows, growth in transshipment (transport) capacities, attraction of new investors, positive impact on the state of the competitive environment, and improvement of the quality of management with respect to such enterprises. As an additional argument in favor of the sale of federally owned blocks of shares the document indicated the expected reduction of the value of such blocks in the case the budgetary financing of the respective enterprises was insufficient.

The draft Decree also proposed to exclude from the List of strategic enterprises 73 joint stock companies, where the blocks of shares in federal ownership were below 51 per cent of authorized capitals. This proposal was based on the analysis of the operations carried out by these companies, which had revealed that they failed to ensure the production of goods necessary for the defense and security of the state, protection of morals, health, rights, and lawful interests of RF citizens. There were no legislative acts, in accordance with which exceptionally state-owned enterprises should be eligible to produce respective goods (carry out works, render services). In some cases, open joint stock companies were not the only producers of strategically important goods, since similar products (works, services) were provided by the private sector, what, according to the RF Ministry of Economic Development and Trade, made the retention of federal blocks of shares in such organizations unfeasible, since the size thereof permitted the state only to block decisions taken by the respective general meetings of shareholders.

Besides, federal state-owned unitary enterprises and open joint stock companies approved by the respective sectoral federal executive authorities for the inclusion in the privatization programs for years 2004 and 2005 should be also removed from the List.

The document was prepared taking into account the proposals made by the federal executive authorities responsible for the implementation of state policies in the respective sectors. The disputes were resolved under conciliatory procedures with participation of the said Ministries and departments.

In spite of the fact that the draft Presidential Decree presented by the RF Ministry of Economic Development and Trade took into account the sectoral specifics, it was significantly changed by the RF Government Office. As the result, the number of organizations excluded from the List of strategic enterprises and strategic joint stock companies was reduced. After the adjustment of the document for the proposals made by the RF Government Office, to the RF Presidential Administration there was submitted a draft containing the list of 8 federal state-owned unitary enterprises and 179 open joint stock companies. Therefore, the number of joint stock companies proposed to be excluded from the list of strategic enterprises was reduced by about 15 per cent and the number of FSUE – more than 5 times in comparison with the first version of the draft document.

Nevertheless, the Legal Department of the RF Presidential Administration rejected the draft Decree and returned for a revision. Alongside with a number of technical corrections, the statement contained doubts concerning the necessity to exclude from the aforesaid List such a large number of enterprises and joint stock companies without a detailed analysis of the role they played in the ensuring of security and defense capabilities of the state. This circumstance made it necessary to hold a meeting aimed at the settlement of these differences. In the process of further work on the document the comments made by

the Legal Department of the RF Presidential Administration with respect to the analysis of the role played by enterprises in the ensuring of security and defense capabilities of the state were taken into account. In this connection, the RF Ministry of Economic Development and Trade found it reasonable to implement the proposal advanced by the RF Security Council Office concerning the development of a regulation envisaging the preparation of proposals aimed at the adjustment of the List of strategic enterprises and strategic open joint stock companies in order to regularly update the List as it is required by the law on privatization currently in force.

In practice, after the exclusion of Rosneft (substituted with Rosneftegaz in connection with the implementation of the project aimed at the consolidation of state control over Gazprom), 12 unitary enterprises and 8 joint stock companies operating in mechanical engineering and defense industry in 2004 and early 2005 there were introduced just a few changes. After January of 2005, in the List there were included only 2 FSUE: Goznak (8 unitary enterprises engaged in the similar activities were transformed in its subsidiaries) and the ITAR-TASS news agency¹⁹. Yet another unitary enterprise (a research and development institute) was excluded from the List because of its merger with another enterprise.

Second, the size of the public sector and, indirectly, the processes underway in it, was affected by the decline in the rate of progress of the process of privatization resulting from the conflict between the Russian Federal Property Fund (RFPF) and the Federal Property Management Agency (Rosimushchestvo).

The new administration of the Federal Property Management Agency headed by V. Nazarov, which was vested with the management of this agency created to regulate property relations after the launch of the administrative reform in the spring of 2004, made an attempt to implement the long existing plans to expand the circle of the sellers of federal property in the course of privatization justifying this move by the necessity to accelerate the rate of the privatization process. It should be noted that in all the preceding years this function had been performed exclusively by the RFPF. There was imitated the process of amendment of the law on privatization depriving the said structure of the right to be the exclusive seller. In the course of development of the new charter of the Federal Property Management Agency there was introduced the provision envisaging the right of the Agency to keep in its possession shares owned by the state until the date the new owner take possession of such shares. The Federal Property Management Agency also was the initiator of the process of amendment of the RFPF charter, which were aimed at the deprivation of the Fund of the right to own and manage assets of privatized enterprises and switch the RFPF to the financing from the budget. It should be noted that at present this organization is financed at the expense of the commission fees for sales of privatized property. Perhaps, this circumstance was one of the implicit factors behind the acute conflict between two organizations alongside with purely bureaucratic tensions resulting from the administrative reform.

Basing on its charter and the regulations governing its relations with the Federal Property Management Agency, the RFPF demanded that the Agency transferred to it the shares subject to privatization in advance. However, by the early summer of RFPF could not transfer any enterprises bought by the winners of the respective tenders to the new owners because it could not receive the shares from the Federal Property Management Agency. The RFPF administration headed by Yu. Petrov voiced its intention to suspend the

¹⁹ In accordance with Decree of the RF President No. 1470 of November 22, 2004, the Russian News and Information Agency RIA "Novosti" was included in the list of strategic enterprises.

publication of all notifications on future tenders, what would mean the complete freezing of the privatization process. In total, over the last year the Russian Federal Property Fund did not publish informational notifications about the sale of 183 joint stock companies for the first time included in the privatization program²⁰.

Temporarily, this issue was settled by Order of the RF Ministry of Economic Development and Trade No. 122 of June 7, 2005. In accordance with the procedure set forth by the Order, the Federal Property Management Agency should document and transfer to the Russian Federal Property Fund original instruments of share transfer concerning the shares subject to privatization not later than after 3 days since the date the RFPF receives copies of records concerning the results of the respective tenders and sale and purchase contracts regarding shares, the sale of which was recognized as valid. In its turn, the RFPF should document the instruments of share transfer with respect to the transfer of shares to buyers and work in cooperation with the persons maintaining registers of shareholders. The instruments of transfer of shares to the Fund should be forwarded to the registrars simultaneously with the forwarding of instruments of transfer of shares to the buyers, what permits to minimize the time of possession of shares by a person not authorized to exercise the rights of a shareholder on behalf of the Russian Federation (in fact, shares just transit the personal account of the seller).

In order to improve the procedure governing the sales of privatized shares, the RF Ministry of Economic Development and Trade prepared a draft resolution of the Government of the Russian Federation "On the Russian Federal Property Fund".

The draft resolution stipulates that since the date the RF Government approves the estimated plan (program) of privatization of federal property for the respective period, the registers of shareholders in the joint stock companies included in the estimated plan (program) of privatization of federal property for the respective period should indicate the Russian Federation as represented by the Federal Property Management Agency and the Russian Federal Property Fund as the owner of the shares being the property of the Russian Federation.

At the same time, the Federal Property Management Agency should exercise the full rights of the shareholder, whereas the RFPF is vested with the powers to request information necessary for the presale preparation and conduct of evaluation of shares under the established procedure, as well as the powers to directly transfer to the buyers privatized shares upon the establishment of the results of the sales recognized as valid, on the basis of the purchase and sale contracts made in accordance with the privatization laws on behalf of the Russian Federation. Besides, the draft resolution vests the Federal Property Management Agency with the powers pertaining to the setting of the initial price of the privatized federal property²¹.

Nevertheless, until present time there has not been approved the new version of the Charter of the Russian Federal Property Fund and there have not been brought into compliance with Decree of the President of the Russian Federation No. 649 of May 20, 2004, "Issues concerning the structure of the executive authorities" the regulatory and legal acts of the Government of the Russian Federation regulating the issues of organization of sales of federal property.

A result of the uncompleted reform of relations pertaining to privatization and management of federal property and the conflict between the Federal Property Management

²⁰ On privatization of federal property in year 2005. A report of the Federal Agency for the Management of Federal Property, M., 2006.

²¹ On the results of privatization of federal property in the first six months of 2005 // Center of Parliamentary Communications, August 5, 2005, www.rosim.ru.

Agency and the Russian Federal Property Fund, which arose in the course of the implementation of the administrative reform was an apparent deceleration of the rates of implementation of a rather ambitious privatization program developed by the RF Ministry of Economic Development and Trade yet in 2003 before the start of the administrative reform. It should be reminded that the Estimated plan (program) of privatization of federal property for year 2004 and principal strategy of privatization of federal property until year 2006 approved by Resolution of the RF Government No. 1165 r of August 15, 2003, embraced a 3 year period (2003 through 2006) and set as its target to offer to the private sector all properties not related to the performing of state functions by 2006, whereas the privatization process should be completed by 2008.

In particular, as concerns the state participation in the corporate sector, as the key targets of the implementation of privatization programs there were set the sale of all state-owned blocks of shares making up to 25 per cent of the respective authorized capitals in 2004, blocks of shares making up to 50 per cent of the respective authorized capitals – in 2005, and all other, with the exception of strategic enterprises, in 2006. In accordance with the estimates presented by the RF Ministry of Economic Development and Trade such a program required that each year there would be carried out the sales of shares in 4000 joint stock companies (including reorganized FSUE). It was planned that in the result of the implementation of the program by the end of 2008 no more than 2000 FSUE and 500 different blocks of shares should remain in the state ownership.

The specific feature of the next privatization programs was the use of the previous targets; however, without the explicit indication that all blocks of shares owned by the state with the exception of strategic ones should be sold in 2006.

Thus, the Estimated plan (program) of privatization of federal property for year 2005 approved by Resolution of the RF Government No. 1124 r of August 26, 2004, stipulated that in 2005 there should be offered for privatization the blocks of shares, the sizes of which were below 25 per cent of the authorized capitals of the respective joint stock companies with the exception of the blocks of shares in strategic joint stock companies or those taking part in the formation of integrated structures, as well as the blocks of shares to be sold proceeding from the need of formation of revenues of the federal budget in 2005 and in the period until 2007 in accordance with the long term financial plan. The Estimated plan (program) of privatization of federal property for year 2006 and principal strategy of privatization of federal property in years 2006 through 2008 approved by Resolution of the RF Government No. 1306 r of August 25, 2005, stipulated in practically the same wordings that in 2006 there should be offered for privatization the blocks of shares, the sizes of which were below 50 per cent of the authorized capitals of the respective joint stock companies. In 2007 and 2008, for privatization there should be offered all federal state-owned unitary enterprises not engaged in the performance of state functions of the Russian Federation, as well as the shares in open joint stock companies created in the course of transformation of the said federal state-owned unitary enterprises.

A graphic illustration of the extent of difference between the planned and actual rates of privatization is the results of 2004, when there were privatized 565 federal blocks of shares (not taking into account 31 blocks of shares, with respect to the sales of which the results were registered only in 2005) and 525 FSUE²², although it had been planned to privatize shares in 1702 joint stock companies and 1374 FSUE²³. A similar situation was ob-

²² It is the number of unitary enterprises, with respect to which all preparatory measures had been completed and the decisions on the terms of privatization thereof taken.

²³ In reality, not all enterprises included in the plan could be privatized, since some of them were included in the List of strategic enterprises, or represented joint stock companies, which were the RF contributions in the authorized capitals of inte-

served in 2005, when out of 1481 blocks of shares planned for privatization there were sold 521 blocks of shares (not taking into account 273 blocks of shares, with respect to the sales of which the results should be registered only in 2006). However, it should be noted that the number of privatized unitary enterprises being in federal ownership grew significantly and made 741 units; nevertheless, this number made just above the half of the targets set by the privatization program for year 2005 (1453 units)²⁴.

In order to create incentives for the intensification of the privatization process, Resolution of the RF Government No. 806 of December 26, 2005, approved the new Rules governing the formation of estimated plans (programs) of privatization of federal property.

This document envisages that not later than on February 1 the RF Ministry of Economic Development and Trade should submit to the RF Government the report on the results of implementation of the program in the reporting year, including the lists of federal property not privatized in the reporting year and being subject to the inclusion in the program, supplemented with the draft decision of the RF Government. Not later than on April 1, the RF Ministry of Economic Development and Trade should issue the instructions for the Federal Property Management Agency concerning the development of the draft program for the next year prepared taking into account the results of privatization of federal property in the reporting year discussed at a meeting of the RF Government, as well as the principal strategies of privatization for the planning period.

In the course of formation of the program there should be taken into account the proposals advanced by federal executive authorities, authorities of RF subjects, local governments, FSUE, and open joint stock companies, shares in which are in federal property, as well as other legal entities and citizens, which were submitted to the Federal Property Management Agency not later than on May 1.

Not later than on May 20, the Federal Property Management Agency should forward to the federal agencies performing the functions of management of state-owned property under their respective jurisdictions and other federal executive bodies performing such functions (hereinafter referred to as sectoral agencies) the lists of federal state-owned unitary enterprises under their jurisdictions, as well as open joint stock companies operating in the respective sectors, and other properties subject to the inclusion in the draft program (with the exception of properties to be included in the draft program on the mandatory basis in accordance with decisions taken by the RF Government) in order to be agreed under the established procedures. The proposals concerning the inclusion in the draft program of federal properties to be privatized on the mandatory basis in accordance with decisions taken by the RF Government should not be agreed with the sectoral agencies.

Not later than on June 10, the sectoral agencies should submit the agreed lists to the Federal Property Management Agency, which, in the case there are disputes on the draft program, should hold reconciliatory meetings with sectoral agencies attended by representatives of the RF Ministry of Economic Development and Trade not later than on June 20. Sectoral agencies should submit proposals concerning the exclusion of federal state-owned unitary enterprises under their respective jurisdictions and shares in joint stock companies operating in the respective sectors from the draft program in accordance with the special forms set yet by Resolution of the RF Government No. 252 of May 5, 2003.

grated structures; absence of real economic operations on the part thereof, the fact that such enterprises were at the stages of bankruptcy proceedings or liquidation processes; flaws in documentation or total lack thereof; failures of the management to comply with the requirements pertaining to the preparation of respective enterprises for privatization; and various technical problems.

²⁴ On privatization of federal property in year 2005. A report of the Federal Agency for the Management of Federal Property, M., 2006.

These forms should indicate the base characteristics of the objects offered to be excluded from the privatization program and contain justification of the infeasibility of privatization thereof. The proposals documented in contravention of the said requirements should not be accepted for examination.

Not later than on June 30, the Federal Property Management Agency should submit to the RF Ministry of Economic Development and Trade the agreed draft program supplemented with extracts from the register of federal property and other documents, the list of which should be determined by the RF Ministry of Economic Development and Trade. In the case there are unsettled disputes, the draft program should be submitted as supplemented with the records of the reconciliatory meetings and original copies of respective corrections signed by the heads of respective sectoral agencies. The RF Ministry of Economic Development and Trade should hold reconciliatory meetings with respect to the unsettled disputes under the established procedures. Not later than on July 15, the RF Ministry of Economic Development and Trade should submit the draft program agreed with the Federal Antimonopoly Service (FAS) and the RF Finance Ministry to the RF Government in accordance with the established procedures. The RF Government should discuss the draft program at its meeting. Not later than on August 25, the RF Government should approve the program.

Alongside with the updated schedule of processing of the respective documents envisaging deadlines at each stage of processing, the key innovation introduced by the said document in the organization of the privatization process is the provision stipulating that the proposals on the inclusion in the draft program of federal properties to be privatized on the mandatory basis in accordance with decisions taken by the RF Government should not be agreed with the sectoral agencies.

Third, the optimization of the network of FSUE and federal state institutions (FSI) being under jurisdiction of the federal executive authorities carried out in the framework of the work performed by the Governmental Commission on the Implementation of the Administrative Reform, which had been created in accordance with Resolution of the RF Government No. 451 of July 31, 2005, will have a certain impact on the further prospects of the management of unitary enterprises and joint stock companies, in the capitals of which the state has its shares.

As on March 1, 2005, this Commission examined 25473 organizations financed from the budget, including 6498 federal state-owned unitary enterprises and 18975 federal state institutions. In accordance with the officially recorded decisions taken by the Commission, there were set five groups of enterprises and institutions with respect to which there was proposed to take the following decisions²⁵:

The first group includes the organizations to be retained in federal ownership. This group was composed of state organizations engaged in the ensuring of defense and security of the Russian Federation, performance of federal state functions, and preservation of national and cultural values of the Russian Federation. In accordance with the decisions taken by the Commission, in total 10538 organizations (41 per cent of the total number of entities examined by the Commission) should be retained in federal ownership (1019 unitary enterprises, or 15.7 per cent and 9519 institutions, or 50.2 per cent). This group also includes unitary enterprises, which should be converted into joint stock companies, 100 per cent of the shares in which should be retained in federal ownership).

The second group includes federal state-owned unitary enterprises, the assets of which should be transferred in ownership of subjects of the Russian Federation and mu-

²⁵ Rossiyskaya biznes-gazeta, March 22, 2005.

municipal entities, as well as federal state institutions subject to the transfer under jurisdiction of the executive authorities of subjects of the Russian Federation. In total, this group includes 3970 organizations (16 per cent of the total number of entities examined by the Commission), of which 202 entities are unitary enterprises (3.1 per cent) and 3768 entities are institutions (19.8 per cent).

The third group is composed of organizations planned for privatization or liquidation as not answering the criteria permitting to retain them in federal ownership. In total, there should be privatized or liquidated under the procedures established by the law 6119 organizations (24 per cent of the total number of entities examined by the Commission), of which 3384 entities are unitary enterprises (52.1 per cent) and 2735 entities are institutions (14.4 per cent).

The fourth group includes enterprises and institutions to be additionally examined after the adoption of regulatory legal acts concerning the social package for civil servants. This group consists of certain state organizations operating in the sphere of health care, health resorts, and transport facilities created to service the federal executive authorities. The Commission decided that additional examination after the adoption of respective regulatory legal acts should be carried out with respect to 70 organizations (0.3 per cent of the total number of entities examined by the Commission), of which 37 entities are unitary enterprises (0.6 per cent) and 33 entities are institutions (0.2 per cent).

Besides, a separate group is formed of the organizations with respect to which there is required more precise definition of their statuses, carrying out and documentation of reorganization and liquidation procedures, and the introduction of respective changes in the register of federal property. The total number of such organizations makes 4776 entities (19 per cent of the total number of entities examined by the Commission), of which 1856 entities are unitary enterprises (28.5 per cent) and 2920 entities are institutions (15.4 per cent).

On the face of it, the work carried out by the Commission primarily concerns the sub-sector of unitary enterprises, since the issues pertaining to the management of joint stock companies with participation of the state were touched upon only as concerns the fact that there were selected just above 1 thousand FSUE to be retained in federal ownership (these FSUE should be included in the number of enterprises subject to conversion into joint stock companies, 100 per cent of shares in which should be retained in federal ownership) and about 3.4 thousand FSUE subject to liquidation and privatization, which may be carried out in the form of conversion of such FSUE in joint stock companies.

However, it should be reminded that about 1.9 thousand FSUE with respect to which there is required more precise definition of their statuses, carrying out and documentation of reorganization and liquidation procedures, and the introduction of respective changes in the register of federal property may be included in the two groups of unitary enterprises listed above after a certain period of time. It should be noted that at present it is not clear in what proportion these FSUE will be distributed among these groups. The possible adoption of amendments to the law on privatization permitting to privatize state and municipal institutions may have even greater influence on the size of the sector of joint stock companies with state participation. The respective draft law extends the procedures governing the conversion of unitary enterprises in open joint stock companies to such entities.

Taking into account the fact that basing on the results of the work carried out by the Governmental Commission on the Implementation of the Administrative Reform there were revealed at least 6503 federal state institutions redundant in terms of performance of func-

tions of federal executive agencies²⁶, it becomes possible to evaluate the field for later potential corporatization. In this connection it should be reminded that in the result of the work carried out in 2004 almost 99 per cent of all privatized FSUE were converted in open joint stock companies. Besides, about 23 per cent of FSUE and 48 per cent of FSI, proceeding from the number of such entities registered as on March 1, 2005, have not been yet subject to the efforts aimed at the optimization of the network of organizations financed from the budget.

Nevertheless, special attention should be paid to the issues pertaining to the scale, motivations, and consequences of the property expansion of the state, which became the specific feature of year 2005.

4.4. Property expansion of the state: a new stage

4.4.1. The state on the corporate control market

Specific activities of the state on the corporate control market are determined by three key functions: privatization sales, acquisition (through administrative or market methods) of such or other assets and regulation (legislation, departmental control, law enforcement). Such or other model of regulating the corporate control market (with all its national peculiarities) being an indispensable attribute of any relatively developed legal system but practical implementation of the first two functions (not as a one-time acts but as a component of the economic policy) can be connected only with a relatively short historic period. As a rule, such implementation is possible only on an alternative basis (for instance, due to ideological preferences of the ruling party) the choice itself depending on a wide range of economic, legal, historic and ethic traditions in a concrete society. A peculiar feature of Russia in the middle of the first decade of the new age was a parallel development of both processes²⁷.

By the late 90s – early 2000s, the state presence in the corporate sector, while quite expansive and proceeding from formal quantitative parameters, was significantly dispersed in the shape of multiple badly or totally uncontrolled unitary enterprises as well as packages of shares pertaining to joint stock societies set up recently in practically all industries of the Russian economy. The integrated structures, initiated by the government and with its participation during the early privatization stages, functioned basically in the fuel and energy complex representing natural-monopoly activities as well.

The 2000–2004 period was characterized by certain efforts to raise efficiency of managing the dispersed assets through their integrating into the state holding structures in such branches as nuclear-power engineering, railway transport, defense and alcoholic industries, air and sea transport servicing and infrastructure, postal service. Greater state share in the capital of certain companies outside the framework of the integration processes was rather an exception and could be taken as a “piece” thing. The process of the natural monopolies restructuring started in parallel with this.

Within the same period, more active attempts were registered to establish control (expansion) over the basis financial flows in the Russian economy and, in a somewhat wider sense, stronger movement towards greater dependence of business on the state institutions despite all the respective deregulation decisions, the administrative reform and

²⁶ However, it should be noted that 3768 organizations out of this number are subject to transfer under jurisdiction of RF subjects' executive authorities.

²⁷ In view of the main theme, articles of the privatization problem and legal regulation are not subject to special consideration here.

the plans for further privatization²⁸. The main peculiarity of 2005 was displacement of priorities in favor of direct state participation in the economy. Let us consider some exemplary examples and trends²⁹.

As is well known, one of the noteworthy events in 2004 (apart from the “YUKOS” case) was the start of the scaled “Gasprom” OJJS – “Rosneft” PC merger project. Initially, the state intended to exchange “Rosneft” for 10.74 % of the “Gasprom” OJJS’s shares which were on the balance of its daughter companies³⁰ and were necessary for the state to consolidate the control package of the gas holding in its ownership which, in its turn, permitted liberalizing the market of the “Gasprom” shares with no any particular risk of losing such control.

On the strength of the RF President’s decree, dated December 7, 2004, No. 1502, “Rosneft” was excluded from the strategic JSS list and 100 % of its shares were deposited as the RF’s contribution in the authorized capital of the new “Rosneftegas” OJSS entered in the list of the strategic companies. “Rosneftegas” was intended to appear as a temporary economic organization within which assets could be exchanged.

In 2005, the format of the deal changed. After a lengthy confrontation between the governing bodies of the two state companies, each of them relying on its own administrative resource, it was at last decided that the payment source for 10.74 % of the “Gasprom” shares, to be re-registered as “Rosneftegas” in the summer of 2005, shall be not assets of “Rosneft” but rather a credit (7.5 bln USD) which “Rosneft” is to get from the consortium of Western banks on the security of the non-controlling package of “Rosneft”. The payment source for such credit can be monies obtained from selling another non-controlling package of “Rosneft” including due to conducting the respective IPO. By the end of 2005, “Rosneftegas” had paid the first two transfers for the shares of “Gasprom” (about 1.3 bln USD) although the main payments are yet to be made.

Putting such a scheme into practice allows to set up majoritary control over “Gasprom” although with retaining independence of “Rosneft” (including “Yuganskneftegas”, its new member) and control over it. According to the FAUFI data, after the “Rosneft” PC’s stock floatation and getting the monies sufficient to pay off the debt for buying 10.74 % shares of “Gasprom” have been completed, “Rosneftegas” may be liquidated in the late 2006 – early 2007. Be such a case, the shares of “Gasprom” shall carry over to the balance of “Rosimushestvo”, i.e. will become property of the Treasury. In the end of 2005, adopted were also amendments to the law on gas supply which lifted off the limitation for foreign owners (not more than 20 % of shares) and raised, up to the threshold of 50 % plus 1 share, the minimum permissible aggregate share of the federal property and that pertaining to such JSS where there more than 50 % of shares, put on by the previous reading³¹. Simultaneously, the share of the state in the fixed capital of the “Rosgazifikatsia” company (at present, it owns 0.89 % of the “Gasprom” OJSS’s shares) must be significantly increased from 72 % to 100 % through depositing it in the authorized capital of the minority packages of shares owned by the gas distributing companies which remain in

²⁸ For more detail see: Radygin A. *Russia in 2000–2004: on the Road towards State Capitalism?* – Questions of economics, No. 4, pp. 42–65.

²⁹ The respective sources for the factual data were official press releases and interviews by top executives from the RF ministry of economic development, FAUFI, informational materials “Prime – TASS”, “Interfax”, “RBK”, the “lin.ru” project, periodic publications – “Kommersant”, “Vedomosti”, “Izvestia”, “Time of news”, “Finance”, “Merges and take overs”, company web-sites.

³⁰ Daughter companies of “Gasprom”: “Gasprominvestholding”, Gasprombank, “Gasfond”, “Gaspromfinans” and Gasprom Finance BV.

³¹ In the previous reading, the minimum permissible state share comprised no more than 35 % but at that allowing ownership of this package exclusively for the federal treasury and absolutely without any other economic bodies.

the ownership of the state. Further on, "Rosgazifikatsia" may be reorganized with singling out of the main asset – shares of "Gasprom" – to the balance of a separate company. At that, the share of the state in such company will comprise practically 100 % and this "special purpose" company as such will be liquidated later.

Nevertheless, failure of the deal in "Rosneft" take over by "Gasprom" did not change the plans of "Gasprom" and its curators in the power bodies to increase the oil component of the holding. In October 2005, the largest deal in the history of the Russian corporate control market took place – acquisition by "Gasprom" of 72.66 % "Sibneft" shares (13.091 bln USD) through one of its daughter companies. This package, along with 3.016 % of "Sibneft" shares, bought from "Gasprombank" earlier, ensure to the holding the required qualified majority when passing a decision.

Hence, both the factual nationalization of "Sibneft" and completion of "Yuganskneftegas"'s passing over under the control of "Rosneft" not only *de jure* but *de facto* as well, did significantly change the balance of forces in the oil industry where only the respective state and "loyal" companies are functioning at present. Open so far remains the question regarding the take over of part of the "Rosneft" oil assets by "Gasprom" which will depend primarily on the balance of power in the respective power bodies. Further growth of their oil (up to 55 % of the whole business) and energy components comprising the gas holding, is nevertheless positioned as a long – term strategy while at the same time preparing grounds for establishing control over the independent gas producers (the "Nortgas" OJSS) or by blocking selling of their packages to other companies (the "NOVATEK OJSS"). Among those oil companies which may become victims of the expansion by "Gasprom", are "Tatneft" which at present belongs to the "Systema" AFC, assets of the Bashkir fuel and energy complex, etc.

To go on expanding in the industry after *de facto* control over "Yuganskneftegas" has been completed, "Rosneft" has to solve a whole number of problems of the corporate and finance nature: capital consolidation in the main daughter companies and transition to a single share, solving the problem with minorities in the daughter companies (perspective of having court hearings connected both with possible exchange ratios and still continuing conflicts caused by transfer price formation in the holding), finding monies for paying for credits received in 2004–2005 to buy "Yuganskneftegas" and, possibly, credits to buy shares of "Gasprom" by the "Rosneftegas" company.

Continuing the expansion trend of the natural monopolies was acquisition by the "UES of Russia" RJSS, in the late 2005, of 22.43 % shares of the "Interros" business group controlled the "Power Machines" energy machine building concern (101.4 mln USD). This acquisition, with account taken of more than 3 % of "Lenenergo" owned shares, ensured the energy monopoly control over the blocking package of shares and, accordingly, as well possibility to exert influence on decision taking processes. At the same time, however, an important task for the modern stage in reforming electrical energy system is now liquidation of no specialized assets. It was already in 2006 that 20.62 % of the "Power machines" shares were bought by the "Siemens AG" electrotechnical concern which actually brought its share, with account taken of its current 4.38 % shares, up to the controlling package value. It is to be remembered that FAS refused "Siemens AG" a permission to buy 73.46 % shares of "Power machines" in the spring of 2005 even though this deal had been approved earlier at the level of top executives of both Russia and the FRG.

Apart from the natural monopolies, the "Rosoboronexport" FSUE, a state foreign economic enterprise whose share accounts for the main part of the Russian export of military and technical production, came out as a new and serious player actively engaged in acquiring earlier privatized assets. The sphere of its activities so far includes the defense

industry and machine building. It was as far back as 2002 when the “Rosoboronexport” FSUE and the State investment corporation³² set up the “Oboronprom” United industrial corporation whose activities could well be taken as a good illustration of a combined application of administrative and market methods to set up corporate control. In 2005, forming a helicopter building holding became one of its main directions of activity – the authorized capital of “Oboronprom” received state share packages of the Ulan Ude aviation plant (UUAP, 49.18 %), the Mill Moscow helicopter plant (MHP, 31 %), the Kazan helicopter plant (KHP, 29.92 %), the “Forward” Moscow machine building plant (MMP, 38 %) and the Stupino machine building production enterprise (SMPE, 60 %). To ensure the majority control over the enterprises mentioned above, “Oboronprom” purchased from private shareholders additional packages of shares of UUAP (25 %), MHP (12.5 %) and MMP (31 %). In November 2005, the “Kamov – Holding” OJSS was purchased from the “System” AFC, the former in its turn being the owner of 49 % of shares belonging to the “Kamov” OJSS (11.8 mln USD).

Another method to set up control over a number of enterprises was additional emission of the shares by “Oboronprom” during which 15.07 % of its shares were exchanged for 29.92 % of the KHP’s shares being in the ownership of Tatarstan. Still another new participant of the holding was private shareholders controlled the “Rostvertol” Rostov helicopter plant which bought its 2.79 % shares for cash. The holding at that is going to spend the obtained monies on redeeming the additional emission of shares belonging to “Rostvertol” itself since but only 3.73 % of the shares of the enterprise are currently in the ownership of the state. As to the feasible future, “Oboronprom” is planning to increase the package size of its shares in “Rostvertol” up to the controlling value having confined the first stage to the blocking package. “Oboronprom” also controls a number of enterprises having nothing to do with production of helicopters, including the “Defensive Systems” OJSS (more than 75 % of shares) and the “Oboronpromleasing” OJSS (100 %).

As shown by the 2005–2006 events, interests of “Rosoboronexport” go far beyond the defense industry confines covering, in particular, the civilian car building industry. In 2005, for instance, there took place a change in the top management in “AutoVAZ” whose Board of Directors was then joined by representatives from “Rosoboronexport” and the Foreign Economic Bank. Although these changes among the top executives are positioned as attraction of anti-crisis managers no radical changes in the company’s policy are expected. The scheme of setting up property control still remains nontransparent although certain sources do point as to the size of the package acquired (about 60 % of shares) and the sum of the deal (about 700 mln USD). In October 2005, instead of placing the state package of shares in the London stock exchange, the “KamAZ” OJSS and its three daughter companies were, by the instruction of the RF government, included in the list of strategic enterprises and as of February 2006, according to the available data, 34.01 % of the shares of “KamAZ” can be transferred for administration to the “Rosoboronexport” FSUE which had earlier sent the respective request to the FAUFI (a unitary enterprise has no right to directly participate in any privatization deals). It became known in January 2006 that the “Rosoboronexport” FSUE made an offer to the major property owners of the “Verhnesaldin metallurgic production amalgamation” OJSS, the titan monopolist, concerning redemption of their shares.

The government is now preparing a draft project for creating a unified National automobile building company by analogy with the Unified aviation construction company (UAC)

³² The share of “Gosincor”, after its liquidation in 2003, went over to “Rosimushestvo” which at present shares the capital of “Oboronprom” and “Rosoboronexport” (31.13 %), Tatarstan and the “Rostvertol” OJSS.

principle decision on creation of which was taken in the winter of 2006. Simultaneously, already in 2006, a question of setting up a similar company in the sphere of engine building was also considered (6 large enterprises). As was to be expected, one of the serious obstacles on the way of setting up the UAC is defining proportions in the structure of capital of the holding to be created between the state and other shareholder groups as well as between interests of private shareholders who own different size packages of shares in the enterprises being united in the holding. Possibly, the experience received in the course of setting up the "Oboronprom" helicopter building holding, will be needed when making the UAC. Further plans include the National energy machine building corporation which, in perspective, is quite capable of integrating the "UES of Russia" RJSS and "Gasprom" acquired assets of "Power machines" and "United machine building plants", respectively, the state controlled (51 %) holding of above the water shipbuilding enterprises on the basis of the Baltic plant and "Northern shipyard" as well as a number of others.

In 2005, certain changes, as connected with actions on the part of the state and companies with its participation, concerned aviation adjacent activities such as air transportation and functioning of airports. In August, the RF Saving bank ("Sberbank") became a nominal holder of 25 % shares of "Aeroflot – Russian Avialines". The "Pulkovo" FSUJSE completed its internal division into enterprises engaged in the airport activities and those dealing with air transportation. Later on, "Pulkovo" (air transportation) is to be affiliated to the "Russia" State transport company (STC) which shall apportion and transfer to the RF President's Administrative department property to ensure air transport for the first persons of the state. Court proceedings at the suit of "Rosimushestvo" recognized as illegal the transfer of the "Domodedovo" airport's movable property to the "East Line" company which was the most notorious case of 2005 in recognizing as illegal deals with state property stricken in 1990s. Apart from that, a similar suit is under consideration involving the terminal of the said airport.

Another example of more active effort of the state in increasing its share in the companies with mixed capital up to the required controlling values can be well taken from the relatively recently revived (June 2005) discussion of methods to increase the federal share in the "ALROSA" diamond holding. Increasing the federal share from 37 % to 51 % may be possible through exchanging shares of "ALROSA" issued during the additional emission, for the state packages of shares of five profile companies ("Smolenski crystal" – 100 %; the "Crystal" Special engineering and design bureau – 100 %; The Prioksk plant of non ferrous metals – 100 %; the Vliuysk HPS – less than 1 %; and "Diamand world" – 52.37 %). "ALROSA", in its turn, is viewed as a potentially main partner of the "GMK "Norilski nickel" OJSS. Like in the case with "Gasprom", such a deal may require large crediting with the respective guarantees.

Practical implementation of this scheme faced a strong resistance from the Government of Yakutia, the second large shareholder of "ALROSA" (32 % of shares) which, not even wishing to burden itself with any efforts in taking part in acquiring the "Norilsk nickel", nevertheless had to face the actual need to seek for assets to be entered in the capital of "ALROSA" to prevent possible reduction of their share. This is closely connected with the question of transferring into the federal property of the property complex which earlier belonged to the "Yakutalmaz" Scientific and production amalgamation. Be such a case, the republic then will lose the right to collect rental payments from "ALROSA" comprising at present up to three quarters of its budget revenues. To preserve the existing balance of forces, Yakutia is quite ready for a compromise: greater capitalization of "ALROSA" through depositing in its capital shares of other republican enterprises (75 % minus one share of "Yakutugol", 34.6 % shares of "Elgauglya" and 10 % shares of "ALROSA - Nyrba").

In 2006, the list of large state holdings can be widened because of the appearance of a new holding – “Atomprom” (NPS, atomic industry, profile scientific research institutions). The basis for such amalgamation is comprised by assets of the “Rosenergoatom” concern being in the process of becoming a shareholding company, and a number of enterprises making the “United machine building plants” group (actually in the ownership of the “Gasprom” group which also owns other assets of the nuclear industry as well). Circulating currently on the open market, shares of the UMP group can be subjected to the delisting procedure with further transforming of the company into a closed joint stock society. The only shareholder of the new holding will in all probability be the state.

Quite symptomatic is also slowing down processes of the natural monopolies restructuring which was typical for the year of 2005. Further reorganization processes in the railway industry are directly connected with discussing possible strategic risks when privatizing various objects of the “RZhD” OJSS. An important question to be answered remains the sources of covering damages of the railway transport should passenger conveyance be singled out of the “RZhD” OJSS into an independent company, its status and owner being then the “RZhD” OJSS itself directly or the respective federal and, possibly, regional authorities. Part of the respective package of shares may be offered for sale already by the end of the third stage of the railway transport reforming (2006–2008) along with shares belonging to the respective daughter companies of the “RZhD” OJSS functioning in the competitor segment of the market.

In the sphere of electrical energy, problems remain as connected with selling the generating capacities after they have been divided by kinds of activities in the regional energy companies accompanied with completion of forming wholesale generating companies as well as with the state of the dispatching offices and network objects. In the end of 2005, a new aspect could be seen in the restructuring plans of the “UES of Russia” RJSS as connected with the additional emission of shares by a number of the generating companies. Quite debatable in this connection remains distribution of their capital, the degree to which participation in them of the “UES of Russia” RJSS itself and shareholders of the holding will be preserved. It should be reminded in this connection that fully in accordance with the original restructurization of the industry plans, upon liquidation of the said RJSS, the state actually intended to leave in its ownership 75 % plus one share in the Federal network company and the System operator as well as the controlling package in the generating company set up on the basis of assets in the hydro-power engineering.

As regards the “Gasprom” OJSS, in practical terms, the problem of radical transforming has always remained at the level of projects and discussions. According to the official statements, these efforts can be understood as an intention to carry out certain measures aimed at reduction of costs, higher transparency and financial recovery. Thus, I. Shuvalov, advisor to the RF President, openly announced that, as different from the electrical energy industry, no global reform in the gas branch of the company was to be expected – the pipe line shall remain within the company which must have a monopoly right for exports provided non-discriminatory access to the pipeline is ensured for the independent producers. Discussed was also a question of creating, as something like a pilot project, free market of gas in the volume of about five (5) bln cub. m a year³³.

It is to be particularly emphasized here that the question of the very possibility for privatizing assets of the natural monopolies and its respective conditions is quite far from being obvious and that is graphically confirmed by the example of “Svyazinvest” which, in the period of early 90s when joint stock companies were being set up *en masse*, was, in fact,

³³ Izvestia, 2005, March 18.

also enjoying a monopoly position of the market of communication services. Although the question of selling the state package of shares in “Svyazinvest” have been quite frequently discussed in the recent years, last year objections by the RF power bodies resulted in the fact that privatization had to be put off because it was necessary first to adopt a law protecting the interests of special-type consumers of communication services as well as to develop the respective practical mechanisms.

Since selling the package of shares of the “Svyazinvest” telecommunication holding was intended during all the recent years, inclusion of this object in the privatization list for 2005 did not at all mean any final decision. *First*, further privatization is directly connected with completing the reorganization processes, the tariff reform, solving the social loads problems of the regional companies and providing communication services to the power bodies (over 600 thousand numbers, that with 600 mln rouble indebtedness to the holding as per July 1, 2005). *Second*, with account taken of the growing attractiveness of the telecommunication shares, urgent sales of the holding’s securities have little sense in any case. However, there is a counter trend too. According to the estimations of the RF ministry of economic development, even though the holding does own both the controlling and the blocking packages of shares belonging to the regional operators of wire communication, operability of control has been lost by them. *Third*, any concrete variant of selling does need serious and sufficiently detailed study and work over.

From the viewpoint of the RF ministry of economic development, the most rational approach seems to be a single step privatization of the whole state package (75 % minus one share) which was discussed in 2005 along with the RF President’s Decree on excluding the holding from the list of strategic enterprises. Simultaneously, in the course of 2005, continued was coordination and authorization of the terms of sale with the respective power bodies. In October 2005, fundamental amendments of the President’s State Legal Department were introduced in the draft project of this decree providing for the necessity to legislatively execute guarantees for the power bodies until the holding has been included in the privatization program. It means in fact that, in all probability, no privatization of the holding is not to be expected in 2006 either. V. Yashin, Head of the holding, announced in the end of 2005 that the said state package could be sold either before July 2006 or only after the 2008 presidential elections.

On the whole, the privatization story (as well as the respective plans) of the “Svyazinvest” holding really deserves a special study much because it graphically manifested practically all the specific features of the Russian post massive period of privatization: the 1997 “oligarchic war”, intransparency of the first package sale, intensive use of the administrative resource both in 1997 and in 2005, risks of the “double” privatization (the holding itself and its daughter companies) as similar to the oil industry of the 90s, a whole set of social and regional problems, strategic limitations and concernment of the respective power bodies, problems of reorganizing and optimizing the corporate structures, concealed struggling between different power and financial groups in the early 2000s and a whole number of others.

Let us now draw some conclusions. The year of 2005 witnessed noteworthy changes in the respective approaches, namely:

- greater activity of the already functioning state holdings and companies which began expanding the scales of their business and its diversification by way of take overs and merges (“Gasprom”, “Rosneft”);
- involving new “players” (the “Rosoboronexport” FSUE, the “UES of Russia” RJSS) in the property expansion process;

- policy of integrating scattered assets remaining in the ownership of the state, in the respective holding structures becomes of secondary importance³⁴ yet the new structures are beginning actively, although in a rather selective way, function on the corporate control market as independent subjects (the “Oboronprom” OJSS and others);
- although it so far seems to be a little early to speak about actual formation of multi industry conglomerates, progressing of expansion beyond the confines of the fuel and energy sector has become a fact (in 2005 – early 2006, the state manifested its obvious interest to AutoVAZ, KamAZ, the “Verkhnesaldinsk metallurgy production combine” OJSS and others);
- there is taking place gradual shifting of interest from “problematic” or “unfair” assets of companies as from the viewpoint of the state structures (YUKOS, the “Guta” group) towards assets of “neutral” or “loyal” property owners;
- intensification of state participation on the corporate control market is taking place in the context of significant overall growth of deals on the Russian market accompanies with simultaneous recession of “hostile” take overs;
- more wide practice is made of such methods as bringing the size of the respective share in the authorized capital of the company up to the value permitting to exert the decisive influence on their business activity (“Gasprom”, “ALROSA”, “Rosgazifikatsia”, the “Vperiod” Moscow machine building plant, the Mill Moscow helicopter plant, the Ulan Ude aviation plant);
- need in political authorization of possibly large deals both in the country and with participation of foreign companies becomes a necessary component in working such business decisions over (practically all the large deals completed in 2005 with participation of the respective state structures as well as those rejected – sale of the NOVATEK package of shares to the French “Total”, placement of the shares of KamAZ on the London stock exchange, sale of the controlling package of “Power machines” to the “Siemens AG” concern).

Special mention should be made here as regards their payment terms and, what is no less important, possibility to export the capital obtained. Actually, what we can see here is something like a “triple standard” which *a priori* excludes any truly market approach to the respective deals with not at all clear motives for taking such or other decisions. At least two extreme possible variants are well known. First – destruction of the company and *de facto* nationalization of assets when the question of the deal’s market price and possibilities for exporting of the monies obtained, for reasons quite understandable, was not even discussed (“YUKOS”). The second – a deal in acquiring “Sibneft” by “Gasprom” which brought 13 bln USD to the main beneficiary of the company as well as a possibility to use it legitimately both in Russia and abroad. As compared against this, all the preceding sales of *Millhouse Capital* (aluminum, etc) look real small. With even quite modest understanding of how to have business with the state, one may assume inevitably significant transaction taken by the beneficiary upon himself but actually that’s not the point.

Two radically *contrary* scenarios of completing business which has been created by approximately *similar* (but not at all necessarily legal) methods during approximately the same period of time (about 10 years) and equally successful from the economic point of

³⁴ Nevertheless, this process is still going on, primarily so in the defense industry. According to the FAUFI data, in 2005, completed was formation of the “Corporation “Tactical missile armament” OJSS, the “United industrial corporation “Oboronprom” OJSS; transformed were all the FSUE subject to depositing in the authorized capitals of the “Constellation” concern” OJSS, the “Vega” radio building concern” OJSS, the ‘Okeanpribor’ concern” OJSS, the “Morinformsystema – Agat” concern” OJSS, the “Granit – Electron” OJSS. There was but one contrary decision concerning the fuel industry: shares of 77 societies were planned to be deposited in the authorized capital of the “Russian fuel company” OJSS but setting up of the latter was then considered as inexpedient.

view – an ideal illustration of what private property in the contemporary Russia actually is and how significant – as different from the modern Western world – its having to do with the top political power like, for instance, in the countries of the Ancient Orient.

These two extreme variants are characterized by a wide range of possible compromise solutions related, in the spirit of the classical tradition, to the “*offer which cannot be rejected*” category. Nor it will be sufficiently easy to refer the said deals to market ones as with even all the impression of a fair market price, the state will always have at its disposal certain arguments from the “YUKOS case”. In May 2005, according to some data, a question was raised with regard to selling to “Gasprom” a share of Russian THK – BP shareholders (50 %), in January, 2006 – 30 % shares of “Aeroflot” which remain in the ownership of HPK, one of the largest state banks or to “Gasprombank”.

According to certain forecasts for the 2006–2007 period, as targets for nationalization or take over on the part of the state companies could become “Norilsk nickel” (51 % shares, 8 bln USD), Promstroibank (1.5 bln USD), the Ural mining company (5 bln USD), “Surgutneftegas” (62 % shares, 20 bln USD), “Vossibneftegas” (130 mln USD), “Tomskneft”, “Samaraneftegas”, the Achinsk NPZ, the Angar oil and chemical company (8.5 bln USD, altogether), the Syzran NPZ, the Kuibyshev NPZ, the Novokuibyshev NPZ (0.5 bln USD), THK – BP (50 % shares in the ownership of Russian shareholders, 9 – 10 bln USD), “Power machines” (450 mln USD, “Uralkaly” (2 bln USD), “Silvint” (1 bln USD)³⁵.

Nationalization will continue in the oil and gas sector involving also the mining industry and certain segments of the chemical production as well. Probable seems to be nationalization in the transport industry for control over export – import supplies (sea, railway and avia holdings).

In the context of significantly growing direct state participation in the economy of Russia, of particular importance becomes the question of possible aims and consequences of this given process.

4.4.2. *Motives for expansion: an attempt of interpretation*

Although the expansion processes of direct state participation in the national economy in 2005 became obvious needing to be such or otherwise motivated as a general economic strategy no sufficiently coherent official grounds at the state level so far seem to be in existence at this present time. Let us try to single out several possible variants (hypotheses) at that understanding but too well that they all may become closely and variatively interwoven in real life.

Variant one – “*management and efficiency*” – is, in such or other form, traditionally present in many leftist and centrist programs of 1990s – early 2000s. Its varieties are mostly apology of advantages in managing economy through large state economic structures as well as more general ideas of the “state capitalism”.

Possibilities of setting up holding companies with the state participation in the privatization process were, as is well known, strictly limited (with quite a number of “piece like” exceptions though) by the RF legislation already in the beginning of 90s. A special project was prepared for the V. Chernomyrdin government in the middle 90s to set up one hundred state holdings which actually was a sort of a reaction to the mass privatization of 1992–1994. One of the tasks in G.A. Ziuganov’s 1996 pre-election program was “setting up state holdings controlling the state packages of shares fully in accordance with state

³⁵ Mergers and take overs, 2005, No. 12 (34), p. 13–15.

industrial policy”³⁶. In its resolution, dated September 1, 2000, No. 29 (221), the Collegium of the RF Counting Chamber raised the question of the need in legal support for procedures of setting up state holdings in the basic industries of the national economy with strategic significance for ensuring security of the country (i.e. adoption of the “On State Holding” law). Finally, in 2001, the Federal Assembly considered a draft project of the “On Holdings” law which provided for setting up state holdings and other state hierarchy structures on the basis of the respective state bodies.

The model of (state) holding detailed analysis of which can be found in a great number of publications has both its obvious merits (in some branches) and no less obvious shortcomings. As concerns the aims of this particular article, we will confine ourselves to just noting that seeming simplicity and order of the *system* of the state holdings can be quite a significant incentive for another national level experiment. To see an illustrative example, it is enough to have a look at those problems which had to be faced in the early 2000s when trying to form a system of holdings just in one sector – military and industrial complex where the expediency of such structures is usually neither much disputed nor doubted.

Respective references are often made to the state holdings in a number of countries of the world (Italy, Norway, Mexico, Venezuela, China and others). The world experience does contain quite different models, yet the greater part of the state sector, even in those countries which do not share the total de-governmentalization ideology, are usually connected with interests of the national security and social loads. It is also commonly accepted that any attempts to replace private business with state structures are most often fraught with negative economic consequences in the long term perspective. The wave of intensive “deregulation” of economy and privatization which swept through many developed countries during the period of 80s–90s, can also be taken as evidence of serious disappointment with the results of activities carried out on the basis of the nationalized and/or rigidly regulated sectors of the national economy.

Variant two – “*global competition and national security*” – can be considered by the authorities as justified only if similar private structure do not “reach” the level of the modern international corporations³⁷. Accordingly, forming large state structures in Russia, including such by means of nationalization, can be understood in two ways: *firstly*, as a method of absolute state support of the selected “power centers” for global positioning in the world (the extractive industries and the military industrial complex), and, *secondly*, as an instrument of protectionism in such sectors which are most subject to impacts of the global competition simultaneously shouldering on themselves social or infrastructure loads (avia- and automobile building, communications and others). Nevertheless, the number of such sectors is, as a rule, rather limited with the national security criteria being in need of thorough legislative execution. It is also quite obvious that governmentilisation of a whole number of economic sectors actually means transition to the policy of state financial support (with all possible costs) of strategically significant projects which are otherwise doomed to in viability.

In 90s, this given problem was solved in a formal way through introducing endless limitations in the privatization legislation (most of which were as successfully evaded), fixing the respective packages of shares in the ownership of the state and quoting the share

³⁶ From destruction to creation. The way of Russia, XXI century. The main theses of the social and economic program of G.A. Ziuganov, candidate for the presidency from the people – patriotic forces. Moscow, May 25, 1996.

³⁷ Greater role of the state “in many countries of the world is a *natural reaction* of such or other nation to the interference of transnational structures in the intra-national processes..., making the national sovereignty notion relevant and limited”. (Popadiuk N. *Is Private Property Private in Russia?* – Questions of Economics, 2006, No. 1, p. 144).

of foreign investors in the shareholding capital in a number of Russian companies. Interpreting of external threats can be typically exemplified in the “*Policy of the RF national security (1996–2000)*” report prepared in 1996 by the personnel of the Secretary for the RF Security Council, where “possibilities for foreign companies to buy up Russian enterprises intensively and at an obviously lower price” are interpreted as a significant threat³⁸. In the new century, the list of strategic enterprises, forbidden for privatization, is annually undergoing such or other changes yet, any sufficiently precise criteria of its formation are still absent.

It is proposed in the RF President’s address to the RF National Assembly, dated April 25, 2005, that “... strictly defined must be those spheres of the national economy where the interests of strengthening independence and security of Russia do imperatively dictate the necessity of paramount control on the part of the national capital, the state one inclusive”. Such spheres include “certain infrastructure objects, enterprises fulfilling defense orders, mineral ore fields with strategic significance for the future of the country, for the future generations of Russians as well as the infrastructure monopolies”. Nevertheless, as V.V. Putin declared, we still do not have any clarity as to what model of Russia’s economic development is best (paternalist or liberal) nor with regard to the optimum scales of the presence of the state in the national economy. M.E. Fradkov, Prime Minister of the Russian Federation, expressed himself even more definitely: concentration of production is not to be considered as monopolization but rather as participation in competition.

It could be logically assumed that positioning of Russia both on the world market and in its relationships with the leading industrial countries of the world as an “energy power” and a guarantor of “energy stability” (this subject was declared to be one of the key ones for meetings of the “Great Eight” to come in 2006) is under consideration at present as a dominant of foreign political and foreign economic activities. A lot of reservations taken into account, this can somehow explain creation and/or preservation mega corporations of the fuel and energy sector in the ownership of the state although the very scope of the 2005 expansion makes the exclusiveness of the given variant rather doubtful.

Variant three – the “*state rent*” – was actively discussed in 2003–2004. It is primarily connected with the idea of the natural rent nationalization (requisitioning of super profits) in the oil and gas sector, ferrous and non ferrous metallurgy moved forward by S.Yu. Glaziev, former leader of the “Rodina” political party³⁹ today, there is no sense to consider conceptually neither the “On natural rent requisitioning” legislation (2003) nor the absolute figures given which are quite contradictory in themselves (from 10 to 80 bln US dollars). Certain direct populist measures in this sphere could, no doubt, meet adequate support in the Russian society but the choice was made in favor of the set of indirect measures which are, in a normal case, implemented gradually during 2003–2005: a new tax on extraction of minerals and other tax instruments, export duties, pre-charging of taxes and collecting tax arrears from the previous years, review of the legislation on the Earth’s interior, the licensing policy and procedures for taking part in auctions for the natural resources, etc⁴⁰.

In other words, the state was as active during the recent years in conducting the policy aimed at redistributing incomes of the fuel and energy complex, which at that does not actually require any serious expansion of the state’s direct presence in the sector. It can be assumed, indeed, that nationalization of significant assets is considered as the com-

³⁸ Policy of the RF national security (1996–2000) (draft project). NG – Scenarios, 1996, No. 2.

³⁹ See, for example: Round table “Estimating the rental revenues value as formed in the fuel – energy and metallurgy complexes of Russia”, <http://atvr.ru/soveshyanie/2003/10/10/4015.html>.

⁴⁰ As regards the subject under discussion, neither economic justification, nor efficiency or transparency of the respective concrete mechanisms play any significant role.

pleting stage in the general “nationalization of the natural rent” policy (with all the uncertainty of the terminology of this notion) but this does not explain the interest shown by the state in 2005 to other sectors of the national economy either. Variant four – “*strengthening personal influence and private rent*” – is most complicated for such or other interpretations due to factual and/or ethical considerations. Nevertheless, both its triviality and potential pragmatism give it full right of existence *pari passu* with others, if proceeding from the “*principle of Okkama*”.

Distribution of political power in the society is determined by the existing political institutions and distribution of resources. The natural wants of any new power inevitably include intention to set up maximum possible control over the available resources which is initially ensured with the help of the so called “*personnel decisions*” in the largest state companies and banks. Further steps are usually directly determined by concrete views as regards the place and functions of bureaucracy in society and the state as well as, what is quite evident, those possibilities which are opened to them by the existing (being built) political system. While the current political institutions do not provide for effective limitations against actions of powers that be and/or getting significant rent from being in power⁴¹, the economic institutions, on the other hand, not only do not stimulate economic growth but are even being transformed in the interests of “rent formation”⁴².

The system becomes workable when control over financial flows is locked on the built state and private “profit centers” both in Russia and abroad. Although vividness of the terminology used by A.N. Illarionov, ex-advisor to the RF President (the “Russian state” open joint stock society and many others), does somewhat simplify the situation. Suffice it to give just one such illustration:

“The main encouragement for a corporate member – his landing in the respective state company whose financial flows size is the most precise appraisal of his/her place in the corporate hierarchy”⁴³.

Under the conditions in the sphere of political institutions, as described above, further development of events logic directly presupposes expansion of the state sector – not because of some abstract motives of the respective strategic interests and the national security but rather in quite a pointed way due to such economic sectors and companies which are highly profitable and do not require any significant and momentary managerial, investment or innovational efforts. To determine a possible scope of the state intervention under the given prerequisites, of significance are two basic factors – time and finance. Each of them has its own limitations: the time factor is, in all probability, connected with the electorate cycle while the finance one – with the presence and volume of available sources to finance new take overs. It is quite possible in this connection that less favorable world price situation for the raw materials in 2000s could lead, *inter alia*, to a much greater number of cases somewhat similar to that of YUKOS. It seems a situation could be also excluded within the framework of this particular variant when the nationalization of economy process is acquiring a total character.

Finally, the system to be built also means the appearance of new potential “oligarchs” who, at a certain stage of their expansion as well as with the overall support of the state, will make every effort to transform the respective rent into property. Accordingly, a situation seems to be quite possible when completion of the “putting in order” the respec-

⁴¹ See: Acemoglu D., Johnson J. Institutions as the Fundamental Cause of Long-Run Growth. – In: Aghion Ph., Durlauf St., eds., *Handbook of Economic Growth*, North Holland, 2004.

⁴² In V.A. Mau’s terminology, “the country is in a situation which can be described as “falling productivity” of the economic institutions” (Mau V.A. *New NEP*. – *Kommersant*, 2006, February 9, p. 1.8).

⁴³ Illarionov A.N. *Another country*, *Kommersant*, 2006, January 23, p. 1, 8.

tive financial flows pertaining to the state holdings and putting up the state “power centers” in the economy, will be inevitably followed with their management receiving *carte blanche* to use them as a basis to start setting up their own private groups. In this connection, it makes sense to mention here an article published recently by M.E. Dmitriev, President of the “Centre of Strategic Problems” foundation, dealing with the nationalization issues where its author, one of the leading Russian liberal economists, suggests a rather unique construction⁴⁴. Partly because the present day public opinion negatively perceives the 90s privatization results, the author takes the current (and, possibly, the further) nationalization as sufficiently justified “*expiation of the original sin*”, yet the subject of discussion in the article mostly concerns possibilities for new privatization which may be able to “establish a distributed structure of corporate property with greater role of petty shareholders and institutional investors who are backed by interests of millions of people”.

Naïveté of such argumentation is but obvious: *first*, the acuteness degree of the negative appraisals as regards the Russian privatization was no less in the 90s as well but the question of nationalization then was raised only on the level of populist slogans moved forward by the left forces⁴⁵; *second*, appealing to the interests of millions of people even in a large corporation with highly dispersed structure of the joint stock capital is as senseless as it is senseless when discussing the “socialist property common to all the people” (this relates to the Anglo-Saxon corporate system as well); *third*, this shift from the “oligarchic” to the “public” corporate model is all the same taking place in, minimum, 1/3 of the 20 Russian largest private companies; *fourth*, doubtful seems to be consistency of the processes – nationalization on the wave of perspective stock rise as well as the growth of companies’ capitalization and privatization in the context of rather unclear economic situation. However, in case these nationalization processes are financed from the respective budget funds then such consistency – particularly so in the format of the variant under discussion – actually has but very little significance⁴⁶.

Now, is the question of revising the privatization results is to be raised and discussed it should be done then in accordance with the formulae suggested by A.A. Auzan, President of the Institute for the “Public Agreement” National Project: “introduce a federal law which shall regulate converting the value of the state enterprises which became private property by way of mortgage auctions! However, these rules must be the same for all but not changing in accordance with the principle of proximity to or “equidistant” from the President⁴⁷. The said M.E. Dmitriev’s construction, with all its *pros* and *contras*, has one undoubted merit – it can really be implemented only in future but the nature of “a distributed structure of corporate property” can be forecasted, although with some error degree, already today.

⁴⁴ Dmitriev M.E. *In Defense of Nationalization*, Kommersant, 2006, January 30, pp. 1, 8.

⁴⁵ It is to be noted, nevertheless, that the 2004–2005 period saw a sharp growth in the number of “public opinion polls” demonstrating negative attitudes of the population towards private property in the national economy and “oligarchs”. In our opinion, it is to a much greater degree connected with providing for the ideological platform of the state expansion than with taking into account the “opinions of the population”.

⁴⁶ Noteworthy mentioning here are also the ideas, moved forward as far back as 2003–2004, which suggested that the state use the Stabilization Fund’s monies to redeem part of shares from the most liquid Russian companies, for example, “Gasprom”.

⁴⁷ *Merges and take overs*, 2005, No. 11, p. 11.

4.4.3. Perspectives and consequences

Regardless the above interpretations, the main distinctive feature of the year of 2005 can be considered to be evident and much more intensive activities of large holdings with the state participation which did significantly expand the scope of their business through its further diversification and vertical integration. This was accompanied, in parallel, with continued integration of atomized state assets and setting up of new holding structures.

In vast majority of the cases, it does not make much sense to talk about nationalization in the direct meaning of the term since the state (treasury) did not formally become the owner of new assets resulting from confiscation or redemption with the budget monies. At the same time, expansion of companies with the state participation was taking place, at least outwardly, with no any obvious use of the budget means. Holdings with the state participation, as the main objects of the given process, became owners of the property rights for new assets resulting from certain market deals which were actually authorized by the respective power bodies and using their own and, mainly the attracted, capital or credits obtained not so much from Russian but rather foreign banks.

That such actions are capable of exerting but indirect influence of the state's property and financial situation goes without saying. Under a favorable development of events scenario, the state, as the owner of large holding companies, can count on certain growth of their capitalization which, though indirectly, implies increasing budget profits when selling (potentially) state owned packages of shares in future. There are also some prerequisites for increasing dividend payments (share of profits) in the budget at the expense of potential incomes growth in the respective holding structures from the activities of their new and otherwise dependent companies. However, this all does require an adequate level of corporate management, transparency and affiliation both in relationships between the state and the respective holdings and between these holdings and their daughter companies.

At present, it seems rather difficult to give a simple estimation to these processes from the viewpoint of their influence on the situation in individual branches and in the economy as a whole. It is only subsequent development of events that can show the extent to which large holdings with the state participation are capable of efficient managing a large number of acquired and/or obtained most different assets. At the same time, however, the scope of the state companies' activities on the corporate control market, graphically demonstrated in 2005 and, in all probability, having all the chances for further development in 2006–2007, make one get thinking as regards the price of such expansion in the context of the general economic perspective.

During the recent 30 years, the world have accumulated quite significant theoretical and applied experience of comparative analysis in the area of *efficiency of the state and private forms of property* to ignore which is absolutely inadmissible and which, indeed with certain specific exceptions, almost finally does witness in favor of the latter.

A.E. Boardman and A.R. Vining who have quite thoroughly studied over 50 publications devoted to comparative analysis of the state and private property, formulate their main conclusion, including the results of their own calculations, in the following way: "The obtained investigation results prove that if account is taken of a sufficiently wide range of factors [exerting influence on efficiency of economic operations – *note by the authors*], large industrial companies with a mixed form of property as well as similar firms fully belonging to the state, demonstrate much lesser efficiency level as compared against the like

private enterprises"⁴⁸. The available multiple empiric studies of comparative efficiency of the state dominant companies and private owners in Russia in 90s – early 2000s differ a lot in their estimations of influence exerted by various types of private property owners on efficiency although such conclusions with regard to the state dominant companies are similarly simple.

Although an extensive referenced – legal basis for regulating the state sector (mixed societies and unitary enterprises) has been created and developed since formal adoption of the well known Concept of Managing the State Property and Privatization (1999), *management efficiency in the sector is slightly different from the level of 90s*. The guide lines designed (retaining no more than 1000 FSUE and 500 shares in the economic societies in the state ownership of the RF by the year of 2008) do not look too much truthful for two circumstances at least.

First, organizational abilities of the managing bodies for sufficiently rapid reforming the state sector are in serious contradiction with the quantity limitation – its scope as of the year of 2005 (8 300 FSUE and 3 500 shares). *Second*, sharp reduction in the number of all levels unitary enterprises, with the perspective of their possible conversion into open joint stock societies, explicitly increases loading on the state governing bodies which are quite far from being enough efficient as state representatives at the present time as well. In this context, the counter process – expanding the scope of the state sector – looks at least unnatural particularly so if estimated from the viewpoint of efficiency of the state policy in the given sphere.

In the context of the more general problems Russian companies experience in the sphere of *transparency* of financial flows, the state holding structures do not traditionally belong to the group of leaders as concerns the respective ratings⁴⁹. A vivid example of poor transparency in activities of companies with the state participation is provided by organizing export of the Russian and transit of the Central Asian natural gas to Ukraine and/or to other countries on the post-Soviet space which was manifested during the respective negotiations which "Gasprom" conducted in late 2005 – early 2006.

The policy of building up and diversifying assets of the largest state holdings create prerequisites for conserving informational shut down both because of the necessity to practically implement long reorganization procedures and – depending on concrete motives for take over – of optimization of the respective financial flows of the acquired (being set up) companies.

As a mechanism for regulating economic efficiency, the corporate control market is connected with the market redistribution of joint stock property and, accordingly, with the change in the development strategy of the respective corporation. Theory⁵⁰ distinguishes two groups of incentives which serve to induce to implementing operations on such market: these are the "general" interestedness, e.g., interests in profits which the companies distribute between all the shareholders in accordance with the number of shares they own,

⁴⁸ Boardman A.E., A.R. Vining: Ownership and Performance in Collective Environments: a Comparison of the Performance of Private, Mixed and State Owned Enterprises. – Journal of Law and Economics. Vol. 32, p. 29.

⁴⁹ See, for instance, ratings of informational openness of the largest, in terms of capitalization, Russian companies prepared by the Standard & Poor agency in 2003–2005. According to the results of the investigation for the year Of 2005, in 23 of 54 companies the state still controls over 25 % of equities. While the total share of directly or indirectly state controlled packages of shares in the overall capitalization of the 54 companies comprised 18 % in 2004, it grew up to 24 % in 2005. As to the 2005 transparency rating, "Gasprom" was 16th, the UES of Russia" RJSS – 26th, "Aeroflot" – 27th, Sberbank – 35th, KamAZ – 39th and AvtoVAZ – 42nd. It is also noteworthy that as regards the largest state holdings, a correction should be made concerning the objectively given transparency of the property structure whose intransparency is in many other cases significantly decreasing the respective indicators of transparency.

⁵⁰ For more detail see: Radygin A.D., Entov R.M., Shmeliyova N.A. *Problems of Merges and Take Overs in the Corporate Sector*. M., IET, 2002.

and “private” interests characterizing special advantages for those who own the given corporation (let us say, half of all the shares plus one share). As different from usual financial markets, the corporate control markets are controlled primarily through private benefits. At that, when studying mechanisms of market change of the owner and control, the authors of the well known theoretical models (S. Grossman and O. Hart, A. Shlaifer and R. Vishny, D. Hirshlaifer and Sh. Titman and others) – it is usually assumed that many (all) participants of the said operations are capable of sufficiently precise foreseeing the economic results of such reorganization of the company which will then be undertaken by the new owner.

Among the most important functions of mergers and take overs are redistribution of production resources in favor of more efficient companies and it is usually a less efficient company that becomes the target for the respective take over. This hypothesis quite agrees with the available data on the relationship of the market value of the company to the restorative value of its real capital: value of the *Tobin q* ratio for the buyer – companies was, as a rule, much higher than that of the respective ratio for the target – corporations⁵¹. Favorable influence of mergers and take overs on the efficiency of acquired and reorganized enterprises is quite obviously demonstrated in the results of multiple investigations. Thus, for example, results of the analysis of over 20 thousand enterprises, belonging to 5 700 corporations of the USA, for a sufficiently long time period, shows that change of the owner was, as a rule, accompanied with raising economic efficiency, growth of the total productivity of factors included⁵². In a number of cases, interception of control over a corporation was followed with dismissal of the respective team of managers who were responsible for inefficient management of the company as well as with radical reorganization of its subsequent activities. The “non-horizontal” merges and take overs, *inter alia*, showed a more favorable effect than the “horizontal” ones.

According to a comparative analysis of potential goals and effects on the classical market of corporate control, these are significantly different from the contemporary practice of the Russian state companies. Although it does not yet seem possible to estimate even the middle term consequences of 2005 take overs, as from the efficiency and change of strategy viewpoint, it is nonetheless obvious that the target – companies, *firstly*, were not inferior to the “aggressor” as regards the level of efficiency and, *secondly*, – at least in case of horizontal take overs – showed the so called “primary” negative effect with regard to production indicators (thus, in 2005, both in “Yuganskneftegas” and in “Sibneft” registered was reduction of extraction and growth of production costs as compared against the year of 2004).

Expansion of the state companies – natural monopolies into other industries is in obvious contradiction to the earlier efforts to reduce their participation in non-profile businesses which but distract monies from investing in the major kinds of activity by exerting mediated pressure on the production costs and, indirectly, on the process of price formation on both the respective production and services.

So far, in all probability, only one formally common feature can be noted – that of changing the management team which is pretty typical for any respective model. At the same time, however, while changing management as a consequence in the classical case of merger or take over, is determined by the disciplining role of the corporate control market (sanctions for the previous failures of the top management), in the respective Russian

⁵¹ Andrade G., Mitchell M., Stafford E. *New Evidence and Perspectives on Mergers*. – Journal of Economic Perspectives, 2001, Vol. 15, May.

⁵² Lichtenberg F. *Corporate Takeovers and Productivity*. MIT Press, 1992.

practice, of priority is the task of intercepting control over the financial flows. Certain similar trends can be found in the cases when merges and take overs were used not so much for intercepting the corporate control but rather for using the advantages of uniting the respective capitals or withdrawing shares of some companies from the market turnover.

It is also noteworthy that regular operations, as connected with merges and take overs, suppose a rather high (nowadays comparatively rare) development level of the corporate control markets. As well demonstrated by the practical experience of the countries of the Western Europe and Japan, the corporate control market is capable of fully exercising the functions of decentralized efficiency regulation only in case when it rests mainly on the developed infrastructure of market relationships in general and on sufficiently distinctly defined rights of property, efficient enforcement of contract and property rights and efficient procedures of bankruptcy in particular. Finally, it is almost impossible to make comparisons between the world and Russian (where interventions by the state companies are concerned) practice of applying methods of protection from hostile take overs. That they can not work against the administrative resource, named as “the state”, seems to be quite obvious.

One more matter of principal significance – aggravation of the conflict of interests when the state plays simultaneously as the legislator, the regulator and an active independent player (through the respective state companies and banks) on the corporate control market.

Further perspectives for development of the companies with the state participation which became the “main body” of the state expansion in 2005, will be determined, their *abilities for paying off the credits taken* included, depending on the situation as regards the world prices on the energy carriers. In 2000–2005, foreign debt of the Russian state companies increased many times over (2000 – 570 mln USD, 2002 – 12 bln USD, 2005–28 bln USD)⁵³ which makes it quite comparable to the debt to the Paris Club. The above described plans of take overs in the 2006–2007 period can easily lead to doubling this amount.

The most pessimistic forecast is based on the significant price decrease for the energy carriers which, to a considerable degree, determine business of the largest state companies – borrowers. The falling oil prices will result in reduction of access to the financial resources on the external markets used to refinance the indebtedness accumulated and hence the price of servicing the attracted credits will go up indeed. This situation is most probably fraught with outflow of short term foreign capital, falling stock market and hard problems in the banking system closely connected with reduction of liquidity⁵⁴. From the viewpoint of the RF ministry of finance, the state has to have certain responsibility for the activities of such companies by working out unifies approaches to both external and internal loans made by the respective state companies. Foreign loans should not be banned in principle indeed, yet they must be limited quantitatively and, wherever possible, replaced with borrowings on the internal financial market⁵⁵. Since the question of attracting the borrowed funds is closely connected with proportions in distributing net company profits (dividend payments to shareholders, the state included), a package of the respective documents is being prepared for setting up a unified system of borrowings and a unified

⁵³ Estimation made by the “Trust” investment bank. – *Vedomosti*, 2005, December 9.

⁵⁴ Interview with E.T. Gaidar. – *Expert*, 2006, 2006, No. 3, p. 6.

⁵⁵ RIA “Novosti”, December 8, 2005.

dividend policy⁵⁶. To what extent such unification of the said processes is possible in principle and how “favorites” of the state property expansion can be fit in it will be shown only by time.

Besides, administratively limited access of the state companies to foreign sources of the debt financing can hardly be considered as an effective anti inflationary mechanism (as was intended by the RF ministry of finance) – rather, probable growth of stakes on the internal debt market will be stimulating an outlet for the private companies to get to the foreign markets in search of “cheaper” and “longer” loans. Solution of the problem of foreign borrowings by the state holdings should rather be sought in another plane – determining their place in the system of state priorities, transparency of the respective financial flows, efficient management of the profile assets.

Both the scope and the nature of direct state participation in the national economy, the more so if the “private rent” variant is taken as viable, exert direct influence on the state of affairs in the sphere of *guarantees and protection of property rights*.

It is just the state, being the initiator of the property expansion, that become most interested in the absence of distinct rules of the game in the sphere of the property relations. A comparative analogy seems to be quite expedient here with the second half of the 90s when certain interests of the subjects of the post privatization property redistribution process in the private sector accompanied with rapid growth of private corporate groups, were effectively preventing introduction of the adequate limiting norms in the sphere of corporate rights, bankruptcies, market of securities, optimization of the reorganization procedures, state owned enterprises and so on. In the middle of this new decade, they are steadily being replaced by the state companies and enterprises which mostly perform interventionist functions.

Simultaneously, there takes place obvious narrowing of possibilities for fully fledged implementation by a private owner of his basic rights – primarily, that of being in command (according to the “classical triad” terminology) or the right of alienation of all totality of other rights (in the terminology of the theory of property rights). The necessity of political authorizing any deals with such or other significant assets, the more so abroad, not only confirms the system-like character of the state’s interference in the sphere of market relationships but does devalue the very notion of private property in principle. Who will need property which, other things being equal, can not be sold by its owner without prior approval of the third persons and for the adequate price?

That the evolutionary history of private property forms means primarily drawing a division line between political power and property is common knowledge. Its contemporary forms first of all presume that belonging to the (supreme) power is no longer considered to be the necessary condition for practical implementing the rights of property. What can be observed in the contemporary Russia really is not too much in agreement with this given thesis. It is indeed only with an obvious share of conventionality that certain analogies could be drawn with the countries of the ancient Orient where power – property – “is not so much property but rather power since functions of the owner are mediated here by belonging to power...”⁵⁷ A constructive (in the context of the contemporary Russian practice) approach with regard to private property was, for instance, formulated by Shan Yan, the most well known Chinese lawyer (IV century B.C.) the main idea of which came down to the

⁵⁶ It is rather to be reminded in this connection that in 2005, “Rosimushestvo” guide lined the state representatives towards achieving the 10 % net profits transferred as dividends at that adding that higher indicators were to be expected for the future.

⁵⁷ Vasiliev L.S., *History of the Orient*. Moscow, 1998, Vol. 1, p. 69.

fact that a rich property owner is a force which is undermining the power of authority⁵⁸. Although the thesis on instability and protection of property rights in the contemporary Russia have in the recent years begun to sound more like populist rhetoric or even like a sort of a ritual incantation, the problem nevertheless does not become any less acute. In view of the contemporary state of the respective political institutions in Russia, expansion of the state sector in the format as described above, will rather conserve instability of the rights of property ownership for an indefinite term of time.

4.5. Corporate Management Reform: Unsteady Demand

Major objective forces behind the current wave of corporate reform that is gaining momentum in a number of countries is globalization, increased competition, changing nature and rapid growth in the number of shareholders, development of new industries, financial markets and advancement of technology. Unsurprisingly views on which reforms are needed and how best to approach their implementation vary significantly depending on the social status of reform authors. For instance, focus on the institution of Board of Directors is favored by reform activists in the Anglo-Saxon economies, strengthening the role of individual and institutional shareholders is a focus of those concerned with some of the damaging effects of globalization, introduction of tougher legislation for different “groups of industries” finds natural advocates in by judges and regulators in some countries of the Continental Europe. Cooperation between hired labor and the Board of Directors, guaranteeing the rights of shareholders as an absolute priority for economic growth and accompanying reform as well as free market forces’ dominance over inflexible government policies are just a few of the notions defended by practitioners of modern economic theory⁵⁹.

Various national and international codes of corporate practice that have emerged in the late 90’s are now gaining influence on the more traditional types of corporate legislation⁶⁰. Infamous scandals associated with Enron and other big corporations, investment banking and consulting firms in the United States, Germany, France, Italy, Sweden, Japan and South Korea have only added to the already present momentum for a change in the way corporations are run in the new millennium. Ability to transcend national boundaries and attract the attention of the OECD (which has published a review of “Principles of Corporate Management, 1999, new edition 2003), the European Union (which in 2001 has created a special task force dedicated to the subject and in 2003 developed a Plan of Actions) as well as special meetings of the “Big 8” (a privileged club of 8 largest industrialized countries) – all reflect the widening importance of the subject of corporate reform in the eyes of global community.

Corporate reform in Russia, like in other emerging market economies has undergone a certain evolution in the reform’s legal and regulatory base as well as in the attitude of various economic players to the subject⁶¹.

⁵⁸ *The Book of the Ruler of the Shan Region*. Transl. from Chinese by L.S. Perelomov, M., 1968.

⁵⁹ Hopt K. Modern Company Law Problems: A European Perspective. – In: *Company Law Reform in OECD Countries. A Comparative Outlook of Current Trends*. Stockholm, Sweden, 7–8 December 2000.

⁶⁰ Gregory H.J. *The globalization of corporate governance*, Weil, Gotshal and Manges LLP, 2001; Gregory H.J. *Comparative Matrix of Corporate Governance Codes Relevant to the European Union and its Member States*, Weil Gotshal and Manges LLP, 2002.

⁶¹ An overwhelming number of publications on this subject currently available in Russia and abroad make any singular references inadequate. Among others, an interested reader can consult the following works: T. Dolgolyatova., *Russian Manufacturing: Institutional Development.*, Moscow, 2002; Code of Corporate Behavior. *Corporate Behavior in Russia.*, Moscow, Economics, 2003; Radygin, Entov, etc. *Economic and Legal Factors and Limitations in Economic Model Formation*, Moscow, IET, 2004; *Transitional Economics. Abstracts on Economic Policy of Post-Communist Russia, 1998-2002*. Moscow, Delo, 2003 chapters 12–13, p. 441–522; Radygin A., Shmeleva N. *Main Corporate Governance Mechanisms and Their Specific*

In the 90's *foreign institutional investors* were virtually the only sources expressing interest in the subject of corporate management in Russia (very much like their colleagues a decade earlier were the lone voices for corporate reform in the United States). Since 2000, however, large Russian companies, created either from scratch or through privatization, took over the leadership on the subject of corporate management. Their active involvement in the matter has spawned an entire corporate management industry, complete with Russian subsidiaries of multinational finance and consulting companies, rating agencies, shareholder interest associations, etc. In spite of a recent slump in the number of Russian corporate initiatives, the Russian corporate management industry has developed enough to support a number of dedicated research centers, legal and consulting firms.

Government agencies, on the other hand, have been either overtly deterring positive changes on a company level by sending out investor-unfriendly signals (an occurrence that has become quite typical for this decade); or chronically slugging in addressing some of the most egregious concerns of corporate management, as demonstrated by virtually all amendments and procedural changes to the Law on Joint Ventures made after 2000. Modern corporate Russian history in general has demonstrated a very strong correlation between interests of certain groups and government's level of involvement in the matter. At the same time, topic of corporate management retains its importance as one of the very few areas to which the government can point at as a display of its concern for institutional reform.

A certain evolution of the corporate management theme is also evident in the specialized, academic literature on the subject. First research papers on corporate management in emerging economies were published at the end of first mass privatization schemes. In that period, the idea of corporate management was regarded as an important but not a key component of the enterprise reform. By the end of the 90's and beginning of 2000's, the situation has changed and the theme of corporate management becomes a priority in the list of further transitional reforms. This shift in focus also coincides with realization that many of the economic models being formed in various not only transitional economies were exhibiting serious shortcomings, even if their governments followed textbook privatization recipes deemed flawless at the time.

By the middle of the first decade in 2000's the discussion shifts from a general prescription of measures for a successful transition to the identification and attempts for understanding the reasons behind the most odious fiascos of the transitional process. Numerous empirical studies of corporate management, its various forms and its relation to the general enterprise reform that have been written since then have not, unfortunately, narrowed down the impractically wide array of subtopics reviewed under the umbrella of corporate management⁶². On the contrary, last few years have seen a number of research projects and papers published with the term "corporate management" in the title line but in reality having very little to do with the subject. Often the term itself is substituted with other notions of "corporate structure", "corporate law" or "restructuring", etc, while a whole array of truly relevant and specialized topics of corporate management were often left outside of the scope of academic research.

Features in Russia. – In: The Economics of Russian Transition. Ed. by Y.Gaidar. Foreword by S. Fischer. The MIT Press, Cambridge, Massachusetts, 2003, Ch.15, pp. 461–510.

⁶² In particular, empirical studies on Russia notable for their scope were carried out in 2000-2004 by the Bureau of Economic Analysis (BEA), Russian Institute of Directors (RID), Institute for Economies in Transition, (IET)), Russian Economic Barometer (REB) International Finance Corporation (IFC), High School for Economics (HSE), World Bank, Center for Economic and Financial Research (CEFIR) etc.

A true step forward has occurred only in first years of 2000's when the issues of corporate management have started to present interest to Russia's largest companies formed as a result of inter- and intra-industry mergers, acquisitions and other forms of venture capital concentration and expansion in the country as well as abroad – a process that characterized the Russia's corporate development in the 2000.

In the first half of the current decade, a number of large Russian companies, such as Yukos, LUKoil, Vimm-Bill-Dann, AFK "Systema", Norilsk Nickel, SUAL, a large metallurgical concern from Magnitogorsk have all disclosed information on their beneficiary shareholders. More Russian companies have started placing independent directors, often foreigners, on their boards. Yukos, for instance, was the first Russian company to have a majority of independent directors on its board, while a Russian Joint Venture "United Machine-Building Plants" was the first Russian company to have its board majority to be made up of independent foreign directors. In the period from 2000–2005 some Russian companies have even paid out considerable dividends to their shareholders, though seldom did such generosity signify any true improvement in a firm's corporate practices. Among other such pioneers, LUKoil became the first Russian company to disclose its dividend policy, Norilsk Nickel was the first company to disclose amounts paid to each of its Board's members, while RAO UES was the first company to introduce share-dealing rules for its top management and members of its board⁶³.

The new millennium has also ushered in significant changes to the decision-making process at Russian companies. In the 90's virtually all corporate decisions were made on a "limited partnership" principle, i.e. within a close circle of actual partners-owners, without any concern for interests of minority shareholders. The gradual arrival of truly "outside" business participants, often foreign shareholders with 3–4% stakes, has paved a way for a different, more "corporate" method for making decisions that showed more consideration for views of minority shareholders. Curiously enough, these "outsiders" were evidently brought in by founding partners' initiative and not forced on them by mass privatization or interim re-structuring. In that sense, one could claim an emergence of a new type of outside influence in the Russian corporate system and with that a tendency for a modification of that system from its "oligarchic" principles to the norms more reminiscent of "public" corporation⁶⁴.

In light of these optimistic observations one would expect a real demand for ideas on how to further change and improve the corporate culture in Russia. In practice, however, the companies' perception of any innovations in that sphere sets certain limits to further reform.

First of all, level of transparency and types of goals pursued in the process of corporate management reform depend very much on a company's stage in business development. Ideas for a set of corporate behavior standards, in addition, would naturally be tied to a company's long-term strategy, its intentions (if any) to expand internationally, and/or re-structuring needs.

⁶³ For instance, please see V. Golikov, M. Burmistrova, Survey of Corporate Management Trends in Russia, Round Table, "Corporate Management in Russia", Moscow, October 2–3, 2003.

⁶⁴ This relatively new process is present at about a third of 20 largest Russian extraction companies (excluding state-owned firms). Its substance is a gradual expansion of the equity base by selling a part of shares on the open market by the largest shareholders ("partners", "oligarchs". In doing so, they are driven by various motives, which often appear being far from attraction of investment. legalization of the stock (shares) that remain under their control; a double financial effect from the sales – direct gains from placement and compensation in cash equivalent that appears due to a considerable rise of the company capitalization; enhancement of transparency of the revenue part of the company's budget (a relatively risky carrying out of "gray" and other optimization schemes becomes senseless, because of the growth in the number of outsider shareholders who can pretend for additional benefits without bearing any risks.

Secondly, one has to mention a distinct qualitative gap between those Russian companies who have adopted methods of modern corporate management and those who still have a very vague idea on what the subject entails. At the start of 2000's as various polling data suggests, management of a majority of "typical" Russian companies (80–90%) had a very blurred perception of advantages and standards of efficient corporate practices. By the mid decade, though awareness on the subject has increased considerably, readiness to put this knowledge into practice has not. Interestingly, knowledge of modern corporate practices was highest among Russia's larger companies. Thus, as early as in 2002, according to RID polls, more than a third of 200 largest Russian companies have claimed to have been very familiar with details of the Code of Corporate Behavior. Within this "informed" group of companies there was however a noticeable rift between companies (a minority) that have actually incorporated the Code's practices into use and those who have not.

Data from the polls conducted annually by Standard & Poor among Russia's largest companies reveal that when it comes to financial transparency and disclosure, companies that were made "from scratch", i.e. not from privatization and companies that raise public funds abroad, and often listed on the US exchanges are the ones that come on top. Other factors such as ownership structure, chief executives' remuneration, investor relationship, capital concentration and internal transparency also play a role in determining company's forwardness and readiness to provide information about its finances and accept the corporate norms.

Optimistically enough, in 2006 average transparency rating for Russia's companies rose to 50% from 46% in 2004 and 40% in 2003. In 2002, 2 of the 42 largest Russian companies surveyed, have disclosed more than 70% of the information required, a level quite comparable with Western companies. For largest British companies, for instance, that figure for 2003 was 71%, while 10% was the number for 3 bottom companies on the British list. Russia's average disclosure ratings were comparable to their Latin American peers. In 2005, 6 leading companies on the Russian openness list have disclosed about 75% of the information, while the 6 bottom companies only 17%. Though some progress among the Russian "blue chip" companies is evident, Standard & Poor's survey does little to provide a general picture typical for most of the Russian companies. The survey's main limitation is that it covers only large companies whose shares form about 90% of capitalization on the Russian exchanges. The survey's target audience, i.e. Western institutional investors inadvertently serve as yet another constrain inherent in most all polls of that nature⁶⁵.

Another factor curbing the apparent optimistic numbers sited above, is that very often paper progress is far from reality on the ground. For now most of the changes for the better are strictly of a quantitative nature, in other words, more of disclosed information, higher number of independent directors (in most cases done under pressure to comply with new listing rules on local exchanges). Qualitative improvements, on the other hand, such as minimizing risks for violation of rights of minority shareholders, streamlining the executive, fair and efficient dividend policy, internal control, beneficiary proprietors, etc are yet to exhibit any significant progress. To a certain extent, one could blame Russian companies' preference for debt over shareholder financing, as creditors tend to value

⁶⁵ For instance, the annual rating of corporate management at publicly-traded oil and gas companies (Energy Intelligence, CLJA), which is based on the following criteria: number of directors, separation of powers between chairman of the board and the CEO, independent directors, shares held by directors, independent audit, remuneration and promotion committees, board members selection process and term limits. As the survey's authors aptly note, "there are poorly-run companies that score high on all six criteria and there are excellently-run companies who do not". Enron, for instance received a rating of 81.8% in 2001 and was the top company according the survey's criteria (Vedomosti, 2004, January 16).

transparency in financial reporting over protection of minority shareholder rights⁶⁶. Enterprises with partial government ownership face a host of other challenges on a road to efficient corporate management.

Here it also has to be noted that a success of free market development is closely tied to the scope of information made available through decentralized independent channels⁶⁷. In other words, the more developed the market is the wider and more reliable is the regular information provided by a company to the public.

Though Russian corporate legislation, in spite of some serious shortcomings, can overall be described as fairly developed. Legislative innovations alone however will not improve the way corporations are run. Good initiatives within companies that serve as a foundation of an efficient corporate culture are equally important. Though building a corporate culture is a lengthy historical process, individual innovations and changes within a particular company can happen once certain environment is in place. In Russia it is a lack of this environment and instead a different set of its “peculiar” conditions, such as a high ownership concentration, fusion (and confusion) of principle/agent roles, self-financing, corrupt and inefficient boards, lack of any competent and meaningful oversight mechanisms, supposedly “public” companies that in practice are impenetrable to outside influence – all prevent true and beneficial innovations from taking place.

Finally, general protection of property rights and the ambivalent nature of signals on the subject coming out from the Russian government also play a role. The infamous Yukos affair of 2003–2005 played a major detrimental role in “freezing” any further progress on increasing transparency and building efficient corporate culture for all large Russian companies.

In conclusion, one could identify three stages of formation of Russian “standards” of corporate management: 1) the so-called “wild” period in early 90’s; 2) the somewhat “progressive” period when at least some formal improvements in corporate management were taking place in early 2000’s; 3) a certain “freeze” period starting in the middle of this decade when progress on corporate reform is being stalled. This latter period is particularly evident at Russia’s largest companies. Though most of qualitative changes in areas such as transparency levels, beneficiary shareholders, financial disclosure were influenced primarily by certain political dynamics, other objective factors such as creation within companies of adequate infrastructures (internal company codes, board charters, etc) that lay some basic rules for that company’s actions. Large private Russian companies proved adept at using this new framework and have in 2005 authored a number of internal corporate initiatives, a phenomenon certainly very much tied to an increase in the number of Russian IPOs. Unfortunately to expect that further qualitative improvements of corporate management would be more than cosmetic touch-ups, given the current environment is a bit too optimistic. The change will certainly have to be prompted by a combination of powerful political and financial motivations. A certain “inertia” demand is now being voiced only by smaller companies, which are just now getting ready to make their own foray into financial markets abroad.

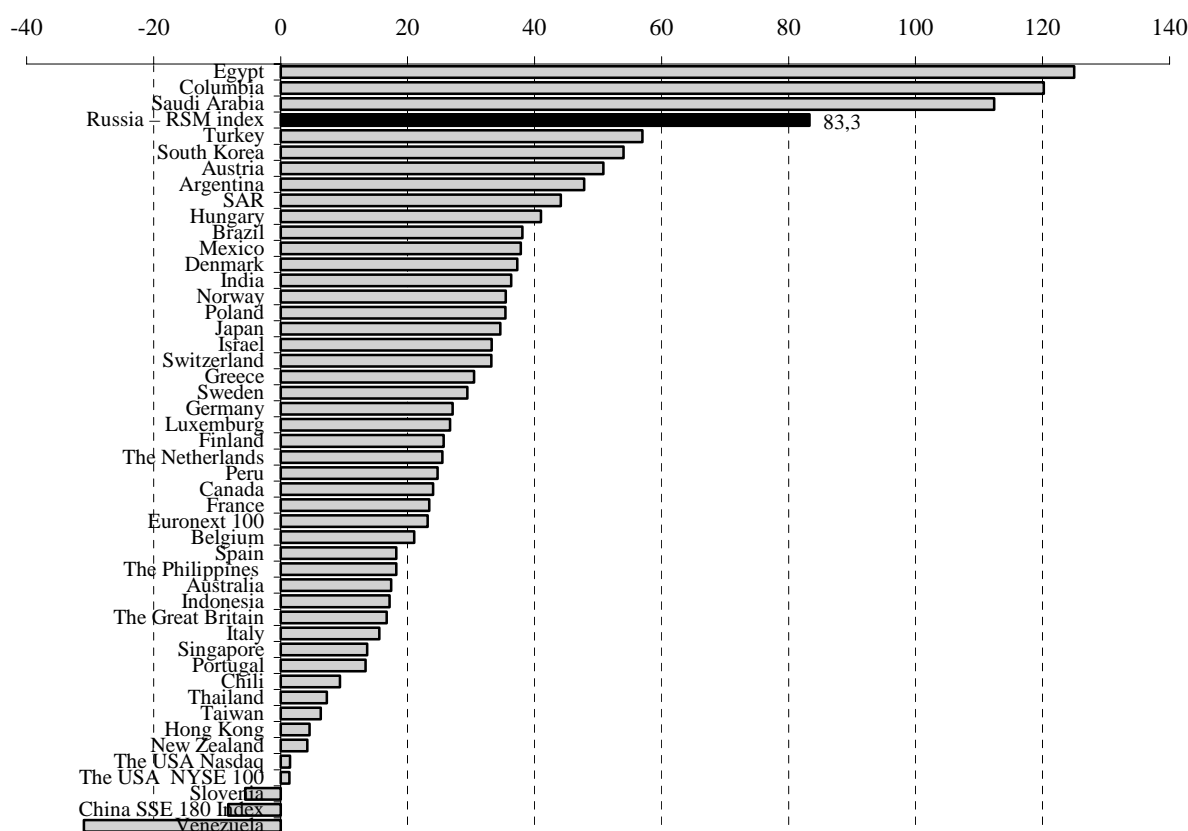
⁶⁶ Please see: V. Bashun, S. Gorbovzov, *Waiting for Demand – Expert*, 2005, issue 12, p. 52 and *National Rating of Corporate Management*, RID Consortium (www.rid.ru, www.raexpert.ru).

⁶⁷ Acemoglu D., Zilibotti F. *Information Accumulation in Development*. – *Journal of Economic Growth*, 1999, Vol. 4, Issue 1, March, pp. 5ff.

4.6. Russian Stock Market in 2005: Success or “Soap Bubble” Growth?

Indicators of the Russian stock market (RSM)⁶⁸ in 2005 cause but quite opposite feelings. Its irrepressible growth in the context of slower growth rates in the national economy, its much greater raw materials orientation, nationalization of the largest companies and ever increasing RSM dependence on the liquidity factor on the global financial markets make one get thinking about the possible risks of the said “Soap Bubble”.

As different from the situation in the 2004 period, during which the RSE index practically did not change, the RSM in 2005 became of the world leaders in profitability of investments in shares (see Fig. 1).



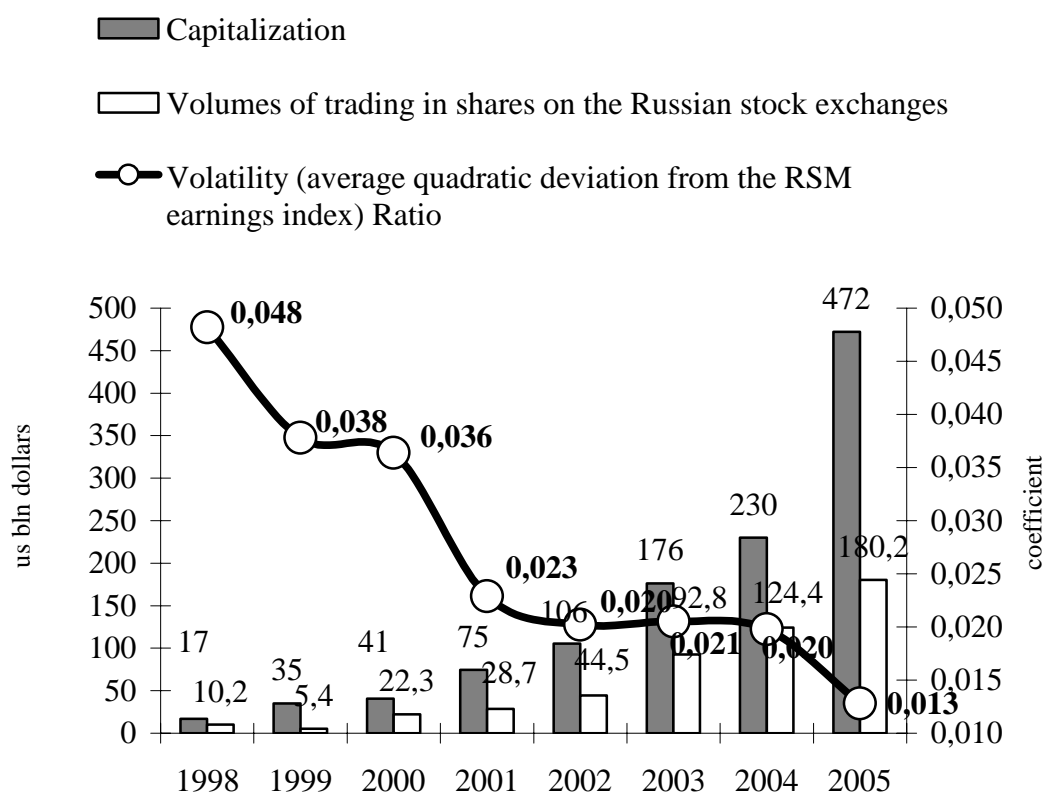
Source: according to the data of the World Federation of Stock Exchanges and the “Economist” magazine.

Fig. 1. Growth of Stock Indices (% , December 2005 to December 2004)

On December 30, 2005, the RSE index increased by 83.3 % as compared against the respective values for the end 2004. Somewhat higher were the results but for the stock indices of the Saudi Arabia, Columbia and Egypt.

High profitability level of the Russian market of securities (shares) was accompanied with obvious improvements in its qualitative parameters – liquidity, volatility and capitalization of companies as shown in Fig. 2.

⁶⁸ The Russian Stock Market (hereinafter called as “RSM”) is understood here as the stock market for emissive securities liabilities for which are denominated in Russian roubles.



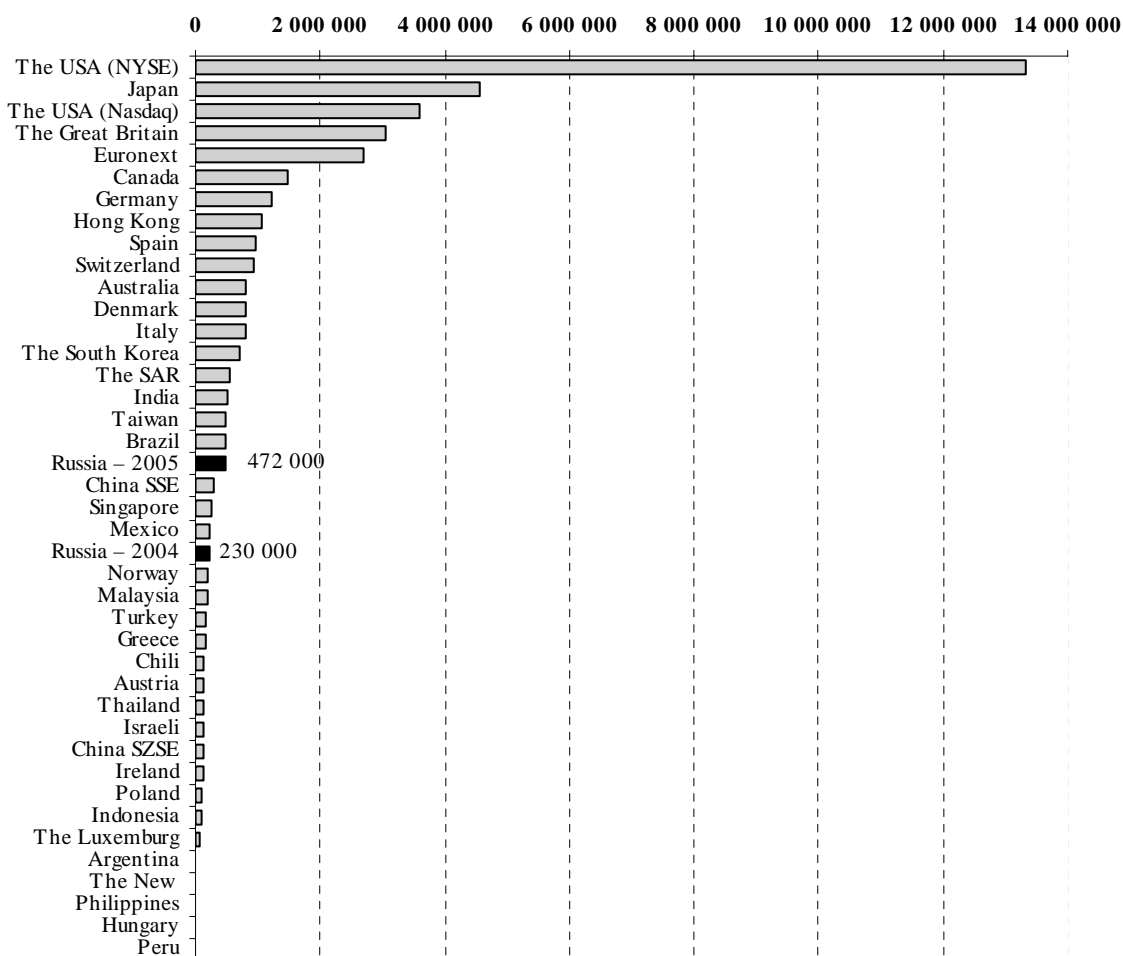
Source: according to the data of the RBC and the Russian stock exchanges.

Fig. 2. Capitalization, Liquidity and Volatility of the Russian Market of Share

In 2005, capitalization of the Russian companies grew from 230 up to 472 bln US dollars or 2.1 times; volume of the stock exchange trading in shares on the MICSE, RSE and the “Saint Petersburg” stock exchanges increased from 124.4 up to 180.2 bln US dollars or 1.5 times. The indicator of the daily average quadratic deviation of the RSE index, as characterizing the “blue chips” price volatility, in 2005, comprised 0.013 as against 0.020 in 2004, which means lesser risks for investing in investing in shares by 35 %. High profitability, moderate risks and availability of the investment ratings make the said RSM sufficiently attractive for all categories of investors.

Fig. 3 and 4 show the RSM capitalization and liquidity as compared against similar parameters demonstrated by the respective foreign stock markets in the year of 2005.

In 2005, the RSM outstripped the stock markets of China, Singapore, Mexico, Norway, Argentina, Chili and Turkey in the absolute level of capitalization. However, the RSM lagging in capitalization from the developed markets of capital still remains practically quite huge and will hardly be overcome in any feasible future. A somewhat more realistic development aim of the RSM in the nearest years could be an attempt to catch up in capitalization with the respective markets of Brazil, Taiwan, India, the South Africa and the South Korea.



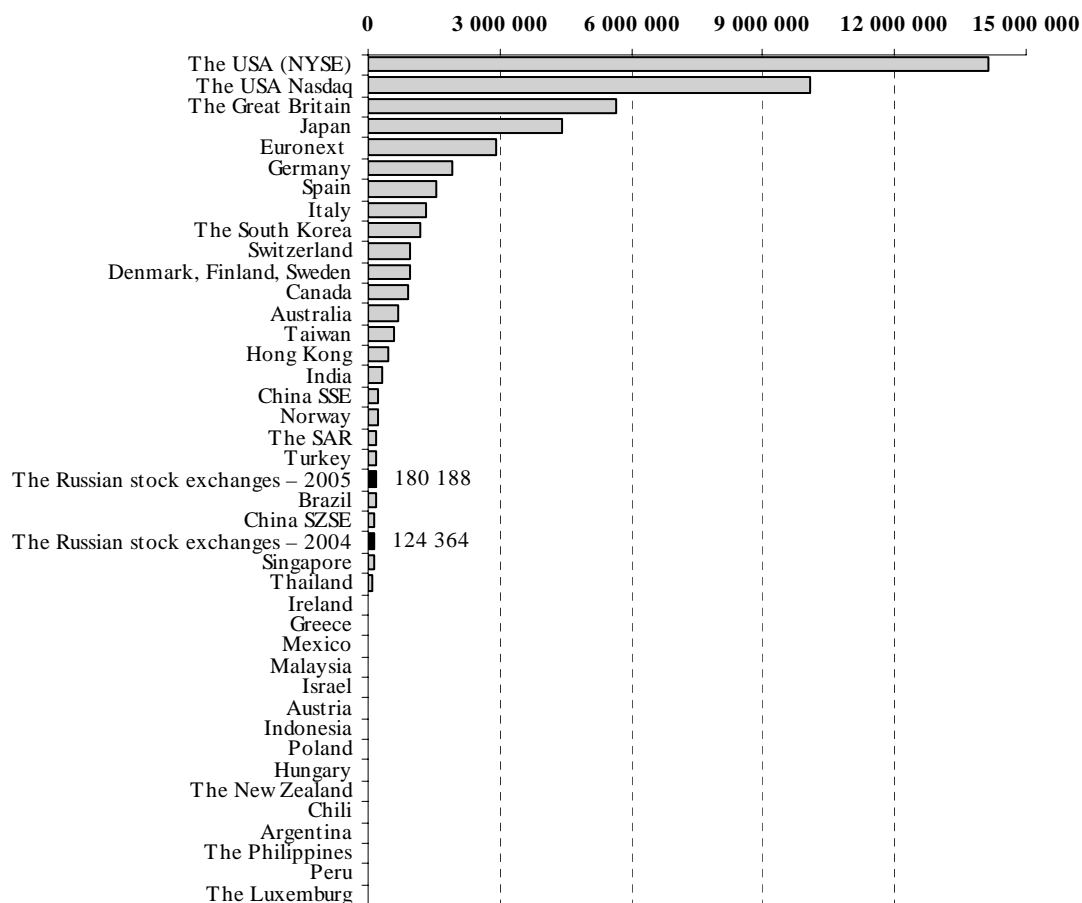
Source: according to the data of the World Federation of Stock Exchanges.

Fig. 3. Capitalization of Companies, bln US dollars

As regards liquidity of shares in 2005, the Russian stock exchanges manifested somewhat higher results as compared against the respective stock markets of Brazil, Mexico, Chili, Argentina, Singapore, Thailand, Malaysia and Indonesia. However, similar to the indicator of capitalization, the RSM lags behind not only the developed capital markets but from a number of developing markets as well – the South Korea, Taiwan, India, China, the South Africa and Turkey. On the whole, according to the data in Fig. 3 and 4, despite all the records of 2005, the RSM still remain somewhere in the middle when viewed in the context of the largest developing capital markets. This also means its greater role in developing the respective behavioral factors of the global investors as well as the state of the global markets of capital, primarily that of the American one.

As the positive trend of 2005 we can take obvious strengthening of the RSM positions on the global market of shares and the depositary receipts by the Russian issuers which fact is graphically reflected in Fig. 5. The London Stock Exchange share in the overall volume of trading in shares and the depositary receipts by the Russian joint stock societies went down from 74.0 % in 2004 to 45.9 % in 2005; the share of the MICE stock exchange in the same period went up from 21.0 % to 40.6 %; the sum total share of the RSE and “Saint Petersburg” stock exchanges – from 2.1 % to 10.0 %. It is quite noteworthy that de-

spite the leading positions in the market liquidity sphere of the MICE group's shares, the year of 2005 showed a trend towards somewhat lesser lagging behind such within this RSM segment of the RSE group of companies including the "Saint Petersburg" stock exchange.



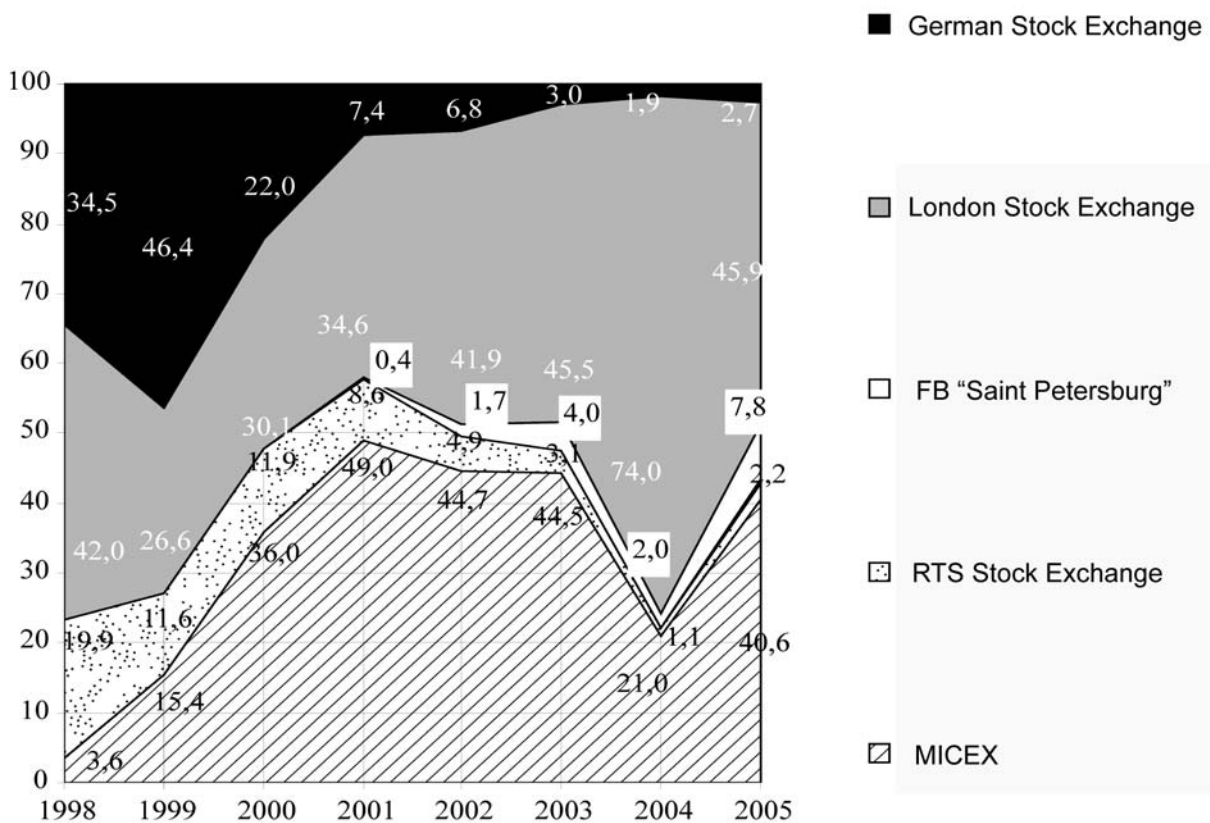
Source: according to the data of the World Federation of Stock Exchanges.

Fig. 4. Volume of Stock Trading in Shares, mln US dollars

The changing balance of forces between stock exchanges in 2005 was caused not only by the growth of volumes in the stock trading on the RSM from 124.4 bln US dollars to 180.2 bln US dollars (i.e. 1.5 times) but even more due to a considerably greater fall in the volumes of trading in the depositary receipts for shares of the Russian joint stock societies on the London Stock Exchange from 381.3 bln US dollars to 161.2 bln US dollars or 2.4 times. This, in our opinion, is indeed connected with the fact that although part of the respective global investors did reorient their operations to the internal RSM in 2005, the other part of much more conservative investors cut down significantly operations with share instruments of the Russian issuers having actually not recovered after the shock as connected with the "Yukos" affair.

The 2005 period saw a rather intensive growth of the internal bond market. The overall volume of the rouble bonds circulating on the RSM, including the respective federal security, as well as corporate and regional bonds grew from 1.1 trillion roubles in 2004 up to 1.5 trillion roubles in 2005, or almost by a third. The volume of the rouble bonds floatation,

as is graphically shown in Fig. 6, exceeded the maxima for the State Short Term Obligations in the middle of 1990s.

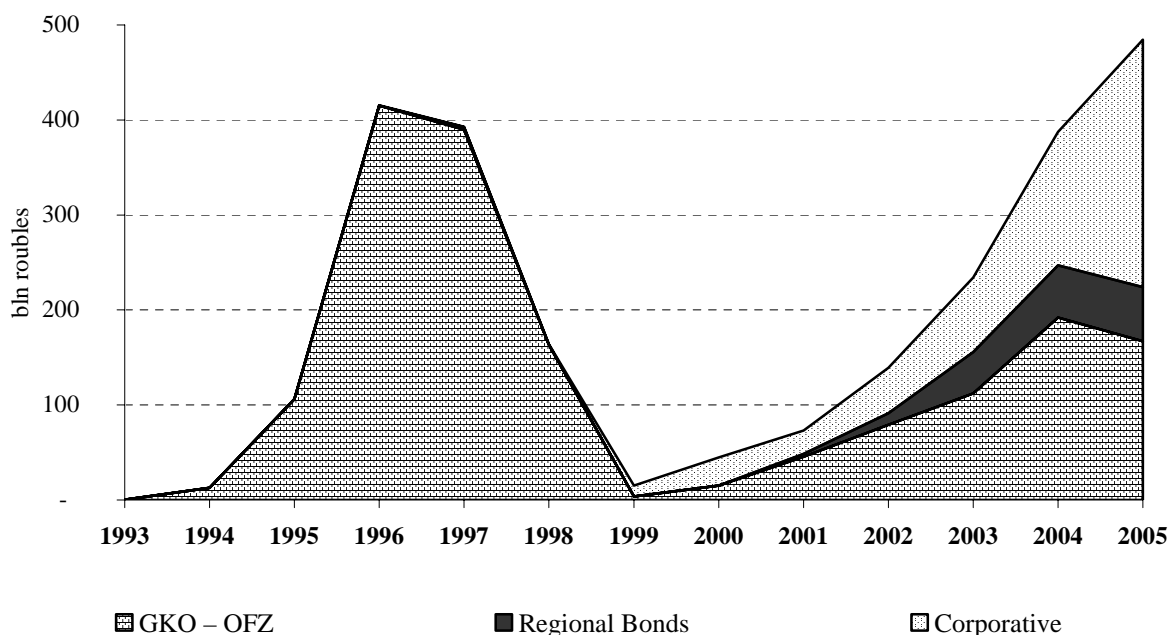


Source: according to the data of stock exchanges (without the NYSE).

Fig. 5. Relative Weight of Stock Exchanges in volumes of trading in shares of the Russian Joint Stock Societies

The moving force for the growth of the bond market emissions get implemented in the shape of corporate bonds whose floatation volume increased from 140.4 bln roubles in 2004 to 260.6 bln roubles in 2005 (or 1.9 times). Under conditions of negative real profitability of the most large and liquid issues of the corporate bonds, the major investors on the given market are banks and non residents as possessing possibilities for using different speculator strategies to compensate for the losses from somewhat "passive" ownership of such bonds.

At the same time, the emission volume of the regional bonds which comprised 56.8 bln roubles in 2005, did not practically increase as compared against 2004. The cost of OFZ floating in 2005 reached 167.2 bln roubles having thus decreased by 24.8 bln roubles or by 12.9 % as compared against the preceding year. Availability of the stable profits base of both the federal and regional budgets serves to lower the respective interest of different level power bodies with regard to financing expenditures through involving the respective borrowed funds. Such a trend is expected to continue in 2006 as well.



Source: according to the data of the RF Ministry of Finance, CBonds and stock exchanges.

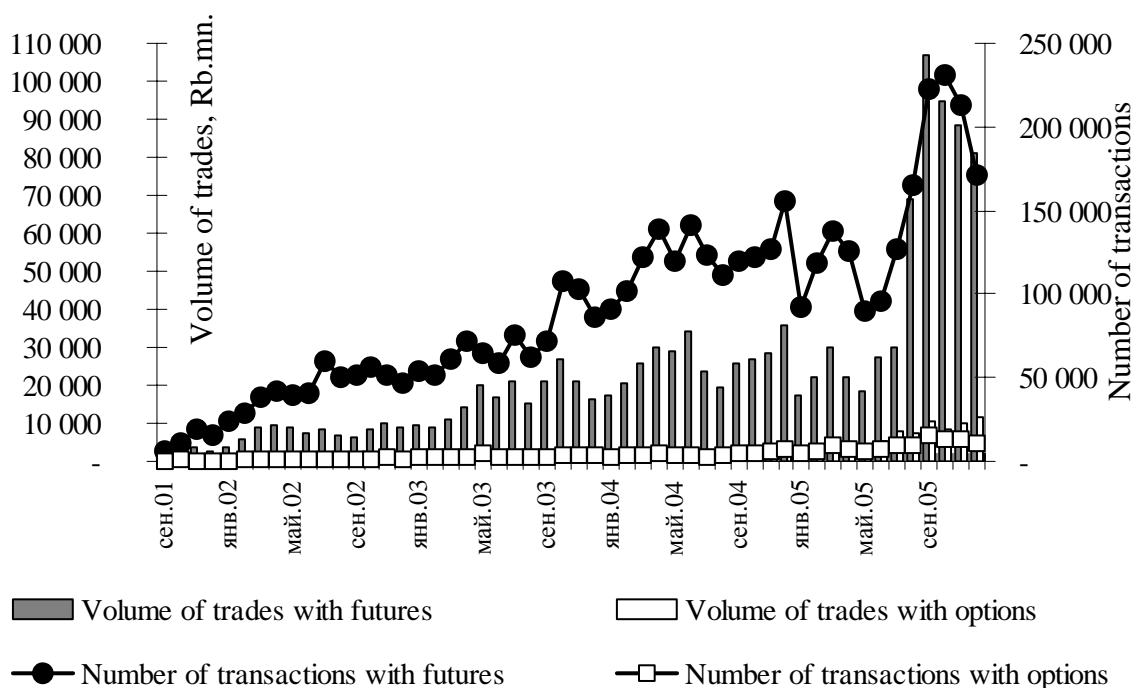
Fig. 6. Volumes of the bond floatation on the RSM

An important event on the RSM in 2005 was accelerated development of the time-termed market. After its crash in Russia in 1998, when the Western investors suffered billions worth of losses in fixed-termed contracts, any hopes for the restoration of the market of the derivative financial instruments in our country seemed to be quite illusory. However, the 2005 events did disprove such doubts which fact is further witnessed in the data presented in Fig. 7.

In 2005, the volumes of the stock exchange trading in Russia comprised: futures contracts – 21.5 bln US dollars and options – 2.8 bln US dollars. This sharp increase in the volumes of trading on the RSE fixed-termed market in the second half of 2005 was determined by appearance of new financial instruments – fixed-termed contracts for the RSE index and the portfolio of bonds of the city of Moscow playing, in the absence of the liquid market of the state bonds in Russia, the role of the sample securities with minimum risk for the RSM. The said financial instruments became particularly attractive for different categories of portfolio investors who are interested in investing in the “sample” RSM instruments.

Factors which actually determined growth of the Russian fix-termed market, are to a considerable extent similar to the circumstances resulting in the appearance of the stock fix-termed market in the USA in the middle 1970s which were then mentioned in the Nobel lecture of R. Merton⁶⁹. Lower volatility of the finance assets spot-market makes investors and in-betweens start using finance instruments with a wider choice of the range of risks. At the same time, however, growth of the portfolio investors does increase the topicality of the respective derivative financial instruments helping to raise the degree of the market forecast ability, to lower the operational costs of investors and to practically implement the hedging of financial risks strategy.

⁶⁹ Merton, R.K. Supplements to the Estimation Theory of Options: Twenty Years Later. Nobel Lecture. December 9, 1997 – The World Economic Thought. *Through the Prism of Ages*. T.N. book 2. — M.: Mysl, 2005. — pp. 207–209.



Source: according to the data of the “Russian Trading Systems” Stock Exchange” OJSS.

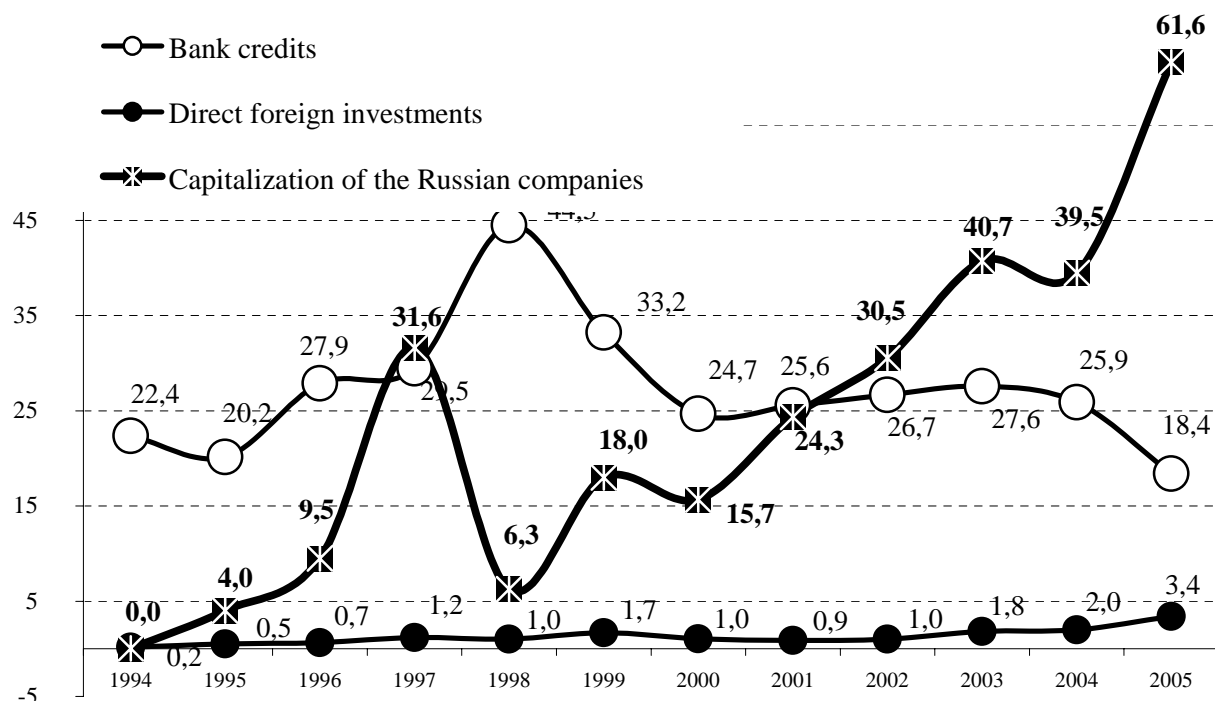
Fig. 7. Volumes of Trading and Quantity of Deals on the OJSS RSE Fixed-Termed Market from 1.09.2001 to 1.01.2006

Thus, in 2005, practically all the RSM segments manifested accelerated cost growth of the finance assets, denominated in roubles, which significantly outstripped the growth rates of the national economy, earnings of the population and other macroeconomic indicators.

At the same time, however, the RSM growth in 2005 brought about a whole number of questions and problems.

1. *Disproportion in the development of RSM and the banking system.* In 2005, quite obvious became certain inconsistency between efficacy and the development level of the national banking system, on the one hand, and the development scale of the economy of Russia and the requirements level of the largest companies in the borrowed funds, on the other. Growth of the companies’ capitalization factor does reflect growth of their requirements in investments and the respective borrowed funds. However, the Russian banks turned out to be rather unable to satisfy the growing investment requirements of Russian companies.

Fig. 8 contains data on the share of internal banking credits, capitalization and direct foreign investments (DFI) in the GDP of Russia.



Source: according to data of the CBR, Rosstat, the World Bank and the UNCTAD.

Fig. 8. Relative Weight of Banking Credits, Direct Foreign Investments and Capitalization of Companies in the GDP of Russia, %

The capitalization share of companies in the 2005 GDP increased up to 61.5 % as compared against 39.5 % in the preceding year. In the same period (year) Russia became one of the world leaders in direct foreign investments which, according to the estimations of UNCTAD, comprised 26.1 bln US dollars, having thus doubled as compared against the year of 2004. In this context, the yearly share of internal credit in the GDP went down from 25.9 % to 18.4 % of the GDP⁷⁰. Disparities between the indicators of capitalization and internal credits show significant disproportions between the development level of the banking system and growth of the respective Russian companies.

Fig. 8 contains the data on the share of internal banking credits, capitalization and direct foreign investments (DFI) in the GDP of Russia.

A significant factor explaining the low efficiency of banking activities in Russia is the lack of the refinancing of banks mechanism which stimulates issuance of credits to business. Though such a conclusion may seem somewhat strange in the context of the statistical data, as shown in Table 6 below.

⁷⁰ This indicator reflects banking credits to different sectors of economy, including credits to the state management bodies, non-finance organizations, the population and other finance institutions. Decrease in this indicator in the year of 2005 was determined by the fact that under conditions of the growing Stabilization Fund of Russia, the respective state governing bodies changed their status from the net – debtors to the net – creditors of the banking system which, nevertheless, did not result in any additional growth of crediting in other sectors of the national economy.

Table 6

Volume of Crediting Operations by the Bank of Russia, bln roubles

	2004	2005	Прирост, %
Intraday credits	3 051,9	6 014,0	97,1
Overnight credits	30,3	30,8	1,7
Pawn-shop credits	4,5	1,4	-70,1
Credits in the "direct REPO" form	594,2	1 495,7	151,7

Source: according to the CBR data.

The crediting volumes of banks by the Bank of Russia in 2005 reached 7500 bln roubles. Yet, the intra day credits as well as the overnight (for one day) credits which, in 2005, comprised 6014.0 bln roubles and 30.8 bln roubles, respectively, can hardly be referred to the mechanisms of refinancing banks engaged in crediting business owing primarily to their short term and issuance with no due security. However, refinancing the banks in the form of pawn-shop credits and direct REPO assumes issuing of credits for the term from one to several days which prevents their calling as instruments of refinancing the banking activity as such. Giving credits to banks in the form of direct REPO and the pawn-shop credits is implemented on the security of the respective state securities and bonds of somewhat larger issuers which, in its turn, does stimulate primarily bank speculations with the above mentioned securities but not the activities in long-term crediting of business.

The most efficient mechanism of the bank refinancing seems to be the Central Bank's stock-taking of the respective bills of exchange issued by companies when formally executing the credits being received by them. Owing to their rather insignificant volumes, such operations, even through they were executed in 2005, are not disclosed by the Bank of Russia. Meanwhile, crediting is quite capable of bringing additional profits to banks due to the latter's being much better informed on the real situation with regard to their clients. When acquiring bond, the bank inevitably loses part of its incomes since the public nature of disclosing the relevant information with regard to their issuers and securities brings up the problem of the so called "free rider" thus lowering the expected return from the credit resources involved. A moderate profitability level of the banking business at the level of 20 % which actually obstructs attraction of long-term investment resources to the respective banks is the result of excessive involvement of such banks in speculations with securities as well as with foreign currencies to the detriment of the credit activities.

2. Growth of Russian Companies' Foreign Debt. Weakness of Russian banks compels business companies to come to the aid of more active attraction of the borrowed funds abroad, primarily in the form of credits and issues of securities which resulted in significant changes in the foreign debt of Russia and the respective Russian companies in the year of 2005 (see *Fig. 9*, below).

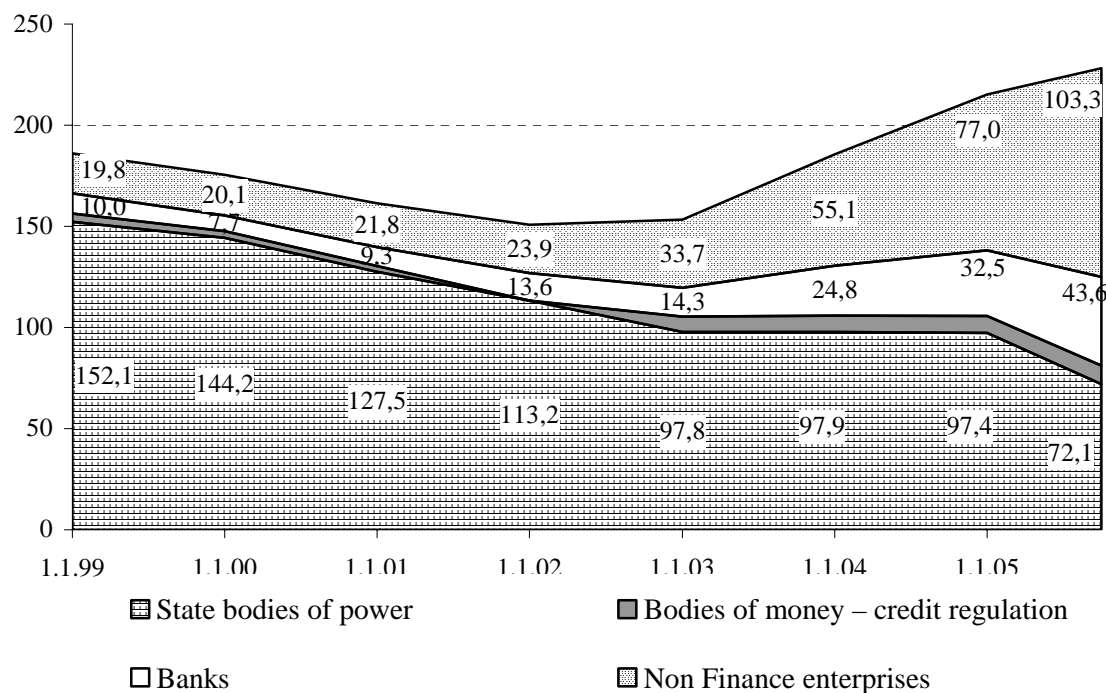


Fig. 9. Foreign Debt of the Russian Federation in 1999–2005, bln US dollars

In 2005, foreign indebtedness of the respective non finance companies and commercial banks comprised 103.3 bln US dollars and 43.6 bln US dollars, respectively. Then, within the year period, the debt of the non finance companies increased by 34.2 % and that of the banks – by 34.1 %. The sum total foreign debt of the respective banks and companies two (2) times exceeded the debt of the respective state control bodies.

Outstripping growth of foreign indebtedness of the respective non state organizations is not anything like a negative trend in itself representing but one of the consequences of a high investment activity level of business under conditions of the weak national banking system. At the same time, however, stronger market position of external creditors is fraught with potent risk of further weakening of the Russian banks' competitive positions.

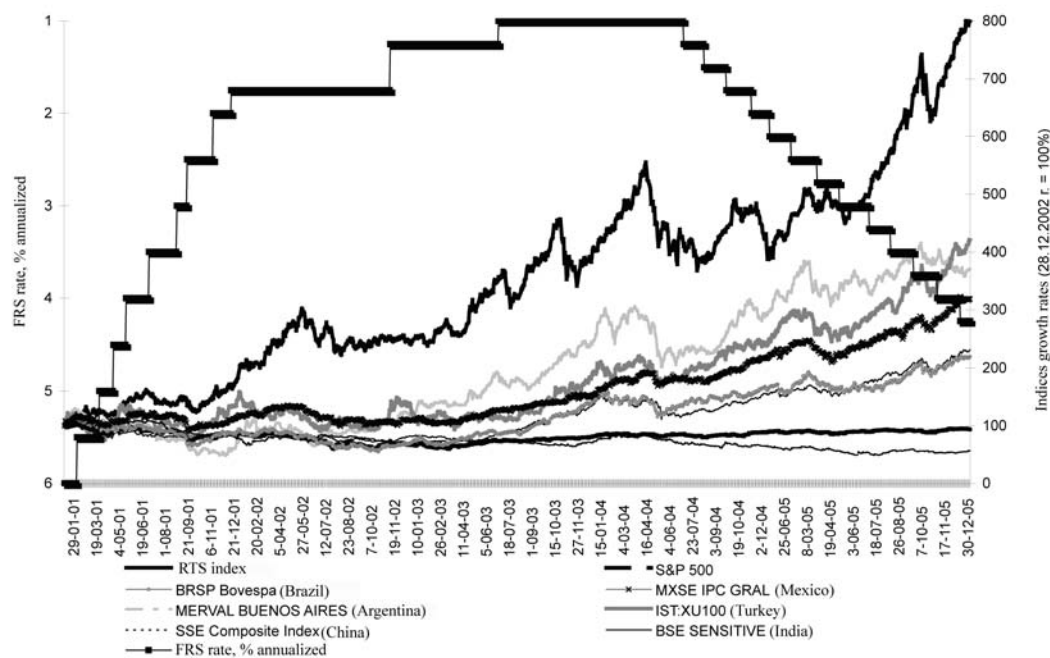
3. *Greater RSM dependence on the liquidity of the American finance market and the behavior of the global investors.* Positive trends in the RSM in the year of 2005 were to a certain extent connected with the internal factors. The country is characterized with a rather stable macroeconomic situation. Within one year, the GDP growth rates exceeded 6 %, the cost of the gold and currency reserve and that of the Stabilization Fund reached, by the end of 2005, 182.2 bln US dollars and 51.6 bln US dollars, respectively. Obtaining the investment ratings by Russia made its financial markets accessible for the respective global investors. In 2005, the largest world investment banks (Goldman Sax, Morgan Stanley and others) opened their branches in Russia, operative activity of the investment funds, companies and banks which had long before functioned on the RSM. In the year of 2005, certain obstacles were removed thus enabling the non residents to acquire shares of the Saving Bank of Russia and liberalization of the "Gasprom" shares was completed by the end of the same year. Hence, the prices of both the ordinary and the preference shares of the Saving Bank of Russia grew 2.7 and 4.6 times, respectively, and those of the

“Gasprom” OJSS – 2.6 times. Early in the year of 2006, “Gasprom” joined the top ten largest world corporations as regards capitalization.

Registered has been greater demand for the shares on the part of the internal investors – physical entities, company managers of the unit investment funds (UIF) portfolios, the pension funds, private investors and insurance societies. In the course of only one year, assets of just the said UIFs grew from 111.6 bln roubles up to 223.9 bln roubles, i.e. more than two times over.

However, the actual influence of the said internal factors on the growth of the RSM should not be overestimated. The decisive influence on the growth of markets for different assets in the developing countries during the recent years was exerted by rather high levels of liquidity which was characteristic for the US finance system⁷¹ which was set up resulting from implementing the “cheap money” policy in 2001–2004 for purposes of financing deficits of the trade balance and the budget in this country. Surpluses of such liquidity which do not find any effective use on the little-profit American stock market, are ever more and more actively placed in the developing countries⁷².

More significant influence exerted on the growth of the RSM liquidity factor of the global financial markets as compared against the values of the respective macroeconomic factors in Russia does reflect the specific features of the growing stock indices on most largest developing markets as is clearly shown in *Fig. 10* and *Table 2*.



Source: according to the data of the FRS USA and the respective stock exchanges.

Fig. 10. Growth Rates of the Stock Indices and the FRS Rate in 2001–2005

⁷¹ Liquidity is understood in this case as a volume of means available for investments.

⁷² Dependence of the developing stock markets on the state of liquidity on the American and European markets was well justified in the book by M. Pettis “The Volatility Machine: Emerging Economies And the Threat of Collapse” (Oxford University, 2001). Growth of the liquidity role in the developing countries was analyzed in Chapter 1.3 of C. Wein’s book “Investments and Trading: Forming the Individual Approach Towards Taking Investment Decisions”. M.: Alpina Business Books, 2006.

In 2001–2005, the S&P index of the American market practically did not grow. While at the same time most of the developing markets were growing at quite accelerated rates. The growth rates of the RSE index for the given time period comprised 799.3 %, that of the respective stock indices of Argentina – 370.3 %, of Turkey – 420.2 %, of Mexico – 318.4 %, of Brazil – 219.6 %, of India – 231.5 %. Until June 29, 2004, such growth of the developing markets was accompanied with obvious decrease (from 6 % down to 1 %) of the refinancing rate of the US Federal Reserve System which is the basic indicator of the cost of money on the American finance market. At that, as is clear from Table 2, both in 2003 and in 2005 observed was a higher RSE index of correlation with the S&P 500 and even higher level of RSM index of correlation with the respective stock indices of India, Brazil, Mexico, Turkey and Argentina. In 2004, correlation of the RSE index with all the said indices was rather weak which fact can be explained by the outflow of liquidity with the RSM because of the well known events with regard to the “YUKOS” company.

Table 7

**Correlation of Indices of the USA and the Largest Developing Markets
with the RSE Index in 2001–2005**

Коэффициент корреляции индекса РТС с:								
	S&P 500	BSE SEN- SITIVE (In- dia)	IST:XU10 0 (Tur- key)	MXSE IPC GRAL (Mex- ico)	BRSP Bovespa (Brazil)	STRAITS TIME (Singa- pore)	MERVAL BUENOS AIRES (Argen- tina)	SSE Composi te (China)
2001	-0.27	-0.47	0.59	0.25	-0.37	-0.43	-0.57	-0.32
2002	-0.17	-0.19	-0.28	0.23	-0.16	-0.07	-0.11	0.21
2003	0.89	0.81	0.71	0.89	0.83	0.88	0.83	-0.54
2004	0.14	0.34	0.16	0.13	0.04	0.02	0.53	0.55
2005	0.73	0.98	0.95	0.96	0.92	0.81	0.72	-0.28
2001– 2005	0.28	0.91	0.92	0.92	0.87	0.74	0.93	-0.79

Almost synchronous growth of most developing markets in 2003 and 2005 clearly shows that the global investment funds invest in these markets practically simultaneously being guided preferably by concrete needs in diversified floatation of additional finance resources than by any specific features in the macroeconomic situation of the developing countries.

In this given case, the RSM growth acquires the well known features of the “soap bubble” which is growing not on the basis of the rising efficacy of the internal national economy but rather under the influence of the global liquidity factors. This phenomenon is fraught with new risks and limitations for the Russian finance system. *In the first place*, factors of this given RSM growth are outside the competence sphere of the respective Russian power bodies the monetary authorities. *Secondly*, greater RSM dependence on the state of other developing markets and factors determining behavior of the global investment funds whose influence on the developing financial markets (as clearly demonstrated by the experience of the known financial crises in the South East Asia, Argentina, Turkey, Brazil and Russia) is not infrequently of critical nature. And *thirdly*, additional difficulties appear on the RSM for the internal investors in the form of limitations for possibilities to create diversified portfolios through the respective securities of Russian issuers.

The latter circumstance is directly connected with certain specific features in taking business decisions by the global investors when investing in the developing markets:

- significance of the factor of the current state of the developing markets on the whole does override that of certain peculiar features typical for the developing markets so to say individually⁷³;
- should the decision on investing in some developing market be taken then the so called “country-wise” approach prevails over the industry-wise approach⁷⁴.

In the result, the price dynamics of the largest national companies on the developing market is tied up to that of its respective stock index while any changes in the latter – to indices of the other developing markets.

4. *RSM dependence on the foreign investment funds with short-term speculative strategies.* Transformation of the RSM from a sort of “the middling market” up to the leader assumes its purposeful promotion as among the global investors. This actually means not only greater share of the Russian issuers in the respective global indices, including the diversified portfolios of the international investors, but formation of large investment funds specializing in investing in Russia as well, including also greater share of the respective Russian companies in the largest industrial investment funds.

Russia, even despite somewhat higher interest towards the RSM, is so far losing in this struggle to the other developing markets. There are not any large enough conservative investment funds among the largest investment funds in the USA, Europe and the South East Asia which specialize in the Russian stock market⁷⁵. Those of them which do specialize in Russia are, as a rule, low capitalized⁷⁶ and mostly have the status of *hedge-funds* or funds oriented towards qualified investors (e.g., the *Hermitage* Fund or investment trusts under the control of J.P. Morgan Fleming).

The RSM remains the only large developing market for the shares of which no one stock exchange index fund (ETFs) has been set up to be included in the respective listing of the American or the leading European stock exchanges. Funds specializing in Russia, are not to be found among customers of the international Euroclear and Clearstream clearing systems which cover the securities market of more than 20 thousand European investment funds. As different from the markets of China and India, the RSM does not yet attract attention of the largest direct investment funds which mostly specialize in restructuring the largest companies. Such a situation seems to be rather unjust with regard to the RSM which regularly takes the leading positions in the world as to its investments attractiveness, their profitability and risks factor taken into due consideration.

⁷³ This regularity has been well justified in the *candidate – of – sciences* dissertation of Kudinova, M.M. “Russian and Foreign Markets of Securities: Problems of Interactions”. M.: Finance Academy under the RF Government, 2005. An example of such an approach is the Morgan Stanley’s promoting among other investors of the idea to invest in the portfolio instruments of the BRIC countries (Brazil, Russia, India, China).

⁷⁴ Brooks R., Del Negro M. The Rise in Co-movement across National Stock Markets: Market Integration or IT Bubble. Federal Reserve Bank of Atlanta. – Working Paper 2002 – 17a, September, 2002.

⁷⁵ A rare exception here is the example of the ING Russia Fund fully controlled by the ING Investments, LLC company. In the end of 2005, according to the WSJ quarterly report, dated January 5, 2006, as regards the overall profitability for the last five – year period, this given fund was the first among all the American mutual funds while that for such as regards *per annum* profitability, came second. At the same time, its assets are rather insignificant as compared against other American mutual funds comprising but no more than 300 mln US dollars.

⁷⁶ Classification of such funds is cited in the third chapter of the dissertation by Khromushin, I.V. “Portfolio Investment Funds in the International Finance and Credit System and Their Role in the Development of the Russian Market of Shares”. The RAS Institute of World Economy and International Relations, 2004.

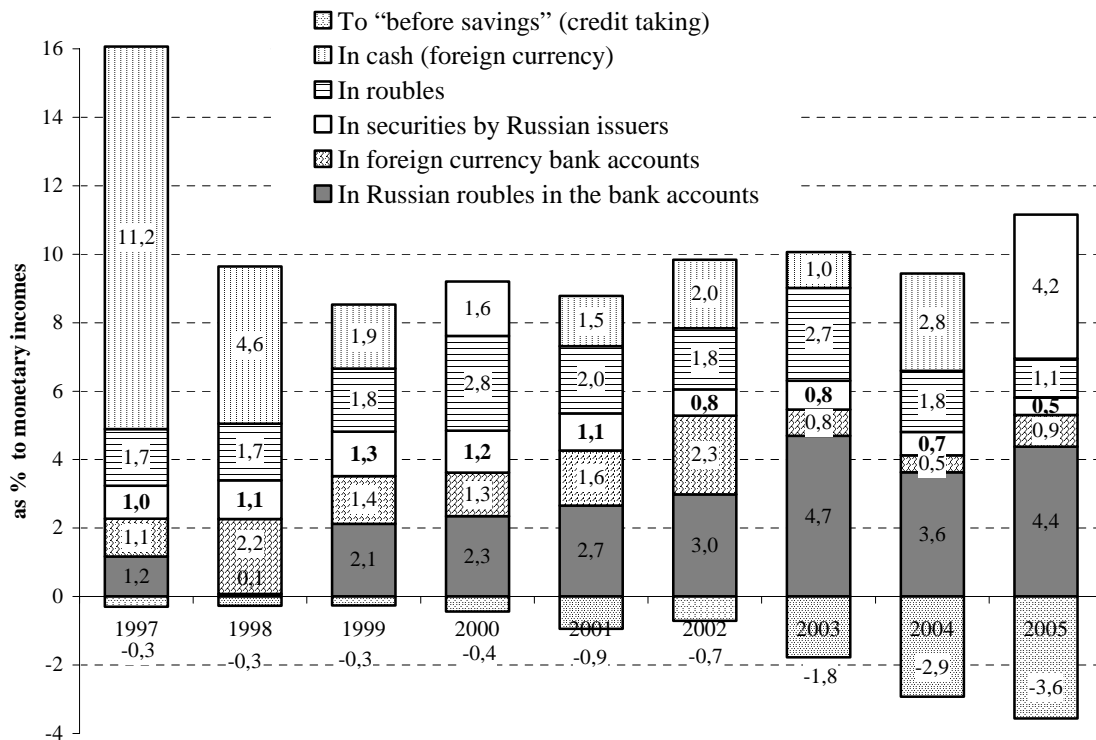
5. *The development risks of the state capitalism in Russia.* Stronger role of large state corporations is inevitably becoming an obvious trend in the economic development of Russia. These exert ever increasing influence on both the external and internal finance markets. This initiates the risks of the RSM “degrading” in future much because of the liquidity flows switching over, including the non resident ones, into the intra corporate sphere. The most fresh examples of these given instances on the RSM are purchase of large packages of the “Mosenergo” OJSS and the “UES of Russia” RJSS shares by the Gasprom structures, transition of the “Sibneft” OJSS under the “Gasprom” control, transition of the OMZ and the AutoVAZ controlling packages to the “Rosoboronexport”, etc. In the years to come, this chain reaction is going to involve ever new and new spheres.

At that the facts do show: of priority for the state corporations are not so much the RSMs but rather the global stock markets. In accordance with the 2006 decision taken by the power bodies of Russia, 35 % of the “Gasprom” OJSS shares representing 90 % shares of the companies being in the so called “free circulation”, will be transformed into the depositary receipts and will leave the RSM for the NYSE (the USA) and LSE (the Great Britain). A somewhat similar scenario is awaiting the shares of Rosneft, BTB and other largest Russian issuers.

Consequences of such policies for Russia can be well seen in the example of China whose experience ever more actively followed by the Russian internal economic policy. As shown in Fig. 9, the 2001–2005 internal stock market (SSE Composite) index went down by 43.5 % which even outstripped the falling rates of the American stock market which S&P index went down by 1.4 %. The main reasons for the deplorable state of the stock market in the mainland China are not in any inefficiency of the state policy in this given sphere⁷⁷. Under conditions of orientation towards promoting large state corporations (Bank of China, etc.) on the Western stock markets and restructurization of the commercial banks credit portfolios the powers that be show ever less and less interest to developing the internal stock market, greater efficacy of those working in it as financial middle-men and savings of the population in securities.

6. *Low level of savings by the population in securities.* Despite the obvious progress in developing collective investments, somewhat accelerated RSM growth does not exert any significant influence on bettering welfare of the country’s citizens nor on strengthening the national system of savings. According to the 2005 statistical data on investments of the population in securities as compared against other financial assets (see Fig. 11, below), make rather a painful expression.

⁷⁷ China’s securities industry. Fixing broken brokers / “The Economist”, February 11th, 2006. – pp. 67–68.



Source: according to the CBR and Rosstat data.

Fig. 11. Inclination of the Country's Population Towards Savings in 1997–2005

According to the 2005 data, the incomes share of the population invested in securities, comprised but only 0.5 %. This indicator turned out to be almost two (2) times less as compared against the crisis 1998 year. As the Rosstat figures say: the net investments of the population growth in securities in 2005 comprised something about 68 bln roubles while the growth of the country's citizens' earnings in the bank deposits as well as the greater indebtedness in the bank loans comprised 587 bln roubles and 479 bln roubles, respectively. Even though with the statistical data incompleteness, as regards the population's investments in securities, taken into due consideration in the context of the market cost growth of the shares of the Russian companies during the same period in the sum of 242 bln US dollars, the 68 bln roubles (or 2.4 bln US dollars) figure shows the absence of any direct connection between the RSM growth and incomes of the population.

The almost paradoxical situation with the population's non participation in obvious advantages which were brought by the RSM in 2005, has a number of explanations. This is connected with insufficient development level of collective investments, finance in-between, informativeness of the population, defenselessness of the minority shareholders' rights and other factors as well. However, to a much greater extent, this is a result of the economic policy conducted in the recent years by the Government of the Russian Federation in the sphere of the pension reform and the collective investments. Most unfortunately, the year of 2005 will be remembered as the year of missed opportunities as regards setting up the finance – stable pension system. When liberalizing the "Gasprom" OJSS shares market, when taking off limitations in issuing the depositary promissory notes for the RF Saving Bank, when stimulating the inflow of the strategic investor – non residents into oil companies, it was not at all difficult to see the much divisible growth of the said fi-

nance assets. In the context of rather permanently discussed deficit of sufficiently reliable instruments to shape the Pension Fund of Russia (PFR) portfolio, the 2005 period did not see any changes in the PFR legislation permitting investment of the respective pension accumulations, at present under the Vnesheconombank control into the shares of the above said issuers⁷⁸. Thus, subjectively, real possibilities were missed to include into the PRF portfolio of high profit and sufficiently reliable assets⁷⁹.

Changing in the set up situation does require the RSM forming as regards the compatibility factor for finance middleman ship quite capable of sufficiently increasing the investment processes, the lesser investment risks, including the information asymmetry and the global markets also capable of bringing about real profitability in various categories of investors. Except for certain segments of the finance market, e.g. the sphere of clients' asset management, this problem is rather far from its solution. Weakness of its regulation bodies here can be noted in the absence of any open statistics on the assets, the own capital and other finance indicators of activities caused by the major bulk of non bank finance in-betweeners.

So, let us do some sum up. The rapid RSM growth in 2005 causes not only the feeling of optimism for its future but also alarm with regard to obvious lagging behind of the banking system from investment requirements of business, greater RSM dependence on the state of the global markets under conditions of its excessive orientation towards short-term speculative investors, insufficient development level of the national saving system strengthening the trends of making the public OJSS state entities.

Ensuring the RSM compatibility requires a somewhat complex approach. Successful RSM development must first of all rely on conducting a coherent and efficient economic policy which assumes lower inflation, re-orientation of the finance system to functioning under conditions of positive interest rate, real bank reform as well as the system of their refinancing. The RSM development strategy should provide for: the system of "soap bubble" risk control including stimulation of diversifying the portfolio investment funds, etc; RSM promotion among the largest and most conservative institutional investors on the global market; creating conditions for the come of the largest direct Western investors to the RSM. Noteworthy steps are needed in the area of the investment climate betterment in the country, taking the law on insider trading on the stock and currency markets, further development of the respective legislation on joint stock societies towards protection of rights of minority shareholders. The priority here must be creating the conditions for outstripping growth of collective investments as well as more active position in the field of reforming the corporate control.

4.7. Merges and takeovers: dynamics, factors, branch peculiarities

According to the data of the M & A Agency analytical agency, 894 merger and takeover deals were completed in Russia during the nine months of 2005 with the total amount of such deals comprising up to 30.9 bln USD. Cost estimation of the market in 2004 comprised, according to different relevant data, from 22.9 to 26.7 bln USD and in 2003 – 18.3 bln USD. Thus, the respective growth in this area comprised about 70 % during the three years.

⁷⁸ Representatives of the Finance Service for Finance Markets and the RF Ministry of Finance declared but too often that such proposals were being discussed.

⁷⁹ It is not at all surprising that none of the Public PRF Council members, called upon to control the efficacy of the PRF reserve system, on the part of the managing companies which include a lot of the respective market structure components, has not so far expressed its due attitude to what is going on in this sphere.

If we now turn to analysis of the branch structure of the merges and takeovers in Russia in the year of 2006 as compared against 2004, then the results thus obtained, can not be taken as vivid demonstration of any revolutionary shifts in the branch structure of the companies which took part in the said deals directly connected with merges and takeovers. The branch structure of such deals as regards the cost criteria for January – November 2005, is shown in *Fig. 12*⁸⁰.

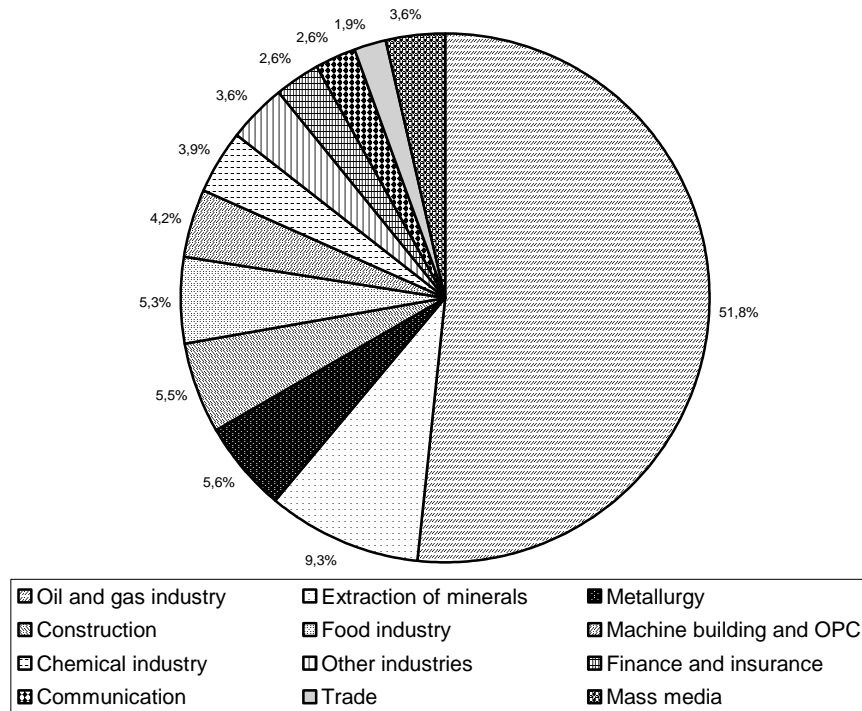


Fig. 12. The branch structure of the merges and takeovers market as regards the volumes of deals completed during January – November 2005

The data as shown in *Fig. 12*, permits to make the following conclusions:

First, the oil and gas industry still keeps the leading positions as to the volume of the deals completed. At that, although the largest in the history of Russia takeover deal was registered in October 2005 – redemption by “Gasprom” of 72.663 % of the shares of “Sibneft” for 13.09 bln USD, – the share of the oil and gas industry in the overall volume of such deals, as compared against the similar indicator in 2004, went down by more than 9.7 per cent points⁸¹.

Second, much greater amount of deals in the field of minerals extraction – by 5.2 p.p. It is also noteworthy here that the main contribution to achieving such a high indicator was due to the deal in redeeming of 97.5 % shares of the “Mikhailovski ore mining and processing enterprise” OJSS (1.65 bln USD or about 65 % of the overall volume of the respective deals in the industry) by the A. Usmanov’s structures.

⁸⁰ Hereinafter use is made of the materials and data base for the deals in merges and takeovers in the Russian economy which were published in the “Merges and Takeovers” magazine for the respective periods of time.

⁸¹ At that, the high 2004 indicator was also to a considerable extent backed by the largest at the time deal – auction selling of 76.79 % of the “Yuganskneftegas” OJSS shares for 9.35 bln USD.

Third, increased in the overall market volume was the share of the construction industry (it did not go beyond the 1 % confines in 2004 but it comprised 5.5 % in 2005) as well as that of the food industry (its yearly growth comprised 1.7 p.p.).

Fourth, there was a sharp decrease in the volume of deals in the transport and finance industries – by 2.61 and 1.9 p.p., respectively.

To have a fuller estimation of mergers and takeovers intensity in the industry it also seems quite expedient to consider the respective statistics as regards the number of deals completed in the year of 2005 as compared against the year of 2004 (see *Fig. 13*).

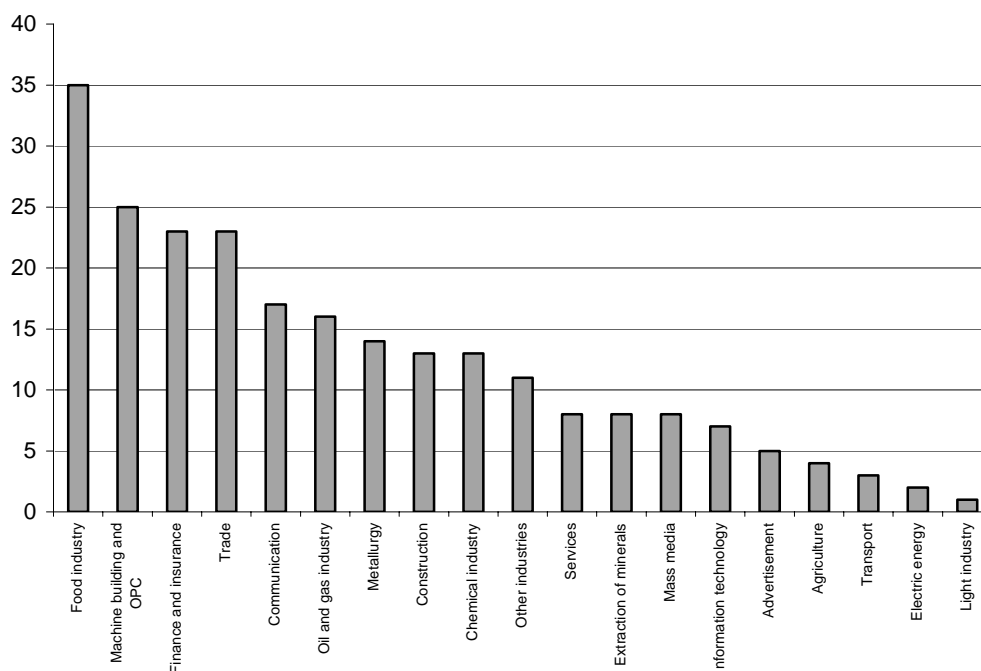


Fig. 13. Qualitative parameters of the merger and takeover deal in Russia for January – November 2005

As can be seen from the data in *Fig. 13*, the highest intensity for the period under consideration was demonstrated in the food industry, machine building, trade, finance and insurance, communication and oil and gas industry. It is also noteworthy here that, as compared against the year of 2004, the leaders have not practically changed but only somehow exchanged their places. The first as regards the number of deals in 2004 was the oil and gas industry, then there followed the food industry, communication, transport, finance and machine building. As we can clearly see, significant reduction in the indicator of the amount of such deals in the transport industry is also followed with some reduction in the number of deals being made — in 2005, this branch is no longer among the said leaders. At the same time, however, even despite the decreasing share in the overall amount of deals on the market, the finance industry still remains among the leaders as regards intensity of the merger and takeover processes.

Special mention should also be made of the rapid development of the respective merger and takeover processes in the sphere of trade. In 2005, completed were deals for the overall amount of 528 mln USD with the average deal price being rather low as compared against other industries under consideration: 23 mln USD is the lowest indicator among the leading industries in the year of 2005.

In our opinion, the more general development direction in the market of corporate control in 2005 consists in greater informational openness of the processes of transferring the property rights on to the respective assets, greater share of using the “civilized” forms in merges and takeovers, lesser average cost of deals as well as greater share of the state in the property rights on the basic industrial (mainly those pertaining to raw materials) assets of the Russian national economy.

The trend towards the *decreasing average cost of deals in mergers and takeovers* has been observed, minimum, during the last three years. Now, while the average cost of such deals on the Russian market comprised 107.5 mln USD in 2003, but in 2004, this indicator already equaled but only 96.1 mln USD. At that, as different from 2004, no high cost deals which frequently distort the overall picture, were registered in 2003 (selling the “Yuganskneftegas” OJSS shares). The average cost for such deals comprised 116.1 mln USD in the 2005 January – November period. These figures, it would seem, demonstrate growth of the 2005 indicator as compared against the year of 2004. To make it more obvious, however, excluded from the said calculations should be the largest for the history of Russia deal in acquiring by “Gasprom” shares of the “Sibneft” OJSS the amount of which comprised about 48 % of the total volume of the market for the period under consideration. Provided it is excluded from the said calculations, the average cost value of the respective deals, during the eleven months of 2005, is about 61 mln USD.

These data graphically demonstrate a trend towards lessening of the average cost of deals which, in our opinion, can be considered as positive proving growth in the investment activities of the middle business environment. Moreover, the monies obtained resulting from selling the business, will most probably be invested in creating new sources of income. At that, the decreasing concentration of investments resources “in one and the same hands” can stimulate greater competition and quality growth of the products and services produced.

It also seems quite necessary to mention here decreasing activities on the market of unfriendly takeovers in the context of retaining high level of law offence in this sphere. Since any sufficiently exact statistics with regard to the number of unfriendly takeovers is actually absent, it is easily explained by lack of desire on the participants in these processes to spread any respective information of the kind. Meanwhile, of definite interest for better understanding of this phenomenon seems to be the statistical data as regards the quantity of criminal cases instituted by the respective law enforcement bodies in connection with such “unfriendly seizures”. Accordingly, while 36 criminal cases were initiated by the respective law enforcement bodies and the Prosecutor’s Office of Moscow in 2004 for the ascertained facts of “coercive seizure” and unfriendly takeovers (Criminal Code articles: “fraud”, “property damage”, “coercion to making a deal” and others), only 8 such criminal cases⁸² were initiated as of August 2005.

The following could be mentioned among the main reasons of this given trend:

- tougher factual administration in the sphere of corporate seizures by the state executive power bodies regardless of how populist these action may look or actually are;
- stronger factual administration of the transferring processes of property rights to the respective assets by the anti monopoly regulation bodies;
- partial changes of the respective legislation in the field of regulation in the executive power bodies of official changes concerning legal persons (for instance, introduction of the notarizing the signature of the previous Director General on the application sub-

⁸² In accordance with the information of the SEPD (Security of Economic Policy Department) press-service of Moscow.

mitted to the tax service for entering the respective data on the new single executive body in the Unified State Register of Legal Persons);

- using by the companies of efficient (preventive ones included) anti seizure measures.

A significant factor here is retaining the trend, which became quite discernible in 2004, of *increasing share of the state participation in the redistribution process of property rights* to the largest assets in the Russian national economy. At that, if in the preceding years the said participation was to a considerable extent evidenced in solving conflicts between the acting state power bodies and some large owners (for example, the “YUKOS” case; redeeming the assets of the Guta Group [the Guta – Bank, the Perm Motors] when the state interests were mainly directed to the so called “unfair” [from their point of view] owners) and increasing the state component in the strategic raw materials branches of economy (for instance, consolidation of “Gasprom” shares), but in the 2005 – early 2006 period, the authorities started to show obvious interest to the assets of “loyal” and “non problematic” oligarchs as well. Thus, it became known in 2006 that the “Rosoboronexport” FSUE made an offer to the main owners of the titan monopolist, the “Verkhnesaldinsk metallurgy production amalgamation” OJSS concerning possible redemption of their shares. A similar example of the same kind can be seen in the factual setting of the state control (in 2005) over one of the largest automobile building enterprises of Russia – the “AutoVAZ” OJSS.

One more factor of significance – *consolidating the role of the stock market as well as strengthening the informational openness of business companies*. One confirmation of the given thesis can be taken in the volume dynamics of public placing of the Russian companies’ shares during the recent years. The quantitative parameters for then primary placement of the Russian companies’ shares in the period from 1997 to 2005 look as follows.

Table 8

Dynamics of volumes for Russian IPO in 1997–2005

Indicator	2004	2005	% of growth	2003	1997–2002
Quantitative volume of IPO market, pieces	5	13	116.67	2 (RBK, Drugstore Network)	3 (VimpelKom, MTS, Vimm- Bill-Dann)
Volume of IPO completed, mln dol.	619.6	4 550.6	624.4	34.4	627

Source: M & A Agency (www.mergers.ru), VEB – PLAN Group, data from companies.

Significant growth of the monetary and in-kind volume indicators stimulated through the stock markets of attracting investments can be taken as vivid evidence proving also that Russian owners are quite ready to reveal information on the structure of their property to third persons since its public placing demands full disclosure of info on the current company beneficiaries which in most cases was not at all typical for Russian companies only 3–4 years ago. Another thing confirming this given trend can be sought in the results of the study in the field of Russian companies’ informational transparency conducted annually by the Standard & Poor’s. In the recent years, the said results have been demonstrating better disclosure of information standards as compared against the respective preceding periods. Thus, in 2005, for example, the transparency index for the largest Russian companies comprised 50 %, with the 2004, 2003 and 2002 indicators being 46 %, 40 % and 34 %, respectively.

Besides, it seems quite expedient to touch upon the subject of modern world trends in the field of mergers and takeovers, the more so because further development of the

world capital market will be indeed telling on the integration processes with participation of the foreign capital in Russia. It was already in May 2005 that the World Bank predicted the first case of a positive value for the net inflow of capital to Russia in the year of 2005. According to the data of the RF Central Bank, this indicator was registered at the level of about 3 bln USD already in the 3rd quarter of 2005, even though the summary value of the said indicator for the nine months of 2005 remained negative. These forecasts were then further confirmed by the end results of the year – the value for the net inflow of capital to Russia comprised 0.3 bln USD which took place at that in the context of reducing inflow value of the speculative foreign capital.

According to the data of the “Thompson Financial” research company, volume of the world mergers and takeovers market for the nine months of 2005 comprised 1.8 trillion USD. As calculated by the “Dealogic” analytical agency, this indicator turned out to be even greater and comprises 1.97 trillion USD which is almost 52 % higher than the similar indicator for the year of 2004 (1.3 trillion USD). Analysts of the “Credit Suisse First Boston” tend to interpret these figures as the beginning of a new (the sixth, but already the world one) wave of mergers and takeovers (at the present stage, 5 waves are usually considered in the US history of mergers and takeovers which took place in the period from late XIX to late XX centuries). To confirm this assumption, let us turn to the figures for the preceding years.

The data on the volume of the world mergers and takeovers market in 2001–2003, as regards the number of declared deals, are presented in *Table 9*. In 2003, as compared against 2001, there was significant fall in the respective activity on the world mergers and takeovers market – more than by 25 %. In 2002–2003, this indicator remained almost unchanged and comprised about 1.25 trillion USD. In 2004, according to the KPMG data, volume of the world mergers and takeovers market reached the level of 2001 and comprised 1.73 trillion USD. Extrapolating the respective values for the January – September 2005⁸³, it can be assumed that the world mergers and takeovers market will reach 2.5 trillion USD which is 45 % more than in 2004. Thus, in the course of 2004–2005, the world mergers and takeovers market averagely grows 40–45 % a year (2005 – forecast). However, these statistical data are not at all really indicative. The length of one mergers and takeovers wave in the United States comprised 8 to 12 years in average. Thus, the following conclusion seems to be quite logical: the sudden leap of the voluminous world mergers and takeovers market indicators did take place in 2004–2005 but to talk about the beginning of a new wave of mergers and takeovers, it is necessary to at least subject to sufficiently thorough analysis further (during not less than 2–3 years) changes in this indicator.

Table 9

Volume of the world mergers and takeovers in 2001–2003 (by number of declared deals), bln dollars

Period/Region	World	USA	Western Europe
2001	1 700.5	771.4	519.7
2002	1 231.4	458.3	462.3
2003	1 260.0	490.0–556.0	no data

Source: M & A Agency.

These trends appear to be most interesting, particularly so in the context of the investment ratings of Russia (both the long — term credit rating and the short — term sovereign rating – S & P) which evidently grew in 2005. Besides, according to the data of the

⁸³ At present, we do not have the final data for the year of 2005 in our possession yet.

“A.T. Kearney” consulting company, Russia was the sixth in the rating for the countries *most attractive for direct foreign investments* in 2005, while in 2004, as regards the above said indicator, Russia was but only eleventh (the eighth in 2003). The capital, being freed as a result of the mergers and takeovers, can be invested in the respective Russian assets which fact, although so far only in part, is already taking place (see indicator values of the capital net – inflow in Russian in 2005, as cited above). Hence, further strengthening of transparency on the corporate control market as well as its regulation on the territory of the Russian Federation seems to be one of the priority directions for the economic policy of the state since it does provide for stronger current trends and further growth of the positive balance of the international movement of capital in Russia.

4.8. Some Innovations in the State Regulation

4.8.1. Development of the Contemporary Legislation on Privatizing the State and Municipal Property in the Russian Federation

Most commonly, privatization can be understood as any economic process resulting from which the state loses its control over production in such or other field of the respective activities. Be such a case, we can talk then about both privatization of an individual industrial enterprise and privatization of the whole economic industry if the state stakes its development on private business. In the latter case, privatization can also be implemented through cutting down the state monopoly on performing functions which were earlier exclusively controlled by the state.

However, the respective legislation on privatization regulates but only relationships directly or indirectly connected with alienation to private property of such state and municipal property which is recognized as privatization proper. Both the first Acts on privatization and the current Law, dated 21. 12. 2001, No. 178-FZ “*On Privatization of the State and Municipal Property*” (hereinafter called the Law on Privatization), interpret privatization as selling (alienation) different state and municipal property objects into private ownership. That, as is noteworthy here, also includes transforming any unitary enterprise into any open joint stock society in question.

The RF legislation on privatization does recognize such transformation as an independent method of privatization beginning from the year of 1997. Conceptually speaking, such treatment of the question is deemed possible only with a rather large share of relativity. In case of transforming a state enterprise into a joint stock society, privatization as such can be understood exceptionally in the strictly legal sense of the word: the ownership right of the state on the property, earlier vested in the enterprise thus transformed, is being passed over to the new joint stock society through the process of the said transformation. This is accompanied with certain changes only as regards the respective regulations within the framework of which the state can exert influence on the business decisions to be taken by the enterprise – instead of the legislation on the unitary enterprises, that on the joint stock societies is practically applied⁸⁴ in the configuration as provided in it for such socie-

⁸⁴ This most vividly manifested itself only after the law, dated on 14. 11. 2002, No. 161-FZ, “On the State and Municipal Unitary Enterprises”, had entered into force. Before that, turning a unitary enterprise into a joint stock society made it potentially possible for the state management bodies to improve their control over the said economic activity subject through using the already existing but complemented with greater detail corporate legislation, for instance, the law on joint stock societies which entered into force beginning from January 1, 1996. A component part in practical controlling such OJSS on the part of the state must also be certain indirect property control ensuing from Art. 65 of the “Law on Joint Stock Societies” which refers to the competence of the respective Board of Directors (Supervisory Board) of the said joint stock society decision of a number of questions having actual influence on the property state of this joint stock society (increasing the authorized

ties with the sole founder. Controllability of the enterprise on the part of the state structures loses practically nothing in its fullness degree (with due account taken of the regulations contained in the Charter of a concrete joint stock society in which it is possible to set up, in particular, certain additional requirements as regards the deals stricken by the society in question in the category of – and respectively the appropriate regime – “large”).

It is rather interesting that the Civil Code of the Russian Federation which, as per its Article 217, provided for the notion of privatization, at the same time does interpret it as “alienation of property” but at that not specifically stipulating for the role of “turning it into a joint stock society” in the process of such privatization implementation. The first law on privatization, passed in 1991, also provided for a possibility for “turning it into a joint stock society” as part of the privatization arsenal but only implying it in the context and not directly from defining the notion of privatization proper. *De facto*, as an economic process, privatization will become a true reality only when the state has sold (has privatized) its share in the respective authorized capital of the joint stock society which it set up. Actually, turning an enterprise into a joint stock society is either some intermediate stage of privatization or some particular case when the property owner of the unitary enterprise wishes to go no further than changing the organizational and legal form of the person managing the business under the owner’s control. However, the “instrument kit” used by the respective legislation on privatization, almost prevents taking these rather insignificant fine points (at least for a lawyer) into any practical consideration.

Thus, the legal language of the legislation on privatization, to a certain degree, does resist attempts to define privatization as a reality of economic life. This language, on the contrary, means privatization as alienation of while the “state or municipal enterprise” – a legal person set up in the organizational form of a unitary enterprise. That is why, for example, the word combination “privatization of enterprise” causes quite understandable indignation of legal experts who, in our opinion, quite justly think that a legal person simple can not be subjected to alienation. A more correct expression for such a case is deemed to be the following: “privatization of the property complex of the respective state and municipal enterprise”.

At the same time, however, it is not to be doubted that the Civil Code refers transforming a state and/or a municipal enterprise into an open joint stock society to the notion of privatization as well: Article 96 of the CC is quite explicit about peculiarities of setting up and the respective legal status of joint stock societies created in the process of such privatization, referring this legal substance, quite naturally, to the subject of regulation by the said legislation on privatization.

Transforming a unitary enterprise into a joint stock society is, undoubtedly, a necessary component for the “toolbox” of privatization. Except that it is exactly the enterprise which become the object of privatization as a legal person that is subjected to reorganization through transformation. From our point of view, this fact permits to do without terminological errors in using the “privatization of enterprise” notion in the respective normative – legal acts having in mind just such transformation. Otherwise the legal regulation of privatization becomes rather difficult, including establishing order in forming the prediction plan (program) of the said privatization: instead of unitary enterprises as objects of privatizations, the program shall have to mention their respective property complexes while it is exactly enterprises that are objects of privatization in the form of the above said transformation.

capital through additional emission, issue of bonds, determining the price [monetary evaluation] of the property, the price of placing and redeeming the emission securities, approval of large deals and those with interest, etc).

Nevertheless, the notion of privatization does depend on the sense – economic or legal – in which it is used. Thus, what is called as a “complete privatization” of a unitary enterprise, that is privatization in its economic sense, makes it necessary to execute privatization in its legal sense two times: first to transform the unitary enterprise in question into a joint stock society and only then to privatize its shares⁸⁵.

As objects of privatization are, on the one hand, all kinds of the state property, neither withdrawn from the circulation⁸⁶ nor confined to such, including unitary enterprises, packages of shares pertaining to joint stock societies (less frequent – shares) in the authorized capital (property) of other legal persons as well as individual property objects being in the state treasury or the respective municipal formation. On the other hand, however, privatization has never been intended to cover the whole range of possible deals with the state and/or municipal property. On the contrary, it was as far back as December 3, 1991, that the Decree of the RF President No. 255 “On Primary Measures in Organizing Work in the Industry of the RSFSR” recognized property, registered on the balance of state enterprises, registered in then proper name as the “right for full economic use” while the enterprises themselves – as having “full business and economic independence”. Both in this here and further legislation on privatization, quite distinctly traced can be the line of non interference in internal affairs (business and/or economic activities) of such unitary enterprises. Thus, the respective 1997 and 2001 laws on privatization point out directly that the sphere of their effect does not include deals with the property of the state and municipal enterprises, i.e. such deals which are carried out by them in their own name within the framework of the legal capacity as prescribed to these subjects.

Of secured character is the prohibition on carrying out certain property deals by the state and municipal enterprises without agreement of its owner as well as for cutting down the number of those employed, as written in Point 3, Article 14 of the Law on Privatization. This prohibition is designed to protect enterprise property from alienation from the moment it has been included in the program of privatization. In its time, this particular norm also made up for the gap with regard to the unitary enterprise legal capacity which was actually removed in the end of 2002 by the No. 161-FZ Federal Law “On the State and Municipal Unitary Enterprises”: practically all the “privatization” bans were accordingly absorbed by the usual requirements of this Law to making deals with unitary enterprises (large deals, credits and loans)⁸⁷.

Thus, the normative legal acts on privatization regulate the system processes of shaping the private sector in the national economy of the Russian Federation though not involving making deals with the state and/municipal property in the process of usual economic activity of business enterprises. Since most part of the so called “excessive” state and municipal property, not used directly for performing the basic authority of the Constitution and Law based state power bodies of the Russian Federation as well as those of the local self-government, is to be transferred to private property, the respective legislation on

⁸⁵ Such a possibility to privatize an enterprise as selling its property complex is not subject to any special treatment here since its presence does not exert any system influence either on the theory or the respective practice of privatization.

⁸⁶ In this context, of significance are also limitations for property circulation capacity establishing that it can be exclusively in the state ownership. Such a record does not at all mean full withdrawal of the property from circulation because it allows involving it in the civil – legal deals which do not have any property alienation as one of their consequences.

⁸⁷ The exception, probably, being only the ban on cutting down the number of those employed in the respective unitary enterprise beginning from the date when the privatization of the federal property feasibility plan (program) was approved of and to the moment the respective ownership rights on the privatized property are transferred to the buyer of the unitary enterprise property complex or the moment the newly set up open joint stock society is officially and duly registered by the respective state body.

privatization for the medium term perspective shall also retain its role both in the system of the civil legislation and in its adjoining branches of law.

Further on, after the optimum volume of the state and municipal has been achieved the respective privatization legislation can be reduced having lost at least its civil – legal component. The deals within the framework of which alienation of the state and municipal property proper is completed, are, both in form and essence, of the respective civil and legal character. Transforming the state and municipal enterprises into open joint stock societies are also subject to the common reorganization rules of legal persons in general and to those on the said transformation, in particular. Special legal regulation of the respective civil and legal aspects of property alienation in the former and in the currently acting legislation on privatization are both connected with the necessity of introducing into practice certain uniform procedures for sufficiently efficacy in using the respective state and/or municipal property. Further on, it will be quite enough to legislatively fix up requirements on total and unconditional publicity of all the respective deals including the stages of their completion, actions in selling the state and municipal property and to select, on the competitive basis, agents representing a state or a municipal formation as well as to carry out a competitive “chose a buyer” procedure.

At this present time, however, privatization of both the state and municipal property does need a more distinct and detailed legislative regulation at the federal level. Yet, even if such is present, locally practical privatization is sometimes typical of significant deviations from the procedures respectively prescribed. It is because of this that the legislation on property, at the present modern stage, rests on further specifying the normative instructions which provide for, transparent for both the economic agents and the public, efficient and enough uniform gratuitous alienation of the respective state and/or municipal property.

Contemporary legislation on privatization of the state and municipal property is based on the Federal Law “On Privatization of the State and Municipal Property”, dated December 21, 2001, No. 178-FZ, which was prepared by a group of experts in the field of the state property management (mainly – those from the RF Ministry of Property and the Russian Federal Property Fund) basing their work on the available practical experience of the earlier legislation on privatization.

By that time, the said privatization was being regulated through a rather cumbersome body of various normative and legal acts developed and accumulated during the economic reform years: decrees by the President of the Russian Federation, adopted in the period beginning from 1992, and the 1997 half – and – half Law on Privatization intended for the consequent passing of the law on the state program of privatization (which actually never happened) as well as acts of the Government of the Russian Federation and those of the RF State Committee for Property. Certain internal contradictions in the said acts (due to relatively wide time dispersal of the dates when they were adopted in the context of rapidly developing civil legislation) in fact permitted selling at the respective auctions and contests securities (shares) pertaining to only newly set up (privatized) joint stock societies and/or other property. The said process of transforming the state unitary enterprises into the respective open joint stock societies was actually stopped by the year of 2000.

This year of 2000 did manifest obvious disproportion between the rates and efficacy of privatizing the unitary enterprises and the respective packages of shares. Profits from selling the latter brought to the national budget 31.5 bln roubles which 1.5 times exceeded the planned figure. It was the best result for all the previous years of privatization. Practice of selling the state property, as permanently complemented with both the national and international enriching experience, was developing much faster than the respective norma-

tive and legal basis which, in turn, required its rapid improvement. The main problems here were: a rather limited “tool box” of privatization methods, quite sophisticated selection procedures of objects to be then duly privatized and getting the necessary approvals, numerous obstacles in forming the property complex of practical steps and quite a number of others. In 1998, for instance, Federal Law “On Estimating Activities in the Russian Federation”, No. 135-FZ, dated July 29, 1998, was adopted as making it compulsory to apply an independent estimate in all the cases where the state and/or municipal property was involved in the civil turnover. Market-based estimation of property was already practiced in privatizing at that moment but it was still necessary to establish it normative-based with regard to all the respective privatization deals.

The said bill, worked out in the period from 2000 to 2001, was based on the new methodology for initiating and planning the said privatization process; broadening the range of privatization methods; tuning up the privatization “tool box” for selling the property depending on the respective demand (liquidity); involvement into the privatization process of the land plots under the enterprises in question; registration of the rights for intellectual property; greater responsibility of the state and of the enterprise administration. The law was passed in the end of 2001 and entered into force beginning from April 26, 2002. This postponement not so frequently practiced with regard to federal laws, does somehow characterize the degree of novelty in the ensuing new order of privatization: it was quite clear for those who had been preparing the said bill that both the state and other participants in the privatization process really needed some period of time to get better acquainted with the new rules of privatization as well as to prepare them for practical use.

The Law provides the right to initiate privatization only and exclusively to the owner of the respective state or municipal property in the person of the respective bodies. Privatization planning has become more tough and realistic, it also got a sort of anchored to the budgeting process: on the one hand, the program should include all the federal property subject to privatization in the respective year regardless of its cost or other parameters; on the other hand, such a program is to be taken not by the Duma but by the Government which then submits it to the Duma along with the draft project of the budget for the year to come (as part of the documents and materials set enclosed). Individual objects, as directly stated in the Law, are to be privatized in accordance with a special law – these are shares of the “UES of Russia” RJSS, the “Gasprom” OJSS and property in the natural monopoly sphere in the railway transport. In the latter case, such privatization has already taken place on the basis of the Federal Law “On Specific Features of Controlling and Managing Property of the Railway Transport”, No. 29-FZ, dated February, 2003, owing to which the “Russian Railway Roads” Open Joint Stock Society was set up. Other objects, somewhat connected with ensuring the defense capability and security of the Russian Federation in accordance with the list as determined by the RF President, can not be included in the privatization program during this period. However, subject to privatization is a package of shares of an open joint stock society, if included in the above said list, to the extent which is higher than the share thus stated. The lists of the respective strategic enterprises and the joint stock societies were later approved by the Decree of the RF President, dated August 4, 2004, No. 1009.

Share packages of joint stock societies, enterprises and other property, included in the privatization program, shall be privatized exclusively by means and methods as stated by the Law including those for privatization of the municipal property. The respective Law has provided for such means which also enable practical implementing of property not in demand when being sold at the auctions but the only criterion for their use is the very fact that such demand is really not registered and not just supposed or expected. Thus, the ba-

sic method of privatization, both in the former and the new legislation on privatization, was and still remains to be auction whose starting price is set up exclusively on the basis of the market cost of the property as estimated by an independent broker.

Advertised bidding in the form of auctions is really the best way to sell property which is in the ownership of public education. All the shortcomings as they come out into the open during such auctions, should be viewed as resulting from objectively existing differences between those as described in the “ideal model of the efficient market” theory and the market which exists in reality. At the same time, however, it is just this theoretical model of ideal trading that allows us first to evaluate both the nature and the manifestation degree of deviations from it, practically observed, and then to accordingly correct the rules for the given trading in its broadest possible sense – from the respective informational supply to the order of qualifying its participants and the procedure of trading as such.

The Efficient Markets Hypothesis (EMH) assumes fulfillment of three conditions:

1. availability of a large number of buyers and sellers due to which actions of individual buyers and/or sellers do not exert any significant influence on the price of the respective security;
2. information shall become available for all the market participants simultaneously and to receive it shall not be connected with any expenditures;
3. all subjects of the market shall act rationally and striving towards profits maximization.

Since, under privatization in the general case, no external influence can be exerted on the first condition because the shares to be privatized, particularly so for newly set up joint stock societies, can not be represented on the stock market, the resource for increasing efficacy of the trading, all its shortcomings taken into due account, is to be sought for primarily in the area of normative bringing the said conditions closer to the two remaining assumptions. And although the Law on Privatization has already undergone certain changes as regards the order of auction conducting, which do somehow strengthen its market potential, the present experience nevertheless demands that these activities be continued indeed.

The situation where the demand for the property to be auctioned, is actually non-existent (which fact can be clearly seen in complete absence of the respective applications for participation or appearance of the sole participant), is not at all anything extraordinary for the privatization phenomenon as such but for other cases when auctions are to be held. The former legislation on privatization had but one and only way to correct such a situation – repeated carrying out of the auction with lowering the originally declared initial price. Be such a case, the Law on Privatization permits the owner (but does not oblige him/her) to carry out trading with lower proposal price but starting from the level not lower than that of the initial price of the trading not performed. Thus, having tried an unsuccessful attempt to find the true property market price that is higher than his/her supposed minimum market value (the initial price of the auction trading not performed), the owner, step by step, fully in accordance with the lowering of price stages, is moving towards the maximum price of demand for property which is below the stated value. In the text of the Law, such trading is normally called as sales of property by means of public supply.

In the absence of proposals on acquiring property, sales of property by means of public supply stop at the level of 50 % of the price of the auction not carried out. At the stage when market did not show any interest to selling property even at a 50 % discount with regard to the earlier price, property owner has the right to chose one more method of privatization. Selling property without declaring its price (just by the very mechanism of carrying out) can be defined as a zero initial price auction carried out in the closed form of price offering.

The said bill on introducing changes in the Law on Privatization, worked out on the basis of the privatization results analysis of the 2003–2004 period, has a new form of selling by means of public offering – trading by voice, i.e. in accordance with the usual procedure Dutch auction is conducted. Probably, it seems quite sensible then to think of initiating a similar face – to – face form of auctioning for selling property without prior declaring of the initial price as well.

In case an auction could not be held, the Law on Privatization also allows use of other methods of privatization, namely selling on the organized market of securities (on the stock exchange), depositing in the authorized capital of a joint stock society (the authorized capital of a strategic joint stock society can take shares of another joint stock society so to say “ahead of line”, i.e. with no need for factual confirmation of the absence of the market demand through an attempt to carry out the auction). Selling of shares according to the auction results by means of their preliminary transference into the asset management⁸⁸, provided for in the Law on Privatization as one more possibility for the “second rank composition” of privatization means, was not fixed normative-wise in the said Regulation of the RF Government and hence can not be applied when privatizing not only the state property but the municipal one as well. At the same time, however, inclusion into the above mentioned “second rank composition” selling of shares through the stock exchange is understood as a sign of excessive caution of the legislator manifested with regard to this new method of privatization. In the bill in question, the said perspective type of trading has its due place, along with auctioning, in the system of privatization “tool box”.

Non optimum queue in applying certain privatization means is not the only compromise achieved when adopting the said Law on Privatization, to be later appropriately corrected. The most manifest example of such a compromise – requirements to the order of determining the initial selling price of the property in question as fixed in the Law on Privatization. On the one hand, the Law fully supports the ideology of the previous Law on Estimation accordingly requiring that the initial property price be set up on the basis of some independent estimation. But on the hand, it does introduce into the privatization price formation process a rather artificial element of the owner’s control over the lower limit in setting the initial price of the trading in question – the normative price. Thus, in the Law on Privatization, the structure ensuring performing a privatization deal, does not formally borrow the respective instruments from the earlier legislation and privatization (for instance, a commission for establishing the initial price on property) but is essentially oriented towards balanced participation in this process of “two centers”: the owner in the person of authorized state body and the same owner in the person of a specialized organization – the seller. And it is the latter that the principally important function of setting up the initial trading price actually belongs to.

In such relationships, the owner in the person of the respective state body, is endowed with the right to set up the said normative price as the minimum possible value of the initial price. From the economic point of view, such a possibility does not provoke any significant criticism just like the very presence in the legislation on privatization of the insti-

⁸⁸ At present, the order of transferring into asset management the federally owned shares of joint stock societies which were set up during the privatization period, and concluding the respective management contracts for such shares are regulated by the respective articles of the Resolution of the RF Government No. 989, dated August 7, 1997 (in further editions), which provide for the rules conducting the respective contests and samples of the standard documentation. Nevertheless, it seems necessary to emphasize that this particular mechanism does not provide for a possibility to alienate the shared transferred into asset management during the validity term of the said contract and after such term of the asset management has been completed in case of duly performance of the terms of such contract. It naturally goes without saying that in case of the subsequent sale of the said shares, the respective asset manager is entitled to take part in the standard privatization procedures, and all the other potential participants also are.

tution of the seller which is not a state body taking decisions with regard to privatization. In the relationships of selling a thing on the commission basis, for example, its owner is also entitled to declare to the respective broker the minimum price size of the property in question. That the Law on Privatization has not set up the criteria for determining the size of the normative price is quite a different story. In principle, two variants to calculate it are possible: the market one as based on the independent estimation and the normative proper implying use of a certain formulae which is actually a surrogate result of the respective independent estimation. The Law on Privatization related the order of setting up the said normative price to the competence of the executive power (in the person of the Government of the Russian Federation) which fact, however, is, most unfortunately, also met with in other legislative acts when the legislator finds it difficult to give a sufficiently clear answer to a rather complicated question.

As to the first of the outlined above ways to calculate the normative price, the said norm-making thought has not yet progressed further than the then existing roles distribution between the owner who appears in the two above mentioned persons. Now if both the state body when setting up the normative price, and the seller when setting up the initial price, use one and the same broker's report (which is necessary for the first of the stated prices to correlate correctly with the second one), then it is primarily the said state body that in fact determines both the time-term for completing the privatization deal in question and its starting conditions. In that time, this structure was considered to be a violation of the seller's competence when in the process of privatization and, accordingly, the normative approach to setting up the same normative price triumphed. In such a paradigm, even though the formulae of its calculation, as determined in the Regulation of the Russian Government No. 369, dated May 31, 2002⁸⁹, actually borrowed the standard methodology of three approaches to property estimation, the normative price seems to have fully lost practically any economic sense like, however, any other attempt of normative (designed) determination of the market indicators admitting no expert correcting whatsoever. In practical terms, values of the normative price were placed both into the field of possible meanings of the property market price when the normative price was actually performing its function with such or other efficacy degree, and into the area below these meanings (which is equivalent to its absence) as well as into the field above them which inevitably resulted in breakdown of the trading forcing the owner to take untimely decisions with regard to changing the method of privatization for selling through the said public offer.

The said bill on amendments to the Law on Privatization rests on the assumption that the initial price of the privatized property is a most important condition for efficacy of trading and, therefore, has to be determined by the state but, no doubt, with practical use of the independent estimation. This, quite naturally, somehow reduces the range of the seller's possibilities in independent determining the respective sale of property policy. Such methodology is fully used in the respective bill on selling the federal property whence the RF subjects and the municipal formations retain the possibility to delegate their authorities in setting up the initial property price to the respective sellers⁹⁰.

⁸⁹ Calculation based on the data of the summary book-keeper's balance for the given society as the average weighted meaning of the whole number of values (cost of shares on the basis of net profits, on the basis of stock exchange quotations and for net assets) with use of special purpose ratios as reflecting the degree of shareholder's influence on decision taking in the given OJSS depending on his/her share or on using the special "golden share" right.

⁹⁰ At the same time, however, abolition of the normative price does increase both potential possibilities and incentives for the buyer to get the evaluator interested in making a lower estimate of the property to be privatized. It goes without saying, indeed, that there is also a probability that the buyer will too try to get representatives of the respective property management body interested in the "proper" calculation of the initial price. Yet, it is quite necessary to have it in mind that determining the

The subject of orderly privatization of the state and municipal unitary enterprises does deserve a separate consideration. The Law on Privatization brought about a great step on the way towards more detailed description of such order fully in accordance with the general principles of the civil law. The main privatization means for a unitary enterprise still remains transforming into an open joint stock society. Since the universal succession is the key feature for any reorganization of a legal person, the Law requires compulsory stock taking of the property and all the respective liabilities of the enterprise in question fully in accordance with the general rules (as set up by the RF Ministry of Finance, the intermediary book-keeper's account compiled according to the results of the respective stock taking on the basis of which (based on the results of the auditor examination) and property composition subject to privatization (including the respective land plot which is then also included in the deed of assignment) as well as the list of property not subject to privatization, and the list of all limitations and burdens on the rights on the property of the enterprise. It is specifically emphasized in the Law that there is no need in estimating property for purposes of privatization in the form of transforming the enterprise in question since this process does not contain the purchase and sale element, nor any economic prerequisites for finding out its market value.

Noteworthy among the gaps in the normative regulation of the transforming processes of unitary enterprises under privatization is the absence of the requirement on the compulsory notifying the enterprise's creditors and among its shortcomings – rather tough choosing the form of an open joint stock society as *de facto* the only variant to privatize such an enterprise. The above mentioned bill proceeds from the assumption that the most optimum form of privatization for most state and municipal unitary enterprises is vividly demonstrated by the method of duly transforming into a joint stock society, Ltd.

Noteworthy is also one more subject of regulation by the Law on Privatization as the starting point for further improvement of the Law without creating a wrong impression that such necessity has been caused by an incorrect or gap prone regulation of this matter in the Law. The subject matter here concerns the informational support for the respective privatization process. The said Law on Privatization introduced principally new requirements with regard to ensuring openness and transparency of the privatization process during all the stages of its implementation which, in fact, was one of the main motives for its adoption. To begin with, the first stage in informing the public about the said privatization is the publication of the privatization program which has been earlier approved (within the framework of the budget process in the summer of the year preceding the planned one). Further, also to be published are decisions concerning the terms of the said privatization which determine the privatization method and other relevant requirements. Publication of informational reports on property sales, inviting the buyers to take part in the respective trading, which formerly used to be the only compulsory element of informational support for privatization, is now the third stage in disclosing the privatization information which is followed with publication of the trading results. Actually, the only things that the Law is lacking to improve the quality of openness and transparency of privatization, is a formalized requirement to the "coverage area" of information on privatization. Even though general availability of the informational sources on privatization was theoretically assumed, our practical experience insistently demands that direct indication to that be made. The said bill not only establishes that the mass media means, actively used during the privatization

normative price is also leading to higher degree of control and authenticity of estimations due to using various sources of information.

process, should be available to all but also demands that information on privatization in the general electronic mass media means, i.e. Internet, be published as well.

Practical introduction of the above described novelties has already brought quite positive results. Accordingly, the main task was solved as posed when developing the said Law: the privatization process of unitary enterprises got at last moving. At the same time, significant growth in the rates of privatizing the federal state unitary enterprises (FSUEs) can be also considered as an indirect effect from entering into force of the Federal Law No. 161-FZ "On the State and Municipal Unitary Enterprises" which contains norms making their economic activities more difficult because their top management has to get a lot of authorizations and/or approvals of the respective higher administrative bodies and that, in the opinion of the RF ministry of property, is expected to become a significant stimulus for reducing this given sector of economy.

Another achievement of the acting Law is that its text, when being worked at and analyzed, it allowed to be given a somewhat technological character. The privatization alienating of the public property procedure is sufficiently uniform regardless of the actual for the given moment aims of its practical conducting. There are no limitations on foreign investors taking part in the said privatization which fact makes it absolutely unnecessary to change the text of the law every time under each change in the situation with regard to the role of privatization in the national economy. The very process of aim setting both in privatization and in other organized activities involved in reforming the state sector lie in the area of the institutions for planning the social and economic development of the Russian Federation during which interacting with each other are the presidential, the executive and the legislative branches of power.

Concluding, it is necessary to point out that involving a state or a municipal enterprise in the respective privatization process inevitably makes correct understanding of the ideology of the Law as well as good knowledge of its order and procedures when practically using such critically important. Particular consideration, for example, is required by such questions as involvement into privatization of the land plots under real estate property subject to private property alienation; the order of preparing a unitary enterprise for privatization; the order of trading in the sales of property and perspectives for greater improvement of the rules regulating these relationships. Further development of the respective legislation on privatization would undoubtedly be efficiently stimulated by sufficiently serious and thorough discussion of such aspects as, e.g., the role of the special right for participation of the state in managing a joint stock company (the *golden share*); the content and normative regulating of burdens on the rights on the real estate property as necessary for the privatization purposes; the optimum privatization model of municipal unitary enterprises in the communal housing sector and quite a lot of others.

4.8.2. Hostile Takeovers as an Object of the Respective State Regulation: Some Legislative Modifications

The questions of regulating unfriendly takeovers have been attracting ever growing attention including that of the most various levels of the state management in the business sphere as well. In 2004, special hearings were held in the State Duma; in August and September, 2005, conferences on the problems of unfriendly takeovers and protection means against them were held in the RF Trade and Industrial Chamber and in the Moscow Trade and Industrial Chamber with participation of representatives from the state power bodies, respectively. Similar problems were also considered by the Expert Council for Corporate Management under the RF ministry of economic development and trade in

2005 when preparing the Development Concept of the Corporate Legislation up to the year of 2008 (hereinafter called as "the Concept").

The Concept's authors point to several tasks of improving the respective corporate legislation including those as regards protecting the ownership rights in the corporate sphere, development of the stock market as well through stimulating use of the joint stock form to conduct business, forming adequate legal support for the required business concentration and diversification. Practical implementation of its key provisions can result in significant positive changes in the legislation on the respective economic subjects (registration, transference of ownership rights, etc), on the disclosure of information and the corporate conflicts regulating. Considered below are such novelties which are primarily connected with regulating the said unfriendly takeovers.

One of the most important novelties is deemed to be legal fixing the mechanisms of securing the rights of owners and/or investors in case of probable chance of control over the company. The Concept also offers legislative setting up of certain procedures for the following directions:

1. Setting up the procedure for timely and full informing the respective shareholders and investors on intentions and actions of the company – buyer. Such a norm, widely used in the USA and the countries of the European Union, is, no doubt, a necessary novelty since it allows a minor shareholder to take a decision on quitting membership of the company's owners in case either the new main owner himself or his new strategy of development suit the said minor shareholder. When working out a concrete legislative act with regard to this question, it seems rationally expedient to use the experience of the United States (the Williams Law), when a company – buyer discloses the relevant information on a tender offer through filling in the respective standard blank – form which includes a special section on plans of the company – buyer with regard to the company to be acquired (plans to sell any assets, reorganization of the company, changes in the composition of the Board of Directors, the dividend policy, etc). This blank – form is to be sent out to all the shareholders of the target – company as well as to be presented to the stock exchanges where shares of the said target – company are in trading;
2. Creating the mechanism for practical implementing the right of minority shareholders to sell shares for a just price in case the significant conditions change as compared against those on the basis of which the shareholder took the respective investment decision. This situation continues the previous one and ensures the rights of the minority shareholder should he/she decide to evaluate the changes undergoing in the composition of the owners of the company and/or in their understanding the development strategy by the new owners as negative;
3. introducing a more complicated procedure of taking decisions with regard to protective measures when in the process of taking over in order to provide the shareholders with the right to chose a more efficient owner and stopping the respective management from withdrawing the capital. Such a situation does not yet seem of current importance for Russia because it is so far is quite necessary for observing the lawful economic interests of the owners of the company with a dispersed structure of property when no one of the owners is in the possession of the controlling package and hence do not have any real possibility to control activity of the respective management enough quickly and efficiently. In Russia, the overwhelming majority of companies (both large, medium and small) have but one main real owner. The situation described above, is the future of Russia which can be quite definitely asserted through analyzing the respective experience of the Western countries. We are not going to make any detailed comments

on the given direction of changes because the very text of the Concept, *inter alia*, does not contain any concrete mechanism for its practical implementation;

4. fixing the mechanisms providing for the balance of interests of the largest corporate owner (90 % or 95 % of the authorized capital) and that of the minority shareholders when implementing the so called “displacement” process under which shares of the minority shareholders are bought out at a just price. This particular proposal has quite a “long” story already. To maintain the balance of interests between the majority and minority shareholders, it is necessary to set up sufficiently reasonable principles for estimating the real cost of purchasing out shares of the minority shareholders. It was proposed some years ago that this given estimation be determined on the basis of some independent market estimation when it shall be the majority owner who will be the customer of such independent market estimation which is quite explainable and logical from the economic point of view (i.e., determining the subject to incur the respective expenses). Unfortunately, the available practical experience shows the reverse. The estimation services market in Russia can hardly be considered as truly independent which explicitly implies distorting the real values of the shares under the respective estimation. We are proposing a somewhat different method to estimate the cost of shares to be redeemed: in case a company’s shares are traded on the stock exchange, their market cost is determined as average weighted for a certain time period (a month, for instance) but not less than the cost for which the new majority shareholder acquired the shares in question from the former owner. If, on the contrary, such shares are not traded on the stock exchange, it shall be possible to use the prices of only the latest deal. The said method does also have a number of shortcomings though primarily because the “official” cost of the deal between the new and the previous majority shareholders in Russia can still remain quite different from the real one. Yet, it does seem to be somewhat more objective nevertheless. Besides, assuming all sorts of possible abuses, it is necessary to establish that such a redemption can not be made compulsory should both the seller and the buyer of the majority package in question happen to be affiliated persons because in this case, selling such majority package can very well be used as a mechanism for redeeming shares from minor shareholders at a low price.

Another novelty of obvious significance can be establishing the procedure for preliminary judiciary investigation of the appropriateness of the refusal by the Board of Directors to convoke an extraordinary general meeting of the shareholders as requested by the shareholders with more than 10 % of shares. This given initiative is motivated by the fact that convocation and conducting of such extraordinary general meeting of shareholders by the said shareholder – initiator usually results in setting up of two parallel bodies of control – the board of directors and the board of general directors – which are then used for unfair purposes by certain unfair people in the ensuing corporate disputes. On the one hand, consideration of this question seems to be both timely and necessary because setting up any parallel bodies of control is quite a widely spread tactics of unfriendly seizure of companies. However, this measure, in our opinion, is not at all the only way out of such a situation since holding of the extraordinary general meeting of shareholders with the preliminary judicial control is going to be rather difficult in practical terms: the said judicial procedure, after the decision of which the respective shareholder will be entitled to convene such a meeting independently, is normally going to take a lot of time – from four to eight months (with account taken of possible appeal of the judicial decision). This is the period during which the relevancy of the questions the respective shareholder was planning for discussion and consideration at the said extraordinary general meeting may very

well be lost and even forgotten. Thus, speaking in practical terms, when taking on such a clause, shareholders owning more than 10 % shares of the respective company can find themselves deprived of one of their legitimate rights – that of convening and holding the extraordinary general meeting of shareholders. Therefore, while preserving the acting order of convening and holding the extraordinary general meeting of shareholders, it is deemed both necessary and possible to entrust such control to a specialized self-regulating body which is expected to take decisions on the possibility to convene and hold such shareholders' meetings in a more timely and mobile way than the respective arbitration courts (first of all because of their greater specialization and lesser loading).

Of undoubtedly positive significance are further improvements in the procedural legislation and substantive regulation in the sphere of procedures for resolution of corporate disputes, namely:

- establishing a list of categories of corporate disputes pertaining to special jurisdiction of the arbitration court;
- determining exclusive cognizance (to the respective arbitration courts at the location of the respective legal person) of all cases regarding disputes between members of organizations as connected with participation in economic partnerships and societies; setting up the rule in accordance with which measures for providing for claims and applications in regard of the said requirements are implemented only by the arbitration court at the location where the said legal person resides;
- setting up the rule on compulsory uniting into a joint judicial proceeding of closely interconnected requirements pertaining to one and the same corporate dispute;
- limiting of possibilities for introducing the respective securing measures (introduction of either the compulsory counter security for the non-property claims or individual measures exclusively in the course of the respective court proceedings);
- disclosure of information on the court proceedings, being prepared or initiated, as connected with such or other corporate dispute.

Should these proposals be practically implemented, they will make it much more difficult to use the said unfriendly tactics of company takeovers.

Besides, it is noteworthy that these proposals have already been reflected in the draft project of the Federal Law "On Introduction of Changes in the Arbitration Procedural Code of the Russian Federation and Some Other Legislative Acts of the Russian Federation for the Purpose of Improving the Procedure of Resolving Corporate Disputes" (hereinafter called as "Draft Law") prepared with participation of the MERT Expert Council. The said Draft Law also provides for introducing in the RF CoAP of the respective measures of responsibility for violating the said clauses which, in turn, ensure the efficacy of the said norms (rules). It is particularly noteworthy that this Draft Law distinctly and precisely regulates the question on informational openness of economic disputes in the respective arbitration courts for all those participating in the said disputes. It is exactly this clause that makes the corner stone in the "black" and "grey" schemes of property "seizure" and its efficient regulation at the legislative level will significantly strengthen the position of lawful owners in their struggling against "raiders", the more so because, in real practice, it is only from the resolution of the court produced that such owners of valuable assets not infrequently find out that the said asset does not belong to them any longer.

A significant novelty seriously limiting a possible range for using the current methods of unfriendly seizures and conducive to more orderly account of lawful owners' rights, can also be produced by measures in improving regulation of the respective accounting system of the securities market, namely establishing certain solidary responsibility of both the registrar and the issuer for the damage incurred to the owner of securities by illegitimate

actions of the said registrar. This given measure is deemed to be quite ripe and efficient since it does help strengthen material responsibility of the said registrar for the actions accordingly performed. In our opinion, its adoption will significantly increase the “cost price” of aggressive ways to seize such or other assets and, hence, cut down possibilities for their practical application. Other measures for improving regulation of depositaries and registrars have been formulated more generally which fact, therefore, does not allow for their critical appraisal.

Another rather important novelty is greater responsibility on the part of those in the governing company bodies, namely boards of directors and directors general, achieved through their initiative to abolish clauses of the Labor Code should a claim is presented in connection with compensation of damages caused by the respective actions of these bodies. So far, the Concept does not yet contain any concrete mechanisms in the form of conceptual formulations of the respective changes in the said Labor Code. Meanwhile, practical implementation of these initiatives makes it necessary to preserve the existing balance of interests between the plaintiffs concerned and the company in the person of the respective executive bodies for the purpose of preventing the law permitted freedom of actions limitations for the said executive bodies to perform their functions under constant threat of facing such claims. Particularly significant in this light appears to be a possibility of judicial disqualifying of the executive bodies members at the lawsuits of the company’ owners which initiative is also provided for in the Concept. As to the mergers and takeovers sphere, practical implementation of the said measures is expected to help in cutting down the area of abuses by the “temporary” executive bodies which got their commanding positions in the result of their aggressive actions.

At the same time, however, it seems worth to cast doubts on implementation efficacy of one of the measures as suggested in the Concept, namely: “a member of the Board of Directors (the supervisory board, the respective collegial executive body) can not vote at any meeting nor on any resolution regarding the question in which this given person or a person with whom this given person is somehow connected, is materially interested or an obligation which contradicts or may lead to appearance of a conflict with the interests of the company in question”. Since the company’s Board of Directors is formed at the general meeting of the shareholders (in case of a joint stock society), it is the shareholders themselves who move forward such or other candidatures for approval. Thus it follows that, in accordance with the above interpretation, accusation in material interestedness of a member of the Board of Directors can be applied to any of them since, being proposed by the interested owner, such a member of the Board of Directors is connected materially with the interested person – a shareholder. In our opinion, in case of a corporate dispute, when the company’s owners have opposite interests, this clause will enable initiating judicial claims practically for all disputable questions duly considered by the said Board of Directors.

An important initiative, quite ripe for practical use, is represented in the regulation procedures for mixed type reorganization of legal persons when different organizational and legal form economic subjects (non commercial organizations included) are involved in such reorganization. At present, such forms of reorganization are not permitted by the current legislation thus making the respective owners additionally do certain preliminary work for changing the said organizational and legal forms of the economic subjects under reorganization. This is but just an extra barrier fraught with unnecessary monetary and time expenses at that not at all compensated with any tangible advantages.

Of no less importance is the legislative regulation of relations as connected with the so called insider information as well as with measures to prevent its practical use by insid-

ers to the detriment of the third persons. The Concept's draft project does not contain any concrete description of directions in which this given question could be resolved. Hence, it seems more expedient to turn to another relevant document – Development Strategy of the Finance Market (DSFM) in the Russian Federation, prepared by the Federal Service for the Finance Markets in the year of 2005 (hereinafter called as “Strategy”). The given document is also compiled with the help of the Expert Council for Corporate Management set up under the said FSFM in April 2005. The FSFM itself have prepared the respective concept of the draft bill and is also planning to complete in the nearest future the law “On the Insider Information and Market Manipulation”. The authors of this Strategy intend to develop special mechanisms for exposing violations of the law and calling to account for illegal use of insider information of civil servants. The Strategy also contains a number of concrete proposals concerning qualification of law violations in the field under consideration which are to be reflected in the said bill and seems to be quite effective, namely:

- making a deal by two or more participants of the trading in their own interests or in the interests of clients of two or more mutual deals, i.e. deals in which each of the participants in the trading, during a comparative short period of time and under the same market conditions, act both as the buyer and the seller of one and the same security. At that, the said deals do not have any economic sense either for one of the participants of such trading (or his/her client) or for both of the participants in this trading (or their client);
- repeated placing by a participant in the trading in his/her own interests or in the interests of his/her client of claims with either the greatest price for purchasing or the least price for selling in the result of which deals are concluded as leading to a considerable increase or, on the contrary, decrease in the price of the given security.

Noteworthy here are also two more quite ambiguous initiatives. The first of them concerns the principles of forming the respective documentation which puts this reorganization into the necessary formal shape. It follows from the Concept, it is necessary to legislatively strengthen the norm according to which when taking a decision on reorganization, the corresponding legal body is obliged to simultaneously approve both the general quantitative and the qualitative parameters of the rights and obligations (or the respective property complexes or their component parts) to be passed over from the legal person under the reorganization process to all the organizations being set up as a result of such reorganization. The said “novelty”, at that, is explained by the fact that since the process of such reorganization can take months or even years, both the separating balance and/or the respective deed of assignment then actually do lose their due authenticity. It is, nevertheless, to be particularly mentioned here that certain changes are to be expected in the said quantitative and qualitative parameters as determined in accordance with the notion stated above, as well. Thus, this particular measure seems to be rather unnecessary and not at all any transforming the existing state of affairs in the area. In our opinion, there is no need to change such whatsoever. We think this is just a case when it seems possible to fix legislatively the clause that the said separating balance, which is approved together with the protocol of the general shareholders meeting where the decision on reorganization was taken, is subject to the second consideration and approval before the reorganization has been completed with due account taken of the corrective should there arise need in the latter.

The other initiative deals with fixing the creditor rights of the society to be reorganized on requesting pre-term performance of the obligations to them of such company being reorganized. The authors of the Concept suggest that the judicial order for such requesting be formally introduced. This novelty seems to be infringing upon the said creditor

rights because (as has been mentioned above) this “judicial order” is quite a long story during which certain suffering will befall not only the creditor himself but the company under reorganization as well. We think it quite natural if a temporary ban on such reorganization is put should this case become subject of the respective court hearing (before such or other verdict has been passed). In our opinion, it also seems expedient to preserve the present legislative level order when consideration of the creditor rights of the company under reorganization is brought not to the competence of the arbitrage court but rather to that of the respective self-regulating organization.

It is also noteworthy that the Concept a sort of “ignores” the necessity of legislative adoption of the norm in accordance with which, during the reorganization of a legal person, at least one legal assignee reserves for himself the licenses issued in the name of the said legal person being reorganized. This norm seems to be quite natural much owing to the fact that a lot of companies find themselves practically faced with such a problem (This can be well exemplified by the situation which was brought to life by joining the “VympelKom – Region” OJSS to the “VympelKom” OJSS obviously connected with the risk to lose the respective license for providing the communication services by both companies which are among the leaders on the respective markets; in connection with this, the merger process of these two companies was significantly delayed). Another “omission” in the Concept is lack of proposals for determining sufficiently accurate list of the so called “affiliated persons”. Absence of, for instance, close relatives – owners of the company in such a list may lead to certain divergences in the respective list of formal and real beneficiaries of the company and hence – the informational closeness of such companies. This has been clearly noted in the Strategy but with no any concrete recommendations as regards reforming the existing legislation as connected with this particular issue.

The analytical results of these given novelties permit the following conclusions:

- The Development concept of corporate legislation for the period of up to the year of 2005, should it be adopted and practically implemented, could become quite a positive step in putting in order and regulating the existing development sphere of corporate control over the situation. The main notions of this Concept, the respective remarks, proposals and amendments indeed taken into due consideration, could well become the basis for modifying the current legislation in the field.
- The most important and on the whole ripe initiatives of the Concept are issues of suppressing possibilities for unlawful seizures of economic subjects, legislative fixing of the necessity for informational openness of the companies as well as increasing the responsibility level of the respective executive bodies. Mechanisms of these given initiatives, as defined in the Concept, on the whole seem rather efficient from the view point of their practical implementation (provided due account has been taken of the above remarks).

There is a number of arguable questions in the Concept, namely:

- establishing the judicial control procedures over convening the extraordinary general meeting of shareholders by the owner having not less than 10 % shares at his/her disposal;
- ban on voting by a member of the Board of Directors as connected with a person having material interest in the issue to be voted. In case this norms has been adopted, it is necessary to concretely define the degree of such interaction between the said director and such interested person as well as sufficiently precise definition criterion of such interconnection;
- additional (apart from the above said separating balance and the deed of assignment) approval of quantitative and qualitative parameters of the companies’ reorganization;

- the judicial order of creditor claims of indebtedness of the company under reorganization.

Two important questions have been omitted in the Concept:

- succession of licensing rights of the respective economic subjects which appear as a result of reorganizing companies having such licenses;
- lack of sufficiently distinct list of the affiliated persons as established at the legislative level.

Certain questions, as suggested in the Concept for preliminary court investigation, can be submitted for the resolving of the respective self – regulating organization. Be such a case, the principles of this organization’s activities must be clearly defined in the said Concept (without any legislative fixing of its creation) while the initiative of such creation is to proceed from the respective executive power bodies of the state.

Special mention should also be made of other initiatives as connected with the regulation procedures in this given field of civic and legal relationships. In particular, it seems expedient to spare some time on one of the latest initiatives of the RF Ministry of Internal Affairs (RF MIA) in the field of regulating the corporate control market. In order to protect enterprises from possible unfriendly takeovers, the RF MIA prepared and directed to the Federal Taxation Service (FTS) a draft bill which provides for notary certification of the most significant events in the business life of the economic subjects. This bill will also be concerned, *inter alia*, with decisions taken by the respective boards of directors and/or general meetings of shareholders and connected with election of their executive bodies, reorganization and liquidation, increasing of the authorized capital and so on and so forth. In our opinion, except for significant complications in the process of documenting most important decisions, made by the said owners, *for all legal persons without exception*, this initiative simply can not any significantly tell on the efficiency of struggle against unfriendly takeovers because no full checking of legality of the respective documents prepared for duly notarization as well as the proxy of the persons who signed such, seem to be possible.

Finally, it is also necessary to mention practically the only legislative initiative which was later implemented in the year of 2005. On January 5, 2006, the RF President signed the Federal Law “On Entering Changes in the Federal Law “On Joint Stock Societies” and some other legislative acts of the Russian Federation (hereinafter called as the “Law”). This Law has become a result of a year and a half long discussion which took place with participation of the RF President’s Administration, representatives of the RF State Duma, various investment funds. It was as far back as July 2004 that the RF State Duma considered, in the first reading, the draft bill moved forward by a group of deputies, including V. Ple-skachevsky, Head of the Duma Committee on Property, and V. Reznik, Head of the Duma Committee on Credit Organizations and Finance Markets. The basic assumption of this draft bill was: shareholder having 90 % plus 1 and more shares in the OJSS with over 1000 shareholders, can carry out compulsory redemption of shares from the rest of the shareholders for the price as confirmed by an independent appraiser. The bill caused a wave of justified criticism because the mechanism of estimation, proposed in it, could be leading to a forced sale of minority shares at an obviously lower price – the customer for the estimation service was the buyer of such shares. In the Autumn of 2004, a group of official representatives from various investment funds, certain international ones included, prepared a letter to the address of the RF President in which they expressed serious concern with the fact that the RF State Duma passed the said draft bill in this form in the first reading.

Apart from the above stated problem as connected with estimating the redemption price for shares of the minority shareholders, the said Law has quite a number of other shortcomings, namely:

- rather limited sphere of application – OJSS with over 1000 shareholders;
- too high a cut off threshold of the minority shareholders who can be forced to sell their package of shares – 10 % minus 1 share. It is to be remembered that the Federal Service for Finance Markets (FSFM) at the same time did suggest to use the said forced redemption only when the main shareholder has reached the quantity of shares threshold of 98 %;
- the law does not provide for the government control over vetting a fair price for which the redemption is effected.

Thus corrected draft Law, prepared by deputies L. Pepeliaeva and V. Piligin, was directed for the consideration of the RF State Duma in April 2005, and in the summer of the same year was already approved by its Committee on Property. In December 2005, the draft Law was approved by the RF Council of Federation, then, in January 2006, it was duly signed by the RF President. The essence of this newly adopted Law can be better understood through separate consideration of both its advantages and shortcomings.

The Law is aimed at cutting off the so called “greenmail” – a sort of corporate blackmail on the part of the minority shareholder who has only an insignificant package of shares but nevertheless uses his/her legal right to register claims on reimbursing damages inflicted on him/her by the top management of the company. Similar instances are not at all anything new for the respective practice in Russia. In the officially adopted version of the Law, the owner with 95 % and more shares (in the quantitative terms) is entitled to buying from the minority owners their shares for a just market price. It is to be noted here that most Western countries also have a similar legal norm in their respective corporate legislation in accordance with which redemption can be done in case 90 % to 98 % package of the company’s shares is to be acquired.

The Law does reasonably define the principles of estimating the just price of shares. Thus, in case shares of the company are traded on the stock exchange, such “just price” is usually understood as the average weighted price for the given share during the last 6 (six) months. Otherwise, in case these shares are not traded on the finance markets, such price is determined by the respective independent appraiser but it can not be lower than the highest price at which the 95 % — th owner or his/her affiliated persons were buying these shares during the last 6 (six) months.

The Law also provides for the state control in determining the correct redemption price: the FSFM is entitled to suspend redemption should it any suspicions arise with regard to obviously lower redemption price when dealing with the prospect for such redemption which is duly sent to the said FSFM.

Normally, shareholders of the company mostly know about the appearance of any new large shareholder as when acquiring a package of shares, a physical or a legal person becomes the owner of 30 % or more shares of the company, such physical or legal entity is obliged to officially send the respective proposal on such redemption to other shareholders of the company. At that, if the initiator of such proposal is the said legal entity then such proposal must contain information on its owners as well. It is also quite noteworthy that we consider this particular change as exerting extremely positive impacts on the market of unfriendly takeovers by significantly limiting the scope of its effectiveness.

Along with adopting changes in the Law “On Joint Stock Societies”, material responsibility of citizens, functionaries and legal persons is also provided for the violation of the respective regulations being introduced in the said Law. Similarly stipulated is the responsibility for the respective appraisers in case of a non objective estimating of the “just price” for the redemption of shares from the minority shareholders.

Viewing this adopted Law positively on the whole, we nevertheless think it worthy to specially note such a shortcoming in the corporate legislation of Russia as lack of any law with regard to the so called “affiliated persons”. This situation permits manipulating with regulations of the Law on compulsory redemption by a large property owner formally having in his/her possession less than 95 % of shares. It is also noteworthy that the said Law enters into force beginning from July 1, 2006, so there is still some time to prepare and practically consider the draft bill on the above said affiliated persons the acute need in which has been long spoken much about both by representatives of the state power and by those of business.

4.8.3. Problems of Legislative Regulation of Competition and Monopolistic Activities on the Commodity and Finance Markets

One of more significant initiatives was preparing in 2004–2005 a draft project for the new version of the Federal Law “On Protection of competition” (hereinafter called as “Draft Law” which caused quite an ambiguous reaction. Three major blocks can be singled out in the changes with regard to the acting legislation:

- expansion and unification of civil rights objects (respective deals, provision of the state and municipal aid, etc) as regulated by the acting legislation on competition and monopolistic activities;
- specifying the definitions used in the field of protection of competition (as compared against the currently acting legislative norms), as well as defining certain procedural questions as connected with possible abuses in the regulated area in question;
- changing the threshold norms and values for some indicators which are considered as key ones for determining the dominating position on the respective commodity and finance markets, and require approval of the regulating executive power body or its timely notification as well as time-terms for formal appeals against decisions taken by the respective anti monopoly bodies.

One of the main system – forming novelties in the draft Law is that it is called upon to unite two currently acting federal laws – the RSFSR Law No. 948-I “On Competition and Limiting the Monopolistic Activities on the Commodity Markets”, dated March 22, 1991 (with multiple changes and amendments) and Federal Law No. 117-FZ “On Protection of Competition on the Market for Finance Services”, dated June 23, 1999 — into one regulative document.

Thus, should the new Law be adopted, the object of its regulation will become “relationships connected with protection of competition on the *commodity markets and markets of financial services* in the Russian Federation, prevention and suppression of monopolistic and unfair competition which are participated in by *Russian and foreign legal entities, the Central Bank of the Russian Federation, the federal bodies of the state executive power, the state power bodies of the subjects of the Russian Federation, bodies of the local self-government, other entities performing functions of the said bodies of power or the respective bodies of local self-government bodies or organizations as well as physical persons and/or individual entrepreneurs*” (Art. 3 of the draft Law). This novelty is not without certain economic sense because, from our point of view, it does contain absolutely correct and fully justified approach: application of unified regulation standards to all subjects of civil and legal relationships regardless of the branch and essence of the relationships entered into by all subjects of civil rights on the territory of the Russian Federation.

Another, no doubt, positive novelty contained in the said draft Law is, in our opinion, regulation of the procedure for providing state and municipal aid. Taking the norms regu-

lating the given sphere of the civil and legal relationships up to the federal law level with sufficiently detailed defining the rules for providing such aid, in our opinion, is leading to greater transparency and easier control over the targeted spending of the respective federal and municipal means. The only question as regards this section of the said draft Law which requires additional explanation, is establishing the threshold for such aid – not more than 5 % of the given economic subject's incomes for the previous year (in case this aid is provided neither to the R&D, nor to agricultural producers and the like – P. 3.1, Art. 16 of the draft Law). Unfortunately, the general aim of providing the said state and municipal aid, as worded in the draft Law, is not sufficiently distinctly formulated. Meanwhile, truly important seems to be just one goal – assisting further development of socially significant entrepreneurship initiatives and projects. At that, the investment requirements of business which, apart from purely economic aims, are targeted at the social result as well, can, to a considerable extent, exceed the said 5 % incomes threshold for the previous year with the overall significance of the project for the state being quite high. At the same time, however, such a threshold should indeed be set up for purposes of unification and retaining the equality factor for all beneficiaries of this aid. In connection with this, it is suggested to increase this said threshold minimum up to 10 %–15 % of the incomes received – the minimum tax load on the commercial organization (for instance, the unified tax rate for the imputed earnings in Moscow comprises 15 % of the imputed proceedings).

It is also noteworthy that according to the respective explanatory note to the draft Law, one of its obvious advantages is that should the new Law be adopted, a definite ban shall be imposed on combining functions of the economic subjects and the respective bodies of power. We can not agree to such interpretation as is contained in the said P. 3, Art. 7 of Law No. 948-I, i.e. the law currently acting at the present time as well, because this ban is also manifestly present in no less clear formulation.

The draft Law does distinctly define such kinds of monopolistic activities as *coordinated actions* of the respective economic subjects and *coordination of economic activities* by the third person, at that:

- coordinated actions of the respective economic subjects are such “actions of the economic subject on the commodity market the economic results of which corresponds to the interests of the given economic subject only if other economic subjects, whose sum total share on the given commodity market exceeds 35 %, act in the same way, and if such actions are leading or may be leading to barring, limiting or eliminating competition on the respective commodity markets and (or) impair interests of other persons” P. 17, Art. 4 of the draft Law);
- coordination of economic activities is “coordinating actions of the respective economic subjects by the third person not being part of any one group of persons with any of such economic subjects” (P. 18, Art. 4 of the draft Law).

While the acting legislation (Art. 6 of Law No. 948-I) defines “*coordinated actions of the respective economic subject*” rather essentially (even though somehow taken out of the context), the “*coordination of economic activities*” notion is actually a new definition and, essentially, provides for and regulates certain actions of the respective regulating body in finding and suppressing such activities. This norms is deemed as necessary since it does suppress certain actions of non-formalized holdings in their strive towards monopolistic activity. Besides, despite the fact that the coordination of economic activity definition is of a rather general nature it nevertheless does seem quite sufficient for finding any forms of abuses in this sphere and hence – efficient from the point of view of its practical application.

Some modification in the version of the said draft Law also undergone the understanding of a certain group of persons: conventionally expanded was the list of several economic subjects classifying mutual economic interests. Apart from those already existing in the respective current legislation, the following was also added to the list of such conditions: several persons have either concluded an agreement with each other or are performing a sort of coordinated actions which give these participants considerable technologic or trading advantages as against the other economic subjects on the corresponding commodity market which further improves the required understanding of coordinated actions of the respective persons (P. 21, Art. 4 of the said draft Law).

Certain initiatives, as represented in the said draft Law, seem to be rather controversial. In the first place, p. 4, Art. 6 of the draft Law – violation of the *coordination of economic activity* clause is understood as comprising a justification for liquidating the economic subject judicially. Since this preventive punishment is considered to be unnecessarily cruel, it seems expedient to replace this measure with certain penalty provisions in the first case with the respective liquidation sanction permitted only in case of repeated violations (two or more times in the course of three years). Secondly, the anti-monopoly body is entitled to put forward proposals to the respective licensing bodies with regard to withdrawing licenses from those violating legislation in the sphere of monopolistic activities (p. 20, Art. 20 of the draft Law). In our opinion, withdrawal of licenses is also somewhat too hard a form of regulation since the economic sense of licensing is not in any way connected with whether the licensee does or does not enjoy the monopoly position on the respective market. It is therefore advised that this given norm be totally excluded from the said draft Law.

We deem as particularly important initiatives defined in the said draft Law with regard to changes in certain threshold values which currently still exist in the Russian legislation as well as introduction of new threshold values.

As dominating recognized is position of the economic subject in question whose share on the market of a certain commodity exceeds 50 % (p. 11, Art. 4 of the draft Law); in Law No. 948-I, this value was 65 %. It is not at all simple to determine the threshold which it will be necessary to proceed from owing to the absence of sufficiently rich practical experience in applying the currently acting legislation to the area under consideration. Meanwhile, quite possibly, it is just because of lack of such practice in Russia that this currently acting higher threshold value has been determined.

This dominating position notion is introduced by the sum total share of several economic subjects on the market. Thus, the position of each of several economic subjects (except for financial organizations) is recognized as dominant if the following conditions are observed with regard to them: (1) the sum total share of no more than three economic subjects where the share of each of them is greater than those of other economic subjects on the given market, exceeds 50 %; (2) the sum total share of no more than five economic subjects where the share of each of them is greater than those of other economic subjects on the given market, exceeds 70 % (at that, this rule is not applicable if the respective market share in at least one of these economic subjects does not exceed 5 % – p. 11, Art. 11 of the said draft Law). Accordingly, the given norm can be related to both the second and the third of the above enumerated groups of novelties because the application sphere of the said draft Law involves not only the monopolistic but the oligopoly activities as well thus expanding the field of regulation covered by the said Law.

There have been some changes and significant narrowing of the range of deals in reorganizing the respective legal entities which require neither approval nor any notification of the anti-monopoly body. Thus, preliminary agreement of the said anti-monopoly body is

required by the deals as connected with the said reorganization of the legal entities (merger, joining, etc) if the summary earnings of these legal entities for the calendar year or the balance value of the respective assets for the last accounting period exceeds 3 (three) bln roubles (p.p. 1, p. 1, Art. 25 of the said draft Law). This novelty can be taken as positive because it does somewhat simplify and significantly reduces the time terms for practical implementing the reorganization procedures for small and medium size economic subjects. Notification by the respective anti-monopoly body is required for the deals concerned with reorganizing the legal entities whose similar sum total indicators comprise not more than 200 mln roubles (p. 2, Art. 25 of the said draft Law). The earlier threshold value in need of approval by the respective anti-monopoly body was 200 thousand MROD (Minimum payment for Labor Size), that for the respective notification – 100 thousand of MROD (Art. 17, of Law No. 948-I).

As to exercising control over acquiring rights for the shares in the respective economic societies, the Law stipulates that such an order of things be retained only with regard to the deals in the result of which the getter is for the first time given the right to be the boss of the blocking package of shares, the controlling packet of shares and the 75 % package of shares (Art. 25 of the said draft Law). At present, the necessary approval is needed in case 20 % of shares of the legal entity in question are to be acquired (Art. 18 of Law No. 948-I). This novelty is to be positively estimated too because the new threshold values are well justified from the economic point of view (it is primarily they that endow the new owner with different levels of authority with regard to the legal entity in question fully in accordance with the respective Russian legislation on legal entities).

It is in such formulation that the said regulation seems to be efficient because regardless of the quantity of shares being acquired, under control remains any changes in the owner's status of influence on the company in question and not just the quantitative parameters of such deals (the quantity of shares being acquired in a particular deal) which fact inevitably includes the deals that objectively become subject to such regulation, into the range of those regulated. However, in our opinion, even this formulation can be extended to cover the cases when part of the company's shares have already been redeemed and is taken into account in the balance sheet of the company itself. Subject to control in such a case are the deals in the result of which the property share in the company, with account taken of the respective correction factor as reflecting the relation of the new package of shares to that not yet redeemed by the said company itself, comprises more than 50 % to 75 %. For instance, if 5 % shares of the company belong to the very company and if that same company has not yet decreased its authorized capital by the sum of the shares redeemed, then the shareholder who increases his/her package from 40 % up to 49 % of the package of shares, in fact owns the controlling package of shares since all the other owners (except for the company itself) have at their disposal but only 46 % shares.

Besides, agreement of the anti-monopoly body, as per clauses of the said draft Law, is required for the payment of the authorized capital in shares of the finance organization in question strictly in accordance with the rules (size of the authorized capital of the respective financial organization) set up by the RF Government (p. 1, p. 1, Art. 25 of the said draft Law).

Another novelty here is that the time term has been significantly lowered in the said draft Law during which any decision of the respective anti-monopoly body can be appealed against in the court. The current legislation stipulates a three month term for such cases (p. 2, Art. 28 of Law No. 948-I) while the said draft Law stipulates but only one month for the court appeal against injunctions of the respective anti-monopoly body (Art. 32 of the

said draft Law). This particular novelty does not seem quite expedient because such a court appeal usually requires serious preparation and, as is to be expected, considerable time of the respective experts in plaintiff organization and hence – quite a sum of money. Moreover, should such preparation for the respective court hearing will lack the necessary quality, this fact may be leading to significant financial losses while there are not many evident advantages, it seems, to be gained from shorter time terms for the appeal procedures in the end result.

The said draft Law still retains one of the more disputable aspects, namely relating the unjustified reduction or complete stoppage of production of commodities which have consumer demand and/or concrete orders, accompanied with definite possibilities for their profitable production (p. 1, Art. 5 of the said draft Law), to the monopoly activity. It is undoubtedly necessary to ensure freedom of business activity for the economic subject in producing such or other commodity. Also, it would seem more reasonable to give up such definition of the said violation. Moreover, should this producer who chooses to give up production of such or other commodity (service, work), does nevertheless has at his/her disposal really unique factors of production, it is suggested to include into the said draft Law a clause on transference of these factors to the new owner, *gratis*, but on the competitive basis only.

Another rather disputable norm which is also still in existence in the current legislation, is the following: obtaining into ownership, practical use or owing by one economic subject (a group of persons) of the basic production means or non material assets of another economic subject, should the balance cost of the property making the subject of the deal (several interconnected deals) in question, exceed 10 % of the balance cost of the said basic production means and the said non material assets of the economic subject which alienating or transferring the property in question (p. 2, p. 1, Art. 25 of the said draft Law). At that, if we are, for such or other reason, not inclined to agree with the general meaning of this point in the said draft Law, then its universality can not be agreed with either. In our opinion, apart from a relative value – percentage of the organization's property cost, — it is imperative to set up the minimum cost of such property deals with which are subject to certain preliminary coordination with the respective anti-monopoly body. Otherwise, for instance, selling the office equipment being the property of a small auditing company to be liquidated, may be subject to approval on the part of the FAS. Besides, it is also suggested that excluded out of the list of deals subject to the said regulation, be selling of the buildings and other respective constructions not being directly related to the production activities of the legal persons taking part in the deal in question, because such deals, as we deem, can not in any way limit competition either on the respective commodity or the respective finance markets.

In conclusion, it is quite noteworthy that, on the whole, the said draft Law does correspond to the contemporary needs in regulating economic activities of the respective economic subjects of the Russian Federation since it makes it somewhat easier to set up unjustified administrative barriers when performing entrepreneurship activities, it regulates a number of economic functions, it distinctly enough defines the processes rather vaguely defined in terms of the respective legislative notions. This, *inter alia*, does somewhat simplify possibilities for proper administration in the protection of competition and monopolistic activities area. Nevertheless, to our mind, a number of shortcomings, as mentioned above, still remain which are subject to further and more detailed working out before the said federal law has been formally adopted.

4.9. The Housing Market of Moscow Region⁹¹

The first months of 2005 created a clearly unfavorable socio-economic background that exerted an adverse influence on the state of the real estate market. The conflict between business and state power encouraged the capital flight. There appeared projections of a downfall of prices for energy sources. The acceleration of inflation in January 2005, which has long become traditional for Russian economy, was further aggravated by the “monetization “ of benefits that provoked mass street protests. As a result, savings and bank deposits were inflated.

However, the pessimistic forecasts have failed to come true. The oil prices continued to soar, while the population’s discontent was gradually put out by growing allowances and pensions and a partial return to the in-kind and subsidized delivery of benefits, and freezing of the plans to spread the monetization on payments for the housing and communal services. As a result, a great amount of money was infused in the economy. The positive dynamics of Russia’s socio-economic development have also had their effects. The distinctive features of Russia’s economic development in 2005 that played a notable role in the dynamics of the real estate market were:

First, high oil prices that provided a considerable support to the economy on the whole and the real estate market in particular.

Second, there remained rather a stable rise of investment demand, which was backed-up by positive trends in the financial sphere (excessive liquidity in the banking sector and declining domestic interest rates, and a relative stability on the world debt markets).

Russia’s rising investment attractiveness has become a key factor that drove the real estate market. Despite the noted capital flights due to the conflict between business and the state, both parties have gradually adjusted themselves to new conditions, which resulted in a gradual fall in the capital flight.

Third, the 2005 main targets in the financial area became curbing inflation to 8.5% and a moderate (at 8%) appreciation of the Ruble vis-à-vis the forex basket. However, the government has failed to reach both macroeconomic targets. According to the 2005 results, inflation accounted for 10.9%, thus being greater than the government had initially planned and not differing greatly from the 2004 level (11.7%). The average monthly nominal USD to Rb. exchange rate was fluctuating between 27.6 and 28.8 Rb./USD, with an upward trend in place, while the depreciation index of the USD vis-à-vis Rb. in relation to December 2004 made up 1.031. The average monthly Euro rate was on decline over the years from 37.3 to 34.2 Rb/Euro, while the depreciation index of the Rb. vis-à-vis Euro in December 2005 vs. December 2004 made up 0.915.

The general dynamics of the Rb. appreciation vis-à-vis foreign currencies and a fairly high inflation rate lay a critical role, as far as the real estate market is concerned. Housing has become one of investment instruments, which guarantees a fairly stable income level, while the stability of macroeconomic parameters only increases the attractiveness of such investment and gives positive signals to operators and customers on the real estate market.

Fourth, the consumer demand was on the rise in 2005 and it was backed-up by the soaring population’s incomes and boom on the market for consumer credits.

⁹¹ In this section, we used the data of the research entitled “Рынок недвижимости Московского региона. Анализ развития и прогноз на 2006 год” by “MIEL-Nedvizhimost” company (November-December 2005). The research team comprised: Sternik G.M., Lutskov V.M., Kazimir L.M., Logvina E.A., Mironchuk Ya. S., Ascheulova N.A., Korobkova M.V., Rzhavsky A.I., Krasnopolskaya A.N., Sternik S.G., Prokofyeva V.V., Shlelenko N. V.

The integrity of the aforementioned factors has changed both the aggregate effective demand on the market and the population's readiness to spend their savings. As a result, after nearly a year of a relative stability between the summer and autumn 2005 the real estate market in Moscow regions once again saw the rise in prices and demand.

4.9.1. The Secondary Housing Market

The rise in demand and prices on the secondary market for housing of the city of Moscow started in June-July 2005, followed by the same process in the Moscow oblast housing market since October 2005. In December 2005, the average proportional prices for Moscow apartments hit USD 2, 658/sq.m., and USD 1, 121/sq.m. in Moscow oblast.

Given that in the first half year the price rise rates in Moscow made up "inflationary" 1.0-1.5% a month, since July they grew up to 2.0–2.5%, followed by 4.5–5.5% reported in September through December, which speaks of a sudden rush demand. In Moscow oblast, the prices had been practically stalled, with up- and downward fluctuations accounting for 0.7.–0.8% a month. September 2005 saw a 1.2% increment of the average proportional price, which was further proved by the further rise in October, November and December (at 5.2, 3.1 and 7.2%, respectively) (Fig. 14).

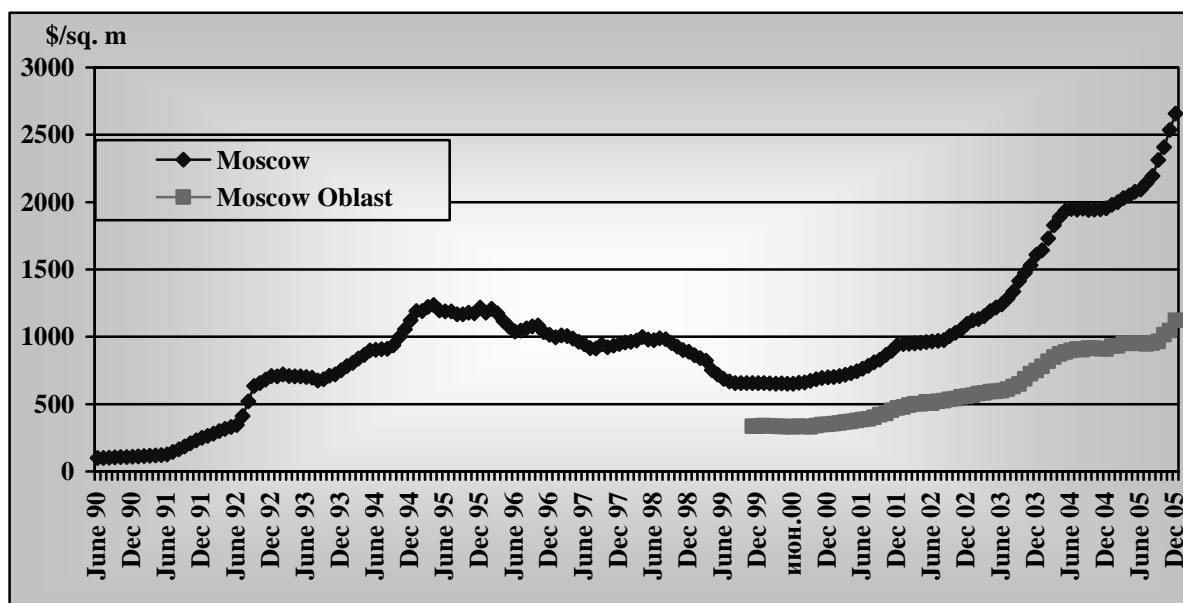


Fig. 14. The Dynamics of the Average Proportional Offer Price of Apartments in Moscow and Moscow Oblast between 1990 and 2005

In the second half 2005 the average proportional offer price for apartments on the secondary market for housing in Moscow grew by 26.9%, while with account of the price rise of the first half of the year – by 7.3%.

By results of 2005 the housing prices in the city of Moscow grew by 36%, which is lower than the respective 2003 index (46.9%), but over 1.5 times greater than the 2004 annual increment rate (21.4). The nominal price index vs. December 2003 grew by 1.651 and 2.425- vs. December 2002. In Moscow oblast, the 2005 housing prices grew by 23.5%, which became slightly different from the 2004 results (21.4%), but notably lower the respective index of 2003 (33.8%) (Table 10).

Table 10

**The Dynamics of Increment Rates and Housing Offer Price Growth Rates
in Moscow Between 2002 and 2005 (December)**

Month, year	Moscow			Moscow oblast		
	The average proportional price for apartment (offer), as USD/ sq.m.	Growth index relative to the basic period (nominal)	Increment rate (relative to the prior period), as %	The average proportional price for apartment (offer), as USD/ sq.m	Growth in- dex relative to the basic period (nominal)	Increment rate (rela- tive to the prior pe- riod), as %
12.2002	1096	1.0	-	559	1.0	-
12.2003	1610	1.469	46.9	748	1.338	33.8
12.2004	1954	1.783	21.4	908	1.624	21.4
06.2005	2095	1.911	7.3	954	1.707	5.1
12.2005	2658	2.425	26.9	1121	2.005	17.5
12.2005*	2658	2.425	36.0	1121	2.005	23.5

* – values that characterize the December 2005 increment vis-à-vis December 2004.

Just a reminder, the consumer prices showed a 10.9% rise in 2005. The USD average nominal rate in December 2005 was 28.81 Rb. vs. 27.92 registered a year earlier. Hence, the Rb.-to-USD depreciation index made up 1.031 in 2005. Accordingly, the 2004 USD inflation index in Russia accounted for 1.076. Thus, the USD continued to depreciate in Russia last year, albeit the rate of decline of its purchasing power decelerated notably (some 7% vs. 15% in 2004).

As for the index of real (cleared from inflation of both the Rb. and US) housing prices (the IGS index)⁹², its 2005 value vs. its respective value of 2004 made up 1.264 for Moscow and 1.148 for Moscow oblast. Thus, the year of 2005 repeated the 2003 situation, when both nominal and real housing prices in the city of Moscow had demonstrated a greater pace of growth than those in Moscow oblast, while in 2002 and 2004 the growth rates of the indices in both Subjects of RF were roughly equal.

Since early 2004 the secondary market for housing in the city Moscow and Moscow oblast demonstrated a fairly steady rise of volumes of offer of apartments, which can be easily attributed to the stagnation of prices and fall in the market turnover. The tendency was in place until March-April 2005, except for January, when the fortnight-long Christmas holidays resulted in the contraction in the population's business activity and affected the aggregate volume of apartments on sale. The tendency reversed in March-April and the number of flats offered on the secondary market began to fall: from the monthly offered 30,000–35,000 in the city of Moscow to 9,000–11,000 in Moscow oblast to 17,000–20,000 and 7,000–8,000, respectively.

This change can be explained by two causes:

- a growing rate of apartments withdrawn from the market (primarily, due to sales, as well as withdrawals from sales); and
- maintenance of the rate of putting apartments for sale (the monthly number of apartments newly put for sale in the city of Moscow is stable and accounts for 8,000-10,000). It traditionally declines in December.

The decline in the offer volume against the rising demand in turn triggered a further rise in price growth rate.

⁹² The IGS index is computed according to the formula: $IGS = I_{hp} / I_{cpi} = I_{dp} / I_{di}$, where I_{hp} – the Rb. –denominated housing price, I_{cpi} – consumer price index, I_{dp} – USD-denominated housing price, $I_{di} = I_{cpi} / I_{drb}$ – the USD inflation rate in Russia (vs. the dynamics of consumer prices), I_{drb} – index of the Rb depreciation vs. USD.

If the rates of sales of apartments remain unchanged, one should expect a rise in the volume of their offer, thanks to an additional putting of apartments on the market, only with a 3–6- month lag, when their owners and sellers realize the new situation and discontinue to anticipate a further price rise on the market.

The dynamics of sales volumes of apartments on the secondary market in the city of Moscow and Moscow oblast proved to be in many ways similar to the dynamics of their offer. Because of the growing demand, the turnovers on the Moscow oblast secondary market for housing began to grow in the 2nd–3rd quarters (*Fig. 15*).

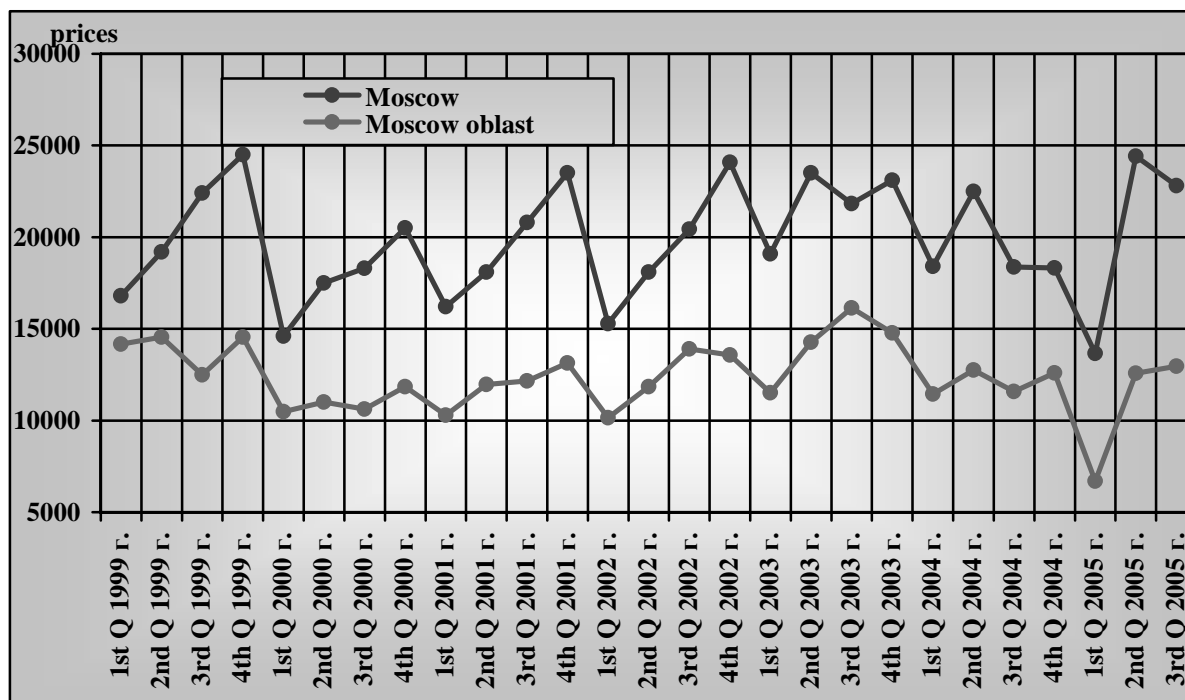


Fig. 15. The Dynamics of the Number of Registered Transactions on the Secondary Market for Housing of the City of Moscow and Moscow Oblast in 1999–2005

The annual turnover of the Moscow city secondary market for housing reached its peak in 2003 (87.53,000 apartments, the 12.4% increment) and consequently plunged to 77.600 (the 11.3% fall). In 2005, the turnover made up 82.38,000 apartments (6.2% up) (*Fig. 16*).

Thus, the progress in the macroeconomic situation in the country has led to a rising effective demand on the real estate market in Russia’s capital. The rise in the turnover on the secondary market for housing and prices for apartments that started between the summer and autumn 2005 fueled the “washing out” of objects and contraction in the offer volume, which in turn triggered the further price growth rates.

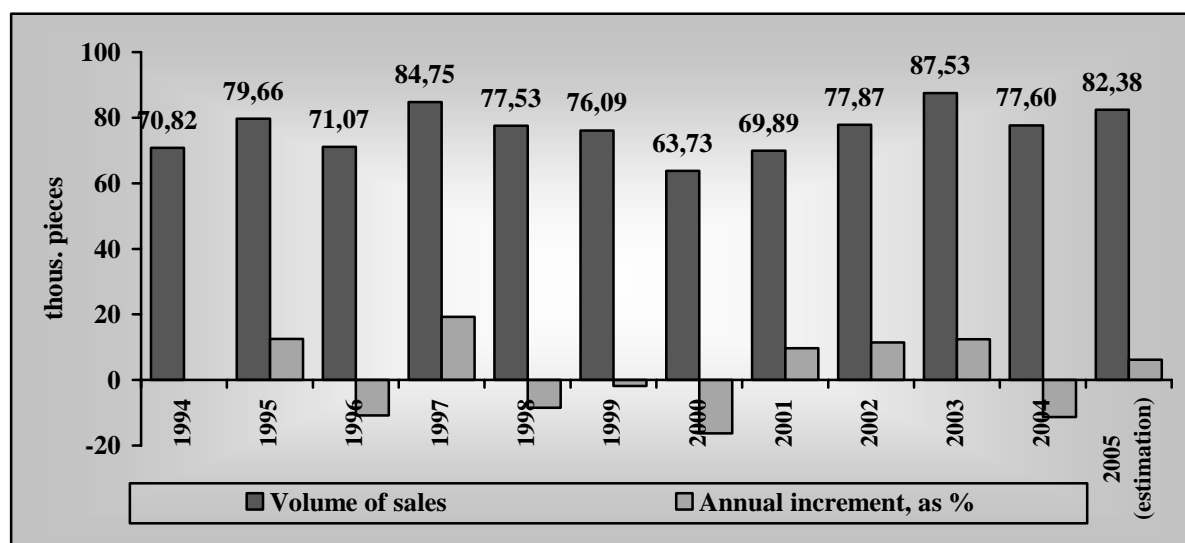


Fig. 16. The Annual Volume of Apartment Sales on the Moscow City Secondary Housing Market in 1994–2005

4.9.2. The Primary Market for Housing

The main factor underlying the state of the primary market for housing in the city of Moscow and Moscow oblast became volumes and growth rates of house building.

Different sources provide somewhat confusing data (Table 11).

Table 11

Volumes of Placement into Operation of Housing in the City of Moscow and Moscow Oblast in 2000–2005

year	By Moscow-headquartered construction companies in and outside Moscow (according to the Rosstat data)		By the city of Moscow (according to the Rosstat data)		In Moscow (according to the Moscow Mayor's office)		By Moscow oblast (according to the Rosstat data)	
	Sq.m. Thos.	As % to the prior year	Sq.m. Thos.	As % to the prior year	Sq.m. Thos.	As % to the prior year	Sq.m. Thos.	As % to the prior year
2000	3530.2	104.8	3342.3	109.5	33342.3	...	2610.9	95.7
2001	3821.5	108.3	3690.6	110.4	3706.1*	110.9	2827.8	108.3
2002	4469.6	116.9	4274.1	115.8	4310.9*	116.3	3414.8	120.7
2003	4703.2	105.2	4443.0	103.9	4441.9*	103.0	4136.4	121.1
2004	4794.7	101.9	4578.6	103.1	4576.8*	103.0	5738.2	138.7
2005	5224.1	108.9	4644.3	101.4	4644.3	101.5	5271.4	91.9

* – built in the city of Moscow by local construction companies; on 2001 the volume of newly built housing is estimated at the level of 3824,9 Thos. sq.m., accordingly the growth rate vs. 2000 г. roughly makes up 114.4%.

Source: Rossiysky statistichesky ezhegodnik. 2004: Statistics collection. / Rossta, M., 2004, p. 463; Investitsii v Rossii 2003: Statistics collection. / Rosstat, M., 2003, p. 163, 165; Investitsii v Rossii. 2005: Statistics collection. / Poccтaт, M., 2005, p. 256, 258; www.mos.ru; Sotsialno-ekonomicheskoye polozhenie Rossii, 2005 god, M., Posstat, p. 365–366, the authors' computations.

Notwithstanding the above, it is possible to consider main trends. The volumes of placement of blocs of apartments in the territory of the city of Moscow have recently been on the rise and accounted for over 4.6 mn. sq.m. in 2005 alone. Meanwhile, all the sources

are unanimous in concluding that the growth rates of volumes of house building were clearly fading. The 2002 record-breaking increment (a. 16%) was changed by moderate (3–4%) rates hence. The 2005 increment rate of placement housing in operation proved to be yet more modest (some 1.5%). The aggregate performance results of construction companies that headquarter in Moscow and work both in the city and other regions are greater (9%). Notably, while between 2001 and 2004 the volume of their operations outside Moscow accounted for just 4–6%, the respective 2005 index made up over 11%. As for a vice versa phenomenon, construction companies that base in other regions practically did not contribute to house building in the capital in 2003–04⁹³.

In Moscow oblast, since 2001 the growth rates of volumes of house building were steadily greater than those in the city of Moscow. In 2004 they grew by nearly 38% vs. 20–21% reported in 2002–03. In 2004–05 the absolute volume of placement of housing in operation in the Oblast (in sq.m. equivalent) became greater than the respective Moscow city indicator, which has never been occurred before.

However, it should be noted at this point that starting from 2004 a drastic rise in annual volumes of house building, according to Mosoblastat and Rosstat, can be partly attributed to the transition from the accounting of the volume of house building by enterprises of the Oblast construction complex to the accounting of volumes of placement of new housing in operation in the region's territory by all the developers, including those headquartering in the capital. The latter appears adequately corresponding to the 2005 Rosstat data according to which the Moscow-headquartered building companies practically doubled the share of housing put into operation outside the city. Nonetheless, the volumes of placement of housing into operation in Moscow oblast plunged last year by 8% vs. 2004. That occurred for the first time over the past five years, and the causes for the drop will be highlighted below.

Let us briefly focus on the structure of the newly built housing⁹⁴ (*Tables 12 and 13*).

Table 12

Volumes and Structure of Placement into Operation of Housing, by Types of Houses, in Moscow between 2002 and 2005

year	Total, as sq.m. Thos.	Brick		Panel		Monolith		Cottages/townhouses	
		sq.m. Thos	%	sq.m. Thos	%	sq.m. Thos	%	sq.m. Thos	%
2002	4469.6	88.6	2.0	2555.8	57.2	1785.0	39.9	40.2	0.9
2003	4474.4	88.7	2.0	2558.5	57.2	1786.9	39.9	40.3	0.9
2004	4597.4	45.6	1.0	2549.4	55.4	1965.6	42.8	36.8	0.8
2005	4700.0	94.0	2.0	1696.7	36.1	2876.4	61.2	32.9	0.7

Source: Mosgorstat, the authors' computations.

In Moscow, in 2002–04 over half of all the housing placed into operation fell on panel houses, while some 40% – on monolith ones. The proportion of the latter began to grow yet in 2004 (a. 43%) and, according to preliminary estimates, should rise drastically up to 61%. The proportion of panel houses fell down to 36%, while the other two categories of houses (brick and cottages) have not ever played a significant role in the aggregate volume of placement of housing into operation and their proportions accounted for 2% and

⁹³ According to the Moscow Mayor's office, the 2001–02 volumes of placement of housing in operation in the city by local construction companies was greater than the Rosstat's respective aggregate indicator, which can be explained by deficiencies and inaccuracies in the respective accounting procedures.

⁹⁴ According to the Moscow city government, in 2001–2002 volumes of placement of housing into operation by the local construction companies were greater than the aggregate housing placement indicator provided by Rosstat, which can be explained by defects and inaccuracies of the respective accounting.

under 1% of the built volumes, respectively. Let us note that the value of placement into operation of monolith and brick housing showed nearly 1.5 and 2 times growth, respectively, in 2005 against a fall in placement into operation of panel houses and townhouses.

In Moscow oblast, in 2004 construction companies put into operation 3.23 mn. sq. m. of general area of blocs of apartments and another 2.44 mn. sq.m. – of individual houses. In 2005, the respective volumes slid to 2.78 mn. and 2.27 mn., accordingly. Thus, the intensity of the fall in the volumes of placement of blocs of apartments into operation (nearly 14%) was twice as high as that of the volumes of individual construction (a. 7%).

Table 13

**Volumes and Structure of Placement into Operation of Housing by Types
of Houses in Moscow Oblast in 2002–2005**

year	Total, sq.m.	Blocs of apartments		Individual construction	
	Thos.	sq.m. Thos.	%	sq.m. Thos.	%
2002	3414	1783	52.2	1631	47.8
2003	4136	2022	48.9	2114	51.1
2004	5671	3231	57.0	2440	43.0
2005	5048	2776	55.0	2272	45.0

Source: Mosoblstat, authors' calculations.

The data of *Table 13* evidence that in 2002–05 the structure of placement of housing into operation in Moscow oblast remained relatively stable, with more than a half of it falling on areas in blocs of apartments, while the rest – on individual construction. The sole exception became the year 2003 when the share of the latter accounted for 51%.

According to the announced preliminary plans for 2006, the volume of house building in the city of Moscow should remain at the prior year's level and account for 4.7 mn. sq.m. In Moscow oblast, it should be somewhat greater and reach 5.2 mn. sq.m. However, the probability of that is small, as evidenced by some statements made by representatives of the city and oblast governments.

The causes for contraction in the volume of new house building lie primarily with the consequences of the 2004 crisis on the market for new houses. The crisis triggered a customers outflow, reduction in volume of funds controlled by developers and their possibilities to continue construction, and the need to repay earlier disbursed to them loans. Plus, in the first half of 2004 Russian banks experienced the decline in their liquidity and, accordingly, they opted for reducing volumes of crediting the developers. All that brought many construction sites to a halt and got developers go bankrupt. While the processes are selective, that, nonetheless, battered volumes of construction and placement of housing into operation.

The situation was aggravated by provisions and standards of the new Town-Planning Code and the federal statute "On participation in the mutual construction of blocs of apartments and other real estate objects and on introducing amendments to some legal acts of the Russian Federation" No. 214-FZ of December 30, 2004) effective as of April 1, 2005. Aimed at regulation and development of market relations in the sector, as well as protection of both the developers and population's rights, these statutes pursue a long-term goal of giving a significant boost to growth rates of the house building and volumes of offer on the market, which should exert a constraining influence on the dynamics of the housing prices. However, the immediate effect from their adoption became deceleration of the construction process and disorganization of the developers' operations.

The law is clearly biased towards protection of interests of participants in the mutual house building and penalties and fines terms therein appear overly high. Upon canceling a

contract in unilateral order, a private investor would receive the actually paid money plus such penalties and fines that would bring him another 30–40% in interest. Thus, a unilateral cancellation of contracts under alleged pretexts for the sake of profit may mature into a real business. By contrast, the developer may cancel a contract with a participant that has failed to honor, or who unduly honor his obligations as per the contract only by appealing to the court of law.

Participants in mutual construction are pawnbrokers of a part of the mortgaged property. Banks may not possess the mortgaged mass as a whole, while crediting the mutual construction. If the developed fails to repay the loan, the bank cannot satisfy its claims at the expense of the real estate. This is one of the reasons for banks discontinuing to disburse loans to developers, while the other one is the joint responsibility of the developer and the creditor institution before participants in mutual construction.

Developers will be able to attract credits and loans only against their fixed assets or other liquid assets, which is affordable only for large developers who have a credit record and may mortgage the company's other assets. Large construction companies can fund their construction projects in full or to a great extent without attracting individual participants' funds., while smaller-sized companies are compelled to refuse them and seek banking loans under a fairly high interest rate (up to 25% annualized). All this leads to the situation in which they find themselves incapable to carry out profit-making construction operations and consequently go bankrupt.

The above negative processes and factors made financing of future projects practically impossible. Whereas the new statute tightened procedures and conditions of conclusion of contracts under which the rights for apartments in currently built houses are purchased, today developers no longer conclude agreements on mutual participation in the construction of new objects. Rather, they are keen to sell objects the permit on the construction of which was received prior to April 1. On the other hand, apartments in "newly built" houses have not been put on sale as yet, while the start of construction of some objects was put off, because of the absence of the respective permit.

The companies that cannot fund their construction operations due to various reasons, dodge the statute in question using alternative schemes of attraction of investments. The most popular dodges are a promissory note-based scheme and the one that implies conclusion of a real estate sale/purchase agreement. The promissory note-based scheme implies conclusion of a contract in which technical characteristics of an apartment, its cost and terms of registration are stipulated, but not a single word of the parties' financial obligations. Upon its conclusion the developer issues a promissory note in exchange for cash invested. The cost of the paper equals the cost of the apartment. The defect of the transaction is that there is a risk that the court of law will recognize it (for instance, on the statement of a competent government body) as a fake deal, i.e. the one that camouflages a mutual construction contract. According to a sample of the preliminary contract, there should be stipulated an obligation to conclude an agreement upon completion of the construction. Under such an agreement the developer may not receive cash funds, for it will be stipulated therein that a certain agreement under which the payment shall be effected will be concluded in the future.

It should be noted that banks will not ever support alternative schemes of attraction of investors if there arise risks of the court of law recognizing a given scheme as falling under the jurisdiction of the statute on mutual construction, or if there arise negative legal risks. The scheme will eventually batter developers and investors. Most likely, there will occur a growth in the proportion of developers that would not attract mutual participants'

cash at the stage of construction, but who would be selling real estate objects upon completion of their construction.

The amendments to the noted Statute underway (the replacement of the provision of the bank's joint responsibility with introduction of insuring terms and conditions of the contract, introduction of the developer's obligation to issue the mutual participant with documentation on the building in which he invests his money, which does not constitute commercial secret, granting the developer with the right to cancel a contract with the participant in the event the latter fails to follow payments deadlines)⁹⁵ seem to lift the developers' and banks' burden, but, regretfully, they appear dispersed across confusing packages of proposals, have failed to pass through the necessary discussion procedures and even if they are enacted, the current situation would last, at least, for another half-year to year. Meanwhile, the legally set requirements to the developer to demonstrate a good credit record and the absence of debts are still there.

The situation is further aggravated because of the tsunami of scandals that involved developers. The city of Moscow and Moscow oblast have recently witnessed street protests of those who suffered from unscrupulous construction companies' misdemeanors. Having entrusted their saving to such companies, private investors demanded not only to compensate for the losses. Rather, they sought the authorities' interference with the situation on the construction market and forewarned of the threat of emergence in the society of a new socially abused citizens – that is, cheated mutual investors as legal heirs of those cheated by the notorious financial pyramids of the mid-1990s. Overall, the construction of as many as two hundred blocs of apartments was frozen in the capital and the Oblast. According to Mr. A. Panteleev, the Oblast Vice Governor, the sum of contracts of cheated investors in Moscow oblast accounts for USD 240 mn⁹⁶.

The Moscow attorney's office instituted legal proceedings against heads of a number of construction companies that failed to honor their obligations before the investors. According to the Moscow oblast attorney's office, it instituted legal proceedings against heads of 23 construction companies and local authorities that in many cases entered into bilateral contracts with legal entities and attempted to cover unscrupulous developers.

Authorities in both Subjects of RF try to find a solution by re-assigning the rights for construction to decent developers who will complete the works at their own expense. They have been promised various benefits for that. The Moscow Mayor's office established a Commission on examination of implementation of investment projects on housing construction that assumed control over the situation on the market for newly built housing. The Mayor and his team gave public promises to organize completion of currently frozen construction projects and started canceling contracts with previous investors and attracting new ones. In some cases, houses will be built using the budget funds. The prospects for remedying the situation in Moscow oblast appear less certain.

Such a situation resulted in an outflow of buyers from the market for newly built houses. They partially switched to the secondary market and partly to objects whose developers and brokers had not stained their good names (even unintentionally) with such situations. Consequent upon the above became the situation that starting from the 2nd quarter 2005 the number of objects (newly built houses) for sale began to fall. The volume of offer on the market for newly built houses in the city of Moscow in the 4th quarter 2005 made up 74% of the respective level of 2004.

⁹⁵ Teper prizhmut grazhdanina?//Kvartirny ryad, 26 January–1 February 2006, No. 3(574), p. 8.

⁹⁶ bez kvartir ne ostanutsya, uveryaet podmoskovnoe nachalstvo// Kvartirny ryad, 26 January–1 February 2006, No. 3(574), p. 3.

Caused by changes in the law, the contraction in offer in the primary housing market in turn also drove downward the number of objects offered on the secondary market, for because of the fall in offer on the primary one, buyers switched their demand (both the delayed since 2004 and current ones) to the secondary market. The process was complemented by realtors buying apartments for the sake of creating their own reserve, as well as the noted scandals that involved unscrupulous developers. As a result, the fall in offer on the secondary market in the 4th quarter 2005 vis-à-vis the 4th quarter 2004 was greater (nearly 40%) than on the primary one (26%)⁹⁷.

The volume of offer on the Moscow oblast market for newly built housing also began to slide since the 2nd quarter 2005, while yet in the 4th quarter 2005 it was still greater than its respective index of the 4th quarter 2004 (lacking liquidity, developers put all their stock on sale). However, as early as between August and September 2005 Moscow oblast began to witness Moscow-based realtor companies buy apartments there. In parallel with that, in the 4th quarter 2005 vis-à-vis the 4th quarter of 2004 the volume of offer on the Oblast secondary market fell, too, albeit at a pace slower than that in the capital (at 13%).

Thus, it can be reckoned that the offer volume of apartments on the primary market in the city of Moscow and Moscow oblast has been declining for three straight quarters against a great demand for housing and today there is a great gap between offer and demand.

According to the 2005 preliminary estimates, the Moscow city turnover of the market for newly built housing in sq.m. Thos. equivalent exceeded the 2004 index by 2.3% against a 5.4% fall of it in Moscow oblast. It should be emphasized that the noted turnovers of the primary market were computed proceeding from the above data of volumes of construction of blocs of apartments in the capital and the Oblast, less the share of the city and local authorities that use received living area to satisfy the needs of all categories of those who are to receive free housing under the social programs. In the city of Moscow, only slightly over 50% of the newly built housing becomes available on the open market, which is why to compute turnovers of the primary market we deducted the following proportions: for the city of Moscow – 45%, and 12% for Moscow oblast (averaged across its towns).

As concerns price levels on the primary market, in the 4th quarter 2005 the average specific offer price in newly built houses in the city of Moscow was USD 2,330/sq.m. (3.5% up vs. the 3rd quarter 2005 and 14.8% up vs. the 4th quarter 2004. In Moscow oblast, the respective index in the period in question accounted for USD 895/sq.m. Meanwhile, the price rise index in the Oblast was notably greater than that in Moscow (+10.4% vs. the 3rd quarter 2005 and 19.2% vs. the 4th quarter 2004).

Thus, the last year's crisis on the real estate market coupled with the banking microcrisis triggered some decline in the volume of construction and placement of new housing into operation. The process is intensified by short-term effects from the aforementioned Statute on participation in mutual construction. In addition, numerous scandals between developers, local administrations and private investors have resulted in the outflow of buyers from the "problematic" construction projects to successful ones and, partially, to the secondary market.

Summing up the above, one can state that the main tendency on **the real estate market as a whole** in the second half 2005 was price rise and decline in the offer volume against the backdrop of a great activity of the market. The buyers realized that real estate prices were not going to collapse, nor they were going to decline, while the government

⁹⁷ At this point, it is worthwhile noting that a direct comparison of newly built housing and the number of apartments is to some extent conditional.

was not going to artificially control them. The year-long “wait-and-see” period has been over. The rise in the population’s activity that started between May and June was accompanied by growing turnovers on the housing market, which resulted in washing objects out of the market, emergence of shortages, and further acceleration of the price rise rates.

These processes on the primary market were aggravated by falling volumes of construction and placement of housing into operation. Since September 2005 a cautious rise of activity and prices has also covered the market for outskirts housing. By contrast, the market for office space lease still finds itself at the stage of fluctuation stability with a tendency to an insignificant rise in the lease rates.

4.9.3. Housing as a Priority National Program

The nomination by the country’s leadership of the problem of provision of housing a priority national project has become a pivotal event of 2005.

Despite an insufficient financing, the house-building sector has been displaying an impressive progress over the past five years (*Table 14*).

Table 14

Placement of New Houses into Operation in Russia between 1999 and 2005

year	Sq.m. mn.of general area	Growth rates, as, %	
		To the prior year	To 2000
1999	32.0	104.2	105.6
2000	30.3	94.7	100.0
2001	31.7	104.6	104.6
2002	33.8	106.6	111.5
2003	36.4	107.7	120.1
2004	41.0	112.6	135.3
2005	43.6	106.3	143.9

Source: Rossiysky statistichesky ezhegodnik. 2004: Statistics collection./ Rossta, M., 2004, p. 463; Investitsii v Rossii 2005: Statistics collection / Rosstat, M., 2005, p. 256; Sotsialno-ekonomicheskoye polozhenie Rossii , 2005 god, M., Posstat, p. 365, the authors’ computations.

As evidenced by the data of *Table 14*, after hitting the historical minimum in 2000 (30.3 mn. sq.m.) in the modern Russia’s history, the placement of new housing into operation began to grow hence. As a result, in 2005 it accounted for 43.6 sq.m. mn., or at 44% more than in 2000.

Notwithstanding the results, they should not be overestimated. The economic crisis of the 1990s resulted in a considerable decline in the volumes of housing construction and intensified yet a great degree of dissatisfaction of the country’s population with their living conditions. To merely reproduce the housing fund, the country has to place into operation not less than 90 mn. sq.m. annually, while to catch up with the European standards, some 200 mn. sq.m. annually is needed. The real dynamics of placement of housing into operation falls short of securing even a half of the much-needed volumes and in 2005 it roughly accounted for 71% of the pre-reform volume of housing construction (61.7 mn. sq.m. reported in 1990) and was smaller than the respective 1970 index (58.6 mn. sq.m.).

One of manifestations of Russia’s uneven economic development in territorial terms became a considerable rise in the level of concentration of house building in the capital area (*Table 15*).

Table 15

**Volumes of New Houses in Russia, Moscow and Moscow region
between 1999–2005**

year	Across Russia as a whole (according to Rosstat)	By the city of Moscow (according to Rosstat)	As % of placement across Russia as a whole	Across Moscow oblast (according to Rosstat)	As % of placement across Russia as a whole	By Moscow and Moscow oblast, total	As % of placement across Russia as a whole
	Sq.m. Thos.	Sq.m. Thos.		Sq.m. Thos.		Sq.m. Thos.	
1999	32017	3052.5	9.55	2728.6	8.5	5781.1	18.05
2000	30296	3342.3	11.0	2610.9	8.6	5953.2	19.6
2001	31703	3690.6	11.65	2827.8	8.9	6518.4	20.55
2002	33832	4274.1	12.6	3414.8	10.1	7688.9	22.7
2003	36449	4443.0	12.2	4136.4	11.3	8579.4	23.5
2004	41040	4578.6	11.15	5738.2	14.0	10316.8	25.15
2005	43609	4644.3	10.6	5271.4	12.1	9915.7	22.7

Source: Rossiyskiy statisticheskiy ezhegodnik. 2004: Statistics collection./ Rossta, M., 2004, p. 463; Investitsii v Rossii 2005: Statistics collection / Rosstat, M., 2005, p. 256, 258; Sotsialno-ekonomicheskoye polozhenie Rossii, 2005 god, M., Posstat, p. 365–366, the authors' computations.

The specific weight of housing built in Moscow after 1999 did not sink below 10% of the placement of the newly built housing into operation nationwide. It reached its maximum in 2002 (12.6%), while the value of the index began declining between 2003 and 2005. However, the specific weight of housing built in Moscow oblast continued its permanent rise and after exceeding 10% in 2002, it hit the peak value (14%) in 2004⁹⁸. It was only last year that the proportion of housing placed into operation in Moscow oblast slid to 12%. As a result, the aggregate specific weight of housing built in the city of Moscow and Moscow oblast together was on the rise until end-2004. Given that the 1999 share of the capital region in the volume of housing put into operation nationwide accounted for 18%, in 2001 it grew up to 20.6%, while in 2004 – up to more than one-fourth. The index sunk slightly in 2005 – down to 22.7%. For reference, in 1980 the city of Moscow and Moscow oblast together held less than 11% of the total volume of housing built nationwide, in 1990- the meager 7.5%, while in 1995 – under 12%.

To solve the challenges in the housing sphere, the government proposed the “Affordable and comfort housing – to Russia’s citizens” program. In September 2005, the RF President included it into the set of priority national projects.

Its principal organizational and financial engine should become the updated and recently adjudicated Federal Targeted Program “Zhilische” (“Housing”), with the volume of funding between 2006 and 2010 worth a total of a. Rb. 640 bn. The Program provides for development of house building, engineering and communal infrastructure, provision of the “social” housing and fulfillment of the government obligations on provision of individual categories of citizens with housing, as well as stimulation of the market for housing and mortgage to the population. The updated version of the program provides for the doubling of volumes of placement of housing into operation by 2010, up to 80 mn. sq. m.

Overall, Rb. 213 bn. is provided for the project implementation in 2006–07, including 146.1 bn. to be allocated from the federal budget and 66.8 bn. – from regional and local budgets. Notwithstanding the impressions such figures make, the bulk of them is formed by government guarantees of loans that can be utilized only in the event other participants in the program fail to honor their obligations. Another main avenue of the program shall

⁹⁸ It should be remembered that a drastic rise in the annual volumes of house construction in Moscow oblast since 2004 is partially explained by the transition from the accounting of volumes of construction by the Oblast construction companies to the accounting of the volumes of placement into operation in the region’s territory of housing built by all developers.

become a financing of development of land sites designated for house building, installment of communications (in 2006, Rb. 13 bn. is to be earmarked shortly from the federal budget), including subsidizing interest rates on loans to provide the construction sites with engineering infrastructure, provided the volume of allocations from the federal budget does not exceed the respective appropriations from the regional and local budgets.

Whereas under a great demand for housing the majority of the population's effective demand is fairly low, the government has developed a series of measures to give it a boost, including:

- increasing the affordability of housing by means of an alternative housing purchasing program, using the population's own savings, housing loans, savings systems, and budget subsidies;
- boosting the volume of mortgage. In 2006 alone as much as Rb. 20 bn. should be allocated for this purpose with a projected subsequent rise to 415 bn. by 2010, which should roughly equal 1 mn. of loans;
- implementation of the "Young Family" program. The program provides for subsidizing the first instalment. In 2006–07 housing loans should become available to between 6 and 15% of young families, while 110,000 of them are to enjoy an opportunity to improve their housing conditions (there were only 2,000 of them in 2005). Given that the 2005 budget provided for allocation of Rb. 550 mn. for the support of young families, the 2006 budget provides for Rb. 2.1 bn., while the 2007 one – 5.3 bn. (including 4.3 bn. in subsidies to young families and 1 bn. – on insuring mortgage for young families). In the city of Moscow, the local program entitled "Affordable Housing to the Young family" contains plans to increase the volume of house building from 200,000 sq.m. in 2005 to 270,000 sq. m. in 2006, with a further annual increment of 100,000 sq.m. over subsequent years;
- fulfillment of the government obligations before individual categories of citizens. The federal targeted program known as "The State Housing Certificates" (SHC) became effective yet in 1998 and it provides for allocation from the budget of free subsidies payable to the military and other categories of *l'gotniki* to purchase housing. However, an insufficient efficiency of the program (associated with a low pre-set projected cost of sq.m.)⁹⁹ resulted in the situation in which, according to the RF Defense Ministry, 160,000 officers' families experience problems with housing. That is why authors of the SHC program paid a special attention to making certificate secured by cash. A considerable funding (Rb. 10 bn.) has already been allocated from the federal budget to make the program a success.

Despite the fact that the launch of the program was scheduled for January 2006, it should bring the first fruits in the part of greater volumes of house building only in a few years. As for the short term prospects, there may happen even a reverse effect – effective demand will undoubtedly be growing at a pace faster than offer volumes, which should result in shortages of housing offer and, consequently, in a price rise. The stabilization may take a few years, as even with housing building volumes progressing, it is going to take quite a time to saturate the market. The implementation of the current plans to a great degree will depend on growth rates of the population's real incomes, as well as regional and local budgets' capacity. They in turn will be affected by the progress in the area of the housing and communal reforms and implementation of provisions of the newly adopted Housing Code (primarily in the part of the transition of the housing and communal sector towards

⁹⁹ The program was funded basing on the price of Rb. 11,000 /sq.m., while at the time the average housing price was Rb. 29,000/ sq.m.

funding without subsidizing and the population paying for the housing and communal services in full), among other factors.

4.9.4. Fostering Mortgage

As noted above, the mortgage arrangements are supposed to play a notable role in implementation of the national project on housing. No doubt, a rise in the volume of mortgage contracts should form a critical factor of the rise in demand and prices for housing.

The volume of mortgage loans has recently been on a stable rise across the country and in the city of Moscow, in particular. Thus, according to the Association of Russian Banks, the amount of the credits in question disbursed nationwide accounted: in 2001-USD 56 mn., 2002 – 260 mn., 2003 – some 500 mn., 2004 – 1 bn. According to some experts, this figure should further make up over 1 bn. in 2005 and nearly hit 2 bn. in 2006.

In Moscow, according to the International Academy of Mortgage and Real Estate's report entitled "An Analysis of Competitive Advantages of Banking Mortgage Products", between 2000 and June 2005 the volume of mortgage loans was growing at an average annual rate of 46%. According to Rosregistration, the number of mortgage contracts concluded in Moscow has shown a slower growth rate since 2000.

Table 16

The Number of Mortgage Loans Disbursed in Moscow in 2000–2005

Year	Number, as units	Growth rates, as %	
		To the prior year	To 2000
2000	1364	...	...
2001	1970	144.4	144.4
2002	2753	139.7	201.8
2003	3075	111.7	225.4
2004	4358	141.7	319.5
2005	4600	105.5	337.2

Source: programma razvitiya ipotechnogo kreditovaniya v gorode Moskve na 2006–2008 gody.

As evidenced by *Table 16*, the annual increment rates of disbursement of mortgage loans were over 40% only in 2001 and 2004, however, overall, their number grew nearly 3.4 times over the last five years, nonetheless.

"MIEL-Nedvizhimost" realtors report a rapid rise of mortgage transactions since the 1st quarter 2004. With the 1st quarter of 2003 as the basic period, their number grew 2.0, then 10.2 by the 3rd quarter 2005, while in the 4th quarter 2005 fell to 9.1.

The proportion of mortgage transactions in the total number of the company's transactions in Moscow was also growing rapidly in 2004 and stabilized in 2005 (*Fig. 17*).

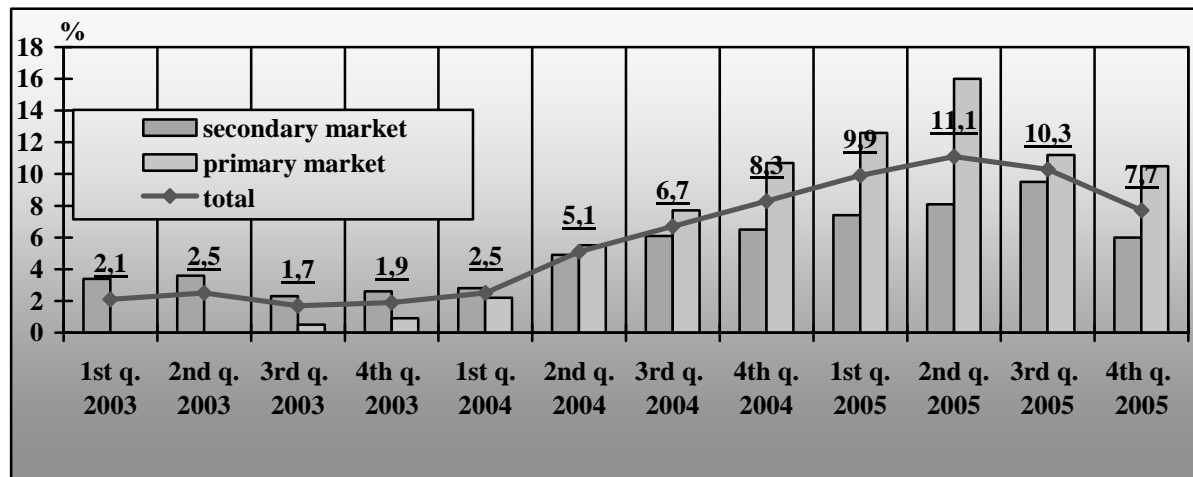


Fig. 4. The Quarterly Dynamics of the Share of Mortgage Transactions of MIEL-Nedvizhimost in Moscow in 2003–05

In the first quarter 2004 it made up 2.5%, in the 2nd – 5.1%, 3rd – 6.7 and in the 4th quarter – 8.3%. During the first three quarters 2005 the respective index was fluctuation around the level of 10–11% of the total number of the company’s transactions and finally dropped to 7.7% in the 4th quarter. Let us note that despite the fall in the share of mortgage transactions on the whole, the value of this indicator on the primary market since the 2nd quarter 2004 has been greater than that on the secondary market. In Moscow oblast, the respective value of the indicator accounted for 6–8%.

Overall, the year 2005 is characterized by the growth in the absolute number of mortgage transactions against the fall in the annual indexes of the growth of mortgage transactions both in the city Moscow and Moscow oblast vs. 2004. Mortgage-based sales on the primary market re complicated by the contracting number of MIEL’s own objects, the sales of which secured the bulk of the noted transactions that involve newly built housing. Mortgage transactions on the primary market with “outside” (not being the company’s property) objects are complicated by the mismatch between the documentation their sellers provide and banks’ requirements to the mortgaged property.

Overall, despite a rapid rise over the last two years, the scale of mortgage in Russia has remained insignificant in the total volume of housing sales and accounted for 1% of GDP, while in UK the respective index made 62%, the US – 53%, Germany – a. 50%.

Let us remember that it was yet in 2004 that the government recognized the fostering of mortgage as a priority activity for the emergence of the market for affordable housing, which demanded a serious update of then effective legal base.

The 1st half of 2005 saw coming into force of legal acts enacted in late 2004. The acts introduced amendments to then effective law; plus, a series of new statutes that concerned mortgage came into effect.

The crucial amendments were:

- Amendments to the Civil Code of RF of December 30, 2004 (No. 213-FZ) concerning cancellation of the mandatory notary registration of mortgage contracts and using buildings located or being built on the depositor’s site as a security;
- Amendments to the Federal Statute “On mortgage” of December 30, 2004 No. 216-FZ) that:

- enable one to modify the term and interest rates on mortgage loans certified by the mortgage;
 - helping to spread mortgage on the land site purchased with the use of credit funds and on the land site (the rental right on it) on which the construction takes place or a living facility is purchased on credit;
 - setting the possibility for execution upon the living facility and suspension of the right for the use by the former owner and his family members of the mortgaged living facility as a security against the loan on improvement of living conditions, including not only the living facility purchased at the expense of credit funds but also any other living facility;
 - limiting the possibility of an ungrounded interference of guardianship bodies with the mortgage process;
 - securing the legal base of the system of insuring credit risks in the housing mortgage area.
- Modifications in the Federal Statute “On credit records” of December 30, 2004 (No. 218-FZ), for the sake of creating a system of information disclosure of scrupulousness of execution of borrowers of their obligations before creditors (commercial banks) through regulation of operations of credit records bureaus.

In conjunction with enactment of this particular act, amendments were introduced to the Civil Code of RF (specification of the banking secret), in the RF Code on Administrative Abuses (provides for sanctions for breaching the procedures of conduct and storage of credit records, and procedures of spreading of information), the Federal Statute “On banks and banking activities” (sets the credit institutions’ obligation to submit information to at least a sole bureau of credit records).

- Amendments to the Federal Statute “On Mortgage Securities” of December 29 (No. 193-FZ), which:
 - set the procedure of sales of the mortgaged security in the event of insolvency (bankruptcy) of the issuer of bonds with mortgaged security;
 - set requirements that the size of the mortgaged security of the respective bonds may exceed the volume of obligations on the bonds at not more than 20%;
 - introduce the housing mortgage bonds;
 - grant credit institutions with the right to issue mortgage participation certificates;
 - ensures the possibility for issuing mortgage bonds with varying interest rates.
- Because of the enactment of the law on mortgage securities, there appeared amendments to the Civil Code of RF in the part of setting the value of mortgage security as the cap on the volume of bonds issuance by joint-stock companies, as well as to the federal statutes “On insolvency (bankruptcy)” and “On insolvency (bankruptcy) of credit institutions” in the part of setting the requirement to exclude from the tender mass in the event of bankruptcy of the issuer of mortgage secured bonds of the assets that form an element of the mortgage security.
- Amendments to the federal statute “On the state fee” in the part of abolition of the state fee for the state registration of mortgage contract, issuance of a document on the given registration and an excerpt from the register on the state registration of the mortgage contract, which duplicates the registration fee.

However, despite the government’s serious attention to and support of formation of the market for affordable housing, there exist a series of challenges that appear deter-

mined by the situation on the real estate market and exert an adverse influence on the progress in the mortgage area.

Overall, it can be noted that today the mortgage market undergoes a deceleration of its growth rates and sees its volumes fall vis-à-vis the general market for housing sales/purchases in Moscow region. Sales of newly built housing with the use of mortgage are limited only with the objects, the permits on construction of which were received prior to April 1, 2005. Other objects under construction do not meet the banks' requirements (do not have the necessary or correctly produced documentation and may not form subjects of mortgage contracts). This can force potential mortgage consumers to switch from the primary to secondary market for housing, thus increasingly fueling demand on that, which in turn does not help increase the number of mortgage contracts on the market. Under a limited offer and growing demand the housing sellers on the secondary market tend to prefer customers with all the necessary cash in full in hands.

In such a situation, the offer of apartments that can be sold under mortgage terms at large realtor companies on the market for newly built housing is limited by the objects adjudicated by banks and the companies' own newly built housing fund. Thus, by late 2005 the housing market of the city of Moscow and Moscow oblast saw a situation in which the number of borrowers adjudicated by banks was on a steady rise, while the number of actually mortgaged apartments was declining. According to "MIEL-Nedvizhimost", the quarterly indices of volumes of mortgage transactions computed relative to volumes of the respective period in prior years, have tended to fall since the 3rd quarter 2004.

The progress on the market for mortgage is also inhibited by the absence of an effective mechanism of securitization of loans, which forms the most optimal means for banks to attract capital. Securitization is broadly used overseas – for instance, in DK, the mortgage securities account for 70% of the national stock market, while in Germany – 36%, and Sweden – 45%. The respective statute in Russia was enacted yet in November 2003, however, it remained idle hence, for it requires adoption of 15 by-law acts, including the following amendments:

- those that regulate insurance of mortgage loans. Today, in compliance with the law, the mortgage loan that falls under the mortgage coverage should be insured in favor of the borrower in the event of issuance of mortgage bonds. The Federal Securities Commission believes this requirements is excessive, for mortgage papers are sufficiently reliable, anyway;
- amendments that provide for the possibility to forward cash funds received from the borrower as payments on the credit to pay interest on mortgage bonds. The current law does not provide or the possibility;
- amendments that provide for the possibility of "tranching issues of mortgage securities". As of today, there is no mechanism of application and size of possible tranches stipulated in the law.

It is the Agency on Mortgage Loans (AML) that is going to pioneer in this area with the first Rb. 1.5 bn.-worth tranche of mortgage bonds in the 1st quarter 2006. Some experts forecast that by 2008 Russian banks would be able to issue annually mortgage bonds worth a total of Rb. 60 bn. and by 2010 – over 200 bn. Should such a critical instrument as secutirization emerge, that would entail a substantial decline in interest rates on mortgage loans.

In the future, the progress in the area should be fueled chiefly by the implementation of the national project "Affordable and comfortable housing to citizens of Russia". The rise in the number of issued mortgage loans should result in a substantial decline of inter-

est rates on them from the current 13–14% to 8% by 2010. On the city of Moscow level the noted national project is mirrored by the recently approved three-year mortgage development program for 2006–2008. It is planned to spend Rb. 72.4 bn. on its implementation, including 51.1 bn. out of the city budget.

As Moscow expects the mortgage volumes to double in 2006 (in particular, the subsidized mortgage, as per the priority national project), one can forecast a considerable rise in mortgage transactions on the market.

4.9.5. Prospects of the Real Estate Market

The 2005 macroeconomic situation in Russia and its impact on the real estate market on the whole appeared positive. The state and progress of the economy back-ups effective demand and secures normal conditions for operators on the market. The government can extend a vigorous support to the progress in the frame of the noted priority national project on housing, which will fuel a further rise in real estate prices.

However, macroeconomic trends bear certain challenges and risks in this respect. The most probable ones can be caused by the growing social tension. Inflation and the price rise for the housing and communal services will derail the material state of recipients of budget funds, which will result in their lower support of the current government. In parallel with that, the opening of markets to foreign capital after Russia's possible accession to WTO and appreciation of the Ruble will undermine small and medium-sized businesses' competitiveness. From the perspective of the present paper the noted challenges go beyond the horizon of forecasting – that is why they are not considered herein.

It is the market for newly build housing that will become a locomotive of the housing market in 2006. The stumbling block for the progress on the market will remain the statute "On participation in the mutual construction of blocs of apartments..."

There will be attempts to modify the statute and put off the coming into effect of the suggested standards on the developers' quarterly reporting set by Government Resolution No. 645 of October 27, 2005 "On quarterly reporting by developers on carrying out activities on attraction of cash funds from participants in mutual construction". The contours of the conflict between developers, banks, on the one hand and a number of business groups that are keen to change the balance of forces on the market by means of government agencies' intervention, on the other. Clearly, the business groups are anxious to break by means of law enforcement agencies normal rules of the game on the market. Meanwhile, neither developers, nor banks are happy with the rules of the game, as per the noted statute. The former have found it impossible to attract private investors without breaching the law, while banks are no longer able to credit developers and disburse mortgage loans (due to the aforementioned reasons). In any case, this particular factor should drive the volumes of house building and offer on the market for newly built housing down.

Notwithstanding the noted scandals, the market progress has restored its momentum. The steadily declining offer of the newly built housing with the respective permits received prior to the respective law coming into effect will be pushing prices upwards. The problems of organization of financing of new project will get new players on the market and 2006 will see numerous takeovers and mergers. It is fairly unlikely that volumes of house building will grow under such circumstances – more than that, the earlier announced plans will likely to be adjusted towards their contraction. In the conditions of a limited offer volume, a part of consumers will switch to the secondary market for housing. The pressing on the part of the delayed demand, as well as a rising number of consumers will fuel further price rise.

The city of Moscow and Moscow oblast likewise will see the offer volumes on the primary market fall, and, given a high level of demand, we expect a 2.5–3% growth in the annual turnover of the market in natural equivalent.

Given the background, a vigorous demand for the secondary housing in the capital and the Oblast, perhaps, stirred by the negative situation on the primary market, as well as advancement of the mortgage system that leads to growth in the number of real consumers on the secondary market for housing (determined primarily by the fact that banks are more keen to extend credits against the ready housing, than otherwise) can get the 2006 sales volume to the 2004 level, or event exceed that at 3–5%, or at 84–86,000 apartments in the city of Moscow and 49–51,000 of them in the Oblast.

A high demand and the fall in the offer volume which, perhaps, are going to last until mid-2006, because of inertia, can result in a price rise for apartments on the secondary housing markets in both regions until the end of the year. Under great rates of contraction in the offer it should account for 30–35% (expert forecast 1), or, given a possible compensation for the offer shortage in the second half 2006 – 20–25% (expert forecast 2). Thus, the forecasted average specific price until end-2006 can reach in Moscow – USD 3,100 – 3,500/sq.m., while in the Oblast – 1,350–1,500 sq.m. (*Fig. 18*).

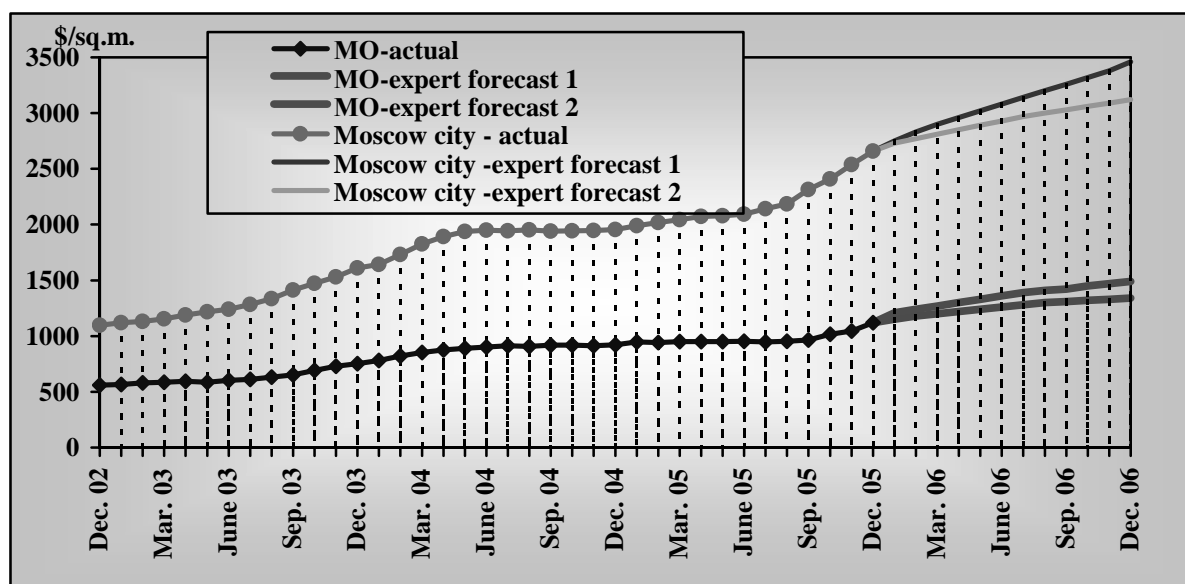


Fig. 5. The Dynamics of Forecast of the Average Specific Offer Price on the Secondary Market for Housing in the City of Moscow and Moscow Oblast

With account of forecasted indices of the sales volumes in natural equivalent and the 2006 average specific offer price, one can expect a 30–45% rise in the cash volume of sales on the secondary market of the city of Moscow and Moscow oblast vs. 2005, or at USD 15.0 and 3.3 bn., respectively.

With account of the forecasted average annual prices (USD 2.265/sq.m.) and volume of the commercial house building in natural equivalent (2.460,000 sq.m.) in Moscow, one should expect a 15–20% rise in the volume of sales on the market for newly built housing in 2006 vis-à-vis 2005, or at USD 6.5 bn., and at 2.6 bn. in Moscow oblast.

Thus, the projections for the year 2006 are as follows:

- fall in the volume of construction and placement of newly built housing into operation;

- fall in the offer volume of apartments in the newly built housing until the end of the year and for 3–6 months – on the secondary market, with a subsequent rise in that;
- growth in the volume of sales in natural equivalent by 2–3% on the primary and 3-5% on the secondary markets;
- a 25–30% price rise on the primary and secondary markets;
- growth in the cash turnover at 15–20% on the primary and 30–45% on the secondary markets;
- a continuous deceleration of the growth rate in mortgage transactions, however their volume on the capital market should grow soar by 60–80%.

4.10. Efficiency of Banking Operations in 2005

2005 proved to be a good year for Russian banks. Indeed by the end of the 3rd quarter return on assets (ROA) for the aggregate banking system, excluding Sberbank¹⁰⁰ was 3.6%, while for the same period a year ago the figure stood at just 3.3% and only at 3% for 2004 as a whole. Even more impressively banks' return on equity (ROE) for the first 3 quarters of 2005 rose to 25.2% from a 19.6% base for 2004.

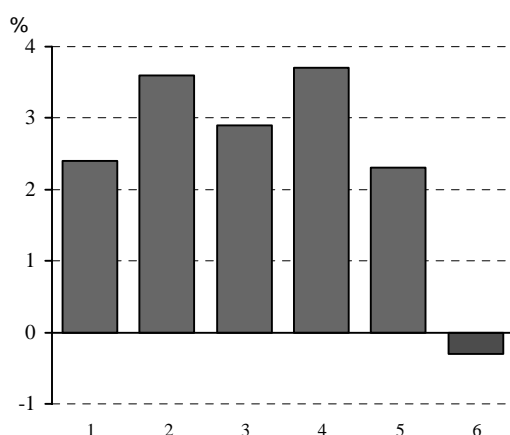
Though it must be admitted that the first quarter in 2005 has demonstrated somewhat weaker results than in 2004. Annualized 2005 ROA ratio stood at 2.8% for banks on average, which is lower than similar figures for 2004 and is actually closer aligned with results achieved in 2003.

At the same time, certain tendencies observed in 2004 continued throughout the last year as well. Difference in ROA, for instance, for banks of varying asset size has remained insignificant. In 2004 the climate of near-crisis and general sector decline caused some typical divergence in ROA ratios. Just as in 1998, the year of devastating financial crisis for Russia, its smaller banks proved better at weathering storms and have posted healthier profits. As can be seen from *Fig. 19*, in 2003 the country's smallest banks were in general losing money¹⁰¹. But just in the first half of 2004 these banks were able to get back into black by raising their annual ROA ratios to 2.5%. In 2005 smaller banks continued this trend and posted first quarter 2.6% ROA.

ROA figures for Russia's bigger banks too, in 2005 showed fairly strong results (*please see group 1 on Figures 19–21*). If in 2003 the average ROA for the aggregate banking sector stood at 2.4%, in the first 2 quarters of 2004 large banks profitability as measured by ROA rose to 2.7%. In the first quarter of 2005 large banks' ROA continued to climb to 3.1%, and exceeded the industry's aggregate figures. The progress is particularly notable given that in the past years from 1998 and onward profitability of Russia's larger banks trailed behind industry averages.

¹⁰⁰ All relative profitability figures for a certain period refer to average size of assets in a given year. Group-wide figures are calculated as weighted averages.

¹⁰¹ Banks are divided into groups based on their asset size as of a certain date. First group are the largest 10 banks (excluding Sberbank and Vnesheconombank), second group covers the following 40, third group – the following 50, fourth group has the following 100, fifth – the following 300 and the sixth group all remaining smallest banks.



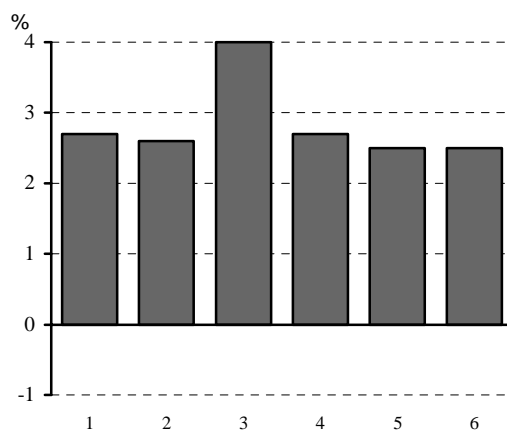
Bank Groups in the Order of Size Assets as of January 1, 2004:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1326.

Note: Size of assets as recorded by the end of the specified period. Average values were used for the analysis.

Source: STIik data.

Fig. 19. 2003 ROA Figures For Banks Of Varying Asset Size (Excluding Sberbank)



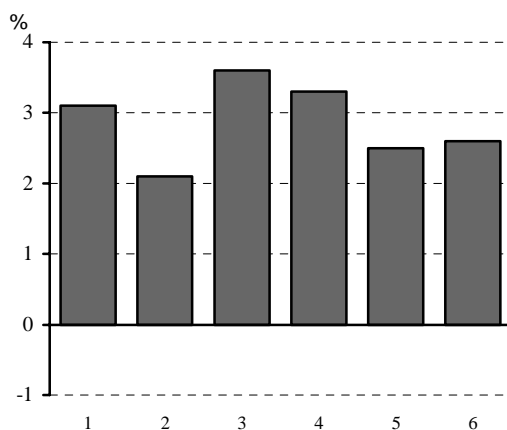
Banks Groups in the Order of Size Assets as of July 7, 2004:

- 1– Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1321.

Note: Size of assets as recorded by the end of the specified period. Average values were used for the analysis.

Source: STIik data.

Fig. 20. Annualized ROA For The 6 Months Of 2004 For Banks Of Varying Asset Size (excluding Sberbank)



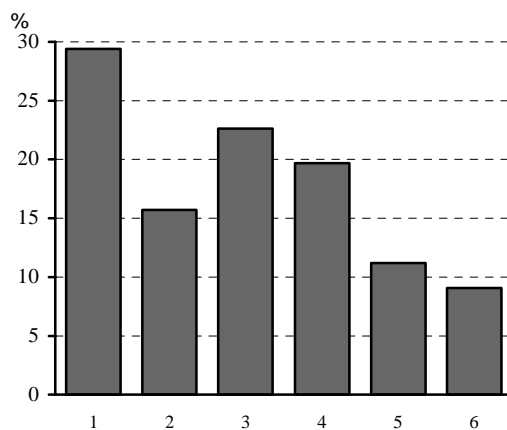
Banks Groups According to Asset Size as of April 1, 2005:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1284.

Note: Size of assets as recorded by the end of the specified period. Average values were used for the analysis.

Source: STIik data.

Fig. 21. Annualized 1st Quarter 2005 ROA For Banks Of Varying Asset Size (Excluding Sberbank)



Banks Groups as of April 1, 2005:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1284.

Note: Size of assets as recorded by the end of the specified period. Average values were used for the analysis.

Source: STIik data.

Fig. 22. Annualized First Quarter Of 2005 ROE For Banks Of Varying Asset Size (Excluding Sberbank)

Conversely, banks profitability as measured by return on equity (ROE) shows a lot more inter-group variation. Since the ratio of equity to assets has traditionally been higher for smaller and medium-sized banks than their larger-asset peers, ROE differences between smaller and larger banks fluctuate anywhere from 29% to 9%, while their ROA figures may differ little. Though for banks grouped in the 11th to 50th group, both ROA and ROE figures are below industry averages.

A review of banks' income vs. expenses in the first quarter of 2005 demonstrates that the country's largest banks had lowest ratios of financial returns on assets – 6.3% against 11.1% for smallest banks (*please see Table 17*). Such discrepancy is partially due to lower interest income received by large banks as well as by lesser fees and commissions (1% for 1st group vs. 3% for 6th group). Though large banks unlike their smaller counterparts do better when it comes to reining in overhead expenses as percent of their assets. It has to be noted though that overhead expenses for the Russian banking system as a whole remain quite high, which obviously negatively affects their competitiveness. Personnel expenses, lease and other overhead expenses gobble up over 7% of assets for smaller banks, thus wiping out their edge from higher interest and non-interest income they may have earned over their larger competitors.

Table 17

**Annualized 1st Quarter Financial Results for Russian Banks in 2005
(as percentage of assets)**

Indicators	Bank Groups According to Asset Size					
	1	2	3	4	5	6
Net Financial Income	6.3	8.3	8.5	9.4	9.2	11.1
<i>Net interest income</i>	4.4	4.4	4.8	6	5.6	6.3
Interest income	7.2	7.7	7.9	10.1	9	9.2
Interest expenses	2.9	3.3	3.1	4.1	3.4	2.9
<i>Net Non-Interest Income</i>	1.9	3.9	3.7	3.4	3.6	4.8
Commissions	1	2	1.6	2.5	1.9	3
Capital Market Transactions	-0.1	0.8	0.5	0.2	1.2	1.3
In Foreign Currency	0.2	0.2	0.6	0.2	0.6	0.7
In Precious Metals	0	0	0	0	0	0
Foreign Exchange and Derivatives	-0.2	-0.2	-0.1	0	0	0
Stocks and Bonds	-0.1	0.7	0	-0.1	0.6	0.6
Securities And Foreign Currency Re-Evaluation	0.4	0.6	1	0.4	0.1	0
Re-Evaluation Of Foreign Currency Reserves	0.1	0.1	0.1	0	0	0
Re-Evaluation Of Securities Portfolios	0.3	0.5	0.9	0.4	0.1	0
Leasing	0	0	0.1	0	0	0
Other Operational Income	0.6	0.4	0.5	0.3	0.4	0.4
<i>Administrative Expenses, including:</i>	3.1	4.3	4.3	5.4	5.6	7.6
Personnel Costs, Including Social Security Expenses	1.5	2.1	2.3	2.8	2.8	3.6
Depreciation	0.1	0.2	0.2	0.2	0.3	0.3
Lease	0.2	0.4	0.3	0.5	0.5	1
Taxes	0.1	0.3	0.2	0.3	0.3	0.4
<i>Net Operational Income</i>	3.2	4	4.2	4	3.6	3.4
Changes in Reserves	0	2	0.6	0.8	1.2	1
Net Figures from Non-Regular Activities	-0.0	0.1	0	0.1	0.1	0.1
<i>Pre-tax Income</i>	3.1	2.1	3.6	3.3	2.5	2.6
Statistical Reference: Number of Banks' whose figures were involved in the review	10	40	48	98	296	766

Source: STIiK database.

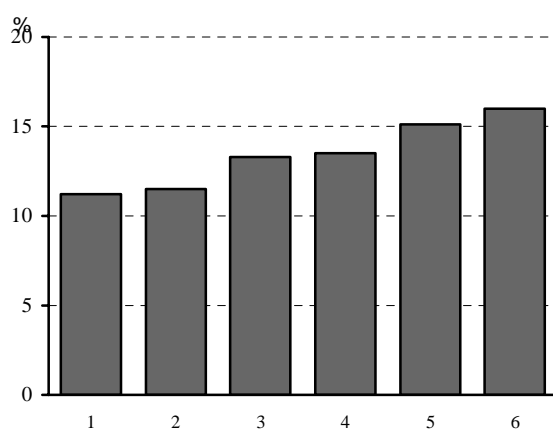
A further analysis of banks' income and expenses for 3 quarters of 2005 also shows that efficiency of banking operations is becoming less dependent on loan and deposit activities, though interest income still constitutes over half of banks' net earnings.

According to the Russian Central Bank¹⁰² in the course of 2005, interest rates banks charge on business loans have decreased from 10.5%–12.9% to 10.1%–10.7%. Rates paid on private deposits changed even less. Thus in 2004 ruble deposit accounts with the exclusion of demand deposits offered 11.4% in January and 9.7% in June, while in 2005 this figure stood at 10.2% in January and went down only to 8.7% for April, August and October.

Similarly insignificant changes were observed in the ratios of loans and deposits recorded in the banks' assets and liabilities. As of January 1, 2005 ratio of loans to the non-financial sector in the banks' assets stood at 54.9% and remained virtually unchanged at 54.8% by October 1, 2005. Share of individual deposits after growing in the period from 2002 to the first quarter of 2005, by the end of the 3rd quarter lapsed back to its 2004 level and constituted 16.2%, an almost negligible change from 16.1% recorded in the 1st quarter of 2005.

These insignificant changes in the banks' interest expenses and income as percentages of their assets corresponds to similarly minor adjustments in the interest rate margins. For 2004 the spread between lending and borrowing rates stood at 4.8%, for 3 quarters of 2005 the figure was 4.9%. The overall climate of declining interest rates for both loans and deposits and their steady share on banks' balance sheets have prompted the banks to reconsider their strategies for consumer vs. business markets. Thus, banks not only made more consumer loans, on which banks tend to charge higher rates than on business loans but raised the share of consumer loans in their overall loan portfolio. In 9 months of 2005, share of consumer loans grew from 12% to 15%.

Please see *Fig. 23* and *24* for comparisons on banks' profitability from business vs. consumer loans.



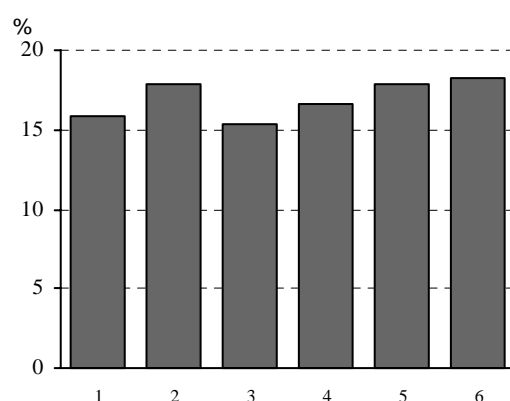
Groups According to Asset Size as of October 1, 2005:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1262.

Source: STIiK Data.

Fig. 23. Interest-Based Income on Business Loans for Banks of Varying Asset Size (excluding Sberbank)

¹⁰² "Vestnik Bank of Russia", issue No. 66, 2005. Data for 10 months of 2005 excludes Sberbank.



Groups According to Asset Size as of October 1, 2005:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1262.

Source: STIiK Data.

Fig. 24. Interest-Based Income on Consumer Loans for Banks of Varying Asset Size (excluding Sberbank)

Overhead expenses as a percentage of banks' assets stabilized at 4.5%, but as can be seen from *Table 18* for smaller banks these expenses were 2.2 times higher than for their larger counterparts.

Table 18

**Annualized 3 Quarter Financial Results for Russian Banks
in 2005 (as percentage of assets)**

Indicators	Groups According to Asset Size						Averages
	1	2	3	4	5	6	
1	2	3	4	5	6	7	8
Net Financial Income	7.7	9.6	9.5	10.1	10.4	11.2	9.1
Net interest income	4.3	4.9	5.3	5.6	5.9	6.3	4.9
Interest income	7.4	8.3	8.6	9.3	9.5	9.2	8.2
Interest expenses	3.2	3.4	3.3	3.7	3.6	2.9	3.3
Net Non-Interest Income	3.4	4.7	4.2	4.5	4.5	4.9	4.1
Commissions	1.1	2.3	1.6	1.9	2.3	2.9	1.8
Capital Market Transactions	0.6	0.5	1	0.6	1	1.4	0.7
In Foreign Currency	0.3	0.2	0.8	0.3	0.5	0.8	0.4
In Precious Metals	0	0	0	0	0	0	0
Foreign Exchange and Derivatives	-0.2	0	-0.2	0	0	0	-0.1
Stocks and Bonds	0.5	0.3	0.4	0.3	0.5	0.6	0.4
Securities And Foreign Currency Re-Evaluation	1.1	1.2	1.2	1.6	0.3	0.2	1.1
Re-Evaluation Of Foreign Currency Reserves	0.1	0	0	0.1	0	0	0.1
Re-Evaluation Of Securities Portfolios	1	1.2	1.2	1.5	0.3	0.2	1
Leasing	0	0	0.1	0	0	0	0
Other Operational Income	0.6	0.7	0.3	0.3	0.8	0.4	0.6

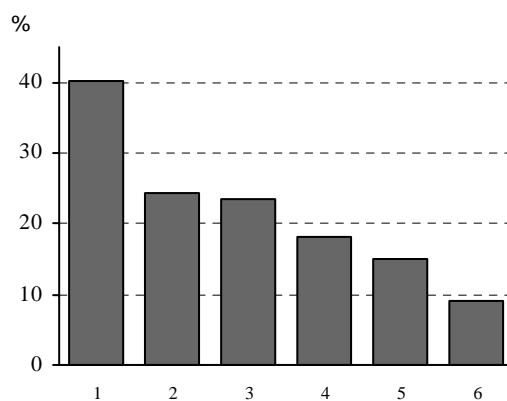
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	1	2	3	4	5	6	7	8
<i>Administrative Expenses, including:</i>		3.5	4.5	4.4	5	6	7.6	4.5
Personnel Costs, Including Social Security Expenses		1.7	2.1	2.3	2.5	3	3.6	2.2
Depreciation		0.1	0.2	0.2	0.2	0.2	0.3	0.2
Lease		0.3	0.4	0.3	0.4	0.6	1	0.4
Taxes		0.2	0.3	0.2	0.3	0.3	0.4	0.2
<i>Net Operational Income</i>		4.2	5.1	5.1	5.1	4.4	3.6	4.6
Changes in Reserves		-0.1	2	1.6	1.9	1.5	1.3	1.1
Net Figures from Non-Regular Activities		0	0.1	0	0.1	0.1	0.1	0.1
<i>Pre-Non Regular Activities Profits</i>		4.2	3.1	3.5	3.1	2.9	2.3	3.5
<i>Pre-tax Income</i>		4.3	3.2	3.5	3.2	3	2.5	3.6
Statistical Reference: Number of Banks' whose figures were involved in the review		10	40	50	98	297	753	

Source: STIiK Data.

With net interest rate based income and overhead expenses remaining more or less stable, banks' overall efficiency naturally becomes quite sensitive to changes in non-interest operations. By the end of the 3rd quarter of 2005, Russian banks' income earned on non-interest activities as a percentage of assets was 10.8% higher than in the similar period in 2004 (4.1% and 3.7% respectively). Banks' operations with securities and re-evaluation of their securities portfolios in particular have contributed to this change. Re-evaluation of banks' securities portfolios alone for the first 3 quarters of 2005 earned banks 11% of their net income and comprised 1% of their total assets.

At the end of the day, Russia's largest banks appeared to reap the biggest profits. All other groups of banks recorded figures below aggregate averages (*please see Table 18*). Such variations in earnings as percentage of assets are particularly stark between the top (in terms of asset size) and bottom-ranked banks: 40.2% for the 10 largest banks against a meager 9.1% for their smallest rivals (*please see Fig. 25*).



Groups According to Asset Size as of October 1, 2005:

- 1 – Banks ranked 1–10;
- 2 – Banks ranked 11–50;
- 3 – Banks ranked 51–100;
- 4 – Banks ranked 101–200;
- 5 – Banks ranked 201–500;
- 6 – Banks ranked 501–1262.

Source: STIiK Data.

Fig. 25. Annualized 3rd Quarter ROE For Banks Of Varying Asset Size (excluding Sberbank)

4.11. Problems of Introduction of the Municipal Reform

4.11.1. *The General Characteristics of the Progress with the Reform in 2005*

In compliance with the recently enacted municipal law (Federal law No. 131-FZ of October 6, 2003, “On general principles of organization of local self-governance in the Russian Federation”, below referred to as law No. 131-FZ), the year of 2005 should have formed a critical period in preparation for a comprehensive introduction of the municipal reform. During the period:

- The process of setting municipal entities’ borders and status should have been over (until 1 March 2006);
- Their charters and local self-governance bodies’ other legal acts should have been brought in line with the new federal law (until July 1, 2005);
- The structure of local self governance bodies should have been set and municipal elections should have been conducted in the newly established municipal entities (until November 1, 2005);
- The processes of free transferring by municipal entities of their property objects under the regional and federal control and those by the Federation and regions – to municipal entities should have been complete.

In practice, however, the process of launching the municipal reform proved to be far more controversial than envisaged. Given that, 2005 can be divided into several stages.

The first one, which can be conditionally labeled as evolutionary one, lasted through June 2005. At the time, the work was under way to prepare for introduction of Law No. 131-FZ according to a timetable as per transitional provisions of the Law. All tiers of government busied themselves with completion of demarcation of municipal entities’ borders and setting their status, adoption of new charters, establishment of the structures of local self-governance bodies, and holding municipal elections.

However, the summer of 2005 displayed the first signs of crisis phenomena. A group of the Duma Deputies submitted a clause to law 131-FZ (aka “Grishankov’s Clause”) that provided for a postponement of the reform implementation timelines. Between June and September political proponents of the reform fought for the destiny of the reform with their antagonists. On September 21, 2005, the State Duma ultimately passed the clause, albeit in somewhat moderate form. That essentially meant that the strategy of the postponement of the reform has won.

The last quarter 2005 can be viewed as a stage of regionalization and compromises. At the time the federal center was making decisions that had a considerable mitigation effect on the ideological rigidity of Law No. 131-FZ and introduced a great deal of vagueness into mechanisms of its implementation. In parallel with that regions were identifying their genuine strategies of the reform implementation in the frame of the new powers granted to them by the Grishankov’s Clause (law No. 129-FZ of October 12, 2005).

Overall, the intrigue around the destiny of the municipal reform in 2005 proved that those were right who, during debates around Law No. 131-FZ, had forewarned of its conceptual vulnerability and insufficient adaptation to Russian realities. However, the postponement of the reform implementation timelines cannot be perceived as a positive step which should facilitate its implementation afterwards. The postponement of the reform timelines per se does not solve critical problems that exist in its conceptual fundamentals. Recent amendments to federal laws signal the refusal of pursuing a distinctive ideology, rather than an ideological swing, which can devaluate even those elements of the original concept of the reform which may help develop local self-governance. Finally, the decision to put off the reform bears serious reputation risks both

to put off the reform bears serious reputation risks both for the federal government that has developed and vigorously promoted it and for local self-governance. Establishment of a great number of municipal entities, with their elected bodies, that have no clearly set powers and lack certain financial resources can result in a substantial discrediting of the concept of local self-governance as an institution.

4.11.2. Evolutionary Stage of the Reform Implementation

The progress in the municipal reform implementation. As long as the decisions to put the reform on hold and postpone its implementation, it is particularly interesting to analyze the preparation for a comprehensive enforcement of Law No.131-FZ in the first half 2005. In the course of the analysis we employed the following data:

First, various government agencies' reform progress reports, such as the Analytical newsletter of the State Duma staff and certain departmental documents, among others. At this point, it is worthwhile to note that data supplied by different agencies does not always appear consistent and find themselves under the impact of political factors. To exemplify this, suffice it to mention that once the decision to shift the reform timelines was made, the documents began to radiate far lesser optimism with regard to regions' level of preparedness for its implementation. Given that, however this information covers the situation nationwide, which allows to evaluate general tendencies and results of preparations for the comprehensive launch of Law No. 131-FZ.

Second, we used a huge volume of specific information received from unofficial sources, such as municipal entities homepages on the Internet, media, etc.

Finally, third, we collected a part of information by ourselves while conducting municipal research in a number of regions.

Legal regulation. During the period in question, the legislative process was rather active, with bills drafted yet in the first half 2005 being passed through the end of summer (with the peak of the process falling on June and July). The legal base of local self-governance was being amended, by and large, in two major areas.

First, the legal regulation, as per law No. 131-FZ, the RF Government Plan on development of bills needed for the sake of the municipal reform implementation¹⁰³. For instance, the following had been accomplished until then:

- Federal Law No. 97- FZ "On state registration of municipal entities' charters" was developed and passed as late as in July 2005 and consequently became effective as of September 1, 2005;
- The electoral law of RF was modified, in particular with regard to specification of the status of elected local self-governance authorities;
- The possibility for setting a mixed or proportional system at municipal elections was stipulated in the law;
- A new status and procedures of formation of election commissions at municipal entities were set.

Accordingly, the respective amendments were introduced to the federal law of RF "On mass media", the Criminal Code of RF, Tax Code of RF; the Code of RF on Administrative Offenses, the Civil-Judicial Code of RF, and the federal law "On provision of constitutional rights of citizens of RF to elect and be elected into bodies of local self-governance", and a number of other statutes.

Second, the process of introduction of amendments was associated with an intense debate that started at the time with regard to the possibility to modify mechanisms of elec-

¹⁰³ Order by the RF Government of March 3, 2004, No. 307-p.

tion of heads of municipal entities by analogy with the governors election one. That meant the transition to a system under which the municipal entity head is elected by the representative body of local self-governance upon nomination by the governor. While the principle of separation of the government power from local self-governance stipulated in the RF Constitution (self-governance bodies do not fall into the system of government bodies) did not allow to directly implant the mechanism, however, certain steps were undertaken to ensure the regional authorities' greater influence on formation of local self-governance bodies.

More specifically, on April 8, 2005, Art. 85 of the Law (i.e. transitional provisions) was amended as follows: in the event the head of administration of a municipal district or urban district is employed under contractual terms, the proportion of members of the tender commission formed by the regional government is increased from one-third to a half. As far as newly established municipal entities are concerned, should a local referendum or citizens' meeting fail to identify the structure of local self-governance bodies, the regional authorities are enjoy the right to set by their statute procedures for election of heads of the newly established municipal entities for the first term of their powers, as well as the status of the said position in the structure of local self-governance bodies.

Reforming the territorial organization of local self-governance. The shift of the timeline of the reform of territorial organization of local self-governance until March 1, 2005, enabled most regions to complete the process, by and large, within the legal framework. The setting of borders and status of municipal entities had been accomplished by the date in all the constituent members (aka Subjects) of the Federation, except for Chechen Republic and Republic of Ingoushetia. However, some regions continued to adjust their territorial structures afterwards as well, which was driven in particular by decisions of the court of law. Trials on the matter were initiated in Vladimir, Kaliningrad, Yaroslavl, Sakhalin oblasts, and some other Subjects. Trials were mostly associated with rural settlements being deprived of the right for local self-governance (resulting from the establishment of urban *okrug* on the basis of rural *rayons*), as well as towns' struggle for the right to win the status of urban *okrug*, rather than urban settlement). In some regions, for instance, Orenburg oblast, such matters were resolved pre-trial.

According to the Russian Electoral Commission, as of may 2005, roughly as many as 12,000 new municipal entities had been established, of which some 10,000 were rural ones. The attribution of municipal rayons to newly established municipal entities was mostly associated with the inclusion into them earlier independent towns; the attribution of urban okrugs to newly established municipal entities occurred primarily because of the inclusion into them of additional rural territories. As of October 1, 2005, the RF Ministry of Regional Development (below referred to as 'Minregion') estimated the number of newly established entities accounting for 13,000. Thus, the number of municipal entities in RF grew slightly more than twice, with 83% of them being rural settlements.

This is a fairly considerable rise, however it appears far less than some experts' predictions of some greater, up to 5-fold growth in the number of municipalities. Major factors that have constrained the rise of the number of municipal entities vis-à-vis the forecasts were:

- 1) Drastic decline of the number of newly established municipal entities vis-à-vis the previously existed number of sub-municipal structures in the regions where the rayon model had been existing prior to the reform. Thus, in 9 regions, such a contraction accounted for 40 to 70%, while in most others it did not surpass 10–20%. The overall number of newly established settlements failed to equal the number of the previously

existed sub-municipal structures by one-fourth. It became possible thanks to consolidation of sub-municipal structures in the course of formation of rural settlements and integration of a number of rural territories into urban ones and urban okrugs. As concerns the regions that had created municipalities at the settlement level long prior to the municipal reform, with some rare exceptions, the number of settlements there remained practically unchanged.

- 2) Establishment in a number of regions of urban okrugs on the basis of rural rayons which de-facto resulted in maintaining the former one-tier model of territorial organization of local self-governance. This approach prevails, at least, in three Subjects of the Federation and it is partly employed in a few others. It should be noted that notwithstanding the enactment of amendments to Law 131-FZ in 2004 that ensured a stricter approach to the setting of borders of urban okrugs, the federal center failed to duly counteract. As a result the two-tier model in the said Subjects is introduced only within single territories and at the scale of single settlements.

Shaping the system of local-self-governance bodies. The process of formation of local self-governance bodies likewise was unfolding fairly rapidly. By June 2005 over 20 Subjects (the data vary) had conducted municipal elections, while the majority of others set dates of elections. In this area, the key political issue became the selection of the position of the head of municipal entity in the system of local self-governance bodies. In compliance with Law No. 131-FZ, the municipal entity head may be elected:

- at the municipal elections and run the local administration;
- at the municipal elections and preside the representative body of the local entity;
- from members of the local legislature and head the representative body of the municipal entity.

Different regions and individual municipal entities addressed this issue in different ways. Thus, according to Minregion, in 27 Subjects of the Federation, heads of municipal entities are elected solely at municipal elections and nationwide the aggregate proportion of municipal entity heads elected by the population accounts for over 60%. Nonetheless, according to the very Ministry, heads of municipal entities will run local administrations only in 35% of municipal entities, thus meaning that the remaining 65% will contract out their heads. It often happened that decision became an unbiased choice of a given municipality, or instance, in the event there were a few conflicting groups of interest. They were keen to ensure the head of the local administration should be a compromise figure, rather than any group's protégé. However, there would occur a serious political pressure in favor of this particular model as the best match to the concept of solidifying the "power vertical", sometimes even against the local community's opinion.

This can be best illustrated by the situation in the town of Obninsk. The city council ruled to modify the structure of the local self-governance bodies and procedures of election of the local head, while the previous structure that provided for direct elections had been approved by the local referendum. The local mayor resided in protest, while a group of local residents filed a lawsuit claiming the ruling was illicit. The tag of war between the local representative body and the voters was there through the whole 2005 and the final decision has not been made as yet.

The overall assessment of results of the evolutionary stage. It can be argued that by summer 2005 the situation appeared fairly controversial.

On the one hand, the overwhelming majority of regions had been vigorously getting themselves ready for a comprehensive introduction of Law No. 131-FZ, generally orienting to the timetable set by its transitional provisions. From the formal perspective, the process

was running fairly smoothly, albeit with numerous conflicts. The regions that since 2005 had been introducing numerous mechanisms as per the said Law in the testing mode likewise generally demonstrated that the model of the municipal reform can be implemented.

On the other hand, with the reform in progress, there began to accumulate objective and subjective challenges and complexities. Accordingly, the comprehensive implementation of Law No. 131-FZ starting from 2006 began to be questioned. Generally, the challenges were quite predictable, however the authors of the reform did not pay them much attention while developing the reform implementation mechanisms. It is impossible to further evaluate the future situation around the municipal reform without considering the challenges, their causes and degree of their intensity.

4.11.3. Problems with Implementation of the Municipal Reform

The common view on challenges facing the reform usually implies fairly evident and superficial factors, as follows:

- Insufficient legal provision of the reform: thus, notwithstanding the timelines set by Law No.131-FZ, the RF Government has failed to approve procedures of property redistribution between the Russian Federation, its Subjects, municipal entities, as well as procedures of assigning property under municipalities' control between municipal rayons, settlements, and urban okrugs;
- Inadequate assignment of revenue sources between different tiers of government, which does not allow for municipal entities' financial back-up to tackle issues of local significance;
- Shortages of qualified cadres, material and technical provision to solve issues of local significance in the newly established rural settlements;
- Risks associated with the parallel implementation of other reforms, such as tax (in part of land tax), housing, etc;
- A number of institutional mechanisms provided for by Law No. 131-FZ proved to be not ready yet: this concerns, or instance, the absence of registration of municipal property, failure to complete the land reform, the tax service's failure to be ready to work with municipalities of the settlement level, etc.

Given this particular context, one can argue that the bulk of the problems, indeed, should mitigate or dissipate over time. That is why procrastination of the reform implementation period would appear quite a well-grounded strategy. This, however, is just a superficial viewpoint, for many challenges visible on the surface by their essence highlight on fundamental problems associated with the failure to duly develop numerous conceptual provisions of the Law and their insufficient adaptation to long-term institutional constraints that exist in the society.

Thus, it has not appeared evident that strict financial and staff restrictions exposed in many settlements pose a short-term and easily remedied problem. It may well happen they mirror the impracticability of attempts to spread the two-tier system of territorial organization of local self-governance throughout the country, which is one of the cornerstones of the concept of municipal reform.

A brief analysis of financial mechanisms provide for by the local self-governance reform makes the conceptual challenges yet more visible – the possibility for ensuring self-financing of a significant part of municipal entities within the frame of the mechanisms is illusive from the beginning.

Municipalities were guaranteed two main revenue sources – that is, local taxes and deductions from federal taxes and levies, while the number of local taxes is limited just by

two ones – that is, physical individual property and land taxes. Both are fixed with the settlement level and their share in the municipal entities' overall revenues appears insignificant. With these taxes, their independence is seriously limited – the federal level has set limits of modification of the tax rates and a broad list of tax benefits. Besides, as long as these particular taxes are concerned, the tax base assessment methods suffer substantial drawbacks, which cannot be remedied at the local level. At the municipal rayon level it is possible to regulate some parameters of the presumptive tax, which is a special tax regime set for small businesses, however it cannot substantially affect the volume of the respective revenues.

As concerns the share of the federal taxes and levies, given a considerable diversity of the level of economic development across municipal entities, their role can become considerable only for municipalities that enjoy the most developed tax base, primarily, large cities. Should one attempt to employ uniform standards of the share of taxes due to municipalities, which are set at the federal level, to remedy problems of the bulk of municipal entities, there would arise substantial imbalances. In the circumstances, financially self-sufficient municipalities would enjoy considerable additional revenues, which would constrain possibilities for the financial equalization between municipal entities that find themselves in a less favorable. The same situation is noted, as far as setting uniform standards of contributions on the regional level. Preliminary estimates show that while decreasing incentives to boosting tax base in the most financially self-sufficient municipal entities, the mechanism of negative transfer is incapable to seriously affect the solution of the problem.

Thus, the financial mechanism suggested in the frame of the reform could not secure a substantial level of municipalities' own revenues for the bulk of them. Thus, it was initially suggested that financial aid would inevitably lay a substantial role in financing the bulk of municipal entities.

The mass resentment against the financial mechanisms in the frame of the municipal reform can be attributed to yet another conceptual contradiction underlying it. Rather a strict regulation of the list of matters of local significance and territorial fundamentals of local self-governance was coupled with the absence of any substantial guarantee of allocation of financial aid to local budgets. If the state sets a municipal entity's territory and powers, it would be logical to have the state assume certain obligations with regard to their financial provision. If, on the contrary, the state stakes on the municipal entities' eagerness to boost their revenues and optimize expenditures, the state should ensure a sufficient level of freedom in formation of municipal entities, or in their powers, or territory (which appears more preferable than the first two options). Thus, a rigid uniform variant of formation of municipalities' territories and powers inevitably stirs and will further generate their parasitical mood with regard to their financing, the revival of approaches associated with financial guarantees on the basis of "uniform social standards" and other paternalist-type mechanisms in this particular sphere.

Finally, the belated federal regulation with regard to the free property redistribution between different tiers of power was as well driven both by the federal bureaucrats' failures and technical and political complexities of the process, and a high degree of probability of its immanent conflicts. Thus, in the health care, the division of powers between different tiers of government with regard to provision of primary and specialized medical and sanitary assistance has extremely complicated the matters of property redistribution, for such kinds of medical assistance were usually delivered in the frame of the same institutions. As concerns concentration of all the forms of social security of the population at the regional level, it particularly required withdrawing from the municipal control objects whose erec-

tion was sponsored by the population. Overall, it is not evident that the mechanism of free property transfer fits the common legal pattern of property relations in Russia.

Thus, even assuming that some of the problems that arose in the course of the reform implementation can be mitigated over time, clearly it does not concern all of them.

Meanwhile, we cannot blame only objective factors, be those short-term challenges of the transitional period, or substantial conceptual drawbacks of the reform per se, for the postponement of the reform. Clearly, pursuing their political interests, regional elites played a substantial part in initiating such a decision. When Law No.131-FZ was being passed, pressed by the federal center, they did not speak up openly against the new municipal legislation. However, the law did not match their political interests, as it implied a further decentralization of budgetary funds and property and emergence of new players in the political process whose existence will affect regional policy-making. These problems appeared yet more persistent in the regions where settlements were supposed to assume control over fairly valuable resources, such as expensive land and the respective future tax revenues. Thus, behind the eagerness to decelerate the reform pace there were both technical problems and political interests.

4.11.4. Struggling for the Reform – Results and Consequences

As noted above, the destiny of the municipal reform began being questioned since early June, when Grishankov clause was submitted to the Duma. The clause provided for postponement of the reform until January 1, 2009. Despite a fairly vigorous counteraction of a number of MPs and an ambiguous stance of the presidential Administration on the matter, on September 21, 2005, the clause was passed in the second and third readings, albeit in a somewhat moderate form.

The clause provided for a transitional period until January 1, 2009. Meanwhile, the amendments read that provisions of Law No.131-FZ in the part that did not concern powers and budgets of the newly established settlements should become effective as of January 1, 2006. As concerns the newly established settlements, during the transitional period procedures of their tackling matters of local significance should be subject to annually adopted statutes of the Subjects of the Federation. This means that matters of local significance of the newly established urban and rural settlements may be assigned, in full or in part, to the municipal rayons. Given that, it is allowed to re-channel revenue sources foxed with the settlements (including local taxes- that is, the land tax and the one on private individuals' property) to the rayon budget. In this case the settlements' revenues and expenditures may be consolidated into the municipal rayon's budget, i.e. the financing of the settlements may become estimate-based.

In addition, the financial equalization mechanisms were modified substantially. Originally, Law No. 131-FZ as well as amendments to the Budget Code of RF, suggested that subsidies both to municipal rayons and urban okrugs, and settlements should be granted primarily for the sake of equalizing their budget sufficiency. The respective provisions read that it would be just for some time that a limited and increasingly diminishing art of the subsidies might be allocated to bridge the gap between actual or projected revenues and expenditures. In accordance to the passed amendments, as far as settlements are concerned, during the transitional period the total amount of subsidies can be assigned using actual or projected revenue and expenditure indicators. As concerns municipal rayons or urban okrugs where the respective proportion should fall from 40% in 2006 to 20% in 2008, there also was introduced a new scale – in 2006, 100% of subsidies out of the re-

gional fund of financial support can be allocated to them using the noted indicators, while in 2007 – 80% and in 2008 – 50%.

The requirement of Law No. 131-FZ concerning a free property transfer in the aftermath of the reallocation of powers is still there, albeit the property transfer timeline have been put off until January 1, 2008. During thus appeared transitional period and until the registration of the right for a given property government agencies of the respective level can control this property for free, to duly exercise their powers.

The transitional provisions of the noted Law mere further modified, however, those amendments appeared less significant.

The analysis of the clauses shows that they can exert a substantial influence on the pace, vector and conditions of the reform implementation.

First, the ideology of the reform in the part of the balance of decisions to be made by the Federation and its Subjects has undergone considerable changes. Originally, Law 131-FZ read that all main parameters of the reform, including measures on preparations for its launch, were subject to the federal law, with the level of freedom of Subjects being substantially constrained. The noted modifications resulted in the situation in which , at least, for the coming 3 years the impact of decisions made at the regional level that concern allocation of powers between municipal rayons and settlements, as well as introduction of new financial equalization mechanisms becomes critical.

Second, the softening of conditions and procrastination of the transition deadlines with regard both to settlements and municipal rayons and urban okrugs will inevitably lower the municipal entities' eagerness to conduct measures that would ensure a grater efficiency of budget expenditures and the budget network restructuring, in particular. The impact of such measures can become particularly adverse, should the municipality community perceive them as the uncertainty about the adequacy of the respective conceptual approaches, rather than granting the municipal entities with extra timing to optimize their budget expenditures (which overall appears justified).

Third, the inevitable for the two-tier system rise of conflicts between settlements and municipal rayons may further aggravate with settlements seeing the formation of the local elected authority which should pursue the voters' interests, but practically would not be able to do it, as most powers and expenditure mandates have been assigned to municipal rayons. The experiences of the regions that had found themselves in such a situation pre-reform proves substantial costs associated with this particular model of municipal governance. The existence of the elected authority at the settlement level drastically changes the situation vis-avis the rayon model that prevailed in the regions prior to the start of the municipal reform, even if the settlements' powers are reduced to those once exercised by rural councils, *volosts* and other sub-municipal structures that had failed to obtain the status of municipal entity. Plus, their financing will be based on estimates.

4.11.5. The stage of Regionalization and Compromises

Once enacted, the amendments to the law on local self-governance armed the regional administrations with rather an ample set of policy options towards the newly established municipal settlements. There exist several basic models that differ by ways they address matters of municipal settlements' financing and powers:

1. the newly established settlements execute the complete list of matters of local significance, as per Law No. 131-FZ and form and execute their own budgets;
2. a part of such matters is assigned to the municipal rayon level, however, the settlements retain control over their budgets;

3. a part of such matters is assigned to the municipal rayon level, with the settlements being financed on the basis of estimate;
4. practically all such matters are assigned to the municipal rayon level, with the settlements being financed on the basis of estimate;
5. different models are employed for different groups of the newly established settlements within a given region.

There may also exist differences with regard to identification of revenue sources fixed with the newly established settlements in the event they have their own budgets.

According to the currently available information, quite a number of regions (47 of them) are going to fully implement Law No.131-FZ since January 1, 2006. However, it seems that differences between them and other regions mostly should not be so great.

As concerns matters of local significance, in the latter group of Subjects (those that put off the implementation of the Law) their list is regulated by the regional law. By contrast, in pursuance of the same goal, the former group of regions (those who declared a complete implementation of the Law) can jump on agreements on the transfer by the settlements of their powers to municipal rayons concluded in a mass way. Law No. 131-FZ originally provided for this particular instrument. The decision on the possibility for allocation of subsidies to settlements to finance the gap between actual (projected) revenues and expenditures makes the difference between budgetary and estimate-based financing not as much substantial as in the case for equalization of budgetary sufficiency. Thus, the real progress of the municipal reform in the pioneering regions requires a thorough monitoring.

Together with the reform regionalization processes, late 2005 saw the introduction of fairly essential modifications to its conceptual fundamentals on the federal level. It was Law No. 199-FZ of 31 December 2005 "On introducing amendments to individual statutes of the Russian Federation in conjunction with improvement of division of powers" (below referred to as Law No. 199-FZ) that contributed the most to the process. More specifically, it has made possible the following amendments to the reform concept:

First, one of the basic provisions of the concept of municipal reform was a clear division of matters of local significance between two levels of municipal settlements – that is, municipal rayons and settlements. While formally failing to break this principle, Law No. 199-FZ essentially allowed its substantial dilution.

Thus, in compliance with the Law, the settlements either retain or were additionally granted with such matters of local significance as organization of librarian services to their residents; creation of conditions for organization of leisure and provision of the local residents with services of organizations of culture; creation of conditions for development of physical culture and mass sports, local traditional folk arts; assistance to development of agricultural production; organization and implementation of measures on the work with children and the youth. In parallel with that, at the level of municipal rayons, there were added such matters of local significance as organization of librarian services to their residents by *inter-settlement* libraries; organization and implementation of measures of *inter-settlement nature* on the work with children and the youth, as *well as creation of conditions for providing the settlements that form the municipal rayon* with services on organization of leisure and provision of the local residents with services of organizations of culture; *creation of conditions* for development of local traditional folk arts; for development of agricultural production in *providing the settlements that form the municipal rayon*; *securing conditions for development in the territory of the municipal rayon* of physical culture and mass sports, etc.

Evidently, in the event, for instance, library services to the population it is yet possible to draw distinction between inter-settlement and settlement libraries (though the law does not specify such a distinction), but unlike this, it is impossible to do the same with regard to most other matters of local significance.

Secondly, the uncertainty with the division of powers compels one to question yet another conceptual provision of the municipal reform, which is, property should follow the power. In the conditions of uncertainty with division of powers there also inevitably arises with the problem of property assignment between the rayon and settlement levels. In other words, in practice this particular matter will increasingly grow political, though Law No. 199-FZ is supposed to regulate a certain procedure of interaction between different parties concerned. The inconsistency of the interrelation between powers and property also manifests itself in the fact that the list of object of property that can belong to municipal entities in compliance with Art. 50 of Law No. 131-FZ has not been extended in accordance with new matters of local significance that Law No. 199-FZ has included in the municipal rayons and settlements' mandates.

Third, the original reform concept was built upon a clear distinction of matters of local significance and reassigned government powers from the perspective of sources of financing, degree of freedom and organization of solving the respective matters, etc. At this point, Law No. 199-FZ loosened the conceptual rigidity of the municipal law by reading that in the cases provide for by the law municipal entities may exercise powers the government failed to reassign to them-following their own initiative, so to speak. Law No. 199-FZ by itself granted local self-governance bodies with the right to independently introduce additional social protection and social assistance measures for individual categories of citizens without regard to the presence in federal statutes of provisions that stipulate the said right.

Law No. 199-FZ also provided for additional measures aimed at simplification of the originally set mechanisms of introduction of the municipal reform. More specifically, it softened requirements to registration of municipal property. Meanwhile the adoption at the very end of 2005 of amendments to basic statutes that regulate the division of powers that came in effect as of January 1, 2006, will inevitably cause an additional disorganization in the course of the municipal reform implementation and aggravates the problem of the mismatch between municipal powers and sufficient financial sources.

Overall the amendments introduced by Law 199-FZ to the concept of municipal reform do not allow an unambiguous interpretation. On the one hand, they proceed from practical needs and enable one to soften evident conflicts and inconsistencies caused by Law No. 131-FZ. However, on the other hand, they made a substantial step towards substituting for a consistently implemented concept with fairly chaotic and conceptually untested steps caused by certain groups of interests. This can just complicates the reform implementation in the future.

Still another factor that influences the legal field and within the framework of which the municipal reform is implemented is the adoption of Law No. 198-FZ of 27 December 2005. The Law introduced amendments to the Budget Code of RF. The amendments have been debated for fairly long, which is why the given Law does not appear directly associated with the postponement of the reform, though the formally introduced amendments mostly concerned the period between 2006 through 2008. The amendments in question primarily highlighted the discussion on two fundamental issues in the area of interbudgetary relations whose importance goes far beyond the three-year transitional period.

On the one hand, regions with the most financially prosperous municipal entities were displeased with too "liberal" approach to setting a negative transfer. The Budget Code provided for the possibility of setting such transfer only for the benefit of municipal

entities whose level of budgetary sufficiency was more than twice over the average one across the Subject of the Federation, with not more than 50% of the excess amount being withdrawn. The amendments in question capped the level of setting of the negative transfer at the level of 1.3 vs. the average budget sufficiency Subject-wide, while leaving the maximum level of withdrawal unchanged. The latter is a critical decision, as in the course of debates there were recommendations to increase the level up to 75 and even 100%, which would have an extremely adverse effect on incentives for such municipal entities to the boost their tax bases.

On the other hand, there arose the problem of motivating municipal entities that receive financial aid to boost their budget revenues. The possibility for the annual substitution for financial aid with rates of deductions from personal income tax as per the Budget Code did not help solve the problem. As a result the suggestion was made to grant Subjects of the Federation with the right to fix with municipal entities for the medium-term perspective (upon conciliation with them) standards of deductions from any taxes collected to the regional budget as a swap for the regional financial aid. While the first part of the suggestion – that is, the expansion of the list of revenue sources deductions from which can be fixed with municipal entities against financial aid, – was stipulated in full in the amendments, the possibility for fixing tax deductions for the term of over 1 year remained unclear. The law has set that the deductions rates should be fixed for the *term of not less than one year*, with no additional clarifications in the adopted amendments. Thus, the question as to whether recipient municipalities could have a possibility for the emergence of incentives to boost their tax bases has remained unanswered.

In conclusion, one can single out the following essential tendencies that arose in 2005 and which will be exerting a strong impact on the progress of the municipal reform:

- regionalization of the progress with the reform implementation, substantial interregional differences, coupled with many regions' eagerness to make the federal center believe they carry out a full-scale reform;
- retreat from the conceptual fundamentals of the municipal reform at the federal level, adaptation of the reform both to practical needs and regions' lobbyist pressures;
- the federal center's eagerness to ensure an adequate financing of municipal entities' powers, which will always come across constraints generated by the selected concept of municipal reform.

Annex 1.

An Overview of Legislation Adopted in 2005 in the Sphere of Tax Regulation¹

In 2005, the reforming of tax legislation continued, its priorities, as before, being the need to decrease the tax load, and also to bring into order and to further improve tax legislation, including tax administration. During the year, some amendments were made to Part One of the Tax Code (RF TC), and to almost all the chapters of Part Two.

As the most significant changes in the tax sphere, there can be pointed out the amendments and alterations introduced to Part One of the Tax Code concerning the granting to tax agencies the right to extrajudicial recovery of mandatory payments and fines, as well as those introduced to Part Two of the RF Tax Code, Chapter 21 "Value Added Tax", Chapter 22 "Excises", Chapter 25 "Tax on profit of organizations", Chapter 26.2 "Simplified system of taxation", Chapter 26.3 "System of taxation in the form of single tax on presumptive income for some types of activity", and Chapter 28 "Transport Tax".

Besides, written explanations of the empowered bodies concerning some issues of applying tax legislation are discussed here.

Extrajudicial Recovery of Mandatory Payments and Fines by Tax Agencies

The most important changes in the part of improving tax administration were introduced by Federal Law No. 137-FZ, of 4 November 2005, "On making amendments to some legislative acts of the Russian Federation, and recognizing as null and void some provisions of legislative acts of the Russian Federation in connection with the implementation of measures designed to improve the administrative procedures for settling disputes", which is to come into force from 1 January 2006.

The Law has introduced a uniform administrative procedure for compulsory recovery, from juridical persons and individual entrepreneurs, of mandatory payments and sanctions to the budget.

In accordance with the existing version of Part One of the RF Tax Code, tax agencies do not have the right to recover fines by sending to the bank, where the accounts of a taxpayer or a tax agent have been opened, a letter of collection (or encasement), for the necessary monies to be written off the accounts of a taxpayer or a tax agent and transferred to the corresponding budgets (or off-budget funds). The new Law has considerably expanded the rights of tax agencies. Now tax agencies, beside forfeits and arrears of taxes and levies, can also recover fines. Moreover, they have been granted the right to recover tax sanctions from organizations and individual entrepreneurs independently, without petitioning to a court of justice, within the established limits.

For these purposes, Chapter 14 "Tax Control" of the RF TC has been augmented by Article. 103.1, which regulates the recovery of a tax sanction on the basis of a decision made by a tax agency. The Article consolidates the right of tax agencies on their own, without appealing to a court of justice, to recover sanctions from organizations and individual entrepreneurs in the event of the size of a fine imposed on an individual entrepreneurs not exceeding 5,000 roubles for each tax within a given tax period, and that of a fine imposed on an organization – 50,000 roubles for each tax within a given tax period.

Appropriate changes have also been introduced in Article 114 of the RF TC, which regulates the application of tax sanctions. Prior to the changes, it was stipulated in Item 7 that tax sanctions were to be recovered from taxpayers only by judicial proceeding. According to the new wording of the Item, a tax sanction is to be recovered from a taxpayer

¹ The overview was prepared with assistance from the Legal System Consultant Plus.

on the basis of a decision made by the director (or deputy director) of a tax agency in the procedure established by the Code, in the event the amount of a fine imposed on a taxpayer – individual entrepreneur not exceeding 5,000 roubles for each unpaid tax within a tax period, and (or) other violation of legislation on taxes and levies; and a fine imposed on an organization – 50,000 roubles for each unpaid tax within a tax period, and (or) other violation of legislation on taxes and levies. In the event when the amount of sanctions imposed on the aforementioned taxpayers is in excess of these limits, or in the event of a physical person, who is not an individual entrepreneur, being brought to responsibility, the amount of a fine is to be recovered by judicial proceeding in accordance with the RF Tax Code.

The new Article 103.1 of the RF TC also envisages the administrative procedure for settling disputes. In the event of an appeal against the recovery of a tax sanction having been submitted to a superior tax body (or to a superior official), the execution of the aforesaid decision is to be suspended. In the event of this decision having been appealed against to an arbitration court, its execution can be suspended in the procedure established by the legislation on arbitration procedure of the Russian Federation.

It should be noted that the new recovery procedure implies that a juridical person or an individual entrepreneur will have an unconditional right to appeal against the decision of a tax agency to a superior body or to an arbitration court. Thus, Item 3 of Article 101 of the RF TC has been augmented by a norm stipulating that such a decision, made by a tax agency, must specify the period during which the person being brought to responsibility for the commitment of a tax violation will have the right to submit an appeal against the aforesaid decision to a superior tax body (or to a superior official), or to a court of justice (or an arbitration court), and also contain stipulations concerning the procedure for submitting such an appeal, and other necessary information.

Besides, the Law has introduced a single administrative procedure for compulsory recovery of arrears from the payers of contributions to mandatory pension insurance.

According to Federal Law No. 167-FZ of 15 December 2001 “On mandatory pension insurance in the Russian Federation”, the correctness of the computation and payment of contributions to mandatory pension insurance is to be controlled by tax agencies in the procedure established by legislation of the Russian Federation that regulates the operation of tax agencies. At the same time, the right to recover arrears of insurance contributions, forfeits and fines, in the event of the amount due to be paid by an individual entrepreneur being no more than 5,000 roubles, and by a juridical person – no more than 50,000 roubles, has been granted to territorial agencies of the RF Pension Fund, to be based on the decisions made by these agencies. If the amount due to be paid is in excess of the aforesaid amounts, or if the insured person is a physical person who is not an individual entrepreneur, the recovery is executed by territorial agencies of the RF Pension Fund by judicial proceeding.

For the purpose of introducing a uniform administrative procedure for the recovery of arrears of insurance contributions, forfeits and fines, it has been established that the tax agency must send to an appropriate territorial agency of the RF Pension Fund the information concerning the amounts of arrears accumulated by payers of the contributions to mandatory pension insurance, as well as the documents confirming the fact of such arrears having been accumulated, within two months from the day of detecting the arrears.

*The Single Standard for Taxpayer Services and the Regulation
for the Interaction with Taxpayers*

One of the goals of improving tax administration consists in making the administration procedures convenient and transparent for taxpayers, as well as creating the most appropriate conditions for them to easily perform their duties relating to the payment of taxes and levies. To achieve this goal, tax inspectorates must provide services to taxpayers in accordance with uniform standards and strictly comply with the established timelines.

Thus, by Order of the RF Federal Tax Service (FTS) No. SAE-3-25/422, of 2 September 2005, the Single Standard for providing taxpayer services was approved. It should be noted that this document has introduced no new norms – it only contains a reference table, listing all the procedures that tax agencies are obliged to implement with regard to taxpayers: the definition of the service to be provided, the exact timelines for its provision, the documents to be composed in this connection, as well as references to those legislative acts and other normative acts by which these forms and timelines have been introduced.

Resulting was the greater ease for a taxpayer to search for necessary information in tax legislation: in respect to each action, the Single Standard specified the grounds for a given procedure to be performed, its timelines, and the resulting document to be issued to the taxpayer.

The Single Standard is subdivided into six sections, which are as follows:

- registration of taxpayers and the keeping of taxpayer records;
- services associated with the submission of tax declarations and other documents, as well as access to the information concerning the activities and incomes of citizens;
- the provision of information concerning settlements with budgets;
- services pertaining to the registration of controlling and cashier equipment (CCE);
- services pertaining to the issuing of permits, licensing, expert's estimations and registration of gaming businesses;
- information services in respect to all areas of taxpayer activity. Each of these sections contains a list of specific services (or procedures) to be performed by tax agencies in respect to taxpayers.

Another document, aimed at improving the efficiency level of organizing the interaction with taxpayers, is the updated Regulation for the organization of work with taxpayers, payers of levies and contributions to mandatory pension insurance, and tax agents, approved by Order of the RF FTS No. SAE-3-01/444, of 9 September 2005.

The Regulation for the organization of work with taxpayers encompasses five areas of activity:

- the organization of personal meetings with taxpayers;
- the organization of acceptance, registration and issue of documents by departments responsible for the interaction with taxpayers;
- the procedure for verifying taxpayers' computations of taxes, levies and contributions to mandatory pension insurance, as well as the specific features of applying this procedure;
- the organization of information services;
- the specific features of organizing the interaction with taxpayers for officials employed at territorially isolated sites by the interregional tax inspectorates subordinated to the RF FTS.

The new Regulation does not differ in any fundamental way from its older version adopted in 2004; however, a number of noteworthy changes should be mentioned.

1. *The procedure for submitting reports.* Tax declaration forms are changed frequently, and it often happens so that, by the moment a tax declaration is due to be submitted, the RF Ministry of Finance will have introduced new changes. Previously, a tax inspector could refuse to accept a tax declaration if its form was different from the established one. As a result, such a declaration was returned to the taxpayer without having been registered, which was fraught with a fine to be imposed for a failure to submit it in time, because the taxpayers had no proof of the declaration having been actually submitted. This situation is in direct conflict with the RF Tax Code: by Item 2 of Article 80 of the RF TC it is forbidden to refuse the acceptance of tax declarations on any grounds, and all reporting documents must be accepted, with the date of submission to be marked on it.

In the new Regulation, this conflict has been eliminated: a tax inspector no more has the right to decide whether such reports may be accepted or not; in any event, they have to be rejected. At the same time, the rule was introduced, in accordance with which a tax agency is obliged to register any postal correspondence it receives. And if the form of a declaration differs from the established one, a notification must be sent to the taxpayer concerning the necessity for the declaration to be submitted in the established form.

2. *Verification of computations.* The new Regulation had increased from three to five days the period during which a tax agency is obliged to correct, in a taxpayer's individual account, the error that has arisen at the former's fault.

3. *The informing of taxpayers concerning the status of their settlements with the budget.* The Regulation has been made compatible with the new powers granted to tax agencies, which are to control not only the payment of taxes and levies, but also the contributions to mandatory pension insurance. The period for preparing the certificates concerning the status of settlements with the budget has been somewhat changed. If the request for such a certificate is submitted by a taxpayer in person, the period remains as before – 10 days from the day of the request being received; if the request was sent through a postal service, the period is extended to 12 days. Also changed have been the periods for the consideration of written applications by taxpayers – physical persons and other payers, if they submit their reports through telecommunications channels. Under the previous Regulation, the period of preparing a reply to the request by a physical person without any additional verification, or to the requests of payers who send their reporting documents through telecommunications channels, was 15 days. In accordance with the new Regulation, the period for replying to all categories of persons is 30 days from the day of the request being received.

The Procedure for Excluding Organizations from the Single State Register of Juridical Persons (SSRJP)

By Federal Law No. 83-FZ, of 2 July 2005, "On the introduction of alterations in the Federal Law "On State registration of juridical persons and individual entrepreneurs" and to Article 49 of the Civil Code of the Russian Federation", the procedure has been established for a juridical person, which has in effect terminated its activity, to be excluded from the Single State Register of Juridical Persons (SSRJP) by decision of the registering agency. The registering agency has the right to exclude a juridical person from the Register if, during twelve calendar months, it has not been submitting the reporting documents envisaged by legislation, and has not been conducting operations on at least one of its bank accounts. The mandatory condition for the effectuation of the exclusion procedure is the publication of the decision concerning the forthcoming exclusion, within three days from the making of such a decision, in those press organs where the information concern-

ing the State registration of a juridical person is to be published. Simultaneously with the decision concerning the forthcoming exclusion, the information concerning the procedure and timelines for the submitting of applications by the non-operating juridical persons, creditors or other persons, whose rights and lawful interests are influenced by the exclusion of the non-operating juridical person from the SSRJP, must be published, with the address to which the applications can be sent. The applications are to be sent within a period of no later than three months since the date on which the decision concerning the forthcoming exclusion was published.

The RF FTS, by Order No. SAE-3-09/591, of 16 November 2005, "On the organization of the work of tax agencies relating to the exclusion of a juridical person, that has terminated its activity, from the Single State Register of Juridical Persons", approved the procedure for organizations that have terminated their activity to be excluded from the SSRJP. In accordance with this document, the departments for in-house verification are obliged, on a quarterly basis, to compile the lists of such organizations, which have not been reporting to the tax inspectorate during the specified period. To the banks where the settlement accounts of the organizations to be excluded are kept, requests concerning their operations are to be sent. If no operations have been effectuated, or the tax agency has no information concerning the settlement accounts, the department for in-house verifications must issue a statement entitled "On the presence of the indicia of a non-operating juridical person", on the basis of which the decision concerning the exclusion of the organization from the SSRJP will be made. The statement is sent to the tax agency's structural subdivision at the location of this juridical person, which performs the functions in relation to the State registration of juridical persons. The latter is to prepare a draft decision concerning the forthcoming exclusion and to effectuate the publication of the aforesaid information. In the event of no applications having been submitted by this organization, or its creditors, or other related persons within three months from the decision's publication, the tax agency makes the entry in the Single State Register concerning the exclusion of this organization from the SSRJP.

The tax on profit of organizations

A great number of amendments have been made to Chapter 25 "Tax on profit of organizations" by Federal Law No. 58-FZ, of 6 June 2005, "On the introduction of alterations in Part Two of the Tax Code and some other legislative acts of the Russian Federation on taxes and levies". The Law has altered the composition of incomes and expenditures, further specified some notions, and augmented the previously existing rules for determining the tax base by new provisions. Since it is not possible to discuss all the changes in this overview, we are going to point out some of the most significant ones.

The Law introduces a number of changes to be applied to the legal relations that have arisen from 1 January 2002.

From the list of non-realization incomes and expenditures regulated by Article 250, the differences in rates arising when the value of securities denominated in foreign currencies is reevaluated are excluded.

Simultaneously, the procedure for determining the financial result when securities are withdrawn has been changed (Article 280), in particular the rules for determining the amount of expenditures. The purchase price of a security denominated in a foreign currency (including the cost of its purchase) is to be determined by the exchange rate established by the RF Central Bank as of the moment of this security being taken on discount. Previously, the value of property was to be determined by the official exchange rate estab-

lished by the RF Central Bank as of the date of the ownership right being transferred as a result of purchase, and (or) as of the last day of a reporting (or tax) period (the date of re-evaluation).

For those taxpayers that have reevaluated their securities, a simplified procedure for recalculating their tax liabilities is established. Organizations have the right to decrease (or increase) the amount of profit, calculated as the difference between the realization (or withdrawal) price and the purchase price of a security, with taking into account the expenditures associated with its purchase or realization, by the amount of positive (or negative) balance resulting from such a reevaluation in the part corresponding to the securities that have been realized. When securities are realized at a loss, the amount of which is determined as the difference between the realization price and the purchase price, with taking into account the expenditures associated with its purchase or realization, an organization has the right to decrease (or increase) the amount of the tax base of the profits tax by the amount of positive (or negative) balance resulting from such a reevaluation in the part corresponding to the securities that have been realized.

Also, the definition of “national legislation” is presented, to be applied in accordance with Item 3 of Article 280 of the RF TC when determining the criteria for recognizing a security being circulated on the organized market. National legislation is understood as legislation of the state on the territory of which the circulation of the securities is taking place (the effectuation of civil-legal transactions entailing the transfer of the ownership right to securities, including outside of the organized securities market).

The Law contains a large number of norms regulating the legal relations that have arisen from 1 January 2005.

Out of the list of non-realization incomes received from shared partnership in other organizations, the income allocated to the payment for additional shares to be placed among the organization’s shareholders (or participants) (Item 1 of Article 250).

Articles 251 and 252 of the RF TC are augmented by new provisions regulating the actions of taxpayers when property is being transferred. In the event of reorganization of a juridical person, the value of property, of property and non-property rights with money value, and (or) of the obligations received (or transferred) in the legal succession procedure during reorganization of juridical persons, which have been purchased (or created) by the companies being reorganized prior to the date on which the reorganization has been completed, are not to be taken into account when determining the tax base (Item 3 of Article 251). It has been established that for purposes of applying the Chapter “Profits Tax”, the expenditures of newly created or reorganized companies are to be recognized as the value (or residual value) of property, of property and non-property rights with money value, and (or) of the obligations received (or transferred) in the legal succession procedure during reorganization of juridical persons, which have been purchased (or created) by the companies being reorganized prior to the date on which the reorganization has been completed. The value of property and of property rights with money value is to be determined on the basis of the tax accounting data and documents of the transferring party as of the date on which the ownership right to the aforesaid property and property rights are being transferred.

From January 2005, targeted funding means are to include property, in particular in the form of monies received in order to create the Russian Fund for Technological Development, as well as other sectoral and intersectoral funds designed to finance research and development and registered in the procedure envisaged by Federal Law No. 127-FZ, of 23 August 1996, “On science and on government policy in the sphere of science and technol-

ogy" (Subitem 14 of Item 1 of Article 251 of the RF TC). Previously, a similar norm was applied only to not-for-profit organizations.

Article 259 has been augmented by the provision concerning the right of an organization, which is receiving previously used fixed assets as a contribution to its charter (or joint stock) capital, or in the legal succession procedure during reorganization of juridical persons, to determine the period of the aforesaid fixed assets' useful life as the period equal to their useful life as determined by their previous owner, diminished by the number of years (or months) during which the previous owner has been exploiting this property.

Organizations now have the right to record, as part of their other expenditures, the cost of services provided by the extradepartmental security agencies under the law-enforcement agencies of the Russian Federation, as established by legislation of the Russian Federation (Subitem 6 of Item 1 of Article 264 of the RF TC). In order to avoid different interpretations, Subitem 48 of Item 1 of Article 264 RF TC has been amended to the effect that the expenditures relating to the upkeep of the premises of public catering enterprises are to be recorded as part of other expenditures only in the event they have not been recorded as part of the expenditures associated with the use of servicing facilities.

Article 265 of the RF TC has been augmented by some new provisions. Non-realization expenditures are now to include the expenditures in the form of interest paid as a result of the arrears of tax and levies having been restructured, in accordance with the procedure established by the RF Government. Taxpayers will also be able to record, as their justified expenditures, the costs of their activity which is not directly related to production and (or) realization, the expenditures in the form of a bonus (or discount), paid (or granted) by the seller to the buyer as a result of certain terms of a contract having been fulfilled, in particular those relating to the volume of purchase, as well as expenditures in the form of targeted deductions from lotteries in the amount and in the procedure envisaged in legislation of the Russian Federation.

Beginning from the year 2005, any indebtedness to a taxpayer that has arisen due to sales of commodities, or performance of work, or rendering of services, will be recognized as dubious debt in the event when this indebtedness has not been redeemed within the timelines established by a contract, and is not secured by a pledge, surety, or bank guarantee (Item 1 of Article 266). Previously, as dubious debt any type of indebtedness was recognized, which was not secured by a pledge, surety, or bank guarantee.

A different subdivision of expenditures into direct and indirect ones has been envisaged in the new version of Article 318 of the RF TC. The Article is augmented by a norm that allows taxpayers to determine on their own in their accounting policy for purposes of taxation the list of direct expenditures associated with production of commodities (or performance of work, or rendering of services). The list of costs that were previously placed in the category of direct expenditures is now recognized only as a recommendatory list. Additionally, as part of costs that can be classified as direct expenditures, there have been specified the costs of mandatory pension insurance contributions (the financing of both the insured and the funded components of labor pension), charged on salaries.

Taxpayers engaged in production activity may on their own determine the procedure for distributing their direct expenditures on work in progress (WIP) and the product completed in a current month (or work performed, or services rendered), with due regard to the actual costs corresponding to the actual product (or work performed, or services rendered), having consolidated this principle in their accounting policy for purposes of taxation.

The rules for recognizing non-realization expenditures as such have also been made clearer. It has been specified that non-realization expenditures are to be included in the

expenditures of a current tax period in the same procedure as established for indirect expenditures (Item 2 of Article 318 of the RF TC). It is determined that taxpayers rendering services have the right to diminish, by the full amount of their direct expenditures executed within a reporting (or tax) period, their income from production and realization within a given reporting (or tax) period, without distributing it to their residual work in progress (Item 2 of Article 318 of the RF TC).

Besides, the Law under consideration contains a number of norms, to come into force from January 2006.

A taxpayer's incomes will be determined not only on the basis of source documents and tax accounting documents (Item 1 of Article 248 RF TC), but also other documents confirming the taxpayer's received earnings.

In Article 252 of the RF TC, documented expenditures are understood as costs confirmed by documents formalized in accordance with legislation of the Russian Federation. As stipulated by the introduced changes, documented expenditures are now to be understood also as costs confirmed by documents formalized in accordance with the traditions of business turnover applied in the foreign country on whose territory the aforesaid expenditures have been executed, and (or) documents that confirm the executed expenditures indirectly, including by a customs declaration, an order concerning a business trip, or a report on the work performed under a contract.

From the year 2006, the norms regulating the procedure for recording the relations between lessors and lessees, as well as the actual costs of a leaseholder that have made certain improvements to the leased property, are also to come into force.

It has been established that, when determining the tax base, expenditures in the form of capital investments implemented as unalienable improvements of the leased property made by a leaseholder are not to be taken into account (Subitem 32 of Item 1 of Article 251). With due regard to Article 623 of the RF TC, unalienable improvements can be made with a lessor's consent, as well as without such a consent. The new provision in the Code is of importance, primarily, to a lessor of property who has not given consent to improvements to be made, because finally it is to the lessor that the property will be transferred after the termination of the lease contract, without the obligation to redeem the expenditures.

In the new version of the RF TC, one more object for depreciation has been envisaged: capital investments in leased fixed objects, implemented in the form of inalienable improvements.

Article 256 has been augmented by a provision according to which capital investments in leased fixed objects, implemented in the form of inalienable improvements made by the lessee with the lessor's consent, are also to be recognized as depreciable property.

Capital investments, whose value is redeemed by the lessor to the lessee, are to be depreciated by the lessor in the procedure established by Chapter 25 of the RF TC; capital investments made by the lessee with the lessor's consent, whose value is not redeemed by the lessor, are to be depreciated by the lessee during the period of the lease agreement, based on the amounts of depreciation calculated on the basis of their useful life, which for leased fixed assets is to be determined in accordance with the Classification of Fixed Assets approved by the RF Government (Article 258).

At the same time, by Article 259 of the RF TC, the highest acceptable amount of expenditures to be made in the form of depreciation deductions is established. A taxpayer has the right to include in the amount of expenditures, made within a reporting (or tax) period, the costs of capital investments equal to no more than 10% of the fixed assets' initial value (with the exception of fixed assets received on a gratis basis), and (or) the costs of

construction being completed, or additional equipment, or modernization, or technical renovation, or partial liquidation of fixed assets, the amount of which is to be determined in accordance with Article 257 of the existing Tax Code.

The depreciation deductions on property in the form of capital investments in leased fixed assets, which are depreciable in accordance with the aforesaid Chapter, are to be started by the lessor from the 1st day of the month following the month during which this property was placed into operation, but not before the month during which the lessor effected the redemption to the lessee of the cost of the aforementioned capital investments, and by the lessee – from the 1st day of the month following the month during which the property was placed into operation.

In Article 254 of the RF TC, a new type of costs is specified – the value of production stock, instead of the value of material assets: the value of production stock in the form of production surplus revealed during an inventory, and (or) of property received as a result of dismantling or disassembly of fixed assets being put out of operation, is to be determined as the amount of tax imposed on the income envisaged in Items 13 and 20 of Part 2 of Article 250 of the Tax Code.

The list of material expenditures has been supplemented by technological losses during production and (or) transportation. Technological losses are recognized as losses that have occurred during the production or transportation of goods (or work, or services) as a result of the specific technological features of the production cycle and the transportation process, as well as those arising from the physical and chemical properties of the raw materials being used.

Some alterations have been introduced in Article 262, which deals with the costs of scientific research and development (R&D). A taxpayer's expenditures on scientific research and (or) development are recognized, for purposes of taxation, after the completion of the aforesaid research or development (or completion of certain stages in the work) and the signing, by the parties involved, of a record of acceptance. From January 2006, the period during which taxpayer's expenditures on R&D can be taken into account for purposes of taxation has been shortened. Previously, this could be done within 3 years from the 1st day of the month following the month during which such work (or certain stages in the work) had been completed. Now, the expenditures can be written off within 2 years.

In addition, it has been established that a taxpayer's expenditures on R&D executed for purposes of creating new technologies or improving the ones already being applied, or creating new types of raw materials or other materials, that have not yielded any positive results, are to be included in other expenditures in the form of an even distribution over the period of three years, in the amount equal to the actual expenditures, in the procedure envisaged in Item 2 of Article 262 of the RF TC. In the Article's previous version, the upper limit of 70% of the actual expenditures was established.

The list of targeted expenditures associated with the social protection of disabled employees, to which organizations – employers of disabled persons may allocate their profit, on condition they comply with the requirements stipulated in Subitem 38 of Item 1 of Article 264 of the RF TC, has been expanded. Besides, new Article 267.1 has been introduced, which determines the procedure for forming and using, by an organization, its reserves against future expenditures, to be executed for purposes of social protection of disabled employees.

For those organizations that attract credits (or loaned funds) for their activity, the alterations introduced in Article 269 of the RF TC are of significance. For purposes of calculating the profits tax, the interest on credits and loans can be accepted as part of produc-

tion costs. In the existing version, the upper limit of the amount of interest to be recognized as costs is recognized as being equal to the rate of refinancing established by the RF Central Bank, multiplied by 1.1 in the event of a rouble-denominated obligation, and equal to 15 % – in the event of an obligation denominated in a foreign currency. Prior to the introduction of these amendments, it was unclear as to which rate of refinancing was to be applied: that established as of the date on which the credit (or loan) was received, or that established as of the date on which the interest was charged. In accordance with the recent amendment, the RF CB's rate of refinancing is to be understood as follows: if a debt obligation does not contain a clause to the effect that the interest rate is to be changed during the whole period of the debt obligation, the rate of refinancing of the RF Central Bank established as of the date when the monies were attracted is applied; and in other cases – the rate of refinancing of the RF Central Bank established as of the date of recognizing the expenditures executed in the form of interest payment.

Besides, it should be noted that in 2007 the upper limit to the amount of loss to be carried forward, established by Article 283 of the RF TC, is to be abolished. The norm, in accordance with which the total amount of the carried-forward loss in any reporting (or tax) period cannot be in excess of 30 % of the tax base calculated in accordance with Article 274 of the RF TC, will become invalid in 2007. In this connection, it has been established that in 2006 the total amount of a carried-forward loss cannot exceed 50 % of the tax base.

Value Added Tax (VAT)

Following the amendments concerning the profits tax, some amendments to Chapter 21 "Value added tax" were also introduced. Here we are going to discuss those of them that are most important.

Presently, the payers of VAT are applying two methods for calculating the tax: either as of the moment of a commodity's delivery, or at the moment of the payment for it being transferred. Recently adopted Federal Law No. 119-FZ, of 22 July 2005, "On making amendments to Chapter 21 of Part Two of the Tax Code of the Russian Federation and recognizing as null and void some provisions in the legislative acts (or provisions of legislative acts) of the Russian Federation on taxes and levies" has established, from 1 January 2006, a single procedure for determining the appropriate moment for calculating the tax base for all taxpayers (Article 167). It is to be determined as the earliest of the following dates:

- 1) the day of delivery (or transfer) of commodities (or work, or services), or of ownership rights;
- 2) the day of payment (or payment in part) toward future deliveries or transfer of ownership rights.

When ownership rights are being transferred, the appropriate moment for calculating the tax base is to be determined in accordance with Article 155 "Specificities of determining the tax base when transferring ownership rights".

The moment for calculating the tax base in the event of construction and assembly work being performed for a taxpayer's own use is determined as the last day in the month at the end of each tax period.

Thus, all taxpayers will have to calculate VAT immediately after the delivery of commodities (or work, or services), or before that date if the payment is executed prior to delivery. As a result, the buyers will be entitled to VAT deduction irrespective of the fact of

payment, because any mention of the tax payment has been eliminated in Item 2 of Article 171 of the RF TC.

Due to the establishment of a new procedure, some transition provisions have been envisaged. All payers of VAT must conduct an inventory of their receivables and payables as of 31 December 2005 inclusive. Based on the inventory's results, the following items are to be determined: receivables against realized commodities (or work, or services), the payment for which has not been received; property rights, the operations pertaining to the realization (or transfer) of which are recognized as objects for taxation; payables against commodities (or work, or services) and property rights, the payment for which has not been transferred, but which have been entered in accounting records prior to 1 January 2006, that incorporate the amounts of VAT presented for payment by the sellers of the aforesaid commodities (or work, or services) and property rights and subject to tax deduction. The subsequent actions will depend upon the specific method chosen for determining the amount of proceeds for purposes of calculating VAT.

Those payers of VAT, that prior to 2006 determined the tax base as of the day of payment, are to include in the tax base the monies received prior to 1 January 2008 against their receivables and payables.

For this purpose, the payment for commodities (or work, or services) is recognized as the termination of a counter obligation of the buyer of the aforesaid commodities (or work, or services) to the taxpayer, directly associated with the delivery (or transfer) or these commodities (or with the performance of work, or the rendering of services), except in the instances of the counter-obligation being terminated by the buyer – promisor by drawing its own promissory note. The payment for commodities (or work, or services), in particular, is recognized as follows: as monies received at the bank accounts of the taxpayer or the taxpayer's commissioner, attorney or agent, or monies paid to the cash office of the taxpayer (or commissioner, attorney or agent); the termination of an obligation by a set-off; the transfer, by the taxpayer, of the right of claim to a third party on the basis of a contract or as established by the law. In the event of the counter obligation of the buyer of commodities (or work, or services) to pay for these commodities (or work, or services), being terminated by the transfer, by the buyer – promisor, of its own promissory note, the payment for the aforesaid commodities (or work, or services) is recognized as the settlement by the buyer – promisor (or some other person) of the aforesaid note, or the transfer, by the taxpayer's endorsement, of the aforesaid note to a third party.

In the event of the buyer's failure to fulfill the counter obligation prior to the expiry of the period of limitation of action in respect to the claims pertaining to the fulfillment of the counter obligation to deliver commodities (or perform work, or render services), the date of payment for the commodities (or work, or services) is recognized as the earliest of the following dates: the day on which the aforesaid period of limitation of action expires, or the day on which the receivables are written off.

If the receivables are not settled before 1 January 2008, their amount is to be included by the taxpayer in the tax base in the first tax period of the year 2008. If the amounts of tax as presented to a taxpayer by the sellers of commodities (or work, or services), or of property rights, which have been entered in the taxpayer's accounting records before 1 January 2006, are not paid by the taxpayer before 1 January 2008, the deduction of the aforesaid amounts is to be made in the first tax period of the year 2008.

The payers of VAT, which until 2006 are to determine the tax base as of the day of delivery, will be deducting the tax that has not been paid at the moment of purchasing the commodities (or work, or services), or property rights, which have been entered in their

accounting records before 1 January 2006, in the first half-year of 2006 in equally spread amounts.

Thus, not only the method of paying VAT, but also the mechanism of tax deduction has been changed.

If fixed assets are immovables (purchased, or constructed by a contracting company, or constructed by the organization on its own, in the course of construction and assembly work for its own use), the process of redemption of the previously deducted tax amounts has become more complicated. By the new wording of Item 6 of Article 171 of the RF TC, the following procedure has been established. The tax amounts presented to the taxpayer during the capital construction of immovable objects (or fixed assets) by contractors, or during the purchase of immovable property (with the exception of aircraft, sea-going vessels and inland ships, or outer space objects), and those calculated by the taxpayer during the construction and assembly work performed for the taxpayer's own use, and accepted for tax deduction in the procedure envisaged in Chapter 21 of the RF TC, are to be restored in the event of the aforesaid immovable objects (or fixed assets) being subsequently used for purposes of executing the operations specified in Item 2 of Article 170, with the exception of those fixed assets which have been fully depreciated, or of the instances when from the moment of their having been put into operation by a given taxpayer no less than 15 years have passed.

In this case, the taxpayer is obliged, after the end of each calendar year, starting from the year during which the property began to be depreciated, in the tax declaration submitted to the tax agencies at the place of the taxpayer's registration, in respect to the last tax period of each of these ten calendar years, to reflect the restored tax amount. The amount of tax to be restored and paid to the budget is calculated as one-tenth of the deducted amount, as a corresponding percentage. This percentage is determined on the basis of the value of tax-exempted commodities delivered (or work performed, or services rendered), or of property rights transferred, all supplied or transferred within one calendar year. The amount of tax to be restored is not included in the value of this property, being instead recorded as part of other expenditures in accordance with Article 264 of the RF TC.

Some changes have also been made to the list of property rights, the transfer of which is subject to VAT. These also include the transfer, by participants in construction partnerships, of their rights to housing buildings or dwelling premises, to shares in such buildings or premises, or garages or parking lots. The tax base in this case is determined as the difference between the transfer value of the rights and the cost of their acquisition. The rights associated with the right to conclude a contract (or option), and the lease rights are also mentioned. The tax base for these rights is determined in the general procedure in accordance with Article 154 of the RF TC, that is, when the amount of VAT is calculated, the price specified in the contract is applied. It should be noted that a person, having acquired one of the property rights, is entitled to a tax deduction, as established by the amendments made to Articles 171 and 172 of the RF TC.

The list of tax-exempted operations (Article 149) has been augmented by some more types of operations, such as: the services associated with the servicing of bank cards; the conducting of lotteries (by decisions of an authorized executive body), including the services relating to the sales of lottery tickets; the conducting of notarial actions by privately practicing notaries; the sale of scrap and ferrous and non-ferrous metal waste; and the transfer of commodities, the cost of one unit of which is no more than 100 roubles, for purposes of advertising.

Chapter 21 of the RF TC was augmented by Article 162.1, which deals with reorganization issues, that is, the ways for determining the tax base and the procedure for VAT de-

duction. Thus, a legal successor has the right to accept a certain amount of VAT for deduction only when the fact of payment has been confirmed either by the organization being reorganized, or by the legal successor itself. It should be noted that the changes in the reorganization procedure have been introduced from 1 January 2005.

By Item 2 of Article 163 of the RF TC, for those taxpayers whose tax period has been established as one quarter, the amount of proceeds of realization of commodities (or work, or services), without tax, has been increased to 2 million roubles.

Chapter 21 has also been augmented by Article 174.1, which regulated the specific features of the calculation and payment to the budget of the tax imposed on operations effectuated under a simple partnership agreement (or an agreement on a joint activity), or a contract on entrusted management of property on the RF's territory. Tax deduction is granted only to a participant in the partnership, or to the administrator, if the invoices drawn up by the sellers to these persons are available.

From January 2007, Article 176 of the RF TC, which determines the procedure for VAT refunding, will be in effect in a new version. The period of refund has not changed, being three months as before, whereas the refunding procedure has been somewhat adjusted.

A refund is to be effectuated no later than within three months, starting from the day of a tax declaration being submitted by the taxpayer. Within this period, a tax agency in two months verifies the justification for the amounts of tax to be refunded. After the completion of the verification, the tax agency within seven days makes the decision to the effect that the refund of the amount being claimed be granted, in the form of a set-off or a repayment, or to be refused (in part or in full).

In the event a tax agency has decided to refuse the refund (in part or in full), it will be obliged to issue to the taxpayer a substantiated statement no later than 10 days after the day on which the aforesaid decision has been made.

If during the established period the tax agency has not made the decision concerning a refusal of refund, and (or) it has not issued the aforesaid statement to the taxpayer, it will be obliged to make the decision to the effect that the amount, in respect to which no decision concerning a refusal of refund has been made, be refunded, and to notify, within 10 days, the taxpayer concerning the decision that has been made.

If a taxpayer has VAT arrears and forfeits, or arrears of other taxes and forfeits, as well as arrears of tax sanctions imposed by a court and due to the same budget from which the refund is due, these are subject to set-off as a priority, by decision of a tax agency.

Tax agency are to effectuate the set-off on their own, and to notify the taxpayer accordingly within 10 days.

If a tax agency has made the decision concerning a refund, in the presence of tax arrears, accumulated in the period between the date of the declaration being submitted and the date on which the amounts claimed are refunded, and not in excess of the amount to be refunded by decision of a tax agency, no forfeit is charged on the amount of arrears.

When a taxpayer has no tax arrears or forfeits, or arrears and forfeits relating to other taxes and levies, or arrears of imposed tax sanctions, which are due to the same budget from which the refund is due, the amounts to be refunded are carried forward toward current payments of this tax and (or) other taxes and levies due to the same budget, as well as the taxes imposed in relation to the transfer of commodities across the Russian Federation's border, and those imposed in relation to the realization of work or services directly associated with the production and (or) realization of such commodities, by agreement with the customs agencies; or, the amounts to be refunded are to be transferred to the taxpayer at the latter's request.

In the event a tax agency has made the decision that certain amounts of tax are to be refunded from a given budget, this decision is to be sent, no later than on the next day, to an appropriate body of the RF Federal Treasury.

These amounts are to be refunded by the RF Federal Treasury within seven days after the receipt of the tax agency's decision. In the event such a decision has not been received by an appropriate body of the RF Federal Treasury within seven days from the day of its being sent by the tax agency, the day on which this decision is received will be recognized as the 8th day from the day of its being sent by the tax agency.

When the timelines established by this Item are not complied with, interest is to be charged on the amount to be refunded to a taxpayer, in accordance with the rate of refinancing of the RF CB.

Excises

Here we are going to discuss the most important changes among those introduced by Federal Law No. 107-FZ of 21 July 2005 to Chapter 22 "Excises" of Part Two of the RF TC, which are to come into force from 1 January 2006.

First of all, there should be noted the increased rates of the excises on most of the excisable commodities. Traditionally, once more the rates applied to ethyl alcohol and alcohol products, beer, wines (with the exception of natural wines, champaign, and prickling wines), tobacco products, and passenger cars with engine power of over 67.5 kW and over 112,5 kW, as well as motorcycles, were raised.

The greatest increase in the excise rates was seen in respect to cigarettes. The hard components of the combined rates went up by approximately 20 %, and the lower margin of disbursing prices – by 5 % (from 20 % to 25 %).

Besides, the rate of excise on distilled gasoline was raised dramatically – from 0 roubles to 2657 roubles per 1 ton. Now the rate of excise on distilled gasoline corresponds to the rate established in respect to gasoline with octane values of up to 80.

The rates of excises on natural wines, including champaign, prickling, aerated, and sparkling wines; beer with normative (or standard) content of ethyl alcohol of up to 0.5 % inclusive; passenger cars (with engine power of under 67.5 kW (or 90 hp); and petroleum products, with the exception of distilled gasoline, have not been changed.

From the year 2006, the regime of an excise warehouse in respect to alcohol products is to be abolished, and the excise warehouses of wholesale organizations are to be excluded from the number of the payers of excises. The producers of alcohol products are to pay full amounts of excises to the budget, no matter to whom these products are to be realized.

At the same time, some transition provisions concerning the payment of excises have been established from the year 2006. Those wholesale organizations that established their excise warehouses prior to 1 January 2006 and have been realizing since 1 January 2006 the alcohol products with the content of ethyl alcohol of over 9%, received before 1 January 2006, and (or) delivered to their address before the aforesaid date, are to be recognized as payers of excises until they have sold out the whole volume of their alcohol products.

Three additional types of registration certificates have been introduced for persons engaged in transactions with excisable commodities. Alongside four types of certificates for petroleum products – their production, retail, wholesale and wholesale-retail trade - from 1 January 2006 tax agencies are authorized to issue certificates for the procession of distilled gasoline. Such certificates will be issued to those organizations and individual en-

trepreneurs which produce petrochemical products and use distilled gasoline as raw material.

Besides, depending on the type of activity, registration certificates are to be issued to organizations engaged in transactions with denatured alcohol. Thus, those organizations that produce denatured ethyl alcohol will receive certificates for the production of denatured ethyl alcohol, and those organizations that use it for producing non-alcohol products - certificates for the production of non-alcohol products.

From 1 January 2006, for those taxpayers that hold only the certificate for wholesale realization of petroleum products, two timelines for the payment of excises have been established: those on petroleum products, with the exception of distilled gasoline, and separately for distilled gasoline. In the first instance, the excise is to be paid within the usual timeline – no later than on the 25th day of the second month following the completed tax period, and in respect to distilled gasoline – one month afterwards, no later than on the 25th day of the third month following the completed tax period. The timeline for the submitting of tax declarations for those taxpayers that hold only the certificate for wholesale realization of petroleum products has remained as before - no later than on the 25th day of the second month following the completed tax period.

Thus, in 2006 the excises on petroleum products, with the exception of distilled gasoline, are to be paid by taxpayers in the same manner as before – simultaneously with the submitting of their tax declaration, and the excise on distilled gasoline – one month later.

Also, the timeline for the payment of the excise by taxpayers holding only the certificate for the procession of distilled gasoline has been established: they are to pay the excises no later than on the 25th day of the third month following the completed tax period. The timeline has also been established for the payment of the excise by organizations holding the certificate for the production of non-alcohol products, when they receive denatured ethyl alcohol (or enter it in their books), - also no later than on the 25th day of the third month following the completed tax period. In other words, in such cases the timeline for the payment of excises lags two months behind that established for the submitting of declaration (or by two tax periods).

Besides, the list of alcohol products that have been taken off the list of excisable commodities has been augmented by perfumery and cosmetic products in aerosol-type metal packaging. From 1 January 2006, the perfumery and cosmetic products (solutions, emulsions, suspensions and other liquid products) with ethyl alcohol content over 9 % are to be exempted from excises, which is to be reflected in the lowered prices of such commodities.

Transport Tax

Besides, we are going to discuss the most important ones among the changes introduced to Chapter 28 “Transport tax” by Federal Laws No. 131-FZ, of 20 October 2005, “On making amendments to Chapter 28 of Part Two of the Tax Code of the Russian Federation”, and No. 62-FZ, of 18 June 2005, “On making amendments to Article 363 of Part Two of the Tax Code of the Russian Federation”, which are to come into force from 1 January 2006.

In accordance with the amendments introduced by Federal Law No. 131-FZ, of 20 October 2005, the reporting periods for taxpayers – organizations are established as the first, second and third quarters; the legislative (or representative) bodies of subjects of the Russian Federation have the right not to establish any reporting periods.

Simultaneously with the introduction of reporting periods, the procedure for calculating the tax amount has also been changed. Beginning from next year, by the results of reporting periods, taxpayers will be obliged to make advance tax payments. The amounts of the advance tax payments are to be calculated by organizations independently, as equal to one-fourth of the appropriate tax base multiplied by the tax rate, and are to be taken into account when settling the results of each tax period.

In the event of the registration (or taking off the register) of a transport vehicle during a reporting period, the amount of an advance payment is to be calculated in the same manner as the tax amount is presently calculated, that is, by applying a special coefficient. In other words, the amount of an advance tax payment will depend on the number of whole months during which a given transport vehicle has been registered as belonging to a given taxpayer.

The advance payments are to be paid similarly to the tax payments, at the location of transport vehicles in the same procedure and within the same timelines as those established by subjects of the Russian Federation. In this connection, the legislative (or representative) bodies of RF subjects, as before, will have the right to exempt certain categories of taxpayers from calculating and paying advance payments against this tax within a given tax period.

For the legislative (or representative) bodies of RF subjects it has been established that the timeline for the payment of the transport tax for taxpayers – organizations cannot be established before 1 February of the year following a completed tax period.

Among the most noticeable amendments, we can mention the establishing of final timelines for taxpayers – organizations for the submitting of their tax declarations and of tax settlements in respect to advance tax payments.

These calculations are to be submitted after the expiry of each reporting period to the tax agency at the location of transport vehicles. The form to be submitted is the same as the tax declaration form established for the transport tax; it will be approved by the RF Ministry of Finance. Thus, from 1 January 2006 the legislative (or representative) bodies of RF subjects will no more have the right to establish the reporting forms for the transport tax.

The ultimate timelines for the reporting to be submitted by organizations are as follows. A tax declaration is to be submitted no later than 1 February of the year following a completed tax period, and the tax settlements in respect to advance payments – during a tax period and no later than on the last day of the month following a completed reporting period.

By Federal Law No. 62-FZ of 18 June 2005, from 1 January 2006 the provision that determines, as the ultimate deadline for tax notifications to be delivered to physical persons, the day of 1 June of a current tax period, is to be excluded from Item 3 of Article 363 of the RF TC.

Thus, from the next tax period onward, tax agencies will have more time at their disposal for calculating the transport tax. When these amendments were introduced, it was taken into consideration that by Article 52 of the RF TC it was determined that a tax notification was to be sent to a taxpayer no later than 30 days before the timeline established for the transfer of a payment. And in accordance with Item 1 of Article 363 of the RF TC, the timeline for the payment of the transport tax is to be established by a RF subject. Thus, from the year 2006 the timeline for tax notifications to be sent to physical persons will be determined by Article 52 of the RF TC, depending on the specific timeline for the payment of the tax established by a given subject of the Russian Federation.

By Letter of the RF FTS of 24 January 2005 No. MM-6-21/44, the issues relating to the payment of the transport tax in the event of transport vehicles being utilized have also been clarified. In the event of utilization (or destruction) of a transport vehicle, that is, its physical elimination as an object, no object for imposing the transport tax is present any more. Therefore, in the event of a transport vehicle having been utilized (or destroyed), as the justification for tax agencies' imposing no transport tax, the document will serve, issued by the organization that has actually performed the aforesaid actions, that determines the fact and date of utilizing (or destroying) a transport vehicle.

Simplified taxation system (STS)

In this sections, the changes introduced to Chapter 26.2 of the RF TC "Simplified taxation system" by Federal Law No. 101-FZ, of 21 July 2005, "On making amendments to Chapters 26.2 and 26.3 of Part Two of the Tax Code of the Russian Federation and some legislative acts of the Russian Federation on taxes and levies, as well as recognizing as null and void some provisions of the legislative acts of the Russian Federation" will be discussed.

From the year 2006, the maximum income from realization that will make it possible to switchover to this tax regime, is to be increased from 11 to 15 million roubles (with the exception of some organization, to the list of which the advocates that have established advocate's offices or other forms of advocacy agencies, budget-funded institutions, subsidiaries and representative offices of foreign companies, are added). The restriction on the direct participation of other organizations (over 25%) is no more extended to not-for-profit organizations and the organizations of consumer cooperatives.

The marginal amount of income received during a reporting (or tax) period is increased to 20 million roubles, in excess of which the right to apply the simplified regime ceases. At the same time, this amount is to be indexed by the deflator coefficient, the value of which is to be established on an annual basis for each following calendar year² (Item 4 of Article 346.13 of the RF TC).

Also, the list of fixed assets and intangibles, the exceeding of the residual value of which in the amount of 100 million roubles will prevent organizations from applying the simplified system, has been made more precise.

Somewhat simpler has also become the procedure for switching over to the simplified taxation system (STS). An organization can make such a decision within 5 days from the moment of its registration at a tax agency. The former payers of the single tax on presumptive income (STPI) have the right to declare their desire to apply STS beginning from the month in which the duty to pay the single tax has ceased in accordance with legislations of RF subjects (Item 2 of Article 346.13 of the RF TC).

Prior to the introduction of these amendments, the choice of the object of taxation was to be made independently by a taxpayer. In this connection, it was established that the object of taxation could not be changed throughout the whole period of the simplified taxation system being applied. Now, it has become permissible to change the object of taxation during three years of the simplified taxation system being applied.

Article 346.14, which deals with objects of taxation, has also been augmented by a new norm. The participants in the agreement on a simple partnership (or an agreement on joint activity, or of trust management of property) now no more have the right to choose the

² The coefficient established for the year 2006 is equal to 1.132, in accordance with Order of the Ministry of Economic Development and Trade of 3 November 2005 No. 284 "On establishing the deflator coefficient, for purposes of applying Article 26.2 of the Tax Code of the Russian Federation "Simplified System of Taxation", for the year 2006".

object of taxation, the object – incomes less expenditures – being now consolidated to them.

For the taxpayers who decrease their incomes by the amount of their expenditures, the list of expenditure items acceptable for deduction has been augmented. The procedure for recording certain operations has been made more precise. A single procedure for writing off fixed assets and intangibles has been established. From 1 January 2006, taxpayers will have the right to write off, in accordance with the same procedure, the expenditures on the creation (or manufacture) of fixed assets and intangibles by their own means. Alongside auditing services, entrepreneurs now have the right to decrease the amount of their incomes by the costs of accounting and legal services.

The following types of expenditures have been added to such costs:

- the costs of commissions, agent's remunerations and remunerations paid under contracts of agency;
- the costs of services relating to guarantee-based maintenance and repair;
- the costs of confirming the conformance of products and other objects, the processes of production, exploitation, storage, transportation, realization and utilization, the performance of work or rendering of services, to the requirements of technical regulations, standard provisions or terms of contracts;
- the costs of mandatory assessment, for purposes of control, of the correctness of tax payments in the event of a dispute concerning the calculation of the tax base;
- the costs of providing the information concerning registered rights;
- the costs of the services provided by specialized organizations that prepare the documents for cadastral and technical registration (or an inventory) of immovable objects (including documents that establish the rights to land plots, and land surveying documents);
- the costs of the services provided by specialized organizations that conduct expert estimations and surveying, or issue resolutions and prepare other documents necessary for obtaining a license (or permit) to a specific type of activity;
- the costs of judicial proceeding and arbitration charges;
- the costs of periodical (or current) payments for the use of the rights to the results of intellectual activity and to means of individualization (in particular, the rights arising from patents to inventions, industrial designs and other types of intellectual property);
- the costs of training and retraining of the personnel employed by a taxpayer on a contractual basis;
- the costs represented by a negative difference in the exchange rate arising as a result of re-estimation of property in the form of valuables denominated in foreign currencies, and claims (or liabilities) denominated in foreign currencies, including those at foreign-currency bank accounts, conducted in connection with the changes in the official exchange rates of foreign currencies in respect to the Russian rouble, introduced by the bank of Russia.

Besides, the rules for switching over from the simplified taxation system to the general regime (or other regimes), and vice versa, as regulated by Article 346.25, were made more specific; some clarification was offered concerning the procedures for recording the settlement of arrears against commodities previously delivered, or work performed, or services rendered (as part of incomes), or purchased commodities, or work, or services (as part of expenditures), in the course of a switchover from STS to the profits tax.

Chapter 26.2 of the RF TC "Simplified taxation system" was augmented by new Article 346.25.1, that established the specific features of the simplified taxation system being applied by individual entrepreneurs on the basis of a patent.

The application of STS on the basis of a patent is permitted to individual entrepreneurs who do not make use, in their activity, of employed workers, including under contracts of civil-legal character, and engaged in one of the types of entrepreneurial activity envisaged in the aforesaid Article, e.g., dress-making and dress-mending, as well as the making and mending of other types of garments (knitwear, etc.); shoe-making and shoe-repairing; hairdresser's and cosmetic services; repairs of household appliances, radio and television equipment, and computers; maintenance and repair of motor cars; renovation of apartments; leasing of apartments and garages; hire and sale of video- and audiocassettes, DVDs and CDs; sports and fitness activities and coaching services; undertaker's services. All in all, the list includes 58 types of activity.

The size of an annual potentially permissible income to be received by an individual entrepreneur, as well as the decision as to the introduction of such a system, is to be established by the laws of RF subjects for each of the types of activity in respect to which the application of the simplified taxation system on the basis of a patent is allowed. In this connection, this annual income can be subject to differentiation depending on local specificities and the location of the entrepreneurial activity conducted by individual entrepreneurs on the territory of each RF subjects.

A patent is issued, based on a taxpayer's choice, for one of the following periods, beginning from the first day of a quarter: one quarter, one half-year, nine months, or one year. The application for the issuance of a patent is to be submitted to the tax agency at the location of an individual entrepreneur's registration no later than one month prior to the application, by the individual entrepreneur, of the simplified taxation system on the basis of a patent.

Those individual entrepreneurs who have switched over to the simplified taxation system on the basis of a patent must make the payment of one-third of the patent's value no later than within 25 days after they have started their entrepreneurial activity on the basis of the patent. The payment of the remaining part of the patent's value is to take place no later than within 25 days after the end of the period for which the patent has been obtained.

Besides, by the RF Ministry of Finance's Letter of 25 March 2005, No. 03-03-02-04/1/88, some clarification was offered in respect to issues relating to the recording, for purposes of taxation, by the organizations applying the simplified system, of the cost of acquisition of new fixed assets. In accordance with Subitem 1 of Item 1 of Article 346.16 of the RF TC, when determining the object of taxation, the taxpayers applying the simplified system of taxation are to decrease their incomes received by the cost of acquisition of fixed assets.

In other words, the costs are accepted for deduction after an object's entry into records. Capital investments do not belong to the category of fixed assets.

The cost of leased fixed assets is not included in expenditures. In this case, when the tax base for the single tax is determined, the rent payments for the leased fixed assets are taken into account. Therefore those organizations – lessees that apply the simplified taxation system can record the cost of the fixed assets received under lease agreements in respect to the reporting period during which the right of ownership to these fixed assets was transferred.

*The System of Taxation in the Form of a Single Tax on Presumptive Income (STPI)
Established for Certain Types of Activity*

The main changes to the system of taxation in the form of a single tax on presumptive income have been as follows:

1. By Federal Law of 18 June 2005, No. 63-FZ, "On making amendments to Article 346.26 of Part Two of the Tax Code of the Russian Federation", whereby from the year 2006 municipal formations have been granted the right to introduce STPI in respect to public services on a differentiating basis.

When a RF subject introduces the single tax on presumptive income in the sphere of public services, the tax is to be extended simultaneously to all the public services listed in the All-Russian Classifier of Public Services. This procedure makes no allowances to regional specificities and often results in a situation when RF subjects exclude public services from the sphere of STPI application altogether. The changes introduced by Article 346.26 of the RF TC make it possible to establish, at the level of municipal raions, urban districts, and the federal cities – Moscow and St. Petersburg³, in respect to which services listed in the All-Russian Classifier it will be feasible (or not feasible) to introduce STPI.

2. By Federal Law of 18 June 2005, No. 64-FZ, "On making amendments to Article 346.29 of Part Two of the Tax Code of the Russian Federation", municipal formations have been granted the right, when introducing STPI, to determine the procedure for calculating the basic profitability adjustment coefficient K2.

From the year 2006, the representative bodies of municipal raions and urban districts, and the legislative (representative) bodies of the federal cities - Moscow and St. Petersburg - have been granted the right not only to establish the value of coefficient K2, but also that of calculating this value, which will enable them to fully apply this coefficient for purposes of taking into account all the existing factors that influence the base profitability value of different economic subjects. In this connection, the value of adjustment coefficient K2 will depend on the actual duration of entrepreneurial activity in a given tax period, and will be determined as the ratio of the number of calendar days on which the entrepreneurial activity has actually taken place during a given month to the total number of calendar days in that month.

3. By Federal Law of 21 July 2005, No. 101-FZ, "On making amendments to Chapters 26.2 and 26.3 of Part Two of the Tax Code of the Russian Federation and some legislative acts of the Russian Federation on taxes and levies, as well as on recognizing as null and void some provisions of the legislative acts of the Russian Federation". The main changes have been those that now make it possible to apply this system of taxation to the activities relating to public catering that are being performed not only by those organizations that have in their possession, in respect to each of their objects, public halls whose area is no more than 150 ml, but also by those that have in their possession no halls for servicing their customers.

The notion of retail trade has been further specified, in accordance with which retail trade for purposes of this regime is to be understood as sales of commodities on the basis of a contract of retail purchase and sale.

³ It is based on their decision that from 1 January 2006 the aforesaid tax regime be applied, in accordance with Federal Law No. 95-FZ of 29 July 2004 "On making amendments to Parts One and Two of the Tax Code of the Russian Federation and recognizing as null and void some legislative acts (or provisions of legislative acts) of the Russian Federation on taxes and levies".

It is established that the single tax is not to be applied to the types of entrepreneurial activity envisaged in the Tax Code in the event when these are carried out within the framework of a simple partnership agreement (or an agreement on joint activity).

Besides, by Letter of the RF FTS of 1 February 2005, No. 22-2-14/092, some issues have also been clarified that relate to the application, to some specific types of activity, of the taxation system in the form of a single tax on presumptive income. The circumstance which, in accordance with the RF TC, represents the grounds for the duty to pay the aforesaid tax, is recognized as the performance, by this taxpayer, of certain types of entrepreneurial activity that are subject to a switchover to the system of taxation in the form of a single tax on presumptive income. Those taxpayers that have temporarily suspended such an activity during a given tax period, will accordingly no more be obliged to pay the single tax for those tax periods (or calendar months of a given tax period) during which they were not performing the aforesaid entrepreneurial activity. At the same time, the tax declarations in respect to the single tax on presumptive income for the periods during which they temporarily were not performing such an activity, must be submitted regardless.

The Explanations, by Authorized Agencies, of Certain Issues of Applying Tax Legislation

Taxpayers, in accordance with Articles 21 and 34.2 of the RF TC, have the right to receive, from the RF Ministry of Finance, the financial agencies of RF subjects, and the tax agencies at the place of their registration, written explanations concerning the issues of applying legislation of the Russian Federation on taxes and levies and the normative legal acts adopted in accordance with this legislation, the procedure for calculating and paying taxes and levies, etc.

Under Article 111 of the RF TC, the execution, by a taxpayer or a tax agent, of written explanations concerning the applying of legislation on taxes and levies, issued by an authorized state agency or its officials within the limits of their competence, is to be recognized as the circumstance that eliminates any guilt of the taxpayer in terms of tax violations of the tax laws. Under such circumstances, the aforesaid person is not responsible for having committed a violation of the tax laws.

In this connection, in addition to the following-up of the novelties introduced to legislative and other normative legal acts, some attention has been paid to the creation of a data base on the written explanations sent to taxpayers in respect to issues of applying tax legislation. Taxation is largely determined by the specific content and rules for formalizing civil-legal transactions; it is also influenced by the norms of specific branch legislation regulating the issues of conducting economic operations in certain branches or spheres of activity. Therefore, written explanations of authorized agencies concerning specific issues of applying tax legislation represent a necessary condition for ensuring a flexible linking of tax legislation to the changing conditions under which economic subjects are carrying out their activities. So, the most important explanations among those issued by authorized agencies on issues of taxation have been incorporated in our overview, alongside other legislative acts.

The Possibility for Banks to Make Changes to the Payment Documents of Taxpayers

By Letter of the RF FTS of 14 January 2005, No. ShS-6-10/8, the procedure for executing, by credit institutions, of the settlement documents of the clients of banks relating to the transfer of taxes, levies and other payments to the budget system of the Russian Federation, formalized prior to 1 January 2005 and kept in the card-index entitled "Settlement documents that have not been settled within the established term". In accordance with Letter

of the RF Central Bank of the Russian Federation of 31 December 2004, No. 08-17/5677, the aforesaid settlement documents are to be executed by credit institutions in accordance with the norms stipulated in the Provision of the Bank of Russia of 3 October 2002, No 2-P "On clearing settlements in the Russian Federation", effective as of the moment of receipt of the settlement documents prepared directly by the payers, and are not to be re-drafted by the credit institutions.

The issue as to the possibility of changes to be made by banks to the payment documents of taxpayers has become very acute for the following reasons. For one thing, the RF TC contains a direct norm (Art. 45) to the effect that a tax is considered to be paid as of the date of a payment document being submitted to a bank, provided that there are sufficient resources available on the taxpayer's account to cover the payment. At the same time, according to the explanation of the RF Constitutional Court (RF CC) No. 138-O of 25 April 2001, this norm is to be applied only to honest taxpayers. Since the issue as to the honesty of any taxpayer in each specific case can be investigated only by a court of justice, the delays in payments occurring through the fault of banks quite often result in untimely tax settlements and the withdrawals, in the indisputable procedure by tax agencies, of taxpayers' resources in the form of arrears and forfeits from their bank accounts. In effect, the RF CC's explanation reestablished the situation of taxpayers being unprotected from the actions of tax agencies as it had existed prior to the 1998 banking crisis.

As for the date of payment to be established by a client, in accordance with banking legislation, the transfer of monies from the correspondent account at a payer's bank to the correspondent account of a recipient's bank is effectuated through a payment document issued by a bank as of the day of the monies actually being written off the correspondent account. The original payment document of a client for the payment of a tax is attached to the bank's payment document. The bank has no right to make any changes in a client's payment document. The real problem is that the system of recording the execution of tax obligation by tax agencies has so far not been adjusted to the control of the movement of payment documents in banks' card indexes. Tax agencies (thereby deviating from the norms of tax legislation) in their accounting systems register the presence of tax arrears of a given taxpayers until the moment when they receive from the treasury a notification that the monies in question have been transferred to the budget revenue account. The lack of appropriately organized recording, by tax agencies, of the movement of payment documents through the "taxpayer – bank" system results in excessively high administrative costs being borne by taxpayers in respect to the payment of taxes, while the risks associated with unjustified actions of tax agencies are too high as well.

The Inclusion of the Payment (in Full or in Part) of the Value of an Apartment of a Physical Persons from the Funds of an Organization in the Tax Base for Calculating the Tax on Incomes of Physical Persons

By Letter of the RF FTS of 24 January 2005, No. 04-1-03/800, it has been explained that the covering (in full or in part) of the value of an apartment of a physical person from the funds of an organization represents an income received in kind, and therefore is to be included in that physical person's tax base for purposes of calculating the tax on incomes of physical persons at the rate of 13 %. In this connection the employer, which has paid the amount equal to the value of the apartment being purchased by the physical person under a contract of purchase and sale, with its formalization as property, is obliged to determine the tax base, and to calculate and deduct the tax on the incomes of physical persons as of the moment of this apartment being transferred to the ownership of the aforesaid person.

In the event of the impossibility of the calculated tax amount to be deducted from the taxpayer, the tax agent is obliged, within one month from the moment of such obligations having arisen, to inform, in writing, the tax agency at the location of its registration as to the impossibility of deducting the tax and the amount of the taxpayer's arrears.

The Imposition of the Tax on Incomes of Physical Persons on the Payment of Per Diem Allowances or Field Allowances

By decision of the RF Supreme Arbitrage Court of 26 January 2005, No. 16141/04, Letter of the RF Ministry of Taxes and Levies of 17 February, 2004 No. 04-2-06/127, "On the taxation of compensatory payments associated with business trips", is recognized as incompatible with the Tax Code of the Russian Federation, and fully null and void.

In accordance with the abolished Letter, the expenditures of organizations on the payment of per diem allowances or field allowances in excess of the limits established by Decrees of the RF Government of 8 February 2002, No. 93, and of 2 October 2002, No. 729, were subject to the tax on incomes of physical persons.

The Court noticed that, according to Article 168 of the Labor Code of the Russian Federation, the procedure for and the amount of per diem allowances to employees are to be established by a collective agreement or by a local normative act adopted by an organization. Therefore taxable income must not include the amounts of per diem allowances which are not in excess of the limits established by such an agreement or act. This provision is effective also in respect to budget-funded organizations.

The Court noted that legislation on taxes and levies established neither the standard amounts of per diem allowances, nor the procedure for the determination of such amounts in respect to incomes of physical persons. The general procedure for establishing such norms and the limits to their amounts are envisaged in labor legislation only.

The Court explained that, as far as the organizations funded from the federal budget are concerned, the aforementioned Decrees of the RF Government impose limitations only to the amount of financing from the federal budget earmarked for such purposes, while not limiting the amount of payments to employees if these are agreed upon with the employer. In this case the expenditures in excess of the established limits are to be compensated by organizations through the saving of resources allocated in the federal budget to their upkeep, as well as from the funds received by organizations from their entrepreneurial or other revenue-generating activities. At the same time, an employer cannot diminish, by this amount, its taxable base in respect to the profits tax, while it can be diminished by the amount of labor costs.

The aforesaid Decrees of the RF Government limit only the amount of expenditures on business trips to be covered from the federal budget, while imposing no limits in the event they are covered from other sources, and if they are not resulting in an unequal position of the organizations funded from the federal budget, as compared to other organization, in terms of applying Article 168 of the Labor Code of the Russian Federation.

Some Issues Relating to the Application of Chapter 24 of the RF TC "Single Social Tax"

By Letter of the RF FTS of 11 February 2005, No. GV-6-05/118, with due regard to the Letter of the RF Ministry of Finance of 1 February 2005, No. 03-05-02-03/6, some issues relating to the application of Chapter 24 of the RF TC in respect to the rate of the single social tax (SST) are explained, including the calculation of the amount of the tax due to the federal budget.

Thus, the mechanism for calculating the tax due to the federal budget (or deducting the tax), as determined by the second paragraph of Item 2 of Article 243 of the Tax Code, has remained unchanged. From the tax amount due to the federal budget, the amount of contributions to mandatory pension insurance, calculated in accordance with the tariffs established by Federal Law of 15 December 2001, No. 167-FZ, "On mandatory pension insurance in the Russian Federation", is to be excluded. From the amount of the tax due to the federal budget, calculated at the maximum rate of 20% (15.8%), the amount of contributions calculated at the maximum tariff rate of 14% (10.3%) can be deducted in full.

As for advance payments of SST, they are to be transferred monthly, throughout the whole current tax period. The ultimate timeline for the advance payments of the contributions to mandatory pension insurance is the 15th day of the month following the month in respect to which the advance payment is to be paid.

The monthly advance payments of SST and insurance contributions are to be calculated and transferred in accordance with the actual tax base, as it emerged from the start of a tax (or accounting) period through the last month, at the established tariff rates, and therefore can be regarded as part of the tax and insurance contributions that are due to be paid throughout the period of a tax (or accounting) period and ensure regular (monthly) transfers of funds.

Consequently, tax agencies must deduct forfeits on the arrears of advance payments of the single social tax and insurance contributions, beginning from the 16th day of the month following the month in respect to which the advance payment is to be paid.

Concerning the Application, from 1 January 2005, of the Treaty Agreement between the Government of the Russian Federation and the Government of the Republic of Belarus on the Principles of Indirect Taxation on Export and Import of Commodities, Performance of Work, or Rendering of Services

By Letter of the RF FTS of 2 March 2005, No. MM-6-03/167, the procedure for applying the Treaty Agreement between the Government of the Russian Federation and the Government of the Republic of Belarus on the principles of indirect taxation on export and import of commodities, performance of work, or rendering of services, that came in force from 1 January 2005, has been explained. In accordance with the Treaty, the amounts of indirect taxes paid on the commodities being imported from the territory of one Party into the territory of the other Party are subject to deduction in the procedure envisaged by the Parties' national legislations, respectively.

Thus, when commodities are imported into Russia's territory, taxpayers have the right to decrease the total VAT amount by the corresponding tax deductions in the event the commodities that have been imported into Russia's territory are entered into records on the basis of primary documents and are used for the execution of operations which are taxable by VAT.

Concerning the Procedure for Imposing the Tax on Incomes of Physical Persons – Non-Residents, and Its Specificities in Respect to Citizens of the Republic of Belarus

By Letter of the RF FTS of 21 September 2005, No. VE-6-26/786, and by Letter of the RF Ministry of Finance of 15 August 2005, No. 03-05-01-03/82, the procedure for imposing the tax on incomes of physical persons – non-residents, and its specificities in respect to citizens of the Republic of Belarus as potential RF residents, with due regard for the Inter-State Treaty, has been explained.

Foreign citizens, who have received, from agencies of internal affairs, permits for permanent residence or residence cards, are to be considered RF tax residents as of the beginning of a reporting period, and their earnings resulting from employment are to be taxed at the rate of 13 %.

All other categories of foreign citizens as of the beginning of a tax period are to be regarded as RF non-residents, and their earnings during the first 183 days of staying in the RF territory within the framework of a calendar year are taxed at the rate of 30 %. The tax status of such taxpayers is specified only as of the date following the expiry of 183 days of a foreign citizen having stayed in the RF territory. In such a case, the rate of the tax on incomes of physical persons throughout the whole period of a foreigner's staying in the territory of the Russian Federation is to be equal to 13 %

An exception was made for citizens of the Republic of Belarus as potential RF residents. When a long-term labor contract is concluded with an employer organization, the tax rate is substantially reduced from the very beginning. However, if such a contract is terminated during the first 183 days of a citizen of the Republic of Belarus staying in the RF, the employer organization is obliged to recalculate the tax imposed on the income paid to the aforesaid citizen at the rate of 30 %.

Explanations Concerning the Procedure of Taxation of Plots of Land Acquired as Property on Conditions of Housing Construction to Be Implemented on them (Including Individual Housing Construction)

By Letter of the RF FTS of 27 January 2005, No. MM-6-21/63, official explanations were issued by the RF Ministry of Finance of 14 January 2005, No. 03-06-02-02/01, concerning the application of Federal Law of 20 August 2004, No. 116-FZ, "On making amendments to Article 8 of the Law of the Russian Federation "On the land payment".

By Federal Law of 20 August 2004, No. 116-FZ, the procedure of taxation of plots of land granted (or acquired) for housing construction, including individual housing construction, was defined, and thereby any legal uncertainty has been eliminated in respect to the notion of "lands occupied by the housing fund", noted in the resolution of the Supreme Court of the Russian Federation of 13 February 2003, No. 78-VOZ-pr-3, and in the resolution of the Constitutional Court of the Russian Federation of 5 June 2003, No. 276-O.

In this connection, Federal Law of 20 August 2004, No. 116-FZ, determined different procedures for the taxation of plots of land acquired as property on condition of housing construction to be implemented on them (including individual housing construction) prior to 1 January 2005, and those acquired from 1 January 2005.

Thus, in respect to the plots of land acquired as property from 1 January 2005 by physical persons and juridical persons on condition of housing construction to be implemented on them, with the exception of individual housing construction, for three years the taxation is imposed at a doubled full rate of the land tax established in towns and urban-type settlements. In subsequent years, until the moment of the State registration of the constructed immovable object, the land tax is imposed at a fourfold rate. After the State registration of the rights to the constructed immovable object, the land tax is to be paid as for the lands occupied by the housing fund.

In respect to the plots of land acquired as property from 1 January 2005 by physical persons for individual housing construction, for ten years they are to be taxed at full rates of the land tax established in towns and urban-type settlements. In subsequent years, until the moment of State registration of the constructed immovable object, the land tax is im-

posed at a double rate. After the State registration of the rights to the constructed immovable object, the land tax is to be paid as for the lands occupied by the housing fund.

In respect to the plots of land acquired as property prior to 1 January 2005 by physical persons and juridical persons on condition of housing construction to be implemented on them, including individual housing construction, the taxation is imposed at the full rate of the land tax established in towns and urban-type settlements, until the moment of the State registration of the rights to the constructed immovable object. After the State registration of the rights to the constructed immovable object, the land tax is to be paid as for lands occupied by the housing fund.

The Determination of the Estimated Value of Extracted Mineral Resources for Purposes of Calculating the Mineral Resources Extraction Tax

By Letter of the RF FTS of 2 February 2005, No. 21-2-05/8, the issues relating to the determination of the estimated value of extracted mineral resources for purposes of calculating the mineral resources extraction tax are explained. Certain limitations are imposed on the composition of expenditures to be included in the estimated value of extracted mineral resources, and the costs which are not directly associated with the extraction of mineral resources and not to be taken into accounts when their value is estimated. Indirect expenditures associated with the extraction of mineral resources are included in the estimated value in proportion to the direct costs of the extraction of mineral resources within the total amount of direct expenditures. The costs of preparatory mining work associated with the extraction of mineral resources, with stripping work in quarries, and with the dewatering of deposits (material costs), as well as the costs of maintenance and repair of electric equipment, cables and power lines placed directly in the quarries (costs of repairs of fixed assets), represent indirect expenditures relating to the extraction of mineral resources and are to be fully included in their estimated value.

Some Issues Relating to the Recording, by Taxpayers, of the Monies Received from the RF Social Insurance Fund for Purposes of Mandatory Social Insurance

By Letter of the RF FTS of 15 June 2005, No. GI-6-22/488, Letter of the RF Ministry of Finance of 1 June 2005, No. 03-03-02-02/80, "On the recording, by taxpayers, of the monies received from the Social Insurance Fund of the Russian Federation for purposes of mandatory social insurance", was distributed for information and guidance in work.

In the letter, the types of benefits are listed that are to be paid by employers to their employees at the expense of the resources of the RF Social Insurance Fund (SIF); it is explained that the amounts of benefits paid to the employees are to be subsequently refunded to the employers by the Fund on the basis of a pay sheet, to be submitted by them to the Fund, which was approved by Decree of the RF SIF of 22 December 2004, No. 111.

Thus, the monies received by employers – taxpayers from the RF SIF, in the procedure of compensation of the monies paid to the employers for purposes of mandatory social insurance, are not regarded as incomes for purposes of Chapter 25 "Tax on profit of organizations", Chapter 26.1 "System of taxation of agricultural businesses (single agricultural tax)" and Chapter 26.2 "Simplified taxation system" of the RF Tax Code, and when determining the tax base for the tax on profit of organizations, the single agricultural tax, and the single tax imposed within the framework of the simplified taxation system, and are not to be taken into account.

Such payments include the following:

- benefits for temporary disability, maternity benefits and benefits in the event of death;

- benefits for temporary disability resulting from illness or trauma (with the exception of industrial accidents and occupational diseases), to be paid from the third day of temporary disability (the maximum amount to be paid for one full calendar month should not exceed 12,480 roubles);
- mandatory social insurance benefits to citizens employed by organizations and individual entrepreneurs applying special tax regimes (no more than 1 minimum salary for one full calendar month);
- benefits paid from the SIF in accordance with the Federal Laws (the list of such benefits is included in Article 8 of the Federal Law of 16 July 1999, No. 165-FZ, "On the fundamental principles of mandatory social insurance", in particular the benefit in the event of pregnancy and delivery, and the benefit for the caring of a child until it reaches the age of one and a half years).

Annex 2

Changes in the Taxation of Small Businesses in 2005

On 21 July 2005, the State Duma adopted Law No. 101-FZ "On the Introduction of Alterations in Chapters 26.2 and 26.3 of Part 2 of the Tax Code of the Russian Federation, and in Some Legislative Acts of the Russian Federation on Taxes and Charges". In order to assess the changes introduced in legislation on the taxation of small businesses, it will be necessary to begin with the definition of appropriate criterions. Certainly, the major criterion should be the correspondence between the forecasted results of the policy which is to be implemented, and its established goals. However, as far as the clarity of the goals of the tax policy toward small businesses is concerned, there exist a number of problems. The explanatory note to the draft law introduced by the RF Government does not contain any clear definition of the policy's goals. As stated in the explanatory note, the draft law "is aimed at improving the taxation of small businesses, and at eliminating the existing drawbacks in the established procedure for applying" Chapter 26.2, "The Simplified System of Taxation", and Chapter 26.3, "The System of Taxation in the Form of a Single Tax on Imputed Income for Some Types of Activity", of the RF Tax Code. While the elimination of the existing drawbacks in the procedure for applying the Code's chapters is a rather definite task, which implies the correction of certain contradictions and discrepancies, as well as the clarification of those provisions that have been giving rise to disputes between taxpayers and tax authorities, the task of improving the taxation procedures has not been specified in exact terms. Therefore, there have emerged the grounds for formulating some presumably rational goals of the tax policy to be applied to small businesses, from the point of view of tax legislation's efficiency and fairness.

If the costs incurred by enterprises were to be reduced only to those associated with the production technologies and the transactions with other economic subjects, it would have been difficult to find appropriate grounds for introducing special tax treatments for small businesses, or for any other specific features of taxation depending on the scale of production. On the contrary, in the long-term perspective, any interference aimed toward shifting the minimum efficient scale of production may result in an inefficient distribution of resources, because thereby the average production costs will be increased. The amounts of tax liabilities proper are also part of the costs incurred by enterprises, but when the tax laws are rational, and the objects of taxation are clearly defined, such costs are not expected to distort the choice of a scale of activity. If such distortions do emerge, it becomes

necessary to introduce appropriate alterations in corresponding laws (and in case when any such alterations cannot be made for some reasons, the possibility of potential distortions must be investigated prior to choosing tax regulations based on the scale of production).

However, when operating in a real economy, enterprises usually incur some costs that are not limited to the amounts of taxes alone, but have to do with the activity of the State - namely, the compliance costs related to the payment of taxes, as well as to the implementation of state regulation requirements. Usually, those costs are close to quasi-constant ones, and therefore they tend to decrease significantly as an enterprise's scale of activity goes up. Also, the economic (alternative) compliance costs associated with the payment of taxes can be higher for small businesses. This can happen, for example, when the amounts of taxes must be calculated on the basis of certain accounting data which are intrinsically indispensable for big business and are not relevant for small businesses. It is the adjustment of the amount of such costs, which is made in order to achieve greater efficiency and fairness, that can become the aim of establishing special tax treatments for small businesses. Usually, costs become lower when simplified rules for calculating tax liabilities are applied, or when simpler accounting procedures are introduced, or when the duration of an accounting period becomes longer, or due to the implementation of some other measures. Sometimes, instead of directly influencing the amount of such costs, or alongside the measures designed to produce such an influence, an incremental rate of income taxation can be applied. However, if the benefits granted to enterprises result in the tax liability becoming much lower than is necessary for the adjustment of the aforesaid compliance costs associated with the activity of the State, there may emerge a downward shift in the minimum efficient scale of production, which will result, in the long term, in growing production costs and an overall inefficiency of the national economy.

One further aim of using simplified tax treatments, which is common in international practice, is to reduce budget losses in the situation of a widespread tax evasion by small businesses, when there are no resources for ending this practice by any other means. In this connection, it should be noted that such special tax treatments must not create new opportunities for tax evasion.

The existing procedure for the taxation of small businesses does not meet these requirements. The combination of simplified tax treatments with a variety of different rules has made it possible for many enterprises to significantly reduce their tax liabilities, in particular through creating, instead of one firm, two or even more, each of them subject to different tax treatments. The existence of high thresholds for the eligibility to special tax treatments makes it possible for them to be used, in particular, also by those taxpayers whose average compliance costs are relatively low. At the same time, the benefits from the application of simplified tax treatments are much lower for the smallest taxpayers than for those who are relatively larger. We should also like to note another important circumstance – that of the existing regulations being disadvantageous for small-sized businesses whose production activity requires the use of technologies associated with relatively large fixed capital per worker.

Below, we are going to consider the main changes introduced in the procedure of taxation of small businesses, and the expected consequences thereof.

1. The recent alterations include a number of editorial correction, which have clarified the essence of the law and eliminated its potential misinterpretations. These alterations were necessitated by the practice of the law's application.

2. The new version makes it possible to directly switch over from one special tax treatment to another. In the past, it was possible only to switch over from a simplified tax

treatment to the general one, and vice versa. The only exception was the instance of a forced switchover to compulsory presumptive taxation. The above alteration has apparently been dictated by the existence of a multitude of special tax treatments, and a high degree of variability of the potential scenarios of taxpayers' economic activity, with the situation frequently arising when the use of a certain tax treatment is no longer possible, while the option of selecting some other special tax treatment is still available. On the one hand, it is true that if, as a result of certain alterations in a taxpayer's activity, this taxpayer becomes no longer eligible for the use of the single agricultural tax, but still qualifies for the switchover to the simplified system, the prohibition of a direct switchover to the simplified system places him in disadvantageous conditions by comparison with other taxpayers, who at the moment have similar characteristics. On the other hand, the simplification of the choice to be made between various tax treatments also simplifies the procedures of tax planning. However, in any case, both in the former and in the new versions of the law, the switchover to another taxation procedure is associated with certain costs, which are relatively lower in the new version of the simplified system of taxation, as we will see it below.

Apart from the possibility to switch over to a new tax treatment, the new version of the law also makes it easier to change the object of taxation: while previously it was impossible to change the object of taxation when applying the simplified system of taxation (Article 346.14), in the new version this is allowed after three years of the simplified tax treatment having been applied. However, in the text of the article it is not indicated whether it will still be possible to repeat such a switchover after three more years, without temporarily abandoning the simplified tax treatment.

A considerable proportion of other alterations have been introduced because of the necessity for many of the provisions contained in the above chapters of the Tax Code to be brought into compliance with these alterations.

3. Some changes have been introduced in the procedure for determining the amount of a taxpayer's income, which will entitle the latter to switch over to a simplified tax treatment; the amount of this marginal income was also changed. In the new version of the law, this income is to include not only the incomes from realization, but also all the other types of income determined in accordance with Article 248 of the Tax Code. Thus, it has become possible not to extend the simplified tax treatment to those taxpayers who have substantial non-realization incomes. It should be noted that some of non-realization incomes are associated with relatively low costs. Therefore, when the simplified tax treatment is used, in the event of the income being taxed at the rate of 6%, this tax rate is applied, in fact, to the net income. The threshold values of incomes, which entitle a taxpayer to the right to use the simplified system, have been made higher in the new version of the law. In order to switch over to the simplified tax treatment, it is necessary for the amount of income, received in 9 months of the year during which the application for the switchover to the simplified tax treatment has been submitted, to be no more than 15 million roubles (the threshold index formerly applied, which included only incomes from realization, was equal to 11 million roubles). For the simplified tax treatment to be continued, the amount of income must not exceed 20 million roubles (the former threshold was 15 million roubles, but only in respect to incomes from realization). Thus changed, the threshold income values are still rather high, which makes it possible for those taxpayers, whose alternative tax compliance costs are not critically significant for their business activity, to use the simplified tax treatment. At the same time, bearing in mind the fact that the list of income types to be taken into account when calculating these values has been expanded, and also bearing in mind the effects of inflation accumulated since the enactment of Chapter 26.2, the new limitations regarding incomes have become relatively more rigid, as compared to the time when

this tax treatment was launched in 2002. One really important change is represented by the introduction of a deflator coefficient (to be established by the Government) for the indexation of these threshold values. Such a solution to the problem, apparently, represents just a half-measure, because in a situation when the rate of inflation is high it is advisable to provide for the changes of all those threshold values (or at least most of them) which are being applied, directly or indirectly, while determining the amount of tax liabilities. This can be achieved either by means of indexation, or by expressing such values in special taxation units, instead of roubles. The task of determining the value of the deflator or of the taxation unit can be entrusted, by the State Duma, to the Government; however, it can also be the subject of a special law.

When the imputed tax treatment and the simplified system are used simultaneously, the limitations applied to the indicators of the number of workers and the value of assets are to be extended to all types of activity, similarly to the requirements established by the previous version of the chapter. But the corresponding rule, previously used when calculating the income for the purpose of determining the right to use the simplified tax treatment, has been excluded from the new version (Item 4 of Article 346.12). It should be noted that the procedure of determining the residual value of depreciable property is associated with much higher costs than the determination of gross income, and therefore the reduction in costs achieved in the instances when the criteria are met is relatively small. At the same time, it has now become possible for organizations engaged in those types of activity that are liable to presumptive taxation to apply the simplified tax treatment in respect to their second type of activity when the turnover thereof is rather significant. Moreover, in the new version of Article 346.18 it is envisaged that, when the presumptive and the simplified tax treatments are used simultaneously, "in the event when it is impossible, while calculating a tax base, to distribute the expenses between the taxes calculated in accordance with different tax treatments, these expenses shall be distributed in proportion to the shares of respective incomes in the overall volume of incomes acquired during the period when the above-noted special tax treatments were applied". Bearing in mind that the combination of several tax treatments creates opportunities for tax evasion, which in this case would be difficult to detect, the advisability of this change seems dubious. The explanatory note of the RF Government, while mentioning the advisability of this measure, does not offer any arguments in its favor.

4. By the Government's suggestion, the list of persons who do not have the right to use the simplified tax treatment includes lawyers who have established lawyer's offices and other forms of lawyer's agencies. This change can be recognized as rational, because the alternative costs of tax accounting, incurred by such persons, are relatively small due to the high qualification level of their personnel and to the uniformity of the operations subject to accounting, while the costs associated with the generation of income are mostly represented by salaries, which makes it possible to reduce, by several times as compared to the general tax treatment, the aggregate tax liabilities of a taxpayer, by means of using the simplified tax treatment, with "incomes" as the object of taxation and the rate set at 6%.

5. The limitation concerning the participation of other organizations in the capital of a taxpayer has also been altered. In the new version, it is not to be extended to not-for-profit organizations. This alteration was not suggested by the Government, having been introduced in the draft law during its consideration in the State Duma. We assume that, as far as not-for-profit organizations are concerned, it would be more advisable to introduce a special taxation procedure corresponding to the specificity of their activity, rather than to extend to them simplified tax treatments, irrespective of the share of participation of other

organizations. In such organizations, the requirements to the quality of accounting must be at least as rigid as those established for commercial organizations, and therefore any additional control on the part of tax authorities would not be superfluous. At the same time, rigid requirements to accounting reduce the alternative compliance costs of tax accounting. This is also true in respect to budget-funded organizations which, after the new version of the Chapter has been introduced, have become completely deprived of the right to use the simplified tax treatment. The above alteration have been introduced by the government's version of the draft law similarly to the prohibition for foreign organizations, which have their subsidiaries, representations or any other detached subdivisions in the territory of the Russian Federation, to use the simplified system.

6. Changes have also been introduced in the procedure for VAT deduction from the tax base in instances when the object of taxation is "incomes less expenses". On the one hand, it is permitted to deduct the paid VAT from the tax base, if the expenses on which it has been paid are acceptable for deduction within the framework of the simplified system, in accordance with Articles 346.16 and 346.17. On the other hand, the list of deductible expenses has been extended. The first of the aforementioned measures corresponds to the procedure under which the expenses incurred by persons who are not payers of VAT must be accepted for deduction in the amount of the sums actually paid, including indirect taxes. If the expenses are not accepted for deduction, the amounts of indirect taxes are not deductible either. Such an approach has logic of its own, but at the same time, the amount of VAT received by a partner must to be transferred to the budget. Moreover, Article 346.17, especially in its new version, sometimes envisages longer periods for the expenses to be accepted for deduction than those envisaged for the offsetting of VAT by Chapter 21 of the Tax Code. From this point of view, this restriction seems rather tough.

7. Despite the extension of the list of deductible expenses, the procedure for deducting the residual value of the fixed assets acquired prior to the date of switching over to the simplified tax treatment is not equivalent to the procedure for deducting the value of the fixed assets acquired after the transition to the simplified tax treatment. However, because of the preservation of the existing limitations on the tax loss carry-forward, in combination with the rule that the tax base of the future periods can be reduced only by 1/15 of the nominal value of the minimum tax, immediate deduction of the costs of the acquisition of capital assets can be less profitable for many taxpayers than gradual deduction of these expenses over the course of several years.

The following provision has also remained intact: in the event of the realization of assets, whose service life is more than 15 years, after less than 10 years of their having been in service, instead of the expenses being deducted in compliance with the rules of the simplified system, the tax base must be recalculated in accordance with the depreciation norms. Any additional revenues for the budget can be generated in such a situation only by the payment of forfeits in the course of the recalculation procedure.

Nevertheless, it should be noted that, in accordance with the rules of depreciation specified in Chapter 25, the new version of the Article has abolished the procedure for recalculating the residual value of fixed assets during the transition from the simplified tax treatment to the general one.

In general, it can be noted that, despite the cancellation of the procedure for recalculating the tax base during the switchover from the simplified tax treatment to other tax treatments, this procedure remains disadvantageous for those taxpayers whose production technology is associated with a substantial amount of fixed capital per worker, if their investments are financed from their own resources. This is typical of a large number of

production enterprises, and special tax treatments are evidently hostile to them, by contrast with the enterprises in the trade and services sectors.

8. It has been already mentioned that the list of deductible expenses is extended in the new version of Chapter 26.2. Nevertheless, it should be noted that, while previously it was possible to accept expenses for deduction while the products were being paid for - which, despite a number of differences, made the simplified system, with its “incomes less expenses” base, similar to the tax on cash flows, in the new version this possibility exists no more. Now, the tax base is to be decreased by the amount of expenses simultaneously with the realization of goods (for acquired goods), or as the goods are written off into production (for raw materials and other materials). This rule further differentiates this tax from the tax on cash flows, i.e., it can be said that this procedure has become much more similar to the general tax treatment, which follows the cash-based method. Moreover, the major advantage of the simplified system of taxation (based on “incomes less expenses”) over the cash-based method remains the tax rate reduced to 15%, the benefit concerning the single social tax, and the absence of the property tax. As already noted, under conditions of rigid limitations on tax-loss carry-forward and the minimum tax, which does not, in fact, results in any significant reduction in the future tax liabilities, the immediate deduction of expenses on capital assets does not represent an advantage; sometimes it can even increase the amount of tax liabilities.

There is an obvious tendency for the simplified system, with its “incomes less expenses” object of taxation, to be made unprofitable, as compared to other tax treatments, for the majority of enterprises (with a possible exception of those operating in the sphere of wholesale trade).

9. Chapter 26.2 has been augmented by Article 346.25.1, “The Peculiarities of the Usage of the Simplified System of Taxation by Individual Entrepreneurs, Based on a Patent”. This alteration has not been envisaged in the draft law introduced by the Government, and therefore the explanatory note does not offer any arguments in favor of such a step. The following specific features of this article are worth mentioning. The right to use this tax treatment is to be extended to those individual entrepreneurs who do not employ hired workers. As the threshold values of income, which entitle one to the right to apply this tax treatment, are similar to the threshold values applied to any taxpayers claiming the simplified tax treatment, they are sufficiently high for such individual entrepreneurs. The receipts of 20 million roubles per year, or approximately 1.7 million roubles per month, are sufficiently high for an individual entrepreneur, especially considering the fact that the majority of the types of activity included in the list are highly labor-intensive. Thus, it can be said that the limitation concerning the amount of income is, in fact, not restrictive in a situation when this tax treatment is applied (except when the tax treatment is made use of for the purpose of tax evasion). It should also be noted that, although the majority of the types of activity imply the provision of services to the population, some of them are also oriented to the performance of work and the provision of services to enterprises (for example, the cleaning of offices; although some other types of activity can also be interpreted in favor of enterprises). As in this case the expenses incurred by enterprises are deductible, and the tax amounts are apparently expected to be small, tax evasion by means of applying this tax treatment can be rather lucrative. The size of the expected tax amounts cannot be estimated “a priori”; it can become clear only after the adoption of the corresponding laws by those subjects of the Federation who are going to introduce this tax treatment. The tax rate for potential income is set at 6%, while the size of potentially permissible income cannot be higher than the 30-fold base profitability level established for the regime of presumptive taxation, in the event when the type of activity, in respect to which the patent-

based system is introduced, is included in the list specified in Chapter 26.3. However, if the patent value is established at a high level, the system will become useless for the category of smallest taxpayers. The main drawback of such regimes is their regressive nature (or the mean norm of the taxation of incomes that decreases as the size of incomes grows), insensitivity to changes in expenditures, and the opportunities for tax evasion. Such regimes can be justifiable as a temporary measure, in situations when the population is “not literate enough” in terms of taxation, when the administration system applied in respect to ordinary taxes is underdeveloped, when the agencies executing the control over the correctness of tax records suffer from lack of sufficient resources and (or) proper qualification of their staff, and also in other instances when control is difficult for some or other reason (e. g., in respect to seasonal services of non-residents). But even in such cases these regimes can be justified only when applied to smallest taxpayers. It is difficult to believe that any such measures are indeed necessary in Russia – fifteen years after the onset of its actual transition to market relations. However, if the regions are sufficiently interested in keeping their tax revenues at their present levels, they have the possibility to abstain from establishing such procedures in their respective territories.

10. Chapter 26.3 has also been changed in some of its aspects. In particular, the list of activities in respect to which the presumptive tax can be applied has been restructured and expanded. Those types of activity that can be performed on orders of enterprises, in particular the types of promotion-related services that are subject to presumptive taxation, the list of which has been expanded, are causing especial anxiety. In fact, the list of basic profitability indices, as well as their values, has been augmented and, in some of its aspects, changed. In the instances when presumptive taxation is applied, the tax liabilities of the supplier of services are not changed (when the amount of a transaction is increased, while those of the purchaser of services are decreased if the expenditures can be deducted from the tax base. Thus, there arise opportunities for the aggregate tax liabilities of contractors to become lower. The main drawbacks of the system of presumptive taxation are same as those of the patenting system described above, which is also a subtype of presumptive taxation. There exists a clearly observed tendency for a departure from the principle of taxation neutrality and fairness, as well as for an easier detection of the instances of tax evasion achieved by legal means, while the detection of illegal tax evasion is becoming more difficult.

In the chapter’s new version, the number of adjustment coefficients has been reduced, which is a reflection of the actual state of affairs: the coefficient based on the cadastre value of land has never been applied in actual practice, while having been initially envisaged in the law. It is noteworthy that these changes have not resulted in a higher transparency of the procedure for determining the adjustment coefficients.

By way of conclusion, it can be stated that the changes in the taxation procedure for small-sized businesses, as introduced by Law No. 101-FZ “On the Introduction of Alterations in Chapters 26.2 and 26.3 of Part 2 of the Tax Code of the Russian Federation, and in Some Legislative Acts of the Russian Federation on Taxes and Charges”, are not going, on the whole, to further improve the neutrality and justness of the tax system; also, they create additional opportunities for tax evasion. Especially alarming is the fact that, resulting from the introduction of such regimes, the small-sized enterprises that apply in their production technologies associated with large fixed capital per worker will be faced with a rather unfavorable situation.

Annex 3.

Reforming of the System of Accounting in Russia

The trends that emerged in 2004 and made it possible to speak with greater assurance of the prospects for implementing the International Accounting Standards (IAS) in Russia, in the year 2005 could be noted no more. The issue of granting a legal status to IAS has lost its priority status, and the procedure for adopting the draft law "On consolidated financial reporting" has been suspended.

The developments in the sphere of reforming the system of accounting in Russia that took place in 2005 are an evidence of a turnback toward the previously practiced approach of building a system of national standards "based on the IAS" without any definition as to how this system is going to coexist with the IAS proper, or with the other internationally recognized standards (e. g., US GAAP), which are being applied by some Russian enterprises, on their own initiative, in their financial reporting.

Besides, last year the focus of attention moved on to another aspect of the reform of the accounting system in Russia, which thereto had not been so obvious: the actual measures designed to change the system of accounting regulation and financial reporting gave the issue of switching over to the IAS a political coloring.

Reform of Accounting and Financial Reporting in Russia: the Form or the Content?

A Brief History of the Issue

The switchover to the International Accounting Standards was determined as the main direction for reforming the system of accounting by Decree of the Government of the Russian Federation No. 283, of 6 March 1998, "On the approval of *The Program for Reforming the System of Accounting in Accordance with the International Accounting Standards (IAS)*". Simultaneously with the approval of the Program, the *Plan of Measures* for its implementation over the period of two years was approved⁴.

Thus, by the year 2001 it was intended to implement the basic set of measures aimed at making the Russian system of accounting compatible with the IAS, that is: to create the normative base, to implement appropriate measures for providing in with the necessary methodology and cadres, as well as to participate in international cooperation aimed at the development of accounting standards and regulation procedures.

The normative base was considered to be a priority, but the question as to the legal status of the IAS in Russia was not even raised. According to the Program, the key element in reforming the accounting and financial reporting in Russia was to be the development of new accounting provisions (or standards), as well as further refinement of the previously established ones, and their practical implementation.

The reforming of Russian accounting under the 1998 Program failed to yield the desired results. In 2004, *The Concept of the Development of Accounting and Reporting in the Medium Term* was approved⁵. The *Plan of Measures* for its implementation⁶ covers the period until the year 2007 and incorporates the following directions of activity:

- improvement of the quality of information generated through accounting and reporting;
- creation of appropriate infrastructure for applying the IAS;

⁴ See Annex to Decree of the Government of the Russian Federation No. 283, of 6 March 1998, "On the approval of the Program for Reforming the System of Accounting in accordance with the International Accounting Standards (IAS)".

⁵ Approved by Order of the Minister of Finance of the Russian Federation No. 180 of 1 July 2004.

⁶ Approved by Order of the Minister of Finance of the Russian Federation No. 263 of 16 September 2004.

- the introduction of changes to the system for accounting and reporting regulation;
- tougher control over the quality of accounting reports;
- training and retraining of personnel;
- international cooperation.

Thus, it became obvious that the measures undertaken for the 1998 Program's implementation were not efficient enough, because exactly the same tasks, only elaborated in more detail, were outlined in *The Concept of the Development of Accounting and Reporting in the Medium Term*, adopted in 2004.

In the Concept, the necessity and the actual intentions of granting the International Accounting Standards a legal status in Russia have for the first time been recognized at the level of state administrative bodies that regulate the system of accounting.

In 2004 the State Duma, in two readings, discussed the draft law "On consolidated financial reporting"⁷, wherein the procedure for the development and submission of the consolidated financial reporting of groups of enterprises in accordance with the International Accounting Standards was envisaged. Thus, there emerged a trend toward applying the IAS in Russia as an independent system of standards, to coexist with the established national accounting standards.

The enactment of the Federal Law "On consolidated financial reporting" is envisaged in the *Plan of Measures for implementing The Concept of the Development of Accounting and Reporting in the year 2004*⁸. In 2005 the law did not come into force; after the discussion of its draft by the State Duma in the second reading in December 2004, the procedure was suspended. Consequently, the legislative recognition of the International Accounting Standards on the territory of the Russian Federation was also suspended⁹.

The Year 2005 – New Priorities

The past year's experience demonstrated that among all the areas where *The Concept of the Development of Accounting and Reporting in the Medium Term* was to be implemented, the changes in the system of regulating this sphere would become the priority in the nearest future. Throughout the year 2005, the debate concerning the regulation system's structure was eclipsing both the issue of the legal recognition of the IAS and that of the principles to be established for the interaction within the framework of all the existing requirements to the organization of accounting and financial reporting in Russia.

This status quo was maintained not only by representatives of the state agencies that regulate this sphere, but also by some representatives of the professional community. Andrei Burenin, Chairman of the Board of the Foundation "The National Organization For Accounting and Reporting Standards" (NOARS, hereinafter – NSFO), in an interview with the periodical "Nef't' Rossii" (Russia's Oil)¹⁰, described the priorities in the Russian accounting system's reforming as follows: "Which product will then be manufactured by it [the system] – be it the new national standards, or the international standards adjusted to our economic realities, or something else – is a secondary matter ..."

The professional community (in particular, the National Organization for Accounting and Reporting Standards, and the Institute of Professional Accountants of Russia), as well

⁷ Project No. 55792-4.

⁸ See Item 17 of the Plan of Measures adopted by the Ministry of Finance of the Russian Federation for the years 2004 – 2007 for purposes of implementing *The Concept of the Development of Accounting and Reporting in the Russian Federation in the Medium Term*.

⁹ Ibid, Item 19.

¹⁰ Published at <http://www.gaap.ru> on 31 October 2005.

as government agencies (in particular, the Ministry of Finance of the Russian Federation), began to develop draft laws designed to define the accounting regulation system, which were to replace the outdated 1996 Federal Law "On accounting". By late 2005, there emerged two alternative draft laws to address this sphere – "On the regulation of accounting and financial reporting" (developed by the NSFO) and "On official accounting" (developed by the RF Ministry of Finance).

The Draft Law "On the Regulation of Accounting and Financial Reporting"

On 16 May 2005, the National Organization For Accounting and Reporting Standards put forth, for public discussion, the draft Federal Law "On the regulation of accounting and financial reporting"¹¹.

This draft Law is aimed at changing the currently existing regulation system through dividing the regulating functions between an authorized government regulatory body and a non-government body for regulating accounting and financial reporting. In addition to introducing a regulation system to this sphere, the draft Law defines a system of "acts of accounting legislation of the Russian Federation", the requirements to financial reporting, and the responsibility for the violations of legislation in the sphere of accounting.

First of all, we are going to discuss the regulation system, as it is suggested by the draft Law. This system is to incorporate two fully developed levels:

- government level – the Government of the Russian Federation, the Central Bank, as well as the authorized federal body for executing state powers in the sphere of regulation of accounting and financial reporting;
- non-government regulatory body.

The authorized government body is to be appointed by the Government of the Russian Federation on the basis of its functions; however, it cannot combine the function of regulating accounting and financial reporting and functions relating to the taxation sphere¹².

The non-government regulatory body is to be represented by an organization established in the form of a fund in accordance with legislation of the Russian Federation¹³. Within the framework of the non-government regulatory body, on the basis of a contest, the council for accounting standards is to be formed, which is a collegial body endowed with exclusive competence in respect to issues placed within the jurisdiction of this non-government regulatory body. The non-government regulatory body may be divested of its powers by a court of justice on a suit of the Government of the Russian Federation in the event of its failure to comply with the requirements stipulated in the aforesaid Federal Law¹⁴.

It is the non-government regulatory body that develops the procedure for and conducts the public experts' estimation of the normative acts establishing the requirements for keeping accounting records and the submission of financial reports in the Russian Federation, as well as issues official explanations concerning the application of the accounting standards. To the authorized government body, the function of approving the normative acts is delegated.

¹¹ The text of the draft law is posted at: <http://www.nsfo.ru>

¹² Item 7 of Art. 4 of the draft law.

¹³ Item 1 of Art. 5 of the draft law.

¹⁴ Item 11 of Art. 5 of the draft law.

The Government of the Russian Federation settles the unregulated disputes arising between the regulatory bodies of different levels.

Within the framework of the draft Law under consideration, one can also speak of the existence of two “smaller” levels of the accounting system’s regulation. One is represented by the professional community and other related persons, which are not represented in the council for accounting standards but may participate in the public experts’ estimation of draft normative acts, and the other – by enterprises and organization. They latter can depart from some or other requirement stipulated in legislation in respect to accounting in instances when they happen to believe that this requirement prevents them from objectively, completely and reliably reflecting the necessary information in their financial reports¹⁵. However, this may become possible only if the accounting standards contain a special procedure for disclosing the information concerning this instance of departure from legislation in a financial report¹⁶.

We have termed these levels “the smaller ones” because they do not possess appropriate means for influencing the formation of the legislative base in the sphere of accounting and financial reporting, because in this draft Law there is no precise definition of the procedure for conducting a public experts’ estimation of draft normative acts in the sphere of accounting and financial reporting. Thus, it cannot be expected with certainty that, during the approving of the normative acts, some or other opinion of an ordinary user will, indeed, be passed all the way up to the council for accounting standards of the non-government regulatory body, and moreover – to the authorized government regulatory body.

The powers of enterprises and organizations, which are obliged to comply with the requirements stipulated in the normative acts of the Russian Federation in respect to accounting and financial reporting, are also subject to considerable limitations: they cannot reliably reflect some or other fact of their economic activity, unless the regulatory bodies have envisaged, in the accounting standards, the possibility of a specific situation relating to such a fact. Thus, it is the regulatory bodies that have the exclusive powers to determine the procedure for the facts of economic activity to be “reliably reflected” in financial reports.

The latter shortcoming is the result of a too formal approached being practiced by the bodies responsible for the implementation of the accounting system reform in Russia, which has also been designated as one of the main problems in *The Concept of the Development of Accounting and Reporting in the Medium Term* in Russia, adopted in 2004¹⁷. When the form becomes more important than the content, irresolvable contradictions inevitably arise within a system. Resulting from the proposed amendments to be made to the accounting system regulation, the form is going to change, but not the content. When the interpretation of the notions of objectivity, completeness and reliability of the information reflected in financial reports depends only on regulatory bodies – be they government or non-government – the user of the reporting standards will have no access to useful information on which to base adequate economic decisions.

Some attention should also be given to the system of “the acts of accounting legislation of the Russian Federation”, the establishment of which is proposed in the draft Law being analyzed here. According to Item 1 of Art. 2 of the draft Law, “accounting legislation

¹⁵ Item 2 of Art. 11 of the draft law.

¹⁶ Ibid.

¹⁷ See Item 1 of *The Concept*.

of the Russian Federation shall consist of this Federal Law and the provisions on accounting and financial reporting standards adopted in accordance with it”.

Presently, there exist in Russia a number of Accounting Provisions (AP) that regulate both the procedures for reflecting certain facts of economic activity in accounting records and those for disclosing information in financial reporting. At the same time, in the draft Law the introduction of a single Accounting Provision is envisaged, which is to regulate technical issues (those relating to primary documents, etc.)¹⁸ and financial reporting standards “on the basis of best international practices to the degree which will correspond to the interests of the Russian users of the financial reporting standards”¹⁹.

Considering the fact that the IAS are never even mentioned in the draft Law under consideration, it may mean only a return to the previously attempts to build a national accounting and reporting system “based on the IAS”, and thereby to overcome the lack of trust on the part of users and organization – reporting subjects – in the Russian standards. The currently existing Accounting Provisions (AP), in all probability, will be renamed “The Accounting Standards”, while in the single document (named “The AP”) the technical requirements will be stipulated – and all this will be done instead of establishing, for once, the fundamental principles of information recording, without which no regulation system would be capable of coping with the gaps in the existing normative acts and the resulting lack of trust on the part of the users of the financial reporting procedures.

The draft Law “On the regulation of accounting and financial reporting” will, in effect, alter only the procedure for submitting financial reports. In accordance with Article 9 of the draft Law, the annual financial reports of organizations are to be submitted, within three months after the reporting date, to the state statistics agency, to be made available to interested users²⁰. The financial reports of socially important organizations²¹ and not-for-profit organization, which attract public funds, are subject to mandatory publication in the mass media or on the Internet, with due regard to the established requirements as to the number of copies of a given periodical, the region for its distribution, and its target audience²².

Financial reports will no more be submitted to tax agencies, which will ensure a more reliable compliance with the principle of information neutrality than the corresponding restriction imposed on the powers of a government regulatory body.

Thus, the financial reporting of subjects not belonging to the socially important category will now be serving a purely statistical function. This will further limit the chances of enterprises and organizations, which are already making their financial reports available to external users in accordance with the standards recognized in international practice (IAS or US GAAP), to be granted the opportunity to avoid the excessive costs associated with the preparation of reports in accordance with the Russian standards, because otherwise the system of statistical reporting currently existing in this country will be undermined.

¹⁸ see, e. g., the interview of a member of the board of experts of the National Organizations for Accounting Standards, Professor V. Palii, to the periodical “Double Entry” (posted to the website <http://www.gaap.ru> on 29 June 2005).

¹⁹ Item 6 of the draft law “On the regulation of accounting and financial reporting”.

²⁰ Item 2 of the aforesaid Article.

²¹ The drafts law (Item 4 of Art. 3) places in the category of socially important organizations those organizations whose securities are listed for circulation through the organizers of trade on the securities market, as well as open-end joint-stock companies, professional participants of the securities market, insurance organizations and credit institutions, pension funds, and exchanges.

²² Idem, Item 3.

The Draft Law “On Official Accounting”

The text of the draft Law “On official accounting” has been posted to the official website of the RF Ministry of Finance of the Russian Federation on 26 December 2005²³.

This draft Law, similarly to the draft Federal Law “On the regulation of accounting and financial reporting” discussed earlier in our overview, is aimed at altering the existing system of regulation in this sphere by dividing the powers between the government and non-government regulatory bodies. Beside the regulation system for accounting and financial reporting in Russia, the draft Law also addresses the general requirements to accounting and financial reporting. These requirements include technical provisions (concerning the necessary primary documentation, the reporting period, etc.) which, according to the authors of the draft Law “On the regulation of accounting and financial reporting”, are to be incorporated in the Accounting Provision. Also, the second draft Law contains the norms specifying the financial reporting procedures peculiar to the reorganization and liquidation of juridical persons.

As we have done in the previous section, here we are also going to begin with the discussion of the suggested system of regulation. In the draft Law “On official accounting”, it also consists of two levels²⁴:

- government bodies for accounting regulation;
- non-government bodies for accounting regulation.

The Government of the Russian Federation is to appoint the authorized federal body; no limitations are envisaged in this respect.

There is no definition of the single non-government regulatory body; this level is to include self-regulating organizations of accountants, auditors, users of the financial reports, other related self-regulating organizations, as well as not-for-profit organizations whose purpose is to further develop the accounting procedures.

The non-government bodies for accounting regulation are to develop draft national standards and to participate in their experts’ estimations, organized by the authorized federal body. For purposes of conducting experts’ estimations, at the authorized federal body an experts’ council for accounting standards is to be created. This council is to consist of representatives of the government and non-government regulatory bodies, as well as scientists. The sessions of the experts’ council are to be open²⁵.

Thus, as compared to the draft Law developed by the National Organization for Accounting and Reporting Standards, the degree of non-government regulation in the sphere of accounting and reporting procedures is much higher. The opportunities available to the professional community and other related persons for influencing the process of creating the national standards are not limited to the single non-government regulatory body. Even if a self-regulating organization does not have the status of a non-government body for accounting regulation²⁶, its representatives may attend the meetings of the experts’ council and offer their comments concerning the draft standards being discussed.

Article 23 of the draft Law “On official accounting” contains requirements for compulsory consideration of all such comments. These are the requirements concerning the availability of the text of the draft national standards, the organization of their public dis-

²³ http://www1.minfin.ru/buh/pfz_obu.doc

²⁴ Art. 19 of the draft law.

²⁵ Item 5 of Art. 20 of the draft law.

²⁶ The status of a non-government regulating body is granted to an organization after its accreditation at the authorized federal agency, which is understood as the recognition of the aforesaid agency of the applicant’s competence to perform certain functions pertaining to the regulation of accounting (Item 5 of Art. 21 of the draft Law).

cussion and the duration of it, the listing of all the submitted written comments concerning the draft, and the free access to this list for all related persons. The draft standards are to be submitted to the council for accounting standards together with the list of all the written comments submitted by related persons²⁷; besides, it is established that it is the duty of the non-government body which has developed the standards to keep these written comments and to submit them to the authorized federal body at the latter's request²⁸.

At the same time, there is no possibility for enterprises and organizations to depart from the requirements stipulated in the established national accounting standards.

The draft Law "On official accounting" has also a number of both technical and contextual shortcomings.

In Article 12 of the draft Law, the general requirements to the financial reporting of subjects are established. In accordance with Item 1 of the Article, financial reporting must reflect true information concerning the financial status of a subject as of a reporting date, the financial result of its activity, and the cash flow during a reporting period. At the same time, in Item 1 of Art. 13 of the draft Law it is stipulated that a subject's financial reporting must consist of its balance sheet, a statement of its profits and losses, and the appendices thereto. Thus, as a result, the cash flow report must be generated independently by a related user on the basis of the two mandatory reports and appendices. It should be added that no explanatory note is listed as a mandatory component of financial reporting, either.

In the Concept of the draft Federal Law "On accounting" (the new version)²⁹ it is stated: "As part of an accounting report, an explanatory note shall be envisaged, which shall contain significant information concerning the organization, its financial status, the comparability of the data for a reporting year and the years preceding thereto, the methods of estimation and the important items of accounting reporting. The realization of this requirement of the Federal Law [No. 129-FZ of 21 November 1996] (in the part of the data which are different from the information on the organization's accounting policy and the explanation of the important indices of accounting reporting) results in a situation when organizations are obliged to incorporate in their accounting reports information which has no relation to accounting and does not follow from accounting procedures" (p. 8).

This stipulation has, in all probability, served as the grounds for excluding the explanatory note from the list of mandatory financial reporting documents, which is to be approved as part of the new version of the Federal Law "On official accounting". In this connection it should be specified that the reports intended for external users (investors, creditors, etc.) are by definition financial (to be applied for purposes of financial analysis), and not accounting (for purposes of reporting, statistical records, etc.). It is difficult to imagine a high-quality financial report without an explanatory note, because, as a rule, such a note is more voluminous and, quite often, contains more information for the user than the reports, as such, do.

In this connection, the statement as to the fundamental importance of the draft Law³⁰ for improving the quality of information contained in the financial reports of subjects appears to be groundless.

In Article 17 "Mandatory Copy" it is envisaged that a mandatory copy of a financial report must be submitted to a state statistics agency, which is responsible for generating the information resources of the State and making them available to all interested users. The duty of the so-called socially important organizations to publish financial reports in the

²⁷ Item 6 of Art. 23 of the draft Law.

²⁸ Item 3 of Art. 23 of the draft Law.

²⁹ Approved by the Commission for Draft Laws of the Government of the Russian Federation on 17 October 2005.

³⁰ P. 9, Concept of the draft Federal Law "On accounting" (the new version).

mass media is not envisaged in the draft Law “On official accounting”, which further underlines the statistical function of the financial reporting documents prepared by Russian enterprises in accordance with the national standards.

In this draft Law, just as in the draft Federal Law “On the regulation of accounting and financial reporting”, there is no mentioning of the International Accounting Standards as a component of the normative base for accounting and reporting procedures. Thus, it can be concluded that the IAS, as an independent system of standards, have a chance to be introduced in Russia only in the sphere of consolidated reporting (if the draft Law “On consolidated financial reporting” is passed as the law), without little bearing, if any, to the sphere of accounting as such (because it is not feasible for enterprises to keep parallel records in accordance with the IAS), where the actual reporting information is being generated.

The “application of international standards as the basis for developing the national standards”, which is declared in the draft Law, can hardly be acceptable in combination with some of the norms incorporated in the draft Law. In particular, the very next among the principles of accounting regulation goes “the ensuring of appropriate conditions for a uniform application of the national standards”³¹. Coupled with the norm stipulating that a national standard can be rejected whenever it does not provide appropriate conditions for uniform application³², this provisions deprive the Russian system of accounting of the principle of priority of the economic content over the legal form, of any concept of fair value, or even market value, and on the whole of the possibility for an accountant to apply any estimation-based judgments. As a result, we thereby come back to the very thing that we have been trying hard to avoid – the directive-based system of accounting and reporting, which is useful only for the performance of controlling functions. Thus, the form has won over the content.

For statistical reporting, a uniform methodology of data collection is important; for tax reporting it is indispensable; but when applied in financial reporting, it often becomes an obstacle to an objective reflection of the actual facts of economic activity.

One more example of inconsistency in the “application of international standards as the basis for developing the national standards” is the list of objects to be entered into accounting records, as it is stated in Item 1 of Art. 5 of the draft Law.

According to the Conceptual Fundamental Principles for the preparation and submission of financial reports³³ within the IAS’ framework, assets represent not an enterprise’s or an organization’s property, but the resources controlled by a given enterprise or an organization, which is important in terms of generating an objective judgment of the financial status of a subject of reporting. Besides, it is incorrect to distinguish “the facts of economic life” of an economic subject as an independent object of accounting records. The events and operations named “the facts of economic life” are not separate objects of recording – they are reflected in the accounting records through the changes in their other components – assets, liabilities, an enterprise’s own capital (or other sources of financing), incomes, and expenditures.

* * *

The two draft Laws discussed above – “On the regulation of accounting and financial reporting” (developed by the National Organization For Accounting and Reporting Stan-

³¹ See Art. 18 of the draft Law “On official accounting”.

³² Subitem 4 of Item 8 of Art. 23 of the draft Law.

³³ Item 49 (a).

dards) and “On official accounting” (developed by the Ministry of Finance of the Russian Federation) – are on the whole very similar. Both are focused on the division of powers within the system of accounting and reporting regulation, and are considerably underdeveloped in the part relating to the content proper of the system of standards designed to regulate this sphere.

It should be noted that the division of regulating powers between the State and self-regulating organizations in the sphere of accounting and reporting represents, undoubtedly, a positive development in the reforming of the Russian system of accounting. Besides, the two draft Laws have also become a landmark of some other positive developments: the abolition of the requirement that financial reports be submitted to tax agencies; the abolition of the rule whereby the citizens engaged in entrepreneurial activity without establishing themselves as juridical persons were obliged to keep accounting records and prepare financial reports (in the draft Law “On official accounting”); the possibility for enterprises and organizations to depart from the requirements established by the national accounting and reporting standards, when the compliance with these requirements cannot ensure a complete and objective reflection of a certain event or operation in their records (in the draft Law “On the regulation of accounting and financial reporting”).

The issue as to which level – the government or non-government – should belong the function of creating and running an experts’ council for performing the experts’ estimations of draft standards does not seem to be of paramount importance. However, it is necessary to point out that this aspect in the draft Law put forth by representatives of the professional community leaves far fewer opportunities for related public to influence the process of developing the accounting and reporting standards. The National Organization for Accounting and Reporting Standards displayed a rather unfair approach while preparing the draft Law “On the regulation of accounting and financial reporting”, when it, in fact, was expecting to monopolize the non-government level of regulation. As far as the procedure for adopting the national standards is concerned, the RF Ministry of Finance was behaving much more fairly when it developed its own version of the law. At the same time, in the draft Law developed by the National Organization for Accounting and Reporting Standards (NSFO), the issue relating to the mandatory presentation (or publication) of financial reports has been substantiated and elaborated much better .

However, neither of the two draft Laws did, in fact, provide an answer to the question as to for which purposes the financial reports prepared in accordance with the Russian standards are to be applied. If they are needed for statistical records – then why is the mechanism for a public discussion of the draft standards provided? If for external users – then why are their interests neglected for the sake of government regulation?

No matter what the priorities in the reforming of the Russian system of accounting might be – the administrative reform, or new principles for distributing the budget funding, or the need to come to an agreement concerning the status of the IAS in Russia, – one should always remember the primary goal – that of creating a system of accounting disciplines capable of providing the users with appropriate information to be applied in well-substantiated decision-making under the conditions of a market economy.

Both the draft Laws, in the opinion of their developers, are aimed at ensuring appropriate guarantees for the users of the information being generated in the course of accounting to obtain reliable and useful financial information³⁴. It should be well understood that the reliability and usefulness of the information contained in the financial reports of economic subjects must be ensured by the established standards and unchanging princi-

³⁴ See, e. g., the Concept of the Draft Federal Law “On accounting” (the new version), p. 8.

ples on which these standards are to be founded, and not by the established requirements to primary documentation, accounting registers, and their keeping. It not easy to generate any qualitative indices if they are based only on purely technical requirements.

Our analysis of the content of the draft Laws on the regulation of accounting has once more demonstrated the impossibility of developing a system of Russian accounting and reporting standards "based on the IAS". These two systems are fundamentally different. The international standards have, as their foundation, a set of clearly determined and unchanging principles, which ensure the system's normal functioning even when the external conditions for the functioning of enterprises are continually changing. When the procedure for reflecting actual events and operations is not envisaged in the established standards (although, quite understandably, the whole spectrum of possible situations that may develop in the actual practice of enterprises cannot possibly be foreseen), an enterprise will be founding its activity on certain principles, the most important among which is the principle of the accounting information being useful for the well-substantiated decision-making process of the external users of its reports.

Russia, however, while accepting the international standards as a basis for building her own national standards, leaves the fundamental principles beyond the system's framework. As a result, new provisions for regulating the accounting procedures are being developed and introduced that are only partially compatible with the international standards, while their goal, as such, is left outside the framework of reform.

The approach to reforming the Russian system of accounting that involves the development and practical implementation of national standards to be based on international standards, coupled with the vague legal status of the International Accounting Standards, has not proved very useful. Russian enterprises, despite bearing additional costs, have not abandoned their practice of submitting to external users their financial reports prepared, on a voluntary basis, so as to be made compatible with the IAS or US GAAP. The persistent application of such an approach is no longer based on economic principles, and consequently, the issue of Russia's switching over to the IAS, even as a partial measure, has a distinct political character.

Some Problems That Are As Yet Unresolved

In the overview "The Russian economy in 2003. Trends and prospects"³⁵ we distinguished three interrelated sets of problems that have been encountered on the way toward the creation, in Russia, of a system of accounting disciplines compatible with the requirements of the market economy:

- some underdeveloped areas in legislation;
- issues pertaining to personnel training and technical foundations for the accounting system;
- absence of a clear understanding of the fundamental principles of the system of accounting disciplines as they exist in the contemporary market economies, and the real conditions for the application of some of these principles in domestic practice³⁶.

³⁵ See Chapter 4.5 "Reforming of the system of accounting in Russia", in: Rossiiskaiia ekonomika v 2003 godu. Tendentsii i perspektivy" ("The Russian economy in 2003. Trends and prospects"). M.: IET, 2004.

³⁶ For example, the state regulating bodies' intention to assume the responsibility of determining the notion of reliable representation of information in the financial reporting of subjects is the consequence of their acknowledgement of the fact that there exists, in fact, no interested group of users of reports prepared in accordance with the presently existing Russian standards, or, if such a group does exist, it consists only of the state bodies for the regulation of accounting procedures and reporting, and no one else.

In *The Concept of the Development of Accounting and Reporting in the Medium Term*, adopted in 2004, the existence of certain problems associated with legislation, cadres, and the conceptual foundation itself, that represent obstacles in the way of achieving the goals of reforming the system of accounting in Russia, have also been acknowledged³⁷. In particular, the list of such problems includes the absence of any official status of the accounting reports prepared in accordance with the IAS, and also the purely formal approach practiced by the regulating agencies, as well as by enterprises, to many of the established categories, principles and requirements of the accounting and reporting procedures that are supposed to be compatible with the conditions peculiar to a market economy.

Accordingly, into the *Plan of Measures* intended for *The Concept's* implementation, the measures designed to train and retrain the cadres, to create appropriate infrastructure for the IAS to be applied, as well as to ensure the monitoring of the specific needs of different user groups for certain types of financial information, have all been incorporated.

However, it so happened that in 2005, within the framework of an ongoing discussion concerning the introduction of the system for regulating accounting and financial reporting in this country, these measures became secondary to “the formal approach” (characterized as one of the main problems in the way of reforming), because the very construction of the regulation system is such that it cannot provide appropriate solutions to any of the problems mentioned above.

The new version of the Federal Law “On accounting” is, indeed, capable of eliminating some of the aspects of the currently existing so-called “legislative block of problems”. However, for this end to be achieved, it must be focused not so much on the system for accounting and reporting regulation in this country, but rather on the interaction between the existing variety of requirements to the organization of the system of accounting disciplines. It is this Law (because accounting procedures are the basis for obtaining the data needed for different types of reporting to be submitted by enterprises and organization) that must provide the answers to the existing questions concerning the purposes of financial and statistical reporting, the coordination of these two spheres with the sphere of taxation, as well as the status of the International Accounting Standards in Russia.

In 2005, within the framework of the draft Law “Reform of accounting and reporting II”, a survey was conducted, the goal of which was to determine the factors that were serving as obstacles to the smooth switchover of Russian enterprises to the IAS. According to the respondents – Russian accountants, these factors are as follows³⁸:

- discrepancies between the IAS and the Russian Accounting Provisions;
- absence of an appropriate legislative base;
- inadequate quality of training, as well as of the educational materials presently available.

The respondents noted that, despite the existence, in Russia, of many training courses in IAS and managerial accounting, the quality of teaching remains low³⁹.

It should also be noted that, despite the eight years of reforms (1998–2005), whose goal has been to approximate the Russian accounting practice to the International Accounting Standards, accountants are still pointing to the existence of significant differences between the two systems. This is yet another piece of evidence in support of the

³⁷ See Item 1 of the Concept.

³⁸ Results of a survey on the IAS, see at <http://www.accountingreform.ru>

³⁹ “Two-thirds of accountants noted the low quality level of the training. This opinion was confirmed by their tutors”. (The results of a survey concerning the IAS, <http://www.accountingreform.ru>).

conclusion that the approach aimed at building the national system of standards “on the basis of the IAS” as an alternative to the IAS proper has not been successful.

The professional community, on the whole, is supportive toward the idea of Russia switching over to the International Accounting Standards⁴⁰. In particular, the complete adoption of the IAS (that is, their adoption as a complete system) has been favored by professor V. Palii, Deputy Chairman of the Methodological Council for Accounting at the RF Ministry of Finance, and a member of the experts’ council of the National Organization for Accounting and Reporting Standards (NSFO). In an interview with the periodical “Double Entry”⁴¹, he noted that the whole system had to be switched over to the IAS, because financial reports prepared on the basis of the transformation method are not entirely trustworthy. Unfortunately, this standpoint has not been reflected in the draft Law “On the regulation of accounting and financial reporting” developed by the NSFO.

Representatives of Russian enterprises have also spoken of the necessity to grant a legal status to the International Accounting Standards in this country. Vice President of the Chamber of Commerce and Industry B. Isakov, when addressing the 4th International Forum of Accountants and Auditors, said the following⁴²: “It has become quite obvious that the transition period of switching over to the IAS cannot be too long, and this double burden [mandatory submission of reports prepared in accordance with the Russian standards and the presentation, to investors, of IAS-based financial reports] has to be got rid of at some stage. This is vitally important”.

Regretfully, the developments and trends observed in 2005 have not made it possible to expect that the *Plan of Measures* designed to implement *The Concept of the Development of Accounting and Reporting in the Medium Term* in the Russian Federation, which envisages the recognition of the IAS at the legislative level, will be actually implemented in accordance with the initial schedule. Its destiny will probably be the same as that of the Plan of Measures attached to the 1998 Program. But is it worthwhile to delay for too long the solutions to urgent problems, so as to begin the reforming of the sphere of accounting and reporting once again, as if nothing has been done before?

The absence of any legal status for the financial reports prepared in Russia in accordance with the IAS does not only result in additional expenses being borne by enterprises, but also deprives the users of such reports of one of vital instruments for controlling the quality of information being submitted by reporting subjects, because neither courts of justice nor regulatory bodies (e.g., the Federal Service for Financial Markets) do accept any complaints concerning the violations encountered in these reports.

The conceptual problems arising during the implementation of reforms in the sphere of accounting and reporting in Russia have led to a situation when not only the interests of the users of financial reports are ignored, but upsetting misunderstandings arise in the organization of the system of accounting disciplines.

In October 2005, the newspaper “Vedomosti” published an article⁴³ whose author promised to Russian businesses some “unpleasant tax consequences” that may result from their switching over to the International Accounting Standards.

In foreign accounting practice, there is a distinct line being drawn between the spheres of financial (accounting) records and tax records, and therefore the simple fact of

⁴⁰ “83 % of respondents noted that the switchover to the IAS is necessary” (according to the data posted to the website <http://www.gaap.ru>).

⁴¹ See at: <http://www.gaap.ru> on 29 June 2005.

⁴² See the publication “V Kremliie problemy MSFO raz’iasniaiut na paltsakh” (“In the Kremlin, the problems associated with the IAS are being explained in every detail”), posted to the website <http://www.gaap.ru> on 7 June 2005.

⁴³ See “Milliardy iz nichego” (“Billions made out of nothing”) // Vedomosti, No 189 (1470) of 10 October 2005.

Russian enterprises having switched over to making their reports in accordance with the IAS cannot, in principle, have any consequences in terms of taxation. On the other hand, the Tax Code of the Russian Federation contains references to accounting procedures, in particular, in relation to the calculation of the property tax. It is the misunderstanding of the first circumstance, coupled with the second one, that has given rise to a wave of indignation among representatives of Russian enterprises⁴⁴.

In order to avoid such incidents in the future, it will be necessary to provide support to the initiative of Chairman of the Experts' Council for Tax Legislation at the RF State Duma's Committee for Budget and Taxes M. Orlov, which is as follows⁴⁵:

- to determine the forms of tax reporting at the legislative level directly, in the RF Tax Code, or to establish a rigid framework for their approval by government agencies;
- to abolish the mandatory submission of financial reports to tax agencies. To exclude from legislation on taxes and levies the provision concerning the responsibility for incorrect keeping of accounting records and for entering incorrect information into financial reports.

The Banking Sector

For two years already, Russian banks have been preparing their financial reports in accordance with the IAS in a situation when neither the officially approved translation of the document's text into the Russian language is available, nor any legal status for such reporting is established. The banks, similarly to organizations operating in other sectors of the national economy, have been challenged by some technical and personnel-related problems.

As required by the Central Bank of the Russian Federation (RF CB)⁴⁶, credit institutions are obliged to submit to the RF CB their financial reports prepared in accordance with the IAS. From 1 January 2006, it has been intended to apply these reports for purposes of banking supervision⁴⁷.

Despite the declared switchover to the IAS, the informational transparency of Russian banks remains at a rather low level. In 2005, the agency "Standard & Poors" published the results of its survey of the degree of transparency of Russia's 30 biggest banks⁴⁸, which demonstrated that the average level of information disclosure by banks included in the survey amounts to 36 %. By way of example, for the sample of 54 Russian companies from different sectors of the national economy the value of this index is 50 %, and for the top 10 international banks – 85 %.

The same survey has also shown that Russian banks are lagging behind, in their practice of information disclosure, in the following areas: transactions with related parties; the structure and procedures of corporate governance; and the risk management policies.

These data are an evidence of Russian banks' low efficiency in applying the International Accounting Standards. Given the fact that the IAS, when applied in the banking sector, are primarily aimed at an adequate assessment of risks and appropriate reflection of their consequences in financial reports, the presence of the item "Risk Management" in

⁴⁴ Ibid.

⁴⁵ "Iskliuchit' iz Nalogovogo Kodeksa ssylki na bukhgalterskii uchiot" ("To exclude from the Tax Code any references to accounting procedures", posted to the website <http://www.gaap.ru> 22 September 2005.

⁴⁶ Instruction of the RF CB No 1363-U of 25 December 2003.

⁴⁷ The official announcement of the Bank of Russia concerning the switchover of the banking sector of the Russian Federation to the International Accounting Standards see at its official website <http://www.cbr.ru/MSFO/>.

⁴⁸ "A study of the informational transparency of Russian banks: insufficiently effective practice of information disclosure" – Standard & Poors, 26.10.2005.

the financial reporting of Russian banks, which belongs to the group of the least open items, is an evidence that the advantages offered by IAS are not duly being made use of in this sphere.

A possible reason for the emergence of such a situation may be the mandatory requirement that the financial reports submitted to the RF CB must be prepared in accordance with the International Accounting Standards, for the RF CB to use these reports for purposes of executing its supervisory functions. This assumption is supported by the higher financial transparency index being displayed by Russian companies in other sectors of the national economy, which are currently preparing their reports according to the IAS on their own initiative, exclusively for their external users.

In September 2005, the RF CB announced that the issue of financial reports being applied for purposes of supervision after 1 January 2006 will be additionally considered⁴⁹. This, most probably, is associated with the fact that the RF CB is not yet ready to impose any sanctions based on reports prepared in accordance with the IAS, because the existing system of mandatory standards builds upon the Russian accounting standards.

Also, it is not considered to be feasible to apply the reports prepared by banks according to the international standards for purposes of supervision, because they reflect past events, and not events expectable in the future. However, until a system of new supervision-oriented reporting is developed and distributed among banks, they will be estimating the risk of being brought to responsibility for incorrect information entered in their financial reports as high, and so the level of information disclosure will remain low.

Thus, the mandatory switchover of the Russian banking sector to the IAS has resulted in a situation when this reporting is being regarded by banks exclusively as that to be used for purposes of supervision, and no benefits are expected to arise from the application of this instrument of best international practice⁵⁰.

The question as to whether the financial reporting of credit institutions prepared according to the IAS can become an instrument for increasing the transparency of the banking sector in the interests of the users of banking services remains open, despite its current application for supervision only, which is not customary in universally accepted practice. The prospect of such a possibility will depend both on the level of activity of the users of such reports and on the further measures designed to reform the Russian system of accounting, which will have to result in providing the users with efficient mechanisms of influencing the qualitative indices incorporated in the information submitted as part of financial reporting.

Conclusions and Proposals

The analysis of the events and trends observed in the year 2005 in the sphere of reforming the Russian system of accounting has led us to the following conclusions.

1. The establishment of the legal status of the International Accounting Standards in Russia is necessary. The legislative recognition of the IAS will, indeed, serve the purpose of improving the quality of the information contained in the financial reports prepared by Russian companies. In this connection, it should be noted that this measure will by no means entail the abolition of the national system of accounting and reporting standards.

2. Enterprises and organizations should be able, when preparing their individual financial reports, to make a choice between the Russian standards and the IAS. Firstly, this will

⁴⁹ Official materials of the RF CB, posted to the website <http://www.cbr.ru> on 9 September 2005.

⁵⁰ Indeed, some big banks had been estimating their financial status and the results of their activity in accordance with international standards even before the year 2004 – for purposes of keeping managerial records or meeting the interests of external clients.

help to reduce their costs associated with superfluous reporting. And secondly, this measure will demonstrate the degree to which the Russian standards can meet the users' demands to the quality of financial information.

3. At present, the Russian accounting standards (or Accounting Provisions) are not found to be satisfactory by the users of reports. This has been demonstrated by the fact that large enterprises are not against their financial reports being submitted in accordance with the standards accepted in international practice, despite the considerable additional costs. At the same time, it cannot be said that, after the IAS are adopted in Russia, no one will be applying the national standards any more, provided they can become more efficient than they are now. Thus, for example, small- and medium-sized Russian companies may well become the target group of users for such standards.

For the system of national standards to become, indeed, compatible with best international practices, as well as competitive, it has to be based upon clearly defined and unchangeable principles, capable of guaranteeing adequate qualitative characteristics of financial information and meeting the requirements of the external users of financial reports. It is these principles that will need to be consolidated in the law, around which the system of normative regulation of the national accounting and reporting standards will be built.

The unchangeable foundation will make it possible for the system of national standards to operate efficiently even under the perpetually altering conditions of functioning faced by economic subjects. When some or other situation of a subject's economic life is not being reflected by the accounting standards, stable grounds can be provided by the clear idea as to which purposes the resulting information must serve. Thus, the priority of the content over the form within the system of standards as a whole is observed.

4. The basic principles of the system of accounting disciplines must be uniform; as for the uniformity of accounting procedures, it will not only deprive the accounting practice of its universally recognized instruments for objective reflection, in financial reporting, of actual events and operations, but also limit its potential for further development.

If enterprises and organizations have no opportunity for adjusting their accounting procedures in instances when those established by the existing standards do not allow them to completely and objectively reflect their actual situations, the agencies responsible for the development of the national standards will no more have an appropriate base for analyzing the changes taking place in the environment where the enterprises and organizations are functioning. In that case, the system of national standards will be static.

However, it is true that in absence of fundamental principles, the freedom of accounting practice granted to economic subjects will not be a guarantee of information objectivity. Therefore, of paramount importance is not the way the system of accounting and reporting regulation is organized in Russia, but the results it is going to yield.

5. While building a national system of accounting disciplines, it will also be important to determine the percentages of financial, statistical and tax information. All these data are, to a varying degree, being generated in the course of accounting procedures, and therefore it will be feasible to outline the principles on the basis of which the different disciplines are going to interact.

The procedure for tax calculation must not be dependent on the ways a given object of taxation is reflected in the accounting records. The supervisory and control functions must be excluded from the sphere of financial reporting; the notions of auditing and state control should not be confused, either.

Our analysis has also demonstrated that the combining of financial and statistical reporting may result in a confusing of the functions to be performed by these different types

of information. The variability of the accounting practice, which is useful in terms of an objective reflection of actual events and operations for purposes of financial analysis, may give rise to serious complications when statistical data bases are being created.

6. The ongoing discussions concerning the distribution of powers within the system of accounting and reporting regulation in Russia have overlooked certain problems that are more important in terms of achieving the goals of reforming. These are, primarily, the training and retraining programs for accountants, auditors and other state officials, as well as measures designed to provide external users of financial reports (actual or potential) with appropriate knowledge. In this connection, the quality of training and educational materials must be a priority.

The formation of a range of related users and their professional training will provide a necessary supplement to the organization of accounting and reporting procedures for companies, aimed at ensuring adequate qualitative characteristics of their information. This instrument does not belong to the accounting system regulation; however, it represents one of the components of quality control over the information contained in financial reports. In absence of an established range of related users, capable of influencing a company's status through economic decision-making, the application of best international practices in the preparation of financial reports will not be efficient enough.

Special attention should be focused on international cooperation. Russia must not be left outside the framework of the processes of developing the accounting and reporting standards, which have already become recognized as a universal business language, to be applied in international interaction. This measure will also preclude any fears that the International Accounting Standards are just being "thoughtlessly transplanted" into the Russian practices.

Annex 4.

Establishment of Special Economic Zones and their Prospects for Creation of Motivation to Speed-Up Social and Economic Development of Russia

An important event of the year 2005 was an adoption of a legal base regulating a relatively new instrument of the Russian economic policy, that is, special economic zones (SEZ) and implementation of a policy and decisions as regards establishment in the Russian Federation of special economic zones of the following two types: industrial and manufacturing zones and technical and innovation zones. In 2006, it is planned to introduce such amendments in the legislation as are aimed at establishment in the Russian Federation of other two types of economic zones, that is, port zones and holiday-and recreation zones. It is to be noted that at present in Russia in addition to newly established special economic zones there are special economic zones, which date back to the 90s; such zones are situated in Kaliningrad Region and Magadan Region.

Special economic zones in Russia have a rather long history. From the beginning of the 90s, a few special economic zones have been established in Russia; participants in such zones enjoyed a number of privileges related mainly to payment of taxes and customs duties. At the same time, an initiative to unify legislations regulating issues related to special economic zones was made for the first time by the Ministry of Economic Development and Trade of the RF a few years ago. However, the above initiative materialized in a statutory act only last year.

Such developments can be explained by the following factors. On the one hand, such high rates of growth in budget expenses as were observed of late permit the authorities to take decisions related to an increase in public expenses (or decrease in public revenues)

easier than before. On the other hand, at present there is a problem related to an exhaustion of sources of recovery growth, which followed the economic crisis of the late 80s and the early 90s. In such a situation the state authorities face the problem of creation of proper motivation in order to raise the rates of the present-day economic growth on the basis of innovation technologies and fast development of the services sector.

For that purpose, it is important to upgrade operation of main market institutions, optimize activities by the state authorities, make Russia more attractive for investment and raise competitiveness of the Russian economy. With taking into account the above objectives faced by the authorities, it is to be noted that the principal objective of the modernization policy consists in a change in the composition of branches of the economy and correlation between them. It can be assumed that in an existing situation in Russia restructuring should be carried out with a view to abandon the raw materials trend in the economy in favor of development of other branches, which ensure both the required extent of economic diversification and sustained economic growth. At the same time, it is to be noted that a policy aimed at public support of individual branches of the economy normally happens to be ineffective. Firstly, state authorities lack flexibility in selection of such sectors of the economy whose financial support may in the long-term prospect have an effect on economic growth. Secondly, in selection of branches of the economy and investment projects to be supported by the government, state authorities (particularly in countries with transition economy) can be guided by considerations, which have nothing to do with economic efficiency. Consequently, it would be expedient to use government support in respect of investment projects, which are normally related to the public sphere, primarily, infrastructure. In addition to the above, in carrying out structural and institutional changes public authorities should contribute to development of competitiveness, which would determine the required extent of flexibility of the business environment required for introduction of new conditions.

It is to be noted that development of the institution of public-private partnership (which permits to combine resources of both the public sector and entrepreneurial sector for the purpose of creation of the “new economy”) will contribute to the above processes.

As a result, Federal Law No. 116-FZ on Special Economic Zones in the Russian Federation was passed on July 22, 2005, while the first results of a tender-based selection of bids were received as early as December 2005. By decision of the Government of the RF, six special economic zones were set up – four technical and innovation zones – one in Moscow (the City of Zelenograd) specializing in development of microelectronics; the second, in the City of Dubna in the Moscow Region (development of nuclear and physics technologies); the third, in St. Petersburg (development of information technologies) and the fourth, in the City of Tomsk (development of new materials) and two industrial and manufacturing zones: one in Lipetsk Region specializing in production of consumer electronics and the other in the City of Elabuga in Tatarstan (manufacturing of auto components and high-tech products for petrochemical industry).

Though the first steps in execution of Federal Law No. 116-FZ of July 22, 2005 on Special Economic Zones in the Russian Federation (hereinafter referred to as the law) have been made it would be expedient (from the point of view of identification of implications related to implementation of that law in the Russian Federation for the purpose of solution of a strategically important objective, that is, restructuring of the national economy) to carry out a thorough expert examination of the above law.

Problem No. 1 – Lack of clear understanding of the structure of the “new economy” of Russia.

As seen from the text of the law, the purpose of establishment of special economic zones as an instrument of economic policy is not quite clear. Though the law provides for a possibility for the government of the RF to set up permitted types of activities in the territory of special economic zones (Article 4), the actual selection is limited to those activities, which are specified by bidders participating in the tender.

Thus, again the declared determination to carry out serious structural and institutional reforms gives place to application of motivation measures aimed at development of the already existing specialization of individual territories, rather than formation in those territories of such institutional conditions through establishment of new production facilities and research complexes as would suit to a greater extent accelerated economic development. Unfortunately, the existing methods (set out in Cl.4 of the tender documentation approved by Order No. 223 of September 14, 2005 of the Minister of Economic Development and Trade of the RF) of evaluation of bids for creation of special economic zones of both the types are as such that in tender selection preference is given to those bidders who have a developed resource base (financial, property and labor resources), research and infrastructure needed for establishment and efficient operation of special economic zones, as well as experience in implementation of large investment projects; a combination of the above factors serves as evidence of the bidder's experience in carrying out of technical and innovation activities and industrial and manufacturing activities specified by it in its tender bids.

However, in establishment of special economic zones, in our opinion, one should not rely on support of individual branches of the economy, since such a support is normally inefficient for the reasons stated above. Rather, government support is to be rendered to creation of a favorable business and investment climate, which is important to efficient functioning of the economy.

In taking of federal decisions, consideration of the specifics of development of individual territories, undoubtedly, deserves high praise, since such an approach is different from 'red tape' procedures for selection of priorities, however such a practice points to a lack by the federal authorities of a clear understanding of the essence of the present-day economic growth; evidence of that is, in particular, vague wordings of the purposes of creation of special economic zones (Article 3): "Special economic zones are established for the purpose of development of manufacturing industries of the economy, high-tech industries, production of new types of goods and development of transportation infrastructure".

A lack of clear benchmarks in terms of specific strategic goals (for which purposes the law in question is adopted) makes it virtually impossible to evaluate adequately efficiency of such a law and, consequently, brings into question importance of that law for implementation of structural reforms in the Russian economy in order to ensure proper conditions for economic development.

Problem No. 2 – Formulation of conditions for establishment of special economic zones and ambiguity of interpretation thereof complicate fulfillment of the law

Article 4 of the law introduces a definition of "a participant in the territory" (which does not exist in the Land Code of the Russian Federation), but at the same time fails not define it; as a result different interpretations of the above definition arise. Despite the fact that an established legislative definition of "a land plot" is further used in the language of the law, provisions of Article 4 lack an unambiguous interpretation.

Following the logic of architects of the law and the common sense, Article 4 of the law should read as follows: a special economic zone can be established in a portion of a terri-

tory of a certain size, which portion can be made up of an indefinite number of land plots, which constitute a single territory of a zone. The principle of integrity of the territory is a priority in the Law, and for that reason, for instance, industrial and manufacturing zones (a type of a special economic zone) cannot be established in the territory of two or more isolated land plots, which have no common border.

Another bottleneck of the Law is Article 5, which determines the following two principal conditions, which are required for establishment of a special economic zone in municipal territories: ownership status of facilities, including land plots and their current legal status (such facilities cannot be owned and (or) used by individuals and legal entities). The law specifies in particular that land plots which constitute a territory of the zone are to be in a public and (or) municipal ownership and as of the time of establishment of a special economic zone cannot be owned and (or) used by individuals and legal entities, except for land plots allocated for use or location of utilities. As for technical and innovation zones, the above requirements do not apply to land plots owned and (or) used by educational establishments and (or) research institutions.

Requirements to the ownership status (public and/or municipal) of land plots, which constitute the territory of a zone limit a possibility of establishment of a special economic zone on land plots, which are assigned de jure to commercial entities (federal public unitary enterprises, municipal unitary enterprises, joint-stock companies with 100% authorized capital owned by the state and other) actually managed solely by public or municipal entities; taking the above factors into account such entities can participate in fulfillment of an integrated government structural and investment policy.

Limitations on the ban on ownership by individuals and legal entities of the real property, except for infrastructure facilities results in a situation where motor roads and railways are defined as transportation infrastructure facilities, and for that reason land plots where such facilities are situated are not covered by exclusive provisions of Article 5 of the law. Legally, motor roads and railways, as well as land plots where such motor roads and railways are situated are the property of legal entities (for instance, railways and land plots through which they go are the property of OAO RZhD) and for that reason such land plots cannot be included in the territory of a special economic zone. Thus, there is a contradiction: on the one hand, territories with better infrastructure facilities are sought for establishment of special economic zones, while, on the other hand, land plots with such infrastructure facilities cannot be included in the territory of SEZs due to formal (though insignificant) parameters.

Also, a comprehensive definition of 'educational establishments' used in Article 5 of the law gives rise to questions as regards the essence and role of such establishments in the ideology of the law.

As types of educational establishments are not specified in the law, bidders at the tender need to be guided by Article 11 and Article 12 of Federal Law No. 3266-1 of July 10, 1992 on Education. According to the above articles, educational establishments include all non-profit institutions (irregardless of their legal status and type), which engage in implementation of educational programs and public educational standards of all the levels and lines, including educational training (preschool education, elementary general education, basic education and secondary (complete) general education) and vocational training (basic vocational education, secondary vocational education, higher vocational education, post-graduate vocational education). It only remains to guess what role educational establishments have to play in setting up of technical and innovation zones.

The law lacks elaborations as regards a possibility of establishment of SEZ in a closed administrative territory (CAT) As no direct ban on such a SEZ is provided for in the law, to answer that question one has to refer to Federal Law No. 3297-1 of July 14 1992 on Closed Administrative Territories and the Land Code of the RF.

According to Article 27 of the Land Code of the RF, such land plots within the borders of the closed administrative territory as are either in public or municipal ownership belong to the land, which is either withdrawn from circulation (if occupied by facilities, which purpose such a CAT was established for) or restricted for circulation in all other cases. In addition to the above, in accordance with Article 93 of the Federal Law of the RF by decision of the Government of the Russian Federation a special regime of utilization of the land is introduced in CATs, which factor provides for limitations or a ban on those activities which are incompatible with a use of land for defense and security purposes.

Along with limitations on a circulation of land plots, the Federal Law on Closed Administrative territories in the RF introduces additional restrictions and bans. According to Article 3 of the above Law, a special regime of safe operation of industries and (or) facilities in a closed administrative territory implies such limitations on business and entrepreneurial activities, ownership and use and disposition of the land, natural resources, real property as may arise from restrictions related to entrance and (or) permanent residence in such territories.

However, the main obstacle on the way of establishment of SEZ in CAT consists in a mismatch of purposes for which SEZ is established with those of CAT. Whereas SEZs are established for the purpose of industrial and innovation development of the national economy, CATs are set up for accommodation of industrial enterprises specializing in processing, manufacture, storage and utilization of weapons of mass destruction and reprocessing of radioactive and other materials, as well as military and other facilities; for such enterprises a special security regime of operation and protection of state secrets is established.

Certainly, taking into account the above arguments it is impossible and inexpedient to establish SEZ in CATs, however, this needs to be specified in the Federal Law on Special Economic Zones in the Russian Federation in order to prevent bids with such proposals.

Problem No. 3 – Fulfillment of financial obligations by the parties under a tripartite agreement on establishment of a special economic zone is made conditional by the law on declaration of will of representatives of legislative authorities

Article 6 of the Law provides for a need to conclude within 30 days from the day of signature of a Resolution of the RF Government on Establishment of SEZ a tripartite agreement on establishment of SEZ between the Government of RF, supreme executive authorities of the constituent entity of the RF and executive municipal authority. The main provisions of the above agreement (which provisions are determined by the law) include, first of all, a need to specify in the agreement volumes and time-limits of financing of utility, transport and social infrastructure of SEZ out of the federal budget, budget of the constituent entity of the RF and the local budget. Though other provisions of the agreement are undoubtedly important because they set a procedure for interaction of the authorities of all the three levels in respect of establishment and ensuring of proper operation of SEZ, privileged taxation regime for residents of SEZ, a complex of measures on development of a long-term development plan for SEZ and mechanisms of formation of a supervision council, yet they are less important and dependant on fulfillment by the parties to the agreement of financial obligations in respect of establishment of the infrastructure of the zone. Actually, with absence of the required utilities, railways and motor roads and social

facilities it would be almost impossible to attract investors to such a territory by offering them customs and tax privileges alone. For that reason, financing of establishment and development of infrastructure facilities is a priority, but at the same time, the most complex issue.

The fact is, the agreement is a long-term legal document, because it specifies the period of functioning of SEZ for any period within 20 years from the day of its establishment as provided for in the law and remains in force throughout that period. Also, it is clear that the process of establishment of infrastructure of SEZ will take more than a year. For instance, in schedules of financing of expenses related to establishment of infrastructure of SEZ (which schedules were attached to bids at the tender) a period of three to seven years was specified. Consequently, the parties should include a preliminary schedule of financing of expenses related to establishment and development of infrastructure, as well as a procedure for amendment thereof if required.

However, the problem of the above agreement consists in the fact that such an allocation of infrastructure-related expenses cannot be considered as an obligation by the parties, since all the expenditures of public and municipal authorities are financed only out of the respective budgets, which are approved by law for a forthcoming fiscal year. In other words, the parties can assume obligations under the above agreement at formation of a draft budget for each subsequent year and include in their budgets the amount of financing specified in the agreement and submit such budgets for approval by public (municipal) legislative (representative) authorities. However, fulfillment of financial obligations by the parties under a tripartite agreement on establishment of SEZ actually depends on the willingness of legislative authorities, which factor brings into question feasibility of the entire agreement.

Problem No. 4 – Limitation of direct financing to issues related to establishment of utilities, transportation and social infrastructure.

According to Article 6 of the law, expenses related to establishment and support of utilities, transportation and social infrastructure are financed out of the public budget, however the direct public financing does not go beyond that; only indirect adjustment mechanisms, such as customs and tax benefits are applied. At first sight, the idea of the architects of the law is quite clear: the state undertakes direct investment in construction, modernization and overhaul of infrastructure facilities, however loss-making those lines of business might be a priori, they are needed for establishment of normal business conditions for residents of the zone, which conditions can be ensured through a reduction of transaction costs. At a later stage, the role of the state can be limited to an application of indirect mechanisms of adjustment of a business climate in SEZ. However, there are a few “but”.

Firstly, (the formal “but”) the law does not specify the complete list of infrastructure facilities of SEZ. For that reason, in attribution of different facilities to utilities, transportation and social infrastructure one should be guided by functional purposes for which those facilities were established. With such an approach in place, facilities of utilities infrastructure should include water supply and water discharge facilities, including pumping stations; heat-supply, energy-supply and gas-supply facilities, as well as communications facilities and data-processing facilities. Information infrastructure facilities normally include motor roads and railways; seaports and river ports; civil airdromes and main pipelines. The social infrastructure includes the aggregate of educational establishments, healthcare institutions and culture, physical training and sports facilities. But here a question arises what needs to be done in respect of establishment of market infrastructure fa-

cilities which are required for ensuring of proper functioning of the zone, but not related to the above-mentioned facilities, for instance, landfill operation and building of a dam and a road network on the territory of the zone and other. As a procedure for handling of such issues is not specified in the law, a tripartite agreement on establishment of SEZ needs to include a list of facilities, which are to be built with use of budgetary funds. If establishment of such facilities, including non-traditional ones has not been supported by that time by accurate economic and technical calculations, which justify importance of such facilities for a proper functioning of the zone no financing will be provided in the near future.

Secondly, there is no doubt that establishment of utilities, transportation and social infrastructure creates the required conditions (though not always sufficient ones) for business activities by residents in accordance with the profile of the zone. It is obvious that such facilities do not cover the entire list of market infrastructure facilities, which contribute to a decrease in transaction costs of businessmen and increase in a return on the invested capital. The law does not provide for budget financing of expenses related to establishment of business-incubators, centers for collective use of equipment, present-day research laboratories, public leasing companies and other. Handling of those issues is particularly important to technical and innovation zones where the investment potential of residents is less significant as compared to financial abilities of representatives of industrial and manufacturing zones where large investors (which are able to finance single-handedly establishment of the required infrastructure facilities) are attracted to. For that reason, it would be expedient not to limit the list of infrastructure facilities financed out of the public budget to utilities, transportation and social infrastructure facilities alone, which facilities often fail to meet residents' crucial needs in infrastructure services.

Problem No. 5 – Possible implications of a formal approach to assignment of a status of a resident of a special economic zone

To receive a status of a resident of a special economic zone, commercial institutions (in case of a technical and innovation zone, individual businessmen included) are required to submit in addition to formal documents (a copy of the state registration certificate, copy of registration with tax authorities, copy of founding documents) a business plan which permits to evaluate the scope and lines of activities of a potential resident of SEZ. It is to be noted that whereas in case of technical and innovation zone due diligence of business plans submitted by bidders for securing assignment of a status of a resident of SEZ is carried out by an expert council (established particularly for those purposes), which checks compliance of such business plans with evaluation criteria set by the Ministry of Economic Development of RF (which factor points to the fact that results of selection of bidders are to a certain extent fair and justified), in case of an industrial and manufacturing zone the law provides for a private procedure for carrying out of due diligence of business-plans. For instance, a package of documents (which needs to be submitted by bidders for securing assignment of the status of a resident of an industrial and manufacturing zone) includes a positive conclusion (in a free format) by a credit institution on the submitted business plan. It is noteworthy that selection of a credit institution to carry out due diligence of the business plan is reserved by law for the bidder. Consequently, the bidder can secure directly from a credit institution a positive conclusion on its business plan with banks, which need to comply to a greater extent with formal selection criteria set by the Ministry of Economic Development of Russia. As can be seen from above, the state is prepared to award the status of resident to any commercial institution, which will be registered at the municipal territory (which boundaries SEZ is situated within), whose by-law provides for such lines of

business as comply with the type of a zone, and which is prepared to invest for a certain period of time cash amounts specified in the agreement.

The case for such a formal and explicitly simple approach to awarding of the status of a resident consists in a lack of any direct support (subsidies, loans, investments in charter capital and other) by the state of the resident. Most importantly, in return for entitlement to tax and customs privileges the resident assumes an obligation to make capital investments in the amount, which is equivalent to at least EURO10 million within the entire period of its activities in the territory of the zone. Unfortunately, the law fails to provide for sanctions, which are to be imposed on a commercial institution or individual businessman in case of violation by them of their obligations related to the status of a resident. The only sanction consists in payment of a penalty provided for in the agreement on industrial activities in case of early termination of the agreement on activities due to a gross violation by a SEZ resident of conditions thereof. However, the sum of the penalty is likely to be insignificant and can serve only as an instrument of influence against the defaulter, while facts of existence of material violations need to be proved in a court of law, because in accordance with the law the status of a SEZ resident can be withdrawn only on the basis of a court decision on the following grounds:

- in case of a failure by a SEZ resident to comply with the order to eliminate violations prior to fulfillment of an extraordinary examination (Article 11);
- in case of two or more material violations by a SEZ resident of provisions of the tax legislation and (or) customs legislation (Article 11);
- in case of a termination of the agreement on industrial activities (Article 19).

Consequently, implications of the formal approach to assignment of the status of a resident of an industrial and manufacturing zone against a “promise” by a potential SEZ resident to carry out activities in conformity with the type of the zone and make large capital investments as per the schedule provided for in the agreement on activities can be a chain of court proceedings, which even in case of a ruling in favor of the state cannot compensate in full all the budgetary expenses related to infrastructure and management of special economic zones.

Problem No. 6 – Implications of establishment of a favorable business climate for attainment of the aims of the law

A favorable business climate for residents of a special economic zone is based on provision of a beneficial taxation and customs treatment and simplified administration procedure.

Application of a duty free zone regime in the territory of SEZ regulates correlation between foreign goods and domestic goods as regards their allocation and utilization in the territory of the zone in the following way: special conditions are created for fast modernization of the main business assets and less expensive procurement of working assets by virtue of absence of customs duties on imported goods and VAT; it is to be noted that this regime applies both to Russian-made goods and foreign products.

Beneficial taxation treatment is also applied to manufactured goods and transit goods, which are delivered abroad from the territory of SEZ. In other words, residents of the zone engaging in export activities are charged VAT at a zero % rate and exempted from payment of import duties. However, if the flow of goods goes to counter parties in other parts of RF the resident is liable to pay all the taxes and duties to the budget in conformity with the requirements set by the tax regime and customs regime. Thus, the regime in question is aimed at securing export orientation of SEZ by promotion of foreign economic competition through a price formation process.

Certain privileges are granted to residents in accordance with the Tax Code of the RF. For instance, the base rate of a single social tax is reduced for residents of a technical and innovation zone from 26% to 14%. SEZ residents are exempted from payment of a corporate property tax and land tax within five years from the date of registration of the property or origin of the right of entitlement to a land plot, respectively.

A corporate profit tax rate can be reduced to 20 percent, which factor needs to be provided for in a tripartite agreement on establishment of a zone. In addition to the above, residents of industrial and manufacturing zones are in a position to apply a special ratio of no more than 2 to the ratio of own fixed assets to the depreciation norm, which factor serves as evidence of application of early depreciation to production capacities; also residents are permitted to carry over a loss to a later date within the next ten years without any limitations in respect of amounts, which are written-off as a loss.

In their actual work, territorial authorities of the Federal Agency for SEZ Management should be guided by the 'one window' principle in their relations with SEZ residents, which factor makes the administrative regime less complicated and constitutes a significant advantage of the law.

Generally, tax privileges, customs benefits and administrative privileges which ensure a certain relaxation of a fiscal and administrative burden on the business sector are sooner related to assignment of the status of a resident of the zone to a commercial institution or a businessman, rather than priority lines of economic activities. Thus, their efficiency in handling of issues of structural reforms in the Russian economy depends on a strategically justified selection by the Government of the RF of specialization of such zones.

* * *

Implementation of the law has already begun; it is to be noted that the first stage of it (consisting in selection of the most promising regions for establishment of SEZs in their territories) has been completed. At present, receipt of benefits (administrative privileges, tax benefits and customs benefits provided for by the law) by businessmen depends on early formation of a legal space, which is required for proper functioning of special economic zones in the territory of the selected regions.

Considering the fact that the process of formation and functioning of special economic zones is rather long, the first results can be expected not sooner than in 3–4 years; for that reason, at this stage provisions of the law can be assessed only analytically.

In the end, it seems necessary to sum up the above in a few conclusions.

Firstly, the idea of establishment of special economic zones has proved its viability as seen from experience of other countries, and it has the right to be implemented in Russia. However, it is important to understand that in order to carry out radical transformations in the national economy towards development of industries with a high added value Russia's structural and investment policy should not be limited only to establishment of individual 'spots' of growth. However, at present the idea of special economic zones as instruments of promotion of structural reforms in such a form as provided for in the law does not guarantee that it will go beyond establishment of a few SEZ for handling of local problems, which have nothing to do with nationwide objectives. A lack of well-defined priorities in the structural policy (which priorities need to be integrated into a common strategy of social and economic development of Russia) results in a prevalence of such a non-systematic approach to handling of important issues as is evident in adoption of inefficient laws, such as the one considered above.

Secondly, creation of favorable economic conditions, certainly, has a significant effect on the growing economy. However, at present the Russian economy is in such a situation where those measures alone are not enough to help the private sector overcome accumulated difficulties and differences. Consequently, considering the state's withdrawal from active financing of structural reforms and limitation of the state's role to improvement of economic environment it can be asserted that the approach to structural and investment policy of Russia is incomprehensive.

In such a situation, it is important to change radically an approach to the state's role in reforming of the Russian economy, which change in approach means a multiple increase in public investments in the real sector, establishment of a modern market infrastructure and ensuring of fast development of the R&D potential. Relying on public institutions and using the entire range of instruments of public interference, the state should single-handedly form relevant proportions between industries in favor of manufacturers of consumer goods, while to ensure a fast switch over by industries of the consumers' sector to present-day technologies it has to make active efforts to develop the country's investment complex and research base.

Thirdly, it is necessary to amend the effective law with the above problems and drawbacks taken into account, otherwise reforms in Russia (in the context of the Law in question) will proceed again in accordance with the principle: "We wanted to do it better, but it happened as always".

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