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**Director: Yegor Gaidar**

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

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The review provides a detailed analysis of main trends in Russia's economy in 2007. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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## Authors:

- section 1.1* – E. Gaidar;
- section 1.2* – V. Mau;
- section 1.3* – V. Dashkeev, L. Freinkman
- section 2.1* – P. Trunin;
- section 2.2* – S. Drobyshevskiy
- section 2.3.1–2.3.4, 2.3.6* – I. Sokolov;
- section 2.3.5* – M. Kazakova;
- section 2.4* – P. Kadochnikov, V. Nazarov,  
S. Sinelnikov-Murylev;
- section 2.5* – A. Mamedov, V. Nazarov;
- section 2.6.1, 2.6.3* – N. Burkova;
- section 2.6.2* – A. Shadrin;
- section 2.6.4* – L. Mikhailov, L. Sycheva;
- section 3.1* – E. Astafieva, Yu. Bobylev,  
O. Izriadnova;
- section 3.2* – S. Tsukhlo;
- section 3.3* – O. Izriadnova, E. Ilukhina;
- section 3.4* – N. Volovik, S. Prikhodko;
- section 3.5* – O. Shik;
- section 4.1* – I. Kolosnitsyn, A. Surinov;
- section 4.2* – L. Karachurina (SU-HSE);
- section 4.3* – E. Kobzar (SU-HSE);
- section 4.4.1* – T. Kliachko;
- section 4.4.2* – S. Shishkin;
- section 4.5* – I. Dezhina;
- section 5.1* – G. Malginov, A. Radygin;
- section 5.2* – M. Kuzyk, Yu. Simachev;
- section 5.3* – E. Apevalova;
- section 5.4* – G. Malginov, G. Sternick  
(G. Plekhanov REA,  
The Russian Realtor Guild);
- section 5.5* – V. Zatsepin, V. Tsymbal;
- section 5.6* – N. Mironova, M. Slavgorodskaya,  
I. Starodubrovskaya;
- section 5.7* – A. Kireeva;
- annex* – I. Tolmacheva;





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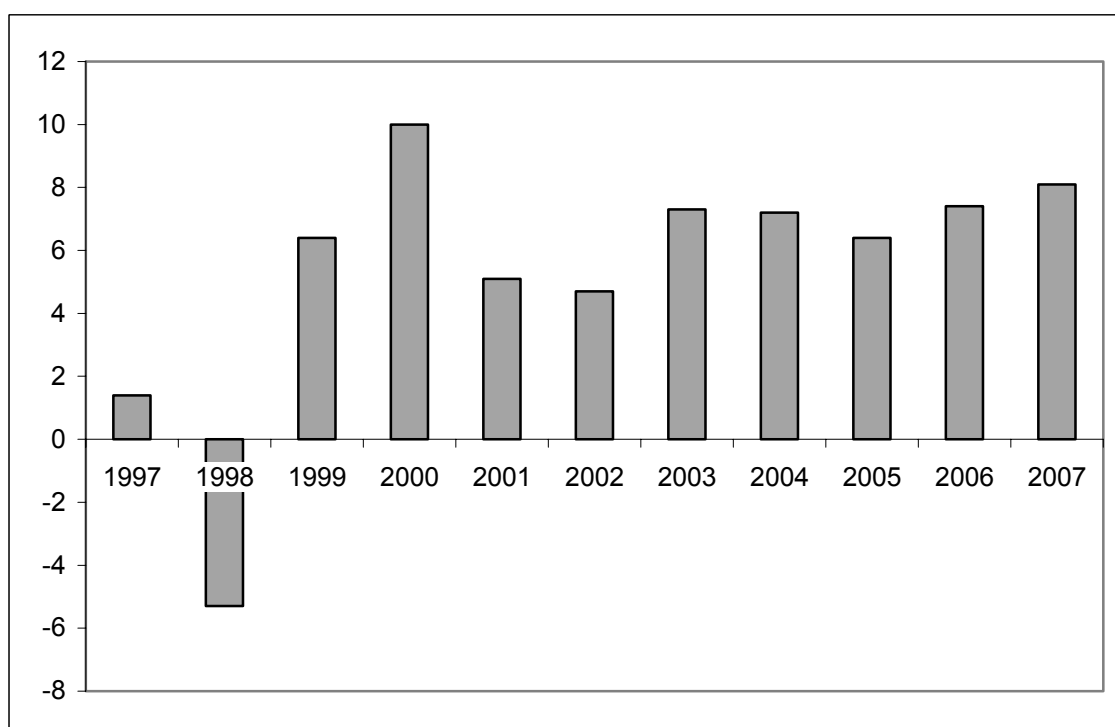
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## Section 1. Socio-Political Context

### 1.1. Global Economic Environment and Russia

Changes in the US economic situation, high recession risk and its growing impact on external economies, prospects for the decline in the global economic growth, its tentative scale and duration are the subjects of lively discussions. In the United States, at the background of the beginning presidential election campaign, the problems associated with the risk of recession have pushed aside all other problems, including such an acute issue as the situation in Iraq. At the 2008 World Economic Forum in Davos the issues of the global economic situation were beyond competition, what is quite understandable. Economic growth volatility is directly dependent not only on the situation in the financial markets, but on the state of the banking system as well, an access to credits, the scale of housing construction, the state of the national budget, the dynamics in social spending, the level of living standards.

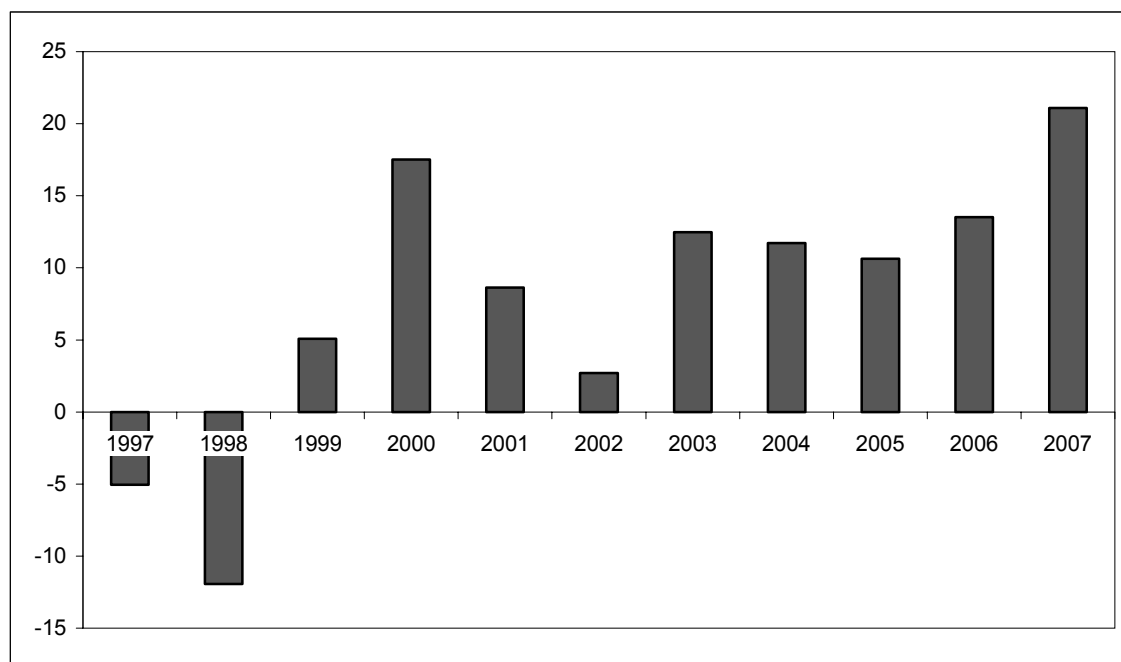
Economic growth in Russia began in 1997, upon recovery from the post-socialist recession, provoked by the collapse of the Soviet economy and global restructuring of the major economic institutions. In 1998, the growth was held on by the sharp deterioration in the world economic environment, capital outflow from emerging markets (including Russia), the decline in oil prices (in real terms) to its lowest level in the past 30 years. Economic growth has been resumed in 1999 and since then it has been sustained for 9 years. The average annual growth rate within that period made 6.9 per cent (see *Fig. 1*).



Source: RF Statistical Service.

*Fig. 1.* GDP Growth Rate in Russia, 1997–2007 (% versus Preceding Year)

Initially the economic growth had a recovery nature. Its main source was the use of production capacities created in the Soviet era. Starting from 2003–2004, the investment nature is getting increasingly expressed. Growth of investments in fixed assets is still sustained at a high level. In 2007, the investments exceeded 20 per cent (see *Fig. 2*).

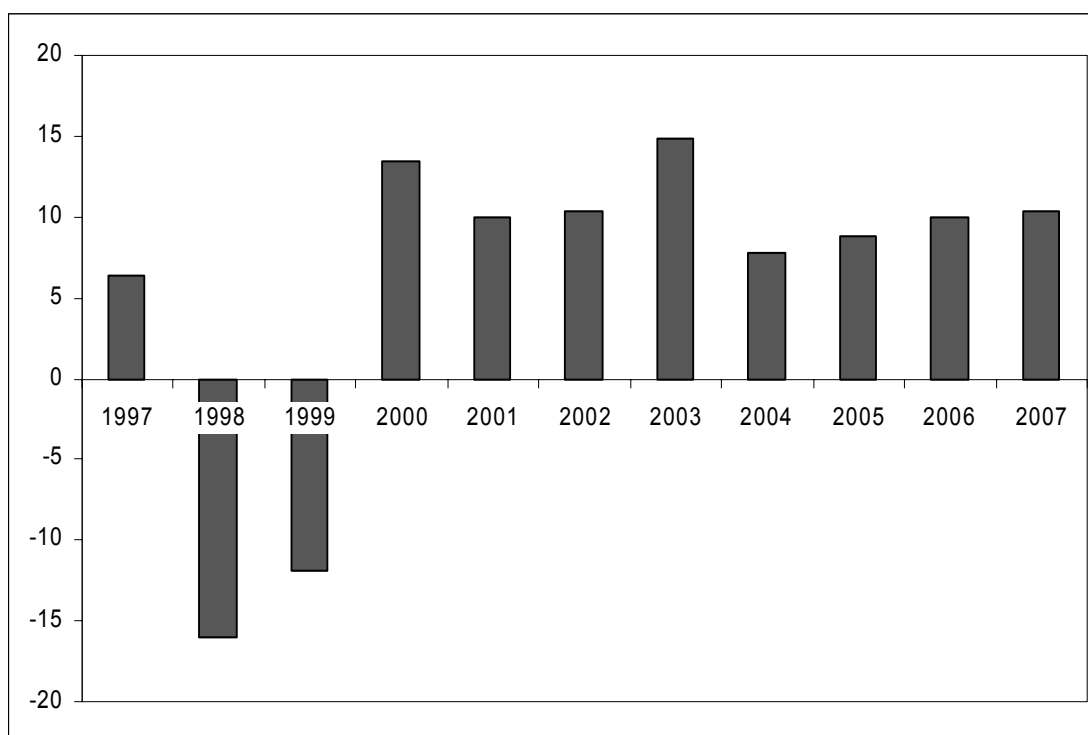


Source: RF State Service.

*Fig. 2.* Growth Rates of Investments in Fixed Assets in 1997–2007  
(% versus preceding year)

At the background of those growth rates of the Russian economy in general and its private sector in particular, the Russian economy, integrated into the system of global markets was using convertible currency since 1992 for current operations and from 2007 for capital transactions. With the stable situation in the financial and monetary system, personal incomes of the population (in real terms) in the recent 8 years have been growing at the rate exceeding 10 per cent per annum (see *Fig. 3*).

Against the background of such expressed dynamics in living standards, those who govern our state, should have made all efforts to be unpopular. Growing income, rather than just manipulation with election campaign and control over mass media is the basis of stability in the Russian political structure in recent years.

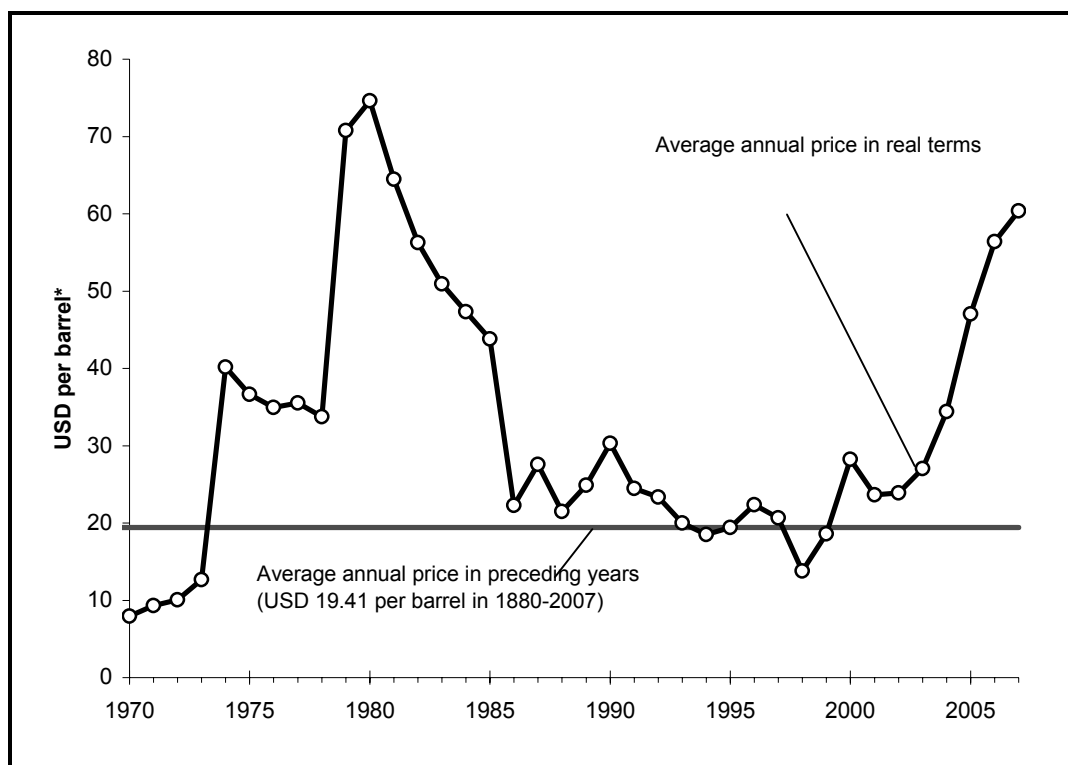


Source: RF Statistic Service.

*Fig. 3. Personal Income Dynamics (in Real Terms) in 1997–2007  
(% versus preceding year)*

One would often hear and read, that the current high rate of economic growth in Russia is based only on favorable situation in the oil market. This market indeed provides a serious impact on the external balance of payments and the budget of Russia. Nevertheless, the beginning of post-communist economic growth in Russia was not based just on positive dynamics in oil sector. In 1997, those prices (in real terms) were within the average indicators of many preceding years, the same applies to 1999, when economic growth has recovered from the crisis. In 2000–2003, prices also were close to the average level of many earlier years (while in 1998 they were even significantly lower). Only in 2004, after 5 years of the Russian economy dynamic development, supported by favorable economic situation, oil prices have approached the level of 1970-s – early 1980-s (see *Fig. 4*).

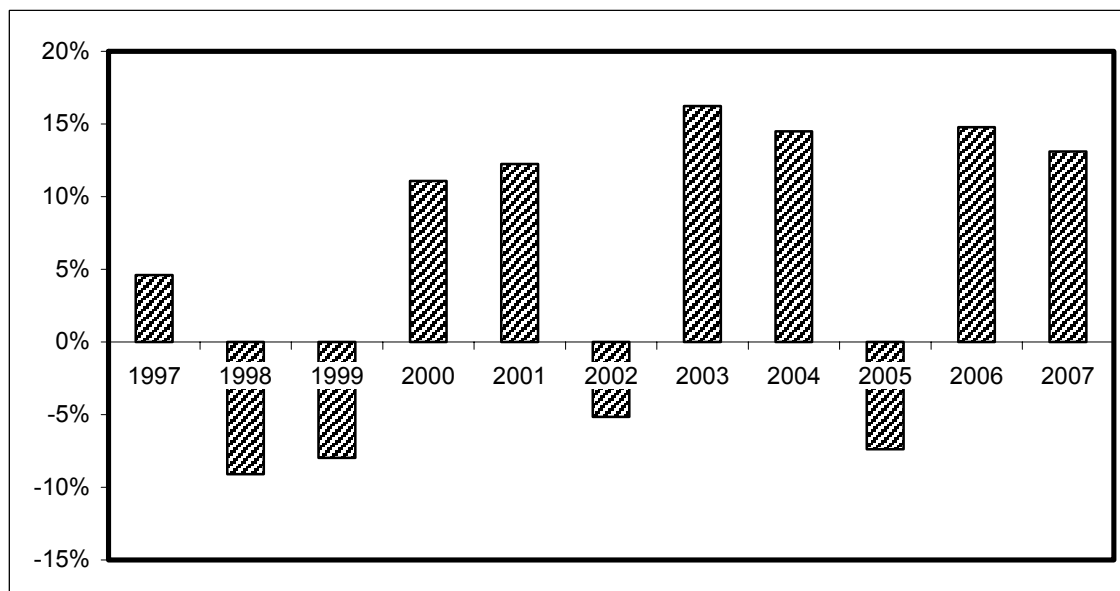
The fastest growing sector of the Russian economy is not oil and gas, but manufacturing of machinery and electrical equipment (average annual growth over the past 8 years is approximately 11 and 15 per cent). Apparently, one can make an assumption, that high oil prices inspire both, high demand for Russian machine-building products and fast dynamics in output extension. However, such an assumption is in contradiction with the indicators of the rapid growth in mechanical engineering exports, where the growth rate in 2006–2007 have reached 15 per cent (see *Fig. 5*).



Note. 2000 Prices.

Source: IMF International financial Statistics; WTRG Economics (<http://wtrg.com>).

Fig. 4. Oil Prices Dynamics in Long-Term Retrospective, 1970–2007

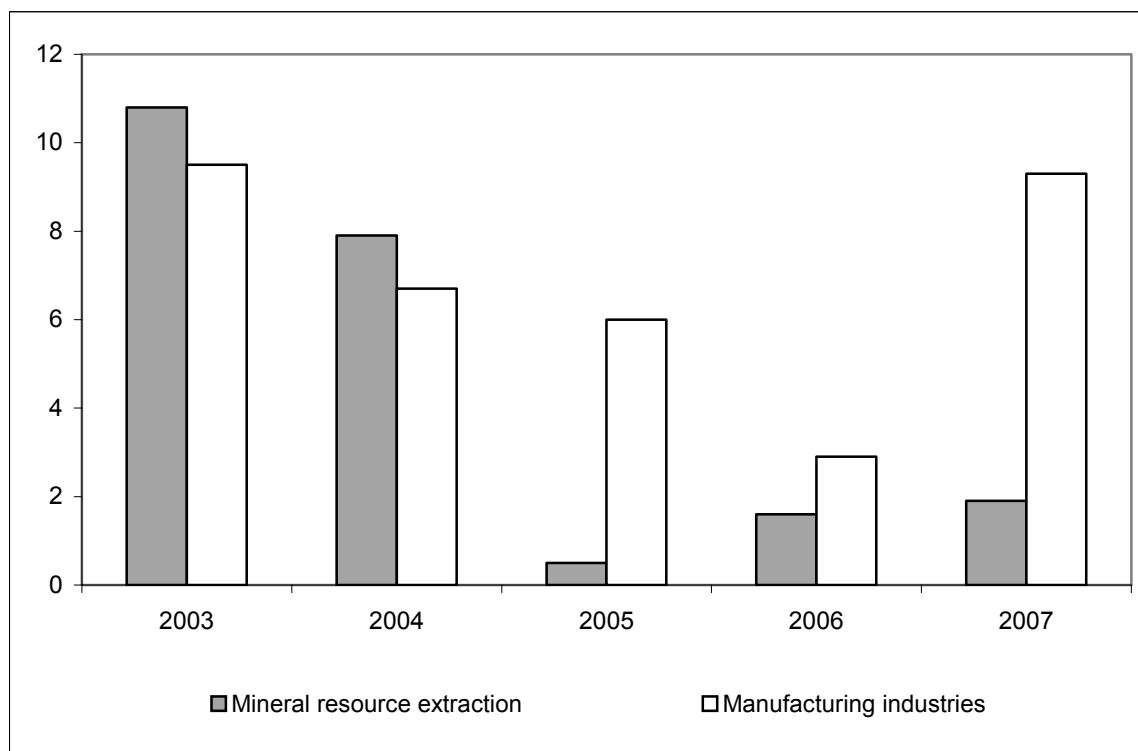


Source: RF Statistic Service, IMF IFS 2007; WDI online, World Bank.

Fig. 5. Dynamics in Machinery and Equipment Exports from Russia (% versus preceding year)



Diversification of the Russian economy, reduction in its dependence on oil and commodity markets is a strategic challenge for our country. Discussing it, it is worth to remember that the process is in progress. In the recent years the growth rates in manufacturing industries are markedly higher than those demonstrated by mineral resource exploration sector (see Fig. 6).



Source: RF Statistic Service.

*Fig. 6. Growth Rates in Resource Exploration and Manufacturing Industries, 2003–2007 (% versus preceding year)*

After 2004 structural reforms in Russia have been slowed down. Developments are not as dynamic as in the years of 2000–2003, when tax reform, the reform of the system of fiscal federalism were implemented, the budget process was transformed, Stabilization Fund was established and a legal basis was provided for land ownership and many other changes were introduced, vital for the stable economic growth. One should not neglect serious positive decisions taken in 2007, namely the distinction between oil and gas proceeds and other budget revenues, formation of Reserve Fund and the Foundation for National Prosperity (on the basis of the Stabilization Fund), positive decisions taken in migration policy.

In early October last year, the country was on the verge of a serious banking crisis, what happened due to developments in the international financial markets. Efficient actions of the Central Bank allowed to avoid that danger. The vast majority of our population simply did not notice, what happened.

In the last year there were developed and adopted certain documents, defining the medium-term (up to 2010) and long-term (up to 2020) prospects for the Russian financial, mone-

tary and general economic policies. There are some deficiencies in those documents, but in general they reflect challenges that Russia may face, and tools of control.

However, having reviewed policy documents, prepared by the Ministry of Finance, Ministry of Economy, the RF Central Bank, one can notice their common feature. They are written as if the cyclic fluctuations in global economic environment do not exist, or their impact on the evolution of the situation in Russia is negligibly insignificant. There are grounds for that. When Russia was establishing the framework for a market economy, it was natural to use the evaluation tools, developed in highly developed countries.

A lot of modern economic research works deal with an analysis of market cycles, influenced by the dynamics in aggregate demand and supply, interest rates, monetary and fiscal policy, foreign currency exchange rates. These issues are highlighted in a vast number of publications. Naturally, there is a tendency to apply the world cycle analysis methods when discussing what is happening in Russia. The results were discouraging.

The consequences and magnitude of changes, associated with the collapse of communist economy, followed by recession and later beginning of recovering growth, are incomparable with those that are typically faced by highly developed market economies at different cycles of their development.

Estimates, built on the basis of models, describing the cyclic fluctuations in the developed market economies, applied to Russia, happened to be dramatically different from reality. By the middle of the last decade, the research works, in which attempts were made to apply cyclic methodology to the analysis of the situation in Russia, went out of fashion. This happened just at the time, when Russia entered the phase of investment growth, and the world economic environment has become a critical factor to be taken into regard in the Russian economic policy.

American economy was the core engine in the global economic environment of recent decades. There were periods of slow-down in the world economic development, whereas the growth rates were sustained in the USA economic development. That happened in 1997–1998, in the background of financial crisis in Southeast Asia, further spread to the countries of CIS and Latin America. However, this is an exception from the regular case. The US share in the global economy, irrespective of the way of measurement (either by purchasing power parity, or by current exchange rates), amounts to 20–25 per cent. Capitalization of the American market makes about 40 per cent in the global capitalization.

The slowdown in the American economy provided a major impact on the development of the economic situation in the world for decades. Since 1950, the U.S. economy was in a state of recession in 1954, 1958, 1970, 1974–1975, 1980–1982, 1990–1991 and 2001. As a rule, the time between recession cycles in the United States made from 5 to 10 years.

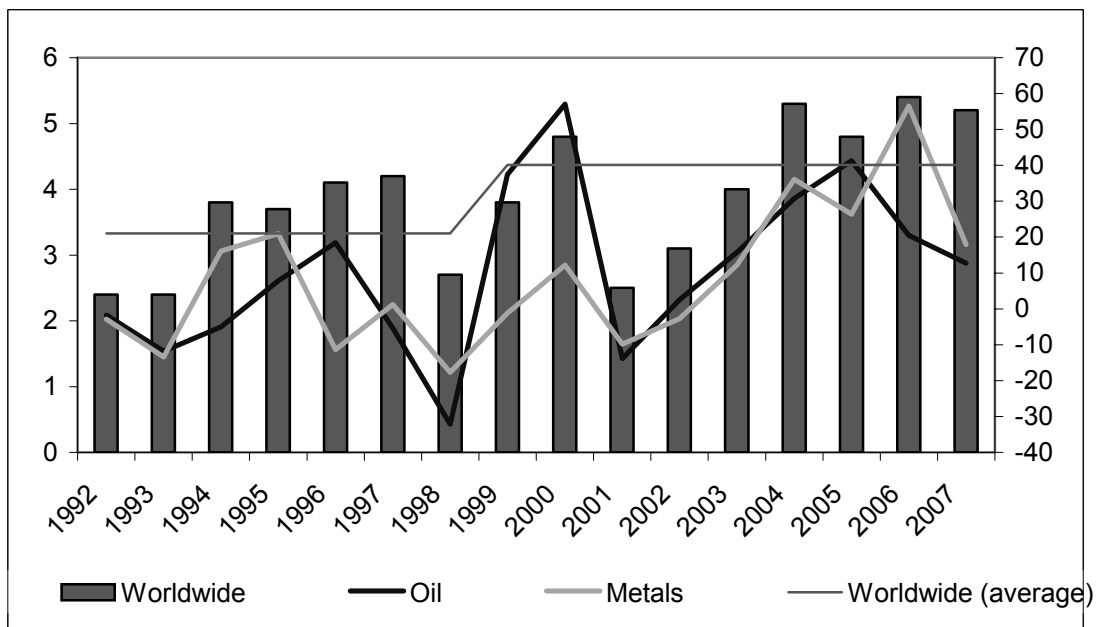
Since the beginning of 1980-s, the typical signs of deceleration in the world economic growth, closely associated with recession in the United States, have changed. Volatility in economic growth rates and the difference between the highest peak values and the lowest rates were reduced. Herewith, the problems, arising in one of the largest global economies, are quickly spread worldwide. There observed a greater dependence of economic growth on international capital flows. While twenty years ago, the share of deficit in the global GDP was 2–2.5 per cent, today it amounts to 5.5–6 per cent (according to IMF estimates).

At first glance, the reaction of financial markets to the recession in the United States looks inconsistent. The recession is provoked by adverse changes in the American economy.

Based on common sense, one would assume that in such a situation the capital should be withdrawn from the country. In fact, an adverse situation is observed. In the background of recession in the United States, the US investors prefer reliability and liquidity, rather than high returns on their assets.

Financial markets are reacting to the downfall in the American economy by a growing capital inflow in the US Treasury securities. The last global recession (in 2001) has confirmed this consistent pattern. Economic growth volatility affect the situation in the markets of the major export products to Russia: oil and oil products, gas and metals. In 1998, the economic growth in the world have fallen down by 1.4 per cent, the extent of the downfall in prices for metals were measured by two-digit numbers.

The same was happening in 2001, when mild recession in the United States, the collapse of the world GDP by 2.3 per cent, the shift from growth in oil prices by 60 per cent per annum was replaced by their decline over 10 per cent. A similar situation takes place during recession in the metals market (see Fig. 7).



Source: IMF World Economic Outlook, 2007.

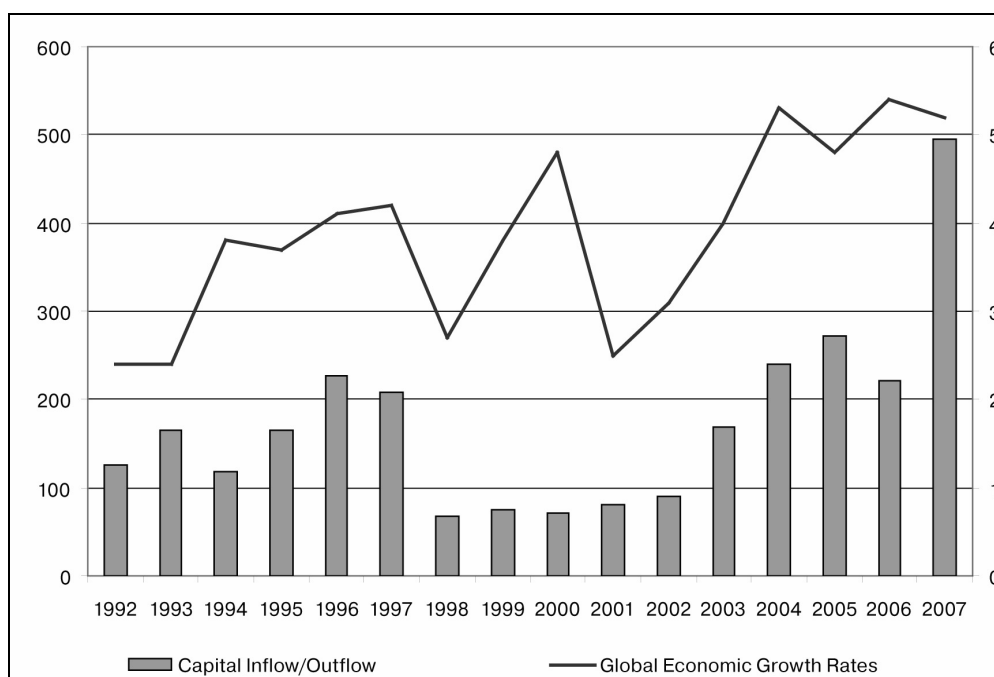
*Fig. 7. Global GDP Growth Rates (Left Scale), Dynamics in Oil and Metals Prices (Right Scale) in 1992–2008 (% versus preceding year)*

Another attribute of a recession period is the change in the financial market situation. The utmost dynamics is observed in portfolio investments. In regard to capital flows in general, the impact of cyclic changes is weaker.

This is explained by the inertia in the process of adoption and implementation of investment decisions in real sector. In the 1998–2002, in the background of two periods of significant slowdown in global economic growth, capital inflows to emerging markets has been declined almost twice as compared with the period of favourable economic conditions (1995–1996 and 2004–2007) (see Fig. 8).

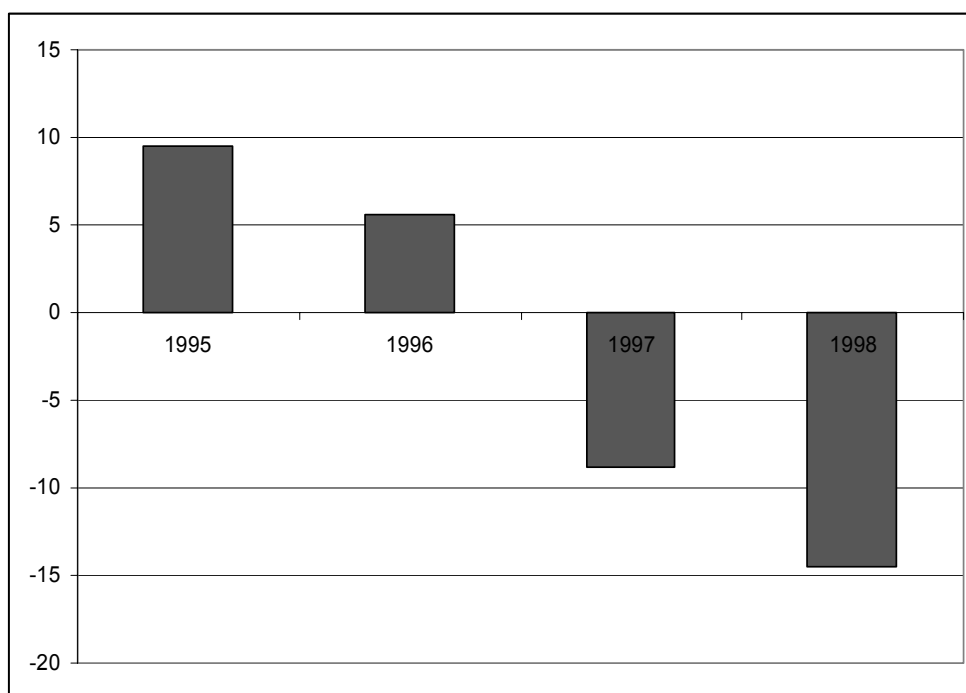
## RUSSIAN ECONOMY IN 2006

trends and outlooks



Source: IMF World Economic Outlook, 2007.

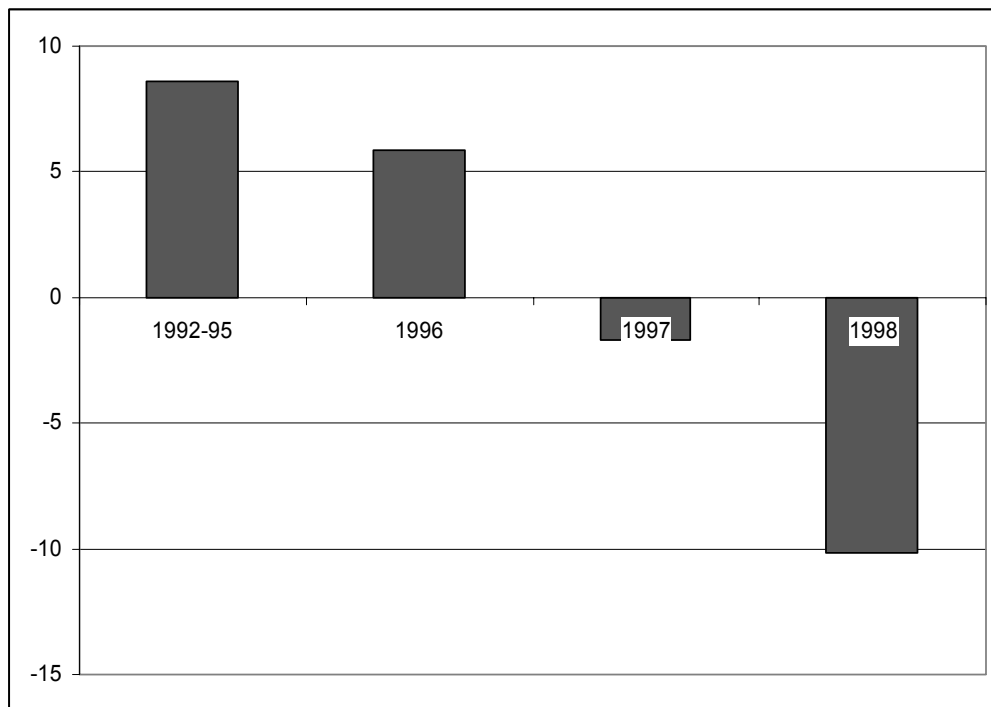
*Fig. 8. Capital Inflow/Outflow in the Emerging Markets, USD bln and Global Economic Growth Rates (Right Scale), % in 1992–2007*



Source: World Bank data, IMF estimates; Berg, A. The Asia Crisis: Causes, Policy Responses, and Outcomes. IMF Working Paper, 1999.

*Fig. 9. Balance of Capital Operations in Thailand Prior and During the Asian Financial Crisis (% in GDP)*

The impact of capital outflow from the national economies can be far more powerful than the worldwide impact. In 1996, Thailand was fairly regarded as one of the most dynamically developing countries. Nobody expected the dramatic changes in the capital flow in a short while, that could be measurable with one forth of national GDP (see *Fig. 9*). As a result, the national policy has been drastically changed. Thailand, the government of which was used to the dynamic economic growth in the first part of 1990, had to get adapted to an explicit reduction in economic activities (See *Fig. 10*).



Source: IMF.

*Fig. 10.* GDP Growth Rates in Thailand, 1992–1998 (% versus preceding year)

The impact the situation in the US on the global economic environment is provided basically by ways. The first one is foreign trade. The recession in the American economy limits the opportunities for exports to America. The second way is the state of the world financial markets. The events that happen in the American stock markets, affect the investors' actions. Therefore, the financial, banking system and economic situation are dependent on the dynamics in the stock market.

There are ongoing worldwide debates on the prospects of recession in the American economy in 2008, and there is no unanimity in this issue. However, it is not so important to regard the recession in the United States in 2008–2009 from the technical point of view, than to highlight that the growth of American economy will be significantly downgraded as compared with the average indicators of 2004–2007. There is no disputes on this point, the question is how long will be the period of low growth rates in economy and what is the extent of that decline.

In the first weeks of January 2008 the number of experts, convinced that the United States economy in the current year will be in a state of recession has grown under the impact

of information on the scale of unemployment in the United States, published in January. As of late December 2007, the share of the unemployed has grown by about 0.6 per cent as compared with the end of March of the same year (according to Bureau of Labor Statistics).

The growing risk of recession is also confirmed by the data on the low volume of pre-holiday sales and further deterioration in housing market. The scale of new construction projects has been reduced by 25 per cent against the preceding year, which is the lowest level within the past 26 years. The top American banks have announced about the write-off USD tens of billions as bad loans.

In October the IMF has reduced the 2008 estimates of the global GDP by 0.4 per cent (from 5.2 to 4.8 per cent). On January 25, the Fund assumed to publish revised forecasts. Publication had to be postponed. The situation was so dynamic that the respectable organization decided not to risk its reputation.

Among other things, Economist magazine is popular for using amusing, but well-functioning indices, such as “Big Mac” indicator, i.e., the price of a hamburger in various countries as an indicator of a certain living standard.

For decades Economist is using a special index for analyzing the recession process by the number of daily references to the word “recession” in “Washington Post” and “New York Times”. Analysis of that index dynamics enabled to predict the recessions in 1980–1982, 1990–1991 and 2001. When that indicator begins to grow rapidly, it means there is a growing probability of recession in the United States. Now its value is at the highest level ever since 2001.

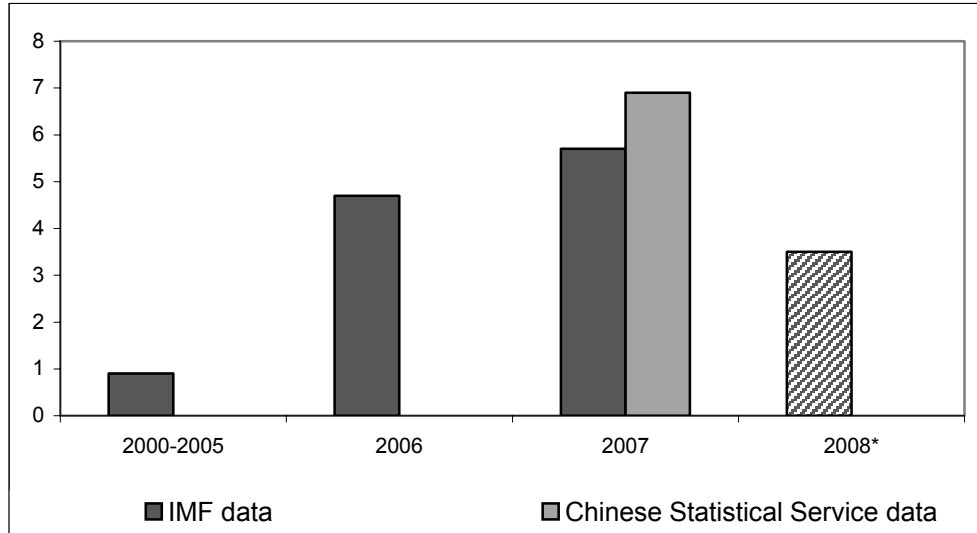
There is no reason to think that the difficulties in the American economy would only be short-term. Recession of 2001 was moderate and short, but the period of slow growth rates in the American economy were sustained till 2001–2003. Only at the end of 2003, the FRS decided to raise the interest rate from unusually low level (1 per cent). The fundamental problem with the current situation in the United States is that the crisis had affected the banking system. Experience has proved that when the banking system gets affected with recession, at least 2–3 years are required to restore the dynamic economic growth.

Moreover, the current situation in the U.S. mortgage market reminds the problematic situation, that occurred in the economy of Japan after the collapse of the domestic real estate market (in 1989). Japan, which used to be one of the leaders in the world economy, has entered a long period of low or negative growth rates.

Many observers hope the *emerging markets*, especially such dynamically growing as China, India – will benefit to sustainability of the global economic growth, even in the face of worsening economic conditions in the United States.

I am afraid, this assessment of the situation is inaccurate, as it does not take into account the impact of the US developments on the Chinese economy. The economic growth of China is largely based on growing exports. However, the 1-per cent decline in GDP growth rates in the United States leads to the decline in the volume of Chinese exports by 4per cent and to a slowdown in the growth of China's economy by 0.5 per cent. Moreover, the Chinese economy is overheated – at least according to the assessment, made by the Chinese government. Economic growth rates in 2000–2005 were estimated at 9–10 per cent, whereas in 2007 they have exceeded 11 per cent. This happened in the background of drastic upsurge of inflation rates. In 2007 (IV quarter of 2007 as compared with the IV quarter of 2006) the annual inflation rate came close to 7 per cent (against 7 per cent annual average rate in 2000–2005). This has be-

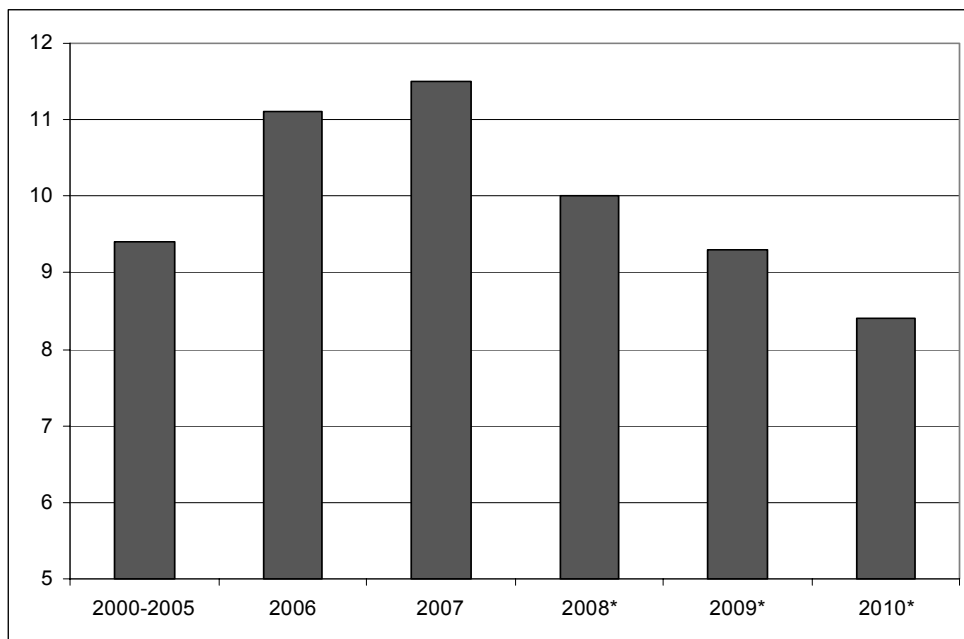
come a serious social and political issue. The Chinese leadership realises that disinflation in the economy is the highest priority and it's necessary to tighten monetary policy, even at the expense of reduced rate of economic growth (see *Figs. 11, 12*).



\* - Estimates.

Source: IMF, Chinese Statistical Service.

*Fig. 11. Consumer Price Index Growth Rates in China in 2000–2008 (% against preceding year)*



\* - Estimates.

Source: IMF.

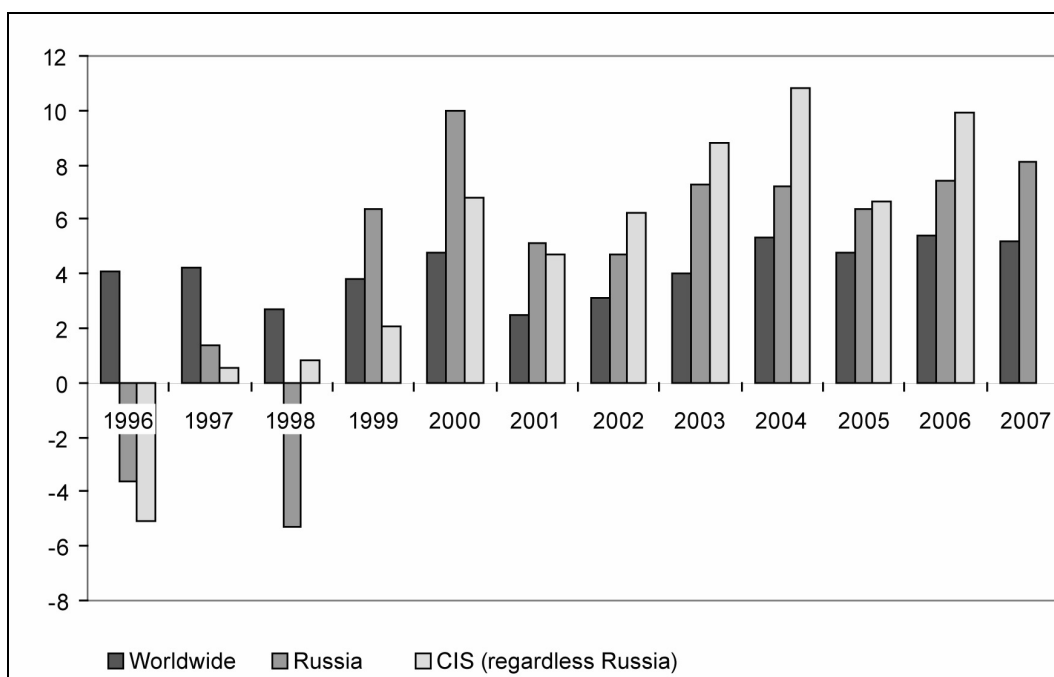
*Fig. 12. GDP Growth Rates in China in 2000–2010 (% against preceding year)*

In recent years the USA and China were making the greatest contribution to sustained high economic growth rates in the world due to the vast scale of the US economy and highest development rate in China. When a decline happens in their economies, it has to be taken into regard worldwide.

The situation is far from favorable in other major world economies as well. In January the question was widely debated, whether Japan will be found in the state of recession in 2008. In the EU countries the opportunity to continue the economic growth at the rate, exceeding 3 per cent, observed in 2006–2007, was restrained by strengthening of EURO against USD (which hinders exports from the EU zone) and high inflation (by European standards), not allowing to reduce the base interest rate and accelerate economic growth. India depends on the global economic situation to a lesser extent than China and the EU. Anyway, a decline in economic growth is expected according to tentative assessments (by 1 per cent in 2008 as compared with 2006).

The Russian economy depends on the global economic situation to a greater extent than the economies of other CIS countries (see *Fig. 13*). When in 1997–1998 the country was facing a crisis in emerging markets, which began in 1997, the economic growth has been replaced with a downfall. In 2001, the American economy was in the state of recession, which has provided a strong impact over the Russian economy: in 2001 GDP growth rate has dropped down by 4.9 p.p. against 2000 level, and in 2005 such decline exceeded 5 p.p.

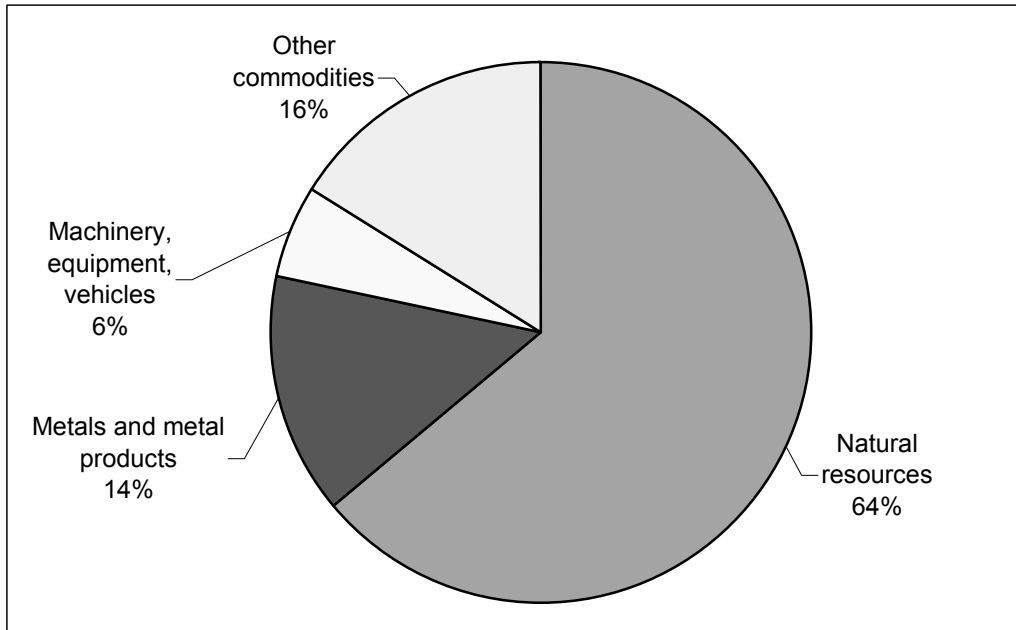
It is not difficult to understand, why the global market volatility affects Russia stronger than the rest of the world. 80 per cent of our country exports consists of oil, oil products, natural gas and metals (see *Fig. 14*). Prices of those commodities are sensitive to the changes in the growth rate in the global economic environment (see *Fig. 4*).



Source: Russian Statistical Service, IMF World Economic Outlook, 2007.

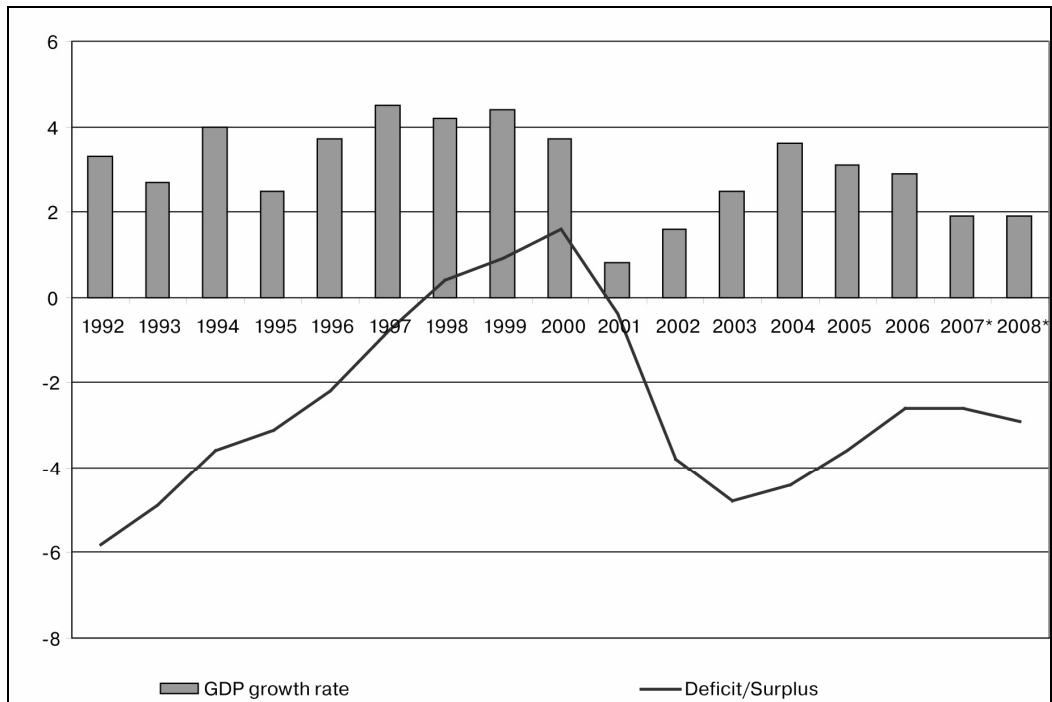
*Fig. 13.* GDP Growth Rates: Worldwide, in Russia and in CIS (regardless Russia) in 1996–2007 (% against preceding year)





Source: Russian Federal Customs Service.

Fig. 14. RF Exports Structure in 2007, %



\* - Tentative assessment/estimates.

Source: IMF World Economic Outlook, 2007.

Fig. 15. GDP Dynamics in % Versus Preceding Period, Deficit/Surplus of the US Extended Government Budget, % in GDP, 1992-2008

Apparently, there is a possibility for the decline in the global economic growth in 2008–2010. The period of an extraordinary high growth rates of 2004–2007, similar to the rate, observed in late 1960s – early 1970s, is completed. One has to admit it and develop a relevant economic policy for Russia with due regard to that fact.

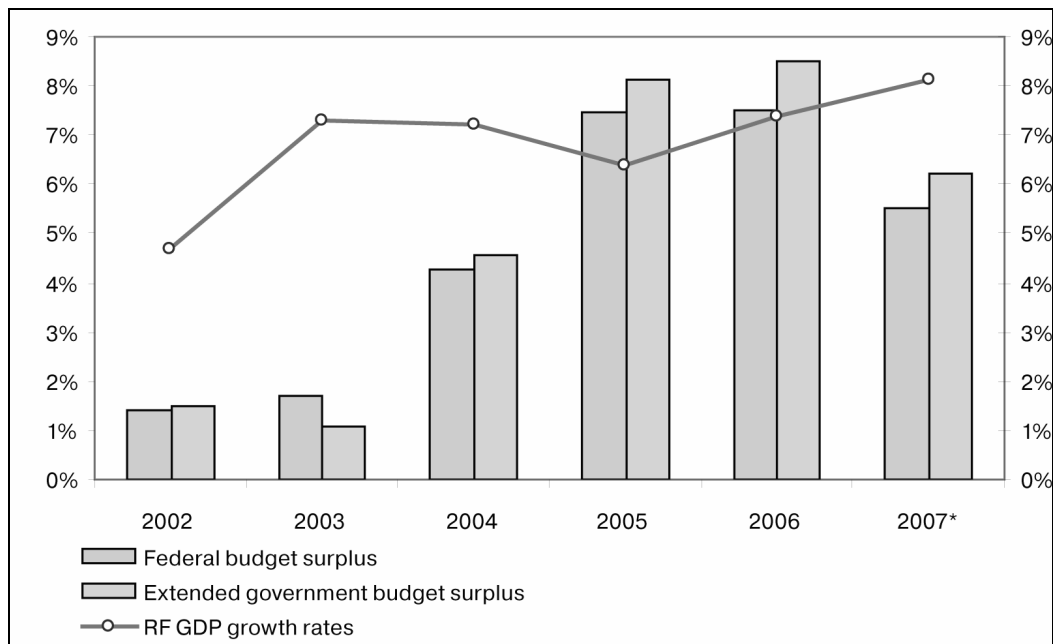
In this relation, it is useful to review, how the American government, responsible for guiding the world largest economy, was resolving the problems, caused by the market volatility, in the preceding 15 years.

The chart (see *Fig. 15*) reflects the approaches to budget policy of the USA, pursued by two governments, headed by Presidents B. Clinton and J. Bush. At the time, when the government has been headed by B. Clinton, the favourable economic conditions and high growth rates were used for the rapid improvement of the budget balance. This allowed to cool the economy and form a reserve for sustainable budget process for the future. The fiscal balance between 1992 and 2000 has been strengthened by nearly 8 per cent. When upon the collapse of the NASDAQ system, aggravated by the events of September 9, 2001, America has entered a recession phase, the government, headed by that time by J. Bush had wide opportunities for a maneuver. In the background of the reduced base rate by FRS to 1 per cent, the budget balance was declined by more than 6 per cent. This enabled to withdraw the US economy from the period of low economic growth and form the the basis for sustainable development in 2004–2007.

Nevertheless, even with relatively high growth rates the general scale of budget balance strengthening was modest (about 2 per cent of GDP). Currently it is disputed, what is the best budget policy in this case (a package of fiscal policy measures, aimed at economic growth promotion through lower taxes and /or increased public expenditures). At some point the amount of USD 100 billion was mentioned (or less than 1 per cent of GDP), revised later to USD 150 billion (just over 1 per cent of GDP). Those figures were not really impressive. However, the government does not have the capacity, available in 2001, which could help to suppress the recession with mitigated fiscal policy; the state of public finances is far from perfect. B. Clinton policy was counter-cyclic in general terms, whereas President J. Bush was pursuing the procyclic policy.

In the period of 2000–2005 the Russian financial policy was built on B. Clinton scenario. In the favorable situation the government was quickly improving the budget balance, accumulating financial reserves, what permitted to get adapted to the volatility of out major markets. In 2006, the fiscal policy was neutral, the country ceased to extend the budget surplus. In 2007, in a favorable situation, the federal budget expenditures were rapidly growing, what accelerated the economic growth at the expense of reduced budget balance. Fiscal policy has become explicitly procyclic. All that was happening in the background of obvious signs of the economy overheating (see *Fig. 16, 17*).

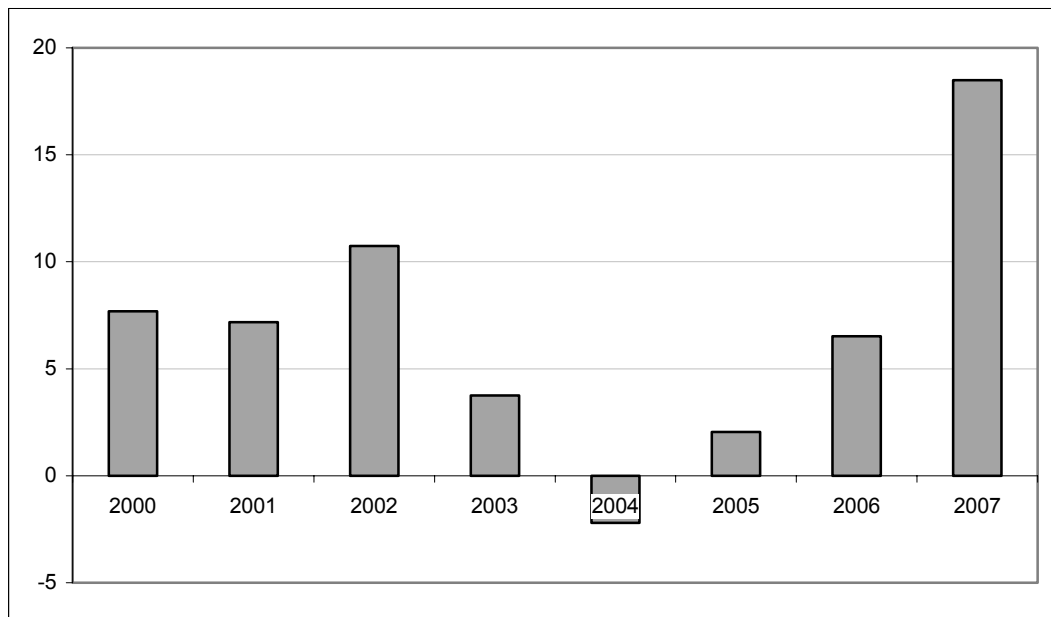
Throughout 2000–2006, inflation rate was either getting declined, or was not growing in our country. In 2007, in the background of dynamic growth of budget expenditures and reduced budget balance, inflation rates were accelerated (see *Fig. 18*).



\* - tentative assessments.

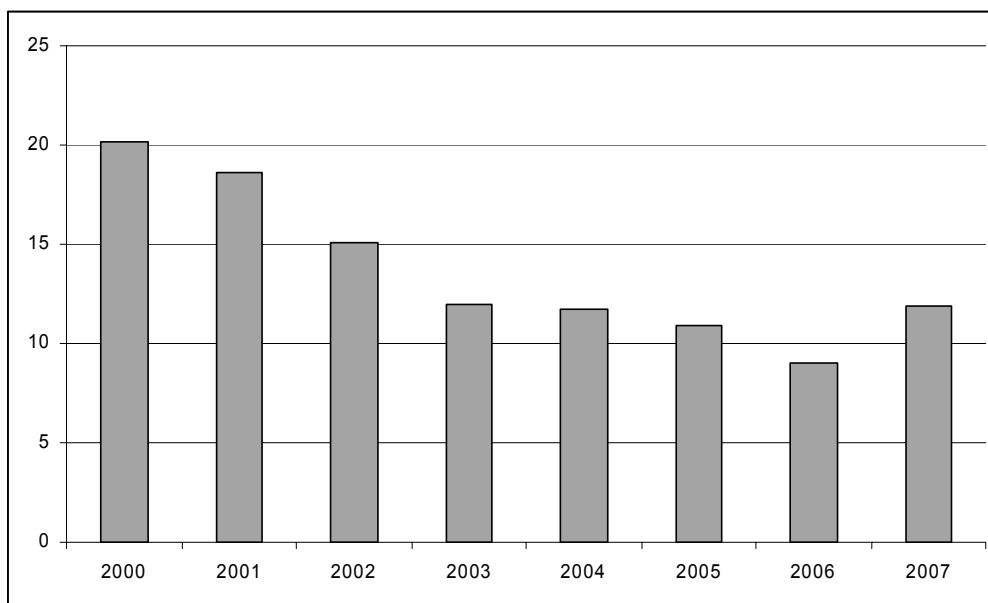
Source: RF Ministry of Finance, Russian Statistical Service.

Fig. 16. Execution of the RF Extended Government Budget (left scale) and RF GDP Growth Rates (right scale) in 2002–2007



Source: RF Ministry of Finance, Russian Statistical Service estimates.

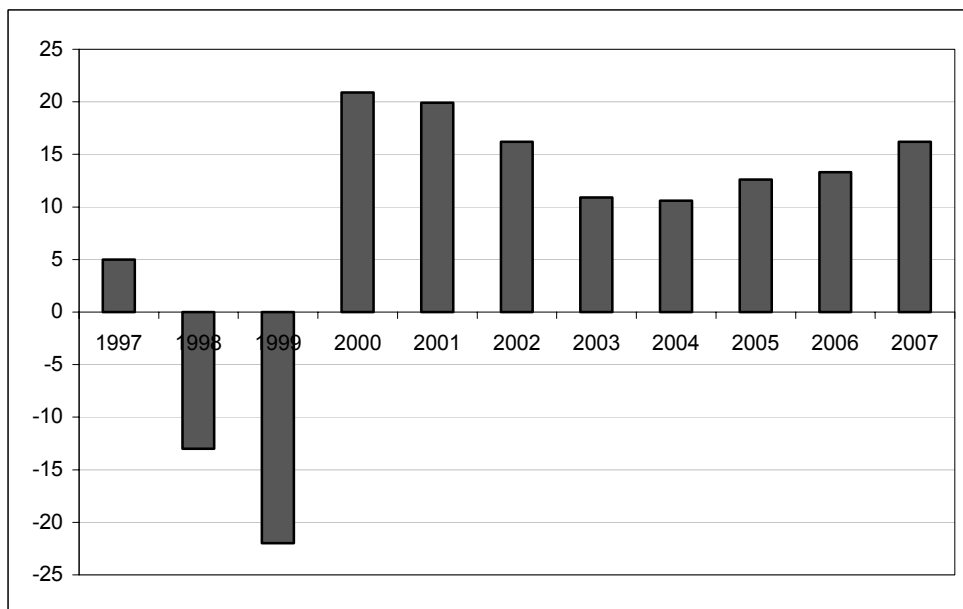
Fig. 17. Growth Rate of the RF Extended Government Budget Expenditures (in Real Terms) in 2000–2007



Source: Russian Statistical Service estimates.

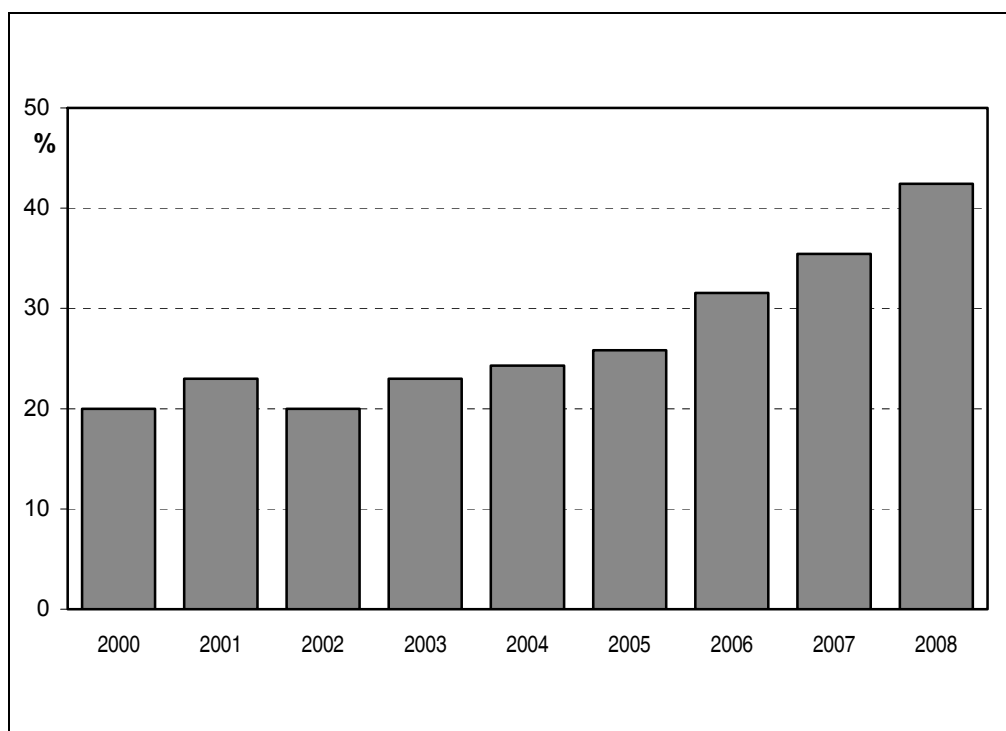
*Fig. 18. Consumer Price Index in Russia in 2000–2007, %*

This is not the only indicator of overheating in the economy. Since 2004, a high rate of wages growth (in real terms) was noted in the country. In 2007, its growth accelerated to 15 per cent (see *Fig. 19*). According to the surveys, conducted by IET for many years, an increasing number of business leaders are complaining that labor shortage is the major factor, working against the production growth (see *Fig. 20*).



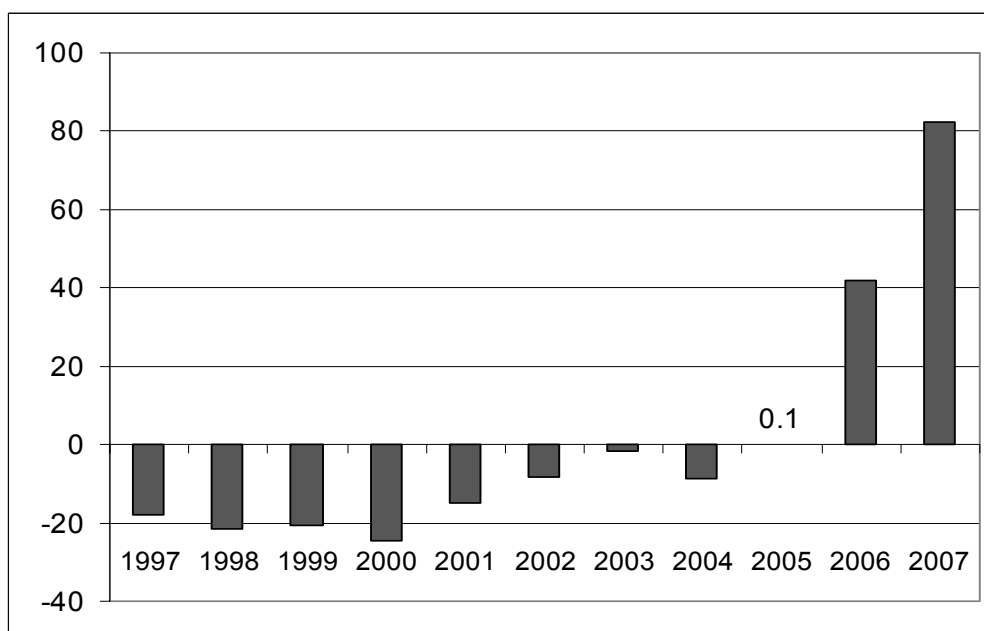
Source: Russian Statistical Service.

*Fig. 19. Wages Growth Rates in Real Terms in 1997–2007 (% against preceding year)*



Note: tentative assessment for the I Quarter 2008.  
Source: IET surveys data.

Fig. 20. Share of Businesses in the Russian Industry, where Output Growth is Hindered by Labor Shortage (average annual indicators)

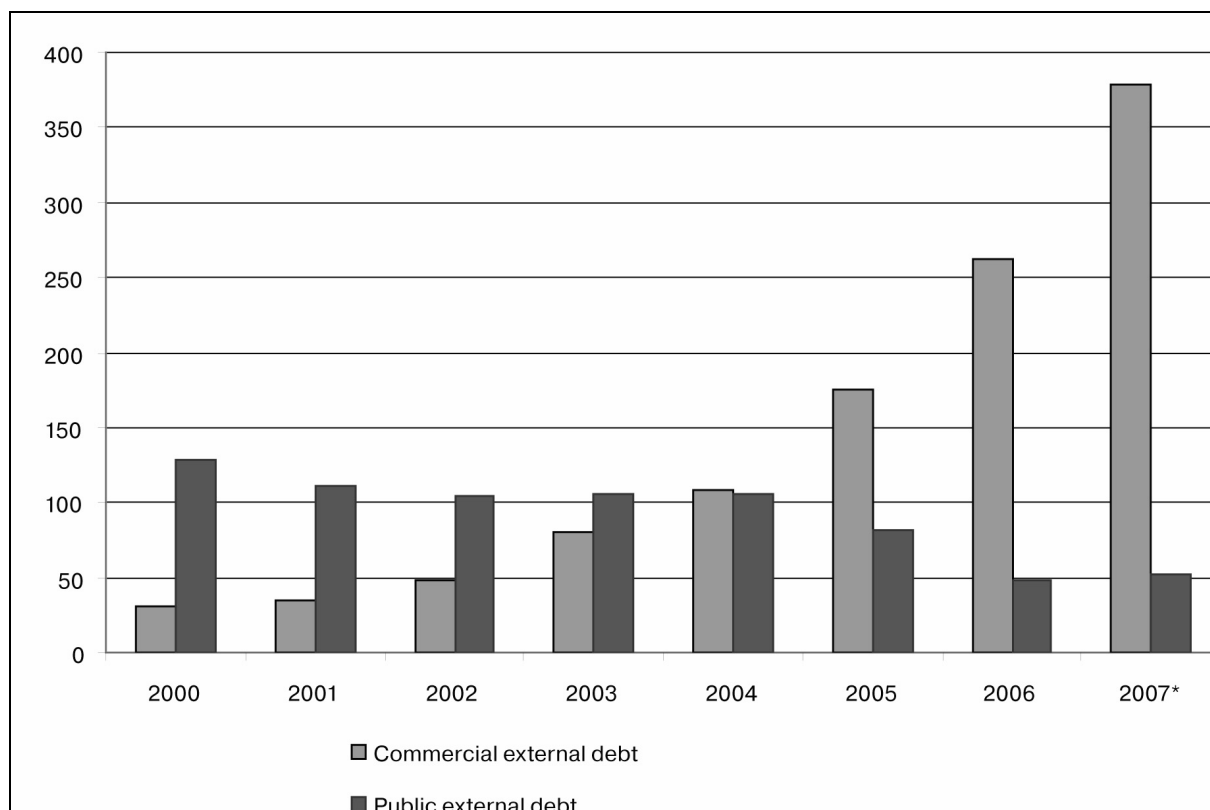


Note: below zero level – capital outflow, above zero – inflow.  
Source: RF Central Bank.

Fig. 21. Net Private Capital Inflow/Outflow in Russia within 1997–2007, USD bln

As is often the case in the face of overheated economy, an accelerated capital inflow to the country started in Russia (*Fig. 21*). In 2007, the external capital, brought in our country, has exceeded USD 80 billion. No one can guarantee, that in case of deterioration in the global financial situation we will be able to refinance the grown commercial loans through new borrowings.

Measures, taken within 2000–2007 assisted to reduce the public external debt. Here-with, external commercial debt was growing at a high rate (see *Fig. 22*).

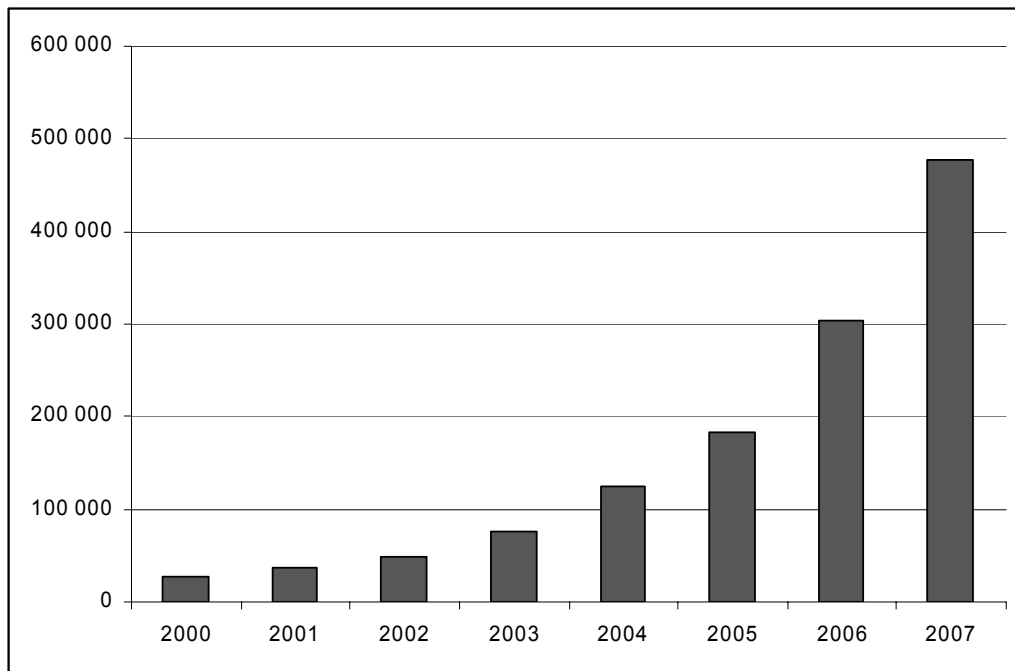


\* - III Quarter indicators.

Source: RF Central Bank.

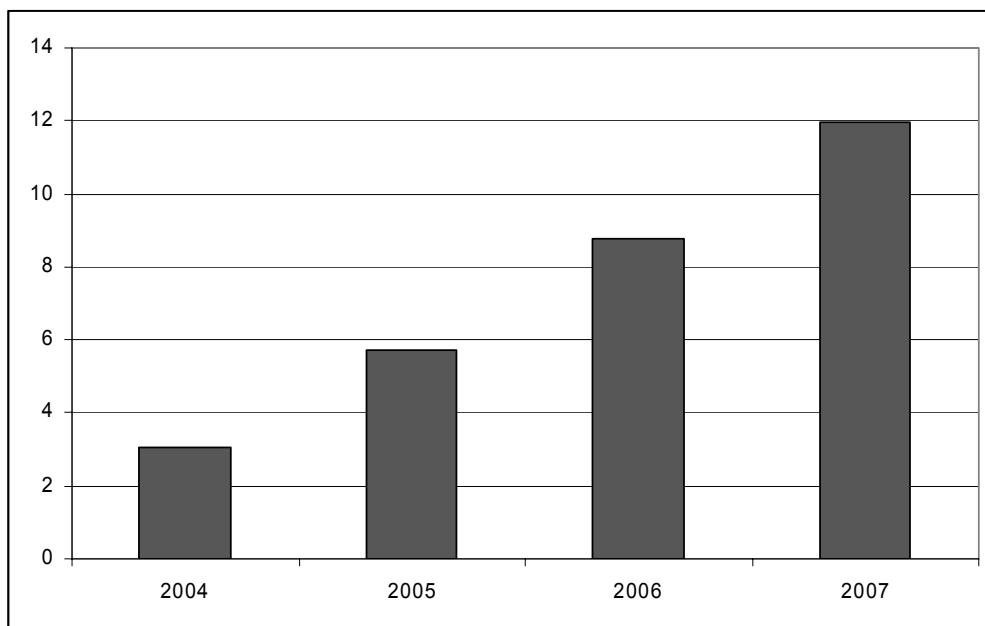
*Fig. 22.* RF External Debt within 2000–2007, USD bln

Our country is well prepared for the period of unfavorable economic situation. Unlike actions, taken by the former Soviet Union, when oil prices were extremely high, modern Russia has accumulated some reserves to mitigate the impact of adverse changes in the global economic environment: golden and foreign currency reserves, the Stabilization Fund (see *Figs. 23, 24*). In the short term the recession in the United States will not become a disaster to Russia. Applying reasonable and consistent economic policy, the government will be able to cope with difficulties.



Source: RF Central Bank.

Fig. 23. RF Gold and Foreign Currency Reserves as of Year End, USD bln



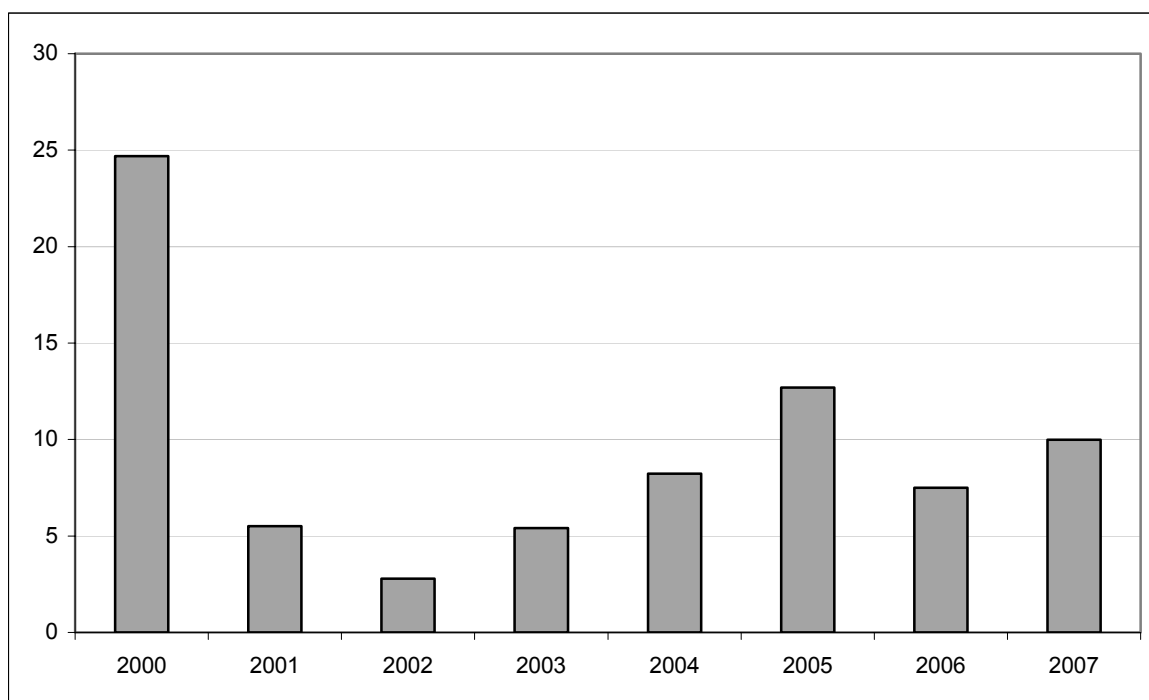
Source: RF Ministry of Finance, Russian Statistical Service.

Fig. 24. RF Stabilization Fund, 2004–2007, December 31 of Relevant Year (% of GDP)

However, there is no guarantee that the policy will be reasonable and consistent. In the last 8 years budget revenues were rapidly growing in Russia (see Fig. 25). This was happening due to the started economic growth, the successful tax reform, implemented in 2000–

2002, the improved situation in the oil market (since 2004). The growth rate of revenues reached an extremely high level.

Periods of robust growth in budget revenues happened in other countries as well. For example, the growth rates of revenues (in real terms) in France in 1950–1980-s were much higher as compared with whatever known about public finance. In such a situation, one might get an impression that the State is almighty and can afford everything. In such periods extensive and costly projects are initiated, involving the country in substantial financial obligations for decades.



Source: RF Ministry of Finance, Russian Statistical Service.

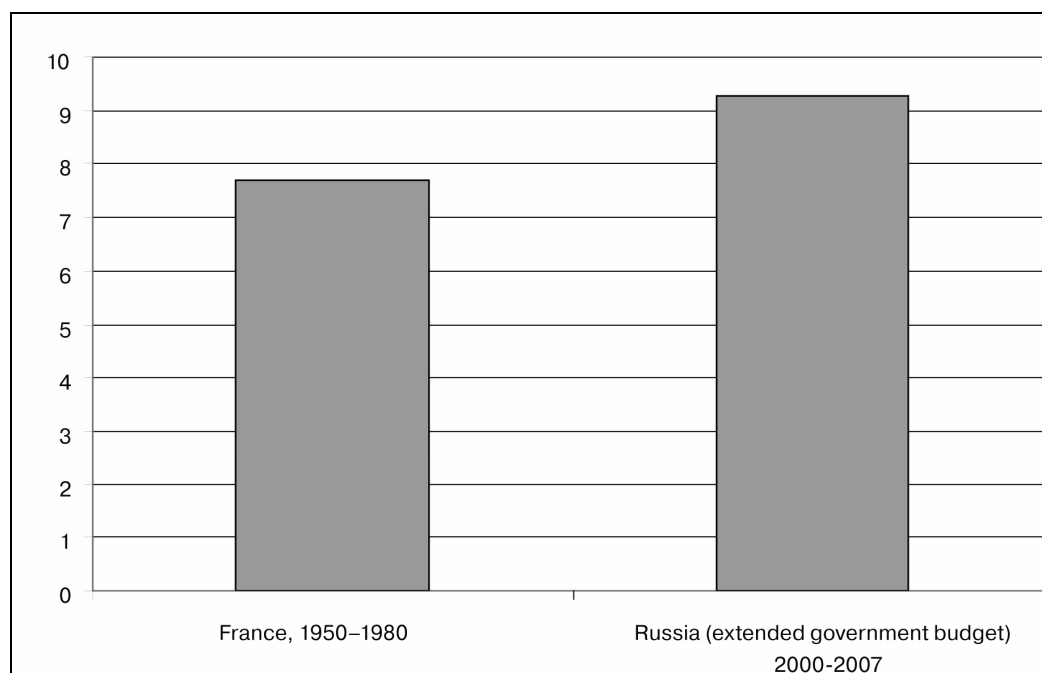
*Fig. 25. Growth Rate of the RF Extended Government Budget Revenues (in Real Terms) in 2000–2007*

In Russia the rate of budget revenues growth in real terms is much higher today than in 1950s – 1970s in France (see *Fig. 26*). At such periods, the government authorities can afford to avoid troubles about expenses. In this background, the decisions on tax rates reduction and on supplementary budgetary donations are taken easily. Thus, in Mexico, in late 1970s – early 1980s, when major oil fields were discovered, whereas world oil prices have jumped up, the primary challenge of the government, according to the words of Lopez Portillo, the Mexican President at that time, was management of the welfare growth. This is a pleasant work. Unfortunately, it does not prepare for the challenges of crisis management.

National reserves, available in our country, make it possible to go through the period of downgrading in the global economy, in case global errors are avoided. Reduced growth rate from 7 per cent to 3 per cent of GDP is not a disaster. This is just a trouble, and it happened more than once before. The American economy, the largest in the world, dynamically developing for more than 200 years, regularly demonstrates negative rates of economic develop-



ment in every 5–10 years. This is uncomfortable to both, the community and the government, but there is an understanding that this happens sometimes. For the Russian society, with its short experience of living in the market economy, a decline in economic growth, similar to the one that occurred in 2001–2002, might become a serious injury.



Source: France – IMF IFS 2006, p. 121; Russia – IET estimates.

*Fig. 26. Average Annual Growth Rates of Budget Revenues, %*

Moreover, the situation is aggravated by the changes in political environment due to the presidential elections. In public opinion, the notions “after” and “as a result of” are often understood as synonyms. In case of unfortunate developments in the global economy, the slowdown in economic growth in Russia can provoke an illusion in the society, that it is directly connected with the replacement of the country leader. In such a situation, one can make a lot of mistakes. For instance, further mitigate fiscal and monetary policy, make an attempt to sustain earlier growth rates through spending gold and foreign currency reserves for keeping up RUR nominal exchange rate, neglecting unfavorable situation in global economy. The price to be paid for those errors will be very high. Unfortunately, that price should be paid not only by those individuals who commit the mistakes, but nationwide.

## **1.2. Economic Policy in 2007: Successes and Risks**

### **1.2.1. Achievements and Problems**

The economic and political results of 2007 are rather controversial. The evident successes displayed by economic dynamics were accompanied by alarming trends of growing populism. The current stability of economic and political life is fraught with risks of self-delusion and eminent destabilization. Presently there is a need for a serious analysis of achievements and opportunities, difficulties and risks of further development.

The achievements of last year were reflected in the positive dynamics of several basic socio-economic indices (*Table 1*).

*Table 1*

**Main Macroeconomic Indices of Russia's Socio-Economic Development**

	1999	2000	2001	2002	2003	2004	2005	2006	2007
1	2	3	4	5	6	7	8	9	10
<b>GDP</b> ( <i>billion rubles</i> )	4,823	7,306	8,944	10,831	13,243	17,048	21,620	26,781	32,988.60
<b>GDP</b> (as percentage of previous year)	106.4	110.0	105.1	104.7	107.3	107.2	106.4	107.4	108.1
<b>GDP per capita – nominal</b> (in <i>USD</i> )	1,328	1,768	2,096	2,379	2,975	4,104	5,325	6,897	8,612
<b>Index of industrial growth</b> (as percentage of previous year)				103.1	108.9	108.3	104.0	103.9	106.3
<b>Agricultural product of farms of all categories</b> (as percentage of previous year)	104.1	107.7	107.5	101.5	101.3	103.0	102.4	102.8	103.3
<b>Investments in fixed assets</b>									
<i>billion rubles</i>	670.4	1,165.2	1,504.7	1,762	2,186	2,865	3,611	4,580.5	6,419
as percentage of previous year	105.3	117.4	110.0	102.8	112.5	113.7	110.7	113.7	121.1
<b>Accumulated foreign capital in Russia's economy</b> ( <i>billion USD</i> )							111.8	142.9	220.6
<b>Foreign investments</b> ( <i>billion USD</i> )	9.6	11.0	14.3	19.8	29.7	40.5	53.7	55.1	120.9
including									
<i>direct</i>	4.3	4.4	4.0	4.0	6.8	9.4	13.1	13.7	27.8
<i>portfolio</i>	0.031	0.145	0.451	0.472	0.401	0.333	0.453	3.2	4.2
<i>other</i>	5.3	6.4	9.8	15.3	22.5	30.8	40.1	38.2	88.9
<b>Foreign trade turnover</b>									
<i>billion USD</i>	115.1	149.9	155.6	168.3	212.0	280.6	369.2	468.6	578.3
as percentage of previous year	86.9	130.2	103.8	108.1	126.0	132.4	131.5	127.0	123.4
<b>Exports</b>									
<i>billion USD</i>	75.6	105.0	101.9	107.3	135.9	183.2	243.8	303.9	355.2
as percentage of previous year	101.5	139.0	97.0	105.3	126.7	134.8	133.1	124.7	116.9
<b>Imports</b>									
<i>billion USD</i>	39.5	44.9	53.8	61.0	76.1	97.4	125.4	164.7	223.1
as percentage of previous year	68.1	113.5	119.8	113.4	124.8	128.0	128.8	131.3	135.4
<b>Retail trade turnover</b> (as percentage of previous year)	94.2	109.0	111.0	109.3	108.8	113.3	112.8	113.0	115.2
<b>Consumer price index</b> ( <i>as percentage of December of previous year</i> )	136.5	120.2	118.6	115.1	112.0	111.7	110.9	109.0	111.9
<b>Industrial producers' price index</b> ( <i>as % of December of previous year</i> )	170.7	131.9	108.3	117.7	112.5	128.8	113.4	110.4	125.1
<b>Total number of unemployed, period's average</b>									
<i>million persons</i>	9.4	7.6	6.4	5.8	6.2	6	5.6	5.3	4.6
as percentage of corresponding period of previous year	116.0	82.0	83.2	89.2	107.3	96.1	90.2	95.6	88.3
as percentage of economically active population	13.0	10.5	9.0	8.1	8.6	8.3	7.7	7.3	6.1
<b>Average monthly charged wage of one employee</b> ( <i>rubles</i> )	1,523	2,223	3,240	4,360	5,499	6,740	8,555	10,634	13,518
<b>Real charged wage of one employee</b> ( <i>as percentage of corresponding period of previous year</i> )	78.0	120.9	119.9	116.2	110.9	110.6	112.6	113.4	116.2

*Table 1 (continued)*

1	2	3	4	5	6	7	8	9	10
<b>Average money incomes per capita, per month (rubles.)</b>	1,658.9	2,281.1	3,062.0	3,947.2	5,170.4	6,410.4	8,023.2	9,947.3	12,490
<b>International reserve assets (as of end of period, billion USD)</b>	12.5	28.0	36.6	47.8	76.9	124.5	182.2	303.0	476.4
<b>RTS Index</b>				359.07	567.25	614.11	1,125.6	1,921.92	2,290.51
<b>Aggregate volume of resources in Stabilization Fund of Russian Federation</b>									
<i>billion rubles</i>					106	522.3	1,237.0	2,346.92	3,849.1
<i>billion USD</i>						18.8	43.0	89.1	156.8

*Sources:* Rosstat, Ministry of Finance of the Russian Federation ([www.minfin.ru](http://www.minfin.ru)), Federal State Statistics Service ([www.gks.ru](http://www.gks.ru)), Central Bank of the Russian Federation ([www.cbr.ru](http://www.cbr.ru)).

GDP growth by 8.1% represents one of its highest rates throughout the post-crisis period and is indicative of the Russian national economy's serious potential (this index was higher only in 2000 (10%), but then it had been a pure example of rehabilitative growth). Industry's growth became even more rapid, being 6.3 % against 3.9 % in 2006, and in the manufacturing industries – as high as 9.3 %. The manufacturing industries are displaying an accelerated growth by comparison with the extraction of mineral resources (9.4 % and 2 %, respectively). Now, this dynamics can no more be explained by either the ruble's low exchange rate or the presence of surplus capacities. It is quite obvious that the rehabilitative period is over, and the economy is switching over to an investment-based growth model.

The growth of investments has indeed reached its absolute historic high, amounting to 20 %. The volume of foreign investments was 120 billion USD (against 55 billion USD in 2006), while that of direct investments – 20 billion USD (against 14 billion USD).

An important factor contributing to the Russian economy's dynamic growth has become the rapid growth in household consumption, amounting to approximately 13.1 %.

Stable growth was demonstrated by the most important indices of the budgetary and monetary systems. The Russian Federation's foreign currency reserves exceeded 450 billion USD, while the Stabilization Fund amounted to 150 billion USD. The budget continued to display a surplus, although now it was lower by approximately 2 p.p. of GDP. External government debt amounted to a negligible sum of about 4.3% of GDP.

The doubtless (and important) last year's result has become the inertia-level dynamics ultimately acquired by national projects. They have finally been taken seriously by society, and not just as part of propaganda campaigns. One more contributing factor in this respect was D. Medvedev's nomination as candidate for the post of RF President, which served as a sign of a long-term character of the selected priorities.

Finally, the institutional (as opposed to purely financial) problems associated with the functioning of sectors aimed at developing human capital began to be discussed in earnest. Some positive trends have appeared in the ways the problem of the nation's health are being approached.

Unemployment continued to be on the decline, its level in one year dropping by 7.3 p.p., while the average monthly wage exceeded 500 USD.

One of the recent positive trends has been this country's political and economic elite's growing interest in long-term development issues. The Government's three-year program was

augmented by a three-year federal budget and the Government's report on the results and main directions for the Government's activity, also encompassing a three-year period.

Last year the Government began elaborating this country's Long-Term Strategy of Socio-Economic Development for the period until 2020. This is to be followed by long-term budget projecting. Besides, prospective documents are also to be developed at the level of the federation's subjects and municipal formations. It is planned that all these documents should be united within a single system by means of issuing a federal law on this country's socio-economic development strategy, which is being mapped on the RF President's assignment.

Russia is not unique in this respect. The desire to develop long-term planning and forecasting documents has been demonstrated, in the past two years, by nearly all the post-Soviet countries – members of the CIS<sup>1</sup>. It appears that there are two reasons for such an interest on their part. On the one hand, this interest is pragmatic, because stabilization and economic growth have made such goals both achievable and desirable. On the other, there are traditions dating back to the days of the Soviet economy, since a considerable part of the post-Soviet state elite have their roots within their Gosplan past, and the existence of so many forecasting documents clearly reflects the influence of the directive-based planned system with its main attribute – “marks” given for plans. These principles are quite dangerous, if attempts are made to consistently implement them in a situation of a modern-type dynamic economy.

At the same time, the year 2007 saw the emergence of some *alarming trends* in economic development and economic policy.

The main problem, which became the focus of both the political leaders' and the population's attention, was an accelerated growth of prices. From the year 1999 onward the inflation rate in Russia had been steadily declining, although more slowly than forecasted in budget projecting. Until last year, the discussions of this problem were mainly centered on the accuracy of forecasting, since the Government's estimations had always been more optimistic than the actual results. However, everybody understood that this had to do with the authorities' wish to obtain additional nominal revenues by a year's results, and so, political criticism in parliament quite apart, these rules of the game were, after all, universally accepted. However, in 2007 inflation for the first time began to accelerate, and significantly so – the consumer price index leaped from 9% to 12%, while the producers price index exceeded 25%. An acute discussion as to the causes of such a turn of events followed. Three main causes were pointed out as being quite obvious:

- growing prices of foodstuffs on the international markets;
- efforts on the part of monetary authorities to restrict the ruble's strengthening;
- and an expansionist budgeting policy.

The latter factor is of particular importance, since in 2007 budgeting policy underwent considerable changes. Now one may already speak of the onset of a large-scale budget expansion. In spring it was decided that budget expenditure should be increased against the previously approved Law “On the 2007 Federal Budget”. The corresponding draft law was approved in November. The suggested amendments were aimed at increasing non-interest revenues by more than 1 trillion rubles, which resulted in budget surplus being decreased from 4.8% to 2.8% of GDP. A considerable amount of additional budget resources was allocated

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<sup>1</sup> See a collection of articles on the contemporary experience of prospective planning and forecasting in some CIS countries published in the journal “Obshchestvo i ekonomika” [“Society and the Economy”] (2007, No. 1112).

to social and infrastructural projects, as well as to capitalization of state corporations and development institutions (the Bank of Development, the Investment Fund, the Russian Nanotechnologies Corporation, the Fund for Promoting Reform of the Housing and Utilities Sector, etc.). All this has led to the conclusion that *populist trends are becoming increasingly prominent in Russian economic policy*.

From the point of view of formal balancing, the weakening of budget constraints should not result in budget deficit in the next three years, if the current forecasts of oil prices remain true. However, such undertakings have served as a clear indication to economic agents, who have accordingly adjusted their pricing policies, which have been then reflected in accelerated inflation.

The transition to an expansionist budgeting policy could only in part be explained by the specific features of the current political cycle. Last year's pre-election character was, no doubt, a political reality. However, the high ratings of the present President and "United Russia" made such budgeting populism rather unnecessary. The growth of budget expenditure was caused not so much by the standard peculiarities of the political and business cycle, but by the unprecedented pressure on the RF Ministry of Finance from all the sectors of the national economy and political forces. The presence of substantial monetary resources in a country plagued by serious social and economic disbalances has become a factor of a very strong pressure, suppressible by the financial authorities only if they are decisively supported by the head of the State. But even this support cannot be unlimited, which was fully demonstrated last year.

The reverse side of budgeting expansion has become the slow-down in implementing institutional reforms. Here one can also observe the influence of the political cycle: reforms are unlikely in a pre-election period, and the only thing to be done then is to develop the basic outlines of economic policy for the "window of opportunity" that may appear soon after the election. However, this does not mean that institutional transformations are going to be curbed completely. In some sectors relating to priority national projects certain important institutional decisions have been made, thus determining the principles of their functioning during the forthcoming period (primarily in the sphere of public education).

Some alarming symptoms have been noticed on the external debt market. The amount of sovereign external debt continued to decline alongside increasing private external debt. Besides, last year also saw an important change in this trend: if previously the aggregate debt load had been diminishing, in 2007 it began to grow. This has significantly increased the dependence of Russia's economic situation on the fluctuations of the international financial one. Moreover, a considerable part of the debt is accounted for by quasi-private (but actually controlled by the State) corporations and banks, which means that the government will have to act as their savior in an event of economic crisis. One can speak of a growing trend toward chaebolization of a number of prominent Russian companies, as exemplified by South Korean chaebols (that is, companies actually controlled by the State and governed on the principle of "privatization of profits and nationalization of losses").

A serious problem observed last year was, as before, the ruble's strengthening as a result of a substantial capital inflow created by both proceeds from exports and foreign investments. Big corporate borrowings did indeed play their part in this process. As a consequence, Russia's imports were rapidly growing, which was in no way conducive to the activity of domestic manufacturers. However, the competitive capacity of domestic production was undoubt-

edly increasing, which has been proved by the very fact of accelerating economic growth, although the ruble's purchasing power has long ago been exceeding the level of 1997 – which has been regarded by some Russian analysts as very dangerous and fraught with a new crisis.

Another alarming, although also a logical trend in the second half-year 2007 became the increased interest rates on the interbank market. This was largely the result of the mortgage crunch in the USA, although a certain part had also been played by increased inflation expectations. In this connection, the measures undertaken by the Central Bank of Russia were decisive and adequate, thus preventing further development of this crisis, which was almost unnoticed by the majority of Russians.

Finally, the processes of social differentiation were developing at a more profound level. Russian society has got used to this process in the course of the past one and a half decades, given that differentiation has so far been increasing against the backdrop of an overall growth of well-being (in terms of wages and the population's incomes). However, the long-term implications of this trend may become rather dangerous.

Thus, the total results of the current situation's development in 2007 are rather controversial. Some important successes are undeniable, but the situation remains intrinsically unstable. Below we are going to discuss in more detail the causes of this lack of stability and the possibly applicable compensatory mechanisms.

### 1.2.2. The problems of Economic Growth

Last year was characterized by a high rate of economic growth, which became even slightly accelerated by comparison with the year 2006.

Nevertheless, the dynamics of Russian GDP is by no means unique, if one takes a look at the post-communist space as a whole. The growth rates displayed by a majority of the former USSR countries were higher than that in Russia. This was a feature typical not only of those post-Soviet countries where the higher growth rate was to a certain extent the result of the "base effect" (depth of slump) and the continuing effect of the remaining rehabilitative trends, but also of the countries of Central and Eastern Europe, which joined the EU and created in their territories some economic institutions that were not entirely conducive to economic growth<sup>2</sup>. Exceptionally high rates are characteristic of China and India. The data in *Table 2* also vividly demonstrate that high growth rates are not necessarily the result of high international prices of energy carriers. High growth rates are also displayed by Azerbaijan, Turkmenistan and Kazakhstan, while at the same time growth in most of the countries deficient in natural resources is higher than that in Russia. Thus, the source and reserves of growth should be looked for in factors other than those governing the development of the oil and gas sector.

It seems that we are now in the upward phase of the economic cycle, and it can be assumed that the Russian economy has indeed entered the system of a normal business cycle. It is for the future to prove the truth of this assumption, but in any case time has come for us to depart from the stereotypes of anti-crisis management and whipping up growth at any cost, and to formulate an economic policy model based on the mechanisms of cyclic regulation. In other words, it is time to switch over from an anti-crisis policy to a cyclic one.

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<sup>2</sup> The issue of the restricting effect of the membership in the EU on economic growth was analyzed by A. Aslund and A. Warner (see Aslund A., Warner A. *The EU Enlargement: Consequences for CIS Countries // Beyond Transition. Development Perspectives and Dilemmas*. Aldershot: Ashgate, 2004).

*Table 2*

**GDP Dynamics in Post-Communist Countries, in %**

Country	Years	
	2006	2007
<i>Azerbaijan</i>	31.0	29.3
Albania	5.0	6.0
Armenia	13.3	11.1
Belarus	9.9	7.8
Bulgaria	6.1	6.0
Hungary	3.9	2.1
Georgia	9.4	11
Kazakhstan	10.7	8.7
Kyrgyz Republic	2.7	7.5
China	11.1	11.5
India	9.7	8.9
Latvia	11.9	10.5
Lithuania	7.5	8.0
Macedonia	3.0	5.0
Moldova	4.0	5.0
Mongolia	8.6	8.5
Poland	6.1	6.6
Romania	7.7	6.3
<b>Russia</b>	<b>6.7</b>	<b>8.1</b>
Serbia	5.7	6.0
Slovakia	8.3	8.8
Slovenia	5.7	5.4
Tajikistan	7.0	7.5
Turkmenistan	9.0	10.0
Ukraine	7.1	6.7
Uzbekistan	7.3	8.8
Croatia	4.8	5.6
Czech Republic	6.4	5.6
Estonia	11.2	8.0

*Source:* International Monetary Fund (IMF).

Meanwhile, the State continues to follow the principle of “growth at any cost”. Despite the economic boom and associated inflation, the government is promoting further growth through budget allocations. These allocations are mainly earmarked for the social sphere (investments in human capital), infrastructure development, and innovative activity. This approach is quite understandable because these sectors, in fact, contain the bottlenecks restricting this country’s development. Also understandable is the political context of this approach – for the present-day Russian authorities, a high rate of growth represents the source of their legitimization – a kind of a “social contract”, typical of the first phase of post-revolution stabilization. However, all these measures appear strange enough in a situation of economic boom and high inflation rate. The risks of the economy getting overheated and then spiraling down into crisis are thus becoming very real.

Economic growth so far has remained predominantly quantitative. Although the services sectors are growing at high rates, they offer mainly traditional services (primarily those of intermediaries in trade), and not high-tech ones. The special economic zones for the implementation of technologies are indeed developing, but they have not yet become the foci for innovations growth capable of influencing the character of economic growth in any significant

way. Russia is developing within the framework of an industrial model, having no serious competitive advantages in such a system of coordinates – in terms of either human resources or natural and climatic parameters<sup>3</sup>. However, structural transformation is a lengthy process, which accumulates its potential slowly and can fully unfold only over time. At the same time, is it impossible to judge in advance whether the accumulation of forces for a future structural breakthrough is indeed currently under way<sup>4</sup>.

There exists a need for decisive structural shifts designed to diminish the country's dependency on the situation in the fuel and energy complex. This goal has been determined as the core of the Concept of the Long-Term Socio-Economic Development of the Russian Federation, encompassing the period until 2020; its draft was prepared by the RF Ministry of Economic Development and Trade in the second half of 2007. When setting, as the goal for the next 12-year period, Russia's joining the top five economies of the world (by its GDP size), the Concept envisages three possible scenarios of long-term development: this country's continuous inertia, or an economy based on export of raw materials, or innovations. The main parameters of the three scenarios are presented in *Table 3*.

*The inertia-based scenario* assumes that the raw materials sectors will continue to prevail in the national economy, against the backdrop of a gradual slowdown in the growth rate of extraction and exports of the products yielded by the fuel and energy complex (FEC) resulting from underdeveloped infrastructure. The average per annum growth rates will not exceed 3.5%. If this scenario is realized, it is unlikely that any large-scale investment projects will be undertaken in any sectors beyond the FEC. However, there is still the possibility of an intensification of the processes of social and regional differentiation, a decline in the quality of human capital, a reduction in the competitive capacities of manufacturing industries and their substitution by imports.

*The scenario envisaging the supremacy of export of raw materials* builds upon Russia's competitive advantages in the energy sector and the implementation of large-scale infrastructural projects, thus making it possible to increase the industrial capacities of the traditional branches of Russian exports. The average per annum growth of the national economy will in this case amount to approximately 5.5%. Special attention will be focused on the development of power engineering and transport, while owing to the specificity of these sectors it can be expected that the State's role in the organization and regulation of economic life will become more prominent. In this scenario, the necessity to establish public-private partnerships will become especially important. Such a scenario, naturally, will imply Russia's increasing dependency on the international prices of the FEC's products and raw materials.

*The innovations scenario* builds upon the use of Russia's competitive advantages existing in the sector of fuel and raw materials in order to diversify and qualitatively upgrade this country's national economy. In this case, of fundamental importance will be the ability to

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<sup>3</sup> There exist some studies aimed at providing a proof of the Russian economy's fundamental inability to be competitive even in face of a preserved industrial paradigm, which can be explained by a set of natural (primarily nature- and climate-related) factors. However, the specific features of a postindustrial (informational) economy have significantly changed the relative importance of such factors and make it possible to view the issues of national competitive capacities at a new angle. (See, e. g., Lynch Allen C. *Roots of Russia's Economic Dilemmas: Liberal Economics and Liberal Geography // Europe-Asia Studies*. 2002. Vol. 54. No. 1).

<sup>4</sup> One should recall the experience of developed countries of the West in the 1970s, when many observers believed that they were stagnant, demonstrating to the rest of the world their low growth rates and high inflation rates, whereas in fact they were accumulating a potential for their subsequent powerful structural breakthrough.



make a dramatic breakthrough in the quality of human capital and to use it as a base for creating hi-tech production capacities. Economic growth may become as high as 6–6.5% per annum. In effect, this is a scenario of Russia’s postindustrial breakthrough enabling it to find its own niche within the labor division system resulting from the current globalization processes. The scenario envisages a structural maneuver resulting in the innovations sector’s share increasing from the present-day level of 10% of GDP to approximately 20%, while the oil and gas sector’s share will, on the contrary, diminish from the currently observed 20% to 10–12%.

*Table 3*

**Scenarios of Russia’s Socio-Economic Development  
in 2011–2020**

Parameters	2011–2015	2016–2020
<b>GDP – average per annum growth in %</b>		
<i>inertia</i>	103.2	103.2
<i>exports of raw materials</i>	105.7	105.0
<i>innovations</i>	106.3	106.6
<b>Industrial production – average per annum growth in %</b>		
<i>inertia</i>	102.3	102.3
<i>export of raw materials</i>	104.7	104.2
<i>innovations</i>	105.2	105.0
<b>Investments – average per annum growth in %</b>		
<i>inertia</i>	102.8	104.3
<i>export of raw materials</i>	109.2	107.4
<i>innovations</i>	110.2	110.1
<b>Real disposable incomes of the population – average per annum growth in %</b>		
<i>inertia</i>	104.3	103.9
<i>export of raw materials</i>	106.2	105.0
<i>innovations</i>	107.2	106.9
<b>Real wage – average per annum growth in %</b>		
<i>inertia</i>	104.4	103.9
<i>export of raw materials</i>	107.5	106.0
<i>innovations</i>	108.2	108.2
<b>Retail turnover – average per annum growth in %</b>		
<i>inertia</i>	104.2	103.9
<i>export of raw materials</i>	105.9	104.7
<i>innovations</i>	106.6	106.4
<b>Exports – average per annum growth in %</b>		
<i>inertia</i>	101.3	101.8
<i>export of raw materials</i>	103.3	103.5
<i>innovations</i>	103.5	104.5
<b>Imports – average per annum growth in %</b>		
<i>inertia</i>	101.7	103.5
<i>export of raw materials</i>	106.2	104.9
<i>innovations</i>	106.9	106.7

*Source:* the Ministry of Economic Development and Trade of the Russian Federation.

With a certain degree of conventionality, these three scenarios can be termed “Nigerian”, “Mexican” and “Australian”, respectively. Nigeria is a country where the abundance of fuel and energy resources produced stagnation and the degradation of political and economic institutions resulting in a severe political and economic crisis. In Mexico, the enormous revenues from oil production ensured a noticeable although uneven economic growth, accompanied by a moderate diversification of the national economy and low level of human capital

development, while the existing institutions were unable to take advantage of the proximity to the North American market. And lastly, Australia is demonstrating its successful experience of a country rich in natural resources. The substantial revenues generated by the export of natural raw materials to Japan and the countries of South-East Asia were used for diversifying the country's domestic production and creating a modern postindustrial economy<sup>5</sup>.

These three scenarios cannot be regarded as three alternatives. Rather, they represent three successive phases in the Russian economy's movement toward obtaining new qualitative properties. A favorable variant of development will involve a transition from the inertia-based scenario to export of raw materials, and then, on this newly created base (and with due regard for the Australian experience), to increasing the role of innovation mechanisms in socio-economic development. In other words, the first and the second scenarios are simple successive stages on the way toward providing solutions to Russia's strategic goals of development. However, these variants may also become alternative ones, if it becomes impossible to achieve transition from one stage to another.

Then, one key question will arise: what can ensure the transition between different growth models? In principle, there exist two mechanisms of influence – money and institutions. The switchover from one development model to another may be achieved by a country by means of large-scale (and associated with the State) investments in certain sectors of the national economy and in-depth institutional reforms designed to create favorable conditions for the operation of economic agents, as well as incentives for an accelerated development of the branches promoting growth of human capital.

But here we are faced with the actually existing alternatives in the choice of a strategy for Russia's socio-economic development. *One strategy* builds upon the ideology of dirigisme and envisages the State's leading role in ensuring the desirable rate of economic growth by specifically creating strong organizational and financial preconditions. The leaders in the game thus become the corporations formally owned or unofficially controlled by the State. The state budget begins to play an active part in providing funding for big economic projects, and not only for those being implemented in the infrastructural sphere. Special "development institutions" are created, whose purpose is to provide special conditions for sectors treated by the State as preferential ones. The institutional system is tailored to serve the State's leading role, including in relation to property issues, bankruptcy, foreign economic activity, etc.

This model can indeed ensure high rates of economic growth during a certain phase, especially if there is a strong inflow of financial resources into the state budget. However, the problem inherent in this model is the well-known low efficiency of state investments (including those made by the State through formally private agents), as confirmed by practical experience, by comparison with truly private investments, when the investor puts at stake his own money. And this low efficiency has two aspects to it.

Firstly, there is the inefficiency of decision-making concerning investment priorities, which becomes a most acute problem in the highly dynamic conditions of the postindustrial era. Nowadays, challenges and priorities change so quickly that any state bureaucracy, no matter how efficient, is simply unable to respond to these changes in a timely and adequate man-

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<sup>5</sup> For more details, see Mau V. Rossiiskaia ekonomika: sil'nye i slabye storony. [The Russian economy: strengths and weaknesses] // Ekonomicheskaiia politika [Economic Policy]. 2006. No. 2; Brich A. Put' Rossii k protsvetaniiu v postindustrial'nom mire. [Russia's way to prosperity in the postindustrial world] // Voprosy ekonomiki [Issues of Economics]. 2003. No. 5.

ner. The decisions made by authorities always result from a complex system of coordinated interests. And the challenges presented by a current situation are by no means the most important argument in such a context. Moreover, sometimes it is virtually impossible to change a decision arrived at after so many difficulties, once it is made.

Secondly, there still remains the notorious problem of inefficient (inflated) estimations of the cost of investment projects involving the spending of public (or quasi-public) funds<sup>6</sup>.

The basis for another approach to modernization would be the formation of a modern institutional environment capable of promoting stable economic growth and adaptable to contemporary challenges. It is specifically the use of modern institutions (naturally, appropriately adapted to the individual features of a given country) that can serve as the most important source for modernization in countries involved in catching-up development in a situation of transition toward the postindustrial era. And it is the stage-by-stage formation of institutions peculiar to a modern developed society (the institutions of modern market democracy) that is particularly conducive to providing solution to a complex set of modernization-oriented problems.

Last year, the State's attention was focused on the financial and regulatory ("dirigisme"), rather than institutional, aspects of economic growth. This was achieved mainly through pumping money into development institutions, as well as through creating public corporations designed to play key roles in the Russian economy's structuring. This sequence of events is quite natural in a situation of a strong inflow of "cheap money", which has been flooding this country for several years in a row.

The direct outcome of such developments has been so far only the further enhancement of inflation. Modern inflation is a rather complex phenomenon, produced by a variety of factors: growing prices of foodstuffs, the striving of monetary authorities to restrict the ruble's strengthening, as well as an expansionist budgeting policy. The latter circumstance was playing a particularly important role in the realities of the year 2007.

Budget expansionism aimed at promoting growth, in fact, represents a growth-restricting factor. On the one hand, additional demand, instead of promoting domestic production, is largely focused on imported goods. On the other, inflation results in banks increasing their interest rates on the domestic market (as it happened in the autumn of 2007), which is an unfavorable circumstance from the point of view of growth consolidation. This latter phenomenon is also conducive to increasing the competitive capacities of imports by comparison with those of domestic manufacturers.

### 1.2.3. Institutional Factors of Economic Growth

One of the main issues involved in the discussion of economic growth has been the formation of modern – that is, adequate in terms of its responses to the challenges of the postindustrial era – system of political, economic and social institutions. The key role of the building of appropriate institutions has been rather well substantiated in the literature published in course of the past two decades.

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<sup>6</sup> For an interesting analysis of the efficiency of public investment utilization, see Fluvb'erg B. Strategicheskaya otsenka planirovaniya krupnykh infrastrukturykh projektov. [A strategic estimation of plans for big infrastructural projects] // Ekonomicheskaya politika [Economic Policy]. 2006. No. 1. It should be noted that the author of this article discusses the experience of developed market democracies, for which rather high standards of government decision-making are typical.

While analyzing the institutional problems that need to be solved in order to ensure stable economic development and structural transformation in contemporary Russia, it is feasible to single out several categories of institutions and to determine their intrinsic hierarchy based on logic. There exist *four categories of institutions*.

*Firstly*, the political and legal institutions designed to ensure the civil and political rights of citizens, and economic agents in particular. These have to do with the protection of basic rights, whose recognition by the State once became the foundation of modern economic growth. Here belong the guarantees of inviolability of person and property, independence of courts of justice, efficiency of the law enforcement system, and freedom for the mass media.

*Secondly*, the institutions ensuring human capital's development. First of all, this applies to public education, public health care, the pension system and housing provision. It would have been an error to reduce the problems existing in these sectors to those associated with insufficient funding. In fact, the key problem of their development lies in the need for institutional reforms, that is, the emergence of new rules for their functioning. The majority of the currently functioning models in the social sphere were created at the time when the agricultural economy was transforming into an industrial one, characterized by a set of entirely different conditions (demographic, social, etc.). At present, when the situation in developed countries, Russia including, has undergone fundamental changes, the traditional (that is, elaborated at the turn of the 20<sup>th</sup> century) social support institutions are becoming too expensive and inefficient.

*Thirdly*, economic institutions proper, that is, economic legislation appropriate for the stable functioning and development of the national economy. Modern legislation must be capable of ensuring economic growth and structural modernization of the economy.

*Fourthly*, specialized institutions designed to provide solutions to certain specific problems associated with economic growth, namely those that have recently been termed "development institutions", that is, establishing rules of game applicable not to all the participants in economic or political life, but only to some of them, specially selected. In other words, these institutions exert discretionary influence on the economy, in contrast to the previously existing one, whose influence was of a general nature.

The four categories of institutions are listed in the order of their relative importance and logical hierarchy. It is the guarantees of basic rights that can create the base of stable economic growth, as well as its fundamental prerequisites – at least within an economy that builds upon private entrepreneurship. It should be emphasized that we mean primarily the issues of personal and property safety, and of the efficiency of state administration, and not the well-known set of political rights typical of modern market democracies. As demonstrated by the experience of the past three centuries, confidence in personal safety and in that of the accumulated wealth can create sufficient preconditions for active entrepreneurship, irrespective of whether an entrepreneur is granted passive, or even active, voting right, or lives under a republican system or a monarchy, etc. In order to ensure adequate guarantees, of far greater importance is the existence of a reliable judicial system and law enforcement mechanisms, which are also conducive to lower transaction costs and increasing business competitiveness. And the independent mass media perform the function of public control over the operation of those institutions. At the same time, the traditional democratic institutions are also necessary for a country to achieve a certain level of socio-economic development, especially if there is a prevalence of educated urban population.

The recent economic and political discussions are largely characterized by a viewpoint that the modernization of a political system is not an issue of paramount importance. There exist two lines of argumentation in its support.

One of them emphasizes the specific character of Russia's political institutions (and, accordingly, the institutions of democracy) as compared to modern developed democracies. Such argumentation implies that this country has its own individual way of development, which cannot be a replica of that of Western democracies. The gist of this viewpoint can be found in the concept of "sovereign democracy" that has been discussed in the past two years<sup>7</sup>.

The other viewpoint, while recognizing the modern Western model as a target for developing domestic political institutions, does not regard such institutions as a necessary precondition for consolidating economic growth in this particular phase of this country's evolution. In a visible perspective, stable growth is linked not to the formation of a modern efficient state administration system, but to the existence of a potential for catching-up development based on borrowed technologies. It is these technologies that could ensure a high rate of economic growth even in face of underdeveloped institutions. And only at later stages, after the modernization of the economy's industrial branches is accomplished, that of political institutions will provide the ground for this country's further development.

This viewpoint is at least an arguable one. It is quite applicable to the countries transiting from an agricultural economy to an industrial one, that is, those undergoing industrial modernization. Their predominantly agrarian population is, as a rule, very sensitive to improving well-being and does not display a demand for modern political institutions. The response of the urban educated population is quite different – it demands certain guarantees, and therefore is prepared to participate in government decision-making. That is why *the modernization of the political system is an absolute priority in terms of providing adequate solutions to all the other problems relating to economic and social modernization*.

The second very important factor determining the success of modernization is the development of human capital. This represents a fundamental institutional task, to be tackled by every country undergoing postindustrial transformation. The currently observed crisis in the social sphere has its roots not only in the Soviet system's general crisis. Its nature reflects *the crisis of the industrial system*. The present welfare state model (the human potential model development) arose in a fundamentally different demographic and social situation, characterized by growing population, prevalence of younger age groups, and prevalence of rural population excluded from a social support system. Nowadays, when the process of population's ageing has acquired a stable rate, and the demand for social services is permanently on rise, it is necessary to create a fundamentally new welfare state model<sup>8</sup>.

Thus, in a search for an adequate model for human capital development, the international experience accumulated so far can be made use of only to a very limited extent, there currently being no effective systems capable of adequately responding to modern challenges. Moreover, *the country that will manage to create an efficient modern model for developing human capital will thus gain tremendous advantages in the postindustrial world*.

The improvement of economic legislation is another important area for institutional modernization. Much has already been done in this direction in the past ten years. This coun-

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<sup>7</sup> The materials relating to the discussion of this theme can be found in the following collection of essays: *Pro suverenuiu demokratiu* [Pro sovereign democracy]. M.: Evropa, 2007.

<sup>8</sup> For more details, see *Gaidar Ye. T. Dolgoe vremia*. [A long time]. M.: Delo, 2005. Chapters 12 and 13.

try is now endowed with a sufficiently well-developed system of economic legislation. Its shortcomings are associated with underdeveloped institutions for political and administrative regulation and weak mechanisms for law enforcement.

At the present moment, the following main directions for further development of economic institutions can be listed as the most important ones:

- *The formation of a competitive environment and overcoming of monopolistic trends in the national economy.* In this connection, the most important goal is to ensure efficient and transparent state regulation, to formulate clear criteria and transparency of decision-making in respect of state participation (and state support) in some specific areas of economic and social life, as well as to prevent a conflict of interests between government officials in regulatory decision-making, and to further improve the mechanisms for government procurements.
- *The promotion of new companies' entry into the market, and the removal of existing barriers in their way.* This is the most important precondition for the intensification of the innovation process, since it is the new enterprises, being prepared to take risks, that achieve, as a rule, a higher productivity level. It would be feasible to create a special infrastructure designed to support new small and medium-sized companies, to simplify the access of minor businesses to the leasing of premises, to establish technoparks and business incubators, to promote export of raw materials (including by small and medium-sized companies), etc.
- *The development of the land and real estate market,* because these types of property provide the foundation for property relations and serve as an important source of economic guarantees of property rights. This is especially important for new innovative companies, as a basis for their access to credit resources.
- *The development of financial markets* as sources of capital for economic growth. This will require a higher reliability of financial institutions, the creation and constant upgrading of new financial instruments providing types of savings alternative to the already existing ones, and a more reliable protection of the rights of participants in financial markets.

When forming a system of economic institutions, it is feasible to be oriented to the ways in which EU legislation is being adapted<sup>9</sup>, which is a sufficiently successful example of modern market legislation and of particular importance for this country, since Europe accounts for more than 50% of Russian trade turnover. It is quite natural that not all the sections of European legislation are feasible in terms of growth promotion, but its main sections addressing economic freedoms, antimonopoly regulation, etc. are applicable to modern Russia<sup>10</sup>.

However, when moving in this direction, one important circumstance should by no means be overlooked. European economic institutions require that law enforcement should be effectuated by similarly European-type institutions including, first of all, the judicial system. The one cannot work efficiently enough without the other. But while the laws regulating the economy can be rather easily reproduced in the domestic law and practice, the judicial system cannot be replicated with the same ease – considerable time will be required for ensuring the

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<sup>9</sup> For more details, see *Obshchee ekonomicheskoe prostranstvo: Perspektivy vzaimootnoshenii Rossii i ES*. [Single economic space: the prospects of relations between Russian and the EU]. M.: Delo, 2004.

<sup>10</sup> For more details, see *Mau V., Novikov V. Otnoshenie Rossii i ES: prostranstvo vybora ili vybor prostranstva?* [The relations between Russia and the EU: a space of choice or a choice of space?] // *Voprosy ekonomiki* [Issues of Economics]. 2002. No. 6.

necessary level of its efficiency. And this is what constitutes one of the fundamental problems faced by modern Russia.

And finally, special place belongs to *development institutions*, which in the past two years have become a very important component of economic and political discourse. There is as yet no clear understanding as to what exactly can be placed within this institutional category: one of the approaches visualizes them as an organizational form for public-private partnerships, another – the forms for direct financing by the State of projects designed to speed up economic growth. It seems that the most precise way would be to define them as discretionary rules of game, that is, government decision-making in the economic sphere that applies not to economic space as a whole but to some specific subjects of economic life.

Development institutions can be both financial (e.g., investment funds) and administrative (e.g., special economic zones). The latter distinction is, however, rather arbitrary. Non-financial institutions are also associated with budget expenditures.

Among *financial development institutions*, there are the RF Investment Fund (hereinafter – Investfond), Vneshekonombank, the Russian Venture Company (hereinafter – RVC), the Agency for Housing Mortgage Crediting (hereinafter – AHMC), Rosselkhozbank, Rosagrolizing, the Russian Nanotechnologies Corporation (hereinafter – Rosnanotekh), the Russian Investment Fund for Information and Communications Technologies, and the Fund for Promoting Reform in the Housing and Utilities Sector.

Among *non-financial institutions*, one can point to special economic zones (industrial production zones, technologies implementation zones, tourism and recreation zones, port zones), technoparks, industrial parks, business incubators, technologies transfer centers, and others.

The most important among development institutions so far have been the following ones:

- Vneshekonombank, designed to ensure diversification and higher competitive capacities of the national economy, develop infrastructure, promote innovations, and support small and medium-sized companies as well as exports;
- Investfond, for creating national infrastructures designed to ensure regional development and promote the implementation of large-scale private investment projects;
- RVC, which should serve as a base for creating Russia’s own venture investment system and selecting the best venture companies through organizing tenders, and to purchase stakes in the venture funds established by these companies;
- special economic zones, in particular the OJSC “OEZ”, whose purpose is to create the engineering, transport, innovations and social infrastructures for special economic zones;
- AHMC, for developing housing mortgage crediting in this country by means of refinancing mortgage credits;
- Rosnanotekh, whose goal is to develop innovational infrastructures in the sphere of nanotechnologies and to promote the implementation of related prospective projects by providing their organizational and financial support.

The most important function of development institutions will be to create appropriate conditions for the implementation of long-term investment projects. As a matter of fact, the share of credits granted by Russian banks for a period longer than 3 years presently constitutes no more than 15% of the total volume of crediting. For a number of reasons, and primarily the lack of credit history displayed by nearly all the participants in economic life, private in-

vestors do not dare to take upon themselves long-term credit risks. However, if one has in mind the use of development institutions, one must also be aware of the existence of some serious risks: on the one hand, their substitution for private businesses (and private risks) during the implementation of commercially attractive projects, on the other – subsidizing of loss-making enterprises or branches for political reasons (or by way of corruption).

Time will show just how efficient these institutions are going to be. In principle, the reasons for their creation are rather understandable. There exists a politically motivated desire to speed up economic growth and the diversification of the economy and exports, as well as to compensate for the absence of credit histories. No less important is the very fact of availability of enormous financial resources, inevitably serving as the object of political struggle.

However, the most fundamental problem faced by development institutions is that nearly all of them have their roots in the industrial era, when the State was capable of centrally determining the priorities of long-term development and concentrating resources in these areas. But it becomes increasingly difficult to set priorities in this manner in a situation of the highly dynamic demand and technologies typical of the postindustrial era, when the price of an error is too costly.

There is also yet another open question as to whether it would be possible to prevent development institutions from becoming a factor of macroeconomic destabilization. So far they have been attracting strong inflow of budget funding. Only in November of last year, 300 billion rubles from the Stabilization Fund were directed to refinancing Vneshekonombank, Investfond and Rosnanotekh.

The most important area of institutional reform is the implementation of *priority national projects*. The general idea itself, as well as the principle for their selection, is indisputable since it has to do with the development of human capital, which is a very real priority in conditions of postindustrial transformation. From the very start, two fundamental directions for their implementation have become obvious: the strengthening of budget financing of the related sectors, and institutional reform. It would be both politically dangerous and economically unfeasible to try to solve one of the problems while ignoring the other. However, the risk of such a course of events is very real<sup>11</sup>.

At the first stage, the budget aspect was clearly dominating over the institutional one, and this caused serious concerns, since financing without institutional reform could even produce a negative outcome. Higher salaries result in personnel conservation instead of personnel upgrading, when government-paid physicians and teachers, who have long ago lost their former level of qualification and are not going to treat their patients or teach their students any better even if their salary level is raised hundred-fold, hold on to their posts. Higher expenditures on equipment may result in its overpricing and in selecting items that are not really needed by public hospitals and laboratories. And increased funding of public housing construction in face of a monopolized construction services market can produce only skyrocketing prices and enrichment of local monopolists.

The year 2007 saw certain important shifts in the implementation of national projects.

Firstly, their long-term character received an official recognition. Initially, in September 2005, the projects were declared for a period of 2 years, which made them seem to be part of the election campaign and was evidently not compatible with the scope of the country's goals.

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<sup>11</sup> See Rossiiskaia ekonomika v 2005 godu: tendentsii i perspektivy. [The Russian economy in 2005: trends and prospects]. M: IET, 2006.



Now it has been officially recognized that human potential development represents a strategic goal, to be achieved in a foreseeable future.

Secondly, the focus on institutional reforms has evidently become more pronounced. This can be felt in different ways within each category of priority national projects. Most consistently the institutional aspect is visualized in public education, where reformers have achieved a consensus in respect of the main directions of its modernization. Last year, a package of laws was adopted, which determined the most important area of public education development in the medium term. In other sectors, discussions are still going on as to which institutional decisions are the most urgent ones. This is not surprising, since the elaboration of efficient decisions in sectors belonging to the social sphere represents an enormous intellectual task, while international experience can be borrowed from only to a very limited degree.

Thirdly, some success has been achieved in dealing with the specific tasks of improving these sectors' functioning. Schools are being equipped with computers, the equipment of hospitals is being upgraded, and other practical problems are also being solved.

Fourthly, the implementation of national projects is increasingly based on tenders among the draft projects submitted by individual institutions and regions. The lack of ready-made and obvious solutions to the problems faced by human capital has resulted in a decision (quite reasonably arrived at) to create incentives for the social policy subjects to elaborate their own proposals and to submit the resulting versions of decision-making to the federal government.

#### 1.2.4. Trends and Risks

For 8 years already, the Russian economy has been developing at a persistently high rate. This is an undisputable source of economic well-being and political stability. However, this favorable situation has also its reverse side. A new generation of Russian politicians is emerging, who are becoming used to "welfare growth management"<sup>12</sup> and are increasingly oblivious of the crisis management skills. The same habits are becoming increasingly common among the population at large. However, the Russian political system's stability – just as, in a certain sense, the legitimization of the existing political regime – depends on its ability to truly ensure this high rate of economic growth and public welfare.

Meanwhile it should be remembered that an economic boom may last for a long but by no means indefinite period, especially given the fact that Russia's success builds upon such unstable factors as high prices of energy carriers and the availability of cheap money on international financial markets. As for the institutional environment, which alone can be a reliable guarantee of stable economic growth, it is regrettably underdeveloped. Russian institutions (economic as well as political) are still hardly capable of softening and adjusting the consequences of both a worsening economic situation and a potential economic crisis.

A slowdown in economic growth, or, more dangerously, a slump, in our situation can be fraught not only with economic problems but also with political crises. A threat of a dramatic fall in the growth rate may produce an inadequate response on the part of the authorities, which would only exacerbate the economic problems. Our further development, in many of its aspects, is very dependent on the authorities' ability to adequately and calmly deal with a cri-

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<sup>12</sup> This expression was used by X. L. Portillo (Mexico's President in 1976–1982), when on the peak of the oil boom he believed that now his country would be moving from one success to another. In a few years, this ended in a collapse.

sis. Therefore, *another most important problem faced by Russia's currently existing political and economic system is the necessity to adequately respond to possible shocks*. This will be the main test for the maturity of the Russian political and economic elite.

*The causes and sources of a possible crisis* can not be forecasted with certainty. On the basis of the contemporary realities and trends one can single out several sources of potential problems influencing economic growth and conducive to political and financial destabilization. These, however, are very closely interconnected.

*Firstly*, it is the onset of a global recession, which has been in the air for some time already. This will mean transition to another phase of the business cycle, which for Russia may become especially painful by contrast with its currently high rate of development. Throughout the greater part of the 20<sup>th</sup> century this country was safeguarded from the cyclic fluctuations characteristic of a market economy. However, there are no grounds for believing that we are going to be similarly impervious to such influences in the future. Moreover, the lack of any experience in applying a cyclical adjustment policy, well-known to the market economies of the past century, makes Russia especially vulnerable to the threat of cyclic fluctuations. And since the Russian economy has not yet been integrated into the global economy to such an extent as to participate in the cyclic adjustment regulation adopted by developed countries, one may expect, sooner or later, that one more classical economic crisis will unfold here.

*Secondly*, a drop in oil prices. Nowadays hardly anybody regards this as a serious option, but it cannot be entirely ruled out. One has only to recall the 1970s, when everybody was sure that the prices of fuel and energy resources had reached a new plateau. Besides, a crisis must not necessarily be provoked only by a fall in prices below 10 USD per barrel. In recent years, Russia has already gone a long way toward increasing its budget expenditure and the domestic situation's dependency on the fluctuations of the global economic situation. Any relatively significant drop in oil prices will have a painful impact on budget liabilities, which can hardly be successfully compensated for by the Stabilization Fund's resources. Moreover, the exacerbation of Russia's economic troubles will occur in face of a worsening situation in the majority of the world's leading economies, while Russia's competitors in business will have additional stimuli for growth due to declining oil prices.

*Thirdly*, there is a possibility of a deficit in the balance of payments, and the ensuing dependence of this country's domestic status on the inflow of foreign investments. In this situation, foreign investments can become a crucial growth factor, at the same time being critically dependent on the state of Russia's political, legal and economic institutions. It is these institutions that are capable of either making a country attractive for foreign capital, or of becoming a major obstacle in its way.

*Fourthly*, destabilization may also be associated with the onset of an energy crisis. The rapidly developing Russian economy requires and will continue to require an increasing amount of energy resources. At the same time, the activity of energy producers (mainly oil and gas companies) in surveying and developing new deposits is very low. We are still regarding this country as a big energy producer (lately, a new term has appeared – “energy superpower”), considering it as one of the foundations of “sovereign democracy”. However, the real course of events may very soon give rise to disillusionment. An energy crisis is in no way conducive to political stability or further consistent economic growth – it can by itself serve as a powerful factor of recession.

And fifthly and finally, serious problems can arise in the future as a result of the rapidly increasing external debt. There are two reasons why such a situation can be very dangerous.

On the one hand, there is a growing dependence of the national economy on the situation on the international financial markets. Today, when the price of borrowings is low, economic growth in Russia is sustained by a substantial inflow of external credits. The availability of cheap credits is no less important for growth than high prices of oil and gas. However, a changed situation on the debt market may give rise to serious economic problems. Increasing costs of credit resources will then become a very important restricting factor in the way of economic development.

On the other, more expensive borrowings may create grave problems for the state budget. Many borrowing companies are closely connected to the State and operate on the principle of “privatization of profits and nationalization of losses”. This is also the way they are perceived by financial markets, where it is well understood that, in the event of a crisis, Russia’s biggest private borrowers will be able to rely on the support from the federal budget. Thus there emerges a situation known since the 1997 Asian crisis as *moral hazard*, when some may irresponsibly borrow money, while others may grant this money without giving the matter any serious consideration.

Another problem worth discussing in the medium- and long-term perspective is the continuing social and regional differentiation. These processes, quite explicable in the initial phases of economic growth and the economy’s structural adaptation to new challenges, are fraught with serious threats for future stability.

Rising inflation represents a grave problem, as well. The growth of inflation in 2007 was in part the result of the pre-election policy of whipping up economic growth, and reflected the desire of the ruling party (in the broad sense of the term) to enter the parliamentary and presidential elections on the crest of this wave. Moreover, the upward trend of prices is already guaranteed to continue in 2008, since the bulk of budget allocations of last year was spent in November and December. And this circumstance, as shown earlier, will have a suppressing effect on domestic production (through increasing interest rates).

Any responsible government will have to curb this trend. As early as mid-2008, there will emerge a need for a switchover to another policy, aimed at preventing the economy’s overheating through improving the structure of economic growth. But there also arises another key question, of a purely political nature: will the new President and the new Chairman of the Government agree to it? If the answer is yes, this will mean their taking full responsibility, which is fraught with the risk of losing popularity. They will then be responsible for slower growth and the hardships associated with structural reforms. However, this choice will be inevitable, and no later than 2008.

Serious risks are also inherent in the investment projects being implemented in the sphere of public-private partnerships (PPP). This currently fashionable model implies the pooling of government and private resources in order to provide solutions to major problems faced by the national economy. It is assumed that private businesses invest in construction of enterprises, while the State invests in related infrastructure. All the experience of the State’s participation in business has demonstrated the low efficiency of such participation and the need for much higher expenditures in terms of time and money than those initially planned. As a result, one cannot entirely rule out a situation when private businesses persist in realizing

their part of a project, while the State (quite significantly) falls behind the approved schedule. Thus, the effect of such projects will be markedly diminished.

This is also fraught with the additional risks resulting from global recession. The investment strategy currently adopted by the State and related big businesses, in fact, builds upon the hypothesis of long-term constant growth. Substantial resources are being invested in the development of new export-oriented production, primarily of non-ferrous metals, which constitute an important component of Russia's non-energy exports. However, the demand for such products is very sensitive to the fluctuations of the international market. When there is a boom, both demand and prices grow rapidly, while during recession the trend is exactly reverse. But the output of the newly created businesses is oriented to the contemporary level of demand, which can be fraught with severe financial losses – first of all, for the state budget. The State is a big investing partner in the corresponding projects (mainly in providing appropriate infrastructure), being so closely associated with private businesses that it will be obliged, most probably, to take it upon itself to compensate for their losses in the event of a recession. But this can also lead to a serious macroeconomic crisis.

An important trend in this country's long-term development will also be the existence of a stable one-and-a-half-party democracy. This type of regime, typical of Mexico throughout the greater part of the 20<sup>th</sup> century, is now emerging in contemporary Russia. This is quite natural for a country with a medium level of development and the availability of a powerful source of "cheap money". The one-and-a-half-party democracy can ensure long-term political stability, while at the same time creating additional risks inherent in large-scale corruption and a relatively low efficiency of the basic political and legal institutions. Only the actual course of events will show just how stable the emerging system of power is going to be, and whether it will possess intrinsic mechanisms of modernization.

And the last but not the least key problem of Russia's socio-economic development will remain its readiness and ability to ensure macroeconomic stability. Despite the impressive size of the Stabilization Fund and the unprecedented foreign currency reserves of the Russian Federation, its long-term stability is in no way guaranteed. Just a few errors in macroeconomic policy will be enough for stability to quickly disappear. Moreover, crisis is virtually inevitable, as is taught by the logic of post-revolution development, when periods of stability periodically give way to political explosions, as well as by the logic of economic cycles characteristic of market economies. Thus, our task for the future is to adapt our policy to the functioning under the conditions of the global market.

### **1.3. Lasting Institutional Stagnation Sets the Background for Economic Recession Risks**

A striking feature of the institutional development in modern Russia is considerable discrepancies between two groups of indicators. While the majority of indicators of business environment quality continue to show negative dynamics, the indicators that reflect the level of country investment and credit risks demonstrate a sustainable positive trend. The second group of indicators including e.g. Standard and Poor's investment ratings and the index of OECD country risks, is steadily growing thus reflecting general improvement of macroeconomics in the country: budget stability, government debt reduction, growth of household income, etc. Better indicators of credit risks are an important growth factor of external (short-term mainly) borrowings by the Russian companies as well as the growth of their investments.

International practices show, however, that the sustainable growth of direct foreign investments and entry of new foreign investors to the market (besides the production of mineral resources and manufacturing of consumer goods) to a greater extent is related to profound institutional changes that are described by general indicators of the institutional environment. In the countries attractive for international investors these two groups of indicators develop in parallel, as a rule. Therefore the recent increase of the credit and investment ratings for Russia should not be interpreted as a radical way of resolving the problems of the country's competitiveness at the world investment markets. Changes in these ratings to a certain extent disguise serious problems in functioning of Russia's basic institutions and associated risks that impede the flow of new investments and long-term economic growth.

The differences in the dynamics of the country risk indicators and quality of institutions may be also interpreted as follows: international analysts evaluate general macroeconomic attractiveness of the Russian economy (in terms of income level and macroeconomic management) at a much higher level than the quality of public services required for effective business management and mitigation of risks of direct investment into the real economy.

One can also speak about the growing divergence in the speed of processes that take place inside the private and public sector. The last decade shows that regardless of some negative institutional conditions the Russian business has demonstrated a sufficiently high potential for modernization (higher business efficiency, new markets entry, intensification and diversification of production, improvement of management systems, more transparent ownership, etc.). The public sector has not been so perceptive to development. The reforms that are "state owned" (judicial system, enforcement, economic regulation, public benefits, etc.) are stagnating, at best. While all indicators of the economic creditworthiness are growing (primarily due to the favorable trends of the world raw market development) the confidence in the Russian private business increases at a much higher rate than the confidence in the Russian public institutions.

In this section the institutional environment in Russia is analyzed based on the development history data of a number of international institutional indicators. The focus is placed on the discussion of institutional limitations to sustainable long-term economic growth. The international comparative review reveals a considerable gap between the dynamics of institutional development indicators and the rates of economic growth demonstrated since early 2007 which are believed to be quite substantial by the world standards though they are not typical for the countries with sustainable growth rates. Two major issues of economic policy are discussed using the proposed approach to the analysis of institutional growth factors: possible growth restrictions of the Russian economy given unchanged institutional environment and scope of institutional changes that may be necessary to overcome the widened gap in development of the institutions and to support high rates of growth in the long-term. Some conclusions on the current and future development of the institutions in Russia are also presented.

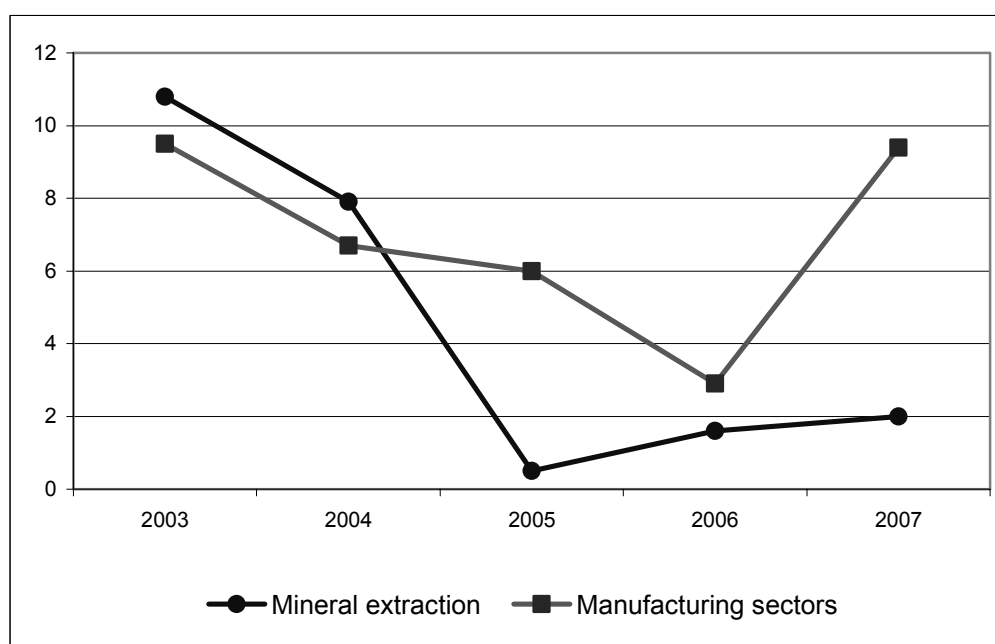
### 1.3.1. Specific Features and Risks of Economic Growth in Current Russia

The Russian Federation declared as a long-term development priority the improvement of the living standards of the Russia's population by reaching per capita GDP of \$20,000 in terms of purchasing power parity which is close to the current GDP of Portugal and Greece. According to the official statistics the economy of Russia rehabilitated completely since 1999

as compared to the pre-crisis level (1997), and surpassed the 1991 level in terms of certain indicators. However the quality of the economic growth raises concerns.

Should the current growth rates (from 1999 onward) remain, the government target can be achieved in 8 years, by 2017. At the same time the capacity of the Russian economy to support the high rates of growth in the long-term is limited since the resources for rehabilitation have been almost exhausted<sup>13</sup>, and the accelerated rates of growth are likely to be achieved at the expense of more efficient use of the current capacity and labor resources given restricted volume of new investments. Besides by mid-2000 the support of competitiveness and growth in the real sector that had been provided by the Ruble exchange rate devaluated after 1998 was cut down<sup>14</sup>. To facilitate the economic growth in the short and long-term perspective, much larger volumes of investments will be required; however the growth rates can slow down considerably due to institutional, structural and demographic limitations.

Major risks of sustainable economic growth are associated with imbalances in the economic structure. The share of the raw producing sector of the Russian economy remains excessive. From 2002 through 2006 the share of the natural resources production in GDP of Russia grew from 6% to 9.5% while the share of the manufacturing sectors fluctuated from 15% to 16% of GDP. Though since 2005 the rates of growth of the manufacturing sectors have outraced the growth rates of the producing sectors (*Fig. 27*) it is still premature to speak about a sustainable structural shift.



Source: Rosstat.

*Fig. 27. Growth Rates of Mineral Extraction and Manufacturing Sectors in 2003–2007, in %*

<sup>13</sup> The period characterized by a higher degree of loading of production factors: fixed assets and labor. For details see: Egor Gaidar (2005) Long time. Russia and the world: essays of the economic history. M.: Delo.

<sup>14</sup> See, e.g. World Bank (2006) “Report on the economics of Russia”. No. 13. December 2006” – World Bank ([http://ns.worldbank.org.ru/files/rer/RER\\_13\\_rus.pdf](http://ns.worldbank.org.ru/files/rer/RER_13_rus.pdf)), OECD (2006) “OECD. Economic reviews of 2006. The Russian Federation” OECD.

The export share of the manufacturing sector (the so-called non-traditional exports for Russia) has recently reduced down to 6.8% (*Table 4*). As a result risks associated with possible drop of prices on the traditional export products in Russia remain high both for the real sector and the federal budget, given that 40% of budget revenues come from the raw producing sectors.

*Table 4*

**Russian Export of Manufactured Products in 2000–2006**

	2000	2001	2002	2003	2004	2005	2006
Export of goods and services, in billion USD	105	102	107	136	183	244	304
Value of exports of manufacturing sector, in billion USD	11,5	11,4	11,3	13,2	14,8	15,4	19,6
as a % to the export value	10,9	11,2	10,5	9,7	8,1	6,7	6,8
Textile products, footwear in billion USD	0,8	0,6	0,7	0,7	0,7	0,7	0,6
Machines, equipment and transportation vehicles, in billion USD.	9,1	9,7	9,2	10,8	12,3	12,4	16,0
Other goods, in billion USD	1,6	1,1	1,4	1,7	1,8	2,4	3,0

*Source:* estimates based on FTS data.

Such strong orientation of the Russian economy towards the raw producing sectors complicates the achievement of the declared economic development targets due to a number of reasons.

First, the prices on raw commodities are highly volatile and fluctuate much stronger than the prices on other commodities. Therefore the countries which economic structure is based on raw commodities face additional problems in their macroeconomic policies since ever changing prices on raw commodities lead to considerable changes in the budget revenues and actual exchange rates of the currencies of the exporting countries. In a stable price environment budget revenues tend to grow, as a rule, hand in hand with budget expenditures, and in the long-term perspective the size of expenditures depends on the size of the future revenues generated by raw materials, i.e. on the situation on the world markets. Where the government does not take any actions to diversify the national economy, risks evolve that the budget policy will not be balanced. In the period of high prices the exporting countries often face the problem of large increase of the exchange rates of their national currencies, this deteriorates competitiveness of the national producers of the traded goods<sup>15</sup> and enhances risks of de-industrialization of the economy. The macroeconomic exposure of the exporting countries increases their risks and decreases their attractiveness for investors.

Secondly, this dependency on raw materials negatively affects economic dynamics due to technological reasons. Thus low labor intensity of the raw-based production even with account of jobs created in the related sectors does not usually allow for creating a sufficient number of jobs in the highly-productive sectors of the economy. Besides, technologies applied in the raw producing sector are relatively simple and therefore have a weak impact on the de-

<sup>15</sup> See, e.g., Collier, Paul, Jan Willem Gunning (1996) Policy Towards Commodity Shocks in Developing Countries, IMF Working Paper 1996–84, IMF, Washington DC.

velopment of manufacturing companies with a high share of added value thus limiting the growth of labor productivity in the entire economy.

Due to the sizable effect of the economy of scale the producing sectors have a high degree of concentration of operations. In such sectors the dominance of a few companies that play a specific role in the country's economic and political spheres is a typical phenomenon; the interests of the government and the major producers are closely interrelated. Such social and economic structure might slow down competition both in politics and in the economy, some developing countries and good examples of this process.

Thirdly, in the countries with raw exposure, all other conditions being equal, the size of the public sector is large and the level of public expenditures is also high. Production of mineral resources generates considerable resource rent which is re-distributed through the budget. Therefore the economic policy in those countries sets forth more rigid requirements to the system of public finance administration and to the quality of institutions in the public sector<sup>16</sup>. Where such institutions are weak, the concentration of the tax base in the producing sectors with economic dominance of producing companies strongly undermines public control over public expenditures, and corruption risks of the government institutions go up<sup>17</sup>. The increase of public expenditures funded from the resource rent and not from regular taxes on business and individuals creates a puffed-up and low efficient public sector in the exporting countries. There is the so-called "damned mineral resources" phenomenon<sup>18</sup>, when major exporters of raw materials are unable to use reasonably the revenues from raw exports and lag behind those countries that have lean mineral resources.

Note that diversification of the economy does not guarantee successful development of the country and, visa versa, the raw-based economy does not necessarily make the country lagging behind the world economic country-leaders. There are examples of highly developed countries with a large proportion of the raw-based sector in their GDP (Norway, Australia) likewise there are countries with highly diversified economies that are stagnating (Japan, Portugal). In the majority of cases, however, the successful economic development goes hand in hand with the increase of the share of non-raw sectors in the industrial structure and the enhancing role of hi-tech sectors and services in the economy.

Thus the risks of raw-based development strategy are pretty high. For Russia it appears extremely difficult to create the environment for a long-term sustainable social and economic development and narrowing gaps in the national living standards vs OECD countries unless the national economy becomes fully diversified. Regardless of the recent enhanced economic activity in the non-raw-based sectors and a growing number of the government resolutions where the need in diversification is highlighted, it is still premature to speak about the lasting

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<sup>16</sup> In the works by Collier, Paul, Anke Hoeffler (2006) *Testing the Neocon Agenda: Resource Rents, Democracy and Growth*. Centre for the Study of African Economies, Oxford University and Collier, Paul (2007) *Managing Commodity Booms: Lessons of International Experience*. Centre for the Study of African Economies, Oxford University, the author highlights the importance of the system of checks and balances to ensure effective functioning of the public sector. At the same time the author demonstrates that in exporting countries of raw materials a high share of the public sector in GDP as a rule is combined with a weak checks and balances system, thus their long-term growth is impeded.

<sup>17</sup> Krueger, Anne (1974). "The Political Economy of the Rent-Seeking Society". *American Economic Review* 64: 291–303.

<sup>18</sup> Auty, Richard (1993). *Sustaining Development in Mineral Economies: The Resource Curse Thesis*. London: Routledge.



structural shift towards manufacturing sectors since the rates of production growth in these sectors are insufficient to support the declared objectives of the diversification of the economy and GDP growth. Moreover the economic strategy noticeably neglects the development of appropriate institutional environment which is the basis of diversification.

### 1.3.2. Institutional Development as a Key Diversification Tool

Before 1980 public investments into “strategic” or “priority” sectors and other tools of direct participation of the government in the economy had been the most popular tool of the economic growth policy used by the developing countries; however in the last 25 years of the XX century a visible reshaping of the government role in the regulation and restructuring of the national economy occurred.

According to the present-day concept, the key role of the government in the economic development is to assure favorable and equal business conditions for all the subjects of the economic activity. To implement this role, the government concentrates its efforts in two major areas: support of the macroeconomic stability and improvement of the institutional environment.

The institutions are understood as socially accepted norms and rules that ensure the functions of the economy and the state. The institutions are generally defined as both formal and informal statutory norms such as business traditions and established informal rules of behavior in the society. The quality and stability of the national institution depends, among others, on the level of business development costs, the degree of business attractiveness for private investors, investment activity in the country, competition on the markets; these factors directly affect economic development. Numerous cross-country surveys show that a sustainable correlation exists between the quality of institutions and long-term growth rates<sup>19</sup>.

The countries with per capita income over \$10,000 (purchasing power parity) are generally believed to have effective institutions. For a highly developed country to have weak institutions is something out of order in the world economic history. Therefore a country where the degree of development of basic institutions is below an implicitly fixed level can not be considered a full-fledged member of the prestigious international organizations that lead in the world economy such as OECD or G8. For Russia to be a member of G8 is a certain credit which also reflects the military potential of the country; however this membership should not be definitely viewed as the recognition of Russia as a world leader.

In a broader sense the economic institutions may be described as a set of mechanisms and rules ensuring re-distribution of resources in the economy, engagement of new investments, training of human resources and creation of incentives for higher economic efficiency. The economic institutions may be grouped as follows:

- legal institutions (judicial, legislative and administrative systems);
- regulatory institutions (the bodies in charge of control and regulation of various aspects of daily business activities of the companies and having the right to suspend these activities);

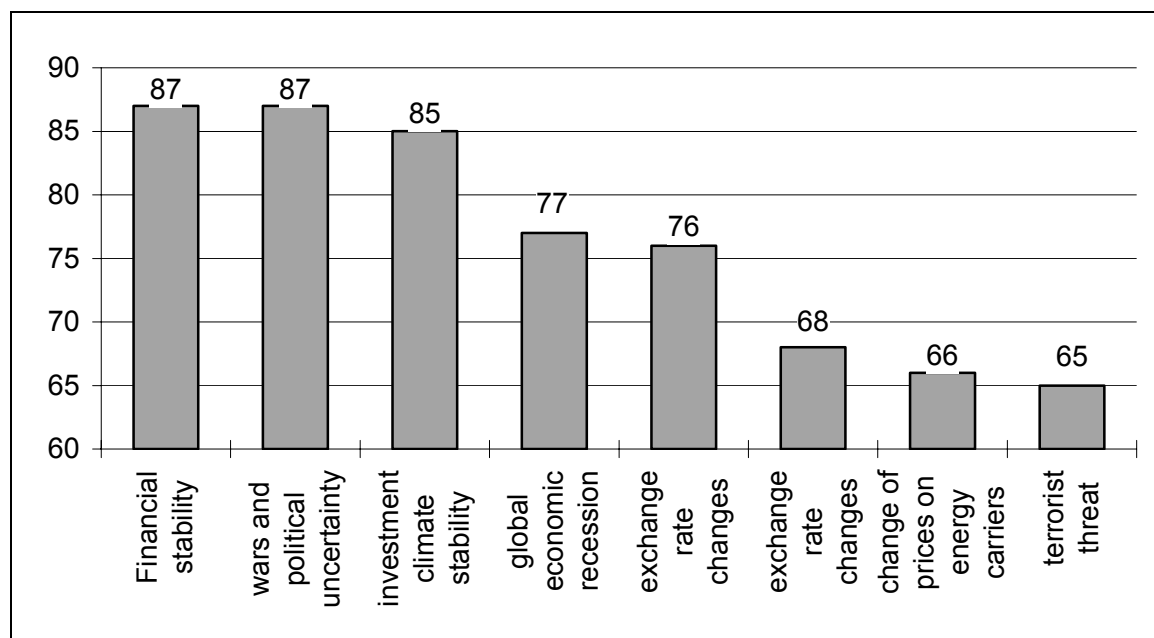
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<sup>19</sup> This link is demonstrated in a number of academic works, (see, Keefer, Philip, Stephen Knack (1997) “Why Don’t Poor Countries Catch Up? A Cross-National Test of Institutional Explanation,” *Economic Inquiry* 35: 590–602, Knack, Stephen, Philip Keefer (1995) “Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures”, *Economics and Politics*, 7: 209, Shleifer, Andrei, Rafael La Porta, Florencio Lopez-de-Silanes, Robert Vishny (1997) *Legal Determinants of External Finance*, *Journal of Finance*, Shleifer, Andrei, Rafael La Porta, Florencio Lopez-de-Silanes, Robert Vishny (1998) *Law and Finance*, *Journal of Political Economy*, and also applied studies (see, e.g. reports of Fraser Institute *Economic Freedom of the World*).

- human resources development institutions (in health, education and social insurance);
- risk coordination and allocation institutions (credit and banking system, stock market, insurance companies and pension funds).

The efforts of the public and private sectors can make a definite impact on the development of the institutions in the last two groups while the development of the institutions in the first two groups may be realistically influenced by the government carrying out institutional reforms. In other words the improvement of the business environment and the creation of favorable conditions for the long-term development of Russia is a direct function of the action (or no action) of the government to reform these groups of institutions. The 2007 outcomes, however, do not demonstrate a serious progress in this direction and show continuation of the trends of the previous years. Thus the need in promotion of the institutional reform continues to grow.

The problem of improvement of the system of national institutions is especially acute for diversification since the decision on establishment of new enterprises and investments into new projects is linked directly to the quality and stability of the institutional environment. National and international investors are very sensitive to the capacity of institutions to assure functioning of newly created enterprises. The UNCTAD survey of 2007<sup>20</sup> showed that transnational corporations when deciding to invest directly in a particular country take into account macroeconomic, institutional and geopolitical (probability of military conflicts, acts of terror, etc.) risks. The share of companies that consider stability of national investment climate as a key or major factor makes up 85% – running third after political uncertainty and war probability factor (87%), and financial instability (87%) (Fig 28).



Source: UNCTAD survey results.

Fig. 28. Major Risk Factors in Taking Investment Decisions in %

<sup>20</sup> UNCTAD (2007) World Investment Prospects Survey 2007–2009, UN, New York and Geneva.

Внести в легенду! Financial stability, wars and political uncertainty, investment climate stability, global economic recession, corruption, exchange rate changes, change of prices on energy carriers and raw materials, terrorist threat.

Corruption was placed fifth by 76% of the surveyed companies. This may be explained by that the problem of corruption for transnational companies operating in a particular country can be resolved by exclusive (formal and informal) arrangements/agreements with the national administrations that actually “protect” these transnationals from many problems of the national institutional environment. Such system of arrangements, however, is non-transparent and therefore does not equal the system of general national institutions capable of supporting the creation and functioning of competitive markets.

In recent years a relatively high level of external and internal investments in Russia has been supported by high oil prices. Fast growth of internal revenues compensated to a certain extent the institutional weakness of the economy, i.e. the rates of market expansion and profit growth compensated risks of backwardness of the economy. This situation does not seem to be stable. If the oil prices drop, the requirements to the Russian institutions would become tougher. Investors most likely will not ignore institutional problems and country risks if the national revenue growth rates are lower than 10% per year. Recently serious restrictions in the investment structure have been observed in Russia. Investments grow primarily in the raw-based sectors<sup>21</sup>, in the sectors producing consumer goods and at the real estate market. Investments in the high-tech sectors and in the development of export commodities that are new for Russia (where risks are higher) are still very low.

During the transition to a post-industrial development stage the requirements to the quality of institutions become more stringent since as compared to the industrial stage the dynamics of the development of the post-industrial economy is determined by somewhat different factors that are more sensitive to the quality aspects of the institutional environment. The set of interrelated factors includes:

- higher requirements to the quality of human resources: this implies radical changes in the national education and health systems as well as in other institutions capable of ensuring positive dynamics of the broad term “life quality” (including personal safety, protection of environment, access to information and public confidence);
- innovative nature of the economy with adequate support (financial instruments and business services, copyright protection, low cost of market entry and fair competition);
- further specialization and division of labor that will require better coordination and reduction of transactional costs;
- complicated economic system and new comprehensive risks for sustainable development demanding that secure systems of risks distribution are developed, social and economic processes are effectively monitored, partnership between the state and non-state participants is strengthened;
- the larger role of information and information technologies that leads to further growth of requests for information about activities of all leading institutions and organizations, enhanced requirements to their transparency and demand for democratization of various as-

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<sup>21</sup> Even in the raw-based sectors investments into exploration are insufficient i.e. investments in the long-term sector development are lagging behind.

pects of public life, and alleviates conditions for establishment of numerous coalitions and specialized groups of interests.

### 1.3.3. Correlation of the Dynamics of Economic and Institutional Development Indicators: Russia's Experience in the Context of International Development

For the last 10–15 years the method of cross-country comparison where for assessment indicators of the institutional environment and certain components are used developed into an independent and prestigious section of empirical studies in public sciences. Reaching a consensus on what can be considered the best international practice in public administration and what are major factors of public sector efficiency is a methodological foundation of this research. The indices of the institutional environment used in the analytical research reflect the established ideas of the key institutional determinants of the economic growth such as effective protection of the property rights, effective enforcement, accountability of government officials, budget transparency, absence of corruption, etc.

Macroeconomic data, surveys of the companies and other users of public services, expert polls, election results and various combinations of these information sources are used for building up institutional indicators. Considerable correlation between the indicators built on various data and for varying research needs is observed<sup>22</sup>. Such indicators are widely used in economic modeling.

Quality indicators of the institutional environment demonstrate a more or less correlated assessment of the dynamics of quality of the key institutions in the economy of Russia. Present Russia in terms of institutions is lagging behind countries with fully developed economy and those with economy in transition in Central and Eastern Europe.

Ex-socialist states can be grouped into two categories. The first category includes the countries of Central and Eastern Europe and the Baltic countries where the quality of institutions is much better than in the second category and the institutional environment demonstrates stable and positive changes. The second category includes CIS countries that recently showed signs of economic stagnation and in some cases stagnation in their institutional environment.

It is worth mentioning that in India and China with their lower GDP level vs in Russia and high sustainable rates of growth the quality assessment of institutions was higher during the period with available records, i.e. since 1996 (see, e.g. the report of World Bank – Worldwide Governance Indicators (WGI)). The dynamics of institutional improvements in India for the reporting period was not worse than in Russia while in China – much better than in Russia.

The majority of the reviewed international indicators that reflect the level of institutional development demonstrate similar trends. We can reasonably assume that the results of the trend analysis of several indicators built by independent agencies confirm the conclusion of no stable institutional progress in Russia.

As shown by the review of various international indicators, the economic growth observed in Russia since 1999 so far has not been accompanied by changes in quality; e.g. in those institutions that assure property rights and appropriate regulation corruption was not

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<sup>22</sup>Kaufmann Daniel, Aart Kraay (2007). Governance Indicators: Where Are We, Where Should We Be Going? World Bank. Policy Research Working Paper No. 4370.

taken under control. High transactional costs typical for Russia reduce potential attractiveness of the country for investors and create negative environment for market new comers. The internal market is less competitive due to high market entry and business costs, and corruption-related burden on the entrepreneurs. Besides, as shown by direct foreign investment factor (OECD), in Russia there have been excessive barriers on the way of investments as compared to other countries. In certain important sectors with good prospects of growth in Russia (e.g. transportation, finances, telecommunications) discrimination of foreign investors have been considerable (or even excessive).

Therefore in current Russia unlike in the majority of other countries of the world a combination of relatively high economic development and relatively low quality of the institutional environment is observed. In this paper we call such combination “an institutional gap”.

It should be noted that Russia demonstrates pretty high values of the institutional indicators mainly in the areas of human resources as a legacy. These advantages reflect ex-Soviet successes in education and national health but also considerable inertia in the development of the mentioned sectors.

As said earlier, an obvious gap between the economic and institutional development in Russia props up when most popular indicators/indices are reviewed including World Bank’s WGI<sup>23</sup> mentioned above (2006 data), Transparency International’s CPI<sup>24</sup> (2006 data), Political Risk Services Group’s ICRG<sup>25</sup> (2005 data). In recent years the institutional gap has widened (see *Fig. 29–37*). This conclusion can be drawn based on the review of the comprehensive sample of the world countries and a narrower group of ex-socialist countries.

During 1996–2006, as most of the scatter diagrams show, a sizable growth of production and revenue in Russia occurred with no improvement of quality of the institutional parameters. In certain cases the growth of per capita GDP was accompanied by a limited improvement of the quality of the institutional environment (public governance or corruption control indicators) while in other cases (quality of legal institutions) the assessments were negative.

As shown by all scatter diagrams, Russia is found in the left area, above the area of distribution of the majority of the world countries and OECD countries i.e. it is surrounded by a specific and relatively stable group of countries. Other countries that have compatible institutional gaps include Argentina, Venezuela, Byelorussia, Iran, Kuwait, Italy and Saudi Arabia. All these countries (except Italy) demonstrate serious obstacles on the way of sustainable post-industrial development. The gap is wider only in such tiny states as Bahrain, Seashell Islands, Trinidad and Tobago, and Equatorial Guinea.

We stress that the gap between the economic and institutional development of Russia has increased recently. Thus, Transparency International Corruption Index (*Fig. 36–37*) shows that in 1995 the income level in Russia was better aligned with the level of the institutional development than in 2005 when the income grew considerably while the quality of the institutions has not changed much, and the gap became wider (on the diagram Russia drifts to the left and the top).

A reverse situation where the economic development is far behind the institutional development is observed in the countries plunged in war conflicts or engaged in post-war reha-

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<sup>23</sup> World Bank Worldwide Governance Indicators (Governance Matters).

<sup>24</sup> Transparency International Corruption Perceptions Index.

<sup>25</sup> Political Risk Services Group International Country Risk Guide.

bilitation, when business is run in the context of extraordinary country risks. Tajikistan is an example of such country; it is placed below the regression level and the confidence band. For the countries of this group (includes Georgia and Moldavia) the combination of relatively mature institutions with extremely low income means that they have institutional reserves for active short-term growth provided the existing institutions would not deteriorate.

Important is that presently there is no country in the world having per capita GDP above \$18,000 (according to the consumer power parity) where the level of the institutional development is equal to or lower than that in Russia. This empiric observation may be interpreted as follows: the lag of the institutional development can not expand unlimitedly, and when the country reaches a certain development level a situation develops when economic growth cannot be attained without adequate institutional changes.

The stable correlation between the institutional development and per capita GDP in the global sample is not a strict formal proof of that further fast growth of Russia is impossible. This correlation, however, is a convincing illustration of the fact that within the scope of the average development pathway observed in the post-war period in successfully developing countries there is no large gap between the growth of revenues and improvement of institutions. Exemptions are likely to occur, but statistically with such gap the country can not be successful economically. At least nothing like that has been observed in the recent economic history.

It would be short-sighted to ignore the existing global interrelations between institutions and economic growth in planning a national economic strategy. Given the world experience, the hope for further development of Russia without serious institutional modernization seems irrational and politically dangerous. To believe in possible long-term growth based on the unique Russian way of development is very risky. The Russian per capita GDP is already beyond the statistical allowable range which corresponds to the current quality of the Russian institutional environment.

In other words with account of the scale of the economic development in Russia in the recent decade and also the global trends, one can speak about the risk for Russia to attain the set objectives of the economic development if the current quality of the national institutions remains unchanged.

Using the World Bank database – Worldwide Governance Indicators, the scale of institutional improvements may be assessed as necessary to overcome the institutional gap and mitigate current risks. The assessment is based on that the countries with GDP equal to \$18,000 (per capita) on the average have better quality of their institutions. In particular, the following target assessments for acceleration of the institutional reform in Russia can be set:

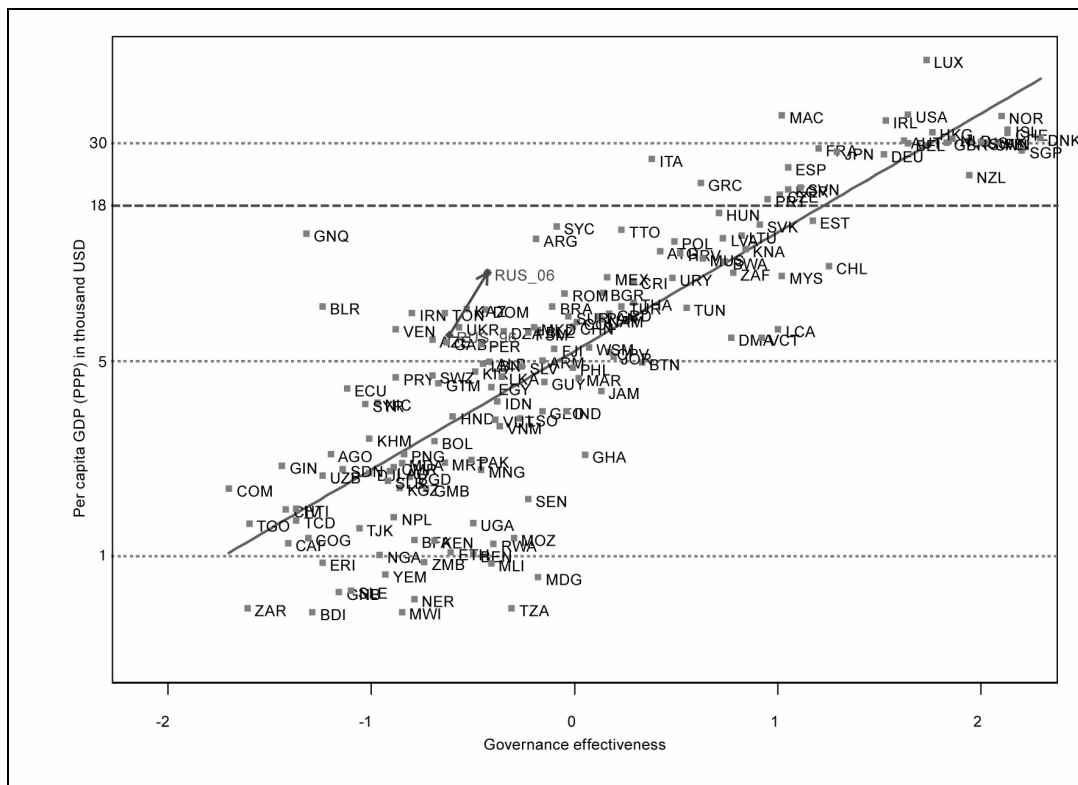
- Public governance indicator – the level of Italy = 0.38 (the scale from –2.5 to 2.5), the current value for Russia –0.43 (see *Fig. 29*),
- Quality of regulatory authorities indicator – the level of Korea = 0.70; the current value for Russia –0.45 (see *Fig. 30*),
- Quality of legal authorities indicator – the level of Italy = 0.37; the current value for Russia –0.91 (see *Fig. 31*),
- Corruption control indicator – the level of Italy, Korea, Slovakia = 0.31; the current value for Russia –0.76 (see *Fig. 32*).

The analysis of fast and successful institutional transformations in the countries of Central and Eastern Europe carried out during their preparation for EU ascension shows that the

scales of similar institutional developments (app. 1 score, 5-score scale) are likely to be implemented within 8–10 years (see Fig. 39–40).

Let us note that the countries with the level of development of their legal institutions comparable to that of Russia<sup>26</sup> (the institutional index range:  $-0.96$  to  $-0.86$ ) grew moderately during 1996–2006: their average annual growth rates were from  $-2.9\%$  to  $4.4\%$ <sup>27</sup>. In other words, presently there is no single country in the world that would demonstrate sustainable growth rates about  $7\%$  per year having the level of institutional development like that in Russia. This speaks of the risks of sharp reduction of economic growth rates moreover in the context of falling prices at the raw materials markets; this is the basic reason behind the extraordinary high institutional gap in Russia.

Similar conclusions can be drawn on the basis of analysis of the “Corruption Perception Index” generated by a non-governmental agency “Transparency International”. According to this index the gap between the economic and institutional development of Russia is more serious than in any ex-socialist country (see Fig. 37–38).



Note. List of abbreviations for the countries (Fig. 29–37) is given at the end of the section in Table 5.

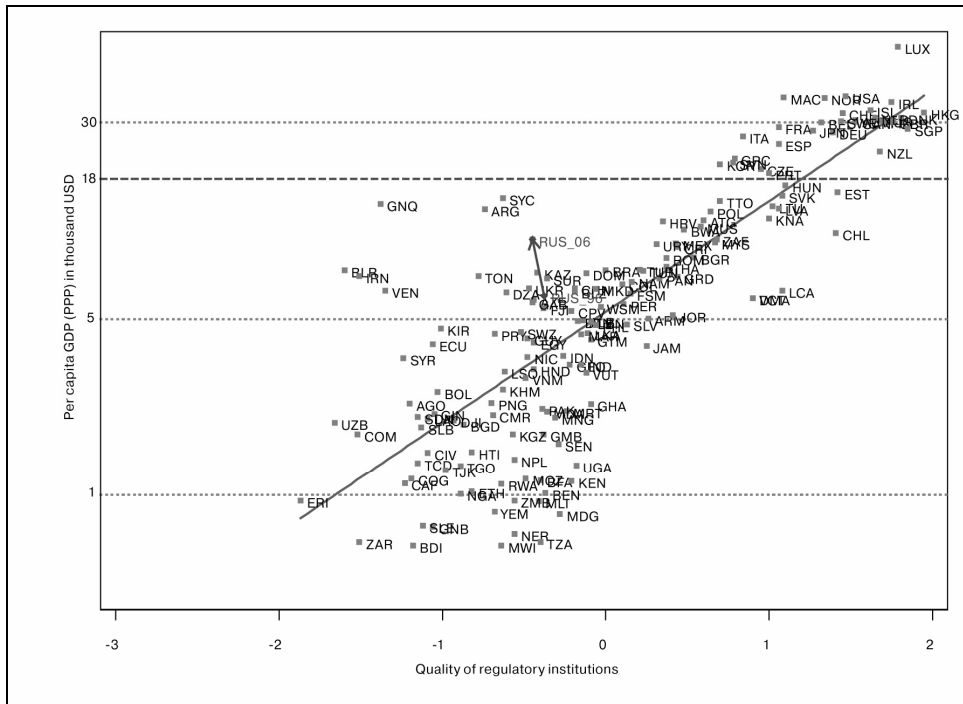
Source: World Bank World Governance Indicators, World Bank World Development Indicators.

Fig 29. Per Capita GDP and Public Governance Effectiveness (WB WGI), 2006<sup>28</sup>

<sup>26</sup> Bangladesh, Bolivia, Burundi, Cuba, Laos, Niger, Paraguay, Ecuador.

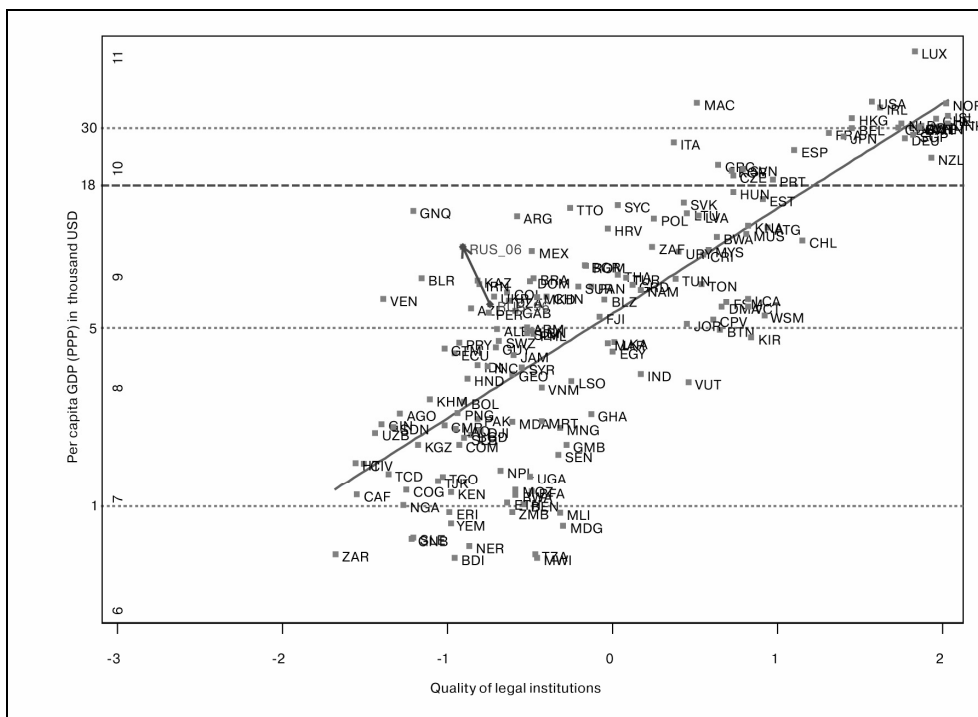
<sup>27</sup> If to exclude Azerbaijan from this group, where the average rates of growth were determined by a sharp increase of oil production making  $12.4\%$  per year.

<sup>28</sup> The grey range here and thereafter shows a 10% confidence range built on the basis of econometric assessment of the function of per capita GDP/institutional variable. The Y-values are shown in a log scale. Abbreviations of the country names are given in the Attachment.



Source: World Bank World Governance Indicators, World Bank World Development Indicators.

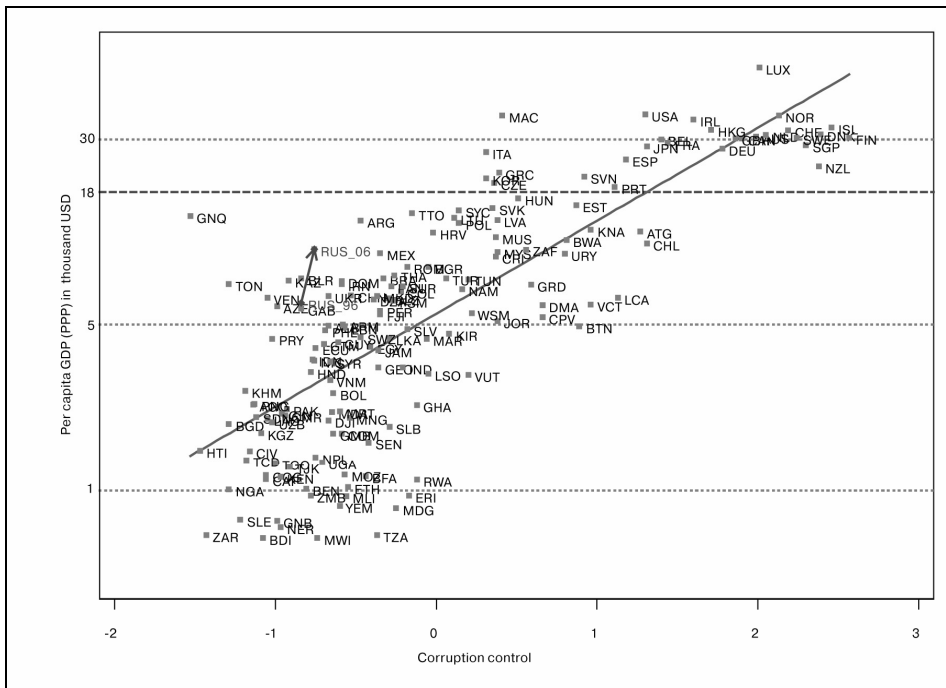
Fig. 30. Per Capita GDP and the Quality of Regulatory Institutions (WB WGI), 2006



Source: World Bank World Governance Indicators, World Bank World Development Indicators.

Fig. 31. Per Capita GDP and the Quality of Legal Institutions (WB WGI), 2006

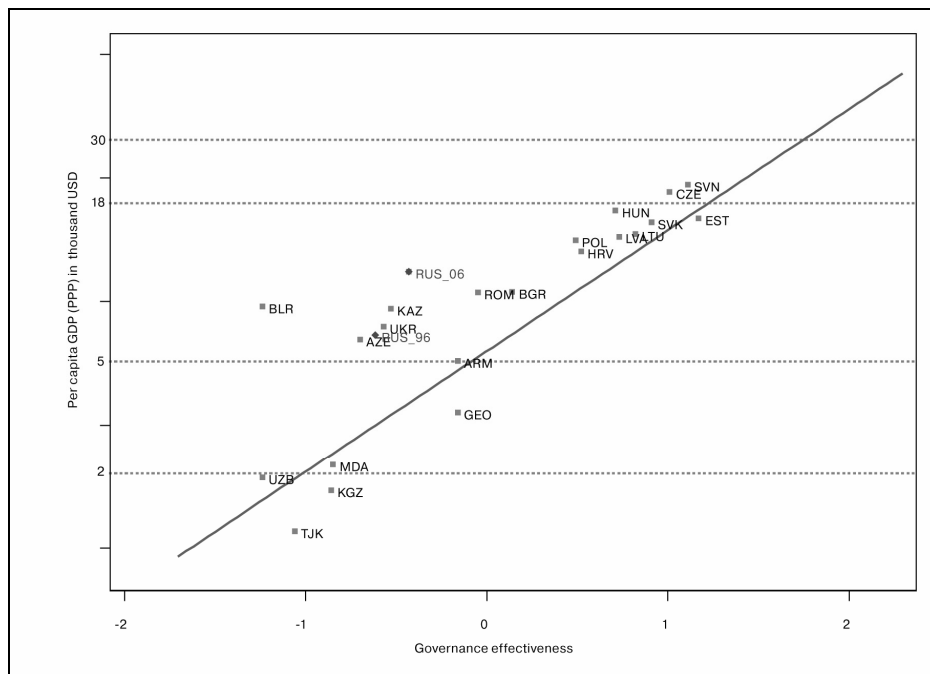




Source: World Bank World Governance Indicators, World Bank World Development Indicators.

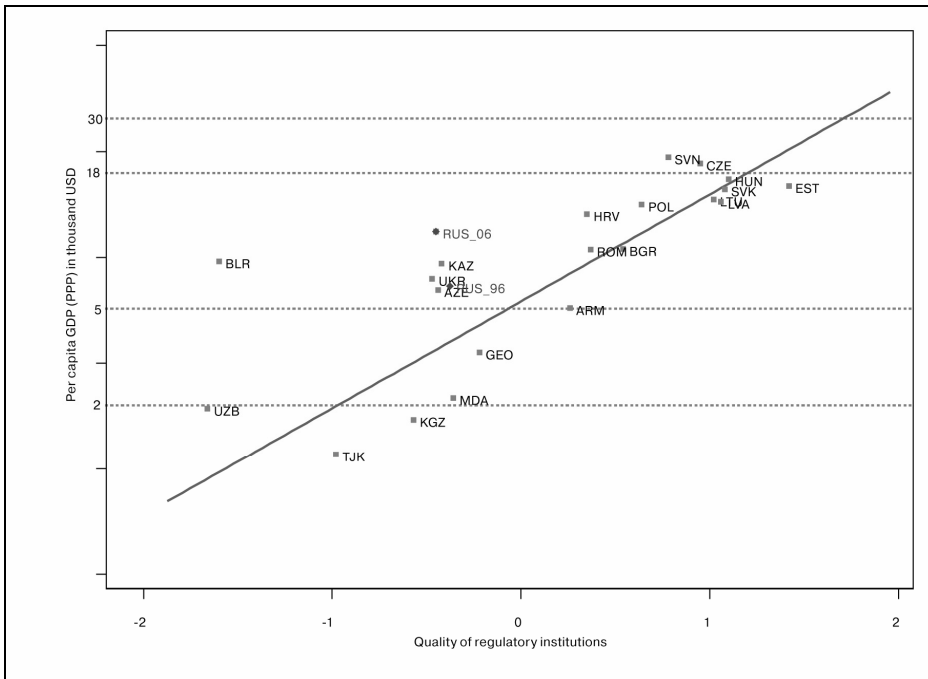
Fig. 32. Per Capita GDP and Corruption Control (WB WGI), 2006

*Sample of ex-socialist countries*



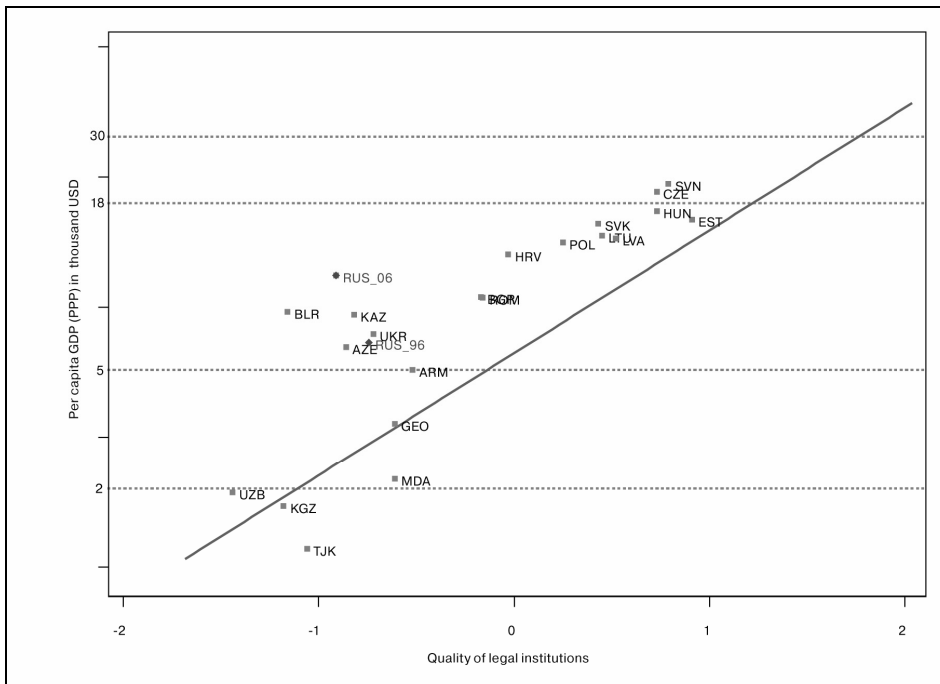
Source: World Bank World Governance Indicators, World Bank World Development Indicators.

Fig 33. Per Capita GDP and Public Governance Effectiveness (WB WGI) in Ex-Socialist Countries, 2006



Source: World Bank World Governance Indicators, World Bank World Development Indicators.

*Fig. 34. Per Capita GDP and the Quality of Regulatory Institutions (WB WGI) in Ex-Socialist Countries, 2006*



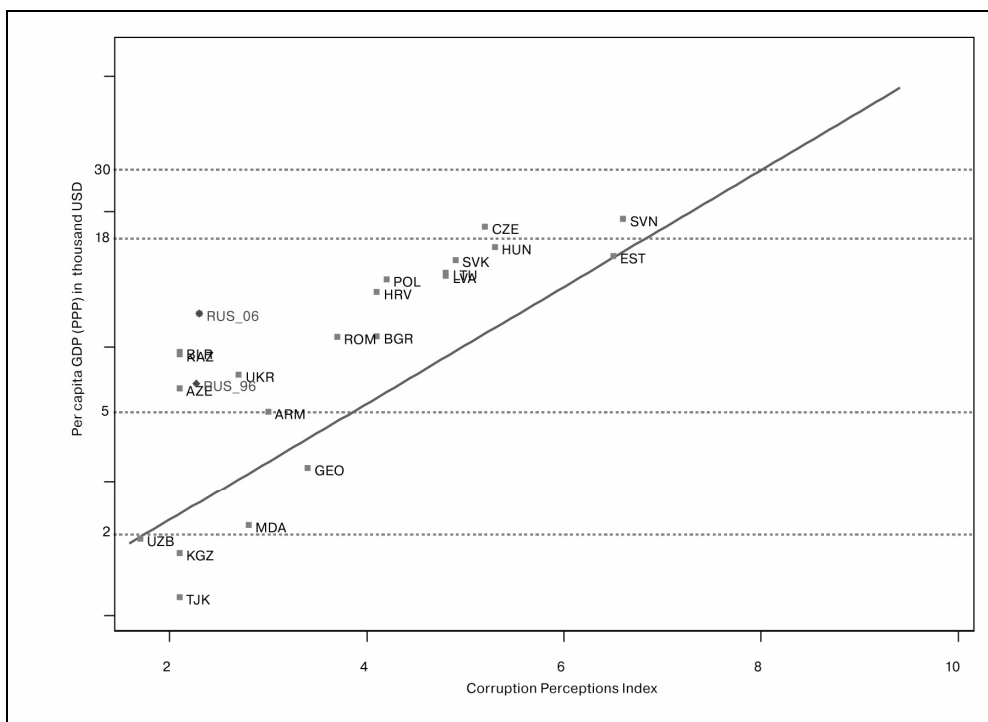
Source: World Bank World Governance Indicators, World Bank World Development Indicators.

*Fig. 35. Per Capita GDP and the Quality of Legal Institutions (WB WGI) in Ex-Socialist Countries, 2006*



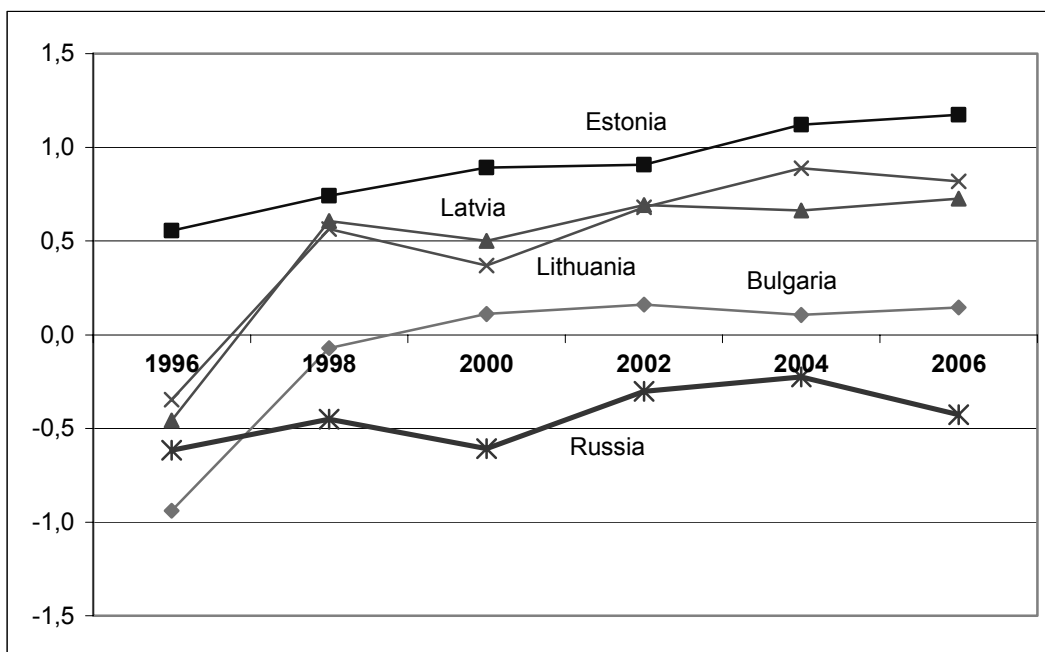
# RUSSIAN ECONOMY IN 2006

trends and outlooks



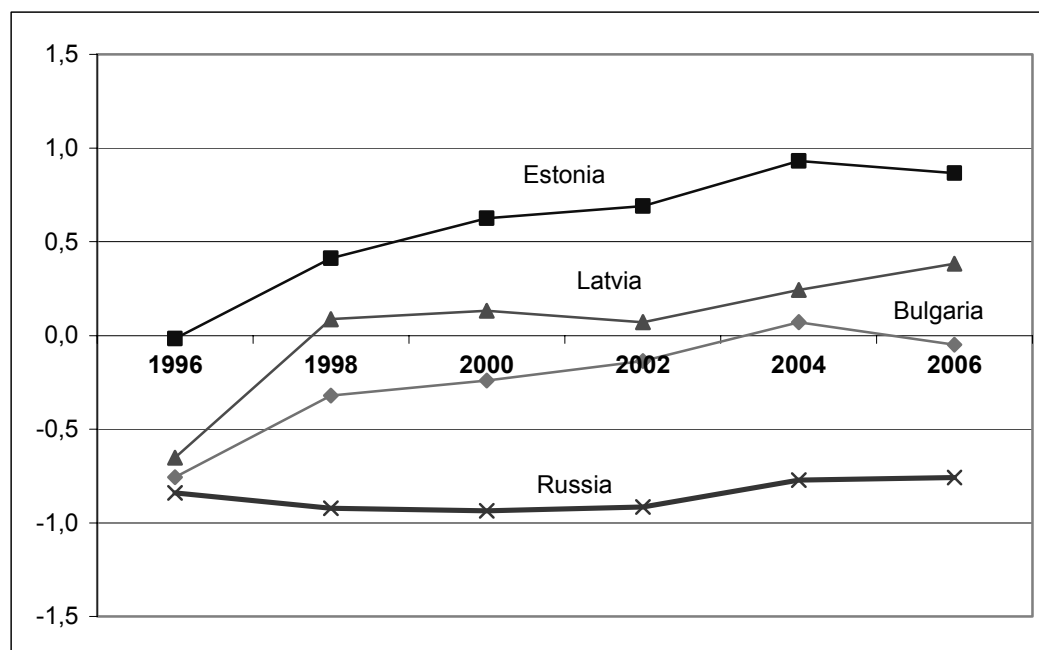
Source: Transparency International Corruption Perceptions Index, World Bank World Development Indicators.

Fig. 38. Per Capita GDP and Corruption Perceptions (TI CPI) in Ex-Socialist Countries, 2006



Source: World Bank World Governance Indicators.

Fig. 39. Increase of Public Governance Effectiveness in Ex-Socialist Countries, 1996–2006



Source: World Bank World Governance Indicators.

Fig. 40. Greater Corruption Control in Ex-Socialist Countries, 1996–2006

#### 1.3.4. Some conclusions on the nature of present institutional dynamics in Russia<sup>29</sup>

The findings of the analysis of theoretical and empirical literature on the problems of interrelation between the economic growth and institutional dynamics and also the study of the trends of quality changes in the Russian institutions allow making certain conclusions regarding general problems in this area.

Primarily it should be noted that the modern institutional and economic theory defines maturity of the national institutional environment on the basis of the following criteria: 1) general stability of the established structures of the property rights and the rules of appropriation at all stages of the investment cycle; 2) political and legal stability; 3) capacity of the judiciary system; 4) enforcement of contracts and commitments. The analysis using these criteria shows that the institutions set in Russia for the last 15 years are far from being mature. The functioning system has certain weaknesses that undermine institutional dynamics:

1) The asymmetry of economic, institutional and political factors of the Russian economy that emerged in the years of 2000 has been overshadowed by general indicators of economic surge, favorable situation on the raw materials markets, stability of the public finance (budget surplus, increasing volumes of the Stabilization Fund and forex/gold holdings), indicators of exceptional profitability of the Russian stock market. Opposite development trends of the institutional and investment ratings for Russia demonstrate that in the years of 2000 the negative impact of the “state” has increased with simultaneous positive influence of pure “market factors”. The growing scale of the state interference into the national economy holds

<sup>29</sup> In this section the results of the recent studies in the Institute of Economy in Transition are summarized. For details see: Russian economy in 2006. Trends and prospects. Moscow, IET, 2007.

back the development rates of the private sector and pure market structures. The conclusion *on the opposite trends of the "state" and "market" factors development* in Russia of 2000 has been confirmed by sociological survey data.

2) This problem of asymmetry of the economic and institutional factors of the development of the Russian economy can become critical *in the long-term prospective* in the context of the role played by the institutions in support of the economic dynamics moreover given the share of short-term market factors in the sources that determine current economic growth and budget revenues.

3) In the years of 2000 there was *no expansion of potential social basis* that would facilitate accelerated formation of effective economic institutions supported by traditional political processes (i.e. through elections and political representation). On the contrary, those mechanisms that back in the 1990's impeded the expansion of demand for effective economic institutions have been modified and function till now. If prior to 2000 (the terms are conventional) we were talking about the model of "capitalism of oligarchs" now the most popular term has been *"state capitalism" in its Russian version* within which framework powerful interests have developed to support status quo. Where the government does not take active actions to improve business environment such model of capitalism would inevitably run into risk of losing economic impetus. The main sources of innovations on the market (competition and entry of new companies) require on-going efforts taken by the government to strengthen the existing market institutions.

4) In mid-2000's the risks brought into legal entrepreneurship by institutions and the regulatory function of the state remained and preserved their impact. However, another factor came into play: the state expanded *the scale of direct economic interference*. There was a high probability of correlation between direct and indirect interference of the state in the national economy and *growing corruption* in this period.

5) Cross influence of such institutions as protection of property rights and financial system in their current form in Russia is *more negative* than positive. The absence of institutional transformations and/or aggravation of the investment climate in some of the areas gives rise to direct risks for investment dynamics and may restrict the growth of investments into fixed assets in the near future, in particular, if prices on raw materials fall and revenue growth rates are seriously disrupted.

6) During 2000–2007 the progress in the development of basic market institutions (such as protection of property rights, protection of shareholders' rights, formation of land and real estate market, management of government property, bankruptcy and protection of creditors' rights) proved to be slow. The findings make us assume that legislative and regulatory support of the development of economic institutions has not been appropriate and adequate. *The law has been lagging behind the economic reality*.

7) The formation of a *"double standard" and different game rules for various classes of the market participants* was a specific feature of the institutional development in the 2000's. The cultivation of the double standard at the federal and regional levels creates insurmountable obstacles for the formation of favorable institutional environment at the national level and local institutional changes in the area of competition, protection of property rights, corporate governance, financial markets, stringent budget restrictions, etc.

8) By the end of the 1990's – beginning of the 2000's a situation evolved in the country where the economic law was relatively developed while enforcement was the most critical

issue. By mid of the 2000'es a new trend in the area of the economic law appeared complementing the traditional problem of enforcement and expanding the range of selective and ambiguous interpretation of the economic law. This legislative shift increased uncertainty of impact on economic decisions passed by business and made assessment of possible reactions from the government more difficult; on the other hand, it obviously tightened the relationship between the state and the private business. The enforcement problem in Russia complicated by larger uncertainty and rehabilitation of some rigid legislative norms *noticeably expands the risk zone in the area of property rights.*

*Table 5*

**List of abbreviated names of the countries**

Code	Country Name	Code	Country name
1	2	3	4
ABW	Aruba	LBN	Lebanon
ADO	Andorra	LBR	Liberia
AFG	Afghanistan	LBY	Libya
AGO	Angola	LCA	St-Lucia
ALB	Albania	LIE	Lichtenstein
ANT	Netherlands Antilles	LKA	SriLanka
ARE	United Arab Emirates	LSO	Lesoto
ARG	Argentina	LTU	Lithuania
ARM	Armenia	LUX	Luxemburg
ASM	American Samoa	LVA	Latvia
ATG	Antigua and Barbuda	MAC	Macao
AUS	Australia	MAR	Morocco
AUT	Austria	MCO	Monaco
AZE	Azerbaijan	MDA	Moldavia
BDI	Burundi	MDG	Madagascar
BEL	Belgium	MDV	Maldives
BEN	Benin	MEX	Mexico
BFA	Burkina Faso	MHL	Marshall Islands
BGD	Bangladesh	MKD	Macedonia
BGR	Bulgaria	MLI	Mali
BHR	Bahrain	MLT	Malta
BHS	Bahamas	MMR	Myanma
BIH	Bosnia and Herzegovina	MNE	Montenegro
BLR	Byelorussia	MNG	Mongolia
BLZ	Belize	MNP	Mariana Islands
BMU	Bermudez	MOZ	Mozambique
BOL	Bolivia	MRT	Mauritania
BRA	Brazil	MUS	Mauritius
BRB	Barbados	MWI	Malawi

*Table 5 (continued)*

1	2	3	4
BRN	Brunei	MYS	Malaysia
BTN	Butane	NAM	Namibia
BWA	Botswana	NCL	New Caledonia
CAF	Central African Republic	NER	Nigger
CAN	Canada	NGA	Nigeria
CHE	Switzerland	NIC	Nicaragua
CHL	Chile	NLD	Netherlands
CHN	China	NOR	Norway
CIV	Ivory Coast	NPL	Nepal
CMR	Cameron	NZL	New Zealand
COG	Congo	OMN	Oman
COL	Columbia	PAK	Pakistan
COM	Comoro Islands	PAN	Panama
CPV	Cape-Verde	PER	Peru
CRI	Costa Rika	PHL	Philippines
CUB	Cuba	PLW	Palau
CYM	Snapper Islands	PNG	Papua-New Guinea
CYP	Cyprus	POL	Poland
CZE	Czechia	PRI	Puerto Rico
DEU	Germany	PRK	Korean Peoples Republic
DJI	Djibouti	PRT	Portugal
DMA	Dominica	PRY	Paraguay
DNK	Denmark	QAT	Qatar
DOM	Dominican Republic	ROM	Rumania
DZA	Algeria	RUS	Russia
ECU	Ecuador	RWA	Ruanda
EGY	Egypt	SAU	Saudi Arabia
ERI	Eritrea	SDN	Sudan
ESP	Spain	SEN	Senegal
EST	Estonia	SGP	Singapore
ETH	Ethiopia	SLB	Solomon Islands
FIN	Finland	SLE	Sierra Leone
FJI	Fiji	SLV	Salvador
FRA	France	SMR	San-Marino
FSM	Micronesia	SOM	Somali
GAB	Gabon	SRB	Serbia
GBR	Great Britain	STP	Saint-Tome and Principe
GEO	Georgia	SUR	Surinam
GHA	Ghana	SVK	Slovakia



*Table 5 (continued)*

1	2	3	4
GIN	Guinea	SVN	Slovenia
GMB	Gambia	SWE	Sweden
GNB	Guinea-Bissau	SWZ	Swaziland
GNQ	Equatorial Guinea	SYC	Seashell Islands
GRC	Greece	SYR	Syria
GRD	Grenada	TCD	Chad
GTM	Guatemala	TGO	Togo
GUM	Guam	THA	Thailand
GUY	Guyana	TJK	Tajikistan
HKG	Hong Kong	TKM	Turkmenistan
HND	Honduras	TMP	Timor-Leshti
HRV	Croatia	TON	Tonga
HTI	Haiti	TTO	Trinidad and Tobago
HUN	Hungary	TUN	Tunis
IDN	Indonesia	TUR	Turkey
IND	India	TZA	Tanzania
IRL	Ireland	UGA	Uganda
IRN	Iran	UKR	Ukraine
IRQ	Iraq	URY	Uruguay
ISL	Iceland	USA	USA
ISR	Israel	UZB	Uzbekistan
ITA	Italy	VCT	St. Vincent and Grenadines
JAM	Jamaica	VEN	Venezuela
JOR	Jordan	VIR	Virgin Islands
JPN	Japan	VNM	Vietnam
KAZ	Kazakhstan	VUT	Vanuatu
KEN	Kenya	WBG	Gaza
KGZ	Kirgizia	WSM	Samoa
KHM	Cambodia	YEM	Yemen
KIR	Kiribati	YUG	Serbia
KNA	Saint Christopher and Nevis	ZAF	South-African Republic
KOR	Korea	ZAR	Congo, Dem. Republic
KWT	Kuwait	ZMB	Zambia
LAO	Laos		

## Section 2. Monetary and Budgetary Spheres

### 2.1. Monetary and Credit Policy

The major development in the Russian monetary and credit policy in the year of 2007 was an explicit inflation acceleration in autumn, as well as tensed situation in interbanking credit market in August-November. As of 2007 results, for the first time upon 1998, when the RF economy was struck with a vast-scale financial crisis, the CPI exceeded the relevant indicator of preceding year. It is worth noting, that there were no signs of such development at the beginning of the year, and only in autumn it became clear that the downward trend of inflation was broken. Moreover, in August the attributes of instability were noted in the world credit market, provoked by the crisis in the US mortgage securities. Hereinafter we will try to analyse the grounds of those developments, review the trends and interrelations at the national monetary market, the interbanking credit market, inflation processes, and outline major developments in the RF monetary and credit sphere in 2007.

#### 2.1.1. Monetary Market

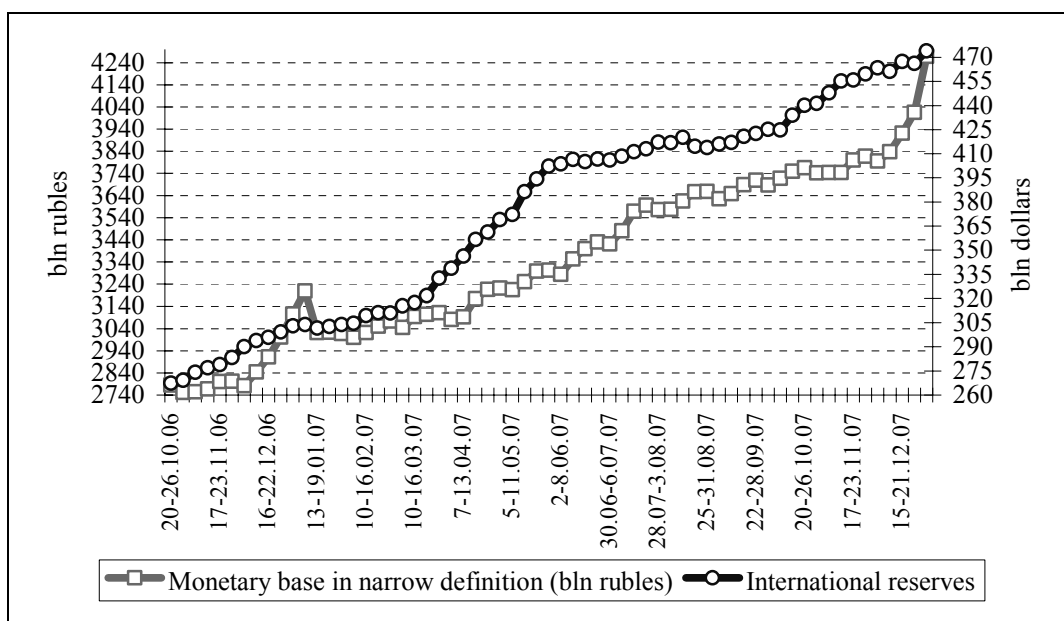
In 2006 a considerable growth of gold and foreign currency reserves was observed in the RF (See *Fig. 1*). The basic factors of growth were the peak prices for the major Russian export commodities, primarily oil prices, as well as massive capital inflow. Some reduction of reserves (as per results of the month) was noticed only in August and was caused by the outflow of capital from domestic market due to the global financial crisis. By the end of the year the volume of gold and foreign currency reserves has reached an absolute peak record in the history of Russia and amounted to USD 476.4 bln (+56.8 per cent within 2007).

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

In 2007 the monetary base (in a broad definition<sup>1</sup>) increased by RUR 1.4 trillion and reached RUR 5.5 trillion (+33.7 per cent). It should be reminded, that as per results of the year of 2006, that indicator has grown by 41.4 per cent. The monetary base volume in broad definition as of January 1, 2008 was RUR 4.1 trillion (See *Table 1*). The cash in circulation volume, including the cash balances of credit institutions, as of January 1, 2008 was RUR 4.1 trillion (+34.5 per cent as compared with January 1, 2007), the correspondent accounts of credit institutions with the Bank of Russia made RUR 802.2 bln (+25.7 per cent), mandatory reserves – RUR 221.6 bln (+ 0.2 per cent), credit organizations' deposits with the Bank of Russia – RUR 270.3 bln (1.8 times growth), the value of the Bank of Russia's bonds held by credit institutions made RUR 100.7 bln (–2.3 per cent).

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



Source: RF Central Bank.

Fig. 1. Dynamics of Monetary Base and International Reserves in 2006–2007

In 2007 the growth of cash in circulation (by 34.5 per cent at the background of sustained level of mandatory reserves (+0.2 per cent) have resulted in extension of the monetary base in narrow definition (cash + mandatory reserves)<sup>2</sup> by 37.5 per cent (See Fig. 1). At the same time, the gold and foreign currency reserves of the RF Central Bank also grew within the year by 56.8 per cent and amounted, as of January 1, 2008 to USD 476.4 bln. A greater portion of the liquidity inflow to the domestic market was accumulated in the RF Stabilization Fund, which volume as of January 1, 2007 amounted to RUR 3849.1 bln. (USD 156.8 bln, 11.8 per cent of GDP, i.e., the growth was RUR 1502.2 bln against January 1, 2007). On January 1, 2007 the volume of Stabilization Fund accounted to RUR 2346.9 bln (USD 89.1 bln, 8.7 per cent of GDP). Monetary supply M<sub>2</sub> in national terms has grown in 2006 by 47.5 per cent and made as of January 1, 2008 RUR 13272.1 bln, or 40.2 per cent of GDP (as of January 1, 2007 the monetary indicator M<sub>2</sub> was equal to RUR 8995.8 bln (33.8 per cent of GDP).

Therefore, as of results of the year of 2007, the growth rate of monetary supply was rather high. However, it could be still higher in case there were no shortage of liquidity in interbanking credit market, observed in August – November. Thus, in June the bank deposits with the RF Central Bank exceeded RUR 1.2 trillion, while the value of the Bank of Russia's bonds held by commercial banks made RUR 350 bln. In December, due to the inflow of the budget assets, addressed to development institutions to the banking system, the tensed situation in the interbanking credit market got improved, though the level of excessive reserves in the banking sphere has not returned to the peak values, observed in summer.

<sup>2</sup> Monetary base in a narrow definition is a monetary instrument (an indicator of monetary supply volume), which is fully controlled by the RF Central Bank. The Monetary base in narrow definition includes the cash in circulation, issued by the Bank of Russia (and the balance on the accounts of credit organizations), balances on the accounts of mandatory reserves of the funds in the national currency attracted by credit institutions in national currency, deposited with the Bank of Russia.

Table 1

**Dynamics in Monetary Base in Broad Definition in 2007 (RUR bln)**

	01.01.2007	01.04.2007	01.07.2007	01.10.2007	01.01.2008
<i>Monetary base (in broad definition)</i>	4,121.60	4,210.2	5,139.1	4,587.2	5,513.3
Including:					
Cash in circulation with regard to balances in credit organizations	3,062.10	2,942.6	3,254.6	3,470.2	4,118.6
Correspondence accounts of credit organizations of the Bank of Russia	638.1	518.1	528.7	576.3	802.2
Mandatory reserves	221.1	209.6	244.8	318.8	221.6
Deposits of credit organizations in the Bank of Russia	98.1	245.8	758.6	72.2	270.3
Securities of the Bank of Russia in credit organizations	102.2	294.2	352.4	149.6	100.7
Reserve funds in foreign currency, deposited with the Bank of Russia					

Source: RF Central Bank.

It is worth noting, that the extension of monetary supply was based largely on accelerated growth of budgetary expenses. However, with regard to relatively insignificant monetization of the RF GDP as compared with other highly developed and developing countries, the growing monetary demand in the RF economy required an accelerated monetary offer as compared with prices. In other words, in case the lower level of budget expenditures, apparently, the Bank of Russia would extend the monetary base.

To assess the success of efforts taken by monetary and financial institutions with the aim to increase liquidity sterilization, an analysis is made of the correlation between monetary demand and supply<sup>3</sup>. The dynamics in monetary demand and supply is shown in *Fig. 2*.

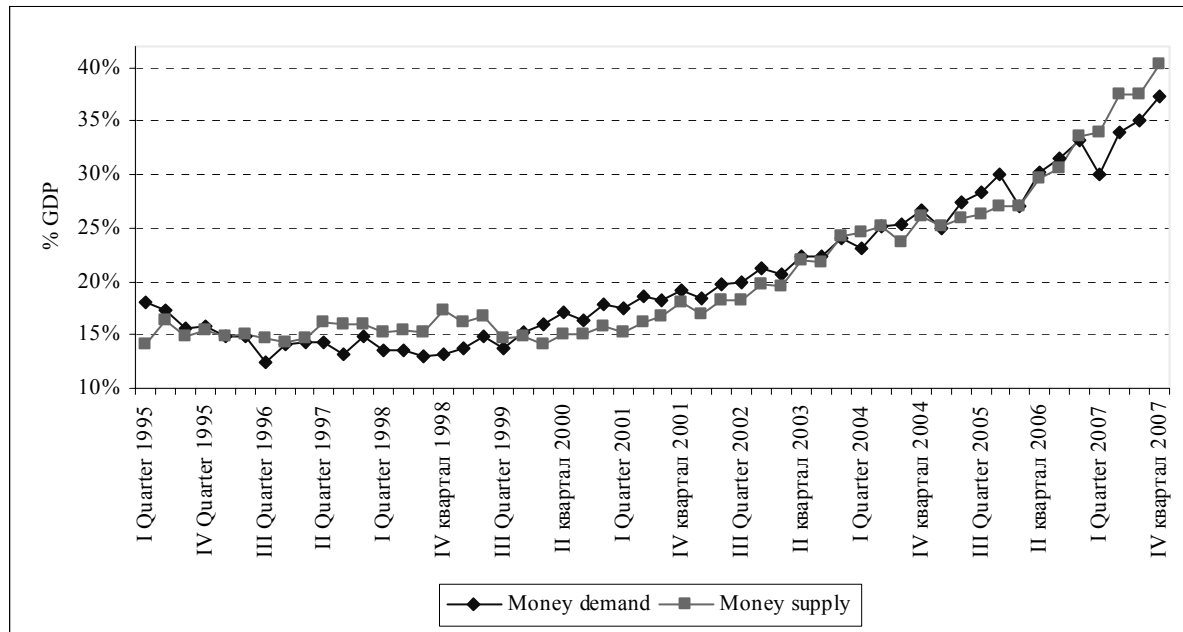
One can note, that within 2007 monetary supply was exceeding the demand for money, which can cause excessive inflation pressure in 2008, caused by a delayed impact of changes in the monetary supply over the inflation processes. In our estimates, the lag of the monetary supply changes impact on consumer price index is one-two calendar quarters<sup>4</sup>.

It should be also noted, that despite the increased monetary supply, the money multiplier in the RF remains at a low level as compared with the countries of Eastern Europe, where, as a rule, its index value considerably exceeds 3. Against this background, the index value of 2.6, achieved by late 2007, appears rather insignificant (See *Fig. 3*). Herewith, since mid-2004, the multiplier is characterized by an upgrading trend, reflecting the gradual development of the RF banking sphere. Up to mid-2004 the multiplier' value was varying within the range of 1.5–1.9.

<sup>3</sup> We assess the demand for money equation of the type  $\frac{M_t}{GDP_t} = a_0 + a_1 Y_t + a_2 \Delta p_t + a_3 t + \varepsilon_t$

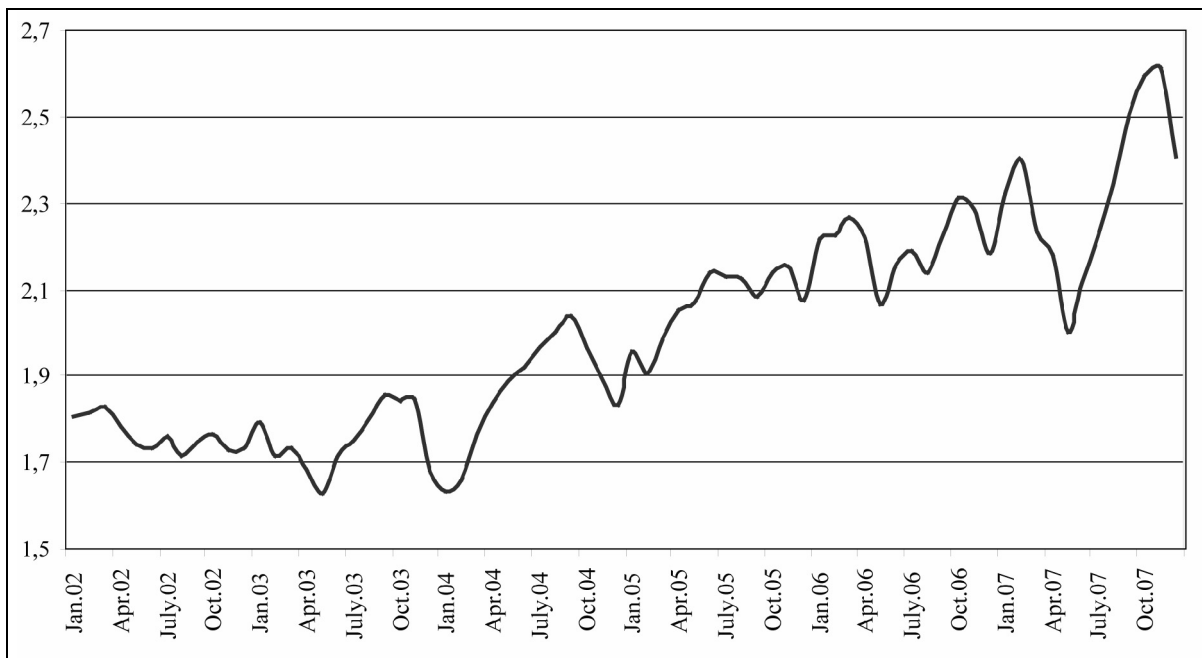
where  $M_t$  – money supply M2,  $GDP_t$  – nominal GDP, value,  $Y_t$  – GDP volume in prices of 1995,  $\Delta p_t$  – consumer price index,  $t$  – time. The assessment was based on the quarterly data of the years 1999–2006 with no regard to seasonal data. The resulting residual values can be interpreted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

<sup>4</sup> Ref: “Some Approaches to Economic Indicators’ Estimates”, published by IET, Section 3.2.2, the CPI No. 89P, M.: IET, 2005.



Source: RF Central Bank, IET estimates.

Fig. 2. Dynamics of Demand for Monetary and Monetary Supply (Money Aggregate M<sub>2</sub>) in Quarter IV, 2007



Source: RF Central Bank, IET estimates.

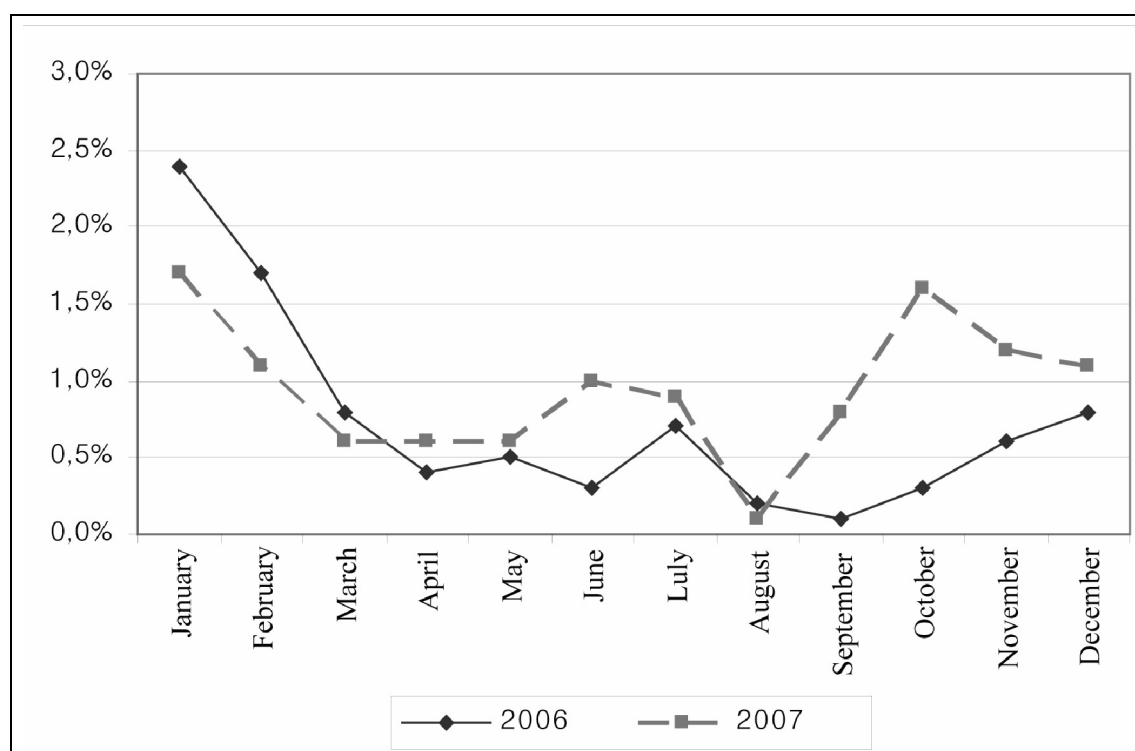
Fig. 3. Money Multiplier in the RF in 2002–2007

Therefore, basing on the obtained results of the estimates, the increased monetary supply, provoked by the extensive purchases of foreign currency by the RF Central Bank, was

exceeding the demand for money in 2007. In our view, under those conditions further slow-down of the inflation base rate will be rather difficult, especially in view of the RF GDP low monetization and accelerated monetary demand growth. Let us review the inflation processes in detail and try to detect non-monetary inflation factors in the RF.

### 2.1.2. Inflation Processes

Early 2007 saw explicit acceleration in the rate of inflation (*Fig. 4*). As a result, there were expectations to stay within the threshold of 8 per cent, estimated by the government. However, as early as in April, the CPI has exceeded the estimates and in September an expressed upsurge of inflation happened, bringing at risk the medium-term estimates. As of the year results, CPI made 11.9 per cent. We are going to take a closer look at the dynamics of inflation rates throughout the year.



Source: RF Statistic Service.

*Fig. 4. Dynamics of CPI in the RF in 2006–2007*

In the category of food products prices rose by 15.6 per cent (8.7 per cent in 2006) (see *Table 2*). Thus, for the first time since 1999 food products made the greatest contribution to the growth of the annual CPI: in the preceding few years, the fastest growth was observed in commercial public services. Within January–December 2007 the basic contribution in food prices upsurge was made by sunflower oil (+52.3 per cent), butter (+40.3 per cent), milk and dairy products (+30.4 per cent), cereals and beans (+24.7 per cent), pasta (+23.6 per cent), bread and bakery products (+22.4 per cent), as well as fruit and vegetables (+22.2 per cent). Herewith, downgrading in prices was noted in 2007 for granulated sugar (–4.3 per cent). Commercial public services went up by 13.3 per cent within the year (against 13.9 per cent in

2006). For the twelve months of 2007, the outmost growth in prices was observed in fitness and sports (+17.5 per cent), health resorts services (+15.6 per cent), education (+17.5 per cent), hotels and recreational services (+15.6 per cent), education (+15.4 per cent), services of cultural organisations (+ 14.5 per cent), utilities (+14.4 per cent). In general, in the twelve months non-food items prices have grown on average by 6.5 per cent (as compared with the 12 months of 2006, when that growth made 6 per cent). In January–December the utmost growth took place in prices for construction materials (+16.2 per cent) and gasoline (+8.5 per cent), whereas prices for audio-video items were downgraded within the year by 1.2 per cent on average. The growth of basic consumer price index<sup>5</sup> amounted to 11 per cent in 2007 (versus 7.8 in the relevant period of 2006).

Therefore, the basic reasons of expressed inflation as per 2006 results was the rapid upsurge of food products prices, construction materials, gasoline and a number of commercial public services.

As one can see from *Table 2*, the core inflation element in 2004–2007 was the growth of tariffs for housing utilities and pre-school education: their prices within that period have grown more than twice. The next largest contribution to the overall inflation was made by prices for the services of cultural organisations (+86.8 per cent) and gasoline (+83 per cent). Rapid growth was noted in public transport prices (+77.3 per cent), milk and dairy products (+76.7 per cent) and butter (+73.2 per cent).

A review of the dynamics in prices and charges for the commodities and services, provided by monopolies in natural resources (electricity, gas), as well as freight services in 2002–2007 shows that in the period under review the highest rates of growth were noted in prices for gas and freight services. The rate of electricity tariffs growth in 2002–2006 was only slightly higher than the growth rate of consumer prices, but in 2007 it has reached 14,6 per cent over January–November, while the CPI for the same period was at the level of 10.7 per cent.

It is worth mentioning that in 2008, the Central Bank of Russia is planning to reduce the inflation rate to the level of 6–7 per cent. This task seems to be quite unrealistic in view of the significant acceleration of inflation in the last six months of 2007 and excessive budget expenditures, planned for 2008. According to the IET model forecast, the CPI in 2008 should make 10–12 per cent.

*Table 2*

**Yearly Price Growth Rates as per Types of Goods and Services  
in 2004–2007 (% per year)**

	2004	2005	2006	2007	2004–2007
1	2	3	4	5	6
<b>CPI</b>	<b>11.7</b>	<b>10.9</b>	<b>9.0</b>	<b>11.9</b>	<b>51.1</b>
<b>Foodstuffs</b>	12.3	9.6	8.7	15.6	54.7
<i>Milk and dairy products</i>	12.8	10.5	8.7	30.4	76.7
<i>Butter</i>	6.8	8.2	6.8	40.3	73.2
<i>Bread and bakery products</i>	16.7	3	11.1	22.4	63.5

<sup>5</sup> Basic index of consumer prices is an indicator of the inflation level without regard to seasonal price reduction (fruit and vegetable products) and to administrative measures (tariffs for government-regulated services, etc.). It is estimated by the RF Statistics Service.

*Table 2 (continued)*

1	2	3	4	5	6
<i>Meat and poultry</i>	19.6	18.6	5.9	8.4	62.8
<i>Sunflower oil</i>	2.1	2.1	-1.2	52.3	56.9
<i>Grits and beans</i>	11.6	0.2	12.1	24.7	56.3
<i>Pasta products</i>	14.6	1.9	4.7	23.6	51.1
<i>Fish and sea food</i>	11.5	12.7	7.8	9	47.7
<b>Non-food products</b>	7.4	6.4	6.0	6.5	29
<i>Petrol</i>	31.3	15.8	10.9	8.5	83
<i>Construction materials</i>	8.4	9.1	11.5	16.2	53.2
Commercial services	17.7	21	13.9	13.3	83.8
<i>Pre-school education</i>	21.6	32.1	28.5	11.8	130.8
<i>Housing utilities</i>	23.5	32.7	17.9	14	120.3
<i>Culture organizations services</i>	19.9	17.7	15.6	14.5	86.8
<i>Public transportation</i>	18	15.8	14.2	13.6	77.3
<i>Health resort services</i>	12.8	11.2	15.2	15.6	67

Source: RF Statistical Service.

At the end of this section, let us compare the growth rates of consumer prices in the RF and other CIS countries (See *Table 3*).

*Table 3*

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

	2000	2001	2002	2003	2004	2005	2006	2007
Azerbaijan	2	2	3	2	7	10	8	16.7
Armenia	-1	3	1	5	7	1	3	4.4
Belarus	169	61	43	28	18	10	7	8.4
Georgia	4	5	6	5	6	8	9	9.2
Kazakstan	13	8	6	6	7	8	9	10.8
Kyrgyzstan	19	7	2	3	4	4	6	10.2
Moldova	31	10	5	12	12	12	13	12.3
Russia	20	19	15	12	12	11	9	11.9
Tadjikistan	24	37	10	17	7	8	12	21.5
Ukraine	28	12	1	5	9	14	9	12.8

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

One can notice that the inflation rate in the RF is still high even in comparison with other CIS countries. As mentioned above, the reasons for sustained high rates of consumer prices in the RF might be both, high growth rates of monetary supply (See *Fig. 2*), caused by the trend to maintain a stable rouble rate and non-monetary factors, such as high market monopolization, accelerated growth of food products prices, as well as other reasons, not quite clear at this point.



### 2.1.3. State of Balance of Payments<sup>6</sup>

The RF stable situation with the balance of payments in 2007 as in years before was supported largely due to the peak volumes of the Russian main exports, first and foremost its fuel and energy resources. However, for the first time since 2002, positive balance of trade and balance of payments have been reduced by 7.6 per cent and 18.7 per cent, accordingly. At the background of growing prices for energy resources, the Russian export growth has exceeded 16 per cent.

However, the rates of export sales growth have been reduced by one third as compared with the year of 2006, which was based on some decline of oil prices in early 2007. At the same time, the RF Central Bank has been accumulating gold and foreign currency reserves. Moreover, a remarkable factor in 2007 was that the balance of capital transactions and financial instruments account has exceeded the current account balance due to extremely large amount of net capital inflow from private sector, which was nearly doubled as compared with the relevant indicator of preceding year, when for the first time a great capital inflow was also recorded.

According to the tentative estimates of the RF balance of payments in 2007, published by the Bank of Russia, the surplus balance of current account made USD 76.6 bln, i.e., it has declined by 18.7 per cent versus the level of 2006 (See *Table 4*). Trade account surplus in particular was downgraded by 7.6 per cent (from USD 139.2 bln to USD 128.7 bln), while exports have grown by 36.8 per cent (from 303.9 bln to USD 354 bln) and imports also grew by 36.8 per cent (from USD 164.7 bln to USD 225.3 bln).

Therefore, as in preceding years, balance of current account largely depends on its trade component, which in its turn is mostly determined by changes in prices for energy resources and other major Russian export commodities, brought out to the world market. The data presented in *Fig. 5* demonstrates, that the correlation between the Russian trade account balance and the world market energy prices observed within 2002–2006, continued in 2007 as well.

Deficit in services account made USD 19.7 bln and has grown by 42.6 per cent as compared with 2006. Russian exported services amounted to USD 38.6 bln, having grown by USD 7.7 bln (+24.8 per cent) versus the level of preceding year. At the same time, the imported services also grew by 30.3 per cent in 2007 and reached USD 58.3 bln.

Labor cost balance in 2007 continued to decline and made USD 7.1 bln (against USD 4.4 bln in 2006). Deficit of the RF investment income in the balance of payments in 2007 as compared with its 2006 level has declined by 13.6 per cent (to USD 21.8 bln). The investment income increased from USD 27.9 bln to USD 43.7 bln due to considerable growth of the indicators of monetary and credit supervision authorities (from USD 410.7 bln to USD 17.2 bln)<sup>7</sup> and non-financial organizations (from USD 12.8 bln to USD 20.8 bln). Similar growth was noted in terms of investment income payments at the non-financial sector (from USD 44.2 bln to USD 53.1 bln) and banks (from USD 4.6 bln to USD 9.9), what has contributed to larger overall income payments (from USD 53.1 bln to USD 65.6 bln).

The balance of current transfers in 2007 has accounted to USD 3.5 bln (growth times 2.3 as compared with 2006).

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<sup>6</sup> The analysis of the state of balance is made on tentative data of the RF Central Bank.

<sup>7</sup> The high level of income of monetary and credit control authorities is based on the investments in the international debt securities.

Table 4

**Major Components of the RF Balance of Payments and Dynamics  
of External Debt in 2005–2007 (USD bln)**

Balance sheet items	2005					2006					2007				
	I Q	II Q	III Q	IV Q	Year	I Q	II Q	III Q	IV Q	Year	I Q	II Q	III Q	IV Q <sup>8</sup>	Year <sup>9</sup>
Current Account Transactions	20.1	22.3	20	22	84.4	30.3	24.3	23.8	15.9	94.3	22.9	15.9	15.8	22.1	76.6
Capital Account Transactions <sup>10</sup>	-3.5	-2.4	-11.3	2.6	-14.6	-5.9	17.1	-14.9	9.5	5.8	13.5	47.3	-1.6	15.7	75
Changes in Gold and Foreign Currency Reserves ( «+» - a decrease, «-» - growth of reserves)	-14.4	-18	-8.1	-21	-61.5	-21.4	-40.9	-13.8	-31.3	-107.5	-32.9	-65.5	-7.9	-42.5	-148.9
Net Errors & Omissions	-2.2	-1.9	-0.6	-3.6	-8.3	-3	-0.5	5	5.9	7.5	-3.5	2.3	-6.3	4.8	-2.7
Changes in the RF external debt ( «+» - growth, «-» - decrease of external debt)	6.0	8.4	-1.1	30.6	43.9	16.0	15.6	-19.5	41.3	53.4	37.3	43.8	39.2	-	-
Changes in the RF external government debt	-4.8	-0.6	-18.9	1.2	-23.1	4.0	-7.6	-24.5	-5.1	-33.2	3.5	-3.1	3.7	-	-
Changes in the external debt of the RF private sector	10.8	9.1	17.8	29.4	67.1	12.1	22.7	5.1	46.9	86.8	33.9	47	35.3	-	-

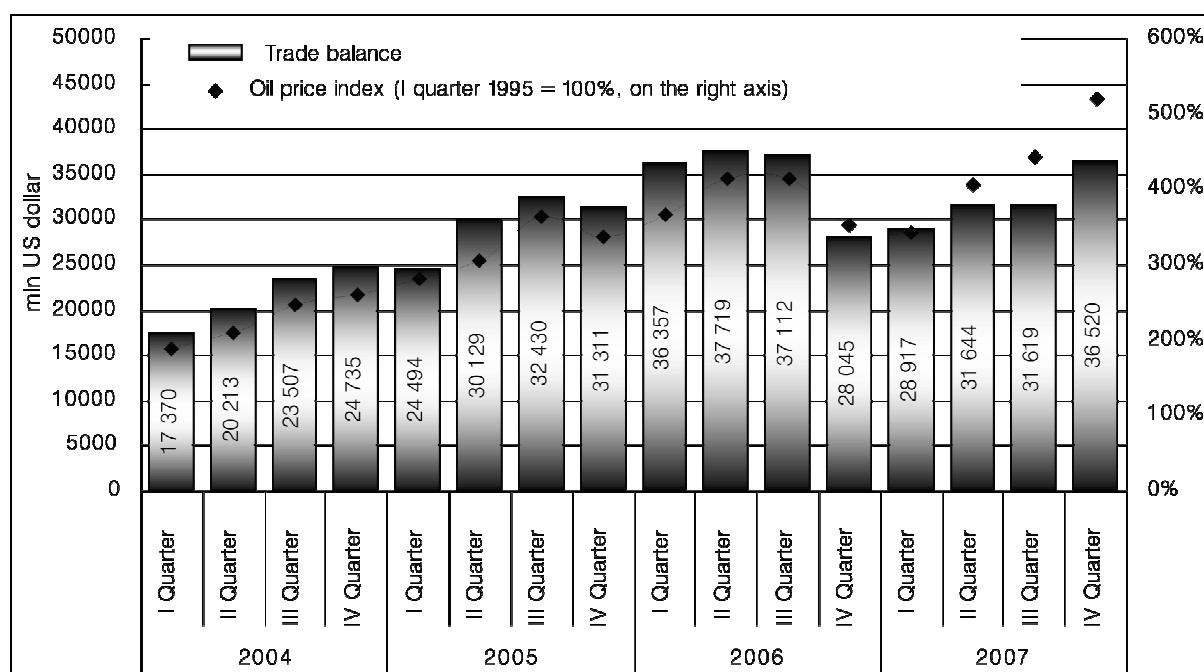
Source: Bank of Russia.

Therefore, the basic reasons for the decline in surplus of the current account balance in 2007 was the large import volume, exceeding the exports, as well as accelerated growth of deficit in labor cost balance. Herewith, despite the RF private sector external debt and its interest growth, the deficit of investment income balance has somewhat decreased in 2007 due to significant investment income, obtained by monetary and credit supervision authorities from gold and foreign currency investments and non-financial organizations.

<sup>8</sup> Tentative estimates.

<sup>9</sup> Tentative estimates.

<sup>10</sup> Minus changes in foreign currency reserves.



Source: RF Central Bank, IFS, IET assessments.

Fig. 5. RF Balance of Trade and Index of World Oil Prices for 2004–2007

In 2007, like a year before, a surplus of balance of capital transactions and financial instruments was observed, which has reached USD 75 bln. The balance of capital transfers in 2007 made USD 11.8 bln. Therefore, regardless capital transfers, made in 2007, the surplus of financial account has amounted to USD 86.8 bln.

Growth of the RF external liabilities as per the year results made USD 186.9 bln, i.e., 165 per cent higher than in preceding year (USD 70.5 bln).

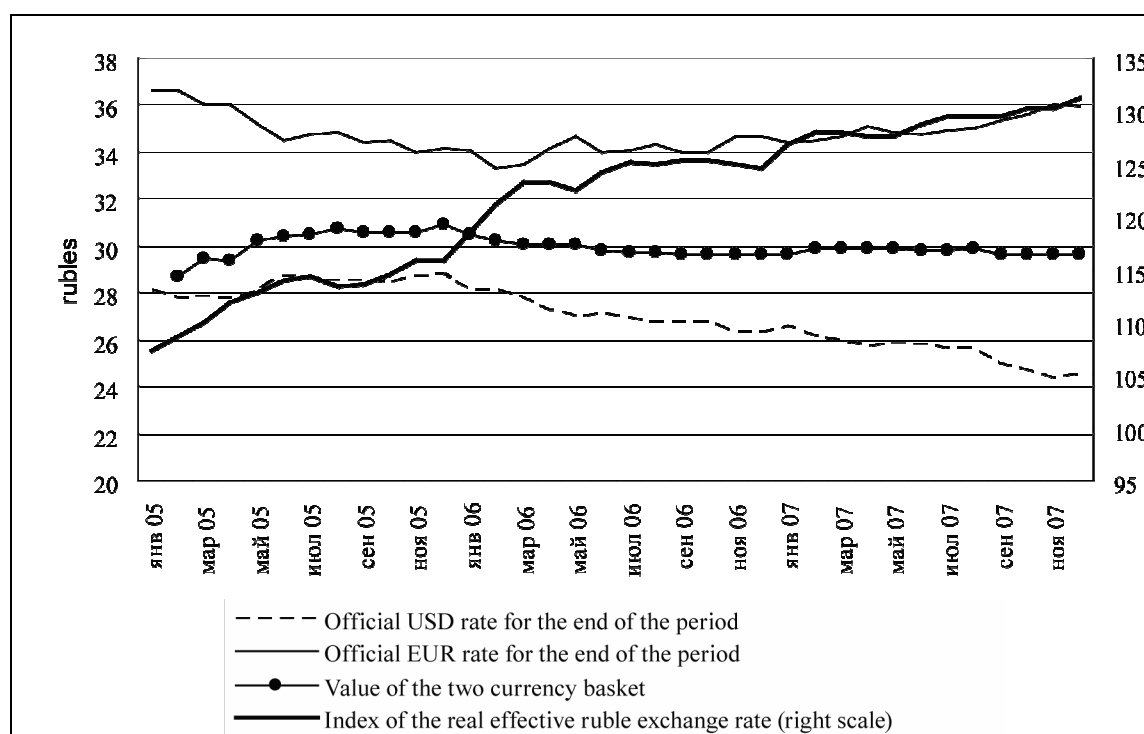
As a year ago, federal government was still a net borrower to non-residents. Their external liabilities have been declined by USD 6.9 bln, basically due to early redemption of the RF external debt. The external liabilities of the RF Subjects made USD 0.1 bln. Liabilities of monetary and credit control organizations have increased to USD 0.7 bln. The expansion of activities of banking sector in terms of foreign capital involvement has resulted in the growth of liabilities of this sector by 37.4 per cent (+ USD 70.3 bln) against the 2006 indicator. Non-residents' investments in the real sector made USD 122.9 bln (USD 54.6 bln in 2006). Therefore, non-residents investments in non-financial sector in 2007 have significantly exceeded investments in the banking sector. Herewith, 38 per cent of overall investments in non-financial sector were direct investments (USD 47.1 bln), 61 per cent of investments were made in the form of loans and credits (USD 75.3 per cent).

Foreign assets held by Russian residents have been increased in 2007 by USD 100.2 bln (in 2006 that indicator was USD 64.9 bln). Practically all surplus is derived from the operations in private sector.

Foreign assets held by the RF federal government have decreased by USD 8.7 bln. Foreign assets held by credit and monetary supervision authorities have grown by USD 0.4 bln and by banking sector by USD 29 bln.

Assets taken out of country by non-financial sector and households have grown by 67 per cent versus 2006 and made USD 79.4 bln. Value of export earnings not received timely, imported goods paid for under import contracts but not delivered and asset transfers under non-existing contracts has increased as compared with 2006 to the level of USD 27.6 bln. At the background of growth in “direct and portfolio investments” (USD 47.8 bln), as well as in “non-delivered commodities under intergovernmental agreements” (USD 0.1 bln), a significant decline was observed in the amount of cash held in foreign currency (USD 13.3 bln). In other words, in the continued strengthening of RUR in nominal terms in 2006, both, individuals and non-financial sector actively disposed foreign currency.

Growth of foreign currency supply was based on both, its continued inflow to the country and the sales, made by the RF non-financial sector. As a result, the ruble real effective exchange rate was raising again and by the end of the year it has grown by 4.2 per cent. In 2007 there was observed further USD decline in the global market and in the RF: in late December USD exchange rate against RUR made 24.55 as compared with 26.33 at the beginning of the year. Despite significant RUR strengthening against USD, the Bank of Russia supported the value of two-currency basket<sup>11</sup> at the same level: from December 2006 through December 2007 that value was downgraded only by 1 kopeck. In view of those developments, in late December EURO rate has grown to RUR 35.93, against RUR 34.7 as of January 2007 (see Fig. 6).



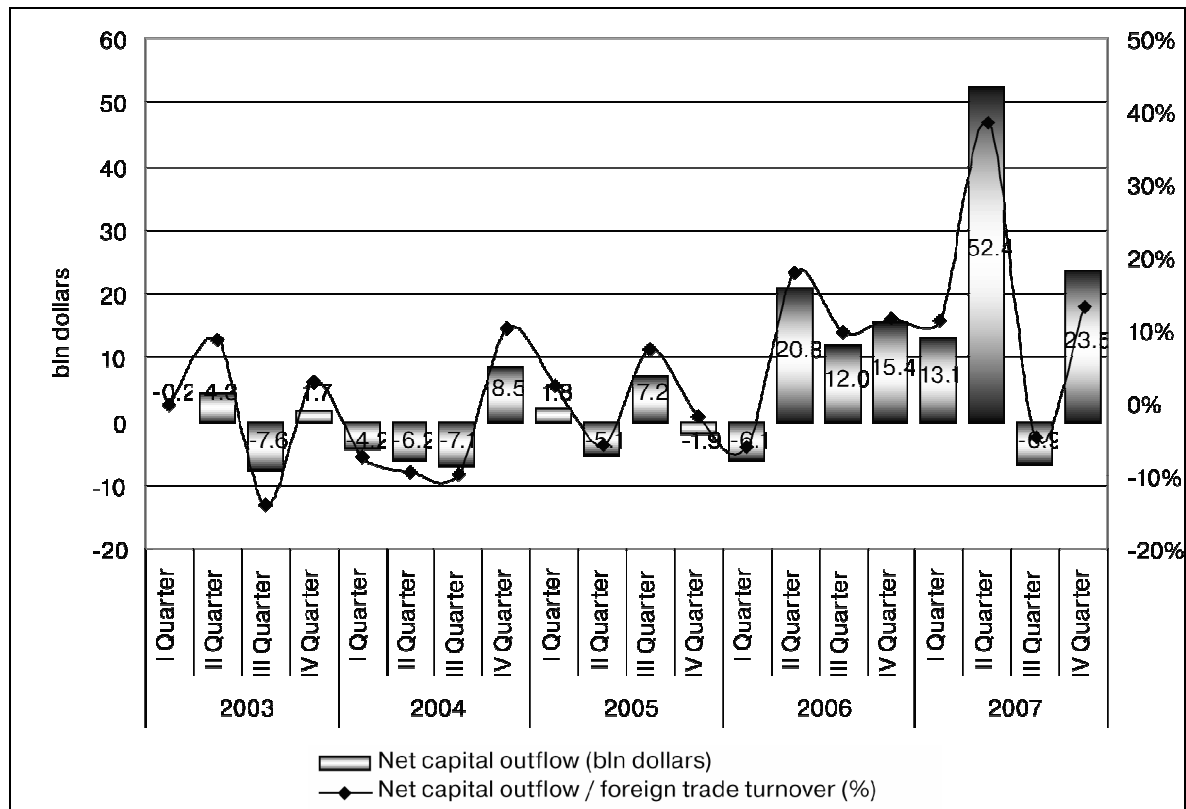
Note. In calculating the real effective exchange rate the level of the year 2002 is regarded as 100.

Source: RF Central Bank, IET assessments.

Fig. 6. RUR Exchange Rate Indicators in January 2005 – December 2007

<sup>11</sup> Two-currency basket is the RF Central Bank operational indicator in its foreign currency policy. Currently the share of EURO in the currency basket makes 45 per cent, USD – 55 per cent.

In our view, the most important trend in the balance of payments dynamics in 2007, in line with reduced balance of payments of current operations, one should consider substantial net capital inflow in the non-financial sector in the amount of 82.1 billion dollars (in 2004 there was an outflow of capital from non-financial sector in the amount of USD 9 bln, in 2005 an inflow of USD 1.9 bln was observed, while in 2006 the net inflow of capital amounted to USD 42.1 bln) (see Fig. 7).

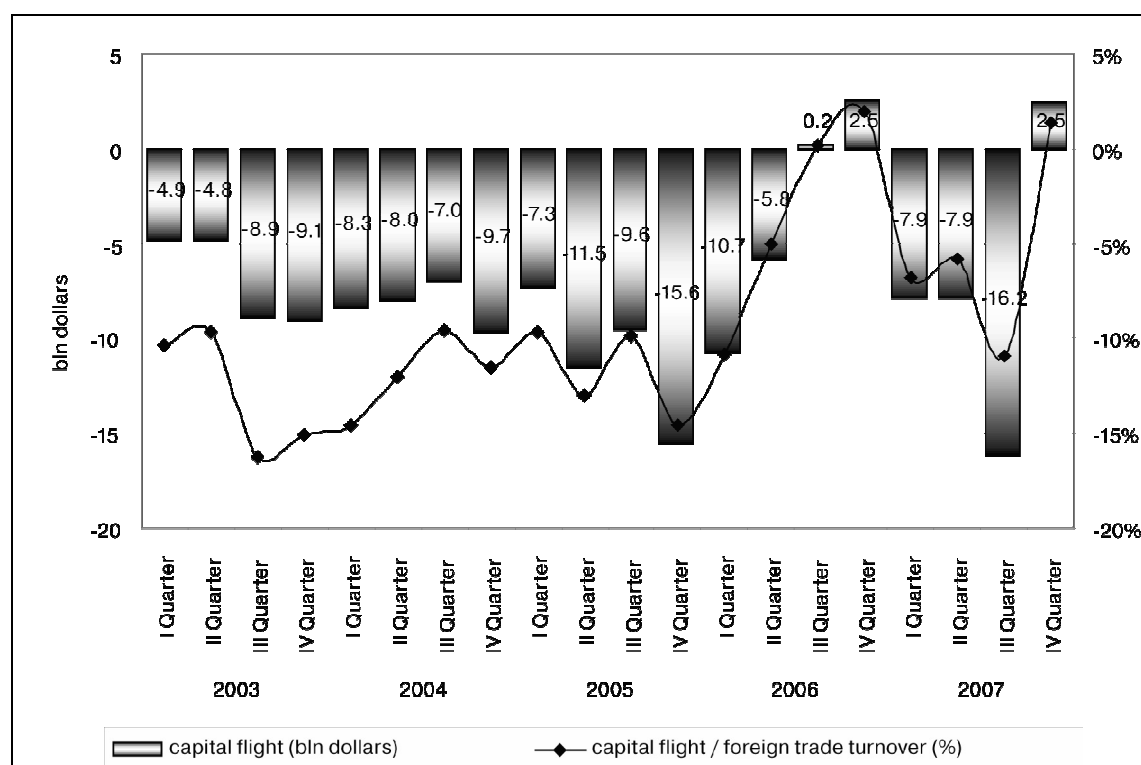


Source: RF Central Bank, IET assessments.

*Fig. 7. Net Capital Outflow Dynamics within 2003–2007*

It has to be noted that as per results of the third quarter, there was observed an outflow of capital in the amount of USD 6.9 bln. Total capital inflow within the year was ensured during the I, III and IV quarters, when the net inflow of capital to non-financial sector made USD 89 bln. These capital inflows were attracted from national companies and banks' active involvement in attraction of foreign credits, as well as foreigners' enthusiasm in lending money to Russian companies in the face of the country sound macroeconomic dynamics. Capital outflow in the III quarter was attributable to the crisis factors in the global financial market, which started in August. At the same time, in the IV quarter capital inflow was resumed and reached USD 23.5 billion, which exceeds the level of the I quarter. We should note also, that the significant capital inflow in the II quarter (USD 52.4 billion) was attracted primarily by IPO, arranged by Sberbank RF, Vneshtorgbank and a number of energy companies.

In 2007, the unofficial capital outflow from the country (capital flight) (see Fig. 8), has grown again as compared with 2006, and reached, according to our estimates<sup>12</sup>, about USD 29.5 billion, which is exceeded by USD 15.7 billion the indicator of 2006. A relevant increase in the share of capital flight in external trade turnover was observed from 2.9 per cent in 2006 to 5.1 per cent in 2007. It should be noted, that the greatest volume of capital flight was taking place in the III quarter, whereas in the IV quarter no capital flight was recorded.



Source: RF Central Bank, IET estimates.

Fig. 8. Capital Flight Dynamics within 2003–2007

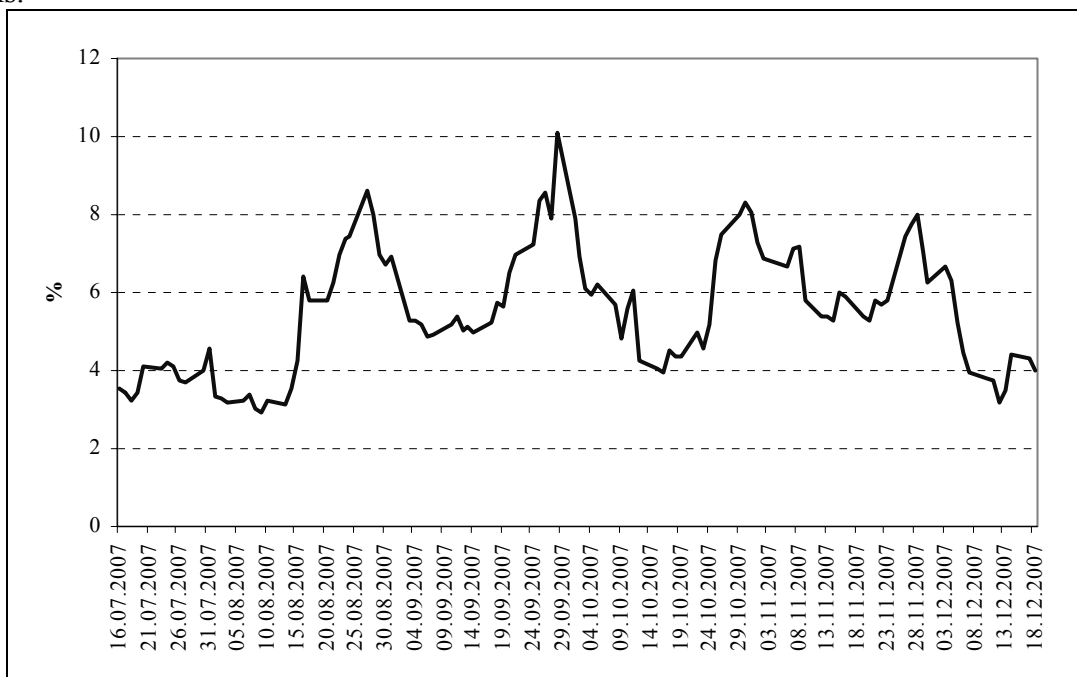
Among other specifics of balance of payments of 2007, one should note high, as before, share of income from energy sources in export sales, once again demonstrating high level of dependence of the Russian economy on natural resources export and market prices. However, in 2008 stabilization in oil prices can be expected in the background of growing import supply, which apparently will lead to further reduction of current account surplus balance of payments. Therefore, in the background of further growth of net capital inflow to the RF and reduced capital outflow, the stability of balance of payments will be maintained both, by the surplus balance of current account and by the account of capital transactions and financial instruments (accompanied by accumulation of gold and foreign currency reserves).

<sup>12</sup> “Capital flight” is assessed in accordance with IMF methodology as a grand total of “trade credits and advance payments”, “export earnings not received timely, imported goods paid for under import contracts but not delivered”, and “net errors and omissions”.

#### 2.1.4. Global Credit Market Crisis and its Impact over the Russian Monetary Market

Russian financial system sensitivity to the dynamics in capital flows was demonstrated by the crisis in the USA mortgage securities market, started in August 2007, which affected the Russian financial sector, provoking capital flight from the country and problems to credit organizations in attracting resources from the external market. The problems in the US financial sector and some other developed countries have significantly limited the amount of free capital, addressed at the markets (credit, stock, and others) of developing countries, including Russia. Therefore, the international financial market has been practically inaccessible to the Russian banks, which has disabled the refund of foreign loans in the short-term prospective, as well as the attraction of foreign interbanking credits for liquidity inflow in the Russian interbanking market. A similar situation in Kazakhstan, where the share of foreign liabilities reached 70 per cent of the total banks liabilities, instigated in October 2007 a downgrading of national credit ratings by global rating agencies.

Growing uncertainty in the international markets has provoked capital outflow from Russia due to the “flight from the risk”, which resulted in increase of demand for ruble resources among banks clients for the purchase to exchanging in foreign currency and withdrawal outside the country<sup>13</sup>. In this situation, to meet the requirements if their clients, the banks have increased their demand in the domestic interbanking credit market, which encouraged interest rates growth (see Fig. 9). The Bank of Russia, as before, was supporting the level of liquidity in the monetary market only by crediting a limited number of the largest banks.



*Fig. 9. MIACR Rate Dynamics over July–December 2007*

<sup>13</sup> At the same time, due to sustained significant surplus of the current account balance of payments, USD decline against RUR continued in the background of USD downgrading versus ther basic foreign currencies.

A number of banks failed to cover the demand for liquidity in the interbanking credit market (either due to the increased interest rates, or because of low assessment of their financial state by other banks with sufficient liquidity), which provoked a general decline in confidence in the banking sector and further restrictions in an access to liquidity for the majority of small and medium-sized banks.

A similar situation was observed in May-June 2004, when a number of medium-sized banks were cut off from all refinancing channels, have closed their business. However, in 2007 the Bank of Russia provided far more significant refinancing to the largest banks and under relatively low interest rate, what enabled to support general level of liquidity in the banking sector, while some banks even derived profit from the interest rates difference. In the past year there were no external negative attributes in the banking sector (such as the withdrawal of licences from “Sodbiznesbank” or Rosfinmonitoring “black list” of banks, compiled in 2004), what enabled to keep up relatively peaceful situation. It is worth noting, that in crisis situations the Central Bank credits enjoyed strong demand, in particular those provided in the framework of direct REPO operations. In crisis conditions such credits became attractive to the banks and hence, the interest rates of the Bank of Russia started to play a greater role in the monetary market. This situation is an example of enhancement of the role of the Bank of Russia interest rate strategy in its monetary policy. Herewith, in the background of the interest rates volatility in the interbanking market, the Bank of Russia has considerably expanded the list of securities, accepted as a guarantee under REPO operations, reduced collateral discounts, as well as increased the number of direct REPO auctions.

All those measures have promoted an easier access the Central Bank credit. In other words, an upsurge in the volume of direct REPO operations in August-September 2007 (see Fig. 10) was the result of both, the growth in demand for refinancing on the part of credit institutions, and increased Central Bank offer in the credit market. In particular, during the crisis with liquidity in the RF banking market in 2004, the volume of direct REPO transactions did not exceed RUR 40 billion per day, whereas in autumn 2007 that indicator reached RUR 300 billion per day.

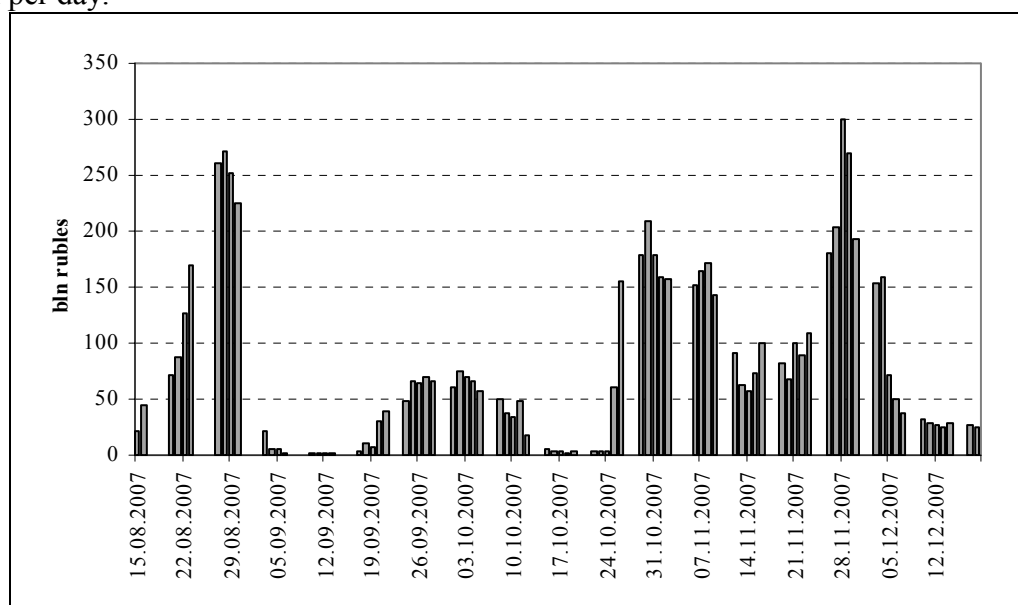


Fig. 10. Direct REPO Volume over August-December 2007



Despite the increased availability of Central Bank credits, downgrading of the interest rate on foreign currency swap transactions and the reduction of the threshold of mandatory reserves, the tense situation in the interbanking market of Russia was sustained till December. At the end of each month the interest rates in the interbanking market were rapidly growing, as well as the volume of direct REPO operations (see *Fig. 10*): in particular, in late November the volume of direct REPO operations has exceeded the relevant levels, achieved in August. Herewith, since October the Bank of Russia started to provide credits not only under security of bonds, but also under promissory notes and credit agreements, though the situation got stabilized in the interbanking credit market only in the first half of December with the help of the assets, allocated by the Government to the Bank of Development.

It is worth noting, that from macroeconomic point, the volatility in global financial markets should not ensue serious consequences to Russia thanks to a large volume of accumulated reserves, substantial capital inflows, persistent surplus of current account balance and meanwhile reasonable amount of private sector external debt. Thus, on January 1, 2007, the Russian external debt accounted to USD 309.7 billion (30.4 per cent of GDP), the share of government foreign debt made USD 48.6 billion (4.8 per cent of GDP), whereas the private debt amounted to USD 261.1 billion (25.6 per cent of GDP). At the same time, by October 1, the volume of public debt was increased to USD 52.7 billion (4.3 per cent of GDP), while private debt has grown to USD 378.1 billion (30.8 per cent of GDP). Consequently, the total national external debt increased to 430.9 billion (35.1 per cent of GDP). This level of external debt can be regarded as steady and fairly average by international standards. However, it is noteworthy that a substantial share of private debt is quasi-public: as of October 1, 2007 the external debt of corporations with significant government participation<sup>14</sup> accounted to USD 132.7 billion, i.e., more than 35 per cent of the total of the external debt is the liability of private sector. It is obvious that creditors of those corporations require inexplicit warranties under such debts from the government, what enables such companies with government participation to increase external debt rapidly and relatively cheaply. At the same time, apparently the quality of risk management in such companies is not at the highest level, which implies a poor quality of projects, financed by credits. Consequently, the expansion of such debt increases the risks to the RF economy, creating grounds for monitoring the dynamics in kvazi-public external debt and to introduce restrictions, if necessary.

It is interesting to note, that since 2006, the monetization of current account surplus (see *Table 5*) with regard to the Stabilization Fund sterilization function is no longer the primary source of national liquidity replenishment. Currently, this function is performed by the balance of account of capital transactions and financial instruments, which is far more volatile and less predictable.

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<sup>14</sup> Banks and non-financial enterprises, where the government or monetary and credit supervision authorities' share directly or indirectly accounts to or exceeds 50 per cent or otherwise otherwise under control of those authorities, are regarded as corporations with significant government participation.

Table 5

**Sterilization Volume of Current Account Surplus within 2006–2007 (USD bln)**

Balance sheet items	2006					2007				
	I Q	II Q	III Q	IV Q	The year	I Q	II Q	III Q	IV Q <sup>15</sup>	The year
<b>Current Account Transactions</b>	30.5	24.8	23.8	16.2	95,3	22.9	15.9	15.8	22	76.6
Balance of trade	36.4	37.7	37.1	28.0	139,2	28.9	31.6	31.6	36.6	128.7
<b>Balance of account of capital transactions and financial instruments<sup>16</sup></b>	-6.1	16.6	-14.6	10.2	6,1	13.5	47.3	-1.6	15.8	75
Private sector capital net inflow	-6.3	20.3	11.9	15.1	41	13.5	52.9	-7.6	23.5	82.3
Dynamics in sterilization volume of assets in the RF Stabilization Fund	17.6	16.2	17.0 <sup>17</sup>	18.4	69,2	19.0	13.6	19.5	22.8 <sup>18</sup>	74.9
«Non-sterilized» balance of current accounts	12.9	8.6	6.8	-2.2	26,1	3.9	2.3	-3.7	-0.8	6.2

Source: The Bank of Russia.

As one can see from *Table 5*, the current account balance surplus has downgraded from the level of USD 30.5 billion in the I quarter of 2006 to USD 22 billion in the IV quarter of 2007. Herewith, the amount of assets, sterilized in the Stabilization Fund of Russia, during the same period rose from USD 17.6 billion to USD 22.8 billion. Thus, liquidity replenishment in the economy through monetization of the current account balance at the end of 2006–2007 was virtually cut down.

In case of the further reduction of the current account balance due to volatility of capital inflow volume, there will be a need for new refinancing tools in the banking system. Herewith, the Stabilization Fund will continue its growth, thus withdrawing the liquidity from economy. In case private capital outflow, such scheme of Stabilization Fund formation can create additional difficulties with liquidity to the economy in general and to the banking system in particular.

One should take into account exchange rate strategy in monetary and credit policy, as strengthening of the ruble, observed in recent years has urged expectations among economic agents, both in Russia and abroad, for further ruble growth against dollar. This encourages the inflow of short-term capital to the RF, contributes to the growth of the monetary supply, increases “dedollarization” and inspires inflationary expectations, which hinders the slow-down of price growth.

It should be noted, that in the face of negative effective interest rates in Russia, its usage as an intermediate objectives of monetary and credit policy is virtually not applicable. Therefore, the government authorities should make a serious effort to combat inflation. Herewith, the Central Bank could be advised to increase gradually the cost of refinancing to the banks,

<sup>15</sup> Tentative estimates.

<sup>16</sup> Regardless changes in foreign currency reserves.

<sup>17</sup> With regard to the assets, addressed to early redemption of external government debt.

<sup>18</sup> With regard to the assets, addressed to capitalization of government corporations “Bank for Development” and “Russian Nanotechnologies Corporation”, Stabilization Fund extension and external debt redemption, regardless proceeds from investments, made from Stabilization Fund.

what would enable as to upgrade the interest rates, as well as to inspire credit organizations to pursue more accountable credit policy. Furthermore, in the background of reduced growth of foreign credits in the Russian banking sector due to general instability in the global financial market, some restrictions can be introduced as to the share of foreign assets in the liabilities of credit institutions, which will enable to reduce foreign currency risks. The example of Kazakhstan, the economy of which was faced with a decline of sovereign credit ratings due to the high dependence of the banking sector on external funding, showed, that limiting the amount of loans, attracted from abroad is a rather logical measure for the Bank of Russia.

Thus, in the next few years, there are several possible scenarios for the dynamics in the situation with the current account balance, and therefore, monetary policy in Russia. One scenario is based on the sustained surplus of current account balance. In case of continued capital inflow into the country, the Bank of Russia, apparently, will be strengthening the exchange rate of national currency. However, capital flows are highly volatile. In the event of a significant capital outflow, which could be urged virtually by any adverse event in the national economy, the continuing replenishment of the Stabilization Fund may result in a shortage of liquidity in domestic economy. In this case, the RF Central Bank will face an urgent problem of development an adequate system of commercial banks refinancing. It is worth noting, that the formation of such a system should be started (along with the implementation of measures of enhancement bank supervision and the criminal banks liquidation) as soon as possible, so that in case of financial instability, it would be effectively functioning.

Along with the scenario of surplus current account balance (or its insignificant reduction), there is a high probability of its decline as a consequence of energy prices downgrading, higher import volumes in the background of ruble strengthening, as well as the growth of interest rates, paid by domestic companies outside the country. In this case, two situations are also possible. While sustained volume of capital inflow is kept up at the level, sufficient to maintain a normal level of liquidity in the economy, the Bank of Russia will be able to continue the current monetary policy. At the same time, given the volatility of capital flows, it will nevertheless have to be prepared to provide the required resources to commercial banks any time. In the event the net capital inflow gets substantially reduced or even negative, the RF Central Bank of Russia is likely to face the necessity of prompt ruble depreciation, as well as of the search for new mechanisms to meet monetary demand of economic agents.

#### 2.1.5. Basic Measures in the Sphere of Monetary and Credit Policy

1. Early in 2007, the Russian Statistical Service has published for the second time in history the basic structure of consumer expenditures of population, used to estimate the consumer price index. This measure is a serious move towards higher transparency in the CPI estimation methodology. According to the disclosed information, in 2008 the share of food products will be somewhat reduced at the expense of increased share of non-food items and services. In our view, those changes are adequately reflecting the actual structure of consumption expenditures, as throughout the world the growth of incomes inspires greater demand for non-food items and services consumption and lower demand for foodstuffs.

2. From February 8, 2007 the RF Central Bank has restructured the two-currency basket, which is used by the Bank of Russia as an effective indicator in monetary policy. The share of EURO in the basket was increased from 4 per cent to 45 per cent, while the share of USD was

respectively reduced from 60 per cent to 55 per cent. It should be noted, that earlier the Central Bank had already amended the structure of the two-currency basket in favor of EURO.

3. Since February 12, 2007 the Russian ruble has been included in the lists of international currencies of Euroclear, the International Depository-Clearing Centre. Moreover, the ICAP broker company has approved on February 14 the decision to make RUR e-commerce transactions on the basis of EBS platform, which allows to perform operations with ruble-dollar pair with a one-day deadline for enrollment. In our view, these developments reflect the increasing demand of market participants in the ruble transactions, that will inevitably lead to greater RUR liquidity as payment instrument.

4. In 2007, the RF Central Bank continued to publish reports on the structure and results of the foreign currency and gold reserves investments. In general, this step can be evaluated positively, as it is aimed at increased transparency of the Russian Bank operations. However, it should be noted that the results of the assets investments were disclosed with more than a six-month delay, which in our view, is beyond reasonable limits. Moreover, the reports provide no information on the revenues derived from all financial instruments used for investments, as broken down by individual foreign currencies. Such information would enable us to make better assessment of the results of the assets management. The most interesting part of the report is the information on the outcome of national gold reserves management. According to the latest report, within April 2006 – March 2007, the reserve assets of the Bank of Russia have been increased by USD 129.4 billion, including the interest yield and revaluation of securities by USD 10.9 billion (8 per cent of the total growth). Therefore, currently, in the background of significant inflow of foreign currency to the country, the interest yield is an insignificant factor in gold reserve dynamics. Nevertheless, in case of external economic environment deterioration and decreased capital inflow, the results of national reserves management will doubtlessly play a significant role.

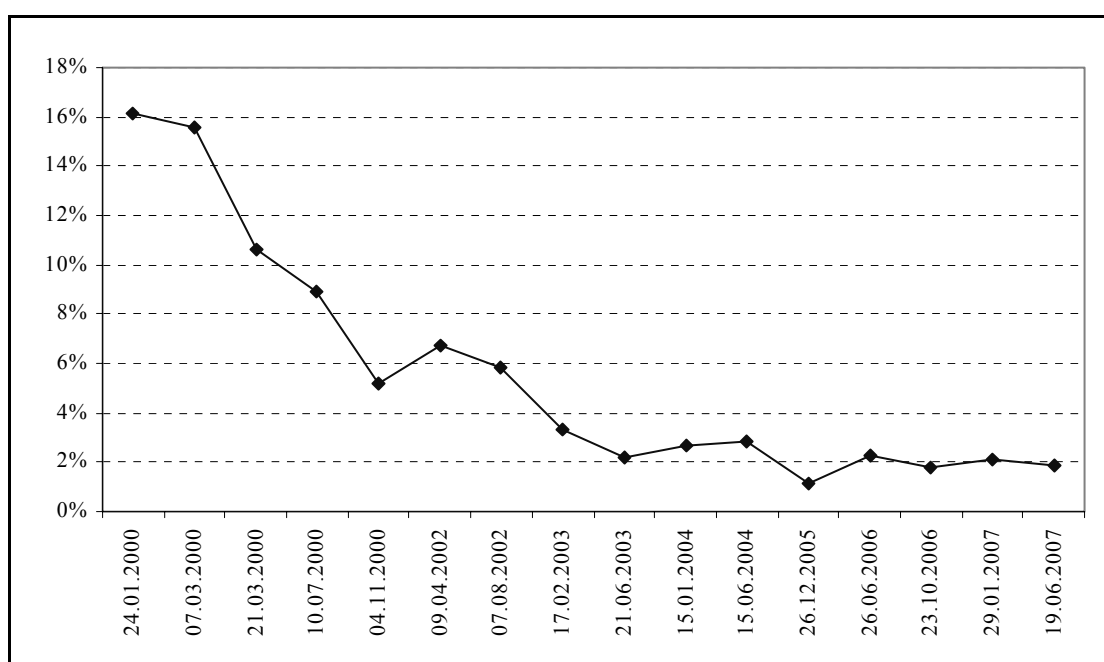
To evaluate the RF Central Bank performance in the reserve funds management, it is proposed in the report to use the so-called standard portfolios, which in fact are the indexes of those markets, in which the assets are invested. It is worth noting, that the application of the standard portfolios for the yields comparison with the common actual yields is largely in line with the international best practice in assessment of portfolio management efficiency.

Reserve currencies of the Bank of Russia are distributed between operational and investment portfolios. Apparently, the operational portfolio is designated to maintain high level of reserves liquidity, required for the implementation of the RF Central Bank functions in monetary-credit and foreign currency policy. The investment portfolio, as is indicated in its name, was created for investments in less liquid, but more risky financial instruments.

Within April 2006 – March 2007, the returns on investments made 5.3 per cent in USD, 3.1 per cent in EURO, 4.2 per cent in GBP and 0.3 per cent in JPY.

5. In 2007 the RF Central Bank has decreased the refund rate twice, on June 29 it was decreased from 11 per cent to 10.5 per cent, and since July 19 it was established at the rate of 10 per cent. It should be noted, that the decrease of the refund rate was implemented at the background of growing interest rates on deposits of credit organizations with the RF Central Bank. The decline of refund rate was aimed at raising the significance of interest rate role in monetary and credit policy. It is worth noting, that in the deteriorated situation in the inter-banking credit market, the demand of commercial banks for the RF Bank credits has significantly grown, what has promoted the role of the Bank of Russia interest rate policy. At the

same time, in late 2007, the information was obtained, that the Central Bank of Russia intends to terminate the long-term cycle of refinancing rate reduction. The expected increase of the refinancing rate is explained by inflation upsurge in autumn of this year, which led to a decline in refinancing rate in real terms. Given that due to the crisis in the global financial market, in autumn the demand for credits, provided by the RF Central Bank has increased sharply on the part of credit institutions, the growth of refinancing rate was supposed to prevent excessive bank borrowings and hence, the possibility of surplus monetary supply in the background of reducing tension in the Russian the inter-banking credit market. Herewith, we should mention that, until recently, refinancing rate had rather little impact on the Russian financial market due to the lack of demand for refinancing on the part of Russian banking system.



Source: RF Central Bank, RF Statistical Service.

*Fig. 11.* RF Central Bank Refinancing Rate in Real Terms over 2000–2007

6. In 2007, the RF Central Bank continued to raise interest rates on the instruments of attraction monetary assets from credit organizations: to 2.75 per cent per annum on the deposits, made under standard conditions “tom-next”, “spot-next” and “on demand”, to 3.25 per cent per annum on the deposits of “one week” and “spot-week” type. The rates increase has been implemented in order to sterilize the excessive liquidity in summer and was introduced in view of the changes in national and external economic environment. Through this measure the Bank of Russia continued its policy of raising interest rates role in monetary policy. At the same time, as a result of the lack of liquidity in the Russian market, in the background of financial instability in the world markets, there was a downfall in the volume of deposits of commercial banks with the Bank of Russia in July, which was sustained at an insignificant level till the end of the year.

7. In July the RF Central Bank has submitted to the RF State Duma the “Major Trends of Consolidated Monetary and Credit Policy for 2008”. For the second consecutive year, the

Bank of Russia has outlined its primary task for the year of 2008, namely – combating of inflation (bringing it to the level of 6–7 per cent as per 2008 results, to 5.5–6.5 in 2009 and to the level of 5–6 per cent as of 2010 results). As concerns the index of inflation targeting in regard to the ruble rate in real terms, it should be held within the range of 0–10 per cent. In our point of view, those measures will help the Bank of Russia to pursue more efficient monetary and credit policy, avoiding attempts to achieve several conflicting targets. In fact, such a wide range of real ruble rate means that the RF Central Bank facilitates this target, while focusing on inflation suppression. According to the Central Bank estimates, the surplus of monetary base in narrow definition will make 18.7–22.9 per cent in 2008. Gold and foreign currency reserves by the end of 2008 should reach USD 456-486 bln.

With regard to the inflation upsurge in autumn of 2007, the achievement of the RF Central Bank milestones in 2008 is unlikely: according to our estimates, in 2008 the CPI will make from 8 to 10 per cent. We consider that gold and foreign currency reserves to the end of 2008 are also underestimated, given the volume of international reserve assets as of January 1, 2008 amounted to USD 476.4 billion. The performance of the planned objectives for the growth of monetary assets will largely depend on the dynamics of currency inflow to the Russian Federation. Unless oil prices get declined and the rate of capital inflow is sustained at the level of 2007, the growth of monetary supply will also exceed the indicators, outlined in the “Major Trends of Consolidated Monetary and Credit Policy for 2008”.

8. Since July 1 of the year, the threshold of mandatory reserves for the RF commercial banks were increased. For credit institutions liabilities to the non-resident banks in national currency of the Russian Federation and in foreign currency, as well as on other liabilities of credit institutions, in national currency of the Russian Federation and in foreign currency, the threshold will be 4.5 per cent, and under the liabilities to physical persons in the national currency of the Russian Federation or in foreign currency it will make 4 per cent. Earlier the threshold of mandatory reserves under those types of liabilities made to 3.5 per cent. Therefore, the Central Bank is trying to reduce the rapid growth of domestic credits, and thus reduce inflationary pressure. We would like to remind, that in autumn 2006, the Bank of Russia has increased the threshold of mandatory reserves under the liabilities of credit institutions to non-resident banks from 2 per cent to 3.5 per cent, while increasing the averaging ratio from 0.2 to 0.3<sup>19</sup>, what partially neutralized the growth of reserve threshold.

As we have mentioned in previous sections, in the second half of 2007, Russian banks faced with a shortage of liquidity resources, which has forced the Bank of Russia to take a number of measures to avoid instability in the Russian banking sector. Thus, since October 11, the RF Central Bank has reduced for three months the threshold of mandatory reserves under the liabilities of credit institutions to physical persons in the national currency of the Russian Federation from 4 to 3 per cent, and under the liabilities to non-resident banks in the national currency of the Russian Federation and in foreign currency, as well as on other liabilities of credit institutions in the currency of the Russian Federation and in foreign currency from 4.5 to 3.5 per cent. Herewith, a possibility was provided to credit organizations, which had an intention to recalculate the threshold of mandatory reserves on the basis of the newly established regulations, to make an extra recalculation within October 11–15.

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<sup>19</sup> The banks could withdraw up to 30 per cent of their assets at the beginning of the month and refund their installments to the Mandatory Reserve Fund at the end of the month.

Since October 11, the interest rate on the ruble assets, used for “foreign currency swap” transactions with the Bank of Russia, has been reduced from 10 to 8 per cent per annum. In other words, the cost was reduced for credits, which can be obtained by commercial banks from the RF Central Bank under security of foreign currency.

From October 15, the list of securities, accepted to ensure direct REPO operations was significantly expanded, as well as that one for lombard credits. Since November 29 Eurobonds of a number of Russian companies have been included in the Lombard List of the Bank of Russia. Since November 1 the averaging ratio for calculation average amount of mandatory reserves has been raised from 0.3 to 0.4, which enabled commercial banks to use the basic share of their mandatory reserves within the month. From November 28, the Bank of Russia started to provide its lombard credits at a fixed interest rate for a period of one calendar day at the rate of 8 per cent per annum. MICEX started a session of direct REPO operations at a fixed rate of 8 per cent per annum for 1 day and under 7 per cent per annum for 1 week. Finally, in October, the RF Central Bank started to provide credits not only under securities, but also on a bail of credits and promissory notes.

In our view, all of those measures will enable the RF banking system to go through the period of financial instability without serious losses. Moreover, we believe that the reduction of the threshold of mandatory reserves could have been avoided, as this is one of the most inefficient instruments of monetary policy, which brings an effect with some delay. At the same time, the volume of untied reserves is not enough to cover the drastic shortage of liquid resources in the event of a serious crisis, whereas an excessive monetary offer can provoke further inflationary pressures.

## **2.2. Forecast Models of the RF Economic Development over a Medium-Term Prospective with Regard to the Trade Balance Dynamics**

One of the key indicators of 2007 were the acceleration of the Russian economy growth rate, as well as the expansion of real investments in fixed assets. Herewith, those factors were inspired as by extremely high oil prices and the surplus of the current account, as well as by high surplus balance of capital account over the greater part of the year.

In the previous edition of the IET annual survey<sup>20</sup> we have reviewed several forecast models of economic development in Russia, based on certain assumptions in terms of economic policy of the Central Bank and the Government of Russia. Distinctions between the models were primarily based on the level of global prices for energy sources and relevant dynamics in the RF trade balance. It was assumed, that the net capital flow in and out of the RF would be insignificant in macroeconomic terms.

Over the past year the situation has changed, and capital inflow in Russia has turned into an important source of financial resources for the investment in real sector and, consequently, for the support of high economic growth rates. Accordingly, we will hereby review four models of the RF economic development in the medium-term prospective (for 5 years till 2012), with regard to volatile dynamics in both components of the RF balance of payments: balance of current account and balance of capital account.

The first three models are based on the current situation with sustained high oil prices in the world market: the average annual price for 2008 is estimated at the level of USD 75 per

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<sup>20</sup> Russian economy in 2006. Trends and Outlooks. Issue 28. M., IET. 2007.

barrel (for Brent), and although prices are expected to be decreasing in subsequent years, they should stay at the level of about USD 60 per barrel, which corresponds to the indicator of no lower than USD 45 per barrel in 2005–2006 prices, in case of USD strengthening in the global market up to USD 1,27–1,30 for EURO 1.

The first model of the RF economic development is inertia-based as a matter of fact. The government will prevent the federal expenditures growth in excess of 18.5 per cent of GDP after the presidential elections in 2008. The current tax system will remain unchanged, the standards of replenishment of the RF Reserve Fund and the National Welfare Fund will not be amended, the annual growth rates of prices and tariffs for the goods and services, produced and provided by natural monopolies will exceed the inflation rate by no more than 2–2.5 p.p. The RF Central Bank will keep up the policy of accumulating foreign currency reserves, which will make for the relevant expansion of monetary supply, including the volume, required to maintain the high GDP growth rate, as well as the policy of restraining the rates of RUR effective exchange rate strengthening in real terms. Favorable external economic market situation and positive domestic macroeconomic indicators will attract both, foreign direct investments and capital inflow to the country.

Model II differs from the first one, it is based on assumption of sustained instability in the global financial system due to the crisis indicators, observed in the second half of 2007 as a result of problems in the USA mortgage market. Therefore, the ability of the Russian companies to attract inexpensive external resources will be restrained, which in turn will lead to a reduction in investment activities in Russia due to limited external resources of funding and growing interest rates in the domestic market. In particular, we anticipate in this situation, that the annual volume of capital inflow will be twice lower than under the first scenario.

Model III is based on the assumption of capital outflow from the country for the reasons, not associated with the trends in the Russian economy and Russian investment environment. This model is crisis-based or, at best, neutral. The situation at the “turning point” will depend on “safety reserve” of economy and financial authorities policy in the face of deteriorating financial crisis. Nevertheless, there is a rather high probability for the developments under such a scenario in the nearest future: due to the USA credit market crisis, the global investors lose interest to the new highly risky markets, including Russia.

It should be noted, that to review the consequences of this scenario, it is not crucial for us to find the basic reason (the “trigger”), that provoked capital outflow (significant deficit of the balance of capital transactions account). The following factors can be related to those reasons:

- problems in the USA credit and other financial markets;
- downgrading of growth rates in the global economy;
- upgrading of interest rates in developed countries;
- financial crisis in one or a number of developing markets.

However, in this scenario, we do not anticipate an abrupt downfall of oil prices. In other words, the situation of the balance of current account will remain favorable, while the outflow from the balance of capital account transactions is expected in the amount up to USD 200 billion (in 2009). In general, under this scenario, we have estimated the total balance of capital flows to/from the Russian Federation, basing on the assumption of the reduction and stabilization of the private sector external debt in 2011–2012 at the level of February–March 2007 (prior to massive capital inflows in the second quarter of 2007), i.e., USD 340–350 billion.



Model IV is based on anticipated decline in oil prices in the world market to the average level, sustained for many years, i.e., USD 20–25 per barrel (for Brent) in prices of 2005–2006, what approximately accounts to USD 30–35 per barrel in 2012.

To avoid arbitrary interpretations of qualitative changes in the economy and in the behaviour of economic agents (for example, a sharp change in prices and the foreign currency exchange rates dynamics in case of oil price downfall, the “swing” of exchange rate in nominal terms, etc.). Due to the application of formal economic-mathematical algorithms for quantitative assessment of the forecast models, we expect responsible and conservative behaviour on the part of economic agents. Thus, in every model, we apply the “equilibrium” variables in certain conditions, though it is unlikely to create such conditions in practice. In particular, this is relevant in regard to the forecast models, based on oil prices downfall.

Therefore, our assumptions provide fairly prudent assessments of the dynamics of macro-economic indicators in the Russian economy in case of both, high and low oil prices. In reality, the situation, with regard to the expectations of economic agents, might be developed in a more negative way. In such a case the authorities should be prepared to take measures aimed at least at mitigation of the estimated negative consequences. Similarly, for the situation of high oil prices, the forecast models are also conservative and demonstrate the bottom level of economic development options.

Modeling of the Russian economy major indicators dynamics in general, and in monetary sphere in particular, was performed on the basis of the IET approximation of medium-term socio-economic indicators modeling<sup>21</sup>. For the purpose of this study, the model was based on a longer time series, and moreover, revised by a number of additional indicators.

The preliminary estimates of final values for 2007 were used as initial indicators.

The dynamics in the basic macroeconomic indicators as per the models are presented in *Table 6*. Hereafter, we will review the basic trends in the Russian economy for each model in detail.

According to the obtained results, in the inertia-based situation in the economy of Russia (model I), the total GDP growth in real terms within 5 years (over 2008–2012) will reach about 35 per cent, while the annual growth rate of GDP in real terms will decline by the end of the period to 5.5–5.7 per cent. The decline in growth rate is attributed to the lower level of cost efficiency and stabilization in the export volumes of oil and gas, whereas the existing industry structure (raw materials in particular) is sustained. Ruble exchange rate growth in real terms will enable Russian economy to reach the volume of GDP, equal to USD 2.2 trillion (according to the current exchange rate) by 2012.

Despite some decrease of federal budget revenues (approximately to 20,5–21 per cent of GDP as a result of lowered level of taxation in the oil sector and the overall cost efficiency downgrading in economy), the federal budget balance remains positive (minimum indicator is 1 per cent of GDP). An expressed effect of the above is the accumulation of assets in the Na-

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<sup>21</sup> Model description in detail is published in the works by M. Turuntseva, A. Yudin, S. Drobyshesky, P. Kadochnikov, S. Ponomarenko, P. Trunin “Some approaches to economic indicators modeling”, “Research Works”, No. 89P, M.: IET, 2005, and some model elements are provided also in the works by S. Drobyshesky, V. Nosko, R. Entov, A. Yudin “Economic Analysis of Basic Macroeconomic Indicators Dynamic Series” “Research Works” No. 34P, M.: IET, 2001; R. Entov, V. Nosko, A. Yudin, A. Kadochnikov, S. Ponomarenko “Some Macroeconomic Indicators Approximation”, “Research Works” No. 46P, M.: IET, 2002.; G. Karasev, S. Chetverikov “Structural Models of RUR Exchange Rates”, No. 88P, M.: IET, 2005.

tional Welfare Fund in the volume of 7,5–8 per cent of GDP (USD 170–180 billion) by the end of 2012.

The RF Central Bank policy on accumulation foreign currency reserves and restriction of annual rates of ruble strengthening in real terms through the inflow of foreign currency sterilization enabled to reach the level of USD 690–700 billion of reserves in foreign currency. Total growth of effective ruble exchange rate in real terms for a 5-year period makes approximately 16 per cent (+31 per cent to the level prior to the 1998 crisis). Herewith, ruble exchange rate in nominal terms will reach approximately 29,0–29,5 rubles against dollar by the end of 2012.

As mentioned above, the key distinguishment of this models from the other ones is continued expressed capital inflow to the RF. According to the forecast model, the support of the desired level of investments in fixed assets requires an extension of the Russian private sector external debt to USD 1.05 trillion (about 47 per cent of GDP) by the end of 2012.

In our estimates, trade balance surplus, supported by the high prices for raw materials in the global market can be sustained practically over all period under review (insignificantly negative indicators are expected only in 2012). However, due to the growth in services import and the upgraded interest rates on the growing external debt, the balance of current account may become negative as early as in 2010–2011 and will overlap the surplus balance of capital account, i.e., the RF balance of payments will be negative. Our estimates are based on the assumptions, that the balance of payments deficit will be funded from the RF gold and foreign currency reserves, while maintaining smooth dynamics in ruble exchange rate in nominal terms against two-currency basket “USD-EURO”.

Proceeding to the review of the situation in the monetary sphere, it is worth noting, that with the anticipated volume of capital inflow in 2008 (corporate and banking sectors debt is expected to be extended up to USD 545 billion), the Central Bank will probably actively use additional instruments of sterilization, rather than face the liquidity shortage problem (in financial system in general). According to our estimates, while federal budget expenditures are sustained at the level of 18.1 per cent of GDP, in order to maintain the annual growth rate of monetary supply ( $M_2$ ) at least within 30–35 per cent (versus 47.5 per cent in 2007), financial authorities will have to sterilize minimum RUR 200 billion, obtained from monetization of balance of payments surplus.

By 2012, the monetary supply growth rates will be declined to 15–16 per cent per annum, exceeding the inflation rates, which will enable to achieve the level of monetization at about 58–59 per cent of GDP. However, in 2009, due to fairly rapid reduction of the balance of payments surplus, in the background of sustained conservative fiscal policy (federal budget expenditures will not exceed 18.5 per cent of GDP), the problem of replenishment of the monetary supply with the help of refinancing instruments of the Bank of Russia becomes rather aggravated. According to our assessments, in order to maintain the real interest rates on credits to non-financial sector not in excess of 3–3,5 per cent per annum, what enables to keep up the investment growth rate, the RF Central Bank in 2012 will have to provide refinancing to the banking sector in the amount of minimum RUR 4 trillion (6.6 per cent of GDP).

According to our estimates, under this scenario, it is impossible to reduce inflation below 5.0 per cent in 2012. The total prices growth over the five years will reach at least 40 per cent.

*Table 6*

**Dynamics in Economic Development of Russia as per Forecast Models  
within 2008–2012**

Model	I	II	III	IV
GDP in real terms (growth within the period), %	33–35	27–28	5–6	1–2
Investment index in capital assets (growth within the period), %	85–90	62–67	–9–10	–11–12
Inflation (2012), %	5.0–5.5	4.5–5.0	10–11	14–15
Balance of current account surplus (% of GDP, 2012)	–4.4	–0.7	5.5	2.7 <sup>22</sup>
Balance of capital account surplus (% of GDP, 2012)	2.2	1.3	–4.6	–3.5
Nominal exchange rate RUR/USD (2012)	29.0–29.5	30	46–48	50–55
Real effective exchange rate, % (growth against July 1998), %	+30–32	+24–25	+4–5	–20–25
Gold and foreign currency reserves (2012), USD bln	690–700	670–680	205–215	180–190
GDP monetization (2012), %	58–59	56–57	32–33	33–34

With lower volume of external financing (model II), growth rate of investment in fixed assets and the RF GDP in real terms will be lower. However, the share of foreign debt in GDP will also not exceed 37.5 per cent of GDP. Our assessments demonstrate, that basing on the given assumptions of capital inflow to Russia, the refinancing volume to the banks, provided by the RF Central Bank as early as in 2008 should reach about RUR 800 billion. Otherwise, real interest rates on credits to non-financial sector can exceed 5 per cent per annum (currently they are practically negative), which means a sharp decline in the availability of investment resources in the economy. Nevertheless, the average annual growth rate of GDP in real terms will remain high enough, at least 4.5–5.0 per cent per annum, while inflation may be decreased to 4.5 per cent in annual terms by the end of 2012.

Thus, this forecast model, although presumes a slight decline in the growth of Russian economy in comparison with the first one, in our view does not bring any threat to the long-term continuous development and is quite favourable.

Comparison of the third and fourth forecast models, which, as a matter of fact are options of crisis scenario, demonstrates that in the current context of increasing dependence of the GDP growth in real terms on investment dynamics in fixed capital, the restriction on external financing over 2–3 years (model III) can provoke the consequences, comparable with the situation of sharp and sustained decline in oil prices (model IV). In both cases, in 1–2 years after the beginning of negative developments (2010–2011), Russia will face the need to quite drastic devaluation of the national currency and equalization of the balance of payments by reducing the attractiveness of imports. However, at least for 2–3 years, the rate of growth in real economic indicators (GDP, investment, incomes) will be experiencing a serious decline, down to negative values.

<sup>22</sup> The surplus of the current account balance, in the background of low oil prices, planned in this in this forecast model is based on the assumption, that the ruble devaluation, as well as the reduction of import for the purpose to equalize the RF balance of payments will already take place by 2012.

## 2.3. State Budget

### 2.3.1. A General Overview of the Budgetary System of the Russian Federation

When analyzing the main parameters of the Russian Federation's budgetary system in 2007, it should be noted that, while the level of revenue as a share of GDP changed only slightly last year by comparison with that in 2006 (*Table 7*), federal budget expenditure demonstrated noticeable growth, amounting to 2.2 p.p. of GDP, while the budget expenditure of RF subjects increased by approximately 1.0 p.p. of GDP, and the general government's budget expenditure – by 2.9 p.p. of GDP. This growth of expenditure resulted both from the fulfillment of the State's increased social obligations with regard to the population, including within the framework of the implementation of priority national projects, and from the State's expanded participation in investment processes all over this country's territory.

However, this growth of expenditure at all the levels of the RF budgetary system was not accompanied by a comparable increase in the volume of a revenue base, which, in the final analysis, produced a diminished surplus. Thus, according to the data concerning the actual execution of the RF federal budget in 2007, its revenue amounted to 23.6% of GDP, which is only by 0.3 p.p. higher than the same index in 2006. It should be specifically noted that the level of revenues received by the federal budget from the single social tax (SST), which in 2002–2006 had been steadily on the decline, finally became stabilized.

Revenue of the RF consolidated budget of RF subjects in 2007 was registered at the level of 14.7% of GDP, which is by 0.6 p.p. higher than the previous year's index. A similar growth was noted in respect of the RF general government's revenue.

Due to the accelerated growth of the general government's expenditure, coupled with the relatively modest increase in its revenue, surplus in the general government's budget as seen by the results of 2007 decreased by 2.3 p.p. of GDP against the index of the previous year and amounted to 6.1% of GDP.

Tax revenues in the budgets of all levels displayed a tendency to grow after their fall in 2006, which had resulted predominantly from decreased revenues from VAT and functioned as a key growth factor for this country's budgetary system's aggregate revenues.

In view of the sufficiently favorable situation of the global oil and metals market, the stabilization of the budget revenue resulted from changes in the revenues in respect of individual taxes, which will be discussed in more detail later in the text.

The rise of oil prices on the level determined in the 2007 budget, just as a year previously, resulted in overfulfillment of the budgetary system's revenue plan, and so on 23 November adjustments were introduced into the law on the federal budget, in accordance with which its revenue was increased to 7,443.9 billion rubles (against 6,965.3 billion rubles in the initial version), and its expenditure – to 6,531.4 billion rubles (against 5,463.5 billion rubles in the initial version).

*Table 7*

**Execution of Revenue and Expenditure in Budgets  
of all Levels of Authority (as % of GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007
<b>Federal budget</b>								
Tax revenues*	10.2	12.5	15.8	14.7	13.5	14.5	13.4	14.0
Including SST <sup>23</sup>	–	–	3.13	2.75	2.60	1.24	1.18	1.18
Revenue	15.5	17.8	20.3	19.5	20.1	23.7	23.3	23.6
Expenditure	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.1
Deficit (-)/Surplus (+)	1.4	3.0	1.4	1.7	4.3	7.4	7.4	5.5
<b>Territorial budgets</b>								
Tax revenues*	10.5	9.9	10.2	10.0	10.5	10.3	10.3	11.0
Revenue	14.1	14.5	15.1	14.6	14.1	13.9	14.1	14.7
Expenditure	13.4	14.5	15.5	14.9	13.9	13.6	13.6	14.6
Deficit (-)/Surplus (+)	0.7	0.0	-0.4	-0.3	0.2	0.3	0.5	0.1
<b>Budget of general government</b>								
Tax revenues*	28.0	27.7	27.0	25.6	24.8	25.5	24.5	25.8
Revenue	38.3	38.4	37.8	37.1	37.5	39.7	39.6	40.2
Expenditure	34.3	35.2	36.3	36.0	32.9	31.6	31.2	34.1
Deficit (-)/Surplus (+)	4.0	3.2	1.5	1.1	4.6	8.1	8.4	6.1

\* Tax revenues are determined in accordance with the provisions stipulated in the current wording of the RF Budget Code (less insurance contributions to compulsory pension insurance (CPI), revenues from foreign economic activity, and revenues of target budget funds).

Source: RF Ministry of Finance; calculations by the IET.

The most important development in the domain of budgeting policy in 2007 were the amendments introduced into the RF Budget Code (by Federal Law of 26 April 2007, No. 63-FZ), whereby the content of many fundamental articles of the Code was dramatically changed. The following innovations can be noted in the Code's new version:

1) the switchover of all budgets within the budgetary system to medium-term financial planning, including the federal budget and state off-budget funds of the Russian Federation, with the formation of budgets for a three-year period;

2) distinct linking of budget allocations to the state (or municipal) services being provided to physical and juridical persons to the carrying out of state (or municipal) assignments, the introduction of the mechanisms of financial backing for the activity of entities of new organizational-legal forms, and the creation of appropriate conditions for restructuring the budgetary network;

3) the regulation, in accordance with uniform organizational principles, of the budgeting process's organization (the preparation, consideration, approval and execution of budgets; the preparation, external auditing, consideration and approval of budgeting reporting documents), including the consolidation of single requirements to budget planning, the switchover to the approval of a federal law on the federal budget in three readings, and a more precise and transparent regulation of the execution of budgets;

<sup>23</sup> From 2001 onward, SST replaced the previously existing deductions to state social off-budget funds. Since 2002, a certain percentage of the aggregate SST rate is being transferred to the federal budget.

4) the planning of expenditure on the basis of delimitation of the existing and newly adopted obligations;

5) a systemic description of the composition and powers of the participants in the budgeting process, and first of all its main executors (or executors) and recipients of budget resources, principal administrators (or administrators) of budget revenues and principal administrators (or administrators) of the source used to cover budget deficit;

6) the confirmation of the fundamental principles and items of the budget classification of the Russian Federation by special provisions in the Budget Code, with a simultaneous expansion of the powers of bodies of state authority and bodies of local self-government to make the classification more detailed, as well as the integration of budget classification and budget accounting.

Special attention should be given to the amendments concerning the use of the “oil and gas” revenues of the federal budget. From the year 2008 onward, Chapter 13.1 “The Stabilization Fund of the Russian Federation” is abolished, to be replaced by Chapter 13.2 “The use of oil and gas revenues of the federal budget”. The category of oil and gas revenues encompasses the revenues from: the tax on the extraction of mineral resources (hydrocarbon raw materials); export customs duties on crude oil; export customs duties on natural gas; and export customs duties on oil products.

A part of oil and gas revenues is earmarked for financing the current expenditures of the federal budget (the oil and gas transfer), while another part can be saved. In order to estimate the situation-linked risks from the point of view of stability of state finances, it is important to know the index of deficit not linked to oil and gas, represented by the difference between the revenues not linked to oil and gas and the aggregate budget expenditure. According to the Budget Code, its value cannot be higher than 4.7% of the value of GDP forecasted for a given financial year.

As is seen from *Fig. 12*, the share of oil and gas revenues in the federal budget as a percentage of GDP in 2007 was displaying a trend toward a gradual decline, which is demonstrative of the budget’s somewhat decreased dependence on the raw materials sector of the national economy. At the same time it should be noted that the share of oil and gas revenues, despite its slight reduction, still remains high. Besides, the federal budget’s average monthly deficit not linked to oil and gas throughout the year 2007 remained within the range of 2–5% of GDP, with the exception of the last two months, when the traditional upsurge in the deficit not linked to oil and gas was observed, which was associated with the specificity of the execution of spending obligations in cash terms. The amplitude of growth displayed by the deficit not linked to oil and gas at the end of a budget year has a tendency of dramatic growth, which points to the presence of serious risks threatening the state financial system’s stability and requires that the government should take special measures aimed at strengthening cash discipline and promoting a more evenly distributed execution of the assumed spending obligations.

In their turn, the transfer linked to oil and gas represents a part of the federal budget’s resources used to cover its deficit not linked to oil and gas by means of drawing on the oil and gas revenues and the Reserve Fund’s resources. The size of the “oil and gas” transfer is limited to 3.7% of GDP. It should be stressed that these norms be applied only beginning from 1 January 2011. In the period of 2008–2010 the marginal size of the “oil and gas” transfer will be: 6.1% of GDP in 2008; 5.5% of GDP – in 2009; and 4.5% of GDP – in 2010.

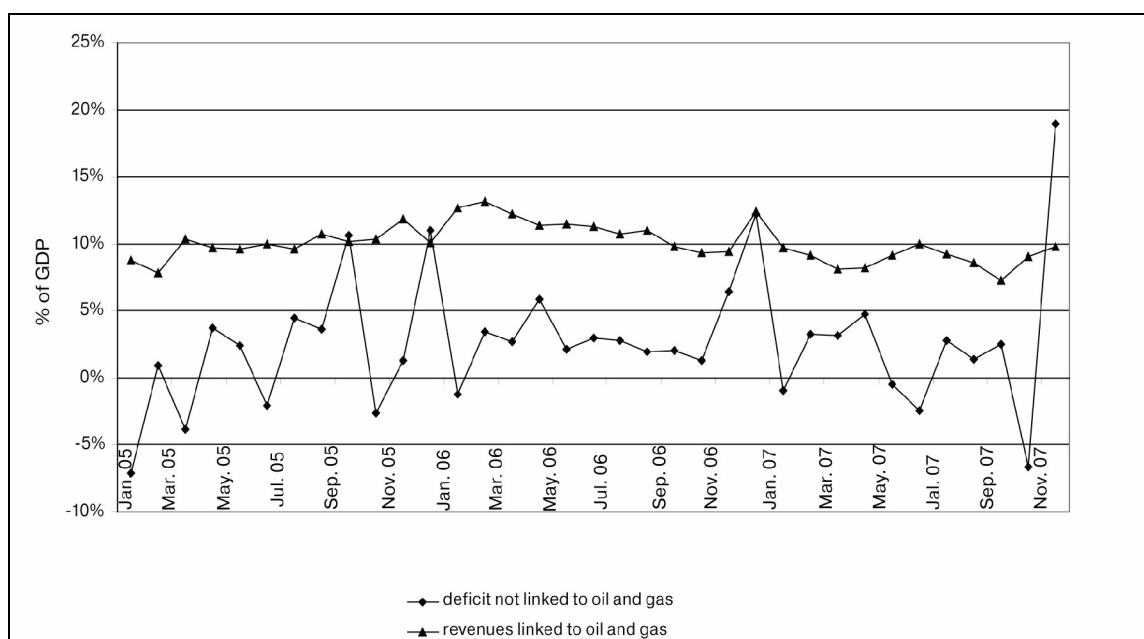


Fig. 12. Average Monthly Revenues Linked to Oil and Gas and the Deficit not Linked to Oil and Gas in the 2005–2007 Federal Budget (as % of GDP)

New Chapter 13.2 of the Budget Code has also introduced some changes into the the procedure for forming the RF Stabilization Fund, which will be replaced, from the year 2008 onward, by two new funds: the Reserve Fund and the National Welfare Fund. It is noteworthy that as of 01.01.2008 the residuals of the Stabilization Fund on the accounts of the RF Federal Treasury amounted to 3,849.1 billion rubles.

The Reserve Fund represents a part of the federal budget’s resources earmarked for separate accounting and management in order to make the “oil and gas” transfer, if oil and gas revenues are not sufficient to cover the amount of the transfer. The normative size of the Reserve Fund is established at the level of 10% of GDP. The Reserve Fund is formed from the oil and gas revenues of the federal budget in an amount higher than the size of the “oil and gas” transfer approved in a given financial year, on condition that the accumulated volume of the Reserve Fund is not higher than its normative size; and from the revenues from the management of the Reserve Fund’s resources.

In its turn, the National Welfare Fund is formed from the oil and gas revenues of the federal budget in an amount higher than the size of the “oil and gas” transfer approved in a given financial year, if the accumulated volume of the Reserve Fund’s resources is equal to its normative size (or exceeds it); and from the revenues from the management of the National Welfare Fund’s resources.

The Reserve Fund and the National Welfare Fund differ in their functions and governance rules. The goal of the Reserve Fund is to ensure stability of federal budget expenditure and the fulfillment in full of the assumed spending obligations in a situation of a potential drop in international prices of oil and gas; whereas that of the National Welfare Fund is to preserve a part of oil and gas revenues for future generations and to ensure long-term stability of the budgetary system. In this connection, it is intended that the volume of the Reserve Fund should be maintained as a constant percentage of GDP.

The resources of the Reserve Fund are to be managed by applying a conservative investment strategy. Thus, these resources must be invested in reliable and highly liquid short- and medium-term debt obligations of foreign governments, state agencies, central banks, international financial organizations, and in foreign currencies. Besides, the Reserve Fund's resources can be invested in deposits and residuals on the accounts at foreign banks and credit institutions, as well as on the accounts of the RF Central Bank (CB). Thus, the principles of this investment strategy and the mechanism of its implementation are on the whole compatible with the procedure for managing the Stabilization Fund's resources.

When managing the resources of the National Welfare Fund, it is planned to apply a strategy involving investments of the Fund's resources, on a long-term basis, not only in highly liquid government securities, but also in certain less liquid financial instruments with higher yields and higher associated risks, such as shares, corporate bonds and stakes in investment funds.

In our opinion, such a strategy of managing the Reserve Fund and the National Welfare Fund is on the whole compatible with best practices of managing national welfare funds. In particular, it is evident more strict requirements in terms of liquidity should be applied to the Reserve Fund's resources, and so there is, in fact, no alternative to them being invested in the highly reliable bonds issued by foreign governments. As for the National Welfare Fund, the investment of its resources in instruments with higher yields also appears to be quite justified. In this connection, it would be feasible to rely on the long-term yield potential of such investments, because in a short term stock markets are prone to serious fluctuations in profitability. The best strategy in such a situation, in all probability, would be to gradually expand the list of instruments suitable for investing the resources of the National Welfare Fund, as well as to assign their management to highly professional asset managers.

From the point of view of expanding the list of securities for investing the resources of these two Funds, an important role is played by the investment portfolio's structure as established by legislation. It should be reminded that in 2007 the resources of the Stabilization Fund were invested with regard to their safety and liquidity as the main priorities. Similar priorities, most obviously, should be applied when investing the Reserve Fund's resources. When making the decision as to the most appropriate structure of the National Welfare Fund's investment portfolio, priority should be given to the size of yield on the invested capital, with due regard for ensuring an acceptable level of involved risks. The international practical experience of managing national welfare funds have demonstrated that the distribution of their assets should be compatible with:

- 1) the structure of imports in the country where a fund is created;
- 2) the structure of its foreign debt;
- 3) the share of GDP of the country (or region), in whose financial instruments the resources are invested, in global GDP;
- 4) the national market's financial instruments' share of the regional or global market for a given type of instruments, with due regard for the country-linked risks.

When investing the resources of the Reserve Fund and the National Welfare Fund, much attention should be given to the issues of their activity's transparency. In our opinion, it would be reasonable that control over the activity of the "oil and gas fund" should be exercised by a Supervisory Board consisting of representatives of the authorities, investment companies and the academic community. Besides, we believe that it is necessary to involve external consult-



ants on investments in the development and adjustment of an investment strategy, because their experience may prove to be very useful in making the best choice of a strategy for managing the Funds' resources.

### 2.3.2. An Analysis of the Execution of the RF Federal Budget in 2007

In accordance with the initial version of the 2007 law on federal budget, its revenue was set at the level of 22.3% of GDP, which is by 1 percent point lower than the actual value of the executed budget revenue as demonstrated by the results of 2006 (see *Table 8*). The planned decrease in the GDP share of revenue 2007 by comparison with the actually executed revenue in the previous year can be explained by changes in RF tax and budget legislation, as well as by the extremely cautious forecasts of the principal macroeconomic indices of the RF for the year 2007. At the same time, without taking into account the deductions to the RF Stabilization Fund, the federal budget revenue in 2007 remained at the level of its actual execution in 2006.

*Table 8*

**Main Parameters of the RF Federal Budget in 2007**

	Reference value: 2006 – executed		2007 – law		2007 – adjusted budget		2007 – executed	
	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP
<b>Revenue</b>	<b>6,276.3</b>	<b>23.3</b>	<b>6,965.3</b>	<b>22.3</b>	<b>7,443.9</b>	<b>23.2</b>	<b>7,779.1</b>	<b>23.6</b>
Including:								
tax revenues	3,595.7	13.4	4,243.0	13.6	4,532.0	14.1	4,633.7	14.0
non-tax revenues*	2,680.6	9.9	2,722.3	8.7	2,911.9	9.1	3,145.4	9.6
<b>Deductions to Stabilization Fund</b>	<b>1,720.7</b>	<b>6.4</b>	<b>1,690.7</b>	<b>5.4</b>	<b>1,550.5</b>	<b>4.8</b>	<b>1,903.1</b>	<b>5.8</b>
Revenues, without resources earmarked for transfer to Stabilization Fund of Russian Federation	4,555.6	16.9	5,274.6	16.9	5,893.4	18.4	5,876.0	17.8
<b>Expenditure</b>	<b>4,281.3</b>	<b>15.9</b>	<b>5,463.5</b>	<b>17.5</b>	<b>6,532.3</b>	<b>20.4</b>	<b>5,983.0</b>	<b>18.1</b>
Including:								
interest	1,69.1	0.6	156.9	0.5	149.1	0.5	143.1	0.4
non- interest	4,112.2	15.3	5,306.6	17.0	6,383.2	19.9	5,839.9	17.7
<b>Federal budget surplus</b>	<b>1,995.0</b>	<b>7.4</b>	<b>1,501.8</b>	<b>4.8</b>	<b>911.6</b>	<b>2.8</b>	<b>1,796.1</b>	<b>5.5</b>
Surplus /deficit (without resources earmarked for transfer to Stabilization Fund of Russian Federation)	274.3	1.0	-188.9	-0.6	-638.9	-2.0	-107.0	-0.3
<b>Sources for covering federal budget deficit</b>	<b>-598.0</b>	<b>-2.2</b>	<b>52.9</b>	<b>0.2</b>	<b>119.1</b>	<b>-0.4</b>	<b>-33.4</b>	<b>-0.1</b>
Including:								
domestic	1,56.3	0.6	2,14.3	0.7	3,14.2	1.0	147.1	0.4
foreign	-754.3	-2.8	-161.4	-0.5	-195.1	-0.6	-180.5	-0.5
<b>GDP</b>	<b>26,882</b>		<b>31,220</b>		<b>32,100</b>		<b>32,989</b>	

\* Including uncompensated receipts.

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

On the basis of the existing dynamics of the receipt of revenues in the first 9 months of 2007 and the estimation of revenues received in Q IV of the same year, the federal budget

revenue was increased by 6.9% against the level approved by the Law “On the 2007 Federal Budget”. In this connection, one cannot overlook the fact that, despite the more than by 20% decline in the receipts of export customs duties as a percentage of GDP, the main factor determining the growth of revenue was, nevertheless, the amount of non-tax revenues. This was achieved due to a considerable growth of revenues from sales of property (the sale of “Yukos”’s assets) and uncompensated receipts.

If the dynamics of receipts of revenues in the federal budget are to be viewed on the whole, the following features can be noted. The greatest drop, in terms of percentage of GDP, was observed in 2007 with regard to the following revenue sources: export customs duties (–1.52% of GDP) and the tax on incomes of enterprises and organizations (TIEO) (–0.69%), which could be explained by changes in oil prices, the USD exchange rate, output volumes of exported goods, as well as by changes in the growth rate and structure of GDP throughout the year 2007. It is the decline in revenues against these four items, which constituted 38.0% of the aggregate federal budget revenue in 2007, that was acting as the main factor restricting the growth of federal budget revenue.

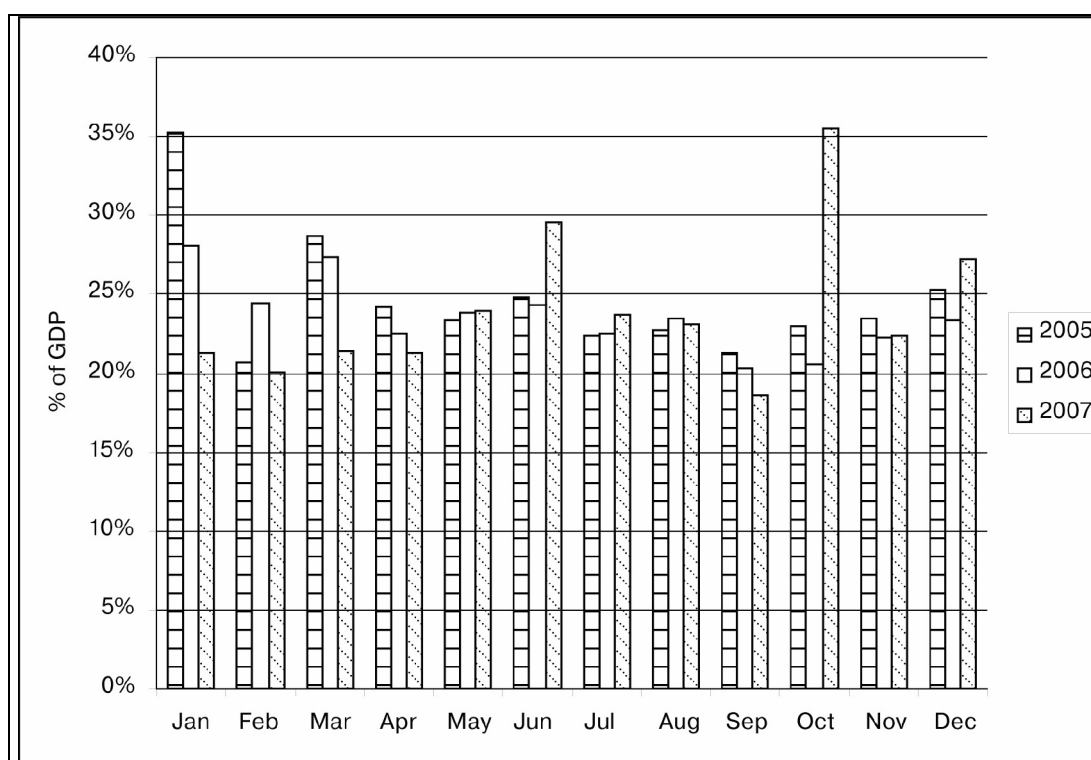
The decline in the receipts of the value added tax levied on the goods sold in the territory of the RF early in the year was caused by the switchover, from 1 January 2007, to the notifying procedure for VAT refunds. However, from mid-year onward, this drop in the tax revenues from VAT was in part compensated for by a considerable rise in the volumes of imports, increased profits of enterprises, increased volumes of output and sales of excisable goods, increased volume of the extraction of mineral resources, and other volume-linked indices, as well as by growing prices of energy resources and a high growth rate of wages and salaries. The impact of these factors had a positive effect on the growth of receipts of the profits tax, SST, excises and VAT levied on the goods imported into the territory of the Russian Federation. The highest growth, in terms of percentages of GDP, was observed in respect of the following items: VAT levied on the goods (or works, or services) being realized in the territory of the Russian Federation (+0.76%, predominantly generated by the receipt, in redemption of the oil company “Yukos”’ debts, of 239.7 billion rubles), and VAT levied on the goods imported into the territory of the RF (+0.45%).

Another problem associated with federal budget revenue was the uneven schedule of receipts in 2007, as compared to that in the previous years. Thus, the level of revenue as % of GDP in the first few months of 2007 was noticeably lower than that in 2005–2006 (*Fig. 13*).

The main reason for the diminishing share of federal budget revenue in GDP in January–April 2007 against that in the same periods of the previous years was the accelerated growth of GDP. The acceleration of GDP growth (by comparison with its growth in January–April 2006) was produced by three factors. Firstly, the unusually warm winter made it possible to continue construction works without interruption. Secondly, in early 2007 the activity with regard to investments and consumption became higher. Thirdly, a significant role was played by the effect of base (GDP in early 2006 was growing at a rather low rate)<sup>24</sup>.

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<sup>24</sup> GDP in Q I 2007 is by 7.9% higher than GDP in Q I 2006; the corresponding index of the same period in 2006 amounted to 4.6%; and in 2005 – to 5.0%.



*Fig. 13. RF Federal Budget Revenue in 2005–2007 (as % of GDP)*

In its turn, the falling of the rate of growth of federal budget revenue behind that of Russia's national economy as a whole in the first four months of 2007 was caused by the following circumstances:

- federal budget revenue strongly depends on receipts from the raw materials sector of the national economy (approximately a half of the federal budget revenue in 2006 was generated by import duties and the tax on the extraction of mineral resources). In Q I 2007, the volume of industrial output exceeded that in the same period of 2006 by 8.4%. As for the extraction of mineral resources, its volume could not grow at the same rate. As a result, the slower growth of the raw materials sector induced a drop in the share of export duties and TIEO in GDP;
- in the first few months of 2007, by comparison with the same period of 2006, oil prices were on the decline. This trend on global markets disappeared as early as mid-2007;
- the switchover to the notifying procedure for VAT refunds.

During the remaining months until the end of 2007, federal budget revenue were, on the whole, repeating the pattern of the two previous years, an exception was represented by June and October, when two peaks of revenues to the federal budget were seen. In June the growth of revenue was produced by 80% rise of VAT receipts on the previous month, as well as by uncompensated receipts from other budgets of the RF budgetary system in the amount of 54.2 billion rubles

October 2007 was a record month, by the size of monthly revenues of the federal budget, of the whole period of 2005–2007, which was primarily due to the receipts of uncompensated payments from other budgets of the RF budgetary system already in the amount of

176.9 billion rubles, as well as to the doubling of VAT receipts and those of the profits tax in the first 9 months of 2007.

In face of a stabilizing level of budget revenues as a percentage of GDP, the liberalization of the budgeting policy resulted in a planned increase of budget expenditure. Thus, in the 2007 Law on Federal Budget, the size of expenditure was set at the level of 17.5% GDP, which is by 1,6 p.p. higher than the same index in 2006. In this connection, as can be seen from *Table 8*, the aggregate growth of budget expenditure can be explained exclusively by that of non-interest expenditures, which increased to 17.0% of GDP against 15.3% of GDP as actually executed in 2006. One of the main reasons for such noticeable growth of non-interest expenditures of the federal budget in 2007 was the RF President's Message to the Federal Assembly, which specified several priority directions for the state policy in 2007. In particular, as priorities were categorized several goals to be achieved in the spheres of social policy and the population's standard of living, the national economy and the further improvement of inter-budgetary relations. The budget's orientation toward the social sphere was reflected, in particular, in the increased size of the Federal Fund for Co-Financing of Social Expenditures – by more than 35%, with its final size in the year 2007 determined in the amount of 355 billion rubles. For the first time, the 2007 budget expenditure incorporated allocations earmarked for the implementation of a set of measures aimed at improving Russia's demographic situation.

As a result of the changes introduced into the budget in 2007, its expenditure was increased by nearly 3 p.p. of GDP. The adjustment of the budget revenues and expenditures was mainly aimed at investment-type expenditures. Thus, additional subsidies were allocated to the budgets of the Federation's subjects for developing the motor road infrastructure in the amount of 30 billion rubles; and those for capital repairs of the housing and utilities fund – in the amount of 10 billion rubles, as well as to cover applied scientific research – in the amount of 2.9 billion rubles.

However, it was decided that the main bulk of the additionally received situation-linked revenues (approximately 300 billion rubles) should be spent on increasing the capital of the existing development institutions:

- 180 billion rubles – to the State Corporation “Bank for Development and Foreign Economic Activity (Vneshekonombank)”;
- 30 billion rubles – to the State Corporation “The Russian Nanotechnologies Corporation” (Rosnanotekh);
- 90 billion rubles to the Investment Fund, including 15 billion rubles to be subsequently transferred to the Russian Venture Company.

Moreover, another 340 billion rubles allocated from the resources received from the sale of “Yukos”'s assets was distributed in the following way: 240 billion rubles – to cover the activity of the Fund for Promoting Reform of the Housing and Utilities Sector; and the remaining 100 billion rubles – to Rosnanotekh.

Thus, the additional investments made by the State in recent years in development institutions were covered by resources in the amount of 2% of GDP. It is noteworthy that the set of instruments applied in federal investment policy has recently been considerably expanded, while the State began to be more actively involved in the investment processes. However, the necessity to maintain macroeconomic stability, as an indispensable condition for the efficient use of government investments, predetermines the need for a very careful policy aimed at increasing the size of investment-type expenditures, in order to prevent any inflation-generating

pressure on the ruble's exchange rate. In this connections, it appears quite natural that the RF Ministry of Finance desires to "spend the resources additionally allocated to development institutions evenly over three or four years", so that not to trigger the inflation spiral.

It should be noted that the dynamics of expenditures was similar in the last three years. In 2007, just as before, there persisted a trend toward a growth in expenditures by the end of a year, caused by the uneven pattern of spending of budget resources by state agencies over a year (see *Table 9*). In 2007, one additional factor was the political component – the elections to the State Duma in December and the presidential election in March 2008.

On the whole, it can be said that the curve of expenditure in 2007 is for the most part plotted higher than that of 2005 and 2006, that is, there occurs a gradual growth of the federal budget expenditure, with a simultaneous increase of its share in GDP (see *Fig. 14*).

*Table 9*

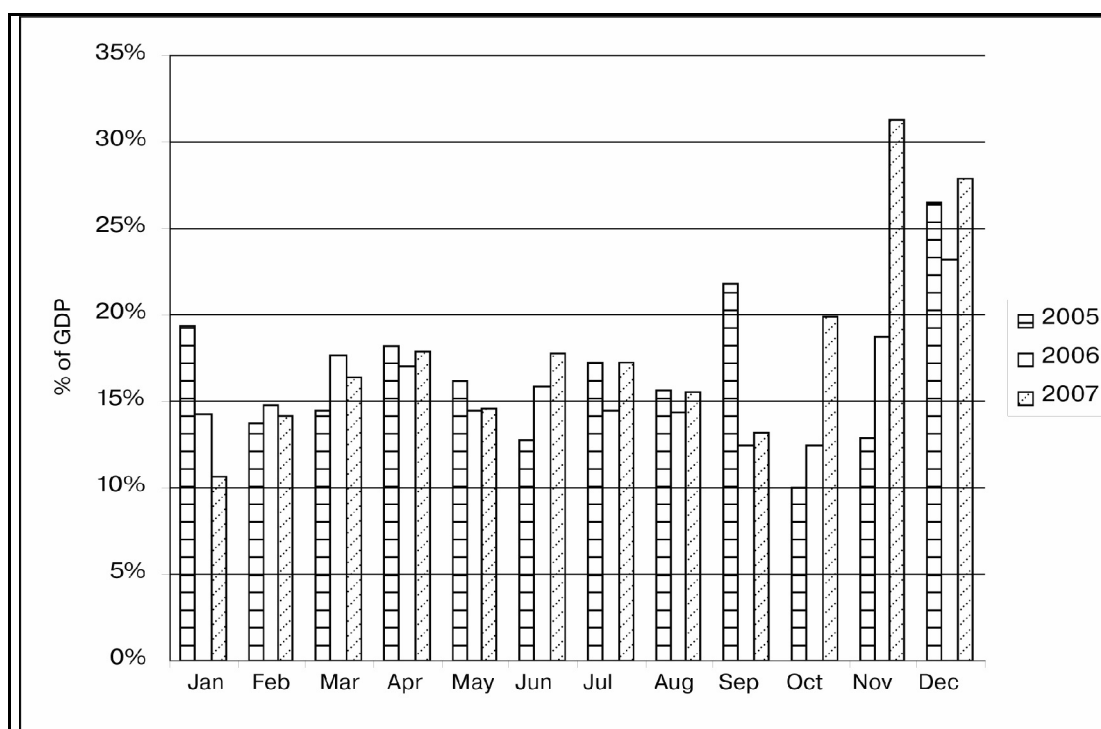
**The Execution of the 2007 Federal Budget in Cash Terms  
(as % of Budget Revenue and Expenditure in that Year)**

	Q I	1st half-year	9 months	Year
<b>EXPENDITURE</b>	14.5	33.2	53.0	91.6
General state issues	10.0	23.0	38.3	75.2
Of these: government debt servicing	28.6	42.2	78.2	96.0
National defense	17.6	42.2	62.5	98.9
National security and law enforcement activity	18.2	41.6	64.4	98.9
National economy	8.3	21.4	35.8	90.2
Housing and utilities	1.0	5.5	10.5	99.4
Environment protection	13.1	36.5	59.4	99.0
Education	13.3	38.3	59.7	101.2
Culture, cinematography and mass media	12.8	34.1	56.9	99.7
Health care and sport	8.3	22.0	37.5	70.6
Social policy	13.5	31.7	50.9	75.7
Interbudgetary transfers	20.1	41.9	67.8	97.8

*Source:* RF Ministry of Finance financial RF; calculations of the IET.

The problem of the execution of federal budget expenditure in cash terms began to be felt acutely as early as in the beginning of 2007. Thus, federal budget expenditure in the 1st half-year 2007 was executed only in the amount of 1/3 of its annual size, as determined in the budget revenues and expenditures. The situation with regard to the housing and utilities sector seemed catastrophic indeed, when by the results of the 1st half-year it became clear that only 5.5% of the resources envisaged in the budget had actually been implemented. As before, extremely low was the level of implemented expenditures on priority national projects (less than 30% of their annual amount).

The main reasons for the existing situation were, firstly, the late conclusion of contracts for the placement of government orders for the procurement of goods (or works, or services) for state needs, and the failure to fulfill their terms in due time; secondly, the absence of government decrees necessary for the execution of the federal budget; and thirdly, the continuing trend of resources being transferred by the principal administrators of budget funds to their recipients at the end of the year.



*Fig. 14. RF Federal Budget Expenditures in 2005–2007 (as % of GDP)*

Since, as seen by the results of the first 9 months of 2007, spending obligations had been fulfilled only by 50%, the upsurge in expenditure at the year’s end was very dramatic. As seen by the year’s results, the expenditures on such items as “General state issues”, “Health care and sports” and “Social policy” were executed only by ¾ of the planned amount.

### 2.3.3. An Analysis of Revenues from the Main Taxes Received by the RF Budgetary System

One of the most important problems is that represented by the interrelation between the tax burden and economic growth. On the one hand, as economic growth produces an expansion of the taxation base, the customs and tax revenues will grow in absolute terms. On the whole, depending on either a regressive or progressive character of the tax system, this may result either in an increasing or a decreasing percentage of taxes in GDP (or its maintenance at a currently existing level). On the other, an excessively heavy tax burden may become an impediment to comprehensive economic development.

As seen from the data presented in *Table 10*, the tax burden on Russia’s economy in the last years of the period under consideration was stable, fluctuating within 36–37 % of GDP.

In 2007 the volume of tax revenues received by this country’s budgetary system increased by 1.4 p.p. of GDP, by comparison with the previous year. Among the main factors determining the growth of tax revenues, there were the favorable situation with regard to Russian exports, and first of all oil, gas and metals; the expansion of the bases for many taxes resulting from growth of the Russian national economy; and improved tax administration.

Table 10

**Changes in the Levels of the Tax Burden and the Revenues  
from the Main Taxes Received by the Budget of the Russian Federation's General  
Government in 2000–2007 (as % of GDP)**

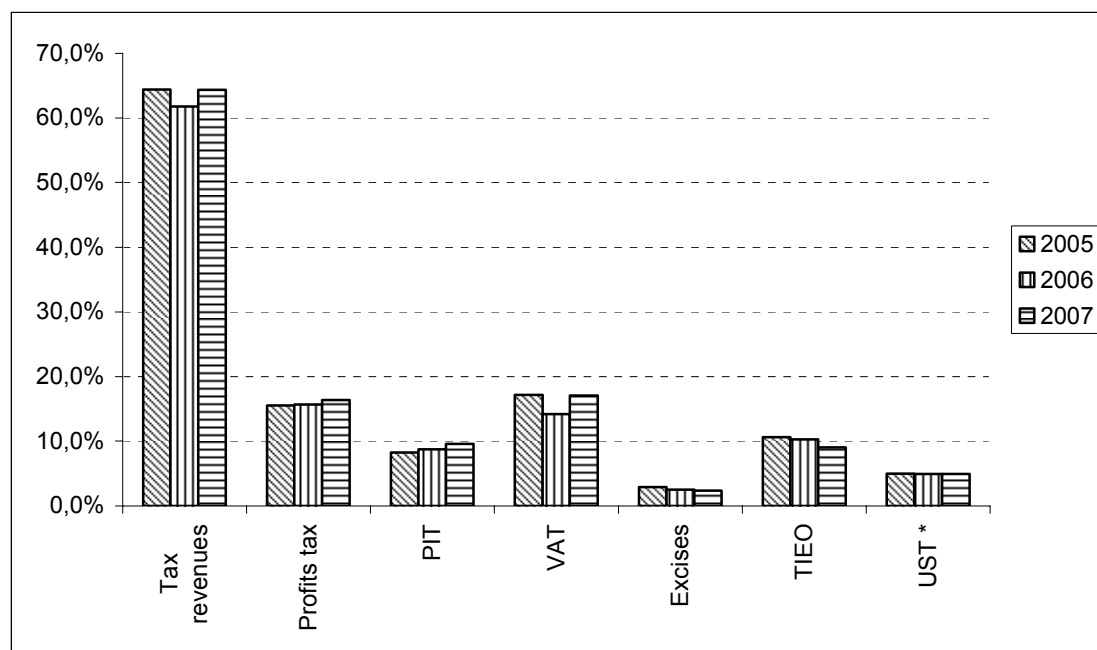
	2000	2001	2002	2003	2004	2005	2006	2007
<b>Level of tax burden (1+2+3)</b>	<b>38.46</b>	<b>33.91</b>	<b>32.74</b>	<b>31.97</b>	<b>32.63</b>	<b>36.20</b>	<b>36.52</b>	<b>36.75</b>
Tax revenues (1)	28.02	27.69	26.99	25.61	24.79	25.55	24.46	25.84
Including:								
Profits tax	5.39	5.75	4.28	3.98	5.09	6.16	6.21	6.58
PIT	2.37	2.86	3.31	3.44	3.37	3.27	3.46	3.84
UST*	-	5.79	4.13	3.68	3.49	1.99	1.96	1.99
VAT	6.20	7.17	6.96	6.66	6.27	6.81	5.62	6.86
Excises	2.27	2.72	2.44	2.59	1.43	1.17	1.01	0.95
TIEO**	-	0.74	2.55	2.50	2.99	4.20	4.07	3.63
Contributions to compulsory pension insurance (2)	7.30	2.51	2.76	2.94	2.80	2.88	3.48	3.61
Revenues from foreign economic activity (3)	3.14	3.71	2.99	3.42	5.04	7.77	8.58	7.30

\* Less contributions to compulsory pension insurance.

\*\* In 2001, instead of TIEO, the amount of fees for the extraction of mineral resources is stated.

Source: RF Ministry of Finance; Rosstat; calculations of the IET.

The structure of tax revenue in the general government's budget is shown in *Fig. 15*.



\* Less contributions to compulsory pension insurance.

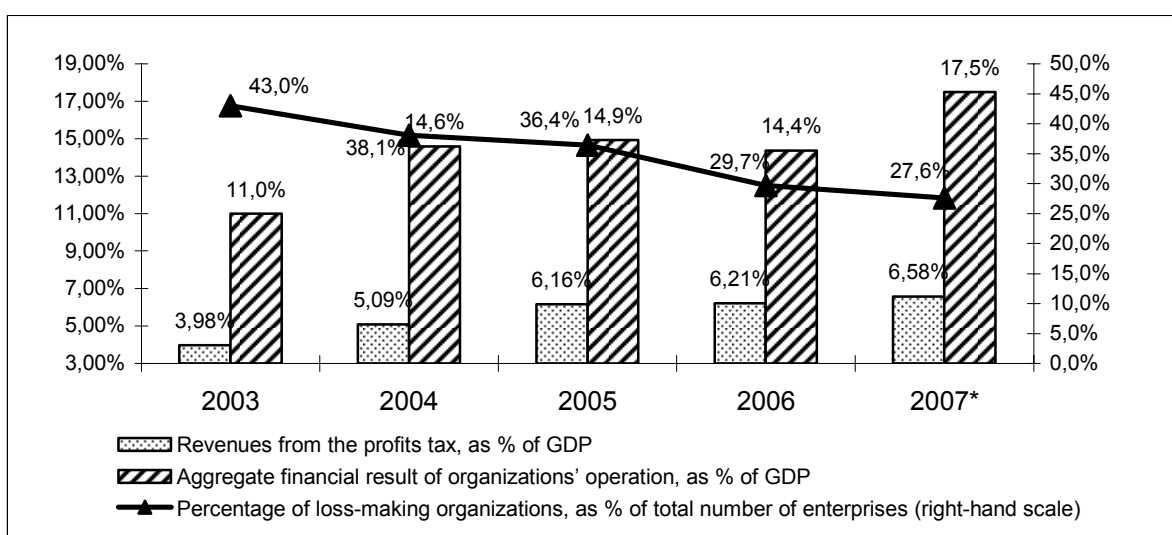
*Fig. 15.* The Share of Tax Revenues in the Aggregate Revenue of the General Government's Budget in 2005–2007, in %

The structure of tax revenue in 2007 demonstrated noticeable changes only in respect of the revenues from VAT, which returned to the level of 2005. This circumstance was the deci-

sive factor determining the situation when the tax revenues of the general government, having overcome their fall in 2006, once again reached the 2005 level. Besides, it should be noted that the share of revenues from TIEO, similarly to that of the revenues from foreign economic activity, for a second successive year continued to decline. As for the shares of the revenues from the profits tax and the personal income tax (PIT), these, on the contrary, during the same period were displaying trends towards growth.

### *Profits Tax*

According to the results of 2007, the revenues from the profits tax somewhat increased by comparison with the previous year and amounted to 6.58% of GDP. The dynamics of the tax on profit of organizations was displaying its traditional seasonality associated with the timelines for its payment, resulting from which the revenues are always higher in Q II and IV of each year.



\* The values of aggregate financial result of organizations' operation and the percentage of loss-making organizations correspond to the results of the first 9 months of 2007.

*Fig. 16. The Dynamics of the Revenues from the Tax on Profit of Organizations Received by the RF Budgetary System, the Aggregate Financial Result of Organizations' Operation and the Percentage of Loss-Making Organizations in 2003–2007*

The main factors determining the growth of revenues from the profits tax were economic growth and the continuing increase in oil prices. The further decline in the percentage of loss-making organizations in the national economy and the renewed growth of the net aggregate financial result of organizations' and enterprises' operation as a percentage of GDP are indicative of an expanding tax base for the tax on profit of organizations (see *Fig. 16*).

The factors restricting the growth of revenues from the profits tax in 2007 were the following changes introduced into tax legislation:

- the lifting of limitations on the size of carried-forward losses. Thus, in 2007 organizations were granted the right to decrease, in full, the tax base for a current tax period by the



amount of losses incurred in the previous tax periods (Item 2 of Article 283 of the RF Tax Code (TC));

- changes in the timelines for writing off the expenditures on research and development. Thus, irrespective of whether research and development have yielded a positive result or not, the expenditures of an organization relating to research and development should be charged to costs for purposes of taxation during the period of one year, from the 1<sup>st</sup> day of the month following the month in which such research was completed;
- the recognition, for purposes of taxation, of the expenditures on purchase of the land plots from lands in state or municipal ownership, on which buildings, structures, and installations are situated, or which are purchased for purposes of capital construction;
- the granting to the organizations operating in the field of information technologies of the right to include the value of computer equipment in the amount of material costs on a lumpsum basis, at the time of it being put in operation;
- changes in the depreciation procedure for payers of tax on profit of organizations in respect of their fixed assets being depreciated, which are used only for scientific and technological research, namely the possibility to apply a special coefficient (but not higher than three) to the basic depreciation norm.

### ***Personal Income Tax***

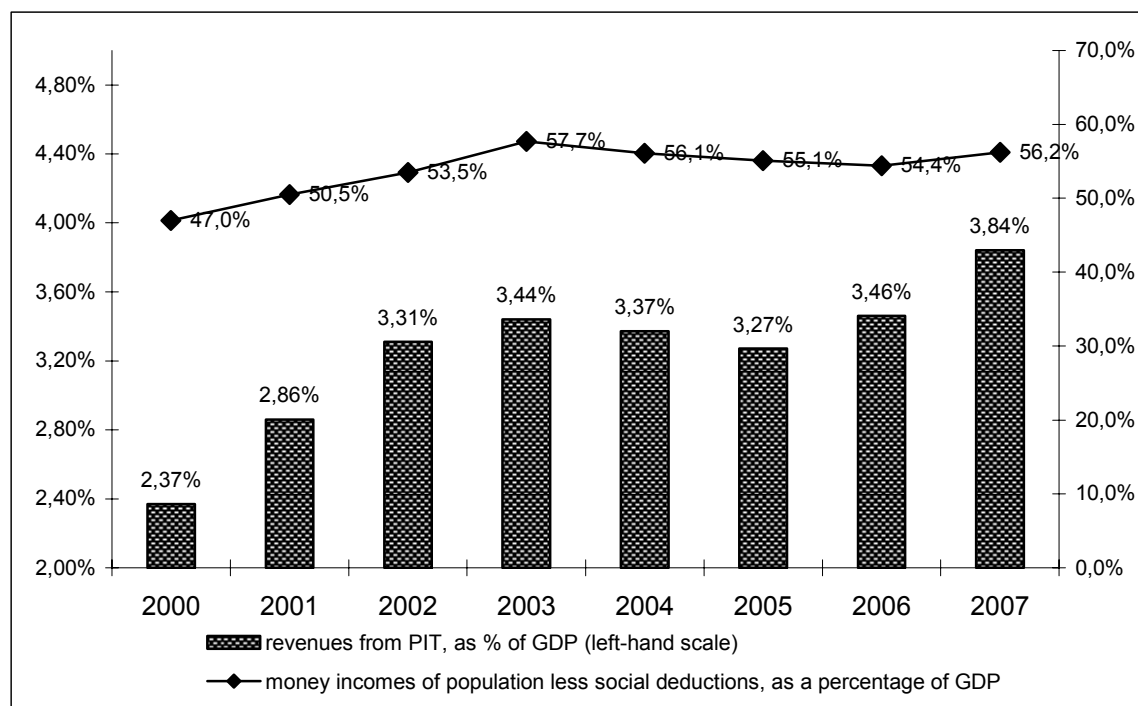
Revenues from the personal income tax in real terms continued their upward trend, which had first emerged in 2006, and by the results of 2007 amounted to 3.84% of GDP, which is nearly by 0.4 p.p. higher than the level of the previous year.

At the same time, in 2007 the money incomes of the population less social deductions (as a percentage of GDP), which represent a baseline macroeconomic index explaining the dynamics of revenues from PIT, increased by 1.8 p.p. of GDP, that is, in 2007 the value of the real effective rate of PIT turned out to be higher than that in 2006. Growth in the share of the tax base for PIT in GDP occurred for the first time in the last 5 years.

As seen from *Fig. 17*, the dynamics of real incomes of the population less social deductions largely explains the peculiarities of the dynamics of the revenues from this tax.

The main restricting factor with regard to the growth of revenues from PIT received by this country's budgetary system in 2007 was the expansion (or indexation) of the existing tax deductions. In particular, from the year 2007 onward, the maximum sum of the deduction from the social tax was increased from 38,000 to 50,000 rubles, and the deductions are granted in the amount of the actual expenditures, but their total cannot be more than 100,000 rubles in a given tax period.

At the same time, Federal Law No. 269-FZ, of 30 December 2006, "On a simplified procedure for declaring the incomes of physical persons" influenced the growth of revenues from PIT only slightly. Thus, the "tax amnesty" in Russia, which took place from 1 March through 31 December 2007, yielded only 3.67 billion rubles as additional budget revenues, or slightly more than 0.01% of GDP.



*Fig. 17. The Dynamics of the Revenues from PIT Received by the RF Budgetary System, and of the Money Incomes of the Population less Social Deductions, in 2000–2007*

### **Unified Social Tax (UST)**

Beginning from the year 2001, the revenues from UST (less the amount of contributions to compulsory pension insurance (CPI)) received by the RF budgetary system have been displaying a downward trend (see *Table 11*), which can largely be explained by changed normative standards for the distribution of tax revenues and social payments between the federal budget and the Pension Fund of the Russian Federation. In 2006, some stabilization of the revenues at the level of 2005 was achieved, the same also being noted by the results of the year 2007.

*Table 11*

#### **A Comparison between the Dynamics of Revenues from UST and that of the Salaries and Wages Fund in 2000–2007, as % of GDP**

	2001	2002	2003	2004	2005	2006	2007
Revenues UST (less contributions to CPI)	5.79	4.13	3.68	3.49	1.99	1.96	1.99
Contributions to compulsory pension insurance	-	2.76	2.94	2.80	2.88	3.48	3.61
Revenues from taxes and social payments	5.79	6.89	6.62	6.29	4.87	5.44	5.60
Wages and salaries fund	35.83	40.88	42.12	41.05	39.22	41.80	44.80

*Source:* RF Ministry of Finance, Rosstat.

Considering the fact that, in accordance with Article 243 of the RF TC, the amount of UST due to be paid to the federal budget is subject to deduction, to be made by taxpayers on their own, in the amount of the sum of contributions to compulsory pension insurance charged to them for the same period, from the point of view of economics it would have been more

feasible to deal with the aggregate sum of revenues from all the taxes and social payments being transferred to the budget. The dynamics of the aggregate social payments was fully consistent with that of the salaries and wages fund, the latter serving as base for calculating both UST and the contributions to CPI.

However, due to the regressive character of the SST scale and no specified intervals for computing its rate, the growth rate of aggregate revenue from social payments during the whole period of 2001–2007 was lower than that of the wages and salaries fund. The year 2007 was no exception.

### *Excises*

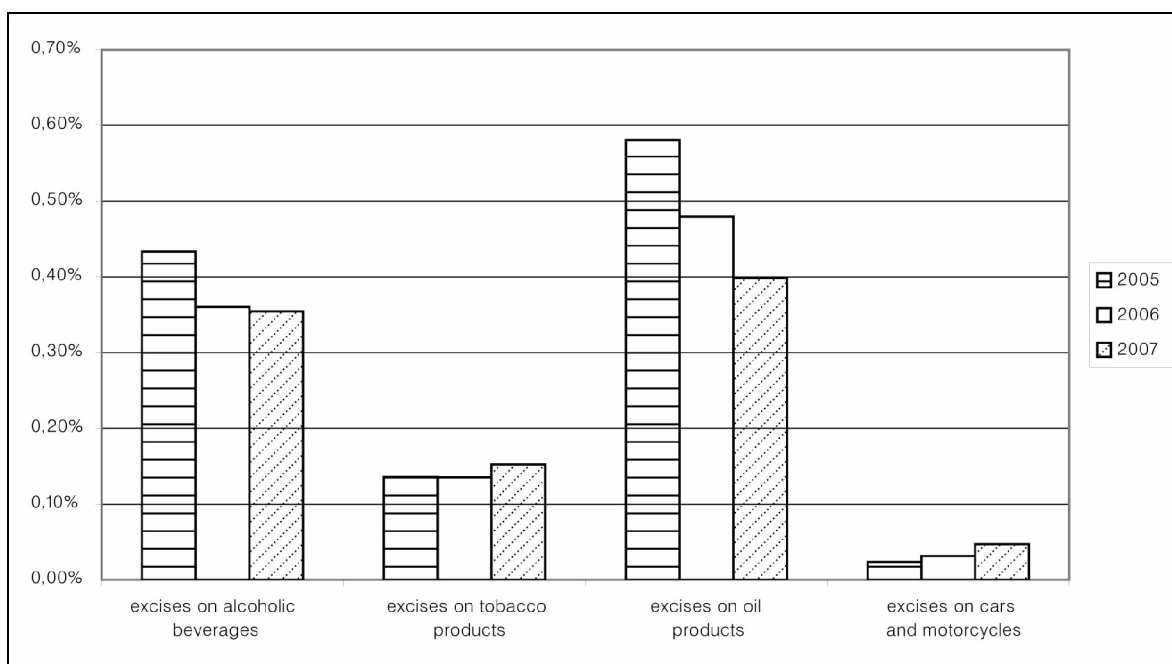
In 2007, the tax revenues from excises as a percentage of GDP continued to display their downward trend which had first appeared in 2004, amounting to 0.95% of GDP, against 1.01% of GDP in 2006. Since excises are levied predominantly on the basis of specific rates, budget revenues strongly depend on the level of indexation applied to their rates in a given year. The rates of excises, as determined in the Tax Code, in 2007 were not indexed at all with regard to oil products; the excises on alcohol-containing beverages were indexed on the average by 8.5–9.3%. An exception was represented by wines and other alcohol-containing beverages with ethyl alcohol content less than 25%, their excise rates being indexed by 35–45%. The level of indexation of the rate of excise on passenger cars varied within the range of 8.3–12.5%.

The greatest changes in 2007 occurred with regard to the rates and the procedure for calculating the excises on tobacco products. Thus, from 1 January 2007 onward, for purposes of levying excises, a fixed maximum retail price of tobacco products was established, to serve as a base for calculating the ad valorem component of the excises. The switchover to the application of a fixed maximum retail price established by manufacturers was necessitated by the need to prevent tax evasion through establishing transfer prices, as part of control over the retail trade in tobacco products. The manufacturing and importing of filter-tipped cigarettes, without indicating on the package their maximum retail price, as well as the month and year of manufacture, was prohibited from 1 January 2007, and their retail sale – from 1 January 2008. In respect of cigarettes without filter and cigarettes with cardboard mouthpieces, their manufacture and imports without indicating such information on the package were prohibited from 1 July 2007, and retail sale – from 1 July 2008 r.

One more important event in 2007 was the approval, by Federal Law No. 75-FZ, “On introducing changes to Chapter 22 of Part Two of the Tax Code of the Russian Federation”, of the indexation regime to be applied to the rates of excises levied on excisable goods in 2008–2010. The dynamics of the indexation patterns applied to different excise rates vary greatly: thus, while it is not planned to change the rate of excise on oil products during the next three years, the rates of excises on alcohol-containing products and passenger cars will be increased during the same period, on the average, by 21–22%, and the excise on tobacco products will be nearly doubled. The indexation of the rates of excises on tobacco products was motivated by several factors: firstly, rapid increase of the tax component in the price of cigarettes, and predominantly that of low-quality brands, always results in an upsurge in prices of cigarettes, especially cheaper segments, which is quite compatible with the general logic of the health protection policies all over the globe. Secondly, rapid adjustment of the tax to the EU stan-

dards and unification of excise policy across the CIS community represents a valid instrument of reducing the scope of the shadow tobacco business.

On the whole, against the backdrop of slight indexations of the rates of excises, the dynamics of the tax base of excisable goods serves as the main factor determining the existing volumes of resulting revenues. It should be noted separately that the general trend characterizing the period of 2000–2006 was the falling of the growth rate of the tax base in respect of all groups of excisable goods, except alcohol-containing products, behind the dynamics of real GDP, which largely explains the declining share of the revenues from excises in this country’s budgetary system. In 2007 this trend, on the whole, persisted, while displaying certain variations depending on specific groups of excisable goods.



*Fig. 18. Revenues from Excises in 2005–2007, by Group of Excisable Goods*

The data presented in *Fig. 18* make it possible to assume that the raised excises on tobacco products and the introduction of a minimum retail price (MRP) had a favorable effect on the budgetary system. The excises were increasing at an accelerated rate, by comparison with the excises on other groups of excisable goods. The experiment with the introduction of MRP can be estimated as quite successful, since it does not only make it possible to influence the “upward” shifts in consumer preferences and to peg the volumes of revenues to changes in the market situation, but also to improve the quality of administering the excise on tobacco products.

The significant increase in the share of revenues from the excise on tobacco products in the overall structure of revenues from excises was simultaneous with a decline in the share of excises on oil products.

*Excises on tobacco products.* While the year 2006 can be regarded as “peak” in terms of both output and sale of tobacco products, in 2007 there occurred a certain stabilization, and sometimes even decline in the demand for tobacco products per capita, which was in the main associated with this country’s negative demographic dynamics, as well as increasing retail

prices, predominantly of cheaper brands, as a result of changes in the rates and the procedure for collecting excises. Manufacturers responded to changes in the demand for tobacco products by diminishing the volumes of output by 3.9% against the level of 2006 (see *Table 12*).

*Table 12*

**Output of Cigarettes, including Cigarettes without Filter and Cigarettes with Cardboard Mouthpieces, in 2000–2007, billion**

	2000	2001	2002	2003	2004	2005	2006	2007
Production of cigarettes with and without filter	348	367	390	383	383	407	414	398

*Source:* Rosstat.

*Excises on alcohol-containing products.* In Russia, the dynamics of demand for alcohol-containing products, although having objective reasons for reproducing, with a certain lag, the situation characterizing the consumption of tobacco products, in 2007 was generally displaying an upward trend. In this connection, a slowdown in the growth of production of alcohol-containing beverages in Russia that has occurred in recent years, predominantly in connection with the changes in the state regulation of this market occurring in 2005–2006, was seen no more in 2007, when all the types of alcohol-containing products were characterized by growing output volumes (see *Table 13*). Regional authorities have been making every effort in support of the development of their own production of vodka, other products of spirits-making, and wines, including through the introduction of various restrictions on imported products. As a result, in the second half of 2007, according to experts, the market for legal alcohol-containing products was very “overheated”, which was demonstrated by overproduction and intensifying competition.

*Table 13*

**Outputs of Legal Alcohol-Containing Products in Russia in 2000–2007 (million deciliters)**

Type of product	2000	2001	2002	2003	2004	2005	2006	2007
Food alcohol	62.4	63.9	71.4	71.5	76.0	70.0	54.6	55.9
Vodka, other products of spirits-making	123.0	131.0	140.0	135.0	136.6	132.4	119.6	131.0
Cognac	1.8	2.1	2.7	3.5	3.9	4.5	6.4	8.0
Champagnes and sparkling wines	6.8	7.7	8.1	8.8	12.1	14.1	15.4	21.6
Vintage wines	24.1	27.4	33.3	36.5	39.1	31.7	47.0	51.2
Fruit wines	2.8	3.5	2.6	3.2	4.2	4.1	3.0	3.4
Beer	516	638	703	755	838	910	999	1 160

*Source:* Rosstat.

*Excises on oil products.* When analyzing the dynamics of the base for excisable oil products, it should be borne in mind that a dominant role in generating revenues from the excises on oil products is being played by the excises on motor gasoline (less straight-run gasoline) and diesel fuel, which in recent years have been accounting for no less than 92% of revenues. In this connection, it would be reasonable to focus attention on the trends being displayed by the domestic markets of these types of oil products in 2007. Thus, the volume of sales of motor gasoline on the domestic market increased in 2007 only by 1.7%.

Table 14

**Dynamics of Output and Sales of Motor Gasoline and Diesel Fuel  
in 2000–2007, million tons**

	2000	2001	2002	2003	2004	2005	2006	2007
Production of motor gasoline	27.2	27.6	29.0	29.3	30.5	32.0	34.4	35.1
Of this, realized on domestic market	23.5	24.4	25.8	25.5	26.5	26.1	28.0	28.5*
Production of diesel fuel	49.2	50.2	52.7	53.9	55.4	60.0	64.2	66.4
Of this, realized on domestic market	25.1	25.3	24.0	23.4	25.2	25.3	27.2	28.2*

\* Estimate.

Source: Rosstat.

With regard to the excises on oil products, the year 2007 saw return to the pre-2003 tax regime, when the payers of taxes were persons engaged in the manufacture and realization of oil products. In this connection, the procedure for the payment of excises on the basis of a statement of operations with oil products was preserved only in respect of straight-run gasoline. There were several reasons for the reestablishment of the old system. Firstly, the currently applied system for the payment of excises gave rise to numerous schemes of tax avoidance, which had also been made easier by the growth in the number of payers from several dozens of oil refineries to 13,000 entities. When payments were distributed along the retail chain, this tax was quite often lost, because neither the buyer nor the supplier were paying it. Besides, there emerged yet another problem: the vertically integrated companies were choosing on their own the regions where it was most convenient for them to register their subdivisions and pay the excise. As a rule, the choice of a region was motivated by opportunities to be granted tax exemptions by local authorities. Thus, the procedure for computation and payment of the excises on oil products existing since 2003 was failing not only to ensure an even distribution of taxes, but also to increase the inflow of revenues into this country's budgetary system.

*Excises on passenger cars.* The dynamics of the tax base for the excises on passenger cars in 2000–2006 was steadily on the rise, the highest input in the rate of growth being produced by imports with regard to this group of commodities, which over 7 years increased by 4.6 times. By the results of 2007, imports also became a major factor determining the growth of revenues from excises in this group of excisable goods: over 2007, the volume of import of passenger cars increased by more than 1.5 times, by comparison with 2006.

In face of rapid increase in the volume of import, the domestic production of cars with typically low-powered engines in recent years has been stagnating, the overall growth being achieved owing to the increasing volumes of industrial assembly output. However, the downward trend in the growth rate of the output of domestic cars is insignificant from the point of view of analysis of tax base for the excises on passenger cars, because excisable rates vary depending on engine power. For cars with engine power of no more than 90 hps (this parameter being true for nearly all the types of Russian-made passenger cars, with the exception of GAZ), tax legislation envisages a zero rate of excise.

Besides, it should be noted that over the period under consideration the growth in the volumes of sales of cars on the domestic market was roughly corresponding to the rate of changes in the real disposable money incomes of the population, and was nearly twice as high as that of real GDP.

*Table 15*

**Dynamics of Tax Base for the Excises on Passenger Cars in 2000–2006, thousand units**

	2000	2001	2002	2003	2004	2005	2006	2007
Production of passenger cars	969.0	1,022.0	981.0	1,012.0	1,110.0	1,069.0	1,175.0	1,290.0
Import of passenger cars	226.2	475.0	697.0	573.0	525.2	773.7	1,049.5	1,601.0

*Source:* Rosstat, Federal Statistics Service.

***Value Added Tax***

A substantial share in the tax revenues of the general government’s budget has traditionally belonged to the revenues from the value added tax. In terms of percentages of GDP, an upward trend in their growth rate had been prevalent only prior to 2002, after which began a steady decline. A slight improvement was demonstrated only by the results of 2005, which was mostly due to the additional revenues resulting from the redemption of the debts of the oil company “Yukos”, and then later, in 2006, the volume of revenues once again noticeably dropped.

In 2007 the share of revenues from the value added tax increased to 6.86% of GDP (from 5.62% of GDP in 2006). However, if one corrects the bias produced by revenues received from the Oil Company “Yukos”, VAT growth will become much more modest (by 9.0%, by comparison with 2006) and on the whole correspond to the dynamics of the tax base (see *Table 16*)<sup>25</sup>.

*Table 16*

**Dynamics of Final Consumption, Imports and Revenues from VAT Received by the RF Budgetary System in 2000–2007 (as % of GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007
Revenues from VAT, less revenues from “Yukos”	6.20	7.17	6.96	6.66	6.27	6.17	5.62	6.13
Final consumption (less VAT charged by declarations)	н/д	59.1	61.5	61.4	60.8	60.1	60.6	60.1
Imports*	13.0	13.7	13.4	13.3	12.8	12.9	13.9	15.5

\* The share of imports in GDP was determined as ratio of the amount of imports according to customs statistics to GDP estimated in USD on the basis of average nominal USD/ruble exchange rate in a given year.

*Source:* Rosstat, RF Ministry of Finance, RF Federal Statistics Service, calculations of the IET.

Final consumption in prices less VAT in 2007 amounted to 60.1% of GDP, which is by 0.5 p.p. of GDP lower than in 2006. In the last years the share of final consumption as a percentage of GDP, cleared of VAT, has been fluctuating within the range of 1 percent point of GDP, thus making it possible to speak of a relative stability of tax base of the VAT levied on the realization of goods (or works, or services) on the domestic market. The dynamics of imports are characterized by higher volatility over the whole period under consideration, despite

<sup>25</sup> In our opinion, it is more feasible to apply as the macroeconomic characteristic of the VAT base the value estimate of final consumption in market prices less the amount of tax, and not the total value added or GDP. This approach is quite justified, because the value added tax is a tax on consumption and is not applied for taxing the investment activity (the amount of tax on capital goods is subject to refund (or deduction), the results of which are also reflected in a country’s GDP.

the level of imports in 2007 amounting to 15.5% of GDP, against 13.0% of GDP in 2000. Thus, the tax base of VAT levied both on domestic operations and on imports indeed somewhat increased, as demonstrated by the results of the 8-year period, and consequently, macro-economic factors create positive preconditions for growth of the revenues from VAT within this particular time interval.

Growth of the revenues from VAT could have been even higher. However, increased tax deductions, resulting from changes in legislation introduced in 2006–2007, acted as one of the main restricting factors in this sphere.

In 2007, the consequences of the switchover from a permitting to a notifying procedure for refunding the amounts of VAT to exporters paid by them in connection with purchases of goods and material resources were still being felt. As shown by taxation statistics, the refunds against this item in 2007 amounted to 312.4 billion rubles.

Besides, the tax deductions claimed by subcontractors carrying out capital construction works in connection with the switchover to a general procedure for paying the tax (1.03% of GDP in 2007 against 1.12% of GDP in 2006 and 0.52% of GDP in 2005) have remained at a high level. As a consequence, the revenues from the VAT levied on the goods realized in this country's territory diminished by 341.2 billion rubles.

On the whole, as seen by the results of the year 2007, the percentage of deductions in the total amounts changed increased by 3.96 p.p. of GDP, which is the consequence of the changed procedure for VAT refunds when the zero rate is applied.

From the year 2007, the list of operations exempted from VAT was augmented by two more items:

- the realization of items used for religious purposes and religious literature produced and realized by religious organizations (or unions) and the organizations whose sole founders (or participants) are religious organizations (or unions);
- the import, into the customs territory of the Russian Federation, of pedigree cattle, pedigree swine, sheep and goats, semen and embryos of the aforesaid stock, pedigree horses and pedigree eggs, in accordance with the list of codes as indicated in the Foreign Trade Commodity Nomenclature, established by the RF Government.

From the year 2008, exemptions from VAT are extended to services relating to the transfer and granting of exclusive rights to inventions, utility models, industrial designs, software, databases, topologies of integral microcircuits, production secrets (know how), as well as the rights to use the aforesaid products of intellectual activity on the basis of a licensing agreement.

Besides, the decision was adopted concerning the exemption from VAT, from 2008 onward, the performance by organizations of the following types of research, research-and-development, and technological engineering works: the development of a construction design for an engineering object or a technological system; the development of new technologies; the creation of utility models of machines, equipment, and materials, characterized by certain fundamental features specific of innovations, when these items are not intended for sale to third persons; and the testing of such items during a period of time appropriate for obtaining data, accumulating experience, and reflecting it in technical documentation.



### ***Tax on the Extraction of Mineral Resources***

One important source of revenues for the budgetary system of the Russian Federation is the payments for the use of natural resources, a substantial part of which is constituted by revenues generated by the tax on the extraction of mineral resources (TIEO). The revenues from TIEO received by the federal budget have been displaying, since 2003, a stable trend toward growth due to increasing global prices of energy carriers. Since the rate of TIEO directly depends on the level of the international price of oil, the improving situation on the international market of energy carriers was automatically being reflected by the level of revenues from this tax.

The main bulk of the aggregate revenues from TIEO is constituted by the revenues from the extraction of oil. In 2002–2007 these accounted for 85–90% of all revenues. Accordingly, the dynamics of the total revenues from TIEO is very strongly determined by the same factors that determine the level of tax revenues from oil extraction. The most important among such factors are the volume of oil extraction and the level of global oil prices.

The extraction of oil in 2007 increased by 2.1%, while its average annual price – by 14.6% (see *Table 17*).

*Table 17*

#### **Dynamics of Revenues from TIEO and of the Main Macroeconomic Indices in 2002–2007**

	2002	2003	2004	2005	2006	2007
TIEO, as % of GDP	2.55	2.50	2.99	4.20	4.07	3.63
Extraction of oil, including gaseous condensate, million tons	379.6	421.4	458.8	470.0	480.5	491.0
Average annual level of price of Urals, USD /barrel	23.43	27.07	34.57	49.63	60.32	69.12

*Source:* RF Ministry of Finance; Rosstat; data published by the Energy Information Administration (EIA) under the US Department of Energy (DDE); calculations of the IET.

On the basis of the estimated regressive dependence of the index of TIEO revenues on the indices of the baseline TIEO rate, oil extraction volume, price of Urals, and the USD exchange rate, it was possible to generate quantitative parameters for estimating the impact of the main structural and situation-linked factors on the dynamics of TIEO revenues in the period under consideration. The results of our estimations are presented in *Table 18*.

*Table 18*

#### **The Contributions of Different Factors to Changes in the Revenues from TIEO, as % of changes in GDP**

	2002	2003	2004	2005	2006	2007
Tax on the extraction of mineral resources, total	7.65	2.31	4.71	7.65	5.86	0.57
Including:						
Baseline rate of TIEO applied to oil extraction	0.95	0.00	0.05	0.45	0.00	0.00
Volume of oil extraction	2.28	2.36	1.34	0.33	0.28	0.23
Price of Urals	1.11	2.83	4.32	7.72	4.60	2.79
USD exchange rate	4.69	-1.16	-1.98	-0.46	-0.86	-1.06
Other factors	-1.37	-1.72	0.98	-0.39	1.84	-1.39

*Source:* calculations of the IET.

As seen from these data, the main impact on changes in the amount of revenues from TIEO over the period under consideration was produced by rising global oil prices: the share of change in the price of Urals that occurred during that period corresponded to more than 81% of the change in the amount of revenues from TIEO. Besides, the contribution of this main situation-linked factor to TIEO dynamics may, to an important degree, be regarded as one of the effects of tax reform, because the TIEO rate actually applied to oil extraction was made to be directly dependent on the dynamics of the global prices of Russia's Urals.

A sufficiently significant influence on changes in the revenues from TIEO in 2002–2007 was exerted by changes in the volumes of oil extraction – one of the main structural factor, which accounted for nearly 24% of the total change in TIEO revenues over this period.

The change in the baseline rate of TIEO applied to oil extraction had a very slight effect on the amount of TIEO revenues, while the dynamics of USD's exchange rate had an altogether negative impact on it: the overall drop in the revenues from TIEO as a result of a lower USD's exchange rate amounted to only 2.9%.

#### 2.3.4. Expenditures in the Budgetary System

The main expenditure characteristics of RF budgets of all levels in 2005–2007 are shown in *Table 19*.

*Table 19*  
**Expenditures of the General Government in 2005–2007, as % of GDP**

	2005	2006	2007	Growth 2007, as compared to 2006
<b>EXPENDITURE</b>	31.54	31.19	34.09	+2.90
General state issues	3.49	3.07	3.54	+0.47
Of these: government debt servicing	1.11	0.74	0.53	-0.21
National defense	2.69	2.54	2.53	-0.01
National security and law-enforcement activity	2.71	2.66	2.62	-0.04
National economy	3.53	3.53	4.73	+1.20
Housing and utilities	2.18	2.35	3.34	+0.99
Environment protection	0.10	0.09	0.08	-0.01
Education	3.71	3.84	4.07	+0.23
Culture, cinematography and mass media	0.71	0.70	0.75	+0.05
Health care and sports	3.69	4.00	4.20	+0.20
Social policy	8.74	8.40	8.24	-0.16
Interbudgetary transfers	x	x	x	x

*Source:* RF Treasury.

Traditionally, high volumes of financing were allocated to the following budget sections: “General state issues”, “National defense”, “National security and law-enforcement activity”, “National economy”, “Education”, “Health care and sports”, and “Social policy”.

Although the expenditure structure of the RF budgetary system in 2007 did not change in any fundamental way by comparison with the previous year, on the basis of that year's results growth can be noted with regard to the sections “National economy” (by 1.2 p.p. of GDP), “Housing and utilities” (by 1,0 p.p. of GDP), and “General state issues” (less the cost of government debt servicing) (by 0.7 p.p. of GDP). Slight growth was also displayed by the “social package” – “Education” (by 0.2 p.p. of GDP) and “Health care and sports” (by 0.2 p.p.

of GDP). Evidently, the increased expenditures on these sections of the functional classification can be explained by the fulfillment of the State's increased social obligations to the population, including within the framework of priority national projects.

The indices of the other sections either demonstrated a slight decline in expenditures, or remained at the previous year's level. The greatest drop was seen with regard to the section "Social policy", where the amount of expenditures decreased from 8.40% to 8.24% of GDP. One positive feature is the strengthened trend toward a reduction in the share of expenditures relating to state and municipal debt servicing.

Simultaneously, it should be noted that the government's tendency to slacken its budgeting policy results in a very rapid increase in the amount of long-term budget liabilities, the servicing of which in an event of a changed macroeconomic situation is fraught with the risks of financial instability of the State. Moreover, if expenditures are increased at a rate higher than that of the Russian economy's growth, this will give rise to additional problems in a situation of excessive inflation pressure, which will be diminishing the anti-inflation effect of the measures undertaken by the government. In 2007 the government did not succeed in maintaining the inflation rate at a predetermined level (8.0–8.6%), and it leaped to 11.9%, and so any further increase in the amount of non-interest expenditures as a share of GDP must be rigidly pegged to the government's policy.

#### 2.3.5. An Estimation of Budget Parameters Cleared of the Contribution of the Oil and Gas Sector and of the Influence of Global Oil Prices

In order to ensure a well-balanced state budget in countries where tax revenues strongly depend on exports of raw materials and the situation on international markets, it is of fundamental importance, when estimating the situation-linked risks for the state budget and the margins for lowering the tax burden on the national economy, to distinguish within the latter its structural and situation-linked components.

The situation-linked component incorporates the part of tax revenues dependent on a favorable situation on foreign markets. The structural component reflects the level of taxes being transferred to the budgetary system at a certain average level of parameters characterizing the foreign economic situation over many years.

Different approaches can be applied to separating the structural and the situation-linked components of the tax burden. Because the dynamics of global oil prices represents one of the most important factors determining the situation-linked component of changes in the levels of GDP and tax revenues in Russia, one of the possible ways to do it would be to determine the situation-linked component through separating the "oil and gas" revenues in the budget. This approach has been applied by the RF Ministry of Finance since 2007. In effect, it is based on the principle of distinguishing between "structural" and "situation-linked" taxes. In this particular case, the term "situation-linked" is applied to the taxes that directly depend on the prices of oil and gas. An indisputable advantage of such an approach is its simplicity, as well as the methodologically definite character of the necessary estimations. At the same time, this approach does not take into account the influence of foreign economic situation on the volumes of revenues from other taxes. For example, it is quite obvious that the level of the prices of oil and gas depends on the profitability of the oil and gas sector, which, in its turn, influences the tax collection aspect of the profits tax.

This disadvantage is eliminated when a fundamentally different approach is applied to separating the structural and situation-linked components of the tax burden. This second approach is based not on distinguishing between the two groups of taxes, but on separating the structural and situation-linked parts within the revenues from the main taxes, based on statistical modeling of the dependence of GDP and tax revenues on the main situation-linked factors<sup>26</sup>, such as:

- factors of domestic demand (in our model these are represented by real investments in fixed assets);
- factors of the international price of oil;
- other factors (including fluctuations of the ruble's real effective exchange rate, and accidental factors determining short-term fluctuations).

In this connection, *structural GDP* represents the volume of GDP that could have been achieved at the average values of explanatory variables. Any deviations from the average level represent the *situation-linked component of GDP*. In order to estimate the structural component of GDP, the leveled values of the model's explanatory variables were calculated. In view of the different nature of each variable, for leveling such factors as real investments in fixed assets and real effective exchange rate, we applied the Hodrick–Prescott filter. The average price of oil over many years was obtained by applying the method of 25-year sliding average.

On the basis of the obtained coefficients, we calculated the shares of a situation-linked GDP explainable by different factors, which were determined earlier (see *Table 20*).

Table 20

**Dynamics of the Structural and Situation-Linked GDP Parameters: Estimates over the Period of 2000–2007**

	2000	2001	2002	2003	2004	2005	2006	2007
Structural GDP, as % of GDP	98.5	97.1	97.1	96.2	90.3	86.1	83.5	81.0
Situation-linked GDP, as % of GDP	1.5	2.9	2.9	3.8	9.7	13.9	16.5	19.6
<b>Including factors influencing changes in situation-linked GDP parameters:</b>								
domestic demand, as % of GDP	1.2	1.6	-0.9	-1.1	0.0	0.0	0.8	0.9
oil prices, as % of GDP	1.0	1.2	3.1	4.6	8.1	12.6	14.0	16.6
other factors, as % of GDP	-0.7	0.1	0.4	0.4	1.6	1.3	1.7	2.0

Source: RF Ministry of Economic Development and Trade; Rosstat; IMF; MEA; calculations of the ET.

<sup>26</sup> The equation applied for determining separately the structural and situation-linked components of GDP is as follows:  $Y_t = a_0 + a_1 Rev_t + a_2 Inv_t + a_3 P_{OILt} + a_4 REER_t + \varepsilon_t$ , where  $Y$  – GDP;

$C$  – consumption;

$Rev$  – real disposable incomes of the population;

$Inv$  – investments in fixed assets;

$P_{OIL}$  – nominal prices of Urals (USD/barrel);

$REER$  – real effective exchange rate of the ruble (based on CPI);

$NEX$  – net exports.

Variables  $Y_t$ ,  $Rev_t$  and  $Inv_t$  in real terms – in the prices of Q IV 1998, deflator index – CPI.

As a result, we obtained dependence  $Y_t = 239,75 + 1,38 * Inv_t + 8,69 * P_{OILt} + 3,19 * REER_t + \omega_t$  (the positive sign of the coefficient applied to variable REER can probably be explained by the model's incomplete specification).

In this analysis we applied the quarterly data published by Rosstat and the International Monetary Fund (International Financial Statistics) over the period of 1999–2007.

Table 21

**Dynamics of the Structural and Situation-Linked Components of Tax Revenues  
Received by the RF Budgetary System<sup>27</sup>: an Estimation over the Period  
of 2000–2007, as % of GDP**

	2000	2001	2002	2003	2004	2005	2006	2007
<b>Tax revenues of the federal budget</b>								
Structural component	10.6	10.9	15.0	14.0	11.8	12.3	12.0	13.7
Situation-linked component	3.9	5.5	3.9	4.2	6.8	9.9	10.0	7.6
Including:								
<i>domestic demand</i>	0.2	0.3	-0.1	-0.3	0.0	0.0	0.2	0.1
<i>oil prices</i>	3.8	5.1	3.9	4.4	6.4	9.7	9.5	7.3
<i>other factors</i>	-0.1	0.0	0.1	0.1	0.4	0.3	0.4	0.2
<b>Tax revenues of general government's budget</b>								
Structural component	30.2	29.9	32.6	31.0	28.2	26.2	25.7	28.2
Situation-linked component	5.5	5.8	3.0	3.6	7.1	10.6	11.0	8.6
Including:								
<i>domestic demand</i>	0.4	0.6	-0.2	-0.4	0.0	0.0	0.3	0.2
<i>oil prices</i>	5.3	5.2	3.1	3.8	6.5	10.2	10.1	8.1
<i>other factors</i>	-0.3	0.1	0.2	0.1	0.6	0.5	0.6	0.4
<b>Personal income tax</b>								
Structural component	2.8	3.2	2.4	2.8	2.4	3.0	2.4	3.1
Situation-linked component	0.1	0.1	0.1	0.3	0.4	0.5	0.4	0.7
Including:								
<i>domestic demand</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>oil prices</i>	0.0	0.1	0.1	0.2	0.4	0.4	0.4	0.7
<i>other factors</i>	0.0	0.0	0.0	0.1	0.0	0.1	0.0	0.0
<b>Unified social tax<sup>28</sup></b>								
Structural component	-	6.0	6.9	6.5	5.8	1.7	1.7	2.8
Situation-linked component	-	0.2	0.2	0.2	0.6	0.3	0.3	-0.8
Including:								
<i>domestic demand</i>	-	0.1	0.0	-0.1	0.0	0.0	0.0	0.0
<i>oil prices</i>	-	0.1	0.2	0.3	0.5	0.2	0.2	-0.7
<i>other factors</i>	-	0.0	0.0	0.0	0.1	0.0	0.0	-0.1
<b>Tax on profit of organization</b>								
Structural component	5.6	4.2	3.8	4.7	5.5	5.4	5.4	4.8
Situation-linked component	0.1	0.1	0.2	0.4	0.6	0.8	0.1	1.8
Including:								
<i>domestic demand</i>	0.1	0.0	0.0	0.0	0.0	0.0	0.1	1.3
<i>oil prices</i>	0.1	0.1	0.2	0.3	0.6	0.7	0.1	1.3
<i>other factors</i>	0.0	0.0	0.0	0.1	0.1	0.1	0.0	-0.8
<b>Value added tax</b>								
Structural component	5.2	6.8	6.4	5.7	5.4	4.8	4.8	7.2
Situation-linked component	0.2	0.2	0.3	0.6	0.8	0.9	0.1	-0.3
Including:								
<i>domestic demand</i>	0.1	0.0	-0.1	0.0	0.0	0.0	0.1	-0.3
<i>oil prices</i>	0.1	0.2	0.3	0.5	0.7	0.7	0.1	-0.3
<i>other factors</i>	0.0	0.0	0.0	0.1	0.1	0.1	-0.1	0.3

*Note.* «-» – SST not levied.

*Source:* RF Ministry of Finance; RF Ministry of Economic Development and Trade, RF Federal Tax Service; Rosstat; MEA, calculations of the IET.

The tax revenues received by the RF budgetary system were divided into structural and situation-linked components on the basis of previously obtained shares of structural and situation-linked GDP, as well as by calculating the share of revenues dependent on oil prices

<sup>27</sup> For purposes of our estimations, the tax revenues of the federal budget and the general government's budget throughout the whole period under consideration include: contributions to compulsory pension insurance; revenues from foreign economic activity; and revenues of targeted off-budget funds.

<sup>28</sup> From the year 2005 onward, the data presented here do not include the contributions to compulsory pension insurance.

(within the framework of building a model of paired regressions of tax revenues from nominal oil prices).

It should be noted that the high share of the situation-linked component of tax revenue in the general government's budget and the federal budget was ensured by growing oil prices (*Table 21*): in 2006, the situation-linked component accounted for the transfer of 11.0% of GDP into the general government's budget (including the contribution of oil prices in the amount of 10.1% of GDP), and 10.0% of GDP into the federal budget (including the contribution of oil prices in the amount of 9.5% of GDP), and in 2007 – 8.6% (the contribution of oil prices in the amount of 8.1%) and 7.6% (the contribution of oil prices in the amount of 7.3%), respectively.

A similar logic of separation into components is also applicable to the personal income tax. As seen from *Table 21*, the share of situation-linked component of PIT in 2006 amounted to 0.4% of GDP, and in 2007 it increased to 0.7% of GDP. The situation-linked component of the revenues from the single social tax in 2006 amounted to 0.3% of GDP (of which 0.2% is accounted for by the positive dynamics of oil prices); in 2007 the sign applied to this component became negative (–0.8% of GDP), which can be explained by the regressive SST scale (in other words, a lowering effective rate of this tax in face of increasing wages and salaries) and, consequently, by an increasing role of structural factors in the revenues generated by SST (2.8% of GDP) in that year.

It is noteworthy that in 2006 the share of the situation-linked component of the revenues from the tax on profit of organizations was not high, amounting to 0.1% of GDP, while the main bulk of revenues was generated by growing oil prices and the domestic demand factors. In 2007, on the contrary, it increased to 1.8%, which can be explained by the positive dynamics of oil prices in the second half-year of 2007.

At the same time, as demonstrated in *Table 21*, VAT depends least of all on the situation-linked factors: in 2006, the situation-linked component of the revenues from this tax amounted to only 0.1% of GDP, whereas in 2007 the sign applied to it became negative (–0.3%), which can be explained by a certain falling behind of the rate of growth of the raw materials sector within the structure of GDP, and by substantially increased tax deductions as a result of changes introduced into the procedure for VAT refunds to Russian exporters.

#### 2.3.6. The Federal Budget for 2008 and for the Period until 2010

At the end of July, the President of Russia signed Federal Law of 24 July 2007, No. 198-FZ, “On the federal budget for the year 2008 and the planned period until the years 2009 and 2010” (hereinafter – the Law). The federal budget indices were approved separately for the years 2008, 2009, and 2010, because it was intended for the indices established for the planned period (2009, 2010) to be further adjusted during the elaboration and approval of the draft federal budget for the years 2009 and 2010. Besides, this Law confirmed several appendices whereby budget allocations from the federal budget were established (separately for 2008, 2009, and 2010) by sections and subsections, target items and types of budget expenditure classification; the departmental structure of the federal budget expenditure; and the aggregate volume of allocations to the fulfillment of public normative obligations. The main administrators of budget resources were granted the right, from the year 2008 onward, to redistribute allocations between a current financial year and the planned period in the course of execution of the federal budget.

It should be noted that, for the first time in Russia's practice of budget planning, the federal budget was drawn for a three-year period which, on the one hand, will certainly be conducive to public understanding of the medium-term budgeting and taxing policy pursued by the RF Government, and will increase the definitiveness of financial backing for the spending obligations assumed for a three-year period; but on the other, will also result in more strict requirements to the quality of budgets being drawn, and in a higher responsibility for errors in planning. Below, we are going to present our analysis of the federal budget's revenue and expenditure for the years 2008–2010, as well as of the sources for covering federal budget deficit.

### *An Analysis of the Main Parameters of the RF Federal Budget*

On the basis of the available data on the actual execution of the RF federal budget over the period of 2000–2006 (see *Table 22*), several general trends can be pointed out: firstly, there has been stable growth in federal budget revenue, which during that period increased by more than 1.5 times; secondly, in the last three years the share of expenditure has become stabilized at the level of 16% of GDP; thirdly, the federal budget surplus has been demonstrating an unprecedented growth rate: between 2002 and 2006, its amount increased by 5.3 times – to 7.5% of GDP in 2006; and fourthly, the persisting high dependency of budget revenue on exports of energy carriers reveals itself in an equally persistent budget deficit (not linked to oil and gas), its value fluctuating within the range of 1.7–3.8% of GDP during the period under consideration.

*Table 22*

### **An Analysis of the Actual and Expected Execution of Revenue and Expenditure of the Federal Budget over the Period of 2000–2010, as % of GDP**

	Actually executed						Law on budget				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue	15.5	17.8	20.3	19.5	20.1	23.7	23.4	23.6	19.0	18.8	18.1
Including: revenues other than "oil and gas" ones	11.7	13.1	15.1	14.1	13.5	13.5	12.3	14.6	12.2	12.9	12.9
"oil and gas" revenues	3.8	4.7	5.2	5.4	6.6	10.2	11.1	9.0	6.8	5.9	5.2
Expenditure	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.1	18.8	18.8	18.1
Including: "oil and gas" transfer	2.5	1.9	2.9	3.7	2.0	2.3	3.0	4.7	6.1	5.3	4.5
savings of "oil and gas" revenues	1.3	2.8	2.3	1.7	4.6	7.9	8.1	4.3	0.7	0.6	0.7
Balance of RF federal budget, as % of GDP	1.3	3.0	1.4	1.7	4.3	7.4	7.5	5.5	0.2	0.0	0.0
Not linked to oil and gas deficit	2.5	1.7	3.8	3.7	2.3	2.8	3.6	3.5	6.6	5.9	5.2

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

As seen from *Table 22*, the RF Ministry of Finance intends to introduce, in 2008–2010, changes that will make a strong impact on all the trends described above. First of all, in response to the forecasted decline in international prices of oil and gas, a slower rate of growth of the extraction and exports of hydrocarbons, and a higher ruble/USD exchange rate, a more than twofold drop is expected in the share of the "oil and gas" revenues in the federal budget

as a percentage of GDP – from 11.1% in 2006 to 5.2% in 2010. This decline in “oil and gas” revenues is not going to be adequately compensated for by growth of structural revenues. Resulting will be a drop in total budget revenue by 5.5 p.p. of GDP by 2010, by comparison with the level of 2006.

A substantial reduction in the volume of budget revenue in face of rising expenditure must produce a zero balance as early as 2009. However, in our opinion, if the existing 7-year cycle of budget surplus growth is taken into consideration, together with the slower rate of exports of hydrocarbons and the ruble’s strengthening in 2006–2007, such a rapid fall in the amount of surplus (from 5.5 % of GDP in 2007 to 0.2 % of GDP in 2008) would not look very probable. More doubtful, obviously, appears the dynamics of budget revenue. However, in this connection one may ask if indeed the forecasted indices of Russia’s socio-economic development, prepared by the RF Ministry of Economic Development and Trade, are reliable enough for such a conclusion to be made.

Of course, the rather strong dependence of the Russian budgetary system on exports of energy carriers and, consequently, on the situation on global markets is fraught with serious risks of a potential destabilization of the state balance. Thus, the importance of structuring oil and gas revenues, and of their further efficient use for the benefit of the Russian national economy, with due regard for their important role in the formation of the state budget, becomes obvious. If long-term macroeconomic stability can be indeed maintained, an attempt will be made in 2008 to make use of oil and gas revenues (as part of budget resources) by means of transforming the Stabilization Fund into the Reserve Fund, whose purpose will be to compensate for the loss of budget revenue in an event of a drop in the price of oil, and the National Welfare Fund, designed to ensure an adequate long-term budget balance. As a result, in the period of 2008–2010 the use of “oil and gas” revenues will be increased, on the average, from 4.7% of GDP in 2007 to 5.3% of GDP in 2008–2010, while the savings of “oil and gas” revenues during the same period will be no more than 0.7% of GDP, against 4.3% of GDP in 2007.

### An Analysis of the RF Federal Budget Revenue

A decline, in 2008–2010, in the GDP share of budget revenue, as compared to the level of 2007, can primarily be explained by the diminishing contribution of revenues from the tax on the extraction of mineral resources and export customs duties, as well as by changes in RF tax legislation which, as estimated by the RF Ministry of Finance, in 2008 will result in a decrease in revenue by 0.68% of GDP. However, these estimates of budget revenue, in our opinion, do not take into account all the possible consequences of certain changes in tax legislation. There have been overlooked such possibilities as, for example, the introduction, from 1 January 2008, of a system for special registration of persons as payers of VAT proposed by the RF Ministry of Finance; shortening of the list of operations to be exempt from VAT, from 1 January 2009; and the annual – from 1 January 2008 onward – indexation of the rate of tax on the extraction of mineral resources applied to the extraction of natural gas, the coefficient being significantly higher than the forecasted inflation rate.

Besides, some doubts arise in connection with the fact that, although there occurred a noticeable decline in the amount of revenues to be received by the federal budget from TIEO and export customs duties in the period of 2008–2010, the share of the main taxes in budget



revenue has remained almost unchanged, the only changes being those that occurred in the structure of tax revenues, as shown in *Table 23*.

*Table 23*

**Dynamics of the Federal Budget's Structure of Tax Revenues over the Period  
of 2004–2010, as % of GDP**

Taxes	Actual execution				Law on budget		
	2004	2005	2006	2007	2008	2009	2010
Tax on profit of organizations	1.2	1.8	1.9	1.9	1.5	1.5	1.4
VAT	6.3	6.2*	5.7	6.1*	6.2	7.0	7.2
Excises	0.7	0.5	0.4	0.4	0.4	0.4	0.4
TIEO	3.0	4.2	4.1	3.6	2.5	2.1	1.9
Share of aforelisted taxes in federal budget revenue, %	55.5	53.2	51.4	51.4	55.8	58.5	60.2
<i>Reference value:</i>	5.0	7.8	8.6	7.3	5.9	5.3	4.8
<i>Revenues from foreign economic activity</i>							

\* Less revenues from “Yukos”.

Judging by these data, it can be assumed that, with the exception of the value added tax, all the other main taxes will be demonstrating either a decreasing amount of revenues (as a percentage of GDP), or its stabilization. And, while the estimated amount of the situation-linked tax revenues, as noted earlier, directly depends, firstly, on the accuracy of the forecast of expected changes in the prices of hydrocarbons, and only secondly on the rate of their extraction and the ruble's exchange rate, the amount of structural revenues (which is not linked to the “oil and gas” factor) should be dependent on the objective changes going on in the domestic economy.

An arguable point in the forecasting of tax revenues is represented by the expectations of a considerable reduction in the amount of revenues from the tax on profit of organizations, which in recent years, on the contrary, has been demonstrating an upward trend. Even in view of the expected decline in the share of the extracting sector of the national economy, the budding growth of the physical production volumes in the manufacturing industry and in the tertiary sector, rising manufacturing prices and the stabilization of net balance of the financial results of enterprises' activity, there are still some reasons to expect that at least the 2007 level of revenues from the tax on profits of organization may be maintained.

Equally doubtful is the forecasted level of revenues from VAT, given the continual on-year expansion of the list of exemptions from the tax, coupled with the increasing demands to lower the rate of the tax.

On the whole, in the medium term, in a situation of structural reforms and economic growth, one can also attempt to structure, in the following way, the risks that may give rise to problems with regard to individual taxes:

1. A strong dependence of tax revenues on oil prices and the risk of a dramatic drop in an event of a worsening foreign economic situation requires adequate planning and the adoption of measures aimed at diminishing the dependence of the budgetary system's tax revenues on international oil prices. With due regard for the existing downward trend of the structural component of the budgetary system's revenues (that is, the component independent of international oil prices), this will involve at the least the preservation of the current level of tax ad-

ministration base and the rates of those taxes that are less dependent on international oil prices (the value added tax, excises).

A lowered rate of the value added tax, coupled with the absence of any indexation of the rates of excises will, on the contrary, dramatically increase the risk that tax revenues may drop as a result of declining international oil prices. In case of a necessity to adopt the decision to further decrease the tax burden, all other conditions being equal, it would be more feasible to lower the rates of those taxes that strongly depend on oil prices, such as the tax on the extraction of mineral resources, or the tax on profit of organizations, with the preservation on the same level of the rate and base of the value added tax, as well as the rates of excises in real terms.

2. Another set of potential risks associated with the strong dependence of the Russian tax system, as well as of the national economy on the whole, on the oil sector is represented by the potential decline in revenues in this sector as a result of diminishing yield and increasing costs of developing natural oil fields. Since oil-extracting enterprises generate more than 1/3 of all tax revenues received by the budgetary system, when natural resources are gradually exhausting their potential and extraction is becoming more costly, it will be necessary to plot long-term forecasts of budget revenue with due regard for a decline of the share of this type of revenues.

One of the key problems associated with TIEO is the estimated feasibility and opportunities for a switchover to applying differentiated rates of this tax. In modern conditions, when oil prices are high, the differentiation of the rates may be fraught with the threat of unsubstantiated discretionary decisions being made, aimed at applying lower tax rates to certain individual oil companies. However, as tax administration, as well as control over the extraction conditions, are becoming stronger, it probably will become necessary to switch over to differentiated rates, and to find some solution to the problem of their justification with regard to the existing differences between oil fields.

3. The future trends in the Russian national economy's development in the medium term will be, most probably, those of a relatively slower development of the manufacturing sector, coupled with a more rapid growth of the construction and retail sectors. This will mean an increasing share, in the national economy, of those sectors where tax administration is most difficult. Besides, it can also be pointed out that transformations aimed at further development of financial institutions will, most probably, also result in a strengthened role of the financial sector in the national economy. In this case, in addition to a more complex administration, the risks faced by the tax system will also necessitate the introduction of special provisions concerning tax revenues and operations in the financial sector.

When planning tax revenues, all these risks will have to be investigated in more detail and estimated in quantitative terms, in order to improve the quality of medium-term federal budgeting

### *An Analysis of the RF Federal Budget's Expenditure*

The changes observed in the share of federal budget expenditure in GDP in 2008–2010 continue the upward trend of the 2007 budget. In this connection, as can be seen from *Table 18*, the aggregate growth of budget expenditure resulted exclusively from increased non-interest expenditures, which will amount, on the average, to 18.0% of GDP in 2008–2010, against 16.0% in 2005–2007.

*Table 24*

**The Expenditure Parameters of the Federal Budget in 2005–2010, in billion rubles**

	2005		2006		2007		2008		2009		2010	
	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP	billion rubles	% of GDP
Expenditure – total	3,514.3	16.3	4,281.3	15.9	5,983.0	18.1	6,570.3	18.8	7,451.2	18.8	8,089.9	18.1
Including: non-interest expenditures	3,306.0	15.3	4,112.3	15.3	5,839.9	17.7	6,382.4	18.2	7,238.6	18.2	7,842.8	17.5
interest expenditures	208.3	1.0	169.1	0.6	143.1	0.4	1,87.9	0.5	212.6	0.5	247.1	0.6
<i>Reference value: GDP</i>	21,625		26,883		32,989		35,000		39,690		44,800	

*Source:* RF Ministry of Finance; calculations of the IET.

One of the reasons for such noticeable growth in the amount of non-interest expenditures in the federal budget in 2008–2010 has been the RF President’s Message to the Federal Assembly, which pointed out a number of priority directions for government policies in the period under consideration. In particular, priority was assigned to several goals to be achieved in the sphere of social policy, namely an improved standard of living of the employees of the organizations belonging to the budget-funded sphere and the federal-level public sphere; servicemen and persons equated thereto; an improved standard of living of pensioners and other citizens in respect of which there exist financial obligations at the federal level; the removal of limitations to the development of the national economy associated with transport and energy supply shortages; and the promotion of growth in the nanoindustry and the aircraft industry. Besides, as part of budget expenditure in 2008–2010, special resources were earmarked for implementing the provisions of the RF President’s Message aimed at improving Russia’s demographic situation.

The structure of RF federal budget expenditure in the period of 2008–2010, by comparison with the previous years, has also demonstrated some changes (see *Table 25*).

*Table 25*

**Dynamics of Changes in the Structure of Federal Budget Expenditure in the Period of 2005–2010, as % of GDP**

	Actual			Law on budget		
	2005	2006	2007	2008	2009	2010
<b>Expenditure – total</b>	<b>16.3</b>	<b>15.9</b>	<b>18.1</b>	<b>18.8</b>	<b>18.8</b>	<b>18.1</b>
Including:						
General state issues	2.3	2.0	2.5	2.5	2.4	2.4
<i>Of these:</i> government debt servicing	1.0	0.6	0.4	0.5	0.5	0.6
National defense	2.7	2.5	2.5	2.7	2.7	2.7
National security and law-enforcement activity	2.1	2.0	2.0	2.2	2.3	2.2
National economy	1.2	1.3	2.1	2.1	2.0	1.2
Expenditures on social policy and social sphere	2.2	2.5	3.3	2.5	2.5	2.6
Interbudgetary transfers	5.8	5.6	5.8	6.5	6.1	6.1

*Source:* RF Ministry of Finance; calculations of the IET.

In face of an overall growth of expenditure, the most noticeable changes, by comparison with the 2005–2007 budgets, are produced by a reduction in the financial measures applied in the social sphere, as well as by fluctuations in the GDP share of the expenditures on nationally economy: in 2008 it remains at its historic high of 2.1% of GDP (over the period of 2005–2010), and then, by 2010, declines to 1.2% GDP, which is largely associated with the rounding-up of several federal target programs. In this connection, it should be emphasized that these are directly aimed at the development of infrastructure and aircraft-building: “Motor Roads”, “The Modernization of Russia’s Transport System”, “Sea Transport”, “Domestic Water Routes”, and “The Development of Russia’s Exports of Transport Services”.

A special mention should be made of the diminishing expenditures on general state issues (less the expenditures on government debt servicing) – from 2.1% of GDP in 2007 to 1.8% of GDP in 2010, – and of the increasing amount of interbudgetary transfers in 2008 (by 0.7 p.p. of GDP), at the expense of increased deductions to off-budget funds.

The other sections of federal budget expenditure in 2008–2010, when estimated as a percentage of GDP, either demonstrated slight changes (within the range of  $\pm 0.1$  p.p. of GDP), or remained unchanged.

Just as a year earlier, substantial volumes of financing were traditionally earmarked for such sections as: “Interbudgetary transfers”, “General state issues”, “National defense”, “National security and law - enforcement activity”, and “National economy”, as well as for social issues.

The situation with regard to budget expenditure in the period of 2008–2010 seems to be rather controversial. On the one hand, federal budget expenditure was orientated toward the financing priorities stated in the RF President’s Message to the Federal Assembly. On the other, such substantial increase in budget expenditure (nearly by 3 p.p. of GDP by comparison with 2006) may have a negative impact on the Russian economy, because in a situation of excessive inflation pressure this is fraught with additional problems that may diminish the effect of the government’s anti-inflation measures. The consequences of such growth of expenditure, as demonstrated by the example of the year 2007, have already resulted in the inflation rate surging higher than its planned value, and therefore any further increase of non-interest expenditures as a percentage of GDP will cast serious doubts onto the government’s activity aimed at further decrease of the growth rate of consumer prices in the short- and medium-term perspective.

Moreover, the substantial obligations with regard to the financing of measures being implemented either within the framework of priority national projects, or through the RF Investment Fund, the Bank for Development, or other development institutions, have been assumed without proper analysis of their long-term financial effect on federal budget expenditure and on the budgetary system as a whole. As a result, no attention is given to the possibility of additional costs to be incurred during the implementation of these projects and programs. Therefore, when planning new spending obligations, it will be necessary to ensure comprehensive records of all costs, and thus to reflect in the budget all the potential financial consequences of the implementation of individual measures within the framework of these projects.

***An Analysis of Debt Policy as Reflected in the RF Federal Budget***

In the sphere of government debt administration at the federal level, the policy of replacing foreign sources of borrowings with domestic ones will be continued (*Table 26*).

*Table 26*

**Dynamics of the Structure of the Russian Federation's Government Debt,  
as of End of Year, as % of GDP**

	2006	2007	2008	2009	2010
Government debt – total	9.0	7.5	8.4	8.7	9.1
Domestic debt	3.9	3.8	5.2	5.7	6.4
Foreign debt	5.1	3.7*	3.2	2.8	2.7

\* Estimate.

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

As seen from the *Table 26*, the share of domestic sources of borrowings in the total volume of RF government debt will be increased, by 2010, to 70%, against 43% in 2006. This ratio of domestic to foreign sources of borrowings is a consequence of the policy of a total refusal to attract new credits from foreign governments and from international capital markets, as well as an accelerated implementation of the majority of the current joint projects with international financial organizations, in order to complete the settlements against the previously assumed obligations and to minimize the volumes of new borrowings from international financial organizations. As a result, the budget envisages only the use of targeted tied credits granted by international financial organizations, whose volume in 2008 will amount to 718 million USD, and in 2009 and 2010 – to 510.6 and 413.6 million USD, respectively.

The main source of financing for the redemption of government debt obligations in the period under consideration will be the resources attracted through placing government securities on the domestic market. Thus, it is planned that in 2008 the placement of government securities on the domestic market will yield 369.0 billion rubles, in 2009 – 396.3 billion rubles, and in 2010 – 522.9 billion rubles. In this connection, the intended, more that twofold, growth in domestic borrowings by comparison with 2007, as well as their medium and long-term character (their share will amount to approximately 98% of the planned volume of borrowings), will not, in our opinion, result in the ousting of the investments needed for growth of the national economy, or in their becoming more expensive.

## **2.4. The Long-Term Sustainability of Russia's Budgetary Policy**

### **2.4.1. Implementation of the Measures from the Conception for the Long-Term Socio-Economic Development in Russian Federation: Evaluating the Consequences to the Budget System**

Debates on drafts of the currently designed Conception for The Long-Term Socio-Economic Development of the Russian Federation (below referred to as the Conception) engender a number of questions concerning the problem of a balanced budgetary policy. To examine budgetary implications of implementation of the Conception's measures we employed preset in the Conception scenario-based conditions of the world oil prices and design parame-

ters of the annual (2008–2020) growth rates of GDP and CPI under the innovation-based scenario. The respective data are given in *Table 27*<sup>29</sup>.

*Table 27*

**Original Data for Calculations**

	2008	2009	2010	2015	2020	Averaged over the period 2008–2020
World oil prices (Urals), as USD/barrel, current prices <sup>30</sup>	62	57	56	60	65	60
GDP, as % to the prior year	106.2	106.2	106.2	106.3	106.8	106.4
CPI, as % to the prior year (December to December)	107.3	106.6	106.0	104.5	102.7	104.9
The population's real disposable incomes, as % to the prior year	108.6	108.6	108.6	106.8	106.7	107.5

In addition to the above data, we employed the following assumptions as original premises:

- The rates and collection rates of main taxes remain unchanged (with account of the oil prices declining in real terms over time);
- Greater revenues from the Personal Income Tax and the Uniform Social Tax along with a rise in the population's real incomes (without account of reduction in the UST-based revenues due to transition to higher schedules);
- Depletion of mineral fields wherein there are no the mineral tax benefits;
- The doubling of GDP over 10 years (2010–2020) and contraction in the proportion of the oil and gas sector from 19.7% in GDP in 2006 to 12.1% of GDP by 2020 will result in a considerable contraction of the share of the oil- and gas-related revenues to the federal budget. Hence the federal budget deficit and the one of the enlarged government's budget.

Whereas the Conception falls short of a detailed projection of the enlarged government's budget revenues, while the respective final values stipulated therein appear somewhat inflated, we have calculated dynamics of tax revenues to the enlarged government in 2006–2020 (*Table 28*) and the federal budget (*Table 29*)<sup>31</sup>.

<sup>29</sup> It should be noted that the data given in *Table 27* corresponds to the innovation-based scenario of the RF Ministry of Economic Development and Trade, according to which the nation will be maintaining high economic growth rates over the whole time interval in question. That the proportion of tax revenues in GDP will fall all the scenarios in question to a significant degree attribute to the process of an accelerated growth in GDP at a rate greater than the growth of the oil and gas sector.

<sup>30</sup> We consider the current oil prices, as the forecast of these very prices is presented in the Concept. However, while examining the effect of the oil prices on GDP and tax revenues to the enlarged government's budget, one should consider real prices for energy sources, rather than the current ones. Translation of the latter into real prices is possible using deflator indexes whose choice appears largely related to the way proceeds from sales of energy sources are consumed. The set of the said indexes comprises the USD inflation (its appreciation against the basket of international currencies, the Russian CPI, Russia's GDP deflator, to name a few).

<sup>31</sup> Here and hereafter the forecast of tax revenues is given on the basis of the IET's calculations, providing tangibility of macroeconomic indicators under the MEDT's innovation-based development scenario.

Table 28

**Assessment of the Dynamics of Tax Revenues to the Budget of the Enlarged Government in Russia in 2008–2020, as % of GDP**

	2008	2009	2010	2015	2020
<b>(1) Revenues to the enlarged government budget</b>	<b>37.48</b>	<b>37.4</b>	<b>33.91</b>	<b>31.52</b>	<b>29.97</b>
<b>(1)=(1.1.)+(1.2)</b>					
(1.1) Tax revenues to the enlarged government budget	34.28	34.2	30.81	28.52	27.07
UST, without indexation of the scale	4.81	4.78	4.72	4.2	3.78
VAT	6.11	6.14	6.18	6.34	6.5
Corporate profit tax	5.21	5.11	5.01	4.49	3.98
PIT	3.7	3.84	3.97	4.39	4.75
Mineral tax	3.75	3.7	2.33	1.59	1.17
Taxes on foreign trade	7.4	7.33	5.31	4.21	3.59
Other taxes	3.3	3.3	3.3	3.3	3.3
(1.2) Non-tax revenues	3.2	3.2	3.1	3	2.9
<b>(2) The enlarged government budgetary expenditures (at the 2006 level=)</b>	<b>31.3</b>	<b>31.3</b>	<b>31.3</b>	<b>31.3</b>	<b>31.3</b>
<b>(3) Surplus prior to increase in expenditures</b>	<b>6.18</b>	<b>6.1</b>	<b>2.61</b>	<b>0.22</b>	<b>-1.33</b>
<b>(3)=(1)-(2)</b>					
<i>Accumulated reserve of the budgetary system* prior to increase in expenditures, as % of GDP (with account of the annual 4% nominal yields)</i>	<i>16.55</i>	<i>20.84</i>	<i>21.35</i>	<i>19.82</i>	<i>15.32</i>

\* Under the accumulated reserve of the budgetary system we understand savings resulting from the excess of the enlarged government's budget revenues over its budgetary expenditures in the Reserve Fund and the Social Welfare Fund.

Table 29

**Main Parameters of the Federal Budget of RF in 2008–20, as % of GDP**

	2008	2009	2010	2015	2020
(1) Federal budget revenues	21.73	21.61	18.24	16.30	15.15
(1)=(1.1.)+(1.2)					
(1.1.) Oil-and-gas	8.86	8.76	6.03	4.55	3.71
(1.2.) Non-oil-and-gas	12.87	12.85	12.21	11.75	11.44
(2) Federal budgetary expenditures (on the 2006 level)	16.00	16.00	16.00	16.00	16.00
(3) Non-oil-and-gas budget deficit	-3.13	-3.15	-3.79	-4.25	-4.56
(3)=(1.2)-(2)					
(4) Oil and gas transfer	3.13	3.15	3.79	3.7	3.7
(5) Oil-and-gas budget deficit	0.00	0.00	0.00	-0.55	-0.86
<i>For reference:</i>					
<i>The Reserve Fund</i>	<i>10</i>	<i>10</i>	<i>10</i>	<i>10</i>	<i>8.44</i>
<i>The Welfare Fund*</i>	<i>6.45</i>	<i>10.65</i>	<i>11.08</i>	<i>9.32</i>	<i>6.53</i>

\* With account of the co-funding of voluntary pension savings at the level of 0.1% of GDP until 2014 (these values are employed in the Conception).

The projected calculations of the dynamics of budgetary spending show that given the oil (Urals) prices hold at the average level of USD 60/barrel over the period 2008–20, as per the Conception, the proportion of the enlarged government budget revenues in GDP should fall from the 2008 GDP level of 37–38% to 30% in 2020. It will be the federal budget revenues that will plummet most dramatically (from 21–22% of GDP to 15% of GDP).

This means the rise and further growth of deficit of the enlarged government's budget, provided expenditures are kept at the 2006–07 level (as % of GDP) since 2016, while the oil-and-gas deficit arises substantially earlier, that is, in 2011. The assessment is made in an as-

sumption that the level of collection of main taxes and their rates remain unchanged, while the world oil prices are down in real terms (which constitutes a fairly moderate, rather than quite conservative, scenario)

Meanwhile the Conception provides for greater public spending to finance health care, education, pensions, as well as other budgetary items, including public capital investment<sup>32</sup>, by 2020.

Table 30

**Estimation of the Dynamics of Budgetary Expenditures of Russia's Enlarged Government in 2006–20, as % of GDP**

	2006	2007	2010	2015	2020
Education	3.9	4.1	3.9	4.3	4.5
Health care	4.0	4.2	4.1	4.3	4.8
Fundamental research and support of the scientific-technical progress	0.7		0.9	1.1	1.3
Public investment	3.3		3.5	4.5	4.0
Pensions (consistent increase in the replacement rate up to 30% by 2020) <sup>33</sup>	4.8		5.9	7.0	8.1
Other expenditures	14.7	14.7	14.7	14.7	14.7
<b>The enlarged government's budgetary expenditures, total</b>	<b>31.3</b>	<b>34.1</b>	<b>33.0</b>	<b>35.9</b>	<b>37.4</b>
<b>Surplus/deficit after expenditures increase, as % of GDP</b>	<b>8.6</b>	<b>6.1</b>	<b>0.91</b>	<b>-4.38</b>	<b>-7.43</b>

\* Expenditure values as per the Conception are marked in color.

The above data evidence that the proposed measures to boost expenditures result in a general rise of the enlarged government budget expenditures at 6 percentage points by 2020 vis-à-vis 2006. The bulk of the rise will be formed by the health care and pension expenditures, and for the given variant the enlarged government budget deficit will account for over 4% of GDP by 2015 and over 7% of GDP by 2020.

Under such circumstances the federal budget will be in a far greater jeopardy. As the non-oil-and-gas deficit may not exceed 4.7% of GDP, a part of the RF Pension Fund's deficit should be funded out of the National Welfare Fund as early as in 2010, and the National Welfare Fund will have consequently exhausted by 2016–17<sup>34</sup>. Since 2010 the oil and gas transfer

<sup>32</sup> At this point it should be noted that according to the Concept, between 2010 and 2015, it is envisaged to cut down health care expenditures from 4.0% of GDP in 2006 to 3.3% of GDP by 2010 and to 3.8% of GDP by 2015. Between 2015 and 2020, on the contrary, the respective expenditures should be up to 4.8% of GDP. Analogously, expenditures on education should be cut back from 3.9% of GDP in 2006 to 3.5% of GDP in 2010, followed by their increase up to 4.5% of GDP by 2020. However, given the current trends in the dynamics of budgetary spending of the enlarged government, dramatic cuts in the healthcare and educational expenditures appear highly unlikely. That is why in *Table 29* we provide expenditures across these items for the period 2010–2015, proceeding from the assumption of a linear rise in these expenditures as percentage of GDP at such a rate, so that to match the values stipulated in the Concept by 2020.

<sup>33</sup> According to the Concept, the rise in the number of pensioners, as well as an assumption of the advanced indexation of pensions for the sake of an increase in the correlation between the average labor pension and the average salaries and wages (the replacement coefficient) up to 30% in 2020 should form the cause for a consistent growth in the volume of public obligations in the pension provision area. In conjunction with this, the RF MEDT projects a rise in the pension expenditures of the budgetary system up to 8.1% of GDP by 2020 against 6.1% in 2011. These values appear close to the IET experts' calculations, which evidence that a keeping of the replacement rate at the level of 30% will necessitate growth in the budgetary system's expenditures on pensions up to 8.2% of GDP by 2020 vs. 6.2% of GDP in 2010.

<sup>34</sup> The current budgetary law seems to care much more of the Reserve Fund than the National Welfare Fund. The Reserve Fund may be consumed only for the sake of the oil-and-gas transfer in the event the oil-and-gas revenues fall short of financially securing the said transfer whose value is strictly limited by the Budgetary Code of RF.



will be short of closing the non-oil-and-gas federal budget gap, while to fund the oil-and-gas federal budget deficit since 2011 the nation will have to attract borrowings in a maximum permissible by the current law volume (1% of GDP). So, by 2017 it will have become impossible to fund the growing spending, complying, at the same time, with the budgetary law requirements not to transcend the oil and gas deficit equivalent up to 4.7% of GDP. Hence the need for either drastic cuts in spending (tax boost), or for raising the values of the permissible non-oil-and-gas deficit and the oil-and-gas transfer. Should the government opt for refusing to cut down budgetary spending (boost taxes), the Reserve Fund would be able to secure the balance of the federal budget just for two years.

*Table 31*

**Main Parameters of the RF Federal Budget in 2008–20, as % of GDP**

	2008	2009	2010	2011	2015	2020
(1) Federal budget revenues	21.73	21.61	18.24	17.85	16.30	15.15
(1)=(1.1.)+(1.2)						
(1.1.) Oil-and-gas	8.86	8.76	6.03	5.74	4.55	3.71
(1.2.) Non-oil-and-gas	12.87	12.85	12.21	12.12	11.75	11.44
(2) Federal budget expenditures*	16.41	16.56	17.46	16.82	19.52	21.86
(3) Consumption of resources of the National Welfare Fund to cover the deficit of the pension system)	0.00	0.00	0.00	1.22	0.84	0.00
(4) Non-oil –and- gas budget deficit (4)=(1.2)–(2)**	–3.54	–3.72	–5.25	–4.70	–7.77	–10.42
(5) Oil and gas transfer***	3.54	3.72	4.50	3.7	3.7	3.7
(6) Oil –and- gas budget deficit	0.00	0.00	–0.75	–1.00	–4.07	–6.72
<i>For reference:</i>						
<i>The Reserve Fund</i>	10.00	10.00	10.00	10.00	10.00	9.85
<i>The national Welfare Fund*</i>	6.04	9.71	9.50	8.63	0.00	0.00

\* Calculated proceeding from the assumption that the increase in public expenditures, as per the Conception, is made at the expense of the federal budget, while the compensation for the Pension Fund's deficit is made at the expense of the federal budget revenues and, accordingly considered to be the federal budget expenditures (until the non-oil-and-gas deficit is in excess of 4.7% of GDP beginning 2011) and the National Welfare Fund (in the event the non-oil-and-gas deficit is in excess of 4.7% of GDP beginning 2011). The use of the National Welfare Fund to cover the Pension Fund deficit is not accounted in the federal budget expenditures (line 3).

\*\* In compliance with the Budgetary Code of RF, the non-oil-and-gas deficit is in excess of 4.7% of GDP.

\*\*\* Parameters of the federal budget whose projected values contradict requirements of the current budgetary law are marked in color.

Under moderate oil prices laid down in the Concept, the amount of oil and gas gains should be in excess of the value of the oil-and-gas transfer within the whole time interval in question, and it will be only in 2020 that they will match. Consequently, providing the current budgetary law is unchanged, it may happen that resources of the Reserve Fund would not be touched in the event of a budgetary crisis, unless it caused by a price downfall for energy resources.

By contrast, the National Welfare Fund's mission, save for other purposes, is to ensure the balanced pension system. As an increase in spending (which, in many ways, appears an objective factor) on the pension system poses the greatest threat to the budgetary system, the Fund may find itself under a serious fiscal pressure. An indirect evidence to this is the current provision, according to which, should the additional 2008 revenues to the federal budget be insufficient to secure the balanced budget of the National Pension Fund, the RF Government will have the right to spend as much as Rb. 138 bln out of the National Welfare Fund to bridge the gap. So, even without grave challenges facing the budgetary sphere, the current law does not prohibit a considerable voluntary consumption of the Fund's resources.

There are some other critical considerations. First, the above data on increase in spending constitute averaged landmarks, while actual figures may prove to be substantially greater, particularly when the respective large-scale project gains momentum. Second, the above calculations are unlikely to take into account a number of expenditures, such as for instance, Sochi-2014; finally, given the aging population factor, the health care expenditures, as well as some other kinds of expenditures, may substantially exceed the planned ones.

Third, in the event oil prices are down earlier than forecasted, the enlarged government budget will be challenged by the problem of the budget balance earlier than in 2020, as the mission of propelling economic growth (following the innovational scenario of the Conception) in 2013–17 would presumably demand for greater expenditures in 2010–15.

Fourth, in full appreciation of the size of the required increase in spending, the RF MEDT laid down proposals to cut other expenditure items (*Table 32*).

*Table 32*

**Proposals to Cut Down Expenditures of the Budget of the Enlarged Government, as per the Conception, as % of GDP**

	2007	2015	2020
General government matters	3.3	3.0	2.4
National defense, security, and law enforcement	5.5	5.3	5.0
National economy	4.0	3.9	3.3
Housing and utilities sector	2.3	1.3	1.0
Culture, cinematography, and mass media	0.7	0.4	0.3
<i>Cuts on the above items to the 2007 level, total</i>		-1.9	-3.8

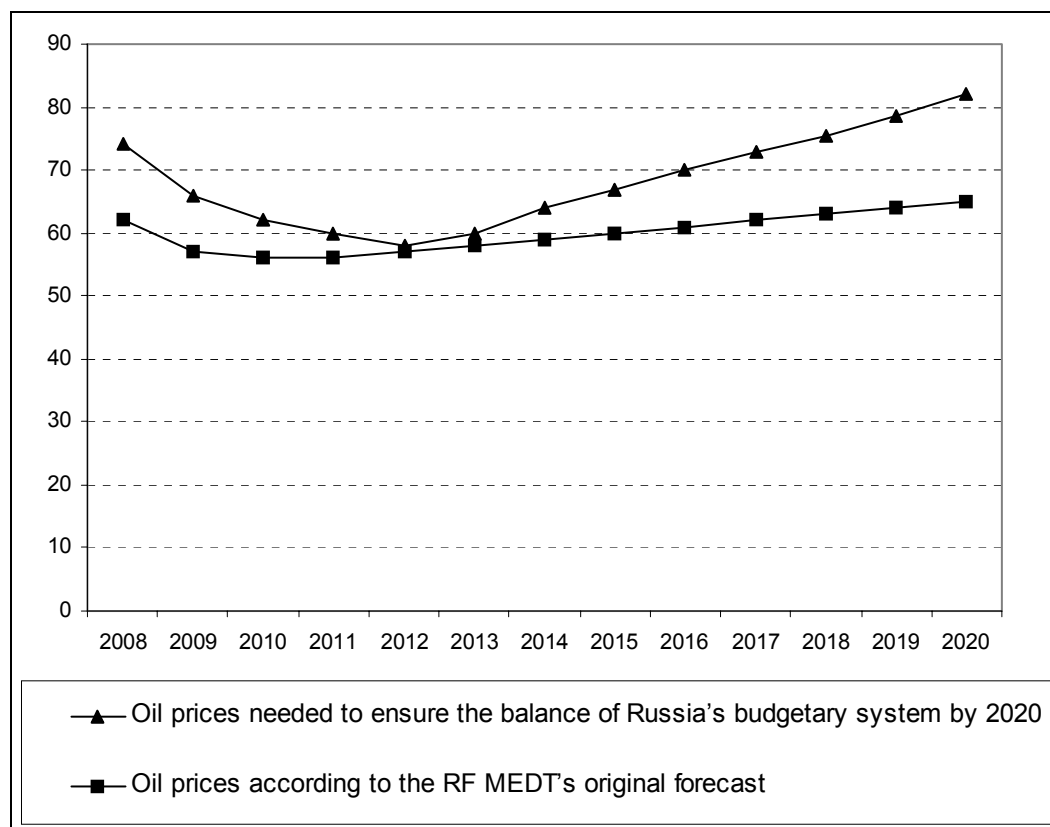
*Source:* the Conception data

So, it is cuts across the expenditure items by which the measures were not definitely estimated that the Conception identifies as one of major sources to compensate for a possibly arising deficit. It appears fairly unfeasible in practice, as out of the 12.1% of GDP these expenditures account for the bulk falls on items that can hardly be cut down, that is, 8.3% on general government matters<sup>35</sup>, law enforcement, and national defense, while another 2.4% – on the housing and utilities sector. Thus, the landmarks given in *Table 32* are fairly unrealistic and unlikely to be realized within the period in question, which, accordingly, would not allow one to balance the budgetary system under the noted circumstances.

Securing Russia's balanced budgetary system under the increase in public spending provided for by the Conception and maintenance of the current tax law is possible only under steadily high prices for energy sources. In its original draft, the Conception projected in 2010–20 the average oil price to be at the level of USD 60/barrel, but during consequent debates around the Conception everyone agreed this forecast was too low and should be revised. We calculated the oil price between 2008–2020 which will ensure a balanced budgetary system in 2020 under the condition of greater budgetary spending, as per the Conception (*Fig. 19, Table 33*). The calculations show that under the average annual oil prices of USD 68/barrel (and

<sup>35</sup> Despite the fact the public spending on general state matters is down, thanks to lower public debt servicing figures, as of Sep.1, 2007, the share of spending on the public debt servicing in the aggregate public expenditures accounted for just 17%. Thus, the respective projected values referenced in the Conception appear substantially lowered.

given a significant price rise for oil up to USD 82/barrel by 2020) the Russian enlarged governments budget should become balanced within the whole time interval in question.



Source: IET's calculations.

*Fig. 19. The World Oil Prices for Urals, USD / barrel*

*Table 33*

**Estimation of Main Parameters of Russia's Budgetary System  
in 2008–20 under the World Prices Forecasted at the Level of USD 68/Barrel,  
as % of GDP**

	2008	2009	2010	2015	2020
<b>(1) The enlarged government budget revenues</b>	<b>43.26</b>	<b>41.69</b>	<b>38.56</b>	<b>36.27</b>	<b>37.49</b>
UST, without indexing the scale	4.4	4.4	4.4	4.1	3.6
VAT	6.11	6.11	6.11	6.11	6.11
Corporate profit tax	7.3	6.7	6.3	6.7	7.8
PIT	3.7	3.84	3.97	4.39	4.75
Mineral tax	4.97	4.6	4.45	2.72	3.36
Taxes on foreign trade	9.68	8.94	6.33	5.35	5.07
Other taxes	3.9	3.9	3.9	3.9	3.9
Tax revenues to the consolidated budget, total	40.06	38.49	35.46	33.27	34.59
Non-tax revenues	3.2	3.2	3.1	3	2.9
<b>(2) Expenditures of the consolidated budget</b>	<b>32.1</b>	<b>32.4</b>	<b>32.7</b>	<b>35.9</b>	<b>37.4</b>
<b>(3) Surplus after increase in spending</b>	<b>11.16</b>	<b>9.29</b>	<b>5.86</b>	<b>0.37</b>	<b>0.09</b>
<b>(3)=(1)-(2)</b>					

But as demonstrated by the data of *Table 33*, even under steadily high prices for energy sources (the nominal prices are constantly on the rise since 2013), the enlarged government budget surplus shrinks.

This modification of the prognosis of macroeconomic indicators can be viewed as a swing-back from the moderate estimation of the world prices for energy sources. At this point it should be noted there presently are no trustworthy methodologies of forecasting oil prices. The uncertainty in the future of the world oil market is also mirrored by medium-term forecasts of the world oil prices. The table below presents results of the December 2007 Reuters's survey on over 20 agencies that deal with forecasting the oil prices. They suggest the 2010 prices for Brent should be within the range between USD 55.75 and 86.8/barrel.

*Table 34*

**Oil Prices in 2008-10, as Forecasted by Participants in the Reuters's Survey,  
as USD/barrel**

	2008	2009	2010
Average	76.49	71.61	68.72
Peak	95.00	82.00	86.80
Minimum	61.75	64.00	55.75

*Source:* Reuters.

The further is the horizon of planning, the greater becomes dispersion in the oil price forecasts. According to the basic variant by OECD's International Energy Agency<sup>36</sup> of November 2007, the world price for oil calculated as an average price for oil imported into OECD countries should fall to USD 60/barrel (in the 2006 prices), followed by its extremely slow growth up to USD 62/barrel (in the 2006 prices), or USD 108/barrel in nominal terms. A scenario of high economic growth rates suggests that in 2030 it should climb up as high as to USD 86/barrel (in the 2006 prices). Interestingly this IEA's forecast reference figures notably greater than the prior one, which suggested that in 2015 the world oil price should stand at USD 47.8/barrel and USD 55/barrel (in the 2005 prices) in 2030<sup>37</sup>.

Not quite in unison, the US Department of Energy suggested in 2007 that in the period through 2020 the world oil prices would be fluctuating within the range between USD 34.1 and 89.1/barrel.

Such a variety of opinions highlights the contemporary science's complete inability to foretell the state of affairs on mineral markets for any reasonably distant perspective. Under the present uncertainty in this area the budgetary planning should be scenario-based, in order to ensure a budgetary system is balanced, regardless of external developments.

All the above implies that as far as the budget expenditures are concerned, the Conception can be realized with a substantial budget deficit, and, only provided the world oil prices stick to the 2006 level in real terms (in the 2006 USD), the balanced budget system can be attained. Even under a slight decline in the oil prices the budgetary system appears unbalanced, and since 2011 the federal public debt begins to grow (at 1% of GDP annually), and the use of the accumulated funds to cover the deficit will result in a complete exhaustion of the National Welfare Fund by 2016 and the Reserve Fund – by 2018–20.

<sup>36</sup> World Energy Outlook 2007. OECD/IEA, 2007.

<sup>37</sup> World Energy Outlook 2007. OECD/IEA, 2006.

#### 2.4.2. An Analysis of Possible Scenarios of Boosting Up the Balance of the Budgetary System in 2008–20

The analysis of possible options with regard to giving a boost to the balance of the RF budgetary system is conducted basing on the premise of a substantial rise in the pension-related expenditures. As evidenced by data of *Table 30*, the imperativeness to increase spending of the budgetary system to hold the replacement coefficient at a socially permissible level (not lower than 30%) will result in a consolidated budget deficit up to 8.1% of GDP by 2020, even providing the state of affairs in the foreign trade area remains relatively favorable. This can be explained by the fact that according to the Conception, the aging population and a rapid rise in salaries and wages will require, from year to year, an increasing proportion of GDP to maintain the replacement coefficient.

The balanced budgetary system can be secured by following means:

1. Prevention the budgetary spending from an accelerating escalation. Specifically, the 2007-to-2006 growth in the federal budget spending accounted for 2.2 percentage points of GDP, while revenues rose at 0.3 percentage points of GDP. In this respect, we mean the refusal to rise spending on capital investment. If the share of the enlarged government spending were maintained at the 2006 level (excluding of pension payments), this would allow one to cut the 2020 budgetary system deficit by 2.7% of GDP (*Table 35*).
2. Conduct of a systematic indexation of the UST scale. *Table 35* presents results of its indexation since 2010 once in three years, with account of growth rates in salaries and wages. It is worth noting that this variant may prove to be unacceptable from the political standpoint (as it may be conceived of as a greater tax pressure on labor). So, a more plausible and, perhaps, even desirable means appears a soft indexation of the UST scale with account of the CPI. However, such an option does not allow one to substantially axe the consolidated government budget deficit (under such a variant, the UST-based revenues would fall from 4.81% of GDP in 2008 to 4.3% in 2020 against 3.87% of GDP in 2020, as suggested by the variant without indexation of the scale).
3. Increase of the mineral tax on natural gas. In compliance with Government Resolution of May 28, 2007, No. 333, it is assumed that since January 1, 2011 Gasprom and its affiliated entities will deliver natural gas at a price calculated by a formula which would ensure an equal profitability rate of domestic and overseas supplies, which would give a dramatic boost to the national gas corporations' gains. Meanwhile, the tax system lacks automatic regulators that would otherwise ensure an adequate rise in the sector's tax payments. *Table 36* contains calculations that demonstrate that should the mineral tax on the natural gas be raised and the tax rate be subject to annual indexation with account of the domestic prices for natural gas, extension of the surplus (reduction of deficit) of the enlarged government's budget may account for 0.25% of GDP in 2008 and 0.43% of GDP in 2020.
4. Refusal to cut down the VAT rate and a partial substitution for the corporate profit tax with VAT. Against the above background, it seems to us proposals to significantly lower the VAT rate are overly provocative. One cannot help but admit that VAT is a complex tax to administer, particularly in Russia, and main challenges in this area most often concern VAT refunds to exporters. Equally challenging are various schemes involving a well-developed infrastructure formed by fly-by-night firms. All this calls for a serious work on refining the VAT administration technique – the developed economies' record in this area

has proved that if a success, this measure substantially diminish magnitude of such phenomena.

Today's heated debate exposed yet another argument in favor of lowering the VAT rate, that is, the statement that whereas the tax is levied on value added, the tax itself affects most seriously the very sectors with a high share of value added, which are most likely to form priority sectors in the future. This is *mal-entendu*, as the VAT burden is divided between producer and consumer according to the correlation between the demand price elasticity for, and the one of offer of the respective product, rather than by the proportion of value added in its cost.

It is a common knowledge that VAT's role in the budgetary system is huge: in 2007 alone, the respective revenues accounted for 6.68% of GDP, or a. 30% of all the budget revenues. Once the current VAT rate is cut down to 15% (along with abrogation of the 10% lowered rate), the budget losses would amount up to 0.8% of GDP. Accordingly, a 5% cut in the current VAT rate would be equivalent to a loss of 1.5% of GDP. It goes without saying, this is almost nothing against the current huge surplus figures (in 2006 – 7.4% of GDP, in 2007 – 5.5% of GDP), but, as demonstrated above, one cannot help ignoring such losses in a longer run, when the budgetary system is started getting out of balance. That is why any proposal on the tax cuts should be concomitant with proposals on cuts in budgetary spending.

The willingness to lower taxes, thus improving corporations and individuals' financial stands, is quite explicable, particularly if one runs a budgetary surplus. It should be remembered, though, that such tax cuts in today's situation, when a tight budgetary policy forms a critical instrument of sterilization of the monetary issuance fueled by monetization of the positive balance of payments, will give a boost to monetary base and, accordingly, inflation. According to some estimations, the transition to the 15% VAT rate will result in a 0.9 p.p. surge of inflation, while the one to the 13% rate will accelerate inflation up to 1.5 p.p.

It should also be noted that proponents of tax cuts often argue that they ensure a quick return in the form of an accelerated economic growth, which in the circumstances does not form a credible assertion. The IET's business surveys show that since 2006 Russian enterprises began to face serious problems with labor force shortages, while since 2007 they were challenged by the shortage of production capacities. So, in the given circumstances it is quite naïve to hope for the tax multiplier, for economic growth in the country can advance only under extension of production opportunities, which is associated with investment in production capital and human capital.

The problem of getting revenues and expenditures balanced under the conservative scenario of price dynamics for oil to some degree can be solved by modifying the structure of the tax system in favor of the taxes revenues from which are to a lesser degree tied with the situation on the world markets for energy sources. According to some estimations, in 2006–07 the proportion of the component (whose value is determined by oil price fluctuations) in corporate tax revenues accounted for some 15%, while in the VAT-based revenues – 1–2%. So, to secure the balance and ensure sustainability of Russia's budgetary system the tax reform should be pursued under the following scenario: raising VAT rates along with a simultaneous cut in the corporate profit tax. As the value of the latter's component (the aforementioned one) is significant, once the state of affairs on the foreign trade arena drakens, the share of the tax in GDP should plummet notably. In proportion to the fall in the share of this tax in GDP the budget system will suffer a lesser loss from its lower rates. In other words, under high oil

prices, it is appropriate to cut the rate of a tax which appears most vulnerable to a price downfall for energy sources.

The tax effect from the proposed reform depends on the degree to which revenues from the corporate profit tax will be substituted by those from VAT. The greater proportion of the corporate profit tax is substituted by the VAT-based revenues, the more sustainable is the budgetary system in the long run. However, in all likelihood, the respective rate of substitution presented in *Table 35* appears ultimately permissible, as further cuts in the corporate profit tax rate may destabilize regional finance, while revenues from this tax become insignificant for the budgetary system. As the developed economies' experience shows, diversification of taxes exerts a positive influence on the tax system's stability, so far as external shocks and tax dodging are concerned.

Let us also note that in contrast to corporate profit tax cuts, those in the VAT rates mean a less effective level of tariff protection of the domestic producer. Indeed, under quite natural assumptions that the offer curve with regard to imports is horizontal (any quantity of goods can be supplied at a given price), while elasticity of offer of domestic goods that compete with the imports has a negative gradient (differs from perpetuity), cuts in the VAT rates will result in a greater price downfall for import, rather than for domestic goods.

Germany has recently launched a reform effort that implies modification of rates of basic taxes. Sensing a certain pressure on the part of eastern European countries (in Poland, the corporate profit tax is 17.4%, in Slovakia – 19%, Estonia – 23%), in 2008 Germany is to cut the respective tax rate from 25 to 15%, extending, at the same time, the tax base using revenues from taxing bank deposit interest rates, rental and leasing operations. These measures are complemented by the recently (in 2007) cut social tax, which is used for the sake of unemployment insurance, and the 3% increase of the VAT rate (from 16 to 19%).

5. Privatization, the growing capitalization and the rise in the share of profits transferred to the federal budget by federal public companies can form one of the most efficient and socially acceptable ways to boost assets of and, accordingly, revenues to the pension Fund of RF or the National Welfare Fund, and, at the same time, the means to lower the role the state plays in economic activities. The aggregate value of the national public companies is estimated at the level of 55% of GDP. Given the volume of foreign investment in Russia in 2005–07 and the peak volume of the federal budget revenues from the public property privatization (0.77% of GDP in 1997), it seems possible to ensure annual additional revenues from the public property (privatization, greater capitalization, dividends, placement of privatization proceeds to financial markets, etc.) which would roughly account for. 1% of GDP, without any risk of a drastic fall in the value of the public assets.

*Table 35*

**Surplus (Deficit) of the Enlarged Government's Budget Under Realization  
of Different Scenarios of Reforming the expenditure and Revenue Components  
of the Budget in 2008–20\*, as % of GDP**

	2010	2015	2020
1	2	3	4
1. Surplus (deficit) of the enlarged government's budget under increase in expenditures, as per the Conception, and the replacement coefficient being maintained at the level of 30%	+0.91	–4.38	–7.43
2. Surplus growth (decrease of deficit) of the federal government's budget in the event:			
2.1. The enlarged government budget spending is at the 2006 level	+0.5	+2.3	+2.7

*Table 35 (continued)*

1	2	3	4
2.2. Indexation of the UST scale since 2010 once in 3 years, with account of the wages growth rates	+0.39	+0.87	+1.22
2.3. Increase of the mineral tax on natural gas	+0.66	+0.66	+0.43
2.4. partial replacement of the corporate profit tax with VAT (cutting the corporate profit tax down to 17%, abolition of the 4% regional benefit with regard to the corporate profit tax, abolition of the beneficial 10% VAT rate, raising the basic VAT rate up to 20%)	+0.07	+0.27	+0.37
2.5. additional privatization of public property	+1.00	+1.00	+1.00
<b>3. Surplus (deficit) of the enlarged government's budget under realization of the integrity of the scenarios of reforming the expenditure and revenue component of the budget over 2008–20**</b>	<b>+3.53</b>	<b>+0.72</b>	<b>-1.71</b>
<i>4. The accumulated reserve of the budgetary system, as % of GDP (with account of the 4% annual nominal interest)***</i>	<i>22.70</i>	<i>23.07</i>	<i>19.43</i>

\* Under costs of energy sources as per the RF MEDT's original forecast.

\*\* Under the replacement coefficient being maintained at the level of 30%.

\*\*\* Understood as savings in the form of excess of revenues to the enlarged government budget over expenditures in the Reserve Fund and the National Welfare Fund, without account of the federal public corporations' assets assigned to the Pension Fund of RF or the National Welfare Fund, as it is only funds collected from sales of the assets in question or from management of them (dividends, profit, etc) that are taken into account.

*Table 36*

**Main Parameters of the Federal Budget of RF in 2008–20 in the Event  
the Proposed Measures Have Been Realized\***

	2008	2009	2010	2015	2020
(1) Federal budget revenues	22.62	22.60	19.40	17.77	16.80
(1)=(1.1.)+(1.2)					
(1.1.) Oil-and-gas	9.11	9.31	6.69	5.21	4.14
(1.2.) Non-oil-and-gas	13.51	13.29	12.71	12.56	12.66
(2) Federal budgetary expenditures (on the 2006 level)	16.41	16.37	16.51	16.57	17.27
(3) Non-oil –and- gas budget deficit	-2.90	-3.09	-3.80	-4.01	-4.61
(3)=(1.2)-(2)					
(4) Oil and gas transfer	2.90	3.09	3.80	3.7	3.7
(5) Oil and gas federal budget deficit	0.00	0.00	0.00	-0.31	-0.91
<i>For reference:</i>					
<i>The Reserve Fund</i>	<i>10.00</i>	<i>10.00</i>	<i>10.00</i>	<i>10.00</i>	<i>9.85</i>
<i>The Welfare Fund*</i>	<i>6.93</i>	<i>11.71</i>	<i>12.70</i>	<i>13.07</i>	<i>9.58</i>

\* Under costs of energy sources as per the RF MEDT's original forecast.

In conclusion, it should be once again stated that a responsible budgetary policy demands for a great deal of conservatism in assessing versatile scenarios of the economic dynamic, as a failure to duly consider effects from decisions made or overestimation of probability of a future favorable contour can entail dire, if not catastrophic, consequences for a country.



## 2.5. Interbudgetary Relations and Subnational Finances

### 2.5.1. Main Trends in the Development of Relations between Budgets of Different Levels

The main trends existing in the sphere of relations between different levels of authority are reflected in the structure of RF consolidated budget revenue and expenditure. The data in *Table 37* demonstrate the share of tax revenues and expenditures of the Federation's subjects, expressed in consolidated budget indicators.

*Table 37*

**The Share of Some Indicators of the Federation's Subjects' Budgets  
in the Consolidated Budget of the Russian Federation  
in 1992–2007 (in %)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Tax revenue	44.2	53.1	53.4	47.6	49.5	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9	31.8	33.9
Expenditure	34.0	40.3	37.7	43.4	45.4	48.1	54.1	51.9	54.4	54.2	49.3	50.0	50.8	49.5	43.4	48.3

*Source:* RF Ministry of Finance; calculations of the IET.

When analyzing the data presented in *Table 37*, one can point out the following features. Over the period of 1999–2005 there occurred a considerable degree of centralization of tax revenues; the share, in the consolidated budget, of this type of revenues received by RF subjects diminished from 56.6% to 30.9%. At the same time, in 2006–2007 this index began to demonstrate a slight growth, which is indicative of a certain adjustment of the trend toward centralizing tax receipts. It is necessary to note that this adjustment was caused not by a redistribution of tax sources between different levels budgetary system, but by a more rapid growth of receipts on the taxes consolidated to regional budgets, as compared to the tax receipts of the federal budget. Simultaneously, in 2007, in contrast to the situation observed in 2006, the share of regional expenditures in the consolidated budget of the Russian Federation substantially increased and amounted to the indices typical of the years 2002–2005. No important changes took place in the structure of tax revenues of RF subjects. As before, more than a half of the tax receipts was generated by two taxes: tax on profit of organizations (42%, or at the level of the year 2006), and personal income tax (PIT) (its share in the tax receipts of the consolidated budget of subjects of the Russian Federation somewhat increased – from 34% in 2006 to 35% in 2007). An analysis of the receipts of the main taxes as percentages of GDP has led to the following observations. The receipts from personal income tax were continuing an upward trend, amounting to 3.8% of GDP (against 3.5% in 2006). The receipts from tax on profit of organizations, which somewhat diminished in 2006 (as a percentage of GDP), by the results of last year, on the contrary, slightly increased – from 4.4% to 4.6% of GDP. Last year's regional budget revenue with regard to excises (similarly to the situation of several previous years) decreased and amounted to 0.54% of GDP (against 0.6% in 2006). The share of taxes on property somewhat increased (from 1.17% to 1.25% of GDP), similarly to the taxes on small businesses (from 0.36% to 0.37% of GDP). At the same time, there was a drop in the receipts from the payments for the use of natural resources – from 0.26% to 0.24% of GDP.

The year 2007 continued the trend toward leveling-down the interregional inequality in the distribution of RF subjects' per capita tax revenues. The value of the corresponding variance coefficient somewhat diminished – from 98.1% in 2006 to 97.6% in 2007. An even greater interregional equalization in the distribution of tax revenues can be observed when tax receipts are adjusted by regional prices (in order to measure the scale of regional prices, we applied the value of a fixed set of consumer goods and services, which is also applied for comparing the purchasing power of the regional population when distributing dotations aimed at equalizing the levels of budget sufficiency of subjects of the Russian Federation). The value of the variance coefficient decreased from 66.6% in 2006 to 61.8% in 2007. It should be noted that no serious changes in the distribution of revenue sources between the levels of authority occurred in 2006–2007 (in contrast to 2005, when a part of the unevenly distributed taxes (tax on profit and PIT) was centralized in the federal budget). The less uneven distribution of tax receipts can be explained as follows. Firstly, the tax revenues of RF subjects displayed a somewhat increased share of personal income tax, which (in contrast to profits tax) is sufficiently evenly distributed across regions. Secondly, the available data have confirmed the hypothesis put forth in the IET's previous overview<sup>38</sup>. Its main idea is that, after an economic crisis, the revival of economic activity begins at first in a small number of regions (in Russia these are the oil-producing regions and biggest economic centers). As a result, there occurs a stratification of regions by different indicators, including those of tax revenues. Such a trend could be observed in Russia in 1999–2004. Further economic growth encompasses more regions across the country and results in a more equalized distribution of tax revenues. This trend, most probably, will continue in the long run. The leveling-down of the interregional differentiation by the main socio-economic indicators will be conducive, on the one hand, to accelerated economic growth in some regions which are at present receiving high dotations, while on the other, to the population's migration from those regions where prospects are rather gloom toward rapidly developing economic centers. As a result of the combination of these ongoing processes, the presently underdeveloped regions will be either catching up with their economically better off neighbors, or will almost entirely "lose" their population. In both cases, the variance coefficient applied to the average per capita tax revenue of RF subjects will be becoming lower. The only factor capable of temporarily slowing down these processes is growth of the federal center's financial resources, which are, in effect, being spent on pinning down the population in the territories of regions "without prospects".

When taken in real terms, the tax revenues of the consolidated budgets of RF subjects have increased by 17.4%. At the same time, in 12 regions the amount of this type of revenue has dropped altogether in real terms<sup>39</sup>. It should be noted that in Magadan Oblast and Koryak Autonomous Okrug (AO) this decrease was only slight – by 0.7% and 0.2%, respectively. The greatest, in absolute terms, decrease in the value of this index was achieved in Tiumen Oblast, Agin Buriat AO, Khanty-Mansi AO, and Lipetsk Oblast. In the majority of cases the decline in regional budget revenue was associated with the "withdrawal" of big taxpayers and decreased payments of profits tax. Thus, receipts from the tax on profit of organizations diminished in real terms in Agin Buriat AO by 98%, in Tiumen Oblast by 54 %, in Lipetsk Oblast by 24%, and in Khanty-Mansi AO by 16%. It is also necessary to note that, in 2006, in all

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<sup>38</sup> The Russian economy in 2006. Trends and outlooks. M. IET, 2007.

<sup>39</sup> Tiumen Oblast, Agin Buriat AO, Khanty-Mansi AO, Lipetsk Oblast, Tomsk Oblast, Yamalo-Nenets AO, Chukotka AO, the Republic of Komi, Nenets AO, the Republic of Kalmykia, Magadan Oblast, and Koryak AO.

these regions the share of profits tax in the budget tax revenues was considerably higher than Russia's average. This index amounted to 97% in Agin Buriat AO, to 63% in Tiumen Oblast, to 62% in Lipetsk Oblast, and to 52% in Khanty – Mansi AO. Evidently, given such a strong dependence of the budgets of these RF subjects on the payments of profits tax, the “withdrawal” of big taxpayers could not but produce a significant drop in the amount of budget revenue. The maximum tax revenue growth in absolute terms was achieved in the city of Moscow, Moscow Oblast, the city of St. Petersburg, and Krasnoyarsk Krai, that is, in regions with high levels of budget sufficiency, and besides, with a high share of profits tax in the structure of tax revenue in 2006–2007.

A comparison between the regions characterized by the most pronounced fluctuations in the amount of budget revenue has led us to the conclusion that such fluctuations were caused in the main by the re-registration of big taxpayers. The high dependence of the regional budgets on the payments of profits tax results in an intensification of the struggle between regional authorities for the registration in their territories of big taxpayers. In this struggle the main emphasis is placed not on improving the investment climate in order to attract taxpayers into a given territory, but rather on drawing on the “administrative resource” or “bribing” big taxpayers by allocating budget subsidies to those projects the implementation of which would be profitable for certain individual companies.

In 2007, for a fourth year in succession, the consolidated budgets of the Federation's subjects demonstrated an aggregate surplus. In this connection, it is necessary to note an interruption in the trend toward a gradually increasing regional budget surplus. In 2007 it fell by 0.41 p.p. and amounted to 0.12% of GDP. This occurred due to a significant increase of RF subjects' consolidated budget expenditure – from 13.74% to 14.56% of GDP. This noticeable drop in surplus could not be prevented by a somewhat increased regional revenue – from 14.27% to 14.68% of GDP. One can point to the fact that at the level of regions (just as at the federal level) there can also be felt the same trend toward increasing state expenditure at a rate higher than that of economic growth.

Let us consider the quantitative parameters of the financial aid being transferred to regional budgets from the federal center. As can be seen from the data presented in *Table 38*, in 2003–2006 there was a trend toward a gradual decline in the volume of federal financial resources transferred to subnational budgets (from 3.03% to 2.17% of GDP). In 2007 this trend was interrupted, and the volume of interbudgetary transfers considerably increased – to 2.6% of GDP.

A more detailed analysis of the structure of interbudgetary transfers has yielded the following conclusions. As we have predicted earlier<sup>40</sup>, the amount of resources allocated from the Federal Fund for Financial Support of the Regions (FFFSR) to RF subjects decreased from 0.94% to 0.79% of GDP. This has been associated primarily with the procedure, introduced in recent years, for annual indexation of the FFFSR's size by the consumer price index. As was expected, the volumes of federal financial aid to regions (similarly to other expenditure items) were increasing in 2007 at a rate higher than that of GDP growth. As a result, the share of the FFFSR in the total volume of interbudgetary transfers became lower.

The year 2007 saw the continuation of the recent trend toward increasing the financing allocated from the Compensation Fund (CP). The total sum of subventions from this Fund in-

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<sup>40</sup> Ibid, p. 12b.

creased, by comparison with that in 2006, from 0.30% to 0.43% of GDP. This trend can be explained by the delimitation of powers between the levels of the budgetary system and the striving of the federal center to finance federal mandates in full. After a sharp increase in the size of the Fund for Co-Financing of Social Expenditures from 0.04% of GDP in 2004 to 0.12% of GDP in 2005, caused by the monetization of privileges (a substantial share of the Fund's expenditures was constituted by subsidies to a partial compensation for the expenditures on the measures of social support to veterans and other categories of citizens), the volume of transfers of this type has been gradually declining. In 2007, the share of the Fund for Co-Financing Social Expenditures decreased by 0.01 p.p. (just as in 2006) and amounted to 0.1% of GDP. The financing from the Fund for Reforming Regional Finances remained nearly unchanged, at approximately 0.01% of GDP. The volume of the Fund for the Development of the Regions somewhat increased – from 0.01% of GDP in 2006 to 0.02% of GDP in 2007.

As a negative trend, it should be noted that the dotations to maintain a well-balanced state of regional budgets increased from 0.16% to 0.17% of GDP. An active use of this financing mechanism, no doubt, is making more pronounced the problem presented by “soft budget constraints”. At the same time, one cannot overlook the fact that in 2007 there occurred a decline in the volume of resources transferred by way of mutual settlements – from 0.05% to 0.02% of GDP. This instrument of interbudgetary relations is one of the least transparent, and therefore its decreased share can be estimated as a positive trend.

From the year 2004 onward, attempts have been made to increase the transparency of interbudgetary relations. At present, the resources of the Federal Fund for Financial Support of the Regions, the Compensation Fund, the Fund for Reforming Regional Finances, and the Fund for the Development of the Regions have been distributed in accordance with the methodology approved by the RF Government's Decree. The formation and use of the Fund for Co-Financing Social Expenditures has also been done on a formalized basis. Nevertheless, a substantial part of federal financial aid to the regions is still being distributed without applying any methodological, financial, or economic substantiation. The share of interbudgetary transfers distributed on formalized basis amounted, in 2007, to approximately 59% of the total sum of resources transferred from the federal center to RF subjects.

The year 2007 saw a continuation of the practice of revising, over a given year, the law on federal budget, in order to increase the volume of financial aid to the regions against that initially envisaged in the budget. The amount of additional aid (not earmarked at the beginning of a financial year) was approximately 65 billion rubles, which is twice as much as the same index in 2006. At the same time, in 2007 special dotations, in the amount of 54.8 billion rubles, were allocated to measures designed to maintain a well-balanced state of regional budgets. Together, these two sources of “soft budget constraints” amounted to approximately 14% of the total volume of interbudgetary transfers, which casts doubt as to the real benefit of the completed reform in the sphere of distribution of financial aid between regions.

As an example of the existing procedure and principles applied in distributing additional financial aid, the following decisions can be referred to: dotations designed to ensure a well-balanced state of regional budgets were increased, during the year 2007, from 50 billion rubles to 55 billion rubles, or by 10%, and additional dotations in the amount of 19 billion rubles were transferred to the Republic of Chechnya.

*Table 38*

**Financial Aid from the Federal Budget Transferred to the Consolidated Budgets  
of the Federation's Subjects in 1992–2006 (in % of GDP)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1. Financial aid to budgets of other levels				1.8	2.3	2.5	1.6	1.18	1.43	1.79	2.2	1.94	1.7	1.65	1.52	1.79
1.1. Federal target programs, as well as subsidies to RF subjects in support of agriculture, measures to maintain the water systems, small businesses, and children's health protection														0.05	0.15	0.39
1.2. Federal Fund for Co-Financing Social Expenditures											0.15	0.11	0.04	0.12	0.11	0.10
1.3. Federal Fund for Financial Support of the Regions, including:																
dotations to equalize the level of budget sufficiency	0	0	0.36	1.17	1.04	1.22	1.12	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.79
government support of "supplies to the North"									0.06	0.08	0.08	0.07	-	-	-	-
transfers at the expense of VAT	0	0	0	0.31	0.36	0.36	0.12	-	-	-	-	-	-	-	-	-

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*Table 38 (continued)*

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.4. Dota- tions and subven- tions, including:	0	0.02	0.09	0.06	0.09	0.13	0.1	0.06	0.15	0.54	0.28	0.29	0.27	0.36	0.21	0.31
dotations to support measures designed to ensure well- balanced state of budgets													0.11	0.24	0.16	0.17
1.5. Resour- ces of the Fund for Reforming Regional Finances										0	0.01	0.01	0.01	0	0.01	0.01
1.6. Other uncompen- sated and non- returnable transfers (subsidies and subven- tions)											0.01	0.01	0.01	0.01	0.08	0.17
1.7. Fund for the Develop- ment of the Regions									0.03	0.05	0.1	0.1	0.15	0.01	0.01	0.02
1.8. Trans- fers by way of mutual settlements	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.28	0.05	0.2	0.14	0.12	0.01	0.05	0.02
1.9. loans and budg- etary cred- its, less redemption to other levels of state ad- ministra- tion*	0.09	0.03	0.02	0.04	0.23	0.64	-0.03	-0.1	-0.08	0.02	0.09	-0.01	-0.02	-0.03	-0.04	-0.01
2. Com- pensation Fund										0.37	0.38	0.36	0.34	0.17	0.30	0.43
3. Other interbudg- etary trans- fers, of these:								0.18	0.11	0.4	0.45	0.54	0.35	0.33	0.34	0.36

*Table 38 (continued)*

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
govern- ment sup- port of the road sys- tem**								0.18	0.11	0.27	0.27	0.31	0.22	0.13	0.15	0.17
<b>Total resources trans- ferred to budgets of other levels of authority</b>	1.49	2.7	3.4	1.8	2.3	2.5	1.6	1.36	1.54	2.56	3.03	2.84	2.39	2.25	2.17	2.57

\* - From 2005 – only budgetary credits.

\*\* - At present, the majority of transfers in support of the road system are listed in Section 1.1.

### 2.5.2. Changes Introduced into the Budget Code of the Russian Federation

The adopted Federal Law, of 26 April 2007, No. 63-FZ, “On introducing changes into the Budget Code of the Russian Federation in the part of regulating the budgeting process, and on bringing in conformity with budget legislation of the Russian Federation of individual legislative acts of the Russian Federation” has substantially increased the opportunities for subjects of the Russian Federation and for municipal formations to administer state and municipal finances, as well as created a legislative base that can on a new level regulate the most important aspects of relations between the budgets of all the levels of the budgetary system of the Russian Federation. The most important changes introduced in budget legislation with regard for the sphere of interbudgetary relations are as follows:

1. The switchover to a three-year federal budget has made it possible to increase the predictability of interbudgetary transfers for subjects of the Russian Federation. A substantial part of the interbudgetary transfers earmarked for subjects of the Russian Federation has been distributed between them for the period of three years, which creates favorable conditions for improving the quality of financial planning in regions.

2. The changes introduced into the Budget Code of the Russian Federation have provided subjects of the Russian Federation and municipal formations with opportunities for making choice between a three-year budget and a medium-term financial plan. The switchover to a three-year budget will make it possible for subjects of the Russian Federation and municipal formations to fully make use of their new opportunities for concluding medium-term contracts and to establish transparent and predictable rules for budgeting and tax policies in the medium-term perspective.

3. Within the framework of achieving the goal of strengthening the financial independence of subjects of the Russian Federation, the stability of tax legislation and interbudgetary relations has been ensured, so as to make possible reliable and objective medium-term budget planning. In accordance with budget legislation, it has become impossible to make any changes, at the federal level, to budget and tax legislation in the part of taxes and levies transferable to the budgets of subjects of the Russian Federation and to local budget are resulting in a decreased taxable base, or to change the spending obligations of regions budgets without allocating an adequate compensation from the federal budget.

4. Changes have been introduced into the procedure for determining the volume of resources of the Federal Fund for Financial Support of the Regions, in accordance with which the volume of dotations earmarked for equalizing the levels of budget sufficiency of subjects of the Russian Federation is to be determined on the basis of the need for achieving the minimum level of estimated budget sufficiency of subjects of the Russian Federation.

5. In order to create incentives for increasing revenue receipts by the budgets of subjects of the Russian Federation and local budgets, different conditions have been established for effectuating the budgeting process of subjects of the Russian Federation, depending on their level of dotations.

At the same time, the changes introduced into existing budget legislation have had almost no bearing to the interbudgetary relations between regions and municipal formations. In current budget legislation, several norms can be distinguished that create obstacles to efficient administration of finances at the regional and local levels:

- at present, by the Budget Code of the Russian Federation (Item 1 of Article 137), the possibility is consolidated to allocate dotations for equalizing the levels of budget sufficiency of settlements on the basis of the population's number and (or) budget sufficiency. However, by Item 2 of Article 137 of the Budget Code of the Russian Federation, it has been established that the size of this dotation should be determined, for each settlement of a subject of the Russian Federation with the right to receive such dotations, on the basis of the number of a settlement's residents and per resident. Evidently, in some subjects of the Russian Federation it would be more feasible to apply a per capita pattern for distributing the dotations earmarked for budget sufficiency equalization, whereas in other regions, due to a very uneven distribution of revenue base, it might be necessary to apply for the same purpose the criterion of settlements' budget sufficiency levels;
- in Item 3 of Article 138 of the Budget Code of the Russian Federation it is stipulated that the level of estimated budget sufficiency of municipal raions (or city okrugs) should be determined only on the basis of per capita tax revenue. However, at the municipal level, non-tax revenues (for example, rent payments) may be comparable with the volumes of tax revenues. Consequently, in some subjects of the Russian Federation, when estimating budget sufficiency levels, it can be feasible to apply the information not only concerning taxes, but also non-tax revenues of municipal formations, if such revenues are received on a permanent basis;
- by Item 1 of Article 142.2. of the Budget Code of the Russian Federation, the possibility is consolidated for granting subsidies to the budget of a subject of the Russian from the budgets of those settlements and (or) municipal raions (or city okrugs) where in a given financial year the estimated tax revenue of a local budget (less the amount of tax revenue in accordance with additional normative deductions) were in excess of the level established by the law of the subject of the Russian Federation. However, in some subjects of the Russian Federation the settlements and municipal raions (or city okrugs) may significantly differ not only by the volumes of their tax revenue, but also by the objective conditions influencing the cost of budget-funded services. Consequently, a situation may arise when municipal formations with a relatively high level of estimated per capita tax revenue will have a rather modest level of budget sufficiency, but nevertheless will be obliged to transfer subsidies to the Russian Federation's budget. In order to provide solution to this problem, it will be necessary to grant to a subject of the Russian Federation the right of choice



- between the budget sufficiency, tax revenue, and aggregate amount of tax and non-tax revenues of a municipal formation, to be applied as a criterion for subsidies to be granted from local budgets to the budget of a subject of the Russian Federation;
- in accordance with Item 3 of Article 138 of the Budget Code of the Russian Federation, the level of estimated budget sufficiency of a municipal raion (or a city okrug), with due regard for the dotations to equalize the budget sufficiency levels of municipal raions (or city okrugs) as established in the aforesaid Item, cannot be in excess of the level of estimated budget sufficiency supplemented by the corresponding dotations from another municipal raion (or a city okrug), which prior to the distribution of the aforesaid dotations, had had a higher level of estimated budget sufficiency. Although this requirement of budget legislation appears to be quite logical, it is necessary to note that it would be rather difficult to comply with this equalization principle (the so-called “monotonous” principle) after the switchover to a three-year budget and the distribution of equalizing transfers between municipal raions (or city okrugs). It is not accidental that a similar requirement in the RF Budget Code for the Federal Fund for Financial Support of the Regions was abolished. In order to eliminate the possibility of the emergence of additional factors serving as obstacles to the switchover to a three-year budget at the regional level, it seems necessary that this stipulation in the RF BC should be revised.

It also appears necessary to apply, as a general rule, the following approach to regulating financial relations between subjects of the Russian Federation and municipal formations at the federal level. Federal legislation should offer a sufficiently broad range of patterns for organizing interbudgetary relations at the regional and local levels of the budgetary system. Each of these patterns must be established so as to exclude the possibility of dual interpretation by different subjects of the budgeting process. Subjects of the Russian Federation and municipal formations must be able to select, out of this list, the most appropriate pattern for organizing interbudgetary relations. In order to take into account the various specific details of the distribution of interbudgetary transfers at the regional and local level that cannot be determined by the Budget Code of the Russian Federation, special attention should be paid to developing a best practices code. This code of best practices of organizing interbudgetary relations and improving the quality of management of regional and municipal finances at the regional and local levels will be prepared by the Ministry of Finance of the Russian Federation, with the participation of independent experts, and will contain, among other things, a detailed description of a methodology for distributing interbudgetary transfers compatible with the set of general patterns for the distribution of interbudgetary transfers established by the Budget Code of the Russian Federation.

### 2.5.3. The Federal Budget for the Year 2008 and the Period until 2010, in the Part of Interbudgetary Transfers Allocated to Other Levels of the Budgetary System

The total sum of resources earmarked for transfers to regional and local budgets in 2008 is approximately 919 billion rubles. This is by 1.17 times higher than the volume of resources envisaged in the law on the 2007 federal budget, given that total federal budget expenditure will grow by 1.20 times. As a result of a slower growth of the amount of interbudgetary transfers to other levels of the budgetary system, their share in federal budget expenditure will be diminished by comparison with that in 2007 – from 14.2% to 14%. Later on, the downward

trend displayed by interbudgetary transfers as a percentage of federal budget expenditure will continue, this index being 12.1% in 2009 and 10.8% in 2010. Considering the fact that in the late 1990s the share of dotations from the FFFSR alone amounted to 14% of federal budget expenditure, and the main revenue sources are at present concentrated in the federal budget, it does not seem very certain that the share of interbudgetary transfers to other levels of the budgetary system in total federal budget expenditure has indeed diminished.

It is also necessary to note that the system of interbudgetary transfers is becoming increasingly complex and intricate. In developed countries with a federative state system there exist, as a rule, two channels for allocating interbudgetary transfers: by way of equalizing regions' budget sufficiency levels and by maintaining at a socially acceptable level the regional expenditures earmarked for priorities relevant for the whole federation. As a result, developed federative states usually allocate 1 or 3 major transfers from the federal budget to the budgets of territories, and from 3 to 15 smaller-sized transfers. In the Russian Federation, in accordance with the 2008 draft budget and the draft budget for the period until 2010, there exist nearly a hundred of different transfers (6 transfers in the subsection of dotations, 58 – in the subsection of subsidies, and 31 – in the subsection of subventions). The efficiency of such a system thus will inevitably be questioned. Similarly to the taxation pattern, the number of transfers must be appropriate for efficient administration. The total financing distributed among 24 directions amounts to less than 1 billion rubles, which means that one subject of the Russian Federation may be receiving financing with regard to several directions amounting to under a hundred thousand rubles, or to several hundreds of thousands rubles. It is evident, given the targeted character of the majority of directions (subsidies and subventions), that the cost of targeted use of such resources, let alone the estimated cost-effect ratio, may be higher than the benefit yielded by the allocated expenditures. It seems necessary to thoroughly revise the existing delimitation of powers between the federal center and regions in order to fully consolidate some of the powers to the regions, while to return the others to the Federation's level (for example, the financing of social benefits paid to the veterans of the World War II labor front and former victims of political repressions).

The main stream of financial aid to regional authorities - in the form of dotations to the equalization of budget sufficiency from the **Federal Fund for Financial Support of the Regions** – will in 2008 be increased by 26.2% (against the level of 2007) and amount to 329 billion rubles (or 0.94 % of GDP). It is necessary to note that in 2008–2010 an attempt will be made to overcome the downward trend displayed by the share of this Fund in interbudgetary transfers: in accordance with the draft law on the 2008 federal budget and the budget for the period until 2010, the share of FFFSR in the interbudgetary transfers to other levels of the budgetary system will grow from 33.6% in 2007 to 35.6% in 2008, to 38.8% in 2009, and to 42.7% in 2010. However, considering that in 1999 the share of this Fund in interbudgetary transfers was 73%, and the unequal character of the budget sufficiency levels of Russian regions since 1999 has become much more pronounced, the suggested increase in the amount of dotations from the FFFSR appears to be insufficient. Besides, the principal purpose of dotations from the FFFSR (to provide all regions with comparatively equal opportunities for receiving budget-funded services) is now being hindered by attempts to pursue other goals initially alien to that Fund: to improve the level of regional authorities' financial discipline, to prevent sharp changes in the level of dotations, and to create incentives for regional authorities to increase their tax potential on their own. Although all these secondary goals are also

important, the attempt to achieve them all by applying a single financial instrument may result in a failure to achieve any of them, while the procedure for distributing dotations from the FFFSR will become even more intricate and less transparent (see a more detailed discussion of the new methodology for distributing dotations from the FFFSR in Section 3).

Beginning from the year 2005, **the Compensation Fund** has been pooling the resources allocated to the financing of all the federal spending mandates explicitly established by legislation. The draft law on the 2008 federal budget and the budget for the period until 2010 has envisaged an increase in the FC's volume from 153.9 billion rubles in 2006 to 190.4 billion in 2010. The share of subventions in the interbudgetary transfers to other levels of the budgetary system remains high – 18–22 %. On the one hand, the desire of the federal center to finance all the spending mandates is an indisputable benefit for the whole budgetary system. On the other, in a medium-term perspective it might be feasible to test the efficiency of the existing delimitation of powers, and in case of necessary do the following:

a) to discontinue the delegation, to the regions, of some of the federal powers and to switch over to their financing from the federal budget;

b) to delegate some federal powers to the Federation's subjects in full, while correspondingly increasing the volume of non-targeted transfers and transfers with soft conditions for spending the allocated resources and/or expansion of regional budgets' own revenue;

c) to consider the possibility of delegating/centralizing some powers on a contractual basis, with precise terms of such contracts being consolidated by legislation. It is necessary to note that Russia has had, indeed, considerable negative experience of delimitating powers on a contractual basis, although foreign experience sometimes confirms the efficiency of this particular mechanism. Therefore it might be feasible to return to this issue in the long-term perspective, after thoroughly studying it from the point of view of law and economics.

In the part relating to **subsidies**, their marked growth had been planned in the draft budget for the year 2008 and the period until 2010: the subsidies allocated in 2008 are increased by 1.84 times against the volume planned in the 2007 budget, or up to 311 billion rubles. The main directions for spending these resources in 2008 are as follows:

- the Federal Target Program “Modernization of Russia's Transport System (2002–2010)” – 15.2% of the total sum of subsidies;
- subsidies to the road system – 11.3% of the total sum of subsidies;
- subsidies to support agricultural production – 10.7% of the total sum of subsidies;
- social aid – 10.5 % of the total sum of subsidies.

The subsidies from the federal budget allocated to the road system and the Federal Target Program “Modernization of Russia's Transport System (2002–2010)” are of a high social importance, because they are designed to maintain the country's territorial and economic integrity and to promote the population's mobility. The corresponding obligations to implement large-scale motor road projects are rather high and in a majority of cases cannot be financed exclusively from regional (or regional and local) budgets. In this connection, it seems feasible to preserve the existing mechanisms for distributing these subsidies, which on the whole are quite compatible with the established requirements to such instruments.

At the same time, in order to improve the efficiency of planning and of the use of these resources, it would be necessary to pay attention to at least two specific features characterizing of the process of allocating subsidies to the road system. Firstly, it will be necessary to strengthen the linking of the subsidized projects to the general directions and priorities of ter-

ritorial development, the development of federal and territorial roads in a given region, as well as other mechanisms, and to the volumes of financial aid being allocated (the decision concerning the allocation of subsidies to the road system must take into consideration the level of budget sufficiency and the volumes of financial aid received by the region through other channels). Secondly, it will be necessary to toughen the formal procedure for considering applications and selecting projects on the basis of the criteria of social and economic efficiency, so that financing in the form of subsidies could be obtained with due regard for the opportunities in terms of co-financing on the part of regions.

As for the subsidies to agricultural production, the situation regarding these is fundamentally different. The transfer to the regional level of the powers to support agricultural production has resulted in this support being most actively provided not to those regions where the natural and climatic conditions are most favorable, but to those where the financial opportunities for implementing such a policy are greatest. The allocation from the federal budget of resources to support agricultural production on the basis of the principle of co-financing may make this trend even more prominent, and in particular, to result in the most financially “strong” regions being supported in their “trade wars” being waged for agricultural markets with “weaker” regions. Therefore, one may feel doubtful in respect of the true effect of such subsidies. This issue can be resolved by centralizing, at the federal level, the subsidies earmarked for the support of agricultural production, while minimizing the regional expenditures allocated to this direction. Simultaneously, the Federation’s role in the co-financing of expenditures allocated to the social development of rural areas should be increased.

As for the Fund for Co-Financing Social Expenditures, the directions for allocating resources from it need to be somewhat adjusted. In particular, it would be feasible to gradually discontinue the co-financing of the social support of veterans of the World War II labor front, by establishing, say, a transition period of 5 years, after which no co-financing will be allocated to this direction. The title of “veteran of the labor front” is still being granted in Russian regions, the criteria for eligibility varying greatly from region to region (see *Box 1*). Thus, this direction of social support is not an objectively substantiated and just one, and so the co-financing of the corresponding expenditures from the federal budget in the long-term perspective cannot be estimated as feasible. It would be better to provide the social support of politically rehabilitated persons and persons recognized as victims of political repressions, as well as veterans of the labor front, from the federal level. Indeed, these categories of privileged persons have been created by decisions made by the country’s leadership, and not by regional or local authorities. So, the granting of social aid to them must be within the competence of the bodies of state authority of the Russian Federation. However, in accordance with the existing delimitation of powers, the social support of these categories of the population belongs to the sphere of competence of subjects of the Russian Federation, and for these powers to be transferred to the federal level it will be necessary to make amendments to a number of federal laws<sup>41</sup>.

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<sup>41</sup> Law of the RSFSR, No. 1107-1, of 26 April 1991, “On the rehabilitation of the peoples – victims of political repressions”; Law of the Russian Federation No. 1761-1, of 18 October 1991, “On the rehabilitation of victims of political repressions”, Federal Law No. 5-FZ of 12 January 1995, “On veterans”, No. 184-FZ of 6 October 1999, “On the general principles of organization of legislative (representative) and executive bodies of state authority of subjects of the Russian Federation”.

As for the subsidies allocated to the budgets of subjects of the Russian Federation with regard to the upkeep of a child in a guardian's family or a foster family, as well as the remuneration to foster parents, and the subsidies to the budgets of subjects of the Russian Federation for the provision with housing to orphaned children; to the children left without the care of parents; and to the children under guardianship (or trusteeship), who have no dwelling consolidated to them. It appears necessary to formalize both the procedure for distributing these subsidies and the procedure for determining the total volume of resources allocated to these purposes.

**Box 1**

***Changes in the Procedure for Granting the Title of "Veteran of the Labor Front" in Cheliabinsk Oblast***

In Cheliabinsk Oblast, the regional authorities decided to change the procedure for granting the title of "veteran of the labor front". The right to this title will be enjoyed by all the retired persons who have employment history of 35 years (for females) and 40 years (for males). Until now, only the pensioners with government decorations and certificates of faultless work could become "veteran of the labor front". Today, 384 thousand persons in Cheliabinsk Oblast have the title of "veteran of the labor front". From 1 January 2008, the right to this title will be granted to another 270 thousand persons (approximately). Alongside the title, this category of population will also enjoy the right to privileges: the compensation for 50% of the cost of their housing and utilities, as well as solid fuel; free-of-charge use of city and commuter transport; and privileges with regard for the payment for dental services, postal services, etc. The sum of financial coverage of the privileges granted to "veteran of the labor front" from the oblast budget will be increased by 1 billion 550 million rubles. In connection with this decision of the leadership of Cheliabinsk Oblast, two groups of problems can be considered.

Firstly, this decision in many ways contradicts the logic of reform aimed at "monetization of privileges", because it extends the list of in kind privileges. Besides, the targeted character of the social support provided to the population becomes less pronounced, because these resources are allocated to pensioners irrespective of their level of living.

Secondly, certain problems arise in connection with the co-financing of this decision from the federal budget. At present, in accordance with the methodology for distributing subsidies among the budgets of subjects of the Russian Federation within the framework of co-financing of some of the social expenditures of subjects of the Russian Federation in 2008 and over the period until 2010, the size of subsidies allocated from the federal budget to the budgets of RF subjects for the social support of "veterans of the labor front" is determined on the basis of the following parameters: the number of citizens enjoying the right to receive social support in a given subject of the Russian Federation; the budget expenditure index in a region; the established norm for the volume of expenditure to be allocated per one recipient of privileges; and the level of co-financing which, in its turn, depends on a region's budget sufficiency level. If the number of "veterans of the labor front" is increased in a region, there arises a necessity to symmetrically increase the volume of co-financing. The level of co-financing of this type of social expenditures for Cheliabinsk Oblast in 2008 is established in the amount of 20.3% of the estimated need for social support of "veterans of the labor front". Most probably, the level of co-financing will be changed only slightly. Thus, for the year 2009 it is planned that the level of co-financing will constitute 18.8% of the estimated requirements for the social support of "veterans of the labor front"; and in 2010 it will be 19.1%. This means that this decision of the leadership of Cheliabinsk Oblast may result in an annual increase of the amount of federal budget expenditure by 138 million rubles, in the 2008 prices.

Thus "regional financial mandates" are created, that is, regional authorities make decisions that have a direct impact on the size of federal budget expenditure. This situation appears to be unacceptable, because it creates a precedent to be followed by the other Russian regions – to overestimate their spending obligations in order to receive additional financial resources from the federal budget.

In principle, it is doubtful whether it is indeed feasible to allocate small sums to the co-financing of some or other regional powers. It is evident that the negligible scale of co-

financing makes it impossible to grant to the Federation's subjects any substantial additional financial resources.

In this connection, one can borrow from the experience of those foreign countries where package transfers are allocated to whole sectors (public health care, public education), with rather lax control over how the allocated resources are spent<sup>42</sup>.

Besides, it can be feasible to replace with package transfers the greater part of financing allocated to priority national projects. In 2005–2007, in order to significantly raise the living standards of Russia's citizens, four priority national projects were developed and to a substantial degree implemented. The implementation projects helped to find solutions to many problems existing in the target areas and, which is most important, to focus on these problems the attention of society and bodies of authority of all levels.

The implementation of priority national projects has resulted in substantial investments of the federal budget's resources in the spheres of public education, public health care, and housing construction. However, in course of implementing these national projects there also arose certain problems:

1) the impossibility to fully take into account the preferences of the local population when allocating financing directly from the federal budget; thus, for example, in one region it may be necessary to increase the salaries of general physicians, while another region may have a greater need in medical specialists or in more medical centers to be constructed;

2) the spheres selected as national priorities are mainly consolidated to regional authorities<sup>43</sup>, which results in the creation of additional spending mandates for them:

- within the framework of the projects "Education" and "Health", the granting of additional remuneration and the raising of salaries of certain categories of employees in the budget-funded spheres takes place against the backdrop of a maintained planned growth of payment for labor on the whole across the education and health care sectors. Consequently, there emerge preconditions for an increasing differentiation in the levels of incomes between these categories and all the others. The inevitable result is an overflow of cadres into the better provided for categories, which diminishes the availability of other types of

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<sup>42</sup> A package transfer is applied in Perm Krai. Because of the conservative financial planning principles, the krai budget receives, on an annual basis, substantial additional revenues, which are used to finance priority regional projects. The package transfer accounts for 42% of the additional revenues being distributed per capita between municipal formations. Within the framework of this transfer, the directions for co-financing are determined. A municipality may independently make the choice of one or several directions from the established list.

<sup>43</sup> See: 1) Article 11.1 of Federal Law of 22 August 2004, No. 122-FZ, "On the introduction of changes into the legislative acts of the Russian Federation and recognizing as null and void some of the legislative acts of the Russian Federation in connection with the adoption of the Federal Laws "On the introduction of changes and additions to the Federal Law "On the general principles of organization of the legislative (representative) and executive bodies of state authority of subjects of the Russian Federation", and "On the general principles of organization of local self-government in the Russian Federation";

2) Chapter 3 of Federal Law of 6 October 2003, No. 131-FZ, "On the general principles of organization of local self-government in the Russian Federation";

3) Article 26.3, Items 13 and 21, of Federal Law of 6 October 1999, No. 184-FZ, "On the general principles of organization of the legislative (representative) and executive bodies of state authority of subjects of the Russian Federation";

4) Federal Law of 31 December 2005, No. 199-FZ, "On the introduction of changes into individual legislative acts of the Russian Federation in connection with the improving of delimitation of powers";

5) Article 29 of Federal Law of 10 June 1992, No. 12-FZ, "On education".

- specialists to the population in these sectors. The inevitable response on the part of regional authorities to this situation was the raising of salaries of the other categories in the spheres of public education and health care;
- within the framework of implementing national projects, not only the financing of current expenditures, but capital investments are also envisaged. These investments may also create additional spending obligations for regional authorities. For example, when the supply of hi-tech (that is, expensive) medical technologies to medical institutions was provided, no consideration was given to issues like the availability of the necessary number of specialists capable of operating that equipment, or the supplies of expandable materials and replacement of parts, etc. This also applies to purchases of computers for schools and their connection to the Internet: the equipment will have to be upgraded at the expense of sub-national budgets, and the access to the Internet will have to be paid for. Obviously, this will generate new expenditures for regional budgets.

Therefore it appears necessary, later on, to allocate, to the regions, package transfers in the form of subsidies to finance these sectors, with soft conditions for spending the received resources. In this case, the Federation will, on conditions of co-financing, allocate transfers to regions to cover the development of priority spheres, while regional authorities will independently decide on which individual programs and projects in a given sphere these resources should be spent.

Let us consider three variants of distribution of subsidies: per capita distribution; per capita distribution based on budget expenditure index; and per capita distribution based on regions' budget sufficiency levels. Foreign experience has demonstrated the desirability of distributing package transfers per capita, because such transfers, in fact, are aimed at equalizing vertical budget disbalances. In Russia, in a situation of considerable regional variances in the cost of budget services and the tax capacities of different regions, it would be, probably, most convenient to take into consideration the budget sufficiency of regions: the degree of co-financing of priority directions must depend on the level of budget sufficiency. However, it is necessary to emphasize once again that package transfers indeed equalize vertical budget disbalance by compensating to regions their expenditures associated with further implementation of priority national projects, which are typical of all Russia's regions. In this connection, a compromising solution would be to allocate package transfers with due regard for regions' budget sufficiency levels. However, the progressiveness of equalization must be significantly lower than that associated with the allocation of dotations from the FFFSR. It can be suggested that package transfers should be allocated in proportion to the gap between the budget sufficiency of a given region and that of the richest region. In this case, it is only the richest region (or the richest regions) that will be deprived of package transfers.

Such a pattern of distributing package transfers becomes especially important when the FFFSR's progressiveness is increased. If the majority of dotations from the FFFSR is spent on bringing the budget sufficiency level of the regions with high level of dotations to a certain guaranteed minimum (as it will be done beginning from the year 2008), the allocation of package transfers on a proportional basis will be compensating for the losses of those regions where the level of budget sufficiency was initially higher than the guaranteed minimum.

#### 2.5.4. The New Methodology for the Distribution of Dotations to Equalize the Budget Sufficiency of Subjects of the Russian Federation

Decree of the RF Government No. 745 (of 3 November 2007) approved the changes introduced into the methodology for the distribution of dotations for the equalization of the levels of budget sufficiency of RF subjects allocated from the Federal Fund for Financial Support of the Regions. Among the most important changes introduced into this methodology, the following ones can be pointed out:

1) The determination of the total volume of dotations to the equalization of budget sufficiency of subjects of the Russian Federation on the basis of necessity to achieve the minimum level of estimated budget sufficiency of subjects of the Russian Federation. The minimum level of estimated budget sufficiency for a subject of the Russian Federation, with due regard for the dotations to the equalization of budget sufficiency of subjects of the Russian Federation for the next financial year, was determined as the mean level of estimated budget sufficiency prior to the distribution of these dotations among the subjects of the Russian Federation not included in the list of top ten subjects of the Russian Federation with the highest levels of budget sufficiency, and the ten bottom 10 subjects of the Russian Federation with the lowest levels of budget sufficiency. In contrast to the previously existing procedure for determining the volume of the FFFSR on the basis of a previous year's volume of the Fund multiplied by the consumer price index established by the law on federal budget, the new procedure makes it possible to largely take into consideration the real needs of regions to equalize their levels of budget sufficiency. Despite the somewhat artificial character of excluding the ten richest and ten poorest regions when determining the FFFSR's volume (which was done in order to somewhat underestimate its size), the changes introduced into the procedure for determining the Fund's volume can on the whole be described as positive.

2) The application of indicators describing the tax bases for the taxes transferred to the consolidated budgets of subjects of the Russian Federation, instead of the value added indicators of different branches of the national economy, when calculating the index of a region's tax capacity. The previously applied method of estimating tax capacity by applying value added estimates by branch of the national economy had a number of limitations:

- *absence of data on the structure of the value added.* In the previously applied methodology for estimating tax capacity, the value added in industry was divided by subsectors in proportion to gross output volumes. This division is rather approximate and could have failed to reflect a region's real sectoral structure, since gross output is equal to the sum of intermediate consumption and value added, while the correlation of these two gross output components vary greatly in different sectors;
- *absence of division into federal and regional taxes when determining the tax burden.* In different sectors and regions the shares of different taxes in the structure of value added may also differ substantially;
- *a disproportion between the amounts of tax revenues and value added,* including for reasons of migratory tax bases (predominantly those for the profits tax);
- *discrepancies between tax and statistical data.* A comparison of the available data on the by-sector distribution of value added as stated in the reports published by the Federal Tax Service (FTS) and the Federal State Statistics Service (FSSS) has led to the conclusion that there exist some differences between the reported amounts of tax receipts and the



structure of value added when broken down by sector. In other words, there emerge situations when the actually generated value added is reflected in statistics reports as belonging to one sector, while the taxes paid on it are reflected with regard to another sector in the FTS' reporting forms. Thus the estimated tax loads of different sectors of the national economy may be distorted.

The application of indicators characterizing the tax bases for the taxes transferred to the consolidated budgets of subjects of the Russian Federation<sup>44</sup> has largely provided solutions to all these problems and to estimate more accurately the regions' tax capacities.

3) The distribution of dotations to the equalization of budget sufficiency levels of subjects of the Russian Federation over a three-year period, despite the existence of substantial undistributed reserves (the share of distributed dotations on budget sufficiency equalization in the total volume of the FFFSR at the beginning of the three-year budget period amounts to 100%, in 2009 – 85%, and in 2010 – 80%), is conducive to a better predictability of the volumes of interbudgetary transfers for regional authorities.

Despite the aforesaid merits of the new methodology for distributing dotations from the FFFSR, one can also point to some technical limitations of the formula applied to the distribution of dotations from the FFFSR, which considerably diminish its merits.

1) Attempts to create incentives for regions to independently expand their tax base for the tax on profit of organizations and the personal income tax with the help of dotations from the FFFSR have resulted in a situation when a region with a higher level of budget sufficiency prior to equalization fails to maintain its advantages after it, that is, a region's ranking in terms of budget sufficiency prior to equalization does not correspond to that same region's post-equalization ranking. As a result, the attempt to urge the regions to increase their tax base on their own develops into a de-stimulating measure from the point of view of improving the budget sufficiency level of some regions. In this connection, it has been suggested that the attempts to promote growth of the taxable base with regard to profits tax and personal income tax should either be discontinued altogether when distributing dotations from the FFFSR<sup>45</sup>, be aimed only at promoting accelerated growth of the personal income tax, since the incentives for increasing the taxable base for tax on profit of organizations work only to intensify the struggle between regions for the placement in their territory of the most profitable enterprises. As a result, enterprises apply transfer pricing in order to focus profits in that region where the highest preferences are offered in the form of exemptions and subsidies from the regional budget. It is by no means obvious that the promotion of such an activity is indeed the goal of the dotations allocated from the FFFSR.

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<sup>44</sup> The volume of profit of big and medium-sized organizations; the fund of salaries charged to employees of organizations; average annual value of fixed assets of big and medium-sized commercial organizations; retail turnover; public catering turnover; output of commercial services provided to the population through all the realization channels; the volume of delivered alcohol-containing products, ethyl alcohol, and wine to enterprises; output volumes of beer; oil extraction output (including gaseous condensate); the cost of extraction of natural resources by common type of mineral resources, in the form of natural diamonds and other mineral resources.

<sup>45</sup> Any region would be by all means interested in increasing the amount of payments of these taxes, because these are transferred into its budget, while the potential reduction in the amount of dotations from the FFFSR as a result of growing tax base will occur with a lag of at least two years and will be substantially lower than the additional tax revenues. And in case additional incentives are necessary for promoting a region's efforts to increase its tax base, it would be much more logical to do this by increasing the region's share in the profits tax.

2) The tax capacity with regard to “other types of taxes” is calculated in proportion to the sum of tax receipts from profits tax, personal income tax, tax on property of organizations, and taxes on aggregate income. However, our calculations have demonstrated that it is feasible to estimate the tax capacity with regard to “other types of taxes” in proportion to that of personal income tax, because the latter is distributed more evenly between the regions of the Russian Federation than the sum of four taxes applied in the suggested distribution formula, and the payments of PIT are better correlated with those of “other taxes”.

3) When calculating the tax capacity of a RF subject by type of tax, the forecasted revenues receipts in the consolidated budgets of RF subjects from each tax in the next financial year are applied. If the tax base of all taxes is distributed evenly between regions, such an approach appears well-justified. However, in the instances of the tax on the extraction of mineral resources, the profits tax and some excises it becomes obvious that a substantial share of the tax base is concentrated in a small number of the Federation’s subjects, and so the forecasted receipts are very significant for these subjects from the point of view of dotations distributed from the FFFSR. Besides, the structure of tax revenues may also vary significantly in different subjects of the Russian Federation receiving equalizing dotations. As a result, some subjects and the federal center may wish to produce different forecasts of the amount of receipts from these taxes. In order to avoid complaint on the part of regions that their tax capacities are overestimated on the basis of forecasted tax revenues, it is suggested that the tax capacity formula should make use not of forecasted data concerning revenue receipts in the consolidated budgets of subjects of the Russian Federation, but of the actual data of the latest reporting period.

4) Resulting from the application of the new method for calculating tax capacities, the budget sufficiency levels of many regions have displayed marked changes. In order to avoid dramatic negative fluctuations in the amount of dotations allocated to the Federation’s subjects, the new methodology for distributing dotations from the FFFSR envisages the creation of compensation mechanisms. The degree of compensation of losses to regions after the switchover to a new formula depends on the achievement by regions of certain indices indicative of a reduction in the amount of accounts payable and of increased revenue receipts in the budget of a subject of the Russian Federation. In this connection, it is suggested that certain allocation should be distributed in order to compensate, in part, to subjects of the Russian Federation the drop in the amount of dotations to the equalization of budget sufficiency by comparison with the 2007 level, so that the level of dotations should be increased to 100% if two or three requirements are fulfilled, to 90% when one requirement is fulfilled, and to 85% if none of the requirements is fulfilled. It is necessary to note that this dependency of the amount of compensation on the losses resulting from a drop in the dotations to budget sufficiency equalization on the fulfillment, by a subject of the Russian Federation, of certain requirements in terms of lowering payables and increasing budget revenue seems to be rather disputable. Firstly, it is contrary to the core idea of equalizing the level of budget sufficiency – that of providing all the regions with comparatively equal opportunities to receive budget-funded services, if equal tax rates are applied. Secondly, this dependency will certainly disrupt the “monotony principle”, in accordance with which the region with a higher budget sufficiency level prior to equalization must preserve this advantage thereafter. Thirdly, higher compensation will be received by the better provided for subjects of the Russian Federation

(for example, Belgorod Oblast), which is also contrary to the core idea of financial equalization.

5) In order to ensure the aforesaid partial compensation to those regions where the amounts of dotations to equalize the level of budget sufficiency will be diminished by comparison with the 2007 level, it was decided that the amount of dotations should be decreased for the regions where the growth rate of equalizing dotations against the 2007 level would be higher than 7%. Many regions have been criticizing this proposal, because in terms of methodology these resemble negative interbudgetary transfers.

By way of summing up all the changes introduced into the methodology for distributing dotations from the FFFSR, the following conclusions can be drawn:

- the formula for the distribution of dotations has become more complex and less logical;
- the equalization proper of regions' budget sufficiency is becoming less and less relevant for the actual distribution pattern applied to the dotations from the FFFSR.

Thus, it is suggested that, when distributing dotations from the FFFSR, only one goal should be borne in mind – that of equalizing the budget sufficiency levels of regions, while the other goals (creating incentives for regions to expand their tax base, improve financial discipline, etc.) can be achieved by applying other instruments. Besides, if changes are introduced into the methodology for distributing dotations from the FFFSR every year or two, it is by no means conducive to better stability of the budgetary system.

#### 2.5.5. Issues Relating to the Redistribution of Taxes between Levels of State Authority

When addressing the All-Russian Conference of Councils of municipal formations of subjects of the Russian Federation, the President of Russia V.V. Putin, among other things, touched upon the issue of distributing tax revenues between regional and local levels of authority<sup>46</sup>. Although the RF President in his speech emphasized the necessity to “provide municipalities with sufficient financial and material base”<sup>47</sup>, without specifying the sources to be drawn upon in achieving this goal, in some media organs this was interpreted as a proposal to return to municipal formations a part of the profits tax.

At present, in accordance with Article 284 of the Tax Code of the Russian Federation, the rate of the tax on profit of organizations is established at the level of 24%. The sum of this tax calculated at the rate of 6.5% is transferred to the federal budget, while the rest, calculated at the rate of 17.5%, is transferred to the budgets of subjects of the Russian Federation. In 2002–2004 the amount of the profits tax calculated at the rate of 2% was transferred to local budgets. Then the tax on profit of organizations was redistributed for the benefit of the federal center and regions because of the very uneven character of the tax base's distribution across the country.

The desire to redistribute the tax in favor of municipal formations can be explained by two reasons.

Firstly, there can exist a vertical budget disbalance between the budget of a subject of the Russian Federation and the consolidated budget of municipal formations. A vertical budget disbalance emerges if spending obligations are consolidated to certain levels of

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<sup>46</sup> Newspaper *Business&FM*, “*Nalog na pribyl' poshel po gorodam i vesiam*” [Profits tax is on the loose, at last]. 24 October 2007.

<sup>47</sup> <http://www.rosbalt.ru/print/424809.html>.

authority disproportionately in terms of revenue sources. In other words, if the bulk of revenue in the consolidated budget of subjects of the Russian Federation is consolidated to the regional level of authority, while the bulk of expenditure is executed at a local level, the result would be vertical budget disbalance. This vertical budget disbalance exists between the federal center and regions<sup>48</sup>. However, an analysis of the execution of the consolidated budget of subjects of the Russian Federation in 2006 has demonstrated that between the regional and local levels of authority there is no lack of proper vertical budget balance: the share of regional budget revenue in the consolidated budget revenue of subjects of the Russian Federation is nearly identical to the share of regional budget expenditure in the consolidated budget expenditure of subjects of the Russian Federation (83.67% and 83.22% respectively)<sup>49</sup>. Consequently, there is no need, on a national scale, to withdraw any considerable part of financial resources from regions in favor of municipal formations in order to better balance the Russian budgetary system. This fact is indirectly<sup>50</sup> confirmed by similar figures indicative of the existence of a deficit in regional and local budgets: in 2006, 36 regions of the Russian Federation executed their budget with a deficit, while aggregate deficit in the budgets of city okrugs was registered in 37 regions, in the budgets of municipal raions – in 28 regions, and in the budgets of urban and rural settlements – in 13 regions<sup>51</sup>.

Secondly, there can be a political and economic goal – that of increasing the independence of bodies of local self-government. Local authorities have at their disposal more information concerning local conditions and preferences than the national government, or even regional authorities, and consequently – more opportunities for better decision-making. The more versatile the preferences of the population of some territories and the less capable the center, or even the regional level of authority, by comparison with local self-government, of identifying the population's priorities in terms of budgeting policies, the higher may be the benefit from decentralization<sup>52</sup>. By contrast with the necessity to eliminate a vertical budget disbalance, increased financial independence of local self-government can be a fairly important reason why it may be feasible to transfer some of the tax sources from the regional level of authority to local self-governments. Thus, in 2006, the revenue proper of municipal formations constituted only 42% in their total revenue. The rest was represented by transfers from regional budgets, nearly a half of which were targeted (subventions and subsidies)<sup>53</sup>. Evidently, these indices are not sufficient for ensuring the fiscal autonomy of an elected level of authority, which is also closest to the population.

In this connection, it seems quite justifiable that the share of taxes in the revenues of bodies of local self-government should be increased. However, the profits tax, especially in

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<sup>48</sup> Nazarov V.S. *Nuzhny li regional'nye stabilizatsionnye fondy?* [Are regional stabilization funds really needed?] // *Bankovskoe delo*. – M., 2007 – No. 2.

<sup>49</sup> *Source*: RF Federal Treasury; calculations of the IET.

<sup>50</sup> It should be noted that the considerably lower deficit in the budgets of municipal formations can be explained not only by their financially favorable situation, but also by the rigidity of requirements imposed by budget legislation. In accordance with Article 92 of the Budget Code of the Russian Federation, the size of deficit of a local budget approved by a normative act issued by a representative body of local self-government with regard to a given year's budget cannot exceed 10% of the volume of local budget revenue less financial aid from the federal budget and the budget of subject of the Russian Federation.

<sup>51</sup> <http://www.roskazna.ru/reports/mb.html>.

<sup>52</sup> Oates W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich. – 810 p.

<sup>53</sup> <http://www.roskazna.ru/reports/mb.html>.

conditions of modern Russia, is by far not the most appropriate source of increasing the financial independence of local self-government. Although some disputes are going on concerning the choice of appropriate criteria for selecting a tax transferable to local budgets, everybody agrees as to the importance of complying with the following criteria<sup>54</sup>:

- the tax base should be relatively immobile;
- the tax base should be evenly distributed among municipal formations;
- tax revenues should be stable and predictable;
- the tax should not promote “harmful” competition between municipalities.

The profits tax, if consolidated to the local level of authority, will satisfy none of the aforesaid criteria:

- due to the application of transfer pricing, the profits tax is very mobile even at the level of regions;
- the tax base is distributed very unevenly. For example, in Krasnoyarsk Krai the variance coefficient of per capita revenues across municipal formations was 234% for the profits tax, as compared to 72% for the personal income tax;
- the profits tax is extremely unstable, in the Russian Federation is strongly depends on the situation on foreign markets;
- the consolidation of the profits tax to municipalities will result in the emergence of “harmful” competition between municipalities, including by means of granting subsidies to enterprises in order to attract them into their territory.

In this connection, it does not appear feasible, on a national scale, to return to the practice of transferring the tax on profit of organizations to local budgets.

The alternative ways to increase the financial independence of bodies of local self-government will be as follows:

1. The introduction of a tax on immovable property. Among all the alternatives available to local bodies of authority, the tax on immovable property will best of all satisfy the aforesaid criteria. Its tax base has practically no mobility, and receipts are, as a rule, predictable and stable<sup>55</sup>, because they are less prone to respond to fluctuations in economic activity than the receipts of the personal income tax and the consumption-based taxes. A part of the tax on immovable property can hardly be exportable. This tax is transparent and fair, as far as it covers the cost of services beneficial for an entire local community. If the tax on immovable property is collected exclusively at the local level (without the participation of higher levels of authority), no problems should arise with regard to harmonization or “harmful” tax competition. Although this tax, most probably, will be more difficult to administer than a local tax built into an already existing tax system at a federal or regional level, this rather low price, quite possibly, will have to be paid by municipalities in exchange for autonomy and flexibility in the sphere of tax policy, which are the most important attributes of responsible, efficient and accountable local bodies of authority.

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<sup>54</sup> Charles E., McLuer Jr. (2001), “The Tax Assignment Problem: Ruminations on How Theory and Practice Depend on History”, *National Tax Journal*, Issue LIV, No. 2, 339–363.

<sup>55</sup> Even in an event of considerable fluctuations of prices of immovable property, in some economically developed countries local authorities enjoy broad opportunities for regulating the tax rate. As a result, the tax on immovable property represents, in effect, a tax on households differentiated by the level of prosperity, the measure of which is immovable property. In other words, the volume of revenues from this tax in some countries is dictated by the level of local budget expenditure, and not by changes in property value.

2. A certain increase is possible in the amount of the personal income tax transferred to the budgets of municipal formations, because the personal income tax is one of the most evenly distributed taxes in Russia. Besides, this may make local bodies of authority more interested in encouraging growth of the population's incomes, which can be possible only in conditions of a favorable business climate in a given municipal formation. Perhaps it would be feasible to consolidate additional norms for deductions from the personal income tax to be transferred to municipal formations, and/or consolidate in budget legislation a region's responsibility with regard to an additional distribution of PIT receipts between municipal formations in the form of single or additional normative standards. In this connection, it may be feasible to expand revenue sources at the level of municipal raions because, according to our estimations, the pattern of consolidating revenue sources to settlements is closest to being ideal. As has been noted earlier, the budgets of municipal raions are much more prone to generate deficit than those of settlements.

A separate note should be made in respect of the problems associated with the replacement of dotations to equalize the levels of budget sufficiency of municipal formations by additional PIT deductions. At present, it is envisaged in the Budget Code of the Russian Federation (Articles 137, 138) that it is possibly to fully or partially replace these dotations to municipal formations (settlements and municipal raions (or city okrugs)) by additional normative deductions from the personal income. However, this possibility is not being fully taken advantage of by regional authorities<sup>56</sup>. Besides, the procedure itself for replacing the equalizing dotations by additional PIT deductions, both the existing one and the one to come into force from 1 January 2009, appears to be far from perfect. The methodology for forecasting the amount of receipts from PIT can be arranged in such a way that the forecasted values will be overestimated. This may result in the additional PIT deductions being inadequate for compensating for the loss of equalizing dotations. The procedure for calculating and replacing the equalizing dotations by the additional normative deductions from the personal income tax to local budgets is to be established by the law of a subject of the Russian Federation. However, there is no mention (or written stipulation) anywhere of the necessity to obtain the consent of a municipal formation to such a replacement beginning from 1 January 2009. It seems necessary that a municipal formation should indeed agree for the equalizing dotations to be replaced by PIT deductions after 1 January 2009, because this replacement directly influences the level of its revenue.

Besides, in accordance with the current wording of the RF BC, the switchover to the procedure of normative deductions from the personal income tax to the budgets of settlements and municipal raions (or city okrugs) is not allowed only for the period of one financial year. If the purpose of replacing the equalizing dotations with PIT deductions is to create incentives for local bodies of authority to implement their own measures designed to increase their tax base, it seems quite insufficient to simply consolidate the additional normative standards for one year. During one financial year local authorities will, at best, be able to adopt some measures to improve the investment climate, attract investors, create additional jobs, develop infrastructure, etc. However, these decisions will have a positive effect on growth of the population's incomes only in a medium-term perspective. Therefore it is quite probable that local

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<sup>56</sup> We have investigated the legislative base of 32 subjects of the Russian Federation, of which in only 22 subjects it was envisaged that a part of the dotations to equalize budget sufficiency levels could be replaced by additional PIT deductions.

authorities will simply not be interested in increasing the tax base of PIT, because in the next financial year the normative standards for PIT deductions may be reduced in view of the growing tax base (or if its growth is forecasted), with a simultaneous drop in the amount of equalizing dotations, as the municipality's tax capacity will be growing. Thus, it appears correct to consolidate these norms for additional deductions from PIT for a minimum period of 3 years within the framework of a three-year budget. The best solution, however, would be to consolidate these standards deductions from PIT to municipal formations for 5 years.

3. To transfer to municipal formations a part of the tax on property of organizations seems to be less desirable than to increase the share of municipalities in PIT receipts, due to the very uneven distribution of this tax. As a palliative measure, it can be suggested that the right to provide solutions to this issue should be granted to subjects of the Russian Federation, including for the purpose of replacing the equalizing transfers by receipts from this tax in the medium-term perspective (3–5 years).

#### 2.5.6. The Distribution of Subventions Transferred to the Budgets of Subjects of the Russian Federation to Cover the Dotations to the Budgets of Closed Administrative and Territorial Units

The regulation of the distribution of subventions between the budgets of subjects of the Russian Federation earmarked for the dotations to the budgets of closed administrative and territorial units (CATU), designed to support measures to ensure a well-balanced state of the budgets closed administrative and territorial units (hereinafter – the balancing dotations), is effectuated on the basis of laws on the federal budget and regulations of the Government of the Russian Federation. Thus, from Item 2 of Article 46 of Federal Law “On the 2007 federal budget”, of 19 December 2007, No. 238, it follows that the distribution of subventions to the budgets of subjects of the Russian Federation to cover the dotations to the budgets of closed administrative and territorial units to support measures aimed at ensuring their well-balanced state, in the amount of 1 060 000.0 rubles, should be approved by the Government of the Russian Federation.

Thus, the law on federal budget established only the sum of these transfers, while their distribution among individual CATUs is regulated by the Government of the Russian Federation during the financial year. First of all, it is necessary to note that among all the types of financial support provided to the budgets of closed administrative and territorial units, the balancing dotations are the least transparent, because their distribution is carried out without applying any objective formulas and is consolidated not by a law on the federal budget, but by a regulation issued by the Government. As a result, the dotations to support the measures aimed at ensuring a well-balanced state of budgets represent the principal source of the problems arising in connection with soft budget constraints for CATUs.

As demonstrated by international experience, soft budget constraints imposed on regional and local authorities give rise to a number of negative economic effects, one of which is growth of budget expenditure in excess of an efficient level. Besides, there can be phenomena of a more general nature – obstacles to growth of private investments and a rising number of inefficient investments projects, fraught with increased risks. With regard to CATUs this may mean, in particular, a distortion in the choice between the investments in development infrastructure, increasing budget expenditure and resettling of citizens, and the investments in

the development of social and engineering infrastructure and increasing current budget expenditures, in favor of the latter.

In actual practice this will mean that the situations when a CATU's authorities have every reason to expect additional financial aid in excess of the initially declared amount will be fraught with negative effects of several types. Firstly, the authorities of a CATU may assume increased risks when implementing budget-funded programs. Secondly, the probability of receiving additional financing will make it possible for a CATU to take upon itself obligations in the form of payables, as well as to abstain from measures aimed at making budget expenditures more efficient. Thirdly, in anticipation of the factors that will serve as the criteria for federal authorities to distribute additional financial aid between CATUs, local bodies of authority may attempt to influence the values of certain indices – for example, the level of a CATU's accounts payable, the level of arrears of wages and salaries in the budget-funded sector, the level of budget-funded institutions' arrears of utilities fees, budget deficit, etc. As a result, the decision made by a CATU to grant additional financial aid, which at a first glance may seem to be beneficial for its population, may give rise to negative consequences.

It is necessary to note that the situation with regard to soft budget constraints imposed on CATUs has somewhat improved in recent years. Prior to 2006, all the interbudgetary transfers to CATUs could be redistributed by decision of the Government. From the year 2006 onwards, the situation became a little better: a large part of the financial aid to CATUs has been distributed in accordance with a law on the federal budget, while the Government enjoys only the right to distribute the subventions to the budgets of subjects of the Russian Federation to cover the balancing dotations to the budgets of closed administrative and territorial units. The share of these resources in the total volume of interbudgetary transfers to CATUs is small and amounts, as stated in the laws on the federal budget, to slightly more than 6% in 2006–2010 (*Table 39*).

*Table 39*

**Financial Aid to CATUs' Budgets in 2006–2010**

<b>Forms of interbudgetary transfers to CATUs</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
1. Dotations to budgets of closed administrative and territorial units, billion rubles	8.62	9.14	9.78	10.44	11.12
as % of total volume of financial aid to CATUs' budgets	54.4	54.3	52.7	54.4	54.4
2. Support of measures designed to ensure well-balanced state of budgets of closed administrative and territorial units (CATU), billion rubles	1.00	1.06	1.13	1.21	1.29
as % of total volume of financial aid to CATUs' budgets	6.3	6.3	6.1	6.3	6.3
3. Development and support of social and engineering infrastructure of closed administrative and territorial units, billion rubles	5.13	5.47	6.40	6.21	6.62
as % of total volume of financial aid to CATUs' budgets	32.4	32.5	34.5	32.4	32.4
4. Resettlement of citizens from closed administrative and territorial units, billion rubles	1.09	1.15	1.23	1.32	1.40
as % of total volume of financial aid to CATUs' budgets	6.9	6.9	6.7	6.9	6.9
Total financial aid to CATU budgets, billion rubles	15.84	17.37	18.54	19.18	20.43

*Source:* Laws on the 2006, 2007, and 2008–2010 federal budgets.

On the basis of the data presented in *Table 39* one may assume that the dotations to CATUs' budgets to support the measures aimed at their well-balanced state do not play any



key role their budgeting policies, while the problem of soft budget constraints imposed on CATUs has in effect been adequately solved. However, this is far from being true. While in the total volume of financial aid transferred to the budgets of CATUs the share of the balancing dotations is indeed rather modest, for some individual CATUs their share may be considerably higher. In accordance with the regulations issued by the RF Government<sup>57</sup>, the balancing dotations were received in 2006 by 23, and in 2007 – already by 30 of the total number of 42 closed administrative and territorial units (see *Table 40*).

*Table 40*

**Distribution of Dotations to Support Measures Designed to Ensure  
a Well-Balanced State of Budgets of Closed Administrative  
and Territorial Units (CATU) in 2006–2007**

CATU	Dotations to support designed to ensure a well-balanced state of CATU budgets			
	2006		2007	
	in thousand rubles	as % of total sum of financial aid to CATU budgets	in thousand rubles	as % of total sum of financial aid to CATU budgets
1	2	3	4	5
Raduzhnyi	7,408	2.70	0	-
Poliarnyi	10,523	3.20	8,663	2.4
Mezhorie	7,509	4.10	35,362	13.2
Vidiaevo	10,008	4.20	28,451	15.2
Ulegorsk	5,938	5.00	42,394	32.5
Svobodnyi	8,393	5.30	11,258	8.0
Seversk	65,027	5.40	44,109	3.5
Znamensk	20,013	5.70	30,165	7.2
Oziorsk	58,499	6.80	5,695	0.6
Mirnyi	32,256	6.80	11,477	2.3
Severomorsk	81,547	7.50	63,278	5.3
Snezhinsk	60,465	8.50	9,959	1.5
Zaoziorsk	27,510	10.70	0	-
Snezhnogorsk	43,531	11.90	39,701	10.5
Molodiozhnyi	5,502	14.00	8,703	18.0
Zelenogorsk	141,879	16.70	8,976	1.1
Zarechnyi	152,237	18.00	108,955	11.9
Skalistyi	52,484	18.50	34,012	11.2
Gornyi	5,609	19.40	0	-
Solnechnyi <sup>58</sup>	14,107	23.10	22,927	32.5
Pervomaiskii	28,136	25.20	13,888	11.1

<sup>57</sup> Of 9 June 2006, No. 855-r, and of 24 August 2007, No. 1121-r.

<sup>58</sup> Tver Oblast.

*Table 40 (continued)*

1	2	3	4	5
Solnechnyi <sup>59</sup>	56,672	30.40	21,829	14.5
Ostrovnoi	104,747	34.60	105,627	30.9
Bolshoi Kamen'	0	–	13,164	2.5
Viliuchinsk	0	–	129,481	20.2
Voskhod	0	–	5,678	19.0
Zheleznogorsk	0	–	87 674	6.4
Lokomotivnyi	0	–	1,266	1.1
Mikhailovskii	0	–	9,695	35.2
Oziornyi	0	–	44,145	16.3
Sibirskii	0	–	21,584	11.7
Fokino	0	–	82,301	16.4
Shikhany	0	–	9,583	13.5

*Source:* Regulation of the Government of the Russian Federation, No 855-r., of 24 August 2007.

From the data in *Table 40* it can be seen that for many CATUs the balancing dotations in 2006–2007 became a significant source for softening budget constraints: the share of this type of financial aid in the aggregate volume of interbudgetary transfers was higher than 10% in 11 CATUs in 2006, and in 18 CATUs in 2007. Thus, the subventions to the budgets of subjects of the Russian Federation to cover the balancing dotations transferred to the budgets of CATUs for many of them represent a very important source of softening budget constraints and may result in the appearance of the negative effects described above. Besides, the possibility itself of obtaining substantial additional financial resources may give rise to the problem of soft budget constraints in the other CATUs.

The main reason for such an uneven distribution of additional resources transferred from the federal budget to CATUs is the imperfection of the financial planning procedure. For example, the volumes of subventions from the federal budget to the budgets of subjects of the Russian Federation to cover the dotations and subventions transferred to the budgets of CATUs is determined by multiplying the previous year's volume of these transfers by the consumer price index, which is considerably underestimated. Thus, the 2007 budget envisaged the indexation of these transfers by 6% against the 2006 level. And in Article 1 of the law on the 2007 federal budget the level of inflation (consumer prices) was determined in the range 6.5–8.0%. As for the actual inflation rate, it amounted to 11.9%. Consequently, the volume of interbudgetary transfers to the budgets of CATUs decreased in real terms. Besides, the growth rate of consumer prices in a given CATU (as well as that of all the CATUs) may be higher than Russia's average growth rate of consumer prices. Such rigid constraints imposed on the growth rate of transfers to the budgets of CATUs have urged the Government to make exceptions for some of the CATUs with the gravest problems: to allocate balancing dotations, or to finance some individual CATUs without applying this indexation procedure<sup>60</sup>.

<sup>59</sup> Krasnoyarsk Krai.

<sup>60</sup> For example, in 2007, in accordance with the assignment of the President of the Russian Federation (of 11 September 2006, No. Pr-1545), the estimated subventions to the development of the social and engineering infrastructure for the CATU Viliuchinsk were increased by 580 billion rubles, in order to improve the housing condi-

One more drawback in the planning of transfers for CATUs is the failure to fully take into account the subventions to the budgets of subjects of the Russian Federation, designed to cover the balancing dotations to CATUs transferred in a previous year when calculating the amount of such subventions. As a rule, the allocation of balancing dotations implies that a CATU's actual revenues and/or expenditures have significantly deviated from the planned values, and the volume of interbudgetary transfers earmarked in the federal budget for covering the dotations to CATUs' budgets is clearly insufficient for ensuring the required level of budget sufficiency<sup>61</sup>. Then it would be logical to assume that in the next year it would be necessary to increase the volume of subventions to be transferred to subjects of the Russian Federation for covering the balancing dotations to CATUs' budgets by an amount comparable to that of the balancing dotations allocated in a given year. However, this does not happen (*Table 41*).

As can be seen from the data in *Table 41*, in many of the CATUs that received in 2006 the balancing dotations, the volume of dotations allocated in 2007 is markedly lower than the aggregate volume of dotations in 2006. This means that if the situation with regard to revenue/expenditure in these CATUs is not changed in any radical way, in 2007 they will once again receive the balancing dotations. This is confirmed by the data in *Table 40*. It should be noted that 20 of the 30 CATUs receiving this type of dotations in 2007 also received them in 2006. The regular allocation of the balancing dotations to the same group of CATUs makes the problem of soft budget constraints even more acute due to the "falling into the habit" of receiving additional financial aid from the federal budget.

It is not feasible to solve this problem by keeping annual records of the balancing dotations and applying these data to the allocation of the "ordinary" dotations to CATUs, distributed by applying the established formulas in accordance with Decree of the Government of the Russian Federation of 18 April 2005, No. 232. This will result only in a further aggravation of the problem of soft budget constraints: the greater deficit in the budget of a CATU in a current year, the higher the amount of the balancing dotations, and thus the more "ordinary" dotations to be allocated in the next year.

Most probably, this problem can best be solved in the following way: simultaneous recording of the balancing dotations in order to calculate the amount of dotations based on formulas, and then – complete elimination of the balancing dotations. At the same time, it would be feasible to alter the procedure for indexing the total volume of interbudgetary transfers to CATUs, making it necessary to adjust the overall volume of resources allocated to CATUs to the actual inflation level, as demonstrated by the results of a reporting year, is higher than the forecasted level. This adjustment must be similar to the procedure of indexing applied to the Federal Fund for Financial Support of the Regions.

In order to fully abolish the balancing dotations and to make more healthy CATUs' finances, it will be necessary to adopt a set of measures aimed at optimizing their revenues and expenditures.

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tions of the servicemen and their families residing at the Pacific Navy's submarine base (to be spent on reconstruction of residential buildings).

<sup>61</sup> In 2007 it is planned to cover the forecasted spending powers of CATUs by revenue in the amount of no less than 93.7%. – Materialy k zacedaniiu Rabochei (triohstoronnei) gruppy po sovershenstvovaniuu mezhibudzhethnykh ornoshenii v Rossiiskoi Federatsii 17 oktiabria 2006 goda. [Materials for the meeting of the Task Force (Trilateral) for Improving Interbudgetary Relations in the Russian Federation on 17 October 2006].

Table 41

**Changes in Dotations Allocated to CATU in 2007, as Compared  
to the 2006 Level (for those CATU that Received in 2006 Dotations Designed  
to Ensure a Well-Balanced State of Budgets)**

CATU	Subventions to budgets of subjects of Russian Federation, to provide dotations to CATU budgets in 2006, thou- sand rubles	Subventions to budgets of subjects of Russian Federation, to provide dotations to CATU budgets, to ensure a well-balanced state of budgets in 2006, thou- sand rubles	Subventions to budgets of subjects of Russian Federation, to provide dotations to CATU budgets in 2007, thou- sand rubles	Ratio of dotations to CATO budgets in 2007 to total volume of dotations allo- cated to CATU budgets in 2006, in %
	1	2	3	4=3/(1+2)
Mezghorie	80,934	7,509	128,191	145
Mirnyi	236,665	32,256	274,419	102
Zaoziorsk	141,279	27,510	168,175	100
Raduzhnyi	130,300	7,408	135,359	98
Poliarnyi	205,188	10,523	211,961	98
Severomorsk	695,515	81,547	761,658	98
Seversk	798,930	65,027	841,509	97
Znamensk	145,983	20,013	161,453	97
Molodiozhnyi	9,069	5,502	13,873	95
Oziorsk	511,454	58,499	519,790	91
Zarechnyi	475,870	152,237	565,057	90
Snezhinsk	365,272	60,465	371,921	87
Skalistyi	142,031	52,484	169,299	87
Zelenogorsk	387,593	141,879	456,163	86
Snezhnogorsk	207,972	43,531	211,863	84
Svobodnyi	47,788	8,393	45,682	81
Pervomaiskii	46,957	2,8136	58,999	79
Uglegorsk	69,425	5,938	58,822	78
Solnechnyi <sup>62</sup>	36,830	14,107	38,986	77
Gornyi	3,141	5,609	6,604	75
Ostrovnoi	154,907	104,747	188,214	72
Vidiaevo	112,873	10,008	79,228	64
Solnechnyi <sup>63</sup>	68,941	56,672	70,736	56

Source: Laws on the 2006 and 2007 federal budgets (as of 19 December 2006); Regulation of the Government of the Russian Federation of 9 June 2006, No. 855-r.

1. In order to increase CATUs revenue, it is suggested that some exemptions from the land tax and the tax on property of organizations should be abolished. In accordance with Item 2 of Article 389 of the Tax Code of the Russian Federation, tax is not to be levied on the land plots limited in their turnover in accordance with legislation of the Russian Federation and granted for purposes of national defense, national security and customs. According to Item 4 of Article 374 of the Tax Code of the Russian Federation, the property belonging by right of economic jurisdiction or operative management to federal bodies of executive authority, where military and (or) equal to military service in envisaged by legislation, and which is used by the aforesaid bodies for the needs of defense, civil defense, national security and law en-

<sup>62</sup> Tver Oblast.

<sup>63</sup> Krasnoyarsk Krai.

forcement in the Russian Federation, is not to be recognized as taxable. Considering the fact that practically all the CATUs are organized on the basis of military-industrial complexes, the abolition of these exemptions will result in increased receipts of the land tax and the tax on property of organizations in the budgets of CATUs. If this growth in receipts is substantial, it will be feasible to discontinue not only the subventions to the budgets of subjects of the Russian Federation to cover the balancing dotations to CATUs, but also the subventions to the budgets of subjects of the Russian Federation to cover all the dotations to the budgets of CATUs. This measure will help to improve the budget sufficiency status of CATUs and provide solutions to the problem of soft budget constraints.

2. In order to decrease CATUs' expenditures, it is suggested that additional resources should be allocated from the federal budget to the acceleration of the process of resettling those citizens who have lost any connections, in terms of production or service, with the organizations (or objects) located in the territories of CATUs. For these purposes, the balancing dotations to the budgets of CATUs can also be used<sup>64</sup>. According to the IET's calculations, if the number of permanent residents of CATUs is decreased by 7%, resuning economy for the federal budget will amount to approximately 1.4 billion rubles, or more than 7% of additional expenditure. Given the current volumes of financing, the problem of resettling citizens from CATUs will be finally solved no earlier than 2025<sup>65</sup>, and so it appears feasible, in the next few years, to spend the additional financial resources on resettling. Such a solution seems reasonable, since thus the future obligations will be diminished. When the situation on foreign markets is favorable, it is necessary to increase mostly those expenditure items that can help to diminish impending obligations (debt repayment, etc.). The resettling of citizens from CATUs is also conducive to diminished future obligations. Besides, this may result in diminished CATUs' expenditure. If their expenditure is diminished in proportion to the decreased population numbers, this will save approximately 1.3 billion rubles per annum<sup>66</sup>.

Such a cut in CATUs' expenditure, coupled with their increased tax capacity<sup>67</sup>, will make it possible to completely discontinue the balancing dotations and to substantially decrease the amount of subventions transferred to the budgets of subjects of the Russian Federation to cover the dotations to CATUs' budgets, and finally to provide an adequate solution to the problem of soft budget constraints with regard for CATUs<sup>68</sup>.

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<sup>64</sup> The possibility to use the balancing dotations transferred to CATUs for accelerating the process of citizens' resettling requires an additional legal substantiation, because the non-targeted nature of these dotations makes it impossible to oblige the authorities of CATUs to spend the received funds specifically on the resettling of citizens.

<sup>65</sup> The needed funding to cover the cost of resettling, as of 01.01.2007, amounts to more than 21 billion rubles, while the average level of financing in 2007–2010 is only slightly higher than 1.2 billion rubles per annum.

<sup>66</sup> The estimated spending powers of CATUs according to Law No. 131-FZ for the year 2007 amounted to 18.9 billion rubles. – Materialy k zacedaniuu Rabochei (triokhstoronnei) gruppy po sovershenstvovaniuu mezhibudzhethnykh ornoshenii v Rossiiskoi Federatsii 17 oktiabria 2006 goda. [Materials for the meeting of the Task Force (Trilateral) for Improving Interbudgetary Relations in the Russian Federation on 17 October 2006].

<sup>67</sup> For more details, see above.

<sup>68</sup> If for some reason it will be impossible to allocate substantial sums to the resettling of citizens from CATUs in the next few years, it will be necessary to redistribute the available funding so that to give priority in resettling to the citizens from those CATUs where the per capita dotations from the federal budget are substantially higher than this index' average across all the CATUs. For example, the average amount of dotations per CATU's citizen in 2007 amounted to 7.2 thousand rubles, while the value of this index in the CATU Ostrovnoi was 40.9 thousand rubles. Consequently, the citizens on the waiting list of this CATU must be given priority in resettling, primarily

## 2.6. Russian Financial Markets

### 2.6.1. The Market for Government Securities

By the 2007 results the volume of Russia's domestic public debt in the government securities grew by some 21.5% – from Rb. 1,028.04 bn to 1,248.85 bn (and declined insignificantly in the shares-of-GDP equivalent – from 3.86% to 3.79%) (*Table 42*).

*Table 42*

#### **Volume of Government Papers on the Domestic Market, as Rb. bn\***

Types of securities	As of 01.01.2007	As of 01.01.2008
GKO	0.00 (0.00)	0.00 (0.00)
OFZ-PK	0.00 (0.00)	0.00 (0.00)
OFZ -PD	205.62 (0.77)	288.42 (0.87)
OFZ -FK	94.83 (0.36)	51.43 (0.16)
OFZ -AD	675.16 (2.54)	807.59 (2.45)
GSO-PPS	0.42 (0.002)	10.42 (0.03)
GSO-FPS	52.00 (0.19)	91.00 (0.28)
<b>Total</b>	<b>1,028.04 (3.86)</b>	<b>1,248.85 (3.79)</b>

\* Values in % of GDP are given in brackets.

Source: The RF Ministry of Finance (MinFin).

In the period between January and September 2007, the volume of RF's public external debt (the one accumulated by government agencies and monetary and credit regulating agencies) soared from USD 48.6 bn to 52.7 bn (according to CBR). So, an absolute rise in the amount of the external debt accumulated by the RF government accounted for 8.4%. Meanwhile, over the same period the private sector (banks and other segments of it) increased their debt before non-residents from USD 261.9 bn to 378.1 bn (at 44.4%). Thus, by results of the 9 months 2007 Russia's aggregate external debt posted a considerable growth, that is, from USD 310.6 bn. to 430.9 bn, or at 38.7%.

#### ***The Market for Government Securities on the Domestic Market***

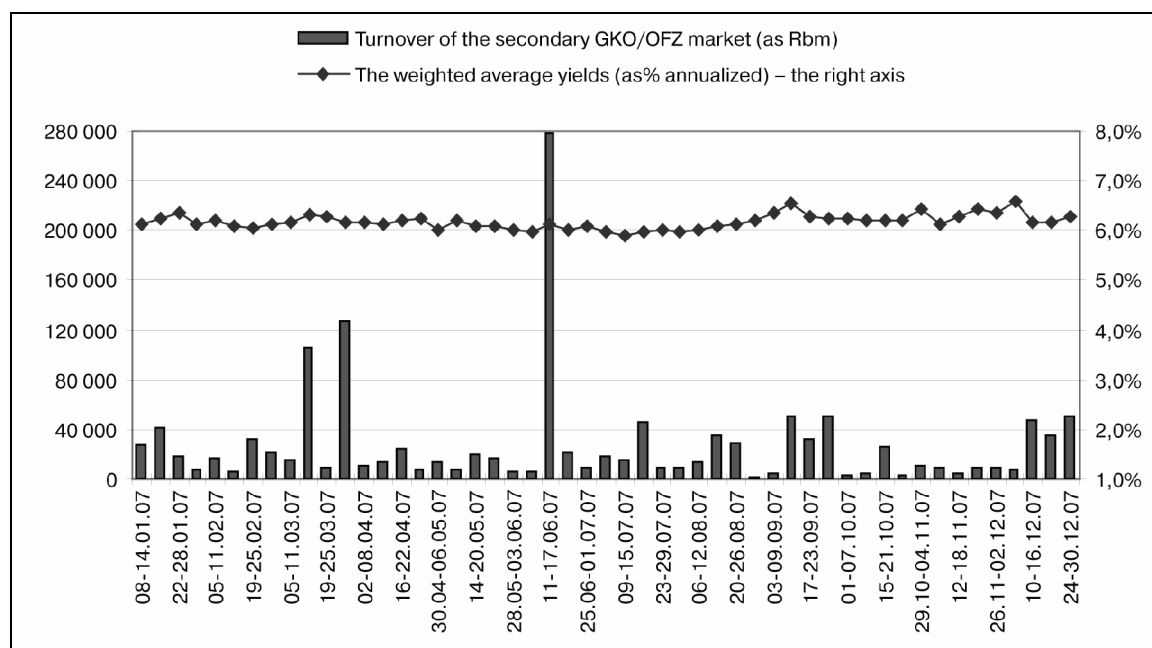
The year of 2007 saw no drastic downfall in the weighted average yields on the market for the Rb-denominated public debt. More specifically, the data as of the closing of trades on December 28, 2007, showed some decline in the respective indicator – to 6.14% annualized vs. 6.39% annualized as of the early 2007 (*Fig. 20*). The situation remained volatile, albeit stable over the period in question, with the weighted average yields rates being within the range between 5.90 to 6.60% annualized. At the same time, while until the late-July 2007 the market experienced some periodical insignificant drops in the weighted average yields rates (they fluctuated between 5.90 and 6.36% annualized on average), they periodically were on the rise during the last two quarters of the year, while the range of their fluctuation extended and accounted for 5.97 – 6.60% annualized.

The investors' activity in 2007 against 2006 is worth a special notion. The aggregate turnover of trades on the GKO-OFZ market in 2007 made up some Rb. 1,405.13 bn vs. 333.04 bn reported in 2006, so the market grew more than 4-fold. Meanwhile, against the backdrop of

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in order to more economically spend budget resources and then to spend the saved amounts of financial resources on the resettling of citizens from other CATUs, as well as to solve some infrastructural problems, etc.

a dramatic rise in its 2007 aggregate volume, the average weekly indicators were on the rise, too – they accounted for some Rb. 27.5 bn. vs. 6.5 bn in 2006. The 2007 peak weekly volume of trades was a. Rb. 278.73 bn (vs. some 32.36 bn. in 2006), while the minimum one was a. 2.15 bn (some 993.8 m in 2006). So, in 2007 the market for Rb.-denominated government bonds posted a considerable growth in the volumes of trades vis-à-vis the prior year, and that manifested itself in far greater indicators of a peak turnover of trades.



Source: IA Finmarket, the authors' calculations.

*Fig. 20. Dynamics of the GKO-OFZ in 2007 Market in 2007*

An analysis of the market dynamic exposed several periods when the nature of quotations' movements was distinct. Specifically, after a brief rise up to 6.3% annualized in the beginning of the year, the GKO-OFZ weighted average yields rate demonstrated a moderately negative dynamic with short-term fluctuations in both directions. That was continuing through the late-July, after which dominant on the market became the trend to a greater dynamic of yields rates, which ultimately stabilized at the level of 6.1–6.6% annualized. Let us examine, in a greater detail, monthly dynamics of the market for the Rb.-denominated public debt.

During the first month of 2007 the market went bullish, but the situation reversed in the late-January, and the dynamic became downwards, so the January cumulative change in the yields rate proved to be insignificant. The MinFin became far more proactive with holding auctions on the market for government papers compared with December 2006. In January 2007 alone, the Ministry held three auctions on the primary market, which helped cash up a total of Rb. 29 bn (vs. some 13 bn. in December 2006). Given a great demand for the government papers, MinFin placed Rb. 28.5 bn of the face-value volume, or some 98% of the offer. In the early January, investors were back to business with much vigor, which told on their activity on this particular market. This can be explained by the fact that the first and second weeks of the month were dominated by sales of “long” issues – investors freed their capital to take part in the primary placements. Meanwhile, the excess of liquidity fueled a partial rise in sales in the

segment of short- and medium-term papers. During the third week of the month, quotations stabilized against the background of a languishing downward trend that reflected the continuous negative state of affairs on external markets steered by uncertainty with regard of the Fed's further policy twists as a lighthouse for agents operating on the world debt market, as well as everyone's anticipation of primary placements whose conditions MinFin found fairly lucrative at the end of the day, as the banking sector boasted a very beneficial situation with liquidity.

In February, again, investors switched most of their operations to the primary market, hence the demand for placed papers several times became greater than the respective offer, which helped MinFin place practically all the volume (Rb. 26.9 bn out of 27 bn). Meanwhile, the market for Rb.-denominated T-bonds was dominated by an insignificant rise in quotations, and prices were changing within a very narrow range. Overall, the market capitalized on a favorable external background and a fairly favorable situation with liquidity. Meanwhile, in the early February the Central Bank modified the composition of the bi-currency basket in favor of a greater fraction of the Euro in it, which automatically resulted in a notable appreciation of the Rb. against the US Dollar. Then the situation with liquidity deteriorated notably, which entailed a short-term drop in demand for the Rb.-denominated bonds. Then, in mid-February, the quotations changed in alternate directions, as some investors fixed their profit against the background of the situation with cash liquidity. A favorable state of affairs on external markets cushioned an otherwise more drastic price downfall. By the late-February the further rise in the interbanking market rates resulted in investors' halting their activity on the secondary market for public debt.

In the early-March, the situation on the market for Rb.-denominated public debt remained moderately negative. Notable problems with liquidity in the banking sector and the depreciation of the Rb. against the US Dollar, along with the upcoming placements on the primary market, fueled the rise in yields rate and regvanized the market. It is a small wonder the OFZ placements were a success, practically without premiums to the secondary market. Quotations remained relatively stable through the middle of the month, which was still determined by liquidity problems. It was only by the late-February that the situation improved slightly and the yields rate resumed their rally.

Despite discontinuation of the rise in quotations in the early April, the market for the Rb.-denominated public debt remained fairly stable, which can be attributed, in particular, to the banking liquidity, as it had surged notably between the late March and the early April. The interbanking market rate plunged from 4–5% to 2–3% annualized. Liquidity in the banking system rose notably during the second week of April, which could be evidenced by a significant rise in funds on corresponding accounts and deposits with the Central Bank. Along with a notable appreciation of Rb. vs. USD, that back-upped the government bonds seriously. Meanwhile, demand was not aggressive, while the external segment began to react to the dynamic of basic assets, which did not help get yields rates down. As a result, the quotations of the federal debt instruments remained stable, while an additional proof of the market's sustainability became results of an auction on placement of GKO-OFZ at which demand was far greater than offer (Rb. 38 bn vs. 15 bn).

In the early-May, the market in question was in a fairly stable state, as there were no factors that would have boosted up a significant positive dynamic of quotations, while the level of liquidity in the banking sector was quite high, which ensured a notable back-up to the Rb.-



denominated bonds. Since mid-May the market began to see prevalence of positive trends associated with a high level of liquidity in the banking sphere. Purchases across a number of series of GKO-OFZ issues were partly engendered by a flow of funds switching from the primary market, where the demand at an auction on an additional placement of OFZ proved to be far greater than offer.

By contrast, the first week of June opened with negative tendencies – after a minor rise in the late-May, prices were gradually declining in the frame of a technical correction, with the Rb-denominated liquidity inhibiting the pace of the decline. But it had accelerated by mid-June, partly because of rising yields rates on the external debt market and in part due to MinFin's announcement of its intention to place considerable volume of bonds shortly. In the second half of the month, the market was dominated by alternate trends, while its agents were very active. While in the beginning of the third week of the month the market continued to slide down, following the US bonds and Russian Eurobonds, the situation stabilized by the end of the month, and quotations slightly recovered from the fall.

Between July and August the market for the Rb-denominated public debt demonstrated prevalence of positive trends, which can be explained by excessive funds in the banking system and depreciation of Rb. against USD. Meanwhile, it was the most liquid issues with a long duration that enjoyed the greatest demand. Activity on the domestic securities market grew particularly notably during the second week of July, along with a substantial rise in issuers' auction activity (the August 2007 volume of placement of OFZ issues accounted for Rb. 30.6 bn).

In the early-September, however, the pressure on the part of external factors in concomitance with a considerable deterioration of the domestic liquidity inhibited the investor's activity on the market, albeit at the same time it displayed an upward dynamic of yields rates. Furthermore, to ensure a necessary degree of their liquidity, Russian banks were also keen to sell their papers, which resulted in an additional pressure on the market. The activity was stalled since mid-September, as the players anticipated the Fed's decision on cuts in the basic interest rate, which immediately soared in the wake of the Fed's decision to lower its rate and resulted in a significant rise in demand for the "long" issues of Russian bonds. That fueled a substantial price rise on the market and a yields rates downward trend on the secondary market. These tendencies persisted in October, too. By late-October CBR has managed to trigger some fall in rates on the interbanking market, which also supported government bonds. Some appreciation of Rb against the US Dollar also back-upped quotations of Russian Rb-denominated bonds.

In November the market for the Rb.-denominated securities demonstrated alternate dynamics of the yields rates and a considerable contraction in the overall volume of circulation of secondary trades. Underpinning a loose activity on the debt market largely were liquidity shortages. To improve the situation, the Central Bank announced the start of holding a direct REPO session under a fixed 8% interest for 1 day, which enabled banks to attract funds not only at an auction, but during the day. The appreciation of Rb. against the US Dollar also back-upped quotations of Russian Rb.-denominated bonds. The CBR's measures on extending the possibility for banks to attract additional resources designated to remedy the liquidity shortages breathed a new life into activity on the debt market, which consequently was several times up during December.

In 2007, MinFin successfully held 25 auctions on placement of GKO-OFZ whose volume totaled some Rb. 280.7 bn (vs. 36 auctions with a volume of some 208.1 bn held in

2006). The actual volume of placement accounted for Rb. 243.9 bn (vs. 186.6 bn in 2006). The level of return by the weighted average price at the auctions varied between 5.93 to 7.06% annualized (in 2006, the respective range was between 6.08 and 7.06% annualized). So, the year of 2007 saw a far greater growth in the volume of government borrowing on the domestic market than 2006, while the yields rate remained nearly the same. As of December 29, 2007, the volume of the GKO-OFZ market accounted for Rb. 1,047.4 bn by face-value and 1,056.5 bn – by market value. The duration of the GKO-OFZ portfolio on the market accounted for 5.77 years, or at 110.5 days longer than the respective index as of the early-2007 (5.46 years).

#### *The Market for Government Papers on the External Market*

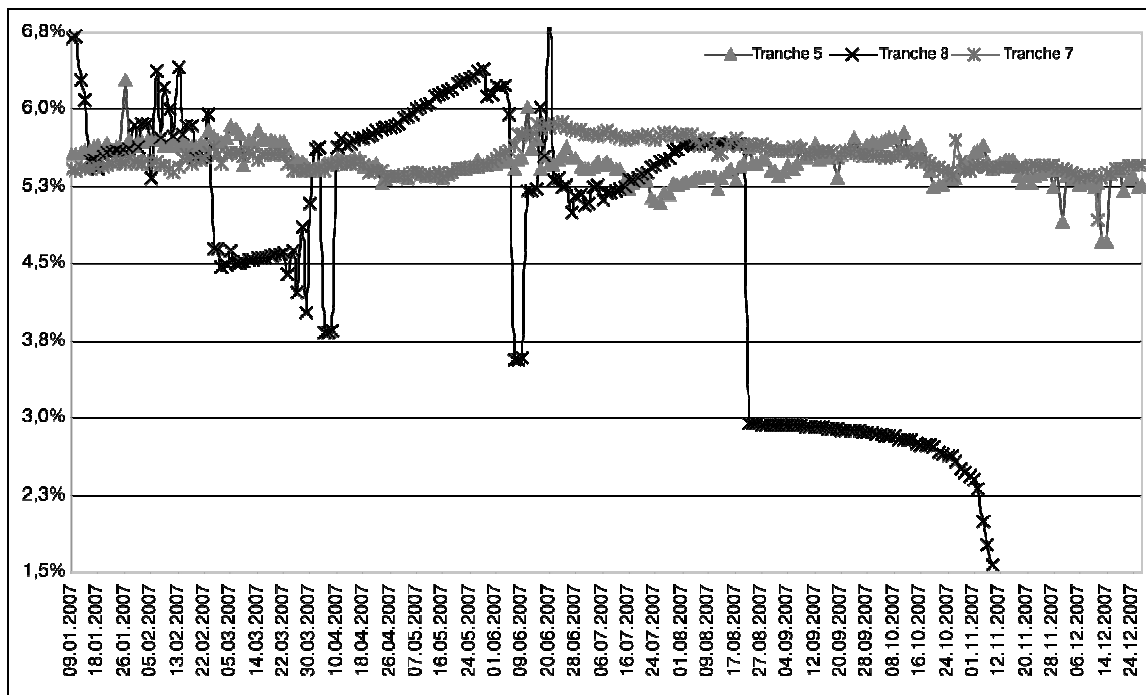
By the 2007 results, the situation on the market for forex-denominated government bonds demonstrated a low volatility of the respective yields rates across most of traded papers (Fig. 21–22). More specifically, as of late-December 2007, the yields rate of papers of the 5<sup>th</sup> tranche of OVVZ made up 5.27% annualized (vs. 5.47% in the beginning of the year), those of the 7<sup>th</sup> tranche of OVVZ – 5.46% (5.48%). By contrast, the dynamic of yields rates of the 8<sup>th</sup> tranche of OVVZ had displayed sharp fluctuations in different directions until the moment VEB (that exercised the function of the paying agent and the servicing depository on MinFin's behalf) redeemed it on November 14, 2007. Meanwhile, the yields rate of RUS-30 changed insignificantly over the year (from 5.5% to 5.7% annualized), the ones of RUS-28 dropped from 5.96 to 5.88% annualized, while as of late-December, the yields rate of RUS-10 accounted for 4.93% vs. 5.16% as of the start of the year, while RUS-18 were traded at prices that corresponded to the yields rate of 5.60% annualized (5.64% as of the early 2007).

The advancement of the 2007 dynamic of the market for Russian Eurobonds was affected by several most significant factors, of which positive were: the impact of cuts in the Fed's interest rate on the US market, periodical price rallies on the world markets for oil and metals, and a stable macroeconomic situation in Russia. As concerns negative factors, the critical ones were deterioration of the state of the US debt market, intensification of inflationary processes in the US economy, dynamics of yields rates of the US T-bonds that reacted to periodical increases of the Fed's interest rates, periodical price downfalls on the world market for oil, which is one of the major factors of stability of Russia's economy, and revision by S&P and Moody's of their methodologies of ratings of risky mortgage-backed securities.

An analysis of the 2007 dynamic of Russian papers allows identification of several periods that appear of different nature in terms of the market situation. More specifically, yields rates had been gradually declining until early May, albeit undergoing occasional adjustments. Between early May and mid-June the yields rates were on the rise, while between mid-June and the end of the year their dynamic dominated by a gradual downward trend, thus winning back a part of the rise in the first half-year. Let us now focus on major factors that steered such dynamics on the market for Russian Eurobonds.

Between January and February 2007 the market for Russia's government Eurobonds displayed a downward dynamic, as these papers appeared very sensitive to updates from the US debt market. In the US, a number of publications in early January highlighted persistence of great inflationary risks which immediately and drastically battered quotations of the US T-bonds. Naturally, against such a background the Russian quotations followed the basic assets. Another negative factor that hit the Russian papers became the price downfall for oil on the world market. In late-January, Russian Eurobonds were swinging: their falls, that followed

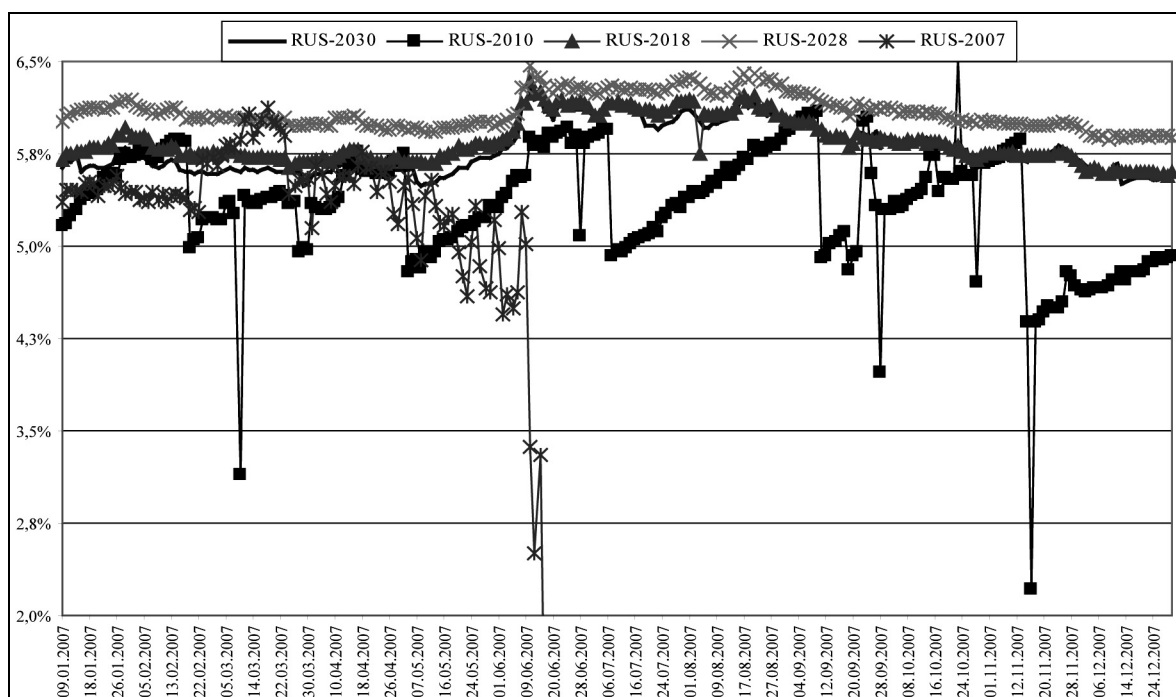
those in the basic assets, would be changed by consolidation on certain levels, which can partly be explained by the price rise for oil on the world market. In February, some basic assets continued their price rise, which was fueled by macroeconomic statistics that evidenced sustained economic growth rates in the US economy in the 3<sup>rd</sup> quarter 2006 and stability of inflation rates there. By contrast to most of other emerging markets, Russian bonds were on the rise against such a background. Meanwhile, their rise was inhibited by growing inflationary expectations in the wake of the publication of the CPI data, which at 0.1% exceeded expectations. In addition, highlighting problems on the US mortgage market, the continuous updates formed the background against which the yields rates of the Russian bonds in February sank vs. their respective indices as of late-January.



Source: IA Finmarket.

*Puc. 21. Yields to Maturity of OVZ in 2007*

Analogous trends had been dominating the market until early May, when the downward trend reversed. Underpinning the upturn in the state of affairs on the market became an upwards dynamic of the US debt market and a number of updates evidencing favorable macroeconomic performance indicators with regard to the housing market and industrial output, to which the US bonds responded by rallying. The need in an easing of the US monetary and credit policy has somewhat loosened, and investors reacted with some rise in demand. Russian Eurobonds, too, undergo a minor adjustment, but to a degree less than that in the US. Inspired by a new block of positive macroeconomic statistics, the rise in the US bonds' yields rates persisted by late-May, while Russian bonds experienced a slightly smaller price fall. In early June, the yields rates of the US T-bonds hoicked against the background formed by maximal values demonstrated by the US stock market, which determined the direction of the funds' overflow from less risky assets to more risky ones, and the Russian market strung along this dynamic.



Source: IA Finmarket.

*Fig. 22. The 2007 Yields to Maturity of Russian Eurobonds with Maturity Dates in 2007, 2010, 2008, 2028 and 2030*

## 2.6.2. The municipal and subnational borrowings market

### *The Dynamics of the Market's Development*

By the results of the year 2007, the consolidated regional budget was drawn with a surplus amounting to 38.5 billion rubles (0.12% of GDP).

The budgets of the Federation's subjects were drawn with a surplus of nearly 25.2 billion rubles, the budgets of city okrugs – with a surplus of 12.0 billion rubles, the budgets of the intracity municipal formations in Moscow and St. Petersburg – with a surplus of 0.4 billion rubles, the budgets of municipal raions – with a deficit of 0.3 billion rubles, and the budgets of urban and rural settlements – with a surplus of 3.1 billion rubles.

In 2006 the consolidated regional budget was drawn with a surplus of 139.8 billion rubles, or 0.53% of GDP. The budgets of the Federation's subjects were drawn with a surplus of nearly 133.8 billion rubles, the budgets of city okrugs and the intracity municipal formations in Moscow and St. Petersburg – with a surplus of 0.3 billion rubles, the budgets of municipal raions – with a surplus of 9.8 billion rubles, and the budgets of urban and rural settlements – with a surplus of 2.2 billion rubles<sup>69</sup> (see *Tables 43–44*).

<sup>69</sup> In respect of five subjects of the Russian Federation (Moscow Oblast, the Republic of Ingushetia, the Republic of Chechnya, Koryak AO, and Chukotka AO), the budget statistics concerning municipal formation in 2006 was not broken up into the categories of “city okrugs”, “municipal raions”, and “urban and rural settlements”. The budgets of the municipal formations in these regions were drawn with a deficit of 2.2 billion rubles.

Thus, within one year the consolidated regional budget surplus, as a share of GDP, decreased by more than 4.4 times.

*Table 43*

**Ratio of Surplus (Deficit) of Territorial Budgets  
to their Total Expenditure (in %)**

Year	Consolidated regional budget	Regional budgets
2007	0.8	0.6
2006	3.7	4.4
2005	1.6	2.3
2004	1.1	1.6
2003	-2.6	-2.3
2002	-2.7	-3.0

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

*Table 44*

**Ratio of Surplus (Deficit) of Territorial Budgets  
to their Total Expenditure in 2007 (in %)**

Budgets of intracity municipal formations in Moscow and St. Petersburg	Budgets of city okrugs	Budgets of municipal raions	Budgets of urban and rural settlements
5.34	1.23	-0.04	2.34

As of 1 January 2008, surplus was demonstrated by the consolidated budgets of 50 subjects of the Russian Federation (against 54 in 2006). The aggregate budget surplus in these regions amounted to 126.1 billion rubles, or to 4.1% of their budget revenue (in 2006 – 6.9%). The average budget surplus amounted to 2.9% of their budget revenue.

The highest surplus to revenue ratio in the consolidated budget was achieved in Koryak AO – 18.0%, Krasnoyarsk Krai – 13.5%, Chukotka AO – 11.4%, Sakhalin Oblast – 10.3%, Leningrad Oblast – 8.3%, and Khabarovsk Krai – 8.0%. More than a half (52.2%) of the aggregate consolidated regional budget surplus was accounted for by 3 RF subjects: the city of Moscow – 22.3%, or 28.1 billion rubles; Krasnoyarsk Krai – 15.0%, or 18.9 billion rubles; and the city of St. Petersburg – 14.9%, or 18.8 billion rubles.

The high surplus level demonstrated by the budgets of Moscow, St. Petersburg, and Krasnoyarsk Krai can be explained, first of all, by the considerable growth of export prices of energy carriers and non-ferrous metals (with due regard for the transfer to St. Petersburg of the tax revenues from Sibneft's enterprises taken over by the OJSC "Gazprom neft", which previously went to Omsk Oblast and Chukotka AO).

Deficit was demonstrated in 2007 by the consolidated budgets of 37 RF subjects (in 2006 – in 33 regions)<sup>70</sup>, its aggregate volume amounting to 89.0 billion rubles, or to 5.0% of their budget revenue (in 2005 – 4.9%).

The average budget deficit amounted to 4.0% of a given budget revenue<sup>71</sup>. The consolidated budget deficit of Tiumen Oblast amounted to 14.3% of its revenue, that of Moscow Oblast – to 8.8%, and that of Khanty-Mansi AO – to 7.1%.

<sup>70</sup> In the reporting documentation published by the RF Ministry of Finance (the federal Treasury) with regard to the execution of the budgets of subjects of the Russian Federation in 2005–2007, the data referring to the Evenk and Taimyr (Dolgano-Nenets) Autonomous Okrugs (AO) are not specified separately.

More than a half (54.0%) of the aggregate deficit was accounted for by 3 Federation's subjects : Moscow Oblast – 24.0%, or 21.4 billion rubles; Tiumen Oblast – 18.7%, or 16.7 billion rubles, and Khanty-Mansi AO – 11.3%, or 10.1 billion rubles (*Table 47*).

*Changes in the Structure of Accumulated Debt*

The amount of accumulated debt in the consolidated regional budget increased in 2007 to 54,814.0 million rubles, or to 0.17 % of GDP (*Table 45*). External debt in regional consolidated budgets increased by 491.5 million rubles, internal debt – by 54,322.5 million rubles.

*Table 45*

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

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Borrowings of subfederal and local authorities, incl.:	0.33	0.15	-0.29	-0.04	0.47	0.37	0.26	0.09	0.21	0.17
Reimbursable loans from budgets of other levels	-0.09	-0.11	-0.03	0.04	0.12	-0.1	-0.02	-0.03	-0.04	-0.01
Subfederal (municipal) bonds	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08
Other borrowings	0.43	0.31	0.01	-0.02	0.19	0.6	...	0.03	0.11	0.10
Diminished residuals on budget accounts	0.02	-0.19	-0.30	-0.05	-0.04	-0.18	-0.62	-0.48		
Funding of deficit at the expense of borrowings and cuts on the residuals on budget accounts	0.35	-0.04	-0.59	-0.09	0.38	0.19	-0.36	-0.38		

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

*The Structure of Borrowings*

The total volume of borrowings in the regional consolidated budget in 2007 amounted to 263,544.3 million rubles, of which external borrowings constituted 1,141.1 million rubles. The only region which was receiving external loans became the Republic of Bashkortostan.

The aggregate volume of the internal borrowings made by regions and municipalities amounted to 262,403.2 million rubles. The biggest borrowers on the internal market were: Moscow Oblast – 59.9 billion rubles; the city of Moscow – 22.5 billion rubles; Omsk Oblast – 17.8 billion rubles; and Irkutsk Oblast – 10.0 billion rubles. By comparison with 2005, the volume of internal borrowings in nominal terms increased by 13.2 billion rubles, or by 5.2%.

Within the total volume of internal borrowings in the consolidated regional budget, the issuance of securities constituted 32.1%, the loans from budgets of superior levels – 3.8%, and the other borrowings (primarily bank credits) – 64.2%.

In a situation of a diminishing volume, in real terms, of subnational borrowings, the level of securities within the structure of borrowings displayed by the consolidated regional budget became somewhat higher, increasing from 29.4% in 2006 to 32.1% in 2007 (although never reaching the level of 2005 – 36.0%) (*Table 46*).

<sup>71</sup> The highest deficit to budget revenue ratio was observed in the Agin Buriat AO (the deficit amounting to 107% of revenue there, which was associated with the Okrug's merging with Chita Oblast, including the use of the previously accumulated residuals on budget accounts, regarded as deficit financing of budget expenditure).

Table 46

**The structure of internal borrowings in subnational budgets (as %)**

	2007			2006			2005		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Issuance of securities	32.1	39.5	7.1	29.4	37.1	9.7	36.0	45.5	10.2
Budget loans	3.8	4.9	0.1	4.4	6.0	0.3	1.2	1.6	0.03
Other borrowings	64.2	55.6	92.8	66.2	56.9	90.1	62.9	52.9	89.8

The highest net borrowings to budget revenue ratio was demonstrated by: Moscow Oblast – 12.3%, Kostroma Oblast – 8.1%, and Novosibirsk Oblast – 7.0% (Table 47).

The biggest net borrowers were: Moscow Oblast – 29.7 billion rubles, Samara Oblast – 5.2 billion rubles, and Irkutsk Oblast – 3.7 billion rubles.

The greatest decline in the amount of accumulated debt was demonstrated by: Khabarovsk Krai – by 7.1 billion rubles, Novosibirsk Oblast – by 5.0 billion rubles, Krasnoyarsk Krai – by 3.1 billion rubles, and St. Petersburg – by 1.6 billion rubles.

Table 47

**The execution of consolidated budgets by subjects of the Russian Federation in 2007**

	Budget revenue (thousand rubles)	Budget surplus (deficit) (thousand rubles)	Surplus (deficit) to revenue ratio, as %	Attracted borrowings to revenue, as %	Net borrowings to revenue, as %	Redemption of borrowings to revenue, %	Net borrowings to surplus (deficit), %
1	2	3	4	5	6	7	8
<b>Central Federal Okrug</b>							
Belgorod Oblast	41,516,675.79	-849,797.09	-2.05	0.00	-0.07	-0.07	3.29
Briansk Oblast	22,268,644.70	-743,435.51	-3.34	12.32	3.06	-9.26	-91.55
Vladimir Oblast	29,537,901.60	210,899.77	0.71	0.12	-0.08	-0.19	-11.15
Voronezh Oblast	41,270,999.59	539,140.38	1.31	5.71	0.94	-4.78	71.62
Ivanovo Oblast	22,018,529.30	58,840.59	0.27	4.73	3.38	-1.35	1,264.63
Tver Oblast	32,338,589.03	-187,101.62	-0.58	8.97	5.06	-3.91	-875.00
Kaluga Oblast	25,679,425.90	-231,862.52	-0.90	8.74	5.49	-3.25	-608.04
Kostroma Oblast	13,678,918.13	-790,367.98	-5.78	21.99	8.08	-13.92	-139.77
Kursk Oblast	22,296,167.58	566,304.60	2.54	0.74	-0.55	-1.30	-21.69
Lipetsk Oblast	30,634,745.58	-1,681,032.39	-5.49	2.61	1.63	-0.98	-29.74
Moscow Oblast	242,477,456.25	-21,365,895.28	-8.81	24.69	12.25	-12.44	-138.99
Orel Oblast	14,191,047.90	717,296.81	5.05	0.78	-0.09	-0.88	-1.87
Riazan Oblast	22,393,664.50	-1,245,620.08	-5.56	13.83	7.05	-6.78	-126.72
Smolensk Oblast	17,494,525.94	429,165.91	2.45	1.72	-0.12	-1.84	-4.71
Tambov Oblast	19,860,720.49	-646,269.41	-3.25	6.00	4.34	-1.66	-133.23
Tula Oblast	32,769,990.30	889,561.24	2.71	13.20	0.09	-13.11	3.28
Yaroslavl Oblast	34,708,715.25	-1,386,325.58	-3.99	16.18	5.81	-10.37	-145.54
Moscow city	957,876,008.33	28,126,052.57	2.94	2.34	-0.09	-2.44	-3.22
<b>Subtotal</b>	<b>1,623,012,726.16</b>	<b>2,409,554.41</b>	<b>0.15</b>	<b>6.92</b>	<b>2.44</b>	<b>-4.48</b>	<b>1,640.56</b>

**RUSSIAN ECONOMY IN 2007**  
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*Table 47 (continued)*

1	2	3	4	5	6	7	8
<b>Northwestern Federal Okrug</b>							
Republic of Karelia	20,116,286.28	-958,639.79	-4.77	17.67	6.65	-11.02	-139.62
Republic of Komi	34,201,307.98	394,135.68	1.15	0.86	-1.17	-2.03	-101.61
Arkhangel'sk Oblast	39,185,857.06	2,574,506.54	6.57	7.64	0.94	-6.70	14.31
Vologda Oblast	42,574,550.22	-34,464.78	-0.08	0.73	-0.63	-1.36	781.18
Kaliningrad Oblast	27,634,456.08	744,517.21	2.69	15.96	3.62	-12.34	134.24
Leningrad Oblast	48,573,044.24	4,016,122.75	8.27	0.10	-0.05	-0.15	-0.66
Murmansk Oblast	40,636,966.63	2,129,335.80	5.24	3.20	-0.65	-3.84	-12.35
Novgorod Oblast	14,851,444.00	227,420.89	1.53	2.15	1.93	-0.23	125.77
Pskov Oblast	14,381,736.29	818,364.02	5.69	0.35	-0.79	-1.14	-13.89
St. Petersburg	281,267,298.57	18,820,096.51	6.69	0.98	-0.58	-1.56	-8.64
Nenets AO	10,068,794.65	-315,664.03	-3.14	0.00	0.00	0.00	0.00
<b>Subtotal</b>	<b>573,491,742.02</b>	<b>28,415,730.80</b>	<b>4.95</b>	<b>2.79</b>	<b>0.05</b>	<b>-2.74</b>	<b>1.03</b>
<b>Southern Federal Okrug</b>							
Republic of Dagestan	38,735,327.65	795,200.81	2.05	0.00	0.00	0.00	0.00
Republic of Kabardino-Balkaria	15,003,340.58	436,049.44	2.91	6.19	-2.13	-8.32	-73.13
Republic of Kalmykia	6,737,062.14	-154,635.94	-2.30	11.57	6.79	-4.78	-295.76
Republic of North Ossetia – Alania	14,218,358.28	-821,745.58	-5.78	8.47	3.85	-4.63	-66.57
Republic of Ingushetia	9,245,258.78	336,525.76	3.64	0.00	0.00	0.00	0.00
Krasnodar Krai	106,475,691.51	1,925,320.78	1.81	2.12	0.84	-1.28	46.58
Stavropol Krai	47,466,761.32	1,628,644.62	3.43	2.47	-0.36	-2.83	-10.48
Astrakhan Oblast	27,613,338.51	-235,955.84	-0.85	27.54	4.81	-22.73	-563.08
Volgograd Oblast	55,409,702.78	1,555,758.69	2.81	6.14	1.97	-4.17	70.07
Rostov Oblast	81,573,705.93	145,944.38	0.18	0.15	-0.25	-0.41	-142.26
Republic of Adygeya (Adygeya)	8,048,619.05	106,407.85	1.32	1.24	1.24	0.00	93.98
Republic of Karachaevo-Cherkessia	8,508,898.49	97,710.03	1.15	10.75	0.19	-10.56	16.40
Republic of Chechnya	63,540,510.39	2,934,414.27	4.62	0.00	0.00	0.00	0.00
<b>Subtotal</b>	<b>482,576,575.41</b>	<b>8,749,639.28</b>	<b>1.81</b>	<b>3.83</b>	<b>0.77</b>	<b>-3.06</b>	<b>42.73</b>
<b>Volga Federal Okrug</b>							
Republic of Bashkortostan	92,579,551.71	699,470.26	0.76	2.84	1.64	-1.20	216.59
Republic of Marii El	13,128,022.11	-592,702.12	-4.51	7.00	4.80	-2.20	-106.31
Republic of Mordovia	20,478,226.97	783,279.89	3.82	0.00	-0.49	-0.49	-12.80
Republic of Tatarstan	106,132,531.90	-2,385,471.72	-2.25	5.19	2.53	-2.66	-112.45
Republic of Udmurtia	34,451,586.93	-914,877.78	-2.66	7.54	4.78	-2.76	-179.82
Republic of Chuvashia	28,244,757.03	-895,311.12	-3.17	4.99	2.17	-2.82	-68.45
Nizhnii Novgorod Oblast	80,358,704.38	468,145.91	0.58	5.43	0.95	-4.48	162.88
Kirov Oblast	29,611,687.81	926,000.43	3.13	4.60	-1.17	-5.77	-37.31
Samara Oblast	82,157,224.34	-4,716,132.03	-5.74	8.74	6.38	-2.35	-111.18
Orenburg Oblast	49,898,389.27	2,881,990.01	5.78	0.07	-0.57	-0.64	-9.78
Penza Oblast	27,879,268.45	-1,280,188.99	-4.59	7.61	6.14	-1.47	-133.71



**Section 2**  
Monetary and budgetary spheres

*Table 47 (continued)*

1	2	3	4	5	6	7	8
Perm Oblast	78,652,551.17	1,076,649.20	1.37	2.39	-0.77	-3.16	-56.34
Saratov Oblast	42,816,991.64	-133,561.87	-0.31	13.72	4.16	-9.56	-1 333.37
Ulianovsk Oblast	27,924,513.67	1,334,045.68	4.78	0.00	-2.07	-2.07	-43.31
Komi-Permiak AO	92,579,551.71	699,470.26	0.76	2.84	1.64	-1.20	216.59
<b>Subtotal</b>	<b>714,314,007.39</b>	<b>-2,748,664.24</b>	<b>-0.38</b>	<b>5.02</b>	<b>2.05</b>	<b>-2.97</b>	<b>-533.79</b>
<b>Urals Federal Okrug</b>							
Kurgan Oblast	19,031,588.33	571,480.95	3.00	0.11	-0.13	-0.24	-4.35
Sverdlovsk Oblast	128,361,459.90	-1,670,701.22	-1.30	0.33	-0.46	-0.79	35.67
Tiumen Oblast	116,758,959.86	-16,672,404.11	-14.28	0.00	0.00	0.00	0.00
Cheliabinsk Oblast	87,362,398.03	6,763,652.90	7.74	0.93	-0.12	-1.06	-1.59
Khanty-Mansi AO	142,436,701.77	-10,085,906.21	-7.08	0.32	0.10	-0.23	-1.34
Yamal-Nenets AO	70,970,620.06	-735,247.69	-1.04	1.59	-1.02	-2.62	98.57
<b>Subtotal</b>	<b>564,921,727.95</b>	<b>-21,829,125.38</b>	<b>-3.86</b>	<b>0.50</b>	<b>-0.23</b>	<b>-0.74</b>	<b>6.03</b>
<b>Siberian Federal Okrug</b>							
Republic of Buriatia	28,166,969.65	279,499.78	0.99	10.89	1.50	-9.39	151.05
Republic of Tyva	10,000,762.46	84,731.85	0.85	1.00	0.94	-0.06	110.75
Altay Krai	47,086,857.66	751,679.61	1.60	2.94	-0.44	-3.38	-27.59
Krasnoyarsk Krai	139,602,541.41	18,876,253.80	13.52	0.50	-2.23	-2.73	-16.50
Irkutsk Oblast	65,743,409.77	-3,363,547.68	-5.12	15.27	5.59	-9.68	-109.18
Kemerovo Oblast	84,258,472.05	-384,086.34	-0.46	2.63	1.10	-1.53	-240.60
Novosibirsk Oblast	72,435,340.13	4,256,321.23	5.88	9.19	-6.96	-16.15	-118.37
Omsk Oblast	51,215,034.17	-3,146,814.32	-6.14	34.76	5.64	-29.11	-91.83
Tomsk Oblast	29,412,047.63	-1,909,180.66	-6.49	28.83	6.81	-22.03	-104.84
Chita Oblast	25,489,357.94	-1,544,476.30	-6.06	6.75	6.67	-0.08	-110.08
Republic of Altay	8,990,361.28	-68,771.17	-0.76	3.39	0.90	-2.49	-117.38
Republic of Khakassia	12,055,910.59	92,648.00	0.77	0.11	-0.06	-0.17	-7.56
Agin Buriat AO	3,725,405.08	-4,013,018.33	-107.72	0.00	0.00	0.00	0.00
Ust-Ordynskii Buriat AO	3,746,947.93	56,467.06	1.51	0.00	0.00	0.00	0.00
<b>Subtotal</b>	<b>581,929,417.74</b>	<b>9,967,706.53</b>	<b>1.71</b>	<b>9.02</b>	<b>0.59</b>	<b>-8.43</b>	<b>34.29</b>
<b>Far-Eastern Federal Okrug</b>							
Republic of Sakha (Yakutia)	65,343,148.94	-751,060.87	-1.15	9.41	0.85	-8.56	-73.54
Primorskii Krai	51,175,077.83	1,967,008.04	3.84	1.34	-0.62	-1.95	-16.03
Khabarovsk Krai	53,844,490.01	4,331,910.13	8.05	2.93	-13.31	-16.23	-165.39
Amur Oblast	28,129,335.38	235,319.21	0.84	9.52	3.08	-6.44	368.46
Kamchatka Oblast	22,469,025.07	1,325,675.00	5.90	27.62	1.51	-26.11	25.67
Magadan Oblast	11,837,588.15	-770,302.34	-6.51	13.47	6.33	-7.15	-97.23
Sakhalin Oblast	37,418,492.61	3,861,515.71	10.32	10.67	-0.97	-11.64	-9.38
Jewish AO	6,372,945.45	67,262.07	1.06	0.47	0.28	-0.19	26.76
Koryak AO	8,333,721.70	1,496,358.40	17.96	13.85	-1.01	-14.87	-5.64
Chukotka AO	14,946,804.60	1,708,345.49	11.43	10.04	-0.81	-10.84	-7.05
<b>Subtotal</b>	<b>299,870,629.73</b>	<b>13,472,030.85</b>	<b>4.49</b>	<b>8.53</b>	<b>-1.84</b>	<b>-10.37</b>	<b>-40.98</b>
<b>Federal Okrugs, total</b>	<b>4,840,116,826.41</b>	<b>38,436,872.27</b>	<b>0.79</b>	<b>5.44</b>	<b>1.13</b>	<b>-4.31</b>	<b>142.61</b>

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

### Internal Bond Loans

In 2007, bond loan issue prospectuses were registered by 26 Federation's subjects and 13 municipal formations (against 27 regional and 16 municipal loans in 2005).

The total volume of bonds being placed in 2007 amounted to 84.2 billion rubles, against 73.3 billion rubles in 2006 (growth, in nominal terms, by 10,9 billion rubles, or by 14.9%). However, the increasing issue volumes, while being ahead of the inflation rate, still fell behind the rate of economic growth. Within one year, the issue volume of subfederal and municipal bonds decreased from 0.28% to 0.26% of GDP (*Table 48*).

On the whole, the volume of the subfederal bonds market increased, in real terms, by 5.2 % – from 189.8 billion rubles in 2006 to 223.6 billion rubles in 2007.

*Table 48*

### Issue Volumes of Subfederal and Municipal Securities (as % of GDP)

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19	0.28	0.14	0.18
Net financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08

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

In 2007, issue prospectuses were registered at the RF Ministry of Finance by: the Republic of Chuvashia, the Republic of Sakha (Yakutia), the Republic of Bashkortostan, the Republic of Karelia, the Republic of Kalmykia, the Republic of Udmurtia, Krasnoyarsk Krai, Krasnodar Krai, the city of St. Petersburg, Volgograd Oblast, Tomsk Oblast, Irkutsk Oblast, Moscow Oblast, Yaroslavl Oblast, Lipetsk Oblast, Nizhnii Novgorod Oblast, Voronezh Oblast, Tver Oblast, Samara Oblast, Kaluga Oblast, Penza Oblast, Novosibirsk Oblast, Kostroma Oblast, Ivanovo Oblast, Ulianovsk Oblast, the cities of Yekaterinburg, Kazan, Tomsk, Blagoveshchensk, Lipetsk, Magadan, Tomsk, Krasnoyarsk, Cheboksary, Elektrostal, Balashikha, as well as Klin and Noginsk raions of Moscow Oblast.

The biggest placements of securities were made by: Moscow Oblast, which accounted for 22.5 billion rubles, or 26.8% of the aggregate volume of territorial issues; the city of Moscow – 22.4 billion rubles, or 26.6%; Irkutsk Oblast – 6.0 billion rubles, or 7.1%; Samara Oblast – 5.0 billion rubles, or 5.9%; Yaroslavl Oblast – 3.6 billion rubles, or 4.3%; and the city of St. Petersburg – 2.8 billion rubles, or 3.3%. Thus, the 6 biggest issuers produced 74.0% of the total volume of issues of regional and municipal bonds being placed.

Besides, big issue volumes were placed by Nizhnii Novgorod Oblast and the Republic of Sakha (Yakutia) – 2.5 billion rubles each; Tomsk Oblast – 1.8 billion rubles; Krasnodar Krai; Republic of Udmurtia and the Republic of Bashkortostan – 1.5 billion rubles each (*Table 49*).

*Table 49*

### Placement of subfederal and municipal securities in 2007

Federation's subject	Issue volume (thousand rubles)	Issuer's share in total issue volume (as %)	Issue volume to internal borrowings (as %)
1	2	3	4
<b>Central Federal Okrug</b>			
Voronezh Oblast	1,000,000.0	1.2	42.4
Ivanovo Oblast	1,000,000.0	1.2	96.0

*Table 49 (continued)*

1	2	3	4
Kaluga Oblast	872,132.0	1.0	38.9
Kostroma Oblast	100.0	...	...
Lipetsk Oblast	800,000.0	1.0	100.0
Moscow Oblast	22,535,327.5	26.8	37.6
Yaroslavl Oblast	3,593,539.9	4.3	64.0
Moscow (city)	22,384,959.5	26.6	99.7
<b>Northwestern Federal Okrug</b>			
Republic of Karelia	985,950.0	1.2	27.7
St. Petersburg (city)	2,750,242.7	3.3	100.0
<b>Southern Federal Okrug</b>			
Republic of Kalmykia	78,344.0	0.1	10.1
Krasnodar Krai	1,500,000.0	1.8	66.5
Volgograd Oblast	1,040,753.2	1.2	30.6
<b>Volga Federal Okrug</b>			
Republic of Bashkortostan	1,488,150.0	1.8	100.0
Republic of Tatarstan (Tatarstan)	1,000,000.0	1.2	18.2
Udmurtia Republic of	1,500,000.0	1.8	57.8
Republic of Chuvashia	1,250,000.0	1.5	88.8
Nizhnii Novgorod Oblast	2,509,400.0	2.98	57.5
Samara Oblast	5,000,000.0	5.94	69.7
Penza Oblast	1,000,000.0	1.2	47.2
<b>Urals Federal Okrug</b>			
Sverdlovsk Oblast	39,175.4	0.1	9.3
<b>Siberian Federal Okrug</b>			
Krasnoyarsk Krai	150,000.0	0.2	21.6
Irkutsk Oblast	6,000,000.0	7.1	59.8
Novosibirsk Oblast	840,000.0	1.0	12.6
Tomsk Oblast	1,891,603.0	2.3	22.3
<b>Far-Eastern Federal Okrug</b>			
Republic of Sakha (Yakutia)	2,500,000.0	3.0	40.7
Amur Oblast	89,519.3	0.1	3.3
Magadan Oblast	360,000.0	0.4	22.6
<b>Russian Federation – total:</b>	<b>84,159,196.5</b>	<b>100.0</b>	<b>32.1</b>

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

So far, a high share of securities was observed mostly in respect of biggest issuers: the city of Moscow – 99.7%, and the city of St. Petersburg – 100%. Lipetsk Oblast и Republic of Bashkortostan borrow exclusively in the form of securities issues.

The aggregate volume of net borrowings on the subfederal and municipal securities market, which are being spent both on covering budget deficit and on debt refinancing against bank credits, amounted in 2007 to 25.9 billion rubles, having decreased by comparison with 2006 (36.5 billion rubles) by nearly 1/3 (*Table 50*).

Table 50

**The Volume of Net Borrowings on the Internal Subfederal and Municipal Securities Market, thousand rubles**

	Consolidated regional budget	Regional budgets	Municipal budgets
<b>2007</b>			
Net borrowings	25,867,011	23,691,970	2,175,041
Attracted resources	84,159,197	79,889,761	4,269,436
Principal debt redemption	58,292,185	56,197,791	2,094,394
<b>2006</b>			
Net borrowings	36,489,742	35,161,627	1,328,115
Attracted resources	73,288,653	66,524,832	6,763,820
Principal debt redemption	36,798,911	31,363,205	5,435,706
<b>2005</b>			
Net borrowings	20,887,596	16,939,894	3,947,703
Attracted resources	81,220,540	75,016,756	6,203,783
Principal debt redemption	60,332,944	58,076,863	2,256,081
<b>2004</b>			
Net borrowings	47,880,300	44,470,128	3,410,172
Attracted resources	79,436,708	74,995,965	4,440,743
Principal debt redemption	31,556,408	30,525,837	1,030,571
<b>2003</b>			
Net borrowings	41,908,199	40,043,511	1,864,688
Attracted resources	61,712,635	59,012,901	2,699,734
Principal debt redemption	19,804,436	18,969,390	835,046
<b>2002</b>			
Net borrowings	17,696,530	17,153,760	542,770
Attracted resources	29,141,777	28,169,158	972,619
Principal debt redemption	11,445,247	11,015,398	429,849
<b>2001</b>			
Net borrowings	6,601,447	6,667,592	-66,145
Attracted resources	15,123,785	14,226,931	896,854
Principal debt redemption	8,522,338	7,559,339	962,999
<b>2000</b>			
Net borrowings	-1,877,328	-2,286,175	408,847
Attracted resources	13,042,220	10,090,208	2,952,012
Principal debt redemption	14,919,548	12,376,383	2,543,165

Source: RF Ministry of Finance.

Most of the regions regularly issuing debt securities continued their issue in 2007. Since 1999, annual issues of bonds are placed by the city of St. Petersburg, the Republic of Chuvashia, and Volgograd Oblast; since 2000 – Tomsk Oblast and the city of Yekaterinburg; and since 2001 – Irkutsk Oblast (Table 51).

Table 51

**Registration Issue Prospectuses of Subfederal and Municipal Securities in 1999–2007**

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007
1	2	3	4	5	6	7	8	9	10
<b>Federation's subject</b>									
St. Petersburg (city)	*	*	*	*	*	*	*	*	*
Republic of Chuvashia	*	*	*	*	*	*	*	*	*
Volgograd Oblast	*	*	*	*	*	*	*	*	*
Tomsk Oblast		*	*	*	*	*	*	*	*
Irkutsk Oblast			*	*	*	*	*	*	*
Moscow Oblast				*	*	*	*	*	*
Republic of Sakha (Yakutia)				*	*	*	*	*	*
Yaroslavl Oblast					*	*	*	*	*
Krasnoyarsk Krai					*	*	*	*	*

*Table 51 (continued)*

1	2	3	4	5	6	7	8	9	10
Republic of Bashkortostan			*	*		*	*	*	*
Republic of Karelia						*	*	*	*
Lipetsk Oblast						*	*	*	*
Nizhnii Novgorod Oblast						*	*	*	*
Voronezh Oblast						*	*	*	*
Tver Oblast				*	*		*	*	*
Samara Oblast					*		*	*	*
Kaluga Oblast						*		*	*
Irkutsk Oblast								*	*
Penza Oblast								*	*
Novosibirsk Oblast	*				*	*	*		*
Kostroma Oblast				*	*		*		*
Republic of Udmurtia							*		*
Krasnodar Krai						*			*
Ivanovo Oblast									*
Republic of Kalmykia									*
Ulianovsk Oblast									*
Moscow (city)	*	*	*	*	*	*	*	*	
Republic of Komi		*	*	*	*	*	*	*	
Belgorod Oblast				*	*		*	*	
Kirov Oblast							*	*	
Republic of Marii El		*			*	*		*	
Tambov Oblast					*			*	
Kurgan Oblast								*	
Tula Oblast								*	
Khabarovsk Krai				*	*	*	*		
Republic of Kabardino-Balkaria		*					*		
Leningrad Oblast			*	*	*	*			
Yamal-Nenets AO					*	*			
Briansk Oblast						*			
Khanty-Mansi AO				*	*				
Murmansk Oblast				*	*				
Republic of Mordovia				*					
Sakhalin Oblast				*					
Kursk Oblast				*					
Stavropol Krai			*						
Primorskii Krai		*							
<b>Municipalities</b>									
Yekaterinburg		*	*	*	*	*	*	*	*
Kazan							*	*	*
Klin raion, Moscow Oblast							*	*	*
Tomsk					*	*		*	*

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*Table 51 (continued)*

1	2	3	4	5	6	7	8	9	10
Noginsk raion, Moscow Oblast						*		*	*
Blagoveshchensk								*	*
Lipetsk								*	*
Magadan								*	*
Tomsk								*	*
Krasnoyarsk					*	*	*		*
Cheboksary	*						*		*
Elektrostal, Moscow Oblast									*
Balashikha, Moscow Oblast									*
Novosibirsk					*	*	*	*	
Volgograd	*	*	*	*	*		*	*	
Odintsovo raion, Moscow Oblast							*	*	
Astrakhan								*	
Briansk								*	
Voronezh								*	
Orehovo-Zuevo, Moscow Oblast								*	
Yaroslavl								*	
Iuzhno-Sakhalinsk					*	*	*		
Novocheboksarsk	*		*			*	*		
Angarsk,							*		
Vurnarskii raion, Republic of Chuvashia							*		
Shumerlia, Republic of Chuvashia							*		
Ufa				*	*	*			
Barnaul						*			
Perm						*			
Nizhnii Novgorod				*					
Kostroma	*	*							
Arkhangelsk	*								
Dzerzhinskii	*								

Source: RF Ministry of Finance.

***Credit Capacity of Territorial Bodies of Authority***

***Credit Rating***

Despite the continuing decline in the accumulated sovereign debt to GDP ratio, in 2007 Russia's by-country credit rating in respect of its obligations in foreign currency was not increased by international credit rating agencies and remained at the 2006 level: "BBB+" by the

scale applied by Standard&Poor's and Fitch. Since 2005, its international sovereign credit rating “Baa2”, as estimated by Moody's, also remained unchanged.

At the same time, the credit ratings of territorial bodies of authority continued to be on the rise. Thus, the rating of St. Petersburg was raised by Fitch to “BBB”. Besides, the investment level credit rating of “BBB-“ was assigned by Standard&Poor's to Khanty-Mansi Autonomous Okrug.

Three rating agencies estimated the credit risk of the city of Moscow against its international obligations as being at a by-country level. None among all the other Russian regions and municipal formations succeeded in obtaining an investment-level credit rating assigned by any of the rating agencies (*Table 52*).

*Table 52*

**Standard&Poor's International Credit Rating, as of early 2008**

Issuer	Denominated in foreign currency / Forecast	Denominated in national currency / Forecast
<b>Sovereign rating</b>		
Russian Federation	“BBB+”/Stable/	“A-”/Stable/
<b>Rating of regional and local bodies of authority</b>		
Balashikha raion	“B”/Positive/	“B”/Positive/
Bashkortostan	“BB”/Positive/	“BB”/Positive/
Bratsk	“B”/Positive/	“B”/Positive/
Volgograd Oblast	“BB-”/Stable/	“BB-“/Stable/
Vologda Oblast	“BB-”/Stable/	“BB-“/Stable/
Irkutsk Oblast	“B+”/Stable/	“B+”/Stable/
Klin raion	“B-”/Positive/	“B-”/Positive/
Krasnodar Krai	“BB-”/Positive/	“BB-”/Positive/
Krasnoyarsk Krai	“BB+”/Stable/	“BB+”/Stable/
Leningrad Oblast	“BB-”/Positive/	“BB-»/Positive/
Moscow (city)	“BBB+”/Stable/	“BBB+»/Stable/
Moscow Oblast	“BB”/Positive/	“BB»/Positive/
Nizhnii Novgorod	“BB-”/Positive/	“BB-”/Positive/
Novosibirsk	“B+”/Positive/	“B+”/Positive/
Omsk	“B”/Stable/	--/--/--
Samara Oblast	“BB”/Positive/	“BB”/Positive/
St. Petersburg (city)	“BBB”/Stable/	“BBB”/Stable/
Sakha (Yakutia)	“B+”/Stable/	“B+”/Stable/
Sverdlovsk Oblast	“BB”/Positive/	“BB»/Positive/
Stavropol Krai	“B+”/Stable/	“B+”/Stable/
Surgut	“BB-”/Stable/	“BB-”/Stable/
Tatarstan	“BB-”/Positive/	“BB-”/Positive/
Tver Oblast	“BB-”/Stable/	--/--/--
Ufa	“B+”/Positive/	“B+”/Positive/
Khanty-Mansi Autonomous Okrug	“BBB-”/Stable/	“BBB-”/Stable/
Yamal-Nenets Autonomous Okrug	“BB+”/Positive/	“BB+”/Positive/

*Source:* Standard&Poor's.

It should be noted that, in accordance with the new wording of Article 104 of the RF Budget Code<sup>72</sup>, those RF subjects whose estimated share of interbudgetary transfers received from the federal budget (except subventions) in the last two out of the last three reporting did not exceed 5 % of the volume of their own consolidated budget revenue, from 1 January 2011 will be granted the right to attract external borrowings not only for purposes of repaying their external debt, but also for covering their budget deficit, i.e., to make new borrowings in foreign currency.

### Settlement of Regional Budgets' Stale Debt

Against the backdrop of a stable improvement of the budget situation in the majority of subjects of the Russian Federation, the process of stale debt settling was continuing.

According to the data published by the RF Ministry of Finance (*Table 53*), the volume of stale (unsettled) debt of regions against their debt obligations as of October 2007 decreased against that in October 2006 by 2.0 billion rubles in face value – from 7.0 to 5.0 billion rubles. By comparison with October 2005 (14.2 billion rubles), stale debt in face value declined nearly threefold, constituting only 0.12% of RF subjects' total budget revenue, or less than 0.02% of GDP.

The most serious situation in respect of unsettled debt obligations was observed in the following regions: Tiumen Oblast – 2.4 billion rubles, or 2.5% of its budget revenue; Kostroma Oblast – 0.6 billion rubles, or 6.0% of its budget revenue; Novgorod Oblast – 0.6 billion rubles, or 5.4% of its budget revenue; the Republic of North Osetia – Alania – 0.6 billion rubles, or 4.9% of its budget revenue; Orenburg Oblast – 0.5 billion rubles, or 1.4% of its budget revenue.

*Table 53*

### Stale (Unsettled) Debt Against RF Subjects' Obligations

Federation's subjects	Volume of stale (unsettled) debt (thousand rubles) <sup>73</sup>	Stale (unsettled) debt to budget revenue ratio (as %) <sup>74</sup>
1	2	3
<b>Central Federal Okrug</b>		
Kostroma Oblast	631,449	6.01
Kursk Oblast	77,982	0.44
Moscow Oblast	8,675	0.01
<b>Northwestern Federal Okrug</b>		
Kaliningrad Oblast	7,220	0.04
Novgorod Oblast	626,078	5.40
Pskov Oblast	26,538	0.23
St. Petersburg (city)	10,690	...
<b>Southern Federal Okrug</b>		
Republic of North Osetia – Alania	612,987	4.87
<b>Volga Federal Okrug</b>		
Republic of Bashkortostan	10,883	0.01
Nizhnii Novgorod Oblast	2,190	...

<sup>72</sup> Envisaged by Federal Law of 26 April 2007, No. 63-FZ3.

<sup>73</sup> As of 1 October 2007.

<sup>74</sup> Ratio of stale (unsettled) debt as of 1 October 2007 to revenue of a regional (non-consolidated) budget in 2007.



*Table 53 (continued)*

1	2	3
Orenburg Oblast	537,872	1.37
Samara Oblast	8,765	0.01
Saratov Oblast	1,170	...
<b>Urals Federal Okrug</b>		
Sverdlovsk Oblast	2,262	...
Tiumen Oblast	2,398,298	2.53
<b>Siberian Federal Okrug</b>		
Novosibirsk Oblast	1,020	...
<b>Far-Eastern Federal Okrug</b>		
Republic of Sakha (Yakutia)	4,276	0.01

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

Besides, the process of diminishing the volumes of accumulated arrears of payables in regional budgets continued as before. According to the data published by the Experts' Economic Group, in 2007 the aggregate volume of arrears of payables in the regions decreased by 16.3 billion rubles (or by 28.1% of its volume as of the end of 2006).

### 2.6.3. Stock Market

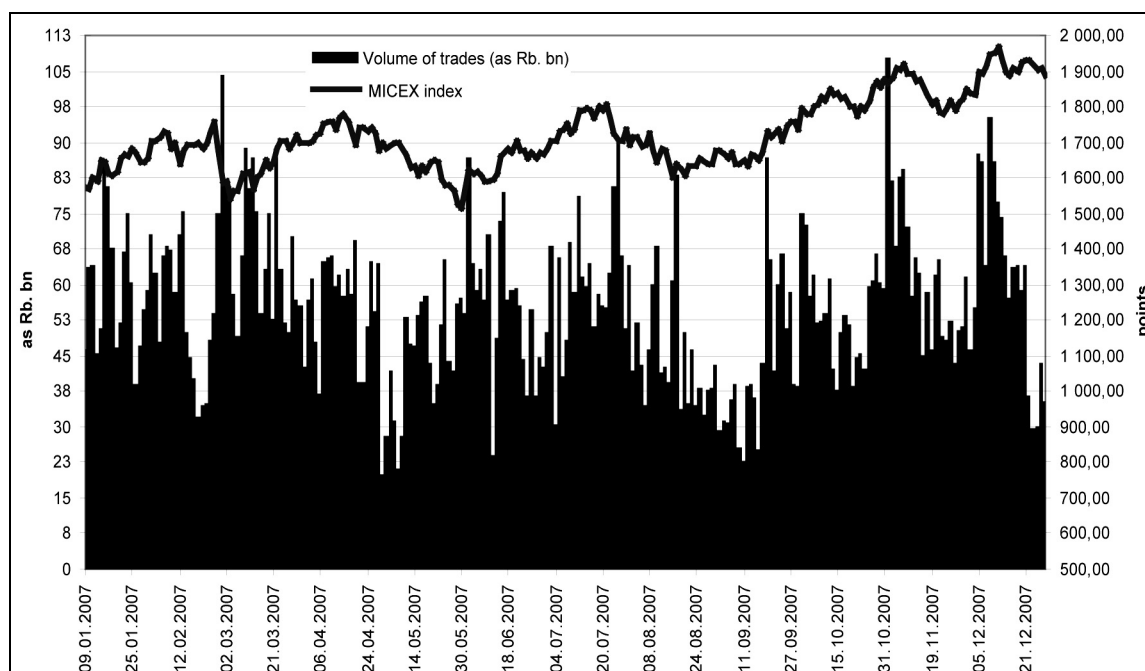
In contrast to the prior year, the 2007 Russia's stock market demonstrated alternate trends. The group of major factors that shaped them comprised negative situation on the US mortgage market and the dynamic of the US bonds, which are beacons for the world debt market, an intense volatility of prices on the world market for oil and metals over the year, and appreciation of Rb. against the US Dollar. Underpinning some fall on the stock market in the early-2007 was a decline in China's stock market after the national government let the world know it might introduce control over transactions involving Chinese companies' stock. That trumpeted the start for investors' quitting the national market, as well as other emerging markets, including Russia's. In addition, Russia's banking sector began to be challenged by a lower volume of liquidity, albeit CBR undertake some steps to boost it, which had a positive effect on the dynamic of the national market. Another boost to the world markets was given by the Fed's decisions to cut the interest rate, because of economic challenges facing the US economy. That was done several times over the year and helped boost the world markets and restore Russia's in particular. Plus, the situation in the macroeconomic sphere in Russia remained fairly favorable.

The market also capitalized on internal corporate news. More specifically, the financial performance by most corporations in the mineral, telecom, as well as other sectors, over the first and second quarters was far better than in 2006, so investors took a greater liking in them. As well, the awarding some public corporations with a higher rating also became a positive signal for the market.

Russia's 2007 MICEX's stock index rose at 316.93 points (from 1,571.93 to 1,888.86), or at 20.16% per cent to its value as of the moment of closure of trades on January 9, 2007 (the respective 2006 index was 59.03%). So, last year, the stock market once again demonstrated rather impressive growth rates, although notably less, in relative terms, than in 2006. The bottom value of the MICEX index in 2007 was registered on May 30 (1,516.09 p.), while the historical peak was reached on December 12 (1,969.91 p.). As concerns investors' activity, it grew notably vs. the prior year. More specifically, the 2007 turnover on the market of stock

included in the base of the MICEX index roughly accounted for Rb. 13,611.71 bn, with the average daily turnover being 55.33 bn, which was far greater than in 2006 (9.907,32 bn and 40.27 bn, respectively). So, the 2007 volume of trades soared at more than 35% vs. its respective index of 2006.

Meanwhile the dynamic of the market displayed a great deal of volatility and allowed identification of several characteristic up-and down-periods, so far as the MICEX index quotations are concerned. Specifically, between January and August 2007 the market passed through three such periods, with an upward trend being in place between January and February and, consequently, between mid-March and mid-April, and early June through mid-July. Interestingly, in these periods there occurred periodical downward adjustments. In the frame of the said interval (until late-August), the index was on the decline during the rest of the periods. In the period in question the peak value was 1,807.28 p. by the MICEX index (registered on July 23, 2007), while the bottom value was registered on May 30, 2007 and it accounted for 1,516.09 p. As seen on *Fig. 23*, while short-living, the adjustment moves were accompanied by a considerable rise in the volume of trade. The distinguishing feature of the next period – between September and December 2007 – became a sustained growth up to the next historical maximums which the MICEX index hit on 12 December (1,969.91 p.). Meanwhile, since mid-September the market was growing upon volumes of trade far greater than those registered in the middle of the year when it displayed a fairly intense volatility. The 2007 MICEX aggregate stock trade volume was some Rb. 13,611.7 bn.



*Fig. 23. Dynamics of the MICEX Index and Trading Volume in 2007*

While analyzing the monthly dynamic of the Russian stock market, it is worthwhile noting that since the opening trading session in January 2007 the stock market demonstrated a notable fall engendered by the declining world prices for minerals, which had occurred in the every early January when Russia's trading spots were on holidays. It was the banking sector's

stock, primarily that of Sberbank of Russia (affected by news on additional placement of its stock in the 1<sup>st</sup> quarter 2007), electricity (RAO UES Riussia), and Norilsk Nickel (in anticipation of the renewal of an upward trend in nickel prices on the world market) that weathered the fall better than others. An additional negative factor became a new fall on the US stock market. However, since the third week of January the set of the pricing factors underwent dramatic changes. Thus, oil prices discontinued to fall and began rising, which automatically affected quotations of the national oil and gas corporations' stock. Besides, a series of favorable corporate news (from RAO UES Russia, Severstal, and Rosneft) provided an additional support to these companies' stock and the market on the whole.

During February the locomotive of the dynamic of Russian stock remained the world oil prices. Specifically, in early February they found themselves within the range between USD 50 and 60/barrel, which engendered instability of the price rise for Russian stock. The situation was fairly favorable in the electricity sector, as investors were clearly in the mood to buy, and quotations were climbing up with much certainty. More specifically, RAO UES's stock was rallying steadily, which can be explained by S&P raising its credit rating from B+ to BB. Plus, except for a short-term adjustment in the middle of the month, the market was steadily on the rise, under the impact of some other factors, through the beginning of the last week of the month.

In early March, Russian stock plummeted on the news China's government let the world know it might introduce control over transactions involving Chinese companies' stock. That trumpeted the start for investors' quitting the national market, as well as other emerging markets, including Russia's. As a result, the MICEX index slid slightly in the first week of the month. The next week the decline ceased, and the market succeeded in winning back the fall a bit, with the help of steadily high oil quotations and thanks to renewal on the world markets. However, the positive adjustment was short-living, and, starting from the second half of the month it was external factors adverse to its rise that played a major part on the market. The world markets were down, and so were the world oil prices, while the price rise for nickel and a number of other metals helped to keep afloat only metallurgical corporations. The presence of uncertainty associated with expectations of the regular Fed's decision on interest rates exerted an inhibiting influence on stock prices. As concerns corporate news, it is worth noting a very successful placement of an additional issue of the OGK-3 stock that Norilsk Nickel bought well above market. That resulted in a notable rally of RAO UES's stock, which in turn propelled the dynamic of stock indices.

In early April, the situation remained fairly favorable, with main stock indicators rising smoothly and the most liquid papers consolidating at earlier attained levels. The consolidation was there, because indices were approaching their historical peaks when a part of investors can fix their packets, as well as because the world oil prices were down after the tension between UK and Iran had eased. It was the stock of the electricity and banking sectors that posted a sustained growth, which was driven by investors' increasing interest against the background of advancement of the electricity sector reform and the upcoming VEB's IPO whose ultimate objective was to extend the list of the blue chips and the one of the banking sector's papers, as investors were keen to buy those. The third week of the month passed under the sign of adjustment, and after some period of rise, Russia's stock market started rolling downhill. Despite a relative stability on the world stock markets, Russian stock prices were going down, driven by falling world prices for oil, as the tension around Iran's nuclear prob-

lem was easing, and, consequently, chances for a military conflict with the US were becoming much lower. It was the beginning of the last week of April that the quotations showed some rise.

In early May, the market was down again, steered by technical and seasonal factors associated with the traditional national holidays. But there also were a series of fundamental factors, the most critical of which became a new downfall in the world oil prices. Even a positive dynamic on the world stock-exchanges failed to keep Russian stock afloat. It was just Sberbank of Russia's stock, which, after publication of its financial performance by IAS, as well as Norilsk Nickel's stock, due to a notable rise in the world nickel prices, that demonstrated a positive dynamic by results of the first week of May. Since the second week of the month quotations of a whole series of the blue chips were up at 1.5–5.5%, which was explained by a notable rise in the world oil prices and a fairly favorable situation on the main stock exchanges worldwide. As well, RAO UES Russia's stock was on the rise, which also had a certain effect on the market dynamic. By contrast, the oil-and gas corporations' stock were either stagnant or even down, as investors were anticipating their poorer performance indicators in the first half of the year. The dynamic was also shaken by such an additional negative factor as Mr. A. Greenspan's presentation: he voiced his concerns of a rapid growth of China's stock market and noted a high probability of its notable decline in the future. The integrity of the above factors aggravated the situation on Russia's market and drove the respective indices down to their early-2007 values.

June 2007 brought about a better mood, as the national stock market began to rise gradually from the beginning of the month. The oil companies' stock quotations found themselves on fairly attractive levels, thus bolstering the respective demand. Plus, the situation on the external market remained favorable, as the developed countries and emerging markets' main trading spots were on the rise, too. The beginning of the second half of the month was signified by a rise in main stock indicators, while by the end of the month the indices were moving in alternate directions. A price downfall for oil in the end of the month drove the oil-and-gas sector's quotations down, while anticipation of positive news of the Russian corporations' performance in early-2007 kept the quotations buoyant. As concerns papers that had a positive impact on quotations, Norilsk Nickel's ones are worth a particular notice, as their price was rising following the price rise for main metals on the world market. Overall, the absence of a clearly visible trend could be determined by investors' anticipating the Fed's meeting scheduled for June 28, 2007.

Since the very early July market was on the rise, steered by an increasing demand for oil, gas and metal companies' papers. While oil prices nearly hit their historical peaks, the investors' enthusiastic demand might have been a consequence of a fundamental reassessment of investment in Russia's oil and gas sector. The domestic news was positive, too. Thus, in July, Moody's raised Rosneft's credit rating from Baa2 up to Baa1. Plus, the national stock market capitalized on the developed nations and emerging markets' positive dynamics. But in the second half of the month the growth ceased, which was caused in part by technical factors, as main stock indices had hit their absolute peak values and a further dynamic required emergence of fundamental factors. In addition, the world stock markets were sending mixed signals, as during a week their rise could alternate with a fall. Overall, oil kept Russia's stock market afloat, which is why after a short-term drop quotations began to rally on the US data.

August became a bad month, with the situation on the national stock market deteriorating and market volatility growing notably. That the market was down in the beginning of the month can be explained by lower oil prices and the absence of significant positive domestic factors. Plus, the situation on the world stock spots was gloomy, due to negative news from the US mortgage and financial sectors, as well as a series of publications on Russian companies' poor performance in the 1<sup>st</sup> quarter 2007. And if it was not enough, the situation with liquidity in the Russian banking sector was far from ideal, too. In the second half of the month, the negative dynamic of Russian stock indices was replaced by their rise, which in part became possible thanks to the rise in the world oil prices and restoration of the world stock indices.

By the end of September it became evident that the Russian stock market posted a significant growth, despite the global financial turmoil and a dramatic aggravation of the situation with Rb.-denominated liquidity in the domestic banking sector. It goes without saying, main factors underpinning the rally became the cuts in the US basic interest rate, historically high oil prices, and a series of positive updates from the corporate sector. While investors' activity on the stock market was fairly low over the first half of the month, the stocks posted a notable rise in the wake of the Fed's decision. The upward trend was there until the end of the month.

In October, the stock market continued its rise. The Russian market closely monitored news from the world ones, which were soaring mostly under the impact of corporate news: while some European banks confirmed their writing off losses engendered by the US mortgage crisis, the rising US indices helped reverse the negative tendency. In mid-October, the growth continued against the background of a stable rise in the world oil prices, CBR's decisions to maintain the Rb.-denominated liquidity, and a number of positive corporate news. The general dynamic of the market found itself under a notable impact of the oil and gas sector, which once again became attractive to investors. After a minor adjustment in the middle of the month indices continued to surge closer to its end, which to a significant degree was determined by record-breaking oil prices and greater expectations of further cuts in the Fed's rate.

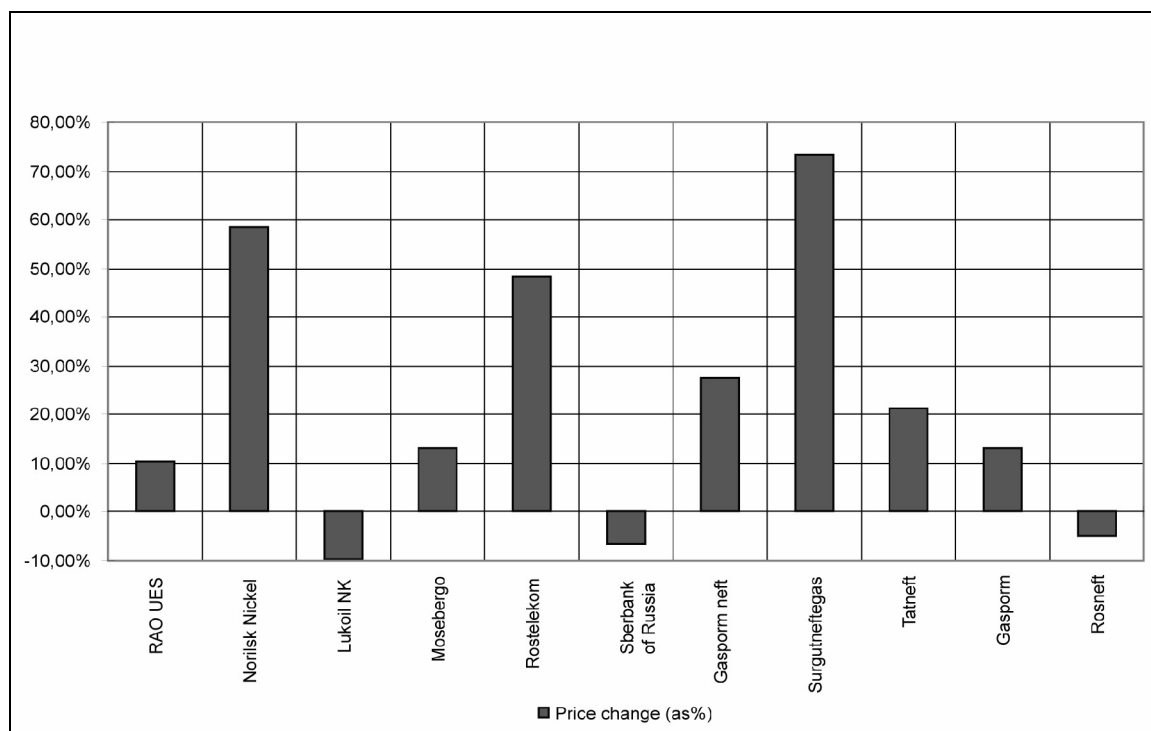
In November, market sensed loose performance of the biggest US mortgage operators, as there intensified the fear of yet greater losses associated with the US mortgage market and stagnation of economic growth. The Russian stock market displayed an obvious downward trend over the month. Meanwhile, the general market dynamic was affected by a growing interest in the oil and gas sector stirred by the rising world oil prices, the CBR's decisions to back-up the Rb.-denominated liquidity, and a series of positive corporate updates. As a result, on November 8, 2007, the MICEX index hit a new record-breaking level, that is, 1,917.29 points, or at 13.22% greater than its respective value as of the early-2007.

Once the Fed ruled to cut its key interest rate at 1.4 p.p., participants in Russian exchanges welcomed it with much gusto, and the Russian stock market enjoyed an upper hand over the month. Meanwhile, the general dynamic of the market was under the positive influence of activity in the oil and gas sector, the CBR's decisions to back-up the Rb.-denominated liquidity, and a series of positive political and macroeconomic factors. As a result, on 12 December the MICEX index once again broke a new record value of 1,969.91 p., or at 16.42% greater than in the early-2007, which mirrored the general trend to growth in quotations of Russian corporate stock.

As in 2006, the year of 2007 saw values of the most liquid Russian companies post a notable rise (*Fig. 24*). Specifically, it was Surgutneftegas' s stock investment in which ensured the greatest return rate of 73.5%, followed by Norilsk Nickel's (58.3% up) and OAO Rostelekom (48.2% up) ones.

The group of the most successful performers also included OAO Gasprom нефт, whose stock posted a 27.5% growth in value over 2007, OAO Tatneft (21.2%), and a group of other corporations whose results appeared slightly less impressive – Gasprom (+13.2%), OAO Mosebergo (13.1%), and RAO UES (10.5%). Meanwhile, quotations of some Russian corporations' stock displayed an opposite dynamic. More specifically, LUKOil suffered from the greatest decline in its stock quotations which last year plunged at 9.6%, while Sberbank and Rosneft's stock dropped at 6.3 and 4.8%, accordingly.

It was Gasprom's stock that became a leader in terms of turnover at MICEX (over 35% of the aggregate turnover at the exchange), which undoubtedly can be attributed largely to the start of their free circulation. Norilsk Nickel also was in the leading group with its proportion of slightly over 15% of the overall stock turnover at MICEX, Lukoil was the third with some 10%, while RAO UES and Sberbank were lagging far behind them (compared with the respective level as of the start of trades at MICEX in 2000), with their 2007 aggregate proportion accounting for some 15%. Hence, in 2007, the proportion of transactions involving the blue chips at MICEX was some 90% of the total turnover at the exchange.



Source: Moscow Interbanking Stock Exchange.

*Fig. 24. Dynamics of Quotations of the Russian “Blue Chips” by the 2007 Results*

According to the MICEX data, as of December 28, 2007, the top five largest corporations by capitalization were: Gasprom – Rb. 7,448.4 bn (vs. 6,960.7 bn in 2006), Sberbank – 2,160.9 bn, Rosneft – 2,067.0 bn (2,269.9 bn in 2007), LUKOil – 1,883.3 bn (1,926.3 bn in

2006), and Norilsk Nickel – 1,362.1 bn (780.8 bn in 2006). So, the rating has not changed drastically since 2006, but it should be noted that 4 out of the top five companies represented the oil and gas sector, which is explained by a very favorable situation on the mineral markets in 2007. Like in 2006, Sberbank once again became the only representative of the non-mining sector with the greatest capitalization.

#### *The market for Open Contracts*

The turnover of the market for open contracts has posted an impressive growth from year to year, and 2007 has not become an exception in this regard. For example, by the 2007 results, the aggregate turnover of trade with futures and options in this particular segment of Russia's financial market at the RTS's market for open contracts roughly accounted for Rb. 7,531.2 bn (vs. nearly 2,708.5bn in 2006). In other words, this market has grown practically 3.5 times since 2006. Participants in the trades stroke over 11.7m deals and concluded 145.1 m contracts (vs. some 5 m deals and 89.6 m contracts reported in 2006). Like in 2006, the segment of open contracts was dominated by transactions with futures, whose proportion roughly accounted for 82.8% of the aggregate volume of trades, or Rb. 6,207.3 bn (2,397 bn in 2006), while options deals were worth a total of Rb. 1,323.9 bn (311.4 bn in 2006), which means that in terms of turnover the 2007 share of transactions with options remained practically the same as in 2006.

As concerns the rating of popularity, investors clearly preferred the RTS index futures, followed by contracts on Gasprom, RAO UES and LUKoil's stock over others.

#### *The Market for Corporate Bonds*

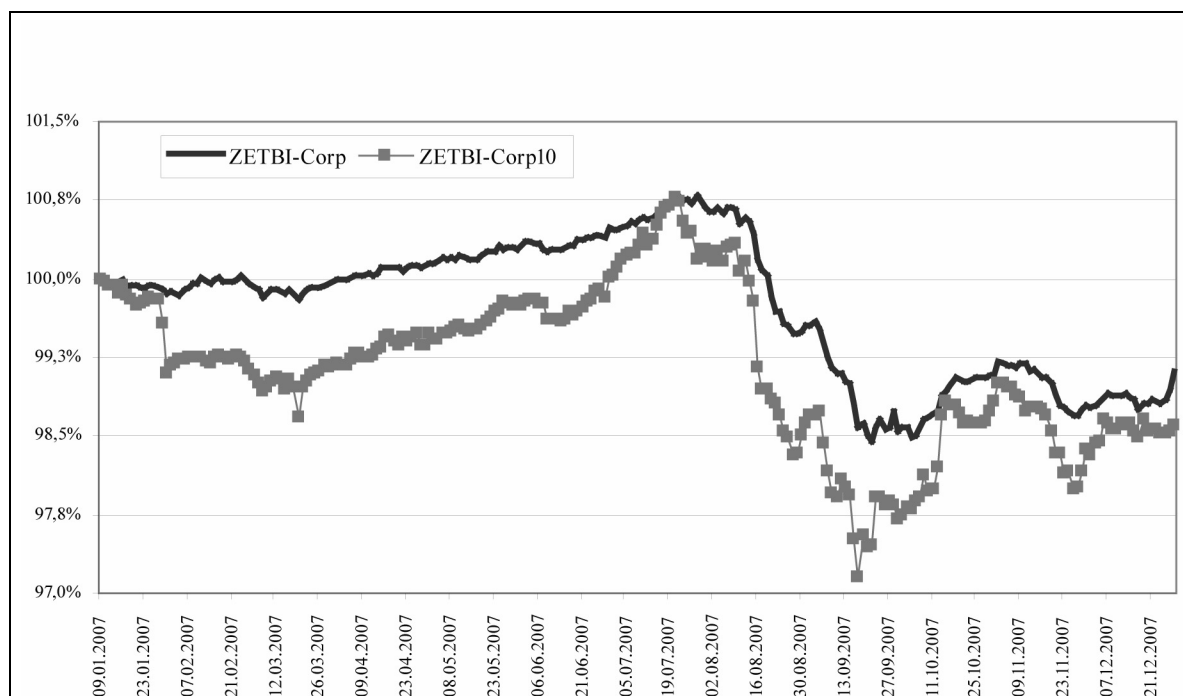
In 2007, the market for corporate and regional bonds was by and large dominated by an upward trend, as evidenced, in particular, by the dynamic of the corporate bond index calculated by Zenit bank on the basis of market quotations of bonds traded at MICEX. Thus, by the 2007 results, the ZETBI-Corp index slid by 0.97 points (–0.85%) – from 111.01 to 110.04 points.

Meanwhile, the 2007 ZETBI-Corp 10 calculated on the basis of quotations of the most liquid corporate bonds demonstrated yet a greater fall – from 119.01 to 117.35 points (–1.39%).

When compared with the market for government bonds, quotations of the corporate debt in 2007 displayed somewhat greater volatility. Meanwhile, it is possible to identify several periods in 2007, during which prices behaved in different ways (*Fig. 25*). More specifically, a downward trend persisted between January and March, August and September (when it became more intense than in the first period), and in November, while during other periods the market dynamic appeared more positive.

An analysis of the monthly dynamic of quotations allows one to note that the market for corporate debt was characterized by alternate dynamics of quotations of trade issues and a poor activity by participants in the primary and secondary markets. Thus, given that in early January the quotations changed insignificantly in both directions, the downward trend manifested itself more distinctly in the second half of the month. A fairly favorable situation with liquidity in the banking sector and the absence of huge placements formed a supporting factor, while the investors' fairly low activity against the background of a deteriorating situation on

the external debt market, declining world prices for oil and the stock market did not encourage a rise in quotations.



Source: Zenit bank.

*Puc. 25. Dynamics of Price Indices of Corporate Bonds in 2007 (9 January 2007 =100%)*

By results of February 2007 the market for the Rb-denominated corporate debt saw some improvement of the state of affairs, as investors' activity rose significantly. In early February, the quotations posted some growth, capitalizing on a fairly favorable situation in the banking sector and a relative stability of the Russian Eurobonds that were following the US T-bonds' path. However, in late-February, because of the impact of the deteriorating situation with liquidity in the banking sector, most quotations of corporate bonds demonstrated a moderate decline, with just positive signals from the external market keeping them afloat.

The quotations of corporate bonds practically had not changed by the end of March, albeit their dynamics during the month were different. Thus, between the beginning of the month and mid-March their yields rates displayed alternate fluctuations. That took place against the background of a dramatic decline in quotations on the stock market, problems with liquidity in the banking sector, and the dynamic of the domestic forex market. The yields rates began to rise since mid-March.

Between April and the first half of June the situation on the market for corporate debt was being fairly favorable against the background of rising quotations of corporate bonds and investors' growing activity. The situation with liquidity stabilized and, along with appreciation of Rb. against USD, that helped boost demand for corporate debt instruments. Auctions held in that period proved that investors were keen to purchase the bonds, as many issues were placed without an additional premium to the secondary market.

The situation changed cardinally between mid-July and September, and like other segments of the national financial market, the one for corporate debt demonstrated a notable fall.



That was chiefly steered by the increasingly negative news from the US. Thus, the Russian market entered the period of a large-scale decline due to activation of the impact of negative factors. The crisis on the US subprime market compelled nonresidents to pull capital out of Russian bonds, which fueled the depreciation process of Rb. That in turn formed an additional factor that lowered attractiveness of investment in Rb-denominated assets. Plus, the deterioration of the situation on the domestic market for debt where interest on financial resources grew dramatically and banks axed volumes of mutual crediting battered heavily the quotations of the Rb-denominated corporate debt. So, most factors in that period fueled decline of the national market for debt.

October ended with some improvement of the situation on the market for Rb-denominated corporate bonds, as the Fed had ruled to cut the basic interest rate. The dynamic of quotations once again became upward, nonetheless, during the first decade of the month prices for bonds were sliding, which was chiefly determined by the continuous problems with liquidity. However, the timely cuts in the norm of compulsory reserves and interest rate by CBR's forex-denominated swaps, as well as extension of its lombard list and the list of instruments that CBR accepts as a collateral under REPO transactions partly improved the situation with liquidity, which propelled the rise in quotations of corporate bonds. But rates on the market for interbanking credits failed to drop lower than 5–6% annualized by the end of the month, thus mirroring not only the banks' need in liquidity to effect tax payments, but an incomplete restoration of the monetary market against the background of a greater uncertainty on external markets, either. As a result, these factors had an inhibiting effect on quotations of the bonds by the end of the month.

November 2007 witnessed a considerable decline in the aggregate volume of trades on corporate bonds (at some 30%) vs. the prior month. The aggregate volume of coupon payments also plunged by some 20%, while in December the market experienced a significant rise in the volume of trades on the corporate bonds (over 30%) vs. that in November.

Overall, in 2007, the aggregate volume of transactions on the market for corporate bonds roughly accounted for Rb. 570.7 bn vs. some 515.4 bn registered in 2006. Thus, it can be argued that there occurred a notable (at 10.7%) growth in offer on the market in question. Specifically, the peak volume of turnover of the section of corporate bonds on the market was registered in December (a. Rb. 58.6 bn vs. 85.8 bn in December 2006), while the minimum one was 23.5 bn – in January (vs. 13.9 bn in May 2006).

#### *Factors of the Dynamics of Russia's Stock Market*

The 2007 dynamic of Russian stock market was steered by a whole series of factors which, for a greater convenience, can be tentatively split into the following groups:

- The domestic political situation;
- Relationship with international financial institutions and organizations;
- Situation on international financial markets;
- Situation on the world mineral markets (the oil market in particular);
- Corporate news.

Each group exerted its specific impact on the dynamic of different segments of Russia's financial market in 2007, and most of them were already referenced while analyzing dynamics of different sectors of the national financial market.

**Relationship with International Financial Institutions and Organizations**

In September, S&P kept Russia's sovereign rating at the level of the "stable" forecast, and Fitch agreed with that, which gave a signal to investors to intensify their operations on the Russian markets. But S&P's report also suggested that Russia's economic stability might collapse in a not-so-distant future.

**Situation on International Financial Markets**

The year of 2007 saw some improvement of the state of affairs on the global stock markets (see *Table 54*), albeit not as notable as in 2006.

*Table 54*

**Dynamics of the World Stock Indices in 2007**

Data as of December 29, 2007	Code	Value	Change over 2007 (as %)
MICEX (Russia)	MICEXINDEXCF	1,888.86	11.54
RTS (Russia)	RTSI	2,290.51	19.18
Dow Jones Industrial Average (US)	DJI	13,365.87	7.24
NASDAQ Composite (US)	NASD	2,674.46	10.73
S&P 500 (US)	SPX	1,478.49	4.24
FTSE 100 (UK)	FTSE	6,476.9	4.12
DAX-30 (Germany)	DAX	8,067.32	22.29
CAC-40 (France)	CAC	5,627.25	1.54
Swiss Market (Switzerland)	SSMI	8,484.46	-3.43
Nikkei-225 (Japan)	NIKKEI	15,307.78	-11.13
Bovespa (Brazil)	BUSP	63,886.1	43.65
IPC (Mexico)	IPC	29,700.19	12.30
IPSA (Chile)	IPSA	3,051.83	13.31
Straits Times (Singapore)	STI	3,445.82	15.41
Seoul Composite (South Korea)	KS11	1,897.13	32.25
ISE National-100 (Turkey)	XU100	55,698.42	42.39
Morgan Stanley Emerging Markets Free Index	EFM	1,005.66	10.19

More specifically, by the 2007 results the US stock indices demonstrated rather a firm growth. Thus, by results of the year Dow Jones Industrial gained 1,028 p. (7.24% up), NASDAQ Composite – 208.45 p (10.73% up) (*see Fig. 26*). The dynamics of the US stock indicators also allow identification of several up and down periods (*Fig. 25*). For example, the indicators were down sharply in April, July and October. Such an alternate movement characterized a strong volatility of the stock indices, however, such trends were noted across all the international stock indices, too.

While analyzing the factors, let us note that in 2007 the major ones became the situation on the US debt market, which was battered by the mortgage crisis, macroeconomic news, the dynamic of the world oil prices, corporate news, and fluctuations of USD and Euro against Rb.

At this point, it is worthwhile to emphasize the critical role of the US debt market in 2007. During the year, the Fed made several decisions to cut the basic interest rate, which affected quotations of the US papers. The decisions were dictated by the nation's macroeco-

economic statistics, which in 2007 evidenced deceleration of its economic growth and increasing inflation risks. An additional factor propelling inflation became a significant rise in the world prices for energy sources, which was replaced by their decline at the end of the year. Between mid-year and its end a number of huge multinationals published negative financial performance reports, as they had suffered from huge losses with mortgage bonds, which formed yet another obstacle to quotations. Plus, the situation around Iran's nuclear program all but exerted a certain negative influence on the situation.

As concerns other nations' stock markets, they basically were on the rise in 2007, with some European indicators posting growth healthier than that in US. Thus, DAX-30 gained 22.29% over the year, while the French CAC-40 – just a meager 1.54%. It should be particularly noted that Japan's Nikkei-225 demonstrated an opposite tendency, as it plunged at 11.3% vs. the early-2007.

Emerging markets boasted a better situation, as in most cases their stock markets demonstrated a double-digit growth, and the Morgan Stanley's 2007 Emerging Markets Free Index gained some 10.19%.

Overall, in 2007, Russia's stock market found itself under the influence of both the developed and emerging markets, which would become particularly visible in the absence of important domestic news and stabilization of oil prices. On the contrary, once domestic news, from the corporate, as well as public sector would start to flow in the market, their impact on quotations was far more profound than fluctuations on the world markets. The only factor to which investors, regardless of a country, paid much attention, was the Fed's policy resulting from the US mortgage crisis, which in the medium term might have affected the markets' liquidity level, because of an outflow of huge US funds and other institutional investors' capital from those.

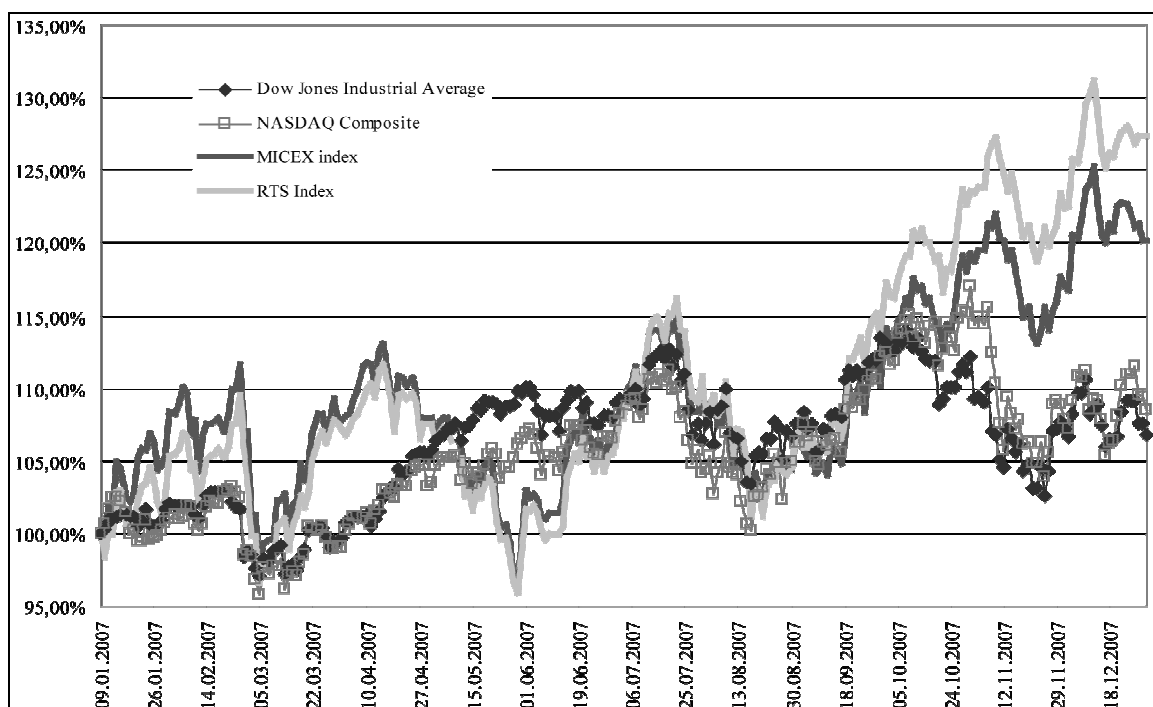


Fig. 26. Dynamics of Main US and Russian Stock Indices in 2007 (9 January 2007=100%)

**Corporate news**

**Changes in credit ratings.** As some Russian corporations notably improved their performance, the international agencies awarded them with long-term credit ratings or revised those in existence.

Thus, in May 2007, S&P raised OAO LUKOil's rating, along with its bonds, from BB+ up to BBB- with the forecast as "stable". S&P believes that this rating highlights LUKOil's position as the largest national vertically-integrated oil company, a high proportion of its export proceeds, international diversification, and stable financial indicators. So, LUKOil has now earned investment ratings from all the three leading rating agencies – S&P (BBB-), Moody's (Baa2), and Fitch (BBB-).

In August 2007, Fitch confirmed Norilsk Nickel's high ratings, namely, the long-term rating of the issuer's default RDE, the priority unsecured rating BBB-, and the short-term RDE F3, with the forecast on the long-term RDE being "stable". The ratings mirror the company's position as the world leading producer of nickel and palladium, as well as copper and platinum.

On February 5, 2007, S&P raised RAO UES Russia's credit rating from B+ up to BB, while along the Russian scale the rating was raised from ruA+ to ruAA, with the forecast being "stable". In addition, according to a S&P's research, RAO UES Russia held the fifth position in the list of the most transparent Russian companies in terms of information (in 2006, the company held the 33th position in the list). However, the research argued that the transparency index of Russian companies remained practically unchanged, and the agency's experts note that a significant enhancement in the electricity holding's transparency is explained by its desire to attract a broad array of minority stockholders to participation in the second (final) reorganization of the company. In addition, RAO UES takes steps to enhance its daughter companies' informational transparency, too.

In July, Moody's raised the credit rating of OAO OC "Rosneft" from Baa2 to Baa1 and awarded its Eurobond issuing program with the Baa1 rating. The change in the rating follows the increase in the basic credit assessment from level "13" (equivalent to Ba3) to level "11" (equivalent to Ba1) along the 21-grade scale. According to Moody's, the fact that Rosneft had acquired new oil-refining assets to a significant degree highlighted the company's medium-term strategic goals. The agency prognosticates this should result in a substantial production diversification, as well as boost net profits and the free cash flow. The increase in the basic credit assessment was also made in a due consideration of other factors. More specifically, driven by a high inventory replenishment coefficient, low operational costs and being in possession of the biggest resource base nationwide, the company's operational and production efficiency is on the rise. Finally, the company's management has multiplied their efforts to ensure Rosneft's greater transparency and to improve its corporate governance system.

On September 20, 2007, Fitch Ratings confirmed Sberbank of Russia's ratings as follows: the long-term issuer default rating at the level of BBB+ with the forecast being "stable"; the short-term issue default rating "F2", the individual rating "C", the rating of support "2", the level of support of the long-term issuer default rating "BBB+".

**Financial performance.** Between August and December 2007 numerous companies published results of their 2007 financial performance, of which some are worth a special notice.

On December 5, 2007, OAO Gasprom presented the unaudited interim abridged financial report for the first half 2007 drafted according to ISA-34. In the period in question, the company's gains (less the excise tax, VAT, and customs duties) rose by Rb. 52,470 m, or at 5% vs. the respective period of the prior year, and accounted for Rb. 1,143.894 m. Meanwhile,

the net gains from gas sales rose at Rb. 36,408 m, or at the same 5% vs. the respective period of 2006 and totaled Rb. 758,293 m.

On December 21, OAO Gasprom neft made its debut as an issuer of the corporate consolidated financial report over the 3<sup>rd</sup> quarter and 9 months of 2007 drafted according to the US GAAP standards. According to the report, the company's gains in the 3<sup>rd</sup> quarter 2007 rose at 0.5% vs. the respective index of the prior year and accounted for USD 5,434 m. The company's EBITDA grossed USD 1,449 m, or at 7.2% up vs. the 3<sup>rd</sup> quarter 2006, while its gains over the 9 months of the year amounted to USD 14,677 m, or at 5.5% down vs. the respective index of the prior year, and the company's net profit over the 9 month period 2007 was USD 2,819 m, or remained unchanged vs. the respective period of 2007.

On December 12, 2007, OAO LUKOil likewise published its financial performance report over the 3<sup>rd</sup> quarter and 9 months of 2007 drafted according to the US GAAP standards. According to the report, the company's net profit in the 3<sup>rd</sup> quarter 2007 rose at 2.1% vs. the respective index of the prior year and accounted for USD 2.482 m. The company's net profit over the 9-month period 2007 was USD 6.298 m, while EBITDA grossed USD 10,370 m, or at 1.9% up vs. the 3<sup>rd</sup> quarter 2006, and gains from sales over the 9 months of the year amounted to USD 57.096 m, or at 11.0% up vs. the respective index of the prior year. The total volume of sales of crude and oil products over the 9 months of 2007 was 98.8 m t., or 4.6% up vs. the 9 months of 2006.

On December 27, 2007, RAO UES Russia published its interim consolidated financial report over the first half 2007 drafted according to the IAS. Over the first 6 months of 2007 profit of the Group RAO UES Russia doubled vs. the respective period of 2006 and totaled Rb. 103.8 bn. The dynamic of the indicator was driven chiefly by rise in revenues from sales of stock in RAO's daughter companies. The pretax profit accounted for Rb. 93.5 bn, i.e. doubled, too.

On November 1, 2007, OAO Rostelecom announced its unaudited performance results over the first 9 months 2007 drafted according to the Russian accounting standards (*aka* RSBU). The company's gains over the period in question made up Rb. 46,541.4 m, or at 6.4% more than in the respective period of the prior year; EBITDA grew by 21.8% (up to Rb. 11,044.7, the company's profit margin by EBITDA accounted for 23.7%, while its net profit over the 9 months of 2007 rose at 76.7% and totaled 8,844.8 m. vs. 5,004.6 m reported over the first 9 months 2006.

In October, Sberbank of Russia published its half-year financial report drafted according to IAS, which also contained its auditor, PWC's, account. According to the report, the bank's assets, by ISA standards, accounted for Rb. 4,282.7 bn as of July 1, 2007, while the pace of growth in assets over the first half of the year was 47.1% annualized. The stockholders' own capital grew by 87.3% and reached the level of Rb. 577.9 bn. The bank's net profit by IAS over the first half of the year amounted to Rb. 48.0 bn, or at 29.6% greater than in the respective period of 2006, while its ROAA rate made up 2.5%

On December 27, 2007, OAO Tatneft also published results of its operational and financial performance by US GAAP over the period of 9 months that had ended on September 30, 2007. In the period in question, the company's gains from sales grossed Rb. 258,436 m, while net profit stood at Rb. 29,531 m.

**Mergers, acquisitions, and partnerships.** In 2007, some Russian corporations continued to acquire new assets, including overseas ones, and to establish new long-term relations that would enable them to expand and enlarge their business, and boost up its efficiency. Also, some companies have completed the business restructuring process.

On April 18, 2007, the stockholders of Sakhalin Energy Investment Ltd, the operator of Sakhalin-2, signed an agreement with RAO Gasprom on completion of the process of the

Sakhalin Energy stock transfer in favor of Gasprom. The deal was concluded according to the protocol the companies signed on December 21, 2006, in Moscow. According to the terms and conditions of the protocol, Gasprom acquires 50% + 1 share in Sakhalin Energy worth a total of USD 7.5 bn. Each of the other three stockholders, that is, Royal Dutch Shell, Mitsui & Co., and Mitsubishi Corporation, reduces its package at 50% and receives a proportional share from the sales price. Now that the deal has been closed, the shares in Sakhalin energy will be as follows: OAO Gasprom – 50% + 1 share, Shell – 27.5%, Mitsui – 12.5%, and Mitsubishi – 10%.

In May 2007, OAO Gasprom and the Belarus State Property Committee signed an agreement on sales of a stake in OAO Beltransgas. According to the agreement, Gasprom pays as much as USD 2.5 bn for the 50% stake in the company. Payments will be effected in equal installments in four stages over 2007–10, and at each stage Gasprom will be acquiring 12.5% of Beltransgas's stock. Until the completion of the deal the stock designated for sale to Gasprom should not be alienated, encumbered, nor they may be serve as collateral. Gasprom and the Belarus Government also signed a supplement to the Protocol of 31 December 2006 on establishment of a joint Russian-Belarus gas transportation company and organization of gas supplies, as well as gas transit via Belarus. Apart from other things, the Supplement particularly provides for a stage-by-stage (during 2008–10) increase in the level of the wholesale premium to the prices for natural gas Beltransgas sales to local customers, as well as the Belarusian party's obligation not to introduce the golden share on participation in control over OAO Beltransgas.

On July 13, 2007, Gasprom made its decision to pick Total as its foreign partner for the first stage of development of Shtokman field. The said stage provides for extraction of 23.7bn. cub. m of natural gas and launching its transportation, by means of gas pipeline, in 2013, while supplies of LNG are scheduled for 2014. To run the project design, funding and construction works, the parties agreed to establish a special company, which in the future will become an owner of the whole infrastructure of the first development phase. Gasprom's share in the authorized capital of the future company will be 75%, while that of Total – 25%. It was also announced that Gasprom was considering a possibility for attracting yet another one or several foreign partners, whose share would account for up to 24%, at Gasprom's expense. At any rate, Gasprom will retain possession of not less than 51% in the future company, as well as of the 100% stake in a company that holds the respective development license and will be the owner of all its future output.

In March 2007, Norilsk Nickel mining company closed a deal on acquisition of OM Group's nickel business. The Russian mining giant purchased a nickel-refining plant in Harjavalta (Finland), nickel producer Cawse in Western Australia, a 20% stake in MPI Nickel Pty. Ltd, that develops nickel mines there, the project developer Nonymoon Well, and a 11.1% of participation in Talvivaaran Kaiveososakeyhtio in the form of ordinary shares and convertible debentures. Norilsk Nickel continues to expand its global production operations by adding new spots in Australia and Finland, which will enable the company to solidify its position in the world mining sector and bolster its nickel-refining capacity by 60,000 t. of nickel a year. Meanwhile, the company's own production of refined nickel (less tolling output) will rise at 35–40,000 t. annually.

On June 26, 2007, Norilsk Nickel announced the Canadian investment and regulatory authority had granted all necessary permits to complete a deal on acquisition of control over LionOre Mining International Ltd.

On September 4, 2007, the first stage of reorganization of the Head Company of RAO UES Russia was over. Two first generating companies – OAOOGK-5 and OAO TGK-5 were separated from RAO UES and became the pioneer private generating companies created in

Russia in the process of the electricity sector reform. Prior to their separation, the companies successfully placed issues of additional stock and attracted Rb. 12.28 bn and 11.63 bn in investment, respectively. As of today, their aggregate capitalization accounts for over Rb. 170 bn.

China's public oil and gas company Sinopec and OAO Rosneft will start in 2008 joint operations on drilling for oil in the shelf oil land of Sakhalin-3. The partners were going to complete the seismic prospecting works at Veninsky bloc by the late-2007. According to the Chinese partner, the volume of oil production in Sakhalin should make up 21m t. by 2010, while that of natural gas – 31 bn cub. m.

On December 27, 2007, OAO Sberbank of Russia acquired the 100% stake in ZAO Bank NRB in Ukraine in a move to establish its daughter bank, OAO Sberbank Russia, on its base.

On December 28, 2007, OAO Gasprom neft and OAO LUKOil established a joint venture OOO Neftgazovaya kompania "Razvitiye regionov", with Gasprom neft holding the 51% share in the newly created company, while LUKOil's share accounts for 49%. The new company's authorized capital will be formed by the partners' cash, and they will be controlling it on parity basis. The profile of the newly created company will be implementation of versatile oil and gas projects.

**Attraction of capital.** In 2007, Russian companies vigorously attracted additional volume of investment, including those from overseas financial markets. They also solidified their positions on the world capital markets.

On February 21, 2007, OAO Gasprom placed Rb.-denominated bonds of A9 series in the volume of Rb. 5bn, with the face-value of Rb. 1,000 and maturity date of 7 years. By results of an auction held at MICEX the coupon rate by this series, payable every 182 days, was set at the level of 7.23% annualized. Investors submitted applications for the amount of over Rb. 9 bn. Underwriters of the loan became Renaissance Capital and OAO Rosbank, co-underwriter was Gorizont investment company, while OAO Federal Investment Corporation became financial consultant of the venture. The attracted capital will be spent on funding investment, implementation of Gasprom's new promising projects, a partial refinancing of the company's debt, and optimization of the structure of its debt portfolio.

On September 19, 2007, OAO Gasprom neft created a syndicate of international banks including ABN AMRO Bank N/V/, Calyon, Citigroup Global Markets Ltd, and Commerzbank Aktiengesellschaft to attract USD 2.2 bn in a new syndicated loan for the term of three years. The company is going to spend the attracted capital to fund its business expansion plans in the oil production and refinery segments. The loan is depreciable and was issued under the rate of LIBOR + 0.75% annualized.

In April 2007, OAO LUKOil successfully obtained a USD 250 m-worth unsecured syndicated loan organized by ABN AMRO and Calyon; some other huge international banks also joined in, and on 23 April, ABN AMRO and Calyon disbursed the first installment under the loan, whose term is 5 years and the annual rate equals LIBOR+0.4%. The same day, this sum was used to refinance a USD 765 m syndicated collateralized loan the company had been granted in 2003 against its export contracts. As the amount of applications for participation in the syndicated loan was twice as high as the volume of required funding, the market participants are evidently confident in the company's creditworthiness. Meanwhile, LUKOil decided not to raise the amount of the loan and lowered the banks' bids accordingly.

In addition, in June 2007 LUKOil placed Eurobonds worth a total of USD 1 bn. The papers were broken into two equal tranches with the maturity dates of 10 and 15 years, accordingly. The coupon rate of the USD 500m-worth 10-year tranche is 6.356% with the spread of +145 basic points to the US T-bonds, while that of the USD 500m-worth 15-year tranche accounts for 6.656% with the spread of +175 basic points to the US Treasuries. The placement

was organized by Deutsche Bank and Credit Suisse, and it should be emphasized that the company's bonds enjoy the highest rating ever awarded to papers issued by a Russian company. OAO LUKOil is going to use the borrowed capital on its general corporate needs, including refinancing its current debt, and on capital investment.

On February 22, 2007, Norilsk Nickel and a group of Western financial institutions signed a contract on opening a USD 450 m credit line organized, fully underwritten and syndicated by Barclays Capital, the investment subsidiary to Barclays Bank PLC, ING Bank N.V., and an investment division of Société Générale. SocGen also played the role of an agent with regard both to the loan and the respective documentation. The overall number of applications for participation in the syndicate significantly exceeded the original amount of USD 300 m, and Norilsk Nickel opted for boosting up the credit line to USD 450 m. The company pays a margin of 4.2 basic points over the LIBOR rate in the first three years, with a consequent increase of that up to 50 basic points in the 4<sup>th</sup> and 5<sup>th</sup> years.

On January 29, 2007, OAO Sberbank of Russia announced the launch of the so-called people's IPO, that is, placement of an additional issue of ordinary shares (3.5 m pcs) in RF available both to legal entities and private individuals. The placement was assisted by ZAO Credit Suisse (Moscow) and J.P. Morgan Bank International, which exercised the broker and book-running functions.

On January 18, 2007, OAO Sberbank of Russia signed an agreement on a syndicated loan totaling USD 750 m organized by The Bank of Tokyo-Mitsubishi UFJ, Ltd., Barclays Capital, Deutsche Bank AG, DZ BANK AG Deutsche Zentral-Genossenschaftsbank, ING Bank N.V., J.P. Morgan Plc, and Sumitomo Mitsui Banking Corporation Europe Limited. As many as 18 leading overseas banks with a broad geography of representation took part in the loan, including Commerzbank AG, Intesa Sanpaolo Bank, Nordea Bank Finland, The Bank of New York that provided the biggest fractions of the loan. The credit rate became LIBOR+0.45% annualized. The loan was arranged for the term of 3 years with a one-off payment at the end of the term, but the agreement also provides for the possibility for the loan extension for another 2 years without a change in the value of the attracted resources. The loan will be spent on general corporate purposes. Interestingly, it became the third syndicated loan Sberbank attracted over the past three years.

Dividend policy. It is a common knowledge that a sound dividend policy constitutes one of the most efficient means of bolstering attractiveness of a company's stock.

On July 22, 2007, at their general meeting stockholders in OAO Gasprom neft approved payment of the 2006 dividends at an amount of Rb. 8,0822 per 1 ordinary share, which means that the company will pay Rb. 38,320 bn in dividends until May 31, 2008.

According to the preliminary results of the voting that took place on December 21, 2007, an early general meeting of Norilsk Nickel's stockholders ruled to approve intermediate dividends totaling Rb. 108 per 1 ordinary share. The dividends are paid on recommendation of the company's Board, with account of its successful performance in the first 9 months of 2007. Norilsk Nickel is going to pay as much as some Rb. 19.8 bn in intermediate dividends.

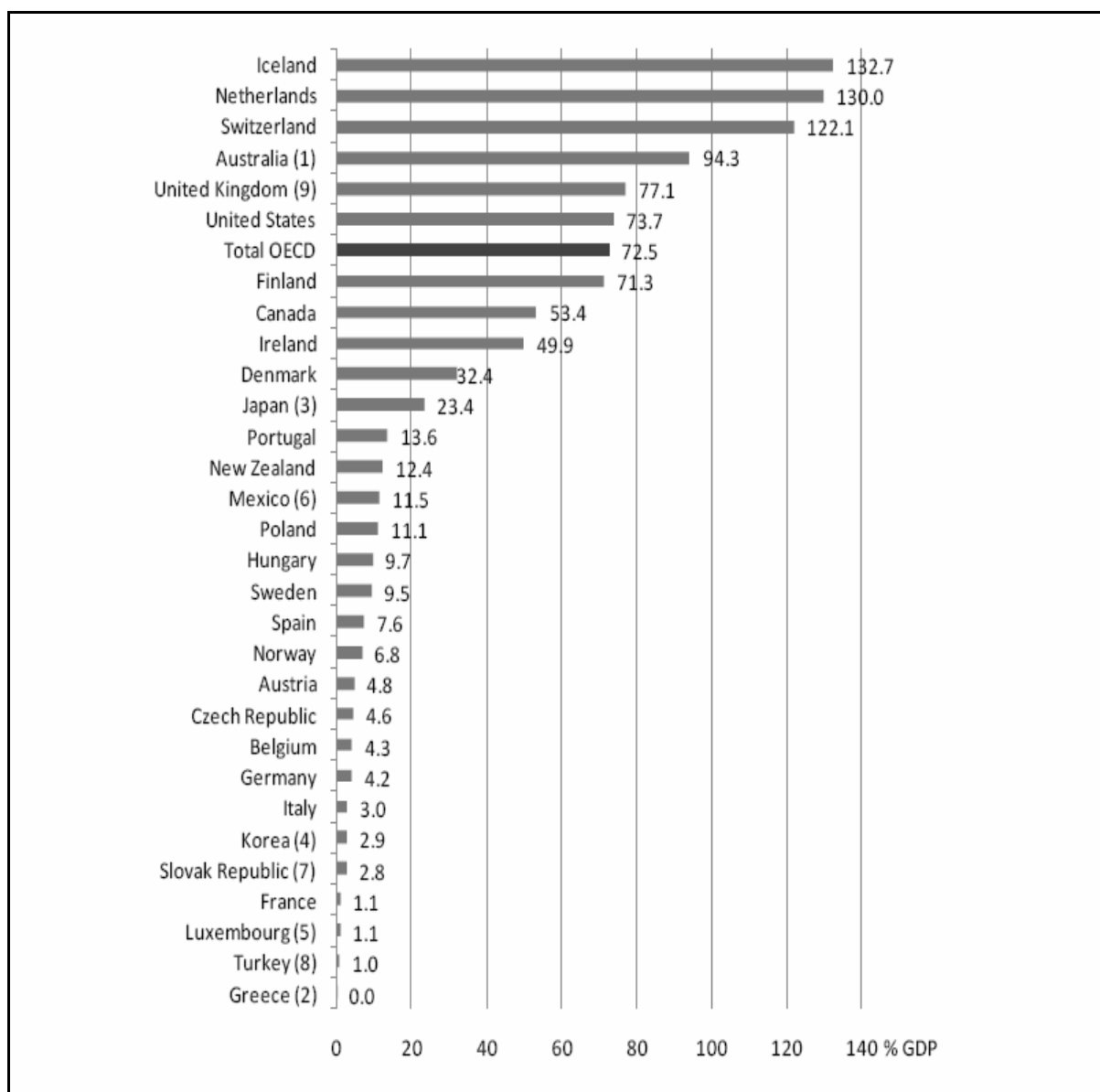
#### 2.6.4. Investment of Pension Savings in the System of Mandatory Pension Insurance

Value of assets within the funded component of the mandatory pension system

The assets within the funded component of the mandatory pension system are evolving at a very dynamic rate, which is natural for an early phase of the system's development. Over the year 2006, the total size of the mandatory pension system's funded component increased by more than one quarter, by early 2007 approximating the level of 350 billion rubles. However, so far Russia's funded system has been undergoing the initial phase of its evolvement,

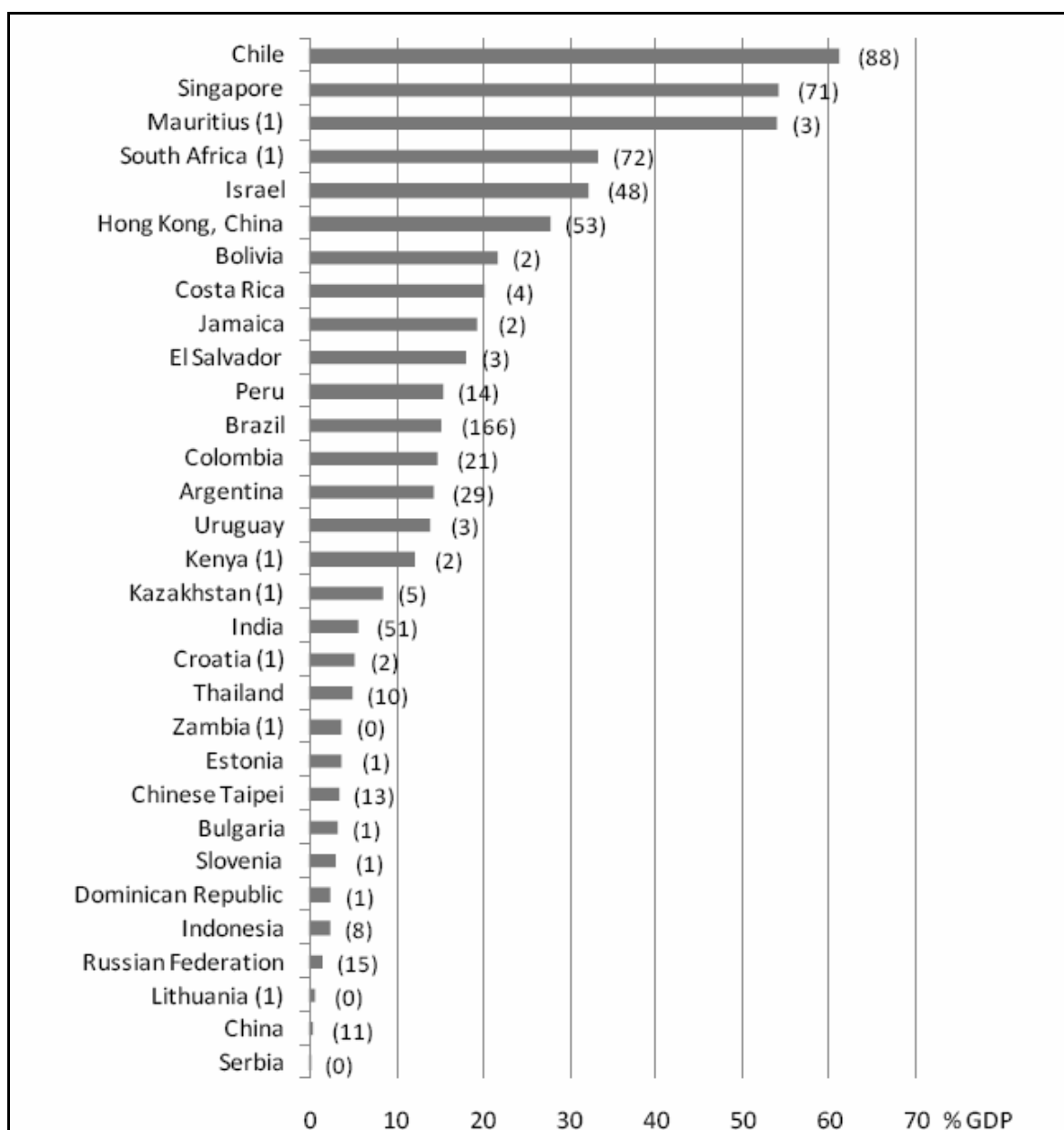


and so, by international standards, its size is relatively small. In 2006 the assets within the mandatory pension system's funded component amounted to approximately 1.4 % of GDP, which is substantially lower than its level in developed countries (see *Fig. 27*) and behind the indices of many countries outside the OECD (*Fig. 28*).



Source: Pension Markets in Focus No. 4. OECD, November 2007.

*Fig. 27.* Assets of Pension Funds Against GDP in OECD Countries, 2006, as % of GDP



Note.

In brackets, see the value of pension funds' assets shown in billion USD.

Source: Pension Markets in Focus No. 4. OECD, November 2007.

*Fig. 28. Assets of Pension Funds Against GDP in Countries outside OECD, 2006, as % of GDP*

The highest growth rate of pension savings was observed in independent pension funds (IPF). In the government asset manager's (Vneshekonombank's) investment portfolio the share of securities was diminishing, while the funds on the accounts of credit institutions were increasing. In the structure of investments held by private asset managers (PAM), a diminishing share of government securities and a simultaneously increasing share of corporate bonds have been very noticeable. The rate of return displayed by the leading PAMs in Q III 2007 became markedly lower.

By early 2007, the value of assets in which pension savings were invested by asset managers (AM), including the government asset manager (GAM) and independent pension funds (IPF) amounted to 286.2 billion rubles (see *Table 55*)<sup>75</sup>. In Q I 2007, the RF Pension Fund (PFR) was transferring pension savings in accordance with the applications submitted in 2006<sup>76</sup>. While the overall investment activity of citizens remained low both in 2005 and 2006, the preferences of the overwhelming majority of those insured persons who effectuated their right of choice between an asset manager and an IPF were in favor of IPFs. Out of the 924 thousand applications received by the PFR in 2006, 796 thousand requested a transfer from the PFR to a IPF.

*Table 55*

**Value of Assets in the Mandatory Funded Pension System, billion rubles**

	01.01.2007	01.04.2007	01.07.2007	01.10.2007
Value of net assets in which pension savings transferred to AMs were invested	276.2	270	274.5	340.1
including government asset manager	267.1	260.7	265.1	329
including private asset managers	9.2	9.4	9.4	11.1
Pension savings held by independent pension funds (IPF)	9.96	19.85	19.25	25.55
Total	286.2	289.85	293.75	365.65

The inflow of pension savings to IPFs on the applications of insured persons, submitted in 2006, produced a more than twofold growth of the mandatory pension insurance funds held by these organizations in Q I 2007 (during that quarter, the IPFs' pension savings increased from 9.96 to 19.85 billion rubles).

In the next two quarters the sum of pension savings held by IPFs rose by further 28%, amounting as of 1 October 2007 to 25.55 billion rubles. Its growth during Q III was also in the main conditioned by a seasonal factor – the transfer of insurance contributions from the PRF. As a result, as of the end of Q III, the IPFs engaged in mandatory pension insurance were accounting for 7% of the total sum of assets managed by the State and by private asset managers (PAMs), as well as by IPFs.

It should also be noted that the transfer from the PRF to an IPF does not necessarily entail the diminishment of the number of the so-called “lurkers” – insured persons who have failed to select a specific investment strategy (namely, a specific asset manager) or a non-government insurer (an IPF). Some of the insured persons were attracted by IPFs from among those who had previously made their choice of an asset manager. As a result, the private asset managers, which had been handling pension savings under their agreements with the PRF concerning the trust management of pension savings, also experienced in Q I 2007 a net

<sup>75</sup> Hereinafter, the data from the official websites of the Pension Fund of the Russian Federation (PFR) and the Federal Service for Financial Markets (FSFM) are applied.

<sup>76</sup> Due to amendments introduced to legislation, the schedule for transfers of pension savings on the applications of insured persons to the AMs and IPFs selected by them has been somewhat changed, the transfers now being executed by the PRF during the first quarter of the year following the year in which an application has been submitted by an insured person to the PRF, instead of the end of that year.

outflow of funds in the amount of 0.2 billion rubles, although to a lesser degree than that experienced by the GAM (Vneshekonombank).

The market value of the assets, in which pension savings had been invested by PAMs, as of the end of Q I 2007 amounted to 9.4 billion rubles. By the end of Q III this index went up to 11.1 billion rubles, while the share of pension savings managed by PAMs constituted 3% of the sum of pension savings transferred by the PFR to asset managers and IPFs.

The total share of pension savings invested by PAMs and held by IPFs by the end of Q III 2007 amounted to 10% against 6.7% at the year's beginning.

Resulting from the transfer of pension savings on the applications of insured persons, the volume of funds managed by Vneshekonombank in Q I 2007 slightly diminished. As of the end of the year 2006, the value of pension savings invested by Vneshekonombank was in excess of 267 billion rubles. By way of executing citizens' applications concerning their choice of an asset manager or an IPF, Vneshekonombank made a transfer of 9.6 billion rubles to the PFR. As a result, the value of assets held by the GAM as of the end of Q I 2007 amounted to 260.6 billion rubles. Over the next quarter, growth in the value of assets held by the GAM was determined by the results of actual investments and amounted to 1.7%. By the end of Q III, the market value of the assets in which the pension savings held by the GAM were invested became as high as 320 billion rubles, mainly due to a seasonal transfer of contributions to the funded component of labor pension from the PFR. The overall increase in the value of the GAM's assets during that quarter amounted to 63.8 billion rubles, of which the net inflow of funds from the PFR was 59.9 billion rubles.

Approximately one half of the pension savings transferred into trust management to PAMs is held by 5 companies (53% as of the end of Q III 2007). The leaders – the AM Posbank and the AM "Pensionnyi rezerv" – accounted for 15% and 12%, respectively, of the total sum of pension savings managed by PAMs.

### *The structure of Investments*

#### *Investments of the Government Asset Manager*

The structure of Vneshekonombank's investments in 2007 and of the aggregate investment portfolio of all the private asset managers as of the end of the year 2006, as well as of the end of Q III 2007, is shown in *Fig. 29–34*.

During the first quarter, the GAM's investment portfolio displayed a diminishing total share of monies invested in securities (the monies at credit institutions, in rubles, decreased from 7.7% to 2.5%). As a result, the share of ruble-denominated government securities went up (from 78% to 82%). The share of RF foreign-currency-denominated government securities in the government asset manager's investment portfolio was around 10% both at the beginning and at the end of Q I.

In Q II, GAMs' investment portfolio demonstrated a slight drop in the share of RF government securities denominated in foreign currencies (from 10.6% to 6.7%). Besides, the PFR for the first time disclosed the structure of pension savings invested in government savings bonds (GSO) – nonmarket securities issued by the RF Ministry of Finance for institutional investors. Their sum in the investment portfolio of GAMs in mid-2007 amounted to 66.2 bil-

lion rubles<sup>77</sup> (41% of the total investments in ruble-denominated government securities), which constitutes 24.1% of the total value of assets held by asset managers (274,5 billion rubles), or 25% of the value of assets managed by Vneshekonombank (265.1 billion rubles).

In Q III the share of investments in GSO in GAMs' investment portfolio increased to 29.2%, against the backdrop of an overall drop in that investment portfolio's share of securities (from 85.6% to 82.8%) and an increase in the amount of deposits on the accounts of credit institutions (from 5.7 to 11%).

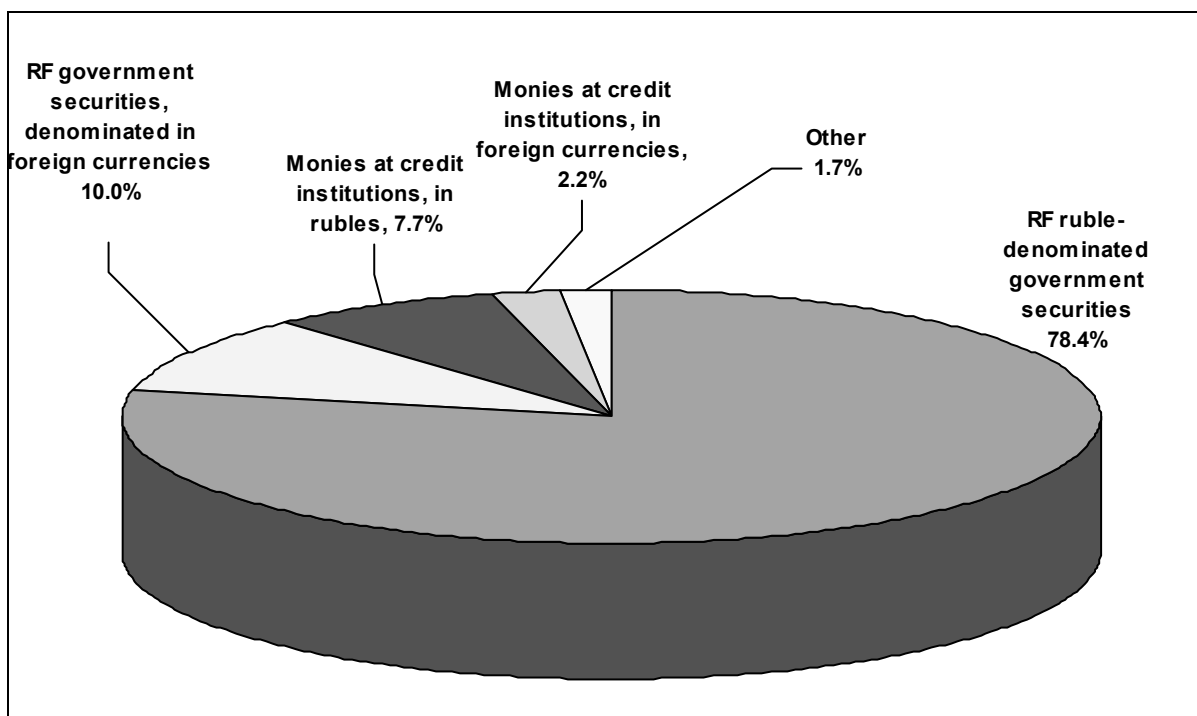
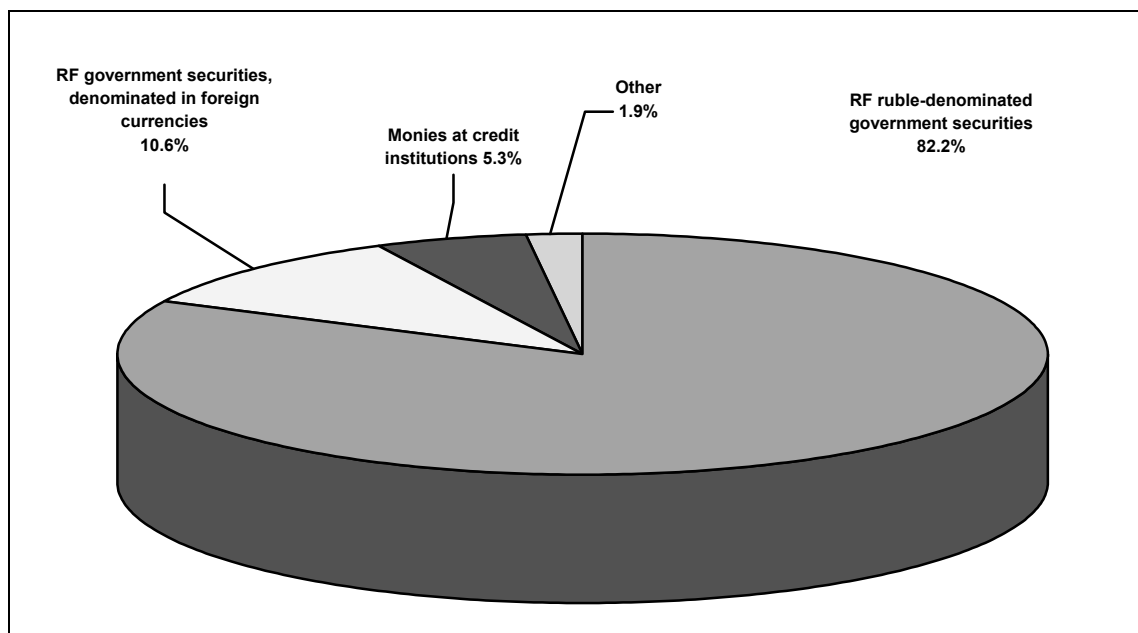
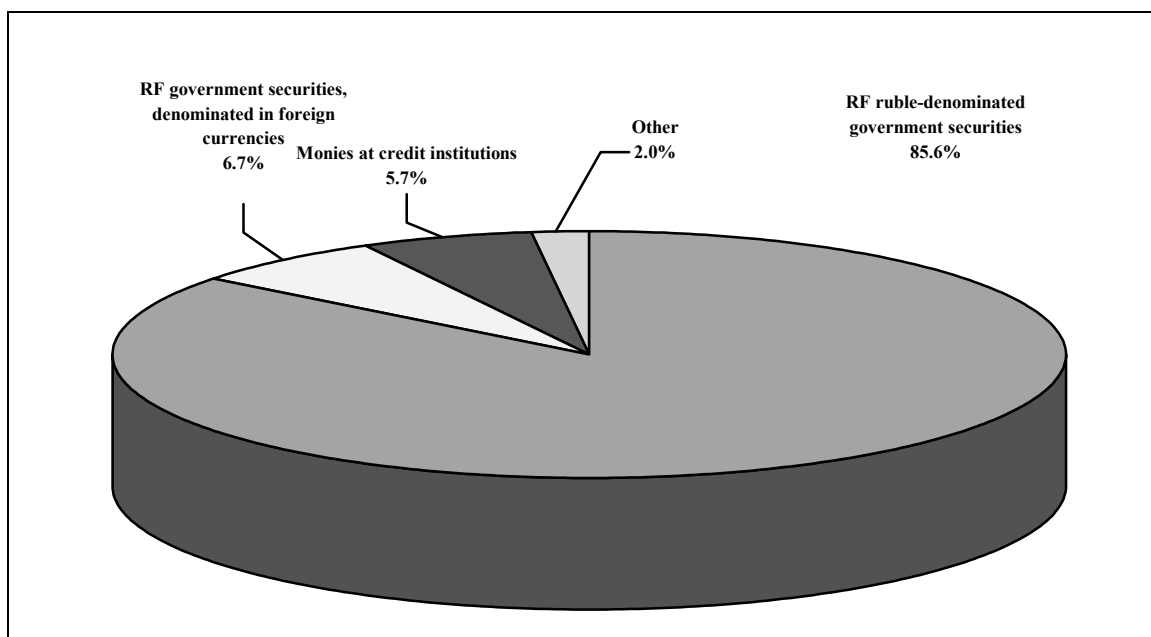


Fig. 29. The structure of the Investment Portfolio of the Government Asset Manager (Vneshekonombank), as of the end of 2006

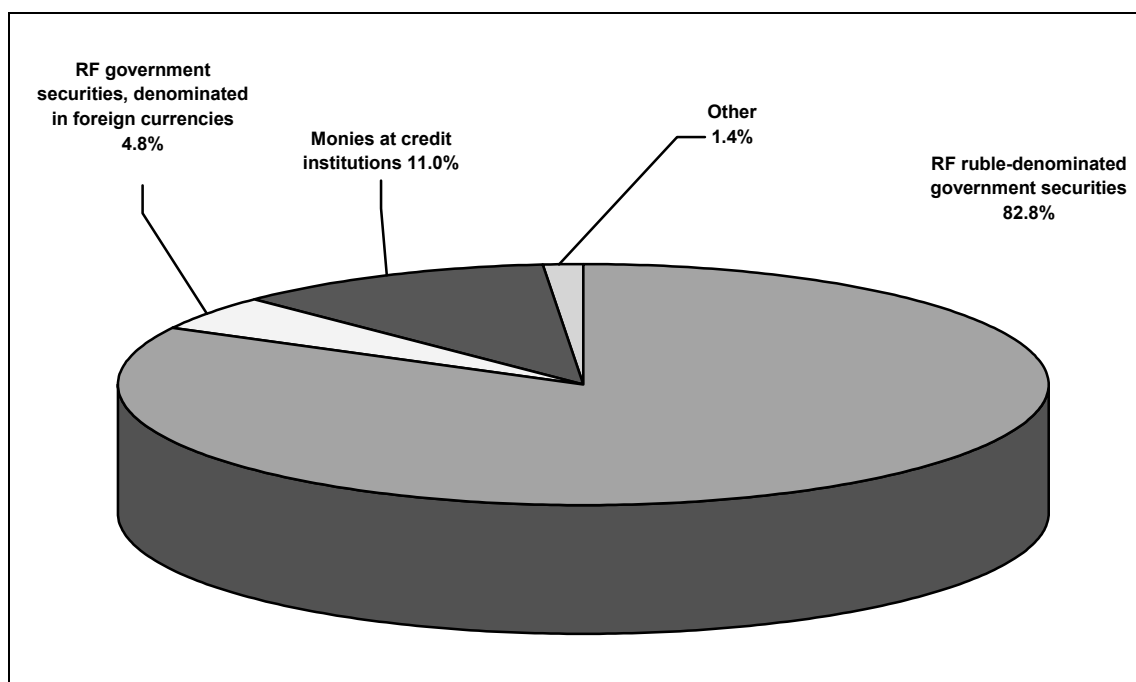
<sup>77</sup> There are no such securities in PAMs' portfolios.



*Fig. 30.* The Structure of the Investment Portfolio of the Government Asset Manager (Vneshekonombank), as of the end of Q I 2007



*Fig. 31.* The Structure of the Investment Portfolio of the Government Asset Manager (Vneshekonombank), as of the end of Q II 2007

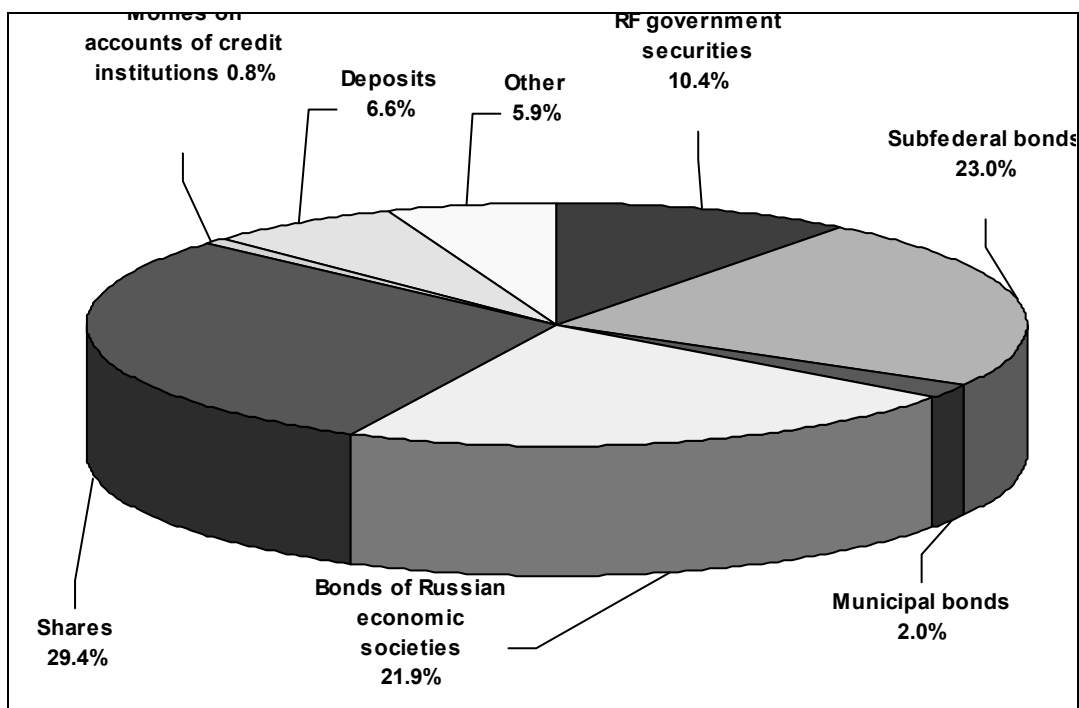


*Fig. 32. The Atructure of the Investment Portfolio of the Government Asset Manager (Vneshekonombank), as of the end of Q III 2007*

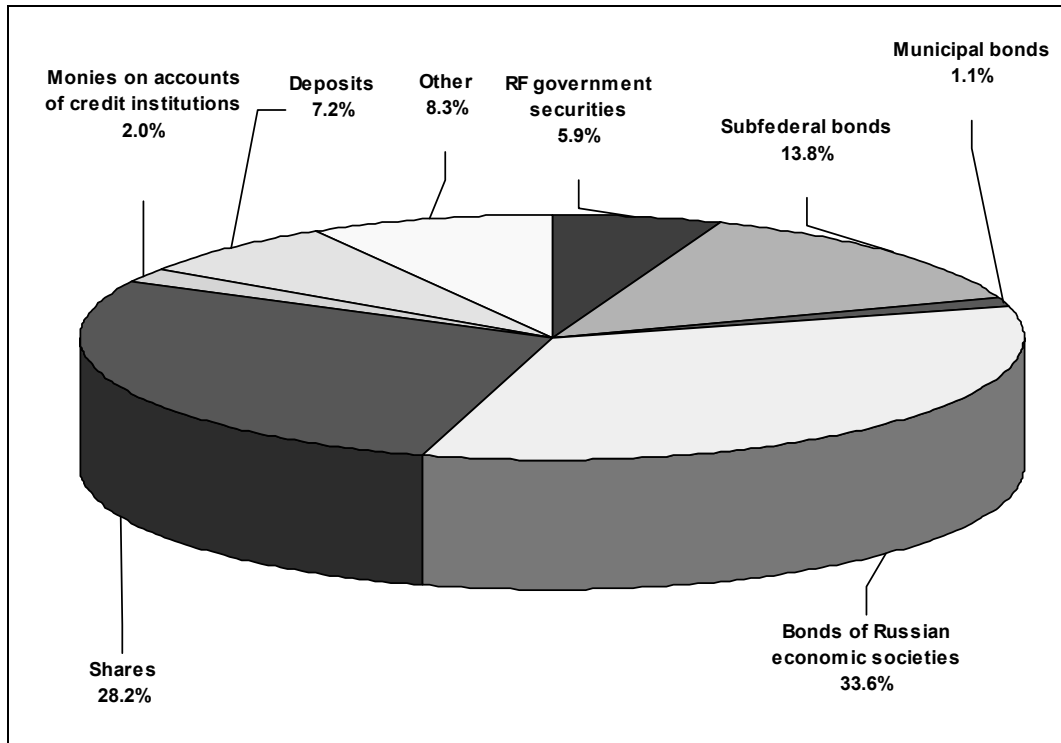
#### *Investments of Private Asset Managers*

Within the structure of investments held by PAMs, one cannot overlook the noticeable fall in the share of government securities and the increasing share of corporate bonds. The share of federal debt liabilities diminished from 10.4% as of the end of 2006 to 5.9% as of the end of Q III 2007 (see *Fig. 31–32*). As for the share of subfederal debt liabilities, it decreased during the same period from 23% to 13.8%. At the same time, the share of corporate bonds in the aggregate investment portfolio of PAMs increased from 21.8% to 33.8%.

The percentage of shares in the aggregate investment portfolio of PAMs was lowest as of the end of Q I 2007 (26.6%), and highest – as of the end of Q II (30%). As of the end of Q III the percentage of shares amounted to 28.2%. Over the period under consideration, the dynamics of Russian stock exchange indices was displaying high volatility, which was inevitably reflected in PAMs' investment policy. However, while in Q I the percentage of shares diminished in the wake of falling indices (see *Fig. 35*), no such correlation was observed any more in Q III: the percentage of shares was diminishing by the end of Q III by 1.8 p.p. against the backdrop of an unstable but nevertheless visible growth on the Russian share market.

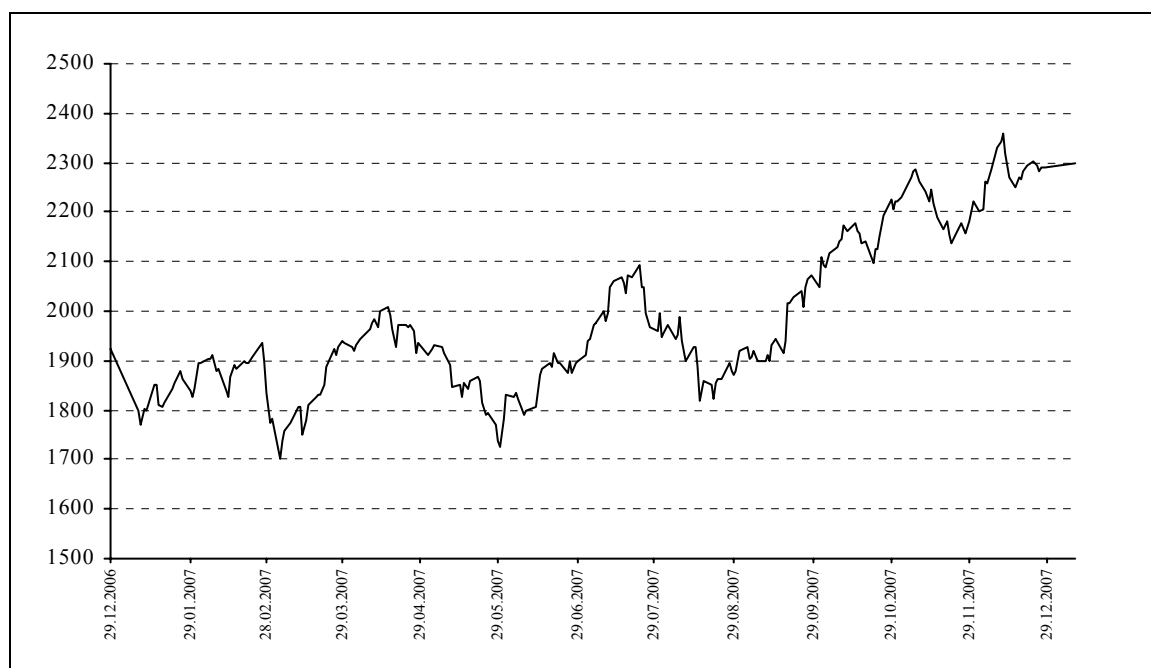


*Fig. 33. The Structure of the Investment Portfolios of Private Asset Managers, as of the end of 2006*



*Fig. 34. The Structure of the Investment Portfolios of Private Asset Managers as of the end of Q III 2007*





*Fig. 35. The RTS index in 2007*

The structure of the investment portfolios held by PAMs – leaders with regard to the size of managed pension savings – is shown in *Table 56*. As seen from this table, the percentage of shares in the investment portfolios of these PAMs was fluctuating, as of the end of Q III, between 24.6% and 39.6%.

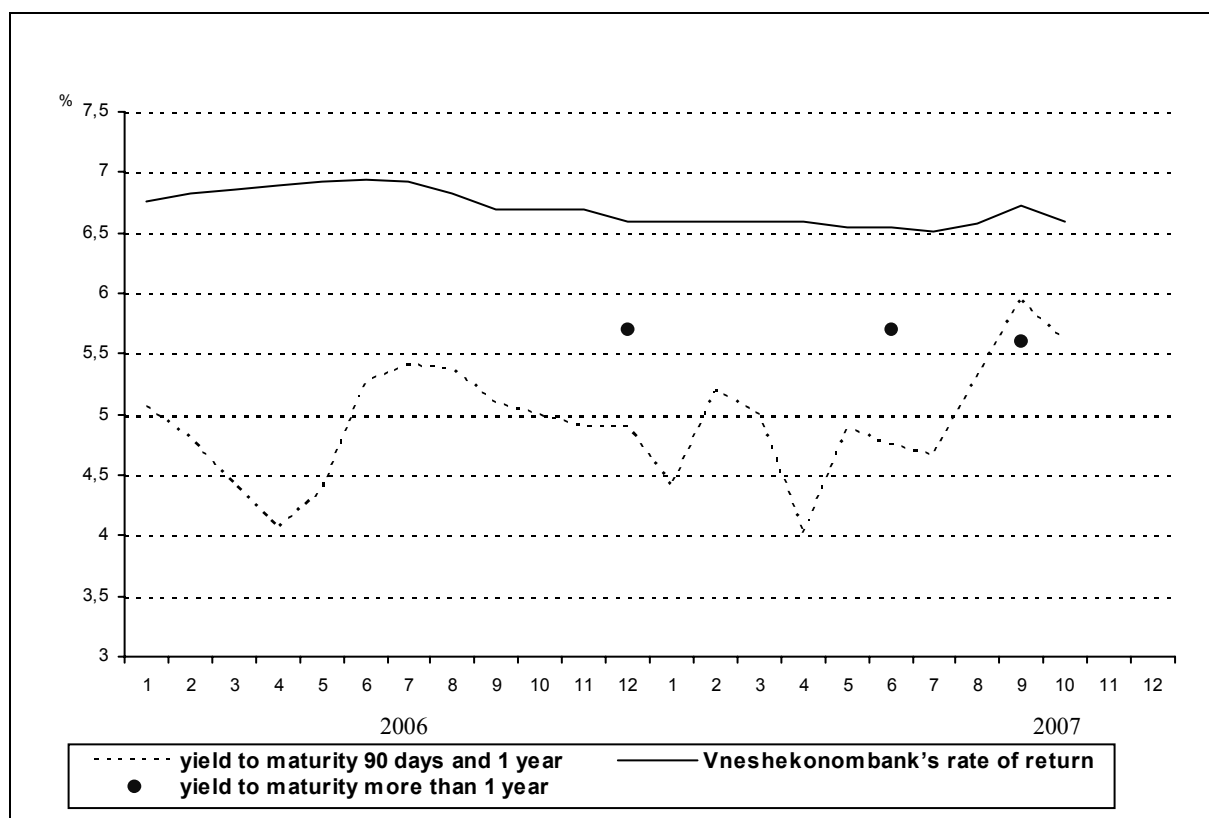
*Table 56*

**The Structure of the Investment Portfolios Held by PAMs – Leaders  
in the Size of Managed Pension Savings (as % of assets)**

Types of assets	Asset managers				
	ROSBANK	PENSIONNYI RE-SERV	SOLID MANAGE-MENT	URALSIB	AK BARS KAPITAL
<i>Securities, total</i>	74.5	75.9	76.8	92.5	90.7
including:					
RF government securities	0.0	0.0	9.7	0.0	12.5
Securities of RF subjects	10.5	22.0	1.7	5.0	17.6
Municipal bonds	0.0	3.0	0.0	0.8	1.5
Bonds of Russian economic societies	33.2	26.3	25.8	47.4	33.6
Shares issued by Russian companies	30.8	24.6	39.6	39.3	25.5
<i>Monies on accounts at credit institutions</i>	4.1	4.5	0.0	0.0	0.1
<i>Ruble-denominated deposits at credit institutions</i>	17.5	16.9	8.1	0.0	3.2
<i>Receivables, including:</i>	3.9	2.7	15.1	7.5	6.0
funds on special broker accounts	3.0	1.6	14.5	6.4	4.8
receivables against interest income on bonds	0.9	1.0	0.6	1.1	1.2
other receivables	0.0	0.1	0.0	0.0	0.0
<i>Total market value of portfolios</i>	100	100	100	100	100

***The Rate of Return on Investments***

The rate of return on the pension savings invested by the GAM, according to the results of the first three quarters, was at a level approximating that at the end of the year 2006 (see Fig. 36). However, while in 2006 and in the first half-year 2007 the rate of return on the GAM’s investment portfolio remained at a level higher than that of the rates of return on the Federal Government’s ruble-denominated bonds (OFZ) with maturities of up to one year, but lower than the rates of return on the securities with maturities of more than one year, by the results of the first three quarters of 2007 this index was found to be lower than OFZ’s rate of return, which in August – September was displaying an upward trend.



Source: RF CB, Vneshekonombank.

**Fig. 36. Average Weighted Interest Rates on the GKO – OFZ Market and the GAM’s Rate of Return in 2006 and first half-year of 2007**

For PAMs, Q III turned out to be unlucky in terms of the results of their investing. As already seen at the end of the first half-year, the average rate of return on PAMs’ investment portfolios was 2.9%, while 14 investment portfolios managed by PAMs in Q III displayed negative results of investing, and only 2 investment portfolios were characterized by rates of return at a level similar to or higher than that of the GAM (those managed by the AM “Univer-management” and “Region asset management”). However, the investment portfolios of these AMs fell outside of the category of big ones (24.7 and 19.3 million rubles, respectively). The results demonstrated by the leaders in the absolute size of their investment portfolios as of mid-2007 and the end of Q III can be seen in Tables 57–58. As shown by the Tables, the vola-

tile situation on the stock market was reflected by the investment results achieved by all the leaders. All these AMs displayed a negative rate of return in real terms, while two AMs in the first half-year and three AMs in the first three quarters also displayed a negative nominal rate of return. However, over a longer period of three years they all displayed rates of returns higher than the average per annum rate of return on the GAM's investments (which amounted to 7.98% as of mid-2007 and 8.11% as of the end of Q III 2007).

*Table 57*

**The Rates of Return on Investments of PAMs with the most Substantial Investment Portfolios, as of end of June 2007**

Asset manager	Net asset value (NAV) as of mid-2007, million rubles	Rate of return per annum, %		
		In 6 months	In 12 months	In 3 years
UK ROSBANKA	1,408.6	3.04	15.65	9.94
PENSIONNYI REZERV	1,071.7	3.90	14.89	16.92
SOLID MANAGEMENT	884.0	-0.48	23.27	19.15
URALSIB UK	799.3	-2.14	16.61	23.48
AK BARS KAPITAL	787.9	4.15	15.58	13.33

*Table 58*

**The Rates of Return on Investments of PAMs with the most Substantial Investment Portfolios, as of end of September 2007**

Asset manager	Net asset value (NAV) as of end of Q III 2007, million rubles	Rate of return per annum, %		
		In 9 months of 2007	In 12 months	In 3 years
UK ROSBANKA	1,656.7	-0.47	9.95	11.24
PENSIONNYI REZERV	1,322.2	3.94	11.46	17.26
SOLID MANAGEMENT	987.2	-3.09	13.83	16.43
URALSIB UK	946.2	-4.03	9.06	21.15
AK BARS KAPITAL	923.3	0.51	8.09	10.47

## Section 3. Real Sector

### 3.1. Macrostructure of Production

#### 3.1.1. Trends and Factors of Final Demand Changes

Characteristic feature of 2006–2007 was economic growth acceleration rates along with positive effect of foreign economic situation factors and internal economic activity. Increase in business activity was based on anticipating growth of investments as compared with the dynamics of final consumption and had the most significant influence on the nature of structural shifts of the produced and used GDP. GDP increasing by 8.1% in 2007 real final consumption of households went up by 13.1% and investments in fixed assets – by 21.1%.

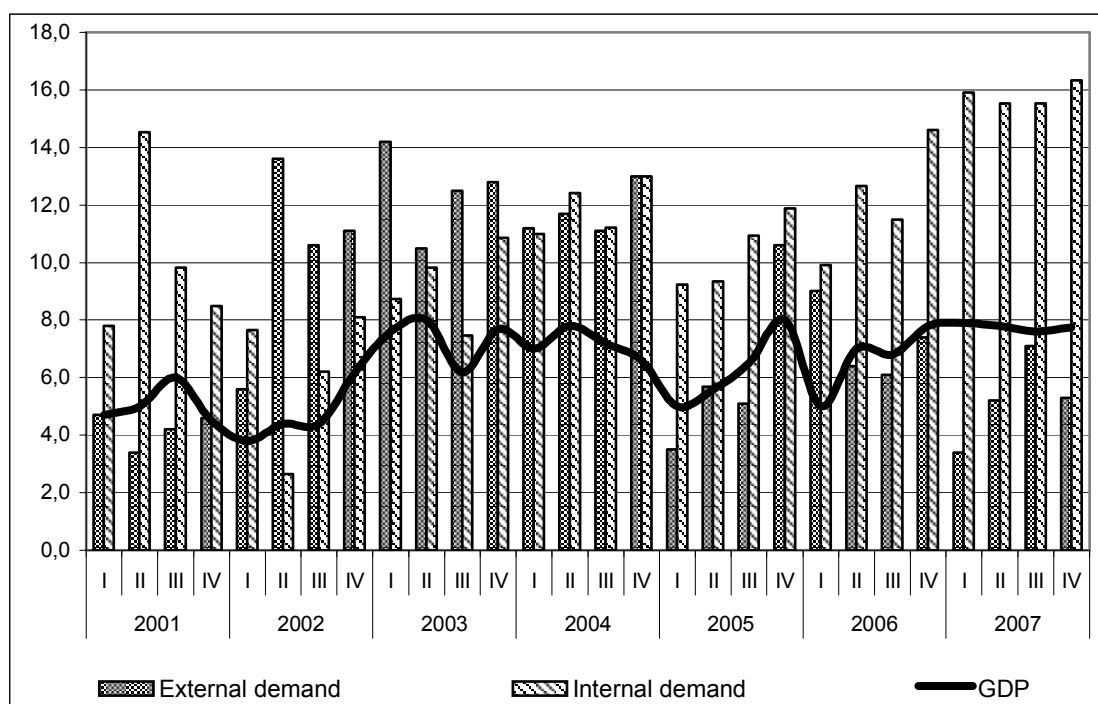
Table 1

**Indices of the Basic Macroeconomic Indicators in 1999–2007,  
as a Percentage versus the Previous Year**

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Gross Domestic Product	106.4	110	105.1	104.7	107.3	107.2	106.4	107.4	108.1
Households' real final consumption	97.1	107.3	109.5	108.5	107.6	112.1	112.7	111.3	113.1
Investments in the fixed assets	105.3	117.4	110	102.8	112.5	111.7	110.7	113.7	121.1
Housing commissioning		94.6	104.6	106.7	107.7	112.6	106.1	116.1	119.4
Industrial production	111	108.7	102.9	103.1	108.9	108.3	104	103.9	106.3
Agriculture production	104.1	107.7	107.5	101.7	101.3	103	102.4	102.8	103.3
Freight turnover	105.8	105	103.2	105.8	108	106.5	102.7	102.5	102.2
Communication services amount	133.1	113.8	119.1	115.6	127.5	129	115.7	124.0	120.1
Retail trade turnover	93.9	109	111	109.3	108.8	113.3	112.8	113	115.2
Paid services rendered to population	107	104.7	101.6	103.7	106.6	108.4	106.8	107.9	107.1
Foreign trade turnover	86.7	130.2	103.8	108.1	126	132.4	131.5	127.0	123.4
Real disposable monetary income	87.7	112	108.7	111.1	115	110.4	111.1	110.2	110.4
Real wages	78	120.9	119.9	116.2	110.9	110.6	112.6	113.4	116.2
Real amount of accrued pensions	60.6	128	121.4	116.3	104.5	105.5	109.6	105.1	103.8
Average number of those employed in the economy	100.6	100.3	100.7	100.9	100.6	100.6	100.6	100.3	102.4
Number of officially registered unemployed	102.1	77	89.1	99.7	92.3	101.6	90.2	95.6	88.3
Consumer prices indices		120.2	118.6	115.1	112.0	111.7	110.9	109.0	111.9
Industrial producers' prices indices		131.9	108.3	117.7	112.5	128.8	113.4	110.4	125.1

Source: Federal State Statistics Service.

Simultaneous expansion of both internal and external markets was a factor of steady economic development. The ratio of external and internal demand over the period of 2001–2007 has varied considerably. Foreign economic situation being exceptionally favorable starting from 2<sup>nd</sup> quarter 2003 the deceleration of physical volumes of export growth rates has been observed and from the same period gradual strengthening of the internal demand influence on the dynamics of economic development has been registered. In 2005–2007 slowdown of foreign demand growth rates proceeded more acutely. Increase in external demand was on average equal to 12.1% in 2003–2004 as compared with 6.9% in 2005–2006, and it is estimated to be 7.4% in 2007.



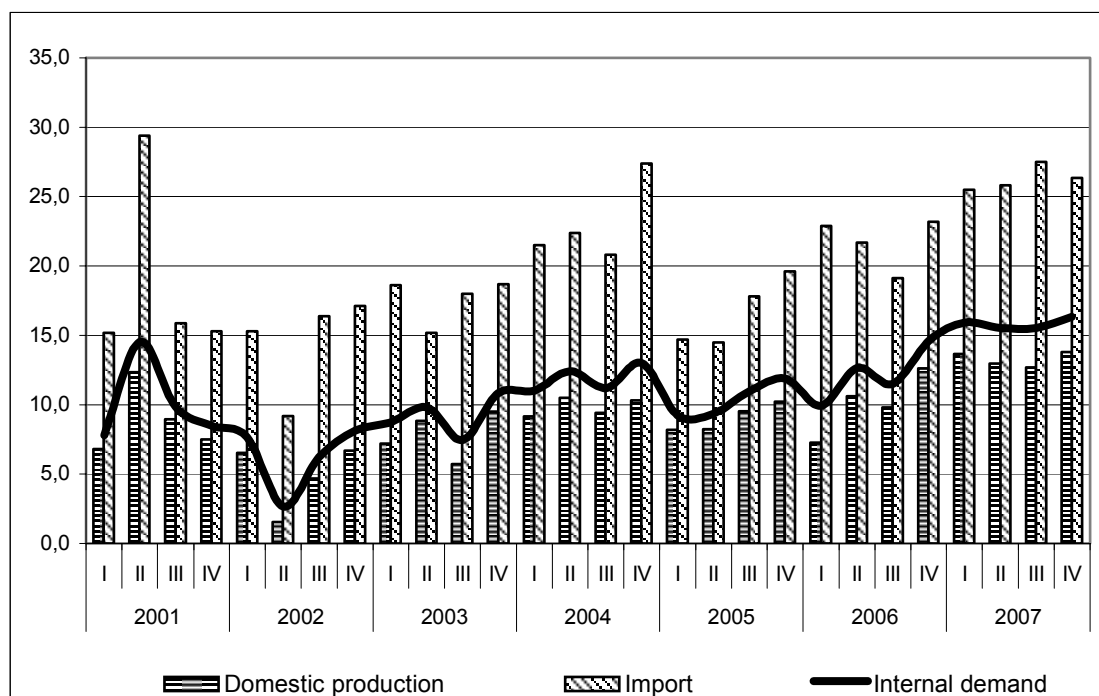
Source: Federal State Statistics Service.

Fig. 1 Growth Rates of Internal and External Demand in 2001–2007, as Percentage versus the Corresponding Quarter of the Previous Year

Joint influence of internal factors that regulate the level of business activity was quite sufficient to make up for the weakening of external demand impact on the economic growth rates. In 2007 the increase in internal demand was equal to 17.0% as compared with 12.9% in 2006 and 10.5% in 2005.

Positive dynamics of the internal market was determined both by the growth of internal production and the expansion of import supplies' scale. After a short-term decrease of import as a result of 1998 devaluation, the import growth rates have been steadily positive since 4th quarter 1999. Whereas at the surge of devaluation the domestic production was characterized by anticipating growth which was partially due to import substitution process, starting from the beginning of 2000 the parameters of standard of living and population's demand restoring, investment activity becoming more lively, market balance was maintained by more intensive growth of import supplies as compared with the domestic production. The situation at the internal market in 2006–2007 was formed under the influence of gradual acceleration of domestic production growth rates. As a result of 2007 the increase in industrial production was 6.3% (as compared with 3.9% in the previous year), workload in construction – 18.2%, agriculture – 3.3%. As a result increase in domestic goods production for consumption at the internal market has increased by 13.7% against 11.0% in 2006 and 8.9% in 2003–2005. This, however, did not change the trend for anticipating import growth in internal market resources formation, which outlined most distinctly in 2007. Increase in import supply of goods in 2007 was equal to 35.4%, exceeding by 4.1 p.p. the level of the previous year. It should be noted that anticipating (as compared with export) import growth both by physical and value volume, which, in

the end, led to absolute reduction in the net export proportion in the GDP was a characteristic feature of 2006–2007.



Source: Federal State Statistics Service.

*Fig. 2. Change in Growth Rates of Internal Demand by Components in 2001–2007, as Percentage versus the Corresponding Quarter of the Previous Year*

Analysis of retail trade resources formation demonstrates that the trend for the growth of the import supplies of both foodstuffs and non-food goods has recovered in 2005–2007. In the structure of retail trade goods resources the share of import went up to 47%, increase in foodstuffs being 37% as compared with 34.8% in the previous year and non-food goods – up to 54.4% as compared with 51.7% in 2006. High proportion of import goods secured balance of demand and supply at the investment market as well. Expenditures for purchase of import equipment in January–September 2007 were equal to 18.6% of the volume of investments into machinery and equipment.

Other circumstances being equal the dynamic growth of import contributed into creation of the competitive environment, while high share of import in the retail trade turnover and in the volume of investments in machinery, equipment and transport vehicles strengthened the dependence of internal market trade resources balance on the change in foreign economic situation.

Starting from the second half-year of 2007 growing prices of the world market for crops, dairy and a number of other foodstuffs, reduction of import supplies of the goods of social significance were among the factors that contributed into inflation processes development in the Russian economy. Internal market reacted to the changes in demand and supply proportions and level of world prices for foodstuffs with the increase in prices for both import and domestic goods.

Agriculture goods producers' prices increased by 30.2% against 10.4% in 2006, prices for crops growing by 45.5%, for sunflower seeds – by 206% and for dairies – by 156%. Raw materials becoming more expensive, foodstuffs producers' prices have grown by 20.0% against 8.3% in 2006, main leap in prices occurring in 2<sup>nd</sup> half-year of 2007. Traditional seasonal decrease or slow-down of prices rates for foodstuffs in autumn that was observed starting from 2004, was succeeded by 1.8% increase in the 3<sup>rd</sup> quarter of 2007. In October growth of prices reached the maximum level for the last three years and was equal to 3.3%, exceeding by 0.3 p.p. the level of February 2006 prices.

It should be noted that steps taken to restrict foodstuffs prices growth – that is import duties for milk, dairies and cheeses decrease, signing of agreements between foodstuffs producers and net trade companies on price freezing for some kinds of socially important goods, conduction of goods interventions to the crops markets – did not have considerable influence on present situation. As a result, prices for foodstuffs in 4<sup>th</sup> quarter 2007 went up by 7.0% and from the beginning of the year – by 15.6%, exceeding the figure of 2006 by 6.9 p.p.

Solution of fundamental problems of balance at the market of foodstuffs in concordance with the program of the Ministry for Trade and Economic Development involves implementation of such instruments as import duties decrease for some kinds of goods, oil, for instance, increase of export duties for crops, development of legal and regulatory measures aimed at agriculture goods production and supply growth, reduction of monopolism and development of competition in the field of production and goods sales. The first results of the declared scheme, however, will evolve only in the first half-year of 2008.

It should be noted that change in price proportions has not reflected on the consumer market as a whole yet. Increase in retail trade turnover in 2007 was equal to 15.2% against 13.9% in the previous year and the volume of paid services rendered to the population – to 7.1%.

Comparatively low dynamics of prices for non-food goods, high quality goods and service remained the factor that partially made up for growth of prices for foodstuffs. In 2007 prices for non-food goods increased by 6.5% and paid services – by 13.3%.

Consumer market was maintained by acceleration of growth rates of real population's incomes and continuous expansion of consumer crediting. Increase in real population's monetary incomes in 2007 was equal to 10.4% as compared with 10.2% in the previous year, of real wages – to 16.2% as compared with 13.4% in 2006. In the structure of population's incomes the share of labor remuneration was only 70.3%, exceeding by 5.4 p.p. the figure of the previous year. Against the background of growing population's incomes it was observed that the population's inclination for savings has been declining more and more intensively. Over 2007 the share of savings in population's incomes has decreased by 1.4 p.p. and was equal to 8.9%. The dynamics of population's savings was considerably influenced by such factors as inflation acceleration, change in the situation at the real estate market and periodically evolving problems with banks liquidity.

### ***Dynamics of Gross Saving and Gross Accumulation and Their Proportion in the GDP***

Favorable combination of factors of domestic business activity and price situation at the world market of raw materials accounted for intensive growth of gross savings scale. The share of gross savings in the last seven years was in the range of 31.1–38.7% of the GDP against 24.0% in the pre-crisis 1997. In 2007 under the influence of export share reduction of

the GDP on the one hand, and increase in households expenditures on the other hand, growth of gross national saving was equal to 34.2%.

Table 2

**Structure of GDP Use for Gross Savings and Accumulation in 2000–2007,  
as Percentage to the Total**

	2000	2001	2002	2003	2004	2005	2006	2007
GDP	100	100	100	100	100	100	100	100
of which:								
Gross savings	38.7	34.2	31.1	31.9	33.6	33.6	34.5	34.2
of which:								
Gross accumulation	18.7	21.9	20.1	20.8	20.9	20.1	21.3	24.5
Gross accumulation of fixed assets	16.9	18.9	17.9	18.4	18.4	17.7	18.4	21.0
Change in the stocks of material circulating assets	1.8	3.1	2.1	2.4	2.5	2.3	2.9	3.5
For reference:								
The share of investments in the fixed assets in the GDP	15.9	16.8	16.3	16.5	16.8	16.7	17.0	17.3

Source: Federal State Statistics Service.

As the experience of the last two years has demonstrated it is the ratio of investment demand and final consumption that reacted most vigorously to the change of export earning and defined peculiar features of the internal market operation. Sudden fluctuations of investment expenditures for reproduction of fixed assets were compensated by smooth change in the dynamics of final consumption. At the same time the strengthening of investment component impact on the dynamics of the economic growth has been observed from 2<sup>nd</sup> quarter 2006. The growth rates of the investments in the fixed assets reached the maximum level after the financial crisis of 1998 in 2007, being equal to 121.1% as compared with 113.7% in 2006 and 109.5% on average over 2000–2005. It should however be noted that whereas in 2007 the volume of the GDP exceeded the pre-reform level of 1991 by 10%, investments in the fixed assets were nearly by 1/3 lower than the corresponding index of the same year.

***Households' Final Consumption and Change in Population Standard of Living Parameters***

Positive dynamics of final consumption was one of the main factors for the development of internal market in 2001–2007, real population's income, real wage and real volume of accrued pensions starting to grow steadily. The growth of the scale of final consumption proceeded against the background of quite steady sustention of the ratio between the consumption of households and the amount of social transfers, received from the governmental institutions and non-commercial organizations. In 2007 the share of expenditures for final consumption in the structure of the GDP was equal to 65.8% in 2007, exceeding the figure of the corresponding period of the previous year by 0.1 p.p.

In 2000 expenditures for households' final consumption reached the level of pre-crisis 1997, and have doubled over seven years that followed. The growth of households' consumption was accounted for by steady increase in population's monetary incomes. Over 2001–2007 real population's incomes have grown by 2.1 times, real wages – by 2.5 times and real volume of accrued pensions – by 1.9 times.



*Table 3*

**Structure of Gross Domestic Product Use in 2001–2007 as Percentage to the Total**

	2001	2002	2003	2004	2005	2006	2007
Gross domestic product	100	100	100	100	100	100	100
Of which							
Expenditures for final consumption	65.8	68.9	68.1	66.9	66.2	65.6	65.8
Including:							
Households	48.3	50	49.4	49.3	49.0	47.9	47.9
Governmental institutions	16.4	17.7	17.6	16.7	16.6	17.0	17.3
Gross accumulation	21.9	20.1	20.8	20.9	20.1	21.3	24.5
Net export of goods and services	12.7	10.8	11.3	12.2	13.7	12.7	8.5

Source: Federal State Statistics Service.

Anticipating growth of wages as compared with other sources of income had the primary influence on the population's incomes dynamics. Population's incomes increasing steadily, the reduction of poverty level has been observed. The proportion of people with monetary incomes lower than subsistence level decreased down to 21.5 mln of people in 2007, which was equal to 15.2% of the total number of population as compared with 25.2 mln of people (17.7%) in 2005 and 42.3 mln of people (29.0%) in 2000.

*Table 4*

**Number of People with Monetary Incomes Lower Than Subsistence Level on the whole throughout the Russian Federation**

	Mln of people	As percentage to the total number of population
<b>2005</b>		
1st quarter	34.9	24.5
1 <sup>st</sup> half-year	31.4	22.1
Yearly	25.2	17.7
<b>2006</b>		
1st quarter	31.7	22.4
1 <sup>st</sup> half-year	27.0	19.1
Yearly	21.6	15.3
<b>2007</b>		
1st quarter	25.8	18.3
1 <sup>st</sup> half-year	22.3	15.8
Yearly	21.5	15.2

Source: Federal State Statistics Service.

Structural shifts in population incomes formation were accompanied with the change of population distribution by the amount of average per capita incomes. In 2007 average per capita incomes increasing by 22.7% and nominal wages – by 26.7%, the share of the population with the average per capita incomes of more than RUR 12000 expanded by 9.1 p.p., and with the incomes below 6000 reduced by more than 8.8 p.p. However this did not relax the social and economic differentiation of the population by incomes. According to estimation, fund coefficient, which characterizes the ratio of the highest and lowest incomes of the corresponding decile groups of the population, was equal to 16.8 in 2007 against 16.0 in 2006, and Gini coefficient characterizing concentration of incomes increased up to 0.422 against 0.416 a year ago.

The specific character of incomes distribution also determined the distinctive features of the current expenses dynamics and the level of savings in the households sector. In 2007 the volume of population's monetary incomes was equal to RUR 21138.9 bln, having increased by 22.4% over the year. For goods purchase and payment for services the population spent RUR 14707.8 bln, which exceeds the level of 2006 by 23.5%, and savings were equal to RUR

2981.4 bln, which is by 0.5% higher than in the previous year. The factor that restricted use of savings for current consumption was high investment activity of the population at the housing market. At the expense of own and loaned funds the population has built by nearly 1/3 more housing floorspace than a year before.

Over the last seven years the change in the consumer spending was determined by the increase in the share of expenditures for non-food goods and services and reduction of the share of expenditures for foodstuffs. It is to be mentioned that the statistic monitoring observed gradual shift of sales assortment structure of foodstuffs towards more expensive and of non-food goods towards imported goods of better quality. The change in the population demand and the increase in the share of non-food durable goods and house furnishing goods stirred up the development of consumer crediting. The volume of credits given to individuals expanded by 1.52 times in comparison with the beginning of 2007.

### 3.1.2. Characteristic Features of GDP Formation by Incomes

The dynamic growth of the population incomes is one of the characteristic features of Russian economy's growth. The sustention of the domestic market dynamics was based on the growth of real wages and was accompanied by the redistribution of incomes from the enterprises to the population. In 2007 the share of the employees labor remuneration in the GDP was equal approximately to 44.8% and remained above the figures of 2005–2006. High differentiation of the average wages by kinds of economic activity was preserved. In the industry the level of wages differentiation was defined by the increase in the gap between the rates of the labor remuneration in extraction and processing industries. Nominal accrued wages in minerals extraction was 2.1 times higher than the average in the economy, including in fuel fossils extraction – by 2.5 times. In processing industries the wages were equal to 97% of the average in the economy and 42% of the figures of extraction industries. The exceeding of the average figure of accrued wages by 2.3 and 2.2 times, respectively, was observed in productions, connected with oil products processing and transportation of fuel fossils. In education and public health care the average wages were equal to 75–7% of the average in the economy, in government administration and military safety security – to 120% and in financial activity – to 260%. The characteristic features of labor remuneration by the kinds of economic activity had a substantial impact on the nature of employment and labor resources distribution in the economy.

*Table 5*

#### **Structure of the GDP Formation by Incomes in 2001–2007, as Percentage to the Total**

	2001	2002	2003	2004	2005	2006	2007
Gross Domestic Product	100	100	100	100	100	100	100
Of which:							
Employees labor remuneration (including hidden wages)	43.0	46.7	47.1	46.0	43.8	44.1	44.8
Net taxes for production and import	15.7	17.0	16.0	16.8	19.7	20.0	18.9
Gross profit of the economy and gross mixed incomes	41.3	36.3	36.9	37.2	36.5	35.9	36.3

*Source:* Federal State Statistics Service.

Only 8% in the structure of the employed population account for people who do not work for a wage; these are employers, who attract employees on a regular base to work for

their own companies, self-employed people. This defined, correspondingly, the nature of the population income structure and the GDP formation. More than 70% of population income accounted for the remuneration of labor of those, who work for wages, the share of the incomes from the entrepreneur's activity and property decreasing.

The level and the share of employers' wages in the structure of the GDP had a prevailing influence on the social profile, including labor market. The typical aspect of the period of 2001–2007 was the tendency for the growth in the demand for the labor force. Average annual number of the employed in the economy process in 2007, according to the preliminary data, was equal to 70.5 mln of people and increased by 2.4% as compared with the previous year. It is to be noted, that the change in labor force demand was determined by the shift of the employment to the kinds of activities that provide market services. The formation of this tendency at the initial stage of the economic growth restoration had a powerful effect on the life quality and gave a stimulus for service sphere development. In past four years the decrease in employment was observed in almost all branches of industry, the decrease in the number of workplaces being the most intensive in the processing industries. In 2006 as compared with 2004 the average annual number of those employed in processing industry reduced by 532 thousand of people, in extraction industries – by 52 thousand of people. This trend was formed against the background of weakening of the trend for labor efficiency in industry.

*Table 6*

**The Dynamics of Labor Efficiency, as % to the Preceding year**

	2003	2004	2005	2006	2007*
Economy as a whole	107.0	106.5	105.5	106.0	106.0
<b>Broken by kinds of economic activities:</b>					
Agriculture, hunting and forestry	106.0	103.6	102.4	104.1	105.0
Fishing and fish breeding	102.1	104.3	100.1	111.2	102.0
Minerals extraction	109.2	107.3	106.2	102.2	102.3
Manufacturing industries	108.8	106.3	107.1	105.5	109.1
Production and distribution of water, gas and electricity	103.7	100.4	103.7	102.3	100.0
Construction	105.3	106.9	105.9	113.3	114.7
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	109.8	110.5	105.1	106.9	107.8
Hotels and restaurants	100.3	103.1	106.5	109.5	No data
Transport and communication	107.5	108.7	102.1	107.9	106.8
Operations with real estate, renting, provision of services	102.5	101.3	112.7	104.8	No data

\* Preliminary data.

Source: Federal State Statistics Service.

The low efficiency in factors of production use is one of the main causes of the decrease in competitive advantages of Russian goods. The growth of discrepancy between the rate of labor productivity and wages in favor of the latter had the negative impact on the economic dynamics indices. However possibilities for further increase of costs for labor remuneration were limited due to the changes in competitive environment at the goods markets because of ruble appreciation and increase in import pressure.

Analysis of economic growth in 2004–2007 enables to highlight three factors that determined specific features and dynamics of this growth: first, the decrease of the employment

in industrial production, the employment in the economy on the whole increasing and the employed distributing towards the sector of services; second, labor efficiency rates deceleration in the industry; third, dynamic growth of investments in the fixed assets.

On the whole output growth in the economy due to the main factors input in 2007 is mainly (by 37.5%) was accounted for by the increase of investments and volume of the capital involved in production in contrast to other periods, when increase of capital input was determined mainly by involving in production. In 2007 this component defined 21.5% of the output growth rates, which was secured by investments growth rates acceleration (21.1% in 2007 as compared with 13.7% in 2006 and 10.9% in 2005) and, as a consequence, intensification of existing facilities renovation processes.

Increase of labor input is also due to the change in “stocks”, that is the number of the employed. In 2007 the increase in the demand for labor force led to the exceeding of the average figure of the employment for the last 7 years. It should be noted that the growth of the number of the employed was mainly due to the sector of services, while in the sector of goods production the employment reduced. At the same time in 2007 the hours of work by one employee a year decreased, which had a negative impact on the GDP growth rates.

Decomposition of output figure (GDP and added value of the industrial production) demonstrates that economic development rates acceleration in 2007 is accounted for mainly by the increase in growth rates of total factor efficiency (TFE) against the background of differentiation of main factors growth rates intensifying. The basis for decomposition<sup>1</sup> is breaking down of the economic growth to extensive and intensive components, which enable estimation growth quality, forecast of further trends for economic development.

TFE growth rates in 2007 was equal to 4.35%, which is three times bigger than the level of 2006, when the corresponding figure was equal to 1.31%, nearly reaching the level of 2004–2005 (4.4%). On average over 2004–2007 annual increase of TFE growth rates was equal to 0.05 p.p., though, according to the linear trend the growth rates decrease annually by 0.29 p.p. In 2007 contribution of TFE in the output growth rates increased as compared with 2006 by 53.8%, the figure being 19.6% then. The value nature of the indices used for estimation makes TFE estimations dependant on the situation factors and especially on oil prices. On exclusion of oil prices growth component from the TFE figure, efficiency growth free from the situation at the world markets changes but little. The contribution of technological component<sup>2</sup> in GDP growth in 2007 was equal to 51.8%. The obtained value considerably exceeds the average figure of this factors' contribution into the GDP over the last years.

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<sup>1</sup> Decomposition of GDP output index growth and added value of industrial production is conducted in accordance with the method presented in the book: *Factors of the economic growth*, “Scientific work” series, No. 70, IET, 2003. TFE is referred to as remainder not accounted for by main factors, labor and capital, characterizing the influence of scientific and technological progress, innovations, increase of production organization efficiency, management quality, as well as change in price situation.

<sup>2</sup> Under “technological” component we understand final remainder obtained after excluding from the productivity evaluation the component determined by the dynamics of the world oil prices.

*Table 7*

**Decomposition of the GDP Annual Growth Rates and Gross Added Value  
by Kinds of Economic Activities in 2004–2007<sup>3</sup>**

	GDP	Factors costs	including:						TFE
			Labor	Of which:		Capital	Of which:		
				Number of the employed	Hours of work*		Fixed funds volume**	Extent of facilities load***	
	7.2	2.99	1.03	0.43	0.60	1.96	0.54	1.42	4.21
Total throughout the economy	6.4	1.82	0.02	0.22	-0.20	1.79	0.68	1.11	4.58
	6.7	5.39	0.28	0.13	0.15	5.11	1.44	3.67	1.31 <sup>4</sup>
	8.1	3.75	0.71	0.84	-0.14 <sup>5</sup>	3.04	1.74 <sup>6</sup>	1.30 <sup>7</sup>	4.35
	8.60	2.34	-4.22	-4.22	-	6.56	3.60	2.96	6.26
Minerals extraction	0.90	3.40	-0.66	-0.66	-	4.06	3.71	0.35	-2.50
	2.10	-0.49	-0.09	-0.23	0.14	-0.40	4.36	-4.76	2.59
	0,3	2,04	-0.55	-0.61	0.06	2.59	2.59	-	-1.74 <sup>8</sup>
Processing industries	6.7	0.27	-3.61	-3.61	-	3.88	1.95	1.92	6.43
	5.7	5.17	-0.94	-0.94	-	6.11	2.31	3.80	0.53
	4.9	5.53	-0.54	-0.75	0.21	6.07	2.82	3.25	-0.63
	7,9	1,35	-0.52	-0.66	0.14	1.87	1.87	-	6.55
Electricity, gas and water production and distribution	2	-3.63	-3.84	-3.84	-	0.21	0.21	0.00	5.63
	1.3	0.67	0.30	0.30	-	0.37	0.37	0.00	0.63
	2.6	0.62	0.26	0.13	0.13	0.36	0.36	0.00	1.98
	-0,3	-1.32	-1.60	-0.85	-0.75	0.28	0.28	0.00	1.02

\* Per one worker.

\*\* For 2004–2006 on the basis of data on the physical volume of fixed assets.

\*\*\* The estimation of the change in facilities utilization throughout the whole economy is based on the data for electricity consumption, in industrial production – on the data for average annual manufacturing capacity of organization, producing different type of goods.

It should be noted that the dynamics of growth rates of technological component of the TFE is a retarded reflection of changes in the dynamics of investments growth rates. This fact characterizes the period necessary to implement and use the accumulated investments. Slow-down of TFE growth rates in 2004–2006 corresponds to the period of moderate investment activity in 2001–2003. At the same time intensification of investment processes that started in 2004 can be considered as one of the reasons for acceleration rates of technological component in 2007.

<sup>3</sup> For each type of the economic activity the first line gives growth decomposition in 2004 r, second line – in 2005, third line – in 2006, fourth line – in 2007. The deviation from the data published earlier is due to the change of data supplied by the Federal State Statistics Service.

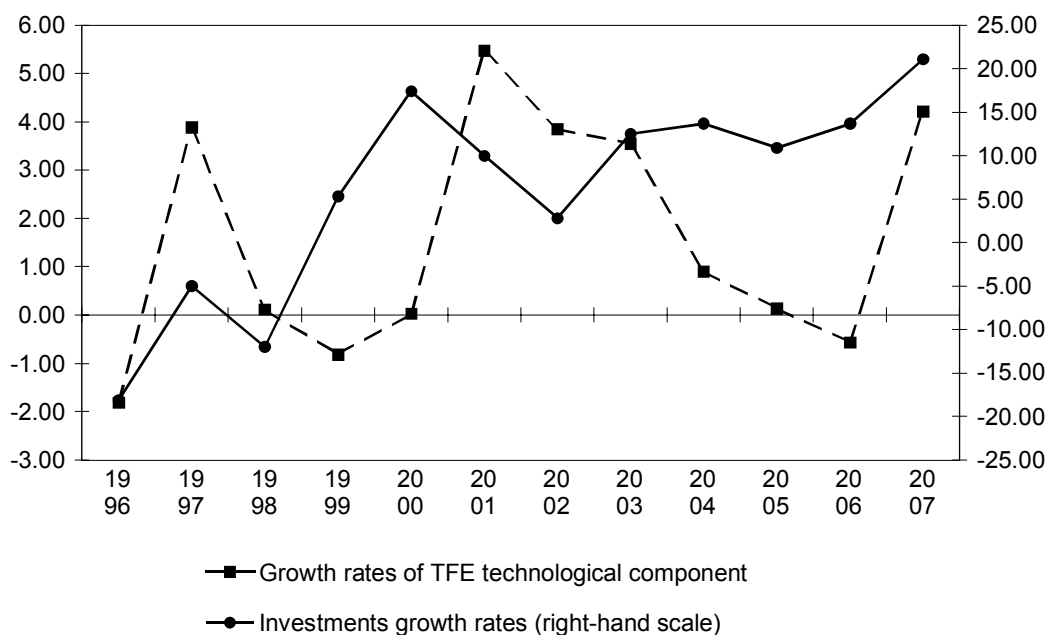
<sup>4</sup> In 2006 the estimation of the TFE growth rates in the industrial production can be slightly underrated, for the shift upwards of the estimation of growth rates caused by the change in the extent of the facilities load which in its turn is due to the change in the methodology of consumed energy volume measuring.

<sup>5</sup> The estimation for the year is based on the data for January–September 2006.

<sup>6</sup> Preliminary data – estimation of the fixed assets volume growth in 2007 is based on the assumption that the coefficient of fixed assets retirement and the share of investments in their renewal are constant.

<sup>7</sup> The estimation of the extent of facilities load is based on the assumption that the share of energy consumed in the volume of the production output is constant.

<sup>8</sup> In 2007 the estimation of the TFE growth rates in the industrial production can be slightly overrated, for the extent of the industrial facilities utilization was not taken into the account in the calculations.



*Fig. 3. Dynamics of “Technological” Component of TFE Growth Rates and Investments Growth Rates in 1996–2007*

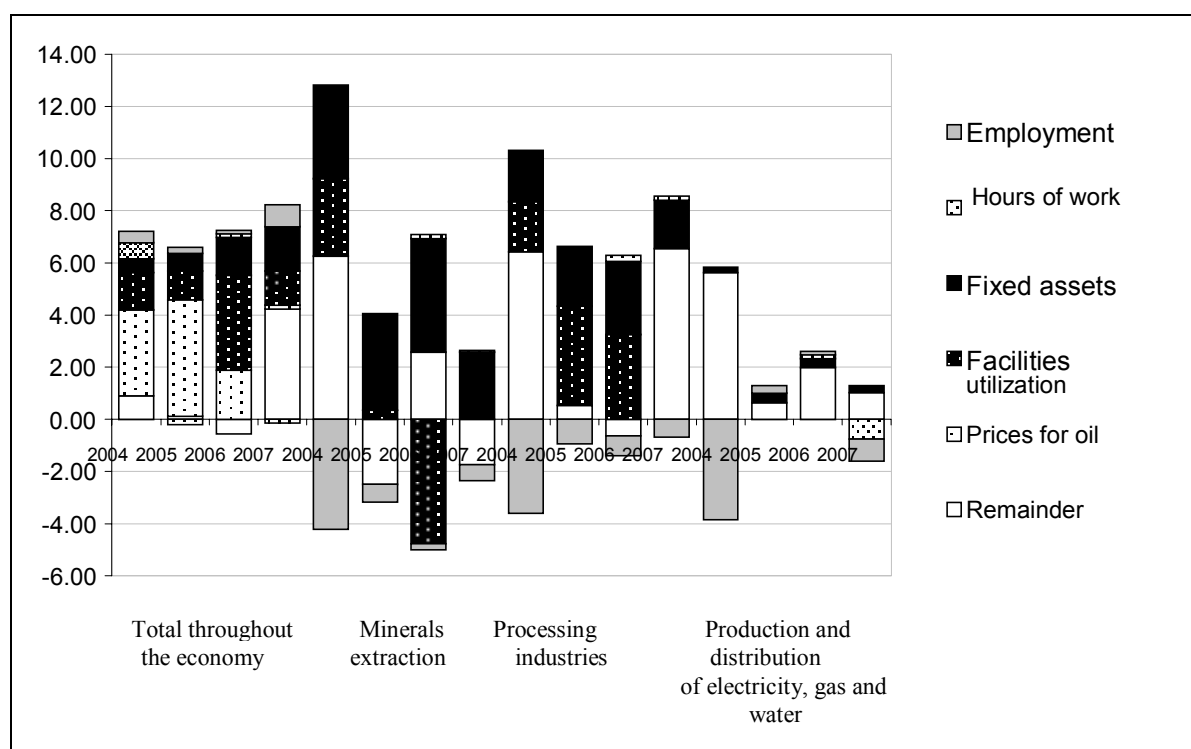
For the enterprises of the minerals extraction sector, in contrast to the economy as the whole, the decrease in gross added value (GAV) growth rates was observed in 2007 as compared with 2006: in 2004–2007 minerals extraction enterprises are characterized with the maximum deceleration of output growth rates in the industrial sector: on average over the period GAV growth rates decrease by 2.77 p.p., and according to the linear trend – by 2.37 p.p.

In accordance with decomposition results the contribution of the labor input to the output growth rates for this type of the economic activity remains negative over the whole period of 2004–2007, which is defined by the decrease in the number of those employed at the extraction industry. The capital input, in contrast, was increasing mainly due to the increase of the industrial facilities in the environment of considerable fluctuation of the extent of their utilization.

TFE of extracting sector dynamics is controversial: extracting enterprises demonstrate negative growth rates of productivity in 2005, in 2004 and 2006 the situation was the opposite – at that time output increase was due to the growth of total factors’ efficiency against the background of their costs decrease. In 2007 TFE of this kind of economic activity again shifted to the field of negative values, which was the main reason for unsteady growth rates of added value. On average over the period TFE growth rates slowed down by 2.67 p.p. (according to the linear trend – by 1.89 p.p.).

The TFE dynamics of the extractive industries sector is more prone to the influence of the price situation at the world markets as compared with other industrial production. It should be noted that separation of the component defined by prices for oil growth from the TFE index demonstrates that technological effectiveness growth rates of the sector has been decreasing since 2005. Against the background of favorable price situation at the world markets of raw materials this testifies that technological characteristics of extraction enterprises functioning

have been worsening. This can be connected both with start of exploitation of oil fields with lower efficiency and with the decrease of management quality in the environment of considerable growth of prices. Slow-down of prices for oil growth rates in 2007 caused decrease of price factor input to the TFE of the extractive sector and, as a result, negative dynamics of the TFE, since “technological productivity” dynamics was also negative. In 2007, as well as in 2005–2006, it is the processing enterprises that are characterized with the biggest growth rates. According to the results of the decomposition over the whole period of 2004–2007 the decrease in the number of the employed at the manufacturing enterprises determines the negative contribution of the labor input to the output growth rates for this kind of economic activities, the absolute value of this input, however, decreasing. The growth in the physical volume of fixed assets accounts for steadily positive capital input contribution into output growth rates, which along with the increase in the intensity of industry capacities utilization defined the prevailing position of the capital as a factor of processing industries economic growth in 2005–2006. In 2007 the changes were registered in the structure of added value growth of this kind of economic activity: the share of output, accounted for by the changes on capital costs decreased down to 23.7%, and the most significant factor of processing enterprises’ output growth was TFE, whose contribution, according to the preliminary estimations, is equal to 82.9%, though this estimation is likely to be overrated, since it does not take into account the changes in industrial facilities utilization.



Note: decomposition for the industrial production of 2004–2005 was made not taking into account work hours, the data being unavailable.

Fig. 4. Structure of Gross Added Value in the Economy on the Whole and in the Industrial Production in 2004–2007

The only kind of economic activity where GAV decrease was observed in 2007 is electricity, gas and water production and distribution (GAV growth rates are equal to 99.7%). It should be noted that in 2004–2006 output growth rates of this kind of economic activity demonstrated the most successful dynamics, which is characterized by constant increase of growth rates. Reduction of added value of this industrial sector was mainly due to with the decrease in the main factors input. Against the background of slight growth of fixed assets volume, the negative dynamics of the main factors input was defined by the reduction of the number of those employed at the enterprises of this kind of economic activity and the hours worked by them, that is why labor input in 2007 was the main factor decreasing GAV growth rates at enterprises of electricity, gas and water production and distribution.

In 2007 the impact of main factors input (labor and capital accumulation taking into account the intensity of their usage) was practically equal to that of TFE on the observed GDP growth. The input of efficiency in GDP growth was about 54%, not taking into account world prices for oil, and 52%, when estimation of price situation at the markets of raw materials contribution is excluded.

Structure of TFE growth rates in the industrial sector is not an even one: as a continuation of the trend for efficiency growth rates deceleration that outlined in 2004–2006, in 2007 the enterprises of extractive sector demonstrate TFE decrease; TFE growth rates at the enterprises of electricity, gas and water production and distribution are reducing; at the processing enterprises, in contrast, TFE growth is observed, it being the prevailing factor that influenced the growth of this industrial sector.

The results presented characterize the transformation of economic growth structure and enable to single out the most significant factors that defined changes in the dynamics of the output growth rates.

As a result of January–September 2007 the economy's profitability was equal to 13.9% against 14.9% in the corresponding period of the previous year. The highest level of profitability is sustained in the industries connected with minerals extraction and processing. The existing differentiation of labor remuneration by kinds of economic activities influences the ratio of labor efficiency and wages growth rates considerably. Average accrued wages in the processing industries is by nearly 1.5 times lower than in extractive industries and its dynamic growth is the factor of attracting qualified labor force.

Disproportions in labor remuneration result in redistribution of decreasing labor resources to the sectors of economy characterized by high profitability, aggravate the deficit of specialists and qualified workers in the majority of processing industries, which is the factor that restricts processing industries development, economy's diversification and efficiency increase.

The profitability of sold goods and services throughout the economy as a whole was equal to, according to the preliminary estimation, 13.9% in 2007 against 14.9% in 2006. The analysis of profits formation by the kinds of activities demonstrates that balanced financial result was formed by 3/5 by economic activities connected with goods production and by 2/5 by services provision. However inside the sectors the industries can be distinguished that have a prevailing impact on the process of profit formation and use in the national economy.

The slowdown in industry financial results was initiated by the reserved dynamics of extractive industries productions. Balanced financial result of fuel fossils excavation in January–September 2007 decreased by 0.2% in comparison with the corresponding period of 2006.



Growth of prices for raw materials and investment goods led to the deceleration of the profit growth rates on the whole at processing enterprises, diversified tendencies for other kinds of activities sustaining.

*Table 8*

**Profitability of Sold Goods, Production, Work, Services of Organizations  
by Kinds of Economic Activity in 2003–2007, %**

	2003	2004	2005	2006	January–September	
					2006	2007
Total throughout the economy	10.2	13.2	13.5	13.2	14.9	13.9
Minerals extraction	19.2	32.5	35.6	30.6	35.3	27.9
Processing industries	12.4	14.9	15.3	16.6	16.8	18.5
Electricity, gas and water production and distribution	6.4	5.4	5.3	3.2	2.7	4.2
Construction	5.7	4.2	3.9	5.1	4.5	5.2
Wholesale and retail trade, motor vehicles servicing etc.	8.9	11.3	9.7	10.1	11.3	8.6
Transport and communication	15.3	13.4	14.4	15.1	16.4	17.7
Of which communication	35.8	32.7	33.6	33	36.9	41.4

*Source:* Federal State Statistics Service.

### 3.1.3. The Dynamics and the Structure of the Production by the Kinds of the Economic Activities

#### ***Main Trends and Factors of the Change of the Produced GDP***

The development of the Russian economy in 2007 was formed under the influence of the following most significant factors: increase in domestic demand impact; advance growth of manufacturing industries in comparison with extraction industries, advance growth of investments in fixed assets in comparison with GDP and final demand dynamics; acceleration of final commodities import with regard to domestic production; intensive growth of the service sector; anticipating growth of wages in comparison with labor productivity, sustention of high customer demand and population inclination for savings; the acceleration of prices growth rates of manufacturing goods producers and service tariffs.

Comparative analysis of the Russian economy dynamics as broken by kinds of activities demonstrates, that the ratio of growth rates of the industry, construction and trade had the most significant impact on the nature and structure of development in 2002–2007.

Starting with the second half of 2005 with the increase of the investment activity in the national economy, the trade gave leading positions to the construction. The share of retail and wholesale trade is the biggest in the produced GDP and equal to 17.7% in 2007. It should be noted that the dynamic structural shifts were characteristic for the development of this kind of activity. The change in the demand at the world market determined anticipating growth and the increase of the foreign trade share in the structure of the trade turnover. Intensive growth of the wholesale trade was sustained due to the extension of the internal demand market for

material and technological resources. The volumes of wholesale trade exceeded the retail trade turnover by more than two times.

Table 9

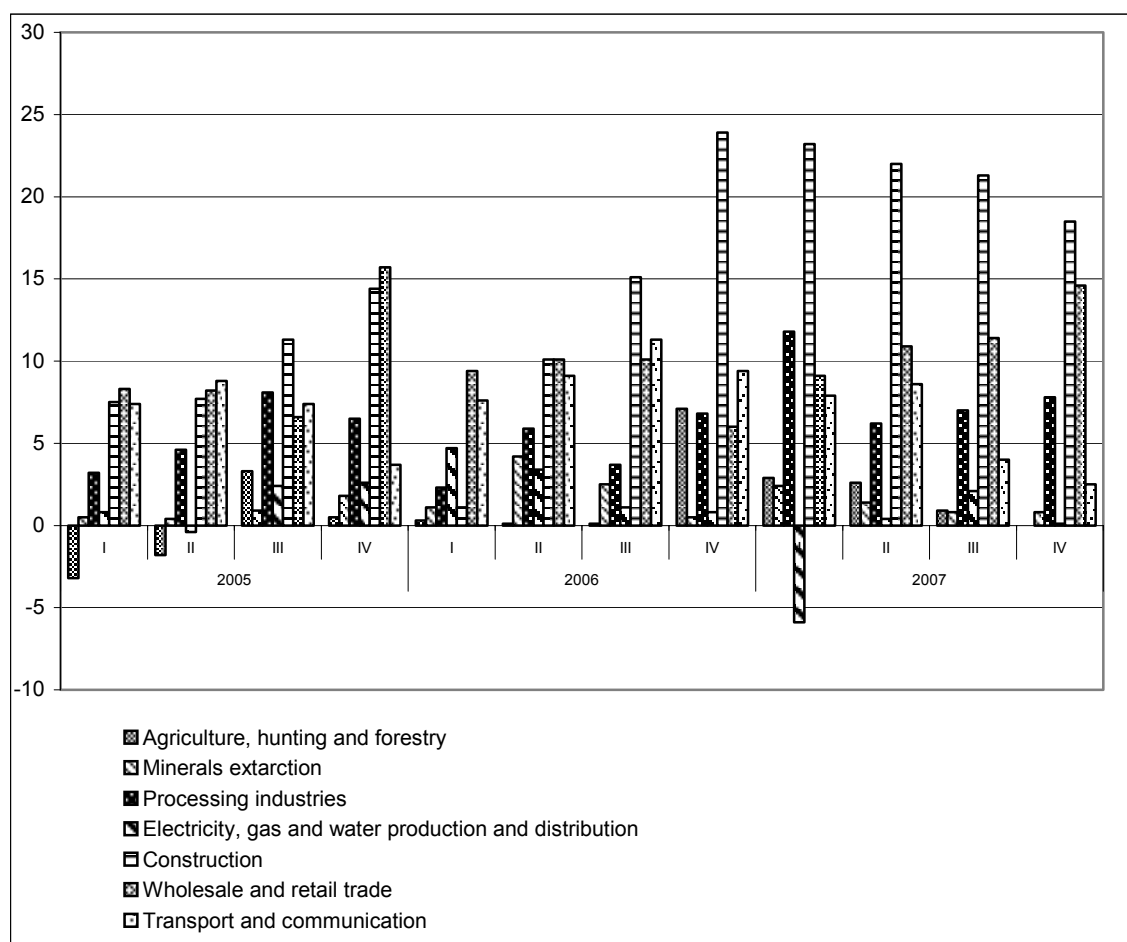
**The Structure of the GDP Produced as Broken by Kinds of Economic Activities  
in 2002–2007, as percentage in current prices**

Section	2002	2003	2004	2005	2006	2007*
	100.0	100.0	100.0	100.0	100.0	100.0
A	5.7	5.5	5.0	4.5	4.1	3.9
B	0.3	0.5	0.4	0.3	0.3	0.2
C	6.0	5.9	8.4	9.6	9.5	9.0
D	15.6	14.9	15.8	16.3	15.6	16.4
E	3.3	3.2	3.3	2.9	2.8	2.7
F	4.8	5.4	5.1	4.8	4.5	5.1
G	20.4	19.6	17.8	16.9	17.7	17.7
H	0.8	0.7	0.8	0.8	0.7	0.8
I	9.2	9.5	9.7	8.9	8.5	8.1
J	2.8	3.0	3.0	3.5	3.9	4.1
K	9.5	9.5	8.3	8.5	8.7	8.9
L	4.5	4.9	4.7	4.4	4.4	4.4
M	2.6	2.4	2.4	2.3	2.3	2.4
N	3.0	2.8	2.8	2.6	2.9	2.9
O	1.7	1.7	1.6	1.5	1.6	1.7
	-1.7	-1.6	-1.8	-2.0	-2.2	-2.3
	88.5	88.0	87.3	85.7	85.4	85.8
	11.5	12.0	12.7	14.3	14.6	14.2

\* Preliminary data.

Source: Federal State Statistics Service.

The extension of the trade volumes in the country and at the international level determined to a great extent the growth of transportation operation. Commercial freight turnover increased by 2.2% over 2007 while the industrial output went up by 6.3%. The state of the transportation system of Russia is a barrier for economic growth, since its inefficiency leads to increased transport costs and the loss of profits from transit transportation.



Source: Federal State Statistics Service.

Fig. 5. Change in the Production Dynamics by Kinds of Economic Activities in 2004–2007, as percentage to the corresponding period of the preceding year

Communication remains the most promising and dynamically developing among the kinds of economic activities. In 2007 the volume of communication services increased by 20.1%. The share of the main communication operators comprised 3/5 of the total volume of the communication services volume and more than a half of population communication services. The telephone communication provides 4/5 of the incomes, obtained from the industry services.

### ***Industry: Production Rates and Structure***

The analysis of industry production dynamics in the classification of kinds of economic activity allows estimating the impact of the extraction and manufacturing industries on the nature of the Russian economy growth nature. The comparison of the dynamics of industry indices demonstrates that whereas the Russian industry crisis was initiated by the slump in manufacturing industries in the environment of the reserved decrease of fuel fossils production, the economic growth was based on the increase in manufacturing industries production and the recovery of fossil fuels production in 2003 at the pre-reform level. Since that moment

the structure shifts in industry were determined by the anticipating growth of manufacturing industry in the Russian economy, the minerals extraction production dynamics being reserved. The main trends for the development of enterprises for minerals extraction were formed under the influence of such factors as the reduction of efficacious reserves facilities, low rates of exploration and putting into operation of new oil fields, limitations from transportation and exploration infrastructure. Underexploitation of extraction industries growth potential was also determined by reserved rates of minerals processing in metallurgy and petrochemistry. The existing structure of fixed assets being what it is the further increase of facilities load was accompanied by production capital intensity growth and the decrease in labor and financial resources efficiency use. This determined the significant impact of the output dynamics volume of the export-orientated industries complex on the structure of the industrial production and demand at the domestic market.

It should be noted that it was the slowdown in the fossil fuels extraction that had the biggest impact on the dynamics of the extraction industries in 2005–2007. The production indices in fossil fuels extraction slowed down to 102.5% in 2006 as compared with 107.5% in 2003, and in metal ores extraction – down to 101.8% against 108.5%.

Structural shifts in industry in 2007 were defined by anticipating growth of processing industries. Increase in industrial production in 2007 was equal to 6.3%, exceeding by 2.4 p.p. the level of the previous year. Increase in production volume of processing industries was 9.3%, extracting industries growing by 1.9% and electricity, gas and water production and distribution reducing by 0.2%. The potential of unused facilities being exhausted, one of the main factors of industry's growth rates acceleration was the growth of the scale of investments in the fixed assets. As a result they were kinds of activities oriented towards investment goods production – for instance machinery and equipment production (growth index 119.3%), electric, electronic and optical equipment production (112.8%), transport vehicles and equipment production (115.9%), non-metal mineral goods production (110.8%) – that had the most considerable influence on the sustention of steady dynamics of processing industries development.

*Table 10*

**Indices of Industrial Production by Kinds of Economic Activities in 2000–2007,  
as percentage to the previous year**

	2000	2001	2002	2003	2004	2005	2006	2007
Industry	108.7	102.9	103.1	108.9	108.3	104	103.9	106.3
Minerals extraction	106.4	106	106.8	108.7	106.8	101.3	102.3	101.9
Fossil fuels extraction	104.9	106.1	107.3	110.3	107.7	101.8	102.5	101.9
Minerals extraction excluding fossil fuels	118.2	96.2	99.1	102.5	108.5	96.8	101.8	101.6
Manufacturing industries	110.9	102	101.1	110.3	110.5	105.7	104.4	109.3
Electricity, gas and water production and distribution	104	101.4	104.8	103.3	101.3	101.2	104.2	99.8

*Source:* Federal State Statistics Service.

### *Oil and Gas Sector*

Oil and gas sector is the basis for the Russian economy, playing a leading role in the formation of state budget earnings and trade balance of the country. The price situation at the world markets had a determining influence on the position of the oil and gas sector in the Russian economy in 2007. Since nearly 75% of the oil produced in the country is exported in crude or processed form, the level of world prices for oil is actually the main factor that determines incomes and financial situation of the Russian oil industry.

World prices in 2007 were at an exceptionally high level. In November 2007 the prices for oil reached unprecedented maximum in nominal terms. The average price for oil grade Brent was equal to USD 92.6 per barrel, Urals – to USD 90.0 per barrel. The main reasons for such a situation were world economy growth rates, which lead to high demand for oil, and conservative politics of OPEC concerning increase in oil production by member countries. The presence of quite considerable geopolitical risks in 2007 that contributed in sustention of high world prices for oil is also to be noted.

As a result, in 2007 the price for oil grade Brent was on average equal to USD 72.5 per barrel, the price of Russian oil Urals being USD 69.4 per barrel. The average price of the Russian oil at the world (European) market was 13.3% higher in 2007 than the average level of the previous year (*Table 11*).

*Table 11*

**World Prices for Oil in 2000–2007, as USD per barrel**

	2000	2001	2002	2003	2004	2005
Price for oil grade Brent, Great Britain	28.50	24.44	25.02	28.83	38.21	54.38
Price for oil Urals, Russia	26.63	22.97	23.73	27.04	34.45	50.75
Price for oil basket of OPEC member countries	27.60	23.12	24.34	28.13	36.05	50.64

	2006	2007 Q I	2007 Q II	2007 Q III	2007 Q IV	2007
Price for oil grade Brent, Great Britain	65.16	57.75	68.76	74.87	88.69	72.52
Price for oil Urals, Russia	61.24	54.30	65.16	72.19	85.91	69.39
Price for oil basket of OPEC member countries	61.08	54.65	64.97	71.59	85.18	69.10

*Table 11 (continued)*

*Source:* OECD International Energy Agency, OPEC.

The level of world prices for oil, which was observed in 2007, is exceptionally high not only for the period of post-reform development of the Russian economy but also from the point of view of historical retrospective. Over the period since 1900 higher level of world prices for oil in real terms was observed only in 1979–1981. For instance, in 1980 the average annual world price for oil in real terms (in 2006 prices) was equal to USD 90.5 per barrel, being in nominal terms USD 36.8 per barrel (*fig. 8*). For reference it can be noted that in 1998 the average annual price for the oil grade Brent in real terms (2006 prices) was only USD 16.2 per barrel (USD 12.7 per barrel in nominal terms), being on average in 1990ies USD 25.2 per barrel.

Data on monthly dynamics of world prices for oil in 2007 are presented in *Table 12*.

Table 12

**Prices for Oil Grades Brent and Urals in 2007, as USD per barrel**

	2007 January	2007 February	2007 March	2007 April	2007 May	2007 June
Price for oil grade Brent, Great Britain	53.68	57.43	62.15	67.51	67.23	71.54
Price for oil Urals, Russia	50.00	54.06	58.84	63.81	64.02	67.66

Table 12 (continued)

	2007 July	2007 August	2007 September	2007 October	2007 November	2007 December
Price for oil grade Brent, Great Britain	77.01	70.73	76.87	82.50	92.61	90.97
Price for oil Urals, Russia	73.88	69.04	73.65	79.47	89.98	88.28

Source: OECD/IEA, OPEC.

The development of the gas and oil sector in the Russian economy in 2007 was characterized by the sustention of the tendency for oil, oil products and natural gas production growth. Oil production, gas condensate included, reached in 2007 491 mln tons. This figure is by 13.8% lower than pre-crisis maximum, reached in 1987, when oil production was equal to 569.4 mln tons and by 63% higher than the minimum level of 1996, when the production decreased down to 301.3 mln tons. The reasons for a considerable growth of oil production in recent years are the expansion of export opportunities, in particular due to the building of the Baltic pipeline system and extension of railway transportation use, as well as the growth in domestic demand and intensification of exploitation of oil fields in operation.

At the same time oil production growth rates in 2005–2007 decreased considerably. Whereas in 2002–2004 the increase in oil production, gas condensate included, reached 8.9–11% per year, in 2007 the increase in production was only 2.1% (Table 13). This is the indicator of exhaustion of reserves for fast increase of oil production in the country and the evidence of necessity of very active actions to develop new oil fields, in the Eastern part of the country, in particular.

The volume of primary oil processing increased by 3.8% in 2007, and the extent of oil processing decreased as compared to 2006 and was equal to 71.7% (in 2006 this index was equal to 72.0%).

The decrease in natural gas production – by 0.8% as compared with 2006 – has been observed for the first time over the recent years. The main reason for it is the drop in external demand for gas, and consequently, its export, because of warm winters and increase in prices for gas supplied to CIS-countries.

In 2007 the biggest amount of oil was produced by oil companies Rosneft, LUKOIL, TNK-BP, Surgutneftegas and Gazprom. The share of these 5 companies is 77.6% of the total oil production in the country. Production share agreement operators produced 2.8% of the Russian oil in 2007. The share of other producers, to which around 150 small scale oil producing enterprises belong, was 4.2% of oil production in the country (Table 14).

*Table 13*

**Oil, Oil Products and Natural Gas Production during 2000–2007,  
as percentage to the preceding year**

	2000	2001	2002	2003	2004	2005	2006	2007
Oil, including gas condensate	106.0	107.7	109.0	111.0	108.9	102.2	102.1	102.1
Primary oil processing	102.7	103.2	103.3	102.7	102.6	106.2	105.7	103.8
Motor petrol	103.6	100.6	104.9	101.2	103.8	104.8	107.4	102.1
Diesel oil	104.9	102.0	104.7	102.0	102.7	108.5	107.0	103.4
Furnace fuel oil	98.3	104.2	107.1	100.3	97.8	105.8	104.5	105.2
Natural gas	98.5	99.2	101.9	103.4	101.6	100.5	102.4	99.2

Source: Federal State Statistics Service.

The increase in the state-owned companies influence in the oil sector was quite characteristic trend for the recent years. The positions of the state-owned companies strengthened considerably due to the purchase of private-owned companies assets (in 2004 of Yuganskneftegas, in 2005 – Sibneft). In December 2006 Gasprom purchased controlling stock in “Sakhalin-2” project, which is being fulfilled by foreign investors on conditions of production share agreement. In 2007 the share of state-owned companies at the market increased due to the purchase of the remaining oil producing and oil processing assets of YUKOS – enterprise was declared bankrupt in 2006 – by Rosneft.

As a result of such redistribution taking place Rosneft became the biggest oil company of the country and the share of state-owned companies in all-Russian oil production increased from 26.6% in 2006 to 31.9% in 2007.

*Table 14*

**The Structure of Oil Production in 2006–2007\***

	Oil production in 2006, mln of tons	Share in the total production, %	Oil production in 2007, mln of tons	Share in the total production, %
<b>Russia - total</b>	480.5	100.0	491.3	100.0
Rosneft	81.7	17.0	110.7	22.5
LUKOIL	90.4	18.8	91.4	18.6
TNK-BP	72.4	15.1	69.4	14.1
Surgutneftegas	65.6	13.7	64.5	13.1
Gasprom+Gaspromneft	46.1	9.6	45.8	9.3
Of which:				
Gasprom	13.4	2.8	13.2	2.7
Gaspromneft	32.7	6.8	32.6	6.6
Tatneft	25.4	5.3	25.7	5.2
Slav-neft	23.3	4.8	20.9	4.3
YUKOS	21.5	4.5	-	-
RussNefit	14.8	3.1	14.2	2.9
Bashneft	11.7	2.4	11.6	2.4
NOVATEC	2.6	0.5	2.6	0.5
Operators of production share agreements	5.1	1.1	13.8	2.8
Other producers	19.9	4.1	20.7	4.2
<b>State-owned companies - total:</b>				
Rosneft+Gasprom + Gasprom- neft	127.8	26.6	156.5	31.9

\* According to the organization structure by 31.12.2007.

Source: Ministry for Industry and Power, IET calculations.

Gasprom, whose share in all-Russian production was equal to 84.4% in 2007, commands as usual the gas production (*Table 15*). At the same time gas production by oil companies has increased. The share of the oil companies in gas production remains, however, quite low (8.7% in 2007). The biggest gas volumes production among oil companies is characteristic for Rosneft (2.6%), Surgutneftegas (2.2%) and LUKOIL (2.1%).

*Table 15*

**Structure of Gas Production in 2007**

	Gas production, bln of cu m	Share in the total production, %
Russia - total	654.1	100.0
Gasprom+Gaspromneft	551.9	84.4
Of which:		
Gasprom	550.1	84.1
Oil companies	56.9	8.7
NOVATEC	28.5	4.4
Operators of production share agreement	6.7	1.0
Other producers	10.1	1.5
<b>State-owned companies - total:</b>		
Rosneft+Gasprom+Gaspromneft	568.9	87.0

*Source:* Ministry for Industry and Power, IET calculations.

Data on oil production by oil companies demonstrate that increase in oil production in Russia in 2007 was mainly due to a considerable growth of oil production by projects of production share agreement operators (Sakhalin-1, Sakhalin-2, Khariyagin oil field). The total increase in oil production in 2007 was 10.8 mln of tons, increase in production share projects – 8.7 mln of tons or 80.6% of the total increase. Oil production in Russia not taking into account production share agreements projects increased only by 0.4% in 2007 (*Table 16*).

*Table 16*

**Structure of Oil Production Increase in Russia in 2007 as Compared with 2006**

	2006, mln of tons	2007, mln of tons	Increase, mln of tons	Increase, %
Oil production in Russia - total	480.5	491.3	10.8	2.2
Oil production by production share agreement operators	5.1	13.8	8.7	170.6
Oil production in Russia, production share agreements operators excluded	475.4	477.5	2.1	0.4

*Source:* Ministry for Industry and Power, IET calculations.

A considerable decrease in new production facilities implementation in 2007 is also noticeable. Implementation of new oil wells in 2007 was equal to 2.7 thousands and was the lowest over the recent years, not taking 2005 into account. Considerable decrease of this figure in 2005 – by 29% as compared with the previous year – was accounted for by sharp decrease of investments in production by YUKOS and Sibneft: YUKOS was busy mainly with urgent payment of taxes imposed on it, and decrease in Sibneft's investments was due to its sale.

In contrast to 2005, in 2007 the drop in investment activity occurred world prices for oil being exceptionally high and there being no destabilizing events. In our opinion, this is an indicator of considerable decrease of incentives for investments in oil production that can be accounted for by two factors.



First in the environment of real worsening of oil production conditions and inflexibility of existing taxation system decrease in expected profitability of investments in the new projects occurred. New oil fields are usually characterized by worse mining, geological and geographical conditions their exploitation requiring increase in capital, operating and transportation costs. At the same time existing taxation system does not provide necessary decrease of tax burden while exploitation of new oil fields with high costs that limits investments in new projects.

Second, governmental expansion in oil sector and apprehensions as to further taking up of the private business considerably decrease willingness of private oil companies to invest in the long run.

As a result, excluding abnormal 2005 out of consideration, in 2007 despite exceptionally favorable situation at the world markets implementation of new oil wells was the lowest over the recent years (*Table 17*).

*Table 17*

#### **Implementation of New Oil Wells in 2000–2007**

	2000	2001	2002	2003	2004	2005	2006	2007
Wells implementation, thousands	2.8	3.8	3.1	3.0	3.1	2.2	3.4	2.7

Source: Federal State Statistics Service.

Such dynamics of new production facilities implementation indicates unsteadiness even of the low oil production growth rates that are being observed at present. The result of the trends mentioned can be a decrease in oil production in the country in the forthcoming years.

Under the influence of oil world prices growth in 2007 a considerable growth in prices for oil and oil products at the domestic market was observed. The producer's prices for oil, car petrol, diesel fuel and furnace fuel oil (mazut) reached the maximum over the whole post-reform period. In December 2007 the average internal price for oil (producers' price) in dollar terms reached USD 222.2 per ton, and average price for car petrol – USD 581.2 per ton, which is the maximum value for oil and car petrol prices over the whole post-reform period (*Table 18*).

Internal prices for natural gas have also increased. The gas producers' prices reached USD 19.2 per 1 thou. cu. m in September 2007. Average price for gas purchase in the industry, including both the gas production price and its transportation costs and trade and sales extra charge reached USD 75.6 per 1 thou. cu. m. in December 2007.

*Table 18*

#### **Internal Prices for Oil, Oil products, Natural Gas in US Dollar Terms over 2000–2007 (average producers' prices, as USD per ton)**

	2000 December	2001 December	2002 December	2003 December	2004 December
Oil	54.9	49.9	60.7	70.1	123.5
Motor petrol	199.3	151.5	168.8	236.9	333.1
Diesel oil	185.0	158.5	153.8	214.3	364.3
Furnace fuel oil	79.7	47.1	66.1	66.0	69.4
Natural gas, as USD per thou. cu. m	3.1	4.8	5.9	4.4	10.5

*Table 18 (continued)*

	2005 December	2006 December	2007 June	2007 September	2007 December
Oil	167.2	168.4	230.3	240.9	288.2
Motor petrol	318.2	416.5	491.7	493.6	581.2
Diesel oil	417.0	426.1	442.0	467.1	692.5
Furnace fuel oil	142.7	148.8	181.6	210.1	276.5
Natural gas, as USD per thou. cu. m	11.5	14.4	15.6	19.2	17.6

*Source:* calculated on the basis of Federal State Statistics Service's data.

In January–November 2007 as compared with the corresponding period of the previous year oil export in natural terms decreased by 4.3% while oil products export increased by 8.0% (*Table 19*). In January–November 2007 the share of export in furnace fuel oil (mazut) production was equal to 83.3%, diesel oil – to 55.7%, motor petrol – to 17.7% (for comparison: in 1999 export share in motor car petrol production was equal only to 7.2%, in 2005 – to 18.5%, in 2006 – to 18.3%). The volume of light oil products export being near the figure of the previous year, increase in their import was observed. In January–November 2007 import of motor petrol nearly doubled as compared with the corresponding period of the previous year, while the share of import in petrol resources was equal only to 0.04% (for reference: in the first half-year of 1998, i.e. before ruble devaluation, the share of the import in petrol resources was equal to just 8.7%, in 2005 – 0.03%, in 2006 – 0.02%). Gas export has reduced considerably as compared with the previous year.

*Table 19*

**Oil, Oil Products and Natural Gas Export from Russia, as percentage to the previous year**

	2002	2003	2004	2005	2006	2007 (11 months)*
<b>Oil, total</b>	113.9	117.8	115.0	98.4	98.0	104.3
including:						
to non-CIS countries	109.9	118.9	116.3	99.1	98.0	104.9
to CIS countries	137.3	112.4	108.3	94.9	98.0	100.5
<b>Oil products, total</b>	118.5	103.6	105.5	117.9	106.3	108.0
including:						
to non-CIS countries	119.1	102.6	104.9	119.1	104.5	107.4
to CIS countries	102.8	132.3	117.9	94.6	148.8	120.1
<b>Gas, total</b>	102.4	102.0	105.5	103.7	97.6	93.8

\* As percentage to January–November 2006.

*Source:* Federal State Statistics Service.

In 2007 net oil and oil products export was equal to 367.7 mln tons, thus increasing by 18.4 mln tons as compared with the previous year. As a result, the share of net oil and oil products export in oil production reached 74.8%, net oil export being 53.3% of its production. The share of net export in gas production was equal to 28.1% in 2007 (*Table 20*).

*Table 20*

**The Ratio of Energy Supplies Production, Consumption and Export in  
2000–2007**

	2000	2001	2002	2003	2004	2005	2006	2007 (estimation)
<b>Oil, mln tons</b>								
Production	323.2	348.1	379.6	421.4	458.8	470.0	480.5	491.3
Export, total	144.5	159.7	187.5	223.5	257.4	252.5	248.4	259.1
Export to non-CIS countries	127.6	137.1	154.8	186.4	217.3	214.4	211.2	221.5
Export to CIS countries	16.9	22.7	32.7	37.1	40.1	38.0	37.3	37.6
Net export	138.7	154.7	181.3	213.4	253.2	250.1	246.1	256.3
Domestic consumption	123.0	122.9	123.5	129.8	124.2	123.1	131.2	123.6
Net export, as percentage to the production	42.9	44.4	47.8	50.6	55.2	53.2	51.2	52.2
<b>Oil products, mln tons</b>								
Export, total	61.9	70.8	75.0	78.4	82.1	97.0	103.5	111.8
Export to non-CIS countries	58.4	68.3	72.5	74.9	78.0	93.1	97.7	104.9
Export to CIS countries	3.5	2.5	2.6	3.5	4.1	3.9	5.8	6.9
Net export	61.5	70.5	74.8	78.2	81.4	96.8	103.2	111.4
<b>Oil and oil products, mln tons</b>								
Oil and oil products net export	200.2	225.2	256.1	291.6	334.6	346.9	349.3	367.7
Oil and oil products net export, as percentage of oil production	61.9	64.7	67.5	69.2	72.9	73.8	72.7	74.8
<b>Natural gas, bln cu. m</b>								
Production	584.2	581.5	594.5	620.3	634.0	636.0	656.2	651.0
Export, total	193.8	180.9	185.5	189.3	200.4	207.3	202.8	190.2
Export to non-CIS countries	133.8	131.9	134.2	142.0	145.3	159.8	161.8	153.2
Export to CIS countries	60.0	48.9	51.3	47.3	55.1	47.5	41.0	37.0
Net export	189.7	176.8	178.3	180.5	193.5	199.6	195.3	182.7
Domestic consumption	394.5	404.7	416.2	439.8	440.5	436.4	460.9	468.3
Net export, as percentage to the production	32.5	30.4	30.0	29.1	30.5	31.4	29.8	28.1

*Source:* Federal State Statistics Service, Ministry for the Industry and Power, Federal Customs Service, IET calculations.

The share of oil products export having increased to some extent, the crude oil export, being about 70% of the total export volume, still prevailed in the structure of oil export. It was the furnace fuel oil, which is used as a primary product in Europe for further processing, and diesel oil that consisted the main part of the oil products export. The main part of the energy supplies (85% of oil, 95% of oil products and 81% of gas) was exported beyond CIS.

As it is demonstrated by the analysis of the Russian oil export dynamics over the long period of time in 2007 the total net export of oil and oil products reached unprecedented level and by 76.1 mln tons (26.1%) exceeded the level of 1988, which was characterized by a maximum oil export volumes (291.6 mln tons) before the crisis. At the same time the increase of oil products share in oil export was observed, their share increasing from 18.2% in 1990 to 30.3% in 2007 (*Table 21*). In the environment of the sharp reduction of domestic oil consumption (according to our calculations it has decreased from 269.9 mln tons in 1990 to 123.6 mln tons in 2007, that is more than by half) the share of oil and oil products net export in oil production increased over this period from 47.7% to 74.8%. In contrast to oil and oil products export the net gas export and its share in production do not exceed the level of 1990ies in recent years and the share of net gas export in its production is about that of the pre-reform period (28.1% in 2007 against 28% in 1990).

Table 21

**Oil Products Net Export in 2002–2007**

	2002	2003	2004	2005	2006	2007 (estimation)
Oil products net export, mln. tons	74.8	78.2	81.4	96.8	103.3	111.4
The share of oil products in net export of oil and oil products, as percentage	29.2	26.8	24.3	27.9	29.6	30.3

Source: Federal State Statistics Service, Federal Customs Service, IET calculations.

The given data testify that the export orientation of oil sector in comparison with the pre-reform period has considerably reinforced. It should be, however, taken into account that it is connected not only with the increase of the absolute export volumes, but also with a considerable decrease in the domestic oil consumption as a result of Russian economy market transformation.

High level of world prices for oil, which was observed in 2007, determined considerable incomes growth in the oil sector of the economy. In January–November 2007 total earnings from oil and main kinds of oil products export (car petrol, diesel oil and furnace fuel oil) reached USD 147.4 bln., which is a record level over the whole post-reform period (Table 22). For reference it can be noted that the minimum level of oil export earnings was observed in the environment of world oil prices fall in 1998, when the export profit was only USD 14 bln.

Table 22

**Oil and Oil Products Export Earnings in 2000–2007, USD bln**

	2000	2001	2002	2003	2004	2005	2006	2007 (11 months)
Oil and main kinds of oil products export earnings	34.9	33.4	38.7	51.1	74.6	112.4	140.0	147.4

Source: calculated on the basis of the Federal State Statistics Service data.

The share of power and energy commodities in Russian export in 2006 was equal to 64%, of which crude oil accounted for 34.4%. The data on the structure of Russian export of energy suppliers are presented in Table 13.

Table 23

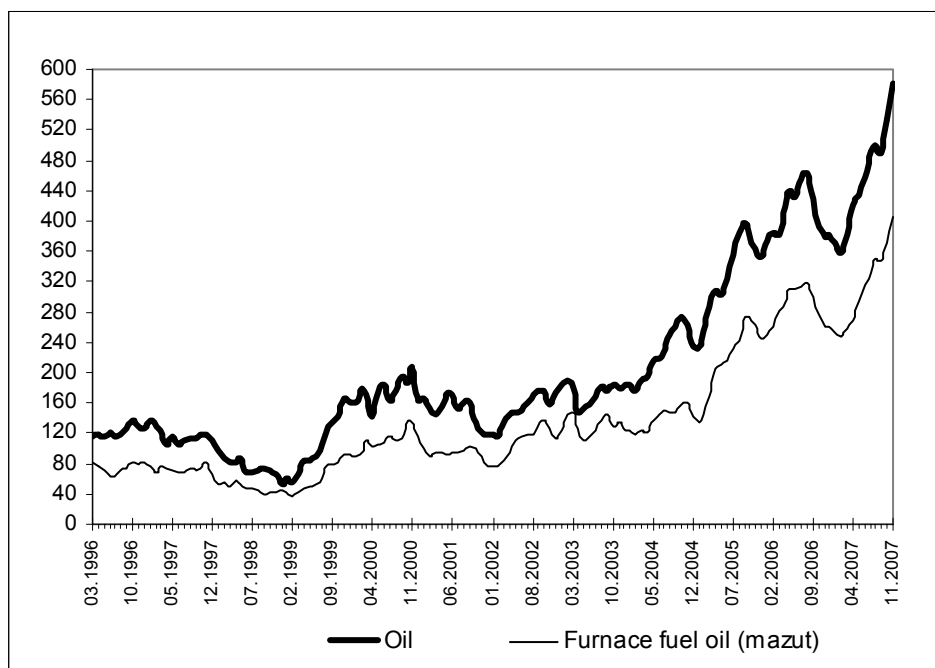
**Value and Share of Fuel and Power Commodities in 2005–2007**

	2005		2006		2007	
	USD bln	%*	USD bln	%*	USD bln	%*
<b>Fuel and Power commodities, total</b>	154.7	64.1	196.9	65.4	225.6	<b>64.0</b>
of which:						
oil	<b>83.8</b>	<b>34.7</b>	<b>102.3</b>	<b>34.0</b>	<b>121.4</b>	<b>34.4</b>
natural gas	<b>31.4</b>	<b>13.0</b>	<b>43.9</b>	<b>14.6</b>	<b>44.8</b>	<b>12.7</b>

\* As percentage to the total volume of Russian export.

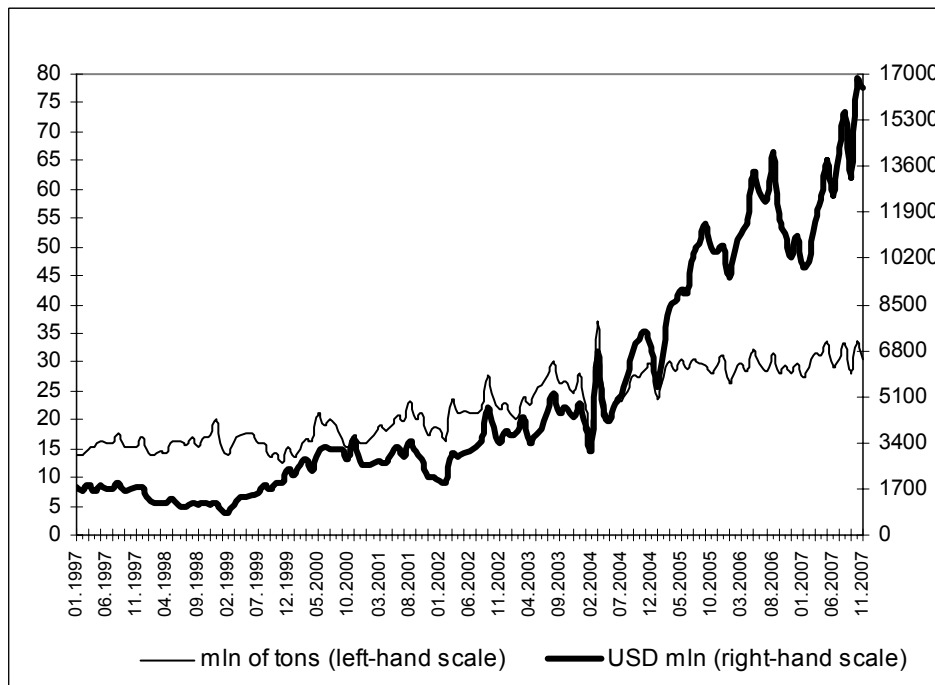
Source: Federal State Statistics Service.

The dynamics of separate indices of oil and gas sector development is shown in fig. 6–9 (value indices are given in current prices).



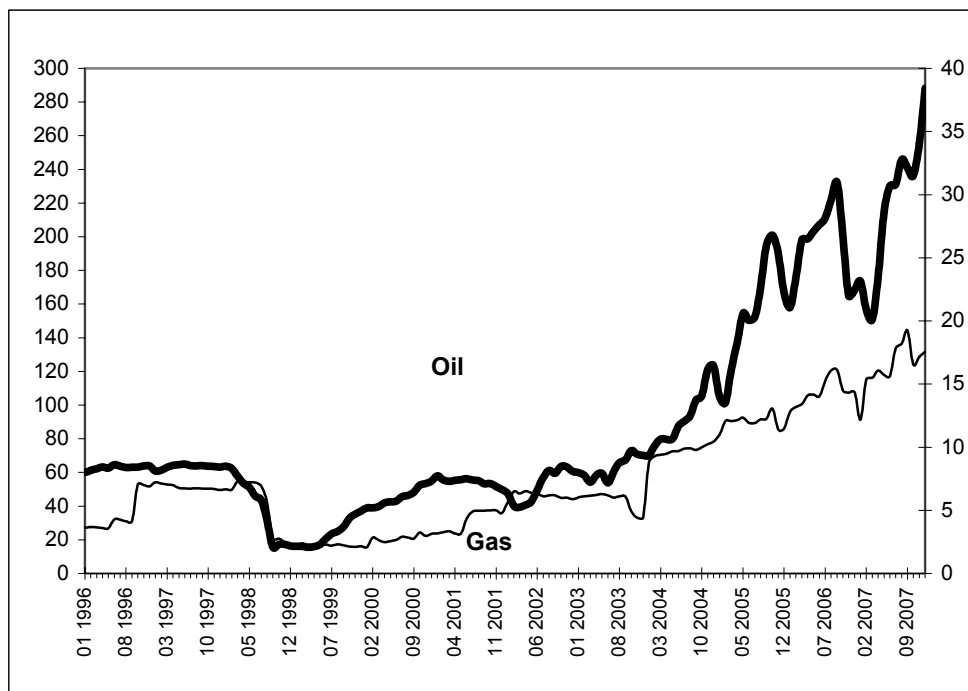
Source: calculated on the basis of the Federal State Statistics Service data.

Fig. 6. Average Export Prices for Oil and Furnace Fuel Oil (mazut) in 1996–2006, as USD per ton



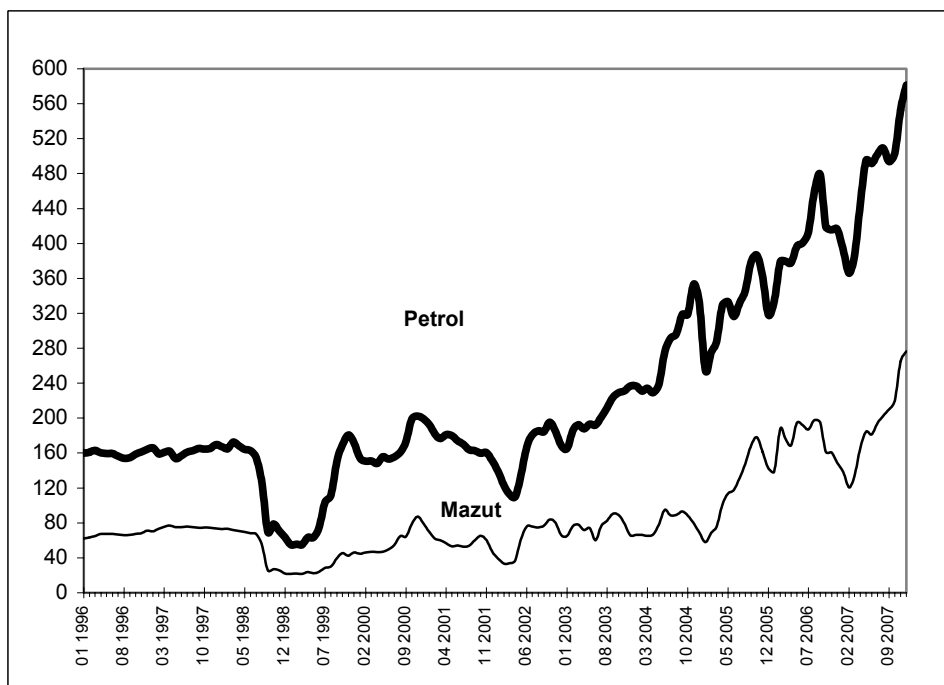
Source: calculated on the basis of the Federal State Statistics Service data.

Fig. 7. Oil and Oil Products Export in Natural and Monetary Terms in 1997–2007, mln tons, USD mln



Source: calculated on the basis of the Federal State Statistics Service data.

Fig. 8. Average Producers Prices for Oil and Gas in Dollar Terms in 1996-2007, as USD per ton and as USD per thou. cu. m, correspondingly



Source: calculated on the basis of the Federal State Statistics Service data.

Fig. 9. Average Producers' Prices for Motor Petrol and Furnace Fuel Oil in Dollar Terms in 1996-2007, as USD per ton

A number of factors provide favorable demand and price prerequisites for further development of oil sector in Russia. The export opportunities of Russian oil to European countries will expand the demand for oil in the countries of Western and Eastern Europe increasing and oil production in the Northern Sea decreasing. At the same time the growth of demand for oil in the countries of Asian-Pacific Region, China in particular, as well as the predicted considerable aggravation of their dependence upon the import create favorable opportunities for Russia's access to the markets of this region's countries and for considerable growth of oil export in this direction.

New oil pipelines projects that are being carried out at present, for instance construction of oil pipeline East Siberia-Pacific Ocean with the branch for China, will enable necessary infrastructure creation to increase Russian oil supplies to the world market. At the same time opportunities for Russian oil export will be more and more limited by the possibilities of its production expansion, real worsening of production conditions.

Increase in oil production and export in the future is possible only on condition of new oil fields development, whose exploitation in many cases is characterized by high capital, exploitation and transportations costs. Start of such oil fields development requires improvement of the existing system of oil sector taxation, pursuing of special tax policy, which provides necessary incentives for investments in oil production.

Worsening of extraction conditions accounts for the necessity of tax load decrease while new oil fields with high costs are being developed, implementation of privileged or more flexible tax regimes. This will enable to start industrial production at such oil fields, which will provide additional oil production and tax earnings.

In order to stimulate development of new oil fields, territorial step-down coefficients for severance rates that are implemented for the whole period of new oil fields exploitation of the particular regions over the whole period of exploitation are preferable as compared with the tax vacations mechanism that was introduced for oil field of East Siberian oil and gas province in 2007, from our point of view. The values of such coefficients can be defined by calculation, based on the requirement to guarantee necessary profitability of the investment in oil fields development of the corresponding territory (shelf zone). Exploitation of oil fields of the continental shelf requires the lowest tax rates – down to zero rates – to be implemented.

Use of territorial step-down coefficients to the severance tax rates has a number of substantial advantages as compared with the scheme of the taxations vacations; it is better suited to protect governments' interest. In contrast to the scheme of taxation vacations such an approach does not induce speeding up of the oil production in the first years of oil field development in order to exempt the biggest amount of the oil produced from taxation, that is it does not have a distorting influence on the behavior of entrails users, production profile or oil extraction level. Severance payment on application of such an approach is made from the very beginning of oil production, and does not have a suspended character. The deeper exploitation of oil field is stimulated since the amount of severance tax is less at the later stages of production than in case of taxation vacation scheme implementation.

A more developed form of oil extraction taxation is taxation of net profit that is defined in some way. Such an approach can be fulfilled in different forms, for instance, on the basis of implementation of tax for additional income from hydrocarbons production, royalty or additional profit tax. As compared with severance tax scheme taxation of net profit is by far more complicated when tax administration is concerned.

Adoption of any decisions on investments in new oil fields development stimulation should correspond to the real opportunities of the government to administer new tax regimes. For the time being it is preferable to use simpler non-individualized tax regimes, for instance, implementation of territorial step-down coefficients to severance tax rate, which, in the environment of high world prices for oil and positive dynamics of oil extraction, is advisable to limit to the regions of Eastern Siberian oil and gas province and continental shelf zones.

In prospect, after necessary prerequisites having been fulfilled, it seems sensible to transfer to more developed forms of taxation of oil production, that are based on the figures of the incomes received and take into account real costs for particular oil fields' exploitation.

### *Manufacturing Industries*

The steady economic growth due to the expansion of the internal market demand as well, gave additional stimulus for the development of the manufacturing industries. The dynamics of the manufacturing industries differentiates substantially by the kinds of the economic activity, the ratio of the rates of investment and consumer's goods production having the biggest influence. The growth fluctuations by the kinds of the economic activity being quite big, the anticipating growth of machine-building production output was the prevailing tendency of the recovery period, which positively affected the level of business activity of industries adjacent to construction materials production and other intermediate goods production. The ratio of growth rates of different kinds of economic activities in 2000–2007 demonstrates the gradual turn from the growth that was orientated towards natural and raw materials potential exploitation towards the formation of the resource system for the investments development. In the environment of the production growth the demand for domestic and imported equipment is growing dynamically.

*Table 24*

### **Change in the Rates of Production by Kinds of Manufacturing Industries Economic Activity in 2000–2007, as percentage to the previous year**

	2000	2001	2002	2003	2004	2005	2006	2007
Manufacturing industries	10.9	2	1.1	10.3	10.5	5.7	4.4	9.3
Foodstuffs, including tobacco and beverages production	5.3	8	7.2	6.9	4.4	4.4	5.4	6.1
Textile and clothing industry	24.9	7.8	-2.5	1.2	-4	-1.5	7.3	-0.3
Leather, leather goods and footwear production	7.6	13.7	11.4	11.5	-0.6	-2.7	16.7	-0.1
Woodwork and wooden goods production	14.1	-2.5	4.2	9.7	8.7	4.5	0.5	6.2
Pulp-and-paper production, editing and printing activity	18	9.6	4.1	7.8	5.1	1.2	6.4	9.0
Coke and oil products production	2.4	2.8	4.6	2.2	2.4	5.4	6.1	2.7
Chemistry industry	15.2	0.3	0.2	5.4	6.6	2.6	1.9	6.1
Rubber and plastic goods production	26.1	1.6	0.2	5.5	13.5	5.5	11.7	23.0
Other non-metal mineral goods production	10.6	3.8	1.2	7.3	8.4	3.5	10.8	10.8
Metallurgical production and finished metal goods production	15.3	4.6	5.1	7.2	3.9	5.7	8.8	2.0
Machinery and equipment production	5.7	6.4	-8.8	19	21.1	-0.1	3.3	19.3
Electric, electronic and optical equipment production	25	8.4	-7.7	43.2	34.5	20.7	-5.5	12.8
Transport vehicles and equipment production	10.7	-26.4	-1	14	11.5	6	3.3	15.9
Other productions	11.5	8.5	3.9	10.8	10.5	0.7	7.2	5.0

*Source:* Federal State Statistics Service.



The analysis of the dynamics of the investment goods market in recent years indicates that the level of the business activity depends considerably on the economy revenues from the foreign economic activity. The additional factor of machine-building industry growth was the improvement in trade of high-tech equipment produced domestically at the external markets as well as the positive changes in investment environment connected with the gradual reduction of the duties for imported components and equipment and the introduction of industrial assemblage regimes in motor-vehicles production. At the same time it should be noted that the production output in some branches of machine building is subjected to quite considerable fluctuations.

Domestic machinery and equipment production increased by 19.3% in January 2007. The dynamics of the machinery and equipment output was determined mainly by the extension of the demand for handling machinery, railway, power and agricultural machine building, instrument making, communication facilities production. Besides, over the last years the steady growth of the demand for the consumer's complex equipment sustained.

Anticipating import growth rates as compared with domestic production also had a considerable influence on the dynamics and nature of machine-building development. This is due to the fact that non-competitiveness of many kinds of machinery and equipment as compared with the import analogues by the criterion of price to quality ratio as well as absence of the facilities for production of the modern equipment limits considerably market for the domestic machine-building.

The influence of import is considerably differentiated by sectors of economy and goods markets. For instance, at the market of intermediate goods import of some kinds of primary products, components for household appliances, components for industrial assemblage within the framework of motor-vehicles assemblage projects has a positive impact on the processes of restructurization and the level of business activity of domestic producers. At the market of the goods of investment machine building increase of import was one of the main factors to fulfill investment projects, modernize production and implement technological innovations. At the same time the competition is observed to become more acute in such machine-building branches as tools making, agriculture machine building, construction and road equipment production, motor-vehicles production. Low investment activity, high level of fixed assets deterioration, outdated technologies were still characteristic for these kinds of production. One of the promising directions of such fields of activity development was active implementation of industrial assemblage mechanism and creation of the environment, which will stimulate foreign companies to transfer their activity into the territory of the Russian Federation. Anticipating growth of goods output at the enterprises with foreign capital participation changes the conditions of the competition and favors increase of efficiency at traditional structures.

Transition from predominantly extensive model of the Russian economy development to the intensive one, involves considerable structural changes, connected with the diversification of the investment activities directions, human resources development, and conduction of thorough institutional reforms that will provide favorable conditions for economic agencies activity.

### **3.2. The Situation in Industry**

The section is based on the data of surveys among directors of industrial enterprises, which have been conducted by the IET according to the European harmonized methodology on a monthly basis since September 1992 and encompass the whole territory of the Russian Federation. The panel's size is approximately 1,100 enterprises, where work more than 15% of those employed in industry. The panel has a shift towards big enterprises by each of the specified subbranches of the national economy. The return of questionnaires is 65–70%.

These research surveys (RS) among directors of enterprises represent a quick method for collecting data concerning the state of affairs at their enterprises and the expected (or planned) changes in the main indices of their performance. RS is a relatively new instrument when applied to economic analysis. The first such survey was conducted by the Ifo Institute for Economic Research (Munich, Germany) in 1949. Before long, this method began to be applied in the UK, France and Italy. From 1962, the EU has been working at harmonizing (making compatible) the results of surveys being conducted in different countries of that continent.

The questionnaire form applied in a research survey contains a limited number of questions (no more than 15–20). These questions are of a qualitative, not quantitative, character. The simple structure of questions and answers makes it possible for the respondents to fill in the questionnaires in a short period of time and without consulting any other staff or documentation. It is of paramount importance that the respondent at each enterprise should be a CEO of the highest level, who has full vision of the enterprise's state of affairs and directly participates in its management. In 2007, 30% of the filled-in questionnaires were returned by the directors of enterprises, 35% – by deputy directors, and 24% – by heads of economic subdivisions.

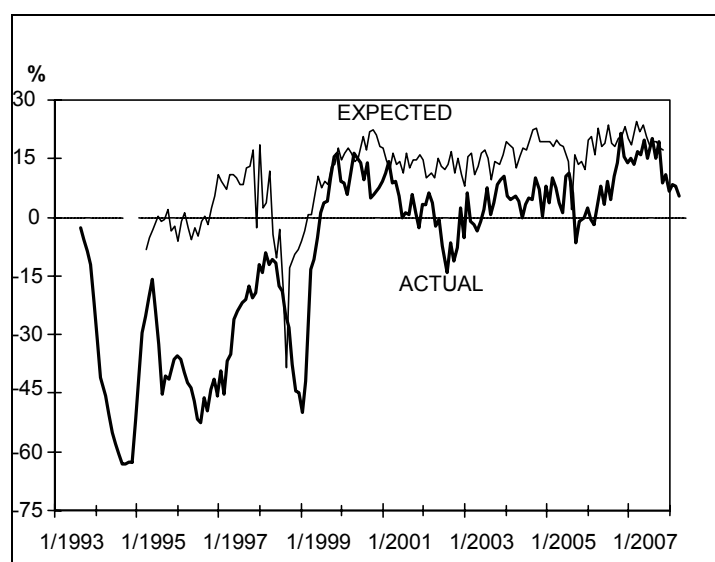
In the analysis of the results of surveys, a specific derivative index – the so-called balance - is applied. Balances are computed as the difference between the percentage of those who have replied “is growing” (or “is above the norm”) and the percentage of those who have replied “is decreasing” (or “is below the norm”). The result makes it possible to represent the distribution of answers to each question by simple digits with signs “+” or “-”.

Balance is interpreted as the first derivative or process speed. If the balance of answers to the question concerning the expected change in prices has the sign “+”, this means that average prices in the nearest future period are going to be on the rise (there is a prevalence of enterprises who have reported a forecasted growth of their prices). Growth of balance in a month from +10% to +17% demonstrates that average prices in industry are going to display a more intensive growth, because the prevalence of enterprises forecasting growth has also increased. Negative balance implies that average prices will go down (a greater number of enterprises are going to lower their prices). A change in balance from –5% to –12% is interpreted as growth in intensity of price decline.

#### **3.2.1. The Dynamics of Demand and Finished Stock in Russian Industry**

The beginning of the year 2007 was rather favorable for Russian industry. The return of typical weather conditions and the already accumulated useful experience of leveling-out the negative effects of the long New Year holiday made it possible for the majority of Russian enterprises to achieve significant positive results in January. The demand for industrial products “slumped” in January very insignificantly. According to the initial data (that is, not cleared of the seasonal factor), the rate of demand's decline was only –7 balance points, while

in January 2006 this index was  $-24$  b.p., and in January 2005  $-26$  b.p. After the elimination of seasonality, demand's dynamics displayed an impressive growth of  $+21$  b.p., which represented an absolute historic high of the whole period of previous observations since 1993 (see *Fig. 10*). As a result,  $68\%$  of Russian industrial enterprises estimated their sales volumes in January as being normal. Thus, the dynamics of demand, anomalously favorable for January, relieved industry of the necessity to dramatically curb its output.



*Fig. 10.* Changes of Effective Demand, Cleared of Seasonality  
(balance = % growth – % decrease)

In February, the demand dynamics displayed a more traditional pattern. The rate of sales growth (before being cleared of seasonality) became  $15$  b.p., which is by  $1$  point higher than the first half-year 2006's average, and by  $2$  point higher than the average per annum value. The clearance of seasonality did not result in either a changed growth rate of demand in February, or its correlation with last year's average indices. The estimations of demand (higher – lower than the norm) confirmed the slowdown in sales growth by comparison with January's indices and an improved dynamics against that of last year.

In March, the growth rate of demand became more intensive. The initial data (not cleared of seasonality) demonstrated a rise in demand of up to  $38$  b.p., which became yet another absolute historic high of the whole period of monitoring, and doubled on the results of March 2006. The elimination of the seasonal factor resulted in growth intensity of  $24$  b.p., which also is an absolute historic high, while being by  $3$  points above the previous record level registered in January 2007. Sales volumes began to satisfy two thirds of Russian industrial enterprises (see *Fig. 11*). The robust growth rate of demand and diminishing finished stocks allowed enterprises to maintain their high output rates.

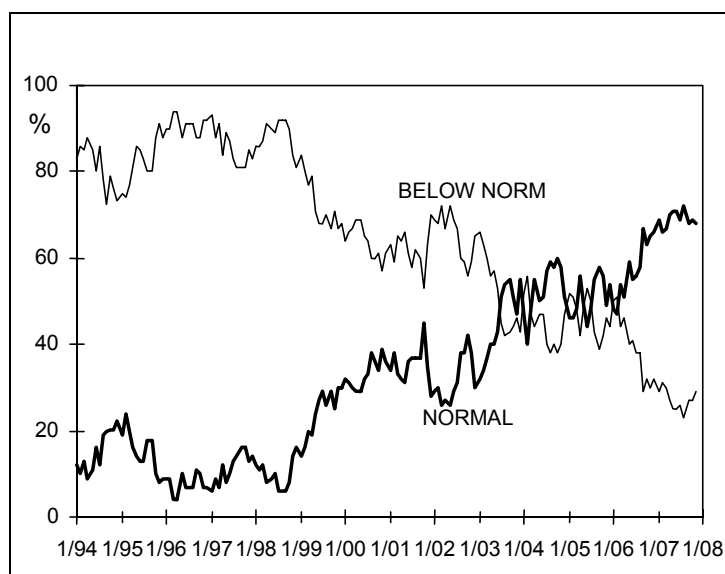


Fig. 11. Dynamics of Basic Indices of Effective Demand

The forecasts concerning changes in demand became more optimistic, as well. The expected rate of sales growth (cleared of seasonality) reached its historic high of the period 1992–2007. As a consequence, the plans for output changes in March were also upwardly revised. The planned growth rates of production were higher than those planned for February by 4 points, and reached their historic high of the last 15 years. Industry was clearly not going to apply the brake.

In April, the positive trends persisted in Russian industry, with some slight negative adjustments. The growth rate of demand for industrial product became slower. After the record levels registered in March, in April this index went down by 10 balance points. However, the decrease after clearance of seasonality was only by 3 b.p., while further clearance of accidental factors demonstrated the result being equal to the March level (historic high). Nevertheless, the slowdown in sales growth in no way disappointed producers – quite the contrary. The level of satisfaction with demand in Russian industry rose to 70%. Such a high level of answers “normal” has never once been registered during all the previous 179 surveys. The slowdown in demand growth did not influence the growth rate of output in April, either. Although the initial data on the dynamics of output demonstrated that growth intensity declined from 52 to 46 b.p., after the elimination of seasonality the growth rate was already seen as being slightly on the rise. The elimination of accidental fluctuations further confirmed this conclusion: indeed, in April industry continued to increase its production intensity.

The maintaining of high rates of output in face of a slowdown in demand growth made it possible for enterprises to somewhat replenish their finished stocks. In April the balance of estimations (“above – below norm”) went up to +4 points, whereas in Q I 2007 it was +2...+3 points (see Fig. 12). However, the stocks in machine-building, non-ferrous metallurgy and the timber industrial complex were still insufficient – there, the balances had remained negative for some months (that is, enterprises with stocks “below norm” were prevalent).

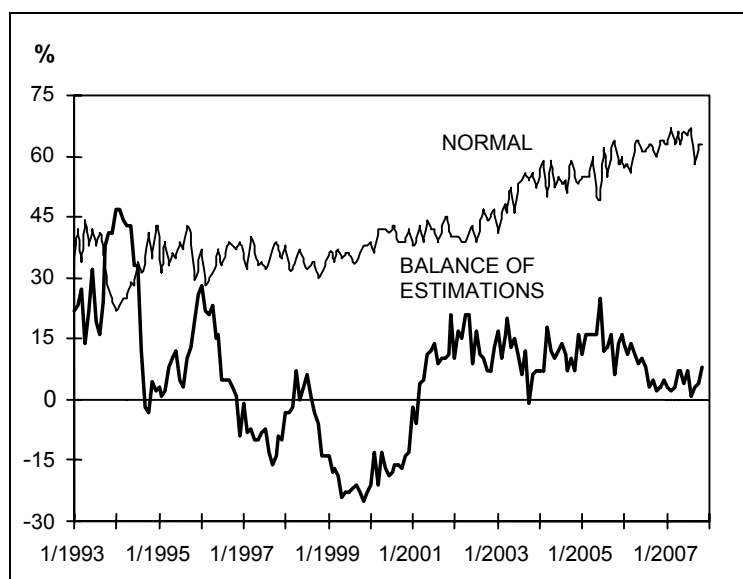


Fig. 12. Balances of Estimates of Finished Stock (balance = % above – % below norm)

Although Rosstat’s official data cited, in April, a considerable slowdown in production growth, the results of the May survey still reflected an optimistic view of the dynamics of Russian industry’s basic economic indices. Firstly, a slowdown in output growth in May was demonstrated only by the “gross” data (before being cleared of seasonal and accidental fluctuations). The elimination of the seasonal factor resulted in a gradual rise in the rate of production growth. As a result, an eventual historic high was yet again achieved in May – 36 b.p., after 34 b.p. in April. Secondly, intensive industrial growth was based on a persistently increasing growing rate of effective demand. Satisfaction with sales volumes also continued to be on the rise. Thirdly, the dynamics of industrial output was also sustaining the necessity to replenish finished stocks. Between August 2006 and March 2007, the balances of estimations of stocks were in the interval between +2 and +5 b.p., which was extremely low by comparison with the level of +10 to +15 b.p. during the previous 12 months. In May this index rose to +9.

The official data later released by Rosstat, indeed, confirmed growth of industrial production in May (by 6.7% against that in May 2006; growth in April – 4.6%).

However, June saw no continuation of the relatively favorable May trend. In June, the enterprises experienced a slowdown in the growth of their sales of finished products. A fall in the growth rate of demand was displayed by all indices – initial, cleared of seasonality, and cleared of accidental fluctuations. As a result, the indices registered in June became the worst in the previous 12 months. Nevertheless, at that time this process did not acquire a critical importance for Russian enterprises. The adjustment of output dynamics followed that of sales. Slower growth was also demonstrated by all the production indices. As a result, the share of the “demand-following” enterprises reached the level of 69 %, whereas usually this index had been no higher than 63–65 %.

The rate of output growth could only be sustained by the necessity of replenishing finished stocks. In June, the balance of estimations of these stocks across industry as a whole once again reached its historic positive low (+2 balance points). It is noteworthy that in big

European countries the balances of stock estimations (displayed by the results of similar surveys) usually remain within the interval between +10 and +20 points.

July's dynamics of the basic economic indices in Russian industry displayed both negative and positive features. Firstly, no obvious further slowdown in industrial growth was observed in July, contrary to enterprises' previous forecasts. The initial data demonstrated a fall in the growth rate of output from 24 to 17 b.p.; when cleared of seasonality, this index displayed stability, which, however, disappeared after the elimination of accidental fluctuations. This situation was a demonstration of quite an adequate response to the dynamics of demand.

Secondly, the growth of demand in July also became slower according to the initial data; this slowdown disappeared after the index was cleared of seasonality, and reappeared after the additional elimination of accidental fluctuations. Although the growth rate of demand had become lower by some 10 b. p. in the previous 3 months; at that time, this did not influence the estimations of its volume by the scale "above – below norm". In July the share of the answers "normal" remained at its historic high.

Thirdly, in July there was growth in enterprises' endowment with finished stocks. The balance of estimations rose to +9 b.p., while the share of the answers "normal" increased to 67% (the latter value being a historic high). The averages of these indices in the first half-year 2007 were +4 b.p. and 65%, respectively. The replenishment of finished stocks sustained the dynamics of output in July, since estimations showed a rise in the share of those enterprises whose output growth was ahead of the dynamics of sales, and a fall in the share of those the changes of whose output and demand coincided.

In August, the growth rate of sales of industrial products remained nearly the same as in July: initial data demonstrated the same rate, after clearance of seasonality it went down by 3 b.p., while the elimination of accidental fluctuations resulted in a decrease by 1 b.p. In other words, the growth rate of demand decreased very slightly, if at all. At the same time, the satisfaction of enterprises with their volumes of sales remained at its absolute historic high. The normal volumes of sales (as estimated by the enterprises) ensured that in 2007 their capacities were exploited at the level of 77%, while in the previous year this index amounted to 73%, and in 1999 – to only 59%. Due to insufficient ("below norm") demand, only 61% of Russian industry's capacities in 2007 were being exploited (in 2006 – 63%, and in 1999 – 44%).

The rate of output growth in August rose on that observed in July, as seen by all the indices: initial data demonstrated growth by 9 b.p., when cleared of seasonality – by 3 b.p., and when cleared of accidental fluctuations – by 2 b.p. As a result, production was growing at an accelerated rate, as compared to that of demand, at 30% of enterprises, while in the first half-year 2007 such a ratio between output and demand was registered, on the average, by 23% of enterprises, and in 2006 – by 22%.

However, the higher growth rate of output against that of demand did not produce a rising overstocking of finished products. On the contrary, any surplus stocks disappeared as a result of the share of answers "below norm" having increased to 16% (the historic high of the previous 10 months), and of the share of answers "above norm" having diminished to 15% (the absolute historic low of the previous surveys). This could result from producers' inability to regularly and reliably replenish their finished stocks and /or to achieve such volumes of sales that their further growth could no more be reliably backed (or covered) by output and available stocks.

September failed to inspire any optimism in Russian industrialists – quite the contrary. Firstly, the rate of growth in effective demand for industrial products continued to decline: by initial data, it lost another 4 points in September, in Q III – 8 points, and in the previous 6 months – 29 points. After clearance of seasonality, the growth rate of demand was shown to be at its August level – the lowest in the previous 18 months. The elimination of accidental fluctuations produced a fall, as compared to August, by 1 point – to the historic low of the previous 18 months. The period of relatively high and stable growth in demand, which had begun in Q II 2006, now ended.

Secondly, the estimations, by enterprises, of their demand indices confirmed the previous conclusion. In September the share of the answers “normal” decreased at once by 6 points, reaching its historic low in the previous 6 months. Only 66% of Russian industrial enterprises were satisfied with the level of demand for their product, while 28% considered it to be “below norm”. During that month, 14% of the enterprises participating in both the August and September surveys reconsidered their estimations of demand with downward results (“above norm” → “normal”, “normal” → “below norm”).

The changes in output in October inspired more optimism, but only at a first glance. In October the growth rate of output increased by all its indices. Initial data displayed a growing balance (growth rate) from 8 to 21 b.p. According to the data cleared of seasonality, the growth rate rose from 15 to 25 points, while after the further elimination of accidental fluctuations the rate went up from 20 to 22 balance points.

However, in October the increased intensity of industrial production was not backed by a corresponding growth rate of demand. That month’s initial data demonstrated a further decline in the growth rate of sales. As a result, in Q II and Q III 2007 this index went down from 36 to 4 b.p. The latter value represents (with the exception of the January data) the worst result since the beginning of the year 2006. When cleared of seasonality, the growth rate of demand in October amounted to 8 b.p. The same level was obtained after the further elimination of accidental fluctuations. Both figures turned out to be the worst of their kind since April 2006. As a consequence, the share of enterprises whose output dynamics coincided with the dynamics of sales was reduced to 66 % after having been 73% in September, while the share of enterprises with an accelerated growth of output against that of demand increased to 25%, after 15% in September. Evidently, in October industry took the risk of “forgetting about demand”. However, demand provided no grounds for this kind of attitude. Its volumes, as before, failed to satisfy 29% of enterprises, which became this index’ historic high since the beginning of Q II 2007. In August, dissatisfaction with demand in Russian industry was only 23% (the absolute historic low of the whole period of monitoring (1992–2007)).

Besides, demand could not be disregarded because of the presence of accumulated finished stocks. By comparison with September, their estimations became somewhat better (the share of enterprises with their normal volumes increased by 3 points, while that of enterprises with surplus stocks decreased by 1 point). Nevertheless, on the whole the estimations in October did not return to the levels prevalent in Russian industry prior to September, when the estimations of accumulated stocks had demonstrated a dramatic shift to the negative. However, the balance of the estimations of stocks at the time of the last survey was only 4 points. This provides grounds for the conclusion that certain factors were still actively preventing industrial enterprises from adequately increasing their output in response to the currently existing situation and replenishing their finished stocks to the traditional surplus level.

November confirmed the truth of the pessimistic October analysis. Firstly, the growth of effective demand for industrial products continued to slow down. According to initial data, in November the balance (or growth rate) amounted to only +1 balance point; when cleared of the seasonal factor, its value went up to +5, while the elimination of accidental fluctuations yielded +6 b.p. But all the obtained values were not only worse than those observed in October and September – they turned out to be the worst ever since early 2006.

Secondly, satisfaction with sales in industry remained the lowest in the preceding 9-month period. Only 68% of enterprises consider the demand for their product to be at a normal level. Dissatisfaction with demand increased in industry to 29%. In machine-building, already as many as 35% of plants are dissatisfied with their volumes of sales (although in August there were only 22%), in light industry – 43% (in April – 28%), in the food industry – 25% (in July – 13%).

Thirdly, the slowdown in the growth of demand, nevertheless, urged enterprises to restrict the growth of their output. In November the balance (or growth rate) based on the initial data demonstrated a diminishing rate of growth from +20 to +14 b.p. Clearance of seasonality yielded a rate of +20 b.p. (after having been +23 b.p. in October), and elimination of accidental fluctuations demonstrated +21 b.p. (after +20 b.p. in October). These data provide enough grounds for the conclusion as to a slowing-down rate of output growth in November 2007.

Fourthly, demand “required” a more substantial adjustment of output volumes, because in November the dynamics of output significantly differed from that of demand. Coincidental changes in output and demand were registered in November by only 59% of enterprises. Such a low level of this index had not been observed for the past 2 years. And the share of enterprises whose output was ahead of demand, on the contrary, went up to 28%. This represents a historic high of the 5 previous months. The share of enterprises whose output was behind demand also increased – to 13%. As a result, 41% of enterprises displayed in November a pattern of output changes that differed from that of demand. Producers were clearly no more perceiving demand as the main target for their output.

Fifthly, the balance of estimations of finished stocks became substantially higher. Within one month, this index increased by 5 points and became the worst in the past 17 months. In other words, such a surplus of stocks had not been observed in Russian industry since July 2006. This is also a sign of an inadequate response of output to current demand. More goods were produced than it was feasible to sell, and the surplus was put in warehouses. As a result, the warehouse stocks turned out to be higher than it had been typical in the preceding months. In fact, in a normal situation warehouses are filled with surplus stock when demand is expected to grow in the next few months, and when enterprises are preparing to satisfy it without overloading their production capacities. However, in our situation the expected level of demand gave no reasons for replenishing finished stocks for subsequent intensive use in the following months.

The end of the year 2007 saw Russian industry being faced with rather gloomy prospects, as estimated by heads of enterprises. Firstly, the comparison of the December results observed in previous years demonstrated that the end of 2007 looked more bleak (from the point of view of demand patterns) than the outcomes of the three previous years. The growth rate of demand for industrial products (after the survey’s results were cleared of seasonality) remained at its historic low since March 2006, while by comparison with March 2007 (the best result of last year) it decreased 4-fold. As a consequence, the satisfaction with the vol-



umes of sales was diminishing. At the time of the last survey, only 66% of enterprises believed that the demand for their products was normal.

Secondly, the dynamics of output did not make producers particularly joyous, either. According to heads of enterprises, the growth rate of output in industry continued to slow down. In December the growth rate of this index turned out to be the worst by comparison with those observed in the same month of each of the last 5 years. When cleared of seasonality, it displayed nearly the lowest result of the year (being next only to that of September).

Thirdly, the changed estimations of finished stocks gave no grounds for optimism, considering the dynamics of the other economic indices. In December the balance of estimations increased to +14 points, after having amounted to +8 in November and +4 in October. As a result, the level of surplus warehouse stocks returned to the level registered by the surveys prior to mid-2006, when there were sufficient capacities and personnel available. In 2007, industry was experiencing shortages of both. This means that everything capable of yielding more or less competitive products was now being made use of. No one wanted to curb output and once again mothball these capacities. In such conditions, slower growing demand makes enterprises work for the warehouse, in hope of sales once again beginning to increase in a few months, and their warehouse stocks starting to “dissolve”. However, forecasts as to the patterns of demand remained discouraging, thus urging enterprises to assess their stocks as excessive more often than as normal or insufficient.

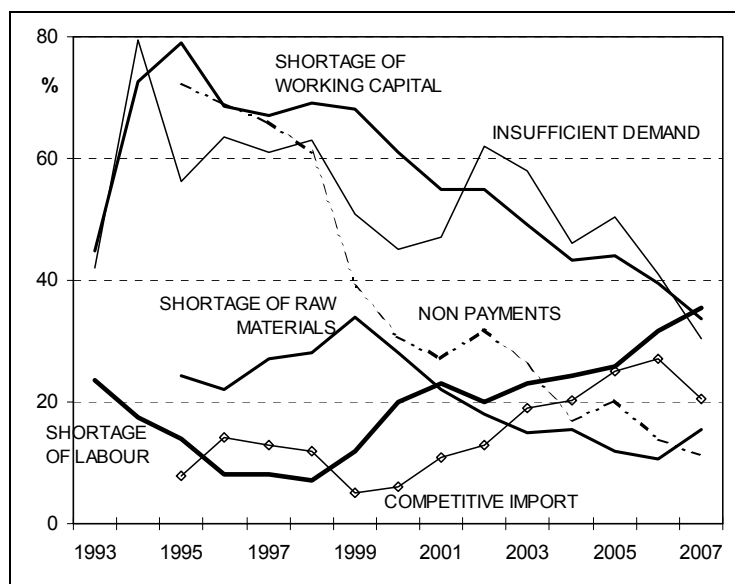
### 3.2.2. The Obstacles to Growth of Industrial Production

In 2007, there emerged a new structure of obstacles to production growth in Russian industry (see *Fig. 13*).

At the beginning of last year, low effective demand was traditionally considered to be the main obstacle to output growth. The incidence of this obstacle across Russian industry in late 2006 – early 2007 became stabilized at the level of 37%. Shortage of current assets, which previously had been producing a similarly restricting effect, now was estimated as an obstacle by only 30% of enterprises. Nearly the same number of enterprises saw an obstacle in the shortage of qualified personnel, but early in the year this factor was mentioned by only 31% as against 36–37% in the second half-year 2006. Competitive import was seen as an obstacle by only 23% of enterprises, which became the historic low of the previous eight quarters.

The “personnel issue” by late 2006 had become more acute than ever since 1993. In 2006, on average, 1/3 of Russian industrial enterprises regarded it as an obstacle to output growth. All this occurred despite the fact that the dynamics of employment and the forecasts of its changes were more favorable than ever previously. During the first three quarters of 2006, enterprises were managing to increase the numbers of their personnel. The only exception was the year’s beginning, when industry traditionally loses many workers who decide to go to a new employer with the start of a new calendar year. A similar situation developed in early 2007. The balance of answers concerning the actual employment changes once again became negative (that is, more personnel had quit than had been registered by enterprises as new employees), but the balance value (–3) looks negligible by comparison with the values observed in early 2006 (–19) or 2005 (–15). As a result, industry had managed to reduce its personnel deficit. The balance of estimations of personnel sufficiency, due to the expected changes in demand, increased from –13 b.p. in the second half-year 2006 to –5 b.p. in early

2007. In other words, in early 2007 industry was still in want of personnel, but to a lesser degree than it had been in the previous half-year period.



Note. 2007 – Q I only.

Fig. 13. Obstacles to Production Growth (average per annum data)

As shown by the analysis of estimations of product competitiveness, Russian manufacturing enterprises believe that approximately 78% of their products are competitive (in relation to import), including on those markets where imported goods are simply absent, those where imported goods are less than competitive in terms of value for money, and those where domestic and imported goods are equally competitive. When estimated by branch, in 2007 the share of such markets was 97% in the construction materials industry and up to 69% in light industry. Given such conditions, there is little surprise in the fact that competitive import is regarded by Russian industrial enterprises as by far not the strongest obstacle to output growth. In Q II 2007 competitive import was rated fifth by the frequency of being mentioned. The list was topped, for the first time, by shortage of qualified personnel, which was viewed as “normal” in a situation of high rates of demand and output growth. This factor now came first, pushing to the second and third places the two formerly most painful problems plaguing Russian industry: shortage of circulating assets and low domestic demand. The fourth place now belonged to shortage of production capacities. In Q II 2007, equipment shortages were already restricting production growth at 1/4 of enterprises (an absolute record of the period of 1993 – early 2007).

Recent developments have also given credence to the warnings of the ongoing increase in personnel shortage taking place against the backdrop of an intensive demand and output growth in the first half-year, and the changing estimations of the actual numbers of personnel in connection with the expected changes in sales. Early in Q II 2007, the shortage of personnel (in connection with the expected changes in demand) reached its historic high. Now, 23% of enterprises were in want of more employees (an absolute historic high), while surplus was reported by only 11% (a nearly absolute historic low). That is, the balance now amounted to –12

points, a worse result having been registered only in Q III 2006. Sufficient numbers of personnel were reported by 66% of enterprises – the lowest result of the previous 17 quarters.

In Q III 2007, insufficient demand (being now viewed as an obstacle by only 26% of enterprises) was in the fourth place among the other 10 obstacles. Shortage of circulating assets (40%), shortage of personnel (40%), and shortage of equipment (32%) were then being mentioned more frequently. The frequency of equipment shortages in 4 quarters nearly doubled (having been 17% in July 2006). Since it is extremely difficult to quickly find the necessary personnel and/or create new capacities within this country's economy (the reserves of personnel and idle capacities having already been exhausted), producers might have been feeling more comfortable in a situation of (nevertheless) growing demand and limited supply.

In late 2007, shortage of personnel was even more confidently topping the list of obstacles to output growth. In Q IV it was already mentioned, across industry as a whole, by 39% of enterprises. An especially strong want of personnel was experienced by enterprises in light industry (frequency – 67%), machine-building (49%) and the timber industrial complex (TIC) (47%). The second place belonged to shortage of circulating assets, which was viewed as a barrier in the way of output growth by 33% of producers (in the chemical and petrochemical industry – by 53%, in light industry – by 51%, and in the TIC – by 45%). The third place was shared by low demand (29%) and shortage of equipment (28%). Competitive import was rated fourth by Russian enterprises. At the time of the latest survey it was described as an obstacle to output growth by only 19% of producers, which represents the last 3 years' historic low. During the year 2007 this factor “lost”, in the eyes of enterprises, 8 of its former points.

However, when recruiting new employees, enterprises do encounter considerable obstacles (see *Table 25*). The most difficult problem is where to find qualified workers. This category of labor can be found without too many difficulties on the labor market, should such a need arise, by only 29% of enterprises, while such reserves are possessed by only 9%. However, the situation as regards the attraction of workers becomes different when being investigated by branch. The least problems are experienced by enterprises in ferrous (where 58% point to absence of any problems when hiring workers) and non-ferrous metallurgy (46%), as well as in the food industry (40%). In the chemical and petrochemical industries and in light industry the situation is reverse: there, qualified workforce can be found by only 17% and 18% of enterprises, respectively. The same industries possess the lowest reserves of such employees – 7% and 4%.

As for other categories of personnel, the situation is fundamentally better (both by possibilities for recruitment and availability of reserves). Unqualified workers can be found without problems by 70% of enterprises, but their reserves in industry are minimal (which is probably normal). Heads of workshops and subdivisions can be attracted “from outside” by only 30% of enterprises; however, the reserves of such employees at enterprises are highest (being possessed by 32%). ETP and office staff can be found on the labor market by only 40% of enterprises, while vacancies can be filled by “inmates” at 25% of enterprises.

The main obstacle relating to the search for all the categories of employees remains the wage level. Nearly a half of all enterprises suffer from this problem when looking for qualified workers. The applicants for other types of vacancies are less frequently dissatisfied with the offered amount of remuneration, but this problem is still being pointed to more frequently than other reasons for dissatisfaction. But enterprises, for their part, are also choosy when recruiting new personnel. This especially applies to those categories of personnel which are not

difficult to find. The highest dissatisfaction is pointed to by enterprises in respect of the employment history, qualification and age of the ETP, office staff and medium-level executives applying for a job. Although such problems relating to the recruitment of qualified workers are mentioned no less frequently, here enterprises are more concerned with the shortage of “free hands” of this type in their regions and the insufficient scope of personnel output by specialized educational establishments.

Table 25

**Obstacles to Recruitment of Basic Categories of Employees in Industry  
(as % of number of respondents)**

Obstacles	Workers		Engineering and technical personnel (ETP) and office staff	Heads of workshops and subdivisions
	unqualified	qualified		
No specific obstacles	70	29	40	30
Enterprises possess reserve of needed personnel	7	9	25	32
Inability to cut redundant employees	4	1	8	2
Shortage of “free hands” in region	7	31	8	12
No output of specialists by secondary and higher educational establishments	1	30	19	12
No job-seekers apply to our enterprise	1	5	4	6
Low wage at enterprise	17	45	32	24
Hard working conditions at enterprise	12	13	5	4
Enterprise dissatisfied with qualification, employment history, age of applicants	13	26	22	16
Taxation of enterprise and tax exemptions enjoyed by its neighbors	2	5	4	3
Other	0	3	1	1

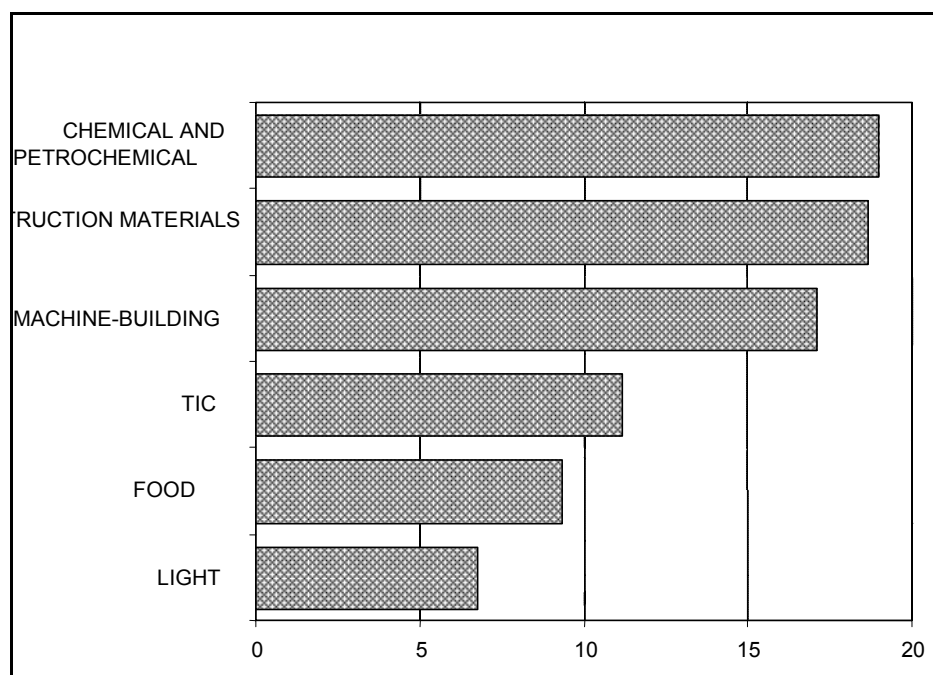
Source: March (2007) survey of the IET.

Now, redundant employees hardly ever represent an obstacle to enterprises in their personnel policy: only the redundancy of ETP and office staff is pointed to as a problem by 8% of producers, while the redundancy of other categories is no longer an obstacle. No problems are experienced by industrial enterprises in connection with their neighbors’ non-competitive advantages in the sphere of taxation and organization of wage payments. Among the applicants for jobs, Russian industry seems to be in high demand. At least, enterprises are quite satisfied by the number of applications for jobs and do not regard themselves as being ignored by potential employees.

In a situation of a stable shortage of personnel and impossibility of large-scale personnel recruitment from the “shrinking” professional training system, enterprises may attempt to find employment reserves among immigrants, whose inflow into Russia is as strong as ever. However, it seems that even this source is not going to save domestic industry from want of personnel.

Firstly, immigrants mostly fill unqualified jobs (this recruitment policy was being practiced by 88% of enterprises in March 2006; in 2007 this question was not asked, but it is unlikely that any fundamental changes could have occurred in this area). Only 4% of enterprises reported that they were using immigrants as workers of medium-level qualification. The March 2007 survey demonstrated that no problems with the recruitment of unqualified workers were being experienced by 77% of enterprises. It is possible, however, that enterprises had indeed begun to “try” immigrants as qualified labor and were disappointed. The level of im-

migrants' qualification at the time of the last survey did not satisfy 15% of employers (see *Fig. 14*), while a year earlier dissatisfaction with their abilities had amounted to only 7%. At the same time, Russian enterprises are displaying a sufficient level of political correctness, since only 1–2% of respondents point to “culture, way of thinking, working style” as obstacles to recruitment.



*Fig. 14.* Dissatisfaction with the Qualification of Immigrants when they are Available in a Region, 2007, in %

Secondly, enterprises are now less frequently “noticing” immigrants in their regions. In 2006, the absence of a considerable number of immigrants “in the vicinity” was described as an obstacle to their recruitment by 27% of enterprises, whereas in 2007 this was done by 37%. The shortage of immigrants residing nearby is most acutely felt by the enterprises in the chemical and petrochemical industries (in 2006 – 52%, in 2007 – 62%), the timber industrial complex (39% and 38%, respectively), machine-building (28% and 32%), and light industry (24% and 59%). But nowadays immigrants apply for jobs at industrial enterprises slightly more frequently. In 2006, the lack of applicants from the immigrant labor force worried 23% of enterprises, in 2007 – 20%. Especially worried by the existing situation were machine-building (27% and 25%, respectively), the food industry (32% and 16%), and light industry (22% and 24%). If immigrants are “available” and apply to enterprises in search for a job, dissatisfaction with their qualification differs by branch as follows (see *Fig. 14*).

Thirdly, some enterprises avoid employing foreign workers as a matter of principle (“we prefer not to hire immigrants, irrespective of their quality”). In 2007 their share became as high as 10%. This standpoint is more typical for the TIC (15%), machine-building (14%) and the food industry (13%). These figures somewhat spoil the previously displayed politically correct image.

Fourthly, the importance of the formalities associated with the employment of immigrants did not change in any dramatic way. In 2006 this was described as an obstacle by 23%

of enterprises, whereas in 2007 – only by 19%. Comparatively more frequently this reason is pointed to in the construction materials industry (53% and 39%).

Fifthly, more than at 1/4 of all enterprises immigrants compete with locals when applying for jobs, and lose. A sufficient number of local applicants is available (and is viewed as an obstacle to the recruitment of immigrants) to 26–28% of enterprises. This index varies greatly from branch to branch (see *Table 26*).

*Table 26*

**Share of Enterprises in Branches with Sufficient Numbers of Local Applicants  
in 2006 and 2007, in %**

Branches of industry	2006	2007
Chemical and petrochemical industry	27	16
Machine-building	23	35
TIC	8	20
Construction materials industry	22	39
Light industry	21	15
Food industry	38	50

*Sources:* March (2006 and 2007) surveys of the IET.

Wage level was not altogether an obstacle to the recruitment of immigrants by Russian enterprises: only 1% enterprises regarded the wage-related expectations of such employees to be too high. In 2006, 82% of heads of enterprises believed that wage should be equal for locals and immigrants of equal qualification levels.

The highest chances for an immigrant to find employment at a Russian industrial enterprise at the time of the latest survey existed in the construction materials industry (16% answered “no obstacles”), the TIC (14%) and light industry (11%). In machine-building only 2% were ready to receive them.

### 3.2.3. The Dynamics of Competition in Russian industry

This section addresses the dynamics of competition in Russian industry in 1995–2007. This period encompasses both the pre-1998 decline in industrial production (when import goods prevailed), and the 1998 default (with the ruble’s depreciation and subsequent import substitution). The latest years of monitoring offer a picture based on enterprises’ estimations of competition on their sales markets in a situation of industrial growth, the ruble’s strengthening, and large-scale growth of imports.

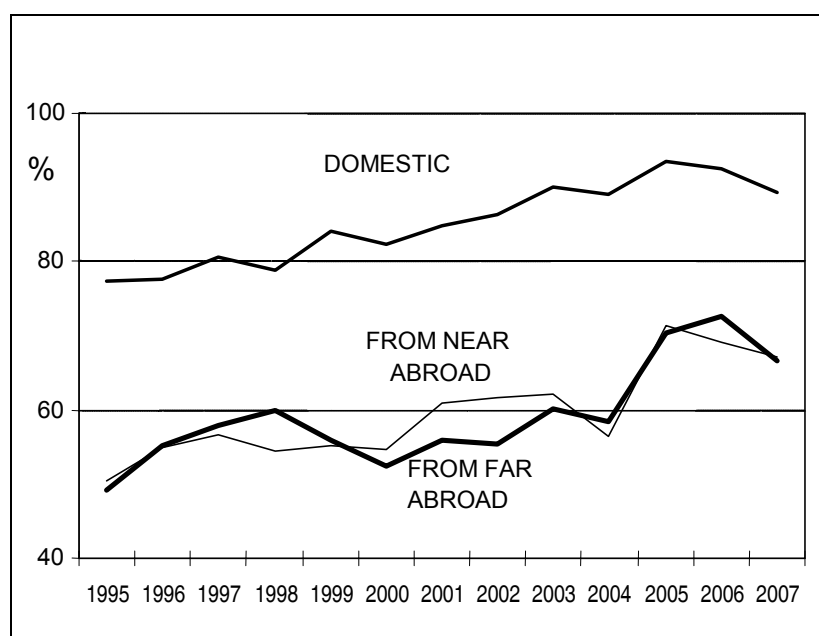
The main indices describing competition can be found in the questionnaires’ sections dealing with the levels of competition on sales markets: “What is your estimation of the level of competition on your enterprise’s sales markets: a) with Russian enterprises, b) with enterprises from near abroad, c) with enterprises from far abroad?”. It was suggested that the respondents should gauge their answers by the scale: “high – moderate – weak – none – difficult to estimate”. These questions were offered to all the enterprises of the April and October panels. For purposes of statistical processing, the five variants of answers are rated 5, 4, 3, 2, and 1. Then these rates are weighted by the number of answers received, and the average rate across industry or by branch is calculated.

This gauged scale of answers makes it possible to introduce the notion of competitive markets. Markets are characterized as competitive when enterprises experience at least a minimum level of competition. The share of competitive markets is estimated as the ratio of

the sum of the answers “high”, “moderate” and “weak” to the sum of all the answers. It should be noted that the share of competitive markets tells nothing about the intensity of competition on these markets – it simply indicates that enterprises do, indeed, experience there a certain level of competition.

### *Competitive Markets in Russian Industry*

As demonstrated by the results of surveys, during the period when competition was monitored (1995–2007) the greatest number of competitive markets with domestic competition was registered in 2005. At that time, 94% of enterprises pointed to the existence of at least some competition with other Russian producers on their sales markets (see *Fig. 15*). The highest share of the markets displaying competition with far abroad was observed in 2006 and amounted to 73%.



*Fig. 15. Dynamics of the Shares of Competitive Markets in Russian Industry, by Types of Competition*

From the year 2005 onward, the share of competitive markets with domestic competition in Russian industry had been displaying a downward trend. In 2006 this index went down by 2 p.p., in 2007 – by another 3 p.p., that is, in the past 2 years the cumulative loss amounted to as much as 5 points. It is possible that the formerly upward trend displayed by changes in the share of competitive markets in Russian industry, which, with slight deviations, persisted throughout the whole period of monitoring, by then had exhausted itself. In 2007, the average per annum share of such markets across all branches constituted 89%.

The share of competitive markets in 2007, when broken up by branch, varies rather narrowly (see *Table 27*). Only metallurgy stands out: there, the share of competitive markets fell in 2007 to 79%, which represents its annual historic low. It should be noted that metallurgy has almost always been at the bottom of the list of branches by its share of competitive markets, especially in the years following the 1998 default. By this index, the leader in 2007, just

as in the preceding year, was light industry, where competition is reported by enterprises to be present on 98% of their markets. This value is the branch's nearly absolute historic high (if one disregards the 100%-level observed in the chemical and petrochemical industries in 2005). However, given that the share of competitive markets in light industry has been stable and high in the last 6 years, this branch may be justifiably regarded as the leader in competition development. The share of competitive markets in the construction materials industry in the post-default years has also been at a high and stable level, this index never decreasing in those branches below 90%; in 2001 and 2005 it was as high as 95%, while lately has decreased to only 91%. This can probably be explained by the construction boom, which allows producers, without any obstacles created by their competitors, to sell their finished products almost at any price they ask.

*Table 27*

**Average per Annum Share of Competitive Markets with Domestic Competition, by branch, in %**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Metallurgy	54	78	80	74	86	75	84	89	85	82	90	80	79
Chemical and petrochemical industries	72	86	89	83	90	86	94	90	96	86	100	94	88
Machine-building	79	80	79	79	83	90	91	89	92	93	95	97	95
TIC	80	81	78	90	83	84	85	91	95	94	95	96	89
Construction materials industry	85	73	90	94	91	94	95	94	93	94	95	91	91
Light industry	72	75	81	85	84	87	85	96	94	97	96	97	98
Food industry	90	90	96	79	90	88	92	97	95	93	90	93	96

*Source:* computations based on the IET's surveys.

Much less homogeneous are the data on the share of competitive markets with competition with enterprises from far abroad (see *Table 28*). Thus, in 2007 the minimum level amounted to 38% and was observed in the construction materials industry. In metallurgy the same index last year was 75% – nearly twice as high. The enterprises belonging to the construction materials industry are more rarely than the enterprises in other branches faced with competitive products arriving from far abroad. On the average in that branch, in 1995–2007 only 25% of its sales markets were competitive (in respect of foreign competition). In 2000 and 2003 this index fell to 10%. But in 2006 it rose to 46% as a result of Russia's construction boom, which attracted to the market the highest possible (for that specific branch) number of foreign competitors. Second by the degree of protection from imports (or, more precisely, of its scarcity) is the food industry. Its enterprises, on the average throughout the period of monitoring, have been confronted by imports only at 49% of their markets. The highest share of competitive markets across the branch was registered in the pre-default year 1997. Slightly more often the competitors from far abroad are encountered by enterprises in the timber industrial complex. On the average, their markets were competitive by 51%. However, in the past 3 years the presence of competitive imports on branch sales markets has been on the rise and reached in 2006 the level of 81% – that year's historic high among branches.



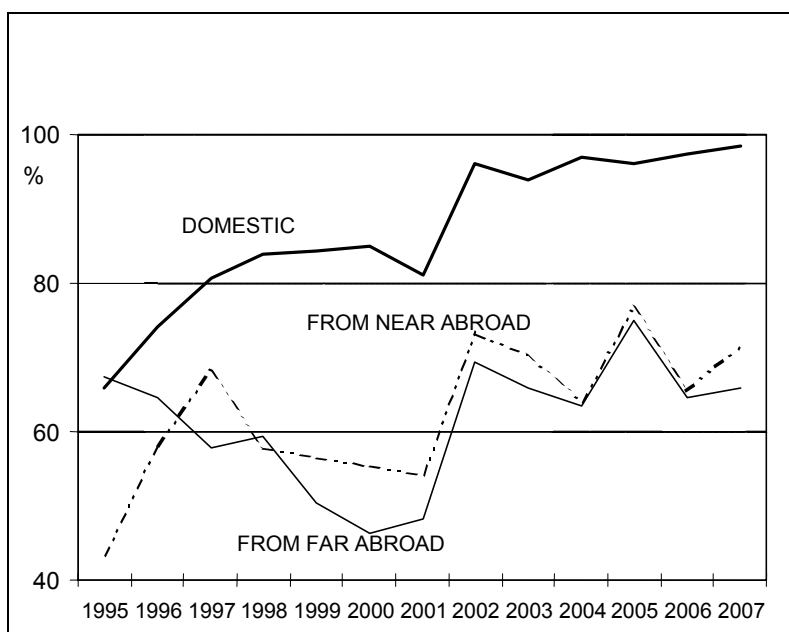
*Table 28*

**Average per Annum Share of Competitive Markets with Competition  
with Enterprises from far abroad, by branch, in %**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Metallurgy	18	48	54	70	65	59	76	61	63	59	84	79	75
Chemical and petrochemical industries	50	68	65	68	65	72	78	68	58	55	81	75	64
Machine-building	51	57	63	60	60	61	63	65	70	67	73	79	71
TIC	55	58	50	55	31	42	32	37	44	47	61	81	68
Construction materials industry	25	20	36	23	27	10	16	32	10	12	24	46	38
Light industry	65	66	58	60	50	47	50	70	66	63	75	65	66
Food industry	60	58	64	45	43	43	37	32	41	43	56	49	62

*Source:* computations based on the IET's surveys.

The presence of competitive imports in the period of 1995–2007 was most strongly felt on the markets of the chemical and petrochemical industries. The average competitiveness level of such markets within the branch amounted to 67%, being in 2000–2007 as high as 69%. A historic high was registered in 2005 at the level of 81%. The second place in the general (for the period of 1995–2007) competitiveness rating on the markets belongs to machine-building. The competitive import on the sales markets of the enterprises in that branch have been expanding their presence throughout the whole period of monitoring, having reached in 2006 the level of 79%; their only setback so far was the loss of 8 points last year, which resulted in their clash with domestic machine-building products to 71%. But even after this decline the machine-building markets still kept their second place by the value of this index. In 2007 the list of branches dealing with competitive imports was topped by metallurgy. But even this result in 2007 was not the highest for this particular branch: the presence of imports has been diminishing there since 2005, when it had reached its absolute historic high of 84%. And only the food industry experienced in 2007 a more strongly felt presence of competitive imports than it did in the preceding years. Now imports are competing with domestic food products on 62% of markets. By comparison with other branches, this result is sufficiently low for the year 2007. But at the same time it should be remembered that the presence of competitive imports in that branch had increased nearly twofold since 2002 – from 32% to 62%. Previously (in 1997–2002) the presence of imports on the branch's markets fell exactly twofold (from 64% to 32%). No other branch of Russian industry has displayed such clearly observable trends.



*Fig. 16.* Dynamics of the share of competitive markets in light industry, with competition

The contact of the enterprises in light industry with competitive imports is not so extensive as it may seem on the basis of certain experts' estimations (see *Fig. 16*). In 2007 the enterprises of that branch were competing with imports only at 66% of their markets, 1/3 of the markets being free from competitive import – “white” as well as “grey”, since enterprises, when offering their own estimations of competition, take into account all the goods imported and circulating on their sales markets, no matter what their status may be in terms of customs clearance. Slightly higher in light industry is the number of those competitive markets where domestic products compete with imports from near abroad – 65% in 2007. The declining share of markets with competition with imports (from both near and far abroad) by 11 and 10 p.p. in 2006 had been associated, most probably, with improved customs control and the diminished, as a result, imports' competitive advantages on the domestic market. And nearly all the sales markets in light industry are competitive with regard to other Russian producers: 98% of enterprises in light industry feel the presence of competition on the part of other domestic producers, this latter index being relatively stable (in the interval of 94–98%) since 2002.

#### *Competition Intensity in Russian Industry*

In 2007 the trend toward a decline in the intensity of the three types of competition, which had first appeared in 2006, became more prominent (see *Table 29*). The main competition indices monitored by the IET since 1995 have demonstrated a declining competitive struggle in all the three “directions” (domestic competition, competition with near abroad, and competition with far abroad). The most remarkable result has been the decrease of the annual index of domestic competition: last year it dropped by 0.15 points, in the past two years – by 0.24 points. The most noticeable change was registered in the first half-year 2007, when this index was only 3.88. This turned out to be the historic low of the period of 2003–2007. The more serious problems with sales in the second half-year led to more intense competition and elevated the index to 4.07. This later phenomenon prevented a more dramatic fall of the per

annum domestic competition index in 2007. The least prominent changes of the years 2005–2007 were registered as regards the competition with imports, the decline of this index being only by 0.07 points, and therefore it would be more correct to describe it as having a constant nature. Thus, competition intensity’s historic high on the sales markets of Russian industrial enterprises in the thirteen years of monitoring was registered in 2005, when all the three indices reached their absolute maximum values.

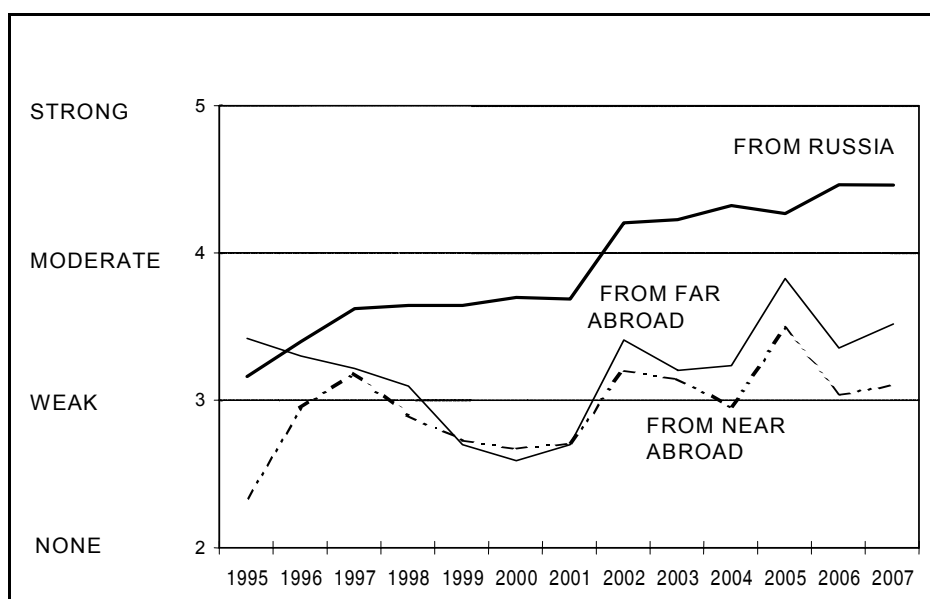
*Table 29*

**Per Annum Indices of Competition with Different Producers**

Year	Domestic	From near abroad	From far abroad	General index
1995	3.39	2.65	2.79	2.94
1996	3.46	2.82	3.01	3.10
1997	3.55	2.81	3.02	3.13
1998	3.52	2.79	3.09	3.13
1999	3.61	2.73	2.87	3.07
2000	3.60	2.70	2.80	3.03
2001	3.73	2.89	2.90	3.17
2002	3.87	2.93	2.96	3.25
2003	3.95	2.92	3.08	3.32
2004	3.94	2.82	3.03	3.27
2005	4.21	3.27	3.49	3.66
2006	4.12	3.20	3.47	3.60
2007	3.97	3.14	3.42	3.51

*Source:* computations based on the IET’s surveys.

The level of domestic competition declined in 2006–2007 nearly in all the branches of Russian industry. Especially dramatic was the fall of this index in metallurgy: the competition index there went down by 0.59 points and amounted in 2007 to only 3.51 points, thus getting halfway between the categories “moderate” and “weak”. The value of this index in other branches of industry did not go below the “moderate” level. The least “loss” was displayed by domestic competition in light industry, where the competition index, after having reached its absolute historic high in 2006, in the next year went down by 0.01 points, that is, remained almost flat. As a result, the branch “strengthened” its leading position by the intensity of domestic competition, achieved a year before. Then, the domestic competition index in this branch had gone up, in one year, by 0.2 points and scored 4.47 points (out of a total of 5), that is, somewhere midway between “moderate” and “strong” (see *Fig. 17*). This is the peak competition value of the whole 13-year period of monitoring at the branch level.



*Fig. 17. Dynamics of the Levels of Competition with Different Manufacturers in Light Industry*

As for the competition with imports in that branch, after 2005 it became weaker. In 2006 it lost as much as 0.48 points, having later once again rebounded by 0.16 points. But the year 2005 still stands out as the period of the highest intensity of competition with imports, requiring not only a profound mobilization of enterprises' efforts in defending their positions on the market, but also certain actions on the part of the State aimed at "de-shadowing" imports. The results of this activity are still visible to the enterprises belonging to this branch.

The food industry, traditionally regarded as being most protected from imports from far abroad, in 2007 once again confirmed its reputation. Although the share of markets with competition with imports became nearly as high as its pre-default peak level, the level of competition inside the branch remained at the same extremely low level (see *Fig. 18*). The level of competition with imports was estimated in 2007 as amounting on the average to 2.92 points, that is, below the "weak" level. In 2002 the situation on sales markets in respect of the competition with imports was extremely comfortable for Russian foodstuffs producers, who were competing with imports on a minimum number of markets, while competition intensity was close to "none". Within 5 years, intensity increased by 0.77 – a rather modest growth for such a long period, and the result itself is far from being ideal. A lower competition level in 2007 was observed only in the construction materials industry. The competition of the food-producing enterprises with producers from near abroad has been becoming more and more intense in recent years, in an equal measure becoming stronger than the competition with imports from far abroad. However, even in this area the absolute competition levels surpassed the "weak" level but, having reached in 2006 the intensity index of 3.29 points, once more dropped in 2007 to 3.11 points. In other words, imports represent no threat to our food industry.

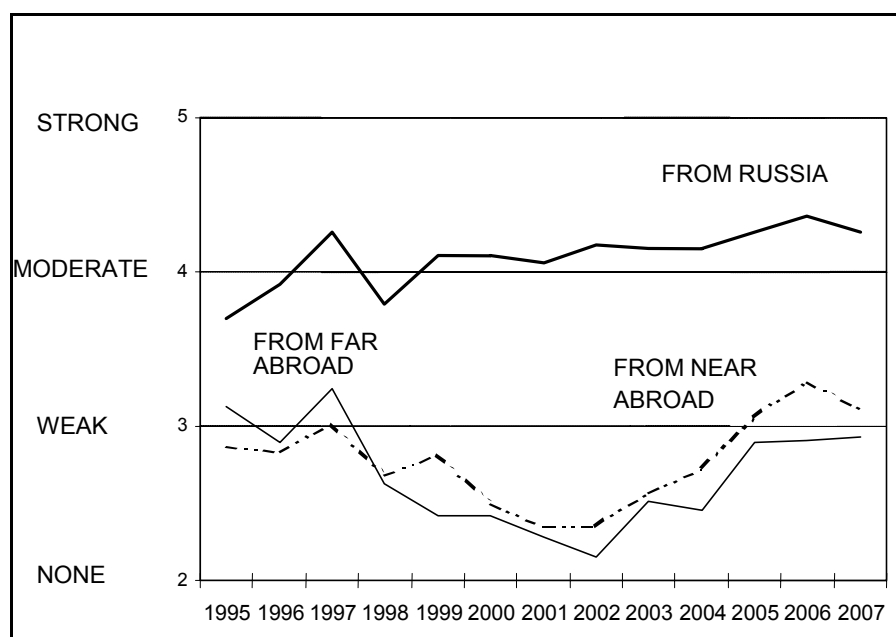
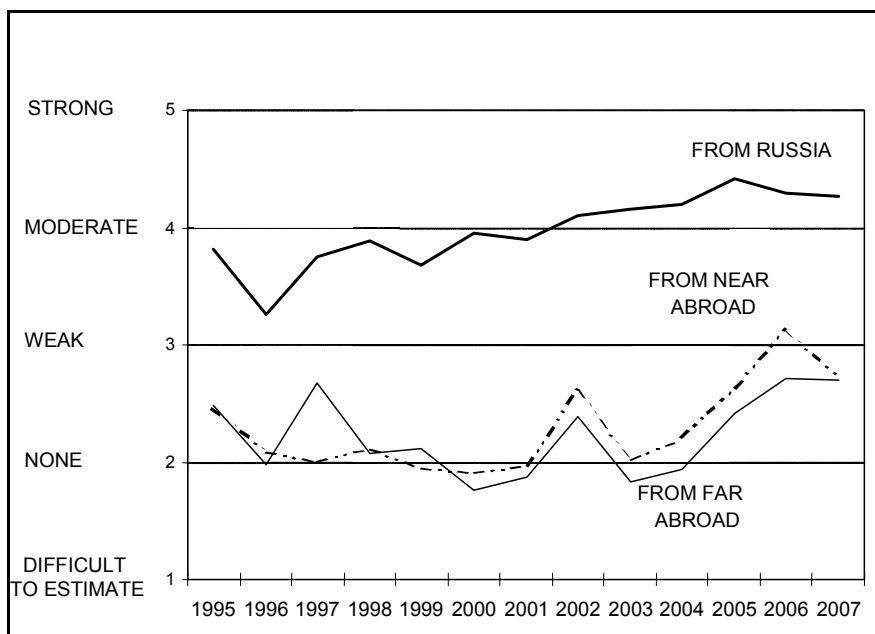


Fig. 18. Dynamics of the Levels of Competition with Different Manufacturers in the Food Industry

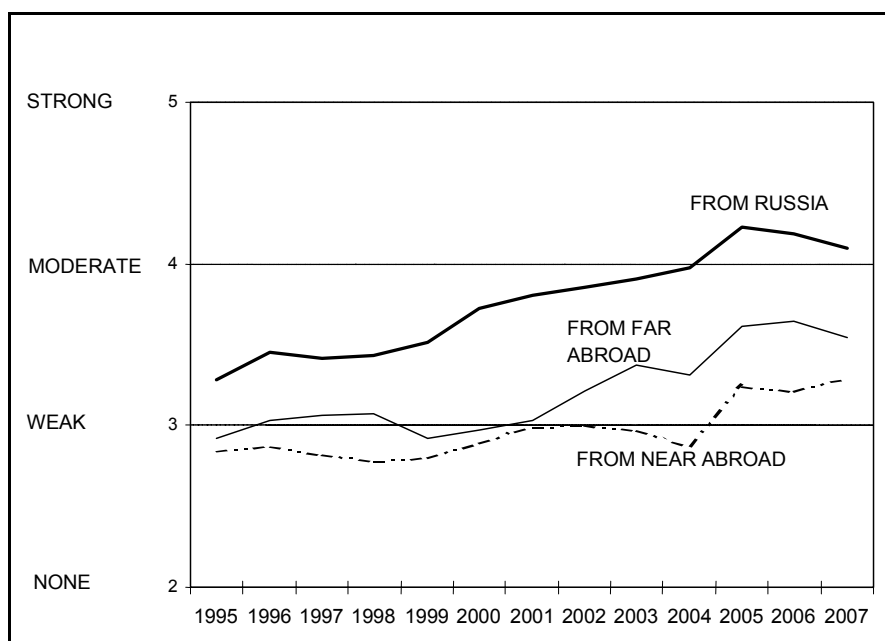
At the same time, domestic competition inside the branch is not only the most widespread, but also the most intense. The average competition indices in any given period of monitoring (1995–2007, either prior to or after the 1998 default) have made this branch the absolute leader among all the other branches. In 2007 its competition intensity level was second only to that of domestic competition in light industry. But while in the latter case it represents a virtual struggle for survival (where the weaklings are literally thrown out of the markets), the foodstuffs producers are simply fighting for a biggest possible share of the expenses on food in the population’s market basket. In 2006 the branch reached its historic high of domestic competition intensity – 4.36 points, which means that this type of competition on the sales markets of food-producing enterprises is gradually shifting from “moderate” to “strong”. But this is indeed a gradual process, since the branch’s competition indices were in 1999 already stably above 4 points (“moderate”), and only in 2005–2006 there emerged a trend toward their “break-off”. In 2007 the level of domestic competition decreased, but only slightly.

The second place on the average intensity scale of domestic competition in 1995–2007 belongs to the construction materials industry. Its competition indices have nearly always been second to those of either the food branch or light industry, and in 2005 topped the list. In the same year the branch displayed its absolute historic high, followed by a gradual decline in the intensity of competition with other Russian producers (see Fig. 19). In 2007, by the intensity of its domestic competition, the construction materials industry was second only to light industry. However, the high level of domestic competition is compensated by a rather low competition with imports. In fact, it is quite normal for this branch to experience a low level of competition with imports, considering the specificity of its products. In the rating by this index, the construction materials industry has always been at the bottom of the list. The values of the index of competition with imports were fluctuating close to “none”, sometimes going even lower (“difficult to estimate”). A relatively stable growth of competition with imports

began in 2004. However, the result proved to be modest: competition with imports from far abroad has never risen to the “weak” level, and in 2007 even slightly declined, while the competition with imports from near abroad managed to reach the “weak” level in 2006, after which once again fell below it.

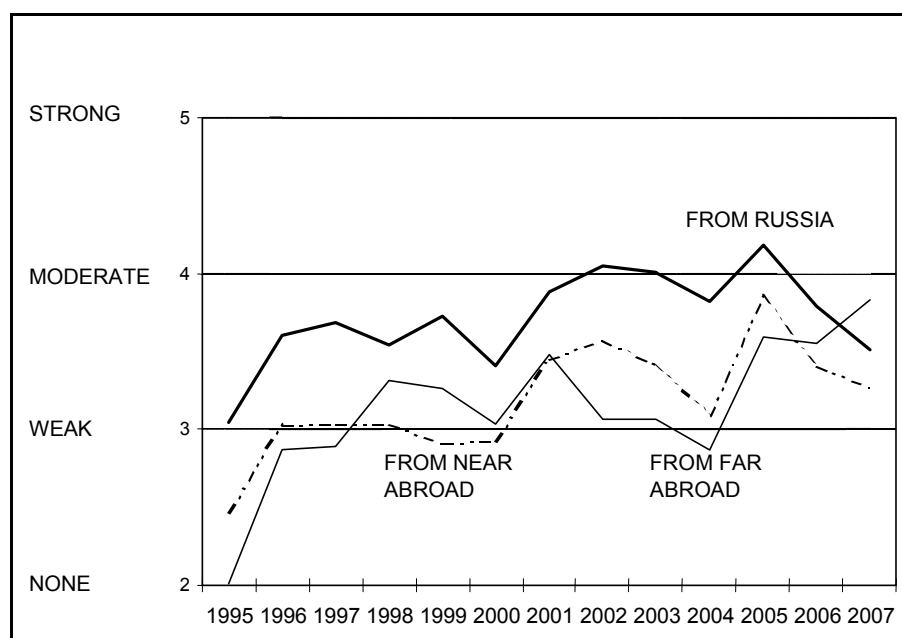


*Fig. 19. Dynamics of the Levels of Competition with Different Manufacturers in the Construction Materials Industry*



*Fig. 20. Dynamics of the Levels of Competition with Different Manufacturers in Machine-Building*

In machine-building, the peak level of domestic competition, just as in the majority of other branches, occurred in 2005. Then, this index for the first time went above the “moderate” level, to 4.23 points. This was the outcome of a slow but persistent growth of competition within this branch during the previous 10 years (see *Fig. 20*). Later on, the index began to decline, and in 2007 amounted to 4.09 points, that is, almost returned to the previously observed moderate level. Similarly to all the other branches, domestic competition here remains the most intensive type of competition on the sales markets of Russian machine-building. Competition with imported products has always been much weaker than that with the “domestic enemy”. Its peak was observed in 2006, but even then it was halfway between “weak” and “moderate”. Prior to 2002, competition with imports from far abroad could not depart from the “weak” score, while competition with imports from near abroad succeeded in this only in 2005. Thus, in the pre-default period, traditionally regarded as that during which imported goods prevailed, machine-building was not suffering much from their presence. This branch was then more concerned with other, today already forgotten, problems, such as barter, non-payments, low demand, and shortage of circulating assets. But even the currently observed level of competition with imports can hardly be regarded as critical – it is described as “strong” by 38% of machine-building plants, “moderate” – by 21 % and “weak” – by 12%. Its absence was declared by 16% of enterprises. The latter figure represents this index’ historic high since 1998, that is, at the time of the last survey competition with producers from far abroad was absent for a higher number of machine-building plants than at the very beginning of this “sweet” period of the ruble’s depreciation and total import-substitution. Presently, the rouble is stronger than ever, and imports are flooding the country like a torrent. However, domestic machine-builders regard this situation more calmly than some analysts and government officials.



*Fig. 21.* Dynamics of the Levels of Competition with Different Manufacturers in Metallurgy

Metallurgy is the only branch where competition with imports turned out to be stronger than domestic competition (see *Fig. 21*). Such a unique situation (for Russia’s economy) de-

veloped here in 2007, having resulted from two oppositely directed processes. On the one hand, the level of domestic competition decreased very dramatically in 2006–2007: the competition index fell by 0.67 points and now is midway between being “weak” and “moderate”. A similar “reshuffle” occurred in the competition with producers from near abroad. It seems that the processes of mergers and takeovers going on in this branch across the territory of the former USSR have done their part. On the other, it is much more difficult to successfully negotiate with metallurgists from far abroad – one has to be competitive. It should be noted in this connection that the level of competition with imports in this branch is not too high by comparison with similar indices observed in other branches. In 2007 it merely reached the level observed 2 years ago in light industry, which was also being approached at that time by the chemical and petrochemical industries. The really important phenomenon is the extremely low level of domestic competition in this branch in 2007. This index in metallurgy is really remarkable against the backdrop of the other branches.

#### 3.2.4. The Creation of a Competitive Environment in Russian Industry

The realization of government competition-promoting policy in conditions of a transition economy is fraught with the objective difficulties associated with the relative shortness of the period within which a competitive environment has emerged, with the rapid development of economic processes, and the weakness of the traditional systems for monitoring competition. The price of a potential failure to properly determine the priorities of competition-promoting policy may become prohibitively high for Russia’s newly developing market economy. In such a situation, studying the real conditions under which a competitive environment in Russian industry is being created may provide an important empirical backing for the elaboration of adequate measures to be incorporated into economic policy.

The issue as to which of the factors mentioned in economic theory can indeed ensure the formation of a truly competitive environment has hardly ever been appropriately studied. The reason is the lack of necessary statistical data describing both the competition level and the factors determining this level. In this connection it should be borne in mind that so far as certain factors are concerned, it would be difficult, in principle, to offer any adequately applicable (that is, direct and practicable) statistical measure, and so they can be described only in qualitative terms. At the same time, it is still important, for the sake of economic analysis, to provide answers to the question as to how the level of competition may be influenced by the existing agreements between producers concerning their pricing policies or the division of sales markets.

The contribution of various factors to the formation of an aggregate (cumulative) competition level in Russian industry can be studied on the basis of surveys of heads of enterprises. If such an approach is applied, then several fundamental methodological problems are removed, and it becomes possible to obtain quite new data capable of providing a basis for adjusting government policy in the sphere of competition promotion. By way of implementing this approach, from the year 2000, at the intervals of 23–26 months (that is, within a two-year cycle) the heads of industrial enterprises participating in the IET’s regular surveys were offered questions as to in which direction and how strongly the major factors singled out by economic theory were influencing competition. The *list of factors included in the questionnaires* was as follows:

- a) the level of production concentration,



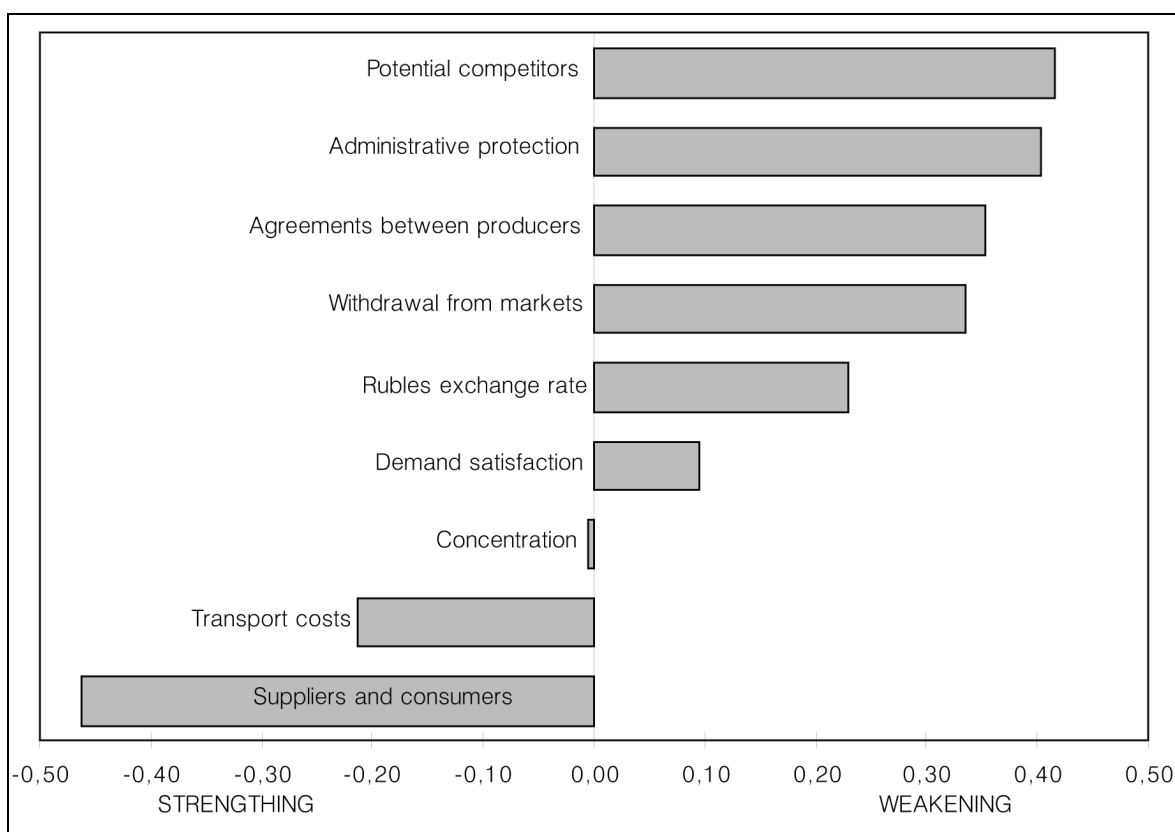
- b) the degree of demand satisfaction and the presence of surplus capacities,
- c) agreements concerning pricing policies and the division of sales markets,
- d) the size of transport costs,
- e) the problem of a search of suppliers and consumers, as faced by a new producer,
- f) administrative protection of markets,
- g) the problem of withdrawal from markets,
- h) the presence of potential competitors.

The majority of the factors being studied either cannot be determined by any adequate statistical indices, or have no reliable statistical base. It was suggested that the influence of each of these factors on enterprises' aggregate competition level should be estimated by the direction ('strengthens', 'weakens') and strength of influence ('considerable', 'moderate', 'negligible', 'none', 'difficult to estimate'). In this connection it was assumed that each factor could both strengthen and weaken competition on specific sales markets. For example, administrative protection may occur on a small part of a producer's markets, and so have a relatively small influence. But on a great majority of that same producer's markets, such barriers would be absent, resulting in an unrestricted circulation of goods and services, thus inevitably strengthening competition. In the final analysis, we obtain the resulting influence of each specific factor on the aggregate competition level.

When the results of a survey are being statistically processed, each answer category ('considerable', 'moderate', 'negligible', 'none', 'difficult to estimate') is scored 5, 4, 3, 2, or 1, respectively, – these scores being then weighted by the share of each answer so as to generate the average answer determining that factor's average impact on the level of competition. The higher the average score of a given factor, the more intensive its influence on competition level. The presence in a questionnaire of an answer concerning both the strengthening and weakening influence of each of the factors makes it possible to obtain the resulting estimation of the factors' influence on the aggregate competition level. To compute such an estimation, it would be necessary to subtract the average value of weakening influence from that of positive influence. The positive value of this resulting index will determine the factors which, in the final analysis, will be positively (strengthening) or negatively (weakening) influencing the level of competition.

#### *The Main Results of the Emergence of Competition in Russian Industry*

Since it was suggested that the enterprises, in course of each of the 4 surveys, should estimate both the positive and negative influence of the same factor (or pairs of opposite vectors of each single factor), the estimation of the resulting average influence (for the whole period of monitoring) of these factors on the level of competition can reveal the average balance of the influences of each factor as the difference between the average estimations of positive and negative influences. The average balances (for the whole period) have demonstrated the resulting picture of competition's development in Russian industry in the period of 2000–2007 (see *Fig. 22*).



Source: computations based on the IET's surveys.

*Fig. 22. Average 2000–2007 Balances of Estimations of Competition Formation in Russian Industry*

*Table 30*

**Resulting Influences of Different Factors on Competition Level in 2000–2007**

Factors	2000	2002	2004	2007
1. Production concentration level	-0.11	0.04	0.14	-0.09
2. Degree of demand satisfaction	0.05	0.14	-0.01	0.20
3. Agreements on pricing policies and division of sales markets	0.38	0.50	0.13	0.40
4. Transport costs	-0.28	-0.02	-0.30	-0.25
5. Search for suppliers and consumers	-0.69	-0.31	-0.38	-0.47
6. Administrative protection of markets	0.31	0.41	0.48	0.41
7. Withdrawal from markets	0.30	0.29	0.30	0.45
8. Potential competitors	0.25	0.46	0.34	0.61
9. Ruble's exchange rate		0.22	0.13	0.34

Source: computations based on the IET's surveys.

The factors being monitored could be quite distinctly and permanently split into two groups. The first group (positive influence on competition) consisted of 6 factors: the degree of demand satisfaction and the presence of surplus capacities, the ruble's exchange rate, opportunities for withdrawal from markets, the agreements on pricing policies and division of sales markets, the administrative protection of markets, and the presence of potential competitors. The second group (negative influence) included 3 factors: the level of production concentration, the size of transport costs, and the problem of a search for suppliers and consumers as faced by a new producer. The degree of the resulting positive or negative influence of the studied factors on the level of competition in Russian industry was variable, with occasional changes in the sign applied to the influence value (see *Table 30*). The obtained results point to the priorities of the competition-promoting policy in Russian industry.

#### *Obstacles to the Development of Competition in Russian Industry*

Producers consider the problem of a search for suppliers and consumers to be the main obstacle to the development of competition (see *Fig. 22*). This factor has a resulting negative influence on competition in all the branches of industry. Especially strong is the ultimate (that is, incorporating both positive and negative influences) restricting influence of this factor in metallurgy, the timber industrial complex, the construction materials industry, and machine-building. The least problems of this type are experienced by the chemical and petrochemical industries, but even there this factor influences competition negatively, if the whole spectrum of estimations is taken into account. This situation may be the result of several phenomena. On the one hand, for objective reasons no well-developed information infrastructure enabling producers to investigate potential sales markets and to find and get into contact with new contractors can be created within the relatively short period of the market economy's emergence. On the other, Russian enterprises probably prefer to deal with their long-established suppliers and consumers, since the primitive "contractual culture" and long experience of non-payments have made them prejudiced against new partners – no matter how brilliant are the prospects they might offer. The government's goal in this sphere, quite obviously, must be to promote the formation of a sufficient information infrastructure on the markets and an adequate business culture (primarily in the sphere of their own obligations).

In the estimation of the initial negative influence, the factor "attachment of suppliers and consumers to traditional products" has always had the strongest influence on competition (see *Table 31*). In 2007, its influence on the average became as high as 3.70 points, which means that across industry as a whole it approached the "moderate" level. Serious problems have arisen in this connection in non-ferrous metallurgy, where the negative influence of the supplier – consumer tie-ups went up to 4.58 points, that is, came close to being "considerable", while the aggregate share of the answers "considerable" and "moderate" was already 87%. Next comes the food industry, where the negative influence of this factor amounted to only 3.89 points (e.i., below "moderate"). This is followed by the group of the other branches of industry (small and densely packed within a short interval). The lowest negative influence of the attachment of suppliers and consumers was observed in the construction materials industry (3.60). Thus, different branches of industry offer sufficiently high and rather similar estimations of the negative influence on the level of competition of their inability to find new suppliers and consumers.

Table 31

**Relevant Factors and the Degree of Competition's Weakening on the Sales Markets of Russian Industrial Enterprises in 2000–2007, average rates**

	Factors	2000	2002	2004	2007
1.	Concentration of main production at several enterprises	3.37	3.39	3.31	3.52
2.	Dissatisfaction with effective demand and absence of surplus capacities	3.28	3.25	3.42	3.28
3.	Informal agreements between producers on market division, pricing policies, etc.	2.90	2.99	3.01	3.03
4.	High transport costs	3.06	3.06	3.44	3.31
5.	Attachment of suppliers and consumers to traditional products	3.45	3.36	3.50	3.70
6.	Administrative protection of sales markets (quotas, licensing, bans on imports and exports)	2.72	2.86	3.09	3.02
7.	Easy withdrawal from markets (real opportunities for return of funds invested in equipment and premises)	2.40	2.34	2.72	2.51
8.	Absence of enterprises capable of rapid intrusion on your sales markets (that is, potential competitors)	3.27	3.15	3.46	3.35
9.	Ruble's too low exchange rate	*	2.43	2.72	2.52

*Note.* \* – In 2000 this question was omitted.

*Source:* the IET's surveys.

This assumption has also been confirmed by the study of the competitive advantages of domestic enterprises. The main advantages of their products on the domestic market are described by Russian enterprises both in 2006 and in 2007 as their long-established connections with consumers (see *Table 32*). In one year the frequency of this factor being mentioned went up by 15 points. At the time of the latest survey it was referred to by more than 70% of enterprises, and it had become a nearly absolute leader at the branch level. Only in the food industry it amounted to 64%, being second to “product's superior quality” (71%) which, in fact, is not surprising given the fact that the lion's share of that branch's output is consumed by the population, and it is sometimes not easy to monitor the stability of connections with such consumers. So, only superior quality can ensure victory in a very tough competition (which has always been demonstrated by our monitoring of the competition level) – both with other Russian enterprises and with imports. However, this evident leadership of the factor “long-established connections with consumers of product” cannot be regarded as a positive phenomenon. As a matter of fact, it represents a serious obstacle to the entry on the markets of other producers, and thus restricts the development of competition in Russian industry.

The final sufficiently considerable obstacle to competition (that is, as the difference between the strengthening and weakening influences) is believed to be represented by high transport costs. The strongest final negative influence on competition is produced by the transport component of costs in the construction materials industry, ferrous metallurgy, timber, woodwork and pulp-and-paper industries. Since transport tariffs and the development of transport are largely controlled by the State, the diminishment of the negative influence of this factor depends on the government's activity in the sphere of tariffs and the development of transport infrastructure.

*Table 32*

**Competitive Advantages of Russian Industry's Products on Different Markets, in %**

Advantages	On domestic market		On external market	
	2006	2007	2006	2007
1. Lower prices	31	28	59	52
2. Superior quality of products	42	55	26	38
3. Rapidity of goods deliveries	17	22	13	13
4. Convenience of settlements for products	14	17	9	9
5. Maintenance services	19	17	15	13
6. Closeness to consumers in terms of transportation	22	19	5	8
7. Fulfillment of nearly every requirement of consumers	32	37	28	27
8. Absence of products similar to ours	21	21	8	11
9. Our label (or brand) is well-known	43	44	33	41
10. Long-established connections with consumers of our products	56	71	38	52
11. Possession of patents, licenses, quotas	18	17	15	15

*Source:* January (2006) and May (2007) surveys of the IET.

The most moderate final negative influence on the level of competition is exerted by production concentration. Although the average balance of influence across all the 4 surveys was found to be negative (see *Fig. 22*), its absolute value is very low, while the results of 2 surveys, at the same time, demonstrate that enterprises considered the influence of production concentration on the level of competition to be positive (see *Table 30*). Thus, industry on the whole displayed a zero balance of positive and negative factors in this sphere. It should be noted that the results of the 2007 survey pointed to a weakening influence of this factor on competition, whereas in the previous 2 surveys (in 2002 and 2004) the negative influence disappeared, while the positive was growing. Given the increasing intensity of the processes of mergers and takeovers in Russian industry, the influence of production concentration on the overall level of competition requires a more accurate monitoring and a detailed analysis.

As regards individual branches, the resulting production concentration in 2007 did not restrict competition in all the branches. In the construction materials, light and the food industries the degree of production concentration's influence on competition is positive rather than negative. An excessively high production concentration has a definitely negative influence on competition only in metallurgy and in the chemical and petrochemical industries. In machine-building and the TIC the two influence vectors are on the whole mutually balanced. This fact shows that, despite the State being traditionally attentive to this problem, the potential for activity in this direction is still substantial, and the monopolists' register still has not lost its importance.

The initial (that is, prior to the computation of the final balance) positive influence of the factor "presence of multiple producers whose individual outputs constitute only a small share in the total amount of marketed products" was stable over time: its average rate varied in the interval between 3.26 and 3.45, being definitely between "negligible" and "moderate". The last 3 surveys have demonstrated that the concentration's increasing influence was stabilized at the level of 3.43–3.45 points. The strongest positive influence of low production concentration was registered at the time of the last survey in the construction materials industry (the average rate is 3.86, the sum of answers "considerable" and "moderate" – is 74%), in the chemical and petrochemical industries (the average rate – 3,75, the sum of answers "considerable" and "moderate" – 68%), in the food industry (average rate – 3,58, the sum of answers "con-

siderable” and “moderate” – 51%), and in machine-building (the average rate – 3,50, the sum of answers “considerable” and “moderate” – 59%).

The influence of main production concentration at several enterprises is generally on the second place (across industry and in all the surveys) by its strength of the initial negative influence on competition. The level of this influence was relatively constant, fluctuating in the interval between 3.31 and 3.52 points (the latest – and highest – value was registered in 2007). The negative influence of this factor was especially high at the time of last survey in ferrous metallurgy, where the level of its influence was estimated by enterprises as amounting to 4.54 points, and the sum of “considerable” and “moderate” answers was 93%. In other branches the production concentration’s negative influence on competition was found to be considerably lower (from 3.63 in non-ferrous metallurgy to 3.23 in the timber industrial complex), somewhere between “moderate” and “negligible”.

#### *What is Conducive to Competition’s Growth in Russian Industry*

As shown by our computations (see *Table 33*), the monitored factors’ initial strengthening influence on competition level was not very considerable. The lowest value of the average influence was obtained for the factor “difficulty in withdrawing from markets (inability to return the funds invested in equipment and premises)” and amounted to 2.63 points, which corresponds to somewhere midway between the estimations “none” and “negligible”.

The highest average estimation was obtained for the factor “presence of enterprises capable of rapid intervention on your sales markets (potential competitors)” in 2007 and amounted to 3.96 points, being nearly similar to the “moderate” level of influence. The average rates (for all the years of monitoring) belong to the interval between 2.79 (the ruble’s excessively high exchange rate) and 3.72 points “presence of enterprises capable of rapid intervention on your sales markets (potential competitors)”.

*Table 33*

#### **Degree of Competition’s Strengthening by the Main Factors Existing on the Sales Markets of Russian Industrial Enterprises in 2000–2007, average rate**

Factors		2000	2002	2004	2007
1.	Presence of multiple producers whose individual outputs constitute only a small share in total product sold on market	3.26	3.43	3.45	3.43
2.	High satisfaction of effective demand and presence of surplus capacities	3.33	3.39	3.41	3.48
3.	Absence of agreements between producers on market division, pricing policy, etc.	3.28	3.49	3.14	3.43
4.	Negligible transport costs	2.78	3.04	3.14	3.06
5.	Opportunities for a new producer to easily find new suppliers and consumers	2.76	3.05	3.12	3.23
6.	Absence of administrative protection of markets (quotas, licensing, bans on imports and exports)	3.03	3.27	3.57	3.43
7.	Difficulty in withdrawing from markets (impossible to return funds invested in equipment and premises)	2.70	2.63	3.02	2.96
8.	Presence of enterprises capable of rapid intervention on your sales markets (potential competitors)	3.52	3.61	3.80	3.96
9.	Ruble’s excessively high exchange rate	*	2.65	2.85	2.86

*Note.* \* – In 2000 this question was not asked.

*Source:* the IET’s surveys.

The “presence of enterprises capable of rapid intervention on attractive sales markets” topped the list of factors generating the resulting positive influence on competition in Russian industry (see *Fig. 22*). It is clear that the emergence and importance of this factor are associ-

ated with diminishing output in the post-Soviet period, low load on existing capacities and the presence of many enterprises on the lookout for sales markets. But by 2007 the “stocks” of surplus capacities in Russian industry had been “dissolved”, while this factor’s importance in strengthening competition was dramatically enhanced. This is demonstrative of the enterprises’ changing strategy, when they undergo a switchover from passive exploitation of their traditional markets – through the use of their existing but idle capacities – to that based on investments and entry onto other markets. Such a strategy and the resulting strengthening of competition is most visible in light industry, followed with a big lag by the food industry and the construction materials industry.

In the list of factors which, in the opinion of heads of enterprises, produced an initial positive (strengthening) influence on competition, the “presence of potential competitors” in all the years of monitoring was the most important factor, whose influence was constantly growing. In 2007, 44% of enterprises across industry believed that this factor was considerably strengthening competition, while 30% estimated it as “moderate”, which means that nearly 3/4 of enterprises are afraid of the intrusion of competitors on their markets. The most serious apprehensions are registered in light industry, where the sum of such estimations amounts to 87%, while the average rate – to 4.28 points (or reliably above “moderate”). Such apprehensions are also sufficiently strong in machine-building (78% of estimations and the average rate of 4.22 points), in the timber industrial complex (79% of estimations and the average rate of 4.6 points), and in the food branches (80% and the average rate of 4.11 points). In all these branches the average rate is above “moderate”, and only 3–4% of enterprises there answered “difficult to estimate”, which means that the probability of competitors’ intervention is high and very definite.

But in some cases (on some markets) the factor “presence of potential competitors” (or, more exactly, its opposite – “absence of potential competitors”) weakened competition and was on the 3<sup>rd</sup> or 4<sup>th</sup> places in the initial rating of restricting factors. Its negative influence was lowest in 2002 and reached its historic high in 2004. The absence of potential competitors in 2007 was significantly weakening competition in the timber industrial complex (3.84), light industry (3.57) and machine-building (3.54). And in metallurgy and the chemical and petrochemical industries the negative influence of the “load” of potential competitors was minimal (“negligible”).

The absence (or low efficiency) of administrative protection of sales markets was, in the final analysis, on the third place by its strength of positive influence on the level of competition. This factor has a resulting positive influence on competition in all the branches. It can be assumed that the active struggle against markets’ regionalization and Russia’s traditional disrespect of the law have done their due: producers now have a single sales market where the circulation of commodities is restricted more by transport costs than by administrative barriers.

The initial positive effect (less all negative influence) of “absence of administrative protection of markets” was increasing from 2000 to 2004. During that time, the average positive influence also increased from 3.03 points (“negligible”) to 3.53 points (midway between “negligible” and “moderate”). The last survey registered a slight (under 3.43 points) decline in the positive influence of this factor on competition. At the branch level the degree of the positive influence of the absence of administrative protection of markets in 2007 varied considerably. In non-ferrous metallurgy, 88% of enterprises believe that this factor “considerably” strength-

ens competition on their markets, 7% – “moderately”. The resulting average level of this factor’s positive influence amounted to 4.95 points (nearly equal to “considerable”). At the time of the last survey the second place, with a big lag, belonged to light industry. The degree of the influence on competition of “absence of administrative protection of markets in this branch is 4.00 points (“moderate”), while 76% of enterprises selected the answers “considerable” and “moderate”. Slightly less, as compared to that in light industry, is the influence of this factor on competition in the food industry. In this industry, the average rate is 3.63 points, while the share of answers “considerable” and “moderate” is 63%. On the opposite pole is the construction materials industry, where the average rate amounts to 2.95 points (below “negligible”), and only 15% of enterprises believe that the absence of administrative protection of their markets is considerably conducive to competition growth.

The scale of “administrative protection of markets” slightly weakens competition: the average level of its influence in 2007 was “negligible”. At the same time, the surveys registered a certain growth of its negative influence in the 2000–2007 period amounting to 0.30 points.

A sufficiently strong positive influence on the level of competition, in the final analysis, is exerted by the negligible number or low efficiency of agreements between producers on their pricing policies and the division of their sales markets. This factor is probably the most sensitive one among those relating to the issue under study. However, given the confidential nature of our relations with the respondents and the sufficiently neutral wording of the questionnaires, it can be assumed that their answers are close to being true. The transition period and the phase of primary capital accumulation do have their impact on the behavior of domestic producers, who so far have been preferring to oust a competitor instead of negotiating with him. The leaders in competition’s strengthening, due to lack of desire to achieve compromise with the competitors, were ferrous metallurgy, the chemical and petrochemical industries, and the food industry. Most probably, the influence of the factor “absence of agreement” in those branches may diminish with time (that is, as civilized relations are developing).

The net initial positive effect (less all negative influence) of “absence of agreements” had an average influence on competition in 2000 and 2002 of 3.28 and 3.49 points, respectively. Later on, positive influence went down to 3.14, and then again increased, in 2007, to 3.43 points. The greatest positive influence of honest competition can be observed, according to producers, in non-ferrous metallurgy (the average rate – 3.96 points, the sum of answers “considerable” and “moderate” – 78%), in the chemical and petrochemical industries (the average rate – 3.71 points, the sum of answers “considerable” and “moderate” – 77%), and in the food industry (the average rate 3.70 points, the sum of answers “considerable” and “moderate” – 69%). Machine-building in 2007 was at the bottom of the rating: the positive effect of “absence of agreement” was estimated at 3.42 points (halfway between “negligible” and “moderate”), with 54% of “considerable” and “moderate” answers. The lowest positive effect of “absence of agreements” was registered in light industry, where the average influence was only 3.06 points (“negligible”), and the highest number of answers (33%) fell within ‘none’.

As for the initial negative contribution of the factor of “informal agreements between producers”, its restricting influence was the most stable over time among all the factors being monitored, which means that enterprises noted no changes in this delicate sphere, which is probably the most tempting one for the State to supervise. Relatively more frequently the



negative influence of this factor is mentioned by the enterprises belonging to non-ferrous metallurgy, the construction materials industry, and the food industry.

“Difficulty in withdrawing from markets” (or of withdrawal of funds) in order to shift production to more attractive sectors is, in the final analysis, only on the fourth place by the strength of its positive influence on competition, and only slightly behind the preceding factor. However, this circumstance can hardly be estimated as a positive one. Enterprises believe that in the current situation it is difficult to liquidate non-competitive companies. They are forced to produce at a loss, thereby “littering” the market with unwanted products and mismanaging resources, whereas on other markets these same funds could have been used to manufacture normal products. This situation has two negative consequences. On those markets from which no funds can be withdrawn, producers are forced to eliminate the problem of sales by resorting to dumping, non-payments and other features of inefficient production. As a result, “normal” producers also begin to experience problems. They lose a part of their sales and profits and suffer from shortage of funds for developing their production and increasing the output of competitive products. On the markets inaccessible to capital, buyers have a more narrow choice of goods and manufacturers and are forced to pay higher prices than in a situation of free capital flows.

“High satisfaction of effective demand and presence of surplus capacities” is at the bottom of the list of factors that ultimately have a positive influence on competition. However, such a “moderate” result was produced by a combination of rather powerful initial estimations. In the positive influence rating, this factor is on the second place (as the average of all the surveys), which can be explained by its positive rate. Its value fluctuated throughout the whole period between 3.33 and 3.48 points. It occupied the second place in some surveys only in 2000 and 2007. However, the low changeability of this factor’s influence on competition placed it ultimately ahead of all the other factors. In 2007 the high satisfaction of demand and the presence of surplus capacities reached the highest degree of their strengthening influence on competition. It was estimated as “considerable” by 24% of enterprises, and as “moderate” – by 27%. As a result, at the time of the last survey, 51% of producers believed that “high satisfaction of demand and presence of surplus capacities” prevented the emergence and relatively long existence of free market niches. However, such estimations apply, most probably, only to demand, since no surplus capacities have been left.

Since April 2007, Russian industry has been demonstrating an absolute shortage of capacities associated with the expected changes in demand. That is, the share of enterprises where production capacities are insufficient for the satisfaction of the expected demand volumes is higher than the share of those considering their capacities to be excessive in relation to their expected sales (see *Fig. 23*). It should be noted that Russian industry has for a long time already been suffering from shortages of personnel – and to a substantial degree. Thus, Russia’s total surplus of capacities, until recently serving as a reserve for expanding production without investments, has been exhausted. As a result, in the next few years growing demand will not be satisfied fully and at a short notice, as it used to be previously.

In the initial rating of the competition-restricting factors, “low satisfaction of demand and absence of free competitive capacities” was on the 3rd and 4<sup>th</sup> places. At the time of the latest survey, this factor’s weakening influence on competition was most prominent in non-ferrous metallurgy, where its average negative influence was 4.06 points (“moderate”), while 51% of enterprises believed its influence to be “considerable”. In 2007, in the other branches

the negative influence of this factor, according to heads of enterprises, was lower, especially in machine-building (average rate – 3.16 points) and in the timber industrial complex (average rate – 3.21 points).

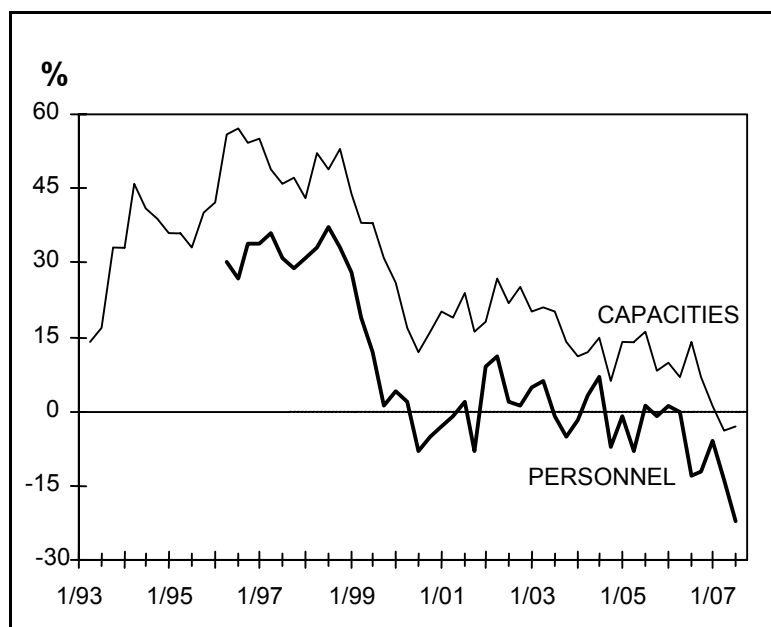


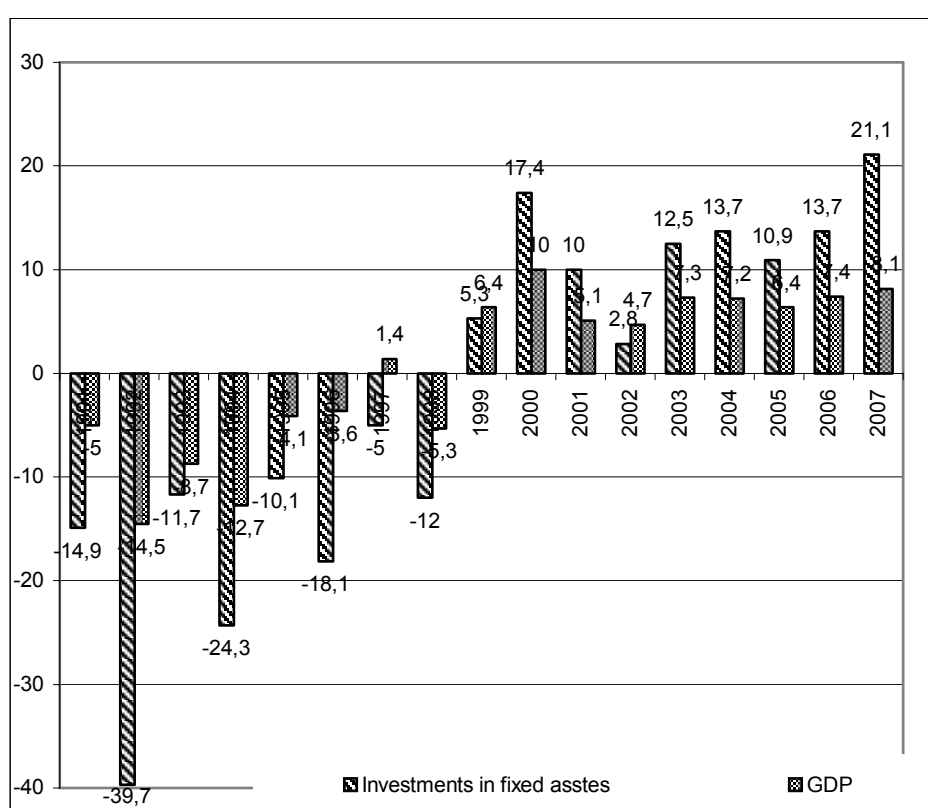
Fig. 23. Balance of Estimations of Capacities and Personnel  
(balance = surplus – insufficient)

In the final analysis, given the economic realities of 2000–2007, the factors under study have indeed been exerting a positive influence on the level of competition across Russian industry as a whole. This provides certain grounds for recognizing that government policy in this sphere has been effective. The real competitive environment is being formed under the influence of both the factors that exist outside the sphere of competence (or responsibility zone) of the antimonopoly agency (potential competitors, opportunities for withdrawal from markets, the ruble's exchange rate, satisfaction of demand), and those that can be directly influenced by the State. At the same time, the absence of agreements between producers can hardly be recognized as a consequence of the antimonopoly agency's activity, since to establish the fact of such conspiracy is a rather difficult and time-consuming business. It seems that so far government agencies have had neither the time nor the experience necessary for successful investigation of such agreements, with the exception of some of the most obvious and crude violations, to which the ingenious Russian businesses are no more resorting now. The principal achievement of the antimonopoly agency and the government as a whole, recognized even by producers, has become the absence of administrative protection of markets. As for the negative influence of production concentration and transport costs on competition, there is little doubt that it must become the State's most important short-term priority.

### 3.3. Investments in Real Sector

#### 3.3.1. Internal Domestic Investments in the Fixed Assets

The trend for anticipating growth of the investments in the fixed assets has been observed in the Russian economy since 2002. Over the period of 2003–2007 investments in the fixed assets have increased by 192%, GDP growing by 142%. The characteristic feature of 2007 was the expansion of the investments in the fixed assets share up to 19.7% of the GDP, which was the maximum value over the whole period of reforms. High growth of investment demand was supported by the growth in internal market significance in the formation of the economic dynamics. Over 2007 the volume of the investments in fixed assets has increased by 21.1% as compared with 13.7% in the previous year.



Source: Federal State Statistics Service.

Fig. 24. GDP and Investments in Fixed Assets Growth Rates in 1991–2007, as percentage to the previous year

Growth of economy and business earnings defined dynamic expansion of the demand for investment goods. Recovery of the positive dynamics of fixed assets implementation observed from 1999 contributed into overcome of the fixed assets recession and improvement of reproduction structure indices. Fixed assets renovation coefficient has increased from 1.8% in 2001 to 3.4% in 2006, extent of deterioration decreasing to 44.4%, and the proportion of completely depreciated assets – to 13.3%.

Focus of the producers on production's modernization and reconstruction induced increase in demand for machinery and equipment in nearly all kinds of economic activities. The growth of expenditures for machinery, equipment and transport vehicles was observed in the structure of investments in the fixed assets by kinds of the fixed assets. Whereas in 2001 the share of investments in machinery, equipment and fixed assets was 35% of the total volume of the investments in the fixed assets, in 2006 their share was more than 37.7%.

*Table 34*

**Structure of Investments in Fixed Assets by Kinds of Fixed Assets in 2000–2007,  
as percentage to the total**

	2000	2001	2002	2003	2004	2005	2006	2006*	2007*
Investments in the fixed assets - total	100	100	100	100	100	100	100	100	100
Including by kinds of the fixed assets:									
Dwellings	11.3	11.4	12.2	12.6	11.9	12.0	12.0	7.1	7.6
Buildings and constructions	43.1	41.8	41.0	43.5	41.9	40.4	42.7	48.4	49.6
Machinery, equipment and transport vehicles	36.6	35.0	37.7	37.1	40.4	41.1	37.7	36.7	35.4
Other	9.0	11.8	9.1	6.8	5.8	6.5	7.6	7.8	7.4

\* Subjects of small business and informal activity parameters not included.

Source: Federal State Statistics Service.

Under existing in 2000–2007 growth rates of the domestic machine-building, the dynamics of investment expenditures and characteristics of fixed assets reproduction at the domestic market the influence of machinery and equipment import supplies has strengthened. The dramatic increase in demand for import equipment was observed in 2000, since that time the trend for anticipating growth rated of machinery and equipment import as compared with the domestic machine-building development was steady and corresponds with the dynamics of investment activity. It is cheapening of import machinery and equipment due to ruble appreciation as well as implementation of zero duty rates for import equipment that is not produced at Russian enterprises (2005–2007) and implementation of industrial assemblage procedure according to which import duty rates for import components were decreased that had positive influence on the change of structure and aspectual structure of the investments in the fixed assets in middle-term and in the long run. Adoption of such measures induced machinery and equipment import growth rates acceleration.

Whereas over 2003–2006 the average annual investments in fixed assets growth rates were about 11.9% and domestic machine building production – about 8.7%, this figure for machinery, equipment and transport vehicles import was 32.2%. In 2007 investments in fixed assets growing by 21.1%, production of machinery and equipment – by 20.9%, of transport vehicles and equipment – by 15.7%, of electric equipment – by 14.8%, machinery and equipment import went up by 155%. Investments in import equipment purchase in the total amount of investments in machinery, equipment and transport vehicles were equal to RUR 308.5 bln or 17.8%.

Characteristic feature of 2007 was the change in the ratio of funds of federal budget and the budgets of subjects of the Federation that is directed towards the investments. In 2007 as compared with the corresponding period of the previous year the increase in the share of budget investments in the GDP is observed by 0.5 p.p. RUR 1042.4 bln was invested in the fixed assets at the expense of the budget funds, which makes up 21.2% of the total volume of investments in the fixed assets throughout the economy, including from the federal budget – 8.4%.

In 2007 the volume of funds envisaged to be allocated to finance FTIP construction sights and objects was reconsidered three times, budget allotments having been increased both for program and for non-program part. Budget assignments for FTIP program part were equal to RUR 360.6 bln, for non-program part – to RUR 223.2 bln. The volume of the government defense order included in FTIP program and non-program parts was RUR 101.5 bln or 17.4% of the total limit.

*Table 35*

**Structure of Investments in the Fixed Assets by the Sources of Financing,  
as percentage to the total**

	2000	2001	2002	2003	2004	2005	2006*	2007*
Investments in the fixed assets – total	100	100	100	100	100	100	100	100
of which by sources of financing:								
<i>Own funds</i>	47.5	49.4	45.0	45.2	45.4	44.5	42.1	41.5
of which:								
Profit	23.4	24.0	19.1	17.8	19.2	20.3	19.9	19.9
<i>Borrowed funds</i>	52.5	50.6	55.0	54.8	54.6	55.5	57.9	58.5
of which:								
Bank credits	2.9	4.4	5.9	6.4	7.9	8.1	9.6	9.4
Of which of foreign banks	0.6	0.9	0.9	1.2	1.1	1.0	1.6	1.1
Funds borrowed from other organizations	7.2	4.9	6.5	6.8	7.3	5.9	6.0	6.1
Budget funds from:	22.0	20.4	19.9	19.6	17.9	20.4	20.2	21.2
Federal budget	6.0	5.8	6.1	6.7	5.3	7.0	7.0	8.4
Budgets of the subjects of the Russian Federation and local budgets	14.3	12.5	12.2	12.1	11.6	12.3	11.8	11.7
Investments from abroad in the total amount of the investments in the fixed assets	4.7	4.5	4.1	4.7	5.0	4.8	6.9	4.6

\* Not including small business enterprises and parameters of informal business.

Source: Federal State Statistics Service.

As a result, government investments for FTIP fulfillment increased by 58.9% in 2007 as compared with 2006 in the prices of the corresponding years. The proportion of the expenditures for FTIP financing in the GDP was equal to 1.77%, exceeding by 0.4 p.p. the level of the previous year.

*Table 36*

**Proportion of Expenditures for the Federal Targeted Investment Program  
in 2004–2007, as percentage to the GDP**

	2004	2005	2006	2007*
FTIP- total	0.47	1.17	1.37	1.77
Program part	0.27	0.85	0.87	1.09
Non-program part	0.21	0.32	0.50	0.68

Source: calculated on the basis of Federal State Statistics Service and Ministry for Trade and Economic Development data.

In concordance with the priorities for the government investments the funds were directed to modernize and develop strategically important for the country objects of production infrastructure, to fulfill investment projects of application of modern technologies to produce competitive goods at the enterprises of the machine-building industry and to conduct works to secure safety of the power, transportation, forestry and water industry objects.

Government investments from the budget were carried out through Investment Fund, Federal Targeted Investment Program and Federal Target Programs (FTP). Investments for different social, economic and industrial programs, recognized as priority ones, were directed through FTPs. In 2007 the number of target programs and subprograms financed from the federal budget decreased. This allowed the budgets to be concentrated on the main directions of social and economic development of the country. Construction of individual objects both necessary for FTP fulfillment and non-program ones was financed through FTIP.

Over January–December 2007 the government customers spent RUR 401.8 bln of investments from all sources of financing, or 99.3% of the total volume of allocated funds by all sources of financing.

Table 37

**Use of Investments from all the Sources to Finance Objects Envisaged  
by the Targeted Investment Program in 2007, as RUR millions**

	Government Investment Limit		Investment from all the sources of financing used	
	total	of which from the federal budget	total	of which from the federal budget
Total	622.4	466.6	401.8	316.8
including:				
Construction complex	0.4	0.4	0.4	0.3
Transportation complex	295.6	190.7	198.0	147.5
Agriculture complex	10.6	9.9	8.2	7.6
Special complex	44.4	29.6	24.0	21.6
Social complex	246.9	217.5	152.4	126.2
Other objects	24.4	18.6	18.7	13.6

Not taking into account construction sights and objects, included in the government defense order

Source: Federal State Statistics Service.

The financing from the yearly limit for government investments of FTIP construction sights and objects that are being monitored by the Federal State Statistics Service was RUR 316.8 bln or 67.9% of the yearly limit. The level of industrial complexes financing is within average figures. The yearly limit for government investments in the social complex was financed considerably less than in the construction sights and objects.

Nearly three quarters of investments volume in 2007 fall for Central, North-Western and Southern Federal Okrugs.

Table 38

**Some Parameters of Federal Targeted Investment Program's Objects Financing  
in 2007 Broken by the Federal Okrugs, as RUR bln**

Federal okrug	Investments limit according to FTIP from all sources	Government investments limit	Really used at the expense of all sources of financing	
			as percentage from the yearly limit	
Central	249.6	157.9	115.4	46.2
North-Western	86.9	76.9	80.0	92.1
Southern	121.8	104.1	71.7	58.9
Privolzhski	55.2	43.2	49.3	89.3
Ural	19.0	14.2	15.1	79.3
Siberian	42.3	36.1	28.3	66.9
Far Eastern	47.8	34.2	42.1	88.1

Source: Federal State Statistics Service and Ministry for Trade and Economic Development.

Comparison of the level of the funds usage by construction sights and objects for federal government needs demonstrates that the figure above the average throughout Russia is registered in North-Western, Far Eastern, Privolzhski, Ural and Siberian federal okrugs, Central and Southern federal okrugs' figures being considerably less in 2007.

In accordance with the Federal Targeted Investment Program by the specified list of the Ministry for Trade and Economic Development of the Russian Federation it was envisaged to allocate funds for 6093 construction sights and objects in 2007. It was designed to put into commission 3696 objects, of which 1041 was actually put into commission, including 913 – at full capacity and 128 – partially. Besides, 100 objects (40 – at full capacity and 60 – partially) from those intended to be put in commission in the following years.

By 1 January 2008 4043 objects were fully financed. At the same time the level of financing of 1668 was below 50% and 1497 objects were not financed. Technical readiness of 51.0–99.9% was registered for 1509 objects or 24.7%.

*Table 39*

### Objects Envisaged by the Targeted Investment Program

	Number of objects for 2007 <sup>1)</sup>		Put in commission in January-October 2007 <sup>2)</sup>	
	total	Including those with the date for putting in commission in 2007	At full capacity	partially
Total	6,093	3,696	953	188
including:				
Construction complex	3	3	-	-
Transportation complex	1,003	512	188	26
Agriculture complex	1,142	967	292	52
Special complex	269	180	18	9
Social complex	3,307	1,785	394	93
Other objects	369	249	61	8

1) including conduction of design and survey works, equipment purchase that is not included in constructions' estimates

2) number of construction sights and objects, put into commission according to the established procedure

*Source:* Federal State Statistics Service.

Delays in financing of some FTPs in 2007 were caused by late approval of a number of FTPs that were adopted during the year. The traditional delay in financing of the FTIP at the beginning of the year, low executive discipline, and absence of firm control over the use of funds are the main factors contributing in the of systematic growth of a number of unfinished construction, the number of new construction sights and objects increasing every year.

According to amendments made to the Budget Code this situation should change in 2008. it is envisaged that no FTP be considered unless it is approved a month before the project is submitted to the State Duma – in other words all FTPs should be approved by 26 July. During next two years the procedure for the formation of the list of construction sights and objects financed from the federal budget that is approved by FTIP will be changed. Just one mentioning of the object in FTP or in the decree of the Government will be enough to make a decision on its financing over the whole period of construction. In such a case there will be no need in annual approval of the expenditures for each object and the discipline of FTP financing will be increased.

Fundamentally new moment feature of economic growth in 2003–2007 was shift from financing of investments in fixed assets from own funds to extension of borrowed funds participation. This was a distinct illustration for quality changes of investments development mechanism that is oriented to rationalize investment resources flows. As a result of 2007 the share of borrowed funds was 58.5% of the total amount of investments in the fixed assets.

The development of this process is accounted for by the increase in banking sector activity, growth of population's investments in housing construction and intensive inflow of foreign capital. Low real value of credit resources, average level of profitability in the economy being quite high, lead to the increase in the number of enterprises-borrowers. Other factors positively influencing the credits and other borrowed funds dynamics the following are the growth of organized forms of savings of the population. The share of funds directed to share holding in construction was 3.3% of the total volume of investments in the fixed assets, and population's – 1.0%.

The share of banks in crediting in the structure of the borrowed funds was 9.4% in the structure of investments resources, which corresponds to the level of the previous year. The trend for the increase in participation of insurance and investments companies, industrial and trade enterprises in financing of investment activity sustained.

The specific features of foreign banks participation in financing of investment activity are also of notice. In the Russian economy the increase of foreign investments share and the growth of foreign banks participation in financing of the investments in the fixed assets was observed from 2000. However in 2007 investments in the fixed assets from abroad were equal to 4.6% of the total volume of investments and decreased by 3.3 p.p. as compared with the previous year, and the share of foreign banks' credits lowered down to 1.1% as compared with 1.6%. In the structure of use of funds from abroad in the form of foreign investments the increase of expenditures for securities purchase and banks' credits and loans repayment up to 27.4% against 7.0% in 2006 was of primary importance, investments in fixed assets decreasing by 10 p.p. down to 13.1%.

The formation of the aforementioned proportions occurred against the background of intensive increase of net capital import and foreign investments. According to the preliminary estimation of the Central Bank of the Russian Federation in 2007 net capital import was USD 82.3 bln compared with USD 41.3 bln in 2006.

The change in investment structure by kinds of economic activities in 2007 was defined by the trends that were formed in the previous year.

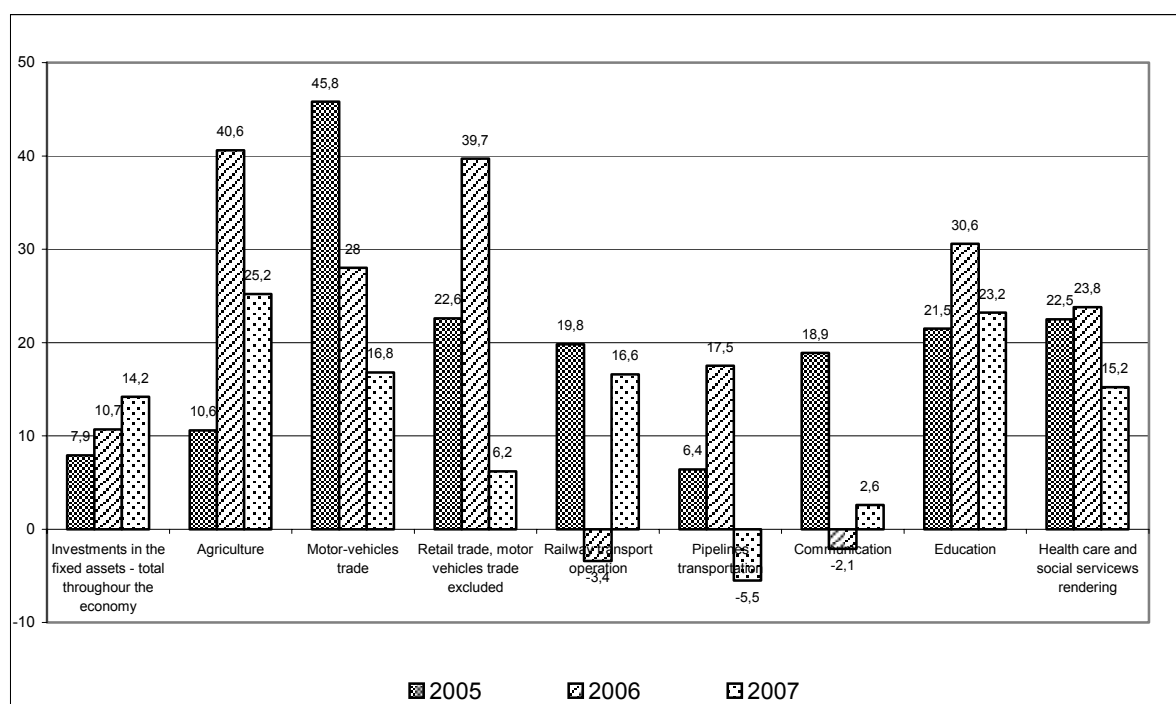
Increase in investment activity in infrastructure branches and growth of demand for these kinds of activities services is an indicator of growth potential, especially since investment policy in this sector was mainly directed to the solution of promising problems. Over the period of 2002–2007 the share of transport, communication and trade has increased by 3.0 p.p. and was equal to 25.3% of the total volume of investments in the fixed assets. Over the years of reform the share of transport in the structure of investments in the real sector of economy has nearly doubled and was equal to 20.2% in 2007. Whereas in 1992 the share of investments in communication was less than 0.6% in the total amount of investments in the national economy, in 2007 it reached 5.3%.

In 2006–2007 the trend for investments in the fixed assets in trade and transport sustained the same is true for the kinds of activities oriented for social services rendering (education, health care). The characteristic feature of investment process in the field of transport in



2007 was the change in the structure of investments by kinds of economic activities. In 2006 reduction of investments in railway transport and communication was observed, for which the period of recovery growth in 1999–2005 was the period of high investment activity, while rates of pipeline transport accelerated and its share increased in the total amount of investments in the fixed assets up to 39.9%. In 2007 the decrease in the investments in pipeline transportation was the factor that contributed into rates deceleration of investments in transport development on the whole.

Against the background of steadily growing demand for trade services in 2006–2007 redistribution of investments by kinds of activities was observed material and technical base of retail trade and motor-vehicles trade expanding.



Note: not including small business enterprises and parameters of informal business.

Source: Federal State Statistics Service.

Fig. 25. Changes of Investments in the Fixed Assets Growth Rates by Kinds of Economic Activities and Services Rendered in 2005–2007, as percentage to the previous year

Structure of investments in goods production in 2006–2007 was defined by anticipating growth of investments in agriculture and minerals extraction.

Characteristic feature of structural shifts in goods production in 2006–2007 was overcoming of the trade of investments in minerals extraction reduction, which was observed since 2002. As a result of 2006 the increase in investments in fossil fuels extraction was equal to 25.1% against the drop of 2.6% last year. In 2007 the increase of investments in minerals extraction was 19.1%, including in fossil fuels extraction – 19.0% investments in processing production increasing by 10.8%. In electricity, gas and water production and distribution increase of investments in 2007 reached 30.0% and was accounted for by the increase in in-

vestment activity in electricity production and transmission by 1.51 times, dynamics of investments in production and distribution of gas fuel being negative.

Table 40

**Structure of Investments in the Fixed Assets by Kinds  
of Economic Activities**

	2000	2001	2002	2003	2004	2005	2006	2006*	2007*
<b>Total</b>	100	100	100	100	100	100	100	100	100
Broken by kinds of economic activities:									
Agriculture, hunting and forestry	3.0	4.0	4.6	4.1	4.1	3.9	4.9	4.0	4.3
Industry	40.4	40.4	38.6	38.2	38.7	37.1	37.2	40.7	41.7
Minerals extraction	18.1	19.0	16.9	16.0	15.4	13.9	15.3	17.0	17.3
Including fossil fuels extraction	16.7	17.5	15.5	14.5	14.0	12.4	13.9	15.5	15.8
Processing industry	16.3	15.9	15.9	15.6	16.4	16.4	15.8	16.1	15.7
Electricity, gas and water production and distribution	6.0	5.5	5.8	6.6	6.9	6.8	6.1	7.6	8.7
Construction	6.4	5.2	5.4	4.9	3.5	3.6	3.5	3.0	2.4
Wholesale and retail trade, motor-vehicles and motorcycles servicing, household appliances and items of the private use repair	2.7	2.9	3.6	3.5	3.5	3.6	3.4	3.1	2.9
Transport	18.5	19.2	15.1	17.5	17.3	19.1	18.8	20.2	20.2
Communication	2.7	3.0	3.4	4.8	5.4	5.4	4.7	5.3	5.1
Financial activity	0.8	0.8	1.0	1.2	1.4	1.4	1.2	1.1	1.4
Operations with real estate, rent, services rendering	15.2	14.7	18.1	17.7	17.3	16.8	16.4	12.0	12.0
Education	1.5	1.5	2.0	1.6	1.7	1.6	1.6	2.2	2.3
Government management, military safety security; compulsory social provision	1.3	1.5	1.5	1.4	1.8	1.9	2.2	2.1	2.0
Health care and social services rendering	2.6	2.4	2.0	2.0	2.5	2.6	2.7	2.7	2.6
Rendering of public utilities, other social and personal services	3.9	3.5	3.8	2.6	2.4	2.5	2.9	2.8	2.7

\* Subjects of small business and parameters of informal activities not included.

Source: Federal State Statistics Service.

The share of processing industries in 2007 structure of investments in the fixed assets throughout the economy was 15.7%. Concentration of income in raw materials export-oriented industries being high, it is the small share of investments in machine-building that is characteristic for the Russian economy. Age, technological and reproduction structure of the fixed assets being as they are, low rates of investments in machine-building complex were the factor that restricted growth rates of enterprises for production of final and investment goods. Under existing structure of domestic production of the investment goods import remains one of the main sources for fixed assets renovation, production reconstruction and modernization.

### 3.3.2. Foreign Investment

The year of 2007 saw record-breaking growth rates in funds foreign agents invested in Russia's economy. In 2007, as much as USD 10.9 bn in foreign investment poured in the country, or 2.2 times greater than in 2006.

According to UNCTAD's World Investment Report 2007 released in October 2007, Russia holds the 10<sup>th</sup> place worldwide in terms of volume of attracted foreign direct investment (in 2005 the country was 15<sup>th</sup> in this respect). Meanwhile, Russia holds the 2<sup>nd</sup> position after China, so far as FDI in developing countries are concerned.

In December 2007, Moody's confirmed Baa2 rating of Russia's T-bonds denominated in Rb. and foreign exchange. Moody's believes that underpinning a significant rise of the country's economy in 2005–07 primarily were the production areas oriented towards the domestic market, such as the construction sector, services sector, finance, transport, and communication. Preceding Moody's statement, S&P had also proved Russia's sovereign credit rating at the level of BBB+ and made a forecast "Stable".

*Table 41*

### Foreign Investment in Russia's Economy<sup>9</sup>

	As USDm.				As % to the prior year			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
2003	29,699	6,781	401	22,517	150.1	169.4	84.9	147.1
2004	40,509	9,420	333	30,756	136.4	138.9	83.0	136.6
2005	53,651	13,072	453	40,126	132.4	138.8	136.3	130.5
2006	55,109	13,678	3,182	38,249	102.7	104.6	700.0	95.3
2007	120,941	27,797	4,194	88,950	219.5	203.2	131.8	232.6

Source: Rosstat.

In 2007, the volume of FDI in Russian economy doubled vs. 2006. The rise was fueled primarily by growth in such components as contributions to corporations' authorized capital and loans received from their overseas owners. While the former component soared up to USD 14.8 bn (68.7% up vs. the respective value of 2006), the latter one tripled over the period in question and hit the level of USD 11.7 bn. So, the specific weight of loans received from the corporations' foreign owners in the structure of FDI in RF surged from 28.5% in 2006 to 42.0% in 2007.

As concerns the 2007 aggregate structure of foreign investment in Russia's economy, the greatest increment was noted in the segment of "other" investment, as the proportion of trade credits in their structure plunged from 24.2% in 2006 to 15.8% in 2007.

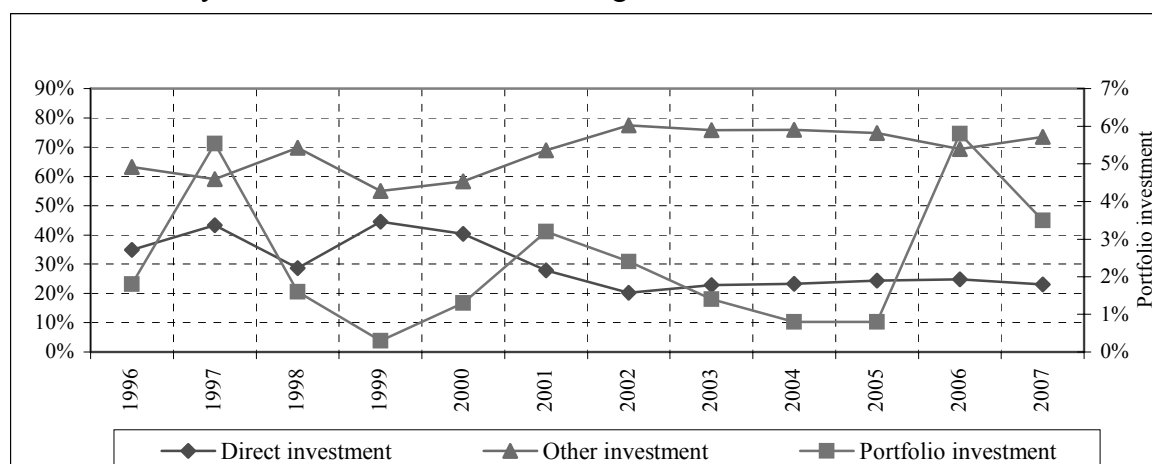
Following the 2006 pattern, the 2007 growth rate of portfolio investment, the bulk of which is formed by those in stock and shares (2006 – 90.8% of the volume of portfolio investment, 2007 – 95.5%) once again remained on a high level (131.8% relative to 2006).

<sup>9</sup> **Direct investments** are those by private individuals and legal entities that own in full or a given corporation or control at least 10% of its stock or its joint-stock capital.

**Portfolio investments** are formed by acquired stock, shares, obligations, promissory notes and other papers, which may account for less than 10% of the corporation's joint-stock capital.

In the event given investment fail to fall under the noted categories it is labeled as "other", such as, for example, trade credits, loans disbursed by overseas governments under the RF Government's guarantee, and other loans (such as from international financial organizations), and bank deposits.

Overall, when compared with the prior year, the 2007 structure of foreign investment in Russia's economy underwent no substantial changes.



Source: Rosstat.

Fig. 26. Structure of Foreign Investment in Russia's Economy in 1996–2007

As in the prior year, 2007 saw foreign investment likewise concentrate in the industrial and trade sectors. By the 2007 results, foreign investment in these sectors grew twice and 3.6 times, accordingly. The substantial growth in investment in trade has resulted in nearly a 1.6 growth in its specific weight in the sectoral structure of foreign investment vs. 2006. The distribution of foreign investment across basic sectors of Russia's economy is given in Table 42.

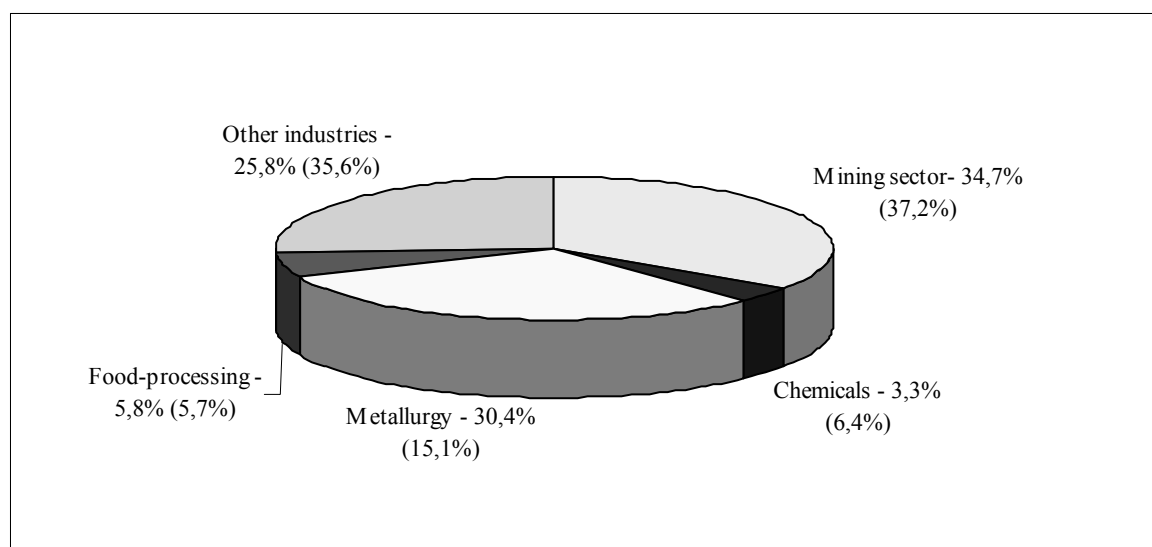
Table 42

**Sectoral Structure of Foreign Investment in Russian Economy in 2005–07**

	As USDm			Change to the prior year, as %			As % to result		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Industrial sector	24,318	24,607	50,163	120.6	101.2	203.9	45.3	44.7	41.5
Transport and communication	3,840	5,297	6,703	188.9	137.9	126.5	7.2	9.6	5.5
Wholesale and retail trade; maintenance and repair of automobiles, motorcycles, household items and personal use items	20,461	13,089	47,310	156.9	64.0	361.4	38.1	23.8	39.1
Real estate, leasing and service delivery	2,602	5,998	8,414	101.2	230.1	140.3	4.8	10.9	7.0
Financial operations	1,813	4,698	4,450	181.1	259.1	94.7	3.4	8.5	3.7
Other sectors	617	1,420	3,901	36.4	231.8	274.7	1.2	2.5	3.2

Source: Rosstat.

It was the manufacturing industry branches that showed the greatest rise of investment in the industrial sector (210.9% vs. the unfortunate 2006, when they had dropped by 15.8% vs. 2005), while foreign investment in the mining sector grew 1.9 times (vs. the 52.5% growth posted in 2006). As concerns the manufacturing sector, investment in the metallurgical industry grew 4.1 times, in the food-processing industry – 2.1 times, and in the chemical industry – at 4.3%, hitting levels of USD 15.2 bn, 12.9 bn and 1.6 bn, respectively.



Source: Rosstat.

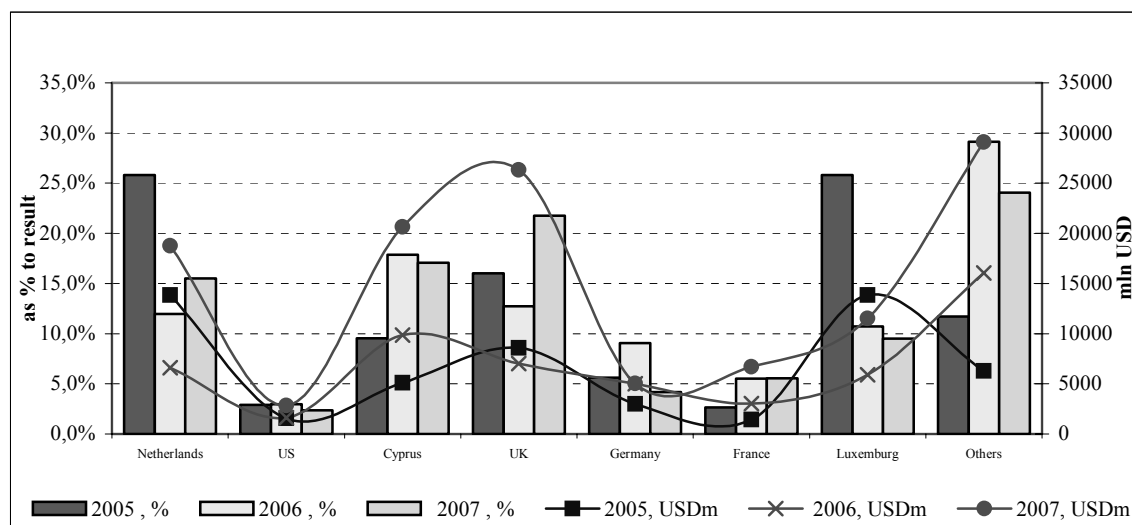
Fig. 27. Sectoral Structure of Foreign Investment in the Industrial Sector in 2007 (the 2006 data are given in parentheses)

The specific weight of direct investment in the industrial sector rose from 29.2% in 2006 up to 36.3% in 2007 while the proportion of “other” investment dropped from 66.7% to 57.3% over the period in question.

The structure of foreign investment, by kinds of economic activity within the industrial sector, also underwent certain changes. In the mineral sector, the proportion of direct investment grew 3.1 times vs. its respective 2006 index and reached 80.1% (vs. 49.4% reported in 2006). The proportion of “other” investment in the sector was down at 25.8% (estimated) and accounted for 19.8% (vs. 50.6% in 2006).

By contrast, the bulk of investments in the manufacturing sector was formed by “other” ones. They grew 2.2 times vs. 2006 and ultimately made up 78.7% of the total volume of investment in the sector (in 2006 the respective figure was 76.8%). Foreign direct investment in the sector rose at 57.6%, while the specific weight of direct investment in the manufacturing industries dropped to 12.8% (vs. 17.2% in 2006). The greatest growth rates in foreign investment in the industrial sector was demonstrated by portfolio investment (3-fold vs. 2006), which resulted in the rise in their proportion up to 8.5% (vs. 6.0% in 2006).

In terms of the 2007 geographic structure of foreign investment the leading position was held by Cyprus with 17.9% of the aggregate volume of foreign investment, followed by UK (12.7%). However, UK became an undisputable leader in terms of absolute volume of investment (USD 26.3 bn, or 21.8% of the aggregate volume of foreign investment), while Cyprus was the second biggest source of investment inflow with USD 20.7 bn, and the Netherlands – the third one (USD 18.8 bn, or 15.5%).



Source: Rosstat.

*Fig. 28. Geographic Structure of Foreign Investment in Russian Economy in 2005–2007*

The greatest rise in 2007 was demonstrated by investment from UK (3.7 times vs. 2006), Cyprus (2-fold), France (2.2 times), the Netherlands (2.8 times), and Luxemburg (1.9 times), while German investment remained at the prior year's level.

Differences in the investment dynamics have resulted in the change of the geographic structure of foreign investment in Russia. While UK and the Netherlands posted a notable growth in this respect – from 12.0 and 12.7% in 2006 up to 15.5% and 21.8% in 2007, the US, Cyprus, Germany and Luxemburg's respective proportions shrunk, and that of France remained practically unchanged, sticking to the level of 5.5%.

In 2007, the top 10 nations that were biggest investors in the country was joined by Ireland whose investment in Russia totaled USD 5.2 bn, or 4.3% of the aggregate volume of foreign investment. The Shamrock Country's investors focused mostly on transport and communication, and it is a small wonder that their investment in this sector accounted for 53.7% of the island's overall volume of investment in Russia.

By contrast, UK investors centered on boosting trade and invested in the sector 4.6 times as high as in 2006, or 64.2% of the Kingdom's aggregate investment volume in Russia (vs. 52.1% in 2006). Plus, the proportion of the UK investment inflow in the manufacturing sector grew from 22.2% in 2006 up to 27.7% in 2007.

The Netherlands increased their investment in the mineral sector from 55.2% in 2006 to 67.1% in 2007.

For Cyprus the most attractive sectors in 2007 became trade, operations on the real estate market, and construction, which received 45.5%, 19.0% and 4.7% of the aggregate investment volume provided by the nation. In 2006, the situation was a bit different, with the manufacturing sector receiving 39.1% of the aggregate investment from Cyprus, while operations on the real estate market absorbed as much as 26.4% of the noted volume.

As of the late-December 2007, the volume of foreign capital accumulated in Russia's economy (less monetary and credit control agencies, commercial and savings banks, but including Rb-denominated investment in the USD equivalent) accounted for USD 220.6 bn, or up at 54.3% against the beginning of the year.

By the 2007 results the leading group in terms of the overall volume of accumulated foreign investment is still dominated by Cyprus, the Netherlands, UK, Luxemburg, and Germany, whose aggregate proportion stood at 72.0%. Meanwhile, the proportion held by the top five investor nations in the segment of direct investment rose up to 77.0% (vs. 71.9% in 2006), while the one in the structure of portfolio and “other” investment dropped to 65.1% (vs. 71.1% in 2006) and to 67.8% (vs. 71.8% in 2006), respectively.

*Table 43*

### Accumulated Foreign Investment By Major Investor Nations

	Accumulated as of October 1, 2007, as USDm				Change to January 1, 2007, as %			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
US	8,579	3,635	1,207	3,737	111.4	79.2	238.1	143.6
Germany	11,786	4,494	98	7,194	96.1	135.4	5.8	99.3
France	5,919	1,554	31	4,334	160.0	146.9	-	164.1
UK	29,235	3,438	2,314	23,483	247.7	118.3	1369.2	269.1
Cyprus	49,593	35,426	1,700	12,467	153.7	155.4	125.2	153.5
Netherlands	39,068	35,254	52	3,762	166.6	183.3	83.9	90.5
Luxemburg	29,161	735	219	28,207	127.5	125.2	107.9	127.7
Other nations	47,254	18,524	1,107	27,623	163.7	138.3	121.5	189.7
<b>Total</b>	<b>220,595</b>	<b>103,060</b>	<b>6,728</b>	<b>110,807</b>	<b>154.3</b>	<b>151.8</b>	<b>137.3</b>	<b>158.0</b>

*Source:* Rosstat.

The structure of foreign investment accumulated as of the late-December 2007 was dominated by “other” investment whose proportion accounted for 50.2% vs. their 2006 index that totaled 46.7%.

Against the background of a large-scale rise in foreign investment in Russia’s economy the volume of capital withdrawn in the form of profit repatriation, as well as interest payments and loan repayment was on the rise in 2007 vs. 2006 (up at 54.3%) and totaled USD 58.4 bn (48.3% of the 2007 investment inflow volume), while in 2006 the respective index accounted for 68.7%.

## 3.4. Foreign Trade

### 3.4.1. Foreign Trade Turnover

In their report entitled “The Global Economic Outlook”<sup>10</sup>, the World Bank experts reckon that the year of 2007 saw the world economy growth rates plummet down to 3.6% vis-à-vis 3.9% reported in 2006. They expect the 2008 rise in the global economy at 3.3%, and it is going to be only in 2009 that the world GDP will bounce back to the level of 3.6%, which is envisaged to be attributed to the renewal of the US economy’s growth rates.

In 2007, the GDP growth rates in Europe and the Central Asia accounted for 6.7% vs. 6.9% reported in the prior year. This is steered by some fall in the domestic, as well as exter-

<sup>10</sup> <http://www.worldbank.org/gep2008>.

nal demand. By contrast, the CIS countries were advancing at a far greater pace – up to 8.2% in 2007 against 7.8% in 2006. This became possible thanks to a considerable rise in consumption and investment, and some growth in net export from the region. The oil-exporting nations (Azerbaijan, Kazakhstan, and Russia in particular) still cash up very handsome profits, while the construction boom in the housing, commercial and infrastructural sectors has contributed engendered the rise in non-oil sectors of their economies in question.

As all the developing world has displayed a steady demand for imports, it helped maintain the global economy's advancement and formed (along with a further depreciation of the US Dollar) a major factor underpinning a rapid growth in the US exports, thus helping the nation to cut down its current accounts deficit and allowing equalization of the global disproportions.

The trade has remained the global economy's major locomotive, with the rise in the world commodity trade over the past four years being twice as high vis-a-vis the rise in the global output. During the period of an intense economic growth, which started in 2001, the volume of the world flows of goods has been on the rise, thanks to the developed and the Eastern Asian nations, however, as evidenced by the 2007 estimates and the 2008 projections, the noted nations' import and export growth rates will fail to match the previously reported indices, and the trend is likely to persist further on.

*Table 44*

**Dynamics of the Global GDP and the World Trade (as % to the prior year)**

	2004	2005	2006	2007*	2008**
GDP					
<b>The world</b>	105.3	103.4	103.9	103.6	103.3
Industrially developed nations	103.2	102.6	102.9	102.6	102.2
The US	103.9	103.1	102.9	102.2	101.9
The EU countries	102.1	101.5	102.8	102.7	102.1
Japan	102.3	101.9	102.2	102.0	101.8
Other developed nations	104.6	103.9	104.4	104.3	103.8
Developing and transitional economies	107.7	106.8	107.5	107.4	107.1
Central and eastern European	106.5	105.6	106.3	105.8	105.2
CIS	108.4	106.6	107.7	107.8	107.0
Russia	107.2	106.4	107.4	108.1	106.5
Asian	108.8	109.2	109.8	109.8	108.8
China	10.1	110.4	111.1	111.3	110.8
<b>The world trade in goods and services</b>	110.6	107.5	109.2	106.6	106.7
Import		105.8	109.5	108.3	107.2
Industrially developed nations	109.1	106.1	107.4	104.3	105.0
Developing and transitional economies	116.4	112.1	114.9	112.5	111.3
Export		105.7	110.1	109.2	107.6
Industrially developed nations	108.8	105.8	108.2	105.4	105.3
Developing and transitional economies	14.6	111.1	111.0	109.2	109.0

\* - Estimated.

\*\* - Projected.

Source: Rosstat, BIKI No. 125, 2006, BIKI No. 143, 2007.

In 2007, Russia's foreign trade advanced under the effect of the following critical factors: a considerable price rise for energy resources on the world markets; instability of international financial flows due to the crisis on the biggest world stock exchanges; and soaring prices for crops. All these factors exercise different by its intensity effect on the dynamic of foreign trade flows.

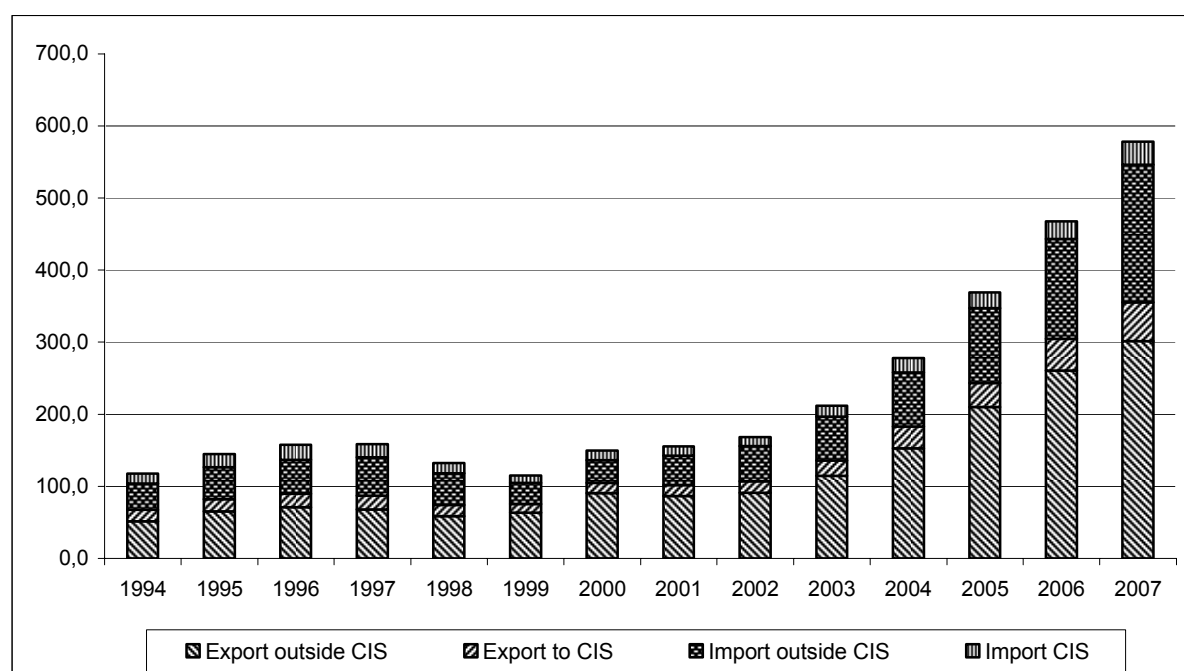


In 2007, the indicators, which characterize Russia's foreign trade, continued their steady rise and hit 17 years-high values.

Calculated by the balance-of-payments methodology, the nation's 2007 foreign trade turnover made up USD 578.2 bn, thus outrunning at 23.4% the respective index of the prior year.

The share of export in the said amount stood at 61.4% (in 2006 it was 64.9%), while that of import – 38.6% (35.1%), which predetermined some deceleration of the nation's growth rates of goods turnover as a result of a substantial decline of growth rates of its export, which accounted for 116.9% vis-à-vis 124.7% reported in 2006.

In 2007, the major trend of Russia's foreign trade was a considerable disequilibrium between growth rates of import and those of export in favor of the former over the first 9 months of the year. The trend reversed only in the 4th quarter. Overall, the trend has resulted in contraction in the 2007 positive balance of foreign trade at 5.1% against the year of 2006 (USD 132.1 bn vs. 139.2 bn). Some experts foretell a far greater contraction rate, and it was just the price rise for oil at the end of the year that cushioned the envisaged process. In the 4th quarter 2007, the balance of foreign trade accounted for USD 39.9 bn, or at 42, 4% up against the respective index of the 4th quarter 2006 (USD 28.045 bn). Interestingly, the balance of Russia's trade with Far-Abroad countries dropped by 8.5%, while the balance of its trade with the CIS countries surged at 16.3%.



Source: the Central Bank of RF.

Fig. 29. Russia's Foreign Trade Turnover (USD bn)

The foreign trade turnover imbalance coefficient (the foreign trade balance to the foreign trade turnover) plunged from 29.7% in 2006 to 22.8% in 2007.

The proportion of import in GDP soared from 16.7% in 2006 to 17.5% in 2007. By contrast, the proportion of export in GDP shrank from 30.8% in 2006 to 27.4% in 2007.

### 3.4.2. Situation on the World Market

In 2007, the world prices for main Russian exports basically remained favorable – they were greater on average than in 2006, with the price rise for energy commodities accounting for 1.9% and that for non-energy ones – 8.2%.

The world oil market was extremely volatile in 2007. The warm winter in the US and other countries of the Northern Hemisphere, as well as some OPEC nations' loose observance with their obligations to cut back their oil output engendered a sharp rise in the world prices for oil in early 2007, but since February they have been on a gradual rise<sup>11</sup>.

The 2007 prices for goods of ferrous and non-ferrous metals were likewise on the rise.

In the 2<sup>nd</sup> and 3<sup>rd</sup> quarters 2007, there was some slight price rise for ferrous metals, but, overall, the 2007 prices for ferrous metals proved to be at 1.7% down on average vs. the 2006 ones.

The price rise on the world market for main non-ferrous metals in the 1<sup>st</sup> quarter and through mid-April was followed by some stabilization in May and June, and after that the prices began to sink.

After some fall in January and February, the world price for copper at the London Metal Exchange has been soaring and remaining at a fairly high historical level. It ultimately proved to be at 4.1% higher than in 2006.

Behind a serious price rise for nickel had been long-standing shortages on the respective market. On May 9, 2007, the price for the metal hit all-time record value – that is, USD 53,000/t. It began to fall since June, but remained at a fairly high level. By results of 2007, it was at 68.5% greater than in 2006.

The world aluminum prices were also at a fairly high level, albeit falling short of hitting their peak value in May 2006 – USD 2,861.5/t. The 2007 average price for aluminum ultimately was at 0.8% greater than in 2006.

Underlying the 2007 price rise for ferrous metals were such main factors as a high industrial demand for them (particularly China's), a low level of the nickel inventory, and contracted copper inventory.

*Table 45*

**The Average World Prices**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Oil (Brent), USD/brl.	17.4	14.1	15.9	28.19	24.843	25.022	28.83	37.4	54.38	65.15	72.32
Natural gas/1 m. BTE	1.9642	2.5469	2.1876	4.3442	3.9764	3.3857	5.461	5.993	8.870	12.2	7.27
Gas USD/Gallon	0.615	0.511	0.529	0.887	0.7922	0.755	0.891	1.197	1.508	1.81	2.06
Copper USD/t	2,369.7	1,775.3	1,539.9	1,863.9	1,613.6	1,592.9	1,785.6	2,808.2	3,606	6,851	7,129
Aluminum USD/t	1,554.0	1,413.5	1,318.0	1,550.0	1,444.7	1,350.7	1,424.7	1,693.2	1,871	2,619	2,639
Nickel USD/t	7,312.4	5,352.5	5,239.5	8,624.0	5,966.0	6,175.1	9,580.8	13,757	14,692	22,038	37,134

*Source:* By the data of the London Metal Exchange and International Petroleum Exchange (London).

As the stock of raw materials was contracting, while demand was rising at an unusually great pace, which left the production expansion rates behind, and more and more volumes of crops have been used to produce biofuel, and the progress in production of freighters was being insufficient and values went up, the world market saw the price rise for food stuffs.

<sup>11</sup> For greater details, see section 3.1.

Meanwhile, as many countries attempt to ensure a partial replacement of the mineral fuel with the biological one, the contemporary world agrarian production has fallen short of meeting such these requirements.

*Table 46*

**The Dynamics of the Average World Prices for Some Agricultural Goods**

	2005	2006	2007								
			July	August	September	October	November	December			
Wheat, USD/t											
Canadian, CWRS	197.6	216.8	277.7	294.9	357.7	386.3	391.0	473.2			
US, HRW	152.4	192.0	238.4	259.7	326.5	335.1	321.8	368.6			
US, SRW	135.7	159.0	225.6	253.9	325.7	325.5	307.7	345.4			
US corn, USD/t	98.7	122.9	138.5	150.3	164.1	164.2	171.3	180.2			
Barley, USD/kg	95.0	117.0	178.0	159.0	185.0	197.0	188.0	199.0			
Soya beans, USD/kg	274.4	268.4	375.5	385.0	426.0	450.0	489.0	515.0			
Soya oil, USD/t	545.1	598.6	885.4	909.0	959.0	1,012.0	1,138.0	1,155.0			

*Source:* the World Bank.

The price rise for dairy products was fueled by a growing demand on the part of a number of developing Asian North African and Middle East economies, as well as their large consumers, that is, the EU and the US. According to OECD, in 2007–2008 and through 2016 prices for powder milk and other dairy products are going to stay high, and they will be under the impact of the world economy's health (particularly of rates of economic advancement of the Asian, African and South American countries), rather than short-term factors (unfavorable weather conditions, exchange rate fluctuations, and quantitative production constraints).

As for prices for other Russian natural exports (except for timber), in 2007 they were higher than in 2006.

### 3.4.3. Export

The persisting favorable state of affairs on the world markets has had a positive effect on the Russian export, which in 2007 became in excess of its annual values reported in the past 17 years. Nonetheless, its increment rates in 2007 were far lower than in recent years. Its value equivalent grew at 16.9%, while in 2004 it was 34.8%, in 2005 – 33.1% and 24.7% in 2006. The growth rates of the physical volumes of export of goods were smaller than the price rise growth rates for them.

*Table 47*

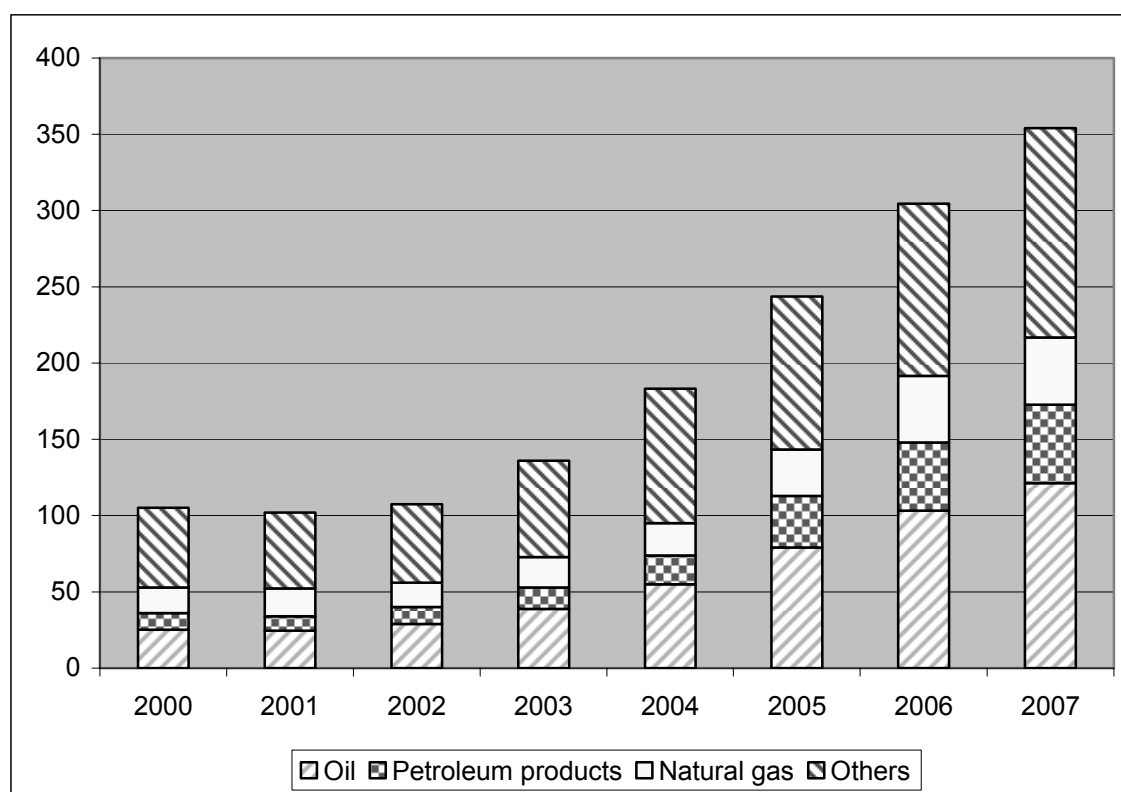
**Dynamics of Russian Export**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Export, USD bn	89,7	86,9	74,4	75,6	105,0	101,9	107,2	135,4	183,2	245,3	303,9	355,2
Including:												
Far Abroad	71,1	67,8	58,7	63,6	90,8	86,6	91,0	113,9	152,9	211,6	260,6	301,5
Growth rate, as % to the previous period												
Index of physical volume	100,1	101,8	99,7	109,4	110,2	104,2	115,0	109,5	110,7	104,7	105,8	105,0
Price index	108,6	98,1	84,2	92,1	128,2	93,8	86,0	113,4	122,7	126,9	119,7	110,9

*Source:* CBR, the RF Ministry for Economic Development and Trade.

It was in the 4<sup>th</sup> quarter 2007 that export volumes reached their peak, with its value demonstrating a 37.2% growth vs. the respective period of the prior year.

Meanwhile, the group of main exports remained practically unchanged – it was still the export of produce of the fuel and energy complex that dominated in the group, albeit the share of the FEC exports in the overall volume of the nation’s export continued shrinking. In 2007, it accounted for 64% vs. 65.4 reported in 2006. This can be explained largely by the declining physical volumes of gas export, which in 2007 accounted for 191 bn cub. m. (94.2% to 2006), with 153.67 bn cub. m. exported to the Far-Abroad and Baltic states (95% to 2006) and another 37.32 bn cub. m. exported to the CIS countries (97.7%).



*Fig. 30. Russian Export (as USD bn)*

The growth in the value of overseas supplies of oil and petroleum derivatives slowed down dramatically when compared with 2006. That happened in the conditions of a loose rise in their physical volumes. In 2007, the country exported as much as 258.96 m t. of oil (104.2% to 2006), with 222.56 m t. supplied to the Far-Abroad and Baltic states (105.4% to 2006), while supplies to the CIS countries accounted for 36.4 m t. (97.7%). Notably, the Russian oil supplies to Ukraine and Belarus were scaled back against their increase to Kazakhstan.

In 2007, Russia exported metals and metal products worth a total of USD 49.9 bn (119.4% to 2006), including the USD 42.8 bn-worth supplies (117.3%) to the Far-Abroad countries) and 7.1 bn-worth (134.1%) supplies to the CIS countries.

The proportion of metals and metal products in Russia's export commodity structure accounted for 14.2% (13.7% in 2006), including 14.6% (14.1%) to the Far-Abroad countries and 13.9% (12.6%) to the CIS countries.

The 2007 volume of export of ferrous metals accounted for USD 22.5 bn (119.1% to 2006), including 18.7 bn (115.8%) – to the Far-Abroad countries and 3.8 bn (140.7%) – to the CIS countries.

*Table 48*

**Value Volume of Russian Export of Oil, Petroleum Products, and Gas  
(in USD m) and Their Share in the Overall Volume of Russian Export (as %)**

	Oil		Petroleum products		Natural gas	
	USD m	%	USD m	%	USD m	%
1992	6,662	12.4	2,202	4.1	6,389	11.9
1993	8,061	13.5	3,061	5.1	6,964	11.7
1994	8,948	13.3	3,398	5.0	7,939	11.8
1995	12,297	15.2	4,108	5.1	13,381	16.5
1996	15,578	17.6	7,442	8.4	14,683	16.6
1997	14,346	16.2	7,145	8.1	16,420	18.6
1998	10,254	13.7	4,262	5.7	...	...
1999	14,101	18.8	4,713	6.3	...	...
2000	25,284	24.1	10,938	10.6	16,644	16.1
2001	24,576	24.1	9,402	9.4	18,303	18.3
2002	28,950	27.0	11,227	10.5	15,897	14.9
2003	38,816	28.6	14,064	10.5	19,981	15.0
2004	55,024	30.0	18,998	10.5	20,918	11.5
2005	79,216	32.5	33,650	13.6	30,424.2	12.9
2006	96,675	31.7	44,217	14.5	42,815	14.1
2007	114,145.2	34.4	51,470.4	14.6	42,755.1	12.1

*Source:* data by Rosstat and the Federal Customs Service.

It was rolled items that dominated the structure of export of ferrous metals. The physical volume of rolled ferrous metals made up 26.8 m t. (94.6% to 2006), with 87% of the ferrous metal exports shipped to the Far-Abroad countries, while the remaining 13% – to the CIS countries.

The 2007 supplies of rolled items to the Far-Abroad countries (in physical equivalent) dropped at 7.9% to the 2006 level, including: sectional iron – at 16.6%, sheet products – at 17.9%. The contraction was caused by the fall of shipments to the Northern American countries (at 85%) and the Asian region (at 40%), while Russia boosted its supplies to the western and eastern Europe at 20% and to the Middle East – at 60%.

Export of steel pipes plummeted by 20% to the 2006 level, as the EU had undertaken measures to protect its domestic market.

The average export prices for semi-finished steel (to the Far-Abroad countries) grew by 25.2% to the 2006 level, those of sectional iron – by 42.6%, and sheet products – 20.4%.

Supplies of rolled items to the CIS countries (in physical equivalent) displayed a 16.1% growth, including those of sectional iron – at 3.2%, sheet products – 34.5%, steel pipes – 2.5%.

The 2007 volume of export of main non-ferrous metals (raw aluminum, refined copper, and raw nickel, which account for 80% of all the non-ferrous metal exports) was worth a total

of USD 17.8 bn (122.8% to the 2006 level), including the one to the Far-Abroad countries – USD 17.6 bn (122.2%) and USD 180m (185.5% – to the CIS countries. Meanwhile, the physical volume of export of raw aluminum to the Far-Abroad countries soared by 10.5%, copper – 2.3%, while supplies of nickel were down by 5.5%. The average export prices for aluminum rose by 17%, those for copper – at 10%, and nickel – at 48%.

In 2007, the share of chemicals in Russia's export was 5.9% (against 5.6% in 2006), with its main export items being mineral fertilizers (37%), collastic (8.8%), automobile tiers (5.8%), plastics and artificial resin (5.3%), paint materials (5.2%), and ammonia (4.7%).

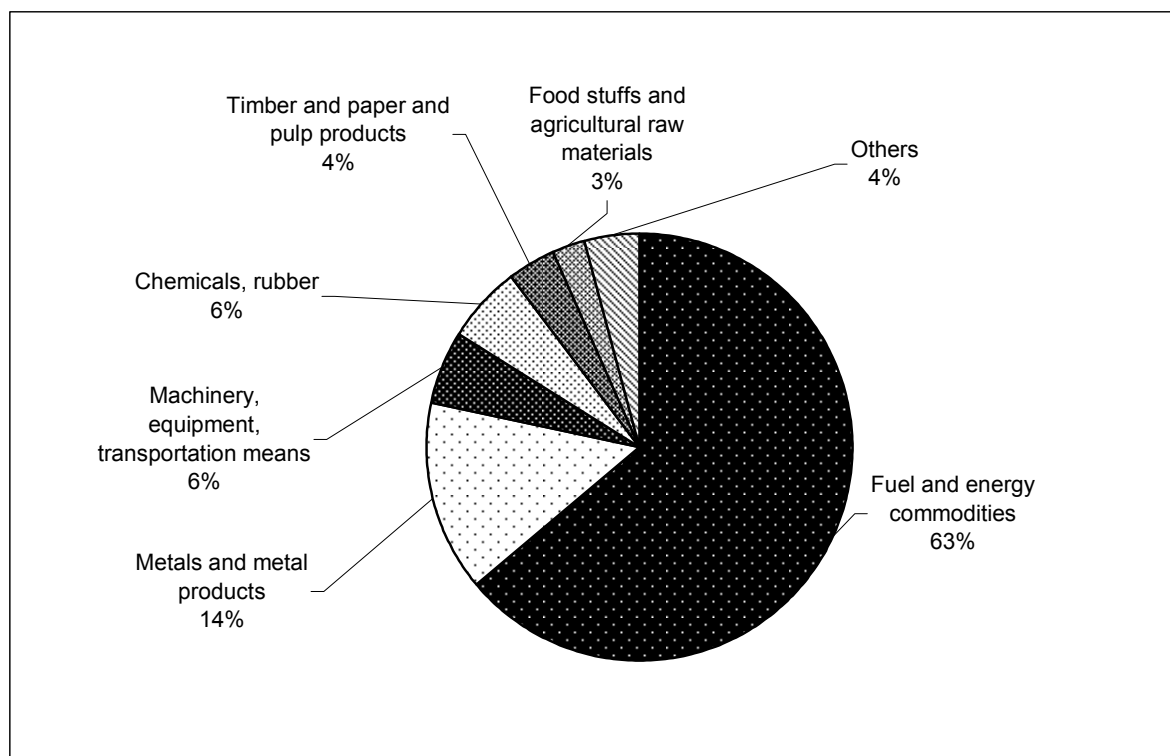
The year of 2007 saw a considerable rise in export supplies of main chemical products. More specifically, export of carbinol rose at 20.1%, mineral fertilizers – 8.5% (including potash fertilizers – at 21.2%), collastic – 0.7%. Meanwhile, there was a fall in export of compound fertilizers (99.5%) and nitrogenous fertilizers (98.1%), as well as ammonia (86.1% to the 2006 level).

The proportion of timber and paper-and-pulp products in the 2007 overall export volume posted a 3.5% growth vs. the 3.2% indicator back in 2006. This occurred due to the price rise for timber, which was likewise noted across practically all the main commodities that fall under this group. For example, the average contractual price for exported plywood was 42.8% up, lumber – 32.3% up, wood pulp – 24.9%, round timber – 31.7% up.

A significant rise in food exports in the structure of Russia's export is worth a particular attention. In 2007, the displayed a 64.2% growth vis-à-vis the respective period of the prior year, while the proportion of food stuffs and agricultural raw material in the overall volume of Russia's export rose to 2.6% vs. 1.8% in 2006.

In the current agricultural year (between July 2007 and July 2008) Russia is going to boost its grain export up to 15m t. The country's 2007 corn crop totaled 87.1m t., which enables the nation both to meet the domestic needs and secure export supplies. In 2007 alone, Russia exported 11.85m t. of grain, and another 12.5m t. was due to be supplied by January 29, 2008. Since that date a new, greater, wheat export duty came into effect. It makes up 40% of the respective customs value, but not less than Euro 105/t. The duty per se became a prohibitive one, as earlier it was 10% of the customs value, but not less than Euro 22/t.

High wheat prices boosted Russia's wheat, as well as rye exports. According to the national Corn Union, between July 1 and December 10, 2007, the country exported 63.3 Thos. t. of rye, while in 2006 as a whole – only 30,000 t. The greater export volumes of rye were fueled by a greater rye production in 2007 and high prices for rye on the world market. In 2007, Russia cropped 3.6–3.7 m t. of rye, which meets the nation's need and enables the country to refuse its importation. In 2006, the crop was 2.96 m t. and import accounted for 20,000 t. In Europe, the rye prices are 310–315 USD/t., while in Russia they are close to USD 230/t.



Source: FCS of RF.

Fig. 31. The 2007 Structure of Russia's Export (as %)

The machine-building export was growing at a far slower pace (13% vs. 2006), with the proportion of machinery, equipment and means of transportation in the overall volume of Russia's export falling from 5.8% reported in 2006 to 5.6% a year later.

Export in this group of goods was propelled chiefly thanks to sales of military equipment. In 2007, the overall amount of export supplies of the Russian military equipment via the state intermediary – Rosoboronexport – made up USD 6.1bn (vs. 5.3 bn in 2006). Behind the record-breaking sales was the renewal of large-scale export sales of Sukhoy-30 MK (52 units, including 16 interceptors and 8 units for the licensed assembly of Sukhoy-330 MKI to India, 6 Sukhoy-30 to Algeria, 10 Sukhoy-30 MKM to Malaysia, and 12 Sukhoy-30 MK2V to Venezuela). The overall value of all the aircraft, along with armament and spare parts, accounted for a half of Russia's overall machine-building export. The aircraft supplies should remain great in 2008, so there should not be a significant drop in the nation's machine-building export sales.

The favorable state of affairs on the world market secured a dramatic rise in contractual prices for Russia's main exports.

In 2007, the proportion of export in production proved to be lower than in 2006 by many major Russian exports.

Table 49

**The Average Contractual Prices for Main Russian Exports  
(supplies to far abroad, as USD/t)**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Crude oil	118.5	74.4	110.9	179.9	156.4	162.4	181.2	231.9	344.3	429.8	485.4
Oil products	115.7	75.7	94.5	171.9	145.2	147.9	180.2	230.3	340.6	430.1	464.1
Natural gas, thous. cub.m.	88.6	72.2	55.31	85.91	105.21	91.4	112.3	113.6	154.7	–	240.6
Ammonia	113.0	83.1	53.0	97.5	81.7	72.4	118.5	158.3	176.2	195.7	224.2
Nitrogen fertilizers	<b>90.3</b>	<b>58.3</b>	<b>36.8</b>	<b>57.9</b>	<b>61.8</b>	<b>60.6</b>	<b>76.0</b>	<b>103.1</b>	<b>139.1</b>	<b>146.0</b>	<b>197.3</b>
Potash fertilizers	<b>79.7</b>	<b>87.4</b>	<b>86.4</b>	<b>86.6</b>	<b>76.8</b>	<b>74.9</b>	<b>77.8</b>	<b>94.3</b>	<b>133.9</b>	<b>150.3</b>	<b>174.5</b>
Round timber, cub.m.	<b>57.5</b>	<b>46.9</b>	<b>43.5</b>	<b>43.4</b>	<b>45.6</b>	<b>44.8</b>	<b>47.8</b>	<b>56.2</b>	<b>59.6</b>	<b>63.8</b>	<b>84.0</b>
Pulp	373.5	342.9	274.0	352.2	293.4	300.0	321.7	371.9	386.1	436.7	545.6
Commercial paper	383.4	394.0	349.5	386.6	421.7	332.2	338.3	387.9	455.3	498.6	527.0
Cast iron	124.2	104.3	66.8	80.7	86.2	91.1	126.8	242.7	274.4	244.4	313.6
Ferro alloys	819.2	740.8	548.2	625.6	601.7	625.7	634.6	1,097.8	1,582.5	1,492.3	1,673.2
Copper	2,099	1,655	1,495	1,675	1,465.3	1,371.4	1,564.9	2,587.6	3,389.8	6,361.7	6,657.8
Nickel	6,733	5,140	5,761	8,629	5,730.9	6,143.9	8,584.0	12,660.0	14,242.5	22,674.4	33,852.1
Aluminum	1,401	1,352	1,157	1,296	1,176.3	1,036.9	1,050.0	1,162.1	1,299.2	1,633.5	1,984.0

Source: the Federal Customs Service.

Table 50

**The Share of Export in Production of Major Goods (as %)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Crude oil	41.7	41.6	45.2	44.2	44.8	46.5	49.7	53.1	56.1	54.0	57.0	52.8
Oil products	32.4	34.7	32.9	33.6	36.3	35.5	40.8	40.9	42.1	46.7	47.8	49.1
Natural gas.	33.1	35.2	34.5	34.6	33.2	31.2	31.2	32.7	33.9	34.2	31.3	28.9
Coal	15.8	14.5	15.7	16.7	25.7	22.2	23.8	30.8	52.9	51.8	53.8	40.4
Nitrogen fertilizers	85.9	80.6	86.5	83.2	82.9	81.8	78.1	76.1	78.5	74.5	62.7	63.2
Raw timber	23.2	29.3	34.1	40.1	42.4	53.4	51.0	46.1	49.6	60.1	61.2	57.2
Pulp	85.7	82.8	77.6	79.1	82.4	83.7	85.1	82.9	77.5	79.7	79.2	79.3
Commercial paper	72.2	70.1	74.6	70.6	69.0	67.4	68.6	66.0	65.6	61.2	57.3	60.9
Sheet iron and steel	59.7	58.6	63.5	60.6	55.3	43.0	50.5	47.1	46.1	48.4	39.7	41.2
Passenger cars	10.4	4.9	8.3	7.3	12.2	10.1	12.3	11.7	11.8	12.5	10.7	10.0
Trucks	17.4	10.7	9.6	8.3	7.0	12.3	20.8	19.3	23.0	22.8	20.6	27.3

Source: Rosstat, the Federal Customs Service.

In 2007, the growth rate in export to the CIS countries considerably outpaced those of export on the whole. Export to the Near-Abroad countries soared by 23.9%, while to the Far-Abroad ones – just by 15.7%. The value volumes of export chemical produce to the CIS countries surged at 25%, those of forestry and wood-working products – at 27%, ferrous metals – at 58%, products of the power machine building – 32%, electric machinery – 38%, means of ground transportation – at 29%.

This evidences that the CIS countries still form a critically important market for the Russian export of highly-processed produce, while the continuous advancement of the post-Soviet economies allows one to extend the volumes of supplies therein.

#### 3.4.4. Import

The year of 2007 saw a record-breaking volume of import, which has proved to be considerably greater than in the past 17 years. Russia imported goods worth a total of USD 223.1



bn, or at 35.4% more than in 2006. The non-CIS countries contributed with their USD 191.2 bn-worth supplies (up 35.4%), while the proportion of import from the CIS countries totaled USD 31.9 bn (up 29.6%). The share held by the non-CIS countries in the overall volume of the 2007 Russian import accounted for 85.7% (vs. 84.6% in 2006).

As in the previous year, the 2007 upsurge in import to Russia likewise became possible thanks to the growing physical volumes of import, whose growth rates were considerably greater than in 2006, while price rise growth rates were fairly moderate over the year. The role played by the price factor intensified in the second half of the year – more specifically, that was noted in the segment of food stuffs and agricultural raw materials.

*Table 51*

**Russia's Import (in USDm)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Import, total	68.1	72.0	58.0	39.5	44.9	53.8	60.5	76.1	97.4	125.3	163.9	223.1
Including:												
Far-Abroad countries	47.3	53.4	43.7	29.2	31.4	40.3	48.2	60.1	76.4	103.5	138.6	191.2
Growth rates, as % to the prior year												
The physical volume index	98.1	121.1	89.0	84.4	129.2	129.1	117.6	119.2	124.2	122.4	130.1	127.1
Price index	100.2	94.8	92.3	82.1	86.7	94.3	93.4	98.7	106.1	106.5	105.5	107.6

*Source:* CBR, MEDT.

Main factors behind the rising imports were high growth rates of the national economy and the population's incomes, plus the continuous appreciation of the Rb. The goods structure of Russia's import is dominated by machinery and equipment (49.1% of the overall volume of import vs. 47.7% reported in 2006). The value volume of import of machinery and equipment grew by 56.1%.

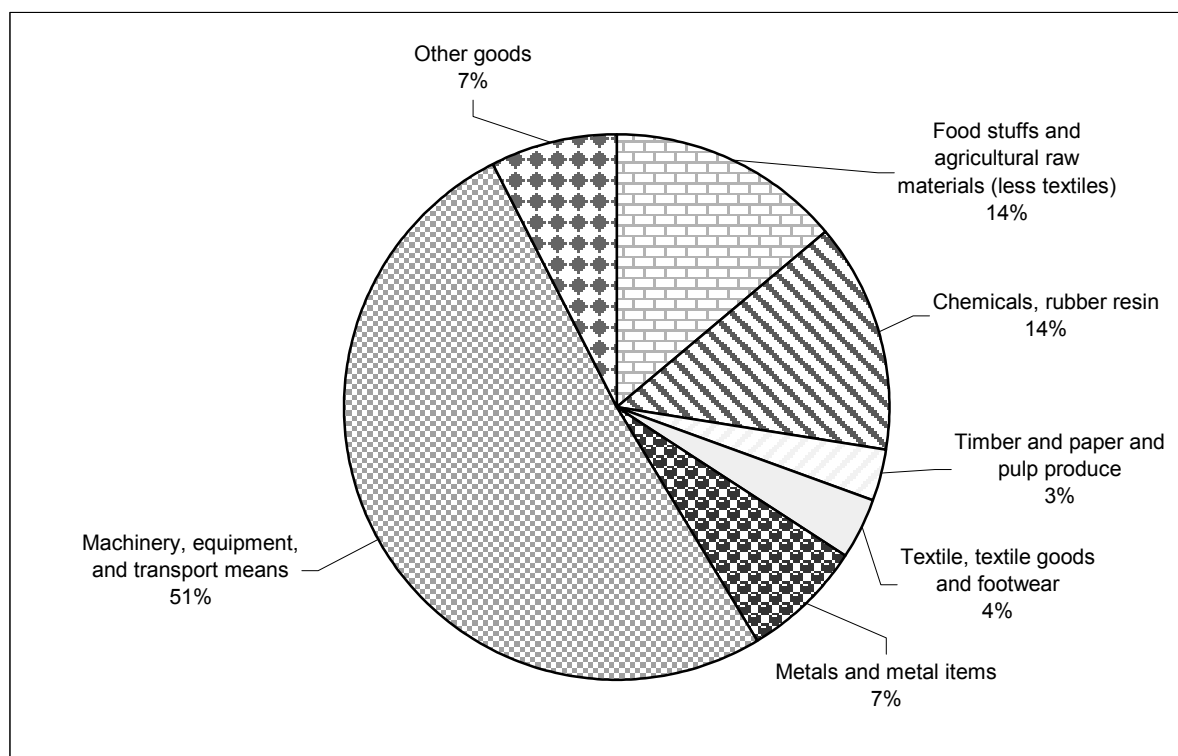
The share of chemical products accounted for 13.9% vs. 15.9% reported in 2006. The goods assortment of the chemical and petrochemical import is considerably broader than the nation's export supplies of analogous goods, and, while the latter are mostly formed by raw materials, imports largely are products of intense processing.

The specific weight of food stuffs and agricultural raw materials in 2007 accounted for 13.7% vis-à-vis 14.3% in 2006. Import flows were to some degree affected by the price rise for foods stuffs on the world markets. Thus, the import of wheat fell by 66.7% as compared with 2006, while that of corn – at 68.4%. At this point, it should be noted that other imported food items likewise grew at a rate slower than the average one.

The greatest growth rates in import supplies were noted in the following sectors: footwear (twofold), Apparel (at 90%), electric machinery and equipment (51%), ferrous metals and products (95%), means of ground transportation and spare parts (81%). Considered in terms of the proportion held in the value structure of import supplies, it is means of ground transportation and spare parts that clearly dominate (17.6%) therein. So one can draw a conclusion that one of the critical factors that propelled import flows in value equivalent in 2007 became the booming automobile production in the frame of industrial assembly agreements concluded between the RF Government and the largest international automakers.

As well, it is worth noting an impressive growth in the value flows of import of power production equipment units (up 47% vs. 2006). Given their great costs and weight in the ag-

gregate volume of the value import in Russia (17%), it can be assumed that large-scale investments in the Russian power-generation sector have also fueled the rise in import.



Source: FCS of RF.

Fig. 32. Commodity Structure of Russia's Import in 2007 (as %)

Whereas the importation of spare parts for automakers operating in Russia's territory can be viewed as import of intermediate goods, while that of power-generation equipment – as investment import, it can be argued that in addition to consumer imports, these two sectors have begun playing a notable part in shaping import flows.

As concerns the situation with import of clothing, footwear, electric machinery and equipment, its analysis shows that the rise in the value volume of these goods to a significant extent can be explained by progress in the customs administration's operational standards and a consequent pulling transactions involving the goods in question out of the effect of the so-called "gray schemes". That said, one should expect a further substantial deceleration of the growth rates of value volumes of import across these groups of goods.

That the customs authorities' assault on the "grey import" has been a serious success can be proved by comparing the data by CBR and those by FCS. The former are prepared according to the balance-of-payments methodology and appear somewhat different from the FCS's ones. The CBR's statistical data accounts import without crossing the customs border (such as fuel purchases by Russian vessels from overseas ports, among other things), while, most importantly, the Bank of Russia adds the "gray import" volumes. Accordingly, FCS estimates the 2007 import at the level of USD 191bn, while CBR cites the figure of 223.06bn, so the approximate estimation of the "gray import" totals USD 23.4 bn (vs. 27.2 bn in 2006). It means that we witness a sustained reversal – in 2000–05 the "gray import" accounted for

21–24% of the aggregate volume of the nation’s import, in 2006 – 20.1%, while in 2007 it shrank to 10.5%.

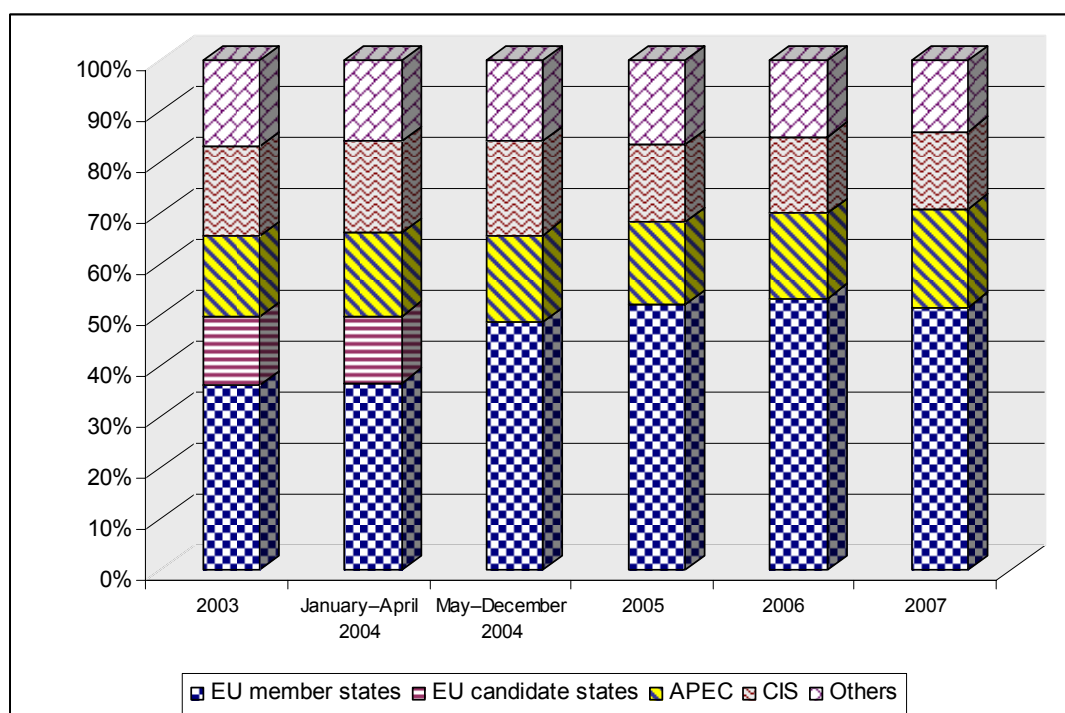
### 3.4.5. The Geographical Structure of Russia’s Foreign Trade

The country’s 2007 geographical structure of foreign trade was still dominated by the EU member states – the volume of the Russia-EU foreign trade turnover posted a 15.6% growth vis-à-vis the respective period of the prior year and made up USD 224.6 bn, with exports soaring at 6.1% and imports up at 42.8%. Notwithstanding the impressive indicators, the proportion of the EU countries in Russia’s foreign trade turnover slid at 2.9 percentage points vs. 2006 and stood at 51%.

The EU member states left behind the second biggest group of countries, that is, the APEC member states. Their specific weight in Russia’s foreign trade turnover in 2007 climbed up to 19.2% vs. 17.1% in 2006 and was worth a total of USD 83.6 bn. All the figures were up: 49% by the foreign trade turnover, 16.6% – by export, and 64.2% by import.

The CIS countries, which held a 14.9% share in Russia’s foreign trade turnover, held the third position, with the trade volumes surging by 25.4%, export – by 20.3% and import – by 35.4%.

That the geographic structure of Russia’s foreign trade underwent changes vs. 2006 can be attributed to a growing share of the Asian countries in its total volume of goods turnover: specifically, China’s share grew from 6.4% to 7.3%, Japan’s from 2.7 to 3.6% and the Republic of Korea’s – from 2.2% to 2.7%.



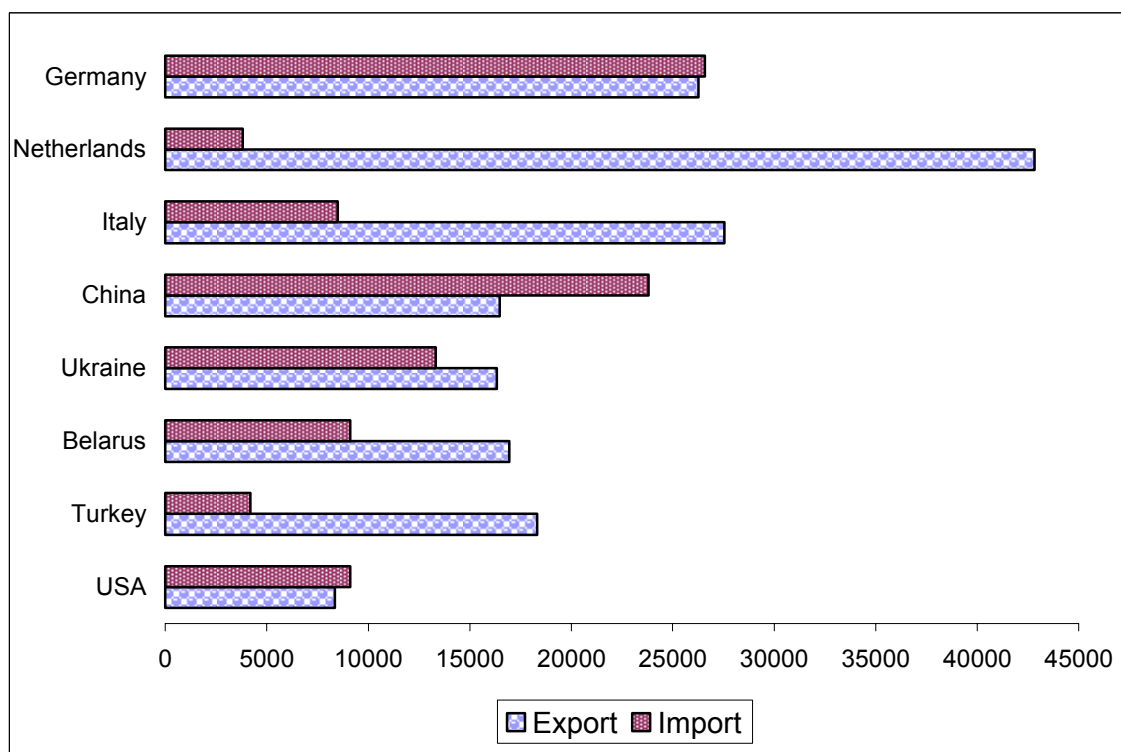
Source: FCS RF.

Fig. 33. The Geographical Structure of Russia’s Foreign Trade

Meanwhile, the alarm bell tolled for some European nations, as Germany, the Netherlands and Italy's shares in Russia's foreign trade turnover began to shrink from 9.7% to 9.5%, 9.1 to 8.5%, and 7.2% to 6.5%, respectively.

By contrast, some CIS countries boasted a greater trade turnover with Russia: Kazakhstan – from 2.9% to 3.1% and Belarus – from 4.6% to 4.7%, and that was propelled by growing imports, as well as exports.

Nonetheless, Germany has retained its position as a leading Russia's trade partner among the Far-Abroad countries, with the Russian-German goods turnover worth a total of USD 52.9 bn (123.0% up vs. 2006), followed by the Netherlands – 46.6 bn (120.9%), China – 40.3 bn (140.6%), Italy – 36.1 bn (117.0%), Turkey – 22.5 bn (132.1%), Japan – 20.1 bn (164.1%), Poland – 17.9 bn (120.4%), USA – 17.5 bn (116.2%), UK – 16.7 bn (118.4%), and France – 16.4 bn (121.4%).



*Fig. 34. Major Trade Partners (in USDm)*

Meanwhile, despite impressive figures, the number of the countries in trade with which Russia has negative balance between export and import has been on the rise in 2007 (24 vs. 19 in 2006).

The change in the correlation between export and import was most dramatic in Russia's trade with Germany, US, and China. In 2006, Russia enjoyed steadily positive trade balances with these countries, which in 2007 became negative.

The 2007 bilateral Russia-China's trade turnover hit a new record value of USD 48.61bn. and posted the 44.3% growth vs. 2006. This is the greatest value since 1992. It was China's import to Russia that displayed the greatest growth rates.

China's supplies of machinery and equipment have formed a key import group, whose growth rate in 2007 was close to 90%, or USD 8.7 bn in value equivalent. Import of vehicles was likewise on the rise and practically doubled over the year. The traditional Chinese exporters were equally happy with a 278% rise in their supplies.

Russian supplies to China grew by humble 12%, or USD 12.7bn, with oil, round timber and chemicals still dominating its export thereto.

The analysis of the current structure of the Russian-US trade exposes its asymmetry: while Russia's export is formed mostly by oil and petroleum products (52.3%) aluminum and aluminum goods (11.7%), ferrous metals (7.3%) and inorganic chemistry items (7%), its machinery, equipment and vehicles account for just 12%, followed by other major exports, such as uranium, platinum, nickel, as well as garments and seafood.

Traditionally, Russian imports from the US are dominated by various machinery and equipment (oil and gas equipment, aircraft, electric equipment, optical and measuring devices, and medical equipment), as well as grain and meat products. So, Russia's export to the US is dominated by raw materials, while the share of finished products is low, and Russia's imports from the US are formed by technologies and food stuffs.

The negative balance of Russia's trade with Germany appeared the most surprising phenomenon. Russia has been the biggest oil and gas exporter to Germany, and the negative balance of trade can to some extent be attributed to the downfall in oil prices in the beginning of 2007, while the last warm winter told on the volume of Russian supplies of natural gas. These factors aside, the major cause became a dramatic (at 44.5%) surge in import supplies from Germany, which were formed chiefly by production equipment and vehicles.

#### 3.4.6. Foreign Trade Regulation

##### ***General Regulation***

In December 2006, the State Duma passed the Federal Act "On special economic measures", which took effect as of January 2007. Special economic measures are the prohibition to exercise certain activities with regard to a foreign state and (or) foreign organizations and citizens and (or) laying an obligation to exercise the noted activities, and other restrictions. Such measures can be aimed at: suspension of implementation of all or a part of economic and technical cooperation programs, as well as military collaboration programs; prohibition of financial transactions and imposition of restrictions on their exercise; prohibition of foreign trade operations or imposition of restrictions on their exercise; termination or suspension of the effect of international trade agreements or other international agreements in the area of foreign-trade connections the RF has entered into; prohibition or limitation of calls to the RF ports and usage of the RF air area or its certain areas; imposition of restrictions on exercise of tourist operations; prohibition of, or refusal from participation in international research and scientific programs and projects.

Special economic measures are of temporary nature, and they are applied independently of other measures that aimed at protection and securing the RF interests, as well as its citizens' rights and freedoms. They are employed in the event there arises integrity of circumstances that require an immediate reaction to an internationally unlawful act or a hostile act by a foreign state or its authorities that poses a threat to the RF's interests and security and (or)

violates its citizens' rights and freedoms, as well as in compliance with the UN Security Council's resolutions.

On January 11, 2007, the presidential Decree "On improvement of the state regulation of export and import of precious metals and precious stones" came in effect. The Decree lifts quantitative limitations on export of these items.

Export of the following precious metals and precious stones requires license: refined gold and silver, in the form of bars, powder, granules; refined platinum and other platinoids, in the form of bars, powder, granules; nuggets of precious stones not subjected to refining; natural pearls, natural precious stones, both shone and unshone, unique amber substances; as well as, ashes, concentrates and semi-finished products of nonferrous metals, ores and concentrates of precious metals, scrap and waste of precious metals, and unprocessed precious metals.

Licenses are not required for export of items made of precious metals, items of production and technical nature of precious stones, those of precious stones, and coins of precious metals.

Private individuals are exempt from customs duty if they export precious metals and stones worth up to USD 10,000.

The RF President has banned export and transit of firearms and goods and technologies that can be used for production of ABC weapons. The ban also concerns transportation of the said goods by Russian vessels and aircraft, provisions of related services and training of the respective cadres, conduct of financial transactions with individuals who take part in creation of ABC weapons or support such activities, purchases of the said goods by Russian private individuals, visits of private individuals, who support or encourage creation of ABC weapons, to the Korean People's Democratic Republic (Decree No. 665 of May 27, 2007).

### *Export Regulation*

#### **Non-Tariff Measures**

The RF Government set procedures with regard to re-export of certain goods originated from the RF territory by other member states of the Eurasian Economic Community. Specifically, organizations from these countries may re-export such goods only if they have a due permit in writing issued by the RF MEDT. The Ministry grants such a permit providing an applicant consequently transfers to the RF budget an amount of export customs duty at a rate effective in RF as of the date of the customs clearance of the re-export operation (RF Government's Resolution No. 66 of February 3, 2007).

With his Decree No. 1083 of August 20, 2007, (effective as of November 24, 2007) the RF President approved the list of microbes, toxins, and equipment and technologies subject to export control.

#### **Tariff and Tax Measures**

In 2007, export duty rates were modified across 63 items, save for oil and petroleum products. As for the latter (73 positions), duty rates were modified once in two months in compliance with the RF Act "On customs tariff".

Export customs duties with regard to crude and oil products produced of bituminous rock, as well as light and dark-oil products exported from RF to outside of the states that participate in the Customs Union, were modified as follows (see *Table 52*).

*Table 52*

**Export Duty Rates on Oil and Oil Products in 2007 (as USD/t)**

	Oil	Oil products	
February 1	179.7	133.4	71.8
April 1	156.4	117.7	63.4
June 1	200.6	147.5	79.4
August 1	223.9	163.2	87.9
October 1	250.3	181	97.5
December 1	275.4	197.8	106.6

*Source:* Resolutions of the RF Government.

Keen to lower the export volumes of unprocessed timber, the RF Government radically changes its export policy with regard to wood-working produce. Presently, Russia holds 40% of the world market of raw coniferous timber, and it lags far behind the countries with the most advanced forestry sector, so far as the intensity of processing of raw timber is concerned. Given that, Russia nonetheless has lately retained a very liberal customs regime in respect to these goods. The export duty rate on round timber has been just 6.5% of its customs value, which was far lower than those applied by Brazil, Canada, US, and other exporters.

The raw timber export volume to the Far-Abroad countries tripled over the past 10 years. In 2005, it accounted for 47.4m. sq.m., in 2006 – 50.4m sq.m. It is worth noting, however, the 2006 export growth rate was 6.3% vs. 15.8% reported in 2005. The slowdown of the export growth rate can be partly explained by the increase of the specific component of the export duty from 2.5 Euro to 4 Euro/cub.m. effective since June 1, 2006.

Radical integration into the world market necessitates pursuance of a certain export policy strategy, which primarily concerns raw timber. In February 2007, the RF Government produced its Resolution No. 275. Its core issue is a three-stage increase in the level of export customs duties on individual kinds of raw timber, except for small merchantable birch wood, as well as finewood and hardwood – since June 1, 2007, the specific component of the export customs duty was set at the level of Euro 10/1 m<sup>3</sup>, since April 1, 2008 – Euro 15/1 m<sup>3</sup>, since January 1, 2009 – Euro 50/1 m<sup>3</sup>.

The Government earlier undertaken measures to reduce export of raw timber and encourage the domestic wood working. Specifically, it zeroed import duties on main kinds of high technological equipment not produced in Russia (over 600 items) and abrogated export customs duties on over 300 kinds of forestry and paper products with a high value-added (slabs, plywood, commercial pulp, mass kinds of paper and cardboard). At the same time, the Government increased export customs duties on individual kinds of timber. To protect the domestic market, import customs duties on furniture were adjusted, while exporters received support in the form of a subsidized interest on export loans.

The Customs Code of RF was modified with regard to coniferous and hardwood (birch and asp) sawnwood, while the respective import customs duty rates remained unchanged. Meanwhile the export customs duty rate on converted (parallel to grain) wood (birch and asp) and coniferous sawnwood (in the form of molded strips) was set at the rate of 0% of their customs value (vs. the previous 10%), but no less than Euro 5/1 m<sup>3</sup>. The RF Government Resolution on the subject took effect on June 14, 2007 (adopted on April 10, 2007, No. 15).

The RF Government set zero export customs duty rates on some kinds of 6mm-plus thick sawnwood since June 22, 2007, with the respective rate on sawnwood falling under position 4407 10 being 3% of its customs value, but not more than Euro 2.5/1 m<sup>3</sup>, while those on

positions 4407 93, 4407 94 and 4407 99 – 10% of their customs value, but not more than Euro 5/1 m<sup>3</sup> (the RF Government's Resolution No. 290 of May 15, 2007).

Since June 19, 2007, natural calcium phosphates and other complex mineral fertilizers containing azote and phosphorus became subject to zero export customs duty rates, while prior to that date they had accounted for 6.5% of the customs value of calcium phosphates and 3% – on the said mineral fertilizers (Government Resolution No. 291 of May 15, 2007).

Since July 16, 2007, the export customs duty rate on coal coke and coal char was lowered from 6.5% of their customs value to 0% (Government Resolution No. 369 of June 12, 2007).

The Government ruled to exempt from export customs duty the export of rapeseed and spring rape originated from the territory of the Special Economic Zone in Kaliningrad Oblast, which had previously accounted for 15% of their customs value, but not less than Euro 3/t. (Government Resolution No. 570 of September 10, 2007).

With its Resolution No. 660 of October 10, 2007, the RF Government set the export duty on wheat at the level of 10% of its customs value, but not less than Euro 0.022/kg, as well as on barley – at the level of 30%, but not less than Euro 0.07. The Resolution came in effect in 30 days upon its publication and will be effective through April 30, 2008. This is one of key measures the Government has undertaken in the frame of its fight against the price rise on the domestic market, for it has to strike a balance between interests of the domestic agrarian producers, the struggle for whose products, primarily, grain, has intensified on both domestic and international markets, and the domestic consumers. High grain prices on the world market have enabled the Russian agrarians, for the first time in many years, to collect profits and bolster their output. In 2007 to 2006, Russian wheat exports grew 2.6 times in value equivalent, with the wheat prices soaring at 77.5% and physical volumes – at 48.8%. Once introduced in November against the background of declining world prices, the export duties on grain lowered the export capacity and created surplus on the domestic market.

### *Import Regulation*

#### **Non-Tariff Measures**

The Federal Customs Service has revised application of individual provisions of Federal Act No. 248-FZ of December 29, 2006 “On introducing amendments to the Federal Act “On state regulation of production and turnover of ethyl alcohol and alcoholic products”. Since January 2007 one no longer needs to seek licenses to import alcoholic products packed into metal cans with a capacity not more than 450 ml; to import ethyl alcohol and alcoholic products for the official use by diplomatic or other official representations of foreign states; to import ethyl alcohol and alcoholic products designated for the displaying as samples at exhibitions or conduct of their certification in quantity of not more than 5 bottles or other tare (Letter by FCS of RF No. 01-06/3517 of February 1, 2007).

Since June 27, 2007, Bulgaria and Romania have been excluded from the list of countries eligible for the RF foreign trade preference scheme (Government Resolution No. 173 of March 22, 2007).

The Federal Service for Veterinary and Phytosanitary Supervision imposed restrictions on import of rice, sesame and peanut from India (Letter by FCS No. 06-73/17473 of May 10, 2007).



The Federal Service for Veterinary and Phytosanitary Supervision stated that rice originated from Thailand should be imported since May 2007 under submission of certificates of the Thai Ministry for Agriculture and Cooperatives (Letter by FCS No. 06-73/17961 of May 15, 2007).

#### *Tariff and Tax Measures*

In 2007, the Government modified customs import duty rates by 1,570 tariff positions, including 307 goods of the agricultural group. The 2007 average weighed import customs duty accounted for 11.25%.

In the late-2006, the RF Government amended the customs tariff with regard to automobile components imported for the sake of industrial assembly, as well as assembly parts and a series of raw materials required for production of aircraft engines. These goods were subjected to temporary (for the term of 9 months beginning January 2, 2007) customs import duty rates between 0 and 5% of their customs value vs. the previously applied 10–20% rates.

Once the said term was over, the decision was made not to extend it, but to make the duty-free import of the said goods permanent. With its Resolution of October 1, 2007, No. 628, the Government set, on a permanent basis, zero import customs duty rates with regard to automobile components imported for the purpose of industrial assembly and a series of raw materials for production of aircraft engines.

Thus, the RF Government is keen to bolster the domestic industrial assembly of foreign automobile brands and to give impetus to production of aircraft engines. As a reminder, import customs duties on imported cars are a. 25%, while assembly parts imported for the purpose other than industrial assembly are subject to the 15% customs duty.

As a reminder, the concept of “industrial assembly” should meet three criteria:

1. The period, in which the cycle of the welding, painting and assembly of automobile bodies should be arranged, should make up 18 months for an already operating production facility and 30 months – for a newly created one.
2. The latter production facility should have the annual capacity of not less than 25,000 units under the two-shift operational mode.
3. Volumes of imported components should be down at 10% within 24 months upon the welding/painting/assembly cycle is put in operation, at another 10% within 42 months, and at yet another 10% within 54 months from the start (i.e. at 30% in total within 10 years).

The agreements on industrial assembly have already attracted into Russia Ford, Renault, Kia, and Toyota, while Fiat and SsangYong have opted for a joint-venture and Volskwagen, Nissan, GM, Peugeot-Citroen and Suzuki expressed their interest in establishing automobile plants, as per respective agreements with Russian counterparts.

Since February 10, 2007, the RF authorities imposed temporary customs import duty rates effective for 9 months on toluene and isocyanate, PVC resins, polyethylene glycol with the hydroxyl number not more than 100 of 0% of their customs value and the 5% rate of the customs value – on foamed polystyrene. The permanent customs import duty rates on these chemicals were 5 and 5%, as well 10 and 10%, respectively (Government Resolution No. 13 of January 16, 2007).

Since February 19, 2007 through December 31, 2007) the effective customs duty rates on fresh and deep-frozen veal imported over the 2007 tariff quota were lowered from 40% of

the customs value, but not less than Euro 0.4/kg, to 30%, but not less than Euro 0.3/kg (Resolution No. 17 of January 17, 2007).

Since February 23, 2007, temporary customs import duty rates were set with regard to black and green tea supplied in packages over 3 kg. The permanent customs duty rate on these goods is 5% of their customs value (Resolution No. 2 of January 18, 2007). The term of effect of the temporary customs duties was 9 months, and they triggered positive changes and helped saturate the market. Thus, in the 9 months of 2007 the physical volume of import supplies of tea in RF grew at 9.4%.

On November 10, 2007, the Government ruled to set the permanent zero import duty on black and green tea, which does not originate from Russia, and some kinds of unprocessed skin. The latter measure is aimed at ensuring the domestic producers would have enough of stock of raw material to keep the leather production on the rise.

As well, the Government passed its Resolution on setting the temporary zero rate of import customs duties on individual kinds of nuts and seeds for the term of 9 months since February 26, 2007, including such products as shelled cashew, almond, hazelnut, and sesame seeds. The previously applied rate was 5% of the customs value (Government Resolution No. 41 of January 23, 2007). With its Resolution No. 756 of November 6, 2007, the RF Government introduced permanent zero customs import duty rates on the following kinds of nuts and seeds: shelled cashew, shelled and unshelled almond, shelled huzelnuts, and sesame seeds.

Also, the seasonal duty was introduced on imported rice and rice products – it totaled Euro 0.12/kg between March 13 and May 31, 2007 and between October 1 and December 31, 2007. The regular rate is Euro 0.07/kg (Resolution No. 85 of February 8, 2007).

Since July 26, 2007, a nine-month temporary import customs duty rate was set on some kinds of new agricultural combine harvesters. It amounted to 5% of their customs value. The permanent rate is 5% of the customs value, but not less than Euro 100 per kWatt of their engine capacity (Resolution No. 393 of June 20, 2007).

As well, the Government set zero temporary import customs duty rate on corrosion-resistant sheet steel rolled items that contain nickel. The duty was to be effective for 9 months beginning August 3, 2007. The earlier set permanent duty was 5% of the customs value of the said goods (Resolution No. 416 of June 29, 2007).

Temporary customs import duty rates were introduced on individual kinds of tropical oil for the term of 9 months, beginning September 12, 2007. Zero rate was introduced on technical or industrial-use oil, while the 5% rate was set on oil packed in boxes, canisters, barrels with the net weight of up to 200kg. The previous rates were 5 and 15% of the customs value of the said goods, but not less than Euro 12/kg. (Resolution No. 435 of July 9, 2007).

Vessels registered with the Russian International Ship Register became exempt from the import customs duty since July 26, 2007 (Resolution No. 448 of July 16, 2007).

Temporary customs import duty rates on individual kinds of rolled goods of aluminum alloys amounting to 10% of their customs value became effective as of September 16, 2007 (Resolution No. 506 of August 11, 2007).

Since September 16, 2007, the unalloyed aluminum became subject to zero customs import duty rate effective for 9 months, while this rate had earlier accounted for 10% of the customs value of such goods (Resolution No. 507 of August 11, 2007).

Since October 16, 2007, civil aircraft became subject to temporary customs import duty rates: the aircraft with the weight up to 20 t. and the number of seats up to 19 are subject to

the rate of 10% of their customs value, while other aircraft with the weight over 15 t are subject to the duty rate of 20%. The previously applied rate was 20% of the customs value of aircraft (Resolution No. 508 of August 11, 2007).

Individual kinds of garments from natural fur are subject to a temporary customs import duty rate. The rate is 10% of their customs value but not less than Euro 30/pc and it became effective as of September 18, 2007. Children's apparel from lambskin, rabbit or hare fur is subject to the 7.5% rate (of their customs value), but not less than Euro 10/pc. The permanent duty rate on these kinds of apparel had was 20% of their customs value, but not less than Euro 30/pc and 15% of their customs value, but not less than Euro 10/pc., respectively (Resolution No. 518 of August 15, 2007).

In the period between October 28, 2007 and July 27, 2008, the temporary customs import duty rate on module construction structures for medical purposes is in effect. The rate accounts for 5% of their customs value, while module construction structures for other purposes are still subject to the previous, 20%, duty rate (Government Resolution No. 532 of August 23, 2007).

The RF Government approved zero temporary import customs duty rate on digital cameras for the period between October 7, 2007 and July 6, 2008. The previous rate was 5% of their customs value (Government Resolution No. 552 of September 3, 2007).

The RF Government introduced a temporary customs import duty rate for the term of 9 months on videogames with the use of TV-receiver, effective as of October 11, 2007. The temporary rate is 10% of their customs value, while the earlier set permanent rate was 20% (Government Resolution No. 564 of September 7, 2007).

The temporary customs import duty rates that equal 10% of the customs value of the respective goods were set on hydride-nickel, lithium-ion and other electric accumulators, other parts for telephone units and digital integral monolith electronics. The rates were introduced for the term of 9 months, effective since mid-October 2007. The earlier set permanent rates on these goods were 5, 10, and 10% of their customs value, accordingly (Government Resolution No. 582 of September 11, 2007).

With its Resolution No. 674 of October 15, 2007, the RF Government lowered import duties on dairy products – from 15 to 5% of their customs value. The rate is effective for 6 months.

This change concerns milk, butter, and cottage cheese, while regular cheese, which, depending on the sort, to which differentiated rates (Euro 0.65–0.7/kg) had been applied, has become subject to a uniform rate of Euro 0.3/kg.

The world has presently faced shortages of dairy raw materials, which were fueled by a considerable growth in consumption of dairy products, which resulted in the price rise for them. And if it was not enough, the situation was aggravated by an intense drought in the producer countries and the price rise for feeders. Challenged by a drastic shortage of raw materials on the market and rising prices for powder milk, Russian producers had to raise their prices in order to compensate for their losses.

This has recently become a common trend on the market, and the noted cuts in duty rates will to some extent help bridge the gap between the domestic and international prices, rather than reverse the general trend to price rise for dairy products.

### 3.4.7. Accession to WTO

Russia has presently found itself at the final stage of negotiations on its accession to WTO. In 2007, there took place a series of multilateral consultations on agriculture and application of sanitary and phytosanitary measures, and several rounds of talks on systemic issues.

The country signed protocols on completion of bilateral negotiations on accession to Russia's market of goods with El Salvador, Costa Rica, Guatemala, Vietnam and Cambodia. So, Russia has successfully completed bilateral talks with 58 out of 60 members of the Task Force on Russia's accession to WTO.

As noted above, the talks are held both in the multilateral and bilateral formats. The country has to deal with multiple counterparts to negotiate two major issues: namely, duties on export of round timber and a maximal permissible degree of support of its agricultural sector. The most problematic remains the issue of subsidies to the agrarian sector. Plus, there has been no notable progress so far at the negotiations with EU on export duties on timber. As a reminder, the Russian party's fundamental stance is a limited access to Russian subsoil resources for foreign companies and the bolstering of the domestic wood-working sector, and the Russians will unlikely to compromise on these issues.

Bilateral meetings, too, engender problems. For instance, Saudi Arabia and the UAE are keen to get access to Russia's strategic oil and gas fields, while Georgia frowns at Russian customs posts in Abkhazia.

Meanwhile, Russia and Saudi Arabia are close to concrete agreements on goods in the frame of the process of Russia's accession to WTO, but so far as services are concerned, the negotiations are in full swing, for the Saudi insist on Russia's undertaking obligations on granting them access to its natural resources.

The negotiations with the UAE have progress farther than those with the Saudi, as their requirements are far narrower, and the parties have practically agreed on the services sector. However, the Russian received a new inquiry regarding the trade regime with regard to the following goods: aluminum, porcelain, ceramics, bricks, among others.

At a meeting with the Georgian delegation in Geneva on February 20, 2008, the parties have agreed on joint approaches to the Georgian' party's requests, particularly in respect to the border control checkpoints and control over the bilateral trade. The experts continue to seek conciliation on the remaining individual issues and are getting ready for the next round due in late March through early April 2008.

The RF Government forecasts possible timelines of completion of all the talks with much caution, as there may soon arise new participants and new issues. Once Ukraine joins WTO in 2008, it is most likely to set additional barriers for Russia. Once granted a legitimate membership in WTO, Ukraine will enjoy the right to immediately enter the Task Force on Russia's accession to WTO and to announce its intention to launch bilateral talks with Russia on accession to markets for goods and services, as well as on systemic issues, including pricing, customs procedures, protectionist measures in trade, etc.

Despite various statements on inappropriateness of such negotiations, one should proceed from the assumption that the Ukrainian party can put forward quite stringent requirements in respect to a broad array of problems associated with the bilateral trade and economic relations. Suffice it to say, presently Ukraine finds itself among the group of Russia's leading trade partners that raise the biggest number of trade disputes and effective restrictions. The Ukrainians, for their part, estimate the imbalance in the bilateral trade with Russia to make up

a. USD 6bn, and they claim that their losses from Russia's protectionist measures make up USD 3bn (Ukraine's 2007 export accounted for some USD 50 bn).

Ukraine has already declared its eagerness to resume talks on the problematic bilateral Free Trade Agreement (which had been signed in 1993, but since then never promulgated), numerous provisions of which the Russian party conceives of as unacceptable. Hence it is hard to foretell timelines and results of the bilateral negotiations.

It is worthwhile to note yet another critical aspect related to Ukraine's very liberal obligations in the area of access to the markets for goods and services: specifically, its average weighed import tariff on industrial goods will be under 5%, and that on agricultural products – 10.7%. In the services sector, the country has assumed obligations on opening practically all the sectors to overseas suppliers. The volume of the annual support to the national agriculture in the frame of the "yellow" basket was fixed at the minimal permissible level, that is, 5% of the sector's gross output plus an additional amount of USD 613m.

As concerns the Task Force, its Report contains fundamentally new obligations that go far beyond the WTO's requirements and rules, including export duties, protection of intellectual property rights, public trade corporations' operations, etc.

So, Ukraine's joining WTO sets an unfavorable for Russia precedent that shapes *de-facto* new standards of membership in the Organization basing on the "WTO+" provisions, which are expected to affect Russia's future rights and obligations as a WTO member.

The negotiations on Russia's accession to WTO have already been in progress for more than 13 years. Russian producers' concern has been that once Russia joins WTO, imports would supplant domestic goods from the national market. But import duties will be cut down just by 3% on average. Speaking of particular kinds of goods, the duties on industrial products will be cut from 11 down to 7.5% and those on agricultural products – from 22 to 18%, while import duties on the basic products, such as grain, meat, and milk, will remain unchanged. There are of course products the import duty on which will be cut back by more than 3%, but this implies a long transitional period. For instance, import duties on automobiles will be cut down from 20% to 15%, but only in seven years after Russia joins WTO. In such sectors as pharmaceuticals, footwear or textiles, cuts in the respective import duties on finished products will be synchronized with cuts in import duties on technological equipment used by these sectors, as well as on raw materials Russian producers are short of (for instance, some substances for the pharmaceutical sector). As for liberalization of the domestic market for services, it will be taking a fairly moderate pace. The government will be in a position to employ instruments that will help support domestic producers, and it will retain the right to introduce restrictions for foreign capital in the event of privatization of domestic corporations, while public services may remain the state monopolist's reign.

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To assess the Russian economy's prospects, it is extremely important to answer the question as to for how long, given the current trends in export and import areas, it will be able to maintain positive balance of its foreign trade.

In the medium run, export may continue to dominate over import, providing observance with a series of conditions: first, the situation on the world commodity markets, as the continuous price rise for oil, metals, chemical raw material, and timber allows one to hope for

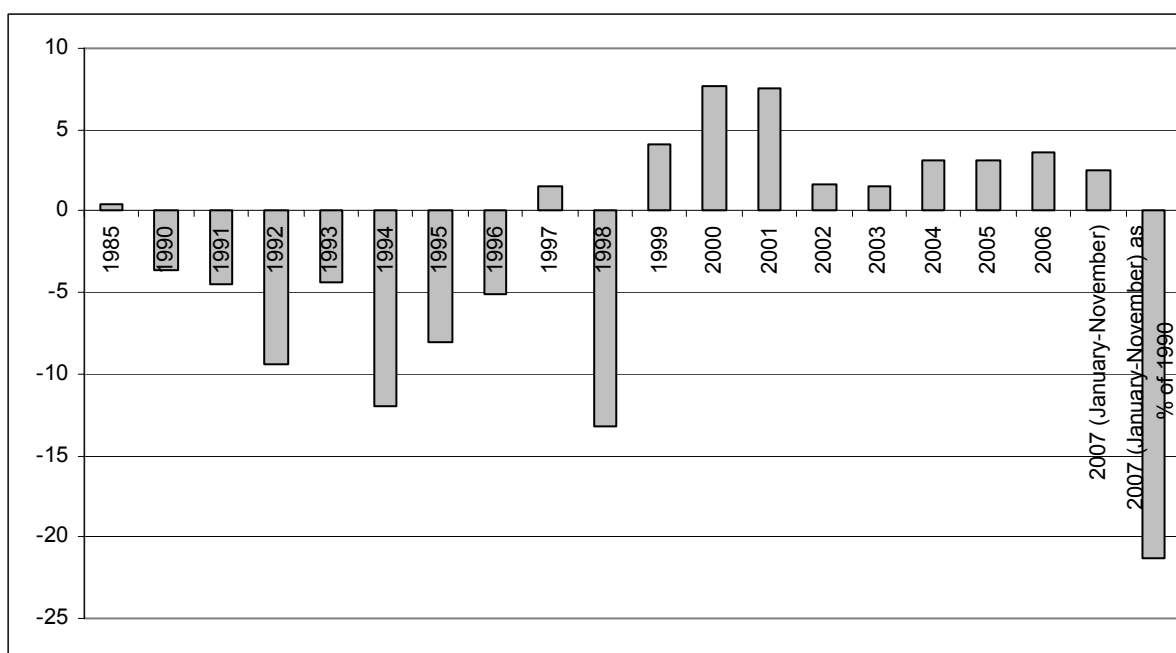
growth in the value volume of exported raw materials, regardless of the stagnation in the physical volume of export. Second, the CBR's exchange rate, which in many ways determines foreign trade flows. Third, depletion of the production and technological base the CIS countries inherited from the USSR creates preconditions for boosting supplies of the manufacturing sector's produce thereto. Finally, the process of fighting against various import schemes, primarily with regard to electronic goods, may form a cause for a slowdown in growth rates of value volume of import across these positions in 2008–2009.

### 3.5. Russian Agrifood Sector: Basic Trends in 2007

#### 3.5.1. Agricultural Performance

##### *General Outline*

In 2007 the growth of gross agricultural output (GAO) continued to slow down. Russian agriculture displays this trend throughout several recent years following the rapid recovery after the 1998 crisis (*Fig. 35*). It's far from having restored the pre-reform level. The key factors of agricultural growth in 1999–2001 wore off while new ones have not arrived on the scene despite favourable price situation during the year and state agrifood policy efforts.



Source: Federal Service of State Statistics.

*Fig. 35.* Russia: Percent Change of Annual Gross Agricultural Output in 1985–2007

Crop production still accounts for over half of the Russian farm output although its share is gradually shrinking. Agricultural growth at large is primarily driven by the upward trend in this sector (the respective indices being 107.5% in 2004, 103.7% in 2005 and 101.3% in 2006. A bigger increase is expected in 2007 – over 3%).

In addition to intra-sector factors, agricultural growth was strongly hindered by macro-economic trends. The rising prices for fuels and oils notably impaired profitability of grain production and eventually induced contraction of areas planted in grain and most other farm crops.

At the same time structural shifts are taking place that enable us to speak of positive developments in the sector. The process of producers' bifurcation is underway – some of them are actively developing, modernizing production and attracting 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.

The sector structure of agriculture is shaping as well: some sectors prove their competitive advantages on international and domestic markets while others are shrinking at a higher or lower pace. For instance, the output of sunflower seeds, vegetables and potatoes is growing and is now above the Soviet period level (*Fig. 36*).

The good grain crop in 2007 will hardly shape a long-term trend on this market and the growth is most likely to slow down: the domestic demand is constrained due to the extremely high prices while the recently acquired competitive advantages on external markets are jeopardized by the state foreign trade policies (the effective export restrictions and the possibility of total grain export ban in 2008).

Despite generally poor performance of the livestock sector, some segments therein demonstrate very high growth (*Fig. 39*). For instance, in January–November 2007 the poultry meat production and the intensive production of pork grew by more than 20%.

The situation in food industry is similar. Output of some products (e.g. vegetable oils and white sugar) has already surpassed the pre-reform level. Production of some food items has been nearly restored – e.g. sausages, pastas, margarine and some other products. Production of meat and milk products is constrained by population's purchasing power but is still growing (*Table 56*).

In January–November 2007 real personal incomes increased by 10.1%, retail food turnover – by 12.3%. It means that the overall elasticity of demand for food remains still rather high. This fact can also be one of the explanations of the speedy rise of prices for meat being one of the most income elastic products. The demand for cheese and fruits (items that are largely consumed by higher income groups) expanded at even higher rates – by 15% and 12.4% in January–September 2007, respectively. The consumption of sugar grew by 25%.

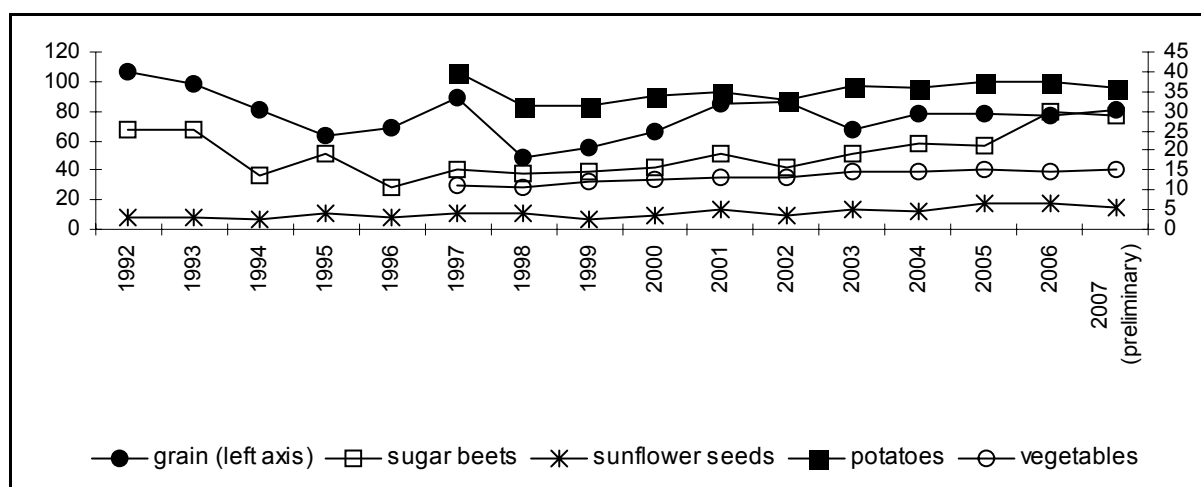
A positive development factor was a certain improvement in rural social sphere. For two years in succession wages in agriculture grew faster (by 31.6% in January–October 2007) than in mining and manufacturing (22.2 and 25.6%, respectively). Wages earned in farm production still constitute the basis of rural residents' well being. Unemployment in rural areas is largely stagnant: this was the case for 1 million (or 45.9%) out of 1.7 million rural unemployed. As compared with August 2006 stagnant rural unemployment in 2007 reduced by 9.6 percent points. The social sphere in countryside still largely lags behind that in urban areas but it's the progressive trend that is important combined with the long awaited shift of state agrarian policies towards its development.

Having transferred farm regulation competences to the regional level, the federal authorities concentrated on strategic administration of agricultural policy and revision of its elaboration procedure. The new principles of shaping farm policies (the National Project "Agrifood sector development", the Law on agricultural development and the 5-year-term

State program for supporting agriculture and regulating markets) as well as foreign trade policies will determine the sector's development in the coming years.

### *Crop Production*

Crop production in Russia is very unstable and largely depends on weather conditions. At the same time some sectors demonstrate high competitive advantages both on domestic and world markets, rapidly restore production on a new technological basis while others are gradually shrinking. The outputs of sunflower seeds, sugar beets, vegetables and potatoes in the 2000s were growing at a high rate and are now above the Soviet period indicators (*Fig. 36*). But beginning from 2006 their growth is slowing down.



Source: Federal Service of State Statistics.

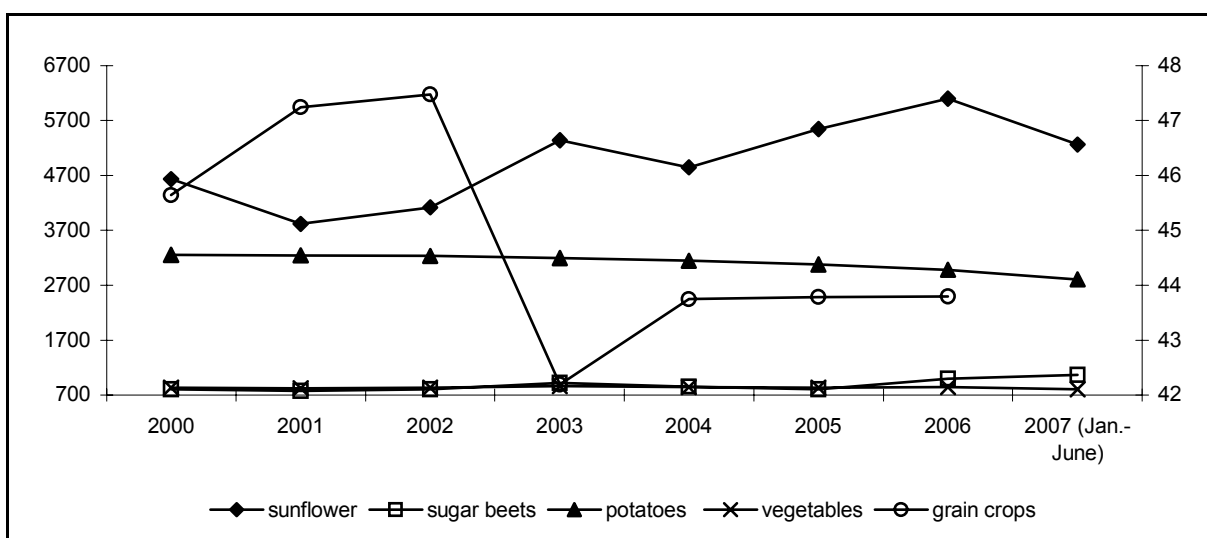
*Fig. 36. Gross Output of Basic Farm Crops, million tons*

Sunflower and grains compete for the same areas and in Russia there is quite an apparent negative correlation between their acreages (*Fig. 37*). In the last 5–6 years areas under potatoes slightly decreased while gross output of this crop steadily increases beginning from 2002. Although the most part of potatoes in the country is produced by household farms (91.4%), the share of large producers in the recent 5 years is getting larger implying expansion of intensive production in potato growing.

Grains remain the basis of Russian crop production, wheat being the dominant one. Structure of grain production varies a lot by years (*Fig. 38*) but an apparent trend is the shrinking of traditional production of rye and a certain expansion of corn production. One of the factors thereof is the situation on the world markets. The growth of demand for corn was most remarkable in the US due to the rapid development of ethanol production. The 2005 US Energy Policy Bill stipulates wider use of biological fuel (on the basis of grains) – up to 7.5 million gallons by 2012 which is twice above the 2005 level<sup>12</sup>. At the same time the domestic factor is also important – the growing interest of Russian livestock producers in corn as a fodder crop due to its much better nutrition value (as compared with wheat).

<sup>12</sup> USDA (2006). USDA Agricultural Baseline Projections to 2015. Baseline Report OCE-2006-1. USDA. Washington, D.C.

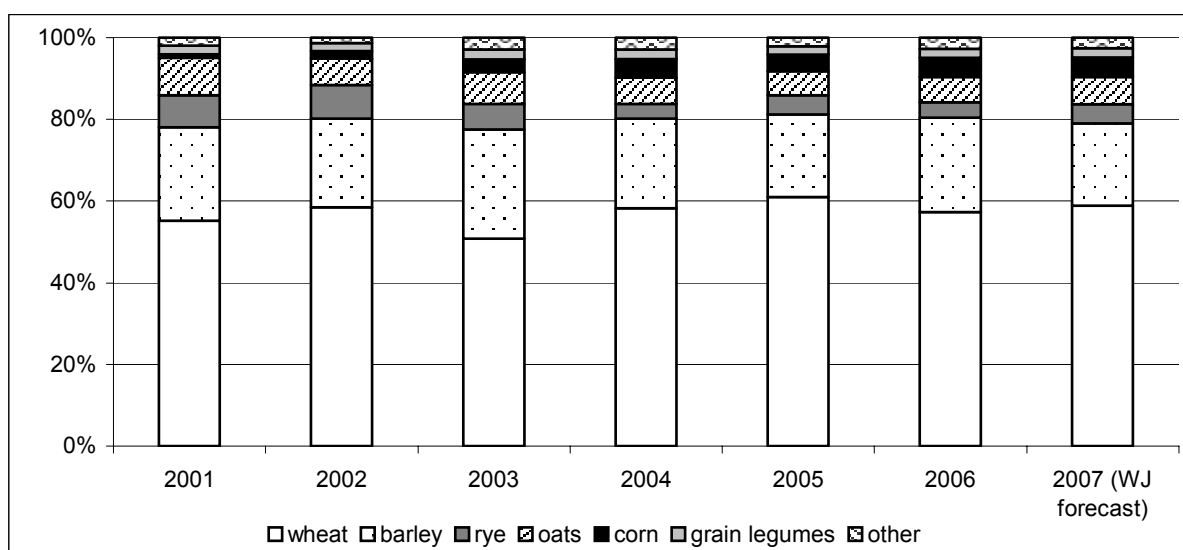




\* - Grain crops – million hectares (right axis).

Source: Federal Service of State Statistics.

Fig. 37. Areas Planted in Selected Farm Crops, thousand hectares\*

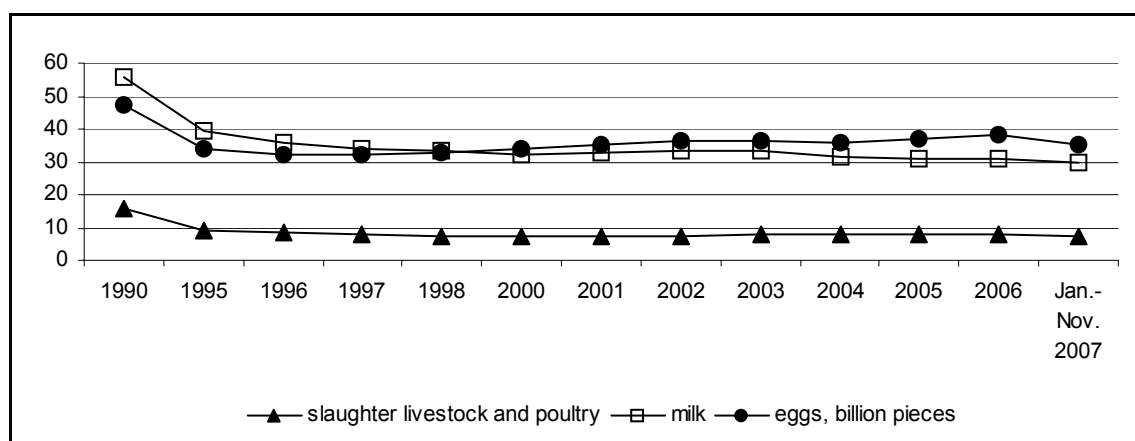


Source: Federal Service of State Statistics, WJ Interagro.

Fig. 38. Structure of Russian Grain Production: Gross Output of Selected Grain Crops as % of the total

### Livestock Production

The situation in Russian livestock production is generally worse than in crop production. Livestock inventories continue falling; the output of basic livestock products is either slightly reducing or marginally and unsteadily growing. However, efforts targeted at the accelerated development of this sector that were made in 2006–2007 resulted in some improvements (Fig. 39).



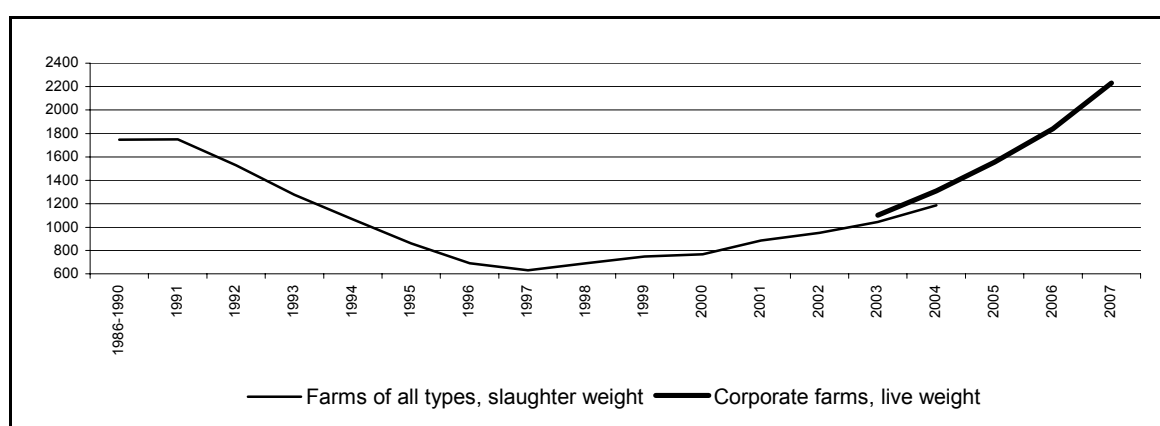
\* - Live weight.

Source: Federal Service of State Statistics.

*Fig. 39. Gross Output of Basic Livestock Products, million tons\**

Despite generally poor performance of the livestock sector, some sub-sectors therein are quite rapidly recovering. In particular, poultry meat production grew by an average 17% a year throughout the surveyed period (*Fig. 40*). Intensive feeding of hogs is growing as well; their inventories noticeably increase for the second year in succession. Thanks to the intensive feeding of poultry and hogs the total meat output in January–November 2007 was up 8.9% as compared with the same period last year (in recent years the share of households in the output of pork and in hog inventories is steadily falling meaning that production increase is provided by large farms applying intensive technologies).

The upsurge of pork production in 2006 resulted in the drop of purchase prices: they lowered by 2% (in nominal terms)<sup>13</sup> after rising by 1/3 in 2005. But despite this drop and high prices for feeds, in 2007 the pork production growth rates were higher than in 2006.



Source: Federal Service of State Statistics.

*Fig. 40. Production of Poultry Meat in Russia, thousand tons*

The country's averages of livestock productivity are steadily improving (*Table 53*); annual milk production per cow is already well above the pick figures of the Soviet period.

<sup>13</sup> RF Ministry of Agriculture.

*Table 53*

**Livestock and Poultry Productivity in Russia**

	2000	2001	2002	2003	2004	2005	2006	2007 (Jan.–Nov.)
Annual milk production per 1 cow, kg	2,343	2,553	2,808	2,979	3,070	3,292	3,105	3,498
Annual egg production per 1 laying hen, pieces	264	273	279	285	292	301	277	275

*Source:* Federal Service of State Statistics.

### 3.5.2. Financial Performance of Farm Producers

Since 1999 the financial performance of Russian agriculture is steadily improving. The share of profitable farms is growing as well as their profitability. This process was mainly determined by the after-effects of 1998 crisis. The only exception was 2002 when agriculture was affected by the sharp drop of prices received by farm producers. Besides, the sector benefited from much stronger government support and growing investments. The farm debt rescheduling campaigns also contributed to the improvement of performance indicators.

A qualitative leap in farm producers' financial performance took place in 2004: its positive balance remarkably grew and the share of profitable enterprises exceeded 50%. The number of farms having overdue debts and the size of these debts are steadily decreasing.

It's generally believed that the most important factor of better financial performance of farm producers is the implementation of farm debt rescheduling program effective since 2003. According to data of the territorial commissions on farm financial recovery by January 1, 2007 agreements on debt rescheduling were signed by 12501 agricultural producers (about 40.1% of their total number). From October 2005 the number of entities participating in the program is actually stagnant. Overall 80.8 billion rubles of participating farms' debts were restructured including 41.7 billion rubles of fines and penalties of which 29.6 billion rubles were written off. At the same time 12553 agricultural producers cannot participate in the financial recovery program: over 5 thousand enterprises go through the bankruptcy procedure, 4.2 thousand are unable to make current payments according to the rescheduling terms and the rest cannot join the program due to other reasons. Besides, 3.8 thousand agricultural producers lost the right to participate in the program having failed to meet current commitments; moreover, in almost 1 thousand enterprises rescheduling was suspended.

The process of bankrupting farm producers is rapidly intensifying: while in 2005 7,385 bankruptcy proceedings against agricultural entities were initiated, in 2006 10,051 bankruptcy cases were under examination. Together with restructuring of farm debts and favourable price situation it had a positive effect on the sector's average financial performance (*Table 54*). In 2007 the share of profitable entities in agriculture exceeded 70%. From 2000 the sector's general profitability increased three fold thus surpassing the economy's averages (13.9%), net profits – by almost 50% while overdue credit indebtedness fell by 2/3.

Apparently the improving financial performance of the sector at large is due to the increase of efficiency in the upper producer groups, their higher attractiveness for investors. Investments in fixed capital continued to grow: their amount in January–September 2007 exceeded the 2006 total. Beginning from 2002 foreign investments increase not only in food industry but also in primary agricultural production (*Fig. 41, 42*). This growth of investments in the sector proves the above formulated thesis about producer bifurcation, the shaping of efficient enterprises that apply intensive technologies and are attractive for investors.

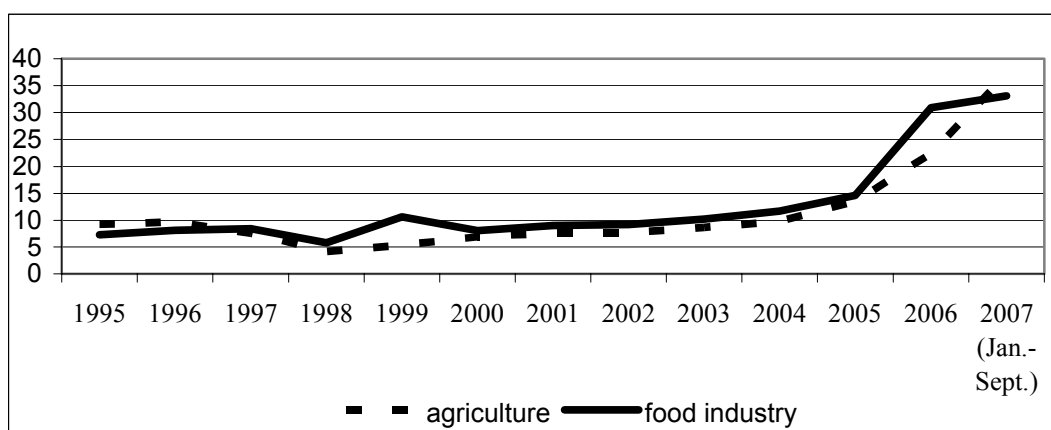
So, it would be a mistake to think that the observed improvement of agricultural producers' financial performance is entirely due to the implementation of farm financial recovery law.

*Table 54*

**Financial Performance of Agricultural Producers**

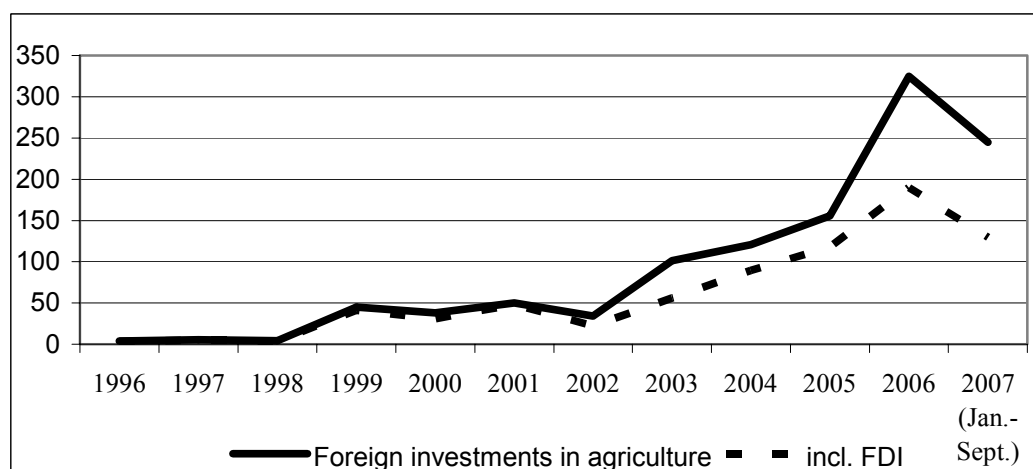
	2000	2001	2002	2003	2004	2005	2006	2007 Jan.-Sept.
Profitability of goods, works, services and assets sold, %	6.3	9.3	1	2.7	6.4	7.5	9.9	17.3
Profit less loss, billion rubles	16.1	25.6	-1	2.2	4.7	2.6	46.7	76.4
Share of profitable entities, %	47	44	42	49	2.2	9.6	67.7	70.4
Number of entities having overdue creditor indebtedness, %	23.9	23	21.8	18.9	16.5	13.3	10.3	8.1
Overdue creditor indebtedness, billion rubles	144.1	162.9	162.3	149.9	113.9	85	64.8	48.4

Source: Federal Service of State Statistics, www.gks.ru.



Source: Federal Service of State Statistics, www.gks.ru.

*Fig. 41.* Direct Investments in the Agrifood Sector, billion rubles (constant 1995 prices)



Source: Federal Service of State Statistics, www.gks.ru.

*Fig. 42.* Foreign Investments in Russian Agriculture, million US dollars

### 3.5.3. Production of Agricultural Inputs

Farm machine building follows the trend of agriculture – after a short upsurge in the early 2000s its growth is slowing down (*Table 55*). Still, producers of grain harvesters managed to enlarge export supplies 5 fold as compared with 2000 thus supporting the upward trend in the sector. Exports of tractors remain insignificant and therefore shrinking domestic demand results in their smaller production. Currently annual domestic production of farm machinery amounts to about 1 billion dollars. Imports total about 2/3 of this amount, exports – 10–12%<sup>14</sup>.

*Table 55*

**Production of Selected Farm Inputs, thousand pieces**

	1990	1995	2000	2001	2002	2003	2004	2005	2006	I-X 2007 as % of I-X 2006
Tractors	214	21.2	19.2	14.2	9.2	8.1	8.7	5.5	5.5	124.2
Tractor ploughs	85.7	4	2.8	3.1	2.3	1	1.2	1.8	1.1	128.7
Tractor seeders	51.1	1.6	5.2	6.4	5.3	4.2	5.7	6.5	5.2	131.6
Tractor cultivators	101	2	4.7	5.6	5.6	6.2	6.7	8.6	6	126.9
Grain harvesters	65.7	6.2	5.2	9.1	7.5	5.4	7.9	7.5	6.9	95.5
Mineral fertilizers, million tons	16.0	9.6	12.2	13.0	13.6	14.1	15.7	16.6	16.2	104.9

*Source:* Federal Service of State Statistics.

Production of mineral fertilizers is still export-oriented while domestic consumption grows at a low rate.

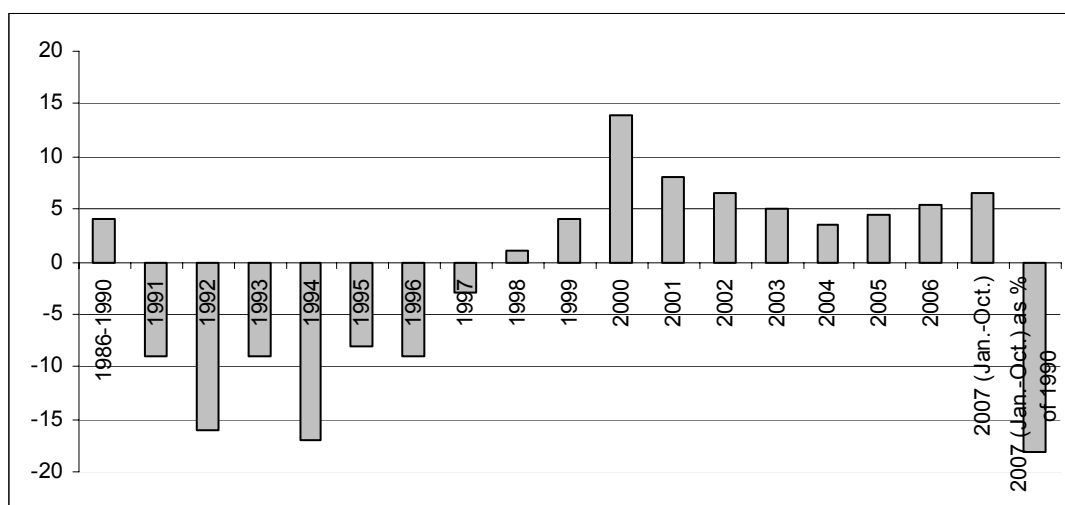
### 3.5.4. Food Industry

In the Russian food industry production grows at noticeably higher rates as compared with agriculture but here too the growth is slowing down versus 1999–2001 indicators (*Fig. 43*).

Similar to agriculture food industry displays very different dynamics by sub-sectors. Production of some food products, e.g. vegetable oils and sugar, has already exceeded the Soviet period indicators. Pre-reform production levels of some other products, e.g. sausages, pastas and margarine are nearly restored (*Table 56*). Growth in the milk and meat sub-sectors is strongly constrained by income trends in the lower income groups but is still continuing at a rather high pace.

The demand for food products grows faster than average real incomes. The demand for fruits and cheese (i.e. very income-elastic products) expands at the highest rate – in recent years their sales increase by over 10% annually. Sales of poultry meat also grow fast – faster than the overall meat sales implying change in the structure of meat consumption.

<sup>14</sup> Data of “Soyuzagromach”.



Source: Federal Service of State Statistics.

Fig. 43. Russian Food Industry: Percent Change of Annual Output

Table 56

**Production of basic food products, thousand tons**

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	I-X 2007 as % of I-X 2006
Meat	6,484	2,370	1,900	1,510	1,315	1,113	1,193	1,284	1,456	1,677	1,698	1,827	2,100	120.9
Sausages	2,283	1,293	1,296	1,147	1,087	948	1,052	1,224	1,468	1,700	1,832	1,957	2,100	106.0
Butter	833	421	323	292	276	262	267	271	279	285	271	277	274	102.1
Dairy products*, million tons	20.8	5.6	5.3	5.2	5.6	5.6	6.2	6.7	7.7	8.5	8.7	9.5	10.0	100.8
Vegetable oils	1,159	802	879	687	782	881	1,375	1,281	1,197	1,598	1,867	2,206	2,600	99.1
Granulated sugar	3,758	3,155	3,294	3,778	4,745	6,808	6,077	6,590	6,165	5,841	4,852	5,588	5,800	108.9
Flour, million tons	20.7	14	11.8	12.2	12	12.7	12.1	12	10.9	11.2	10.8	10.2	10.2	96.3
Groats	2,854	1,418	988	992	1,085	899	932	994	951	890	893	926	966	103.3
Pasta	1,038	603	444	453	554	707	704	764	821	874	950	982	1,028	94.9
Margarine prod- ucts	808	198	200	222	239	379	462	515	536	542	561	630	677	112.9

\* - In liquid milk equivalent.

Source: Federal Service of State Statistics.

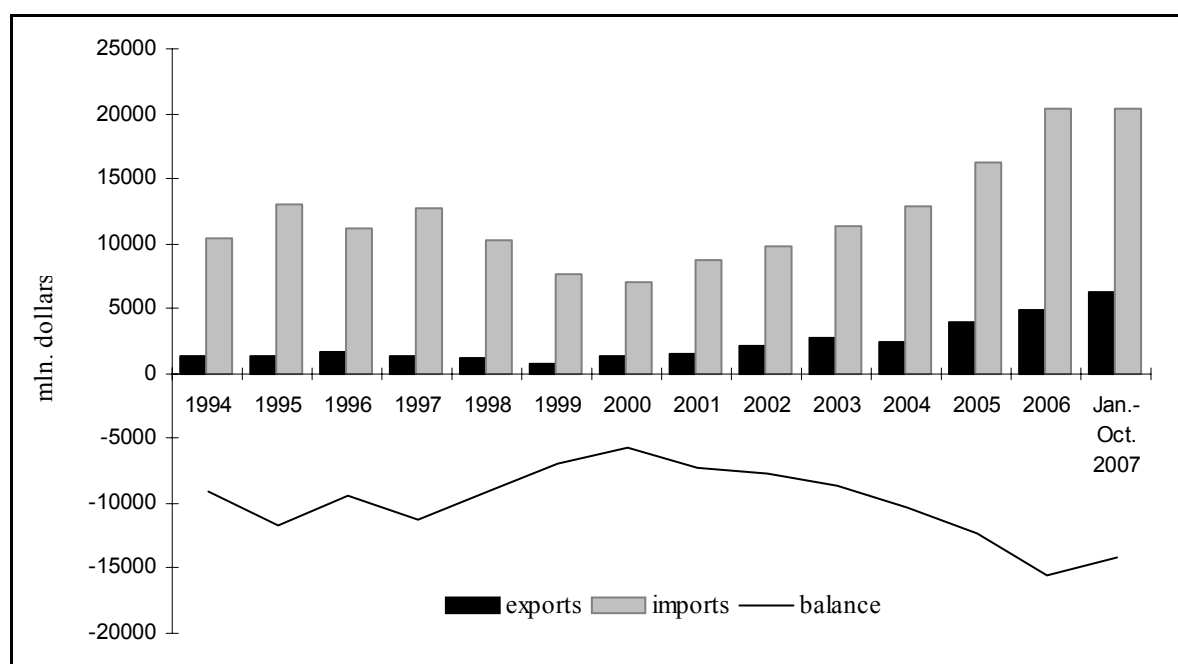
**3.5.5. Foreign Trade in Agricultural and Food Products:  
Trends and Policies**

In recent years the volume of foreign trade in agricultural and food products is steadily growing and 2007 is not an exception. This growth is due to the expansion of both imports and exports (Fig. 44). It's noteworthy that exports grow faster.

While in the first after-crisis years the enlargement of export supplies was primarily due to the ruble devaluation, at present the trend is supported by the strengthening of domestic agriculture's position on the world markets of some products. Imports continue to increase due

to the sustained growth of consumer demand in the situation of slowing down progress in the domestic agrifood sector.

Russia still retains its status of traditional net importer of agricultural and food commodities. The negative trend in the dynamics of agrifood foreign trade deficit that took a start in 2000 still continues (*Fig. 44*). In January–October 2007 the negative balance of trade in respective items exceeded 14 billion rubles.



\*- Less trade with Belarus.

Source: calculated using data of RF Federal Customs Service.

*Fig. 44.* Foreign Trade in Agricultural and Food Products, million dollars\*

The recovery growth that started in the domestic agrifood sector in 1999 revealed the basic segments where Russia has competitive advantages on external and home markets. This had an obvious impact on the commodity structure of foreign trade.

Grains became the principal item of Russian export having surpassed such a traditional item as fish and sea products. In 2007 wheat accounted for 42% of the total food exports. As compared with January–October 2006 the volume of food exports increased by 46.7%, their value – by 91.5%. The volume of export supplies of wheat grew by 59.6%, of barley – by 68.4%, of poultry meat – by 11.5%. Rye has also become an export item – the volume of its export is up from 29 tons in January–October 2006 to 85,813 tons in January–October 2007. At the same time exports of milk fell by 30.8%, of fresh and frozen fish – by 24%. The share of oilseeds in the food export structure remains small while that of sunflower oil increases.

The commodity structure of import has also changed in recent years. After the introduction of meat quotas in 2003 imports of meat (except beef) fell but already in 2005–2006 started to restore. It's noteworthy that import supplies of meat exceed the set quotas. Meat still remains the principal item of Russian agrifood import accounting for 20% thereof (*Table 57*).

Dynamics of sugar imports were also influenced by the government foreign trade policy. Despite its bottlenecks the mechanism of variable import duty on raw sugar enforced in 2003

resulted in smaller supplies from abroad (*Table 57*) thus encouraging rapid development of domestic sugar beet production. The trend became most apparent in 2006.

*Table 57*

**Imports of Basic Agricultural and Food Products in 2000–2007, thousand tons\***

	2000	2001	2002	2003	2004	2005	2006	I–X 2007
Beef	282.3	459.2	504.6	507.8	510.9	696.2	1,411.0**	1,096.30**
Pork	212.9	369.6	602.0	535.2	455.2	562.9		
Poultry meat	687.2	1,383.3	1,375.2	1,190.0	1,101.3	1,318.5	1,282.4	1,034.10
Condensed milk and cream	48.0	85.4	11.8	26.5	35.9	35.5	145.3	5.3
Butter	45.4	81.4	94.1	114.0	70.3	66.0	164.8	62.3
Sunflower oil	149.5	182.8	175.7	200.8	160.4	131.2	100.0	112.5
Wheat and wheat/rye mix	2,631.3	916.2	264.8	640.7	1,364.1	577.1	1,397.5	440.9
Corn	702.2	206.8	448.9	209.5	448.8	200.6	295.5	88.1
Meat products and canned meat	20.6	25.1	19.2	24.7	34.3	33.7	34.8	25.5
Raw sugar	4,546.6	5,410.4	4,441.0	4,112.0	2,582.9	2,892.9	2,632.7	2,703.50
White sugar	271.4	143.1	163.2	151.1	200.1	144.9	349.7	104.4
Citrus fruits	472.2	562.1	701.3	781.1	858.4	952.6	1,187.4	865.5
Coffee	20.3	21.6	25.7	32.0	29.4	39.7	55.3	54.5
Tea	158.3	154.4	165.3	168.9	172.1	179.6	172.9	151.2

\* - Less trade with Belarus.

\*\* - Meat fresh and frozen less poultry meat.

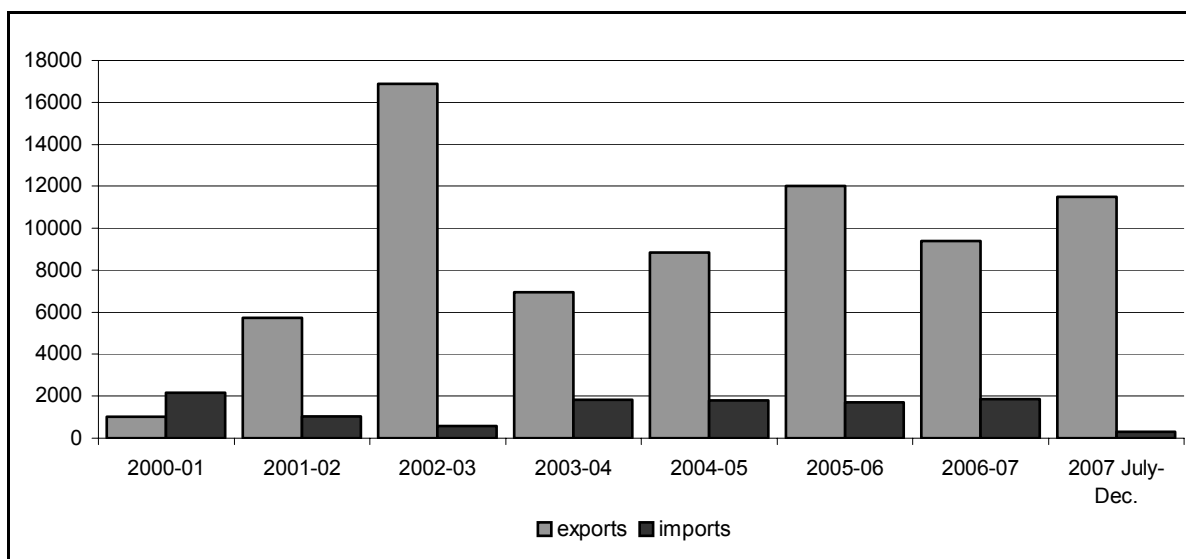
Source: RF Federal Customs Service.

In January–October 2007 imports of fresh and frozen meat from the non-CIS countries grew by 8% as compared with January–October 2006: purchases of beef were up 10.7%, of pork – 6.7%. Imports of fresh and frozen fish grew by 26.0%, of condensed milk – by 30.3%, cheese – by 5.1%, citrus fruits – by 5.5%, coffee – by 26.5%, tea – by 7.3%, barley – by 87.7%, raw sugar – by 21.9%.

*Stability of Russia's Grain Exporter Status Jeopardized by Government Policies*

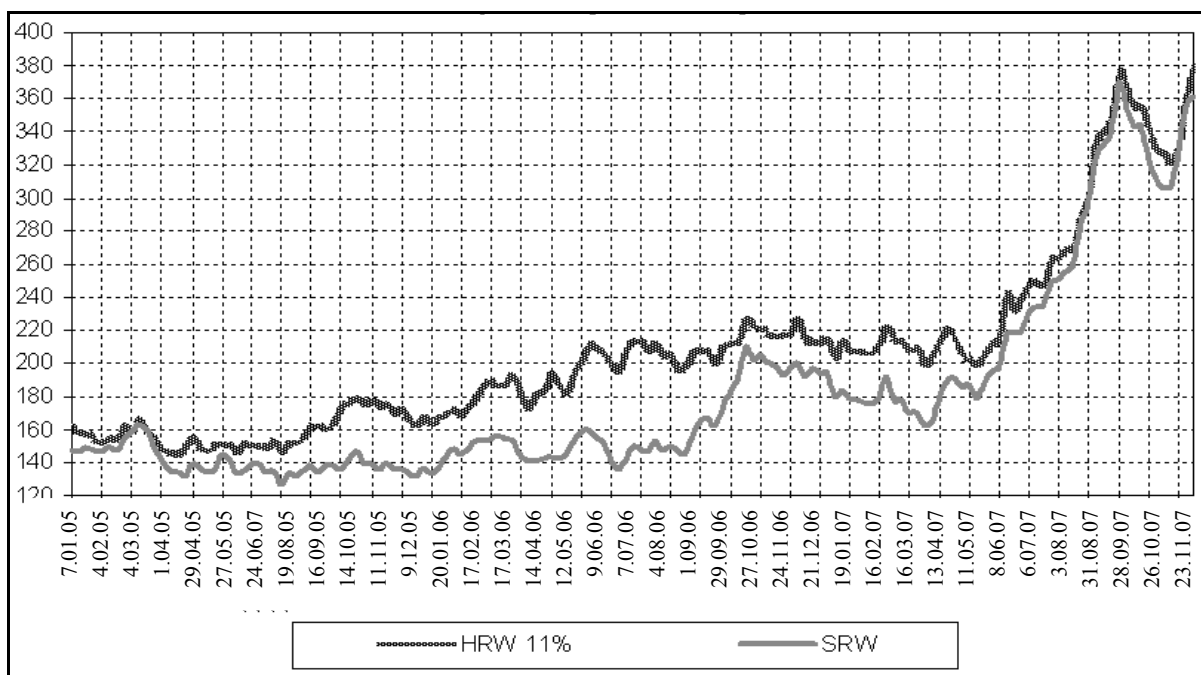
All pessimistic forecasts saying that Russia has traditionally been an importer of grain, has no export infrastructure and therefore cannot export more than 5 million tons of grain a year have been disproved by massive export shipments that started in 2002 (*Fig. 45*). They were encouraged by low prices on the domestic market and high prices on the world market. Having appraised the benefits of grain export, private business started to make large-scale investments in the construction of respective port facilities. The government also allocated funds from the federal budget for partial subsidizing of interest on long-term credits for construction of port elevators. Now it's obvious that Russia becomes a stable exporter of grain. It occupied its niche on the world market exporting annually from 5 to 10 million tons depending on the domestic market situation. In 2007 good crop and favourable world market situation (*Fig. 46*) conditioned growth of grain exports: in September 2007 they were 69% above the September 2006 indicators.





Source: WJ InterAgro.

Fig. 45. Exports of Grain from Russia, thousand tons



SRW – soft red winter wheat.

HRW 11.0 – hard red winter wheat, protein content 11% (moisture 12%).

Source: WJ InterAgro.

Fig. 46. Prices for US Wheat, \$/ton FOB Gulf

Export is not always encouraged by government policies. In 2004 Russian grain exports fell notably due not only to the poor 2003 crop but also to the introduction of temporary restrictions on export of rye, wheat and their mix. Grain interventions carried out in the country affect exporters' interests as well: they are supposed to raise domestic prices thus making ex-

port less profitable. In 2006 terms for Russian grain export deteriorated due to the rise of tariffs for transportation and port services. In 2007 railway tariffs were lifted once more.

The upsurge of grain prices on the world markets in the second half of 2007 (*Fig. 46*) had a serious effect on the situation on domestic market of grain where prices were also high. High domestic prices for grain mean high cost of purchased inputs for livestock production. Besides, the rise of prices for grain gave grounds to blame farm producers for higher prices for food. In order to support domestic livestock production and to prevent further rise of prices for bread and bakery products the RF government has taken a decision to restrict export of grain and to carry out commodity interventions on the grain market (Resolution No. 660 of October 10, 2007).

From November 2007 to April 2008 the main food export items will be subject to export duties that are in fact prohibitive: wheat and wheat-rye mix – 10% but not less than 0.022 EUR per kg, barley – 30% but not less than 0.07 EUR per kg. Besides, Resolution No. 877 of December 15, 2007 allowed to impose bans on export of grain. Such policy tools may be destructive for the position just acquired by Russian exporters on the world market. It's fraught with the loss of market niche and counterparts' confidence (grain is exported under long-term contracts) as well as with the general destabilization that can have negative effects on domestic market including reduction of areas planted in 2008 (*Table 58*).

*Table 58*

**Position of Russia in the World Grain Trade**

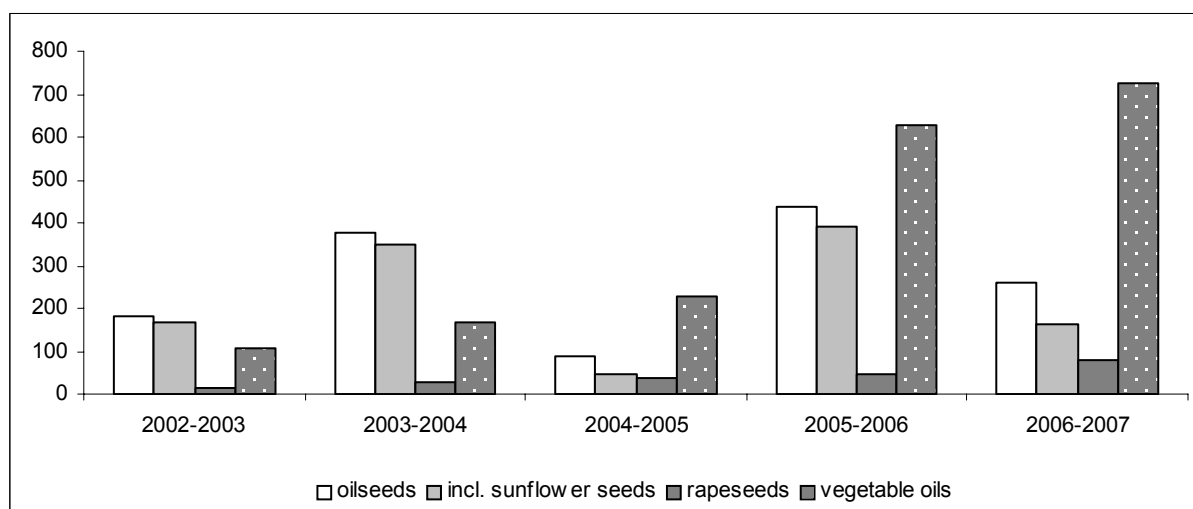
	2003/2004	2004/2005	2005/2006	2006/2007	2007/2008 (till December)
Share of Russia in the world grain exports, %	3	7	9	9	11
Place of Russia in the world grain exports	7	6	5	6	3

Source: www.usda.gov.

*Growing Exports of Oilseeds*

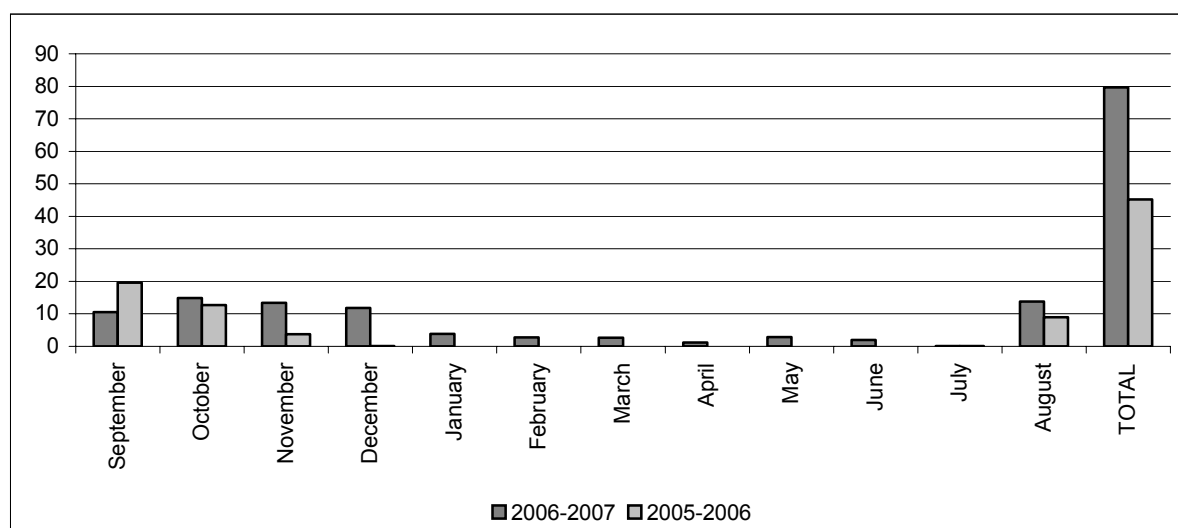
In recent years export shipments of sunflower oil are growing (*Fig. 47*). This trend originated in 2000 and was conditioned by expansion of processing facilities and larger domestic output of vegetable oils. As a result in 2005 Russia became a net exporter of sunflower oil while preserving its status of net exporter of sunflower seeds. However, in 2007 exports of sunflower seeds decreased.

In 2007 export of rapeseeds followed the upward trend that originated in 2006 (*Fig. 48*): in 2006/2007 MY its volume increased by 76% as compared with the previous year. In recent years the world market of this crop is intensely developing due to the expanding manufacturing of biological fuel out of it. Besides, the State program for agrifood sector development adopted in 2007 includes the program of supporting rapeseed production.



Source: WJ InterAgro.

Fig. 47. Exports of Oilseeds and Vegetable Oils from Russia, thousand tons



Source: WJ InterAgro.

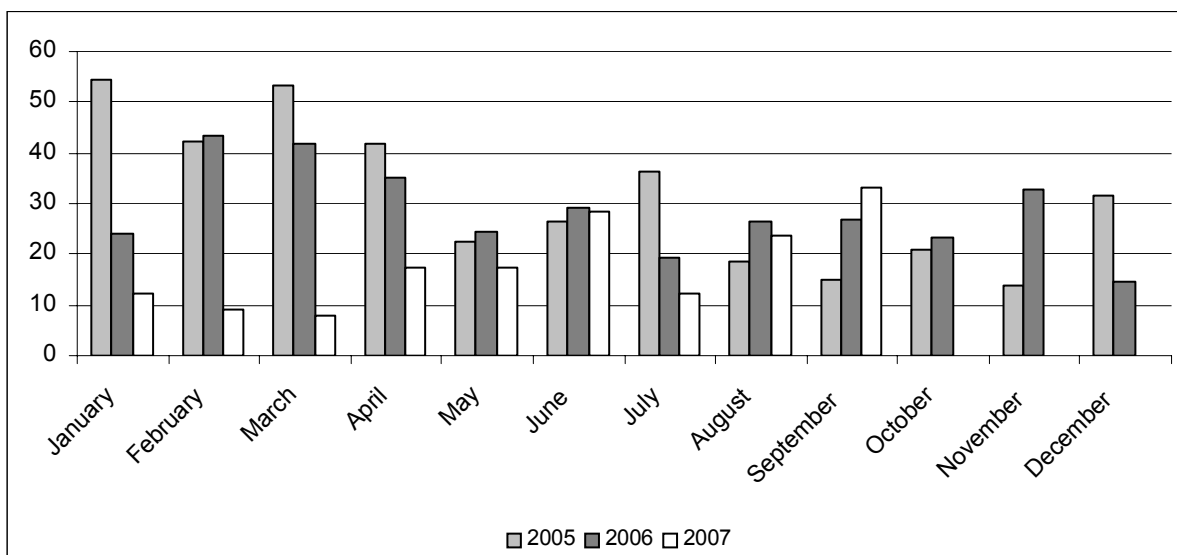
Fig. 48. Exports of Rapeseeds from Russia in 2005/2006 and 2006/2007 MY, thousand tons

#### Regulation of Rice Import: Outcomes for Consumers

In January 2006 the import duty on rice was raised from 10% but not less than 0.03 EUR per kg to 0.07 EUR per kg. This measure resulted in some curtailment of imports and an upsurge of domestic prices beginning from 2006 (Fig. 49, 50). In December 2006 import of rice to Russia was banned completely entailing one more price leap (Fig. 50). From abolition of the ban till May 31, 2007 and from October 1 to December 31, 2007 seasonal duty of 0.12 EUR per kg was levied. Fig. 50 shows that introduction of the duties resulted in upsurges of price for rice.

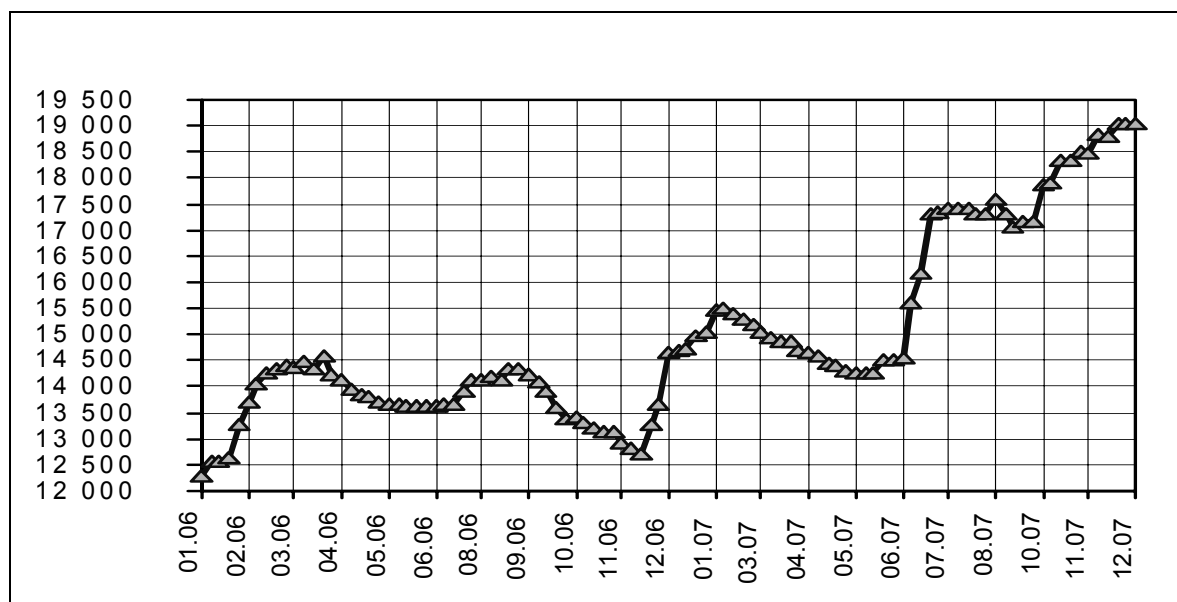
Historically rice is grown in few regions of the country (primarily in Krasnodar kray) unable to meet market demand in full. Some quantities of rice have always been imported

from abroad but they have never been large enough to depress domestic production of this crop. So, state foreign trade policies caused losses for consumers while giving no considerable advantages to producers.



Source: WJ InterAgro.

Fig. 49. Imports of Rice to Russia, thousand tons



Source: WJ InterAgro.

Fig. 50. Average Prices for Rice No.1, rubles per ton EXW

*Changes in Regulation of Foreign Trade in Sugar*

In 2007 the rapid growth observed in sugar beet production since 2003 continued. It started after the revision of sugar trade regime: in 2003 a new regime of regulating foreign trade in sugar was adopted envisaging introduction of variable import duty. Variable duty is bound to the difference between price at the New York Board of Trade and the domestic support price. This regime resulted in larger acreage under and bigger outputs of sugar beets; besides, the share of beet sugar in the total domestic sugar output increased noticeably (from 26% in 2002 to 53% in 2007 – see *Fig. 52*) surpassing the pre-reform level. According to our estimates the rate of white sugar support grew from 29% in 2001 to 49% in 2004 (percent equivalent of producer support estimate – PSE). Yields of sugar beets were growing for seven years running; in 2006 the indicator was up almost 40% and averaged 298 metric centners per hectare. In 2007 it fell to 270 centners per hectare but the productivity in the sector remains still high.

In 2007 the upsurge of prices observed on the world market in 2006 gave place to their fall down to the 2005 level (*Fig. 51*) that is still rather high. In January–June 2007 exchange prices for raw sugar were well below the corresponding 2006 indicators. In the first half of the year they fluctuated in the interval determining the custom duty of 140 dollars per ton. According to data of the state customs statistics, imports of raw sugar in January–June 2007 grew by 20.8% as compared with the same period of 2006. However, so far larger imports have not become an obstacle for the expansion of domestic production of sugar beets.

Notwithstanding, the customs regime has been changed. In October the government adopted rates of seasonal duties on raw cane sugar<sup>15</sup>. Instead of the current 140 dollars per ton, from December 1, 2007 to May 31, 2008 the rate of import duty will range from 220 to 270 dollars per ton depending on the prices at NYBOT (*Table 59*). So, given the current world prices it will rise by almost 60%. Besides, the market expects further growth of prices since Brazil (the origin of 79% of Russian raw sugar imports in 2007) announced that more raw sugar would be used for domestic purposes, e.g. production of bio-fuel. All this can entail higher prices for sugar already at the beginning of 2008. At the same time market situation for domestic sugar beet production will remain favourable.

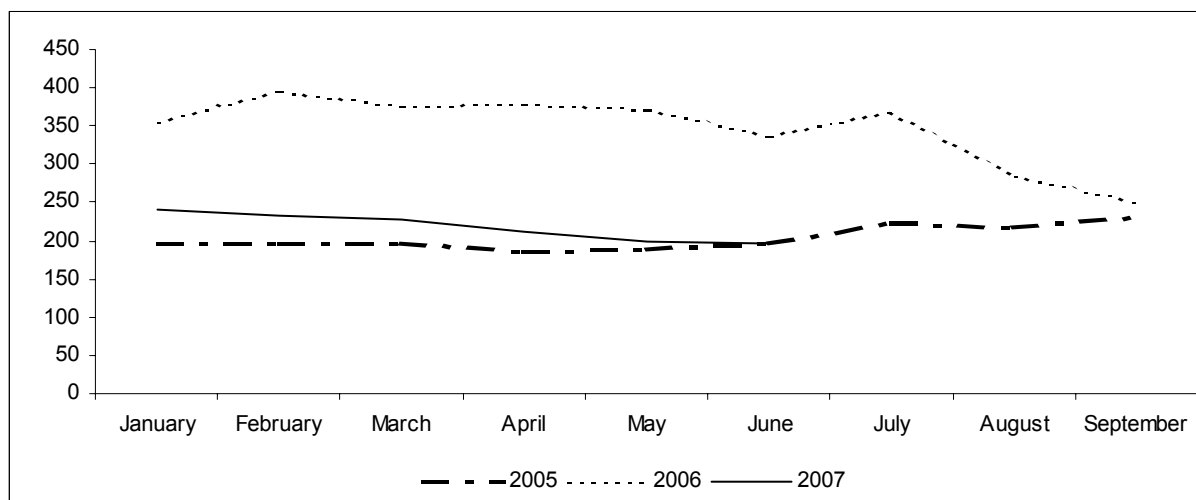
*Table 59*

**Seasonal Import Duties on Raw Sugar**

Average monthly price (p) at the New York Board of Trade (Contract 11), dollars per ton	Rate of custom duty till December 2007, dollars per ton	Rate of custom duty from December 1, 2007 to May 31, 2008, dollars per ton
p >= 198.43	140	220
182.99 <= p <= 198.42	164	235
99.22 <= p <= 198.42	from 180 to 250	250
p <= 99.22	270	270

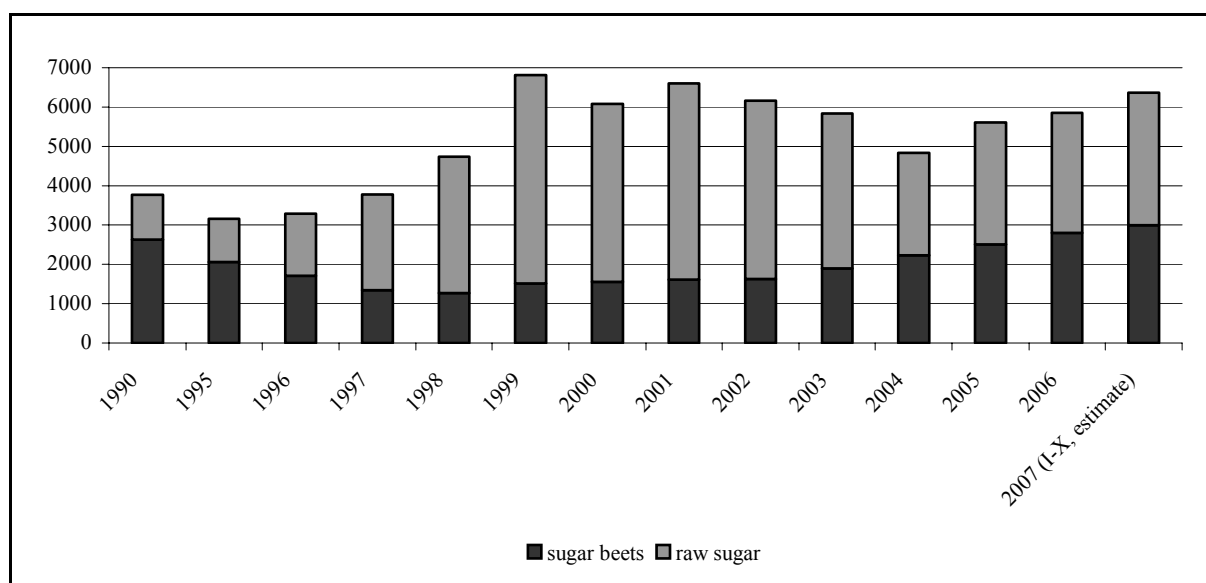
*Source:* www.rg.ru.

<sup>15</sup> RF Government Resolution No. 671 of October 12, 2007.



Source: www.mcx.ru, www.economy.gov.ru.

Fig. 51. Prices for Raw Sugar at the New York Board of Trade (Contract 11), dollars per ton



Source: Federal Service of State Statistics.

Fig. 52. Production of White Sugar out of Sugar Beets and Raw Sugar, thousand tons

### Meat Market Regulation and Domestic Prices for Meat

In the first half of 2007 imports of red meat grew by 19% as compared with the corresponding period last year due to much larger deliveries of beef from Brazil. On the contrary, imports of meat from the CIS countries reduced as a result of curtailed supplies from Belarus. Imports of poultry meat fell by nearly 48 thousand tons or by approximately 5%.

Beginning from spring 2003 import quotas on meat are applied: the absolute quota on poultry (from 2006 – tariff quota) and tariff quotas on beef and pork (Table 60). However, their introduction has not curbed import of meat products to Russia (Fig. 53). They are applied only to import of 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 (in 2003) (*Fig. 54*) and bigger share of meat products (in 2003–2004). But beginning from 2005 meat imports regained growth. So, quotas have failed to reach their main goal – protection of domestic producers from competition with import. After their introduction domestic livestock production displays different trends by sub-sectors. Production of poultry continues growing at a rather high rate – 15–20% per annum. However, this growth has started before the enforcement of quotas on import of poultry. The intensification of hog production resulted in larger output of pork in 2007. Meanwhile production of beef is either falling or growing marginally. On the whole, despite all domestic (the National project) and foreign policy efforts Russian primary meat production has not yet shown any substantial growth.

*Table 60*

**Meat Import Quotas Applied in Russia in 2003–2007**

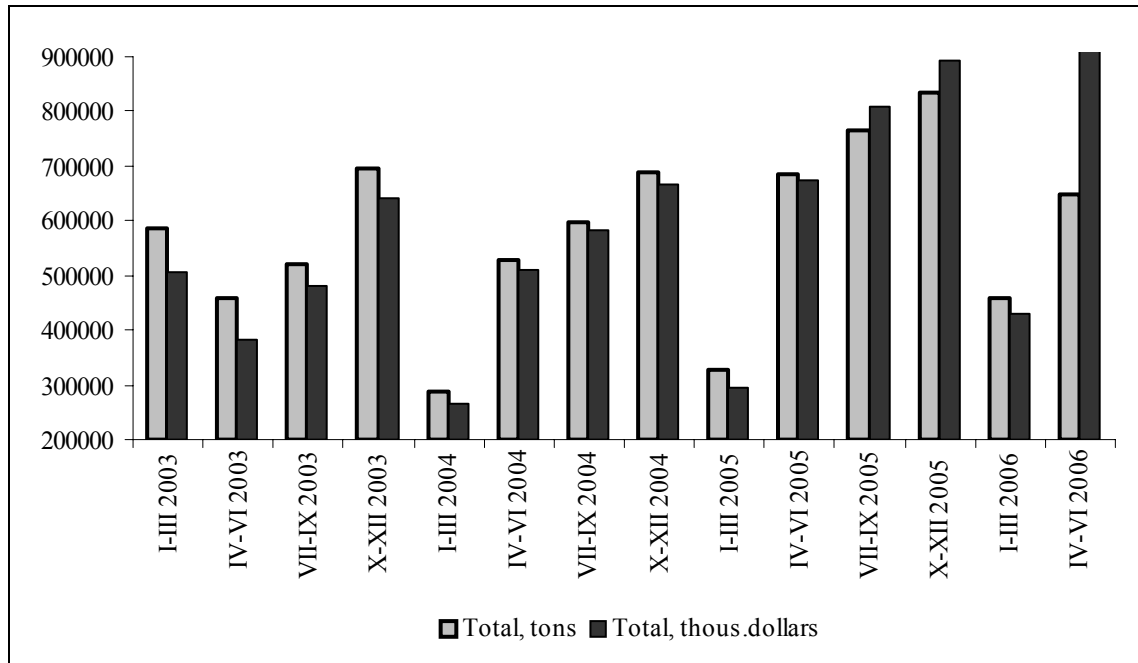
	2003	2004	2005		2006	2007
			since January	since June		
<b>Beef, fresh or chilled</b>						
TRQ, 1000 tons	11.5*	27.5	27.5		27.8	28.3
Within-quota tariff	15%, but not less than 0.2 euro/kg	15%, but not less than 0.2 euro/kg	15%, but not less than 0.2 euro/kg	15%, but not less than 0.2 euro/kg	15%, but not less than 0.2 euro/kg	15%, but not less than 0.2 euro/kg
Out-of-quota tariff	60%, but not less than 0.8 euro/kg	60%, but not less than 0.8 euro/kg	60%, but not less than 0.8 euro/kg	40%, but not less than 0.53 euro/kg	55%, but not less than 0.7 euro/kg	50%, but not less than 0.65 euro/kg
<b>Beef, frozen</b>						
TRQ, 1000 tons	315**	420	430		435	440
Within-quota tariff	15%, but not less than 0.15 euro/kg	15%, but not less than 0.15 euro/kg	15%, but not less than 0.15 euro/kg	15%, but not less than 0.15 euro/kg	15%, but not less than 0.15 euro/kg	15%, but not less than 0.15 euro/kg
Out-of-quota tariff	60%, but not less than 0.6 euro/kg	60%, but not less than 0.6 euro/kg	60%, but not less than 0.6 euro/kg	40%, but not less than 0.4 euro/kg	55%, but not less than 0.55 euro/kg	52.5%, but not less than 0.53 euro/kg
<b>Pork</b>						
TRQ, 1000 tons	337.5**	450	467.4		476.1	484.4
Within-quota tariff	15%, but not less than 0.25 euro/kg	15%, but not less than 0.25 euro/kg	15%, but not less than 0.25 euro/kg	15%, but not less than 0.25 euro/kg	15%, but not less than 0.25 euro/kg	15%, but not less than 0.25 euro/kg
Out-of-quota tariff	80%, but not less than 1.06 euro/kg	80%, but not less than 1.06 euro/kg	80%, but not less than 1.06 euro/kg	80%, but not less than 1.06 euro/kg	60%, but not less than 1.0 euro/kg	60%, but not less than 1.0 euro/kg
<b>Poultry meat</b>						
Quota, 1000 tons	744***	1050	1050		1130.8	1171.2
Within-quota tariff	25%, but not less than 0.2 euro/kg	25%, but not less than 0.2 euro/kg	25%, but not less than 0.2 euro/kg	25%, but not less than 0.2 euro/kg	25%, but not less than 0.2 euro/kg	25%, but not less than 0.2 euro/kg
Out-of-quota tariff	-	-	-	-	60%, but not less than 0.48 euro/kg	60%, but not less than 0.48 euro/kg

\* - Since August 1, 2003.

\*\* - Since April 1, 2003.

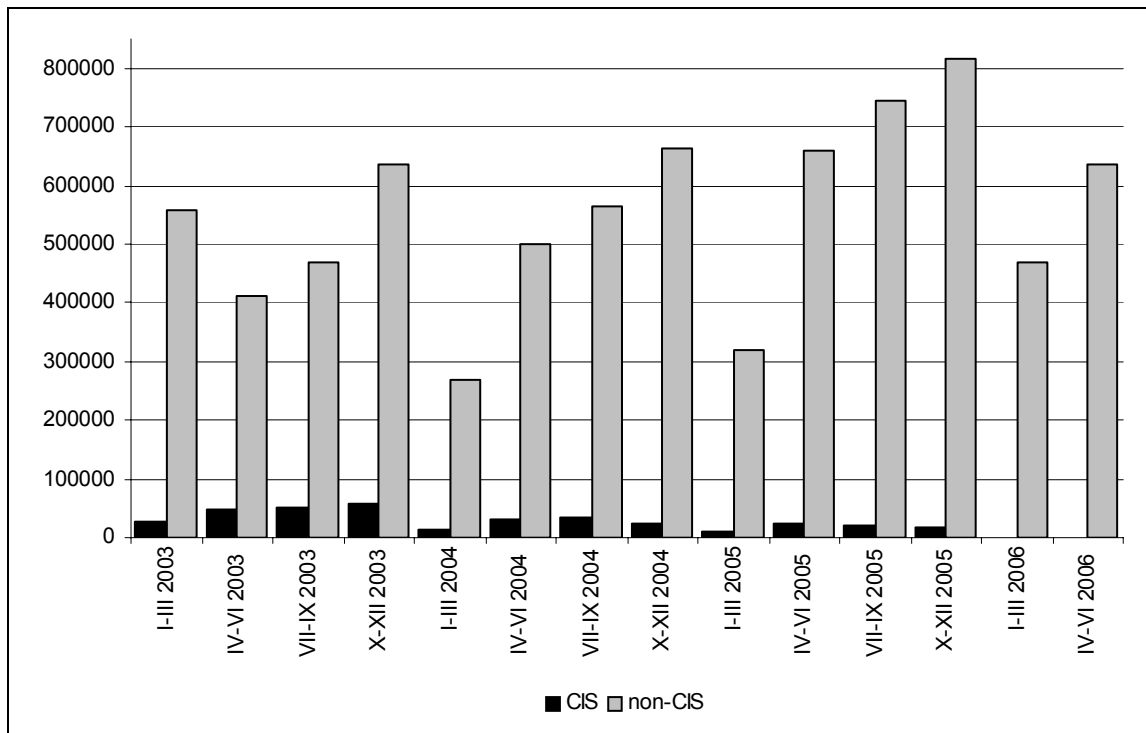
\*\*\* - Since April 30, 2003.

SOURCE: RF customs legislation.



Source: calculated using data of the RF Federal Customs Service.

*Fig. 53. Imports of Beef, Pork, Poultry Meat and Meat Products to Russia*



Source: calculated using data of the RF Federal Customs Service.

*Fig. 54. Imports of Meat and Meat Products from the CIS and non-CIS Countries, tons*



Meat quotas contributed to the rise of domestic prices. Beginning from 2004 prices for meat grew faster than CPI and prices for food products in general. First of all, this growth was due to larger imports from the CIS since average contract prices for meat imported from these countries are higher than those for meat from the non-CIS countries. At the same time prices for meat products from the CIS are lower due to qualitative differences.

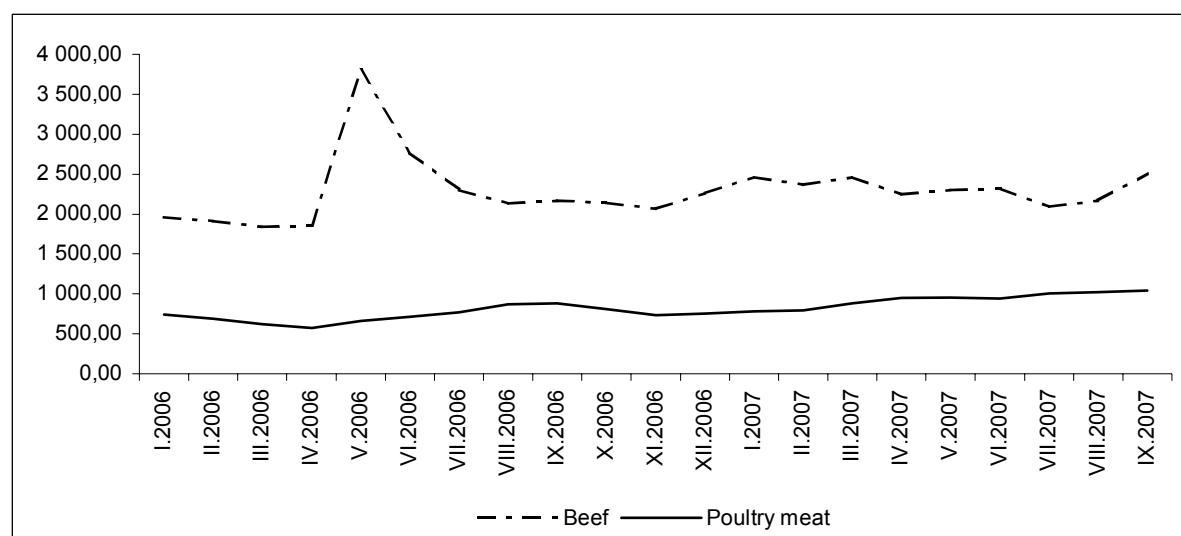
Prices were also affected by sharp fluctuations of import supplies of meat to the domestic market due to quotas. Quotas are distributed at the beginning of a year and uncertainty makes suppliers limit their deliveries (*Fig. 53*). This decrease of supplies to the domestic market can cause growth of prices that is later reflected in the annual price index.

Despite its inefficiency, the quota mechanism of regulating meat import is supposed to be preserved at least till 2009. The size of quotas will be gradually increased. Contrary to the mechanism adopted in 2003, import duties on out-of-quota supplies were raised.

Conditioned by higher real personal incomes, the demand for meat and meat products continued to grow pushing prices upward.

The situation on the world grain market also had a serious effect on the level of meat prices (see the corresponding section).

However, the principal factor of domestic meat price growth was surely the upsurge of prices for beef on the world markets (due to the extremely high grain prices, a series of world cattle epizooties and consequent cattle slaughter and to the lowering of export subsidies in the EU) (*Fig. 55*).



\* Beef – Argentine, frozen beef cuts, export unit value; poultry meat – USA, broiler cuts, export unit value.  
Source: www.fao.org.

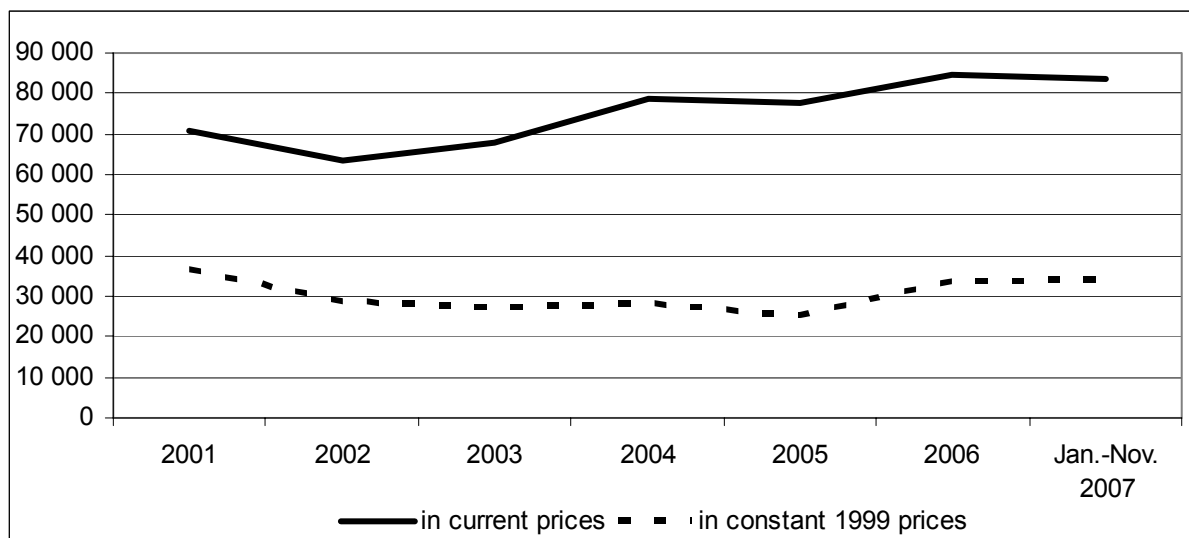
*Fig. 55. World Prices for Meat, dollars per ton\**

In order to restrict growth of domestic consumer prices the rates of import duties on milk and milk products were temporarily (for 6 months) lowered from 15% to 5%.

### 3.5.6. Agrifood Policies

***The Share of Regions in the Consolidated Budget Grows while their Autonomy in Shaping Policy Reduces***

In 2004–2007 important changes have taken place in the mechanism of budget support to agriculture. In compliance with Federal Law No. 95 of July 4, 2003 and Federal Law No. 199 of December 29, 2004 the subsidizing of agriculture was transferred to the competence of Federation’s members. As a result the share of federal budget in the consolidated budget expenditures on agriculture fell to a record low level: 14% in November 2007.



Source: www.minfin.ru.

*Fig. 56. Consolidated Budget Expenditures on Agriculture, million rubles*

The vesting of regions with exclusive powers to regulate agriculture will have the most destructive effect on the sector. First, 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. So, the shifting of farm budget support’s gravity center from the federal to regional level leads to the encouraging of agricultural production in these regions implying non-efficient public resource utilization.

Second, for already many years regional support results in “trade wars” between regions, attempts to oust neighbors from the market by means of direct subsidies to local producers, bans on agricultural and food products’ transit, etc. And all this took place despite high share of federal funds. The transfer of agricultural financing authority to regions will support the trend. In other words, the Federal Law No. 95-FL 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).

At the same time due to the finally realized need of federal participation in shaping regional agrifood policies or to the general centralization of state power in Russia, the regions’ competences in defining these policies are merely formal and in fact regions are unable to implement them without coordination with federal authorities. Federal budget allocations on co-financing of regional subsidies contain all the basic parameters of subsidizing. In accordance with the State program described below all regions should adopt corresponding regional programs and each region should coordinate its program with the federal center.

*National Project “Development of the Agrifood Sector”*

The National Project “Development of the agrifood sector” is one of the four national projects implemented in Russia in 2006–2007 (beginning from 2008 the Project measures are included in the State program “Development of the agrifood sector and regulation of agricultural and food markets in 2008–2012” adopted in 2007).

In 2006–2007 the National Project’s financing was to amount to nearly 47.5 billion rubles. This is quite a large sum – in 2006 funds allocated to the Project accounted for over 20% (18.9 billion rubles) of the total budget expenditures on agriculture. In 2008–2009 the planned expenditures on the National Project are almost 48 billion rubles.

*Table 61*

**Financing of the National Project “Development of the Agrifood Sector”,  
billion rubles**

	2006	2007	Total
<b>Accelerated development of livestock sector</b>			
Subsidizing of interest rate on credits	2.38	17.29	19.67
Enlargement of “Rosagroleasing’s” authorized capital	4	4	8
<b>Facilitation of small-scale farming</b>			
Subsidizing of interest rate on credits	0.91	5.04	5.95
Enlargement of “Rosselkhozbank’s” authorized capital including assigned to: development of the network of consumer cooperatives engaged in procurement, input supply, marketing and processing of output produced by smallholder farms development of rural credit cooperation	8.1	0	8.1
creation of crediting system based on land mortgage	1.3	0	1.3
Methodological and informational support	0.15	0.15	0.3
<b>Subsidizing of construction (purchase) of dwellings for housing young specialists (or their families) in rural areas</b>	2.0	2.0	4.0
<b>TOTAL</b>	<b>18.84</b>	<b>28.48</b>	<b>47.32</b>

*Source:* RF Ministry of Agriculture.

The priority National Project “Development of the agrifood sector” has three components: “Accelerated development of livestock sector”, “Facilitation of small-scale farming” and “Providing of young specialists (or their families) with affordable dwellings in rural areas”.

Beginning from 2007 additional tasks were included in the Project: state support of sheep and reindeer production, drove breeding of horses and industrial fish-farming; extending the availability of credit resources for purchasing pedigree livestock, machinery and equipment for livestock production (credits for term up to 5 years). The most part of these tasks (except fish farming and horse breeding) are not new directions of state support – they simply insert programs effective in recent years into the National Project. In this way these directions get larger funds – in 2007 expenditures on pedigree stockbreeding will double as compared with 2006, 2.5 billion rubles will be additionally allocated to medium (5-year) term credits and 8.3 billion rubles – to 8-year-term credits (versus 3.4 billion rubles in 2006 and the initially envisaged 3.18 billion rubles for 2007).

On the whole the National Project’s implementation has expectedly failed to become a factor able to halt the slowing down of growth in the agrifood sector. It has just helped to arrest production decline in the meat and milk sectors. Notwithstanding, the inventories of cattle

and dairy cows continue falling although the Project is primarily targeted at growth in this particular livestock sub-sector. In November 2007 the number of cattle reduced by 0.4%, that of cows – by 1.4% as compared with November 2006. At the same time the number of hogs notably grew (by 6% as compared with November 2006). The output of milk in 2007 was slightly up as compared with the previous year (by 0.3%)<sup>16</sup>. The recovery in poultry production had started before the National Project was launched. So, the only sub-sector the situation wherein changed during the Project's implementation is hog production. Still, it's not unclouded either: the upsurge of pork production resulted in a price drop that affects the sector's development prospects.

Subsidizing of long-term (up to 8 years) investment credits for financing projects in the livestock sector continues in regions. In 2006 and 9 months 2007 2,040 livestock entities signed 2,191 credit agreements, under 1,911 of them loans were granted, including 1,339 – for cattle production, 366 – for hog production, 206 – for production of other livestock and poultry.

In the framework of the National Project “Rosagroleasing” supplied farm producers with 82.7 thousand heads of cattle and 12.3 thousand heads of pigs. Besides, it spent 1.5 billion rubles on purchasing equipment for livestock production and processing of respective output and plans to modernize 206.8 thousand stalls.

Thanks to the Project the turnover of this state corporation has grown enormously: in 2006 “Rosagroleasing” bought twice more pedigree animals than during all the preceding years of its operation while in 2005 only 6 thousand animals were supplied on leasing terms<sup>17</sup>. However, the overall purchase of livestock exceeded the previous year indicators just marginally – in 2005 farms bought 54 thousand heads of livestock. The average purchase price was slightly over 50 thousand rubles per one head or somewhat below the world market price (due to the purchase of pedigree livestock from domestic producers).

In 2007 the major banks-participants of the priority National Project were “Rosselkhozbank” (Russian Agricultural Bank – 57% of the total number of signed credit agreements and 32% of the total amount of credit resources) and Sberbank of Russia (Russian Savings Bank – 31% and 41% correspondingly). Credit investments of “Rosselkhozbank” in the first half of 2007 were twice above the respective 2006 indicators and exceeded 106 billion rubles (3.4 billion rubles in 2005). The number of extended credits grew 2.3 fold as compared with the same period of 2006.

In 2007 the number of borrowers exceeded 130 thousand versus 2.5 thousand in 2006, household farms being the major contributors to this increase. Individuals engaged in household farming account for about 55% of credits extended in the framework of the National Project, individual private farmers – for 32% and agricultural consumer cooperatives – for the rest<sup>18</sup>.

The crediting on land mortgage has started to develop. “Rosselkhozbank” granted 165 credits to the total amount of 4.6 billion rubles on the mortgage of about 260 thousand hectares of land. The credits were taken for construction and reconstruction of livestock complexes, purchase of farm machinery, equipment, spare parts, fuels and oils, seeds and seedlings, additional farmland plots and for development of smallholder farms.

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<sup>16</sup> Social and economic situation in Russia – 2007, [www.gks.ru](http://www.gks.ru).

<sup>17</sup> <http://www.rosagroleasing.ru/docs/report20061124.pdf>.

<sup>18</sup> [http://www.mcx.ru/dep\\_doc.html?he\\_id=797&doc\\_id=11041](http://www.mcx.ru/dep_doc.html?he_id=797&doc_id=11041).

In 2006 and 10 months 2007 smallholder farms and agricultural consumer cooperatives got over 404 thousand credits to the total amount of 79.2 billion rubles. 3474 agricultural consumer cooperatives were set up.

*Assessment of the National Project*

The system of subsidizing interest rate on credits to Russian agriculture has 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 while the corresponding 2006 Budget indicator is about 13 billion rubles. In other words, this component of the National Project does not seriously influence the level of state support in this field. At the same time, the National Project envisages subsidizing of large and long-term (up to 8 years) credits although its own term is only 2 years (and may be extended into the two following years). This means that investors joining the National Project on these terms get involved in very risky investment projects since there is no certainty about continuation of interest rate subsidizing after the National Project's term is over. There is a danger that regional authorities will use "administrative resource" to make large agribusiness companies participate in such projects, and the potential risk will become quite real for them.

The program of developing livestock production envisages rather large investments in import of pedigree livestock from abroad. There are plans to buy 100 thousand heads of livestock and to lease them to agricultural producers. (By the way, this is in fact an official admission of the domestic selection's complete failure). One should clearly understand that import of highly productive breeds from abroad *per se* does not guarantee high animal productivity in Russia since the latter is pre-conditioned by compliance with certain technological standards, reconstruction of premises, skilled management. Many Russian regions have already funded import of pedigree livestock from regional budgets but these efforts proved to be non-efficient. Certainly, there are private businesses that are capable to meet all the requirements but the prescribed implementation scheme leaves no hope for success of this particular project component. Indeed, it starts with allocating 8 billion rubles to limited liability company "Rosagroleasing" for the enlargement of its authorized capital. This state corporation is supposed to buy pedigree stock that will be distributed between agricultural producers on preferential terms. Life shows that our agrarian bureaucratic system knows no other way of distribution than the one by so called limits that are set for regions, districts and agricultural producers. This means that pedigree livestock will be supplied not to the farms (or not always to the farms) that are capable to use it properly. "Rosagroleasing" is not interested in the efficient use of received funds: the corporation gets allocations not specifically for leasing operations but for the enlargement of its authorized capital conditioned by conducting of leasing operations. The scope of these operations is expectedly not fixed in the documents.

Purchase of 100 thousand heads of pedigree livestock within 2 years is proclaimed. It's quite a large number for the respective world market. Experts say that the available supply is shorter. This means that in order to implement the project, livestock with worse quality parameters will be bought. Besides, an *a priori* announcement of such a sizeable purchase will inevitably result in higher world prices. In other words, not the best livestock will be bought at overstated prices.

The leasing of pedigree livestock should be preserved but its practice should be revised in order to improve the efficiency of respective agricultural policy. The monopoly of “Rosagroleasing” in this field should be abolished. One should subsidize expenditures of farm producers on purchase of pedigree livestock of a certain quality; the eligible number of purchased animals should equal the minimum sufficient for really efficient herd replacement. No additional enlargement of “Rosagroleasing’s” authorized capital is required for this purpose.

The subsidizing of 95% of interest rate on credits granted to small producers actually means a negative interest on bank credits. Agricultural producers could enjoy similar super-beneficial credit terms in 1992 (then individual private farmers got credits at 8% per annum while average bank interests were as high as 120%). This resulted in an intense criminalization of the sector, mass abuses, dissipation of resources and finally – in the bankruptcy of Agroprombank. The advocates of this measure proceed from good intention to provide access to bank credit for small producers but disregard the fact that there are no barriers to prompt creation of small entities just in order to receive such a beneficial credit. To get the status of a household farm it’s enough to buy a house in a village and to till 0.01 ha for planting potatoes.

Similar to its first part, the second part of the National project is also inconsistent. It envisages support to cooperatives marketing milk from households. The authorities still think that rural residents can earn money for decent living by selling milk of 1–2 cows. What’s the logic then? On the one hand, we assist development of large-scale production by importing highly productive pedigree livestock for large commodity corporate farms and by facilitating their modernization, and, on the other hand, we support old women with their tiny milking business. But these are competing sectors. 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?

As a result of all the named measures 130 thousand stalls will be created. Let’s suppose that half of them will be created in dairy cattle production and the sector will attain the European level of 8 thousand liters of milk produced per cow annually. Even given this super good performance milk output will increase by slightly over 0.5 million tons per annum while currently the gross domestic output of milk exceeds 30 million tons. The outcome of all the planned measures will be the growth of milk output by 4.5% and meat output – by 7% within 2 years. Let’s suppose that the profitability of milk production will become incredibly high – 30%. If so, the profit from additionally produced milk will be about 5 billion rubles. Even in case milk production gets only one fourth of the National Project’s funds, the efficiency of their use (the ratio of sector’s increased receipts to used inputs) will be below 100%. The situation for meat is similar.

There is one more problem that can have long-term negative effects. The principal measure targeted at the development of cooperatives in the framework of the National Project is the enlargement of “Rosselkhozbank’s” (Russian Agricultural Bank’s) authorized capital by 9.4 billion rubles within 2 years. “Rosagroleasing’s” authorized capital is also to be enlarged by 8 billion rubles in order to implement such measures as import of pedigree animals and renovation of fixed capital in livestock production. So, the implementation of the National Project is largely (56% of the envisaged expenditures) confined to the transfer of budget funds

to state corporations-monopolists. The intended monopolization of input and financial markets in agriculture hinders their normal development and affects farm producers' access to these resources. On the other hand, neither "Rosselkhozbank" nor "Rosagroleasing" needs enlargement of authorized capital to fulfill functions assigned by the Project. They could cope with their missions even if these funds were simply transferred to their management.

Besides, the initial stage of the Project's implementation revealed some other risks. In particular, the lack of standard designs of livestock farms may result in financing of technically deficient and too expensive projects.

Super-soft crediting of rural population also has negative outcomes. First, an opportunity for fraud, for reselling these credits appears on the credit market. Second, these credits are primarily used for consumer purposes (there is information about a rapid growth of consumer crediting in regions after the Project was launched) implying no sources for their reimbursement. Finally, low-interest money in countryside accompanied by higher prices for alcohol (due to the new regulation of alcohol market in the country) will inevitably bring about an upsurge of hard drinking and shadow turnover of home-brewed alcohol in rural areas.

One of the basic problems of agricultural and rural development in Russia is the excessiveness of agricultural labour aggravating as productivity of this sector grows. Nowadays the commodity agricultural production accounts for only 1/3 of rural employment. The excessive able-bodied population is ousted to the sector of household farming that produces competing agricultural output with lower productivity. Such a dualism on the rural labour market cannot fail to result in lower incomes from agricultural employment. The opportunities for alternative employment in rural areas are still very scarce and include mainly gathering of wildly growing species, non-formal intra-village services and infant rural tourism. This employment is non-formal and non-regular. It primarily attracts marginal population ousted from principal employment. In this situation the country needs strong rural development policies oriented towards creation of adequate off-farm employment in rural areas. Regardless of this, in the framework of the National Project rural residents can get credits only on agricultural activities that will further aggravate the situation.

Finally, there is one more serious deficiency of the Project's logistics. The National Project does not comprehend all the agricultural policy issues. At the same time its implementation requires so much effort from the sector's administration that all other fields of work get simply halted.

The soft crediting of household farms in its current form should be abolished. Instead of it one needs a systematic and well balanced program of rural development targeted at the creation of alternative employment in countryside. A similar EU program (*Pillar II of Common Agricultural Policy*) can be taken as a pattern especially in the part where it applies to newly adopted countries of Central and Eastern Europe. The problem of housing qualified personnel in rural areas should also be solved in the framework of this program. The principal criterion for granting a housing subsidy should be the qualification but not the age of an applicant (which is the case in the effective version of the Project).

Moreover, the National Project complicates implementation of the programs for creating alternative employment already launched in regions. For instance, Perm kray succeeded in establishing municipal funds of rural crediting that for several years have been granting small and micro credits to rural population for any economic activities. Cooperatives created in the framework of the Project credit only farming. Therefore, not to lose a part of federal financing

parallel cooperatives need to be founded in the region. The support of cooperatives in rural areas is an important direction of agricultural policies. But in order to improve its efficiency one should eliminate the establishing monopoly of “Rosselkhozbank” on cooperative movement in countryside. Credit support can be provided by any commercial bank while the federal budget should partially subsidize the interest rate directly to a cooperative at the moment of credit repayment.

The “crediting on mortgage” component of state support is entirely entrusted to one bank – “Rosselkhozbank”. In case such crediting becomes a commercially profitable project, this approach will engender unjustified monopoly of one bank on the respective market with all the associated monopoly costs for borrowers. If one supposes to develop crediting on mortgage as a social project this will inevitably result in bankruptcy of “Rosselkhozbank” which was already the case with its predecessor “Agroprombank” in 1994–1995 when it granted commercially disadvantageous credits to agriculture. Both scenarios contradict the goals of national agrifood sector development.

Basing on the results of pilot projects carried out by “Rosselkhozbank” normative acts should be adopted to extend the practice of crediting on mortgage. Further the monopoly of one bank on such credits should be abolished. The state will subsidize them in the same way it does with other long-term credits.

After 2007 such a type of state support to agriculture as a National Project will be discontinued since it will be incorporated in the “State program of support to agriculture and regulation of agricultural and food market in 2008–2012” adopted in 2007.

### The State Program of Support to Agriculture

The State program of support to agriculture and regulation of agricultural and food markets in 2008–2012 was adopted by the RF Government on July 14, 2007. It was worked out in compliance with provisions of the Federal Law “On agricultural development” of December 29, 2006 (No. 264-FL).

The State program was developed by the RF Ministry of Agriculture in cooperation with representatives of producer unions and associations, scientific institutions and other Ministries of the RF Government. On the one hand, the involvement of a wide range of experts in the Program’s elaboration ensured due regard to opinions of different interest groups; on the other hand, the compromise version of the Program diverges greatly from the initial concept underlying the Law “On agricultural development”.

The State program was not supposed to revise the effective agricultural policies completely. To our mind, the complex arrangement and marginal correction of the currently applied policy tools on the federal level could be a good start for the new system of agrifood sector regulation in Russia.

Instead, the sector’s high officials have made the State program an instrument of lobbying for a sharp increase of budget expenditures on agriculture. Meantime the growth of budget funding is not coupled with better transparency of its planning and execution as could be the case in the framework of sub-program scheme envisaged by the Law “On agricultural development”.

In accordance with provisions of the Law “On agricultural development” each sub-program should incorporate designated goals and, respectively, indicators of their achieve-



ment, mechanisms of state regulation and the amount of funds to be allocated. Such a structure of the State program could give clear signals to agribusiness and other market operators as to the vectors of state policies and market regulation in the medium run. In fact only few sub-programs comply with this scheme. In most cases regulation tools are either not specified at all or are outlined just generally thus sending no signal to business; indicators of goals' achievement are not linked to the implemented measures and the amount of funds; the latter are not conditioned by the goals and mechanisms of their attaining but are set depending on the results of "bargaining" between the respective agencies and departments.

Besides, the program has failed to integrate all state policies and budget expenditures relating to agriculture. Regularly made investments in authorized capitals of state companies, some other measures of agrifood policies have not been included in the Program at all. Such an important component of state agricultural policies as foreign trade market regulation is absolutely missing in the Program. Without knowing basic parameters of foreign trade policies for the next 5 years (such as import duties, quotas, export restrictions, etc.) businesses cannot adequately plan their activities and estimate market prospects.

So, the State program has failed to ensure transition to program and goal-oriented planning in agricultural policies (still being a certain stage on the way to such transition) and to guarantee transparency and predictability of these policies for business – one of the key factors of long-term growth in the agrarian sector.

At the same time larger expenditures on agriculture allowed to incorporate new objects of regulation in the program including the ones long awaited in the sector.

First of all, it concerns the part of the program dealing with rural development. An important novelty is the placing of "Sustainable development of rural areas" section in the beginning of the Program, before market support measures. Such a positioning of the problem that until recently has not been regarded by the sector's administration as a priority one, is a signal of positive shifts in the agrifood policies as it is.

Measures included in the section "Sustainable development of rural areas" are on the one hand quite traditional – continuation of the federal special program "Rural social development till 2010", further carrying out of measures aimed at providing qualified personnel with affordable dwellings in rural areas. On the other hand, they are implemented in a new way, i.e. through supporting investment projects selected on a tender basis. However, only complex projects of construction and community development in rural settlements will be funded in such a way; meantime urgent rural development measures go far beyond these scopes.

The proposed measures are absolutely insufficient for achieving the goal of sustainable development of rural areas set in the Program. The state support of this program component remains declarative. Besides, the problem of developing off-farm employment in rural areas is not addressed at all although it's much spoken about in recent time and the initial versions of the Program contained measures for expanding alternative employment opportunities. This support should first of all base on the backing of small credits on non-agricultural purposes in rural areas. A certain part of grants from the special fund should be used for supporting alternative employment. To improve the efficiency of state support to sustainable rural development applying project funding mechanism, it seems rational to set a fund that would extend tender-based grants for projects in the following fields:

- improvement of the level and quality of engineer services in rural settlements;

- improvement of social and housing conditions of rural residents;
- improvement of rural social infrastructure and development of cultural and leisure opportunities for rural population including children and young people;
- improvement of rural residents' health by means of easier access to and better quality of primary medical service, development of physical culture and sports;
- improvement of educational standards in rural schools by means of their modernization, creation of conditions for inviting and settlement of qualified teachers including young specialists in rural areas;
- development of alternative employment in rural areas including rural tourism, timber production, gathering and processing of wild growing species, niche agriculture, etc.;
- development of social and engineer infrastructure in rural areas;
- development of market infrastructure for household farms and small business in rural areas.

The next section – “Ensuring general conditions for farming” – includes the already running program of soil fertility improvement and some earlier developed but not yet enforced programs for informational support, for development of extension and consulting services, for promotion of land mortgage. There is also a new program for involving producer unions and associations in the process of design, estimation and implementation of selected agrifood policy measures that should contribute to the efficiency and transparency of these policies.

Still, this section as well as the program at large does not define measures to be carried out in the framework of each of the named programs. There should be a clear description of measures targeted at soil fertility improvement (only 30% compensation of expenditures on mineral fertilizers is mentioned so far) or development of land mortgage.

Measures for providing agriculture with skilled labour should also be defined in the program. We find that an efficient tool for solving this problem could be the subsidized construction of residential dwellings for young families working and living in rural areas, since poles show that the lack of affordable housing is one of the key factors hindering the inflow of specialists to countryside.

Besides, the entire system of training personnel for agriculture and rural areas requires cardinal revision. The existing system does not meet the current labour market requirements and fails to ensure long-term competitiveness of Russian agriculture. The revision could start with establishing new centers for training highly skilled specialists of basic agricultural professions within the already existing agrarian universities and academies. The leading world experts in the field of agricultural science and education should be invited there to work out training courses, to organize studies and teach the first Russian graduates of such centers – specialists and teachers.

The involvement of producer associations in shaping and implementation of agricultural policies declared in the program remained just a good intention. Meanwhile, employment of both institutional and financial resources of associations could largely improve the efficiency of state agrifood markets' regulation and become a fruitful form of private-public partnership. We find that the involvement of associations in the process of agricultural policy making could be encouraged by compensating producer associations (the ones complying with requirements of FL “On agricultural development”) for 50% of expenditures on developing technical regulations at their initiative, on establishing their own systems of market information gathering and dissemination (compatible with the United system of informational support

to the agrifood sector), on financing applied agricultural research that their members are interested in.

Deviation from the principle of program integrality is most serious in the section “Development of priority agricultural sub-sectors”. For instance, the sub-program for livestock sector development does not include measures envisaged by the National Project “Development of the agrifood sector”. It’s absolutely unclear why regulation of agricultural and food markets is partitioned off and some measures targeted at the development of priority sub-sectors are placed in this separate section. Besides, tools of foreign trade regulation are not specified in the program which therefore fails to give a clear signal to market operators and to ensure predictability of state policies in this field. Rates of subsidizing pedigree stockbreeding and elite seed production are missing. Consequently, one raises a justified question: how were the amounts of respective allocations calculated? It’s impossible to determine the need for funds if subsidy rates are not known. It’s also impossible to determine the sub-program’s final outcomes. This is the evidence of poor planning of the program measures and related expenditures.

The novelty of this section is the support of regional projects (selected on a tender basis) for developing complex special programs of support to some sectors.

To better meet requirements of market operators, the section on development of priority agricultural sub-sectors should include: 1) mechanisms of grain interventions and intervention prices; 2) all parameters of foreign trade regulation of livestock and crop products’ markets. Otherwise, the risks of agrifood policy changing for market operators will remain as high as before the program’s adoption.

The primary task of the State program as regards foreign trade regulation in the agrifood sector should be the setting of transparent rules for all market operators and the ensuring of this regulation’s stability with the view to create conditions for growth of domestic production, on the one hand, and for supplying Russian consumers with affordable foodstuffs, on the other. Besides, in 2008–2012 Russian agrifood sector should be adapted to the new economic environment after the country joins WTO.

To prepare institutional conditions for agrifood sector’s operation within WTO and to adapt the market to the expected membership in this organization, the first thing to do is to mutually recognize the results of product tests and the documents certifying the compliance of Russian agricultural and food products with international standards and to lower technical barriers to trade.

So, although the State program has become an important step towards transition to program goal-oriented medium-term budget planning in agriculture, it largely requires adjustments and supplements that could reduce market operators’ risks and thus to stabilize market situation. In its turn, one of the results of such stabilization will be the prevention of price leaps in the future.

Table 62

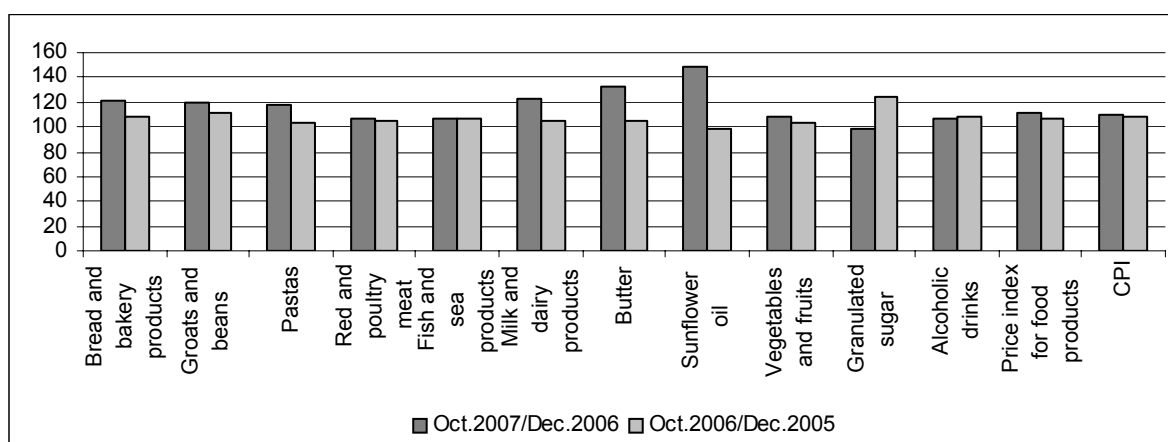
**Financing of State Program for Agrifood Sector Development  
in 2008–2012, billion rubles**

Principal sections	2007	2008	2009	2010	2011	2012	Total 2008-2012	Ratio of 2012 to 2007
Sustainable development of rural areas	5.48	7.34	19.03	25.12	29.60	31.28	112.37	5.7 fold
Ensuring general conditions for farming	4.70	9.86	12.92	13.78	14.66	15.33	66.55	3.3 fold
Development of priority agricultural sub-sectors	8.50	13.73	15.41	14.11	14.37	15.04	72.66	1.8 fold
Ensuring financial sustainability of agriculture	45.43	44.00	51.28	65.62	64.94	66.85	292.69	1.5 fold
Regulation of agricultural and food markets	1.30	1.36	1.36	1.36	1.43	1.50	7.01	115.4%
TOTAL:	65.41	76.3	100	120	125	130	551.3	2.0 fold

Source: RF Ministry of Agriculture.

*Policies Targeted at Arresting Growth of Prices for Food Products*

The upsurge of prices for foodstuffs in the second half of 2007 has drawn close attention of politicians and resulted in a set of measures targeted at arresting inflation in the food sector. The price index for food products amounted to 111.6% (October 2007 as % of December 2006) while consumer price index in the same period was 109.3%. Prices for bread and bakery products, milk and dairy products, butter and sunflower oil demonstrated the largest increase (Fig. 57).



Source: www.gks.ru.

Fig. 57. Price Indices for Selected Food Products, %

Agriculture was blamed for the upsurge of food prices. Indeed, in recent months prices received by farm producers grew faster than prices for food products. The rapid increase of prices for meat was due to both more expensive feeds and the situation on the world market. However, the fast growth of prices for primary agricultural products was not the only factor of food prices' leap. Retail trade margin and prices for agricultural inputs (mineral fertilizers, electricity, fuels and oils) are growing as well. Raw agricultural produce accounts for slightly over one half of the respective food prices (Table 63). Margin between the prices received by farm producers and the wholesale prices for most agricultural products is quite large

(Table 64). Besides, processing costs also contribute a lot to the price for such items as bread, dairy products and sunflower oil. So, the existence of direct correlation between prices for agricultural products and respective food products is not always obvious. An evidence of that is the difference in price growth rates by these groups of products during 2007 (Fig. 58).

*Table 63*

**Structure of Meat Products' Cost: the Growing Share of Trade Margin  
(Commercial Expenses), %**

	2005	2006	2007
Raw meat	59.2	59.2	55.2
Inputs	12.7	10.9	10.9
Labour	12.3	12.6	15.1
Commercial expenses	5.2	6.9	7.8
Production costs	4.9	5.5	5.6
Administrative costs	5.6	4.9	5.5
Total cost	100	100	100

*Source:* AFE Centre estimates using data of Meat Union.

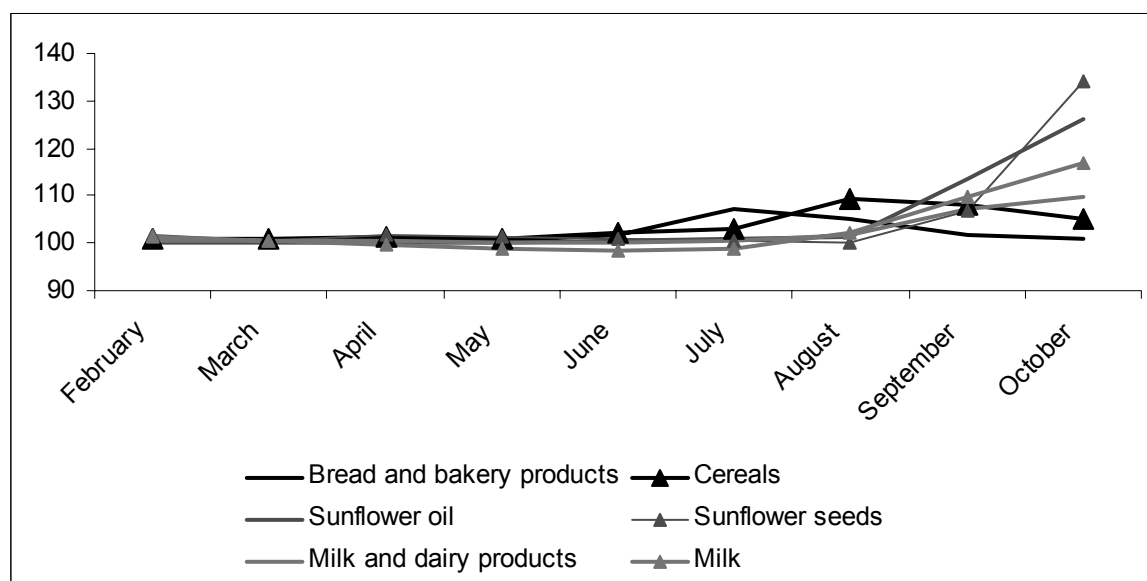
*Table 64*

**Margin between the Price Received by Farm Producers and the Wholesale Price for  
Selected Agricultural Products in 2005–2007, %**

	Margin
Cereals	32–33
Sunflower seeds	258–259
Sugar	61
Pork	25–29
Beef	25–29
Poultry	3
Eggs	24

*Source:* AFE Centre estimates using data of Meat Union, Grain Union, RF Ministry of Agriculture and RF Federal Service of State Statistics.

Interventions on the grain market and the planned ban on export of grain proceed from the assumption that these are the prices for grain that are to blame for more expensive bread. However, the cost of grain accounts for only about 20% of the price for bread. Besides, prices for grain grew not so much as prices for e.g. milk or sunflower seeds. Still, regulation is enforced on this particular market. During 13 days of interventions in 2007 325 thousand tons of wheat were sold: 5.9 thousand tons of wheat No.4 at 4700 rubles per ton and the rest – wheat No.3 at the average price 5,114.7 rubles per ton. This equals about 7% of grain exports in this season, i.e. is quite a large quantity for the market. At the same time interventions started when prices had begun to stabilize as it was. Interventions were carried out rather late since similar to previous years they required a long procedure of intra-government coordination. The cause is the aforementioned absence of definite state regulation parameters in the State program including parameters of automatic launching of interventions when prices reach a certain level.

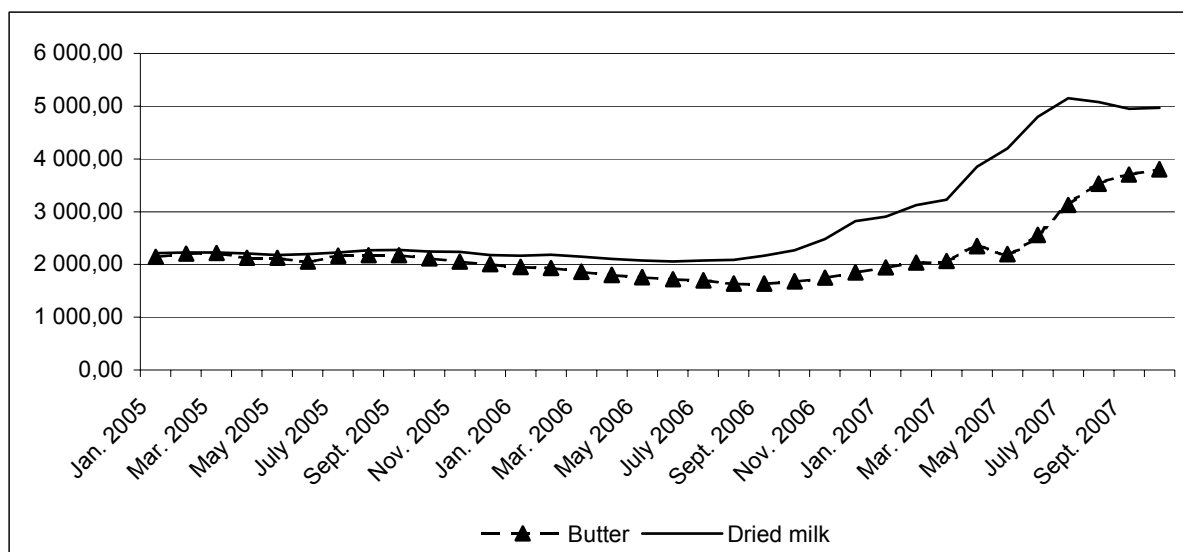


Source: www.gks.ru.

*Fig. 58. Indices of Prices for Selected Agricultural and Food Products, as % of the previous month*

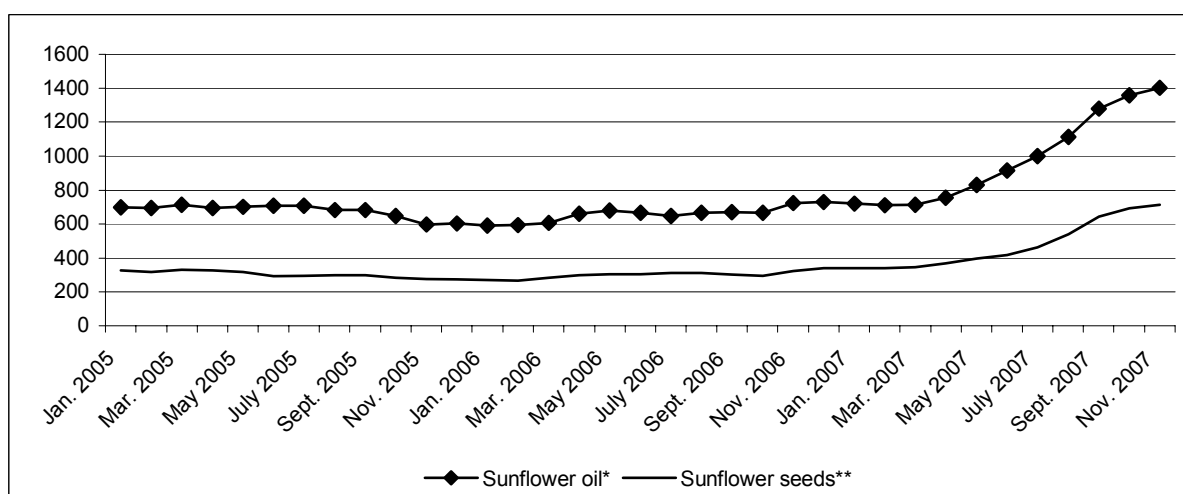
The agreement of some large retailing companies with the RF Ministry of Agriculture to keep prices for basic food products at a certain fixed level won't ensure a long-term effect either. First, prices were fixed at the October 2007 level, i.e. already after their principal rise; second, retailers will compensate their losses from arresting prices for these products by faster raising of prices for other items, so the attempt to halt inflation will also fail. Third, after the restrictions are lifted (they will be in force only for some limited period of time) prices for those very products that were subject to them will grow at accelerated rates as has always been the case when applying administrative restraints on food markets (regional efforts to administrate prices in the post-reform period provide ample evidence).

At the same time the growth of prices for agricultural and food products is the reflection of objective situation on the respective world markets: prices for sunflower seeds, milk, grain and poultry show the largest increase (*Fig. 46, 55, 59, 60*). The upsurge of prices has already resulted in a spectacular improvement of agriculture's profitability that will have a positive effect on the sector's financial performance and investment prospects unless the contributing factors are eliminated by unpredictable government policies restraining consumer prices at the expense of agriculture, supporting import and restricting export. Certainly, parallel measures are needed to mitigate the negative effect of such price situation on the final food consumers. However, these measures should focus on eliminating supply restrictions instead of being carried out at the expense of farm producers since the government allocates quite large funds to long-term programs for their support (as a matter of fact, the effect of which is not always doubtless). It would be short-sighted, however, now to reverse the course from support to taxation of agriculture, either direct or indirect (e.g. export restrictions).



Source: www.fao.org.

Fig. 59. World Prices for Dairy Products (Oceania, Indicative Export Prices, f.o.b.), US dollars per ton



\* - North West European ports, f.o.b.

\*\* - EU, c.i.f. Lower Rhine.

Source: www.fao.org.

Fig. 60. World Prices for Sunflower Seeds and Sunflower Oil, US dollars per ton

### Outlook for Russian Agrifood Sector's Performance and Government Policies in 2008

Outcomes of 2007 evidence that the process of farm producers' bifurcation continues in the sector. The segment of intensive, efficient and financially sustainable production is forming fostered by more active bankruptcy proceedings. However, mass bankrupting of agricultural entities makes the social problem in rural areas very acute. There is a danger that its solution may be put off due to the improving financial performance of farm producers

(conditioned by the favourable situation on agricultural markets) whereas the problem is a system one, its solution is a key factor of Russian agriculture's competitiveness and sustainable growth and is impossible without government participation. So, in 2008 the country's agri-food policy should concentrate on rural social development and alternative rural employment – the problems the importance of which was proclaimed in 2007 but got no support in concrete political actions.

One cannot fail to attribute the unprecedented improvement of farm producers' financial performance to higher prices on the food markets. The price growth was due to both the situation on the world markets (larger demand for crop output used for producing bio-fuel, smaller supply due to poor crops, livestock epidemics and revision of the EU policies) and the state policies resulting in shorter supply on domestic market, e.g. restriction of rice and meat import. Higher predictability of state policies for market operators, getting rid of the required inter-departmental coordination for operative market regulation, adequate liberalization of foreign trade regulation will help to mitigate the effect of high world prices on the domestic food markets.

One more turning point in the 2007 government policies is the switching from protection of Russia's interests on the world markets to restriction of export. Such state policy measures are fraught with the loss of Russian exporters' positions on the world markets the capturing of which cost them much labour, and the general destabilization that can affect domestic market as well and make the problem of high prices for grains even more serious.



## Section 4. Social Sphere

### 4.1. The Population's Finance and the Consumer Market

**Monetary incomes.** The year of 2007 saw a continuous rise of the population real monetary incomes, albeit at a pace slower than in 2006.

The monthly “pattern” of fluctuations of the incomes has recently remained unchanged: because of inflation hikes and lower economic activity in January, on the one hand, and mass payments to the population in December, on the other, incomes shrink at the beginning of a given year. Consequently, between February and November, they gradually bounce back to regular figures (with an interim stagnation during the July and August holidays, following by a new rise in December. The December 2007 increment in incomes vis-à-vis November accounted for 38%, with the rise in salaries and wages being relatively lower (some 25%), while incomes engendered by property, entrepreneurial activities, etc. were growing at a greater pace.

Overall in 2007 the population's average per capita monthly incomes made up Rb. 12, 490 (in December – 19,639). In 2007 relative to 2006 the population's incomes in real terms posted a 10.4% growth. The interregional income differentiation was on the decline – for instance, the 2007 average per capita incomes of Moscow residents were 6.1 times greater than the respective index calculated for Ivanovo oblast ( the region where the amount of the per capita incomes proved to be the minimum one in the Central Federal Okrug), while a year ago the gap was 6.7 times. It was the gap between incomes of Moscow city residents and Moscow oblast population that narrowed to the greatest degree – from 2.8 times to 2.3 times. The city of Moscow still displayed the greatest rate of the intra-regional income differentiation, as the gap between incomes of its 20% of the wealthiest and 20% of the most impoverished residents has not narrowed and has been more than 20-fold; the respective correlation was likewise on the rise in other regions of the Central Federal Okrug, but it did not exceed 5-8 times there, except for St. Petersburg where it was more than 10-fold.

In 2007, real salaries and wages grew by 16.2% vs. 2006. As in the prior years, the peak growth rates in salaries and wages were noted in December, when their values grew at nearly 25% vs. the prior month. The 2007 correlation between the average salaries and wages per employee and the amount of income per capita accounted for 1.08 times, so it was greater than the respective 2006 figure (1.04). In 2007, wage arrears declined, and the number of the group of employees, who fell prey to such arrears, was diminishing, too, and made up 200,000 by the end of the year, or twice as low than in the early 2007. The interregional wages differentiation also declined, for example, the gap between the leading region (Yamal-Nenets AO) and the outsider one (Republic of Dagestan) made up 6.7 times vs. 7.2. times reported in 2006.

In 2007, there still persisted a degree of differentiation of the average salaries and wages across kinds of economic activity. It was the agrarian sector, education, and health care where the costs of labor force proved to be the lowest ones, while maximum values were registered in the mining and financial sectors. Thus, the average wages in the financial sector in 2007 were 4 times greater than in the educational one, which repeats the prior year's situation. Meanwhile, the proportion of staff whose salaries and wages were below the subsistence level value declined to 16.5% (vs. 22.5% in 2006).

Table 1

**Structure of the Population's Monetary Incomes  
in 2000–2007 (as %)**

<i>Year</i>	2000	2001	2002	2003	2004	2005	2006	2007
Monetary incomes, total	100	100	100	100	100	100	100	100
Incomes from entrepreneurial activities	15.4	12.6	11.9	12.0	11.7	11.4	11.2	10
Labor compensations	62.8	64.6	65.8	63.9	65.0	64.8	66.4	70.3
Social payments	13.8	15.2	15.2	14.1	12.8	12.9	13.2	11
Property-based incomes	6.8	5.7	5.2	7.8	8.3	8.9	7.2	6.7
Other incomes	1.2	1.9	1.9	2.2	2.2	2.0	2.0	2.0

Source: Rosstat.

Pensioners in 2007 saw their material situation relatively worsening when compared with the working population. The correlation between the average pension and the average wages fell to 22.8% vs. 25.6% in 2006. This negative tendency has persisted in Russia since 2002. Meanwhile the purchasing power of a pension displayed some growth in the first half 2007 vis-à-vis the respective period of the prior year, and its amount at nearly 2% exceeded the pensioner's subsistence level. In the second half 2007, the pensioners' situation relative to other groups of the population worsened once again – with a notable rise of real disposable monetary incomes (nearly at 50% in December to July), the amount of pensions in real terms remained practically unchanged over the period in question, while adjusted by the advanced price rise to the pensioner's "basket" vs. CPI, it was likely to even fall.

The 2007 correlation between the able-bodied population's average salaries and their subsistence level improved notably – it accounted for 307% vs. 288% reported in the prior year.

In 2007, the proportion of individuals with income lower than the subsistence level minimum accounted for 21.5m, or 15.2% of the overall population. The poverty level and the level of inequality by incomes in Russia are significantly greater than in the developed economies and the Central European countries. Household budget surveys held by Roskomstat showed that the year of 2007 saw acceleration of growth in the income inequality. Thus, the income concentration index (measured through Gini coefficient) soared up to 0.422 vs. 0.409 reported in 2002–06.

The prices for goods and services that form the subsistence-level basket, in 2007 displayed a greater growth rate than the overall Consumer Price Index, particularly, between September and December, with the advanced growth being noted across food stuffs and tariffs for services.

Presently, in Russia, the average subsistence minimum values are set by government agencies of the Subjects of RF, while there is no centralized control over observance with uniformity of approaches to establishment of the poverty criterion by regional governments. Cross-regional differences in the subsistence minimum values cannot be explained solely by differing price levels, for in compliance with the Russian law, the natural and in-kind composition of the basket is region-specific. Territorial differences in the composition of the minimum consumer basket are determined by differentiation of the population's needs, which is engendered by natural and climatic peculiarities, the size of a territory, the level of sufficiency

of institutions of the social sphere, transport, communication, and national and regional peculiarities of consumption, among other factors.

In the 3<sup>rd</sup> quarter 2007 the lowest values of subsistence minimum were set in Dagestan, Tambov oblast, kabardino-Balkaria, North Ossetia-Alania, Kursk oblast, and Karachaevo-Cherkessia – Rb. 2,900–3,000 per capita per month, while the highest values were registered in the Evenk Municipal District and Chukotka Autonomous Okrug – 9,600 and 8,900, respectively.

The last official data on the value of subsistence minimum set by the RF Government establish the estimate of the poverty line in Russia at the level of Rb.3,696 per capita per month in the 1<sup>st</sup> quarter and 3,809 – in the 2<sup>nd</sup> quarter 2007.

Poverty spreads unevenly across Russia. The highest levels of poverty were registered in the Republic of Ingushetia (a. 60%), the Republic of Kalmykia (a. 50%), the Republic of Tyva (over 40%), the Altay Republic, Ivanovo Oblast, the Republic of Adygea, and Amur Oblast (30-37%). The most prosperous (less than 10%) in this respect regions are St. Petersburg, the Republic of Tatarstan, Yamal-Nenets, Khanty-Mansy, and Nenets autonomous okrugs. In the city of Moscow and Moscow Oblast, the proportion of the deprived population accounts for 13.2% and 12.5%, respectively.

**Monetary incomes and the retail turnover.** The 2007-to-2006 share of the population's expenses on purchases of goods and payments for services relative to the population's overall volume of savings remained practically unchanged (67–70%). At the same time, the proportion of the population's savings fell substantially (from 10.3% to 8.9%). Meanwhile, the trend to contraction in their expenses on hard currency purchases, which had manifested itself in 2006, was persisting in 2007, and this indicator plunged from 6.8% in 2006 to 5.2% in 2007.

The rise in the retail trade turnover (as mass of commodities) was being steadily high in 2006–07 and accounted for 14–15%, in the average annual terms. As in the previous years, in 2007 the greatest increment against the prior year's level was noted in the 4<sup>th</sup> quarter, primarily due to the December hike (the December-to-November rise in the goods turnover accounted for 20%). The 2007 structure of goods turnover evidenced stabilization of the proportion of food stuffs, at the level of 45.3% (under 45% in the last quarter 2006). As concerns "the food stuffs" sub-group, the proportion of alcoholic beverages therein declined to 8.7% vs. 9% reported in 2006. In 2007, sales of vodka and strong liqueurs declined against a 12–15% rise (in the absolute alcohol terms) in sales of brandy, natural and fortified wines, and champagne and sparkling wines.

In the group of non-food stuffs, the most notable became the rise in sales of automobiles, which for the 9 months 2007 accounted for 131.4%.

The overall volume of increment in the retail turnover sector in 2007 was boosted chiefly by the rise in trade organizations' turnover, which accounted for 21.5%, while the volume of the local markets' turnover sank at 10.5%. This became a result of the migration policy measures aimed at restricting and prohibiting foreigners to trade at market places.

## 4.2. Migratory Processes

### 4.2.1. 2007 Legislation in the Sphere of Migration Regulation

The migratory situation as it existed in Russia in the year 2007 can hardly be considered outside of the context of decisions adopted in this sphere at the end of 2006. Among the altered or newly adopted normative-legal acts, there are the following documents: the RF President's Edict of 22 June 2006, No. 637, "On the Measures Designed to Facilitate the Voluntary Resettlement to Russia of Compatriots Living Abroad"; "The State Program for Facilitating the Voluntary Resettlement to the RF of Compatriots Living Abroad, and "The Plan of Measures Designed to Facilitate the Voluntary Resettlement to the Russian Federation of Compatriots Living Abroad" (both confirmed by the RF President's Edict of 22 June 2006, No. 637); RF Federal Law of 18 July 2006, No. 109-FZ, "On the Migratory Registration, in the RF, of Foreign Citizens and Persons without Citizenship"; RF Federal Law 18 July 2006, No. 110 – FZ, "On the Introduction of Alterations in the FL "On the Legal Status of Foreign Citizens in the RF" and on Deeming Individual Provisions of the FL "On the Introduction of Alterations in and Amendments to Some Legislative Acts of the RF" to be Null and Void"; RF Federal Law of 5 November 2006, No. 189-FZ, "On the Introduction of Alterations in the Code of Administrative Violations (in the Part of Strengthening the Responsibility for Violations of the Procedure for the Attraction of Foreign Citizens and Persons without Citizenship to Labor Activity in the RF)". The starting point for the enactment of most of the laws and normative acts adopted in the year 2006 was 15 January 2007. In this respect, it can be said that 2007 was the first year of the new legislation on migration being with force. Also it was the year of testing the possibility for implementing the previously adopted provisions of federal migration policy.

Last year, the legislative basis in the sphere of migration continued to change (*Box 1*). However, the character of the above legislative innovations was limited to that of clarifying and making more precise the previously adopted acts.

#### ***Box 1***

The legislative acts in the sphere of migration, adopted in 2007:

- The RF Government's Decree, of 15 January 2007, No. 7 "On the Procedure for Payment of the Lumpsum Grants Designed to Facilitate the Settling-Down of Participants of the State Program for Facilitating the Voluntary Resettlement to the Russian Federation of Compatriots Living Abroad and Members of Their Families, and the Corresponding Rules for Payment...";
- The RF Government's Decree, of 15 January 2007, No. 9 "On the Procedure for Carrying Out the Migration Registration, in the RF, of Foreign Citizens and Persons without Citizenship, and the Corresponding Rules for Carrying Out the Migration Registration...";
- The RF Government's Decree, of 17 January 2007, No. 21 "On the Confirmation of the Rules for the Submission, by a Foreign Citizen or a Person without Citizenship, of a Statement Confirming His or Her Residence in the RF, and the Corresponding Rules for the Submission...";
- The RF Government's Decree, of 9 February 2007, No. 91 "On the Procedure for Determining the Average Monthly Income of a Foreign Citizen or a Person without Citizenship, and the Average Per Capita Income of a Member of the Family of a Foreign Citizen or a Person without Citizenship, and the Corresponding Rules for Determining the Average Monthly Revenue...";
- The RF Government's Decree, of 14 February 2007, No. 94 "On the State Migration System of Migration Registration";

- The RF Government’s Decree, of 26 May 2007, No. 322 “On the Introduction, for the Year 2007, of a Quota Reserve for the Issue, to Foreign Citizens, of Invitations to Enter the Russian Federation for Purposes of Conducting Labor Activity, and on the Distribution of This Quota”;
- The Agreement on Cooperation between the Federal Financial Monitoring Service and the Federal Migration Service (of 15 August 2007);
- The RF Government’s Decree, of 8 October 2007, No. 655 “The Rules for Registering Invitations to Foreign Citizens and Persons without Citizenship to Enter the RF”;
- The Order of the Federal Migration Service of Russia, of 2 August 2007, No. 165 “On the Confirmation of the Instruction Concerning the Work, in a Territorial Body of the Federal Migration Service, with Participants of the State Program for Facilitating the Voluntary Resettlement to the Russian Federation of Compatriots Living Abroad and Members of their Families”;
- The RF Government’s Decree, of 29 December 2007, “On Determining the Demand for the Attraction of Foreign Workers to the RF for the Year 2008”.

Apart from this, well ahead of schedule and without much debate or analysis of the results of the previous concept’s implementation, the Concept of the Demographic Policy of the Russian Federation for the Period Until 2025 was approved by the RF President’ Edict, of 9 October, No. 1351. One of its six major objectives is as follows: “the attraction of migrants, in accordance with the demands of demographic and socio-economic development, with due regard for their social adaptation and integration” (*Box 2*). As it frequently happens in Russia, this document, while being framework in many respects and strategic in character, appeared nearly one year later than a number of the normative-legal documents concerning the sphere of migration and natality (family policy).

### **Box 2**

From the text of “The Concept of the Demographic Policy of the Russian Federation for the Period Until 2025”.

The solution to the problem of attracting migrants in accordance with the demands of demographic and socio-economic development shall include:

- facilitating the voluntary resettlement of compatriots living abroad to permanent places of residence in the Russian Federation, and also stimulating the return of emigrants to the Russian Federation;
- encouraging qualified foreign specialists, including graduates of Russian higher educational establishments, to permanently settle in the Russian Federation; encouraging young people from foreign countries (primarily from CIS member – states, the Latvian Republic, the Lithuanian Republic, and the Estonian Republic) to receive education and undergo training courses in the Russian Federation with the possibility of being granted privileges with regard to the acquisition of Russian citizenship on having completed their education;
- improvement of the Russian Federation’s legislation on migration;
- the development of socio – economic measures aimed at increasing the migratory attractiveness of the territories which are characterized by population outflow and are of priority importance from the point of view of national interests; the development and introduction of federal and regional programs designed to create favorable conditions for the immigrants’ adaptation to a new environment and their integration into Russian society on the basis of respect to Russian culture, religion customs, traditions, and the way of life of the Russians;

- the creation of conditions for the immigrants' integration into Russian society, and the development of tolerance in the relations between the local population and the newcomers from other countries so as to prevent ethnic and religious conflicts.

It should be mentioned that in the year 2007, in parallel with the legislative innovations in the sphere of migration, the Federal Law “On the Additional Measures of State Support for Families with Children” (or “On Mother’s (Family) Capital”) began to be implemented. The purpose of a part of the migration package is to resist the decline in the size of Russia’s population, which began to show several decades ago and developed into a pronounced trend in the first half of the 1990s.

#### 4.2.2. The Dynamics of Migratory Flows

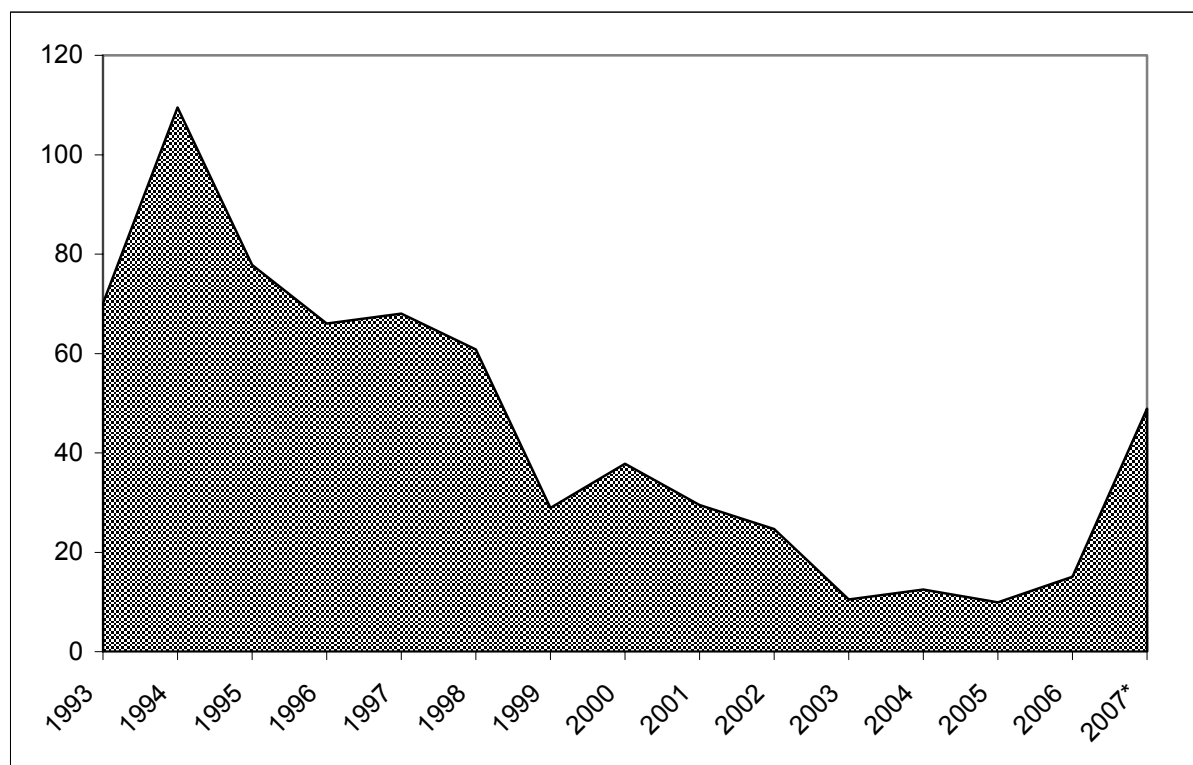
An express analysis of the dynamics of the population size in the year 2007 indicates that the natural decline of Russia’s population indeed diminished. According to preliminary estimates, the size of its permanent population as of 1 November 2007 was 142.0 million, or just 207.6 thousand (or 0.15%) less than at the beginning of the year, whereas the loss over the year 2006 was 479.6 thousand persons, or 0.34%. By comparison with the corresponding period of 2006, natural population loss in Russia diminished by 178.8 thousand (in 2007, it amounted to 406.7 thousand persons). At the same time, the statistically increased migratory growth compensated for natural loss not by 15.1% as in 2006, but by 48.9% (*Fig. 1*).

However, a closer look at these undoubtedly positive data shows that there exist a number of adverse circumstances: by contrast with the USA, where the net coefficient of reproduction has exceeded the threshold of simple reproduction (including due to the reproductive behavior of migrants), in Russia this coefficient continues to be considerably less than necessary; positive changes in the birth rate are capable of changing the timing of births, but it is not absolutely clear how they would influence the ultimate fertility of Russian women; finally, a significant share in migratory growth is accounted for by the arrivals which actually took place not in 2007, but in previous years.

When noting the “doubtless” trend to migratory growth increase, Rosstat’s specialists point it out that “in many respects this <increase> can be attributed to changes in migrant registration”<sup>1</sup>. As a result of both actual the changes and the changes in the procedure for migrant registration, as well as of a decline in mortality and a certain rise in the birth rate also observed in 2007, natural population loss replacement by migratory growth amounted to 80–90% in some months, and, as we have already mentioned, to 48.9% by the general results of the first ten months of the year.

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<sup>1</sup> Head of the Migration Statistics Department Marina Rakhmanova: “When we speak in terms of migratory growth, the case in point is not the pendulum, temporary labor migration but a long-term one. The data on migration are received by Rosstat from the territorial bodies of the Federal Migration Service on the basis of statistics documents on arrivals and departures, which should be drawn up when persons are registered and stricken off the register at the place of residence”. According to her, in the past, that is before the adoption of new legislation in January 2007, “statistics forms” were not issued to “long-term” migrants, because the latter were provided instead with residence permits. / Nikolaeva, D. *Migranty otkryvaiut dlia sebia Rossiiu. Moskva stanovitsia dlia nikh slishkom dorogoi* [Migrants are personally discovering Russia. Moscow is becoming too expensive for them.] // *Kommersant*, 24 September 2007.



\* The year 2007 – according to the data for January–October.

Source: Rosstat's data.

*Fig. 1. Replacement of natural population loss by migratory growth, in %*

#### 4.2.3. External Migration, Long-Term and for Purposes of Permanent Resettlement

As is registered by Rosstat, in 2007, migration for a term of more than one year and also for purposes of permanent resettlement<sup>2</sup> was characterized by the following figures: 239.3 thousand persons arrived in Russia; 40.3 thousand persons departed from Russia; accordingly, net migration amounted to 199.0 thousand persons, which was much higher than in the corresponding period of the previous year. However, these data, as those for preceding years, should be considered as rather approximate. The putting into force, from 15 January 2007, of the Federal Law “On the Migratory Registration, in the Russian Federation, of Foreign Citizens and Persons without Citizenship” was intended, first of all, to make the procedure for registering in the country easier for temporary migrant workers. To a certain degree, this aim has been achieved. However, the afore-mentioned factor had practically no impact on the Rosstat – registered growth of migratory inflow, because those immigrants who are registered at the place of their stay for a period of less than one year are still not included in the statistics. Likewise, no impact whatsoever was produced by the State Program for Facilitating the Voluntary Resettlement to the RF of Compatriots Living Abroad, officially launched on 15 Janu-

<sup>2</sup> According to the data for 10 months of 2007.

ary 2007, because those compatriots who had long resettled to Russia did not come within the purview of the Program.

Of 239.3 thousand migrants who arrived in Russia and were registered in a routine procedure, 228.5 thousand persons were residents of the former Union republics, which makes it possible to affirm that the CIS remains the only zone of Russia's migratory attraction – as it has always been since the early 1990s. However, in the current situation characterized by a rapid growth in the economic potential of Kazakhstan and Azerbaijan, the mounting problems in relations with Georgia, and Ukraine's openly demonstrated orientation to the West, even this niche is gradually losing its exclusive focus on Russia. The migratory flows are becoming increasingly re-orientated.

There is a number of other factors equally unfavorable to Russia. Firstly, the mobile contingents of Russians and Russian-speakers in the CIS countries, which were the core of migratory flows into Russia immediately after the disintegration of the USSR, are seriously depleted if not exhausted by now. The research estimates of the size of the potential migratory contingent are based on the following data: since the year 1989, the Russian diaspora in the non-Slavic post-Soviet countries has declined by 22–25 % owing to migration to Russia. The total losses were even higher, because some of the Russians departed for Ukraine and Belarus or for foreign countries behind the borders of the USSR. As early as the early 2000s it could be said with confidence that the process of repatriation of Russians from the countries of Transcaucasia and Tajikistan, where large-scale armed conflicts had taken place, was nearly over. These countries have lost nearly one half of their Russian population. By now, there are about 100 thousand Russians left in Tajikistan, and no more than 300 thousand in Transcaucasia. From the point of view of a possible inflow of compatriots, the potential of Russians in Kyrgyzstan, Uzbekistan, and Turkmenistan is more significant. In this respect, a rather ambiguous situation exists in Kazakhstan, which has lost no less than one quarter of its 1989 Russian population and is displaying nowadays high rates of economic development. As a result, even if the estimates are based on the research data on the potential mobility of Russians in the late 1990s, the actual potential of ethnic Russians' repatriation to Russia can amount to 3–3.5 million persons. Approximately 0.5 million persons could be provided by Russia's other peoples, with the Tatars being the largest single contributor<sup>3</sup>. To reflect the present-day situation, these estimates dating back to the year 2000 should be reduced by another several hundred thousand persons.

Secondly, the age profile of our compatriots in the CIS is not characterized by youth, and has a clear tendency to ageing. As an example we can cite the data on the age structure of the Russian population of Kazakhstan as reflected in the population censuses carried out in Kazakhstan in 1989 and 1999 (*Table 2*).

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<sup>3</sup> Perspektivy migratsii i etnicheskogo razvitiia Rossii i ikh uchiot pri razrabotke strategicheskikh napravlenii razvitiia strany na dlitel'nuiu perspektivu. [Prospects for migration and ethnic development of Russia and the way they are being taken into account in the course of mapping the strategic directions of the country's long-term development]. Moscow: IET, 2004, pp. 57–58.



Table 2

**The Age Structure of Kazakhstan's Russian Population, according to 1989 and 1999 Population Censuses**

	Russians in Kazakhstan, according to 1989 population census		Russians in Kazakhstan, according to 1999 population census		For reference: Russians in Russia, according to 2002 population census	
	thousand persons	%	Thousand persons	%	thousand persons	%
General population	6,227.5	100	4,479.6	100	115,889.1	100
<i>Including in the age, years:</i>						
0–9	1,233.8	19.8	517.5	11.6	10,270.8	8.9
10–19	1,023.2	16.4	796.9	17.8	18,498.8	16.0
20–29	941.7	15.1	644.8	14.4	17,814.8	15.4
30–39	1,032.5	16.6	614.4	13.7	15,366.4	13.2
40–49	629.5	10.1	703	15.7	19,054.6	16.4
50–59	660.8	10.6	440.7	9.8	12,715.2	11.0
60–69	430.1	6.9	449.2	10	11,743.8	10.1
70 and older	275.9	4.4	313.1	7	10,424.7	9.0

*Source:* Alekseenko, A. *Pervaia perepis' naseleniia v suverennom Kazakhstane: nekotorye itogi i otsenki*. [The first population census in sovereign Kazakhstan: some results and assessments.] // *Migratsiia v SNG i Baltii: cherez razlichii problem k obshchemu informatsionnomu prostranstvu*. Materialy konferentsii (8–9 sentiabria 2000 g., Sankt Peterburg) (Migration in the CIS and in the Baltic States: from the difference of problems to a common information space. Conference materials (8–9 September 2000, St. Petersburg). Edited by G. Vitkovskaia and Zh. Zaionchkovskaya / "Adamant", 2001. Pp. 82–97; data of the Institute of Demography of GU–VShE (State University – Higher School of Economics); data of Rosstat.

Thirdly, the socio-economic potential of a number of the former republics of the USSR is becoming stronger and stronger; and there are pronounced tendencies toward the equalization of their standards of living; all this hampers the formation of significant migratory contingents<sup>4</sup>.

The above-listed conclusions give grounds to affirm that the adopted Program of resettlement to Russia of compatriots living abroad is hopelessly out of date. The figures characterizing the scope of resettlement under the aegis of the Program are simply ridiculous. According to V. Kalanda, the First Deputy Director of the Federal Migration Service of Russia, by November 2007, only 102 persons had resettled to Russia under the Program<sup>5</sup>. It will be recalled that the adopted Program of voluntary resettlement was designed for three years and was aimed at facilitating the resettlement of 300 thousand persons to 12 specially selected "pilot" regions (Primorskii Krai, Khabarovsk Krai, and Krasnoyarsk Krai, and Amur, Irkutsk, Novosibirsk, Tiumen, Kaluga, Lipetsk, Tambov, Tver, and Kaliningrad Oblasts), subdivided

<sup>4</sup> For more details, see: A stoit li pereezhat' v Rossiiu, ili pliusy i minusy pereseleniia po mneniuiu potentsial'nykh immigrantov. [Is it worth, after all, to resettle to Russia; or, the pluses and minuses of resettlement as seen by potential immigrants] // "Fergana.ru", 19 December 2006. Published in Demoskop Weekly. 2007. No. 271. <http://demoscope.ru/weekly/2007/0271/gazeta08.php>.

<sup>5</sup> Smol'iakova, T. Vybiraiia Rossiiu na zhitel'stvo. [When choosing Russia as a country of residence] // Rossiiskaia Gazeta (Russian Newspaper). 8 November 2007.

into three categories, in accordance with the socio-economic and demographic situation therein. Preliminary estimates suggested that 50 thousand persons would be resettled in 2007<sup>6</sup>.

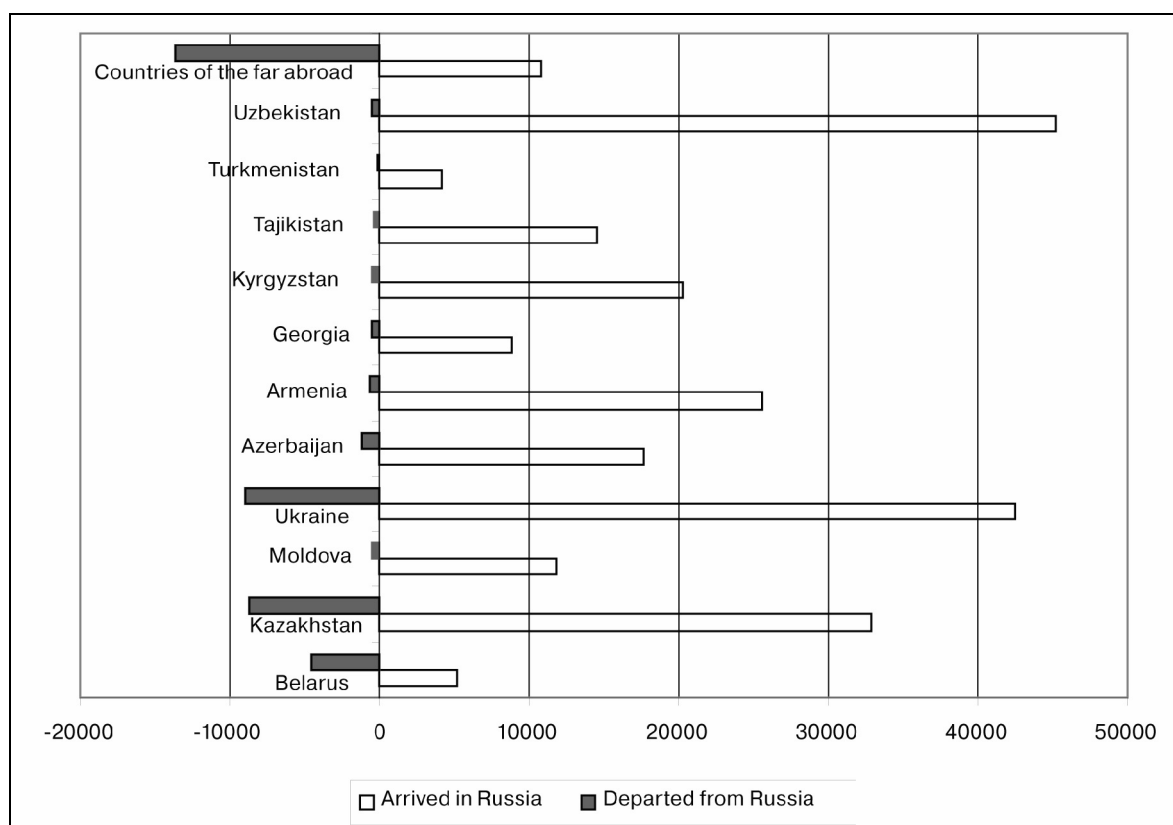
The implementation of these plans was encumbered by a number of objective and subjective difficulties. Apart from the belatedness of such a targeted decision, the obstacles were as follows:

- procrastination in adopting, at the federal and regional levels, the subordinate legislative acts necessary for the resettlement of compatriots (the belated adoption of the Federal Government's corresponding decrees and regulations, and of the corresponding regional programs);
- the manifest desire of regional authorities to shift to employers all the responsibility for caring for the settlers;
- the logical intention of the federal authorities to select such migrants who will suit concrete requirements of the country and the regions, and to offer them to settle in the villages and small towns of the remote and rather depopulated areas of Siberia and the Far East, comes into contradiction with their equally understandable aversion to settling in such places. In fact, under conditions when the housing problem is acute and the funds provided to the migrants are insufficient, one could expect the resurrection of the old Soviet model of migration in quest of housing and not of a job, as is typical of the developed countries of the world, and as it was envisaged in the Program itself;
- the refusal of 14 Russian regions to participate in the implementation of the Program. These include Moscow, Ingushetia, Dagestan, Astrakhan Oblast, and Stavropol Krai.

For the first time, Uzbekistan ranked top in the flow of migrants from the CIS moving to Russia in order to permanently settle there. Starting from 2006, the Kazakh and Ukrainian vectors, still important for Russia, have been somewhat dwindling in significance by comparison with the Uzbek one. In general, the dominant position of the Central Asian flow became stronger last year, and it looks even more prominent in the context of net migration. In 2007, the tendency toward equalization of the direct and reverse flows in the population exchange with Kazakhstan became more pronounced (*Fig. 2*). It is typical that while the volume of arrivals to Russia from the CIS countries displayed an overall growth by 1.5 times by comparison with the corresponding period of the previous year, as recorded by current registration files, the only flows which demonstrated practically no growth were those from Kazakhstan and Belarus. While the Byelorussian flow of migrants coming to Russia in order to permanently settle there has always been rather small, and in some years Russia's migratory exchange was even characterized by slightly negative values, the absence of any increase in the Kazakh flow, in view of the statistically reported general growth, indicates that Kazakhstan's positions in the "struggle for migrants" have become stronger. The increase of migration to Russia from Azerbaijan and Armenia by more than 2.5 times can be explained, first of all, by the afore-mentioned changes in the procedure for registration of migrants.

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<sup>6</sup> Vandysheva, O. Glava FMS Konstantin Romodanovskii uveren, chto migranty dlia Rossii – blago. [Head of the Federal Migration Service is convinced that migrants are a blessing for Russia] // Komsomol'skaiia Pravda (the Komsomol truth). 29 December 2006.



Source: data of Rosstat.

Fig. 2. The Number of Persons Arrived in and Departed from Russia, January–October 2007

The migratory exchange with the countries of the far abroad continued to be negative for Russia. However, some changes could be spotted even here: firstly, the net loss-reduced, by comparison with the previous year, by almost 3 times; secondly, although Germany, the USA, and Israel continued to be the main attractors of outmigration from Russia, the scope of migration thereto decreased by 1.2–1.5 times; thirdly, the numbers of Russians departing for Canada and the Baltic States started to grow; fourthly, the exchange with Israel practically approached the parity level (officially, over the first ten months of 2007, Russia lost no more than 90 persons). Such changes make it possible to state that the tendency toward replacement of the so-called permanent migration to the developed countries of the world by softer and smoother forms of departure (under labor contracts, by way of educational and academic in-depth training abroad, etc.), which first manifested itself several years ago, now is strengthening. At the same time, the potential and the attractiveness of ethnic emigration continue to dwindle, partly due to the rising anti-emigrant feelings in Europe and the tightening of requirements on the part of the European host countries.

#### 4.2.4. Temporary Labor Migration

The part played by temporary labor migration in providing manpower resources to the contemporary Russian economy is very significant. The main mechanism, which determines the demand for the inflow of migrant workers and thus regulates it, is not the willingness or unwillingness of individual administrators of federal or regional level to sanction such a migration, but the labor market itself. It is precisely the situation on local labor markets (within

the limits of specific populated localities) that determines the demand for migratory manpower and the latter's opportunities for getting access to jobs and sources of livelihood. In Russia, as in the multitude of other market economies, the market of manpower demand and supply is formed under the influence of general principles, such as the cyclic nature of economic and demographic development (no matter how out of phase with one another they might be), the presence of a socio-labor pyramid, and the selectivity of labor niches (the lower floors – mass low-skilled labor; the uppermost floors – the elite categories of work).

The typical features of Russia's current labor market are the phase of decline in the size of the able-bodied population, economic growth, the constriction boom, and the practically omnipresent unwillingness of the population to take non-prestigious jobs. At the same time, we witness the survival of the historic unity, within the framework of the former USSR, with a broad spectrum of countries – still poor and characterized by manpower surplus, relatively well-functioning transport links with Russia, and semi-porous frontiers. The afore-listed factors, together with restrictive legislation of the early 2000s and the red tape of the legalization procedures for temporary migrants, contributed to the gradual accumulation of a great mass of illegal migrants<sup>7</sup>.

The acuteness of the situation impelled the authorities to begin reforming this part of Russia's legislation on migration. On 15 January 2007, a package of legislative acts designed to simplify the registration of employment of temporary migrants arriving from the countries with the visa-free regime entered into force. It should be noted that these migrants constitute the majority of those who come to Russia in search of a living. In accordance with the new Law on Migratory Registration, the procedure for registering migrants from CIS countries (except for Georgia and Turkmenistan) is reduced to the following few things: a foreign citizen from these countries, who has come to the territory of Russia, is obliged to receive a migratory form at the border-crossing point, to get registered as a migrant within three days from the date of arrival, and then to submit to the Federal Migration Service an application for a work permit. In contrast to the previous practices, this procedure is, in fact, declarative: the Federal Migration Service is obliged to issue such a permit within ten days. Each migrant has three months to find a job. The conclusion of a labor contract with an employer should be preceded by a compulsory medical examination. At the same time, the Code of Administrative Violations now envisages much tougher sanctions against Russian citizens employing foreign citizens not registered in a procedure established by legislation (fines of up to 800 thousand rubles for one exposed illegal migrant), or renting out to them his or her housing or transport vehicles.

The legal instrument for regulating the inflow of migrant workers is the introduction of quotas (including quotas by region), and the mechanism of by branch shares of foreign workers.

According to the Federal Migration Service of Russia, in the first half-year of 2007, 1.06 million foreign workers were employed in the Russian economy, or by 1.5 times more than in the corresponding period of 2006. Thus, there was a continuation not only of the long-established tendency of growth in the number of migrant workers, but also of rising growth rates. The fact that, contrary to all expectations, the liberalization of legislation on migration

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<sup>7</sup> According to research estimates, the number of foreign workers annually engaged in labor activity in Russia is approximately 4.9 million // Mukomel', V.I. *Migratsionnaia politika Rossii*. [The migration policy of Russia]. Moscow, 2005, pp. 196–197.

has failed to produce any additional rise in the numbers of registered workers, should apparently be seen as a consequence of the novelty and unusualness of the afore-said legal innovations, the weakness of infrastructural support for the new legislative procedure, and the general disinterestedness of entrepreneurs in legalizing their workers. According to the preliminary data given by the head of the Federal Migration Service of Russia, K. Romodanovskii, 7.3 million persons were put on the record in Russia throughout the year 2007. During the same period of time, 2.3 million foreigners applied for work permits<sup>8</sup>, which amounted to approximately 40–45% of the number of foreign workers present in Russia by the estimates of specialists, or to 3.3% of foreign workers officially employed in the country's economy. Therefore, it should be admitted that, as the mutual "adaptation" (that is, on the part of migrants, officials, and employers) to new migratory procedures increased, the growth rates of legalization of foreigners increased as well. In this situation of very gradual normalization of legal relations it was extremely important to at least preserve the existing procedure. However, contrary to all expectations, the overall quota for the year 2008 was reduced by more than three times to 1,828 thousand persons (including 1,156 thousand for workers from "visa-free" countries and 672 thousand for "visa" countries<sup>9</sup>), while the quota for persons who are allowed visa – free entry to Russia was reduced by more than 5 times. Also, the established overall quota for the year 2008 falls short of the number of migrants already registered in 2007. Thus, almost immediately after the beginning of liberalization in the sphere of worker legalization, a new administrative harness was put on the labor market, which meant a departure from the fundamental principle of new legislation on migration – the legalization of migrants. If these decisions are not corrected within one year, migrants will again be driven en masse into illegality.

The legislative innovations concerning migration have been introduced too recently for their consequences to be reflected in statistics, so the time for conclusions has not come yet. However, it is already clear that we are witnessing a continuation of a number of tendencies in the sphere of contemporary labor migration. These tendencies, universal by nature, are as follows:

- the gradual "masculinization" of the flow of temporary migrants: there are fewer and fewer women among temporary migrant workers – no more than 15 % in 2007;
- the predominance of migrants working in Russia on a long – term basis (from 9 months to one year (approximately 91 %));
- the broadness of the range of countries providing the migratory work force (134 states in 2007, 137 – in 2006); some of them are quite exotic in the Russian eyes (Fiji, Namibia, etc.), but in the main the inflow still consists of CIS citizens. Their aggregate share amounts to more than 60 % (*Fig. 3*);
- the strengthening of the Central Asian vector of the migratory labor force in Russia (especially the Uzbekistan vector), and the further of Ukraine's positions;
- the concentration of the recruited foreign work force in two branches, namely the construction industry where 42% of foreign workers are employed, and wholesale and retail trade. In the first half of 2007, this sector provided employment to one migrant in five, which is by 7.6 p.p. less than one year ago (*Fig. 4*). To a certain extent, the

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<sup>8</sup> Moshkin, M. Possiia vtroe urezaet kvoty na gastarbaiterov. [Russia declares a three – fold cut in the quotas on guest workers] *Vremia novostei* [The time of news].

<sup>9</sup> The reserve for recruitment of additional foreign work force was again set at 30%.

drop in the number of legal migrants employed in trade was caused by the RF Government's Decree No. 683, which prohibited the employment of foreign citizens as salespeople at retail markets. As was expected, the implementation of the Decree adopted in the wake of the Kondopoga events of autumn 2006 produced additional problems for migrants: the hide-and-seek games during police raids; the reregistering of salesmen into florists; bribes; extra costs; etc. The Decree brought no palpable benefits to Russians (both customers and salesmen), either: in a number of cities and towns the markets became desolated, and there was a widespread lack of salespersons (most noticeable in big cities, such as Moscow, Yekaterinburg, Irkutsk, Chita, and Vladivostok), especially during the first weeks after the Decree's entry into force; prices shot up, and the first to suffer were the most vulnerable social strata<sup>10</sup>; many technological "producer – consumer" chains, which had taken years to develop, were disrupted; and the share of markets in the general turnover considerably decreased. For all this, the Russians' own problem with employment remained unsolved, because the newly created vacancies were not of a kind they would be eager to fill. At the same time, according to the All-Russian Center for Public Opinion Studies (VTsIOM), there was no significant easing of inter-ethnic tensions<sup>11</sup>, exactly the problem that the Decree had been designed to defuse. Despite the adopted regulatory measures, retail trade remains the most important migratory module of Russia's economy. Same is true for many developed countries of the world. The labor market and the economy in general once again have demonstrated their priority character by comparison with administrative control.

The spatial picture of foreign workers' presence on labor markets also illustrates the priority of market mechanisms. In spite of all the measures being taken against labor migration by the Mayor of the capital and his apparatus, it is in Moscow, with its variegated and plentiful market of vacancies typical of a rapidly growing economy, that the labor of migrants is finding wide application. According to the official data, 23% of foreign workers from the CIS and 38% of foreign workers from other countries are concentrated in Moscow. Also, it is only in Central Okrug (first of all, owing to Moscow), Urals Okrug, and Far-eastern Okrug that the share of foreign workers exceeds 2%<sup>12</sup> as against the national average of 1.5%<sup>13</sup>. Out of nearly 90 Russian regions, 38 RF subjects have the share of foreign workers in excess of 1%, including 24 where it exceeds 1.5% (*Fig. 5*). If several regions where the native labor force is very small in numbers, which makes them a priori responsive to any external interference in the

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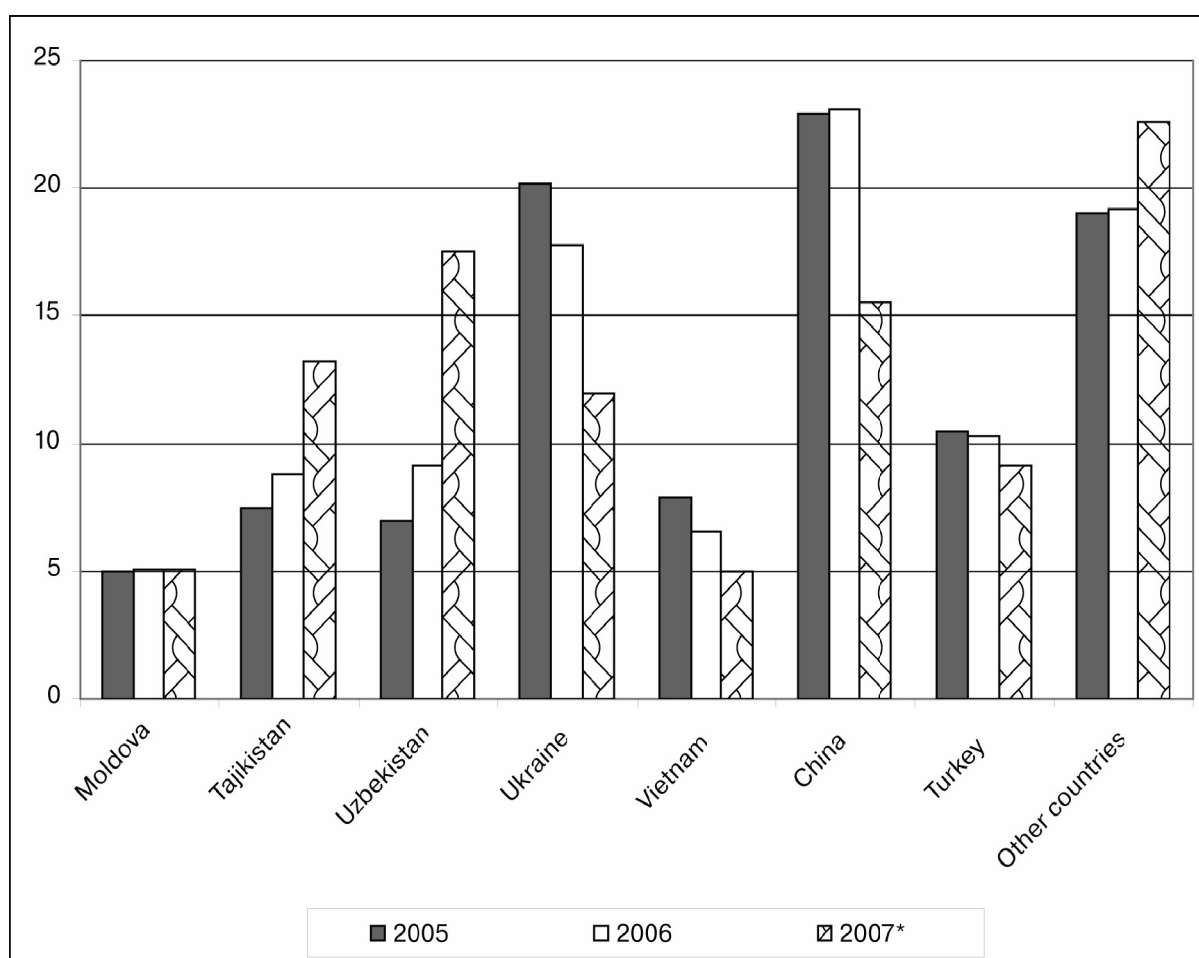
<sup>10</sup> In particular, inflation in April 2007 amounted to 0.6 %, which means that it was by 1.5 times higher than that in April 2006 / Shapovalov, A. *April'skaia inflatsiia prevysila proshlogodniuiu iz-za ataki na rynochnykh torgovtsev*. [Inflation in April surpassed that of last year because of the attack on market vendors] // *Kommersant* (Merchant), 8 May 2007.

<sup>11</sup> "Polit.Ru", 29 March 2007.

<sup>12</sup> The share of foreign workers amounts to 24.6% of the total labor force in Australia, 18.1% – in Switzerland, 11.7% – in the USA, 10.0% – in Austria, 8.8% – in the FRG, and 5.8% – in France // *Migration Policy Issues*. IOM, No. 2, March 2003, p. 2.

<sup>13</sup> At the same time, according to the head of the Federal Migration Service of Russia, K. Romodanovskii, migrants' contribution to Russia's GDP amounts to no less than 50 billion USD (or about 4% of GDP) / Shcheglov, A. *Tsentrobanki stran SNG raportuiut ob ocherednykh rekordnykh perechisleniiakh gastarbaiterov*. [The central banks of CIS countries are announcing further record-high transfers of money by guest workers] // *Nezavisimaya gazeta* [The independent newspaper]. 20 December 2007.

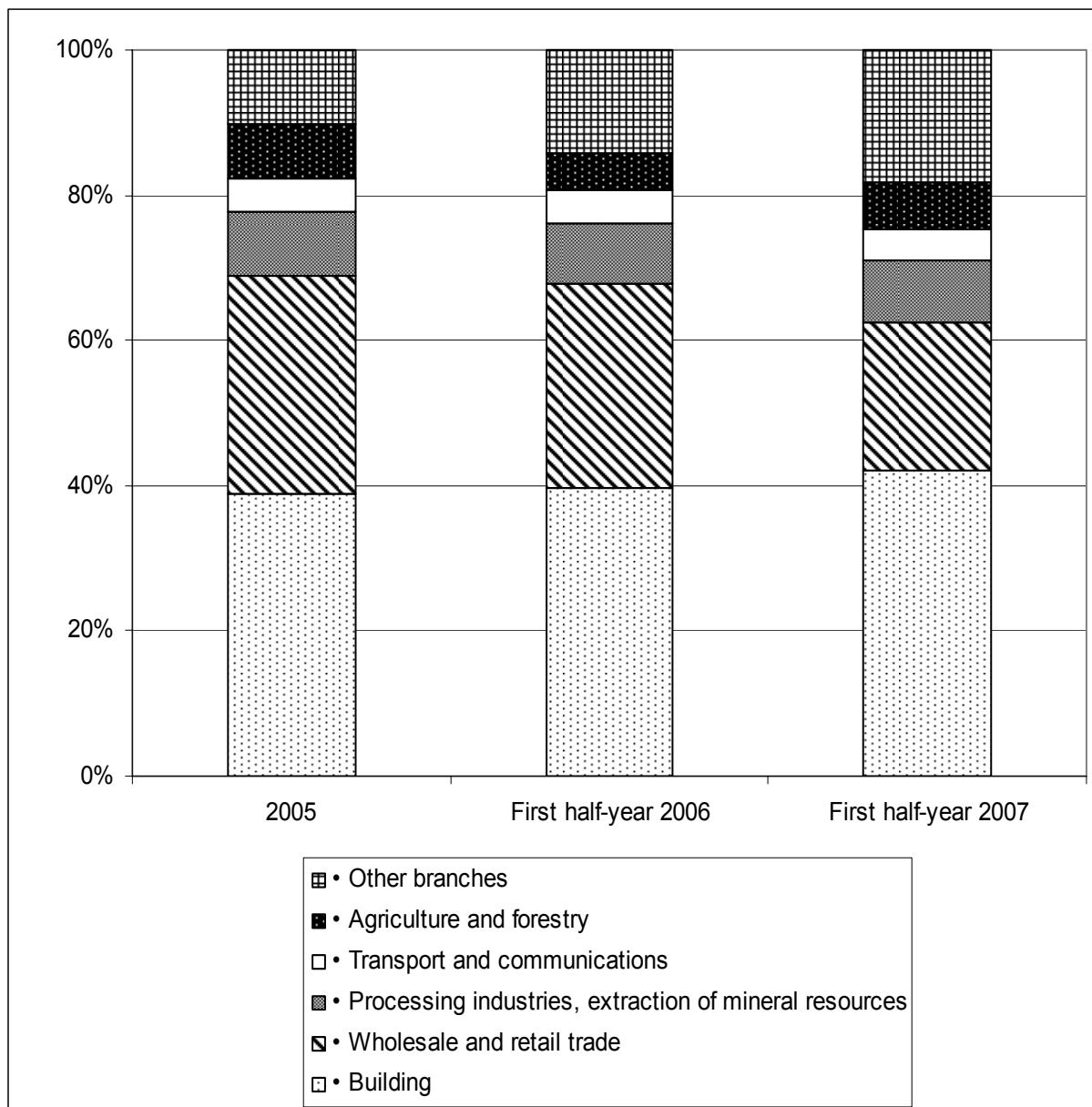
labor market (Agin-Buriat, Chukotka, and other Okrugs, except for the oil and gas producing ones), are excluded from the list, the remaining regions can be broken up into three groups: 1) the regions headed by largest conurbations, and individual regions most dynamic in their development; 2) the rich territories exporting raw materials; and 3) the Far – Eastern border regions. It should also be noted that the majority of regions, where the share of foreign workers is considerable by Russian standards, are characterized by a lower level of unemployment than that displayed by the Okrugs. Thus, apart from the economic power and investment attractiveness of one or other region (or, to be more precise, of specific cities), the other factors influencing the spatial choice on the part of foreign workers are the traditional geographic one – the territorial proximity of the place of departure to the place of settling, and the related factor of the existence of well-established expatriate network (*Fig. 6*).



\* - First half-year.

Source: Federal Migration Service of Russia.

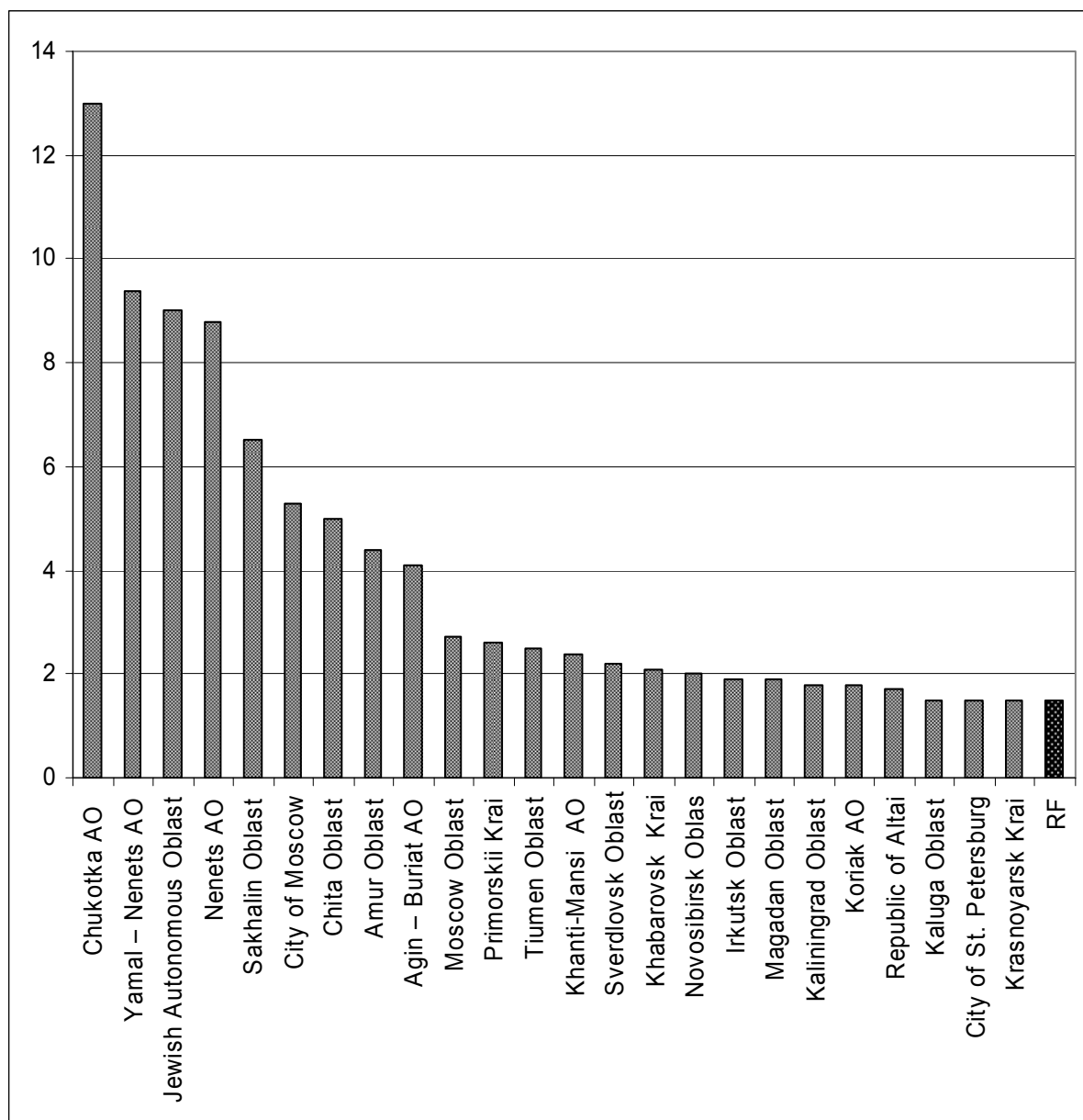
*Fig. 3. The Countries – Suppliers of Foreign Work Force to Russia, %*



Source: data of the Federal Migration Service of Russia.

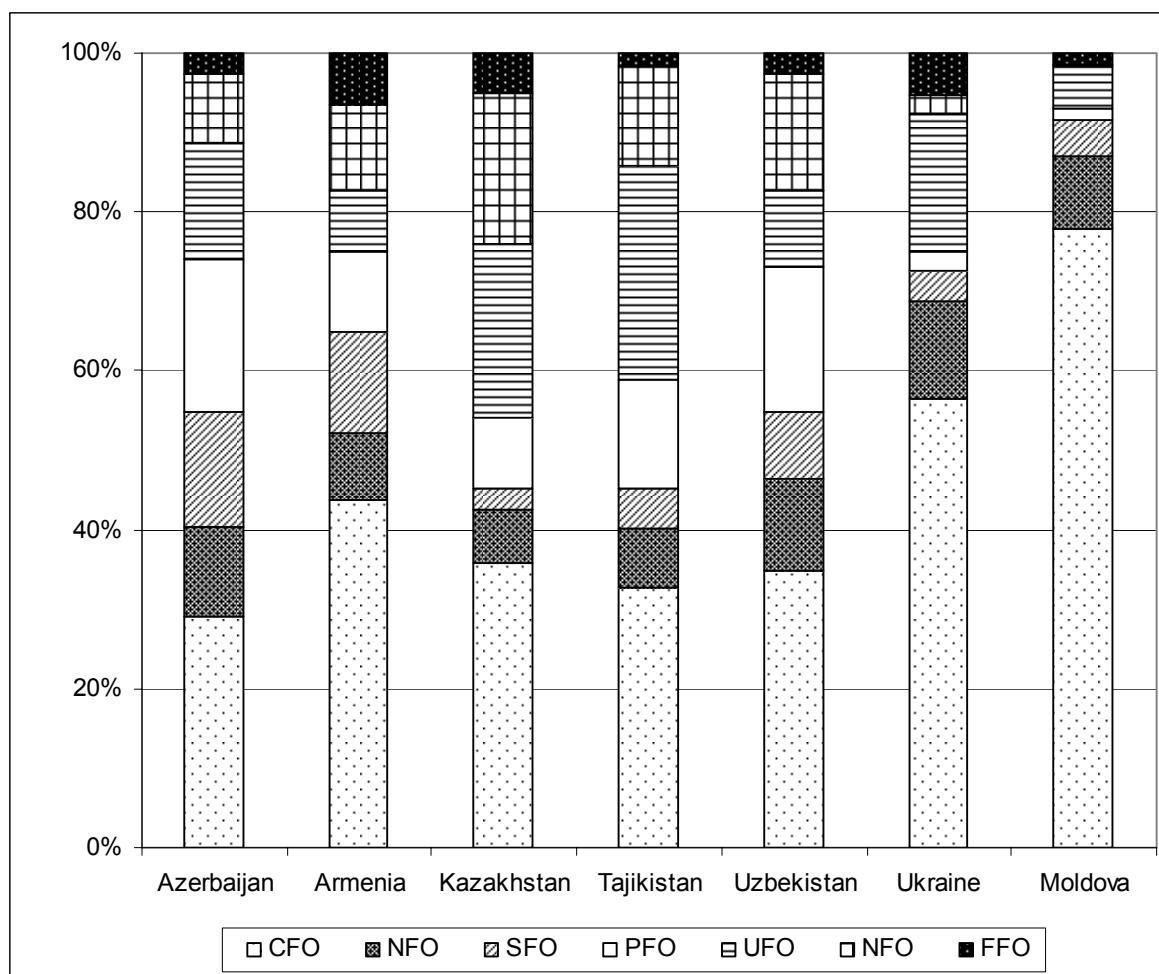
*Fig. 4. Distribution of Foreign Workers by Branch of the Economy, %*





Source: data of the Federal Migration Service of Russia, *Trud i zaniatost' v Rossii – 2007*. [Labor and employment in Russia] / Rosstat, 2007.

Fig. 5. Share of Foreign Workers in the Annual Average Number of Persons Employed in the Regional Economy, %



Notes:

- CFO [Central Fed. Okrug].
- NFO [Northwestern Fed. Okrug].
- SFO [Southern Fed. Okrug].
- PFO [Primorskii Fed. Okrug].
- UFO [Urals Fed. Okrug].
- NFO [Northern Fed. Okrug].
- FFO [Far-Eastern Fed. Okrug].

Source: data of the Federal Migration Service of Russia.

*Fig. 6. Distribution of Foreign Workers from CIS Countries by Federal Okrug of Russia, first half – year 2007, %*

Russia’s migration policy was being repeatedly changed over the past ten years. This time, yet another “migratory revolution”, of 2006–2007 vintage, has taken place de jure. It is too early and simply impossible to draw any final conclusions: the mechanism has just been launched, and it will take some time for it to begin operating in a stable mode. However, the main trouble spots are already discernable:

- the data of special research have indicated that the main channel through which guest workers can obtain employment is, as in the past, the networks of expatriate ethno-territorial fraternities encompassing their acquaintances, relatives, and friends. No dis-

cernible part is being played in this process by the state employment service or traditional employment agencies. The emergence of specialized services to deal with the task of finding employment for the “additional” newly legalized migrant communities is a slow process;

- there are no broadly structured and available integrated migration services capable of ensuring that a migrant indeed undergoes all the necessary procedures for his or her initial “on site” adaptation, and in an event of a migrant’s successful operation in Russia – to offer opportunities for becoming a permanent resident. There are no even any “ordinary” information services, which are indispensable in a situation when legal norms are changing;
- there obviously exists a “gap” between the adopted legislation package and the actual law enforcement practices: thus, the introduction of post office migration records was met with the lack of proper understanding of this mechanism by the officials to whom such responsibilities were assigned;
- the quota mechanism designed to regulate the inflow of labor migrants represents a complex regulation pattern, which has given rise to many questions. The principal issues in this connection are as follows: in order to submit an application and be included in the quota, an employer must know, one year in advance, precisely how many workers, of what qualification, and for what period of time he is going to invite, which in practical terms is unrealistic; no less clear is the procedure for “entering” in the quota the so-called “singular” (but at the same time numerous nation-wise) cases when a childminder, a nurse, or a repair worker are invited to a physical person; the sequestration of the 2008 quota, introduced one year after the adoption of the quota mechanism, has made this procedure illogical and inconsistent, thus depriving both migrants and employers of any confidence in the situation’s stability;
- the limitation of quotas has been yet another blow aimed at small and medium-size businesses, because it is obvious that, when there is shortage of quotas, it would be much easier for the directors of big companies to substantiate the necessity to attract migrants than for the owners of small enterprises. If limitations are imposed on labor quotas, a bizarre situation may emerge when a migrant holding a temporary residence permit (previously obtained) will be unable to find work. But the main point is that quota deficit is a clear and unequivocal step toward strengthening corruption and creating opportunities for a new “delegitimization” in a situation when legitimization has not yet become complete.

Paradoxically enough, the sequestration of the 2008 quota, which has not even been calculated by applying clearly understandable principles, in some regions, and in particular in Moscow, will have a more “devastating” effect for migrants from the CIS. The Moscow quota for them has been diminished threefold, while the quota established for the “visa” countries – by only 1.2 times<sup>14</sup>. The idea of diminishing the capital’s quota materialized after the adoption, in August 2007, of the City Target Program envisaging that by 2010 Moscow (in a situation when its own employable population is steadily decreasing!) should receive only about 200 thousand labor migrants. Despite the unsuccessful experience of replacing migrants with Muscovites at the city retail markets, the goal was set to gradually get rid of the unskilled la-

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<sup>14</sup> For the year 2007 the Moscow Government had established a quota of 810 thousand persons: 60 thousand – for countries applying the visa regime, and 750 thousand – for the “visa-free” countries. For the year 2008 the quotas are as follows: 50 thousand persons – from the “visa-free” countries, and 250 thousand persons – from the “visa” countries.

bor force attracted from outside. The potential consequences of the sequestration of Moscow's visa-free quota by three times will be the appearance of new illegal migrants, additional opportunities for corruption, increased revenues of the city budget generated by fines paid by employers for illegal employment of foreigners, and more intensive replacement of external migrants by domestic ones on the Moscow labor market. This additional (to the existing "background" level) attraction of domestic migrants toward Moscow will mean an increased deficit of labor force in regions, or its local replacement by additional external migrants. Both these phenomena can hardly produce a beneficial effect in terms of economics or Russia's geopolitical situation.

The actual practice has revealed the imperfection of the administrative mechanism for determining the needs in foreign workers and establishing quotas, of the existence of institutional, infrastructural and legal inconsistencies in respect of migration policy. Nevertheless, the overall experience of 2007 has demonstrated that illegal migration can be successfully dealt with (although in a market economy it cannot be altogether uprooted as a phenomenon). The main step has been made – that of attempting to bring migration "out of shadow" and to make migratory process more transparent, thus reducing the government officials' expectations in terms of corruption.

### 4.3. Main Trends on Labor Market

As it was noted over the previous period of economic growth in the country in 1999–2006, in 2007, the national labor market continued to display a positive dynamic. The process of economic growth was concomitant with improvement of main indicators of the state of the labor market: the number of the employed and their incomes were up, while the general unemployment indicators were down both in the absolute (the number of the jobless) and relative (unemployment level) terms.

*Table 3*

#### **Dynamic of Main Indicators of the State of the Labor Market in 2000–2007 (value indicators in comparable prices)**

	2000	2001	2002	2003	2004	2005	2006	2007*
The average annual number of employed in the economy, as Thos.	65,273	65,124	66,266	67,152	67,134	68,603	69,189	70,500
Growth rates in the average number of the employed	–	99.8	101.8	101.3	99.9	102.2	100.9	102.4
Number of unemployed, Thos.	7,059	6,288	6,155	5,683	5,775	5,208	4,999	4,660
Level of unemployment, as % to the economically active population	10.5	9.0	8.0	8.6	8.2	7.6	7.2	6.2
Number of unemployed registered with the public employment agencies (as of end-year), as Thos.	1,037	1,123	1,500	1,639	1,920	1,830	1,742	1,774
The average nominal salaries due to organizations' employees, as Rub.	2,223.4	3,240.4	4,360.3	5,498.5	6,739.5	8,554.9	10,633.9	13,518
The average real salaries and wages due	120.9	119.9	116.2	110.9	110.6	112.6	113.3	116.2

\* - The 2007 data are preliminary.

Source: Rosstat.

The Russian labor market falls short of fitting into the concept of a traditional labor market model, with its adjustment to external shocks by means of a dynamic change in em-

ployment volumes (and, accordingly, the unemployment level), with salaries and wages being relatively rigid. By contrast, tagged as atypical<sup>15</sup>, Russia's model of labor market exhibits a high flexibility of salaries and wages under practically unchanged employment. Meanwhile, the national labor market and mechanisms of its functioning have remained unchanged over the past 1.5 decades and continued to react in a roughly similar way both to positive and negative shocks. To reference a particular example, the past slump went hand in hand with a considerable fall in real salaries and wages, with wage arrears, outspread of non-paid-for vacations, etc., while unemployment grew insignificantly. In the subsequent period of economic growth (1999–2007) the growing demand for labor entailed just a meager rise in employment, while that in salaries and wages proved to be considerable and outpaced the growth rate of labor productivity. The annual increment rates in employment have rarely exceeded 2% over the past seven years, while the average monthly salaries and wages were growing annually at least at 10% (*Table 3*).

While in the initial years of renewal of economic growth challenges facing the labor market were mostly attributed to the pace of generation of job opportunities and restoration of salaries and wages, the previously used reserves of economic growth associated with the labor market have practically exhausted today, and the labor market can form an impediment to a further economic development.

There are at least two aspects that raise concerns, that is, the future labor force shortages and the rise in labor costs in the structure of Russia's GDP.

The booming demand for labor will shortly come across the problem of shortage of labor force, which will be aggravating over time. The Russian labor market's adjustment mechanism, that suggests a high price elasticity, will affect the market by pushing the labor price upwards. That will intensify the tendency to an advanced pace of growth in salaries and wages relative to labor productivity.

The rise in costs associated with labor force will result in Russian economy's losing one of its competitive advantages and will derail the national corporations' competitiveness.

Until now Russia's economy has advanced in the conditions of an expanding labor offer. In the 2000s, against the background of decline in the overall number of the country's population, the level of its participation in labor force continued to grow.

The favorable consequences of evolution of the population's age structure, when the able-bodied age consisted of cohorts of high birth rates being far in excess of relatively small generations exiting the market, manifested themselves in a growing number and proportion of the able-bodied population.

*Table 4*

**The Number of Economically Active Population**

	2000	2001	2002	2003	2004	2005	2006	2007
Economically active population, total, as Thos.	72,332	71,411	72,421	72,835	72,909	73,811	74,187	75,200
Proportion in the overall number of population, as %	49.4	49.0	49.9	50.5	50.8	51.7	52.2	59.9

*Source:* Rosstat.

<sup>15</sup> Nestandartnaya zanyatost v rossiyskoy ekonomike, V. Gimpelson, R. kapelyushnikov, M. GU-VSHE Publishers, 2006.

However, the period of the favorable changes in the age structure is coming to an end. In the future, there will be increasingly fewer generations entering the labor market, while the number of those leaving it will grow. By 2015 decline in the overall number of the able-bodied population will have accounted for 8 m.

These future changes will have a negative effect on the labor market, as it will be advancing under the impact of the growing shortage of labor force engendered by decline in the number of the population of the able-bodied age.

In addition to the absolute decline in the number of economically active population, the situation is aggravated by the aging of labor resources. A twist in the favorable demographic change would very soon lead to renewal of the process of aging of the population of the able-bodied age. This will be able to further intensify the negative influence on labor offer.

Neutralization of the impact of the negative demographic factors on the labor market can be ensured by means of encouragement of economic activity in the "bordering on" the said stratum groups, that is, the young, pensioners, and women. Besides, the labor offer can expand by stimulating the replacement migration.

Traditionally, it is middle-aged men that prove to be most active economically, but the labor offer by this demographic group is very inelastic. By contrast, women, youngsters and seniors' level of economic activity is lower than men's. However, reserves of boosting up economic activities at the expense of these particular groups are scarce in Russia.

More specifically, the Russian women's level of economic activity is greater than the average one worldwide. Plus, the current measures on encouragement of the birth rate fuel women's exit from the labor market. It might be possible to avoid such a tendency, should there will be implemented measures that stimulate women's combining job and household duties, (such as a more intense use of flexible employment modes, part-time jobs, etc.), but presently there are no respective premises to this.

As concerns measures on encouragement of employment of the senior-age citizens, they may become a success. Such measures should include a greater retirement age, which today is relatively young; encouragement of employers to use more flexible employment modes, which will also bring a part of pensioners back to the labor market. In addition, today's substantial gap between incomes of the working and non-working pensioners compels over a half of the "young pensioners"(in the first five years upon retirement) to stay on the market, but the government policy in the part of increase of pensions will lower this specific group's motivation to stay employed.

As concerns expectations of a greater job offer on the part of the young, they can hardly be tagged as grounded. Most young employees enter the labor market upon graduation from educational institutions (the secondary and high education ones alike), while the demand for high education is steady and no one envisages its decline in the foreseeable future.

Unemployment cannot be regarded as a significant resource of extension of employment, either. Until recently the unemployment level did not exceed 7%. The composition of the unemployed is undoubtedly non-homogenous, as causes for unemployment are, but the rise in the number of workforce at the expense of unemployment across the economy as a whole is negligible.

The replacing migration should be viewed as one of the most realistic scenarios of expansion of the labor offer, and the developed nations have exploited this particular form of replenishment of their labor force, albeit with a different degree of success. For example, the

prospects for maintenance the population in Europe, Japan, and Canada appear almost exclusively related to a future immigration. That is why many developed nations pursue a proactive immigration policy.

The migration increment to a significant extent has lately compensated for the natural population decline in Russia. But since the late-1990s the rise in migration has fallen drastically – both in absolute terms and per 1,000 of population. The peak migration into Russia was noted in 1994, with the number of foreigners who entered the country being at over 810,000 greater than those who left it. While in the early 1990s the migration increment in Russia allowed the nation to compensate for some 40% of the natural decline in its population, by the late-1990s this index plunged to 10%. Presently its value has bounced upwards again, and in 2007 as much as 50% of the natural population decline was compensated by the rise in migration.

Some experts assert that to maintain its economic activity on the current level (the proportion of the economically active population in the overall population), by 2020 Russia will need as many as 2.8m immigrants<sup>16</sup>.

It was the CIS and Baltic states that were (and still are) the major source of the immigration inflow in Russia (over 90%), but because of various reasons, this particular source is limited and tends to exhaust. A substantial factor that propels intensity of the migration flows is Russia and other CIS countries' economic growth rates. Not so long ago Russia's economic advantages were greater than those of its neighbors', hence, she attracted migrants. Meanwhile, though, the previous major donors, such as Ukraine, Kazakhstan, and some other CIS and Baltic states, have stabilized their economies and entered the path of sustained growth. So, a gradual normalization of their socio-political conditions mitigates their citizens' gravitation to Russia. It can be suggested that a further improvement of the economic situation in the CIS countries and intensification of their own migration challenges will result in a further contraction of the immigration inflow from them into Russia.

So, Russia will have to compete for migrants from the region with other CIS states and, primarily, Ukraine and Kazakhstan, which have lately posted economic growth rates greater than Russia. The competition for workforce will be intensifying along with the advancement of these countries' economies.

Speaking of migration as a major source of stabilization of volume of labor offer, experts often mean permanent migration. However, like labor markets in other developed countries, Russia's to a greater degree is exposed to the impact of temporary migration. The entrance to the labor market for migrants is regulated by a pretty tight migration law: suffice it to note that until recently employers hiring migrants and the latter themselves had to seek respective permits (presently they must simply notify the authorities). The volume of demand for migrants' labor was formalized in the form of employment quotas for migrants. Thus, the volume of the 2008 quota for granting to foreign citizens invitations to enter RF for the purpose of exercise of labor activity accounted for 672,304 pcs<sup>17</sup>. For reference, the respective indica-

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<sup>16</sup> The World Bank's Russia Report (2007).

<sup>17</sup> See Resolution of the RF Government of December 29, 2007, No. 983 "On approval for the year of 2008 of the quota on granting to foreign citizens invitations to enter the Russian Federation for the purpose of exercise of labor activity".

tor of the prior year was 308,842<sup>18</sup>. However, even with account of the fact that the quotas cover only foreign employees that arrive in Russia from the countries with visa regimes, Russia's need in "non-visa" employees only in 2008 was estimated at the level of 155,941 work permits for foreign citizens that arrive in Russia under non-visa procedures. So, the above indicators do not mirror the actual need of the labor market, nor they highlight on volumes of the migrants' actual employment level. A fairly strict migration law and the correlation between the costs of compliance with the migrant employment law and costs of schemes that enable one to avoid the law resulted in the situation when the bulk of migrant workers on Russia's labor market are illegal. As there are no trustworthy assessments of the illegal migration, some estimations vary between 1.5m and 15m. Identification of migrants' dispersion across various segments of the labor market, that is, by kinds of activity and representation in various professional and qualification groups likewise is a challenging exercise.

A great dispersion in assessments of the number of migrants employed in the national economy does not allow an adequate identification of the labor market's parameters and its trends. Conclusions of an insignificant change in employment in the period of economic growth and its relative stability are based upon the analysis of the employment level data or the data on the total number of the employed, thus does not taking into consideration the migrant employment. The latter is critical, as while calculating the employment volume, it is also necessary to specify labor productivity indicators, as it appears challenging to calculate them across a number of sectors (primarily, construction and the services sector) where the proportion of migrants in the total number of employed individuals is relatively huge, as evidenced by assessments at hand.

Ideas on the substituting migration require a more detailed study into effects migration exerts on Russia's labor market. A series of questions still remain unanswered. The most intensively debated is the question as to whether migrants and the indigenous population compete for jobs. Migrants *en masse* are regarded as a "supplement" to the local labors' qualified labor or as an uncompetitive on the labor market groups that form labor offer on the local (primarily professional) labor markets where in their absence would otherwise arise workforce shortages. If it is correct, the latter problems, which primarily concern the qualified workforce and extension of offer of the qualified employees' labor, cannot be solved by means of intensification of the migration flows that have unfolded by now.

Since 1999 and henceforward, during the whole period of economic growth, the real salaries and wages were growing at a pace of not less than 10% a year. While employment practically did not react to the external shocks, the costs of labor, on the contrary, varied considerably. Thus, in the period of economic slump, Russia's labor market reacted to the fall in the production volume by cutting down real salaries and wages, with the labor market's price adjustment instruments at that time being wage arrears and non-paid-for holidays.

The model of Russia's labor market appears strikingly contrasting to the developed nations' ones. The latter exhibit lesser flexibility in changes in labor compensation. This relative lack of flexibility (particularly so far as wages cuts are concerned) is backed by mature labor market institutions, such as the amount of minimal salaries and wages, etc. Russia also is in possession of such institutions, however, they to a lesser degree contribute to the wages rigid-

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<sup>18</sup> See Resolution of the RF Government of November 11. 2006, No. 665 "On approval for the year of 2007 of the quota on granting to foreign citizens invitations to enter the Russian Federation for the purpose of exercise of labor activity".



ity – the level of minimal wages and the sum of the unemployment benefit are small and until lately did not form strict “bottom-up” limits, that is, barriers to salaries cuts, as they do in the developed economies.

Besides, a great flexibility of salaries and wages became possible thanks to the current structure of employees’ compensations. Today, their labor compensation consists of the permanent (tariff) and the varying (super-tariff) parts, with the latter accounting for as much as 30% of the total amount of the compensation due, which exhibits a striking contrast with other countries, where it does not account even for 10%<sup>19</sup>. Under negative shocks, employers cut their costs by compressing the varying part of employees’ compensations, while in a positive situation their compensation grow, again, at the expense of the varying component. This means that institutional constraints on the mobility of labor compensations are small, and in the future the labor market will prefer varying the labor cost, rather than the number of employees.

Given that the labor market is entering the period of workforce shortages, it should be envisaged that the absence of harmony between demand for labor and its offer will result in a price rise for labor, that is, in salaries and wages.

To what degree does this prospect fit into plans to give the economy a further boost? It should be noted that the price adjustment does not give a rise to imbalances in an economy, providing the rise in salaries and wages is backed by growing labor productivity. In the post-reform Russia, however, growth rates of the former were outpacing the GDP and labor productivity growth rates.

Meanwhile, in the course of our analysis of the correlation between labor productivity and salaries and wages it is necessary to focus on methodology of assessment of the latter. Labor productivity is calculated as a ratio of the real salaries and wages to gross value-added. Usually salaries and wages are deflated by CPI, however, some experts assert that it is more correct to employ a methodology which suggests deflating salaries and wages by the index of industrial output (i.e. the uniform price index is used to convert salary amounts and output volumes into real values). That this methodology is worth a try is backed by the argument that it assesses salaries and wages not from the standpoint of the employee’s purchasing power, but from the employer’s side (as the workforce value). Consequently, in addition to compensations due to employees, costs of labor should also include tax payments to the labor remuneration fund payable by the employer. Different methodologies result in different assessments and, accordingly, diverse conclusions. This is explained primarily by the fact that the dynamics of changes in the 2004–07 consumer prices and producer prices were different. Deflated by the producer price index, nominal salaries and wages will appear lower than in the event they are deflated by CPI. Besides, in 2003, the increment in the workforce plunged sharply, which is attributed to the cut in the UST rate.

Calculations made on the basis of an “alternative” methodology show that since 2004 labor productivity growth rates in the industrial sector have outpaced growth rates of workforce costs in the sector.

But these calculations are accurate as long as the industrial sector is concerned. Meanwhile, the proportion of employees in the sector accounts just for ¼ of the total number of employees in the national economy.

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<sup>19</sup> “Zarabotnaya plata v Rossii”, V. Gimpelson, R. Kapelyushnikov (eds), Moscow, GU-VSHE Publishers, 2007.

According to some estimates received on the basis of the traditional methodology, between 2004 and 2007 the labor compensation growth rates were outrunning the labor productivity ones, which resulted in a growing proportion of salaries and wages in the general volume of production costs.

Pressure on salaries and wages, a giving it a boost as labor market's reaction to shortages of the labor force, as well as to the changes in the institutional environment (a considerable rise in the minimal labor pay and the public employees' salaries) can ultimately result in a consequent growth in the proportion of labor costs in general production costs, which will deprive the national economy of one of its competitive advantages.

Overall, the atypical model of the labor market's adjustment, which emerged in the conditions of negative offer shocks may become inefficient once the economy is on the rise. Whether the model engendered by a strong negative shock can work now, in the period of economic growth, is unclear.

#### **4.4. Social-Cultural Sphere**

##### 4.4.1. Education

##### *Main Trends in the Education System's Development*

In 2007 the Russian public education system was characterized by the same trends as in 2006. The determining factor, in this connection, was the demographic situation. The number of students continued to decline in the systems of universal curriculum (school-based), primary and secondary vocational training, while at the same time increasing in the pre-school and higher professional training systems (*Tables 5–10*).

*Table 5*

##### **Pre-School Educational Establishments**

	1993	1995	2000	2001	2002	2003	2004	2005	2006
Number of pre-school educational establishments, thousands	78.3	68.6	51.3	50.0	48.9	47.8	47.2	46.5	46.2
Number of students at pre-school educational establishments, thousand persons.	6,763	5,584	4,263	4,246	4,267	4,321	4,423	4,530	4,713
<i>Number of students per 100 places at pre-school educational establishments, persons.</i>	90	83	81	83	86	88	92	95	99
<i>Attendance of pre-school educational establishments, as percentage of total number of children aged 1–6 years</i>	57.4	54.3	55.0	56.3	57.4	57.6	57.7	57.3	...

*Source:* Rosstat.

In the pre-school education system the number of students somewhat increased. There were several reasons for this growth: rising birth rate – up to 10.4 births per 1 000 of population in 2006<sup>20</sup>, whereas in 2000 this index was only 8.7; reduction in infant mortality – from 15.3 to 10.2 of deaths per 1 000 live births; growth in female employment in recent years, resulting in increasing demand for the services of educational establishments for children.

<sup>20</sup> The latest available official data.

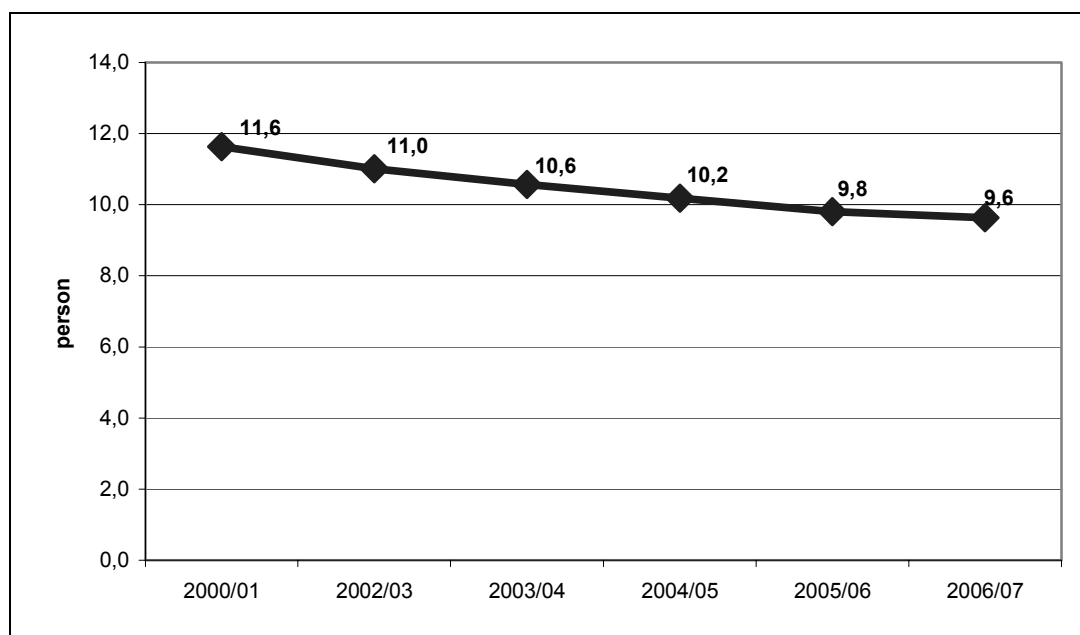
Table 6

**Number of Universal Curriculum Schools, and  
Numbers of Students and Teachers at these Educational Establishments  
(as of beginning of academic year, thousand persons)**

	2000/01	2002/03	2003/04	2004/05	2005/06	2006/07
<b>Number of universal curriculum educational establishment – total</b>	<b>68,804</b>	<b>67,431</b>	<b>66,207</b>	<b>64,908</b>	<b>63,174</b>	<b>61,042</b>
Including:						
for full-time studies	67,063	65,662	64,466	63,182	61,497	59,402
of these:						
state and municipal	66,428	64,979	63,759	62,474	60,771	58,683
non-state	635	683	707	708	726	719
state and municipal, for part-time studies (or in shifts)	1,741	1,769	1,741	1,726	1,677	1,640
Number of students at universal curriculum educational establishments – total	20,554	18,918	17,798	16,631	15,631	14,798
Including:						
for full-time studies	20,074	18,440	17,323	16,168	15,185	14,373
of these:						
at state and municipal	20,013	18,372	17,254	16,098	15,113	14,302
at non-state	61	68	69	70	72	71
at state and municipal, for part-time studies (or in shifts), including extramural students	480	478	475	463	446	425
Number of teachers at universal curriculum educational establishments – total	1,767	1,719	1,684	1,633	1,594	1,537
Including:						
at state and municipal	1,751	1,701	1,666	1,614	1,575	1,518
at non-state	16	18	18	19	19	19

Source: Rosstat.

During the period of 2000–2007, the number of students at state and municipal universal curriculum schools decreased nearly by 30%. Resulting was a significant shrinking of the network of state and municipal schools and reduction in the number of teachers. Between the 2000/01 and 2004/05 academic years, this network was diminishing at the rate of approximately 1,200–1,300 schools per year, but from the 2005/06 academic year onward this process became more intensive: in the 2005/06 academic year the network lost 1,700 schools, and in the 2006/07 academic year – another 2,100. At the same time, it should be noted that, whereas the number of students decreased by 28.5%, that of state and municipal schools declined, on the whole, by 11.7%, while the number of teachers – by 13.3%. As a result, in recent years there has been a constant fall in the number of students per teacher: from 11.7 persons in the 2000/01 academic year to 9.5 in the 2006/07 academic year (*Fig. 7*).



Source: Computations based on Rosstat's data.

Fig. 7. Student-Teacher Ratio at Universal Curriculum Schools  
(number of students per teacher)

Table 7

**Educational establishments for primary vocational training**

	Number of establishments (as of end of year)*	Number of students**, thousand persons	Enrolled students**, thousand persons	Trained (graduated) qualified workers**, thousand persons
<b>All educational establishments for primary vocational training (PVT)</b>				
1993	4,273	1,742	1,007	922
1995	4,166	1,689	928	841
2000	3,893	1,679	845	763
2001	3,872	1,649	837	759
2002	3,843	1,651	842	745
2003	3,798	1,649	823	722
2004	3,686	1,604	783	708
2005	3,392	1,509	688	703
2006	3,206	1,417	632	681

\*Based on the data published by Rosobrazovanie.

\*\* At the educational establishments for primary, secondary vocational and higher professional training implementing primary vocational training curricula.

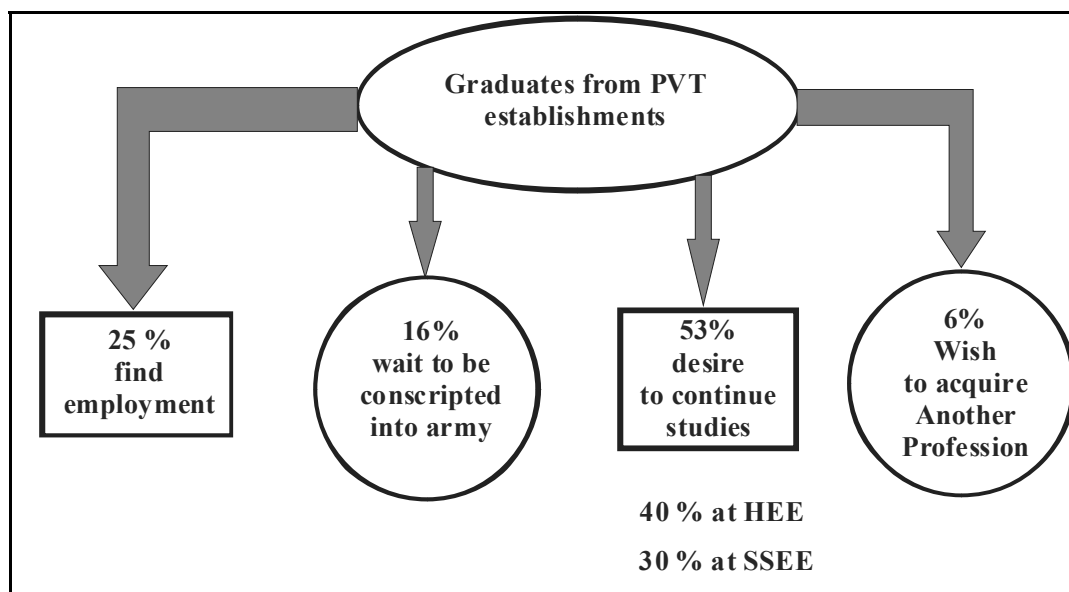
Source: Rosstat.

This index, by European and US standards, is extremely low, even if one takes into account Russia's distances and territorial population structure (the norm being represented by the following indices: 15:1 for primary schools, 25:1 for basic education schools, 20:1 for full secondary schools)<sup>21</sup>. Consequently, it can be said that the existing school network is in need

<sup>21</sup> See, e.g.: *Obrazovanie v stranakh s perekhodnoi ekonomikoi: zadachi razvitiia*. [Education in transition economies: development goals]. The World Bank's report. M., 2002.

of further improvement. However, this process is hindered by serious social limitations, especially in dotation-dependent regions with high unemployment levels, where redundant teachers cannot find another job.

Primary vocational training has been regarded in recent years as one of the most troublesome sectors within the public education system. Although the percentage of persons with this type of degree in the structure of employment is increasing, the growing economy is displaying a constantly rising demand for qualified workers. The enrollment of migrants, whose role is becoming increasingly prominent, cannot provide an adequate solution to this problem, because this contingent is mostly employed at difficult works and as unqualified labor. Big businesses have begun actually to incorporate PVT establishments into their own structures and to invest heavily in the training of workers. However, this policy is not suitable for medium-sized, and especially small, businesses lacking adequate resources. Besides, the teenagers graduating from PVT establishments at the age of 17–18 years will be soon conscripted into the army (see *Fig. 8*), so the students there lack adequate motivation for industrious studies and for acquiring a profession in high demand on the market. After having been demobilized from the army, young people can change their profession, place of residence, or both (and, as a rule, they do so). Accordingly, employers are eager to provide support to PVT establishments, but only in regard of training and retraining of “full adults” (who have already completed their service in the army), who have already determined their true vocation and life goals.

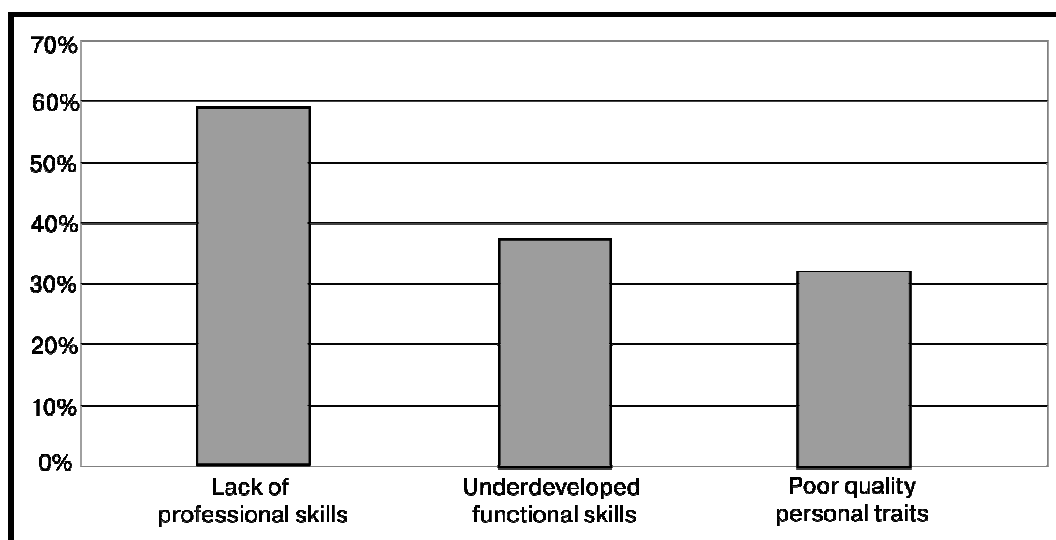


*Fig. 8. Educational Goals of Graduates from PVT Establishments*<sup>22</sup>

<sup>22</sup> See *Beliakov S.A. et al. Monitoring nepreryvnogo obrazovaniia. Instrument upavlennia i sotsiologicheskie aspekty. [Monitoring of continuing education. An instrument for management and the sociological aspects]. M.: MAKSPRESS, 2006. 340 p.*

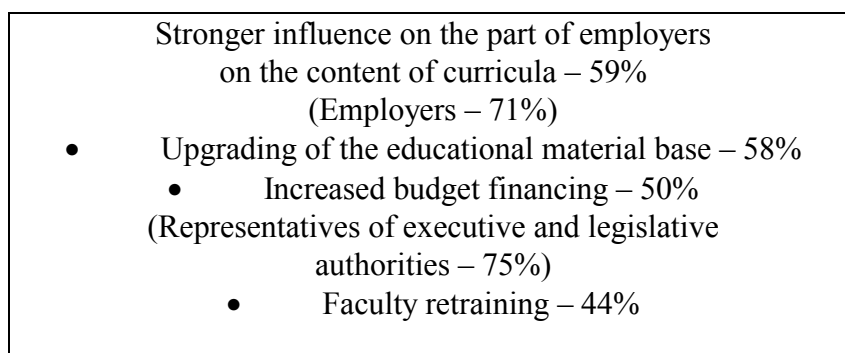
Thus, as follows from *Fig. 8*, at present the effect of PVT establishments' activity is very low, since only 25% of their graduates actually find employment in accordance with their obtained professional skills, while the others either seek to continue their education (and so their motivation for high-quality professional performance is weak), or wait for the conscription into the army without making any attempts to find a job.

Employers are dissatisfied with both the personal traits of the cadres trained in the PVT system and their qualification level<sup>23</sup> (*Fig. 9*).



*Fig. 9.* Main Limitations of Graduates from the PVT System, according to Employers

On the basis of the results of sociological surveys, the following main directions for supporting the improvements in the PVT system can be distinguished<sup>24</sup> (see *Fig. 10*).



*Fig. 10.* Rating of Directions for Potential Support of the PVT System

<sup>23</sup> See: Avraamova E. M. et al. *Trebovaniia rabotodatelei k sisteme professional'nogo obrazovaniia.. [Employer's requirements to the vocational education system.]* M.: MAKS PRESS, 2006. 160 p.

<sup>24</sup> Avraamova E.M. et al. *Trebovaniia rabotodatelei k sisteme professional'nogo obrazovaniia. [Employer's requirements to the vocational education system].* M.: MAKS PRESS, 2006. 160 p.

Topping the list is the upgrading of the education's content, with a more prominent role to be played by employers: the latter believe that they should be the leaders in decision-making as to what should be taught to those who are going to work at their enterprises.

Noteworthy is the respondents' low opinion of the low professional level of the faculty staff employed in the PVT system – nearly every other of them believes that they are in need of being retrained. Even more negative is the respondents' assessment of the state of the material and technical base of the educational establishments for primary vocational training: one cannot learn to become a modern worker while using outdated and poorly functioning equipment.

*Table 8*

**State and Municipal Educational Establishments for Secondary Vocational Training (SVT) (as of beginning of academic year)**

	2000/01	2001/02	2002/03	2003/04	2004/ 05	2005/06	2006/07
<b>Number of secondary specialized educational establishments – total</b>	2,703	2,684	2,816	2,809	2,805	2,905	2,847
Including:							
state and municipal	2,589	2,595	2,626	2,627	2,637	2,688	2,631
non-state	114	89	190	182	168	217	216
<b>Number of students – total, thousand persons</b>	2,361	2,470	2,586	2,612	2,600	2,591	2,514
Including at educational establishments:							
<b>state and municipal</b>	2,309	2,410	2,489	2,502	2,504	2,473	2,389
of these, at departments:							
for full-time studies	1,698	1,757	1,808	1,843	1,878	1,888	1,836
for part time / extramural (evening) studies	87	88	85	81	76	67	60
studies by correspondence	519	559	589	571	542	510	483
external studies	5	5	7	7	8	8	10
<b>non-state</b>	52	60	97	110	96	118	125
of these, at departments:							
for full-time studies	24	32	48	61	55	73	75
for part time / extramural (evening) studies	7	5	11	6	5	4	4
studies by correspondence	21	23	37	43	34	40	45
external studies	1	1	2	1	1	2	2
Students of secondary specialized educational establishments per 10 000 of population	161	170	178	181	181	181	177
Including state and municipal	158	165	172	174	174	173	168
Number of faculty staff at secondary specialized educational establishments, thousand persons:	130.8	136.1	143.3	146.4	145.4	150.8	148.0
state and municipal*	129.5	130.7	134.2	135.6	137.1	140.4	136.4
non-state**	1.3	5.4	9.1	10.8	8.3	10.4	11.6

\* Regular staff.

\*\* Total number of faculty staff, including those combining jobs as part of regular staff.

Source: Rosstat.

According to Rosstat, in 2004, for the first time in a decade, the enrollment to state and municipal educational establishments for secondary vocational training decreased, namely by 12 thousand persons, or by 1.4% against the enrollment index observed in 2003. In 2005 it already diminished by 41.6 thousand persons, and in 2006 – by 55 thousand persons, or by 7% against that of 2005. In 2007 this trend continued: the admission to state and municipal secondary vocational educational establishments fell by comparison with that in 2006 by 26.1 thousand persons, or by 3.4%.

In 2007, SVT establishments admitted 238.1 thousand students, or 32.6% of the total number of those enrolled, on the basis of full compensation for their tuition costs (in 2006 – 260.8 thousand, or 34.5%). Thus, the share of the commercial contingent in this sector of professional training continues to be on decline<sup>25</sup>.

*Table 9*

**Higher Educational Establishments (as of beginning of academic year)**

	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07
<b>Number of higher educational establishments– total</b>	965	1,008	1,039	1,046	1,071	1,068	1,090
Including:							
<b>state and municipal</b>	607	621	655	654	662	655	660
non-state	358	387	384	392	409	413	430
<b>Number of students – total, thousand persons</b>	4,742	5,427	5,948	6,456	6,884	7,064	7,310
Including at educational establishments:							
<b>state and municipal</b>	4,271	4,797	5,229	5,596	5,860	5,985	6,133
of these, at departments:							
for full-time studies	2,442	2,657	2,862	3,010	3,144	3,195	3,251
for part time / extramural (evening) studies	259	285	299	302	300	300	291
studies by correspondence	1,519	1,784	1,973	2,165	2,279	2,348	2,443
external studies	51	71	95	119	137	142	148
<b>non-state</b>	471	630	719	860	1,024	1,079	1,177
of these, at departments:							
for full-time studies	183	224	242	267	290	313	331
for part time / extramural (evening) studies	44	50	47	50	61	71	81
studies by correspondence	243	355	427	539	663	684	753
external studies	1	1	3	4	10	11	12
<b>Number of students of higher educational establishments per 10 000 of population, persons</b>	324	373	410	448	480	495	514
Including state and municipal	292	329	361	388	408	419	431
<b>Number of professors and tutors at higher educational establishments, thousand persons:</b>							
state and municipal*	265.2	272.7	291.8	304.0	313.6	322.1	334.0
Non-state**	42.2	46.9	47.8	50.1	50.7	65.2	75.0

\* Regular staff.

\*\* Total number of faculty staff, including those combining jobs as part of regular staff.

Source: Rosstat.

<sup>25</sup> It should be reminded that in 2005 commercial students constituted 38.3% of the total number of those enrolled at HEEs.



In the 2007/08 academic year the situation in the higher professional education system changed as follows (see *Table 10*).

*Table 10*

**Higher Professional Education in 2007, by comparison with 2006**

	2007	As % of 2006	Reference numbers:	
			2006	As % of 2005
<b>State and municipal educational establishments for higher professional training</b>				
Number of educational establishments, entities	658	99.7	660	100.8
Number of students, thousand persons	6,208.4	101.2	6,133.1	102.5
Admission, thousand persons	1,384.0	100.5	1,376.7	100.3
Graduation, thousand persons	1,108.9	105.0	1,055.9	107.9
<b>Non-state educational establishments for higher professional training</b>				
Number of educational establishments, entities	450	104.7	430	104.1
Number of students, thousand persons	1,252.9	106.5	1,176.8	109.0
Admission, thousand persons	297.6	105.9	280.9	104.8
Graduation, thousand persons	226.6	113.8	199.1	114.9

Source: Rosstat.

As seen from *Tables 9 and 10*, in 2007 there was a slight reduction in the number of state and municipal HEEs (by two entities). At the same time, the number of non-state HEEs increased by 4.7%, or by 20 entities.

The number of students both at state and municipal HEEs, and at non-state higher educational establishments continued to grow, amounting to 7.46 million persons. Simultaneously, in the state sector it increased by 75.3 thousand persons (or by 1.2%), while in the non-state one – by 76.1 thousand persons (or by 6.5%).

The total enrollment to HEEs in 2007 was 681.6 thousand persons, which is by 24 thousand persons more than in 2006. At the same time, the admission to state and municipal higher educational establishments grew only slightly, by 7.3 thousand persons; accordingly, the growth in admission numbers was mainly accounted for by non-state HEEs (by 16.7 thousand persons) (*Table 11*).

The admission to budget-funded groups has been declining for three successive years, its fall over that period amounting to nearly 60 thousand persons, or 9.5 %.

*Table 11*

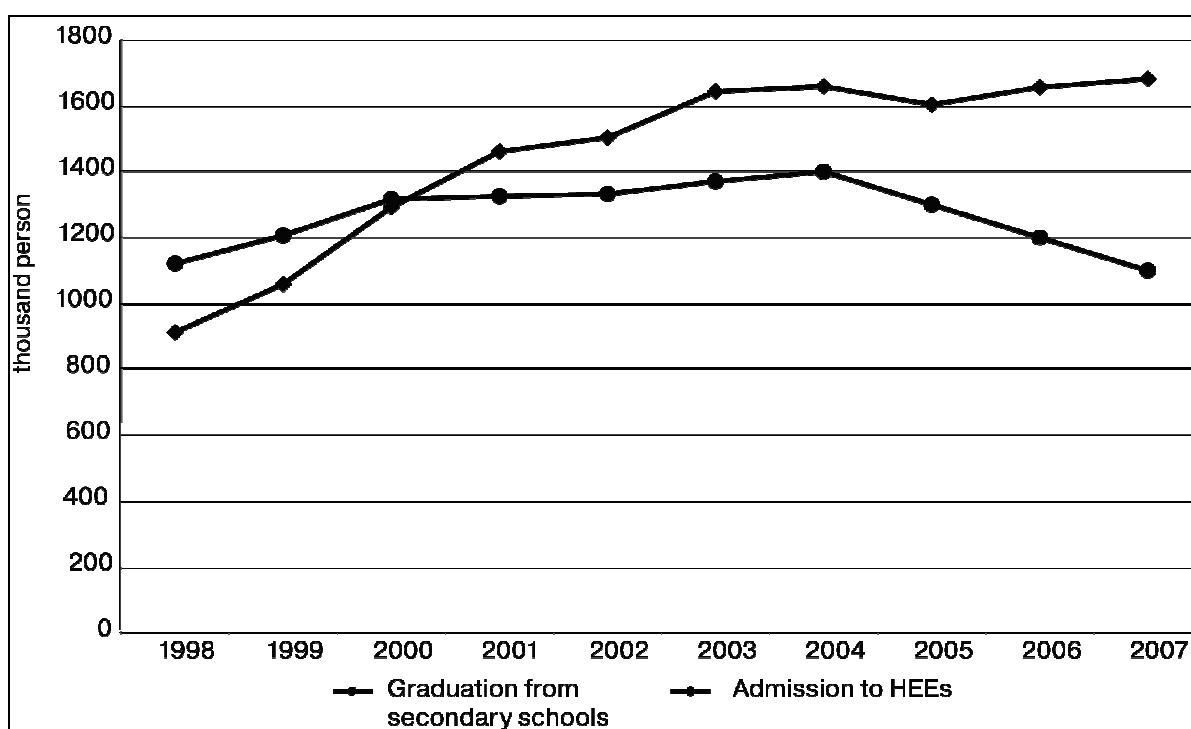
**Dynamics of Admission Numbers at State and Non-State HEEs in 2000–2007**

Years	State and municipal HEEs			Non-state HEEs
	Total	Budget-funded basis	Commercial basis	
2000/01	1,140.3	586.8	553.5	152.2
2001/02	1,263.5	587.9	675.6	198.2
2002/03	1,299.9	608.0	691.9	204.0
2003/04	1,411.7	622.6	789.1	231.7
2004/05	1,384.5	628.6	755.9	274.5
2005/06	1,372.5	613.5	759.0	268.0
2006/07	1,376.7	585.3	791.4	280.9
2007/08	1,384.0	568.8	815.2	297.6

Source: Rosstat.

At the same time, after the significant fall that began in 2004 – by 33.2 thousand persons in three years (2004–2007), the admission to state and municipal HEEs on the commercial basis has been on the rise, having increased, in fact, by the same number of students that the admission of budget-funded students has diminished – by 59.3 thousand persons. On the whole, however, the enrollment on the commercial basis in 2007 was as high 66.2%, that is, amounted to 2/3 of the total number of students. The percentage of commercial students at state and municipal HEEs also rose – to 58.9%.

In 2007 the number of students enrolled in HEEs became by 581.6 thousand persons higher than the number of graduates of secondary (full) schools (their number was 1.1 million, or 91.1% of the 2006 level). Thus, the trend that had emerged in 2006 became even more pronounced – namely, the increasing gap between the diminishing number of young people graduating from secondary schools and the (nevertheless) rising number of those enrolled in HEEs (*Fig. 11*):



Source: Rosstat.

*Fig. 11. Admission to HEEs and Graduation from Secondary Schools*

In 2007, one more trend became stronger in the higher education system, which can be regarded as a negative phenomenon: the percentage of those studying by correspondence in the total number of students is becoming increasingly higher. According to Rosstat, the admission to state and municipal HEEs in 2007 increased mainly due to the greater number of those enrolled at the departments for studies by correspondence, which amounted to 35.8 thousand persons, or 6.6%. At the same time, the number of newly enrolled full-time students diminished by 25.2 thousand students (by 3.4%).

It should be noted that in the professional training system, until recently, the prevailing (either implicit or explicit) goal was to ensure its accessibility, in accordance with which all its organizational and economic mechanisms were tailored. Broader accessibility, especially at the expense of the students paying for their tuition, provided for HEEs the solution to yet another problem – that of acute shortage of budget funding. However, when the accessibility problem had been formally solved, Russia having, in fact, switched over to “universal compulsory” higher education, the issue of professional quality of graduates came to the fore<sup>26</sup>. It appears that in the short-term perspective it is the goal of improving quality that will be determining the requirements to the higher education system’s economy, with the resulting changes in it. The issue of accessibility of high-quality higher education for different strata and population groups is being increasingly understood as a priority. The priority national project “Education” (PNPE) was largely aimed at creating incentives for achieving this specific goal. However, as seen by the experience of the last two years, state higher educational establishments are not yet ready, *by and large*, to undergo such changes.

### *The Policy for Financing the Education System*

In 2000–2007 the expenditures on education, both from state and private sources, were growing. Between 2000 and 2003, the share of budget expenditure allocated to education in total GDP significantly increased, and then began gradually to become stabilized, alongside its growing absolute volume (*Table 12*). In Russia, private expenditures on education are registered in statistical reports as “Volume of paid-for services rendered by the education system”, incorporating the estimates of hidden and informal activities. The overall changes in the volume of paid-for education services thus rendered display stable growth, its rate being higher than that of the growth of budget expenditures on education (*Table 13*).

*Table 12*

### **Budget Expenditures on Education**

	2000	2001	2002	2003	2004	2005	2006
Consolidated education budget, billion rubles, including	214.8	277.8	408	475.6	593.2	801.8	1,033.3
federal budget	38.1	54.5	81.7	99.8	121.6	162.1	201.6
territorial budgets	176.7	223.3	326.3	375.8	471.6	628.6	831.7
Share of expenditures on education in consolidated budget, as % of GDP, including	2.9	3.1	3.8	3.6	3.5	3.7	3.9
federal budget	0.5	0.6	0.8	0.8	0.7	0.8	0.8
territorial budgets	2.4	2.5	3.0	2.8	2.8	2.9	3.1
Share of expenditures on education in RF consolidated budget, as %	9.7	9.7	10.2	12.0	12.7	11.8	12.3
Share of federal budget expenditures on education in consolidated budget expenditure, as %	1.7	1.9	2.0	2.5	2.6	2.4	2.4
Share of territorial budgets’ expenditures on education in consolidated budget expenditure, as %	8.0	7.8	8.1	9.5	10.1	9.4	9.9

*Source:* Rosstat.

<sup>26</sup> In recent years, the demand for improving education quality has been increasingly viewed as that voiced by employers.

Table 13

**The Volume of Paid-for Services Rendered by the Education System  
in 2000–2007**

	2000	2001	2002	2003	2004	2005	2006	2007
Volume of paid-for services rendered by education system, billion rubles	41.5	56	72.9	95.4	118.7	147	189.6	231.7
as % of GDP	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7

Source: Rosstat.

In 2006, the federal budget expenditures on education dramatically rose by comparison with the level of 2005. Especially noticeable growth was observed in the higher education system, which was transferred into federal jurisdiction in accordance with the recent delimitation of powers between different levels of authority. In 2005, nearly all the educational establishments belonging to the PVT system were transferred into the jurisdiction of RF subjects (in federal jurisdiction there remained only 250 PVT educational establishments out of more than 3,800), as well as some of SVT educational establishments. Accordingly, federal expenditures on education were in the main allotted to the financing of the higher education system (*Table 14*).

Table 14

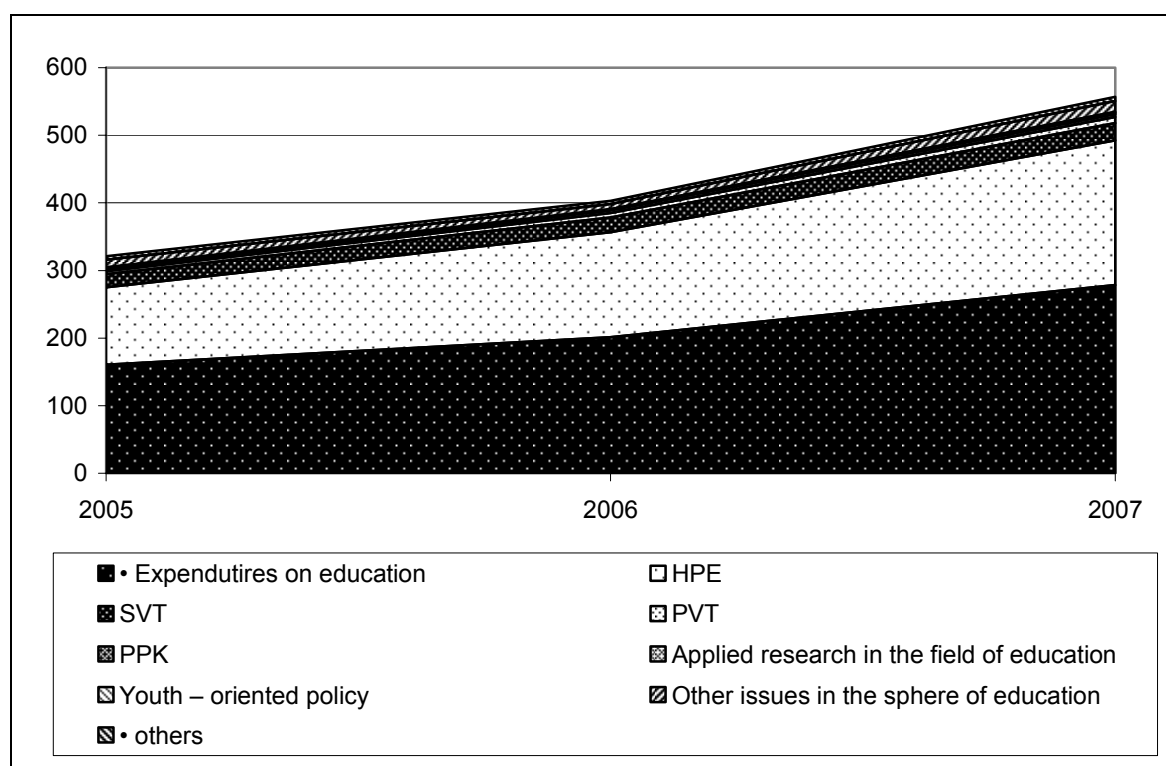
**The Federal Budget Expenditures on Education  
in 2000–2007**

	2000	2001	2002	2003	2004	2005	2006	2007
Federal budget expenditures on education, billion rubles	38.1	54.5	81.7	99.8	121.6	160.5	201.6	278.0
Federal budget expenditures on higher education, billion rubles	22.5	31.3	44.4	56.8	72.1	114.7	155.1	214.0
Federal budget expenditures on education, as % of GDP	0.5	0.6	0.8	0.8	0.7	0.7	0.8	0.9
Federal budget expenditures on higher education, as % of GDP	0.3	0.3	0.4	0.5	0.4	0.5	0.6	0.7
Share of expenditures on education in federal budget expenditure, %	3.8	4.1	4.1	4.1	4.9	4.6	4.7	5.1
Share of expenditures on higher education in federal budget expenditure, %	2.3	2.4	2.2	2.3	2.8	3.2	3.6	3.9

Source: Rosstat.

If the ratios of the federal budget expenditures on education allocated in 2005, 2006 and 2007 are to be compared, the following picture will emerge (*Fig. 12*).

In 2005, the share of expenditures on higher education in the federal budget expenditures on education amounted to 70%; in 2006 it increased to nearly 77%, and remained at that level in the 2007 federal budget. Last year, while the total volume of financing from the federal budget allocated to education increased by 1.3 times, the rise in the expenditures on the educational establishments belonging to the higher education system was by 1.43 times. This has been the highest growth rate observed since 2003. As a result, the share of expenditures on education in federal budget expenditure rose to 5.1% (in 2006 – 4.7%).



Note.

“Other” incorporate the expenditures allocated to the financing of pre-school and universal curriculum educational establishments remaining in federal jurisdiction.

Source: the Ministry of Finance of Russia.

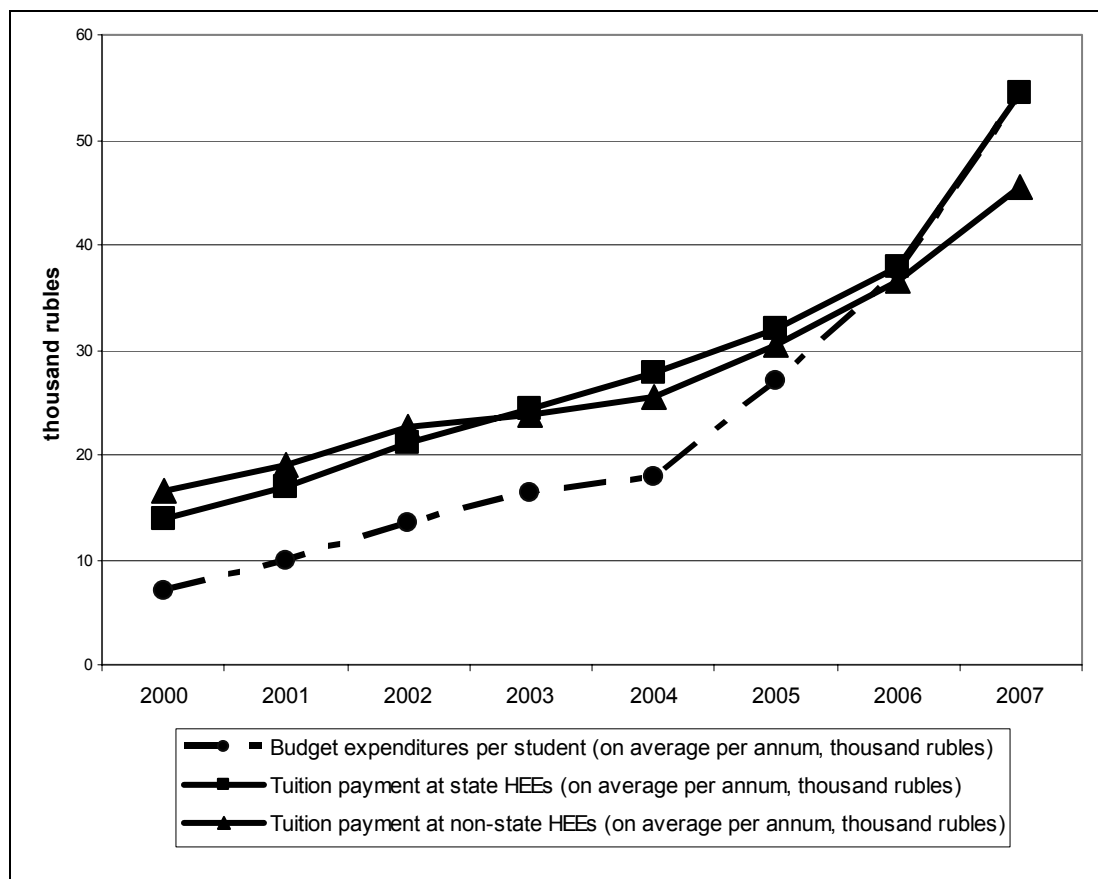
Fig. 12. Shares of Federal Budget Expenditures on Education, by Levels of the Education system, in 2005–2007

Since the budget-funded contingent of students in 2006–2007 remained almost unchanged, the changes in the level of financing resulted in a dramatic increase in the size of allocations per budget-funded student at state HEEs. In 2004 *the average budget expenditures* on one budget-funded student per year amounted to only 18 thousand rubles; in 2005 these expenditures increased to 25.6 thousand rubles; in 2006 they further increased to 37.5 thousand rubles; and in 2007 amounted to 51.6 thousand rubles<sup>27</sup>.

It should also be taken into account that the budget financing of studies in the higher education system is based on arbitrary values, where one full-time student is equal to 1, one part-time student (attending evening classes) – to 0.2, and one student by correspondence – to 0.1. In the 2006/07 academic year, full-time students constituted 65% of the total budget-funded contingent, part-time students – 5%, and students by correspondence – 30%. This means that in 2007 the cost of one budget-funded student’s tuition amounted on the average to 74.4 thousand rubles. This value incorporates, as said, only the cost of tuition proper. This has been done in order to ensure the comparability of federal budget expenditures per budget-funded student (the payment transferred by the State to a *HEE* for the studies of one student) with the amount of payment for the students admitted on a commercial basis, and therefore

<sup>27</sup> These are the expenditures on educational services proper (tuition expenditures), which constitute approximately 70% of the total expenditures on the higher education system.

these expenditures do not incorporate the cost of scholarships, or any other transfers to the population.



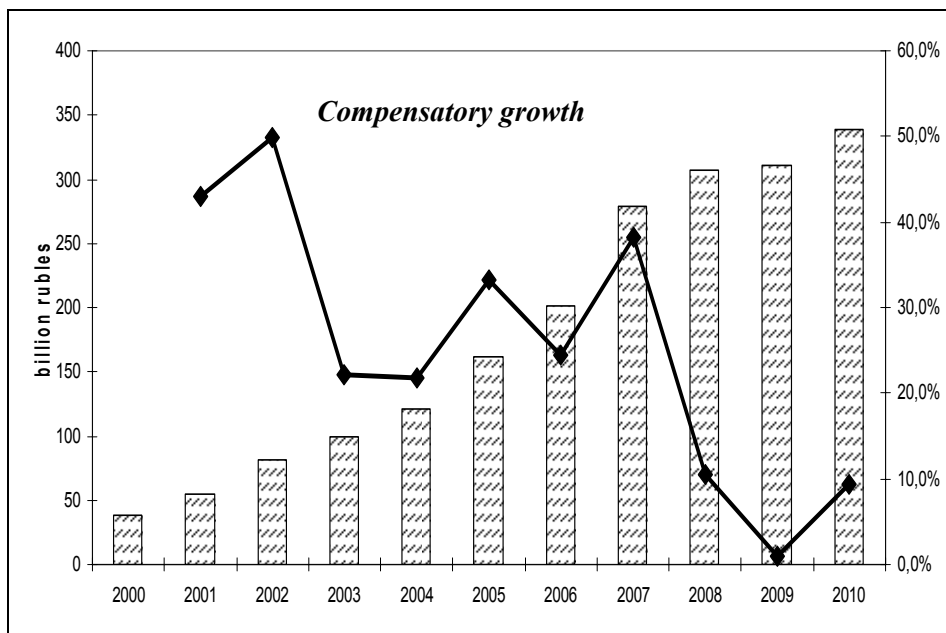
Source: *Obrazovanie v Rossiiskoi Federatsii v 2006 g. Stat. sb.* [Education in the Russian Federation in 2006. A Collection of Statistics]. M.: SU–HSE, 2006; the Ministry of Finance of Russia; the author’s estimations.

*Fig. 13.* Budget expenditures per Student and the Tuition Payments at State and Non-State HEEs in 2000–2007

At the same time, it should be borne in mind that the three-year (2008–2010) federal budget has demonstrated a significant slowdown in the growth of federal budget expenditures on education, including the higher education system.

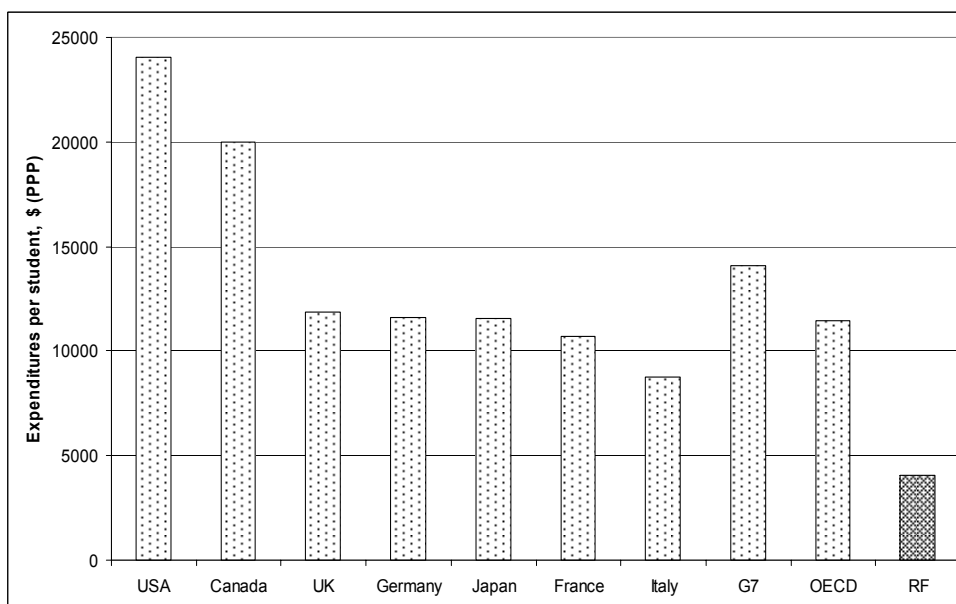
In 2008–2010 the growth rate of federal budget expenditures on education is to become much lower than that in 2007. Thus, in 2008 they are to rise by 10.7% on 2007, after having increased in 2007 by 38.3% against the level of 2006. In 2009, growth in federal budget expenditures on education should amount to 1.0%, which is certainly lower than the expected inflation rate. In 2010 the situation is going to become slightly improved, since the planned growth of expenditures will be 9.3%. On the whole, in 3 years, the expenditures on education are expected to increase by 21.9%. Thus, the education item in the draft budget for 2008–2010 has lost its marked priority character, typical of the period of 2006–2007. The inevitable *conclusion* is as follows: the declared priority of education either implied, quite simply, a compensatory increase in the size of the corresponding expenditures after its previous dramatic reduction (in 1998–1999), or was the outcome of the political decisions made in connection

with the current phase of the electoral cycle. The situation of 2008–2010 is particularly alarming, demonstrating that increasing the expenditures on education cannot be regarded as a strategic priority, being instead merely a transient response to a current situation (*Fig. 14*).



Source: the Ministry of Finance of Russia.

Fig. 14. Dynamics of the Federal Budget Expenditures on Education in 2000–2010



Source: Education at Glance. OECD, 2006; *Obrazovanie v Rossiiskoi Federatsii v 2006 g. Stat. sb.* [Education in the Russian Federation in 2006. A Collection of Statistics]. M.: SU–HSE, 2006.

Fig. 15. Tuition Expenditures at HEEs in OECD Countries and Russia, \$ (PPP)

In 2001 the expenditures on one budget-funded student in the Russian Federation were by 6.5 times lower than the average budget expenditures per student in the OECD countries (in \$ (PPP)). In 2007 this gap diminished, due to accelerated growth of expenditures on higher education in 2006 and 2007, and the difference became 3-fold (*Fig. 15*).

At the same time, the remaining gap in the expenditures on education per student prevents Russia from being competitive on equal terms on the international higher education market: its current share on this market (by the volume of funding received from foreign students in \$ (PPP)) amounts to 0.3% (as compared to that of the EU – 30%, of the USA and Canada – 31%, and of Australia and New Zealand – 10%). This means that the reduction in the rate of growth of expenditures on higher education in 2008–2010 will make it even more difficult, for Russia, to achieve this goal, since this gap between the levels of expenditures in this country and in the OECD will once again begin to grow.

In 2005, nearly all the establishments for primary vocational training (more than 3.4 thousand) were transferred into the jurisdiction of RF subjects. There also began the process of transfer to the regional level of SVT educational establishments.

This decision, although based on quite rational considerations (since the educational establishments belonging to the PVT and SVT systems train predominantly the cadres for regional and local labor markets, they must be regulated and financed at the regional level), will have far-reaching and largely unpredictable consequences. In our opinion, it is not very likely that the system of primary and secondary vocational training, once transferred into the jurisdiction of regions, will become more oriented to regional labor markets. Firstly, the PVT and SVT educational establishments, while being financed from the federal budget, have long been motivated by their own resources in terms of material resources and personnel or by the population's demand, and to a lesser degree, by the expectations of employers. It is these factors that caused the reorientation of many PVT educational establishments toward training hairdressers, chefs, waiters, car repairers and garage mechanics. Similar processes were going on in the SVT system, which began to train accountants and economists, managers and IT specialists. Secondly, the experience of those regions where, in the mid-1990s, PVT educational establishments were transferred into regional jurisdiction, has demonstrated that the situation there, from the point of view of the professional structure of the graduate contingent, differed but little from that existing in the federal PVT system<sup>28</sup> (*Fig. 16*).

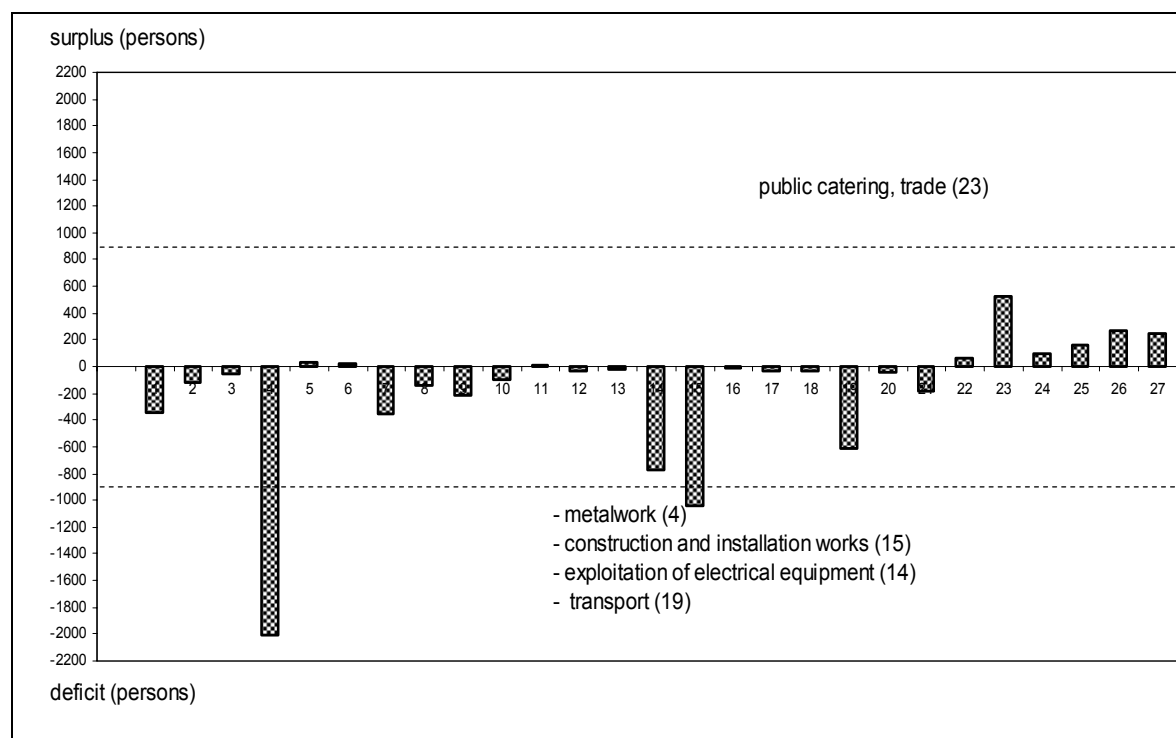
Thirdly, sometimes it is impossible for RF subjects to ensure the full financial coverage of the PVT system's costs, which has already resulted in increased differentiation of the expenditures on education at the regional level. Fourthly, very shortly after graduating from PVT and SVT establishments, young men are conscripted into the army. After demobilization, they either train for a new profession, or change their place of residence, or do both. As a result, no orientation to local labor markets is achieved in the training for "masculine professions and specialties", and the resources of regional budget allocated to this item are spent with very low efficiency. At the same time, as demonstrated by the experience of the past few years, the transfer of PVT and SVT establishments to the regional level results in a more intensive re-

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<sup>28</sup> See, e.g.: Sostoianie sistemy obrazovaniia Samarskoi oblasti v 2002/2003 uchebnom gody. / Analiticheskaia zapiska Departamenta obrazovaniia i nauki Administratsii Samarskoi oblasti i Regional'nogo tsentra monitoringa v obrazovanii. [The state of the education system in Samara Oblast in the 2002/2003 academic year. / An analytical memorandum of the Department for Education and Science of Samara Oblast and the Regional Center for Monitoring in Education]. Samara, 2003.



structuring of the PVT and SVT network (due to shortage of resources) and the creation of integrated educational establishments for vocational training, which in principle can be conducive to better education quality. However, simultaneously this eliminates the opportunities for creating a university complex incorporating three types of educational establishments – PVT, SVT and HEE.



*Fig. 16.* Discrepancy between the Number of Qualified Workers Graduating from PVT Establishments and the Actual Needs of the Branches of Samara Oblast's Economy in 2003

### **Institutional Transformations in the Education System**

On 25 October 2007 the President of Russia signed the law on the introduction of a tiered system for higher professional education, which had been approved by the State Duma on 11 October 2007. This law established independent tiers of higher education, each with separate state standards, granting Bachelor's degree (first tier) and Master's or Specialist's degree (second tier – with in-depth professional specialization). The licensing and state accreditation of the HEEs implementing Bachelor, Master and Specialist programs will also be effectuated separately.

In accordance with this law, the following timelines for studies are established: 4 years for Bachelor's degree and 2 years for Master's degree. For a Specialist's degree, the period of no less than 5 years of studies is required. For some specialties, e.g., in the field of medicine, other timelines may be established. The access to postgraduate programs is envisaged only for those with Master's or Specialist's degree.

Until 1 September 2009, the switchover to the tiered system or to Bachelor or Master programs can be implemented by decisions of the academic councils of HEEs in accordance with the existing state educational standards.

It should be noted that this law was elaborated in 2004, and so the process of its adoption lasted more than three years.

In the course of numerous discussions, one of the main arguments against the switch-over to the two-tier model was that the general reduction in the number of budget-funded places allotted to Master programs, by comparison with the number of those graduating with a Bachelor's degree, will undermine the financial well-being of HEEs. It seems, however, that this is not the most important reason: even if this sources of income had been left intact, HEEs would be resisting the innovations, because the division of all the higher educational establishments into those with and without Master programs would have translated the whole sphere of higher education into a new format, thus lowering the status of many HEEs. Besides, the switchover to a two-tier system should be preceded by serious methodological work and the revision of practically all the existing curricula and academic plans, for which the Russian higher education corpse is largely unprepared – one of important reasons, among other things, being the average age of Russian professors approaching that of retirement.

Meanwhile, no transformations would have been worth the trouble if they were intended only for a formal division of the traditional education system into two levels. In fact, any transition to a new model is worthwhile only if it entails serious alterations of the curricula and the basic organizational principles of the higher education system. Bachelor programs are becoming a component of *universal* and *comprehensive* higher education, because the demand for it, quite evidently, does exist in this country (earlier we have already discussed the issue of demand for higher education). They imply the availability of broad specialization, with the predominance of budget-funded financing. Master programs, on the contrary, should imply narrow specialization and targeted financing (private, corporate, of state-funded). The targeted character of Master programs can help to find solution to the notorious problem of “finding jobs for the alumni in accordance with their specialties”; it is nearly impossible for a 17-year-old person to select precisely the sphere of his or her future activity 5 or 6 years before graduation, but this is **a realistic goal for an adult enrolling into a two-tier Master program**.

“A period of practical work is desirable between Bachelor and Master programs, which implies the necessity to further reform the principles of conscription into the army. It is not imperative that the specialties chosen at the first and second tiers should be the same – the main condition for enrollment into a Master program should be the candidate's ability to pass all the necessary examinations, and not the specialty indicated in a Bachelor's diploma. The programs at both tiers should be reorganized accordingly – they should not be sketchy and artificially divided, but instead have a consistent content. In particular, a Bachelor program should already incorporate adequate practical experience relating to the specialty to be acquired. Only if this approach is implemented, a two-tier model will no more be perceived as something externally imposed. Indeed, this model is determined by Russia's intrinsic needs and those changes that have already been occurring within the Russian higher education system. They have been induced by the necessity to quickly increase the system's flexibility in adjusting its needs and capacities to the rapidly changing social and technological challenges of the postindustrial era”<sup>29</sup>.

On 12 February 2007 the President of Russia signed the Federal Law ‘On the introduction of alterations into the Law of the Russian Federation “On education” and the Federal

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<sup>29</sup> Kliachko T.L., Mau V.A. *Mezhdú den'gami i institutami* [Between money and institutions]. // *Ekspert* [The Expert]. 10–16 September 2007 No. 33 (574).

Law “On higher and post-HEE professional training” in the part of the conduct of the Single State Examination’, adopted by the State Duma on 26 January 2007 and approved by the Council of the Federation on 2 February 2007. In accordance with the Law, from 2009 onward the SSE will be introduced into the regular staff regime and become the main form of the attestation of the alumni of universal curriculum schools, based on which they will be admitted to HEEs. HEEs will admit, alongside those who has gained high SSE grades, the winners in all-Russian and international contests in specific subjects.

At present, the issue is being considered as to whether some HEEs (national universities, system-forming and innovative HEEs) should be allowed to introduce additional tests to supplement the SSE.

While the possibility to apply the results of contests in specific subjects on equal terms with the SSE results is justified by the extraordinary qualities of some of the applicants (who are therefore cannot be attested by means of uniform approaches and procedures), the introduction of supplementary tests can be justified by a higher level of a given HEE and the non-standard tuition it offers.

It seems that the equalization of the results of some precisely defined contests in specific subjects with those of the SEE is quite acceptable. The only requirement should be the clearly defined status of such contests – e.g., it can be all-Russian and international contests with independent juries, but not the various oblast or republican events, where the level and independency of juries cannot be easily checked. But the introduction of additional tests by some HEEs may, in our opinion, result in the very idea of the SEE being grossly discredited in the eyes of the population. Firstly, one would not be able to gain admission to such a HEE by simply sending the necessary documents, since personal attendance of the applicant will be required, which will also significantly elevate the personal expenditures on the entry to these “status” higher educational establishments and make them inaccessible for children from low-income families. Secondly, the existence of an additional barrier may give rise to even more corruption, while the SSE has been essentially intended as a means to eliminate corruption (in this connection, we are referring only to the ideology on which the decision-making concerning the introduction of the SEE was based, and not to the practical results of its implementation). Another important factor is that corruption may indeed flourish in the most prestigious HEEs, which, no doubt, will once again thwart the population’s expectations. As for the SEE, its results will appear useless for this particular group of HEEs. In fact, all this may discredit them (similarly to the SEE) in the eyes of secondary school graduates and their parents.

On 3 November 2006 the Federal Law “On autonomous educational establishments” (FZ No. 74) was adopted. Thus there emerged the opportunities for implementing a new organizational-legal form, designed to ensure greater independence and transparency of the activity of state and municipal educational establishments. However, this form is still the subject of active discussions: the HEE community and the rectors of HEEs are maintaining a very guarded attitude to the idea of transforming HEEs into autonomous educational establishments (AE).

“A cautious attitude to the transition to autonomous educational establishments displayed by a major part of the educational community is associated not only with its, so to say, natural conservatism and lack of desire to change anything in the habitual lifestyle. This is only partly true. The main problem remains the existing lack of trust in the authorities and their decision-making.

One of the most serious reasons for doubt is the fear to lose the property complex over which a HEE has a right of operative management. In accordance with the letter of the law (see Part 11 of Article 5 of the Law “On autonomous educational establishments”), such an outcome is impossible. But the law is one thing, and its interpretation is another. Presently the State (the founder) has the right to seize from a HEE’s its property which is being used inefficiently or for improper purposes. But so far this right has not been exercised. However, the transformation of a HEE into an AE, with the separation of particularly valuable property, is fraught with hidden risks and other issues reflecting the controversial character of the emerging situation.

The main argument in favor of HEEs’ transformation into AEs is as follows: budget-funded educational establishments will be performing exclusively the functions determined by the State, and will be financed strictly on a budget basis. All the off-budget revenues of budget-funded educational establishments, which under the Budget Code represent non-tax budget revenues, will be withdrawn to the budget and then managed by the legislator, which means that these monies might not necessarily be returned to those who have earned them. In this connection, the proponents of the transfer of off-budget monies to the budget, especially those generated by educational activity, resort to a “weighty” argument – that the basis for these earnings is the use of state property. But then the following question arises: what will change after a HEE assumes the form of an AE, with the State remaining the owner of its property? Thus, soon after the transformation of a HEE into an AE, the State may demand that it pay rent for the use of property considered by it to be redundant, which means, most likely, everything enabling a HEE to generate additional revenues by offering tuition on a commercial basis. In view of a significant reduction in the student contingent (which can occur in the nearest future due to demographic reasons), such threat may become a reality<sup>30</sup>.

#### **The Priority National Project “Education”**

The priority national project “Education” (PNPE), as is known, was launched in 2006 (the corresponding decision being adopted on 6 September 2005).

In 2007, within the PNPE’s framework, the implementation of comprehensive programs aimed at modernizing regional education systems was started in the universal curriculum education system. The core components of these programs were full-fledged implementation (down to the level of a school) of per capita financing standards and the testing of a new branch system of remuneration of education personnel.

In 2007, 10 RF subjects became participants of the PNPE. On the basis of a second tender, in 2008 they were joined by another 21 regions.

A new element in the national project “Education” has been the incorporation into it, in 2007, of the systems of primary and secondary vocational training. However, no important innovations are envisaged here. The established goals are the introduction, at PVT and SVT establishments, of standard-based per capita financing, which in the PVT system will be differentiated by profession, and in the SVT system – by specialty.

In 2007, several contests were held within the framework of the priority national project “Education”, with the single aim of developing innovative curricula for PVT and SVT establishments. These contests, no doubt, had a positive effect, making the directors and faculty at

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<sup>30</sup> Kliachko T.L., Mau V.A. *Mezhdru den’gami i institutami* [Between money and institutions]. // *Ekspert* [The Expert]. 10–16 September 2007 No. 33 (574).

establishments these to assess more carefully their role in the training of cadres for regional economies, as well as the potential for their innovative development. Besides, the contests enabled the experts to view from another angle both the potential of this level of the education system and the ways for its modernization in contemporary conditions.

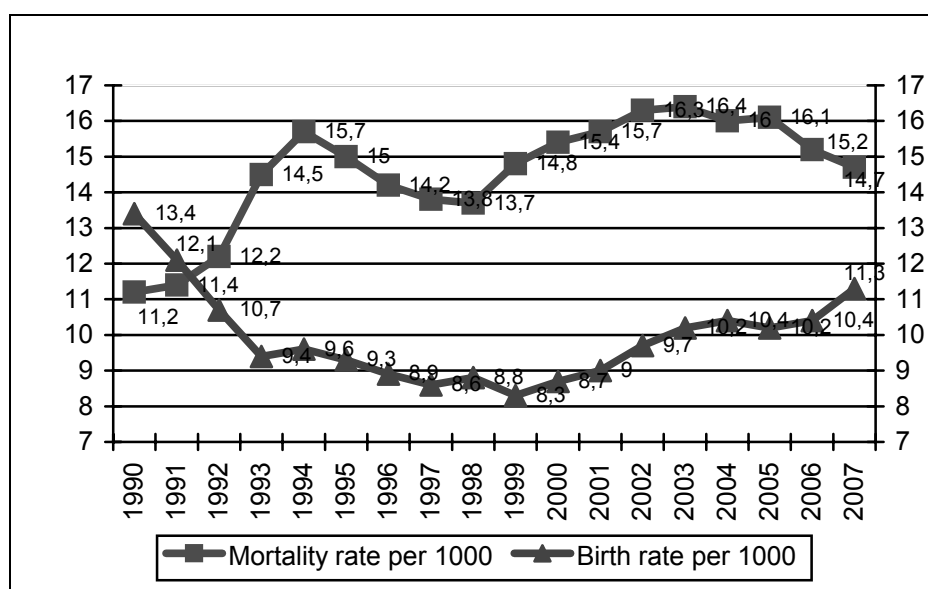
In the higher education system, the 17 HEEs implementing innovative curricula since 2006 were joined, in 2007, by another 40. Thus, their aggregate number is 57, or nearly 10% of the total number of Russian higher educational establishments. The volume of financing allocated to HEEs' innovative curricula will amount, in 2006–2008, to 20 billion rubles.

The year 2007 saw the actual emergence of two federal (national) universities – the Siberian and the Southern. Substantial funding has also been allocated to their development – 3 billion rubles for each university.

All these measures seem to have only one purpose – to create an innovative core inside the Russian higher education system, designed to ensure the intellectual (research and development) and cadre-based (a new generation of specialists) promotion of the innovative economy, in order to ensure Russia's high rate of long-term economic growth, independent of the situation on the international raw materials markets. This is a respectable goal, the achievement of which can determine the strategy of Russia's higher education system for years to come.

#### 4.4.2. Public Health Care

From the point of view of the state of the public health care system, the year 2007 was marked, first of all, by continuing positive changes in the indices of mortality and birth rate – a trend that first appeared in 2006. In two years, the birth rate coefficient rose by 11% (including by 9% in 2007), while the population mortality coefficient dropped by 9%. In officials' speeches these changes are regarded as the proof of positive achievements resulting from government demographic policy and the National Project "Health".



Source: Rosstat, the RF Ministry of Public Health Care and Social Development.

Fig. 17. Birth Rate and Mortality Indices in Russia in 1990–2007

From 1 January 2007, a package of measures designed to provide state support to families in connection with birth and upbringing of children was introduced, among which the following ones should be pointed out:

- expansion of the list of recipients and increase in the amount of the monthly allowance to cover the cost of the care for a child until the age of one and a half years; now, this allowance is being paid to all women, and not only to those employed and currently on a leave to care for a child; the size of the allowance for unemployed women has been increased from 700 rubles to 1,500 rubles in respect of the birth of their first child, and to 3,000 rubles in respect of the birth of their second child, as well as the subsequent children; the size of the allowance granted to employed women is equal to 40% of the size of their salary, while at the same time being no less than the size of the allowance for unemployed, and higher than 6,000 rubles;
- establishment of compensation payments to parents for the upkeep of their child at a pre-school educational establishment: when a first child attends a kindergarten, the payment will constitute 20% of the charges covered by parents, for a second child this payment will amount to 50%, and for a third and subsequent children – 70%;
- grant of a mother's capital in the amount of 250 thousand rubles for women giving birth to their second child; but these funds will be available only from the year 2010 onward.

In all probability, the first of these measures has indeed had a positive effect on the birth rate. The number of recipients of the allowance to cover the cost of the care for a child until the age of one and a half years nearly doubled, while the share of this allowance in the total incomes of their recipients is estimated to be equal to 11%, having thus exceeded the 10% threshold considered significant for a decision in favor of having a second child to be made in families that can ill afford it, according to European surveys<sup>31</sup>.

As for the lowering mortality rate, there are no sufficient grounds for a conclusion that this is indeed the result of the implementation of the national project in the sphere of public health care. It seems more realistic to link this downward trend with the effects of other factors. It should be emphasized that it is from the year 2006 onward that the average per capita level of household incomes became higher, in real terms, than the income level observed prior to the onset of market reforms<sup>32</sup>. It is this factor, coupled with continuing economic growth, diminishing unemployment and the resulting diminishing depression level of some population categories, that has, most probably, influenced the drop in the mortality rate. It should also be noted that in the past two years the State has intensified its struggle against the sale of counterfeit alcoholic beverages, the consumption of which used to be one of the principal causes of high mortality rates among the male population in this country.

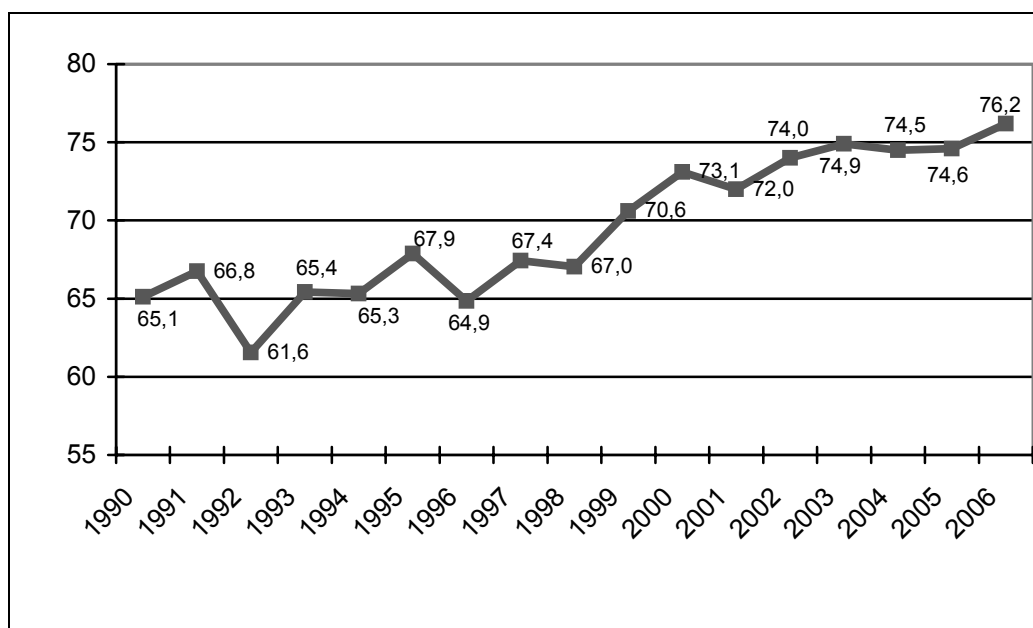
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<sup>31</sup> Ovcharova L.N., Pishniak A.I., Popova D.O. *Novye меры podderzhki materinstva i detstva: rost urovnia zhizni semei s det'mi ili rost rozhdaemosti? Analiz mer podderzhki materinstva i detstva, vnedrionnykh v 2007 godu v Rossiiskoi Federatsii*. [New measures for supporting motherhood and childhood: growth of well-being of families with children, or birth rate growth? An analysis of measures for supporting motherhood and childhood implemented in the Russian Federation]. M.: UNICEF, 2007, p. 18–19.

<sup>32</sup> *Obzor sotsial'noi politiki v Rossii. Nachalo 2000-kh*. [An overview of social policy in Russia. The early 2000s]. / Ed. By T. M. Maleva. *Nezavisimyi institut sotsial'noi politiki* [Independent Social Policy Institute]. M., 2007, p. 218–219.

While noting the positive shifts in mortality rates, one should not forget that the gap between Russia and European countries in this respect is very wide – about 1.5–2 times, and much time and effort will be required to eliminate it.

The data on general population morbidity in 2007 were still unavailable at the moment of completing this overview, but the evident long-term upward trend in morbidity rates (see Fig. 18) is indicative of the overall population health becoming worse.



Source: the Ministry of Public Health Care and Social Development.

Fig. 18. Overall Population Morbidity in Russia in 1990–2006 (per 100 persons)

The main directions of the government policy in the sphere of public health care in 2007 were the national project “Health” and the implementation of the Program for Supplementary Provision of Pharmaceuticals (SPP) to some categories of citizens receiving state social support from the federal budget.

#### *National Project “Health”*

The implementation of the national project “Health” in 2007 was covered by the resources of the federal budget and social insurance funds in accordance with the following federal laws – of 19 December 2006, No. 238-FZ, “On the 2007 federal budget”, of 29 December 2006, No. 243-FZ, “On the 2007 budget of the Federal Compulsory Health Insurance Fund”, and of 19 December 2006, No. 234-FZ, “On the 2007 budget of the Social Insurance Fund”. To the implementation of measures under those projects, 131.3 billion rubles was allocated in 2007 from these sources. In addition to these, in 2007 the residual funds that had not been spent on the project’s measures in 2006 were also earmarked for this purpose, in the amount of 12.3 billion rubles. Thus, the actual amount spent on this project in 2006 was 78.9 billion rubles, in 2007 – 143.6 billion rubles (Table 15).

Table 15

**Expenditures on the Implementation of the Priority National Project  
in Health Care, billion rubles**

National project's direction, types of expenditures and sources of funding	2006	2007
<b>Federal budget</b>		
<i>Priority area "Development of primary care"</i>		
Training and retraining of general practitioners, microdistrict therapists, and microdistrict pediatricians	0.15	0.3
Additional payments to general practitioners, microdistrict therapists and, microdistrict pediatricians, and their assistant nurses	14.6	21.9
Additional payments to medical practitioners of first-aid and toxicological stations (FATS), and physicians, feldshers and nurses of emergency care system	4.1	11.2
Endowment with diagnostic equipment of municipal outpatient clinics	14.3	15.4
Endowment with ambulances of emergency care services	3.6	3.9
Vaccination of population	4.5	6.1
Preventive measures against HIV infection and B and C hepatitis, identification and treatment of HIV patients	2.8	7.8
Screening of newborns for galactosemia, adrenogenital syndrome, mucoviscidosis	0.4	0.4
<i>Priority area "Provision of tertiary care to population"</i>		
Construction of tertiary care centers	3.2	28.8
Provision of tertiary care	9.8	17.5
<i>Implementation of information support and project management</i>		
Implementation of pilot project designed to ensure modernization of public health care system	-	6.1
<i>Subtotal, funded from federal budget</i>	58.1	120.1
<b>Covered by Federal Fund for Compulsory Health Insurance (FFCHI)</b>		
Additional medical screening of employees in budget-funded sphere, aged 35–55 years	1.6	4.0
Additional payments for primary care provided to non-working pensioners (tariffs raised by 25% under territorial compulsory health insurance programs)	4.3	-
<i>Subtotal, funded from FFCHI</i>	5.9	4.0
<b>Covered by Social Insurance Fund of Russian Federation (RF SIF)</b>		
Coverage of health care provided to women during pregnancy and delivery at public health care institutions ("delivery certificate")	9.0	14.5
Coverage of services involving additional medical screening of employed citizens and provision to them of primary care	3.9	3.0
Additional medical check-ups of employees in industries associated with exposure to harmful and (or) dangerous occupational factors	1.9	2.0
<i>Subtotal, funded from RF SIF</i>	14.8	19.5
<b>Total</b>	<b>78.9</b>	<b>143.6</b>

The process of the national project's implementation and its outcomes is analyzed further on the basis of the data published by the RF Ministry of Public Health Care and Social Development<sup>33</sup> and Roszdravnadzor<sup>34</sup>.

<sup>33</sup> <http://www.mzsrff.ru>.

<sup>34</sup> The data cited here were collected by Roszdravnadzor; see N.V. Yurgel, E.L. Nikonov. Monitoring realizatsii meropriatii prioritnogo natsional'nogo proekta v sfere zdravookhraneniia. [Monitoring of the implementation of a priority national project in the sphere of public health care]. – Menedzhment kachestva v sfere zdravookhra-  
396



Allocations to the project from the federal budget and social insurance funds constituted approximately 10% of the total public expenditures on health care in 2006 and 2007. Of course, this amount is insufficient for achieving rapid and significant positive changes. However, there still were some positive results in terms of better access to and higher quality of health care.

The national project envisages the payment of additional money payments to primary care physicians (microdistrict therapists, pediatricians, general practitioners) and their assistant nurses in the amount of 10 thousand rubles and 5 thousand rubles per month, respectively; to the medical staff of first-aid and toxicological stations (FATS), and physicians, feldshers and nurses employed in the emergency care system: 5 thousand rubles per month to physicians; 3.5 thousand rubles per month to feldshers (or midwives); and 2,5 thousand rubles per month to nurses.

As a result, in two years, the salaries of 690 thousand of primary care physicians, nurses and feldshers were increased nearly by 1.6 times (for physicians and nurses – by 2.5–3 times, for feldshers employed in the emergency care system – by 55%), and amounted for microdistrict area therapists, on the average, to 22.6 thousand rubles; for specialists (physicians) – to 15.5 thousand rubles.

The size of the supplementary payments and the terms for their granting turned out to be in no way linked to performance quality. According to the data of Roszdravnadzor, in the past two years there was not a single instance of a primary care practitioner being deprived of the additional payment for an unsubstantiated prescription of pharmaceuticals under the program for supplementary provision of pharmaceuticals (SPP), or for improper execution of his or her duties.

We can point out the following true achievements resulting from the increased remuneration, within the national project's framework, to physicians and nurses employed in the primary care system:

- increased attractiveness of the job of a microdistrict therapist and a pediatrician; a part of the existing vacancies have been filled, and the higher salaries attracted to the primary care system 7.7 thousand physicians, more than 3 thousand young specialists and as many nursing staff; and district services are no more suffering from acute shortages of personnel;
- increased workload / work intensity of microdistrict therapists and pediatricians;
- the increased payments for actual services turned out to be the payment for work under the program for additional provision of pharmaceuticals to some categories of citizens receiving state social support from the federal budget;
- the impact on the performance quality of therapists and pediatricians was found to be controversial:
  - on the one hand, owing to the increased working time potential and elimination of the need to work overtime with the resulting fatigue, physicians now have more opportunities for being more attentive to patients' needs;
  - on the other, the implementation of the SPP program and the national project's reporting requirements, with the resulting paperwork, increased the workload on medical personnel (according to some evidence, up to one-third of a microdistrict

therapists's working time is now taken up by filling-in prescription forms and reports) and, accordingly, diminished the time to be devoted to other categories of patients;

- negative effect on the motivation of the other categories of physicians, who were not granted such payments and thus were estimating as unjust the ratio between the size of their own remuneration and that for the work of microdistrict therapists.

The problems of personnel shortage faced by the primary care system did not entirely disappear as a result of the increased remuneration. Contrary to expectations, there were still some vacancies. The increase in salaries proved to be insufficient to increase the attractiveness of such jobs in small towns and rural areas. According to Roszdravnadzor, in 2006–2007 more than 1.5 thousand first-aid and tocological stations were closed down (a total reduction by 3.6%) because of lack of medical personnel and the stations' failure to comply with licensing requirements.

In 2006–2007, within the framework of the national project, 10 thousand of the health care institutions belonging to the primary care system were equipped with more than 42 thousand units of X-ray, sonography, laboratory, endoscopic and electrocardiography equipment. According to the estimations of the RF Ministry of Public Health Care and Social Development, this resulted in an average reduction of the waiting time for diagnostic procedures from 10 to 7 days. The institutions of the emergency care system, in those two years, were supplied with 13.2 thousand ambulances. The fleet of ambulances was renewed by 70%. As estimated by the RF Ministry of Public Health Care and Social Development, the average waiting time for the arrival of an ambulance was reduced, as a result, from 35 to 25 minutes.

These measures, without any doubt, improved the material and technical state of the primary care institutions and made primary care, secondary outpatient care and emergency care more accessible for the population. However, it was impossible to avoid inefficient spending of a part of the allocated funding. When medical equipment was supplied to hospitals and outpatient clinics, the availability of trained specialists and of the premises suitable for its installation was not taken into account. Similarly disregarded were the actual needs of hospitals and clinics in specific types of equipment, and the local potential for purchasing costly expendable materials. No special funding was allocated to the purchases of expendable materials and repairs of equipment (there is some evidence that sometimes the equipment broke down after less than a year of exploitation) either in the national project itself, or in the expenditures earmarked for the implementation of territorial compulsory health insurance programs. The financing of these expenditures depended on the capacities of local budgets. Resulting were numerous cases when new equipment was no more operating after the initial packages of expendable materials supplied with it had been used up. According to Roszdravnadzor, by late 2007 more than 3.2 thousand units of equipment (or 5.8% of the total quantity) supplied in 2006–2007 and costing 1.5 billion rubles were idle (4% of the national project's expenditures allocated for these purposes).

Within the project's framework, 10.6 million of those employed in the budget-funded sphere and 7.4 million of employees in industries associated with exposure to harmful and (or) dangerous occupational factors underwent additional clinical examination. But the results achieved in respect of this particular component of the national project are controversial. The cost of the clinical examination of one person was determined to be equal to 540 rubles, which does not fully compensate for a medical institution's actual expenditures. For such

clinical examinations, medical specialists were taken off their routine appointments, which resulted in longer waiting time and decreased availability of secondary care for other categories of patients. Medical screenings were sometimes incomplete, due to lack of necessary specialists at municipal medical institutions: according to Roszdravnadzor, in more than 20% of cases clinical examinations was not completed properly. It was sometimes difficult to carry out subsequent targeted diagnostic procedures and treatment of the patients whose pathologies had been revealed during those general screenings, since they were reluctant to make another appointment with a specialist because of long waiting lines at their medical institution. The paperwork load on the medical staff of the primary care system also increased, due to the introduction of a large number of reporting forms. At the same time, the substantially increased turnover of documentation was not backed up by computerization and adequate software backing.

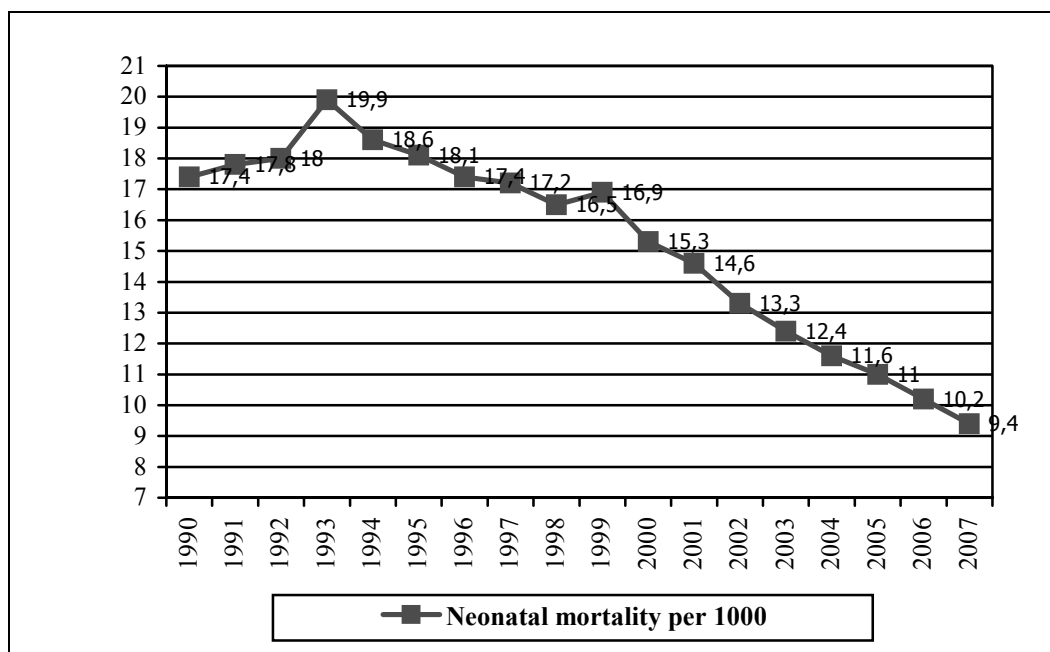
The project also envisages vaccination of the population against hepatitis B, rubella, influenza, and other infections. Besides, the screening of newborns for hereditary diseases has been implemented.

The funding under the project was allocated to supplementary financing of the health care provided to women during pregnancy and birth. "Birth certificates" were serving as the mechanism for payment. From the year 2007 onward, the program was joined by pediatric outpatient institutions. The issue of delivery certificates to 2.6 million women helped to provide maternity hospitals with expendable materials and pharmaceuticals, as well as to raise the salary levels of the medical personnel of maternity hospitals: for physicians – on the average by 5–6 thousand, for nursing staff – by 3–4 thousand, for assistant staff – by 500–600 rubles. The mechanism of birth certificates provided women with opportunities for making a choice between medical institutions and created incentives for competition between such institutions located in oblast centers and cities with population of more than 400 thousand. The supplementary funding received from the federal budget by maternity outpatient institutions [women's consultations], maternity hospitals, and pediatric outpatient institutions became a factor that produced positive effect on neonatal mortality. However, it should be noted that this index has been displaying a downward trend in Russia since 1994 (see *Fig. 19*).

The national project envisages the financial coverage of tertiary care provided to the population. The number of patients receiving such care at the expense of the federal budget increased from 60 thousand in 2005 to 170 thousand in 2007. While in 2006 such funding was allocated only to federal medical institutions, in 2007 this type of care was already being provided by 73 medical institutions of subjects of the Russian Federation. It is worth mentioning that the financial coverage of this type of care from the federal budget means only that a certain category of patients is formally entitled to free of charge care. There is evidence that sometimes the patients, after having received a reference document for treatment at a federal hospital to be covered by funding within the national project's framework, were forced to incur additional costs. Thus, Roszdravnadzor has revealed some facts proving that sometimes patients had to provide additional payment when receiving tertiary care at certain federal specialized medical centers.

The national project envisaged the construction of 14 tertiary care centers. Naturally, it was found to be impossible to put them in operation by the beginning of 2008, as was initially declared. In 2007, 3 new centers were put in operation (two cardiovascular surgery centers in

Penza and Astrakhan, and a trauma, orthopedics and endoprosthesis replacement center in Cheboksary), while the other center will be completed in 2008.



Source: Rosstat, RF Ministry of Public Health Care and Social Development.

Fig. 19. Neonatal Mortality in Russia in 1990–2007 (per 1,000 live births)

The results of the implementation of the national project in 2006–2007 have demonstrated its unquestionably positive contribution to the endowment of the public health care system with resources, but its contribution to the population’s improved health has not yet been confirmed with certainty.

In the years 2008–2009, it is planned to continue the implementation of the priority national project in health care, while further expanding it, which will involve, first of all, measures designed to decrease, across the Russian Federation, the population’s mortality rate associated with such manageable causes as cardiovascular diseases and road traffic accidents. Improved health care provided to patients suffering from cardiovascular diseases is expected to lower this type of mortality by 1.3 times (from 325 to 250 cases per 100 thousand). It is planned to improve the organization of health care for victims of traffic accidents, which will result in a decline in the resulting mortality rate by 2,700 cases per annum, as well as to lower the resulting disability incidence to 8 thousand per annum. Besides, some measures are envisaged in order to further develop the blood product supply system.

New tertiary care technologies will continue to be developed on the basis of federal medical institutions, as well as of those under the jurisdiction of subjects of the Russian Federation and municipal formations, thus increasing the level of the population’s access to tertiary care to 70% of the existing demand.

Within the national project’s framework, there will be the continued financing of measures aimed at preventing diseases, improving the quality of medical services provided at maternity institutions, and strengthening primary care services, including the financial coverage

of the additional payments to the personnel of the primary and emergency care systems, while no increased remuneration is planned for the other categories of medical personnel.

All this is expected to have a positive effect on the Russian public health care system's endowment with resources, as well as on its accessibility and performance level. However, one national project alone is clearly insufficient for ensuring a significant breakthrough in dealing with the core problems plaguing Russia's public health care. Poor indices of the nation's health, inefficient protection of the population from the risks of incurring high costs in an event of an illness, inequality in the distribution of the burden of such expenditures and unequal availability of health care to different social and territorial groups, the overall low efficiency of the public health care system – all these problems cannot effectively be solved without large-scale reform of public health care. The national project's financial resources are insufficient for dealing with such tasks, and no significant institutional changes in the public health care system have been envisaged. However, since 2007, within the national project's framework some financing has been allocated to the implementation, in several RF subjects, of a pilot project designed precisely to initiate such institutional changes. This component of the national project basically differs from all its other components, and thus requires a separate discussion.

#### *The Onset of the Pilot Project's Implementation in the Regions*

In March 2006, the President of the Russian Federation assigned to the government the task of initiating, in 2006, an experiment involving performance-based financing of in-patient clinics and a transition to one-channel financing. The preparations for the experiment were delayed, and therefore the RF Ministry of Health Care and Social Development selected 19 regions for the participation in the experiment only as late as 2007. The RF Government, by its decree of 19 May 2007, No. 296, approved the Regulations for financing, in the year 2007, the expenditures associated with the pilot project's implementation, as well as the list of the participating RF subjects (Astrakhan Oblast, Belgorod Oblast, Vladimir Oblast, Vologda Oblast, Kaliningrad Oblast, Kaluga Oblast, Krasnodar Krai, Leningrad Oblast, the Republic of Chuvashia, Tver Oblast, Tomsk Oblast, the Republic of Tatarstan, Rostov Oblast, Perm Krai, Samara Oblast, Sverdlovsk Oblast, Tiumen Oblast, Khabarovsk Krai, and Khanty-Mansi Autonomous Okrug).

The directions for implementing the pilot project were determined as follows:

- a stage-by-stage transition of public health care institutions predominantly to one-channel financing through the CHI system;
- the purchasing of in-patient care by tariffs calculated on the basis of clinical standards, with due regard for the estimated quality of the actually provided health care;
- the partial accumulation, at the level of an outpatient institution, of the funding earmarked for the coverage of health care, based on per capita financing standards (partial fund-holding), and the creation of a system of intra- and inter-institution mutual settlements;
- reforming of the system for medical personnel remuneration toward performance-based principle;
- ensuring the keeping of records of the volumes of actually provided health care in the compulsory medical insurance system, and the assessment of its quality.

It was planned that the experiment would be financed in the year 2007 in the amount of 6.1 billion rubles from the Federal CHI Fund, to be covered by allocations from the federal

budget (including the residuals of the year 2006 in the amount of 2.1 billion rubles), as well as to be co-financed from the budgets of RF subjects in the amount of 2.6 billion rubles.

Subjects of the Russian Federation are implementing certain directions of the pilot project, depending on the terms of financing:

- the regions receiving co-financing from the Federal CHI Fund, with due regard for the level of their budget provision, are implementing all the five directions of the pilot project, namely Belgorod Oblast, Vladimir Oblast, Kaluga Oblast, Kaliningrad Oblast, Vologda Oblast, Leningrad Oblast, Tomsk Oblast, Khabarovsk Krai, the Republic of Chuvashia;
- the regions receiving federal grants are implementing two directions, based on their own choice, namely Astrakhan Oblast, Tver Oblast, Rostov Oblast, Samara Oblast, Sverdlovsk Oblast, Krasnodar Krai, Perm Krai, and the Republic of Tatarstan;
- those participating in the experiment without attracting funding from the FFCHI are implementing only one direction, based on their own choice, namely Tiumen Oblast and Khanty-Mansi Autonomous Okrug.

The transition to one-channel financing is being tested in 12 regions out of the 19. The leaders in this process are Tiumen Oblast (the share of state financing for the public health care system accumulated in the territorial CHI system has achieved the level of 89%), Tomsk Oblast (68%), Perm Krai (66%), and Vladimir and Kaliningrad Oblasts (60% each).

According to the general rule, the tariffs established in the existing CHI system compensate for five types of medical institutions' costs: salaries, changes to salaries, purchases of pharmaceuticals, minor furnishing and equipment, and the cost of patients' catering. Within the pilot project's framework, in six regions the "expanded" tariffs are being tested, whose purpose is to provide compensation for a more broad range of expenditures. In Vladimir and Kaluga Oblasts, Perm Krai and the Republic of Chuvashia, the tariffs also incorporate the cost of utilities and the upkeep of a medical institution's property. In Tomsk Oblast the tariffs established for the payment for services, and in Kaliningrad Oblast – the per capita standards for financing to be allocated to a medical institution, also incorporate the cost of capital repairs and purchases of medical equipment; in other words, these regions have implemented a "full tariff".

The possibility of incorporating clinical standards into the mechanisms for a medical institution's financing is being tested in 13 regions. However, this process was hindered by some limitations in terms of resources. By the present moment, there have been developed and approved 617 federal standards for health care to be provided for certain diseases, among which more than a half (310) are the standards for tertiary care. According to the estimations prepared in some of the pilot regions, the payment for the health care actually delivered in compliance with these standards will require an increase in expenditures by 2–4 times. And, although this estimation applies to the tertiary care standards, it still creates a barrier in the way of implementing any standards. In the pilot regions it was chosen to selectively implement the standards for assessing the size of financing needed for covering health care provided for certain diseases (from 4 to 21).

Different variants of fund-holding by the primary care subjects (the accumulation at the primary care system's level of the funding earmarked for the purchasing of other types of health care: diagnostic procedures, emergency care, in-patient care) are being implemented in 10 regions among those participating in the project. The highest degree of progress in this respect has been achieved in Kaluga Oblast, but it should be borne in mind that in 1998–2002

this region, within the framework of the World Bank's project, was the site for testing the mechanism of partial fund-holding by outpatient institutions (polyclinics), but after the external financing had been stopped this mechanism was applied no more. The experience then accumulated has enabled the oblast to be ahead of the other regions in implementing the fund-holding mechanism. Meanwhile, in the other 9 regions such innovations have been implemented only in some individual medical institutions.

At present, the reforming of the remuneration system is being carried out in 13 regions. In all of them, additional payments to medical personnel have been introduced, which are determined on the basis of performance indices. At the same time, in 2007 7 regions (Belgorod Oblast, Kaluga Oblast, Rostov Oblast, Samara Oblast, Leningrad Oblast, the Republic of Chuvashia, and Khabarovsk Krai) implemented their own, independently elaborated, branch systems of medical personnel remuneration instead of the Single Tariff System (STS). In Volgda and Sverdlovsk Oblasts this initiative is to be implemented from 2008 onward.

In 18 regions, the personified system for recording the volumes of actually provided health care have been introduced.

The choice of the experiment's directions was in the main correct, but the organization of the preparations for their implementation had some important flaws. There were no precisely formulated questions to which the experiment was to provide answers, and no alternative solutions were offered, to be tested during the experiment. In fact, the experiment is testing the existing opportunities for introducing the variants of one-channel financing organization suggested, structuring the tariffs in the CHI system, fund-holding by the primary care system, and medical personnel remuneration systems, as suggested by the regions, while at the same time identifying the emerging obstacles, as well as positive and negative results. Such an approach provides few chances for justifying the government's expectations that this experiment would create opportunities for determining the mechanism of financing appropriate for being used all over the country. The experiment's results would be clearly insufficient for providing solutions to all these problems. Besides, it should be noted that the pilot experiment overlooks such key problems faced by the existing public health care system as poor protection of the population from the risks of incurring high costs in an event of an illness, and the unequal distribution of such expenditures between population groups differing in their income levels and places of residence.

#### *Implementation of the Program for Supplementary Provision of Pharmaceuticals to Privileged Population Categories*

The year 2007 saw a logical completion of the program for supplementary provision of pharmaceuticals (SPP) to certain population categories receiving state social support from the federal budget. This program, initiated in 2005, had a very ambitious goal of changing, in qualitative terms, the provision of pharmaceuticals to disabled persons, war veterans, and persons exposed to radiation, by considerably expanding the list of pharmaceuticals to be provided to them free of charge, without imposing any limitations on physicians in prescribing these. In the 2005 federal budget the allocations to cover the cost of pharmaceuticals issued to privileged population categories amounted to 48 billion rubles, which is by 6 times higher than in 2004.

However, this scheme had serious flaws from the very start. The privileged population categories were granted the right of choice as to whether to remain in that system, or simply to

receive a money compensation instead. The sum of compensation and the sum allocated to pharmaceuticals per person remaining in the SPP program were identical. Quite naturally, the decision to remain within the system was made by those whose need for pharmaceuticals was greater. And the volumes of pharmaceuticals being prescribed were not subject to any regulation. In such a situation, the system's default was only a matter of time. It should be said that the leadership of the Ministry of Public Health Care and Social Development had been duly warned about these flaws by specialists, but they hoped that the budget allocations would be sufficient for the system to function normally. Indeed, in 2005 there was no shortage of money. The expenditures on pharmaceuticals granted to privileged population categories amounted to 44.0 billion rubles.

Table 16

**Indices of the Implementation of the Program for Supplementary Provision of Pharmaceuticals to Citizens who have the Right to Receive State Social Support from the Federal Budget**

	2005	2006	2007
Number of citizens included in Federal Register of persons entitled to state social support, million persons*	14.5	16.3	16.9
Total number of recipients of package of social services, million persons*	12.6	8.4	7.7
Share of recipients of package of social services in total number of citizens included in Federal Register, as %	87.1	51.4	45.6
Value of package of social services per persons per month, rubles,	450	477	513*
Including value of pharmaceuticals, rubles	350	424	456
Sum of invoices submitted for payment for pharmaceuticals delivered under program of supplementary provision with pharmaceuticals, billion rubles	44.0	74.9	55.0
Federal budget expenditures on program of supplementary provision with pharmaceuticals, billion rubles		29.1	34.9
Initially established size of allocations	48.3	10.0	22.0**
Supplementary allocations		39.1	15.0
Subtotal:	48.3		71.9
Resources of Federal Compulsory Health Insurance Fund, billion rubles		5.0	8.8**
Subtotal:		5.0	18.3
State expenditures on program – total, billion rubles	44.0	44.1	27.1
			99.0

\* – As of 01. 01. of each year.

\*\* – To final settlements in respect of pharmaceuticals delivered in 2006.

Source: The RF Ministry of Health Care and Social Development ([http://www.mzsrff.ru/inform\\_fz/](http://www.mzsrff.ru/inform_fz/)); Federal CHI Fund (<http://www.ffoms.ru/ffoms>).

In 2006 the SPP program was covering the remaining 8.4 million out of the 16.3 million citizens registered as entitled to social support from the federal budget. The rest had preferred money compensation. With due regard for the diminished number of the recipients of the package of social services that included, in addition to pharmaceuticals, also free-of-charge provision of treatment at a sanatorium or a health resort and the payment of the cost of travel to the place of such treatment, the allocations to the SPP program in the 2006 federal budget were initially established in the amount of 29.1 billion rubles. However, the level of demand of the privileged population categories for pharmaceuticals quickly began to soar as a result of



the efforts of pharmaceutical companies, which created incentives for physicians to prescribe more expensive medications. The average cost of a prescription issued increased from 448 rubles in January 2006 to 687 rubles in December 2006<sup>35</sup>. As early as mid-2006 there already emerged a deficit of resources needed for the payment of invoices drawn by pharmaceutical distributors. The sum of invoices for the pharmaceuticals delivered to privileged population categories reached, by the end of 2006, 67.0 billion rubles, and ultimate total sum of the invoices presented by distributors amounted to 75.9 billion rubles

To settle the payment, the residuals in the Federal Compulsory Health Insurance Fund (CHI) for the year 2005 in the amount of 5.0 billion rubles were used. In December 2006, 10 billion rubles were allocated from the 2006 federal budget, and another 6.0 billion rubles – from the 2007 budget (Article 8 of the Federal law “On the budget of the Federal Compulsory Medical Insurance Fund for the year 2007”, of 29 December 2006, No. 243-FZ). In the Federal Law “On the introduction of alterations into Federal Law “On the 2007 federal budget”, No. 132-FZ, of 17 July 2007, it was envisaged that another sum of up to 10 billion rubles was to be allocated to the final settlements against the pharmaceuticals supplied in 2006. But, quite obviously, this money was not sufficient. The sources of funding to cover the remaining 14.8 billion were determined in November 2007 by Federal Law “On the introduction of alterations to Federal Law “On the 2007 federal budget”, No. 269-FZ, of 23 November 2007, and by Federal Law “On the introduction of alterations to Federal Law “On the budget of the Federal Compulsory Medical Insurance Fund for the year 2007”, No. 264-FZ, of 23 November 2007. As a result, in 2007 a total of 22.0 billion rubles was allocated from the federal budget to complete the settlements for the pharmaceuticals delivered under the SPP program in 2006, and it was allowed to use 8.8 billion rubles out of the fixed insurance reserve of the Federal CHI Fund.

It is interesting to note that the Federal CHI Fund carried out an expert’s estimation of the invoices drawn and presented by distributors, in order to check the compatibility between the prescribed and delivered pharmaceutical and a given patient’s diagnosis, the instances of incompatible pharmaceuticals being prescribed to one and the same individual, and the compatibility between a pharmaceutical prescribed and the patient’s age and sex. The expert’s estimation revealed the presence of such incompatibilities amounting to a total of 5.7 billion rubles, or 7.5% of the total volume of pharmaceuticals delivered to privileged population categories. However, despite these results, additional funding was allocated in the amount corresponding to the total sum of invoices drawn.

The financial crisis experienced by the SPP program urged the Ministry of Public Health Care and Social Development to adopt some measures designed to adjust its basic principles. In October 2006 the list of pharmaceuticals to be made available to privileged population categories was shortened. The provision of pharmaceuticals to privileged population categories suffering from severe chronic diseases (7 nosological forms – hemophilia, mucoviscidosis, hypophysial nanism, Gaucher’s disease, myeloleukosis, multiple sclerosis, and immunosuppression associated with organ and (or) tissue transplantation) was separated from the SPP program into a separate program, to be financed from the federal budget. In accordance with Federal Law “On the introduction of alterations to the Federal Law “On the 2007 federal budget” of 24 November 2007, a total of 47.9 billion rubles was allocated to these purposes.

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<sup>35</sup> Hereinafter, if not specified otherwise, the data of the Federal Fund for Mandatory Health Insurance are cited (<http://www.ffoms.ru/ffoms/>).

In February 2007, a new procedure for prescribing pharmaceuticals and filling-up the prescription forms was established (Order of the RF Ministry of Public Health Care and Social Development, No. 110, of 12 February 2007), which required that this was to be done in accordance with the approved clinical standards for each specific disease.

However, these measures proved to be not far-reaching enough to prevent the emergence, in 2007, of the same situation of insufficiency of planned expenditures for the provision of privileged population categories with medications to cover the cost of pharmaceuticals delivered to them. The Ministry of Health Care and Social Development, Roszdravnadzor and the Federal CHI Fund were evidently incapable of ensuring centralized control over the substantiation for the prescription of pharmaceuticals to privileged population categories. This could have been easier to do for regional and local authorities, but they were, from the very start, placed outside of the network of financial flows in the SPP system, and therefore no clearly determined responsibility for the results of its functioning had been delegated to them. The regions were also displeased with the numerous instances of lack of coordination between the actual needs of their populations and the actual items being supplied by distributors, as well as their volumes. The authorities of RF subjects had no effective instruments for influencing these deliveries, because both the list of pharmaceuticals and the list of suppliers were determined by federal agencies.

In the SPP system, by early 2007, there had remained less than 50% of the citizens belonging to such categories – 7.7 million. In the 2007 federal budget it was initially envisaged that 34.9 billion rubles should be allocated to their provision with pharmaceuticals. However, the value of the actually delivered pharmaceuticals in 2007 will amount, according to the Federal CHI Fund, to no less than 55 billion rubles. By Federal Law “On the budget of the Federal Compulsory Health Insurance Fund for the year 2008 and the planned period of the years 2009 and 2010”, of 21 July 2007, No. 184-FZ, it was envisaged to allocate 15 billion rubles from the federal budget to the final settlements for the pharmaceuticals actually delivered in 2007; to allocate to the same purpose 8.0 billion rubles from the Federal CHI Fund as part of subsidies to the CHI territorial funds for the implementation of territorial CHI programs, as well as to spend up to 10.3 billion rubles from the fixed insurance reserve of the Federal CHI Fund. Thus, the total sum of allocated funding will amount to 68.2 billion rubles

Thus, the financial results of the SPP program’s implementation in the past three years are disappointing. In 2006 the sum of invoices drawn by distributors for pharmaceuticals delivered to privileged population categories exceeded the initially planned budget by 2.2 times, and in 2007 – by 1.6 times. The provision of privileged population categories with pharmaceuticals, indeed, improved by comparison with the situation prior to 2005, but the problems arising from untimely settlements of the invoices presented by suppliers resulted in temporarily diminished deliveries and uncertainties as to how long would be the period of waiting for a prescribed pharmaceutical to be actually delivered. At first, privileged population categories had unreasonable hopes, which then gave way to disappointment and dissatisfaction. And for all this, the State had to pay very dearly – no less than 174 billion rubles in three years, without taking into account the size of money compensations paid to the group of more than a half of the “privileged” population which had left the system. In 2008 the number of those belonging to privileged population categories who remained in the SPP program diminished to 5.5 million, thus amounting to 33% of the total number of the population granted the right to social support from the federal budget (16.9 million persons).

The practical experience of implementing the SPP program has made obvious the fact that the exclusion of the authorities of RF subjects from full-fledged participation in it, and the attempt to manage the program exclusively from the federal level was a gross error. As a result, a legislative decision was made to transfer to the bodies of state authority of RF subjects the powers pertaining to the organization of the provision of pharmaceuticals, medical products and specialized dietary foodstuffs for disabled children to the citizens included in the Federal Register of persons entitled to state social support (Article 18 of Federal Law “On the introduction of alterations in individual legislative acts of the Russian Federation in connection with improving the delimitation of powers”). From 1 January 2008, the organization of the placement of orders for the supplies of pharmaceuticals under the SPP program in the form of auctions, the conclusion of government contracts, as well as the organization of the population’s provision with pharmaceuticals purchased under government contracts has been effectuated by the authorities of RF subjects. The SPP program will be financed within the framework of the basic compulsory medical insurance program as part of the subsidies allocated to that program’s implementation, and these expenditures will no more be entered as a separate item into the federal budget and in the budget of the Federal CHI Fund. According to the Federal CHI Fund, the financial backing for the SPP program in 2008, allocated as part of the subventions transferred to territorial CHI funds for the implementation of the basic CHI program, will amount to 27.5 billion rubles. Now, it is, in fact, RF subjects who bear the responsibility for overspending the resources allocated to the SPP program from the federal budget. In addition to the already mentioned expenditures on the SPP program, in the 2008 federal budget it has been envisaged that 18.7 billion rubles should be allocated to centralized purchases of pharmaceuticals needed for the treatment of the 7 severe pathologies listed above.

#### **Challenges Faced by the Public Health Care System**

The completion of the electoral cycle has once more put to the fore the issue as to the prospects for further developing the public health care system, as well as its reforming. The modernization of the public health care system is regarded as one of the most important priority projects envisaged in the Concept for Long-Term Socio-Economic Development of the Russian Federation, the elaboration of which has been going on since the spring of 2007. In the speech “On the Strategy of Russia’s Development Until 2020”, delivered by RF President V. Putin on 8 February 2008 at a plenary meeting of the State Council it was stated, as this country’s goal, that the mortality rate in Russia should decline by 2020 by 1.5 times; and that, in order to achieve this goal, some necessary systemic measures would have to be implemented in the spheres of medical organization, technological upgrading of the equipment of medical institutions, and personnel quality in the public health care system in general.

Lowering the mortality rate and, as a minimum, making the downward trend in the number of Russia’s population less pronounced have been pointed out as political imperatives. Society expects that the public health care system should ensure an increasingly higher quality and accessibility of health care, and a high efficiency of health care system. Meanwhile, the key problems currently faced by the contemporary public health care system in Russia are its inadequate financing level and the vagueness of state health care guarantees, which cannot sufficiently protect the population from the risks of incurring high costs of care in an event of illness, gross inequality in the distribution of the burden of health care expenditures, and its accessibility for the groups of population with different income levels and resid-

ing in different regions and at different types of settlements. Inadequate financial resources and material endowment of medical institutions are coupled with the existence of redundant beds, low efficiency of the use of the available resources, and structural disproportions between different types and levels of health care.

Alongside these problems that have emerged during the past two decades, the Russian public health care system is faced with some new challenges produced by the ongoing socio-demographic processes, economic growth, and the development of medical technologies.

The process of population ageing results in a changing scope and structure of morbidity, thus requiring higher expenditures on health care and the associated social services.

Economic growth will be conducive to increased pressure on the organizational system and financing of health care on the part of the State, the business community, the population, and the communities of medical professionals. The goals of modernizing the Russian economy will be urging the federal government to increase the public health care expenditures and at the same time to impose higher requirements in terms of an efficient use of the allocated resources. The growing regional differentiation in the primary incomes of the bodies of authority and the population, which results from the specific features of Russia's economic growth, will lead to a more pronounced differentiation in the accessibility of health care, which, in its turn, will give rise to higher requirements to the government's redistribution policy on the part of the main bulk of Russian regions.

Economic growth will intensify the competition between businesses for highly qualified workforce. On the one hand, this will increase the demand for efficiently functioning private medical insurance systems and the provision of health care to employees, primarily among big corporations. On the other, the business community will be exerting a stronger political pressure on the State, inducing it to increase the financing of public health care and its efficiency level, viewing it as a factor conducive to lower production costs.

Economic growth will result in a considerable expansion of the middle class, for which a responsible attitude to health will be typical, as well as both the desire and the ability to invest in the prevention and treatment of diseases. The emergence of the middle class will be conducive to higher requirements, on the part of the population, to the quality of health care, including its service parameters.

The development of medical technologies and emergence of new generations of pharmaceuticals will make it easier to diagnose diseases at an earlier stage and to prescribe appropriate treatments. But at the same time this factor will determine growth in the cost of medical services.

The main risks inherent in the public health care system's further development are as follows:

- public and private expenditures on health care will be growing at a high rate, but the health care system's efficiency will remain low;
- the differentiation in the accessibility of quality health care for population groups with unequal income levels and residing in different areas will be becoming more pronounced;
- the State's ability to create adequate institutions for organizing and financing public health care will be developing at a very slow rate;
- society's attitude to health care will, for a long time, remain of a dual nature, combining the principles of universal equality and paternalism in regard of its accessibility with the

preparedness to pay medical personnel under-the-table in order to make them more attentive to a patient's needs and to provide medical services of a higher quality.

The responses to the challenges faced by the public health care system will be determined by the following three main factors: 1) the volume of resources allocated by the State, the population, and corporate entities to the provision of health care; 2) the dynamics of changes in society's attitude to health values and the problems of the public health care system, the strength of the pressure exerted on the State and the public health care system by the population, and first of all the middle class, and employers; 3) the evolution in the State's ability to develop appropriate institutions for the organization and financing of public health care, including the ability to pursue a consistent anti-corruption policy.

One can distinguish, in this connection, three key questions, the answers to which will be determining the character of the Russian public health care system's development in the foreseeable future:

- What should the State be guaranteeing?
- Where will the middle class look for health care?
- To whom shall we be paying: to an insurer or to a physician?

The existing system of state guarantees for the provision of health care will need to be transformed. To leave the existing guarantees for free of charge health care largely unspecified, with vague boundaries between free of charge and paid-for types of care, will mean that the public financial resources will continue to be exploited with low efficiency, and there will remain barriers in terms of health care's accessibility for the poor and for a part of the middle class, as well as general dissatisfaction of the population with the operation of the public health care system.

Among the possible solutions for this problem, the following options should be singled out:

a) to specify the state guarantees for the free of charge health care by its type, volume, and technologies applied, and the procedure and terms for its provision based on a system of standards (the standards for health care in respect of each disease, the standards for equipping medical institutions, the lists of pharmaceuticals to be prescribed, etc.);

b) the categorization of medical institutions as those with and without the right to render medical services on a commercial basis; the provision of free of charge health care at those state and municipal institutions which are not allowed to render similar services on a commercial basis;

c) the introduction of the population's legal co-payments for medical services; state guarantees for free of charge health care are thus transformed into the guarantees for it being co-financed by the State.

Each of these options may entail substantial risks and costs, and therefore the choice of a strategy for solving this problem is not an easy one to make, but it will have to be made all the same.

Of a decisive importance for the way in which the Russian health care system is going to develop will be the answer to the question as to which of its components will be providing health care to the growing middle class: the private one, which is now rapidly emerging and is ready to offer high-quality services to well-to-do patients, or the state one. Will the system be able to transform and serve the population at large, or will it remain a low-quality system for the poor, while the well-to-do will be receiving the main bulk of their health care at private

institutions? This will depend on the desire and ability of the State to restructure the public health care system and to create new motivation mechanism for institutions and medical personnel to improve their efficiency and quality.

The future of the Russian health care system will be largely determined by those mechanisms that will turn out to be the most efficient ones for providing services of a required quality to the population. At present, these are the mechanisms for informal payments for the services provided by medical personnel. But they cannot efficiently protect patients from extortion, the imposition of excessive services, and the consequences of physicians' errors. One alternative would be health insurance, which introduces an informed intermediary between physician and patient, who has an economic interest in the provision of timely, high quality and effective care to insured persons. However, for the health insurance institutions to operate in this manner and to begin to oust the practice of informal payments, it will be necessary to modernize the compulsory health insurance system, as well as to introduce a consistent policy of promoting the development of voluntary health insurance and finding appropriate forms for combining it with compulsory health insurance.

#### **4.5. The Situation in the Sphere of Science and Innovation**

##### **4.5.1. Major Outcomes of the Implementation of the Strategic Plans of the Government in the Sphere of Science and Innovation Policies**

In 2007, there came to end the five year period since the moment of adoption of one of the most important strategic documents concerning the development of the science and technology sphere of Russia – “The principles of the policy of the Russian Federation in the sphere of development of science and technologies for the period until 2010 and beyond” (hereinafter referred to as the “Principles”). This document presented a whole range of avenues, measures and mechanisms of the state science and innovation policies, which are necessary to form a market innovation system in Russia. The program should be implemented in two stages. At the first stage completed in late 2006 it was planned to carry out the reform and reorganization across practically all areas of the national scientific complex. At the second stage (from 2007 till 2010) it was envisaged to “complete the formation of the national innovation system and an integral structure of the scientific and innovation complex able to efficiently function under conditions a market economy.” Now, it is already possible to assess the outcomes of the first stage of implementation of the Principles.

All measures envisaged in the Principles may be conditionally classified as those aimed at the support of science and those aimed at the creation of incentives for innovation activities (see *Table 19*). There were envisaged and implemented more measures aimed at the support of science than the measures to be undertaken in the sphere of creation of incentives for innovation activities. In the sphere of support of science, there was carried out somewhat more than one third of the total planned work. It may be admitted that the most successful were the measures aimed at the development of the forms of financing of science, like the reduction of the share of the estimate based financing, implementation of the most important innovative projects of national significance, introduction of preferential treatment with respect to state scientific funds (the latter came into force on January 1, 2008), creation of the legal framework of integration of education and science (adopted in December of 2007). As concerns the human resources management policy, there was achieved a partial success; however, the im-

plemented measures were not pivotal. The main program aimed to become an accelerator of improvement the personnel structure of science and the quality of scientific capacities – “Scientific and scientific-educational human resources of innovative Russia” – is at the moment at the stage of approval. The least successively implemented measures were those in the sphere of reorganization and reform of the public sector of science. There was carried out no inventory of the network of scientific organizations, and the system of state scientific centers (SSC) was not reoriented towards the settlement of new problems, accreditation of scientific organizations was abolished, what was a rather controversial decision. In spite of the adoption of the federal law “On autonomous institutions,” there were observed no conversion of scientific organizations into autonomous institutions.

The majority of serious measures aimed at the creation of incentives for innovations were either actually launched only in 2007 (support of venture financing, creation of technological parks in the sphere of information technologies), or will be introduced in 2008 (legislation in the sphere of the intellectual property rights, measures of indirect regulation). Many tools applied for creation of incentives for innovations indicated in the Principles either had existed yet prior to the adoption of this document, or were not introduced at all (system of support of “science towns”, establishment of various interdepartmental centers). Therefore, the planned strategic programs are implemented with delays and, similarly to the earlier situation, in a fragmented way.

#### ***Development of Prognostication and the Use of the Foresight Method***

At the level of the RF Government, it has been many times stated that prognostication should become a systematic procedure built in the system of public administration. Indeed, in the last years, prognostic studies have been actively developing and have been constantly modified. There emerged and began to develop such a method of forecasting as foresight<sup>36</sup>, which is sometimes defined as a prognostication method, although it is not quite correct.

In 2007, the RF Government developed a document titled “Long term scientific and technological forecast of development of the Russian Federation for the period until 2025”. This forecast is one of the first attempts to use the foresight method. The document presents the results of the use of this method in such areas as the development of information and communications technologies (ICT), health care and nanotechnologies.

The Forecast offers a rather adequate assessment of the current state of affairs in the field of R & D relating to crucial technologies and the technological base in Russia. At the same time, as yet the forecast is based on a number of uncertain prerequisites, which affect the results of prognostication. First, it appears that the goals of the forecast have been unjustifiably narrowed. As its main goal there is indicated the elaboration of variants of long term scientific and technological development and positioning of the country in the system of international scientific and technological cooperation, whereas the complementary objective is the creation of communication sites for the decision developers and makers. Accordingly, the main tasks are formulated in terms of selection of prospective avenues for improvement of the national competitive power and provision of various analytical reports to the public administration bodies. Therefore, to some extent the objectives of the forecast are of technocratic na-

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<sup>36</sup> Technology foresight in a rapidly globalizing economy. International Practice in Technology Foresight, UNIDO, Vienna, 2002.

ture and fail to take into account social and economic problems, at the settlement of which should be aimed the development of science and technologies. Second, the forecast is based on only one scenario with uncertain parameters, whereas no alternative scenarios are indicated. The scenario, on which the forecast is based, is defined as a “favorable scenario of development of the Russian economy”; however, its parameters are formulated too vaguely and therefore prevent the determination of its specifics. Third, the target parameters of implementation of the favorable scenario are too generalized and, besides, do not permit to compare the level of innovation development in Russia with the situation in other countries.

Therefore, the current version of the “Long term scientific and technological forecast of development of the Russian Federation for the period until 2025” is a sample analysis of the situation in the sphere of science and technologies supplemented by a list of wishes.

#### 4.5.2. Human Resources Policy in Science

Throughout the year, there was discussed the draft federal target program (FTP) “Scientific and scientific-educational human resources of innovative Russia in 2008 through 2012”. This program is an attempt of the Government to adopt a comprehensive approach to the settlement of the human resources problem and to try to create incentives for positive shifts in the human resources structure of science, which at present continues to deteriorate. Younger researchers still work in the field of science for too brief time, the generation gap grows because of the decline in the share of the scientists aged from 30 to 50, there is observed the general aging of personnel, whereas the stratification of the scientific community is increasing.

The program comprises three substantive sections aimed at the settlement of the following problems:

1. training and anchoring of human resources in the sphere of science, education and high technologies;
2. popularization of the scientific profession among schoolchildren;
3. material support of the state system of training of scientific and scientific-educational human resources.

The first task is the most resource intensive – it is planned to spend more than 80 per cent of the total financial resources allocated for the implementation of the program to fulfill this task. As concerns this direction, it is envisaged to annually support the leading scientific and educational centers, as well as finance scientific projects, in which should take part young scientists, students and postgraduate students. Such centers should not necessarily be large; the minimum requirements to the staff of such centers are limited to two professors, three young candidates of science, three postgraduate students, and four students. As concerns the substance of these measures, it resembles the previous program aimed at the support of leading scientific schools, one of the requirements of which was also the participation of young specialists. Therefore, in terms of ideology, the emphasis was again put on the support of “scientific schools”; however, no respective definition of scientific school was provided. If these are scientific schools as they were traditionally defined in the Soviet times, they are rather a deterrent of the development of science, since such schools are conservative and are in fact an antithesis of mobility. As a mechanism of transfer of knowledge, scientific schools were justified when the institution of independent expert assessment did not exist yet and the mobility of human resources was low. Globalization results in growing mobility thus ensuring fast



transfer of knowledge, there is forming a competitive and transparent management system, and, therefore, scientific schools as a form of management and transfer of knowledge prove to become inefficient.

As concerns FTP, a separate task is the improvement of the material base of the state system of training of scientific and scientific-educational human resources. It is envisaged that this task can be fulfilled by selecting and implementing investment projects aimed at the construction of up to 10 guest scientific towns (houses) suitable for a temporary compact residence of invited young promising scientists, as well as the supply of higher educational establishments, scientific organizations and enterprises operating in high technology sectors of the economy (including enterprises belonging to the defense and industrial complex and the nuclear sector) with modern educational, scientific and technological equipment.

However, it should be noted that this program fails to address the urgent housing problem faced by young scientists at the moment. At present, some attempts to resolve this problem are taken in the system of the Russian Academy of Sciences (RAS) and Russian Academy of Medical Sciences (RAMS), where since 2007 young scientists<sup>37</sup> working at scientific organizations of these Academies are eligible to submit applications and receive grants for purchase of housing. It is a rather small scale program; for instance, this year only 250 people will be able to receive grants, whereas basing on the formal criteria, at least 6 thousand persons are eligible to participate in it. Therefore, in the case the FTP is supplemented with a section envisaging the provision of housing to younger scientific personnel, it could render this problem somewhat less urgent.

It should be noted that the program fails to address a number of problems, which need to be settled in order to create incentives for young scientists to pursue full fledged scientific careers. These problems include the issue of training of new leaders – managers of science. In order to fulfill this task it would be feasible to fund projects, where young scientists are research supervisors, and for implementation of which there are provided equipment and premises.

At the same time, the objectives in the sphere of rejuvenation of personnel are formulated in terms of attraction rather than “anchoring” of the youth in science. However, the task should be not to create incentives for an increase of the inflow as it is indicated in the Program, but to make the young researchers to stay in the sphere of science. Accordingly, the target should be not an increase in the share of researchers aged below 39, but of those aged from 30 to 39. It would not be difficult to achieve the target set in the Program by increasing the number of researchers aged below 30 at the expense of the youth temporarily flowing through the sphere of science.

It should be noted that in the framework of the program the youth policy is addressed somewhat outside the general contest of the human resources situation in the sphere of science. For instance, it is not planned to introduce flexible forms of employment (new positions, new posts) for senior scientists, who, it appears, are to be replaced by young scientists “anchored in the sphere of science”. The program also ignores the problem of provision of pensions to scientists. These developments result in a deadlock situation of sorts: it is planned to increase the number of young specialists, whereas the conditions permitting them to pursue scientific careers remain uncertain.

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<sup>37</sup> In formal terms, in the framework of this initiative “young scientist” is defined as a candidate of science under 35 or a doctor of science under 45 with at least a 5 year record of work at a scientific position.

For the total period of implementation of the program it is planned to allocate 61.74 billion rubles from the state budget; however, according to the estimates presented by the RF Ministry of Education and Science, which is simultaneously the chief developer and the state ordering customer and coordinator of the program, three times more financial resources are required to radically change the human resources situation observed at the moment in the sphere of science. Therefore, high hopes are put on the federal target program to become a catalyst of positive shifts, whereas the further improvement of the human resources situation in the sphere of science should, as it appears, occur in the way of evolution. Proceeding from the past experience, in the situation where allocations from the budget are insignificant and there are no other incentives, the probability of the “catalyst effect” is rather low. It should be noted that earlier many initiatives in the sphere of science management have been modeled as “catalysts” of future changes (for instance, the program “Integration,” the program of mega-projects, a number of programs aimed at the support of small businesses); however, in fact they in fact remained only the “demonstration models”.

The planned amount of co-investment of the federal target program from sources outside of the state budget is insignificant and makes only 11 per cent of the total budget of the program. However, it should be noted that both financial resources of higher educational institutions and industrial enterprises interested in cooperation and attraction of young specialists in their R & D departments may be used as sources of co-financing of the program.

In spite of all shortcomings and problem ridden aspects of the program discussed above, this FTP is undoubtedly a step forward in comparison with the previous versions of the similar programs. Among the new and relevant measures introduced in the framework of the federal target program, there should be mentioned the following:

- Creation of incentives for mobility (due to support of training at R & D institutions and higher educational establishments);
- Invitation of foreign specialists (including compatriots who emigrated from the country) to take part in the work in the sphere of education in the territory of Russia;
- Linking of human resources problems with the state of the material and informational base of science and allocation of funds for the renovation thereof.

By the end of 2007, the draft FTP was given the new title – “Scientific and scientific-educational human resources of innovative Russia in 2009 through 2013”, what is an indicator of the fact that due to long drawn out discussions the implementation of the Program can be actually launched only in 2009.

The pilot project envisaging the linking of salaries paid to scientists to the efficiency of the work they perform on the basis of the calculation of individual indicators of the efficiency of scientific work (IESW)<sup>38</sup>, which was continued in 2007 in the RAS system, may be seen as a measure of the human resources management policy aimed at the improvement of the quality and enhancement of efficiency of scientific activities. The second phase of this pilot project, envisaging an almost twofold increase in the base rate of salaries, was launched after a

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<sup>38</sup> A more thorough description of the objectives and terms of this pilot project is presented in: Rossiyskaya ekonomika v 2006 godu. Tendentsii i perspektivy. [Russian economy in 2006. Trends and outlooks]. Issue 28. M.: IET, 2007, p. p. 560–562.

short delay caused by a protracted approval procedures involving the RAS and the RF Ministry of Education and Science, in September of 2007<sup>39</sup>.

The developments observed throughout last year permit to assess the first outcomes of the introduction of the IESW and the problems related to the calculation thereof. On the average, both the scientific administrations and efficiently working researchers and laboratories of scientific institutions engaged in natural sciences have been satisfied with the results of the IESW introduction. The leading role played by efficient scientists was confirmed by the amounts of the bonus payment they received from the budget in addition to their usual pay after the calculation of their IESW. A more complicated situation was observed in the fields of social and humanitarian disciplines, since the method of the IESW calculation is primarily oriented towards the natural and technical sciences, where the quotation of scientific papers is a major criterion of efficient work of scientists. As concerns social sciences, in many cases it turned out that the highest IESW were demonstrated not by most efficiently working scientists, but, for instance, by those who actively lectured in higher educational institutions on the part time basis and took part in numerous seminars and conferences. The control over the calculation of IESW on the part of the RAS Presidium and the RF Ministry of Education and Science was tight and the adaptation of the methods of calculation of the indicator taking into account the specifics of the fields of activities was practically completed.

On the whole, the most serious problems related to the adopted methods of calculation of the individual efficiency of scientific work may be generalized in the following way.

1. The focus on the quantitative parameters gave rise to various tricks aimed at the increase of the total value of the indicator: there was adopted the practice to present same reports at numerous conferences, as well as already mentioned above intensive lecturing on topics formally answering the fields of research of respective institutions; besides there was observed the practice of increase in the number of publications due to reduction of their volumes and so on.
2. In the course of determination of the bonus payment due from the budget, the extent of the work on contracts and projects carried out at the expense of grants on the part of scientists is not taken into account, therefore, the present approach to the assessment of scientific work fails to create incentives for the search for any extra-budgetary sources of financing and orients scientists towards work exclusively on the projects funded from the budget.
3. On the whole, the methods of the IESW calculations make it more profitable for strong scientists to work in weak collectives, since in this case their bonus payments from the budgets become significantly higher.

The application of the IESW had been launched even prior to the publication of the Regulations on the attestation of research workers, which should indicate the qualification criteria of the adequacy for the respective positions. Without a mechanism governing attestation, turnover of heads of scientific teams and contests for filling of scientific positions, the IESW system will not be sufficiently efficient.

However, the IESW system may and should be improved even without the conditions discussed above. As concerns the IESW, it would make sense to reduce the number of formal quantitative indicators and increase the number of indicators to be determined at the discretion

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<sup>39</sup> Resolution of the RF Government No. 565 of September 7, 2007, "On the implementation of the second phase of the pilot project envisaging the improvement of the system of remuneration of scientists and heads of scientific institutions and scientists of scientific centers of the Russian Academy of Sciences".

of academic councils of institutes. At the same time, the share of the reserve fund should be increased from 15 per cent to 40 or 50 per cent. As concerns the formal indicators applicable in natural sciences, there should be primarily taken into account the number of articles and respective quotations. In the case of social and humanitarian sciences, alongside with publications it is important to take into account monographs (classifying them by levels – preprints should be evaluated differently from the books issued by famous publishing houses), as well as the preparation of various analytical materials and expert evaluations (especially it concerns social sciences).

In 2007, there were discussed new aspects of the issue of promotion of mobility and cooperation with the scientific expatriate community. It should be noted that the problem of prevention of the “brain drain” evolved and turned into the problem of “brain return” from abroad. It should be noted that with respect to this issue, the emphasis shifted from the discussion of measures aimed at the attraction of emigrants on the measures aimed at the development of cooperation with the expatriate scientists both in the scientific and educational spheres. The change in the topics of the discussion and approaches towards cooperation with the expatriate community are an indirect evidence of positive shifts in the Russian science.

In fact, as yet there are no serious programs of promotion of mobility, and at this stage there is studied the respective experience of other countries. For instance, there is discussed the possibility to implement programs in the framework of which young scientists could be supported in order to be able to work for 2 or 3 years at the leading laboratories of the world and return to take the offices of the heads of sectors or laboratories; in other words, to create incentives for return in the form of a promising career. Another possible variant of promotion of mobility preventing loss of human resources may be taken from the experience of the German Research Foundation (Deutsche Forschungsgemeinschaft, DFG). In cooperation with the US National Institute of Health, DFG is implementing a program at the first stage of which scientists work on projects in US laboratories and return to Germany for the second half of the respective period. Such a work – internship is financed for 4 to 5 years. On the whole, the most significant principles of support are the facilitation of integration in global science, provision of financing for specific positions, and ensuring of prospects of a further career after the grant based support expires. The opportunity to work abroad has a number of advantages and facilitates career enhancement of scientists. First, it permits to become familiar with the international quality standards, to study new research methods, especially as concerns experimental areas of science, and, second, it facilitates the formation of international scientific ties, what is important for further work and career.

Mobility may be also promoted outside the program based approach. In this case, the system should include the turnover of staff. Abroad, there is such a mechanism – it is the system of temporary post-doctorate positions creating incentives for a change of job. In 2007, an attempt to introduce similar positions was made in the system of RAS, where, for the time of implementation of a pilot project there were allocated additional funds for the creation of temporary jobs for young scientists at academic institutes. Researchers under 33, who have already defended their theses or presented them for defense, are eligible for such positions. At present there are available about 300 such jobs and it is planned to increase this number to 500 to 550; however, it should be noted that it is not much. According to the first estimates, the initiative has worked, it permits to use the period of temporary job for selection of the best

and motivates young scientists to work. At the end of the year, practically all young scientists got offers to take permanent jobs.

In Russia, jobs of junior researchers and researchers may be used as a substitute for post-doctorate positions in order to ensure the turnover of staff. However, in this case an important component should be a contest for such positions. If it is not introduced, the system of mobility promotion will not work.

The problem of “brain drain” is directly linked to mobility. In 2007, this topic was included in the set of urgent issues, since in connection with a growth in the financing of science from the budget and resulting improvement of conditions for scientific activities in Russia, the number of scientists returning in the country increased. At the same time, the terms of grant based financing of scientific researches in the USA, the country being the major recipient of Russian scientists, were tightened and it should be noted that as concerns some avenues the funding is provided for only about 10 per cent of applications<sup>40</sup>.

It should be also noted that among those returning to Russia there are several famous scientists, what has increased the public attention to the problem. Among the most illustrative examples was the return of Prof. B. M. Velichkovsky, a leading scientist in the sphere of cognitive sciences, who over the recent years held the office of the director of the Institute of Psychology of the Dresden Technical University (Technische Universitaet Dresden). Recently, he has returned to Russia to take the post of the managing director of the Russian Research Center “Kurchatov Institute”<sup>41</sup>.

Moreover, in some areas of research the numbers of Russian scientists returning to work in Russia two times exceeds the number of groups (laboratories), which can be created for them<sup>42</sup>. At the same time, many scientists do not wish to return.

There are also several categories of scientists (from the point of view of the standing of their professional careers abroad), for whom the return to Russia may become a next step towards their professional development or career enhancement. These are predominantly the scientists, who completed one or two post-doctorate studies abroad, researchers working under temporary contracts, or accomplished scientists having foreign citizenships, who have opportunities to give some of their time to work in Russia. There is also the category of “senior” scientists, i. e. those aged 60 to 65, who encounter rather tight restrictions as concerns the taking of executive offices in science. For such scientists the return means the continuation of their careers.

It should be noted that the problem of return of emigrant scientists was carried out in a rather constructive way and involved the scientists, who have returned and worked in Russia by that time. Whereas earlier the problem of return of emigrants was analyzed only from the

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<sup>40</sup> The presentation by K. Severinov, head of a laboratory of the RAS Institute of Molecular Genetics and Rutgers University (USA) at the Round table “Nauchnaya diaspora i razvitiye rossiyskogo sektora issledovaniy i razrabotok” [Scientific expatriate community and development of the Russian sector of research and development] Source: the verbatim report of the round table organized by “StratEG” group in cooperation with the Center of Strategic Research on November 12, 2007. [http://www.opec.ru/library/article.asp?d\\_no=5935&c\\_no=83&c1\\_no=](http://www.opec.ru/library/article.asp?d_no=5935&c_no=83&c1_no=)

<sup>41</sup> Ye. Velikhov. Probit golovoi nebo [To break the sky with the head] // Strategiya Rossii, No. 10, October of 2007.

<sup>42</sup> It is referred to the RAS microbiology program. Source: A. Mezchnikov, K. Sinelnikova. V pomoshch zheltorotikam [To help greenhorns] // Nezavisimaya Gazeta – nauka, July 25, 2007. [http://www.ng.ru/science/2007-07-25/13\\_zheltorotiki.html](http://www.ng.ru/science/2007-07-25/13_zheltorotiki.html).

standpoint of the ways permitting to return all the scientists at once, now there is observed a growing understanding that there are possible although more time consuming, but more efficient forms of interactions resulting in the end to the return of emigrant scientists.

There have become apparent two approaches to the methods permitting to create incentives for the emigrants to return to the home country. First, it is to attempt to persuade scientists to stay in Russia permanently by offering them to head an institute or to organize a laboratory, or offer some other exclusive terms and financial incentives. The second approach envisages the so called "part-time return"; in this case it is supposed that scientists should work in Russia only part of his or her time carrying out scientific studies and lecturing. The latter approach envisages many various and rather flexible forms of cooperation. As a rule, such contacts and the beginning of the return are based on informal ties with scientific organizations and groups in Russia.

The experience of such countries as China and Taiwan demonstrates that return of scientists for permanent stay in the home country requires significant financial resources and creation of new organizational structures, since the implantation of returning scientists in traditional institutes causes a lot of problems, including those of social and psychological nature. In the case of "part-time return", some financial issues are not so acute, for instance, scientists pay less attention to salaries, which they continue to receive abroad, than to financial resources required for organization of laboratories, pay to their staff, purchase of equipment and chemical reagents. The practice of creating incentives for "part-time return" as an alternative of the permanent stay in the country was implemented in China and, since 2005, in Finland. In Finland, "part-time return" is implemented via a program envisaging invitation of best foreign scientists, including emigrants, to the country.

In Russia, there have been also advanced several original initiatives on "part-time return"; however, they are implemented not by the federal or regional authorities, but by individual scientific organizations and laboratories. Therefore, these initiatives are implemented on a very limited scale. There should be noted two examples of the new form of organization of cooperation with emigrant scientists. First example is the experience of the Nizhny Novgorod RAS Institute of Applied Physics concerning the establishment of so called "mirror laboratories"<sup>43</sup>. In this case in Russia there is created a laboratory similar to a foreign one headed by a compatriot residing abroad. A similar laboratory was also established in the Moscow State University. It should be situated both in Moscow and in Madrid on the base of research centers created in the universities<sup>44</sup>. This form of organization of research has a number of advantages: an opportunity to study foreign experience and become involved in foreign projects, advanced training of the personnel, easier access to chemical reagents, an opportunity to use modern equipment, and development of international ties. Unfortunately, the creation of laboratories as structural units of R & D institutes and higher educational establishments encounters a number of legal and regulatory limitations. For instance, the status of the head of such a laboratory is not determined and, therefore, the scientist holding this post can not submit applications for Russian grants and invite students and postgraduate students to

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<sup>43</sup> A. Semyanov. "Vozvrashcheniye mozgov": taktika zerkalnykh laboratoriy. ["Brain return": the tactics of mirror laboratories]. [http://opec.ru/analize\\_doc.asp?d\\_no=63767](http://opec.ru/analize_doc.asp?d_no=63767).

<sup>44</sup> A. Nemova. Potentsial v projekte. MGU i Universitet Madrida sozdayut sovmeštnyu nauchnyu laboratoriyu [Potential in the project of MSU and Madrid University create a joint scientific laboratory] // Poisk, No. 31, August 3, 2007, p. 15.

work in the laboratory; the head of this unit also can not determine the rate of remuneration of the employees. An example of the other form of cooperation is the invitation of emigrant scientists to work in the new center of nanotechnologies established in Belgorod on the base of the Belgorod State University. In this case, the factor attracting emigrants is that the laboratory is absolutely new and disposes of the most modern equipment. As a result, at present there is observed competition among the Russian emigrant scientists wishing to work at this nanotechnology center<sup>45</sup>.

Therefore, gradually there is forming the “critical mass” of those ready to return to Russia, both for permanent stay or part-time. The opportunities to attract emigrants, especially young scientists, are available; for instance, the Moscow State Institute of Steel and Alloys started to invite young scientists aged from 30 to 45 to take permanent jobs on the competitive basis offering them conditions for scientific experience and career enhancement and providing on the temporary basis two-room apartments for scientists from outside Moscow. Although only a very small number of organizations is able to ensure such conditions as yet, there are registered more precedents and the situation looks hopeful.

At the level of the RF Government there are made the first steps aimed at the attraction of scientists from abroad – in 2007, there was founded the not-for-profit “Russkiy Mir” Foundation established by the RF Foreign Ministry and the RF Ministry of Education and Science<sup>46</sup>. According to the Foundation’s Charter one of its goals is the facilitation of return of Russian citizens, who emigrated from the country, to Russia<sup>47</sup>. As yet, the Foundation has not developed any program of return of scientists; however, basing on foreign experience<sup>48</sup>, there should be financed the creation of independent laboratories or even institutes, where the scientists returning from abroad could work. Another possible approach is to finance projects headed by the returned scientists, which would be carried out in the existing institutes and higher educational establishments, at the expense of the financial resources of the Foundation.

#### 4.5.3. Problems of Material Base of Russian Science

The assertion that the material and equipment base of the Russian science is poor has become a “commonplace” of sorts and has been repeated in many documents concerning the issues of science and innovation policies. The segmental data on the average age of machinery and equipment concentrated in scientific organizations and higher educational establishments are indeed give rise to concern, since the poor material base of science is a factor affecting the state of the human resources potential of science and its efficiency. Therefore, it is no coincidence that at the meeting of the Council for Science, Technologies and Education under the RF President held on November 30, 2007, it was decided to prepare an instruction for the RF Government to develop a program of further technical modernization of basic science, as well as the strengthening of the technical and technological base of science on the whole<sup>49</sup>.

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<sup>45</sup> V. Filippov. *Pochemu v Rossiyu stali vozvrashchatsya yeyo “mozgi”?* [Why have its “brains” started to return to Russia?] // *Izvestiya*, August 3, 2007, p. 3.

<sup>46</sup> Decree of the RF President No. 796 of June 21, 2007, “On the establishment of the “Russkiy Mir” Foundation”.

<sup>47</sup> <http://www.russkiymir.ru/ru/about/ceci/>.

<sup>48</sup> There are similar foundations in Israel and China.

<sup>49</sup> The verbatim report of the meeting of the Council on Science, Technologies and Education. November 30, 2007. <http://kremlin.ru/text/appears/2007/11/152987.shtml>.

In this context it is of interest to analyze the actual picture of the material base of Russian science, the major trends in this sphere and the efficiency of the current methods and forms of material support of science (for instance, centers for shared use of equipment). The quantitative characteristics of the material base of research in value terms collected by the official statistics fail to give an adequate indication of its state not to mention the problems relating to the modernization and use of the stock of instruments and equipment by scientific organizations and higher educational establishments.

The author of this study has carried out a number of in-depth interviews<sup>50</sup> in organizations of different organizational and legal forms, which represented various sectors of science. In the interviews, there were touched upon the issues of planning, procurement and recognition in the balance sheets of scientific equipment, evaluation of the rate of sufficiency of instruments and equipment, as well as the shared use of equipment in the course of cooperative R & D projects<sup>51</sup>.

As it has turned out, no planning with respect to the modernization of the equipment base is carried out in scientific organizations and higher educational establishments, whereas the procurement of new equipment is carried out depending on the availability of financial resources (mainly due to the performance of contracted works both for domestic and foreign customers). On the whole, across the interviewed organization the expenditures for equipment varied from 3 per cent to 25 per cent of their annual R & D budgets. At the same time, in the majority of organizations and higher educational establishments purchases of equipment of low or medium value is not a problem any more; difficulties are encountered only when it is needed to purchase devices priced at 250 thousand euros and more. The problem is not only the lack of such amounts of financial resources, but also the impossibility to gradually accumulate such sums at the institutes' accounts due to the necessity to spend the budgets within a year (this problem is most acute for state scientific organizations and higher educational establishments).

The current system of taxation of scientific equipment creates incentives for organizations to search for special schemes of purchase and use thereof, which, in the end, have no advantages for scientific organizations. Purchase of scientific equipment encounters significant difficulties of organizational nature; however, there is also the problem of insufficient supply (output) of scientific equipment on the part of domestic producers, as well as human resources problems caused by the lack of skilled engineers and other technical workers able to maintain expensive equipment in good running order. Indeed, according to expert estimates, in the country there are already many scientific organizations disposing of the most modern scientific equipment comparable with the level of western laboratories and even exceeding it in terms of equipment intensiveness<sup>52</sup>; however, there is nobody to work with this equipment

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<sup>50</sup> The survey was carried out in October of 2007. There were taken 6 in-depth interviews: in academic scientific organizations (2), higher educational establishments (2), state research centers (1) and nongovernmental not-for-profit organization (1).

<sup>51</sup> In detail, the results of the survey are presented in: I. Dezhina. Otsenka sostoyaniya i problemy obnovleniya materialnoi bazy nauki v Rossii [Evaluation of the standing and problems of modernization of the material base of science in Russia] // *Innovatsii*, 2007, No. 12 (in print).

<sup>52</sup> The verbatim report of the round table "Nauchnaya diaspora i razvitiye rossiyskogo sektora issledovaniy i razrabotok" [Scientific expatriate community and development of the Russian sector of research and development] organized by "StratEG" group in cooperation with the Center of Strategic Research on November 12, 2007. [http://www.opec.ru/library/article.asp?d\\_no=5935&c\\_no=83&c1\\_no=](http://www.opec.ru/library/article.asp?d_no=5935&c_no=83&c1_no=)



and maintain it, what is a result of the human resources “gap” as concerns both researchers and technical staff.

The estimates of the state of equipment differ across sectors. The academic scientific organizations evaluated the level of their material base as rather good in comparison with the national average, but about an order of magnitude worse than in the best US laboratories. At the same time, it was noted that in developed Western countries there were rather many laboratories, where equipment was worse than in Russian institutes. However, both the academic organizations and higher educational establishments admitted that in the West the number of different instruments and devices and, accordingly, the opportunities to use different technologies for carrying out tests, was significantly higher. Russian scientists continued to work in the situation, where the stock of scientific equipment was constantly modernized, but was significantly below the West in terms of its scale.

Heads of state scientific centers (SSC), in the fixed assets of which there are listed unique and special equipment (testing units, apparatuses), believe that such equipment still remains unique not only on the national scale and that since recently there appeared opportunities to modernize it. Unfortunately, there are no resources to completely modernize unique equipment, since investments in the formation of such a material base need to be enormous.

In higher educational establishments, the assessments of the state of equipment depended on the level of development of their respective scientific bases. In the leading higher educational establishments the level of material bases was admitted to be equal to the level of academic scientific institutes. On the whole, there was noted higher quality of the equipment, which could be simultaneously used for scientific and educational purposes.

The centers for shared use of equipment (CSUE) were created in Russia as a form of support of the material base of science in the situation, where not every institute could have the instruments and equipment it needed. Besides, CSUE served for the deployment of expensive equipment, which could not be purchased on large scale; in such centers it should be accessible for a wide range of users. On the whole, CSUE are considered to be an efficient form of material support of scientific research, since they grant access to equipment for a wide range of users and permit to efficiently use (without delays and with skilled maintenance) the available scientific equipment.

In the framework of the federal target program (FTP) “Research and development across the priority avenues of development of science and technologies in 2002 through 2006,” there were created 56 CSUE. Within the system of RAS there were established 40 per cent of CSUE, 37 per cent of CSUE were created in higher educational establishments, 2 per cent of CSUE were created in the Moscow State University, 2 per cent of CSUE were established in the Russian Academy of Medical Sciences, and other centers were created in organizations of departmental affiliation (RF Ministry of Industry, RF Agency for Subsoil Use and so on). CSUE accumulate about 5.5 per cent of the total domestic stock of machinery and equipment. Therefore, the possible future effect of CSUE operation is comparatively small; however, for regional centers its importance is undoubtedly higher than for Moscow or St. Petersburg.

In reality, the functioning of CSUE, as it has been demonstrated by the survey, depends on the policies pursued by the management of the organization hosting such a center. As a rule, each CSUE is a structural unit of some scientific organization or a higher educational establishment. Such an organization is the actual disposer of the CSUE equipment and in fact determines the terms, on which it may be used.

CSUE may serve as bases for the deployment of large modern apparatuses, the so called mega-science apparatuses, the costs of which are at or above US \$ 100 million. There can not be many of such apparatuses; however, they ensure serious and fast breakthroughs as concerns the development of science. The estimated need for financial resources to create and maintain the mega-science apparatuses makes about 20 billion rubles a year<sup>53</sup>. It should be noted that the total amount of financial resources allocated for the support of CSUE in the framework of the new federal target program “Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012” made 11.6 per cent of the budget of this program (about 20 billion rubles for 6 years), whereas the financial resources allocated for the modernization of the stock of instruments (in the form of investments) amounted to 3.6 per cent or 5.6 billion rubles for 6 years.

Therefore, although there have become available resources sufficient for a selective modernization of the material base of research and procurement of several large instruments, the financial resources necessary to purchase large *apparatuses* are still lacking.

This mini-study does not permit to make wide generalizations; however, it allows to form a view with respect to the avenues of changes in the material base of scientific research and to reveal the range of related problems. The main conclusion derived from the survey is that the widely held opinion about the catastrophic situation regarding the material base of science is not true to facts. Over several recent years, scientific organizations and higher educational establishments have found opportunities to modernize and purchase new equipment and instruments. The majority of actively operating organizations could settle the issue of purchase of inexpensive equipment and instruments of average value (up to US \$ 100 thousand). However, more significant difficulties persisted in the case it was necessary to modernize or purchase expensive equipment. The normative and legal framework regulating the procurement of scientific equipment remains unfavorable with respect to scientific organizations, whereas bureaucratic barriers are still significant. Much time and sometimes substantial resources are required to overcome such barriers.

#### 4.5.4. Institutional Reform of Science

##### *Adoption of the New Charter of RAS*

One of the central developments observed in 2007 was the discussion of the new RAS Charter, which the Academy had to adopt in connection with the amendments made in the federal law “On science and the state scientific and technical policy<sup>54</sup>”.

In the beginning of the year, there was developed and made public a document titled “Draft Model Charter of the State Academy of Sciences”; however, no indication of the author of this document was presented. In a supplement to this document it was indicated that it had been developed by federal executive authorities of the Russian Federation with participation of the expert community. The RF Ministry of Education and Science actively promoted and popularized the major provisions of the Model Charter; however, the RAS developed its own draft Charter, which was supported by the General Meeting of RAS. At the end of the year,

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<sup>53</sup> Poisk, No. 39, September 28, 2007, p. 8.

<sup>54</sup> In accordance with the amendments, which came into force in December of 2006, the RAS Charter should be adopted by the general meeting of the RAS and approved by the RF Government, whereas the RAS President should be elected by the general meeting and approved by the RF President.

the RF Government approved the Charter supported by the General Meeting of RAS<sup>55</sup>. For comparison of the major changes proposed to be introduced in the RAS Charter current at that time as concerns the Model Charter and the Charter developed by the RAS, see *Table 17*.

*Table 17*

### **Changes in the System of Organization and Administration of RAS**

<b>Previous RAS Charter</b>	<b>Proposed Model Charter</b>	<b>RAS Charter approved in 2007</b>
RAS President is elected by the General Meeting	RAS President is elected by the General Meeting subject to the approval by the RF President	RAS President is elected by the General Meeting subject to the approval by the RF President
RAS Charter is approved by the General Meeting	RAS Charter is adopted by the RAS General Meeting subject to the approval by the RF Government	RAS Charter is adopted by the RAS General Meeting subject to the approval by the RF Government
The Academy is granted the state status, is an autonomous establishment and financed from the state budget	The form of incorporation of the Academy is a budget funded entity granted the right to manage its activities	Academy is a not-for-profit scientific organization created in the form of a state Academy of Sciences. It is an autonomous organization
No Supervisory Board is envisaged	Supervisory Board is a collegial administrative body of the Academy. It is composed of three representatives of the Academy, three representatives of the RF Government and one representative from each of the following institutions: the RF State Duma, the RF Federal Council, and the RF Presidential Administration	No Supervisory Board is envisaged
Among those eligible to elect the administration of the Academy, full members of the Academy make two thirds and representatives of academic organizations make one third	Among those eligible to elect the administration of the Academy, full members of the Academy make one half and representatives of academic organizations make the other half	Changes introduced in the Charter of the Russian Academy of Sciences should be adopted at the General Meeting of the Academy by no less than two thirds majority of the members of the General Meeting taking part in the respective voting. However, the vote should represent the majority of the official membership list of the Russian Academy of Sciences and the majority of the official list of the full members of the Russian Academy of Sciences. As concerns other issues, the decisions are taken by the majority of those present at the meeting
No age limit with respect to the administrative posts is imposed	There is imposed an age limit (70) with respect to all administrative posts in the Academy	No age limit with respect to the administrative posts is imposed

*Sources:* Charter of the Russian Academy of Sciences, 1992; Model Charter of the State Academy of Sciences; RAS Charter approved by the RF Government Resolution No. 785 of November 19, 2007.

As concerns the Model Charter, attention was focused on its provision, in accordance with which a Supervisory Board should be introduced in the administrative system of the RAS. The Board should be vested with the regulatory functions concerning the management of financial resources and property of the Academy, as well as the determination of the annual size of the staffs of the Presidium of the RAS, its President, First Vice President and Vice Presidents of the Academy. This proposal could not fail to meet a negative reaction on the part of the RAS administration, and on the whole the Model Charter became the subject of bitter criticism not only on the part of representatives of the academic community. Indeed, the Model Charter did not seem to be an elaborated and well thought out document. Thus, the vesting of regulatory functions in the Supervisory Board in stead of supervisory powers,

<sup>55</sup> The RF Government Resolution No. 785 of November 19, 2007, "On the Russian Academy of Sciences".

which, in accordance with its concept, it should have performed, was at variance with the provision of the law on science stipulating that the RAS President should be approved by the RF President, what meant, accordingly, that the President of the Russian Academy of Sciences was vested not only with the powers, but also was responsible for all decisions taken by the RAS. Besides, the Model Charter failed to determine the main areas of RAS activities and mention about cooperation between the Academy and the spheres of education and industry; at the same time the Charter unclearly defined the structure and mechanisms of administration and harmonization of interests. Therefore, in the case the developers of the Model Charter had better thought out the substance of this document and proposed less radical division of functions between the RAS Presidium and the Supervisory Board, their idea concerning the introduction of external control over the activities carried out by the RAS in the form of the Supervisory Board had chances to be approved.

The approved RAS Charter allows the Academy much more latitude than earlier with respect to the disposition of financial resources and other assets; however, at the same time it increases the responsibility of the Academy for the results of its activities. The RAS becomes a full budget planning entity and in fact acquires a status equal to a federal authority. Now, the Academy and its regional offices should be granted subsidies from the federal budget for the implementation of a program of basic scientific research; the RAS and organizations within its jurisdiction should be able to open accounts with credit institutions. Financing of scientific organizations within the jurisdiction of the RAS should be carried out not on the basis of estimates, but be allocated by a single item of the budget. Academic structures have been granted the right to act as founders of other organizations. The Russian Academy of Sciences should also have the right to contribute in the authorized capitals of commercial organizations established by it the results of its scientific and technical activities on the terms set by the legislation of the Russian Federation. All these developments make the organizational structure of the academic science more flexible and facilitate the opportunities of scientific organizations to participate in innovation activities. Besides, the program based funding of basic research has also been increased. It is planned that for the management of the program of basic research there should be created the Coordination Council composed of representatives of state Academies of Sciences and interested agencies<sup>56</sup>. The establishment of such a Council may be the first step towards the expansion of the program of basic research via the inclusion into it of other organizations belonging to the public sector of science, as well as higher educational establishments.

At the same time, now the institutions of the Russian Academy of Sciences have to meet their obligations with the financial resources and assets acquired at the expense of the means derived from commercial activities. In the case such institutions lack the necessary financial resources and assets acquired at the expense of the means derived from commercial activities, the Russian Academy of Sciences should be held vicariously liable for the obligations of such institutions.

All the changes discussed above should enter into force on January 1, 2009, whereas in 2008 the RF Ministry of Education and Science and the RF Finance Ministry should agree the mechanisms governing the granting of subsidies, there should be restructured the staff of the

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<sup>56</sup> The verbatim report of the meeting of the Council on Science, Technologies and Education. November 30, 2007. <http://kremlin.ru/text/appears/2007/11/152987.shtml>.

RAS Presidium and carried out a number of other administrative and economic transformations.

In the course of development of the RAS Charter, there has been discussed a number of provisions feasible to be introduced, but which were not adopted. Thus, the RAS Charter does not introduce an age limit with respect to administrative posts in the scientific organizations being in the Academy's jurisdiction. However, taking into account the fact that one of the most significant factors negatively affecting the demographic situation in science is the lack of opportunities and conditions for career enhancement of young scientists, the absence of this provision makes it more difficult to solve human resources problems faced by academic institutes. At the same time, the age structure of human resources in the RAS is one of the worst in the public sector of science. According to the data as on January 1, 2007, the average age of the personnel of the Academy makes 61.7 years for doctors of science, 50.6 years for candidates of science and 40.5 years for researchers having no degree<sup>57</sup>.

Yet another provision not included in the final version of the RAS Charter concerns the limitation to serve only two consecutive terms with respect to senior administrative posts in the Academy. So, the concept of turnover of the RAS administration was not approved, what is a certain barrier as concerns the full implementation of the new principles of RAS functioning, since flexible forms of financing and administration are introduced in the framework, where old administrative practices dominate.

### ***Facilitating Integration of Science and Education***

Positive changes in the conditions created by the state in order to integrate science and education may occur in 2008, since only on December 1 of 2007 there was adopted the federal law "On the introduction of amendments in certain legislative acts of the Russian Federation concerning the issues of integration of science and education" (No. 308-FZ). It grants to scientific organizations the right to carry out education in accordance with educational programs concerning postgraduate professional education, as well as educational programs aimed at further professional education. The law permits scientific and educational establishments to jointly use material and human resources in order to carry out both scientific and educational activities. Higher educational establishments and scientific organizations are granted the right to deliver to each other on the contractual basis, including free of charge, immovable and movable assets for use, as well as establish integrated structures, for instance, chairs and laboratories.

Up to the present time, integration of science and education encountered difficulties due to numerous legal and regulatory barriers, which have been removed by the aforesaid law. However, the legislative framework introducing the necessary conditions for integration was developed and approved for a too long time; therefore, at present the disproportions observed in development of science across sectors may become an additional barrier to their cooperation.

Whereas there are 1 071 higher educational establishments in the country, including 662 state higher educational establishments, only 406 of them are engaged in research and devel-

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<sup>57</sup> See the report of Valery Kostyuk, the Chief Academic Secretary of the RAS Presidium // Poisk, No. 13, March 30, 2007, p. 4.

opment<sup>58</sup>. Over the recent years, the number of researchers in higher educational establishments has made less than 8 per cent of their total number in the country<sup>59</sup>. It should be noted that in this case the statistics fail to take into account the size of the teaching staff engaged simultaneously in scientific research and educational activities. It is difficult to carry out respective calculations, since the majority of educators do not engage in research work on the regular basis or any significant scale. In accordance with the data of a sociological survey<sup>60</sup>, only 17.1 per cent of the teaching staff of higher educational establishments is engaged in scientific work. Among the educators engaged in research, 15.8 per cent carry out basic studies understood by the majority as writing of text books or preparation of doctoral dissertations<sup>61</sup>.

A natural advantage of higher educational establishments is the possibility to combine scientific and educational activities, as well as availability of students and postgraduate students, who may be included in the composition of teams of researchers engaged in scientific projects. Students and postgraduate students ensure an inflow, although only temporary, of new personnel providing new ideas, at the same time, it should be noted that such resources are relatively inexpensive. Nevertheless, in this sphere there were also observed negative trends: whereas in the early 1990s about 70 per cent of the total number of postgraduate students and 30 per cent of students were engaged in researches carried out in higher educational establishments, at present these figures are from 3 to 4 times lower<sup>62</sup>.

Scientific organizations and higher educational establishments have a mutual interest and need in integration. Thus, at present the scientists working in the RAS are rather actively engaged in teaching activities – according to some estimates, 34 per cent of RAS researchers are actively engaged in teaching. RAS institutes have established 350 base chairs, and it should be noted that the number of students of these chairs has increased from 6 thousand to 25 thousand over the last five years<sup>63</sup>. Recent sociological studies have also confirmed the positive attitude to integration as a form of cooperation between higher educational establishments and scientific organizations<sup>64</sup>. At present, 63 per cent of scientific organizations already

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<sup>58</sup> Indikatory nauki – 2007. [Indicators of science – 2007] Statistics digest. M.: GU-VShE, 2007, p. 20; Indikatory obrazovaniya, [Indicators of education] Statistics digest. M.: GU-VShE, 2006, p. 74.

<sup>59</sup> Indikatory nauki – 2007. [Indicators of science – 2007] Statistics digest. M.: GU-VShE, 2007, p. 28, 189.

<sup>60</sup> The survey was carried out in 2005 on commission of the RF Ministry of Education and Science; it covered 501 organizations representing academic entities and higher educational establishments, as well as organizations of departmental affiliation situated in 24 regions of Russia. Source: F. E. Sheregi, M. N. Strikhanov. Nauka v Rossii: Sotsiologicheskii analiz. [Science in Russia: A Sociological Analysis] M.: TsSP, 2006.

<sup>61</sup> F. E. Sheregi, M. N. Strikhanov. Nauka v Rossii: Sotsiologicheskii analiz. [Science in Russia: A Sociological Analysis] M.: TsSP, 2006, p. 282.

<sup>62</sup> Analiticheskiy doklad po vyshemu obrazovaniyu v Rossiyskoi Federatsii. [An analytical report on education in the Russian Federation] M. V. Larionova, T. A. Meshkova, Eds. M.: Izdatelskiy dom GU – VshE, 2007, p. 138.

<sup>63</sup> V. V. Kostyuk. Doklad na Obshchem sobranii Rossiyskoi akademii nauk “O rabote Presidiuma RAN vypolnenii vazhneishikh resheniy Obshchego sobraniya RAN v 2006 godu” [Report presented at the General Meeting of the Russian Academy of Sciences “On the work of the RAS Presidium and implementation of the most important decisions taken by the General Meeting of the RAS in 2006”], March 27, 2007. <http://www.ras.ru/news/shownews.aspx?id=245a3435-a96a-4c75-900d-0f176c52ba97&Language=ru>.

<sup>64</sup> There were surveyed 173 scientific organizations engaged in natural, technical and medical sciences, 122 of which were situated in Moscow, 31 in St. Petersburg and 20 in other Russian cities. Source: O. A. Andreyeva, O. A. Antropova, E. V. Arzhanykh, L. G. Zubova. Nauchnye organizatsii v usloviyakh reformirovaniya gosudarstvennogo sektora issledovaniy i razrabotok: rezultaty sotsiologicheskogo issledovaniya [Scientific organizations in the situation of the reform of the public sector of research and development: the results of a sociological

have stable partner relations with higher educational establishments, whereas among the organizations engaged in natural sciences the value of this indicator is even higher and makes 70 per cent.

At the same time, the budget financing of researches carried out in higher educational establishments is rather modest as compared with the academic sector. In 2007, only 3.8 per cent of the total financial resources allocated for civil science from the federal budget were transferred to higher educational establishments<sup>65</sup>. At the same time, the Russian Academy of Sciences receives about 35 per cent of the total outlays for civil science. Such disproportions in financing are a barrier to an equal integration.

#### Reforming the SSC System

There was observed no organizational reform of the SSC system in 2007. However, during this year there was developed a system of target indicators permitting to assess the results of the SSCs work, which could be later used for the purposes of their inventory. Even earlier, SSCs filled in the reporting forms having many quantitative indicators. Now the number of indicators is higher; however, the reporting discipline has deteriorated. The matter is that earlier SSCs had had to accurately fill in the reporting forms because they received additional financing from the budget in the framework of the program aimed at the support of the SSC system. Due to the fact that at present SSCs take part only in general tenders organized by the RF Ministry of Education and Science and certain other agencies, they have special incentives to report to the RF Ministry of Education and Science. Nevertheless, the RF Ministry of Education and Science believe that this initiative is the next step towards the development of a system of quantitative assessment of the results of scientific activities after the introduction of the system of individual indicators of the efficiency of scientific work (IESW) in the Russian Academy of Sciences.

The new assessment system does not just add new indicators, but sets strict threshold values, which should be met by the organizations wishing to retain the SSC status. Thus, not less than 50 per cent of the total amount of work performed by a SSC should be related to research and development activities, whereas not less than 70 per cent of such activities should be carried out in accordance with the list of priority avenues of development of science, technologies, equipment and critical technologies approved by the RF President. As concerns the SSC staff, not less than one third of it should be composed of researchers, at the same time, not less than 30 per cent of this third should be candidates and doctors of science. There were also set the standards concerning the number of publications and patents. Without discussing the issue, what was the point of departure for the setting of the threshold values of the indicators, it is important to note that the system of SSC assessment not linked to their mission and objectives in practically meaningless and therefore can not be seen as a part of the organizational reform of the SSC system.

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study] // *Informatsionno-analitichesky byulleten*, No. 2–3. Series “*Ekonomika i menedzment v sfere nauki i innovatsiy*”. [Economy and management in the sphere of science and innovations] M.: TsISN, 2007.

<sup>65</sup> A. Khlunov, the Director of the Department for State Scientific, Technical and Innovation Policies of the RF Ministry of Education and Science. From the presentation made at the round table “*Vuzovskiy sektor nauki: polozheniye na segodnyashniy den i puti dalneishego razvitiya*” [The higher educational establishments’ sector of science: current situation and the ways of further development] September 14, 2007, Center “*Otkrytaya ekonomika*”.

### *Program of Development of Scientific Research Institutes*

In 2007, there was started the development and discussion of the program aimed at the development of scientific research institutes, which took into account the experience of implementation of innovative educational programs in higher educational establishments in the framework of the national project "Education". In his address to the Federal Assembly<sup>66</sup>, the RF President proposed to launch a tender among the development programs concerning scientific research institutes similar to the competition of innovative higher educational establishments, at the same time the President made public the initiative envisaging the support of nanotechnologies. Therefore, the development of a new program has become a priority.

By the end of the year, there was developed the draft RF Government Resolution "On the measures of state support of scientific organizations implementing development programs in the framework of priority avenues of development of science, technologies, equipment and critical technologies in the Russian Federation in 2009 through 2011". The program of development was primarily defined as the improvement of the material and technological base of research, strengthening of staff capacities, development of cooperation, including international cooperation, and commercialization of the results of research and development work across the priority avenues of development of science and technologies in the Russian Federation. It is proposed to allocate no more than 10 billion rubles a year from the federal budget in order to achieve these objectives and finance development projects of scientific research institutes having won an open tender in the amounts from 300 million rubles to 1 billion rubles per the respective organization. At the same time, scientific organizations should guarantee that they will be able to raise extrabudgetary funds making to not less than 30 per cent of the total amount of the financing from the budget. It is planned to support from 10 to 30 leading scientific organizations in this way. Due to the priority status of this program, its pilot version can be launched already in 2008 as concerns the "nanotechnologies" avenue, since significant amounts of budgetary funding have already been allocated for its development.

The details discussed above confirm that the program based on the Program of innovation development of higher educational establishments. In this connection, there should be noted a number of circumstances and factors originated in the course of implementation of the program concerning higher educational establishments, which should have been taken into account with respect to the development of the programs aimed at the support of scientific research institutes. The first such factor is the difficulties related to the implementation of initiatives envisaging estimate based financing characterized by strictly set of items of expenditures, which can be adjusted only with difficulties. As concerns the implementation of such programs, subsidies would have been a more efficient tool. With respect to such a program, it would be more feasible to extend this form of funding to institutions financed from budget and autonomous institutions. The second factor is that, given the significant expenditures for purchase of equipment (on the average, across innovative higher educational establishments 71 per cent of the total amount of allocated funds were spent for these purposes<sup>67</sup>), it is important to provide financing for operation of the equipment and further training of the personnel engaged in its maintenance. Many innovative higher educational establishments have already

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<sup>66</sup> Poslaniye prezidenta Vladimira Putina Federalnomy Sobraniyu [Address to the Federal Assembly by President Vladimir Putin] // *Izvestiya*, April 27, 2007, p. 4.

<sup>67</sup> Sistemnaya aktsiya [A systemic action] // *Poisk*, September 21, 2007, p. 9.



encountered the problem of the lack of skilled personnel able to maintain new equipment in working order; therefore some purchased equipment is underutilized. The third factor is that serious support efforts such as were made in the framework of development of innovation programs, should not be only a temporary action. In order to fix the achieved results and have systemic effects, including those caused by improved project management skills, state support should be continued in some form. Foreign experience provide evidence that in the course of implementation of such programs state support should be provided over 5 to 7 years, than the outcomes should be thoroughly analyzed and there should be taken a decision if it would be feasible to continue the respective initiative. The fourth and most important circumstance is that the possibilities of institutions financed from the budget, which also include innovative higher educational establishments (and many scientific research institutes), to engage in innovative activities in the sphere of science and technologies are to a significant degree limited by the legislation. Educational establishments can not dispose of the results obtained due to the intellectual activities carried out with the financial support from the budget to the full degree; in particular, they can not make license agreements and concede their rights to third parties. Although in accordance with the RF Government Resolution No. 685 of November 17, 2005, "On the procedures governing the disposal of rights for the results of research and development activities" in formal terms the rights for such results should be retained by federal state institutions, the conditions of disposal of such rights should be set on the basis of agreements made between the respective institutions and the chief administrator or administrator of the budgetary financial resources. There still exists no standard form of such an agreement. Federal state institutions have also no right to found small innovative companies, i.e. in fact all forms of transfer of technologies with the exception of contracting of research and development results, are illegitimate.

In the case the development programs of scientific research institutes are implemented, the latter barrier should be lifted for academic institutions, the rights of which in the sphere of commercialization of results of research and development activities were expanded after the adoption of the new RAS Charter. However, other approaches including estimate based financing and short time of provision of state support are retained in the new program.

The discussion on the new program concerned primarily two aspects<sup>68</sup>. The first issue was if scientific research institutions could and should engage in the commercialization of the results of their research and development activities, and if the activities aimed at commercialization could be seen as their "development". The second issue was if it was possible to mobilize and guarantee extrabudgetary financing amounting to 30 per cent of the financial resources allocated from the budget taking into account the fact that in absolute terms it was a rather large amount.

The majority of representatives of the scientific community (scientific administration) believe that due to the fact that the RF Ministry of Education and Science will define extrabudgetary funds only as extrabudgetary proceeds and borrowed financial resources, it would not be possible to raise such a significant amount of extrabudgetary financing. In practice, this limitation effectively removes the scientific research institutes in the organizational and legal form of an institution financed from the budget from the list of entities eligible to

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<sup>68</sup> The survey is based on the synthesis of the opinions of scientists and representatives of administrations of research and development institutes presented on the web site of the National Information Center for Science and Innovations: [www.strf.ru](http://www.strf.ru).

seek state support. In this connection, it was proposed to define extrabudgetary financial resources as “not included in the original estimate”, what should make the search for co-financing easier for scientific research institutes.

The fact that in the framework of this program commercialization was included in the number of priority types of activities carried out by institutes was also assessed negatively. Alongside with the fact that there existed a number of legislative restrictions on this type of activities as concerned scientific research institutes, it was noted that the development of scientific research institutes should be primarily seen as the improvement of the quality of scientific research. In this connection, in the terms of the selection contests there should be introduced different criteria with respect to the institutes engaged in the sphere of basic science and those carrying out applied research. At the same time, it should be noted that no results suitable for commercialization can be achieved across a number of avenues of applied research including those entered in the list of the state priorities (for instance, in the sphere of development of space based systems). On the whole, the state should not make institutes to engage in commercialization because of additional financing from the budget, but create conditions for development of small science intensive businesses, the aim of which would be the commercialization of the results of research and development activities, and introduce incentives for larger businesses to utilize new technologies.

On the whole, it should be noted that both the purchase of equipment, and maintenance of the personnel and its further training should be carried out proceeding from the initially formulated concrete scientific purposes and objectives (and not the exceedingly generalized items of the list of priority avenues), including the socially and economically important ones set by the government. In this case, institutes will actually orient towards clearly formulated development programs.

#### ***An Alternative Organization of Science: Creation of the Russian Corporation of Nanotechnologies (Rosnanotech)***

The state owned Russian Corporation of Nanotechnologies (Rosnanotech) was established in 2007 with the aim of assistance to the implementation of the state policy in the sphere of nanotechnologies, development of the innovation infrastructure in the sphere of nanotechnologies, implementation of projects concerning the creation of promising nanotechnologies and nanotech industry<sup>69</sup>. In order to ensure its functioning, the RF Government has allocated 130 billion rubles (including 30 billion rubles from the RF Stabilization Fund and 100 billion rubles from the revenues of the federal budget)<sup>70</sup>. This amount by three times exceeded the financing the Russian Academy of Sciences received from the budget in 2007. As concerns its scale, the new initiative in the sphere of nanotechnologies has been already compared with the Soviet nuclear and space projects.

Indeed, the budgetary financial resources allocated to Rosnanotech exceed the amounts spent for nanotechnologies in the majority of the developed countries of the world, although the total budgetary outlays for science in these countries are more significant than in Russia. At the same time, in foreign countries businesses actively co-finances the development of nanotechnologies investing equal or larger amounts of resources than the respective govern-

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<sup>69</sup> Federal law No. 139 FZ of July 19, 2007, “On the Russian Corporation of Nanotechnologies”.

<sup>70</sup> Resolution of the RF Government No. 1687-r of November 11, 2007, “On the transfer of financial resources of the RF Stabilization Fund in November of 2007”.

ments. An opposite situation is observed in Russia – at present the budget is the major and practically only source. The stand the business took on this issue remains unclear and most probably, judging by the statements of officials and experts engaged in the development of the Russian nanotech initiative, it is a passive wait and see attitude<sup>71</sup>. Therefore, the model, which has been implemented in Russia, is that of “technological push,” i.e. first there is financed the creation of new technologies and products and only later there are explored the ways to commercialize them or taken attempts to implement the already developed technologies. In the framework of such an approach the most probable consumer of Russian research and development results can become foreign businesses.

Yet another serious problem is that first there was created the Corporation and allocated the respective financial resources, and only after that there started the discussion of the necessity to develop the glossary and definition of what nanotechnologies were and what objectives should be attained due to the development thereof. Foreign experience provide evidence that first there should be developed concrete purposes and objectives of development of some area of research and only later there should be allocated financial resources and formed necessary organizational structures.

As concerns the financial resources allocated for the development of nanotechnologies, a part of them should be spend for the development of infrastructure. In this connection there was developed a special federal target program “Development of the infrastructure of the nanotech industry in the Russian Federation for years 2008 through 2010”<sup>72</sup>, as well as the procedures governing coordination of work in the sphere of nanotechnologies<sup>73</sup>. It has been allocated 27.7 billion rubles to implement the program during three years, 25 billion rubles of which should be provided from the budget. The program is aimed at the creation of modern infrastructure of the national nanotech network for the development and utilization of the potential of the domestic nanoindustry. The national nanotech network is a system of organizations taking part in the development of nanotechnologies. The premier institution of the network is the Russian Research Center “Kurchatov Institute,” which should perform scientific and methodological functions. At the same time, the Rosnanotech Corporation also is a part of the network and serves as an organizational and financial mechanism supporting and developing nanotechnologies. The scale of the nanotech network has not been determined yet; however it is apparent that it grows rapidly. According to expert estimates, about 700 organizations in the country are active in the sphere of nanotechnologies<sup>74</sup>. Many state initiatives have also being to a greater degree focus on the support of nanotechnologies. Thus, only in 2007 the RF Ministry of Education and Science approved 400 projects in this area, whereas as it has turned out 8 out of 13 mega-projects implemented via the RF Agency for Science and Innova-

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<sup>71</sup> See, for instance, an interview with O. Naraikin, the First Deputy Director of the Russian Research Center “Kurchatov Institute” (Poisk No. 43, October 26, 2007, p. 7) and with Academician Ye. Velikhov, the President of the Russian Research Center “Kurchatov Institute” (Poisk No. 29–30, July 20, 2007, p. 7).

<sup>72</sup> Resolution of the RF Government No. 498 of August 2, 2007, “Development of the infrastructure of the nanotech industry in the Russian Federation for years 2008 through 2010”.

<sup>73</sup> Resolution of the RF Government No. 1188 r of August 25, 2006, “On the program of coordination of works in the sphere of nanotechnologies and nano-materials in the Russian Federation”.

<sup>74</sup> Estimates presented by O. Naraikin, the First Deputy Director of the Russian Research Center “Kurchatov Institute”. Poisk No. 43, October 26, 2007, p. 7.

tion were related to the development of nanotechnologies<sup>75</sup>. In the framework of the federal target program “Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012,” it is planned to spend about 50 per cent of the budget of the program for implementation of projects in the sphere of nanotechnologies<sup>76</sup>. Out of 56 centers for shared use of equipment (CSUE) operating with support of the state, 36 are active in the sphere of nanotechnologies; among 57 higher educational establishments, where are implemented innovative educational programs, in 36 establishments financial resources were allocated for modernization of the material base of the educational and scientific support of development of nanotechnologies<sup>77</sup>.

Within the nanotech network, Rosnanotech has a special place and is a unique organizational structure, which does not correspond to any organizational and legal forms defined in the RF Civil Code. The Corporation is a state owned not for profit structures, which should be engaged in financing of scientific research and commercialization of technologies. It was granted a broad range of rights and a significant degree of independence as concerns the issues related to its sphere of activities, i.e.:

1. to independently select projects for financing and be the ordering customer of the respective works;
2. to carry out the financing of projects aimed at the training of specialists in the sphere of nanotechnologies;
3. to carry out business activities;
4. to create other not for profit organizations at the expense of its assets and join associations and unions on the conditions determined by the supervisory board of the Corporation;
5. to form its own funds, including target capitals;
6. to accumulate financial resources by carrying them forward to the next fiscal year's account (it is important for financing of large projects);
7. the Corporation should not be liable for the debts of the Russian Federation and the Russian Federation should not be liable for the debts of the Corporation;
8. federal state authorities, state authorities of RF subjects and local governments should have no right to interfere in the activities carried out by the Corporation with the exception of cases envisaged by federal laws;
9. the Corporation should not be subject to the provisions of the federal law (No. 7-FZ of January 12, 1996) “On not for profit organizations”, which regulates the procedures governing the control of the activities carried out by not for profit organizations;
10. the Corporation should not be subject of the federal law (No. 127-FZ of October 26, 2002) “On insolvency (bankruptcy).”

In the management of the Corporation should participate the supervisory board, the board of directors, the managing director, the board of auditors and the scientific and technical

<sup>75</sup> The data presented by S. Mazurenko, the Director of the Federal Agency for Science and Innovation at a press conference held in the Russian Research Center “Kurchatov Institute,” July 3, 2007. [http://www.strf.ru/client/news.aspx?ob\\_no=5562&print=1](http://www.strf.ru/client/news.aspx?ob_no=5562&print=1).

<sup>76</sup> Poisk No. 1–2, January 11, 2008, p. 9.

<sup>77</sup> A. Fursenko. O nauchnom i organizatsionnom obespechenii razvitiya nanoindustrii v Rossiyskoi Federatsii. [On scientific and organizational support of development of nanoindustry in the Russian Federation] A report at the meeting of the Government of the Russian Federation. Moscow, January 17, 2008. [http://www.opec.ru/library/article.asp?d\\_no=5991&c\\_no=19&c1\\_no=](http://www.opec.ru/library/article.asp?d_no=5991&c_no=19&c1_no=)

council. The latter should select nanotech projects for financing. The supervisory board of the Corporation consists of five representatives of the RF President, two representatives of the State Duma, two representatives of the Federal Council, and five members of the supervisory board represent the RF Government. The managing director of the Corporation is appointed by the RF President. The chairman of the supervisory board is A. Fursenko, the Minister of Education and Science.

So, Rosnanotech was vested with broad powers in the sphere of expenditure of budgetary financial resources, among which is the right to carry out commercial projects and create legal persons at the expense of these funds. It should be noted that these powers are not balanced with serious responsibilities of the Corporation for expenditure of budgetary financial resources and disposal of state assets. Such a structure of organization is fraught with high risks, especially in the situation, where lobbying and corruption are most serious barriers to the implementation of many state initiatives in the sphere of science and technology. The division of scientific and organizational-financial functions within the national nanotech network can mitigate this situation; however, taking into account the fact that a representative of the Russian Research Center “Kurchatov Institute” is simultaneously a member of the Rosnanotech supervisory board, the division of powers is a rather nominal thing. In this situation, an important parameter of management is organization of control and coordination in such a degree, which is permitted by the legislation with respect to Rosnanotech.

According to the managing director of the Corporation, its main avenue of activities should be the financing of innovative projects and commercialization of already existing technologies<sup>78</sup>; the objective is to achieve market volumes amounting to tens of billions US dollars in the next two to three years. These expectations seem to be somewhat exaggerated, since, on the one hand, the business still demonstrates a wait and see attitude, and, second, judging by the bibliometric indicators, the very scale and the level of scientific research in Russia in the sphere of nanotechnologies is significantly below that registered in the developed countries of the world. According to the data published by the Federal Service for Intellectual Property, Patents and Trademarks (Rospatent), it received only 300 applications concerning the sphere of nanotechnologies and issued no “nanotech patent”, although about 10 thousand of such patents have been already registered in the world.

Some experts believe that the founding of the Rosnanotech Corporation is a principal political decision on the formation of a new public sector of science, including basic science<sup>79</sup>, and to a certain degree it should serve as an alternative to the Russian Academy of Sciences. In other words, the creation of Rosnanotech is the construction of a new parallel structure in science, which, in the case of success, will gradually squeeze out obsolete forms of organization of science. The latter development is really possible, primarily due to the scale of the nanotech initiative. However, yet the situation has developed in such a way that Rosnanotech and the Russian Research Center “Kurchatov Institute” as the premier institution of the network are in alliance with the Russian Academy of Sciences, and it is planned to develop nanotechnologies by the way of combination of forces and coordination of activities.

The concept of a massive support of nanotechnologies, including the formation of a research infrastructure, was to a significant degree borrowed from the foreign experience, in

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<sup>78</sup> [http://www.strf.ru/client/news.aspx?ob\\_no=6125&print=1](http://www.strf.ru/client/news.aspx?ob_no=6125&print=1).

<sup>79</sup> B. Saltykov. Ukroshcheniye stroptivoi [The taming of the shrew] // *Nezavisimaya gazeta*, July 11, 2007. [http://www.ng.ru/science/2007-07-11/13\\_ukroshenie.html](http://www.ng.ru/science/2007-07-11/13_ukroshenie.html).

particular as concerns the approaches towards the development of nanotechnologies, as there was used the experience of the US National Nanotechnology Initiative. In this connection it should be noted that not only massive investments in research and development and construction of infrastructure determine the success of development of nanotechnologies abroad. The study of the experience of the countries most advanced in this area permits to draw a number of important conclusions. First, the business must co-finance projects. Second, the creation of network structures (according to the statements made by the RF Ministry of Education and Science, the nanotech project in Russia is exactly a network project) is as a rule financed on a parity basis with businesses. At the same time, state support is provided over long time (from 7 to 10 years) even in the countries characterized by high levels of development of nanotechnologies (Canada, USA). It should be noted that there is normally introduced a constant monitoring of the functioning of new structures and assessment of intermediate results including the indicators of mobilization of extrabudgetary financial resources, on the basis of which funding from the budget may be provided for a longer time. In the course of formation of network structures, there interacts a significant number of organizations representing all sectors of science – universities, public scientific organizations, small science intensive firms, large businesses. These are more complex partnerships than just cooperation between individual scientific organizations and private companies. Such networks make the system of generation and transfer of knowledge more stable and ensure their diffusion. Third, state regulation measures are applied in a flexible and complex way, they are numerous and complementary. Usually, there are formed several funds and programs of support of nanotechnologies, different types of organizational structures, networks, different types of infrastructure and so on. Implementation of multifunctional measures, which are simultaneously aimed at the settlement of several problems – development of cooperation, training of personnel, creation of incentives for interdisciplinary ties and commercialization of the results of research and development efforts become an important avenue of development. As a rule, both federal and regional authorities jointly participate in the implementation of such measures.

#### 4.5.5. Creating Incentives for Innovative Activities

##### ***Participation of Businesses in Financing of Research and Development Efforts***

In 2007, there was registered no intensification of activity of businesses as concerned the support of research and development efforts; this circumstance was even specifically noted in the statements made by top officials of the country – the RF President, Prime Minister, First Deputy Prime Minister. Moreover, at the end of the year the RF Ministry of Education and Science announced that R & D projects, where businesses failed to ensure the promised levels of co-financing, should be discontinued.

In particular, it was noted that over 9 months of 2007, the amount of extrabudgetary financing of the federal target program “The national technological base” made only 10 per cent of the planned targets. As concerned the federal target program “Development of civil aviation equipment of Russia”, extrabudgetary financing made only 4 per cent of promised investments<sup>80</sup>. With respect to such programs as “Living systems” (a subprogram of the federal

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<sup>80</sup> Biznes lishat dotatsiy na nauku [Businesses will be deprived of grants for science] Kommersant, No. 213, November 20, 2007.

target program “Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012”), there were raised only 1.6 billion rubles out of required 5.5 billion rubles of extrabudgetary financing<sup>81</sup>.

The problem of insufficient financing of R & D on the part of businesses is not new. It can be rather clearly seen by the example of implementation of the most important innovative projects of state importance (the so called *megaprojects*). Megaprojects are one of the first examples of the use of the tool of public-private partnership (PPP) in the sphere of science and technologies. There has been already accumulated a significant experience in this area, and now it is possible to single out at least several factors behind the insufficient activity of businesses. First, businesses are asked to co-finance not R & D, but rather commercialization of technologies. However, the results of research and development carried out in the public sector turn out to be attractive in commercial terms. Second, businesses do not have at present and have not had earlier any incentives to observe obligations and co-finance research and development efforts at all. In particular, federal law No. 94-FZ<sup>82</sup> in fact limits the participation of businesses in co-financing of research and development. According to this law, it is prohibited to include the requirements to mobilize extrabudgetary financial resources in the terms of tenders. Third, some problems still persist in the sphere of distribution of rights for intellectual property. Thus, the draft federal law “On transfer of technologies”, which sets the procedures governing the transfer of rights, has been already discussed for several years.

The decision to discontinue research and development efforts failing to mobilize private co-financing proposed by the RF Ministry of Education and Science is in fact a punishment not for businesses, but for those state organizations and higher educational establishments, which have engaged in the development of such technologies. There should be introduced a system of incentives for businesses to make investments. At the same time, there should be improved the legislative framework, in particular, the laws regulating procurement and supply of products for state needs. The state order mechanism can not serve as an efficient tool of mobilization of private capital for financing of R & D efforts until there are introduced amendments to the normative and legal regulative framework currently in place.

At the same time, it should be noted that businesses have a need in research and development efforts and it grows as equipment and currently used technologies become obsolete. Evidence of this fact is, for instance, the interest of companies in one of the sections of the federal target program “Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012”, in the framework of which businesses may propose their own topics of research and development works, and which can later obtain co-financing from the budgetary financial resources. It should be noted that one of the conditions, on which co-financing can be obtained, is that companies should cover 50 per cent of the respective project costs in case there are carried out applied works, and 70 per cent of the respective project costs in the case of commercialization related projects. In 2007, such a tender attracted about 400 applications on the part of companies<sup>83</sup>, what was significantly above the capacity of the RF Agency for Science and Innovation to co-finance projects. This development is evidence that companies have both the need to imple-

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<sup>81</sup> Poisk No. 50, December 14, 2007, p. 21.

<sup>82</sup> Federal law No. 94-FZ of July 21, 2005, “On the placement of orders for supply of goods, performance of works, provision of services for state and municipal needs”.

<sup>83</sup> Poisk No. 1–2, January 11, 2008, p. 12.

ment research and development and the possibilities to co-finance projects in terms of resources.

### *Creation of Mechanisms of Venture Financing*

Alongside with megaprojects, there has appeared such a new type of public private partnership as formation of an innovation infrastructure, in particular, the creation of venture funds and technological parks with state participation. In 2006, there was initiated several state projects aimed at the development of venture infrastructure. Such projects primarily include the creation of venture funds – “Fund of funds” and a venture fund focusing exceptionally on the sphere of information and communication technologies<sup>84</sup>, similar to the former fund as concerns the principles of its activities.

For the implementation of the first model, the open Russian Venture Company (RVC) was created, where the state was the holder of 100% of the joint stock capital. The RVC should perform two tasks: to carry out competition based selection of venture management companies and purchase stakes in venture funds established in the form of closed end unit investment funds by the selected venture management companies. Venture funds should primarily invest at the early stages of development of projects<sup>85</sup> – it is envisaged that not less than 80 per cent of the total amount of financial resources at the funds’ disposal should be spent for these purposes. However, funds may participate in the next rounds of investment in companies notwithstanding the further amounts of their sales. It is an important condition, since there is created a prerequisite for further stable growth of the firms, which obtained financing. The RVC manages the capital amounting to 15 billion rubles (US \$ 620 million).

It was planned that in 2007 there should be established from 8 to 12 new venture funds with participation of financial resources of the RVC; the total capital of these newly created funds should make about 30 billion rubles. In turn, these funds should provide venture capital to up to 200 new innovation companies and become a catalyst of creation of about other 1000 companies<sup>86</sup>. However, at present the rates of creation of venture funds are below the planned indicators.

The first contest aimed at the selection of venture funds was completed in the spring of 2007; basing on its results there were selected three management companies, the announced amounts of venture funds made 2 billion rubles to 3 billion rubles each. According to the data as in December of 2007, there was completed the process of formation of only one venture fund – “VTB – Venture Fund”.

The second contest should have been held in the autumn of 2007, and basing on its results, the RVC planned to distribute about 11 billion rubles; however, as in February of 2008, this contest was not announced yet. The second contest should be held according to more strict criteria, including presentation of ready investment projects by bidders, the history of transaction and the parameters thereof, the quality of proposed development strategies. The fact that such apparent and necessary parameters were not taken into account during the first

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<sup>84</sup> For details see: Rossiyskaya ekonomika v 2006 godu. Tendentsii i perspektivy. [Russian economy in 2006. Trends and outlooks]. Issue 28. M.: IET, 2007, p. p. 568–570.

<sup>85</sup> As companies being at the early stage of development, there are defined the companies demonstrating annual amounts of sales at or below 150 million rubles at the moment of purchase of their securities by a venture fund.

<sup>86</sup> Information has been provided by press relations service of the open joint stock company “Rossiyskaya venchurnaya kompaniya”, <http://www.rusventure.ru/>.



contest may be explained by small number of bidders seeking RVC financial resources due to the normative and legal restrictions. Only the teams having available already formed investment portfolios could claim the financial resources of the Fund of Funds. Therefore, a large number of venture teams preferred to take no part in the contest.

The current situation is determined by the fact that the legislation currently in force limits the possibilities of formation of venture funds. For now, they are created in the organizational and legal form of closed end unit investment funds (CUIF) envisaging the investment of all financial resources at once and not as the portfolio of projects is formed. Therefore, management teams have to persuade investors first to raise capital and only after that search for the objects of investment. At the same time, in the international practice venture funds as a rule are created in the form of limited liability companies (Ltd). Such funds capitalize as investment transactions are prepared. The selection of the CUIF form in Russia may be explained by the fact that it is the only investment instrument not being subject to taxation. At present, there are elaborated proposals and amendments concerning the legislation currently in force, which should permit to bring the provisions determining the creation of venture funds in line with the international practice.

However, it should be noted that in the course of establishment of the RVC some international experience was taken into account, in particular that of Israel and Finland, where the state took an active part in the creation of venture funds. Therefore, it is not by chance that among the independent directors of the RVC there are the President of the Israeli Association of Venture Funds and the President of the Yozma Fund, as well as the former President of Finland, now the President of the Sitra Fund.

In this context it is important to note the factors, which made successful similar foreign initiatives. The Israeli experience is of special interest, since there were observed both the precedents of failures and successes in this sphere. In 1992, in Israel there was launched the Inbal program. This initiative brought no results, and practically simultaneously there was created a fund of funds, or an investment company named Yozma, which turned out to be very successful. The financial resources of Yozma were used to capitalize 10 other venture funds; later 8 out of 10 funds were redeemed by private cofounders, whereas the Fund itself was privatized. On the whole, there was raised financing by 50 times exceeding the amount of state investments and there were created more than 4000 technological companies.

A number of conclusions having importance for the Russian practice may be drawn by the way of comparison of the principles of operation of Yozma and Inbal. Such a comparison is quite legitimate, since both companies operated in the similar economic environment. For characteristics of the Yozma and Inbal programs, see *Table 18*.

As it may be seen from the comparison of the principles of functioning of two companies, the major approaches ensuring the success of Yozma were the borrowing of the US experience as concerned the choice of the organizational and legal form of operation of the Fund, a limited participation of the state in the day-to-day management and decision-making, reliance on foreign managers and experts in the sphere of venture financing, absence of the overregulation of the operation of the Fund (there were introduced flexible criteria of selection of projects for investment), financing was provided at the early stages of development of companies, as well as thorough maintenance of the projects via several rounds of investments.

Table 18

**Specifics of Designs of the Yozma and Inbal Programs**

YOZMA	INBAL
Established in the form of Fund of Funds with the main purpose of creating incentives for venture financing	Established as a state insurance company (insurance of private investments)
Organizational and legal form of activities – limited partnership – was borrowed from the successful US experience	Form of non-governmental organization providing no incentives for private capital and managers, bureaucratic type of management
The state did not participate in day-to-day management of the Fund	The state currently corrected the rules of operation of the Fund
Short period of the state participation in the Fund and a clear strategy of its withdrawal from the fund	Neither the period of participation of the state in the Program, nor the method of its withdrawal from the Fund were determined
Flexible criteria of selection of projects for investment	Rigidly set criteria of selection of companies for venture financing (primarily administrative and financial)
The Fund invited foreign strategic investors to Israel	No foreign experts were invited
Investments were made at the early stages of development of companies	Investments were made both at the early and later stages of development of firms
Financing was provided in several rounds	As a rule, projects were financed on non-recurrent basis

*Source:* Compiled basin on G. Avnimelech, M. Teubal Evolutionary Innovation and High Tech Policy: What Can We Learn from Israel’s Targeting on Venture Capital? January 2005, p. 16–17.

As concerns Russia, an analysis of the developments discussed above permits to arrive to the conclusion that much will depend on how tightly and thoroughly the state regulates the operation of the RVC and influences the decision-making mechanisms concerning the selection of projects, and to what extent foreign managers are permitted to manage venture funds. Certainly, the attitude of businesses is also important. As yet, according to a survey carried out by the National Association of Innovations and Development of Information Technologies (NAIDIT), the level of confidence demonstrated by domestic entrepreneurs to venture funds is low: no more than 23 per cent of innovation companies give credence to such funds<sup>87</sup>. Partially, this may be explained by the low level of business education, as well as the past negative experience of interaction with similar structures.

On the whole, the “fund-based” design of the state participation in the creation of the venture industry is based on the confidence of the state in the private sector and transfer of the right to take strategic decisions to this sector. In the countries characterized by low levels of social capital (i.e. there, where the level of corruption is high, improper motivation of activities persists, and so on) the efficiency of the fund-based design may be low. At the same time, the creation of a fund of funds should facilitate the formation of the infrastructure and market of capitals. In fact, at the stage of establishment of the venture industry the state substitutes “business-angels”, which in the countries with developed system of venture financing are the main source of support of companies at the earliest “seed” stage.

***Formation of Investment Clusters***

The technology implementation zones (TIZ) and IT technical parks being formed in Russia are also based on the public private partnership. This avenue of state activities was in

<sup>87</sup> [http://www.strf.ru/client/news.aspx?ob\\_no=6440](http://www.strf.ru/client/news.aspx?ob_no=6440).

the focus of attention in 2006; however, next year the intensity of such efforts diminished and, accordingly, the public attention to such projects sharply dropped. However, as it has often been the case with other governmental initiatives, there were made attempts to develop new initiatives on the base of uncompleted or failed projects. In 2007, such a new project was the initiative of the RF Ministry of Economic Development and Trade concerning the implementation of the cluster policy, including the formation of innovation clusters. It is planned to carry out pilot projects aimed at the formation of innovation clusters on the base of special economic zones and technical parks.

The concept of development of the cluster policy in the Russian Federation developed by the RF Ministry of Economic Development and Trade proceeds from the fact that the formation and development of clusters is an efficient mechanism of attraction of foreign direct investments and intensification of external economic integration. Clusters should facilitate the growth of competitive businesses via broader access to innovations, technologies and know how, as well as creation of other opportunities. A specific feature of this concept is that it does not envisage allocation of additional budgetary financial resources for the formation of clusters. The establishment of such clusters is planned to ensure via the use of respective tools. In the case of the innovation sphere, such tools are venture funds, including those established with the participation of the RVC, the Fund of Assistance to Development of Small Enterprises in the Sphere of Science and Technologies, the federal target program “Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012” and so on.

The Concept lists the problems encountered by innovation clusters, which it is planned to settle by the implementation of the cluster policy. These problems include: low intensity of scientific and research activities and commercialization of technologies, the problems of access to financial resources and specialized services needed to develop new technological companies, as well as inefficient sectoral regulation<sup>88</sup>. All the problems listed above have been known and typical not only for clusters, but for the whole innovation sphere, and it is not clear how they can be solved using the already existing tools. The focus of the Concept is on the development of ties between cluster participants via carrying out joint research and development works, educational activities, organization of conferences, provision of consultancy services, implementation of tax regulation measures (in technology implementation zones (TIZ) it is the introduction of tax incentives at the regional and municipal levels).

The main issue is the ways permitting to create competitive clusters on the basis of projects, which at present are developing not efficiently.

At the November meeting of the Council for Science, Technologies and Education under the RF President it was noted that the programs of creation of technological parks and technology implementation zones were in fact frozen. One of the factors behind this development was the poor interdepartmental coordination in the situation, where each department was responsible for an avenue of activity rigidly assigned to it. As concerns technical parks and zones, the problem is that creation of technology implementation zones is in the jurisdiction of the RF Ministry of Economic Development and Trade, the RF Ministry of Information Technologies and Communications is responsible for technological parks and the RF Ministry of Education and Science is responsible for innovation development. As a result, the construc-

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<sup>88</sup> Kontsepsiya Klasternoi politiki v Rossiyskoi Federatsii. [The concept of the Cluster policy in the Russian Federation]. RF Ministry of Economic Development and Trade, 2007, p. 8.

tion of the technical park in the Novosibirsk Academic Town, for instance, started only at the end of November of 2007 after the RF President issued direct instructions to speed up the settlement of the issue concerning the allotment of land. At the same time, as yet no financial resources planned for the development of the engineering infrastructure of the technical park in 2007 have been allocated from the federal budget<sup>89</sup>.

The situation in the technology implementation zones varies; for instance, the Zelenograd TIZ is lagging behind in terms of the number of residents. At the same time, the TIZ in the town of Dubna is developing rather successfully. There was registered the largest number of residents – 15<sup>90</sup>. It should be noted that in Dubna much attention was paid to the development of not only engineering, but also social infrastructure, as well as construction of residential housing. In 2008, in order to accommodate specialists coming from other towns there will be ready two residential hotels and a hotel, later it is planned to commission three blocks of residential housing. These developments should become an incentive for an inflow of specialists in this zone.

It should be noted that zones and technical parks *per se* are not clusters, but they may become participants of clusters. The geographical concentration and proximity of the major participants, their “critical mass” and broad representation of different types of organizations (including scientific research institutes, higher educational establishments, enterprises, small businesses, organizations providing consultancy services and so on), as well as existence of formal and informal ties among the participants of the cluster are important characteristics of a cluster. In order to ensure the existence of a cluster, it is important that among its participants there were several competitive enterprises, as well as a strong R & D sector. As it follows from the description above, technical parks and zones as they are now can not be the centers of “crystallization” of clusters. First of all, it would be feasible to carry out a thorough analysis of the factors behind the slow implementation of projects aimed at the formation of IT parks and TIZ, and form pilot cluster development projects taking into account the revealed problems.

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An analysis of the processes unfolding in the sphere of science and innovation activities in 2007 permits to arrive to the conclusion that the reorganization of the scientific complex and its adaptation to the new economic environment progresses at a very slow rate. The long time required to take any managerial decisions by the executive authorities responsible for science and innovation development has had no small share in the origination of the problems noted above. Thus, the program aimed at the development of human resources and restoration of the staff structure has been discussed for several years similarly to the legislation in the sphere of intellectual property rights; as yet, the organizational reform has affected only the academic sector of science. The second factor to be noted is the half-way nature of the reforms implemented by the Government. This concerns both the tools in the sphere of creation of incentives for innovation activities, and approaches to the reform of the organizational structure of science. The third significant factor is the absence of monitoring and evaluation of the implemented initiatives, what results in repetitions, overlapping, or initially wrong prerequisites,

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<sup>89</sup> <http://kremlin.ru/text/appears/2007/11/152987.shtml>.

<sup>90</sup> In the Zelenograd TIZ there are registered 2 residents, in the St. Petersburg TIZ – 4 residents, in the Tomsk TIZ – 8 residents. Source: Reestr rezidentov TVZ po sostoyaniyu na 03.02.2008. [The Register of TIZ residents as on February 3, 2008] [http://www.rosoez.ru/residents/residents\\_database/1.html](http://www.rosoez.ru/residents/residents_database/1.html).

on which new measures are based. Taking into account the factors discussed above, it may be assumed that in the case the current practice of decision making persist, the continuing increase in the financing of science and innovation activities from the budget would not be utilized in the most efficient way. Besides, a large scale reorientation of the scientific complex towards the intensification of efforts in the sphere of nanotechnologies brings about additional threats, since it severely remakes the structure of the field of scientific research and occurs in the situation, where the country lacks the developed technology intensive production.

Table 19

**Measures and Mechanisms of Reform (Development) Proposed in “the Principles of the Policy of the Russian Federation in the SPHERE of Development of Science and Technologies for the Period until 2010 and beyond” and Actual Implementation thereof**

Parameters	Measures	Mechanisms	Actual implementation
1. Multiple sources of financing, support of target state funds	Search for and efficient utilization of extrabudgetary sources. Development of the Russian Fund of Federal Property (RFFI), The Russian Foundation for Humanitarian Research (RGNF), the Fund of Assistance to Development of Small Enterprises in the Sphere of Science and Technologies, as well as extrabudgetary funds aimed at the support of scientific and research and development activities.  Creation of incentives for the activities of charity organizations aimed at the financing of basic scientific research	-	RFFI and RGNF grants are not subject to the individual income tax (enters into force on January 1, 2008-FZ No. 38-FZ of March 23, 2007).  Organizations should have the right to classify their contributions for the formation of the Russian Fund for Technological Development (RFTR), as well as the formation of other sectoral and inter-sectoral funds of financing of R & D registered under the established procedures as their expenditures for R & D (item 3 of article 262 of the RF Tax Code). Since January 1, 2008, the limits of such expenditures should be increased from 0.5 per cent to 1.5 per cent of proceeds (gross receipts) of a taxpayer.  No measures were undertaken in the sphere of creation of incentives for the activities of charity organizations supporting basic science. It should be noted that at the same time there was adopted the federal law “On the procedures governing the formation and utilization of target capitals of not-for-profit organizations” (FZ No. 275-FZ of December 30, 2006), which permitted to form target capitals and further utilize the respective capital yield in the spheres of education and science. The law envisages no tax or other benefits for the benefactors. The latter may make contributions only from their net profits; therefore the group of potential donors is limited to large businesses. Besides, there are encountered problems related to the founding of companies managing target capitals – only organizations in the organizational and legal form of autonomous institutions should have the right to hire such companies
2. Retreat from the per-item financing of science	Expansion of the scale of tender based financing, targeted financing of scientific research and experimental R & D carried out by state scientific institutions	Implementation of the mechanisms of multi-channel financing of target scientific programs.  To develop and implement the most important innovation projects of state importance	In the framework of federal target scientific and technical programs (in 2002 through 2006), the share of extrabudgetary financial resources should have made not less than 30 per cent of the budget of the respective program. In fact, as per estimates the extrabudgetary financing was significantly below the planned targets.  This reform has been implemented since 2003. There was supported 21 megaprojects, of which 6 were completed and several were defined as successful basing on the criterion of the fivefold excess of the amounts of sales of the output over the amount of budgetary financial resources allocated for the respective projects

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Parameters	Measures	Mechanisms	Actual implementation
3. Development of the material base of science	Development of the research, design, experimental and pilot base of the scientific instrument making industry; creation and provision with resources of unique scientific units; the network of centers for shared use of equipment	To raise the financing of development of the equipment base of science up to 5 per cent of the amount of financial resources allocated from the federal budget for civil science.  To form a network of centers for shared use of unique scientific equipment	In the framework of the federal target program "Research and development across the priority avenues of development of the scientific and technological complex of Russia in 2007 through 2012" there were envisaged capital investments for the support of the material base of science in the amount of 3.6 per cent of the budget of this program.  There were formed 56 centers for shared use of equipment (CSUE), where 5.5 per cent of scientific equipment in terms of value was concentrated. There was allocated insufficient amount of financial resources to reequip large units
4. Restructuring of the network of scientific and technical organizations	Inventory of the scientific and technological complex, including the changing, if necessary, the organizational and legal form and the form of ownership of scientific organizations. Sale of redundant equipment for the strengthening of the material base of science. Improvement of the current system of accreditation of scientific organizations	To optimize the composition of the science and technology complex, including the creation of integrated scientific, scientific technical, and scientific educational structures	No inventory of the scientific complex was carried out.  In 2004, the accreditation of scientific organizations was abolished.  There was adopted federal law No. 174-FZ of November 3, 2006, "On autonomous institutions" (version FZ No. 215-FZ of July 24, 2007; No. 230-FZ of October 18, 2007), which expands the possibilities of scientific organizations transformed into autonomous institutions to carry out innovation activities. The transformation of scientific research institutes and higher educational establishments into autonomous institutions has not been started yet
5. Improvement of the academic sector of science	Improvement of the academic sector of science by concentrating resources for the settlement of basic science problems, optimization of the system of management of science activities, inventory of the departmental scientific organizations and the number of their employees		In accordance with the RF Government Resolution No. 236 of April 22, 2006, "On the implementation of the pilot project for the improvement of the system of remuneration for the research staff and directors of research institutions and the research staff of the research centers of the Russian Academy of Sciences in 2006 through 2008" there is implemented the second stage of this pilot project. There is carried out a reduction of staff in academic institutes (the target indicator is 20 per cent over three years).  In November of 2007, the RF Government approved the new Charter of the Russian Academy of Sciences enhancing its powers concerning the disposal of property and budgetary financial resources; however, the state should not be held vicariously liable for its activities (Resolution of the RF Government No. 785 of November 19, 2007)
6. Creation of national scientific centers	Assignment of the functions of leading organizations across the priority avenues of development of technologies and equipment to state scientific centers		No restructuring of the state scientific centers was carried out

Parameters	Measures	Mechanisms	Actual implementation
7. Integration of science and education	Creation and support of activities of integrated scientific educational structures, shared use of the scientific, experimental, pilot and equipment base		Federal law No. 308-FZ "On the introduction of amendments in certain legislative acts of the Russian Federation concerning the issues of integration of science and education" was adopted on December 1, 2007. It grants to scientific organizations the right to carry out education in accordance with educational programs concerning postgraduate professional education, as well as educational programs aimed at further professional education. The law also permits scientific and educational establishments to jointly use material and human resources in order to carry out both scientific and educational activities
8. Creation of conditions facilitating the attraction of the youth to science	Expansion of the volumes of construction of residential housing for young people, including construction carried out at the expense of mortgage lending. Improvement of the contract based form of employment of scientists and researchers. Increase of the amounts of financing of the support of the leading scientific schools, as well as the works performed by young scientists and students across the priority avenues of scientific and technological progress up to 3 per cent of the total amount of budgetary financial resources allocated for civil science	To develop and approve the federal target program "Scientific human resources"	The program is in the process of approval. Its previous version developed in 2003 was implemented in 2004 as concerned the support of the employees of organizations belonging to the defense and industrial complex of the RF
9. Regulation of pay of scientists	Change of the system of remuneration of employees of the institutions financed from the budget, revision of the system of bonus payments, increase of additional payments for scientific degrees		A pilot project in the RAS.  Additional payments for the degrees of the candidate and doctor of sciences has been increased twice: In 2003 (the RF Government Resolution No. 4 of January 8, 2003) – up to 900 rubles for candidates of sciences and 1500 rubles for doctors of sciences; In 2006 (the RF Government Resolution No. 712 of November 23, 2006) – up to 3000 rubles for candidates of sciences and 7000 rubles for doctors of sciences
10. Changes in the system of pension benefits for scientists	Improvement of pension plans for scientists of highest qualification by creating non-state pension funds. Provision of personal support to veteran scientists		No improvement of pension plans for scientists was implemented

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Parameters	Measures	Mechanisms	Actual implementation
11. Introduction of indirect regulation measures with respect to science	Provision of compensations from the budget to state scientific organizations and state higher educational establishments as concerns the payment of property taxes in accordance with the list approved by the RF Government; reduction of customs duties on the imported specialized scientific equipment not produced domestically (in the framework of the general strategy aimed at the reduction of customs duties on the imported technological equipment)		<p>To state scientific organizations and state higher educational establishments there are provided compensations related to the payment of the property tax.</p> <p>Indirect regulation was introduced in the special economic zones (SEZ) (preferential tax and customs treatment).</p> <p>Other measures of indirect regulation introduced since January 1, 2008:</p> <ul style="list-style-type: none"> <li>- VAT exemption with respect to operations related to the sale of the exclusive rights for inventions, useful models, industrial prototypes, computer software, know how, as well as the rights related to the use of the results of intellectual activities on the basis of license agreements;</li> <li>- with respect to depreciation of financial resources utilized for scientific and research activities, the coefficient to the basic depreciation rate may amount to 3;</li> <li>- VAT benefits may be granted with respect to R &amp; D related to the development of new products and technologies.</li> </ul> <p>(FZ No. 195-FZ of July 19, 2007)</p>
12. Development of the regulatory and legal framework of scientific and technical activities	Special attention should be paid to the regulation of the issues of intellectual property and introduction thereof into commerce	Elaboration of the regulatory and legal framework	The IV part of the RF Civil Code, which abolishes the previous legislation on intellectual property, enters into force on January 1, 2008
13. Creation of innovation infrastructure	Creation of modern corporations (holdings, federal centers of science and high technologies (FCSHT), inter-sectoral centers of science). Support of science towns and the infrastructure for small businesses at the expense of the budgets of all levels		<p>There were created the Russian Corporation of Nanotechnologies (Rosnanotech) (FZ No. 139-FZ of July 19, 2007) and the open joint stock company "United Shipbuilding Corporation" (Decree of the RF President No. 394 of March 21, 2007).</p> <p>The was created one federal center of science and high technologies (FCSHT) (the RF Government Resolution No. 619 of August 20, 2002, "On the granting of the status of the federal center of science and high technologies to the All-Russian Scientific Research Institute for the Problems of Civil Defense and Emergencies"); however, the Regulations on the federal center of science and high technologies ARSRI PCDE were adopted only on September 3, 2007 (Order No. 108 by the head of the Federal State Institution ARSRI PCDE).</p> <p>The system of support of science towns has not changed – the amounts of budgetary financing are determined proceeding from the size of the population of a town (recipients of budgetary services), what does not create incentives for innovation development.</p> <p>For small enterprises using the simplified system of taxation, since January 1, 2008, there was expanded the list of expenditures diminishing the proceeds of taxpayers. At present, in the composition of such expenditures there may be listed expenditures for purchase of exclusive rights for inventions, computer software, databases, production secrets (know how), patenting and / or payments for legal services related to the legal protection of the results of intellectual activities (FZ No. 195-FZ of July 19, 2007)</p>



<b>Parameters</b>	<b>Measures</b>	<b>Mechanisms</b>	<b>Actual implementation</b>
14. Creation of conditions facilitating the investment in science on the part of industry and banks	Development of interaction between public and private capital (PPP). Creation of institutional and legal conditions for the development of venture investment in science intensive projects	Development of mechanisms aimed at the increase of economic interest in the use of the results of R & D efforts	There were created the "Fund of Funds" and the management Russian Venture Company (RVC), where the state was the holder of 100% of the joint stock capital, and the Russian Investment Fund for Information and Communication Technologies  Since 2003, at the scientific organizations and higher educational establishments there have been created Centers for Transfer of Technologies in order to facilitate the processes of commercialization of the results of R & D.  As yet, no legal norms favorable for the development of venture industry have been introduced

## Section 5. Institutional Problems

### 5.1. The State of Property Relations, the Public Sector, and Privatization

#### 5.1.1. The Property Policy of the State: Some General Outlooks

Last year, the sphere of property relations was characterized, on the whole, by the continuation of the tendencies of the past few years, although with a somewhat lesser intensity.

A general *decrease in the number* of federal state unitary enterprises (FSUE) and, to a lesser degree, of joint-stock companies (JSC) with federal stakes has been a sufficiently stable tendency of recent years. On the whole, in 2004–07, the total number of FSUEs dropped by 43%. Nevertheless, it is worth mentioning that the year 2007 was marked by a number of structural changes with regard to SCs with state stakes (*Table 1*).

Table 1

**Joint-Stock Companies with RF Stakes, 2004–2008**

Size of RF's share in charter capital of company	JSCs' share in the total number of companies, as of 1 January of each year, %				
	2004	2005	2006	2007	2008
100%	4	10	30	45	54
Between 50% and 100% – 1 share	15	13	12	10	7
Less than 50%	81	77	58	45	39

Source: Federal Agency for Federal Property Management (FAFPM).

As late as the beginning of 2007<sup>1</sup>, the structure of the bulk of federal blocks of shares was as follows: blocks of shares of up to 25% of capital existed in approximately 25% of all JSCs with state stakes; blocking parcels of shares (between 25 and 50% of capital) – in approximately 20% of companies; while in 55% of all companies the state could exercise either majority or overall control. At the same time, the share of JSCs with a state stake of 100% was 4.5 times larger than of those JSCs in which the State, while being a majority shareholder, had less than 100% of shares (10%).

Last year, the trends toward changes in the structure of federal blocks of shares, which started to take hold during the previous period were gaining momentum. The major quantitative shift which took place in 2006–07 produced an increase in the proportion of JSCs with a federal stake of 100% by 24 percentage points, while the share of companies of all the other categories declined. In this respect, the share of JSCs with minority blocks of shares declined most radically. Also, over the 2004–07 period, the number of the JSCs with regard to which the Russian Federation is entitled to participating in their management under the special “golden share” right dropped twofold.

Thus, by the beginning of 2008, the aggregate share of JSCs over which the State, as a shareholder, can exercise sufficient corporate control through holding a control or a 100%

<sup>1</sup> A detailed analysis is presented in the following sections. See also *Mal'ginov, G.N., Radygin A.D.* Gosudarstvennyi sektor rossiiskoi ekonomiki: dinamika kolichestvennykh kharakteristik i osnovnye tendentsii razvitiia [The public sector of Russia's economy: the dynamics of quantitative characteristics and the main trends of development] // Ekonomiko – politicheskaia situatsiia v Rossii. June 2007 [The economic and political situation in Russia]. June 2007. Moscow: IEPP, 2007, pp. 43–48.

block of shares, had, for the first time since the late 1990s, exceeded one half of all economic societies with state participation (*Table 1*).

As in 2006, the aggregate actual results of 2007 with regard to the proceeds from privatization and the use of federal property turned out to be smaller than forecasted (see *Table 2*).

*Table 2*

**The Dynamics of Proceeds from Privatization and the Use  
of Federal Property, million rubles**

	<b>1. Non-renewable sources, total</b>	<b>1.1. Privatization</b>	<b>1.2. Disposal of FSUEs' and military property</b>	<b>1.3. Sales of land and intangible assets</b>	<b>2. Renewable sources, total</b>	<b>2.1. Dividends (number of enterprises)</b>	<b>2.2. Lease of property</b>	<b>2.3. Lease of land</b>	<b>2.4. FSUEs' Share of proceeds (number of enterprises)</b>	<b>2.5. SE "Vietsoyvetro"</b>	<b>Total</b>
<b>1999*</b>	<b>8,547.4</b>	8,547.4	–	–	<b>8,720.5</b>	848,1 (600)	2,191,4	–	–	5,675,0	<b>17261.,9</b>
<b>2000</b>	<b>31,367.1</b>	31,367.1	–	–	<b>18,790.1</b>	3,675,1 (1050)	3,427,2	–	–	11,687,3	<b>50157.2</b>
<b>2001</b>	<b>10,110.6</b>	9,990.6	–	120,0	<b>29,122.6</b>	6,478,0 (782)	4,896,1	3,917	209,6 (131)	13,621,9	<b>39233.2</b>
<b>2002</b>	<b>14,700.7</b>	12,703.8	–	1,996,9	<b>36,762.2</b>	10,402,3 (747)	7,657,9	4,400	914,2 (809)	13,388,8	<b>51462.,9</b>
<b>2003</b>	<b>95,237.3</b>	90,660**	585	3,992,3	<b>41,143.2</b>	12,395,2	9,573,9	197,3***	2,387,6	16,200	<b>136380.8</b>
<b>2004</b>	<b>65,777</b>	61,856.8	662,7	3257,5	<b>53,710.3</b>	17,222,0 (319)	11,928,8	901,7	2,538,1	17,199,5	<b>119487.2</b>
<b>2005</b>	<b>34,882</b>	29079.2**	522	5280,8	<b>54,404</b>	18,610	14,170	1,748	2,386	17,490	<b>89,286</b>
<b>2006</b>	<b>19,010</b>	17,600	1410	No,data	<b>67,363.6</b>	23,000	16,800	No,data	No,data	No,data	<b>86,373.6</b>
<b>2007 forecast</b>	<b>49,000</b>	41,000	No,data	8,000	<b>73,921.5,****</b>	24,080	17,600	4,000	15,425	12,816,5	<b>Over 120,000</b>
<b>2007 actual</b>	<b>No,less,than 19,300</b>	19,300	No,data.	No,data	<b>81,400</b>	No,data	No,data	No,data	No,data	No,data	<b>Over 100,700</b>

\* The dynamics for 1995–1998 is presented in: Rossiiskaia ekonomika v 2002 godu. Tendentsii i perspektivy (The Russian economy in 2002. Trends and outlooks]. Moscow: IET, 2003, p. 367.

\*\* Proceeds from the sale, in 2002, of 74.95% of shares in the JSC “Slavneft” in the amount of 59,161.95 million rubles were entered in the revenues of 2003 (i.e., more than 60% of the received revenue). Proceeds from the sale, in 2004, of 17.8% of shares in the JSC “Magnitogorskii metallurgicheskii kombinat” [ the Magnitogorsk Integrated Iron-and-Steel Works] in the amount of 21,928.2 million rubles were entered in the revenues of 2005 (i.e., more than 60 % of the received revenue).

\*\*\* The lease payment for land in federal property, after the delimitation. In the following years, the item “Lease payments and the proceeds from selling the right to conclude lease contracts for land in federal property” was also taken into account.

\*\*\*\* Only those renewable sources which are directly related to management of state property (administered by the FAFPM) are taken into account here. In accordance with the Law “On the 2007 Federal Budget”, the total expected income from the use of property should amount, in the year 2007, to 100 billion rubles, including, apart from the sources indicated in the Table, the revenues from the remainder of the funds on the federal budget’s accounts, the interest on state credits, the revenues from transferring part of the RF Central Bank’s profit, etc. Not included in the Table is yet another significant source, which accounts for a large share of the aggregate amount of revenues - “proceeds from the lease of the federally owned property being in the operative management of the federal bodies of state authority and the institutions created thereby, and in the economic management of federal state unitary enterprises” (16.6 billion rubles).

*Source:* the RF Ministry of Economic Development and Trade; the FAFPM; the Federal Law “On the 2007 Federal Budget”; the authors’ estimates.

According to the preliminary data of the FAFPM, in the year 2007, the aggregate proceeds from privatization amounted to 19.3 billion rubles, or were approximately 2 times less than forecasted, which was close to the results of the year 2006. Judging from the estimates of the Russian Fund for Federal Property (RFFP), the reasons for this are as follows: the incomplete reorganization of work caused by the recent change in status; the side effects of administrative reform with regard to relations with the FAFPM; the low quality of the forecast plan of privatization which contains a large amount of objects not to be privatized (bankrupts, liquidated enterprises); and the low liquidity of a large mass of property being privatized<sup>2</sup>. After the RFFP’s autonomy was restricted at the very end of 2006, the reforming of the system of organizing the sales of federal property being privatized went on until July 2007, when the Joint Regulation, of 27 July, No. 2378-r/120, issued by the FAFPM and the RFFP, confirmed the Temporary Reglament for Cooperation between the FAFPM and the Fund for Implementing the Forecast Plans (or Programs) of Federal Property Privatization.

In the year 2007, there were no privatization transactions with regard to assets of national importance. If the revenues from the selling of shares in big and biggest joint-stock companies are not taken into account (when the revenue from a transaction exceeds 3 billion rubles), the dynamics of proceeds from privatization becomes positive: over the 2004–2007 period, the corresponding revenues increased by more than 2.5 times – from 7.8 billion rubles in 2004 to 19.2 billion rubles in 2007. To a certain degree it has to do with the application of some new procedures for price determination and mechanisms for selling minority blocks of shares. On the whole, in the year 2007, shares (or stakes in charter capital) in 377 economic societies were privatized, with more than one third of the said shares being in minority packages, and tenders for shares in another 523 economic societies, to take place in 2008, were announced.

In 2007, the federal budget’s revenues from the use of property (dividends; part of the profit of unitary enterprises; rental income) amounted to 81.4 billion rubles. It should be noted that in contrast to proceeds from privatization (non-renewable), the forecasted indicators in this segment (including those envisaged by the Law “On the 2007 Federal Budget) were exceeded by 9%.

Among the most significant trends characterizing the activity of biggest state companies in 2007, we should traditionally single out the following ones:

- the continuation of the integration of state – owned assets into holding companies;
- the continuation of the activity of the already existing holding companies with state stakes, with the purpose of increasing the scope of their business and its diversification by way of takeovers and mergers, that is, by way of vertical and horizontal integration.

On the whole, in the year 2007, the FAFPM accomplished the formation of 29 integrated structures. The decisions concerning their creation were envisaging that shares in 132 joint-stock companies should be contributed to the charter capital of the head companies, that 117 unitary enterprises be transformed into open-end companies, and that 8 more unitary enterprises should be reorganized by way of affiliation. It should be mentioned that 28 integrated

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<sup>2</sup> Interview, given by Chairman of the FAFPM to the newspaper “*Vedomosti*”, No. 9 (2031), 21 January 2008.

structures were created on the basis of 30 Edicts of the President of the Russian Federation, and 1 – on the basis of a separate decision of the Government of the Russian Federation<sup>3</sup>.

Undoubtedly, the IPOs of the two largest banks with state stakes (Sberbank and Vneshtorgbank)<sup>4</sup>, and the creation of the foundations of a new structure of electrical power engineering as a result of reforming the RJSC “UES of Russia”, whose final reorganization was approved at the meeting of the company’s shareholders in autumn 2007, can be classed among the most important events which took place within the framework of the public sector of the Russian economy in 2007. The liquidation of the RJSC, planned for the summer 2008, should be followed by the transfer to the shareholders of shares in 23 big companies in the sphere of electrical power engineering (OGK, TSK, FSK, etc.). By contrast, no radical reorganization measures (such as split-up, etc.) are contemplated.

A principally new development in the property policy of the State was the emergence, in 2007, of 6 state corporations (see *Section 5.2, 5.8*), created by special federal laws. These corporations are as follows: Vneshekonombank, “Rosnanotech” (Russian nanotechnologies), the Fund for Promoting Reform of the Housing and Utilities Sector, “Olimpstroï” (Olympic construction) (construction of objects for the 2014 Olympic Games in the town of Sochi and its development into a mountain-climatic health resort), “Rostekhnologii” (Russian technologies), and “Rosatom”. Their functional purposes and branch spectrums are very varied, including the implementation of individual projects and programs (“Olimpstroï” and the Fund for Promoting Reform in the Housing and Utilities Sector), the promotion of individual types of activity (Vneshekonombank and “Rosnanotech”), and the management of entire branches (“Rosatom”) and groups of companies (“Rostekhnologii”).

At the same time, RF First Vice-Premier D. A. Medvedev officially stated in January 2008 that the creation of state corporations did not mean that Russia was changing its course and rejecting the market way of development, and that state capitalism was a road to a deadlock<sup>5</sup>. The formation of such structures is being justified by the necessity to support the priority directions, where Russia has begun to lose its previous leadership (the nuclear branch, shipbuilding and aircraft building). Nevertheless, the limits of “admittance” of private businesses are defined with sufficient clarity: while in the majority of cases their participation can be rather significant, the sphere of defense is to be under complete control of the State, and no alternatives will ever be contemplated.

However, the situation with state corporations’ being *a la mode* in 2007 (this fashion has already been imitated at regional level) is fraught with considerably increased various economic and financial risks. First of all, it should be noted that the scheme for creating state corporations involves an individual approach, thus placing them beyond the general legal norms established in legislation for specific organizationa-legal forms by related laws (joint-stock companies, unitary enterprises, not-for-profit organizations). Among other things, it should be noted that there exist potential possibilities to obtain various preferences and to use one’s monopolistic position, and that the efficiency of the control mechanisms, some of which have never been tested, and some have even not been created as yet, is still unclear.

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<sup>3</sup>Otchet o privatizatsii federal’nogo imushchestva v 2007 godu [Report on the privatization of federal property in the year 2007]. Moscow: FAUFI [FAFPM], 2008.

<sup>4</sup>For more details, see Rossiiskaia ekonomika v 2006 godu. Tendentsii i perspektivy [The Russian economy in the year 2006. Trends and outlooks]. Moscow: IEPP [IET], 2007.

<sup>5</sup>“Gazprom” razdelion ne budet [“Gazprom” will not be divided] // Vesti.Ru. 17 January 2008.

On the whole, according to the existing quantitative estimates, the share of state – owned stocks in Russian companies amounted to 29.6% in 2006, and to 35.1% at the beginning of 2007<sup>6</sup>. By early 2008, “the depth of property concentration” in the hands of the State within the framework of the base “Expert-400” amounted to approximately 40–45 %. If in the year 2004 the State controlled 81 companies out of 400 biggest ones (with the aggregate revenue of 145 billion USD), in the year 2006 their number rose to 103 (with the aggregate revenue of 283 billion USD)<sup>7</sup>. While in the year 2004 the State controlled 34.7% of the aggregate revenue of 400 biggest Russian companies, by the results of the year 2007 this percentage increased to approximately 40%<sup>8</sup>.

In early 2008, a certain qualitative shift became evident in researchers’ estimates – from statements of the fact of the State’s increasing its direct participation to attempts to assess the quantitative parameters of the State’s expansion. In our opinion, at present neither the above quantitative estimates of 2004–2007 (however conventional they might be) nor the new directions of the property-related activity of the State and the state economic structures which emerged in 2007, have provided enough grounds for making general conclusions as to any deceleration of the property expansion of the State.

For all this (all other factors, including political ones and those dealing with rents and corruption, being equal), the qualitative threshold of such expansion is sufficiently apparent: the bigger is the state sector, the more limited are the possibilities to ensure the controllability and efficient control. This is evidenced, in particular, by the whole experience of introduction (or attempts at introduction) of some or other mechanisms for management and control of unitary enterprises and joint-stock companies with state stakes, dating back to the second half of the late 1990s and the early 2000s. By analogy with the evolution of private Russian business groups in the second half of the 1990s and the early 2000s<sup>9</sup>, we should expect the emergence, in the medium term, of some or other reorganization procedures aimed at optimizing the structure of the obtained assets and at optimizing the organizational and managerial aspects of functioning of state companies (or groups). Time will show how efficient these procedures are going to be with regard to state companies, and what will be the driving motives for such a reorganization after March 2008.

### 5.1.2. The Size of the State Sector, its Constituents and Basic Characteristics

In the previous years (2003–06), a general quantitative overview of the state sector at the federal level was given in the forecast plans (programs) of federal property privatization, which were usually approved by government decrees issued at the very end of a summer. They contained data on the number of unitary enterprises in federal ownership (FSUEs) and joint-stock companies with RF stakes as of 1 June of each year. In 2007, “The forecast plan (pro-

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<sup>6</sup> Alfa-Bank’s data (Grozovskii, B. Glavnyi sobstvennik strany [The top property owner of the country] // *Vedomosti*, 13 February 2007).

<sup>7</sup> A block of shares not less than a blocking one, or the final phase of establishing control on the part of the State.

<sup>8</sup> See *Vin'kov, A.* Gosudarstvo – eto ty! [The State is you] // *Ekspert* [The expert], 2008, No. 2, pp. 28–31.

<sup>9</sup> See, e.g., *Radygin, A.* Evoliutsiia form integratsii i upravlencheskikh modelei: opyt krupnykh rossiiskikh korporatsii i grupp [The evolution of the forms of integration and models of management: the experience of big Russian corporations and groups] // *Rossiiskii zhurnal menedzhementa* [The Russia Journal of Management], 2004, Vol. 2, No. 4, October–December, pp. 35–58.

gram) of privatization for the year 2008 and the main directions of federal property privatization for the years 2008–2010” were confirmed by the RF Government’s Regulation of 29 April 2007, No. 543-r, containing the data on the number of unitary enterprises in federal ownership (FSUEs) and joint-stock companies with state stakes, as of 1 January 2007. Therefore, there is no sufficient information enabling one to objectively assess the dynamics of these constituents of the state sector precisely in the year 2007.

Let us consider in more detail the quantitative dynamics of the subjects of the said organizational-legal forms, by each of the sub-sectors of the state sector at the federal level, for the past few years.

### *Federal State Unitary Enterprises*

Below (in *Table 3*) are the dynamics of development and the branch structure of FSUEs in 2003–06.

*Table 3*

### **The Number of Federal State Unitary Enterprises and their Branch Structure in 2003–06**

Branch	As of 1 June 2003		As of 1 June 2004		As of 1 June 2005		As of 1 June 2006		As of 1 January 2007	
	units	%	units	%	units	%	units	%	units	%
Non-production sphere	4,357	44.2	4,069	44.1	3,617	43.6	1,817	25.3	1,670	25.55
Industry	2,224	22.6	2,064	22.4	1,870	22.55	1,624	22.6	1,539	23.55
Including:										
Machine-building	908	9.2	827	8.95	734	8.85	660	9.2	634	9.7
Light industry	193	2.0	193	2.1	194	2.3	187	2.6	179	2.7
Construction materials industry	81	0.8	80	0.9	68	0.8	55	0.75	49	0.8
Food industry	60	0.6	61	0.65	55	0.7	55	0.75	51	0.8
Metallurgy	49	0.5	37	0.4	34	0.4	30	0.4	28	0.4
Chemistry	46	0.5	43	0.5	39	0.5	34	0.5	33	0.5
Other branches of industry	887	9.0	823	8.9	746	9.0	603	8.4	565	8.65
Agriculture	1,329	13.5	1,237	13.4	1,111	13.4	913	12.7	826	12.6
Construction	1,035	10.5	978	10.6	903	10.9	752	10.5	668	10.2
Transport and communications	851	8.6	809	8.8	725	8.75	612	8.55	536	8.2
Forestry	64	0.6	65	0.7	67	0.8	53	0.75	49	0.8
Other branches	–	–	–	–	–	–	1,407	19.6	1,245	19.1
Total	9,860	100.0	9,222	100.0	8,293	100.0	7,178	100.0	6,533	100.0

*Source:* The forecast plan (program) of federal property for the year 2004 and the main directions of federal property privatization until the year 2006; The forecast plan (program) of federal property for the year 2005; The forecast plan (program) of federal property for the year 2006 and the main directions of federal property privatization for the years 2007–2009; The forecast plan (program) of federal property for the year 2008 and the main directions of federal property privatization for the years 2008–2010; the authors’ estimates.

As is clear from *Table 3*, over three and a half years (between 1 June 2003 and 1 January 2007), the overall number of FSUEs dropped by 3,327 units, or by nearly one third, including between 1 June 2006 and 1 January 2007 – by 9% (or by 645 units). Quite naturally, the changes which took place in the branch structure of FSUEs over this brief period were small. The greatest reduction was in the absolute number of FSUEs in the group of branches of the non-production sphere (by 146 units), and in the group “other branches” (by 162 units).

It seems more illustrative to compare the branch structures of the FSUEs’ sub-sector as of the beginning of 2002 and 2007 (*Table 4*).

*Table 4*

**The Number of Federal State Unitary Enterprises  
and their Branch Structure in 2002–06**

Branch	As of 1 January 2002		As of 1 January 2007		Changes	
	units	%	units	%	units	%
Industry	1,844	19.6	1539	23.6	-305	-16.5
Including:						
Machine – building and metal processing (without industrial medical technologies)	879	9.4	634*	9.7	-245	-27.9
Light industry	153	1.6	179	2.7	+26	+17.0
Construction materials industry	83	0.9	49	0.8	-34	-41.0
Food industry	64	0.7	51	0.8	-13	-20.3
Metallurgy	43**	0.4	28	0.4	-15	-34.9
Chemical industry	42	0.4	33	0.5	-9	-21.4
Other branches of industry	580	6.2	565	8.6	887	9.0
Agriculture and forestry	1,368	14.6	875	13.4	-493	-36.0
Transport and communications	1,033	11.0	536	8.2	-497	-48.1
Construction	988	10.5	668	10.2	-320	-32.4
Other branches	4,161	44.3	2,915***	44.6	-1,246	-30.0
Total	9,394	100.0	6,533	100.0	-2,861	-30.5

\* Machine-building.

\*\* Including ferrous (16 units) and non-ferrous (27 units) metallurgy.

\*\*\* Including the group of branches of the non-production sphere.

Source: www.mgi.ru, The forecast plan (program) of federal property for the year 2008 and the main directions of federal property privatization for the years 2008–2010; the authors’ estimates.

As regards the absolute decrease in the number of unitary enterprises over the period between 1 January 2002 and 1 January 2007, it was characterized by the following values: in transport and communications – 497 units, in agriculture and forestry – 493 units, in construction – 320 units, and in industry – 305 units.

When assessing the number of unitary enterprises, as of 1 January 2007, as a percentage of their number registered as of 1 January 2002, it can be stated that the most radical reduction (by almost one half) took place in transport and communications. In agriculture and forestry as well as in construction, the reduction in the number of FSUEs was also more considerable than in the sub-sector as a whole (by more than 30%). By contrast, the drop in the number of FSUEs in industry was almost half that much (only by 16.5%), although in the construction materials industry and metallurgy it was also more substantial than in the sub-sector as a whole. Against this background, the situation in light industry looks paradoxical, because the number of unitary enterprises there not only failed to decline by comparison with early 2002, but even went up by 17%. The main shift in the branch structure of FSUEs observed over the five-year period (2002–06) was an increase in the share of industry (by 3 p.p.), and a de-



crease in the share of transport and communications (by 2.8 p.p.), agriculture and forestry (by 1.2 p.p.), and construction (by 0.3 p.p.). The share of enterprises not belonging to the said branches changed insignificantly.

It should be emphasized that the dynamic analysis of changes in the number of FSUEs<sup>10</sup> was carried out on the basis of their number as of a given date, which made it possible to assess only the most general trend – the trend toward decrease in the size of this sub-sector. The available statistics do not allow an assessment of either the scale of creation and liquidation of this category of economic subjects, or the scale of its reorganization into other organizational and legal forms, that is, an assessment of the actions determining the number of the said subjects at a specific point in time.

### *Joint-Stock Companies whose Shares are in Federal Ownership*

Let us consider the by-branch dynamics of the number of joint-stock companies whose shares have been in federal ownership over the past few years (*Table 5*).

*Table 5*

### **The Number and the Branch Structure of Joint-Stock Companies whose Shares are in Federal Ownership, or with Regard to which the “Golden Share” Special Right is Applied, in 2003–2006**

Branch	As of 1 June 2003		As of 1 June 2004		As of 1 June 2005		As of 1 June 2006		As of 1 January 2007	
	units	%	units	%	units	%	units	%	units	%
Non-production sphere	1,918	45.6	1,781	45.6	685	18.1	356	9.6	405	10.1
Industry	1,350	32.1	1,253	32.1	2,078	54.9	1,772	47.6	1,797	44.95
Including:										
Machine - building	225	5.4	209	5.4	187	4.95	663	17.8	632	15.8
Food industry	43	1.0	40	1.0	54	1.4	141	3.8	127	3.2
Metallurgy	34	0.8	32	0.8	28	0.75	101	2.7	94	2.35
Construction materials industry	21	0.5	20	0.5	19	0.5	53	1.4	53	1.35
Chemical industry	19	0.4	18	0.5	46	1.2	98	2.6	89	2.2
Light industry	16	0.4	15	0.4	9	0.2	27	0.7	29	0.7
Other branches of industry	992	23.6	919	23.5	1,735	45.9	689	18.5	773	19.35
Construction	492	11.7	457	11.7	287	7.6	380	10.2	404	10.1
Transport and communications	383	9.1	356	9.1	459	12.1	396	10.6	353	8.9
Agriculture	46	1.1	43	1.1	229	6.1	363	9.7	534	13.35
Forestry	16	0.4	15	0.4	45	1.2	99	2.7	88	2.2
Other branches	–	–	–	–	–	–	358	9.6	416	10.4
Total	4,205	100.0	3,905	100.0	3,783	100.0	3,724	100.0	3,997	100.0

*Source:* The forecast plan (program) of federal property for the year 2004 and the main directions of federal property privatization until the year 2006; The Forecast plan (program) of federal property for the year 2005; The forecast plan (program) of federal property for the year 2006 and the main directions of federal property privatization for the years 2006–2009; The forecast plan (program) of federal property for the year 2008 and the main directions of federal property privatization for the years 2008–2010; the authors’ estimates.

It follows from *Table 5* that, over the period between 1 June 2003 and 1 January 2007 the overall number of joint-stock companies whose shares were in federal ownership declined by 208 units, or by 5%. The distinctive feature of the period between 1 June 2006 and 1 Janu-

<sup>10</sup> Same is true of the following analysis of the number of JSCs with federal blocks of shares.

ary 2007 was an increase of their number by 7.3% (or by 273 units), while during the rest of the periods the number was decreasing. The changes in the branch structure of JSCs with state stakes, which took place in the second half of 2006, were more significant by comparison with the shifts in the branch structure of FSUEs. Thus, while the share of industry declined by more than 2.6 p.p. (principally at the expense of machine-building) – to 45% , the share of agriculture noticeably increased from 9.7% to 13.4% (or by 3.7 p.p.).

In order to obtain the resultant estimates of the shifts which took place in the branch structure of the sub-sector of JSCs whose shares are in federal ownership, it should be necessary to compare the data as of early 2002 and early 2007 (*Table 6*).

*Table 6*

**The Number and the Branch Structure of Joint-Stock Companies whose Shares are in Federal Ownership, or with Regard to which the “Golden Share” Special Right is Applied, in 2002–2006**

Branch	As of 1 January 2002		As of 1 January 2007		Changes	
	units	%	units	%	units	%
Industry	1,837	41.7	1,797	44.9	-40	-2.2
Including:						
Machine-building and metal processing (without industrial medical technologies)	778	17.7	632*	15.8	-146	-18.8
Food industry	214	4.85	127	3.2	-87	-40.7
Construction materials industry	100	2.3	53	1.3	-47	-47.0
Light industry	67	1.5	29	0.7	-38	-56.7
Chemical industry	66	1.5	89	2.2	+23	+34.8
Metallurgy	64**	1.4	94	2.35	+30	+46.9
Other branches of industry	548	12.45	773	19.35	+225	+41.0
Construction	622	14.1	404	10.1	-218	-35.0
Transport and communications	477	10.8	353	8.9	-124	-26.0
Agriculture and forestry	83	1.9	622	15.6	+539	7.5-times growth
Other branches	1,388	31.5	821***	20.5	-567	-40.9
Total	4,407	100.0	3,997	100.0	-410	-9.3

\* Machine-building.

\*\* Including ferrous (26 units) and non-ferrous (38 units) metallurgy.

\*\*\* Including the group of branches of the non-production sphere.

*Source:* www.mgi.ru, The forecast plan (program) of federal property for the year 2008 and the main directions of federal property privatization; the author's estimates.

First of all, it should be noted that, over the 2002–06 period, the overall number of JSCs whose shares are in federal ownership decreased by 9.3%, which was typical of the majority of branches. The decrease in the number of such JSCs in transport and communications (by 26%, or by 124 units), construction (by 35%, or by 218 units), and also in the branches not singled out in this classification (by 41%, or by 567 units), was much more substantial than in the sub-sector as a whole. There was a many-fold increase (by 7.5 times, or by 539 units) in the number of the agriculture- and forestry-related JSCs whose shares are in federal ownership. By contrast, their number in industry remained practically unchanged, having been reduced only by 2.2% (or by 40 units). As regards the dynamics of such companies in individual branches of industry, one could note a rather significant drop in their number (by 40–60%) in light industry, the food industry, and the construction materials industry, and a rise in their number in metallurgy, chemistry, and those branches of industry that are not singled out in this classification after 2003.

In general, as regards the changes in the branch structure of JSCs whose shares are in federal ownership, one could state that in early 2007 there was a sharp rise in the share of agriculture and forestry by comparison with early 2002 (from 1.9% to 15.6%). The share of all the other branches declined. In industry, the most significant change was an increase in the share of the branches not singled out in this classification after 2003 (from 12.5% to 19.4%).

Yet another important characteristic of the sub-sector comprising joint-stock companies with state stakes is the distribution of economic societies in accordance with the size of the state-owned share (*Table 7*).

*Table 7*

**The Number and the Structure of Joint-Stock Companies with State Stakes  
in their Capital, as Assessed on the Basis of the Size of the State's Share,  
in 1999–2000 (Including the Application of the “Golden Share” Special Right)**

Date	Total		Up to 25 %		From 25 % to 50 %		From 50 % to 100 %		100%		“Golden share”	
	units	%	units	%	units	%	units	%	units	%	total	With no shares
1999	3,316/ 3,896*	100	863	26.0	1,601	48.3	470	14.2	382	11.5	580	**
1 January 2001	3,524* **	100	1,746	49.55	1,211	34.4	506	14.35	61	1.7	No data	No data.
August 2001	3,949 ****	100	1,843	46.7	1,393	35.3	625	15.8	88	2.2	542**	
1 January 2002	4,407	100	2,270	51.5	1,401	31.8	646	14.65	90	2.05	750**	
1 January 2003	4,222 *****	100	2,152	51.0	1,382	32.7	589	13.95	99	2.35	1076	118
1 June 2003	4,205	100	2,148	51.1	1,339	31.8	600	14.3	118	2.8	No data	No data.
1 October 2003	4,035	100	2,051	50.8	1,308	32.4	552	13.7	124	3.1	640	148
1 January 2004	3,704	100	1,769	47.75	1,235	33.35	540	14.6	160	4.3	591	251
1 June 2004	3,905	100	1,950	49.9	1,183	30.3	499	12.8	273	7.0	No data	No data
1 March 2005	4,075/ 3,791#	100	1,697	44.8	1,154	30.4	487	12.85	453	11.95	No data	284
1 June 2005	3,783/ 3,524##	100	1,544	43.8	1,093	31.0	474	13.5	413	11.7	No data	259
1 June 2006	3,724/ 3,481##	100	1,063	30.5	885	25.4	397	11.4	1,136	32.6	No data	243
1 January 2007	3,997/ 3,816##	100	932	24.4	814	21.3	368	9.6	1,702	44.6	No data	181

\* The text of the 1999 Concept for the Management of State Property and Privatization refers to 3,896 economic societies (including 3,611 open-end JSCs, 251 closed JSCs, and 34 limited liability companies and limited liability societies) with the RF's participation in their capital. 3,316 units is an estimated figure obtained by adding up the number of the blocks of stocks (or shares, or stakes) of various size mentioned in the text of the Concept.

\*\* The overall number of JSCs with the application of the “golden share” special right, without singling out the number of those companies where, despite this, the State does not own blocks of shares.

\*\*\* Joint-stock companies, without taking into account 48 shares and blocks of stocks in foreign companies. There are also some data indicating that Russia owns 119 shares, stakes, and blocks of stocks in foreign companies with the book value of 1.4 billion USD.

\*\*\*\* The data of the draft program of privatization for the year 2002 submitted to the RF Government by the RF Ministry of State Property. At the same time, according to the Register of the RF Ministry of State Property, 4,308 blocks of shares in JSCs were in state ownership as of 1 September 2001.

\*\*\*\*\* Only open–end joint-stock companies (OJSC), not counting the 118 OJSCs where the “golden share” special right was applied (with no shares being owned), the blocks of shares in 102 JSCs transferred into operative management to the FSUE “Rosspirtprom”, the 75 closed joint-stock companies and the stakes in the authorized capital of limited liability societies transferred in pursuance of Regulation of the RF Government, of 2 April 2002, No. 454-r, “On the discontinuation of state participation in the authorized capital of credit institutions”, or obtained by way of inheritance, or gift, or on other grounds.

# 3,791 units is the estimated number of the JSCs whose shares are in RF ownership, not counting the 284 JSCs where the “golden share” special right is applied (with no block of shares being owned). The share of a JSC with some or other stake in capital is calculated on the basis of this value, for comparison with the data for the previous dates. For reference: as of 1 January 2005, shares in 3,767 JSCs were in federal ownership, not counting the afore-said 284 JSCs with the “golden share” and the stakes in the authorized capital of 24 limited liability societies transferred to the Treasury in pursuance of Regulation of the RF Government, of 2 April 2002, No. 454-r, “On the discontinuation of state participation in the authorized capital of credit institutions”.

## The estimated number of JSCs whose shares are in RF ownership, not counting the JSCs where the “golden share” special right is applied (with no block of shares being owned). The share of a JSC with some or other stake in capital is calculated on the basis of this value for the sake of comparison with the data for the previous dates.

Source: www.mgi.ru; Rossiiskaia ekonomika v 2001 godu. Tendentsii i perspektivy. [The Russian economy in the year 2001. Trends and prospects]. Vyp. 23. Vol. 2. Moscow: IEPP [IET], March 2002, p. 62; *Braverman, A.A.* O merakh po povysheniiu effektivnosti upravleniia federal’noi sobstvennost’iu i kriteriakh ee otsenki (On the measures designed to increase the effectiveness of federal property management and on the criteria for its estimation) // Vestnik Minimushchestva Rossii [The Herald of Russia’s Ministry of State Property], 2003, No. 1, pp. 13–14; *Predpriiatiia s gosudarstvennym uchastiem. Institucional’no-pravovye aspekty i ekonomicheskaiia effektivnost’* [Enterprises with state participation. The institutional and legal aspects and economic efficiency.] Series: “Nauchnye doklady: nezavisimyi ekonomicheskii analiz” [Scientific reports: independent economic analysis], No. 155, Moscow: Moskovskii obshchestvennyi nauchnyi fond; Assotsiatsiia issledovatelei ekonomiki obshchestvennogo sektora [The Moscow Public Research Foundation; The Association of Researchers of the Public Sector’s Economy], 2004, p. 47; *Programma privatizatsii federal’nogo imushchestva na 2004 g. (Prognoznyi plan (programma) federal’nogo imushchestva na 2004 god i osnovnye napravleniia privatizatsii federal’nogo imushchestva do 2006 goda.* [The program for federal property privatization in 2004. (The forecast plan (program) of federal property for the year 2004 and the main directions of federal property privatization until the year 2006)] // Vestnik Minimushchestva Rossii, 2003, No. 3, pp. 4–5; *Kliuchevye problemy povysheniia effektivnosti upravleniia federal’noi sobstvennost’iu i osnovnye napravleniia dividendnoi politiki Rossiskoi Federatsii* [The key issues of increasing the effectiveness of federal property management and the main directions of the dividend policy of the Russian Federation] // Vestnik Minimushchestva Rossii, 2003, No. 4, p. 8; *Andrianov V.* Rossiia v global’noi ekonomike [Russia in the global economy] // Obshchestvo i ekonomika [Society and the economy], 2003, No 11, p. 84; *Prognoznyi plan (programma) federal’nogo imushchestva na 2005 god.* [The forecast plan (program) of federal property for the year 2005]; *Materialy k zasedaniiu Pravitel’sтва RF 17 marta 2005 g.* “O merakh po povysheniiu effektivnosti upravleniia federal’noi sobstvennost’iu”. [Materials for the RF Government’s meeting on 17 March 2005 “On the measures designed to increase the effectiveness of federal property management”]; *Prognoznyi plan (programma) federal’nogo imushchestva na 2006 god i osnovnye napravleniia privatizatsii federal’nogo imushchestva na 2006–2008 gody.* [The forecast plan (program) of federal property for the year 2007 and the main directions of federal property privatization for the years 2007–2009]; *Prognoznyi plan (programma) federal’nogo imushchestva na 2008 god i osnovnye napravleniia privatizatsii federal’nogo imushchestva na 2008–2010 gody.* [The forecast plan (program) of federal property for the year 2008 and the main directions of federal property privatization for the years 2008–2010]; the authors’ estimates.

As is apparent from *Table 7*, as of 1 January 2007 the structure of the main body of federal blocks of shares was as follows: the blocks of shares amounting to 25% of capital accounted for less than 1/4 of all the JSCs with state stakes; the controlling blocks of shares (from 25% to 50% of capital) – slightly more than 1/5; while in more than 54% of all companies the State could exercise majority or overall control. The share of the JSCs fully controlled by the State (with 100% of capital owned thereby) amounted to 44.6%, which was 4.5 times

more than the share of those JSCs where the State, while being a majority shareholder, owned less than 100% of shares (9.6%).

It should be reminded that a comparison between the structure of the federal blocks of shares which had come into being as early as by 1 June 2006, and the structure which the RF Ministry of State Property had expected to emerge on the implementation of the 2003 privatization program<sup>11</sup>, indicates that the objective set in advance has indeed been achieved, although with a more than two-year delay. This has put an end to the situation when the balance was clearly tipped in favor of the blocks of shares which did not provide the State with a proper degree of control over the companies, which was a survival from the period of money privatization of the late 1990s. This control was further consolidated by the changes which took place in the second half-year of 2006.

In the period between 1 June 2006 and 1 January 2007, the share of JSCs with 100% of stocks in federal ownership rose by 12 p.p. (from 32.6 to 44.6%), while the share of companies of all the other categories declined. The most radical decline (by 6 p.p.) was in the share of JSCs with minority federal blocks of stocks (from 30.5 to 24.4%). As a result, by the beginning of 2007, the aggregate share of JSCs where the State, as a stockholder, could exercise adequate corporate control due to owing the controlling block of stocks or the whole capital of a company, exceeded one half of all economic societies with its participation for the first time since the late 1990s.

Approximately the same picture emerges when comparing the structure of the whole bulk of federal blocks of stocks as of the beginning of 2007 and 1999 (according to the data of the Concept). The major new trend was a considerable (by 3.9 times) increase in the share of those JSCs where all capital belonged to the State, while the share of all other groups of blocks of stocks decreased. The maximum drop (by 2.3 times) was experienced by the share of the blocking parcels of stocks (between 25 to 50%); the share of the parcels of stocks sized 50–100% also declined, approximately by 4.6 p.p., while the share of minority parcels of stocks fell by 1.6 p.p. At the same time, it should be kept in mind that the data for the year 1999 are probably incomplete.

Nevertheless, it could be stated that the number of registered federal blocks of shares less than 25% in size as of 1 January 2007 (932 units) was by 8% larger than the corresponding index of 1999; it had reached its peak by the beginning of 2002 (2,270 units), and then steadily declined (except for the first half-year of 2004). In 2006, the number of federal blocks of shares 25 to 50% in size (814 units) was nearly two times lower than in 1999 (1,601 units). Their number at the beginning of 2002 (1,401 units) was higher than a year previously (1,211 units), and then steadily diminished. By the beginning of 2007, the number of the federal blocks of shares 50 to 100% in size (368 units) was by about 21% lower than in 1999 (470 units), although it fluctuated widely over the period under consideration, amounting to 646 at the beginning of 2002 and to 600 as of 1 June 2003, after which it steadily declined. By contrast, in 2006, the number of JSCs where 100% of shares were in federal ownership was by approximately 4.5 times higher than in 1999. Their minimum number was registered at the

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<sup>11</sup> It was expected that the number of blocks of shares in federal ownership would amount to 3,613. See *Braverman A.A.* O merakh po povysheniuiu effektivnosti upravleniia federal'noi sobstvennost'iu i kriteriakh ee otsenki [On the measures designed to increase the effectiveness of federal property management and on the criteria for its estimation] // *Vestnik Minimushchestva Rossii* [The Herald of Russia's Ministry of State Property], 2003, No. 1, p. 29.

beginning of 2001 (61 units). Later on, it was constantly rising, and in the period between 1 June 2005 and 1 January 2007 this rise took the form of a leap with the number of these JSCs increasing by 4.1 times (or by 1,289 units).

The scale of using the “golden share” special right demonstrated an unambiguous tendency toward decrease in the absolute number of such companies: 181 units by the beginning of 2007, against 243 units as of 1 June 2006 and 284 units as of 1 March 2005 (the maximum value for the whole 1999–2006 period).

The composition of the state sector is also monitored by the Russian Statistics Service (Rosstat). It will be recalled that according to Decree of the RF Government, of 4 January 1999, No 1, the state sector includes economic subjects of the three major types existing on the federal and regional levels:

- state unitary enterprises operating by right of economic jurisdiction and operative management (federal treasury enterprises);
- state institutions;
- economic societies with the authorized capital where more than 50% of stocks (or participatory shares) are in state ownership.

According to this document as amended by Decree of the RF Government, of 30 December 2002, No. 939, the state sector of the economy also includes the economic societies with the authorized capital where more than 50% of stocks (or participatory shares) are owned by economic societies belonging to the state sector.

This definition of the state sector has a number of drawbacks, including the following:

- it does not include into the state sector the commercial and not-for-profit organizations with the participation of federal and regional unitary enterprises, or at least those of them where the participatory share of unitary enterprises exceeds 50%;
- in actual practice, it is not always necessary to own more than 50% of stocks (or participatory shares) in order to exercise control over an economic society. It would be more correct to speak in terms of more than 50% of the voting shares, which is especially true of those enterprises where, in the course of mass privatization in 1992–94, one quarter of capital was transferred free of charge, in the form of preference shares, to the personnel (as under the first version of benefits during corporatization), and where, at the same time, the limitations on privatization caused by the branch specificity (for example, in defense industry) required that the controlling block of shares should remain in state ownership. As a result, the size of the block of shares consolidated to the State amounted to 38% of the authorized capital and to more than one half of the voting shares;
- not included in the state sector are those economic societies where the aggregate participatory share of the Treasury and the economic societies with more than 50% of stocks (or participatory shares) in state ownership exceeds one half of their capital, although the individual participatory shares of the Treasury and the economic societies with the prevalence of state capital amount to less than 50%;
- same is true of the situation with regard to those economic societies where, in the aggregate, more than one half of capital is owned by the Treasury, and those where more than 50% of the authorized capital in the form of stocks (or participatory shares) belongs to other economic societies related to the state sector, that is, by those societies where the State’s share in the authorized capital exceeds 50% participation in their authorized capi-

tal, although their individual shares amount to less than 50% each<sup>12</sup>; and same is true of the situations when control over an economic society can be ensured by adding-up the participatory shares of the economic societies belonging to the state sector and the participatory shares of the economic societies controlled by them;

- there is no transparency with regard to the affiliations (“daughter” companies) and dependent companies included in the business-groups formed on the fringes of the organizations belonging to the state sector, which are being controlled indirectly, via several levels (“granddaughters” “great granddaughters”, etc.), or via less than 50% shareholding.

On the basis of Rosstat’s data, the quantitative dynamics of economic subjects in the first half-year of 2007 was as follows (*Table 8*).

*Table 8*

**The Number of Organizations of the State Sector of the Economy Registered by the Territorial Agencies of the FAFPM and by the State Property Management Bodies of RF Subjects in the year 2007, units**

Date	Total	SUEs including federal treasury enterprises	State institutions	Economic societies where more than 50% of stocks (participatory shares) in authorized capital are owned	
				by State	by economic societies belonging to state sector of economy
As of 1 January 2007	82,410*	12,735	64,295	3,920	1,439
As of 1 July 2007	81,076	11,351	64,159	4,111	1,440

\* Including the organizations whose constituent documents do not specify the concrete types of activity, which results in the overall number of organizations of the state sector exceeding that of SUEs, institutions, and economic societies, though exclusive of joint-stock companies with more than 50% of stocks (or participatory shares) in joint, state and foreign, ownership.

*Source:* O razvitii gosudarstvennogo sektora ekonomiki Rossiiskoi Federatsii v 2006 godu [On the development of the state sector of the economy of the Russian Federation in the year 2006]. Moscow: Rosstat, 2007, p. 111.

As is evident from *Table 8*, the first half-year of 2007 saw a rather considerable drop in the number of SUEs (almost by 11%, or by 1,384 units), an insignificant reduction in the number of state institutions (by 0.2%, or by 136 units), and a rise, by approximately 5% (or by 191 units), in the number of economic societies whose authorized capital in the form of stocks (or participatory shares) was more than 50% owned by the State. There were no changes in the number of economic societies whose authorized capital, in the form of stocks (or participatory shares), was more than 50% owned by economic societies belonging to the state sector of the economy.

At the same time, the information contained in Rosstat’s data with regard to the number of organizations of the state sector being classed with federal and regional property, and those being classed with property under joint jurisdiction of the Russian Federation and its subjects, is not sufficiently subdivided into the said organizational and legal forms, which does not make it possible to separately analyze such changes by each of the forms of ownership.

The part played in the contemporary Russian economy by organizations of the state sector is also worthy of notice. Below are Rosstat’s data on their share in the production of goods

<sup>12</sup> This was more or less true of the structure of the capital of the OJSC “Gazprom” before the plan for increasing the state share to the controlling value began to be implemented, although the federal block of shares amounted to less than 50% (38.37%).

(or services, or work) during the past three years, in regard to the major indices and branches, with the most important positions being specified; also indicated is the share of those where the State's input was no less than 10% (Table 9).

Table 9

**The State Sector's Share in the Production of Individual Types of Products  
and in Other Indices, in 2005–2007, in %**

Index	2005	2006	First half-year 2007
1	2	3	4
<b>Industrial production</b>			
<i>Extraction of mineral resources*</i>	5.5	6.0	12.4
- common salt (extraction)	16.0	15.0	18.4
- coal	5.1	4.7	5.0
- extracted oil, including lease condensate	1.2	0.8	0.7
- natural inflammable gas	0.3	0.2	0.1
<i>Processing industries*</i>	8.9	8.2	7.8
- soda ash, 100%	55.8	58.7	57.5
- freight cars (for main lines)	56.1	49.8	42.2
- ethyl alcohol distilled from edible raw materials	44.1	42.4	38.5
- timber sleepers for wide-gauge railroads	36.8	34.0	35.7
- metal-cutting machine tools	21.3	25.5	28.9
- washing machines	46.8	34.0	24.9
- tractor-driven sowers	36.9	22.1	22.7
- vodka and products of spirits-making	21.1	21.9	19.0
- civilian aircraft	21.4	16.7	–
- commercial timber	16.1	16.6	16.7
- polystyrene and styrene copolymers	21.1	15.9	14.1
- shaped timber	15.8	14.3	14.0
- trolleybuses	–	8.4	12.4
- motor cultivators and power cultivators with detachable tools	24.1	10.9	12.3
- stop timbers for switches of wide-gauge	20.5	12.2	–
- pharmaceuticals	19.3	22.3	12.1
- civilian helicopters	19.6	11.0	11.8
- rolling equipment	10.5	12.6	–
- radio receivers	13.3	6.6	11.2
- non-ore building materials	13.2	11.0	10.2
- domestic refrigerators and freezers	10.4	10.6	9.6
- microbiological fodder protein (commodity product)	21.4	7.6	8.1
<i>Production and distribution of electrical energy, gas and water*</i>	13.7	10.7	11.2
- electrical energy, total	19.0	16.5	16.5
- electrical energy generated by nuclear power plants	100.0	100.0	100.0
- electrical energy generated by thermal power plants	4.7	0.9	0.9
- electrical energy generated by hydroelectric power plants	1.4	0.3	0.3



*Table 9 (continued)*

1	2	3	4
<i>Agriculture and forestry</i>			
- eggs**	19.7	18.7	18.2
- vegetables**	15.3	15.0	–
- wool**	13.5	11.9	11.5
Reforestation work	99.9	99.9	–
<i>Construction</i>			
- putting residential houses into operation	5.6	5.2	3.1
- work performed by organizations on their own	5.5	4.4	3.5
<i>Transport</i>			
<i>Volume of commercial freight carriage (or dispatch)***</i>	44.9	67.2	74.2
- by railroad transport (main lines)	100.0	100.0	100.0
- by air transport (transport aviation)	22.8	20.5	19.2
- by sea transport	14.8	10.9	13.6
- by internal waterways transport	9.2	9.8	12.0
<i>Commercial freight turnover***</i>	41.8	93.9	94.0
- of railway transport	100.0	100.0	100.0
- of air transport (transport aviation)	15.0	12.9	12.9
- of internal waterways transport	8.5	10.6	10.8
<i>Passenger turnover****</i>	68.7	68.5	66.9
- of railroad transport (main lines)	100.0	100.0	100.0
- of automobile transport	44.8	43.9	43.7
- of air transport (transport aviation)	33.1	31.3	26.2
- of sea transport	19.4	27.0	31.5
- of internal waterways transport	10.7	13.4	15.3
<i>Volume of freight-dispatching by pipeline transport (trunk pipelines)</i>	0.4	0.5	0.1
<i>Freight turnover of pipeline transport (trunk pipelines)</i>	0.1	0.1	0.08
<i>Internal costs of research and development</i>	69.3	70.4	72.2
<i>Paid services provided to population (VAT included)</i>	18.5	17.2	16.6
- services of educational system	48.8	47.6	46.0
- transport services	34.7	33.2	34.7
- services of sanatoria and health resorts	23.8	25.7	26.2
- medical services	21.1	21.4	22.3
<i>Investments in fixed assets</i>	14.9/	14.4/	11.8/
	19.1*****	18.1*****	15.4*****
<i>Net proceeds of the sale of goods, products , and services (minus VAT, excises and other similar mandatory payments)</i>	11.2	10.2	9.6
<i>Average listed number of workers (regular staff)</i>	25.6	26.0	25.2

\* The volume of dispatched goods and of work and services performed with the executor's own efforts.

\*\* Against the overall volume of production of agricultural organizations.

\*\*\* Less organizations of pipeline transport.

\*\*\*\* Less organizations of city passenger electric transport.

\*\*\*\*\* Without taking into account small businesses.

*Source:* O razvitií gosudarstvennogo sektora ekonomiki Rossiiskoi Federatsii v 2005 godu. [On the development of the state sector of the economy of the Russian Federation in the year 2005]. Moscow: Rosstat, 2006, pp. 8, 19–20, 61, 71, 84, 85, 89, 92, 93, 94, 103, 107, 111, 115, 119, 137, 139, 146, 167; O razvitií gosudarstvennogo sektora ekonomiki Rossiiskoi Federatsii v 2006 godu. [On the development of the state sector of the economy of the Russian Federation in the year 2006]. Moscow: Rosstat, 2007, pp. 8, 19–20, 58, 68, 81, 82, 86, 89, 90, 91, 100, 104, 108, 112, 116, 134, 136, 143, 164; O razvitií gosudarstvennogo sektora ekonomiki Rossiiskoi Federatsii v 1-m polugodii 2007 goda. [On the development of the state sector of the economy of the Russian Federation in the first half-year of 2007]. Moscow: Rosstat, 2007, pp. 8, 18–19, 57, 71, 75, 78, 79, 80, 91, 95, 99, 103, 107, 117, 119, 126, 147.

As is apparent from *Table 9*, the state sector monopolizes only a few types of activity (generation of electrical energy at nuclear power plants, reforestation, and freight and passenger railway carriage) or dominates therein (soda). In the majority of other cases its share is less than 20%, except for alcoholic products, sleepers, some types of machine-building production (freight cars, metal-cutting machines, washing machines, and tractor-drawn sowers), and all types of paid services, where the largest share of the state sector is registered in education (slightly less than 50%). A certain growth in the state sector's share is detectable only in freight and passenger carriage by internal waterways and sea transport, internal costs of research and development, services of sanatoria and health resorts, and medical services. However, a period of less than three years long is clearly too short to discern any definite trends.

Much more importantly, the classification used by Rosstat (or something else) has not made it possible to register, within the framework of the state sector, the volumes of production in such big companies with state participation as “Gazprom”, RJSC “UES of Russia”, “Rosneft”, “Transneft”, and “Transnefteprodukt”, which becomes apparent when comparing the registered share of the state sector with the universally known facts concerning the leadership of the afore – said companies in the Russian economy, let alone the presence of the State in the financial sector. It seems plausible that the data shown in *Table 9* are sketchy in yet another respect, and that defense industry is represented in them, for the most part, by its conversion segment (individual types of machinery, equipment, household appliances, and civilian-aviation technology).

In these conditions, it is vitally important to bring the system of statistical observation into correspondence with a company's belonging to some or other sector of the economy (first of all, to the public one, which should be properly singled out<sup>13</sup>). However, it is evident that the determination of the poles of actual control, in contrast with the formal rights of ownership to some or other enterprise, is a very complicated task. Let us cite several examples concerning the power industry.

For example, the OJSC “Atomenergomash” (a 100% subsidiary of the JSC “TVEL”) owns 50% plus 1 share in the plant “ZiO-Pdol'sk” and 96% of shares in the engineering company “Ziomar”. At present, “Atomenergomash” is preparing to organize a joint venture for the production of steam-turbine equipment for nuclear power plants with the well-known French company “Alstom”<sup>14</sup>. It remains to be reminded that 100% of shares in the OJSC “TVEL” itself are in state ownership, that they should be contributed to the authorized capital of the holding company “Atomenergoprom” (AEP) being established by the State, and that the shares therein would be, in their turn, used for creating the state corporation “Rosatom”. It

<sup>13</sup> All the aforesaid is also true for the municipal level and the participation in the capital of economic societies owned by bodies of local self-government.

<sup>14</sup> Malkova I. *Rosatom vybral Alstom. [Rosatom has chosen Alstom]. // Vedomosti. 3 April 2007.*

should also be mentioned that the OJSC “TVEL”, together with the FSUE “Zarubezhatomenergostroi”, owns a controlling block of shares in the CJSC “Atomenergostroi” engaged in construction of nuclear power plants abroad (in the past the controlling block of shares belonged to Gazprombank, which had bought it in 2004). The shareholders of the largest Russian operator in the sphere of export and import of electrical energy, the CJSC “Inter RJCSC “UES”, are the RJCSC “UES of Russia” (60%) and the FSUE “Kontsern “Rosenergoatom” (40%)<sup>15</sup>. Thus, the only thing possible as yet is to estimate, by way of special applied research, the market shares of various business groups and companies, including those controlled by the State” in some specific markets of commodities and services.

### 5.1.3. Medium-Term Privatization Plans and Current State of Privatization

As already noted, in 2007, as in the previous years, no privatization transactions were implemented with regard to assets of national significance.

The most spoken about was the sale of blocks of shares in the companies “Yakutugol” (75% minus 1 share) and “El’gaugol” (68.8%) for 58.196 billion rubles, which makes it possible to characterize this transaction as one of the largest deals of 2001–05. By its scale it is quite comparable with the sale of federal blocks of shares in the oil companies “Slavneft” (74.95%) in 2002 and “LUKOIL” (7.59%) in 2004. However, the object of this transaction was not in federal ownership: the afore-said block of shares in “Yakutugol”, and also 39.4% of shares in “El’gaugol”, were in republican ownership, after having been contributed, in advance, into the authorized capital of “Respublikanskaia Investitsionnaia Kompaniia” [the Republican Investment Company], while a further 29.5% of shares were owned by the OJSC “RZhD” (which was also the owner of the property complex being sold). True enough, in this transaction, as in the sale of numerous “Yukos” assets, the seller was the Russian Fund for Federal Property (RFFP).

Apart from this, the large transactions (in the amount of more than 100 mn rubles each) handled by the RFFP over the past year include the sale, at auction, of the state-owned blocks of shares in the OJSC “The Siberian Agency for Oil-Well Construction” (SAOWC) (Yamal-Nenets AO, 100% of shares, 741 mn rubles), “Airport “Roshchino” (Tiumen, 100%, 610 mn rubles), “Stroipolimerkeramika” (Kaluga Oblast, 30.99%, 270.3 mn rubles), “The Omsk Institute for Projecting Enterprises of the Oil-Processing and Petrochemical Industries” (38%, 177 mn rubles), “347 Voenproekt” (Samara, 100%, 134.262 mn rubles), “Belgorod Oblast’s Printing House” (100%, 137.262 mn rubles), and “The Novosibirsk Prospecting Expedition” (100%, 115 mn rubles). In the majority of these transactions, the selling price only slightly differed from the initial one. The only exception was the sale of shares in the OJSC “SAOWC”, where the selling price exceeded the initial price by almost three times<sup>16</sup>.

Great progress was achieved with regard to realization of redundant military real estate. In 2007, the RFFP sold 262 such objects for the sum of 1,454 million rubles, or by almost 75% more than in the previous year. For comparison: in 2006, realization of such real estate

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<sup>15</sup> Kudriashov D. *Stantsionnye smotriteli*. [Stationmasters] // RBK daily, 18 May 2007, p. 6.

<sup>16</sup> www.frfp.ru.

yielded 590.6 million rubles, in 2004 – 632 million rubles, and in 2004 – 590.6 million rubles. The main bulk of redundant military real estate (94%) are buildings and constructions<sup>17</sup>.

The 2006 transformation of the RFFP into a budget-funded enterprise was a catalyst, of sorts, for further weakening of its positions in the administrative hierarchy. Immediately afterwards, the Federal Bailiff Service (FBS) and the Customs put forth proposals to deprive the RFFP of its exclusive right to realize arrested property transferred into state ownership. The importance of this aspect is attested to by the fact that in the year 2007, the Fund received 16.3 billion rubles-worth of such property, and the proceeds from sales amounted to 6.4 billion rubles. The above proposals have not been materialized as yet, and the realization of redundant military property is going on. In accordance with the RF President's Commission, of 16 May 2007, No. Pr-817, the Russian Fund for Federal Property (RFFP) and the Central Administration for Material Resources and External Economic Relations of the RF Ministry of Defense signed, on 4 June 2007, an agreement concerning the realization of redundant military property. In accordance with this document, the RFFP could commission the Central Administration to sell objects of real estate, which makes it possible to increase the volumes of realization due to the emergence of yet another trading floor.

In these conditions, various quasi-privatization procedures are increasingly gaining in importance, as exemplified by the transfer into ownership to the city of St. Petersburg of RF-owned 100 % of shares in the OJSC "Airport Pulkovo" (St. Petersburg). The stated purpose of the transfer is to enable the government of St. Petersburg to attract investments in the amount of no less than 30 billion rubles into the comprehensive reconstruction and modernization of the air-transport infrastructure of the airport, which is to be done on the basis of a public-private partnership and in correspondence with a plan of measures concerning the reconstruction of the air-terminal complex the OJSC "Airport "Pulkovo", to be approved by the city government. Similar decisions are being prepared with regard to a number of other airports as well.

Yet another potential claimant to the objects of the 2008–2010 Privatization Program are the state corporations which came into being last year. Thus, at the beginning of the current year, it became known that the federal blocks of shares in "KamAZ" (which had been repeatedly included in the previous privatization plans) and in "Techpromeksport" (a large object planned for privatization in 2008) might be transferred to the corporation "Rostekhnologii".

The latest "Forecast plan (program) of privatization for the year 2008 and the main directions of federal property privatization for the years 2008–2010" was confirmed by Regulation of the RF Government, of 29 April 2007, No. 543–r – that is, after an approximately four-months shorter interval than in the case of the previous similar documents. However, it does not differ much from its predecessors in any other respects.

In 2008–2010, it is planned to offer for sale blocks of shares in the joint stock companies created in the course of corporatization of state unitary enterprises, except for those JSCs included in the list of strategic ones, or taking part in the formation of integrated structures. The annual budget receipts from privatization in 2008–2010 should amount to approximately 12 billion rubles.

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<sup>17</sup> Interview given by Deputy Chairman of the RFFP S. Maksimov to the newspaper "Krasnaia Zvezda" [the Red Star], No. 14 (25017), 30 January 2008.

Among other objects to be offered for privatization in 2008, there are the following ones:

- blocks of shares not exceeding 50% of the authorized capital of a given JSC, except for the blocks of shares in strategic JSCs or the JSCs taking part in the formation of integrated structures, and also the blocks of shares whose sale will be carried out so as to meet the needs of forming the federal budget's revenue in 2008 and for the period until 2010 in accordance with the long-term financial plan;
- blocks of shares in the JSCs of the fuel and energy complex, the electrical-power objects construction complex, the construction complex, external-economic organizations, civil aviation, healthcare, the chemical, petrochemical, and the printing industries, geology, fishing, poultry farming, the crop sector, the livestock sector, the woodwork and timber industry, the medical industry, and machine building, except for strategic JSCs (557 JSCs);
- FSUEs in the spheres of motor transport, the construction complex, civil aviation, geology, the oil-and-gas complex, the fuel industry, sea and river transport, the printing industry, healthcare, fishing, poultry farming, and animal husbandry (573 FSUEs);
- those properties of the RF Treasury which do not perform functions of state importance (101 objects), and shares in the authorized capital of limited responsibility societies (12 shares).

Of the big objects of federal property, it is planned to privatize, in 2008, federal shares in OJSCs “VO “Technopromeksport” and “Kinostudiia “Lenfilm” (the Film-Making Studio “Lenfilm”).

In 2008–2010, the creation of integrated structures in the defense-industrial complex, and in the aviation, ship-building, nuclear, and space industries will continue. In 2009–2010, it is planned to privatize all the FSUEs not performing functions of state importance, as well as shares in the open-end JSCs created in the process of corporatization of the afore-said FSUEs.

#### 5.1.4. The Activity of Big State Companies

By and large, the trends of the past few years essentially analyzed in the previous annual reports, were demonstrating in the year 2007 their growing strength and ability for further development<sup>18</sup>.

So far as the creation of integrated structures is concerned, it is necessary, first of all, to note the adoption of the decision to merge “Transneft” and “Transnefteproduct”, with all 100% of shares therein to be contributed to the authorized capital of “Transneft” as a payment for the additional issue of shares. In addition to this, “Transneft” received blocks of shares (24% in each) in the two operator companies of the “Caspian Pipeline Consortium” situated in Russia and Kazakhstan, respectively. The said blocks of shares were transferred, without any contest, into trust management to “Transneft”. It should be emphasized that this event was one of the examples, extremely rare in the 2000s, of transferring state-owned shares into trust management for the sake of their administering. And the transfer of the blocks of shares into

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<sup>18</sup> See *Rossiiskaia ekonomika v 2005 godu. Tendentsii i perspektivy* [The Russian economy in the year 2005. Trends and outlooks]. Vyp. [Issue] 27. Moscow: IET, pp. 423–467; *Rossiiskaia ekonomika v 2006 godu. Tendentsii i perspektivy* [The Russian economy in the year 2006. Trends and outlooks]. Vyp. [Issue] 28. Moscow: IEPP, pp. 606–645.

trust management to “Transneft” was carried out without resorting to a contest, in a blatant contradiction to the requirements of the normative-legal base adopted in the second half of the 1990s, however imperfect it might have been.

The situation with “Transneft” has found its virtual reenactment in the contribution of the federal block of shares in the OJSC “Novoship” (50.34%) to the authorized capital of the shipping company “Sovkomflot”.

The creation of “The United Shipbuilding Corporation” (USC) (St. Petersburg), which was established in spring 2007, deserves to be described in more detail. By comparison with “The United Aircraft Building Corporation” (UABC), which had been created a year earlier, it has a more complex structure.

In parallel with the OSC proper, which is the head structure, the following entities are established as its subsidiaries: the JSC “The Western Center of shipbuilding” (St. Petersburg), “The Northern Center of Shipbuilding Ship Repair” (Severodvinsk, Archangelsk Oblast), and “The Far-Eastern Center of Shipbuilding and Ship Repair” (Vladivostok). The State’s contribution to the creation of these centers is 100% minus one share in the three JSCs, and the monetary means in the amount of 75 mn rubles for each center.

In the future, by way of repayment of the additional shares to be placed by these subsidiaries in connection with their authorized capital being increased, the following assets should be contributed thereto:

- 100 % minus one share in the 4 OJSCs to be transformed from the existing FSUEs, and blocks of shares in yet another 3 JSCs of different size (the first one – 51%, the second one – 33.53%, and the third – 20.96%) – to the authorized capital of the JSC “The Western Center of Shipbuilding”;
- 100% minus one share in the 4 OJSCs transformed from the existing FSUEs (one of which should be preliminarily transformed by being joined by another 8 FSUEs) – to the authorized capital of the OJSC “The Northern Center of Shipbuilding and Ship Repair”;
- 100% minus one share in the 7 JSCs transformed from the existing FSUEs, and blocks of shares in another 3 JSCs of different size (two – by 20% each, the third one – 10%) – to the authorized capital of the OJSC “The Far-Eastern Center of Shipbuilding and Ship Repair”.

At the same time, the authorized capital of “The United Shipbuilding Corporation” is formed, from the very beginning, by the federal block of shares in one JSC (60%) and the monetary means in the amount of 25 mn rubles, as in the case of each of the three subsidiary JSCs<sup>19</sup>. Apart from this, because of the necessity to repay the additionally placed shares, the following assets should be contributed to its authorized capital: 100% minus 1 share in 6 JSCs transformed from the existing FSUEs, 2 minority federal blocks of shares (24% and 14.99% respectively), and, no later than the end of 2008, 100% minus 1 share in each of the three afore-said subsidiaries, on the completion of forming their authorized capital. The deadline for the formation of the USC is spring 2009.

So far as shipbuilding is concerned, apart from the creation of the USC, it is planned to reorganize 3 FSUEs into OJSCs with 100 % of shares therein to be in federal ownership. In the future, by way of repaying the additional placements of their shares, the following assets will be contributed by the RF to their authorized capital: blocks of shares in 2 JSC (38% and

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<sup>19</sup> The allocation of the corresponding funds was envisaged in the Law on the 2007 Federal Budget.

29.7%), 2 JSC (25.1% and 37.99%), and 1 JSC (38% plus 1 share), respectively. Yet another FSUE will be reorganized by annexing to it 2 FSUEs, after which it will be renamed as a state scientific center (SCC).

In the practical field, 7 unitary enterprises have already been reorganized by way of merger, and the authorities have taken the decisions as to privatizing another 8 FSUEs earmarked for inclusion in the USC.

As regards the USC, blocks of shares in 4 JSCs (only one of them is a controlling block) have been additionally contributed to its authorized capital).

An even more interesting example of the creation of integrated structures was the pooling of state and private assets of the 5 air companies comprising the alliance “Air Union”, by way of creating a new air carrier – the OJSC “Airunion”, third largest in the country”. The State’s contribution will be in the form of its blocks of shares in “The Krasnoyarsk Airlines” (51%), “The Domodedovo Airlines” (50.04%), and in “The Air Company “Samara” (46.5%). It should be noted that, in contrast to the majority of holding companies created in recent years, the State may not get a controlling block of shares in the structure being formed, and will limit its ambitions to obtaining just 45% of shares, although the final proportions in share-distribution should be determined later on. Such a structure of capital is fraught with a high risk of conflicts between the State and the rest of the shareholders, which became apparent almost immediately, in the beginning of the current year, when the constituent shareholders’ meeting failed to come to any decision because of the disagreements in estimating the value of the assets being contributed.

In early 2007, the approval of a corresponding draft law opened way to the creation of a new big state-owned company on the basis of assets of the civilian part of the Russian nuclear industry. 100 % of shares in this company will belong to the State. Edict of the RF President, of 27 April 2007, No 556, initiated the creation of a holding company, the OJSC “The Nuclear Power Engineering Complex” (NPEC), with 100% of shares in federal ownership. To be contributed to its authorized capital are federal blocks of shares in 31 previously created OJSCs, and in another 55 OJSCs which should be created after the reorganization of FSUEs, as well as in 3 federal state educational establishments (FSE) in the sphere of additional professional training (or advanced training), related to the organizations of the nuclear power engineering complex. The united integrated company “The Nuclear Power Engineering Complex” (NPEC) will become a big corporation of the full cycle, including the extraction of uranium, the production of fuel for nuclear power plants, the construction of nuclear power plants in Russia and abroad, nuclear machine-building, planning and designing organizations, and research establishments. By the end of 2007, the first stage of creating the OJSC “The Nuclear Power Engineering Complex” had been fully completed in the part of contributing, to the authorized capital of the said company, of the federal shares in 31 JSCs and the property complexes of 3 FSUEs, and the corporatization of 20 FSUEs had also been completed.

In the second half of 2007, the authorities made public the plans for creating as many as 4 holding companies in the sphere of motor-building. The first step in this direction was the announced reorganization of the FSUE “ The Moscow Motor-Building Production Plant “Salute”, by way of annexing to it another FSUE, “The Omsk P. I. Baranov Motor-Building Corporation”; the authorized capital of the reorganized enterprises was additionally increased by the contribution of the federal blocks of shares in 4 JSCs (two blocks of 38% each, and another two of 25.5% each).

A beginning has been made to the long-expected formation of a holding company for armored vehicles production on the basis of the FSUE "The F. E. Dzershinsky Industrial Association "Uralvagonzavod" [The Urals car-building plant] (Niznii Tagil, Sverdlovsk Oblast), which is being transformed into a OJSC with 100% of shares in federal ownership. As in the case of "Salute", it is planned to increase its authorized capital by all the shares (minus one) in the JSCs created on the basis of transforming 7 FSUEs, and of the blocks of shares in 8 OJSCs (four of them of more than 50% of shares each). By the end of 2007, the decisions had been made as to the terms of privatization of 6 FSUEs for the purpose of contributing the corresponding JSCs' to the authorized capital of the OJSC "The Research and Production Corporation "Uralvagonzavod", including the creation of the head company of this integrated structure.

In 2007, the formation of several integrated structures was completed - mostly those in respect of which the decisions concerning their creation had been made earlier, namely: the OJSC "The Concern Sozvezdie" ["Constellation"]; "The Concern "Avionics" (whose authorized capital was formed by shares in 6 JSCs previously created by way of privatizing corresponding unitary enterprises); "Zarubezhneft" (foreign oil) (whose authorized capital was formed by shares in 2 JSCs); "The State Joint – Stock Company "Obrompromkomplex" (defense – industrial complex) (whose authorized capital was formed by shares in 9 JSCs); and "The Concern "Granite – Electron" (whose authorized capital was formed by shares in 3 JSCs).

Apart from this, the formation of a number of integrated structures, in regard of which the decisions concerning their creation had been made earlier, was going on unabated. The said structures are as follows: "The Corporation "Roskhimzashchita" (Russian gas defense) (1 FSUE was transformed into a corporation); and "The Russian Corporation of Aero-Space Instrument Making and Information Systems" (the decisions were made as to the terms of privatizing all the 7 FSUEs earmarked for the consequent contribution of shares in the newly created JSCs to the authorized capital of the corporation).

The authorized capital of the OJSC "The Corporation "Tactical Missile Armament"" has been augmented by the federal blocks of shares in 11 JSCs, and yet another 4 FSUEs are being transformed into joint-stock companies. The authorized capital of the OJSC "The Anti-Aircraft -Defense Concern "Almaz – Antei" ties up shares in all the 4 FSUEs earmarked for joining the corporation. In the end of 2007, the decision was made that the additional issue of shares in this company should be repaid with the federal blocks of shares in yet another 31 OJSCs.

The first stage of development of the OJSC "Morinformсистема – Agate" (the naval information system "Agate") was brought to conclusion. The federal blocks of shares in 3 JSCs were contributed to its authorized capital, and the decisions were taken as to the terms of privatization of all the three FSUEs to be integrated within its framework. Blocks of shares in another 4 JSCs, created earlier by way of privatizing the corresponding unitary enterprises were contributed to the authorized capital of the OJSC "The Concern "Morinformсистема – Agate" in pursuance of the decisions made earlier. Similarly, the authorized capital of the OJSC "The Concern "Submarine Armament – Gidropribor" (hydraulic instruments) tied up the federal blocks of shares in 2 JSCs, earmarked for this purpose, and the decision was made as to the terms of privatization of 1 FSUE. The extension of the two latter structures, as well



as that of “The Concern “Granite – Electron”, should be considered within the framework of the afore-mentioned measures concerning the integration of the shipbuilding industry.

Apart from this, so far as the creation of integrated structures is concerned, one could note the adoption of decisions on the terms of privatizing 4 FSUEs for the purpose of the subsequent contribution of shares in the corresponding joint-stock companies to the authorized capital of the OJSC “The Academician V. P. Makeev State Missile Center”, and the corporatization of the FSUE “The Kumertau Aircraft Production Enterprise” (Bashkortostan) for the purpose of the subsequent contribution of its shares to the authorized capital of the OJSC “The United Industrial Corporation “Oboronprom” (defense industry), a holding company engaged in consolidating Russian helicopter construction.

The trend toward active property expansion on the part of natural monopolies (“Gazprom” and the RJSC “The UES of Russia”), which had been on the rise over the previous two years, manifested itself yet again in the RZhD’s intention to obtain the blocking parcels of shares in the ports of Ust-Luga and Novorossiisk, which was made public in early 2007. As regards the former, the case in point is the potential purchase of 16.5% of shares in addition to the existing 8.5%; as regards the latter, the privately owned 16% of shares in the port of Novorossiisk were already transferred into trust management to the RZhD in February 2007. Talks are under way with regard to purchasing shares in the ports of Vladivostok and Nakhodka<sup>20</sup>. Similar conclusions can be made concerning the information on the reorganization of “Transmashholding” (the Transport Machinery Holding Company – TMHC) to be accompanied by the consolidation of the assets controlled by the holding companies and listed with its fixed assets. A blocking parcel of shares in the TMHC could be also sold to the RZhD. It should be recalled that the TMHC is the biggest Russian company in the sphere of railroad machine – building, which comprises such enterprises as “Metrovagonmash” and “The Kholmna Plant” (Moscow Oblast), “The October Electric-Car Repair Plant”, “Penzadieselmash” (the Penza Diesel Engine-Building Plant), the Briansk Machine-Building Plant, and “Bezhitsa Steel” (Briansk Oblast)<sup>21</sup>. In the past year, the authorized capital of the RZhD was increased by blocks of shares in 4 joint-stock companies, including the OJSC “Yakutia’s Railroads” (50% of shares), “Transkreditbank” (75%), “Speedways” (87.4%) and “The Newspaper ‘Gudok’” (100% minus 1 share).

The holding company “Russpetsstal” [“Russian Special Steel”], controlled by “Rosoboroneksport” and oriented to production of special sorts of steel, is in the process of organization. It comprises the metallurgical plant “The Red October” (Volgograd), and the Stupino Metallurgical Company (Moscow Oblast). On the agenda is the purchase of a controlling parcel of shares in the enterprise “Ruspolimet” (Nizhnii Novgorod Oblast), and there was information as to the plans to acquire shares in such giants of ferrous metallurgy as the Magnitogorsk Metallurgical Integrated Works and “Mechel”.

“Rosneft” was the major buyer of “Yukos” numerous assets, which were put on sale in the course of bankruptcy proceedings. Although “Gazprom” was much less active in this respect, the gas monopoly did buy from the company TNK-BP 62.8% of shares in the company “RUSIA Petroleum”, a licensee of the potentially lucrative Kovyktino gas field and the holder of 50% of shares in the East-Siberian Gas Company (ESGK), engaged in the regional gasifica-

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<sup>20</sup> Dagaeva, A. RZhD skupaet porty [The RZhD is buying up ports] // Vedomosti, 18 April 2007.

<sup>21</sup> Kudriashov, D. “Transmashholding” sobiraet aktivy [“Transmashholding” is amassing assets] // RBK daily, 2 March 2007, p. 6.

tion project for Irkutsk Oblast. Also, "Gazprom" participated in the redemption of additional issues of shares (for example, in "Mosenergo") and in the acquisition of blocks of shares in energy companies in the course of reform of electric-power engineering industry, and made it clear that it was going to make investments in the coal industry (when implementing a number of projects in cooperation with the Siberian Coal Power-Engineering Company (SCPEC). It should also be mentioned that "Rosneftegaz" (created at the end of 2004 by way of tying-up, in its authorized capital, shares in "Rosneft" for the purpose of effecting a transaction aimed at increasing the state-owned block of shares in "Gazprom" to a controlling size) is going to carry out an additional issue of shares, which would be paid for by the State with 90.6% of shares in "Kamchatgazprom".

Very important not only for the state sector, but also for the Russian economy as a whole was the completion of setting up the contour of the new structure of the power-generating industry within the framework of reforming the RJSC "The UES of Russia".

It should be recalled that the process of transforming the regional JSCs-energo - the subsidiary companies of the energy monopoly, started as early as 2003 with the implementation of several pilot projects, including the reforming of the OJSC "Kalugaenergo", the OJSC "Orelenergo", the OJSC "Brianskenergo", and the OJSC "Tulenergo". Most actively, the structural changes were carried out in the year 2004. The process of reforming involved more than 30 companies. By April 2004, the procedure of reorganizing the first regional energy company, the OJSC "Kalugaenergo", had been completed, and by the end of that year 5 JSCs-energo had been subdivided by type of activity.

Also in 2004, new interregional companies began to be formed. In the final months of that year, the first 3 OGKs and 2 TGKs were created (received State registration). In October 2004, the board of directors of the RJSC "The UES of Russia" made the decision to establish 4 interregional power-distributing grid companies (MRSK). Also in that year, a new vertical of on-line supervisory control was practically set into place: the functions of regional supervisory departments were transferred (with some exceptions) from JSCs-energo to the System's Operator.

In 2005, the process of reforming embraced the majority of JSCs-energo, and many of them were split by the end of the year. Also in 2005, the majority of the remaining interregional companies were constituted: by March, the last of 7 wholesale power-generating companies (OGK) had been registered, and by August – 13 out of 14 territorial power – generating companies (TGK) had been entered into the register. And finally, 4 MRSK were created in that same year.

In 2006 – early 2007, the process of reforming the purpose-oriented companies was nearly completed. By early 2007, approval had been granted to the projects of reforming 70 out of 71 energy joint-stock companies (JSC-energo), and the formation of all 6 thermal whole-sale thermal-power generating companies (OGK) had been completed. By 1 March 2007, the formation of the purpose-oriented structure of TGK-3, TGK-4, TGK-5, TGK-6, TGK-9, TGK-13 ("The Yenisei TGK"), and TGK-14 had been completed; the purchase contracts for power-generating property had been signed by the parties in the persons of "Kuzbasenergo" (TDK-12) and "Altaienergo"; and the first phase of reorganization of TGK-1, TGK-2, TGK-8, and TGK-10 had been completed. By now, the process of the grid compa-

nies' spinning-off is practically completed. 55 out of the initially planned 56 main grid companies have already been created on the basis of the reorganized JSCs-energo<sup>22</sup>.

At the shareholder meeting on 26 October 2007, the final reorganization of the RJSC "The UES of Russia" received full support of the participants.

In autumn 2007, in the course of the first stage of reorganization, the OJSC "OGK-5" and the OJSC "TGK-5" span off from the RJSC "The UES of Russia". These companies were ready to function fully independently and to implement long-term investment projects. They have already carried out additional issues of shares, attracted strategic investors into their share capital, and attracted investments in development. At the same time, the State's share in the authorized capital of these companies will not diminish, because of their spinning-off from the RJSC "The UES of Russia", below 25% plus 1 share (the size of a blocking parcel of shares). As a result of the first reorganization, the shareholders of the RJSC "The UES of Russia" will receive, in addition to their shares therein, shares in the OJSC "OGK-5" and the OJSC "TGK-5" in proportion to their share in the authorized capital of the holding company. The number of shares in the RJSC "The UES of Russia", owned by them, remains unchanged.

The second phase (to be over by 1 July 2008) will see the completion of the structural reorganization of the holding company's assets: the spinning-off, from the OJSC "The UES of Russia", of all the purpose-oriented companies of the branch (FSK, OGK, TGK, etc), and the discontinuation of the activity of the head company – the OJSC "The UES of Russia"<sup>23</sup>.

#### 5.1.5. State Corporations as a New Element of the State's Property Policy at the Present Stage

The year 2007 introduced new realities in the State's property policy with regard to state property management. The case in point is the creation of state corporations, which are now viewed as an integral part of development institutions alongside special economic zones and the Investment Fund.

As such, the term "corporation" has several meanings. In a most general sense, it denotes a body of persons who have joined together for achieving some goal and have formed a separate subject of law – a new juridical person. As a rule, a corporation as a form of a transacting business envisages shared liability of its participants and the participation of professional hired managers in its management<sup>24</sup>. As regards the practice of countries with developed market economies (primarily the USA), the notion of "corporation" is frequently identified with joint-stock societies. Hence the notion of "corporatization", used in analysis of property reform in transition economies (including Russia) as a synonym of transforming the former state-owned enterprise into joint-stock companies in course of privatization. Accordingly, in Russian publications (both of popular scientific and journalistic character), state corporations were viewed, until recently, as big joint-stock companies, mostly created in course of privatization, where the State continued its equity participation and exercised, more or less

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<sup>22</sup> [www.rao-ees.ru](http://www.rao-ees.ru).

<sup>23</sup> [www.rao-ees.ru](http://www.rao-ees.ru).

<sup>24</sup> *Finansovo-kreditnyi entsiklopedicheskii slovar'* [The encyclopedic dictionary of financial and credit terms] / Collective authorship; A. G. Griaznova, Ed. Moscow: Finansy i statistika [Finances and Statistics], 2002, p. 435.

successfully, its shareholder rights (for example, the RJSC “The UES of Russia”, “Gazprom”, “Rosneft” etc), which was not entirely correct<sup>25</sup>.

However, so far as a large number of countries with market economies (in the main Western European) are concerned, the period of strengthening the regulating role of the State – starting from the second third of the 20<sup>th</sup> century – was characterized by large-scale state entrepreneurship, one type of whose institutions, alongside economic societies (mainly joint-stock ones), was the specially established state enterprises with juridical-person status. In some countries (for example, in the United Kingdom) they got the name of “state corporations”. The main purpose of these enterprises was to dampen market collapses, such as those typical of the 1930s depression, to develop and regulate those branches of the economy where the actual capabilities of private capital were clearly insufficient for their modernization, and for successful competitive struggle on world markets. Political factors also played a rather prominent role.

In the Russian legal field, the first mentioning of state corporation as a separate organizational and legal form dates back to summer 1999, when Law of 12 January 1996, No. 7-FZ, “On Nonprofit Organizations” was amended by Article 7.1, which established that state corporation should be defined as a nonprofit organization, without membership, constituted by the Russian Federation on the basis of a property contribution and created for purposes of performing social, managerial, or other socially useful functions. A state corporation should be created on the basis of a federal law. The property transferred to a state corporation by the Russian Federation becomes the ownership of the state corporation. A state corporation is not liable for the obligations of the RF, and the RF is not liable for the obligations of a state corporation, unless provided otherwise by the law envisaging the creation of a state corporation.

Until recently, the only examples of functioning state corporations were the Agency for the Reconstruction of Credit Institutions (ARCI), created for the purpose of overcoming the consequences of the 1998 financial crisis in the banking sector<sup>26</sup>, and the Agency for the Insurance of Deposits (AID), created in 2004 for purposes of performing the functions concerning the mandatory insurance of the population’s deposits.

It is true that there were several organizations, created in the first half of the 1990s, whose names included the term “corporation”. However, in reality, they operated in the organizational-legal forms other than state corporation as a variety of nonprofit organization, as it was defined in the 1996 law.

Among such organizations, there were the federal contract corporations “Roskontrakt” and “Roskhleboprodukt”, organized in 1992 as joint-stock societies for the purpose of carrying out government purchases; the State Investment Corporation (“Gosinkor”) and the Russian Financial Corporation (RFC), created in 1993 with the status of state enterprises designed

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<sup>25</sup> Of course, the term “corporation” can have another meaning, and can be applied not only with regard to juridical persons. For example, it can denote a group of persons, a professional association (a physicians’, or officers’, or judges’ corporation, etc). Apparently, it is this very meaning that have given rise to the use of the term “corporate state” with regard to the political regimes in a number of countries (for example, Spain and Portugal in the 1930s– 970s).

<sup>26</sup> Initially registered as a non-crediting institution in the form of a JSC (with the RFFP being the founder), it obtained the status of a state corporation after the adoption of Federal Law “On the Restructuring of Credit Institutions” of 8 July 1999, No. 144-FZ, and after the corresponding alterations have been introduced in the Law on Nonprofit Organizations.

to stimulate investment activity; and the Federal Food Corporation (FFC), created in 1994 with the status of a federal enterprise designed to regulate the agro-food market.

The destinies of the afore-said organizations were different. “Roskontrakt” and “Roskhleboprodukt” chose the road of gradual privatization, which was to take many years to achieve. Suffice it to say that the last state-owned block of shares in “Roskontrakt” (20.95%) was included in the forecast plan (program) of federal property privatization for the year 2007. Somewhat earlier this was done with regard to “Roskhleboprodukt”, whose last RF-owned share was included in the forecast plan (program) of federal property privatization for the year 2003, and in the summer 2005 the decision was taken that the RF’s “golden share” special right to participate in its management should be discontinued. The Federal Food Corporation was liquidated in 1997, to be replaced with the SUE “The Federal Agency for the Regulation of the Food Market” under the RF Ministry of Agriculture and Food Production. The State Investment Corporation (“Gosinkor”), which had failed to play any considerable role in the investment process of this country, was liquidated in pursuance of Edict of the RF President of 6 February 2003, No 135, and all its property was transferred to the RF Ministry of State Property. In particular, the State, in the person of this body of state authority (and then of the Federal Agency for Federal Property Management), received the “Gosinkor” share in the United Industrial Corporation “Oboronprom”. The latter corporation, having the status of a JSC, has been engaged in the consolidation of helicopter building since 2005.

A new round in the use of state corporation, this time as a special organizational and legal form, started in 2006 when the authorities began to actively discuss the plans for creating a new state corporation, “The Bank for Development and for the External Economic Activity of the Russian Federation (“Vneshekonombank”). As a result, Federal Law “On the Bank for Development” of 17 May 2007, No. 82-FZ, established the legal status, the principles of organization and activity, and the procedure for the reorganization and liquidation of “Vneshekonombank”. Its authorized capital, in the amount of no less than 70 billion rubles, was to be formed by the property of the Bank for the External Economic Activity of the USSR, the RF-owned shares in the OJSC “The Russian Bank for Development” and in the CJSC “The State Specialized Russian Export-Import Bank”, and by other property, by decision of the RF Government.

Later on, the organizational-legal form of state corporation also emerged in the set-up for reorganizing the nuclear industry, which was ultimately determined with the adoption of Federal Law “On the Peculiarities of Managing and Disposing the Property of and the Shares in the Organizations Operating in the Sphere of Use of Atomic Energy, and on the Introduction of Alterations in Individual Legislative Acts of the Russian Federation”, of 5 February 2007, No. 13-FZ; and by Edict of the RF President, of 27 April 2007, No. 556.

As is mentioned above, a holding company – the OJSC “The Nuclear Power-Generating and Industrial Complex” (“NIC”), with all its shares in federal ownership, was created in this branch as early as 2007. In its turn, the NIC itself, alongside the nuclear weapons complex, the nuclear and radiation security complexes, and the fundamental research complex, is to be managed and controlled by the corporation “Rosatom”, which will be formed in 2008. Its status will be determined by the special Law “On the State Nuclear Energy Corporation “Rosatom”, adopted at the end of 2007.

In the wake of these initiatives, which have been under consideration since mid-2007, there emerged other proposals concerning the creation of state corporations in a broad variety

of areas (machine-tool construction, motor-road construction and operation, fishing, provision with pharmaceuticals, etc.). Judging from this range of branches, it is clear that the State's presence in many of them is not justified. In principle, these branches can develop on their own by the sheer action of market mechanisms, provided that the State plays the all-important regulating role in the process (by determining the rules of the game, by organizing tenders, purchases, etc.), or even has a certain part in ownership and production – but only in individual situations which require special consideration.

Until now, the legislature has approved and enacted, in the form of federal laws, the proposals to create the following corporations (apart from “Vneshekonombank”): “Rosnanotekh”, of 19 July 2007, No. 139-FZ; “The Fund for Promoting Reform in the Housing and Utilities Sector”, of 21 July 2007, No. 185-FZ; “Olimpstroi” (to be engaged in the construction of objects for the 2014 Winter Olympic Games in Sochi, and in the development of that locality into a mountain health resort), of 30 October 2007, No. 238-FZ; “Rostekhnologii”, of 23 November 2007, No. 2-FZ; and “Rosatom”, of 1 December 2007, No. 317-FZ.

These corporations considerably differ from one another with regard to the character of their future activity. “Olimpstroi” and “The Fund for the Promoting Reform in the Housing and Utilities Sector” are aimed at implementing specific projects within established timelines. “Rosnanotekh” will find its niche within the range of instruments for stimulating innovation activity, while Vneshekonombank is designed to participate in stimulating the export of products of the processing industry and in the launching of capital-intensive projects. “Rosatom” is an exclusively one-branch organization, while “Rostekhnologii” is a typical conglomerate, because this corporation is to receive 100% of shares in the FSUE “Rosoboroneksport” after the latter's corporatization in pursuance of Edict of the RF President of 26 November 2007, No. 1577, and the structure of “Rosoboroneksport” includes numerous enterprises from different branches (a helicopter-building holding company, “AvtoVAZ”, “VSMPO-Avisma”, “The Motovilikha Plants”, etc.). “Rosoboroneksport”'s plans for the creation of the holding company “Russpetsstal”, an engine-building holding company, and a holding company to be engaged in the production of explosives, are currently undergoing different phases of implementation.

The peculiarities of the organizational-legal form “state corporation” are analyzed in detail in the corresponding section of the present survey. In the main, this status, openly or otherwise, is characterized by features typical of various organizational-legal forms, and is fraught with the inevitable misunderstandings as to the use of the concept of “corporation”.

In this connection, it should be mentioned that this term is present in the name “The State Corporation for the Control of Air Traffic”, which is a federal state unitary enterprise, and in the names of the recently created “The United Aircraft-Building Corporation” (UABC) and “The United Shipbuilding Corporation” (USC), which are open-end joint-stock companies (OJS), and therefore are obliged (at least formally) to comply with the requirements of corporate legislation. This same status of an OJSC is accorded to a number of other enterprises which, by their goals and objectives, can be classed with the companies designed to tackle issues of structural and industrial policy, like the state corporations of the year 2007. These enterprises include: the Agency for the Mortgage Crediting of Housing (AMCH), established as early as 1996 with 100% of shares in state ownership (in 2004, it was included in the list of strategic JSCs); the company “Iliushin Finance Co” and “The Financial Leasing Com-

pany” (both companies were winners in a tender for the best investment project with regard to the leasing of Russian airliners), whose authorized capital was increased in 2002, in the process of which large shares in their capital passed into federal ownership at the expense of budget funds (in 2006–07 they were contributed to the authorized capital of the UABC); and the recently created “The Russian Venture Company” and “The Russian Investment Fund for Information-Communication Technologies”, with all shares in federal ownership.

However, there remains one question yet unanswered: what will be the real mechanism for controlling the activity of such organizations, and how detailed its description is going to be in the applied documents establishing various rights, first of all from the point of view of preserving state property and public funds, and of guaranteeing that they would be used for the specified purposes, as well as from the viewpoint of the conformity of the corporations’ actual activity with the objectives specified in their Charters?

So far, the status of newly created state corporations has remained unclear – even from the point of view of their being classed with one or other form of ownership, because, in contrast to unitary enterprises, the property transferred to a state corporation by the Russian Federation is deemed to be in ownership of the state corporation<sup>27</sup>. And this, in its turn, is closely related to the difficult problem of accurately defining the boundaries of the state sector in the Russian economy as a whole.

#### 5.1.6. Changes in the Normative-Legal Base Regulating the Functioning of the State Sector

In contrast to the year 2006, which was marked by the emergence of a number of innovations in the normative-legal base with regard to the activity of the state sector’s economic subjects (the establishment of the procedure for increasing the authorized capital of the OJSC created in the process of privatization with 25 and more percent of shares in state or municipal ownership, the threshold values of the size of the state-owned block of shares being preserved; and the adoption of a special document concerning the approaches to dividend policy in companies with state stakes, and the termination of the Federal Fund for Federal Property Management’s independence), the past year saw no changes of similar importance with respect to unitary enterprises and economic societies with the State’s participation<sup>28</sup>.

The most important event in this sphere was the adoption of Decree of the RF Government of 15 December 2007, No. 872, “On the Creation of Federal Treasure Enterprises and on the Regulation of the Activity Thereof”, which confirmed the Procedure for Regulating the Activity of Federal State Enterprises (FTE).

The aforesaid document establishes that economic subjects of this type can be created by three ways:

- 1) by way of establishment;

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<sup>27</sup> However imperfect the right of economic jurisdiction might be, existing legislation recognizes that the assets being subject to this legal regime should remain in state ownership (of a RF subject, or of a body of local self-government), while unitary enterprises have the right to dispose of such assets only within those limits that do not prevent them from carrying out their activity, the objectives, the subject, and the types of which are determined by their Charters. Any transactions concluded in violation of this requirement must be deemed to be null and void.

<sup>28</sup> The emergence of a vast normative-legal base concerning state corporations is an issue in its own right, which is analyzed in detail in a separate section.

- 2) by way of reorganizing an existing unitary enterprise (through splitting, spinning-off, or merger);
- 3) by way of changing the type of a FSUE based on the right of economic jurisdiction.

When a FTE is being created, the federal executive body under whose jurisdiction the enterprise will be placed (the empowered body) should submit to the government: a draft of the deed of creation, and a whole package of specially prepared documents, including the feasibility study justifying the creation of the enterprise<sup>29</sup>; drafts of its Charter and of the programs for the enterprise's activity in the next year and in the next planning period; the list of assets to be consolidated to the enterprise by right of operative management for the purpose of fulfilling the State's orders for manufacture of products (or for work, or services); and the report on valuating the assets to be consolidated to the enterprise by right of operative management, including the data on the market value of these assets. When an enterprise is being created by way of reorganizing an existing unitary enterprise or by way of changing the type thereof, the submitted documents should also include notarially attested copies of the constituent documents of the unitary enterprise, copies of its accounts as of the last reporting date and of its annual accounts for the 3 previous years (with a notation of a corresponding taxation body), the statement issued by the taxation body at the place of tax registration with regard to the unitary enterprise's position concerning the payment of taxes, charges, and contributions as of the last reporting date, a draft of the division balance sheet or of the transfer deed (in the event of the enterprise being created by way of reorganizing a unitary enterprise), and the list of assets consolidated to the unitary enterprise, authenticated by a corresponding territorial body of the federal executive body performing the functions of federal property management (The Federal Agency for Federal Property Management).

A FTE's relations with the supervisory body should be based on the following principles: the supervisory body should approve the enterprise's program of activity, its cost-benefit calculation (in accordance with the established forms), and the appointment of its head; the appointment of the enterprise's senior accountant should also be made by the supervisory body's consent. The head of the FTE should annually submit, to the said body, a draft of the FTE's program of activity, its cost-benefit calculations and the reports on implementing thereof, its annual accounts with the auditor's resolutions thereon, and proposals on the distribution of the net profit obtained by the enterprise by the results of a reporting year.

Apart from this, the said Regulations determine the financial mechanism of the FTE's functioning. The enterprise should carry out its activity in accordance with the program of activity and the cost-benefit calculation prepared on the basis of the program of activity, so as to determine the spending of the enterprise's revenues; both the program and the calculation should be approved by the empowered body in the established procedure.

In the event when, in the course of carrying out the enterprise's activity, there emerges an opportunity to obtain revenues, or a necessity to incur expenses, which have not been taken

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<sup>29</sup> A feasibility study should include a financial and economic analysis of the unitary enterprise's state of affairs, with the structure of its accounts payable and receivable being pointed out, and the explanation given as to the sources and conditions of their emergence. Also, it should specify the forecasted volume of production (or work, or services) produced under the State's order for the purpose of meeting the federal state needs, and offer justification for the production of individual types of products (or work, or services) within the framework of independent economic activity. And it should include a forecast of the enterprise's revenues and expenses in the forthcoming year and in the next planning period, as well as proposals concerning the organizational and personnel structure of the enterprise.



into account while forming the cost-benefit calculation, or when the actual expenses exceed the planned ones, the empowered body, on having received the information to this effect from the head of the enterprise, submitted in the established procedure, should introduce appropriate alterations into the cost-benefit calculation.

The financing of the activity of the enterprise should be carried out at the expense of the revenues from the enterprise's realizing, on its own, the products (or work, or services) produced by it, unless established otherwise by federal laws and other normative acts of the RF.

In the event of the enterprise's revenues being insufficient to cover the expenses envisaged in the cost-benefit calculation, the empowered body should carry out, on a quarterly basis, in the established procedure, the financing of the purpose-oriented expenses dealing with the functioning of the enterprise. The procedure for allocating the federal budget's funds to the enterprise is determined by budget legislation.

The enterprise has the right to resort to borrowing only on condition that the volume and the avenues of use of the borrowed means have been agreed upon with the empowered body, which should either give its consent to the planned borrowing, or respond with a motivated refusal to agree therewith; in both cases the response must be given within one week from the date of the enterprise's submitting its petition. Also, the empowered body should keep records of the enterprise's liabilities.

Based on the data contained in the accounts, in the report on the implementing the program of activity, in the cost-benefit calculation, and in the proposals on the distribution of the net profit obtained by the enterprise by the results of the reporting year, the empowered body should determine the amount of the enterprise's net profit to be transferred to the federal budget (with the understanding that no less than 1/4 of the acquired net profit should be transferred thereto), while the rest of the monetary means should be transferred to the reserve fund and other funds in accordance with the Charter of the enterprise, and also be spent for the purposes, including investment, to be agreed upon with the empowered body. The empowered body should submit, in the established procedure, to the Federal Fund for Federal Property Management the decision on the transfer of profit to the federal budget, and then should supervise its implementation.

With the adoption of this document, one could believe that the long-standing issue of renovating the normative-legal base, which regulates the functioning of treasury enterprises, has at last been resolved, at least formally<sup>30</sup>. The corresponding prior documents (Decree of the RF Government of 12 August 1994, No. 908, "On the Confirmation of the Standard Charter of a Treasury Plant (or a Treasury Factory, or a Treasury Enterprise), and Decree of the RF Government, of 6 October, No. 1138, "On the Procedure for Planning and Financing the Activity of Treasury Plants (or Treasury Factories, or Treasury Enterprises?"), adopted before the entry into force of the RF Civil Code, were deemed to be null and void.

Also, mention may be made of the confirmation of the new Regulation on the Registration of Federal Property and on the Procedure for Its Registration (Decree of the RF Government, of 16 July 2007, No. 447)<sup>31</sup>, and of the simplification of the Procedure for the alienation of shares owned by the Russian Federation in the event of the emergence of a situation when

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<sup>30</sup> For example, it was mentioned in the Materials for the RF Government's meeting, of 17 March 2005, "On the Measures Designed to Increase the Efficiency of Federal Property Management", prepared by the RF Ministry of Economic Development and Trade.

<sup>31</sup> Superseded a similar document dating back to 1998.

the Russian Federation has the right to demand that they be redeemed by the joint-stock society (Decree of the RF Government, of 21 March 2007, No. 170).

It should be recalled that the Law on Joint-Stock Societies (Article 75) permits to demand that the society should buy out, from the shareholders, all of the shares, or part of the shares owned by them, in the event of:

- the society's reorganization, or it handling a big transaction, the approval of which should be decided upon by the general meeting of shareholders, if they have voted against the adoption of the decision on its reorganization, or have not participated in voting on these issues;
- the introduction of alterations in and amendments to the Charter of the society, or the approval of a new version of the Charter of the society, which restrict their rights if they have voted against the adoption of the corresponding decision, or have not taken part in voting.

The Government Decree envisages that the State, as a shareholder, may exercise this right by decision of the Federal Agency for Federal Property Management, with the exception of (1) strategic JSCs, with regard to which the RF President's decision is necessary, and (2) the JSCs with regard to which the State's position is determined by the RF Government, or its Chairman, or Deputy Chairman. In these cases, draft decisions should be submitted by the Ministry of Economic Development and Trade on having coordinated the issue with the body of authority supervising the company in question.

The monetary means received from the redemption of shares by the joint-stock society should be transferred, in full, to the federal budget.

Apart from this, it should be pointed out that the list of strategic enterprises and joint – stock societies was also considerably changed. By the results of the year 2007, it underwent the introduction of 42 clarifications (for comparison: in 2004 – 3, in 2005 – 4, in 2006 – 12). As in the previous years, most of these alterations were concerned with the formations of integrated structures. As a result, 72 unitary enterprises and 129 OJSCs were excluded from the list, and only 17 unitary enterprises and 12 OJSCs (including several integrated structures the largest of which were the Nuclear Power-Engineering and Industrial Complex and the United Aircraft-Building Corporation) were added thereto.

## **5.2. Public Corporations as an Essential Element of Institutional Policy in 2007**

A notable and quite surprising to many experts element of public policy in 2007 has been active establishment of public corporations at the federal level. In a relatively short period of time (May–December 2007) there were adopted federal laws on establishment of six public corporations. Those corporations are authorized with a wide range of functions and provided a significant share of public property (funds from the RF federal budget and Stabilization Fund in the amount of approximately RUR 760 billion in 2007; various production facilities and financial assets) for their operation in a long-term prospective. The process of creating public corporations has immediately inspired a lot of debates on efficiency of such activities of the government.

It is worth noting, that government was actively involved in the formation of large national companies in 2006 as well (in the form of open joint stock companies with 100 per cent of federal ownership), but at that time it did not attract so much attention and did not provoke

so extensive critical comments. However, the feed-back to formation of public corporations<sup>32</sup> in 2007 arises concern and incredulity. In our view, it is largely explained by the following distinctions<sup>33</sup> of those business structures:

- non-transparency of the projects on development and the lack of discussion on public corporations establishment;
- limited time frames for the discussion of draft laws on the establishment of public corporations;
- peculiar legal and structural business form (public corporation), indistinct (framework) legal basis;
- involvement of top political resources in public corporations;
- large volume of national property, allocated to public corporations;
- authorization of a wide and diversified range of powers to the corporations;
- poor arguments to the community for the grounds to public corporations establishment;
- uncertainty of strategic planing and operational policy of the corporations;
- a wide range of proposals from various sources on establishment of the new public corporations<sup>34</sup>.

There were discussed the risks of such negative effects, resulting from extensive establishment of public corporations, as:

- increased inexpedient government participation in national economy;
- inefficient utilization of national property use;
- non-transparent operation and low accountability (as well as supervision) of public corporations.

Nevertheless, the greatest concern is based on the *risk of further extension of the number of public corporations*, in particular in the background of proposals to introduce legal framework for public corporations establishment at the level of the Russian Federation Subjects.

In evaluating public policy on the establishment of such corporations, two factors of great importance should be taken into regard: firstly, how justified is the purpose of the business entity and secondly, to what extent is the selection of the legal status of public corporation is justified and reasonable for the purpose of such business functioning (while there are other efficiently operating options, for instance, development and implementation of federal targeted programs, creation of joint-stock holdings, using national property). In our view, the basic concerns in regard to public corporations establishment were primarily related to the choice of the objectives to be achieved. Therefore, we will focus mainly the institutional aspects of public corporations establishment, as well on the assessment of prospective opportunities and accompanying risks.

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<sup>32</sup> Using the term “corporation” in the names of a number of the stock holdings, established by the government (OAO “United Aircraft Corporation”, OAO “Joint Shipbuilding Corporation”) sometimes goes beyond the meaning of the term “public corporation”. Herewith, we are talking about public corporations in the narrow sense, in other words, “public corporation” as a legal entity.

<sup>33</sup> Those distinctions are related to public corporations establishment in general, which are not obligatory to any public corporation (thus, the procedure of the Bank for Development formation has been rather time-consuming and involved a number of open debates and discussions).

<sup>34</sup> In this regard, one could refer to proposals for the establishment of “Rosrybflot” and “Avtodor” public corporations, those ones on purchases of medicines, grain exports, housing construction, etc. It can be said that among the members of the executive and legislative authorities there are some illusions on public corporations capacity to address serious problems of social and economic development.

### 5.2.1. Distinctions in “Public Corporation” Legal Incorporation Form

Public corporation is a type of non-profit organization. The legal incorporation form of a “public corporation” was defined as early as in July 1999 by an amendment to Article 7.1 “Public Corporation” of the Federal Law No. 7 FZ “On non-profit organizations”, adopted in January 1996.

The principal distinctions of this legal business form are as follows:

- 1) the corporation is created to perform social, management and other functions of public significance;
- 2) profit is not the basic objective of public corporation activities as a form of non-profit organizations; corporations may be engaged in business activities only to achieve the objectives of its incorporation;
- 3) each public corporation should be established in compliance with a special federal law;
- 4) the corporation should be incorporated on the basis of federal property, transferred in the ownership of public corporation by the Russian Federation;
- 5) documents of incorporation, specified in the Civil Code of the Russian Federation are not required for public corporation establishment;
- 6) the law “On Non-Profit Organizations” can be inapplicable to the Corporation, in case otherwise is specified by law, under which the corporation was established.

There is a number of other legal provisions, specified in various federal laws, directly related to the public corporations:

- in accordance with the Federal Law No. 178 “On privatization of public and municipal property”, dated December 21, 2001, this law is not applicable to relationships that arise, when federal property is to be transferred to public corporations as contribution from the Russian Federation;
- in accordance with the RF Budget Code, subsidies in the form of property contribution to the public corporations can be specified in the federal law on the federal budget;
- in compliance with the RF Civil Code the public corporation can be recognized insolvent (bankrupt), in case otherwise specified in the federal law on incorporation thereof.

It has been repeatedly noted in regard to the public corporations, that there are significant failures in their legal incorporation form, namely:

- indistinct meaning of the notion “ functions of public significance”, and consequently, an opportunity of extensive interpretations to justify the need to use this wording;
- in fact, the government property is donated to a public corporation in the process of incorporation thereof;
- no clear guidelines are provided for the assets management, which provokes additional risks;
- the issues of transformation and liquidation of public corporations are not legally specified (even as a framework).

In general, the basic Law on Non-Profit Organizations provides only a limited and rather formal list of issues<sup>35</sup>, that should be defined in the laws on the establishment of public corpo-

<sup>35</sup> In accordance with Section 3, Article 7.1 of the federal law “On Non-profit Organizations”, which provides for the establishment of a public corporation, there should be specified its name, location, management of its operations (administration, the procedure of incorporation, management authorities appointment and dismissal), the procedure of the reorganization and liquidation of public corporations, utilization of government property in the event of their liquidation.

rations. Special risks arise from the possibility not to apply the law on non-profit organizations to public corporations, if this is foreseen in the law on corporation establishment (Section 3, Article 7.1 of the law “On Non-Profit Organizations”). In theory, this approach opens great opportunities to create an individual legal form for each new corporation, feeling free to go beyond the basic provisions of the law “On Non-profit Organizations” without any restrictions.

### 5.2.2. Incentives for “Public Corporations” Legal Incorporation Form Introduction to the Russian Legislation and its Distinctions before 2007

The background of this legal incorporation form introduction was largely explained on an urgent issue of the Russian banking system rescue upon 1998 financial crisis. First of all, to overcome this challenge, the RF Government, by the Order No. 1642, dated as of November 20, 1998 has established a non-banking credit organization “Agency for Credit Organizations Restructuring” in the form of OAO, though later (in the course of credit organizations restructuring), it became necessary to significantly expand its powers. As a result, the President has signed two laws on one and the same day (July 8, 1999): one law, defining a new type of additional non-profit organizations (public corporation)<sup>36</sup>, and another one, transforming OAO “Agency for Credit Organizations Restructuring” into public corporation “Agency for Credit Organizations Restructuring”<sup>37</sup>.

Apparently, it was assumed that the requirement to adopt a special federal law for each public corporation would limit the use of this legal form of incorporation. Herewith, in the legal framework of any public corporation the gaps in legislation can be abolished.

For quite a long time it was working: up to 2007, the government established public corporations only twice. First, as mentioned, simultaneously with the introduction of the “public corporation” legal form, when the “Agency for Credit Organizations Restructuring” was established in 1999<sup>38</sup>, and the second time took place only in 2003, when the law was enacted on establishment of the “Deposit Insurance Agency” public corporation<sup>39</sup>. Legal provisions, effective for public corporations were practically frozen, no amendments or revisions were made to them.

Therefore, prior to 2007, public corporations were created in exceptional cases in the sphere of finance at the junction point of the RF Government and the Central Bank of Russia powers. According to the relevant legislation, establishment of those corporations was em-

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<sup>36</sup> Federal law No. 140 “On Amendments to the Federal Law on Non-Commercial Organizations”, according to which the law on non-profit organizations was supplemented with Art. 7.1 “Public corporation”.

<sup>37</sup> Part 4 of Art. 46 of the Federal Law No. 144-FZ “On Credit Organizations Restructuring”.

<sup>38</sup> It should be noted that on July 28, 2004 a law was passed providing for the liquidation of the “Agency for Credit Organizations Restructuring” public corporation and the transfer of assets as the Russian Federation property contribution to the “Deposit Insurance Agency” public corporation (Article 2, Sections 1,2 of the Federal Law No. 87-FZ “On recognition as null and void the Federal law on credit organizations restructuring and some provisions of the Russian Federation legislation, and establishment of the liquidation procedure for the “Agency for Credit Organizations Restructuring” public corporation).

<sup>39</sup> Chapter 3 of the Federal Law No. 177-FZ as of December 23, 2003 “On insurance of individual deposits with the banks of the Russian Federation”. Herewith, RUR 3 billion was supposed to be transferred by the “Agency for Credit Organizations Restructuring” public corporation as property contribution from the Russian Federation (Section. 1, Article 50).

bedded in the broader context of regulations in the relevant fields, and the corporations were positioned as an instrument, rather than an independent business subject<sup>40</sup>. Herewith, there were rather detailed definitions in the laws of the principles and rules of activities of those corporations, as well as regulations for the relevant fields, which to some extent was compensating to the excessive framework-based legal provisions on non-profit organizations.

### 5.2.3. Grounds for Expansion of Public Corporation Legal Form by the Government in 2007

The situation has drastically changed in 2007, when federal laws were adopted on establishment of six large public corporations with rather significant objectives of economic, social and political nature (see *Table 10*).

*Table 10*

**Public Corporations, Established in 2007**

<b>Public corporation</b>	<b>Date of relevant law adoption</b>	<b>Objectives</b>
1. Public Corporation “Bank for Development and Foreign Economic Affairs (Vnesheconombank)”	May 2007	Enhance the competitiveness of the Russian Federation economy, its diversification, encourage innovation through investments, foreign trade, insurance, consulting and other activities for the implementation of new projects in the Russian Federation and outside the country, including projects with the participation of foreign capital, addressed at infrastructure improvement, innovation, special economic zones development, environment protection, support of domestic export of goods, works, and services, as well as support to the small and medium businesses
2. Public Corporation “Russian Nanotechnology Corporation” (PC “Rosnanotech”)	July 2007	Promotion of the government policy in the field of nanotechnologies, development of the innovation environment in the area of nanotechnologies, implementation of the projects for prospective nanotechnologies and nano-industry
3. Foundation for Promotion of Housing and Public Utilities Reform	July 2007	Development of safe and favorable living conditions to the population, promotion of housing and public utilities reform, development of effective mechanisms for the management of the housing resources, introduction of energy-saving technologies with the financial support, provided by the Foundation
4. Public corporation on Olympics objects construction and Sochi city development as a mountain health resort (GK “Olympstroy”)	October 2007	Support in management and other socially efficient functions, related to design, engineering, construction and renovation works, maintenance of housing utilities, required for XXII Olympics and 2014 Para-Olympic Games in Sochi, as well as the development of the city as a health resort
5. “Rostekhnologii”, public corporation on the support in the development, production and export of high-tech industrial products (“Rostekhnologii” public corporation)	November 2007	Support in the development, production and export of high-tech products through promotion of national designers and producers of high-tech commodities in domestic and external market, investments attraction to various industrial sectors, including national military defense
6. “Rosatom”, public corporation on nuclear power (“Rosatom”)	December 2007	Support to government policy, legal regulatory activities, public services and national property management in nuclear power sector, development and support to the safe operation of nuclear power and nuclear weapons sectors of the Russian Federation, ensure nuclear and radiation safety, non-proliferation of nuclear resources and technologies. Assistance in development of nuclear science, technologies and professional training, international cooperation in this area

<sup>40</sup> One can see there is no reference to “corporations” in the names of those laws.

Public corporations, established in 2007 are significantly distinguished in both, the background of incorporation and the objectives and functions thereof. Thus, while the Bank for Development and the Foundation for Promotion of Housing and Public Utilities Reform can be regarded as some elements of progress in “public corporation” legal form, other public corporations are set far apart from them and are much more related to the implementation of industrial (sectional) priorities, as well as to the administrative system enhancement.

Reviewing the basic *incentives of such expressed growth of the government interest in public corporations establishment, one should highlight three major factors.*

*First.* The long-term objectives to promote sustainable economic and social development came to the topside, the inefficiency of the existing tools for government policy implementation became clear. For example, the Federal Targeted Program (Federal Program) is a very mature and transparent tool. In recent years, significant efforts have been made to improve the efficiency and effectiveness of the Federal Programs implementation. However, that tool does not fully meet the new challenges in the development of public policy, as in the current administrative system it is ineffective for the resolution of inter-governmental problems. Moreover, it prevents capital investments in newly incorporated business entities and is restricted in supporting the long-term projects due to accountability within the budget cycle.

*Second.* Inadequate quality of the administrative system, its primary focus on the current challenges, problems in the development and implementation of national policy in terms of improvements in the new sectors of the economy have brought up the need to seek for the new agents of public policy (the government agencies, addressed at long-term challenges). The choice of the “public corporation” legal incorporation form was made in a number of cases due to their ability to provide relevant functions of government management outside the standard framework of the administrative system restructuring.

*Third.* A significant factor in the transfer of government attention to the public corporations is the factor of limited time frames of the elected government power before its reelection, in the pursuit of fixing some priorities in the national policy under such conditions, which have to be ensured by necessary priorities and financial grounds. It should be noted, that within 2006 – early 2007, the government was satisfied with OAO<sup>41</sup> incorporation, a 100per cent of the shares of which were in federal ownership. Herewith, such important tasks were addressed as:

1) restructuring and consolidation of national assets, creation of large economic entities in the public sector of the economy, accelerated development of selected high-tech industries (such as OAO “Consolidated Aircraft Corporation”, OAO “Consolidated Shipbuilding Corporation”);

2) enhancement of effective performance of certain government functions through the transfer of powers to the level of economic entities, incorporated by the government, namely to the OAO “Special economic zone”;

3) creation of Development Institution OAO “Russian Venture Company”.

However, on the one hand, as early as in 2006, it became evident that the process of creating large government-owned structures in the form of OAO is excessively time-consuming

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<sup>41</sup> The objective of establishing public corporations at the highest political level was set forth in 2007: on April 26, the RF President in the message to the Federal Assembly of Russian Federation for the first time noted the need to establish two special corporations (for the development of nanotechnology and for the development of the nuclear industry).

and would sometimes take several years (this was largely dependent on the need to observe the legal regulations on privatization), but on the other hand, in early 2007, there was an experience in the design and discussion of the Russian draft law “On the Bank for Development” in the State Duma for the establishment of a public corporation.

Thus, in some cases, the use of public corporation legal form has helped to simplify necessary procedures, reduce the time frames and expand tentative trends of restructuring national assets in the industry, having transferred (due to establishment of corporations on the basis of special laws), the process of approval of the relevant decisions from the RF Government to the level of the RF Federal Assembly.

*When there were some additional factors in the process of creating any public corporation, (sometimes quite specific and situational), providing a surplus impact over the selection of the legal form of incorporation. Let us consider those factors as per each existing corporation.*

### *1. Public Corporation "Bank for Development and Foreign Economic Affairs"*

The establishment of the corporation was aimed at building an efficient public financial development institution. The RF Government has approved on January 19, 2006, in particular, such measures as the development of the concept for public financial development institutions, as well as preparation of the draft law on export-import bank<sup>42</sup>. In late January 2006, at the top political level, the plans were announced on establishment of the Russian Bank for Development<sup>43</sup>. That objective could be achieved by several means. In particular, the following options were considered:

1) establishment of a public corporation on the basis of the USSR Vnesheconombank assets, including ZAO “Roseksimbank” shares, as well as the transfer of OAO “Russian Bank for Development”, owned by federal government.

2) establishment of a corporation in the form of OAO, 100 per cent of whose shares is in federal ownership, with affiliated companies OAO “Russian Bank for Development” and ZAO “Roseximbank”;

3) extension of OAO “Russian Bank for Development” capital.

However, along with the main challenge, there were set forth two more objectives: (1) reorganization procedure of the USSR Vnesheconombank, outlined in the “development strategy for the banking sector in the Russian Federation until 2008”, definition of the bank status and (2) savings of national assets, allocated to support the activities of the newly incorporated financial institute for development. To implement the second and third options, substantial budgetary resources would be required for initial capitalization. Moreover, the second option looks complicated in terms of legal framework of relations with the USSR Vnesheconombank due to its special status, whereas the third option was restricted, as it did not include bank support to export-import operations.

Thus, the desire to resolve several different tasks has predetermined the option for the RF government to select the first option by the end of 2006, i.e., incorporation of a public cor-

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<sup>42</sup> At a press conference on January 31, 2006, the RF President has informed on the plans to incorporate the Russian Bank for Development with an authorized capital of USD 2.5 billion.

<sup>43</sup> At a press conference on January 31, 2006 the RF President has notified on plans to establish the Russian Development Bank with an authorised capital of USD 2.5 billion.



poration<sup>44</sup>, although the tentative risks were noted, such as restrictions in independent resources attraction, imbalances and conflict of interest in the development of its structural elements, the lack of transparency of activities, excessive bureaucracy.

### *2. Public Corporation “Russian Nanotechnology Corporation”*

Establishment of this public corporation was preceded by a sufficiently long period of public policy development in terms of nanotechnologies. The issues of nanotechnologies and nanoindustry development have been repeatedly discussed at the Russian Government meetings: on November 18, 2004 the Concept on development in the field of nanotechnology for the period until 2010 in the Russian Federation was approved, on August 25, 2006, the Program on coordination in the area of nanotechnologies and materials in the Russian Federation was adopted. However, the measures were not properly coordinated, the decision-making processes on a number of important measures were delayed (for example, the works on the Targeted Federal Program for the Development of Nanotechnology Infrastructure<sup>45</sup>, on formation of the Fund for Nanotechnologies Development for the direct capital investments in companies with high potential).

To a significant extent, this was the result of the absence of any industrial department, involved in nanotechnology development on a priority basis. Under these circumstances, for the purpose to promote the formation of an integral government policy in the development of nanotechnology, an “external” action was required in regard to the Government. The RF President has approved on April 24 2007 the Presidential Initiative “Nanotechnology Development Strategy”, where the Russian Nanotechnology Corporation was defined as one of the key elements of the national nanotechnological network. Its objectives are organizational and financial support to innovation activities in the field of nanotechnology. On April 26, 2007 the RF President in the message to the Russian Federal Assembly Federation has appealed to finalize and adopt the law on the establishment of a special Russian Nanotechnology Corporation as soon as possible. The government should have allocated at least RUR 130 billion for the Corporation funding.

The choice of a public corporation legal status as a form of incorporation<sup>46</sup>, probably, was made due to the initial plans to authorize it with some government functions (in particular, to participate in the development of government policy in the area of nanotechnology and in drafting regulations, in placing orders for research and development in the area of Nanotechnology for national needs, in functioning as government representative in Targeted Federal Programs).

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<sup>44</sup> At the RF Government meeting on December 14, 2006, there was approved the draft of the federal law “On the Development Bank”, outlining the provisions for “public corporation” legal form of incorporation.

<sup>45</sup> In accordance with the Consolidated Plan of activities to implement the basic provisions of the President’s of the Russian Federation Letter to the Federal Assembly of the Russian Federation in 2006 (Government of the Russian Federation (approved by the decision of the government on June 7, 2006), it was planned in October 2006 to approve the program of research, innovation and production infrastructure for nanotechnology for 2007-2009, but the adoption of an appropriate program was made with noticeable delay: Federal Program “Nanotechnology infrastructure development in the Russian Federation for 2008–2010” was approved only on August 2, 2007 by the Resolution of the Government of the Russian Federation No. 498.

<sup>46</sup> In this case, it is difficult to judge, what was the primary factor. Probably, after the decision at the top political level on the establishment of a public corporation, there was an intention to use the corporation (due to its status), in to execute some government functions.

### *3. Foundation for Promotion of Housing and Public Utilities Reform*

Establishment of a corporation in this case has been basically a response to a marked slow-down in addressing the problems of housing and public utilities systems reform. At a meeting of the Russian Government on October 19, 2006 after discussion of the report, made by the Russian Ministry for Regional Development on the plan of measures to reform the housing and utilities system, the work of the Ministry in this area was found unsatisfactory.

The Government has returned again to the discussion of number of measures on the reform of housing and utilities system at its meeting on February 16, 2007. As a result, the projects with a number of measures for the reform of the housing and public utilities in the Russian Federation over 2007–2008 and the plan for development of relevant legal regulations on their implementation were accepted in general. However, in accordance with the adopted documents, the issues of repairs, to be made by the owners of dwelling premises and modernization of apartment buildings were based largely on the amendments, made to the Housing Code of the Russian Federation (on allocation supplementary budget funds, development of relevant regional programs, whereas it was planned to implement those measures only in 2008).

Probably, that fact has urged the government officials to focus on the more intensive measures to accelerate the modernization of housing utilities. On April 26, 2007 the RF President in the Letter to the Federal Assembly of the Russian Federation has stressed the need to create a special fund in the amount of minimum RUR 250 billion, for the repair or resettlement of people from emergency housing stock. The creation of such a fund in the form of a public corporation<sup>47</sup> was clearly motivated by the non-profit nature of the activities, as well as the need to ensure timely decision-making, flexibility in the funds utilization, including measures on co-financing for major repairs, regional co-financing of targeted programs.

### *4. Public Corporation on Olympics Objects Construction and Sochi City Development as a Health Resort*

The establishment of the corporation, in our opinion, is more a consequence of “example” factor of other corporations and the desire to delegate to a an authorized unit the responsibility for the results of activities, to centralize and expand the capacity, ensure flexible and operational management of resources for the timely solution of the tasks. On June 8, 2006 the Resolution of the Government of the Russian Federation No. 357 has approved the Targeted Federal Program “Development of Sochi city as a mountain health resort (over 2006–2014)”. In the process of this program development, two options were considered (dependent on the choice of the country for the Olympics), and the activities were planned with regard to both options. Given the quality requirements, tight time frames and complexity of the project management, it was decided, for the first time (in the framework of Targeted Federal Program) to establish of a joint Management Board in the form of public unitary enterprise, which was delegated the functions of construction (renovation), financing of public capital investments, as well as the responsibility for financing other Program activities.

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<sup>47</sup> It is worth noting, that the idea of “public corporation” as a legal form with regard to the reform of housing and public utilities was expressed as early as in September 2006, in the report of the Ministry for Regional Development of Russia to the Federal Council, when it was proposed to establish a public corporation for investments in housing utilities.

However, the approval of Sochi as the Olympics city and explicit problems in the plans for the construction served as additional arguments in favor of GK "Olimpstroy"<sup>48</sup> establishment as a single monitoring center for Olympic facilities construction, implementation of related management functions, and easier interaction with private investors. According to the federal law on the establishment of the corporation, the RF Government should approve the Program on Olympic construction sites and development of Sochi as the mountain health resort, as well as the transition to the Corporation all the rights and responsibilities under government contracts, signed on behalf of the Joint Management Board of the Targeted Federal Program "Development of Sochi as a mountain resort (2006–2014 years)"<sup>49</sup>.

*5. Public Corporation on the Support in the Development, Production and Export of High-Tech Industrial Products of "Rostekhnologii"*

The basis for the establishment of the corporation was the federal state unitary enterprise "Rosoboronexport"<sup>50</sup>, a government agency on exports (imports) of armaments, and the holder of control packages in a number of large Russian companies, such as OAO "Oboronprom", "Motovilikhinsk Factories", "Corporation VSMPO-Avisma" and "AvtoVAZ".

In early August 2007 the State Legal Department under the RF President has presented to the Russian government a draft law on the establishment of a public corporation "Rostekhnologii". Herewith, it was proposed to transform "Rosoboronexport" in a joint stock company and transfer the shares of OAO, created on its basis, to the public corporation as a property contribution of the Russian Federation. However, the draft law caused some doubts in the Russian government<sup>51</sup>.

Apparently, due to the firm commitment to approve that law in the shortest possible term, the draft law "On Public Corporation on The Support in the Development, Production and Export of High-Tech Industrial Products "Rostekhnologii" was directly submitted to the State Duma by the RF President on September 25, 2007. According to the initial text of the draft law, corporation establishment presumed the accumulation of funds of its member companies, the formation of a number of integrated structures for exports in the industrial and military-industrial sectors.

The law has been adopted on November 23, 2007, and only three days later, on November 26, 2007, the RF President has signed an Order No. 1577 "On the open joint-stock company "Rosoboronexport", which specifies:

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<sup>48</sup> It should be noted that when the draft law on GK "Olimpstroy" establishment was discussed in the State Duma, some doubts were expressed about the feasibility of the establishment of public corporation, especially due to unlimited term of its activities.

<sup>49</sup> Later, in approving the construction of the Olympic program objects, the Russian government also decided to complete the implementation of the Federal Program "Development of Sochi as a mountain resort (2006–2014 years)" ahead of time (from 1 January 2008) (Resolution of the Government of the Russian Federation No. 991, dated December 29, 2007 "On the construction of Olympic facilities and the development of the city as the mountain resort of Sochi").

<sup>50</sup> "Rosoboronexport" has been created by merging the federal state unitary enterprises "State company Rosvooruzhenie" and "Promexport" in accordance with the Presidential Decree No. 1834, dated November 4, 2000 "On establishment of a federal state unitary enterprise "Rosoboronexport".

<sup>51</sup> In early September 2007 the Chairman of the RF Government M. Fradkov called to postpone for a while the establishment of the new public corporation based "Rosoboronexport", notifying that the proposed option of incorporation is not the only version of its formation.

- “FGUP Rosoboronexport”, should be transformed in a joint-stock company “Rosoboronexport”, and its shares are transferred to the Public Corporation OAO “Rostehnologii”;
- OAO “Rosoboronexport” is the government agent for external trade activities with respect to military products;
- Public Corporation “Rostehnologii” shall exercise external trade activities with military products in terms of advertising and marketing activities<sup>52</sup>.

Thus, the corporation directly or indirectly (through OAO “Rosoboronexport”) took under control the important functions of external trade activities with respect to military products.

In our opinion, to a certain extent, the establishment of the corporation means forming one more (along with the current Federal Industry Agency) centre of decision-making in the policy for the development of military and industrial complexes, which can be regarded as strengthening competition among various government institutions and can provide both, positive and negative effects.

#### *6. Public Corporation on Nuclear Power “Rosatom”*

The development of the nuclear power generation complex is included in the priority areas of the Russian government policy, pursued in accordance with a number of strategic documents<sup>53</sup>. Since 2006, the development of the nuclear industry in general, and nuclear power generation complex in particular, is paid special attention. The government has approved the Targeted Federal Program “Development of Atomic Power Industrial Complex of Russia over 2007–2010 and for the prospective till 2015”<sup>54</sup>. There were also defined the objectives of public sector nuclear industry restructuring, corporatization of its state unitary enterprises, formation of a vertically-integrated structure (in February 2007 a special law was adopted for that purpose)<sup>55</sup>, and in April the RF President has signed a decree on establishment of OAO “Nuclear Power Generation Complex”<sup>56</sup>. Therefore, a vast-scale restructuring

<sup>52</sup> Federal Law FZ-№ 271, dated November 26, 2007 (according to the Federal Law “On Amendments to Articles 9 and 12 of the Federal Law “On military-technical cooperation of the Russian Federation with other countries”, the list of enterprises, authorized to participate in external trade activities with respect to military products, has been revised (Article 12). The list has included the public corporation “Rostehnologii”, institutionally expanded the tentative list of “government agencies” or “special companies” (joint-stock companies, 100 per cent of the shares of which are federally owned or transferred to a non-profit organization in the form of a public corporation, are added to the list of state unitary enterprises).

<sup>53</sup> Program of Atomic Energy Development of the Russian Federation for the years 1998–2005 and up to 2010, approved by the Decree of the Government of the Russian Federation No. 815 as of July 21, 1998; Strategy of atomic energy development in Russia for the first half of XXI Century, endorsed by the Government of the Russian Federation on May 25, 2000.

<sup>54</sup> RF Government Resolution No. 605 dated October 6, 2006.

<sup>55</sup> On November 2, 2006 the RF President has introduced a draft law to the State Duma and following its discussion on February 5, 2007, the Federal Law No. 13-FZ was adopted “On the specifics of management and utilization of property and shares of organizations, engaged in the field of atomic power and relevant amendments to the specified legal regulations of the Russian Federation”. Organizational structural revisions in the atomic power sector are also specified.

<sup>56</sup> Presidential Decree as of April 27, 2007 “On the restructuring of nuclear power generation complex of the Russian Federation” has approved establishment of OAO “Nuclear Power Generation Complex”, the investment of OAO civil nuclear industry sector shares to its authorized capital before August 1, 2007; transfer some federal educational institutions of professional training to the OAO and installment of state unitary enterprises shares before December 1, 2007.

of public assets has been started in the civilian sector of the nuclear power industry through the creation of a large-scale share holding structure, incorporating enterprises of the complete production cycle: mining and uranium ore refinement, production and processing of nuclear fuel, design and construction of nuclear power plants.

At the same time, with measurable progress in addressing the energy complex, there remained unresolved issues on improving the nuclear weapons complex management, while the issues of unified investment strategy and technology policy in the entire nuclear industry are not resolved yet<sup>57</sup>. In view of the above, the Federal Law No. 317, adopted on December 1, 2007 (Federal Law “On Public Corporation on Nuclear Power “Rosatom”, specifying, among other things:

- development and implementation of the national policy by the Corporation for the operation and development of atomic power and nuclear weapons complexes, pursuance of national policy in terms of the nuclear industry, execution of national armament programs and government defense order;
- transfer of the functions and powers of the Federal Agency on Nuclear Energy;
- property contribution from the Russian Federation in the form of shares in OAO “Nuclear Power Generation Complex”, shares of joint-stock companies of federal ownership, state unitary enterprises property, included in the list, approved by the President, as well as the property, that is in the operational management of the federal government agencies, as per the list, approved by the RF Government.

In this case, the choice of such legal form as the public corporation was determined probably by the requirement to combine in one entity the functions of government structure management and authority to perform a full-scale restructuring of nuclear industry property and to establish a consolidated system of government control over economic activity of the Corporation member companies.

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For all the diversity of objectives of the public corporations establishment and incentives to the selection of this legal incorporation form, those factors can be summarized as follows:

- the establishment of each public corporation is a link of a very long “chain” of measures of government policy, implemented in a particular direction;
- public corporations are not so much an alternative to such mechanisms as targeted federal programs, joint-stock holdings, funded from national assets, but rather an additional organizational structure, supporting them at some stages of development;
- in some cases, the establishment of the corporation was the way to overcome a problem in the decision-making on some key issues in the government.

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<sup>57</sup> The RF President in the letter to the Federal Assembly of the Russian Federation on April 26, 2007 has indicated the need for significant changes in the structure of power engineering, in particular, by enlarged share of nuclear power generation, the construction of 26 nuclear power plants on the basis of modern technologies in the next 12 years. To this end, it was proposed to establish a special corporation that would incorporate the nuclear power generating and industrial enterprises, operate in both, domestic and external markets, and moreover, serve for the interests of national defense.

#### 5.2.4. Distinctions in Discussion and Adoption of Laws on the Establishment of Public Corporations

It is worth paying particular attention to *tightened time frames in establishment of public corporations from the second half of 2007*. After the discussion and adoption of the Law on Bank for Development, all subsequent draft laws on public corporations have presented either by deputies, or by the RF President<sup>58</sup>. Those draft laws were adopted in the minimum time limits, within 1.5–2 months upon their submission, while only 1–1.5 months was allocated for their consideration by the State Duma (see *Table 11*).

Table 11

**Time Frames for Adoption of the Draft Laws on the Establishment of Public Corporations in 2007**

Laws on establishment of public corporations in 2007	Draft law initiator	Date of presentation to the State Duma	Date of the State Duma adoption in final reading	Date of the RF President's signature
Federal law No. 82-FZ "On the Bank for Development"	Government	19.01.2007	20.04.2007	17.05.2007
Federal law No. 139-FZ "On the Russian Public Corporation for Nanotechnologies"	Deputies	04.06.2007	04.07.2007	19.07.2007
Federal law No. 185-FZ "Foundation for Promotion of Housing and Public Utilities Reform"	Deputies	04.06.2007	06.07.2007	21.07.2007
Federal law No. 238-FZ "On Public corporation on Olympics objects construction and Sochi city development as a mountain health resort"	Deputies	12.09.2007	18.10.2007	30.10.2007
Federal Law No. 270-FZ "On "Rostekhnologii" public corporation"	RF President	25.09.2007	9.11.2007	23.11.2007
Federal law No. 317-FZ "On "Rosatom", public corporation on nuclear power"	RF President	01.10.2007	13.11.2007	01.12.2007

As a rule, the debates on the draft laws for the establishment of public corporations in the State Duma were critical<sup>59</sup>. Most frequently critical remarks were expressed on the functions and powers of corporations, on the procedure of property transfer to their ownership, on various aspects of organization of their interaction with other economic entities in the framework of targeted activities, on management procedures within corporations and on government supervision over their performance. As a result<sup>60</sup>, quite a number of disputable provi-

<sup>58</sup> This "transfer" of legislative initiative from the RF Government to the deputies and the RF President to present draft laws on public corporations establishment is largely explained by rather long term of the draft laws development and discussions in the RF government, particularly noticeable against the background of limited time frames.

<sup>59</sup> This was reflected, in particular, in the final statements on the draft laws, prepared by individual Committees and Legal Department of the State Duma.

<sup>60</sup> There are some examples. In accordance with the initial text of the draft law on the establishment of "Rosnanoteh" public corporation, it was planned to provide the corporation a number of functions of government authorities (development and harmonization of legal regulations, functions of an agent for state-guaranteed orders), the right of corporations to use up to 10 per cent of their budget for the administrative management expenses. In the draft law on PC "Rostekhnologii" establishment it was foreseen to authorize the corporation to determine the

sions have been abolished, including some redundant functions and powers. However, a number of notable remarks (both, applicable to individual corporations<sup>61</sup>, and more universal ones<sup>62</sup>) was not taken into account when finalizing the law drafts.

Finally, the dynamic process of adoption the laws on public corporations in 2007 has brought up a number of important issues, related to their current operation and “quality of legal definition” of that form of incorporation.

First, the *framework nature of the passed laws on public corporations* establishment is worth noting. Practically all laws provide insufficient details<sup>63</sup> on the terms and principles of the corporations activities (with the exception of the Foundation for Promotion Housing and Public Utilities Reform), they require bylaws adoption and a number of regulations at the level of the corporations. There is no procedure of reorganization or liquidation for the majority of the established corporations in the adopted laws: there are only references to provisions of the corresponding federal law (the liquidation of a corporation determined only in relation to the Foundation for Promotion Housing and Public Utilities Reform, where the term of functioning is specified<sup>64</sup>).

Secondly, it is worth pointing to the *low level of harmonization* of provisions of the adopted laws on establishment of public corporations. There is no doubt, that the goals, objectives and activities of each corporation are individual, but even in the case of similar provisions there is a high diversity in their definition, including the details and wording<sup>65</sup>.

Thirdly, the *negative effect on the development of basic law on non-profit organizations* should be pointed out. Basically, one could expect that the wide application of provisions on public corporations, the adoption of appropriate laws could promote general practice development, clarify and supplement the provisions of the Law on Non-Profit Organizations. However, this did not happen; only in one case in 2007, simultaneously with the adoption of the Law “On the Bank for Development” to enable it to borrow funds, an amendment was made to Article 7.1 of the Law “On Non-Profit Organizations”, defining the minimum limit of the authorized capital and property of public corporation, that secures the interests of its creditors<sup>66</sup>.

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procedure and amounts of regular and (or) non-recurrent contributions from organizations, the shares, which are owned by the corporation; in the draft law on PC “Olympstroy” incorporation there was a provision, that the property of the corporation consists of property, allocated by the Russian Federation, by Krasnodar region and Sochi city.

<sup>61</sup> For example, with regard to the draft law on PC “Olympstroy”, there was a number of comments on the lack of rules, restricting the term of activities of the corporation (in view of the nature of the project objectives).

<sup>62</sup> The comments of this nature include the low level of legislative regulation of corporations activities, the lack of rules and criteria for selecting projects for funding, insufficient regulations in regard to conflict of interest, the lack of procedures for government control over the activities of corporation.

<sup>63</sup> For some public corporations (such as the PC “Rosnanotech”, PERCENT “Olympstroy”) provided insufficiently detailed legal base for their establishment, is balanced, to some extent, by strategy and programs of their development.

<sup>64</sup> In accordance with Section 6, Article 3 of Federal Law “On the Fund for assistance to Housing and Public Utilities Reform”, the Fund will be functioning till January 1, 2021.

<sup>65</sup> It should be noted, that even the wording of the full names and abbreviations of corporations is different (such as PC “Rosnanotech”, Pub.Corporation “Rosatom”, public corporation “Rostehnologii”).

<sup>66</sup> Article 3 of the Federal Law No. 83 FZ as of May 17, 2007 “On amendments to some legal regulations of the Russian Federation in view of the adoption of the Federal Law “On Bank for development”.

Insufficiently detailed and poorly structured laws on the establishment of government corporations, the low level of legal regulations of corporations activities have also, in our view, brought up to the following issues.

1) *Delay in the beginning of corporations' performance on their basic objectives.*

As of the end of February 2008, only to the Fund for promotion of housing and public utilities reform started full-scale functioning, whereas other corporations were in the process of formation and approval of various documents, regulating their practice.

2) *Empowering shadow lobbying of various parties and aggravated risk of biased decision-making to the detriment of consistency and strategic planning.*

The establishment of corporations leads to a substantial change in "correlation of force" in the system of public administration, the transition of decision-making authority to the level of corporations in the background of insufficient regulations for corporations activities<sup>67</sup>, absence of legal provisions on identification and resolution of potential conflict of interests in their operation, incomplete provisions on interaction with public authorities significantly increases the relevant risks.

3) *The fears in business environment (sometimes exaggerated) on the tentative risks from the activities of corporations.*

The problem is largely based on the vague boundaries in authority and expansion of corporations' activities, the uncertainty of the procedure and criteria for the selection of entities to be supported, uncertainty in management principles and disposition of its assets, the vagueness of their plans on further development and approach to interaction with the business community.

4) *Mistrust to public corporations on the part of civil society.*

This problem is the result of the lack of procedural rules on government control over the activities of corporations and absence of effective tools of public control over their activities, inadequate requirements to their publicity and transparency.

At the same time, *risks, related to the above issues can be significantly reduced* through the adoption of corporate strategies, definitions and principles of transparency, procedural rules of corporations activities, combined government and civilian control over their activities, greater publicity, the practice of holding regular consultations with interested public organizations and business associations.

#### 5.2.5. Public Corporations Potential and Related Problems

At this point it is quite obvious, that the potential of the established public corporations is dependent to a large extent on property contribution, made by the Russian Federation, empowering them with wide authority and responsibilities, flexibility in the use of financial resources, their administrative status, as well as their experience.

All corporations (perhaps, with the only exception of "Olympstroy") were provided a fairly large property contribution from the Russian Federation, although its structure (packages of shares, property, monetary assets, etc.) is different for each of the individual corpora-

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<sup>67</sup> Only in the Federal Law "On Public Corporation on Nuclear Power "Rosatom" there are provisions, that determine the need for procedural rules. In accordance with Art. 33 of the Law, procedural rules should be approved by the Government, that establishes the order and procedures of a corporation performance, its authority and functions, including the order of its interaction with public authorities, performance of the orders from the RF President and government.



tions: Foundation for Promotion of Housing and Public Utilities Reform and PC “Rosnanoteh” have been primarily funded with monetary assets, which ensured their functioning for a the long term, whereas the contribution to “Rosatom” and “Rostekhnologii” corporations were made with the shares of large manufacturing holdings (see *Table 12*).

*Table 12*

**Property Contribution, Provided by the Russian Federation and Functions,  
Delegated to Public Corporations**

Corporations' Property	Authorities/ Functions	
<b>Bank for Development and Foreign Economic Affairs</b>		
1	2	3
Property of the Bank for Foreign Economic Affairs of the USSR, shares in OAO “Russian Bank for Development”, ZAO “Special Government Russian Export-Import Bank” of federal property; Other property of the Russian Federation upon approval of the RF Government; Voluntary contributions and donations of property	Funds from the federal budget in the amount of RUR 180 billion (November 2007); RF Stabilization Fund assets in the amount of RUR 180 billion (November 2007); Revenues from the activities of Vnesheconombank	All the rights and responsibilities of the Bank for Foreign Economic Affairs of the (former) USSR
<b>Russian Nanotechnology Corporation</b>		
Voluntary contributions and donations of property, as well as other legitimate assets	Funds from the federal budget in the amount of RUR 130 billion (November 2007); RF Stabilization Fund in the amount of RUR 30 billion (November 2007); Revenues, derived from the activities of the corporation	
<b>Foundation for Housing and Public Utilities Reform Promotion</b>		
	Funds from the federal budget in the amount of RUR 240 billion (November 2007); Revenues from the sale of temporarily available assets	
<b>Public Corporation on Olympics Objects Construction and Sochi City Development as a Health Resort</b>		
Property, obtained from government contracts, awarded under the Federal Program “Development of Sochi as a mountain health resort (within 2006–2014)”; Other property of federal ownership, approved by the decision of the Russian Government; Donations	Funds in monetary form from the federal budget, as well as other budgetary allocations; Revenues from the activities of the corporation non-recurring income (contributions) from organizations, the shares, which are owned by corporations; Revenue derived from the use of the corporation of its assets and activities	All rights and obligations under government contracts, signed by the Federal Agency on Nuclear Power on behalf of the Russian Federation
<b>Public Corporation on the Support in the Development, Production and Export of High-Tech Industrial Products “Rostekhnologii”</b>		
100 per cent of shares of OAO, created through transformation of federal government unitary enterprise “Rosoboronexport”; Other property transferred to the corporation in the course of its work		The right for participation in foreign trade activities with respect to military products

*Table 12 (continued)*

1	2	3
<b>Public Corporation on Nuclear Power “Rosatom”</b>		
Federally owned shares in OAO “Nuclear power complex”;	Funds from the federal budget, allocated to the corporation to implement activities of the program of activities of the corporation for a long term;	The right to participate in the implementation of all foreign trade rights and obligations under government contracts (within three years);
Federally owned shares of open joint-stock companies, included in the list, approved by the RF President;	Revenues from the activities of the corporation and special reserve funds and corporate assets, created on their basis	Authority of the federal budget agent and administrator for Atomic Energy of the Russian Federation, acting on the obligations and rights of federal state unitary enterprises, which transferred property;
Capital assets of the federal government unitary enterprises, included in the list, approved by the RF Government;		
Property in the operational management of federal government agencies, corporations, transferred to the corporations as per the list, approved by the RF Government;		Authority to implement on behalf of the Russian Federation the property rights in respect to subordinated federal government unitary enterprises and federal government agencies;
“Rosatom” property in operational management upon the decision on “Rosatom” liquidation of in the prescribed manner;		On behalf of the Russian Federation, represent the shareholder of open joint-stock companies to transfer their shares in the corporation as property contribution of the Russian Federation
Other federally owned property upon the decision of the RF Government;		
Voluntary contributions and donations		

Some of the corporations, to a certain extent, “replace” in a new quality the structures, existed before, such as Vnesheconombank, established on the basis of restructuring and capitalization of existing structures (Roseksimbank, Russian Bank for Development, USSR Vnesheconombank). “Rosatom” public corporation during the transitional period should operate in the new capacity as a “replacement” to the Federal Agency on Nuclear Power, and PC “Olympstroy” in conjunction with the “Program of Olympic construction sites and development of the city as the mountain health resort of Sochi” “replaces”, the Targeted Federal Program on “Sochi development as a mountain health resort (over 2006–2014 years)” and the Directorate of Targeted Federal Program.

In regard to the administrative status of corporations (see *Table 13*), one can note that it is rather high<sup>68</sup>: according to the relevant laws, the heads of those corporations (excluding Foundation for Promotion of Housing and Public Utilities Reform and PC “Olympstroy”) should be appointed directly by the RF President, and the members of Supervisory Board should be either also appointed by the President, or some of them – under presentation of the RF President (with the exception of Vnesheconombank and “Olympstroy”). Moreover, the Supervisory Boards of such corporations as PC “Rosnanotech”, the Foundation for Promotion of Housing and Public Utilities Reform, should be formed upon presentation of several branches of government (the RF President, the State Duma, the Government of the Russian Federation), what is one more confirmation of the nationwide priority of those structures.

<sup>68</sup> In addition, some laws on public corporations directly prohibit the public authorities to interfere in the activities of public corporations, unless otherwise specified by federal laws.

*Таблица 13*

### Requirements to the Structure and the Appointment of Public Corporations Management

	Vnesheconombank	PC “Rosnanotech”	Foundation for promotion of housing and public utilities reform	PC “Olympstroy”	Public Corporation «Rostekhnologii	“Rosatom” Public Corporation
<b>The order of appointment of the responsible executive body</b>	Chairman is appointed by the RF President	Director General is appointed by the RF President	Director General is appointed by the RF government	Director General is appointed by the RF government	Director General is appointed by the RF President	Director General is appointed by the RF President under presentation of the RF government Speaker
<b>Management Board structure</b>	8 Management Board members and the Chairman of Vnesheconombank	8 Management Board members and Director General	8 Management Board members and Director General	10 Management Board members and Corporation President	11 Management Board members, Director General and 5 his Deputies	Director General and other Management Board members
<b>The order of appointment of management board members (except for the sole executive body)</b>	Members of the Board are appointed by the supervisory board under presentation of Vnesheconombank Chairman	Members of the Board are appointed by the supervisory board under presentation of Director General	Members of the Board are appointed by the supervisory board under presentation of Director General	Members of the Board are appointed by the supervisory board under presentation of Director General	Members of the Board (except for Deputies to Director General) are appointed by the supervisory board under presentation of Director General. for Deputies to Director General are appointed by Director General upon agreement with supervisory Board	Members of the Board are appointed by the supervisory board under presentation of Director General
<b>Requirements for the supervisory board structure and formation</b>	9 non-staff members of Vnesheconombank, appointed by the RF Government; Vnesheconombank Chairman is a member of the supervisory board	- 14 non-staff members of the corporation, appointed by the RF Government, among them: 5 members re appointed by the RF President; 2 members are appointed by the State Duma; 2 members are appointed under presentation of the RF Federal Council; 5 members are appointed under presentation of the RF government; - Director General is the member of Supervising Board	16 non-staff members of the Foundation are appointed by the RF government, among them: 6 members under presentation of the RF President; 5 members under presentation of the RF government; 4 members are appointed under presentation of the RF Federal Council; 2 members under presentation of Public Chamber of Russia	- 12 non-staff members of the corporation, appointed by the RF government; - the Corporation Chairman is a member of the supervisory board	- 8 non-staff members are appointed by the RF President, among them: 4 representatives of the RF President, 4 representatives of the RF government; - Director General is a member of the supervisory board	- 8 non-staff members are appointed by the RF President; - Director General
<b>Advisory body</b>		R&D Council				R&D Council

With regard to contribution of relevant experience to corporations’ potential, the evaluations of this kind are always rather subjective. It can be noted, that Vnesheconombank experience can be regarded as a long-term priority projects support to the Russian Bank for Development, as well as a pilot project of Roseksimbank to implement various schemes of export operations. Rosatom Corporation can utilize the experience of the Federal Agency on Nuclear Power in management and strategy development in this sector, Rostekhnologii corporation can

implement its experience in promoting high-tech products for export, while Rosoboronexport can contribute by implementation of foreign trade activities with respect to military products.

*The major constraint in the implementation of public corporations potential can be regarded as generally insufficiently clearformulated objectives and principles of their activities, as well as the process of decision-making.*

One of the potential benefits of all public corporations is significantly greater flexibility in expenditures, expanded capacities in utilization the funds. However, these advanced capabilities to reduce the risk of abuse, and (or) the risk of waste of resources should be "balanced" with detailed and transparent activities, including decision-making procedures to measure performance. This is particularly relevant in view of, on the one hand, internal functional contradictions in some established corporations (for example, the non-profit nature of corporations and commercial activities of the joint stock companies, managed by them). On the other hand, many corporations, in view of their large resource and capabilities, but with the lack of transparency in implementation of government policy and interaction with government authorities, uncertainty in strategy development became weak points for lobbying by various stakeholders.

It should be noted, that these problems can not be solved by simple direct strengthening of government control; on the contrary, if there is no clear definition to criteria for evaluation of the corporations performance and the no basic regulations on their activities, then the audits (because of the uncertainty as to assessment criteria of performance of the corporations) can become an instrument of pressure on the corporation and its leadership on the part of various interested groups.

Another problem also looks important: the laws on public corporations specify their management structure, but do not identify neither the areas, nor the measure of responsibility of the management bodies for their decisions and their accountability within the corporations and to the government. It is indicated in the laws on public corporations, what authorities can take decisions on cessation of responsibilities of supervisory board members and chairmen as their sole executive bodies, but the motives for such decisions are not provided even in general terms. It makes unclear the responsibilities and motivation of the management bodies for the performance of the corporations.

As it has been mentioned earlier, significant challenges in ensuring efficient operation of corporations are created by the inadequacy of the legal provisions, regulating different aspects of their activities.

At the same time, a number of corporations take very active measures in filling up the gaps, at least at the level of secondary legislation (regulations and orders of the RF Government), or at least at the level of documents, adopted by corporations, which determine the rules of their activities (see *Table 14*). The following important documents can be noted in this regard:

- “Vneshekonombank” – the RF Government has approved the Memorandum on Vneshekonombank financial policies, as well as the order of preparation, content and validity term of the Memorandum.

- PC “Rosnanotech” – the Supervisory Board has adopted documents, regulating management activities and approved the concept of projects implementation and control, accepted financial plan for 2008<sup>69</sup>.
- PC “Olympstroy” – the RF Government has approved the Program on construction of Olympic facilities and development of Sochi as the mountain health resort.
- Foundation for Promotion of Housing and Public Utilities Reform – the RF government has determined the procedure of allocation of temporarily uncommitted funds of the corporation.

*Table 14*

### **Follow-up Regulations for Public Corporations upon their Legal Incorporation**

#### **1. Bank for Development and Foreign Economic Affairs**

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17.05.2007	– Federal law “On the Bank for Development” is adopted
07.06.2007	– The government of the Russian Federation has approved the acceptance act of reorganization of the Bank for Foreign Economic Affairs of the USSR in the public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)”
18.06.2007	– The Chairman of the public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)” is appointed by the order of the RF President
19.06.2007.	– Members of Supervisory Board of the public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)” is appointed by the order of the RF government
28.06.2007	– at their first meeting the members of Supervisory Board of the public corporation “Bank for Development Foreign Economic Affairs (Vnesheconombank)” have approved the Board of Directors staff members
12.07.2007	– at the meeting the Supervisory Board of the public corporation “Bank for Development Foreign Economic Affairs (Vnesheconombank)” Memorandum on financial policy of the public corporation was approved
27.07.2007	– The Regulations on the supervisory board of public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)” was approved by the RF government  – The RF Government has issued an order on the preparation, content and validity term of the Memorandum on financial policies of the public corporation Vnesheconombank  – Memorandum on financial policies of the public corporation “Bank for Development Foreign Economic Affairs (Vnesheconombank)” was adopted by the RF government
27.11.2007	– The RF Government issued an order to transfer the funds from the RF Stabilization Fund in the form of property contribution from the Russian Federation to the authorized capital of public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)” in the amount of RUR 180 billion
07.12.2007	– The RF Government issued an order to transfer the federal property of 100 per cent of the shares of OAO “Russian Bank for Development” and 5.226 per cent of the shares of ZAO “Targeted government Russian Export-Import Bank” to the authorized capital of the public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)”
19.02.2008	– the RF government has approved the Regulations for public corporation “Bank for Development of Foreign Economic Affairs (Vnesheconombank)” in export credits insurance against commercial and political risks

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<sup>69</sup> However, none of those documents had not been presented to the public, for example, at the website of the corporation (as of March 1, 2008), although the Supervisory Board meetings were held long ago, on December 11 and 27, 2007, and on January 31, 2008 .

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#### **2. Russian Nanotechnology Corporation**

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- 19.07.2007 – Federal Law is adopted on “Russian Nanotechnology Corporation”
  - 07.09.2007 – General Director of the public corporation “Russian Nanotechnology Corporation” nanotechnology is appointed by the RF President’s decree
    - Members of Supervisory Board of the public corporation “Russian Nanotechnology Corporation” are appointed by the RF government
  - 25.09.2007 – The first meeting of Supervisory Board of the public corporation “Russian Nanotechnology Corporation” took place
  - 27.11.2007 – The RF government issued an order to transfer the federal property as a contribution from the Russian Federation to “Russian Nanotechnology Corporation” in the amount of RUR 130 billion, including RUR 30 billion from the RF Stabilization Fund and RUR 100 billion from the federal budget
  - 11.12.2007 – Supervisory Board of public corporation “Russian Nanotechnology Corporation” has approved the documents, regulating the activities of the corporation management bodies: Regulations on the Supervisory Board, Regulations on the Board of Directors, as well as the Regulations on the Audit Committee
  - 27.12.2007 – Supervisory Board of public corporation “Russian Nanotechnology Corporation” has approved Regulations on PC “Rosnanotech” R&D Council and the concept for development and control over the projects, implemented by the corporation
  - 31.01.2008 – Supervisory Board of public corporation “Russian Nanotechnology Corporation” has approved the financial plan (budget) of the corporation for 2008, objectives of financing and the stuff of R&D Council
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#### **3. Foundation for Promotion of Housing and Public Utilities Reform**

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- 19.07.2007 – Federal Law is adopted on the “Foundation for Promotion of Housing and Public Utilities Reform”
  - 29.10.2007 – General Director of the public corporation “Foundation for Promotion of Housing and Public Utilities Reform” is appointed by the RF government resolution
  - 31.10.2007 – Members of Supervisory Board of the public corporation “Foundation for Promotion of Housing and Public Utilities Reform” are appointed by the RF government
  - 22.11.2007 – At their first meeting members of the Supervisory Board of the public corporation “Foundation for Promotion of Housing and Public Utilities Reform” have discussed the Regulations for the Supervisory Board, Board of Directors and the Foundation structure
  - 27.11.2007 – The RF government issued an order to transfer the federal property as a contribution from the Russian Federation to the public corporation “Foundation for Promotion of Housing and Public Utilities Reform” in the amount of RUR 240 billion from the federal budget
  - 15.02.2008 – The RF government has issued a decision “On placement of temporary uncommitted funds of the public corporation “Foundation for Promotion of Housing and Public Utilities Reform”
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#### **4. Public Corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort**

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- 30.10.2007 – Federal Law is adopted on the Public Corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort
- 03.11.2007 – President of the public corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort is appointed by the RF government decree
- 12.11.2007 – Members of Supervisory Board of the public corporation on Olympics objects Construction and Sochi City Development as a Mountain Health Resort are appointed by the RF government resolution
- 14.11.2007 – At their first meeting members of the Supervisory Board of the public corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort have approved 8 of the 10 corporation Management Board members

*Table 14 (continued)*

01.12.2007	– the Supervisory Board of the public corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort has approved the Program for Olympic objects construction
29.12.2007	– The RF government resolution has approved the Program for Olympic objects construction and Sochi city Development as a Mountain Health Resort and defined the amount of property contribution of the Russian Federation to the public corporation on Olympics objects Construction and Sochi city Development as a Mountain Health Resort for the Program financing over 2008–2014

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### **5. Public Corporation for Assistance in Development, Production and Export of High-Tech Industrial Products “Rostekhnologii”**

23.11.2007	– Federal Law is adopted on the Public Corporation for Assistance in Development, Production and Export of High-Tech Industrial Products
26.11.2007	– General Director of the public corporation for Assistance in Development, Production and Export of High-Tech Industrial Products “Rostekhnologii” is appointed by the RF President decree  – Members of Supervisory Board of the public corporation for Assistance in Development, Production and Export of High-Tech Industrial Products “Rostekhnologii” are appointed by the RF President resolution  – According to the Presidential Decree, FGUP “Rosoboronexport” is transformed in the open joint-stock company, 100 per cent shares of which are in federal ownership, with their further transfer to the public corporation for Assistance in Development, Production and Export of High-Tech Industrial Products “Rostekhnologii”
19.12.2007	–At the first meeting of public corporation for Assistance in Development, Production and Export of High-Tech Industrial Products “Rostekhnologii” Supervisory Board, the organizational structure was approved, Deputies to Director General were appointed, approaches to the formation of property installment of the Russian federation to the corporations

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### **6. Public Corporation on Nuclear Power “Rosatom”**

01.12.2007	– Federal Law is adopted on the Public Corporation on Nuclear Power “Rosatom”
12.12.2007	– General Director of the public corporation on Nuclear Power “Rosatom” is appointed by the RF President decree  – Members of Supervisory Board of the public corporation on Nuclear Power “Rosatom” are appointed by the RF President resolution

#### **5.2.6. Types of the Established Public Corporations**

As one can see, the public corporations differ significantly in terms of their background, objectives, functions, the type of property, contributed by the Russian Federation and by a number of other indicators (see *Table 15*). Let's try to *differentiate various types of public corporations*.

##### *A. Public Institutions for Development*

This type of corporations certainly includes Vnesheconombank, as well as (with certain assumptions) – PC Rosnanotech. The first corporation primary objective is compensation of the market “gaps”. Its targets and focuses are clearly defined to prevent “intrusion” in areas with sufficient business initiative and to maintain fair competition. The second Corporation objective is to cover both, market and national gaps (in terms of administrative system failures).

Table 15

**Conditional Classification of the Established Public Corporations by some Indicators**

Public Corporations	Approved strategy (action plans) in the relevant area of competence prior to the law on corporation establishment	Details on principles and activities, defined at the legal level	Definition of strategy and principles of the corporation upon the adoption of incorporation law	Transfer of some functions and powers from other entities, delegation of rights	Shares of a large production holding as property contribution from the Russian Federation	Considerable monetary assets, provided as the contribution from the Russian Federation a sufficiently long period of activities	The term of activities is defined	High administrative level
Vnesheconombank			+	+		+		+
PC "Rosnanotech"	+					+		+
Foundation for promotions Housing and Public Utilities Reform		+	+			+	+	
PC "Olympstroy"			+	+				
"Rosnanotechnologii" Public Corporation				+	+			+
"Rosatom" Public Corporation	+			+	+			+

Both corporations are independent to some extent and can focus on the long-term strategic objectives, because on the one hand, they have obtained considerable resources to enable them to carry out their activities regardless of the federal budget at least in the next 5–7 years, and on the other hand, their status in the system of public administration is fairly high.

*B. RF Government Agents<sup>70</sup>, "Executors" of Certain Functions*

To this type of corporations PC "Olympstroy" can be attributed, and also, to some extent, the Foundation for Promotion of Housing and Public Utilities Reform. Both corporations actually perform individual operational functions of public management. They have a preset term of operation, during which their targets have to be achieved. These corporations are less independent in their status than public institutions for development in terms of the system of public administration.

*C. "Quasi-Ministries"*

Without any doubt, "Rosatom" public corporation can be attributed to this type of structures, which has the functions of government agency, and in addition to that owns (will own) packages of shares and capital assets in the relevant industry. This group (like the group "Quazi-holdings") is characterized by the lack of a substantial "advanced" financial contribution and funding of the activities by the subsidies from federal budget.

<sup>70</sup> The border between the institutions for development and government agents is rather conventional. In this case, the main distinctions of institution for development is delegation to them a range of public policy tasks (rather than functions), diversified in the forms of their decisions, as well as a significant degree of independence from government.



*D. “Quazi-holdings”*

To this group, we refer those corporations, whose capacity is determined primarily by control over production facilities (in various forms), while they are empowered with certain “soft” (mainly contributing) functions in the framework of government policy. The criterion of attributing a corporation to this type of companies is the overlapping of some corporation functions with the activities of its member companies (or affiliates)<sup>71</sup>.

With certain assumptions, “Rostehnologii” could be included in this group of public corporations, which is largely focused on management of government-controlled companies and restructuring thereof, as well as the formation of integrated structures. While the corporation is a separate entity in implementation of government policy, it does not have a coherent range of significant functions of government management authorities.

There is no doubt, *grouping of the corporations in one or another category is highly conditional, primarily due to similarity of “Institutes for Development” and “Government agents” types, as well as “Quazi-Ministries” and “Quazi-holdings”*. Thus, Vnesheconombank, along with the functions of an Institute for Development, acts also as a government agent of the Russian Federation<sup>72</sup>, the Foundation for Promotion of Housing and Public Utilities Reform can be related to a certain extent to the Institute for Development. Public corporation “Rosatom” certainly has the features of Quazi-holding, while public corporation “Rostehnologii” possesses some indicators of Quazi-Ministry.

In our view, the combination of specific characteristics of different types of corporations can create internal conflicts and ambiguity in their development, for instance, between the tasks and functions of “Institutions for development” and “Government agents” individual functions, between regulatory, law enforcement functions and responsibilities for the management of business entities. In the latter case, there are significant risks of different treatment of businesses on the part of “Quazi-Ministerstries” and “Quazi-holdings”.

It is important not only to classify the established corporations, but also to assess the probability of their transfer to a different type of corporations. In this regard, the question arises: *what are the potential trends of such transfers among the established corporations?*

Common to all corporations is a potential trend to allocation (expansion) of their functions in public administration, that is, enhancement of their role as Quazi-Ministerstry or alternative “shadow” agencies. To a great extent, such a shift may be motivated by an absence or inadequacy of authorized capital. In this situation, the corporations may seek for replacement of funding the gaps with extended powers.

Those corporations, that were initially established as “Quasi-holdings” (or close to this type), might be willing to obtain additional production facilities from the government to expand participation in the equity of individual companies, including those with budgetary support.

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<sup>71</sup> In view of the above, we do not relate Vnesheconombank to the Quasi-holding type of corporations, as it incorporates some credit organizations, whereas its activity is not addressed to the support of credit organizations activities.

<sup>72</sup> In accordance with the law on the Bank for Development, Vnesheconombank implements certain functions (for example, the service of the debt of the former Soviet Union and the Russian Federation, the functions of public management company for the trust management of pension savings) until the date, preset by the Government of the Russian Federation.

Finally, those corporations, that are needed in a certain period, may seek to expand the range of their activities to justify their existence. Herewith, there is a risk of the loss of “individual identity”, distinguishing the corporations from each other and overlapping of the functions of all types of corporations, which brings up inevitable conflict of interests.

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1. Established in 2007 public corporations are deeply diverse as in their background, as in objectives and functions. Each of public corporations is a tool, enabling to resolve contradictions between the national development priorities (diversification, transfer to innovative technologies) and the limited mechanisms, available in the State to settle that issue, as well as insufficient quality of administrative instruments and public administration, focused primarily on the current and standard issues.

The established public corporations can be regarded as new individual approaches to: (1) incorporation and expansion of activities of the institutions for development; (2) enhanced efficiency of the state programs implementation and government functions performance, and (3) transformation of some public authority structures in order to address the strategic objectives comprehensively, (4) expanding the range of authorities, involved in the long-term public policy.

2. The Choice of a public corporation as the legal form of incorporation is determined to a large extent by the opportunities to: (1) simplify and accelerate the process of restructuring and consolidation of public ownership in some sectors of the economy, (2) enhance the flexibility of mechanisms for funding, identify potential areas for investment, to fund long-term programs, and (3) ensure “pin-point” adjustments in public administrative system.

Along with those challenging incentives, there took place an important factor of time constraints and the desire to overcome the slow-down in addressing a number of key issues. In view of that, the establishment of public corporations in 2007 has been largely a preliminary (framework) tool of setting up individual institutional priorities in the implementation of government policy and delegation of responsibilities for performance thereof. The performance is ensured by the legal status of each corporation and supported by significant monetary assets, provided to them for rather long-term perspective, and their high position in the administrative hierarchy.

3. It is extremely difficult to make a precise assessment of the overall effect from established public corporations at this point, in view of great diversity in their types, and with regard to the fact, that their principles and procedures of functioning are still being developed. However, in any cases, the creation of public corporations seems questionable: in some cases, significant doubts arise as to the need for incorporation as the new entity for public policy, in other cases the purpose of establishment in the form of public corporation seems unreasonable.

Along with the new opportunities, there are significant risks: expansion of the process of creating new public corporations, “blurring” of the RF government powers due to unclear allocation of powers, abused relationship between the corporations and business, using their status to gain extended authority and resources, non-transparent process of negotiating and adoption the important decisions in corporations, insufficient quality of management resources, in the background of inadequate accountability to the government and civil society. It

is worth noting, that the establishment of public corporations have set up a new, higher level for corporate and personal ambitions.

4. Accelerated adoption of laws on public corporations establishment in 2007, in particular due to involvement of the top political level, enables to form a kind of proactive range of authority and capacity (potential) to address a number of strategic objectives of socio-economic development in Russia. However, at present time, a critical question arises how efficiently and expediently this potential will be realized: practically any corporation needs significantly extended political and administrative resources to ensure its effective functioning, accountability should be ensured in terms of implementation of the set tasks, the risks of “opportunistic” behavior of the corporations and negative impact on market economy development should be reduced.

In general, one could say that the high status and extensive resources of public corporations are not adequately compensated by comprehensive, clear and transparent institutional requirements to their activities. In this regard, the balance of strengths and weaknesses is more like negative: the problems are already visible, but the advantages are still expected to be seen.

5. In our view, to ensure positive results of public corporations activity and to reduce risks, it would be expedient:

- clearly define the role and authority of each corporation in the implementation of government policy, set up restrictions in terms of irrational expansion of their responsibilities;
- develop individual strategies and programs of their development, evaluation procedures to assess their effectiveness and expediency;
- ensure the balance between flexibility in expenditures and transparency in decision-making process, procedures of government and public control, transparency of performance;
- implement the factor of personal responsibility of the corporations’ managers for the results of their activities;
- in view of public nature of the corporations’ objectives, expand the supervisory board with the popular and reputable representatives, who are not the staff members of any state power authorities or management structures of public companies;
- arrange regular public (independent) audit of the corporations performance results and submit relevant reports to the RF President, RF Federal Assembly and the RF government;
- provide more clear definitions of the terms and objectives of the public corporations establishment at the level of federal law;
- prior to any corporation establishment, set up as a mandatory requirement to provide the strategy for its activities, justification of inability to meet the targets by other means, risk assessments and propose mechanisms of their reduction;
- basing on the best practice, substantially expand and introduce detailed provisions in the articles of the Law on Non-Profit Organizations, related to the public corporations, paying special attention to the issues of corporate decision-making, control functions over other business entities, interaction with public authorities, accountability and transparency of activities, corporations’ management responsibility for performance results, procedures on reorganization and liquidation.

### 5.3. Seizure and Reserving of Land Plots by the State

The problem of compulsory seizure, by the State, of land plots<sup>73</sup> from their owners, possessors and leasers – private persons is presently one of the most acute, in view of the growing number of big public and private projects requiring the attraction of additional resources, including land.

It is rather obvious that the necessary precondition for the State's successful activity in this sphere is the existence of an adequate balance between public and private interests, which can be achieved only in the presence of the following conditions:

- transparency of the State regulation of the grounds for and procedures of seizure;
- a limited list of grounds for seizure of land, and their concrete character;
- true opportunities for receiving, within a minimum period of time, of compensation for a seized land plot and the losses thus incurred, calculated on the basis of property's market value;
- true opportunities for recalling the unlawful decisions and provisions adopted by officials;
- efficient administrative control, with bringing the officials making decisions in the domain of seizures of land plots to responsibility for their violations and misdeeds.

Today there exists quite an impressive number of legal and other problems associated with seizures of land by the State, which hinder the realization of public interests with due regard for the rights and interests of private persons, as well as for the land market's development and its participants, while at the same time being conducive to an increasing number of violations in the domain of granting and seizing of land plots.

#### 5.3.1. Vagueness of the Rights of the State and the Rights of Owners, Possessors and Leasers of Land Plots in the Domain of Seizures of Land Plots for State or Municipal Needs, and Reserving of Land

The practices of arbitration in respect of seizure of land for public or municipal needs cannot as yet be regarded as widespread. However, the high percentage of disputable legal relations arising in connection with this issue in Moscow is quite noteworthy, which has been largely associated with the high concentration of capital and high profits from the use of land there, as well as better developed land and urban development regulations and the availability of "shadow services market". Most of these factors are also operative in Sochi, where the preparations for the Olympic Games are currently under way.

The existing vagueness of law in the domain of seizure of land for state and municipal needs has been induced by several factors. The currently adopted version of the RF Land Code envisages a whole range of circumstances to serve as the grounds for seizure of land for state or municipal needs. These can be the land plots needed for the fulfillment of RF international obligations (Item 1 of Article 49 of the RF LC), for the construction of various objects: the federal power supply system, transport systems, municipal systems for the supply of electric energy, gas and water, motor roads, bridges and other transport engineering structures, etc.

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<sup>73</sup> Seizure of land in this case is understood as enforced termination of both property rights and the right of permanent (or in perpetuity) use of a land plot, the right of its inheritable possession for life, the right of lease, and the right of uncompensated fixed-term use of a land plot.

(Item 2 of Article 49 RF LC). It would be impossible to dispute the necessity of placing such objects and the associated seizure of land plots; however, in order to protect the rights of owners and possessors of land, it seems equally necessary that the responsibility of RF bodies of state authority and of those of RF subjects to publish no later than one year in advance their decisions and plans in respect of seizure of land should be legislatively consolidated. The owners and possessors of land plots should be endowed with the right to dispute such decisions not only in connection with their disagreement and the size of compensation to be paid, but also with the absence, in their opinion, of the necessity to adopt a specific decision resulting in the termination of the rights to a land plot. Such suits (or complaints) can be collective.

One should also note here the possibility to seize land in cases connected with “other circumstances” which, depending on land being federal or municipal property, or property of a RF subject, can be established by federal laws or laws of RF subjects (Item 3 of Article 49 of the RF LC). In fact, this means that the State has virtually unlimited opportunities for introducing any new grounds for seizure of land, if this decision is going to be consolidated by a federal law or a law of a RF subject. This situation is contrary to the conditions consolidated by those same lawmakers in Part 1 of Article 49 of the RF LC, which stipulates that seizure of a land plot for state or municipal needs represents an exception, that is, under a general rule such seizures should be avoided.

Similar legal norms, which envisage as the grounds for seizure of land “other cases envisaged by federal laws”, are consolidated as the grounds for compulsory termination of the rights to land (Subitem 7 of Item 2 of Article 45 of the RF LC) and the termination of the rights of lease on a lessor’s initiative (Subitem 7 of Item 2 of Article 46 of the RF LC), and have been introduced by Federal Law of 18 December 200, No 232-FZ. Thereby extremely comfortable conditions have been created for finding solutions to the problems faced by the State at different levels. However this vagueness, no doubt, is generally conducive to a lower degree of protection of the rights of owners, possessors and leasers of land plots, because it makes their position highly vulnerable and dependent on officials, who presently only rarely are brought to responsibility for violations committed in the domain of land’s granting and seizure.

The grounds envisaged for seizure of lands for state or municipal needs, from May 2007 onward, have become identical to those for reserving land plots being owned or utilized by physical or juridical persons<sup>74</sup>. Federal Law No 69-FZ on reserving, adopted as of 10 May 2007<sup>75</sup>. does not contain any of the provisions regulating the order and procedure for reserving land plots, which were suggested by the RF Ministry of Economic Development and Trade. This Law simply stipulates the possibility, per se, of limiting some of the rights of owners, users, possessors, and leasers of land plots (the right to erect dwellings, production, cultural-domestic, and other buildings, as well as the right to conduct irrigation, drainage, crop-engineering, and other soil conservation work, construct ponds and other similar objects (Subitem 2.3 of Article 56.1, and Article 40 of the RF LC), and consolidates several fundamental provisions concerning the reserving of land. Thus, the reserving of a land plot can serve as the grounds for a refusal to grant land to the ownership of persons (Item 4 of Article

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<sup>74</sup> For the lands in state or municipal ownership, which are not used by any persons, a broader list of grounds for the reserving of lands and a longer period of reserving are envisaged.

<sup>75</sup> Federal Law “On introducing changes into individual legislative acts of the RF in the part of establishing the procedure for reserving lands for state or municipal needs”.

28 of the RF LC). The maximum period of reserving cannot exceed 7 years in respect of lands being in state or municipal ownership and not granted to citizens and juridical persons; in certain cases, the 20-year period of reserving is applied (Item 3 of Article 70.1 of the RF LC). Besides, the reserving of lands is allowed in the zones of planned placement of capital construction objects for state or municipal needs (Item 2 of Article 70.1 of the RF LC). For example, in Moscow the possibility of this type of reserving of land (including with subsequent seizure) with the purpose of placing capital construction objects has been introduced by the City Government's Decree from April 2007, in connection with acute shortage of construction sites<sup>76</sup>. The possessors of land plots will be offered a compensation; its size, however, will be determined by experts appointed by government officials.

The procedure itself for the reserving of lands for state or municipal needs must be determined by the government (Item 4 of Article 70.1 of the RF LC), and so far it has not been regulated in legislative terms. The approved legal norms, in contrast to those formulated in the draft law, envisage lesser limitations of rights as a result of reserving; however, it seems unjustified to have introduced reserving for purposes of "placement of capital construction objects". This has to do with the fact that, according to Director of the Federal Agency for Construction and Utilities S. Kruglik, the deficit of housing alone in Russia in 2006 was 1.6 billion sq m, while the construction rate amounted to 43.5 million sq m per year<sup>77</sup>. In order to provide solution to this problem, it is necessary to keep building millions of square meters of dwellings, in all the regions across the country, for several decades to come. If the solution is to be sought by means of seizure of the lands owned by persons, or granted to them for possession and use, this may become a mechanism for an administrative redistribution of the rights to land. Besides, the absence, in the law, of a mechanism for reserving has given rise to a high degree of vagueness in this sphere, which can be overcome only by consolidating, at the level of the RF Government, a coherent and transparent reserving procedure.

In June 2007, the period for presenting a suit for purchase of a land plot for state or municipal needs was extended from 2 to 3 years, to begin from the moment of sending to a land plot's owner a notification concerning the adopted decision with regard to the seizure of land (Article 282 of the RF Civil Code (CC))<sup>78</sup>. By the same law, the RF Civil Code was augmented by a norm prohibiting for the possessor of a land plot being held by right of its inheritable possession for life, to dispose that land plot, except in the event of the rights being passed as an inheritance (Article 267 of the RF CC).

In addition to the specified grounds for seizure of land as such, the very notion of "*state and municipal needs*" has become a problem that may give rise to numerous violations. In actual practice, as, for example, stipulated in a regulation issued by the Moscow City Government, state and municipal needs can be recognized as follows: the need to prepare the blueprints for and the construction of a mountain ski park; the need to prepare the blueprints for and the construction of a trade and entertainment center by a private person; and the creation of other objects recognized as necessary *for the implementation of the state target pro-*

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<sup>76</sup> Decree of the Government of Moscow "On the interaction between bodies of executive authority of the City of Moscow in respect of issues relating to seizures of land plots", of 10 April 2007, No. 257-PP.

<sup>77</sup> The deficit of housing in Russia at the present moment amounts to approximately 1.6 billion sq m // [www.nevastroyka.ru](http://www.nevastroyka.ru), 13 March 2006.

<sup>78</sup> Federal Law of 26 June 2007, No. 118-FZ, "On introducing changes into legislative acts of the RF in the part of bringing them in conformity with the RF Land Code".

*grams* adopted by the City of Moscow (Articles 4, 32 of the Law of the City of Moscow of 14 May 2003, No. 27, “On the Land Use and Urban Development in the City of Moscow”).

Target programs have various goals, they can be adopted in any number and touch upon any rights and interests. The available sources cannot provide adequate information as to their exact total number. Consequently, due to the vagueness of the notion of “state and municipal needs”, it can be interpreted broadly, and so RF subjects may adopt by-laws specifying more grounds than envisaged in the Land Code. It can be reasonably anticipated that in the nearest future the list of “municipal” needs necessitating seizure of lands will become much longer, as result of bodies of local self-government having been granted the rights to conclude contracts on the development of a built-over territory.

In this connection, a precise definition of the notion of “state and municipal needs”, coupled with the abolition, in respect of seizure of land, of all the norms concerning “other circumstances” and “other cases” envisaged in federal laws, would be conducive to far lesser opportunities for officials to make arbitrary decisions in the domain of seizure of land, as well as better protection of the rights of owners, possessors and users of land.

### 5.3.2. Expansion of the Powers of State Bodies in the Domain of Land, in Absence of Efficient Mechanisms for Administrative Control

The newly introduced procedure for reserving of land envisages that, from May 2007 onward, the rights to reserving land belong both to federal bodies of state authority and the bodies of state authority of RF subjects, as well as to bodies of local self-government (Articles 9 – 11 of the RF LC, in the wording approved by Federal Law of 10 May 2007, No. 69-FZ<sup>79</sup>). In order to effectuate control over the activity of bodies of local self-government in the domain of seizure and reserving of land, federal authority has transferred to bodies of state authority of subjects of the Russian Federation the powers to control the compliance of bodies of local self-government with legislation on urban development (Item 1 of Article 6.1 of the RF Urban Development Code, in the wording approved by Federal Law of 18 December 2006, No. 232-FZ).

One of the mechanisms for controlling the activity of bodies of state authority and local self-government in this domain was to become, from 1 January 2008 onward, the responsibility to make decisions concerning seizures of land plots for state or municipal needs, as well as reserving of lands exclusively on the basis of territorial planning documentations approved by the RF Government (Item 4 of Article 9, and Article 11 of the RF Urban Development Code; Article 3 of Federal Law of 29 December 2004). Nevertheless, the entry into force of this provision, which was to be effectuated in May 2007, has been delayed until the approval of territorial planning documents, but no later than until 1 January 2010. Until that moment, the temporary procedure for coordinating the draft boundaries of the zones for planned placement of capital construction objects of federal, regional or local importance, envisaged in Article 3.1 of Federal Law of 10 May 2007, No. 69-FZ<sup>80</sup>, is to be complied with.

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<sup>79</sup> Federal Law “On introducing changes into individual acts of the RF in the part of establishing the procedure for reserving lands for state or municipal needs”.

<sup>80</sup> Federal Law “On introducing changes into individual acts of the RF in the part of establishing the procedure for reserving lands for state or municipal needs”.

Beginning from January 2007, the bodies of local self-government have been granted the right to make decisions concerning the development of a built-over territory, which can be initiated by a body of state authority of a subject of the Russian Federation, by a body of local self-government, or by a physical or juridical person on the basis of an urban development regulation, as well as local norms for urban development projects (Item 2 of Article 46.1 of the RF Urban Development Code), with the concluding of a contract concerning the development of a built-over territory with the winner in an open auction.

Due to absence of a specified notion of “municipal needs”, it can be stated with a high degree of probability that the land included in the contracts concerning the development of a built-over territory will, in fact, be seized, that is, the development of territories will actually be carried out by means of redistributing the existing rights of ownership, possession and use of land.

Besides, the State has attempted to transfer the rights of managing and disposing of federal lands (when they are not being used by citizens and juridical persons) to RF subjects, by means of incorporating such agricultural lands into the boundaries of inhabited localities for purposes of developing housing construction and building objects of social infrastructure<sup>81</sup>. On the whole, this initiative should be estimated as positive; however, the period of one and a half years for executing such legal powers – from 1 May 2007 to 1 November 2008 – is, perhaps, acceptable for administrative purposes, but is clearly insufficient for implementing large-scale projects. The side effect of this innovation has been the implementation of those projects that require the clearing of neighboring land plots. Resulting has been the seizure of the land plots being used by private persons and situated along the boundaries of federal lands.

On the whole, the distribution of powers between state bodies of different levels in the domain of seizure of land, considering the fact that a considerable portion of lands are still not subdivided into those belonging to the federal level, the level of a RF subject, or the municipal level (which represents the grounds for the functioning of a given body), so far has not been adequate for efficient decision-making in respect of the State’s goals of ensuring lawful and justified seizure of land. This can be explained both by the vagueness of the definitions of those land objects in respect of which such powers must be executed and by the lack of efficient mechanisms for administrative and judicial control over the legal acts being adopted by the bodies of authority of RF subjects and municipal entities, which quite often contrary violate the lawful rights and interests of the owners and possessors of land plots.

### 5.3.3. The Problems Faced by Owners, Possessors and Users of Land when Receiving Compensation for a Seized Land Plot, as well as for the Losses Incurred as a Result of Seizure of Land

Although the responsibility of the State to compensate in full for the losses resulting from the violation of rights of owners, possessors, users and leasers of land, including lost advantage, is consolidated by the Land Code (Item 1 of Article 62), and Article 63 the Land Code established guarantees of related rights in an event of seizure of land plots for state and

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<sup>81</sup> Article 3.2 of Federal Law of 25 October 2007, No. 137-FZ (as amended on 1 December 2007) “On the enactment of the RF Land Code”.



municipal needs<sup>82</sup>, in actual practice it is rather difficult to obtain the compensation for a seized land plot.

Quite often it happens so that the bodies of authority of RF subjects or municipal bodies of authority issue unlawful orders aimed at terminating the right of ownership, possession, or lease of land in an enforced procedure, in absence of the owner's consent and without complying with the conditions stipulated in the law.

Thus, for example, in the city of Moscow a decision was made to terminate the lease contract in respect of a land plot with a leaser who owned the building situated on that land plot, in order to grant the rights to the land plot to another person who was going to design and build a trade and entertainment center there. In this connection, the order of the Moscow Government contained a stipulation concerning the demolition of immovable property without granting to its owner a preliminary compensation of an adequate size, in violation of Articles 235, 239 of the RF CC, and of Article 35 of the RF Constitution. The representatives of the bodies of state authority, in substantiation of this order, pointed to the absence, in the document, of any stipulations as to an uncompensated seizure of land, while saying that the disputed resolution "regulates the preparation and making of the urban development documentation necessary for adopting the decision concerning construction, and points to the submission of the initial permitting documentation". In their opinion, from this it followed that no compliance with the requirements of the law in the part regulating the procedure for seizure of land was required. However, by decision of the Moscow Arbitration Court as of 20 February 2007 in respect of case No. A-40-75225/06-152-373, the Moscow Government's order was deemed to be null and void, and this decision was left without alterations by the appellate and cassational instances.

In December 2007 in Moscow, the City Urban Development Code was once again approved in the first reading. The Code is designed to unify several dozens of the existing city laws. Repeated declarations had been made as to the imminent adoption of the Urban Development Code; however, the rapid changes in federal legislation and the problems associated with the need to coordinate regional interests were hindering the smooth passing of the document.

Another "disguised" method of seizure of a land plot, which is being applied in actual practice, is the issuance by municipal bodies of an order envisaging the termination of the right *per se* of permanent (or in perpetuity) use of a land plot. In this connection it often happens so that this issued legal act violates the compulsory procedure for terminating the right of use of land established by the RF Land Code (Article 45, 54). One example is the Decree of the FAC of the Far-Eastern Okrug of 6 November 2007 in respect of case No. F03-A51/07-1/4389.

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<sup>82</sup> Article 63 of the RF Land Code consolidates the following guarantees of the rights to land during the seizure of land plots for state or municipal needs:

- granting, prior to seizure (or purchase), in accordance with the desire of the persons from whom land plots are seized (including by purchase), of land plots of equal value;
- effectuation of seizure of land plot after compensation of the value of dwelling, production, and other buildings, structures, and installations situated on the land plots being seized, including lost advantage.

Besides, to **the owner** of a land plot being seized for state or municipal needs, together with these guarantees, **the market value of that land plot** must be compensated, unless a land plot of equal value was granted to him free of charge in ownership (Item 4 of Article 63 of the RF LC).

From February 2007 onward the losses incurred in connection with the issuance of an unlawful legal act in the domain of land relations are to be compensated not by the state body that had issued such an act, but by the RF Treasury (Article 61 of the RF LC, as amended by Federal Law No. 21-FZ of 28 February 2007).

One more difficulty in receiving compensation for a seized land plot, which may arise in some instances, is the contesting, by a state body, of the very fact of lawful possession of a land plot. In an event of the recognition of such a fact, an enterprise will be deprived of the right to receive any payments in connection with the seizure of land. Such a situation is associated with the existence of a considerable quantity of lands being used by enterprises and organizations by right of permanent (or in perpetuity) use, or of uncompensated fixed-term use. In order to confirm the fact of their lawful possession of land, the enterprises sometimes are forced to recall the "history of a land plot" from the 1960s and until the present time, and to prove numerous facts of legal succession (for example, Decree of the FAC of the Moscow Okrug of 19 October 2007, No. KG-A40/8939-07-1,2 in respect of case No. A40-68387/06-17-460). All this significantly complicates and lengthens the procedure for receiving compensation, and sometimes makes it altogether impossible, because any gaps and formal inconsistencies in the "history" may be used as grounds for recognizing the fact of unlawful possession of land and, as a consequence, the absence of any rights to receive compensation for its seizure.

Besides, the State has adopted norms designed to limit the rights of private persons in the domain of obtaining fair compensation in an event of seizure of a land plot. Thus, for example, from 1 January 2008, when lands are seized for state or municipal needs, their owners, possessors, users and leasers will receive no compensation for loss of agricultural production (Item 4 of Article 32 of the RF Land Code, in the wording approved by Federal Law of 18 December 2006, No. 232-FZ). The seizure of agricultural lands is currently being done rather actively, in connection with the expansion of the boundaries of cities and megapolises, the latter being very willing to develop the territories formerly belonging to collective and state farms.

The size of compensations for loss of agricultural produce, according to some estimations, were considerable<sup>83</sup>, and the procedure for obtaining them very difficult. This was conducive to efficient protection of agricultural lands from seizure for state needs. In Krasnodar Krai, the agroindustrial complex represents the foundation of the region's economic potential, and in the region of Sochi there still exist agricultural zones<sup>84</sup>. But in Moscow, for purposes of building social infrastructure objects, the land plots of former collective and state farms are being actively developed.

#### 5.3.4. The Introduction of a Special Procedure for Seizure of Land Plots in Krasnodar Krai in Connection with the Conduct of the Olympic Games in the City of Sochi

Today, one of the most vital problems in the domain of land relations is represented by seizure of land in Krasnodar Krai in connection with the construction of sports facilities for

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<sup>83</sup> *Kommentarii k st. 58 Zemel'nogo kodeksa RF*. See: *Kommentarii k Zemel'nomu kodeksu RF s postateinymi materialami i sudebnoi praktikoi*. [Commentary to Article 58 of the RF Land Code. See: Commentary to the RF Land Code, with materials to each Article and judicial practices] / Ed. by S. A. Bogoliubov // [www.garant.ru](http://www.garant.ru).

<sup>84</sup> [www.sochiadm.ru](http://www.sochiadm.ru).

the Olympic Games in the city of Sochi. In December 2007, Federal Law of 1 December 2007, No. 310-FZ<sup>85</sup>, was adopted, which determined, among other issues, also the special procedure for seizure of land. It is envisaged that, when lands are seized in order to build thereon the facilities for the Olympic Games, the norms stipulated in the Land Code are applicable only when not otherwise determined by the Law on the organization and conduct of the Olympic Games.

The newly adopted law introduces in Krasnodar Krai, for the period from 1 January 2008 until 1 January 2012, a different procedure for seizure of land, which envisages the minimum periods for effectuating each phase of the procedure of seizure. Thus, the timeline for the notification of a seizure is 7 days from the moment of making the related decision (under the RF Land Code – 1 year); for the publication of the decision concerning reserving/seizure – 7 days from the moment of it being made (there is no corresponding norm in the RF Land Code); for concluding a contract with a valuer – 7 days from the day of making the decision concerning seizure; for preparing a draft agreement and acquainting with it the person from whom a land plot is being seized – 20 days from the day of receiving the resolution concerning evaluation (no such provisions concerning timelines exist in the Land Code, either) (Items 18–24 of Article 15 of Federal Law No. 310-FZ).

The evaluation of the land plot to be seized and the losses thus incurred is to be made by a valuer, the contract with whom will be concluded by the Administration of Krasnodar Krai and the State Corporation “Olimpstroi” (Item 21 of Article 15 of Federal Law No. 310-FZ). No timelines are established for the payment of compensation for a seized land plot, although the RF Land Code allows the seizure of a land plot for state needs only after the granting, at the wish of the persons from whom seizure of land plots is being made, including by purchase, of land plots of equal value, and the compensation of the value of dwelling, production, and other buildings, structures, and installations situated on the land plots being seized; and compensation of losses in full, including lost advantage (Item 1 of Article 63 of the RF LC). However, neither the preliminary granting of a land plot of equal value, nor the preliminary compensation of losses is envisaged in the “Olympic Law”.

The only way for the owner and for some categories of possessors of land to avoid its seizure would be the financing and construction, on their own, of a facility intended for the Olympic Games on their land plots (Item 2 of Article 15, and Item 15 of Article 14 of Federal Law No. 310-FZ). The idea itself and conditions to be complied with in this connection appear to be bizarre, at the very least.

Besides, such decisions concerning the seizure of land in Krasnodar Krai are not subject to State registration by the agencies responsible for the registration of the rights to immovable property, which in the whole territory of the RF represents a compulsory condition for the transfer of rights to immovable objects and the transactions involving such objects.

In an event of disagreement of an owner or possessor of land with the proposed conditions of seizure, within two months from the day on which he was notified of the forthcoming seizure of land, the Administration of Krasnodar Krai or a body of local self-government have the right to appeal to a court of justice with a suit in respect of seizure of each of the land plots and (or) the immovable objects situated on them (Item 31 of Article 15 of Federal Law No.

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<sup>85</sup> “On the organization and conduct of the 22<sup>nd</sup> White Olympic Games and the 11<sup>th</sup> Paralympic Games – 2014 in the city of Sochi, the development of the city of Sochi as a mountain climate health resort, and the introduction of changes into individual legislative acts of the RF”.

310-FZ). In this connection, the judicial decision concerning the seizure of land plots and (or) the immovable property objects situated on them is subject to immediate execution (Item 33 of Article 15 of Federal Law No. 310-FZ). In other words, while the owner or possessor of a land plot is appealing for the recall or alteration of the judicial decision rendered, his land plot will be kept in the ownership of the federal authorities or the authorities of a RF subject and being used by them in accordance with the plan of preparations for the Olympic Games for building sports facilities. Given such circumstances, it would be naïve to hope for a recall of the judicial decision and a reorganization of the seizure of the land plot on conditions differing from those that have been initially consolidated.

As for the effectuation proper of the payments of compensation for the land plots being seized, these will be made by either the State Corporation or by the organizations carrying out the construction of objects for the Olympic Games (Item 32 of Article 15 of Federal Law No. 310-FZ). The procedure for concluding agreements as envisaged in the law is such that both the State Corporation and the construction organizations may initiate the lowering of the value of purchase, while the owners and possessors of land have no such opportunities.

From all the aforesaid it follows that the necessary condition, on which the adequacy of the compensation for the land plots being seized and the associated losses is going to depend, will be efficient administrative control, to be effectuated by the Government alone. The law *does not provide for any mechanisms to ensure the protection of the interests of owners and possessors of land, nor for any mechanisms to prevent violations on the part of the officials* on whose decisions will depend the determining of the market value of land, the method of evaluation, the procedure for paying compensation, the procedure for granting another land plots in lieu of those being seized, or the settlement of some other issues. The legal regulation of the seizure of land in Krasnodar Krai is organized in such a way that the owners, possessors and leasers of land enjoy only minimum opportunities for influencing the situation in an event of any unjust (in their opinion) decision being made. The shortened periods for nearly all the phases of the procedure of seizure of land are not conducive to improving the situation, either. The powers to seize and reserve land plots in federal ownership have been granted to the Administration of Krasnodar Krai, thus making it possible, when necessary, to shift the political responsibility for possible violations of civil rights onto the authorities of a RF subject.

The necessity of making decision in an operative fashion in respect of the preparation for the Olympic Games has been the reason for adopting legal norms that ensure the priority of public interests, while ignoring private interests in the domain of seizure of land. According to First Vice Governor of Krasnodar Krai Alexandr Remezko, a total of more than 3,000 land plots will be seized in order to place, in the city of Sochi, all the planned sports facilities for the 2014 Olympic Games<sup>86</sup>. As declared by General Director of the Sochi-2014 Organizing Committee D. Chernyshenko, the seizure of lands in the city of Sochi is a “concocted, purposely overblown problem, in order to serve some other interests”. Besides, he noted that he expected few scandals in connection with seizures of lands, because “95% of the territories intended for construction belong to the State, and therefore, in principle, the field for conflict

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<sup>86</sup> *Vstupil v silu osobyi poriadok iz "iatiia zemel' pod ob"ekty Olimpiady-2014*. [“The special procedure for the seizure of lands for objects intended for the 2014 Olympic games has come into force”] //www.rosbaltssouth.ru, 01.01.2008.

is very small”<sup>87</sup>. It is noteworthy that the possession and/or use of the majority of land plots in Russia is based on the right of permanent (or in perpetuity) use of a land plot, the right of its inheritable possession for life, the right of lease, and the right of uncompensated fixed-term use and lease. In all these instances, the rights of ownership most often belong to the State. The right of ownership of land in this case cannot be applied as a valid criterion for determining the scope of potentially conflict-mongering legal relations in the domain of seizure of land plots. Besides, the following question would be quite logical to ask: if the share of deals potentially fraught with conflict is indeed as small as pointed out by the director of the Olympic Committee, why was it necessary to introduce in Krasnodar Krai such a tough administrative procedure for purchasing land, with no regard for the interests of its owners, possessors and leasers?

Such arguments on the part of the Sochi-2014 Organizing Committee’s General Director are, most probably, associated with the fact that the State will be striving to purchase only the land in private ownership<sup>88</sup>. As for the lands in permanent (or in perpetuity) use, in inheritable possession for life, and in uncompensated fixed-term use and lease, these will be seized with the granting of other land plots, with their possessors and users being deprived of the right of choice of a land plot (Item 30 of Article 15 of Federal Law No. 310-FZ).

According to the data presented by Minister for Regional development D. Kozak, “it is planned to settle the issue of formalizing the land plots for the construction of 216 Olympic objects”. As can be judged by the preliminary data, this will involve 4,200 hectares of land, of these more than 3,500 hectares being in state or municipal ownership, and 679 – in that of private persons and juridical entities. In February 2008 the Administration of Krasnodar Krai must conduct full inventory of lands. Besides, according to the Minister, everything will be done in order to ensure the protection of the rights of citizens, while the purchase of lands from citizens will be effectuated “at a fair market price”, the control over this procedure being executed by the State Corporation “Olimpstroi”<sup>89</sup>.

In all probability, the special mechanisms for seizure of land envisaged in the aforesaid law will be very attractive for regional and municipal authorities. In March 2008 the Commission for Urban Development under the Moscow City Duma approved the draft amendments to Article 49 of the Land Code submitted by Moscow Mayor Yu. Luzhkov. The main purpose of this draft law is to extend the list of cases when the authorities will be allowed to seize land plots from their owners. At present such a seizure can be possible only when performing the tasks assigned to the federal level (the construction of power plants, national defense and security objects, transportation routes; the use of nuclear energy; and protection of the state border.). The amendments proposed by the Mayor of Moscow envisage more grounds for seizure of land: the necessity to construct “objects of social infrastructure”, including multi-storied apartment buildings, while the construction will be funded from the federal budget, the budget

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<sup>87</sup> *Chernyshenko: problema iz "iatiia zemel' v Sochi "nadumana"*. [Chernyshenko: the problem of the seizure of lands in Sochi is a “concocted” one’ // *Ekho Moskvy* [The Echo of Moscow] / www.gazeta.ru, 03.10.2007.

<sup>88</sup> Thus, the law envisages that, in an event of concluding an agreement concerning seizure of land, the provision as to the buyout price of the land plot and/or of the immovable objects situated on it shall be compulsory only if “the land plots and (or) the objects of immovable property situated thereon are in private ownership” (Subitem 1 of Item 25 of Article 15, No. 310-FZ).

<sup>89</sup> *Kozak: vykupat' zemliu v Sochi budut "po spravedlivoi rynochnoi tsene*. [Kozak: land in Sochi will be bought out “at a fair market price” //www.rosbalt.ru, 05.02.07.

of a RF subject, or local budget<sup>90</sup>. In fact, this means the creation of a “simplified” scheme for the seizure of a land plot *as a general rule*, including under an existing residential building and for new construction, including for commercial use. The possibilities for obtaining a fair market price and ensuring the judicial protection of the residents being evicted (the owners of dwellings) will thus become very slippery, while the status of a social dwelling can easily be forfeited. Evidently, no more comments are needed.

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Thus, some conclusions can be drawn. The latest changes introduced in state regulation in the domain of seizure and reserving of land are aimed at creating mechanisms for large-scale redistribution of ownership and other rights to land both between different levels of authority and between private persons and the State. In this connection, the powers in the domain of seizure and reserving of land have now been granted to state bodies of all levels, which corresponds to the scope of the problem. However, due to a variety of factors (lack of efficient mechanisms for judicial and administrative control in respect of seizures of land, corruption, and the limitations and gaps existing in state regulation), fertile ground has been provided for misdeeds and violation of the rights of private persons in favor of public interests, or interests disguised as such.

One of the reasons for the emergence of this situation have been the list of the grounds for seizure of land for state and municipal needs, as determined by the RF Land Code, which can be interpreted broadly and grants to the State and to RF subjects the right of unlimited extension of this list. Actually, no one is speaking any more of the minimum necessary violation of private rights by the State; the current legal regulation of this issue allows for the State to impinge on private rights and interests at the levels of federal and municipal authorities, as well as at the level of a RF subject, without any risk of being brought to responsibility for such actions. Given these conditions, operative economic issues will be settled to the detriment of the development of the institution of private property and other rights of possession and use, as well as to the detriment of the of the constitutional rights of the citizens of Russia.

Thus, the most important conditions for improving the efficiency of the State’s activity in this sphere are as follows:

- the consolidation, in the RF Land Code, of a final list of grounds for seizure of land for state and municipal needs, with no possibility of its broader interpretation;
- the adoption, by the RF Government, of such a procedure for reserving of lands that will require the verification of the grounds for making such a decision at the federal level;
- strengthening of the supervision, by the federal government and procuratorship bodies, over the adoption, by RF subjects and municipal bodies, of legal acts concerning the reserving and seizure of land plots, and the introduction of measures aimed at their abolition or at bringing them in conformity with federal legislation;
- the introduction, into the RF Land Code and the RF Government’s Decree concerning the reserving of lands, of norms envisaging preliminary publication of the plans for reserving and seizure of lands at the level of a RF subject or a municipality, as well as the consolida-

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<sup>90</sup> See *Kommersant*. 2008. 5 March.

- tion of the possibility to appeal against the decisions concerning planned seizure and reserving;
- the introduction, into the Land Code, of the notion of “state and municipal needs”, without any possibility of its broader interpretation;
  - the adoption of measures aimed at preventing violations in the domain of seizure and granting of land plots, including misdemeanors in office;
  - promotion of the process of delimitation of lands, as a factor conducive to the execution, by state bodies of different levels, of their powers in respect of land;
  - the adoption, for purposes of it being applied by arbitration courts and courts of general jurisdiction, of an explanation of the procedure for establishing the fact of lawful possession of a land plot, which will recognize, as the sufficient and necessary proof of the possession and use of land, the acts adopted by bodies of state authority, contracts and other documents issued to persons in accordance with the law, say, after 1990; this will make it unnecessary, for persons, to recall and substantiate the lawfulness of their rights of possession and use of a land plot since the 1960s, thus limiting the opportunities for depriving, on formal grounds, the owners and possessors of land of compensation for seized land;
  - the adoption of measures aimed at ensuring the purchase of land by municipalities and RF subjects;
  - the adoption, at the federal level, of a decree consolidating the evaluation of lands in Krasnodar Krai on the basis of its market price, with ensuring adequate control over its implementation, as well as allocating the funds necessary for the payment of compensations.

#### **5.4. Russia’s Housing Market**

In 2007, the national market for housing found itself affected by alternate factors of socio-economic development.

On the one hand, as in the past years, GDP was likewise growing at a high (8.1%) rate, while investment posted yet a greater (20%) growth rate, the budgetary system remained stable, foreign investment and capital continued to pour in, and the net value of the latter proved to be record-breaking. The population’s welfare was on the rise, which was evidenced by growth in real disposable incomes (up 10.4%) and real salaries and wages due (up 16.2%). These favorable developments were propelled by the growing export proceeds in forex equivalent, as the price for Urals on the world market was soaring practically during the whole year, with short breaks in August and December.

On the other hand, however, financial stability was challenged by a clear acceleration of inflation rates on the consumer market, which became particularly notable between the late summer and early spring. As a result, it became evident by the end of the year that the annual inflation rates had accelerated for the first time since the late-1990s. In the late-2007 Russia’s economy began to sense echo from crisis developments in the world economy, which manifested themselves in the decline of stock market indices and some tightening of the consumer loan and mortgage conditions for the population.

Meanwhile, the country held stability and a relative predictability on the domestic political arena, which helped maintain a generally favorable background for the economy on the whole, including, in particular, behavior of players on the real estate market.

#### 5.4.1. Price Situation: Main Outcomes of 2007

The general characteristic of the situation on the housing market is reflected by the data of *Table 16*, which presents the value of the average specific offer price for apartments in Russian cities in the late 2004, 2005, 2006 and 2007 (in USD equivalent) calculated by data provided by the certified RRG real estate market analysts<sup>91</sup>.

Table 16

#### Dynamic of the Average Specific Apartments Offer Price in 2004–2007

City (region)	USD/ sq.m				Index			
	December 2004	December 2005	December 2006	December 2007	December 2005 to December 2004	December 2006 to December 2005	December 2007 to December 2006	December 2007 to December 2004
Moscow*	1,953	2,658	4,828	5,429	1.361	1.816	1.124	2.780
St. Petersburg*	1,083	1,180	2,593	3,200	1.089	2.197	1.234	2.955
Yekaterinburg	882	1,062	2,415	2,615	1.204	2.274	1.083	2.965
Moscow oblast**	908	1,121	2,522	2,536	1.235	2.250	1.006	2.793
Novosibirsk	748	1,012	1,658	2,350	1.353	1.638	1.417	3.142
Perm	680	882	1,430	2,258	1.297	1.621	1.579	3.321
Tyumen	...	864	1,600	2,192	...	1.852	1.370	...
Krasnodar*	720	790	1,370	2,088	1.097	1.734	1.524	2.900
Krasnoyarsk	763	842	1,115	2,016	1.104	1.324	1.808	2.642
Ufa	766	997	1,729	2,000	1.302	1.734	1.157	2.611
Yaroslavl	566	876	1,758	1,910	1.548	2.007	1.086	3.375
Kemerovo	...	...	1,369	1,883	...	...	1.375	...
Izhevsk	663	982	1,837	1,865	1.481	1.871	1.015	2.813
Tver	542	688	1,370	1,833	1.269	1.991	1.338	3.382
Rostov-on-Don	656	830	1,385	1,770	1.265	1.669	1.278	2.698
Ryazan	...	...	993	...	...	...	...	...
Penza	480	536	890	...	1.117	1.660	...	...
Ulyanovsk	405	486	859	1,243	1.200	1.767	1.447	3.069
Petropavlovsk*	595	711	952	1,128	1.195	1.339	1.185	1.896
Sterlitamak (Bashkortostan)	...	...	867	927	...	...	1.069	...
Shakty (Rostov oblast)	...	...	480	...	...	...	...	...

\* – Cities where prices are quoted in USD.

\*\* – The average weighted specific offer price for apartments across 100 locations (cities and settlements), in USD equivalent.

<sup>91</sup> The authors' calculations are based upon monthly data on the average specific housing offer prices in Russia's cities presented by certified by the Russian Realtor Guild analysts of the real estate market: Lutskov V.M., Kazimir L.M. (ACC of MIEL holding), Sternik S/G. (Sternik's Consulting Ltd.), independent analysts Beketov A.G., Sapozhnikov A.Yu. (all from the city of Moscow and Moscow oblast); Khorkov M.A., Antasyuk A.A., Tukhasvili G.T. (all – RITS-UPN, Yekaterinburg), Stepanova A.A. (SAN Expert, Ufa), Cheremnykh A.M. (UK Assa-Stroy, Izhevsk), Smelov P.L., Vysokaya T.V. (Sibakademstroy Nedvizhimost), Ermolayeva E.A. (Rid Analitics) (all Novosibirsk), Troshina V.M. (CG LEX, Tyumen), Chumakov A.M. (Titul), Proskurin E.A. (Yugro) (all Rostov-on-Don), Davletshina R.M. (Perspektiva-Konsalting), Epishina E.D. (all Perm), Kaminsky V.N. (TITAN, Tver), Blinkov S.V. (IKPKG "Zhilye"), Kalinina E.V. (Megapolis-Nedvizhimost) (all Penza), Yarsina N.A. (Tsentral nedvizhimosti), Isaeva M.A. (Zolotoy Klyuch) (all Ulyanovsk), Eydlina G. Yu. (Rielti, city of Shakty, Rostov oblast), Reshetnikov M.A. (Agentstvo "Maximum", Tomsk), Trushnikov AV. (B.I.N.-Expert, Sterlitamak), as well as analysts who are currently undergoing the certification procedure: Zyryanova G.N. (KuzbassInveststroy, Kemerovo), Burmakina E.V., Churinova I.V. (AREVERA) (all Krasnoyarsk), Afanasyeva N.N. (Adalin-Expertiza nedvizhimosti, Yaroslavl). The analysts provided the data in the currency typical of their respective cities' markets. In addition, the authors employed official data on the average monthly USD rate, inflation, and other macroeconomic indicators published by CBR of RF.



So, according to the 2007 results, the greatest price rise rates for housing (over 1.5 times) were noted in Krasnoyarsk (at 81%), Perm (58%), Krasnodar (52%), followed by the group of cities where the price rise increment over the year was in the range between 30 and 45%: those were Ulyanovsk (at 45%), Novosibirsk (42%), Tyumen (42%), Kemerovo (7.5%), Tver (34%). All other cities of the sample (*Table 16*) posted the price rise under 30%, while in Moscow oblast's cities and Izhevsk price levels appeared just slightly different from that of December 2006. In 2007 to 2006 the price rise slowed down in most cities, except for Krasnoyarsk, while the slowdown in prices in Perm proved to be symbolic (58% in 2007 vs. 62% in 2006).

Meanwhile, it is worthwhile to note that despite the deceleration of the 2007 price rise rates for housing in most cities, in the city of Moscow prices exceeded USD 5,000/sq.m., in St. Petersburg – USD 3,000/sq.m., in a group of cities (Perm, Tyumen, Krasnoyarsk, Tyumen, Novosibirsk, Krasnodar) – 2,000/sq.m., and in Ulyanovsk and Petropavlovsk-Kamchatsky – 1,000 USD/sq.m. In Yekaterinburg, the price level for housing began to overrun the Moscow oblast ones, while the situation had been opposite in the past three years.

All the cities of the sample can be split into four groups by the nature of the price dynamics in USD equivalent:

- 1) cities where prices were stable from the early 2007, i.e. they fluctuated insignificantly relative to December of the prior year (or even declined), with a growth noted over recent months: the city of Moscow, Moscow oblast, Yekaterinburg, Izhevsk, Yaroslavl;
- 2) cities where prices were on the rise in the beginning of the year, followed by their stabilization: Ulyanovsk, Ufa, Sterlitamak, Tyumen, Petropavlovsk-Kamchatsky;
- 3) cities where prices were on the rise in the beginning of the year, followed by their stabilization and consequent growth renewal: St. Petersburg, Novosibirsk, Rostov-on-Don, Tver, Perm, Krasnodar;
- 4) cities that displayed a price rise: Krasnoyarsk (where prices posted an extraordinary rise).

In terms of the three year (2005–07) interval, prices more than tripled in Tver, Yaroslavl, Perm and Novosibirsk; rose at 2.9–3 times – in Yekaterinburg, St. Petersburg, and Krasnodar; 2.8 times – in Izhevsk; 2.7–2.8 times in the city of Moscow and Moscow oblast; 2.6–2.7 times – in Rostov-on-Don, Krasnoyarsk, and Ufa; finally, less than doubled – in Petropavlovsk-Kamchatsky.

Whilst considering real (less inflation effects) housing prices, a particular attention should be paid to the dynamic of main macroeconomic indicators. Last year, consumer prices rose at 11.9%. The December 2007 average nominal USD/Rb. rate was 24.57 vis-à-vis 26.29 Rb. in December 2006. So, the 2007 USD/Rb. depreciation index accounted for 0.935, which means appreciation of the Rb. towards USD. Accordingly, the USD inflation index in Russia made up 1.197. The USD continued to depreciate in Russia, and its 2007 purchasing power sank roughly to the same degree as in 2006 (over 16%). On the three-year interval of 2005–07, the Rb /USD depreciation rate was 0.88, while the USD inflation index – 1.537, and the USD purchasing power dropped nearly at 35%.

As concerns the index of real (cleared from inflation of the both currencies) prices for housing (the IGS index<sup>92</sup>), its final values by 2005, 2006, 2007, as well as 2005–2007 relative to December 2004, across cities of the sample are given in *Table 17*.

*Table 17*

**Dynamics of the Average Specific Apartments Offer Price in 2004-2007**

City (region)	Nominal price index				IGS index			
	December 2005 to De- cember 2004	December 2006 to De- cember 2005	December 2007 to De- cember 2006	December 2007 December 2004	December 2005 to De- cember 2004	December 2006 to De- cember 2005	December 2007 to De- cember 2006	December 2007 December 2004
Moscow	1.361	1.816	1.124	2.780	1.265	1.520	0.939	1.809
St. Petersburg	1.089	2.197	1.234	2.955	1.013	1.838	1.031	1.923
Yekaterinburg	1.204	2.274	1.083	2.965	1.119	1.903	0.905	1.929
Moscow oblast**	1.235	2.250	1.006	2.793	1.148	1.882	0.840	1.817
Novosibirsk	1.353	1.638	1.417	3.142	1.257	1.371	1.184	2.044
Perm	1.297	1.621	1.579	3.321	1.205	1.356	1.319	2.161
Tyumen	...	1.852	1.370	...	...	1.550	1.145	...
Krasnodar*	1.097	1.734	1.524	2.900	1.020	1.451	1.273	1.887
Krasnoyarsk	1.104	1.324	1.808	2.642	1.026	1.108	1.510	1.719
Ufa	1.302	1.734	1.157	2.611	1.210	1.451	0.967	1.699
Yaroslavl	1.548	2.007	1.086	3.375	1.439	1.679	0.907	2.196
Kemerovo	...	...	1.375	...	...	...	1.149	...
Izhevsk	1.481	1.871	1.015	2.813	1.376	1.566	0.848	1.830
Tver	1.269	1.991	1.338	3.382	1.179	1.666	1.118	2.200
Rostov-on-Don	1.265	1.669	1.278	2.698	1.176	1.396	1.068	1.755
Penza	1.117	1.660	...	...	1.038	1.389	...	...
Ulyanovsk	1.200	1.767	1.447	3.069	1.115	1.479	1.208	1.997
Petropavlovsk- Kamchatsky	1.195	1.339	1.185	1.896	1.111	1.120	0.990	1.234
Sterlitamak (Bash- kortostan))	...	...	1.069	...	...	...	0.893	...

As evidenced by data of *Table 17*, the greatest real price rise rates for housing in 2007 were registered in Krasnoyarsk (over 1.5 times, followed by Perm (a. 32%), Krasnodar (over 27%), and Ulyanovsk (some 21%). The respective rates in Novosibirsk, Kemerovo, Tyumen, Tver, Rostov-on-Don, and St. Petersburg were under 20%, with St. Petersburg showing the most moderate price rise rate (3%). Meanwhile, there is a big group of cities whose real housing prices (inflation-adjusted) were on the decline – Moscow, Yekaterinburg, Ufa, Yaroslavl, Izhevsk, Petropavlovsk-Kamchatsky, and, finally, Moscow oblast where the IGS index value was the smallest one and roughly matched that of Izhevsk (0.84–0.85). Meanwhile, it should be noted that 2007 became the first calendar year out of the three-year interval of 2005–07 when the real housing prices were down.

<sup>92</sup> The IGS index is calculated by the following formula:  $IGS = \frac{I_{tr}}{I_{ir}} = \frac{I_{td}}{I_{id}}$ , where  $I_{tr}$  – Rb. denominated housing price index,  $I_{ir}$  – consumer price index,  $I_{td}$  – USD denominated housing price index,  $I_{id}$  =  $I_{ir} / I_{rd}$  – index of the USD inflation in Russia (relative to the consumer price dynamics),  $I_{rd}$  – Rb. depreciation against USD index.

Overall, by results of the noted three years the peak values of IGS index (between 2 and 2.2) were noted in Tver, Yaroslavl, Perm, and Novosibirsk. They were a bit lower (between 1.9–2.0) in Ulyanovsk, Yekaterinburg and St. Petersburg, while in Krasnodar, Izhevsk, the city of Moscow and Moscow oblast they accounted for a. 1.8, and in Rostov-on-Don, Krasnoyarsk and Ufa – between 1.7 and 1.8. It was Petropavlovsk-Kamchatsky where the real housing price rise rate was the slowest one (just slightly over 1.2 times).

The process of appreciation of the Rb. over recent years has made it appropriate to reference the data on housing prices in Rb. equivalent and compare the dynamics of price rise indices in USD with those in Rb. equivalent (*Table 18*). As a reminder, out of all the cities presented in the sample it was only three of them (Moscow, St. Petersburg, and Krasnodar), and Moscow oblast (due to its immediate proximity to Russia's capital) that have still stuck to the USD price quotations.

*Table 18*

**Comparative Dynamics of the Average Specific Apartments Offer Prices  
in USD and Rb. Equivalents in 2007**

City (region)	USD/sq.m.			Rb/ sq.m.		
	December 2006	December 2007	December 2007/December 2006	December 2006	December 2007	December 2007/December 2006
Moscow	4,828	5,429	1.124	126.93	133.01	1.048
St. Petersburg	2,593	3,200	1.234	68.17	77.76	1.141
Yekaterinburg	2,415	2,615	1.083	63.51	64.06	1.010
Moscow oblast	2,522	2,536	1.006	66.3	62.13	0.937
Novosibirsk	1,658	2,350	1.417	43.59	55.0	1.262
Perm	1,430	2,258	1.579	36.61	54.87	1.499
Tyumen	1,600	2,192	1.370	42.00	53.72	1.279
Krasnodar	1,370	2,088	1.524	36.02	50.74	1.409
Krasnoyarsk	1,115	2,016	1.808	29.31	54.29	1.852
Ufa	1,729	2,000	1.157	45.85	49.00	1.069
Yaroslavl	1,758	1,910	1.086	46.22	46.83	1.013
Kemerovo	1,369	1,883	1.375	36.00	45.76	1.271
Izhevsk	1,837	1,865	1.015	49.00	45.70	0.933
Tver	1,370	1,833	1.338	36.02	44.91	1.247
Rostov-on-Don	1,385	1,770	1.278	36.41	41.00	1.126
Ulyanovsk	859	1,243	1.447	22.58	30.55	1.353
Sterlitamak (Bashkortostan)	867	927	1.069	22.8	22.72	0.996

As in the case of IGS index, atop of the group of the leading cities in terms of the Rb.-denominated price rise for housing were Krasnoyarsk (1.85 times), Perm (1.5 times), and Ulyanovsk (at 35%). In Tyumen, Kemerovo, Novosibirsk and Tver, the price rise was within the range between 24 and 28%, in St. Petersburg and Rostov-on-Don – 10 and 15%, while the value of the index in Ufa, the city of Moscow, Yaroslavl and Yekaterinburg was under 7%. Finally, in Moscow oblast, Izhevsk and Sterlitamak the housing prices were down in absolute terms.

The price dynamics in Rb. equivalent displayed dynamics slightly differing from those in forex equivalent:

- 1) the first group (the city of Moscow, Moscow oblast, Yekaterinburg, Izhevsk, Yaroslavl) was also joined by St. Petersburg, while the dynamic somewhat changed, that is, the prices were stable and even declined in absolute terms (in Moscow oblast and Izhevsk);
- 2) the second group (Petropavlovsk-Kamchatsky, Ufa, Tyumen, Ulyanovsk, Sterlitamak) was joined by Rostov-on-Don, and the level of price rise indices declined;
- 3) the third group (Novosibirsk, Tver, Perm, Krasnodar) lost St. Petersburg and Rostov-on-Don that had moved to the first and second group, respectively;
- 4) the fourth group remained unchanged (Krasnoyarsk).

The above data evidence that after a rapid price rise in 2006 the housing markets in Russia's cities have stabilized, by and large, in 2007: stabilization was noted in the beginning of the year in the city of Moscow, Moscow oblast, Yekaterinburg, Izhevsk, and Yaroslavl, while in other cities (except for Krasnodar and Krasnoyarsk) stabilization occurred between May and June. Meanwhile, the length of stabilization was between 3–4 months and 10 months (the city of Moscow) and even 12 months (Moscow oblast, Izhevsk, Yaroslavl). Some cities (Moscow, St. Petersburg, Perm, Novosibirsk, Tver, Rostov-on-Don), as well as Moscow oblast, underwent a new price rise in the autumn 2007.

The causes for stabilization were already partly considered in some papers published back in 2006<sup>93</sup>.

The main cause was that after prices had skyrocketed in the previous 2–3 years buyers, whose savings proved to be insufficient to purchase housing (particularly with a mortgage back-up), were ultimately off the market.

Main peculiarities of the 2007 housing price dynamics were as follows:

- some differences in the dynamic and amount of the price rise in Rb. and USD equivalent driven by the Rb. appreciation against USD (at 9.4% as of the end-year);
- an additional fall in the value of the real price increment (exclusive of inflation of the Rb. and USD) vis-à-vis nominal prices in conjunction with a sudden rise in consumer prices (at 12% as of the late-2007);
- substantial differences in terms of moments of the start and length of stabilization and, consequently, between final values of annual price increments across different cities.

While the first two causes are considered in every possible detail in the frame of the analysis of macroeconomic indicators and indices of real (exclusive of inflation) housing prices (*Table 17*), the last one can be explained while examining price dynamics in the medium- and long-term retrospective.

#### 5.4.2. Regularities of the Advancement of the Housing Markets of Russia's Cities in the Medium Run

In 2005–07, the housing markets of Russia's cities witnessed a regular price rise cycle, which resulted in doubling and tripling offer prices (between 2.6 and 3.4 times). Considering results of the past three years, the sample of cities presented in *Table 1* can be broken into two subgroups: (1) Tver, Yaroslavl, Perm, Novosibirsk, and Ulyanovsk where prices more than tri-

<sup>93</sup> Sternik G.M. Tseny predlozheniya zhilya v gorodakh Rossii v 1990–2006 godakh: analiz i prognoz. – www.realtymarket.ru, January 2007. Malgynov G.N., Sternik G.M. Rynok zhilya//Rossiyskaya ekonomika v 2006 gody. Tendetsii i perspektivy (Issue 28). M., IET, 2007, p. 694–727.

pled; and (2) Yekaterinburg, St. Petersburg, Krasnodar, Izhevsk, the city of Moscow and Moscow oblast, Rostov-on-Don, Krasnoyarsk, and Ufa, where prices grew 2.6–3-fold<sup>94</sup>.

The price rise was noted in all these cities/ regions, albeit it appeared dysynchronous: during the first calendar year (2005) the increment rate varied from 9% (St. Petersburg) to 55% (Yaroslavl), while that over two years (2005–06) – between 46% (Krasnoyarsk) and 211% (Yaroslavl), and over three years (2005–07) – between 161% (Ufa) and 238% (Tver). Hence, the price dynamics over the three calendar years made it impossible to identify price rise regularities common for all the cities, thus necessitating an analysis of longer dynamic series.

The monitoring of housing conducted in Moscow since June 1990 and in other cities since 1992–99 provides an opportunity for an objective examination of the market's behavior on the basis of available dynamic series of the average monthly specific prices for apartments (*Table 19*).

*Table 19*

**Stages of Advancement of the Housing Market in Capital Regions  
and Their Duration in 1990–2006**

Name of the stage	Moscow	St. Petersburg	Moscow oblast
1	2	3	4
Start and take-off	June 1990 – March 1995	December 1991 – May 1994	...
Stabilization	April 1995 – August 1998*	June 1994 – October 1998**	December 1996 – July 1998***
Crisis	September 1998 – June 2000	November 1998 – October 2000	August 1998 – December 1999
Post-crisis renewal	July 2000 – December 2001	November 2000 – January 2003	January 2000 – February 2002
Stabilization-2002	January 2002 – August 2002	–	March 2002 r – July 2002
Jubilee rise****	–	February 2003 – August 2003	–
Oil-driven growth	September 2002 – June 2004	August 2003 – July 2004	August 2002 – September 2004
Stabilization-2004	July 2004 – July 2005	July 2004 – July 2005***	October 2004 – September 2005
Mortgage and oil- backed growth	July 2005 – June 2006	August 2005 – December 2006	October 2005 – September 2006
Transition to stabilization	July 2006 – December 2006	–	September 2006 – December 2006
Stabilization-2007	December 2006 – October 2007	December 2006 – March 2007	December 2006 – October 2007

<sup>94</sup> Petropavlovsk-Kamchatsky is a particular case in this respect, as in 2005–07 the price rise rate there was under 1.9 times, which can be attributed to the fact that this city is located far from most of those presented in the sample.

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*Table 19 (continued)*

1	2	3	4
Growth renewal	October 2007 – December 2007.	March 2007 – December 2007.	October 2007 – December 2007
<b>Name of the stage</b>	<b>Novosibirsk</b>	<b>Yekaterinburg</b>	<b>Tver</b>
Start and take-off	...	December 1991 – June 1994	December 1991 – June 1994
Transition to stabilization	...	July 1994 – July 1998	–
Stabilization-1997	December 1996 – July 1998 ***	–	July 1994 – September 1998
Crisis	July 1998 – December 2000	August 1998 – June 2000	October 1998 – September 2000
Post-crisis renewal	January 2001 – December 2001	July 2000 – December 2001	October 2000 – April 2002
Stabilization-2002	December 2001 – January 2003	January 2002 – August 2003	May 2002 – December 2003
Oil-driven growth	January 2003 – March 2005	September 2003 – December 2004	January 2004 – July 2004
Stabilization 2004–2005	March 2005 – June 2005	January 2005 – March 2005	August 2004 – March 2005
Mortgage and oil- backed growth	July 2005 – June 2007	April 2005 – December 2006	April 2005 – December 2006
Transition to stabilization	June 2007 – September 2007	–	–
Stabilization-2007	–	December 2006 – December 2007	June 2007 – September 2007
Growth renewal	September 2007 – December 2007	–	September 2007 – December 2007
<b>Name of the stage</b>	<b>Rostov-on-Don</b>	<b>Perm</b>	<b>Ulyanovsk</b>
Stabilization-2002	December 2001 – May 2003	December 2001 – November 2003	December 2001 – March 2003
Oil-driven growth	June 2003 – May 2004	December 2003 – February 2005	March 2003 – December 2004
Stabilization-2004-2005	June 2004 – August 2005	February 2005 – August 2005	December 2004 – July 2006
Mortgage and oil- backed growth	August 2005 – March 2007	August 2005 – May 2007	July 2006 – April 2007
Stabilization-2007	March 2007 – August 2007	May 2007 – August 2007	April 2007 – December 2007
Growth renewal	August 2007 – December 2007	August – December 2007	–
<b>Name of stage</b>	<b>Izhevsk</b>	<b>Yaroslavl</b>	<b>Krasnodar</b>
Stabilization-2002	December 2001 – May 2004	December 2001 – December 2002	October 2002 – March 2004

*Table 19 (continued)*

1	2	3	4
Oil-driven growth	May 2004 – June 2005	December 2002 – July 2003	March 2004 – February 2005
Stabilization 2003–2005	June 2005 – January 2006	July 2003 – December 2004	February 2005 – November 2005
Mortgage and oil- backed growth	January-2006 – April 2007	December-2004– December 2006	November 2005 – May 2007
Stabilization-2007	April 2007 – December 2007	December 2006 – September 2007	May 2007 – July 2007
Growth renewal	–	September 2007 – December 2007	July 2007 – December 2007

\* - Fluctuating stabilization («with roll-back»).

\*\* - Asymptotic stabilization («with crawl-up»).

\*\*\* - Stabilization (with adjustment).

\*\*\*\* - The stage identified solely with regard to St. Petersburg, when during the period of preparation of celebration of the city's 300<sup>th</sup> anniversary the housing prices overshot expected values.

Data of *Table 19* allow the conclusion that over 16 years of the contemporary history of the market clearly splits into two stages, so far as the housing price dynamics are concerned. The first stage (since June 1990 through June 2000) accounts for 10 years for Moscow and 8–9 years for other cities. The second stage has now been in progress in Moscow for more than 7 years already and over 6 years in other cities. The first decade of the legal estate market involved the market's start and take-off, transition to stabilization, which was followed by the 1998–99 crisis. In mid-2000, when the housing market hit the bottom in the wake of the August 1998 crisis, the first stage of the unstable, fluctuating advancement of the market was over. Over the next 7 years and until now the market has witnessed a constant price rise, with its rates fluctuating occasionally (up to a complete stabilization).

Meanwhile, like the city of Moscow and Moscow oblast, other cities also passed through roughly the same stages: the start and take-off of prices (until 1995), stabilization (though 1997), crisis (until 2000), post-crisis renewal (until 2001), stabilization-2002, the oil-driven growth, stabilization in 2004, mortgage and oil back-upped growth of 2005–06, transition to stabilization (the late 2006), stabilization of 2007, and the start of a new growth.

All the cities displayed the following peculiarities:

- asynchronous beginnings and ends of individual stages;
- some peculiarities in the way individual stages developed.

Below we provide charts of price indices in the cities of the samples relative to December 2001 (*Fig. 1*). They show that over the first three years (2002–04) the price indices accounted for 2.0–2.3, while over six years (2001–2007) – 5.0–6.0.

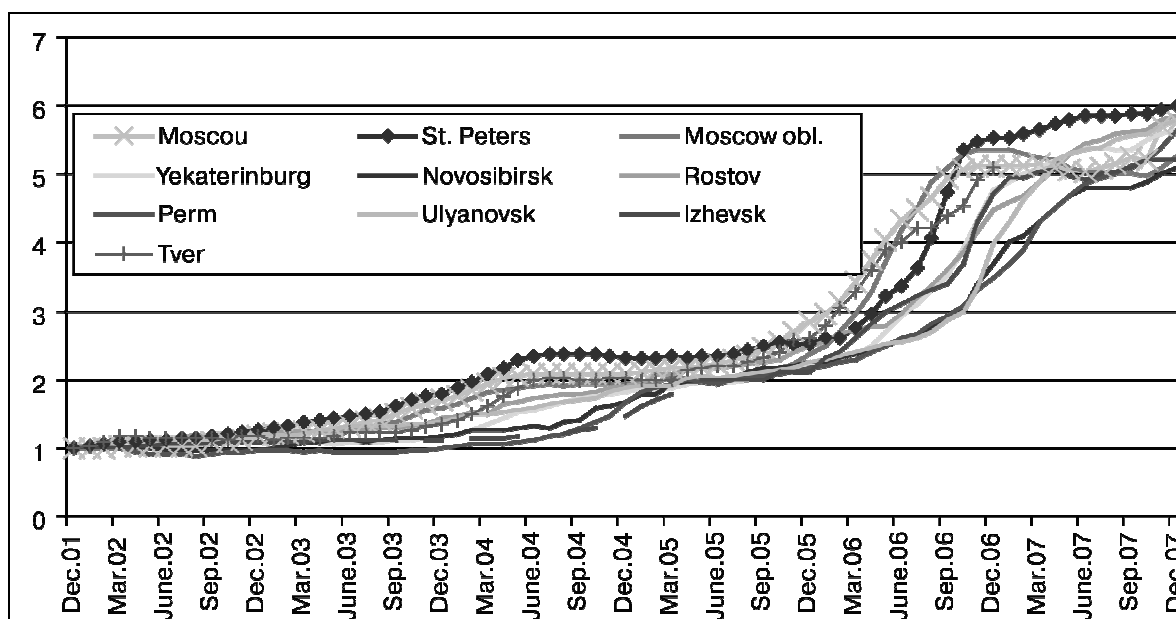


Fig. 1. Housing Price Indices in Moscow and Russia's Cities by December 2001

The above curves allow one to identify a regularity in common for all the cities, that is, the price rise persisting since 2001.

Another regularity of the long-term development of the price situation on the regional markets is engendered by their asynchronous progress, namely, at the beginning of each stage of growth, as regions lag behind the capital locations in terms of the start of price rise, there occurs fractionation of price trends (divergence of the curves). The first case was noted for the periods of 1990–95, 1998–99 (under the price downfall) and is seen on the graph on the summer-to-autumn 2003, on the autumn 2005 and on the late-2007 intervals; the second case – in 1996–97, on the late 2000 – the early 2001, on the early 2005, and on the late 2006 intervals. During the periods of the greatest market fractionation, the value of correlation between the peak and minimum price rise indices accounted for: in June 2004 and October 2006 – 1.8–1.9, while in the periods of the greatest consolidation: in June 2005 and December 2007 – 1.2–1.3.

In the late-2007, there once again occurred consolidation of the trends, which testifies to the general start of a new stage of growth in the price rise rates for housing in Russia's cities. The data show that a long-term price rise on developing markets is wavelike, rather than sustained. It is accompanied by cyclic fluctuations of monthly growth rates between zero and 10–12%, whose period accounts for 2.5–3 years. During a year prices begin to grow, pass the peak of their growth rates and once again stabilize, while over a given period prices grow 2.5–3.5 times.

Such a behavioral pattern is explained primarily by an intense backwardness of offer from the aggregate effective demand – a phenomenon characteristic of developing markets. Given that Russia's population needs housing badly, in the conditions of a sustained rise in effective demand it is possible to avoid next doubling and tripling of prices only under a considerable boost given to the volume of housing construction, placement of new housing in operation and a far greater offer on the market, which necessitates the government's targeted efforts.



### 5.4.3. Housing as the National Priority Program

The year of 2007 saw implementation of the national project entitled “Affordable and comfortable housing to the citizens of Russia” in progress. According to preliminary data, new 60.4m sq.m. of housing were put in operation in 2007, which is 19.4 up vs. 2006 (*Table 20*). These figures also overrun the 2005 increment of (16%). Overall, as many as 714 Thos.-plus apartments were built in 2007.

*Table 20*

**Placement of New Housing in Operation in Russia in 1999–2007**

Year	M. sq.m. of housing	Growth rate, %	
		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
2006	50.6	116.0	165.7
2007	60.4	119.4	199.3

*Source:* Rosstat, the authors’ calculations.

In all, the 2007 housing sector’s performance appears fairly impressive – more specifically, the annual growth rates of placement of new housing in operation have accelerated over the past two years; the actual output (56.3m sq.m.) overrun the planned results; the volume of housing placed in operation practically doubled vis-à-vis the 2000 bottom point and nearly hit the values of registered in 1990 (67.1m sq.m.)<sup>95</sup>. In contrast to 2006, individual developers posted an advanced growth rate (nearly 29%) of placement of new housing in operation, which enabled them to increase their share in the overall volume of placement of new housing in operation up to 42.6% vs. 39.5% reported in 2005–06. The implementation of the program of house building for the military jointly funded by the federal and regional budgets (each providing Rb. 15 bn. in targeted allotments) in Moscow, Moscow oblast, St. Petersburg, Leningrad and Kaliningrad oblasts has also been a success.

Given all the success in implementation of the national housing project, it should be emphasized that the pace of placement of new housing in operation slowed down in 2007: in the 1<sup>st</sup> quarter the volume of house construction grew over 1.5 times, by results of the 1<sup>st</sup> half year – by some 35%, between January and September – less than by one-third (all vs. the respective periods of 2006). The final 2007 increment fell short of hitting 20%, or proved to be roughly at 10% less than originally expected<sup>96</sup>.

Such a situation can be explained by two factors. On the one hand, happy with the 2007 results, government may be interested in having certain reserves that would ensure a positive dynamic in 2008. On the other hand, the 2007 stabilization of housing prices after their rapid

<sup>95</sup> At this point, it should be noted that the 1990 values were not record-breaking, as in 1988 the respective result was 72.3 m. sq.m, and in 1989 – a. 71m sq.m.

<sup>96</sup> In mid-January 2008, at a meeting in Tyumen on the national project implementation in Ural Federal Okrug D. Medvedev informed that the envisioned 2007 result in house-construction was to be 66 m sq.m.

rise in 2006 meant that the previous catalyst of house construction has been lost. That is why one is unlikely to expect a price downfall due to the slowdown of rates of growth in offer.

Production of construction materials progressed in 2007 across the overwhelming majority of items. Meanwhile, there still persist notable imbalances between the output of ceramic and sanitaryware items, which exceeded the 1990 level, on the one hand, and the output of other construction materials, which remained at a level lower than those of 1970 and 1975.

This can be exemplified by cement production. In 2007, its volumes grew at 9.4% and finally overrun that of 1970, but they still are far inferior to their 1980 and 1990 levels. Meanwhile, it was cement prices that were growing at an advanced rate last year. According to the Rosstat's official data, in December 2007 they grew at more than 70% vs. December 2006, thus setting a record compared to other construction materials. The same situation was noted in 2006, but the price increment was under 25%<sup>97</sup>.

Such price rise rates demand for adoption of a special sector development sub-program, which includes establishment of 50 new cement plants (construction of 14 of which is in progress already), allocation of raw materials sites, a free relocation of cement and specialized transport, and activation of private-public partnership mechanisms. The government, of course, is in possession of such standard market mechanisms as the customs and antitrust regulation, which presently have proved to be clearly insufficient<sup>98</sup>.

In addition to problems of provision of the house-building sector with resources and development of its material and technical base, the list of urgent problems includes allocation of sites for construction and making housing genuinely accessible for citizens. Only 8 regions voluntarily and in full honor their obligations with regard to allocations of sites under construction, while most construction projects are in progress on the sites developers had received prior to introduction of legal provisions that require their compulsory assignment by auctions' results.

As concerns accessibility of housing, in its recent report, the Duma Committee for industry, construction and science-intensive technologies argues that the 2005–2006 price rise for housing at 20% exceeded the growth rate in citizens' average incomes<sup>99</sup>. Huge groups of the population have found themselves in between high requirements to the current income level and financial sufficiency the mortgage procedures demand, on the one hand, and tightening requirements to the possibility for getting an apartment from the state under a typical queue for improvement of the housing conditions.

Plus, the official statistics report that the number of families (including the singles) that received housing and improved their housing conditions is on the decline. Thus, in 2006, i.e. after the start of implementation of the national projects, there were 139,000 of such families (or 4% of those considered to be in need for housing) against 151,000 in 2005 (in 2000, there were 253,000 of such families). In parallel with that, there was noted a drastic reduction in the

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<sup>97</sup> *Sotsialno-ekonomicheskoye polozhenie Rossii, 2007 god. M., Rosstat, p. 176.* Some experts even greater figures. Thus, while addressing the International Investment and Construction Forum, Mr. N. Koshman, President of the Association of Builders of Russia (ABR) maintained that cement prices grew at 140% and predicted in 2008 they would soar up to Rb. 10,000/t. see: A. Demin. *Naraschivaem temp.* In: *Rvartirny ryad*, 29 Nov. – 5 Dec. 2007, No. 48 (671), p. 10. The ABR head earlier referenced the price rise for 1 t. of cement from Rb. 1,139 in January 2006 up to 7,000 in the autumn 2007. see: *Tsementnaya stradatelnaya.* In: *Kvartirny ryad*, 4–10 October 2007, No. 40 (663), p.1.

<sup>98</sup> Domnin S. A. "Evrocement" slushayet, da tseny povysyaet. In: *Kvartirny ryad*, 14–20 Feb. 2008, No. 5 (680), p.1.

<sup>99</sup> Domnin S. Rano otbivat ladoshi. In: *Kvartirny ryad*, 4–10 Oct. 2007, No. 40 (663), p.10.

number of families listed in such queues, which can be attributed to the promulgation of the new Housing Code. In 2005, the respective figure fell by 19% and by another 8% – in 2006. In all fairness, it should be noted that this tendency appears characteristic of all the period of market reforms, but it had been smoother before<sup>100</sup>. More specifically, the contraction in the number of citizens lining up for the state-granted housing in 2005–06 proved to be greater than in the four prior years (2001–04).

As in the first year of the national project implementation, the attempt to ensure accessibility of housing for a broader array of citizens likewise implied bolstering the mortgage system. By the autumn 2007 the government had succeeded to slightly lower mortgage interest to 11–11.5% (vs. 12% reported in 2006)<sup>101</sup> and to increase the loan term up to 16.3 year (vs. 13.8% in the late-2005). The mortgage program was granted the budgetary support totaled Rb. 260bn in 2006 and Rb. 206 bn. in the 1<sup>st</sup> half 2007<sup>102</sup>.

But in the summer 2007 the mortgage crisis in the US regvanized earlier cited great doubts of adequacy of this particular instrument to Russia's current realities. The US mortgagers' mass refusals to repay their loans triggered liquidity shortages in the US banking sector, which until then had been a major source of funding for mortgage loans in Russia, as it had disbursed loans to the Russian banks, who had gladly capitalized on the opportunity to compensate for the lack of a huge volume of long money in the country. As a result, the banks cracked down on mortgagers, including tightening their solvency procedures and suspending programs for those of them who fell in the bracket of highly risky ones. Many banks abandoned zero-purchase-money programs and slightly raised their interest rates.

At the end of 2007 experts voiced up preliminary losses the Russian mortgage system suffered due to the US subprime market crisis. Thus, Ms. T. Nikitina, Director General of the International Real Estate Mortgage Academy noted a 7-fold fall in the increment rate of mortgage contracts vs. 2006. According to Mr. A. Skomorokhin, Director General of KUI "Yamal", the system was running short of some USD 2bn, which axed the number of potential mortgagers at 50–100,000. Mr. V. Belov, Director General of "Fousborne Home" company, argued that the rise in interest rates or discontinuation of delivery of this kind of financial services affected banks that had been holding some 23% of the market, while average weighted interest rates soared by 0.2% in USD and 0.7% in Rb.

Given the above, the impact of the US subprime mortgage crisis on Russia's housing situation should not be overestimated, as the role the instrument plays in the country has been quite limited so far (the volume of mortgage loans in Russia accounts under 1% of GDP, while in the US it is over 50% of GDP). Most players have maintained that the US crisis would exert its adverse effect on Russia for no longer than 6–9 months. For example, Mr. A. Pechatnikov, VTB-24's Director for Mortgage Loans, believes that the 2008 growth of the market for mortgage loans should make up not less than 80%, while Mr. V. Gasyak, Deputy Chairman of the Board of Home Credit bank trusts it should be not less than 50%<sup>103</sup>. A survey conducted by Romir holding found that 3% of respondents were keen to seek a mortgage loan over next two years, while another 2.5% of them expressed this desire, but have not decided for sure as yet. So, the potential demand for mortgage loans is estimated at the level of 1.6–

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<sup>100</sup> Rossiysly statistichesky ezhegodnik. 2007: Stat.sb/Rosstat. M., 2007, p. 219.

<sup>101</sup> The announced rates, as a rule, do not contain additional costs and commission fees.

<sup>102</sup> Glan I. Nespetaya pesnya Minregiona. In: Kvartirny ryad, 4–10 Oct. 2007, No. 40 (663), p. 10.

<sup>103</sup> Domnin S. Ne tak strashen chert.... In: Kvartirny ryad, 20–26 Dec. 2007, No. 51 (674), p. 1.

2.8 m pcs., while in 2007 alone banks disbursed just slightly over 400,000 mortgage loans<sup>104</sup>. Their estimated aggregate volume was some Rb. 538 bn (vs. 56 bn in 2005 and 263 bn in 2006<sup>105</sup>).

However, another view on the problem is cited more often, namely, the mortgage interest rate fails to help secure accessibility of housing, while mortgage formed one of the factors that contributed to the price rise for it. Housing prices can be to a far greater extent influenced by subsidies, stimulation of developers, lower costs for access to the engineering infrastructure, and, of course, the volume of market offer. There arises the problem of designing alternative to the classical mortgage mechanisms that would ensure access to housing, such as the social lease and saving-and-loan cooperatives and banks.

In contrast to the past years, the law that regulates the housing market did not see any novelties comparable, in terms of their effect, with Federal Act No. 214-FZ of December 30, 2004 “On participation in the shared construction of apartment houses and other real estate objects”, though, naturally, there were individual amendments to the Urban Development Code, legislation on mortgage, registration of property rights, etc.

The notorious investors’ honoring their obligations before private investors is no longer in the center of attention, as new challenges arose. According to the Moscow Town Hall, there were 3,371 deceived private investors in the city. Authorities expressed their intention to provide citizens suffered from the “construction pyramids” with apartments as early as in 2008, providing those who had invested in several apartments would be granted with just one<sup>106</sup>. The federal center did not do anything in this respect at all. Certain hopes to overcome negative effects from the Act on shared construction are laid upon Act No. 315-FZ of December 1, 2007 “On self-regulating organizations”, albeit it is going to take a lot of time to restore confidence in such forms of investing.

As far as the regional aspect in house building is concerned, it should be emphasized that nearly all the regions reported greater volumes of placement of new housing in operation, except for Ivanovo and Murmansk oblasts, Chechnya, Kamchatka and Chukotsky Autonomous Okrug (AO). By contrast, Kaluga, Yaroslavl, Samara and Irkutsk (including Ust-Ordynsky Buryatsky AO), as well as Adygeya, boast the respective index being over 1.5 times greater than in 2006.

Out of 17 regions presented in the sample given in *Table 16* in 8 ones the 2007 rate of placement of new housing in operation was greater than the average nationwide figure (Krasnodar, Perm and Krasnoyarsk krais, Yaroslavl, Ulyanovsk, Rosotov, Sverdlovsk and Kemerovo oblasts). Meanwhile, in 8 other regions (Moscow, St. Petersburg, Moscow, Tver oblasts, Bashkortostan, Udmurtia, Tyumen and Novosibirsk oblasts) the respective figure sank below the average nationwide one. It was the city of Moscow that reported the smallest figure (1%), while in the other “capital regions” the situation was far more favorable – the index was 17% up in Moscow oblast and 11% up – in St. Petersburg. In Kamchatka, it plummeted well below 50% of the prior year’s index<sup>107</sup>.

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<sup>104</sup> Narod k ipotek ne gotov. In: *Izvestiya*, 29 Feb. 2008, p. 11.

<sup>105</sup> The figures are cited from the address by Mr. D. Kozak, the RF Minister for Regional Development, at a meeting of the Council for the Priority National Projects Implementation of 28 Dec 2008. See: *Kvartirny ryad*, 6–12 Mar. 2008, No. 519 (684), p. 1.

<sup>106</sup> Reshat problemy dolschikov. In: *Kvartirny ryad*, 1–7 Nov. 2007, No. 44 (667), p. 11.

<sup>107</sup> Sotsialno-ekonomicheskoye polozheniye Rossii, 2007 god. Rosstat, p. 374–375.

Some deconcentration of house building in the capital region formed a distinguishing feature of 2007 (*Table 21*).

*Table 21*

**Volumes of Placement of New Housing in Operation in Russia, the City of Moscow, and Moscow Oblast in 1999–2007**

Year	Nationwide (Rosstat)	Moscow (Rosstat)		Moscow oblast (Rosstat)		Total in Moscow and Moscow oblast	
	Thos. Sq.m	Thos. Sq.m	As % of the nationwide index	Thos. Sq.m	% от ввода по России в целом	Thos. Sq.m	As % of the nationwide index
1999	32,017	3,052.5	9.55	2,728.6	8.5	5,781.1	18.05
2000	30,296	3,342.3	11.0	2,610.9	8.6	5,953.2	19.6
2001	31,703	3,690.6	11.65	2,827.8	8.9	6,518.4	20.55
2002	33,832	4,274.1	12.6	3,414.8	10.1	7,688.9	22.7
2003	36,449	4,443.0	12.2	4,114.8	11.3	8,557.8	23.5
2004	41,040	4,578.6	11.2	5,720.1	13.9	10,298.7	25.1
2005	43,560	4,648.5	10.7	5,296.5	12.2	9,945.0	22.8
2006	50,600	4,802.0	9.6	6,484.0	12.8	11,286.0	22.3
2007	60,350	4,827.7	8.0	7,586.6	12.6	12,414.3	20.6

*Source:* Rosstat, authors' calculations.

The city of Moscow's specific weight in the overall nationwide volume of house construction dropped by more than 1.5 p.p., to 8%, while the share of Moscow oblast remained practically unchanged. The 2007 aggregate specific weight of both regions ultimately made up 20.6%, while over the two previous years it was greater at 2 p.p. (for reference, in 2003–04 it was 23–25%).

Details of the dynamic of house construction in the city of Moscow and Moscow oblast are given in *Table 22* below.

*Table 22*

**Volumes of Placement of Housing in Operation in the City of Moscow and Moscow Oblast in 2000–2007**

year	By Moscow builders within the city of Moscow and outside it		Moscow (Rosstat)		Moscow (the city Town-hall's data)		Moscow oblast (Rosstat)	
	Thos. Sq. M.	% to the prior year	Thos. Sq. M.	% to the prior year	Thos. Sq. M.	% to the prior year	Thos. Sq. M.	% to the prior year
2000	3,530.2	104.8	3,342.3	109.5	33,342.3	...	2,610.9	95.7
2001	3,821.5	108.3	3,690.6	110.4	3,706.1*#	110.9	2,827.8	108.3
2002	4,469.6	116.9	4,274.1	115.8	4,310.9*	116.3	3,414.8	120.7
2003	4,703.2	105.2	4,443.0	103.9	4,441.9*	103.0	4,114.8	120.5
2004	4,794.7	101.9	4,578.6	103.1	4,576.8*	103.0	5,720.1	139.0
2005	5,228.3	109.0	4,648.5	101.5	4,644.3	101.5	5,296.5	92.6
2006	5,318.4	101.8	4,802.0	103.3	4,804.5	103.4	6,484.0	122.4
2007	5,413.8	102.2	4,827.7	101.0	4,827.7	100.5	7,586.6	117.0

\* - Built in the city of Moscow by local construction companies.

# - For 2001 there also is an estimation figure of 3,824.9 Thos. sq.m.; accordingly the growth rate vs. 2000 can be estimated at the level of 114.4%.

*Source:* Rosstat, authors' calculations.

As in the past three years, the 2007 showed that the volume of placement of housing in operation in Moscow oblast was greater than the capital city's respective indicator. The latter accounted just for 1%, or thrice as low as in 2006 and became the smallest figure since 2000.

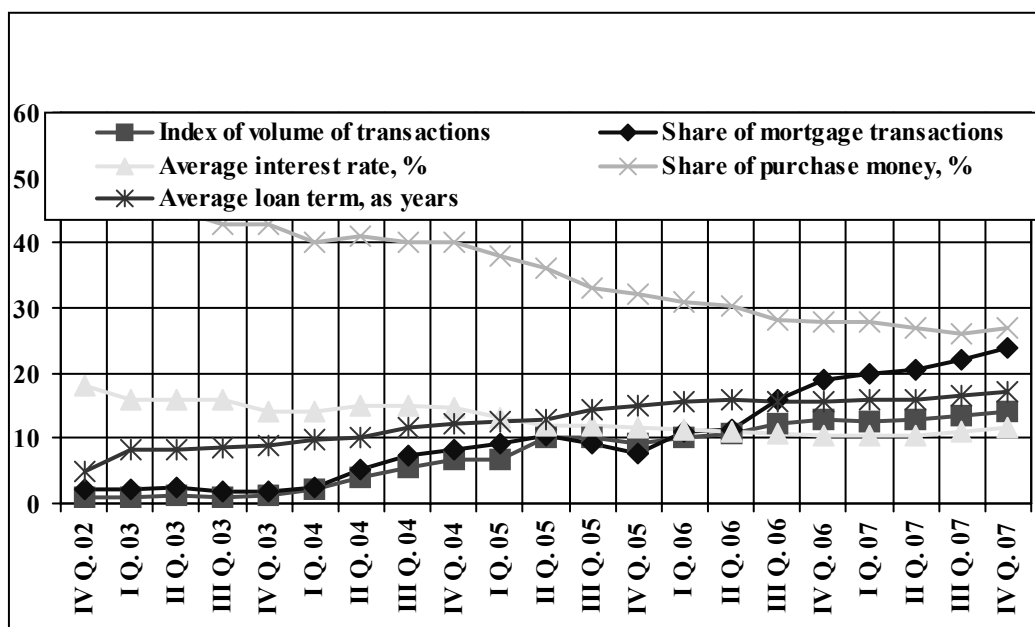
It can be compared only with the 2005 results. At that time, as well as in 2007, construction companies headquartering in Moscow built a. 10% of housing outside the city. In Moscow oblast, the growth rate of house construction also proved to be smaller than in 2006 and 2002–04 and accounted for 17%.

Presently Moscow Mayor has set an ambitious goal to ensure a double reduction of the local queue for housing by 2010. During the past decade it accounted for some 180,00 families, many lining up for some 20 years. Given these figures, the task will inevitably demand for far greater volumes of housing needed for implementation of the city’s housing programs. In 2008 alone, this volume should make up 2.5 m sq m., with the overall volume of placement of new housing in operation amounting to 5 m.sq.m. vs. 1.8 m sq.m. reported in 2006–2007. With the existing physical constraints facing the placement of new housing in operation in the city, an increasing role will be assigned to provision of housing under onerous conditions and through versatile beneficial arrangements, including housing purchases in Moscow oblast, among others.

#### 5.4.4. Moscow City Mortgage Housing Market

An analysis of the emergence and advancement of the mortgage housing market (MHM) was conducted basing on the data of the respective operations by MIEL company on the Moscow city market<sup>108</sup>.

The volume of transactions involving apartment and the proportion of mortgage-based deals in their overall number formed the group of the MHM indicators. The general situation on MHM can be seen on *Fig. 2*.



*Fig. 2. Dynamic of Mortgage Loan Parameters and Indicators of the Market for Mortgage Transactions of MIEL in 2002–2007*

<sup>108</sup> Sternik G.M., Korobkova M.V. et al. Rynok zhilya Moskovskogo regiona v 2005 g. Analiz i prognoz. – MIEL-Nedvizhimost, 2005; Sternik G.M., Korobkova M.V. Vliyanie galopiruyushchego rynka zhilya na razvitiye ipoteki v Moskve. – Doklad na II Peterburgskom imptechnom forume 2 Mar. 2007.

As seen from the *Fig. 2*, MHM passed through the take-off stage (between 2002 and mid-2005), the stabilization stage (through mid-2006), and then entered the new stage of growth.

While the volume of the company's mortgage loan transactions grew 10-fold between 2003 and the 2<sup>nd</sup> quarter 2005), it consequently discontinued to grow and remained practically stagnant over the next four quarters. It renewed its growth in the 3<sup>rd</sup>–4<sup>th</sup> quarters 2006, and in the 4<sup>th</sup> quarter of the year overran the level of the 1<sup>st</sup> quarter 2003 at 12.8 times.

The proportion of mortgage loan deals in the total volume of apartment sales also was on the rise until the 2<sup>nd</sup> quarter 2005 and reached 9%. Then it discontinued to grow for the next four quarters and even dropped slightly (to 6.9% in the 4<sup>th</sup> quarter 2005). It bounced back to its previous value in the 1<sup>st</sup> and 2<sup>nd</sup> quarters 2006, hit the level of 15.8% in the 3<sup>rd</sup> quarter and then 19% in the 4<sup>th</sup> quarter of the year.

MHM found itself affected by two groups of factors: on the one hand, those were conditions of the market for mortgage housing loans (MMHL) (banking interest rates, the amount of purchase money, loan term, and other peculiarities of banking mortgage programs); on the other hand, those were formed by the housing market (HM) per se, including price rise rates and dynamic, housing construction volumes, and volumes of offer of housing on the primary and secondary markets.

MMHL has recently advanced in the following manner.

In 2003, banks were keen to disburse serious money in loans and aggressively launched mortgage loan programs focusing on the population, but to no avail, as there was no radical growth in mortgage loan deals.

In 2004–2005, they continued to cut interest rates and to undertake other measures to improve borrowing conditions, and the population became increasingly keen to apply for the loans. Hence a greater volume of mortgage loan transactions and their greater proportion in the overall volume of apartment sales.

The situation nonetheless changed in the second half 2005: numerous banks argued that the number of actual mortgage deals in progress accounted just for 50–80% of the amount of approved loans, while the 2005 increment rate of newly registered loans was only 5.6%. In the circumstances banks significantly lowered their requirements to mortgagors, and some of them even zeroed the purchase money. However, no substantial changes took place on MHM until the autumn of 2006.

It should be noted that, concerned with the crisis on the US subprime market, since the summer 2007 Russian banks have finally tightened underwriting procedures, started raising the Rb.-denominated mortgage interest rates and even suspended disbursement of loans for a while. Thanks to CBR and the Mortgage Loans Agency's (MLA) vigorous actions on supporting the national banking system's liquidity, the US crisis had no contagion effect on Russia's mortgage system, and, together with the aforementioned negative consequences, has even exerted some positive influence on it.

The impact of factors associated with the situation on the housing market (HM) on MHM worth a good scrutiny.

As a reminder, during the phase of its emergence and development since June 1990 the Moscow city housing market passed through a number of stages: start and take-off (until the spring of 1995), fluctuation stabilization (through the autumn of 1998), crisis (until mid-2000), post-crisis renewal ((until the late-2001), stabilization (during most of 2002).

Between the autumn of 2002 and mid-2004 the market was being in the stage of the oil-driven growth. The average specific offer price for housing grew from USD 1,096/sq.m. in December 2002 up to 1,610 in December 2003 (47% up) and was climbing up hence for another half year (even after demand had begun to decline) and ultimately hit the level of USD 1,950/sq.m. At the time, the volume of mortgage sales was being practically stagnant through December 2003. It renewed only in the last two quarters, and the volume of the noted deals doubled over the half year.

The stabilization period had lasted for nearly a year – until mid 2005. During that period prices rose up to USD 2,142/sq.m. (at 10%), while volume of mortgage sales quintupled vs. the previous one. In mid-2005, there started a new stage of the HM's development, which can be tagged as the mortgage- and oil-driven growth. It was over in mid-2006, and by that time prices had surged up to USD 4,072/sq.m. (1.9 times), while the volume of mortgage sales was fluctuating around index 10.0 (to December 2002).

Research<sup>109</sup> revealed that the deceleration of mortgage between the 3<sup>rd</sup> quarter 2005 and the 2<sup>nd</sup> quarter 2006 could be attributed primarily to a catastrophic scarcity of housing offer on the market and a consequent rapid price rise for housing. That resulted in sellers' refusing to deal with "mortgage" buyers and opting to conduct of a kind of auctions for buyers with cash at hand instead.

The situation further fueled the propelled price rise, which started in the summer 2005 (at a pace of 8–10% a month in the early 2006), which in turn formed yet a Chinese Wall to those who wished to apply for a mortgage loan: while they were dealing with a bank, a seller would raise the price, and a mortgage loan would fall short of securing purchase money.

The federal and regional tiers of the government, as well as operators on the house construction and sales markets, were at great pains to improve the situation on the market, and they ultimately succeeded, as the fall in offer of newly built housing had stopped by mid-2006. Meanwhile, there emerged factors that, since summer that year, began to fuel the volume of offer on the market – the slowdown of price rise rates on the secondary market compelled sellers to get back to the market, while investors decided to fix their profits, etc.

As a result, the pace of the price rise dropped from 8–10% in February and March to 6% in June and further down to 4% in July and August, 2% in October and 0% in December, while the volume of offer on Moscow's secondary market grew from 15–16,000 apartments in the period between June and July up to 23,000 in October and further up 30–31,000 in the period between November and December. By the late-2006 the market had entered the stabilization stage and prices had hit the level of USD4,828/sq.m. (up at 19%). Meanwhile, MHM saw the start of a new stage of growth, and the mortgage sales index soared to 12.5.

Thus the research demonstrated that the situation on a galloping real estate market has a substantial impact on the mortgage dynamic, volume and proportion of mortgage sales.

*Fig. 4* shows that every stage of growth on the MHM market takes place during the stabilization stage on the housing market and, vice versa, at the beginning of the price rise stage the housing market sees discontinuation of growth in the number of mortgage sales.

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<sup>109</sup> Sternik G.M., Korobkova M.V. et al. Rynok zhilya Moskovskogo regiona v 2005 g. Analiz i prognoz. – MIEL-Nedvizhimost, Moscow, 2005.



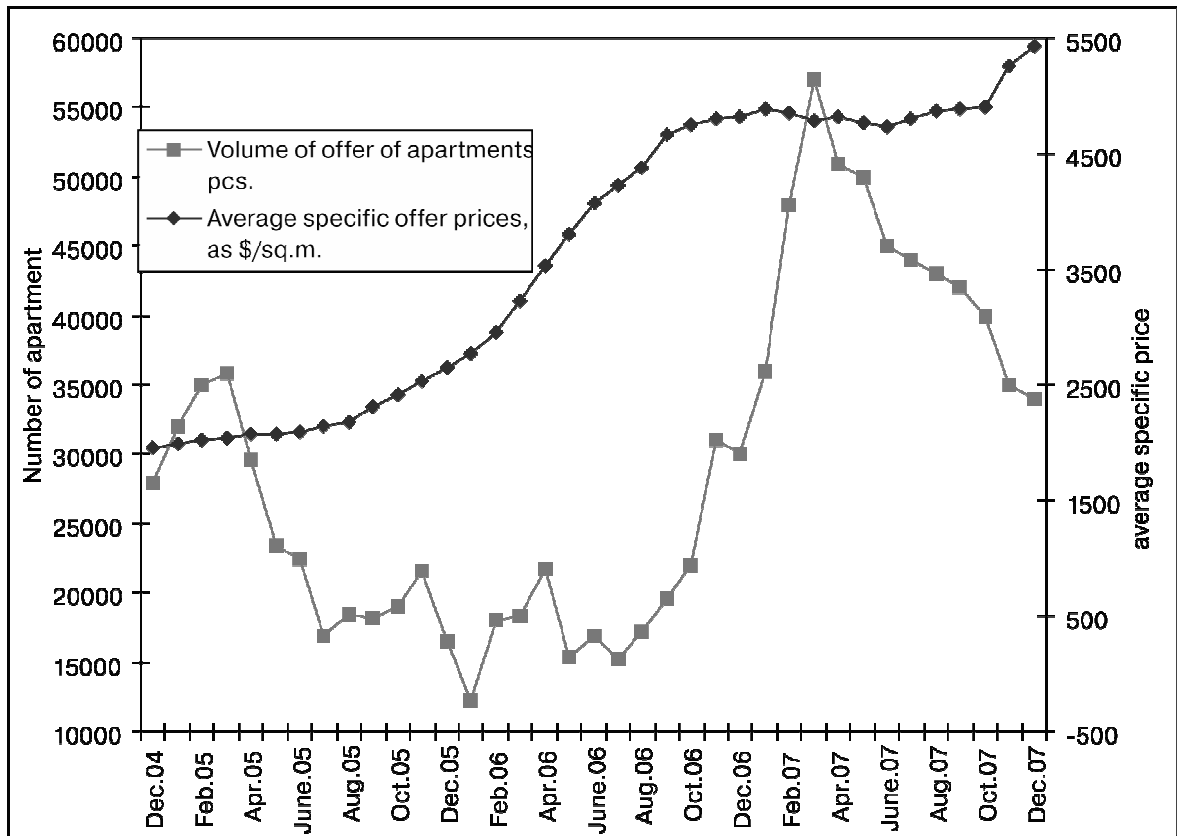


Fig. 3. Dynamics of the Volume of Offer and Prices on the Moscow Housing Market in 2004–07

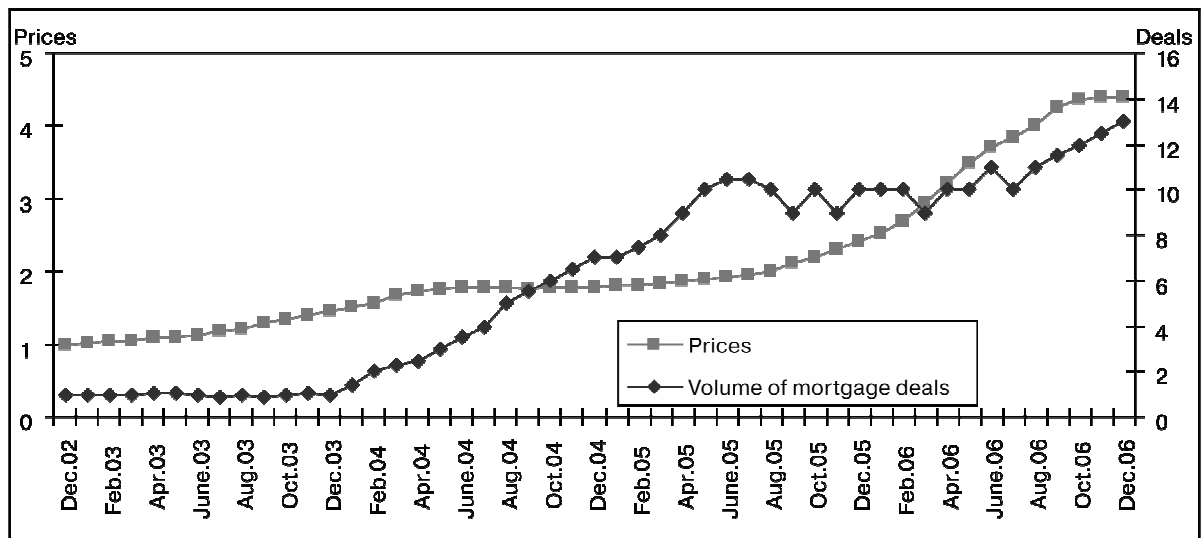
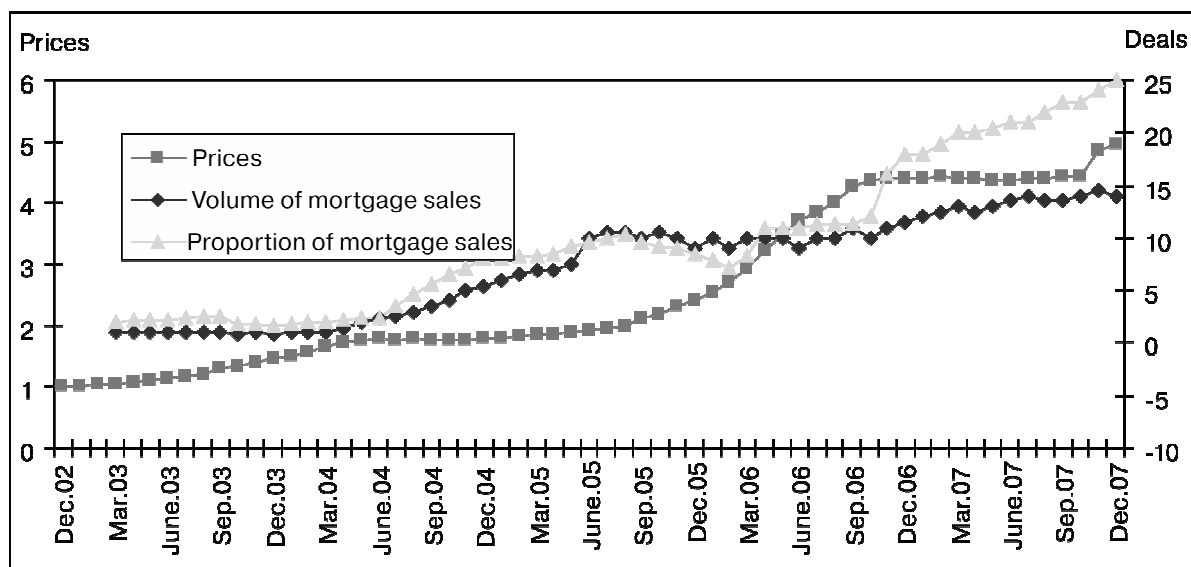


Fig.4. The Apartment Offer Price Index in Moscow and the Index of Volume of Mortgage Sales (by the data of MIEL-Nedvizhimost) in 2002–2006

These processes, however, appear somewhat shifted in time: the start of growth in the volume of mortgage sales outpaces by 3–4 months the start of stability on the housing market.

That is why on *Fig. 5* the curve of the volume of sales is biased forward for 3 months, and it is clear that the volume of mortgage sales changes in phase opposition to price changes on the housing market (the effect of some kind of “mortgage swing”).



*Fig. 5.* The Apartment Offer Price Index in Moscow and the Index of Volume of Mortgage Sales (with a 3-month lag) in 2002–07

The study into statistical relation between monthly price increments on the housing market and monthly increments in the volume of mortgage sales allows one to build correlation as follows: in the period when the prices remain stable (monthly increment values account for +/-1%), the monthly increments in the volume of mortgage sales account for 5–10% on average (the dispersion of points being great – between –5% and 20%). When the pace of the price rise hits the level of 4–5% a month, the volume of mortgage sales discontinues to grow (the respective increment being in the range between –5% and 5%). Finally, under a price rise rate accounting for 7–8% and more, the volume of mortgage sales somewhat declines, with the monthly increment rates being within the range between 0 and –5%.

So, the main cause for MHM’s behavior were changes in the situation on the housing market.

This regularity of the correlation between MHM and HM allows one to extrapolate forecasts of the price dynamics for housing calculated for Moscow since 1995 onto the mortgage sales market. The 2007–08 projection of the dynamic of housing prices in Moscow built in 2006 using the non-harmonic decomposition of the price trend<sup>110</sup> implied stability of prices (with a possibility for a minor correction) in 2007 and transition towards a new stage of acceleration of the price rise rates in 2008. In conjunction with this, the analysts projected a rise in the volume of mortgage sales in 2007 and deceleration of their growth in 2008.

The year of 2007 showed that their projection was quite accurate for the first 10 months, with the renewal of the price rise noted only in the last 2–3 months of the year. As concerns accuracy of the forecast of the dynamic of MHM indicators, the results appeared ambiguous.

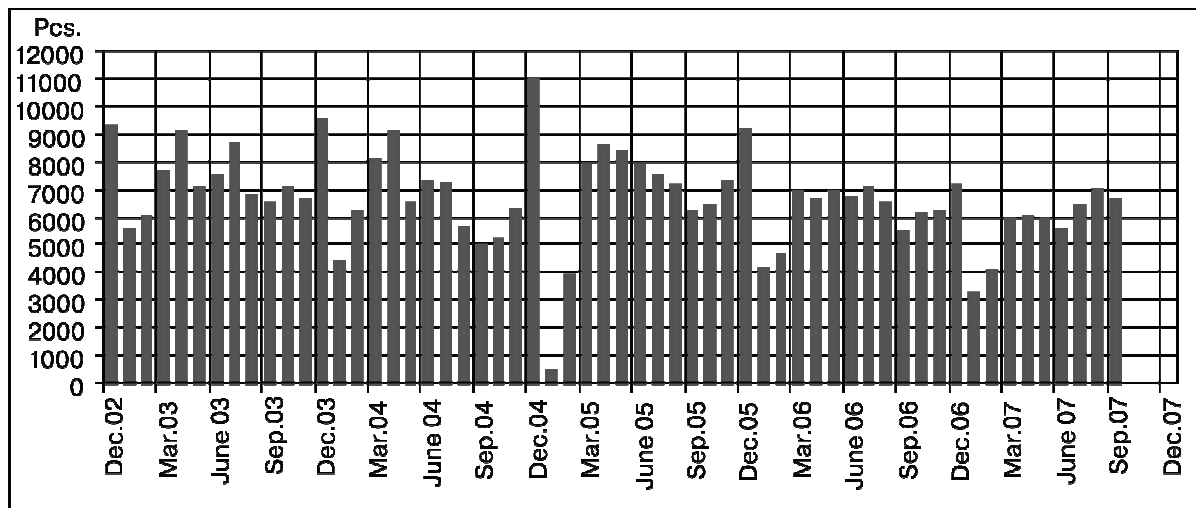
<sup>110</sup> Sternik G/M/, Krasnopolskaya A.N. Metod negarmonicheskogo razlozheniya tsenovogo trenda-www. realty-market.ru, July 2006.

The proportion of mortgage sales was on the rise, as predicted, but the total number of mortgage sales in 2007 displayed practically no rise, albeit the proportion of mortgage sales in the overall number of transactions continued to surge. These results require a more detailed examination.

As shown on *Fig. 3*, in March 2005, the total monthly offer volume of apartments in Moscow accounted for 36,000. That was the moment when demand began to grow, and by July 2005 the number of apartments plunged to 17,000, due to contraction in the time of exposition and “washing-out” of offer. The offer volume had held on this level (17,000–22,000 apartments) until August 2006, while falling down sometimes to 12–15,000. Then demand fell and the market saw the process of accumulation of unsold apartments, and by March 2007 the offer volume skyrocketed to an unprecedented level of 57,000. The offer prices were on the rise until the late-2006 and stabilized since then. Since April there was noted a gradual rise in demand and a new washing out of offer, because of which the offer volume plunged to 40,000 and, during the next two months when prices renewed their rise, further to 34–35,000 apartments.

So, the contraction in the volume of offer between mid-2005 and mid-2006, along with the acceleration of price rise rates, formed the main cause for the slowdown of growth in the number of mortgage sales. The consequent growth in the offer volume in the late-2006, even under the decline that started since the spring 2007, created conditions for an accelerated rise in the volume of mortgage sales. But such a such a rise did not take place in 2007.

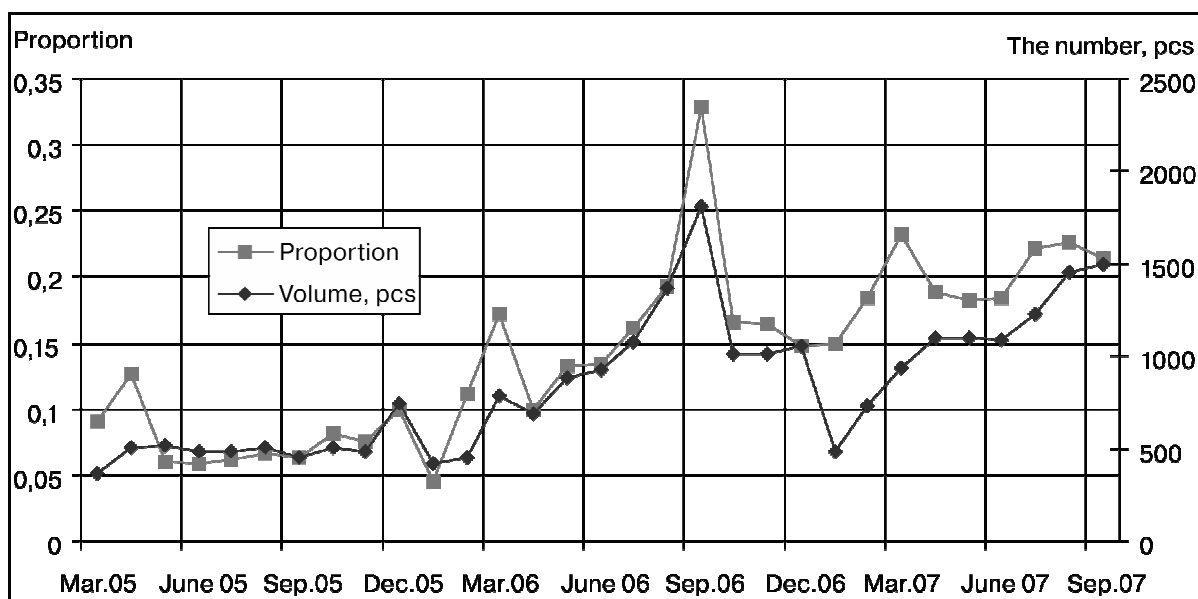
*Fig. 6* references data of the Moscow Division of the Federal Registration Service (DFRS) on the overall number of registered apartment sales on the local secondary market.



*Fig. 6.* Dynamic of the Number of Registered Apartment Sales on the Moscow Secondary Market for Housing in 2002–07

The data evidence that the volume of sales began to decline since 2005. More specifically, between October 2004 and September 2005 the average monthly volume was 6,680 deals, while over the next 12 months it made up 6,300 deals (down at 9.4%), and in the 12 months after that it plunged at another 9.2%. Underpinning the first fall (under a high demand) was scarcity (and even shortage) of offer, while demand dropped substantially in 2007, which fueled a further fall in the volume of sales. Now, basing on the same source, let us ex-

amine data on the volume of mortgage sales (*Fig. 7*). According to Moscow's DFRS, between the spring 2005 and the spring 2006 the number of registered (legitimate<sup>111</sup>) mortgage sales was being stable (some 500 a month). Since March 2006 it began to grow and climbed up to its peak (1,800) in September 2006, after which it was holding at the level of 1,000 to 1,100 until June 2007. The volume of mortgage sales had grown to 1,500 by September 2007. Such a dynamic can be easily explained by the already identified causes, namely, the shortage of offer between 2005 and the early 2006; the rise in the offer volume at the end of the year; a growing demand for mortgage in 2007, despite the overall fall in demand on the market.



*Fig. 7.* The Number of Registered Legitimate Mortgage Sales and Their Proportion in the Aggregate Number of Housing Sales in Moscow in 2005-07.

Because of the above, the proportion of mortgage sales in Moscow was on the rise: in 2005 it accounted for 5–10% a month, in 2006 – 15–17% (with the September peak of 33%), and in 2007 it hit the level of 18–24%.

So, the mortgage market's behavior appeared closely related to the situation on the market for housing as a whole, and the mortgage swing is a steady regularity of MHM: under stable prices and a significant volume of offer on the market, even providing the general demand declines, the volume of mortgage sales and their proportion in particular are on the rise, while a growing demand, lower offer volume and high price rise rates entail deceleration in the growth of the respective indices.

<sup>111</sup> Meaning the genuine mortgage sales, which differ from the simple usage of apartment as collateral against a loan, which can be spent on purposes other than a new apartment.

#### 5.4.5. Forecast and Main Conclusions

Since 1995 the annual forecasting of price trends on the Moscow city and other cities' markets for housing implied employment of economico-mathematical models<sup>112</sup>. Until 2001 (including the post-crisis renewal stage) these models ensured a great accuracy of forecasting.

In the past 6–7 years all Russian cities witnessed a constant price rise for housing. At the beginning the fact was perceived only as an impediment to the building of economico-mathematical models in the conditions of absence of market fluctuations. Experts conducted their forecasting (not always successfully, though) on the basis of analysis of individual factors and their effect on pricing. But the models failed to predict a non-stop price rise on the second stage of development of Russia's housing market and the 2003 and 2005 explosive rise in particular, while we considered the consequences of the stages as prerequisites of the rise and collapse of a bubble on the Moscow city housing market. Interestingly, at the time, British analysts likewise discussed the bubble scenario as the most visible challenge facing the housing markets in UK, US, Canada, Australia, and some other countries worldwide.

In the summer 2006, Russian analysts laid a hypothesis that, trailing the general economic growth in Russia, growth in the housing market became sustained<sup>113</sup>.

Then they developed the non-harmonic price trend decomposition<sup>114</sup>, which enabled them to build, between December and January of the respective years, the medium-term forecast (for 2007 and 2008) of price dynamics in Moscow, Moscow oblast, and another 8 Russian cities<sup>115</sup>. They predicted that a price stabilization stage with possible price fluctuations at  $\pm 5\%$  should have started since the early-2007. It would be lasting at least until the early-2008, after which there should occur a new price rise stage.

The past 12 months allow us to compare the forecasts with the reality.

The final data on 2007 (*Tables 16 and 23*) show that as concerns the transition to stabilization of prices, the forecasts demonstrated a great deal of accuracy (albeit the half-year results across Perm, Novosibirsk, and St. Petersburg biased over 10%). As for Moscow, Moscow oblast, Yekaterinburg, and Tver, life was obediently following the forecasts, but just for the first 10 months of the year. However, the last 2–3 months of the year witnessed a new price rise, which overrun the forecasts, and this needs a further explanation.

The first, major cause for the new price rise lies in the political sphere: the country's leadership has managed to avoid a pre-election clash between power groupings, as well as a conflict between power and business, particularly, after nomination of the most acceptable for the society candidates for presidency and the position of the government head. That prevented a possible capital outflow and encouraged the population to realize their pent-up demand, which was back-upped by a substantial rise in their real incomes and savings (in 2007, the real salaries and wages were up at 16% vs. 13.4% reported in 2006).

The second, macroeconomic cause became a drastic rise in the world oil prices by the end of the year (hitting figures a. USD 100/barrel) in the autumn 2007, unseen before invest-

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<sup>112</sup> Sternik G.M. Statistichesky podkhod k prognoztovaniyu tsen na zhilye. Journal of RAS "Ekonomika i matematicheskiye metody", vol. 34, issue 1, 1998, p. 85–90.

<sup>113</sup> Sternik G.M. Est li tsikly na rynke nedvizhimosti? – www.realtymarket.ru, June 2006.

<sup>114</sup> Sternik G.M., Krasnopol'skaya A.N. Negarmonicheskoye razlozheniye tsenovoy dinamiki rynka zhilya Moskvy. – www.realtymarket.ru, July 2006.

<sup>115</sup> Sternik G.M. Tseny na rynke zhilya gorodov Rossii v 1990–2006 gjdakh: analiz i prognoz. – Analiticheskaya gruppa G. M. Sternika. – www. realtymarket.ru, January 2006.

ment inflow and capital inflow in the national economy (the net capital inflow renewed in the 4<sup>th</sup> quarter of the year, thus reversing the tendency that had been persisting a quarter earlier), with all their respective effects on the real estate market.

Hence the third cause, that is, the continuous depreciation of the US Dollar, some tightening of mortgage loan terms as a reaction to the US crisis on the subprime housing market, and the inflation hike in the fall of 2007 engendered a new wave of mistrust in the state of the national financial system, which formed an additional incentive for a higher-income-bracket strata to shop on the housing market.

As for other factors, they remained within the limits described in our 2006 paper<sup>116</sup>.

As a result, the stabilization stage in the city of Moscow and Moscow oblast proved to be at 3–4 months shorter than the forecasted one and accounted for 10 months vs. 4–8 months registered in other cities, and the respective ultimate increment by the end of the year proved to be somewhat greater (while the forecasts proved to be absolutely accurate, so far as the nature of the price dynamic is concerned).

The respective results allowed the analysts to employ the non-harmonic price trend decomposition to build forecasts of price dynamics in Moscow and Russian cities basing on a mathematical forecast-model, which consists of a system of equations<sup>117</sup>.

The price rise dynamics forecasts (in USD equivalent) for a number of cities for 2008–09 are given in *Table 23*.

*Table 23*

**Forecast of Price Dynamics in Russian Cities in 2008–2009 (Ranked by Descending Increments over the Three Years)**

City (region)	Price rise indices				
	2007/2006	2008/2007	2009/2008	2008/2006	2009/2006
Ulyanovsk	1.45	2.01	1.28	2.91	3.72
Novosibirsk	1.417	1.70	1.45	2.41	3.50
Perm	1.58	1.64	1.31	2.59	3.39
Tver	1.34	1.43	1.51	1.91	2.88
St. Petersburg	1.23	1.84	1.22	2.39	2.80
Yekaterinburg	1.083	1.80	1.30	1.95	2.53
Rostov-on-Don	1.28	1.69	1.17	2.17	2.53
Yaroslavl	1.09	1.79	1.17	1.65	1.94
Moscow	1.124	1.48	1.09	1.67	1.82
Izhevsk	1.015	1.64	1.05	1.66	1.74
Moscow oblast	1.006	1.68	1.001	1.69	1.69

According to the forecast, in 2008, the city of Moscow will see a continuous price rise and by December prices will have been in the interval between USD 7,500 and 8,500/sq.m. (45–50% up over the year, or 80–85% up vs. 2006). In Moscow oblast, they can climb up to

<sup>116</sup> Malginov G.N., Sternik G.M. Rynok zhilya//Rossiyskaya ekonomika v 2006 godu. Tendetsii i perspektivy. (Issue 28). M., IET, 2007, p. 694–727.

<sup>117</sup> Sternik G.M., Pechenkina A.V. Chto prosikhodit na rynke zhilya Moskvy. Makroekonomicheskii podkhod (doklad na Analiticheskoy konferentsii Moskovskoy Assotsiatsii Rieltorov “Rynok nedvizhimosti: situatsiya, tendentsii, prognoz” 30 Aug 2007). – www.realtymarket.ru, Aug. 2007.

USD 4,000–5,000/sq.m. (65–70% up both over the year and vs. 2006). The dynamic of the first months of 2008 allows one to assume that this scenario is highly probable. For example, in January 2008 alone, housing prices soared at 5% against a fall in the volume of offer of apartments, which is a sign of demand being superior to offer on the market<sup>118</sup>.

Forecasts for other regions show that the price situation will be advancing according to the same scenario, with the 2008 price increment rates making up: 40–45% in Tver, 60–70% in Perm, Izhevsk, Rostov-on-Don, Novosibirsk, 80–85% – in Saint Petersburg, Yaroslavl, Yekaterinburg, and over 100% – in Ulyanovsk.

In three years (2007–09) housing prices will rise: in Moscow oblast, Izhevsk, Moscow, Yaroslavl – 1.7–1.9 times, in Yekaterinburg, Rostov-on-Don, St. Petersburg – 2.5–2.8 times, Perm and Novosibirsk – 3.4–3.5 times, and in Ulyanovsk – 3.7 times.

Beyond this time horizon (apparently, after 2010–2011) when volume of construction and offer of apartments have grown substantially, the forecasts suggest decline in the long-term price rise growth rates.

The forecasted price dynamics will be affected by many groups of factors, some of which boosting the price rise, while other inhibiting it. They can be ganged in two groups: factors external to the housing market (political, macroeconomic, factors of interaction with supplier/consumer markets); and internal factors (progress in implementation of the National Priority Project on Housing, the population's greater housing mobility rate, interaction with supplier/consumer segments of the real estate market (*Table 24*).

So, the balance of factors highlights a strong increasing trend in the dynamic of offer prices for housing in Russia's cities and proves accuracy of the mathematical modeling results.

Overall, the 2007 development of the housing market was characterized by a clear and nearly universal deceleration of the price rise growth rates. Given the impact of macroeconomic factors, there arose a group of cities where real (inflation-adjusted) prices even began to decline.

While fairly successful, the implementation of the national housing project complicated the problem of provision of the national construction complex with resources. As well, the social efficacy of the project can be questioned.

The mortgage loan mechanism, which was viewed as a main vehicle for making housing more affordable for the population, was subject to effects triggered by crisis phenomena in the US economy. Its prospects will be determined by the general situation in Russia's economy, including its ability to withstand negative external shocks. Meanwhile, the analysis of development of the market for mortgage sales over recent years showed that it has been to a greater degree determined by the overall situation on the housing market, rather than terms and conditions of a loan disbursement. Even if the overall demand declines, under stable prices and a considerable volume of offer on the market there occurs growth in the volume of mortgage sales and, particularly, in their proportion in the overall volume of sales. Should demand grow, while volume of offer declines and the pace of price rise is high, the growth in the volume and proportion of mortgage sales is down.

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<sup>118</sup> Ignatyeva Yu. Moskovskikh okon nedostupny svet. In: *Izvestiya*, 29 Feb. 2008, p. 1, 7

Table 24

**Balance of Factors That Determine the Medium-Term Price Dynamic  
for Housing in 2008**

Categories of factors	Groups of factors	Impact of factors on prices	
		Upwards	Downwards
External factors	Political	Election campaigns: additional funding of the presidential race, rise in effective demand fueled by fees payable to political technologists, media, showbiz	Some risk of intensification of tensions in the society during the election campaign and because of change of governors in some regions, and formation of a new federal government
	Macroeconomic	Continuation (albeit at a more moderate rate (6-6.5% vs. 8.1% in 2007) of GDP growth, growth in budgetary expenditures and the level of the population's real disposable incomes. Continuation of growth of the capital inflow, primarily in the form of corporate borrowings (the net inflow for the first time became positive in 2005 – USD 0.1 bn, and it consequently soared up to 42.0bn in 2006 and 82.3 bn in 2007). Further price rise for energy sources (up to USD 200/barrel, according to some forecasts). The process of Russia's accession to WTO, as well as low political risks, which encourage capital inflow from overseas companies, banks and funds, particularly due to the possibility for recession in the US, continuation of appreciation of the Rb. and greater inflation rates	Decline in the GDP growth rates, which constrains the government's possibilities for tackling socio-economic challenges and holding growth rates of the population's incomes. Continuation of the capital outflow for the sake of direct investment. Possible decline in the speculative capital inflow as it may be attracted by the US and European financial instruments, providing the respective countries have handled the mortgage and housing crisis
	Factors of interaction with related markets	Fall of the world stock market indices and manifestations of a crisis on Russia's one, including capital repatriation via mutual funds which contributes to the channeling of investment flows to the real estate market and the respective price rise for real estate	Advancement of Russia's stock market, emergence of versatile high-yields financial instruments, which trigger the capital flow from the real estate market to related markets. Continuation of the consumer boom, which reduces the volume of the population's savings spent on housing purchases. The growing bad consumer debts and the consequent liquidity problems in the banking sector and deceleration of the pace of growth in the volume of mortgage loans
Internal factors	Development of the national priority project "Affordable Housing"	Greater volumes of the government support and mortgage loans, primarily on the market for newly built housing. Maintenance or even decline of the volume of offer of housing in Moscow (along with some rise in the volume of its placement in operation from 4.8m sq.m. in 2007 up to 5.0–5.3m sq.m. in 2008) at the expense of some half of the housing area will be assigned to the municipal programs	Growth in the volume of house building in regions (in 2007 – 60.4 sq. m. nationwide, in 2008 – not less than 72m sq.m.) and in the volume of offer of housing on the primary market. Deceleration of the growth rates in the volume of mortgage sales and in the proportion of mortgage sales in the overall volume of apartment sales due to the start of an intense rise in demand and washing-out of offer, as well as because of a 1–2% rise in interest rates (while the Agency for Mortgage Loans is going to raise the volume of refinancing of mortgage loans up to Rb. 65 bn in 2008)
	The population's greater housing mobility	The inflow of buyers from remote regions to those in the Urals, Volga, Center, North-West; from regions – to Moscow and Moscow oblast; from Moscow – to the less expensive Moscow oblast, which results in a greater effective demand in Moscow and other regions	The outflow of lower- and medium-income strata from Moscow to the market of the nearest and medium- distance Moscow oblast – hence a lower effective demand in Moscow. Competitive housing opportunities for the higher-income stratum in St. Petersburg and Sochi, cities of the central and southern Europe – hence a lower effective demand in Moscow
	Interaction with related segments of the real estate market	Continuation of the advanced growth of investment in the retailing and construction of commercial real estate objects, transport and social infrastructure, which bolsters attractiveness of the housing market	The flow of investment into the market for commercial real estate (trade, office facilities, leisure and rehabilitation centers, logistical complex, technoparks, etc. under lower return rates demonstrated by the house building sector



Meanwhile, the longer-term forecast (for 10–15 years) maintains the price rise should be steady (in USD nominal prices) and its annual pace should account for 30–35%, with its monthly growth rates fluctuating between 0 and 8–12%.

### 5.5. Russia's Military Economy and Military Security

The development of the RF military economy in 2007 was mainly determined by the economic and political factors typical of the Russian economy as a whole and also by the necessity to carry on a struggle against terrorist bands. At the same time, the military economy was to a certain extent influenced (at least conceptually) by the military-political declarations and unfriendly intentions on the part of NATO and the USA, as well as by the requirements of military and military-technological cooperation.

#### 5.5.1. The Socio-Economic Aspects of Military Personnel Policy

Among the military-political and socio-economic events which took place in Russia in the year 2007, the following three should be considered the most important:

- firstly, the beginning of transformations within the RF military establishment, reflected in the appointment of an authentically civilian person to the post of RF Minister of Defense, and in a number of far-reaching alterations of both the functions and the style of work of this ministry;
- secondly, the development and adoption of the federal budget, including that of RF military expenditures, for three consecutive years;
- thirdly, the completion of the Federal Target Program (FTP) “The switchover of a number of formations and military units to the system of manning by servicemen enlisted for military service under contracts, for the years 2004–2007”.

While the military-economic consequences of the first two events will become clear only in the years to come, the results of the third one are already apparent, and thus can be summarized, starting with a brief reminder of why the FTP was needed, and how it was developed and implemented. In this connection, our analysis cannot be limited to the events of the year 2007 alone.

After the annihilation of the main rebel force in Chechnya and Dagestan in 1999–2000, the RF Security Council, on 11 August 2000, took the decision that the size of the army should be considerably reduced (in particular, the number of personnel enlisted for military service in the RF Armed Forces under contracts was reduced to 400 thousand), and then, on 9 November, it instructed the Government and the General Staff to initiate the development of “a program for the switchover of the military establishment of the State to being manned *exclusively* by servicemen enlisted for military service under contracts”. It was planned that the Program would be ready by the autumn of 2001.

In this instruction, the word “exclusively” meant a radical approach to simultaneously resolving a number of other military and social problems. But such an approach, quite naturally, required heavy expenditures, at least at the initial stage. The 2001 budget absolutely lacked the necessary funds.

As a matter of fact, the consequences of the 1998 “default” effectively prevented any rapid and efficient transition to the absolutely voluntary principle of enlistment. Also, it was not safe to reduce the size of the army under conditions when military operations in the North Caucasus were far from being over, and when potential military threats were all too real. In

August 2002, the RF Security Council prepared, and the RF President approved, “The Fundamental Principles of the RF State Policy in the Sphere of Force Development for the Period Until the Year 2010”. This document stipulated that a special FTP should be developed in 2003 with regard to the transition of the armed forces to the new system of staffing, and that the transition should begin with the military units of permanent readiness and those on continuous alert, and that the draft should be preserved for the period up to one year for the sole purpose of preparing the necessary mobilization resources.

However, in February 2003, the journal “Voennaia Mysl” (Military Thought) published an article by the head of the General Staff’s GOMU, where the guidelines set forth by the RF President were “clarified”. It was no longer considered necessary that the FTP should be extended to military units on continuous alert. And in general, the only thing to expect was a “systematic increase in the numbers of servicemen enlisted for military service under contracts in the military units of permanent readiness, and in the future – in the other military units and in the military positions which determine their combat readiness (primarily in the NCO positions). It is planned that the rest of the military positions of soldiers, sailors, sergeants, and petty officers should be filled by servicemen drafted to military service”. In other words, the General was sure that the regular armed forces should continue to be staffed by both the volunteers serving under contracts and the draftees. And that the draft would not be abolished in the foreseeable future. At the same time, the author of the article offers no answer to the question as to which positions do not determine the combat readiness of the troops, thus being secondary in importance, and if they are really secondary in importance, then why should there be any servicemen to occupy them.

Before long, in the spring of 2003, the President came up with a somewhat modified vision of the forthcoming transformations in the system of staffing the RF military establishment:

“In accordance with the approved plans, we will continue to form professionally based units of permanent readiness in the land and airborne forces, and in the marines. This work should be completed in 2007. Also, military service will be based on the principles of professionalism in the internal service troops and the frontier troops. In plain and clear words it means the following (apart from other things, but this is the major conclusion): only well-trained and professional units will be employed in the hot spots and local conflicts, if Russia – God forbid – will ever have to answer these challenges. I would also like to point it out that it is the sergeant cadre of our Armed Forces (AF) that will be most urgently transferred to the professional basis. From the year 2008 onwards, the duration of compulsory military service will be reduced to one year. During the first half-year, the draftees will be mastering their military professions at the units. After this, they will be offered an option – either to serve for half a year in line troops or to be transferred to professional service under contract. Those who have served under contract for three years will be entitled to a number of preferences including the guaranteed right to higher education at the State’s expense”.

On 25 August 2003, the program under the title “The switchover of a number of formations and military units to the system of manning by servicemen enlisted for military service under contracts” was approved, for the years 2004–2007, by the RF Government’s resolution. The Ministry of Defense, which had been appointed state customer and coordinator of the Program, was instructed to submit, in the 4th Quarter of 2003, a “draft deferral law setting the duration of compulsory military service at one year”.

Those public figures who had taken part in substantiating the FTP and resisted all attempts to emasculate it were prevented from handling the matter at the stage of the Program's implementation under the pretext of secrecy. Control over the implementation of the Program was entrusted to the Ministry of Defense. Thus, this agency plans all the FTP-related measures, implements them, and controls its own activities.

The analysis of the FTP's tasks and goals, as they were initially formulated, and, more importantly, the results of its implementation, is summarized below in *Table 25*. In the left-hand column of the Table we present the major provisions of the FTP taken from the final version of the main document, and also some comments made by RF top officials so as to clarify the idea of military reform, while the right-hand column contains the assessments obtained at the IET on the basis of the published data.

*Table 25*

**Assessment of the Results of Implementation of the Federal Target Program**

<b>Demands of RF President and Government, as presented in FTP; official statements of RF high officials</b>	<b>Assessment of initially formulated FTP's tasks and goals, and of results of its implementation as of December 2007. Comments</b>
<p>Goals of the Program:</p> <ul style="list-style-type: none"> <li>- to ensure the transition to a new system, whereby the military positions filled by soldiers, sailors, sergeants, and petty officers will be staffed by servicemen enlisted for military service under contracts, and</li> <li>- to improve the combat readiness of the RF Armed Forces' military formations and units of permanent readiness, and of the military units of frontier troops and of the RF Ministry of Internal Affairs' internal service troops.</li> </ul> <p>These formulations of the goals presented in the FTP should be considered in the light of the RF President's preliminary instructions. In particular, one should take into account the following provisions:</p> <p>"One of the unquestionable priorities should be the continuation of military reform and the transition to a professional army, with the simultaneous reduction of the duration of compulsory military service".</p> <p>The reform is necessary for society, but first of all – for the army itself".</p> <p>"In accordance with the approved plans, we will continue the formation, on a professional basis, of units of permanent readiness in the land and airborne forces and in the marines. This work must be completed in the year 2007. Apart from this, service in internal-service and frontier troops will also be based on the principles of professionalism".</p> <p>Some of the President's instructions were further developed by the RF Minister of Defense. In his interview to the newspaper "Krasnaia Zvezda" ["The Red Star"] as of 17. 09. 2004, S. Ivanov said the following: "A partial switchover of the Armed Forces to a contractual basis is not a political declaration and not the goal of development of Russia's Armed Forces. It is one of the avenues to increasing the combat efficiency of Russia's Armed Forces"</p>	<p>When formulated this way, the goals of the FTP take into account only the requirements of the RF military establishment – despite the directives of the Commander in Chief. The socially important goals (the reduction in the general number of citizens being drafted and in the duration of compulsory military service, and most importantly, the task of changing the aim of such service to simply training a person in a military occupation specialty; the improvement of conditions of compulsory military service and contracts, including the suppression of acts of harassment among servicemen and violations of human rights) were not included in the FTP. Therefore, there was no intention to achieve these goals. The results are apparent and could not be different.</p> <p>Of all the military – political goals formulated in the FTP, the first goal has not been achieved in full measure, both with regard to the initially specified numbers of contractees and (even) with regard to their later revised and significantly reduced numbers.</p> <p>The second goal has been achieved only fragmentarily: in the Frontier Service of the FSB, the quotas were exceeded (the draft was completely abandoned), while in the Internal-Service Troops of the Ministry of Internal Affairs the goals were achieved to a large measure. The major failure in implementing the FTP in full was observed in the units and formations of the RF Armed Forces. Most successfully the FTP was implemented in the units stationed in the North Caucasian Military District.</p> <p>In the Land Forces, 60 formations and units, with the overall strength of 100 thousand, were completely switched over to service under contracts. Although not mentioned in the FTP, submarine crews of the Navy were also made to serve under contracts.</p> <p>While considering the improvement of the combat efficiency of the RF military establishment's personnel to represent the achievement of the main military goal as expected by the Minister of Defense, it should be pointed out that this goal, as demonstrated by the estimates, has been achieved only with respect to the military units of permanent readiness; as regards Russia's Armed Forces on the whole, it has not been achieved by the end of 2007, and after the year 2008, their overall combat efficiency may even decline</p>

#### **Major tasks of the Program:**

- to ensure the transition to a professional army based on the principle that the military positions filled by soldiers, sailors, sergeants, and petty officers should be held by servicemen enlisted for military service under contracts;
- to carry out the stage-by-stage transition of these formations and military units to a system when the military positions filled by soldiers, sailors, sergeants, and petty officers are held by servicemen enlisted for military service under contracts in accordance with the time schedule (Annex No. 1, classified);
- to ensure the corresponding adjustment of the system for the training and accumulation of mobilization human resources;
- to ensure the improvement of combat readiness of the afore-said formations and military units by heightening the level of military training and professional capabilities of the servicemen enlisted for military service under contracts.

In his interviews to the newspaper "Krasnaia Zvezda" of 6. November 2004 and 17 November 2004, Head of the General Staff Iu. Baluevskii stated that by the end of 2007, "the proportion of contractees holding the military positions to be filled by sergeants and soldiers will reach 50%", and, as a result, the RF Armed Forces will obtain a "rational system of mixed manning"

#### **Major measures of the Program:**

The Program's measures, designed to **create the conditions ensuring a stable functioning of the system of manning the Armed Forces** and other troops and military bodies by servicemen enlisted for military service under contracts, include:

- scientific backing for the Program;
- the improvement of the normative-legal base of military service under contract with regard to servicemen, in the military units being switched over to the new system of manning, who are holding military positions to be filled by soldiers and sergeants;

- the resolution of the organizational issues concerning the transition to the new system of manning whereby the military positions to be filled by soldiers and sergeants should be given, in the military units being switched over to the new system of manning, to servicemen enlisted for military service under contracts;

- the information support for the Program;
- the creation of a stable and centralized system of manning the Armed Forces, other troops, military formations and organs

The formulated tasks of the FTP correspond to its goals, which means that they are practically unrelated to the concerns expressed by the citizens and society, although the FTP's certificate, when specifying the reason for introducing the Program, has clearly stated that it is "motivated by the military-political, economic, and social importance and the range of the tasks being solved by the Armed Forces and other troops, military formations and organs".

As regards the time schedule of the military establishment's switch-over to the new system of manning, it should be noted that the reason for its being classified is unclear, because when citizens were being attracted to volunteer military service under contracts, they unavoidably had to be informed on the names and addresses of military units and formations by various means, including the mass media. Thus, the whole list of military units of permanent readiness, as well as the places of their stationing and the time table for their switchover to the contractual system have become known to the RF citizens being invited to serve under contracts.

Secondly, in the course of implementing the FTP, the federal authorities with troops at their disposal have been granted the right to introduce adjustments into the time schedule.

Nowadays, Minister of Defense A. Serdiukov states in his report concerning the results of the Ministry's activity in 2007 that the proportion of persons enlisted for military service under contracts in the positions reserved for privates and NCOs will reach 44%. And some top military commanders put to doubt the achievability of even this level of manning. This means that the system of manning which exists in our country is not rational, according to Baluevskii's definition. A similar conclusion could also be made on the basis of our calculations of indices of regular forces and on the ratio of their numbers and the size of mobilization resources

A stable system of manning has failed to materialize. Evidence for this is the failure to abide by the time schedule, and the facts of coercion to conclude contracts and of corruption at military registration and enlistment offices, which forced the Minister of Defense to issue, in 2006, a corresponding anti-corruption order. However, according to the Office of Public Prosecutor, in the course of nearly one and a half year since this memorable date the situation has not notably changed to the better.

As regards scientific backing for the Program, it can only be said that expenditures under this item did go up (when the FTP was repeatedly adjusted), while the results, according to non-classified sources of information, including the military-theoretical journal "Voennaia Mysl" [Military Thought] remained modest at best. If the results of this research are classified, the reasons for this should be clarified, because the case in point is a socially important reform. The normative-legal backing of the FTP contradicted its goals and the RF Government's instruction. The draft law on reducing the term of service was submitted with a delay and in one package with other draft laws, which resulted in it having been considered, behind closed doors, in haste and without a preliminary discussion by experts. Also, a number of drawbacks were revealed, including, in particular, the violation of the right of citizens who have completed one or two terms of service under contracts to labor pensions, which should have taken into account their money allowances during the period of service. The abolition of the draft in Chechnya, thus singled out from the rest of Russian regions, was implemented without having been duly substantiated by the adoption of a corresponding law, which can have negative consequences. From the legal point of view, the Regulation on Military Service does not eliminate the possibility of servicemen enlisted for compulsory military service being dispatched to the "hot spots".

The information support for the Program turned out to be of low efficiency. A number of publications contained disinformation, which inspired justified criticism on the part of citizens and human rights organizations

The Program's measures aimed at **ensuring the attractiveness** of military service under contract envisage the following:

- payment of differentiated bonuses for special conditions of combat training;
- payment of compensations, to the afore-noted servicemen with families, for renting a dwelling, in accordance with the norms stipulated by RF legislation;
- bringing the level of providing the afore-said servicemen with clothing and small stores into correspondence with the norms set by RF legislation;
- ensuring the following rights of the afore-said servicemen:
  - to medical support, including the setting of compensations for sanatorium and spa treatment;
  - to the payment of the cost of travel of a serviceman and members of his family to another place of service, including the compensation for the expenses for travel to the place of use of leave and back;
- the encouragement of fulfillment of battle tasks and military training tasks in special (field) conditions;
- granting the right to free higher education or secondary special education

The measures aimed at **solving the housing problems** of contractees envisage a

change in the billeting of servicemen enlisted for military service under contracts in the positions which should be filled ... (see above); to this end, it is planned to carry out:

- reconstruction (or refitting) of the existing barracks, in order to convert them into military hostels of a simplified type;
- construction of new military hostels;
- upgrading of objects in the barracks sphere, in order to bring them into line with the authorized standards;
- and development of the social and engineering infrastructure, in order to ensure the functioning of both the existing objects of the barracks sphere and those being put into commission

The Program's measures aimed at **improving the combat training and the material and technical support for military units** envisage:

- the relief of servicemen, enlisted for military service under contracts in the military positions which should be filled by soldiers and sergeants in the military units being switched over to the new system of manning, from the fulfillment of duties unrelated to combat (or special) training and their official duties;
- the improvement of the educational-material and technical base for combat training;
- organization of combat training in accordance with the demands set by RF legislation;
- the ensuring of exploitation of objects constituting the educational-material and technical base for combat training, and of an increased number of objects of infrastructure;
- and the ensuring of the most sophisticated forms of combat training to be carried out

The 3,300 rubles / month bonus, calculated in late 2003, was too small, even at that time, for the contractees' money allowance to exceed the average national wage, which has always been the necessary precondition to creating a volunteer army. And it had become less than scanty by the end of the FTP, because it had not been adjusted for inflation, which shot up to more than 40% over this period.

The size of compensation for renting a dwelling also turned out to be insufficient and well below the minimum required level in the majority of RF regions.

The drawbacks in providing all the servicemen with clothing and small stores are forcing the new Defense Minister to start revising the norms and reconsidering the design of the uniform.

The ensuring of the rights to medical support and the payment of the cost of travel had a positive effect, but these measures cannot compensate for the low level of money allowance.

Unfortunately, the payment of "field" and "combat" bonuses lacked due control, which led to financial fraud and court proceedings.

The right to free higher education or secondary special education is now envisaged by a corresponding law. This measure is useful.

However, its efficiency has failed to duly manifest itself so far, due to the low initial educational level of the contractees being enrolled, and, first of all, due to the fact that many of them are disinterested in improving this level; in the future, the efficiency is expected to be low because it is planned to draft mainly graduates of higher educational establishments

As regards the construction component of the measures, it should be noted that expenditures on it were steadily growing during the period of implementing the FTP. Despite some undisputed achievements, even the Supreme Commander's assessment points to the fact that the results of construction are not totally adequate to the said expenditures. The housing problem was resolved most successfully in the military units and formations quartered in the North Caucasian Military District.

During the period of implementing the FTP, the authorities developed the Law on the Funded Mortgage System for Providing Servicemen with Housing. Also included in the system were those privates and noncommissioned officers serving under contracts who were going to sign a second contract for continuation of military service. However, this incentive not only formally exceeds the bounds of the FTP, but also has failed to become an operative factor, because the new system has not been put into operation as yet

As regards the attainment of the normative level of combat training and of the material and technical support for military units and formations of permanent readiness, it should be noted that these measures, in fact, have little to do with the principle of manning, as it was repeatedly pointed out already during the period of feasibility studies for the FTP. It is not very rational, irrespective of the type of a system of manning, to continue the upkeep of the military units not engaged in combat training. This problem should be approached with regard to all regular forces. Otherwise, it would be unclear why they should be kept at all

The Program's measures aimed at **ensuring that military units are adequately equipped with technological means** envisage: the maintenance of weapons and military equipment in good repair (the current maintenance and repair of weapons and military equipment, made necessary by an increased intensity of exploitation in the course of combat training); maintenance of the objects of infrastructure of military units at a level ensuring the strengthening of combat readiness and the conduct of combat training

The Program's measures, aimed at **creating the conditions ensuring the strengthening of combat and mobilization readiness** of the Armed Forces, border troops and Interior troops during the military units' switchover to the new system of manning, envisage the following:

- ensuring the purchasing and assembly of additional security and alarm systems;
- the preliminary training at training centers and units, of the servicemen enlisted for military service under contracts in the military positions which should be filled by soldiers and sergeants in the military units being switched over to the new system of manning.

- ensuring that the afore-said formations and military units are adequately equipped with technological means

**Financing:**

The funds to be allocated to the implementation of the Program amount to **98,913.31 million rubles (in 2003 prices)** (as written in the version of the RF Government's Decree, of 07 September 2006, No. 549).

Initially, it was planned to allocate 79,091.65 million rubles.

The share of capital investments in the total volume of expenditures in the years 2004–07 amounts to **44 percent (43,577.52 million rubles)**.

In the first version of the FTP, their share was 34 percent (27,178.28 million rubles).

The volume and structure of the budget financing of the Program's measures is subject to annual adjustment in accordance with the actual capacity of the federal budget and the degree of actual implementation of the Program's measures

The relief of servicemen from the fulfillment of duties unrelated to combat (or special) training and to their official duties is being successfully practiced in a number of military units by way of attracting, wherever possible, services from the outside, which are provided by commercial organizations at the localities where these military units are quartered. At the same time, human rights activists have exposed, and offices of military prosecutors have confirmed numerous instances of illegal employment of servicemen for performing work unrelated to their official duties, in commercial and other structures, outside their military units. In order to put an end to such violations, a special order of the Minister of Defense was issued, which, according to human rights activists, has failed to produce any palpable changes to the better as yet

The High Command of the Land Forces has developed a number of combat-training programs for the formations and units manned by servicemen enlisted for military service under contracts; from the academic year 2008 onward, the subunits are switched over to the one-year cycle of training.

The implementation of the FTP's measures has made it possible for the majority of objects of the educational material and technical base to be put in line with the demands stipulated in the guiding documents, and for the educational base to be in due time prepared for the beginning of a full-scale one - year combat training cycle. According to the army mass media, the measures are being implemented without any visible violations that could have caused public concern.

A number of publications in the army mass media have confirmed that these measures are indeed being implemented.

It is worth mentioning that state-of-the art security and alarm systems, as well as other means of automation and mechanization, are being successfully applied, especially in the RF frontier service.

The equipment of a number of training centers and the quality of training have been improved. A number of simulators and technical means of education have been developed and purchased

In spite of the fact that in the feasibility study concerning the FTP (and also that regarding its subsequent adjustments) the 2003 prices were applied, in the course of the FTP's actual implementation the expenditures were initially not adjusted by the inflation growth index, and later on were adjusted only with delays.

The distribution of the aggregate amount of the funds was adjusted mainly in terms of increasing capital expenditures.

Out of the total amount of the expenditures' increase (about 20 billion rubles in 2003 prices), virtually nothing was allocated to increasing the money allowance's special increment, introduced in order to increase the attractiveness of service under contract, which significantly hampered the initiative of manning the Armed Forces on the voluntary basis.

Judging from the numerous limitations producing a negative effect on the FTP's ultimate results, any increases in expenditures on research appear to be unmotivated and groundless

*Table 26* presents a comparison of the expected results of the FTP to the estimations based on its actual preliminary results of the Program.

Table 26

**Comparison between the Expected and Actual Results of the FTP**

Expected results, according to FTP certificate	Estimation of preliminary results
<p>1) the creation of adequate conditions for switching over to the system of manning the armed forces with volunteers enlisted for military service under contracts in the military positions which should be filled by soldiers, sailors, sergeants, and petty officers</p>	<p>According to the actual data and the public statements made by a number of high-rank officers, the conditions necessary for the successful manning of military units on the contractual basis have not been created, which became the main obstacle to achieving success</p>
<p><b>2) the regular filling, in these formations and military units, of the military positions which should be filled by soldiers, sailors, sergeants, and petty officers by servicemen enlisted for military service under contracts</b> (primarily in the military units fulfilling missions in the “hot spots” and (or) located therein).</p>	<p><b>The filling of a smaller number of positions at a higher cost does not attest to the successfulness of the FTP. Also, this process can hardly be characterized as regular, because the plans were adjusted towards weakening the demands. The exception is the Frontier Service of the FSB. The undisputed achievement, very important for RF citizens, is that RF servicemen (according to the assurances given by high-rank officers) are no longer taking part in combat actions in the “hot spots”.</b> However, some of the mass media affirm that, according to the servicemen themselves, this practice still survives. <b>Moreover, the legal substantiation for such practice has not been abolished.</b></p>
<p>The RF President’s considerations concerning the sequence of introduction of the new system of manning are formulated differently than in his 2003 Message: “I should also like to note that the NCO component of our Armed Forces will be switched over to the professional basis at priority rates”</p>	<p>In fact, the NCO component of the Armed Forces was not switched over to the contractual system of manning at priority rates. Such a switchover (for all military units) is now included in the new FTP</p>
<p>3) the creation of appropriate conditions for the first contracts to be concluded by citizens being enlisted for military service under contracts in the military positions which should be filled by soldiers, sailors, sergeants, and petty officers in the afore-said formations and military units</p>	<p><b>Although formal conditions have indeed been created, they are totally unattractive. As a result, by the end of the FTP’s period, it had become problematic to induce a serviceman not only to conclude a first contract, but also to prolong it (arrange the conclusion of a second contract)</b></p>
<p>4) the increase of the number of servicemen enlisted for military service under contracts in these positions <b>from 22,1 thousand to 138,722 thousand;</b> in the initial version – <b>to 147,578</b></p>	<p><b>The increase of the number of these servicemen has been adjusted downwards without reducing the expenditures on the FTP; on the contrary, these expenditures have been increased.</b> At the same time, contractees enlisted for military service in the units not included in the category of permanent readiness have not received even the tiny increment to money allowance which was introduced for the units of permanent readiness. As a result, the growing number of contractees in the units of permanent readiness was accompanied by an outflow of contractees from other military units, which means that the number of citizens who would be drafted after the year 2007 have reduced to a lesser degree (by almost 20 thousand) than it was expected at the time of substantiating the FTP</p>
<p>5) the reduction of society’s dissatisfaction with the existing system of manning the RF Armed Forces and other troops, military formations and organs, and with these servicemen being dispatched for military service in the “hot spots”</p>	<p>Owing to these circumstances, society’s dissatisfaction will not be diminished, contrary to expectations. Instead, it will become even greater, because of the cancellation of deferments, primarily for young fathers and graduates of higher educational establishments. Besides, this dissatisfaction will grow as a result of the already appearing upward trends in the size of bribes and in the price of other “services” in the sphere of illegal draft evasion. Officers not serving in the units of permanent readiness are now also dissatisfied even more, because the level of their money allowance has become relatively lower</p>
<p>6) <b>the creation of preconditions for</b> reducing, from the year 2008, the term of compulsory military service to one year</p>	<p>As a result of the FTP having been implemented in such a manner, the preconditions which appeared so promising to the developers of the FTP will, in effect, produce only slight improvements, while the growth of dissatisfaction caused by the cancellation of deferrals can produce an opposite effect, in the form of proposals to return to the two – year term of service, without reintroducing the deferrals</p>

A more detailed quantitative analysis of the FTP's results can be performed on the basis of the data presented in *Table 27*, which contains the FTP's target indicators and indices of effectiveness. This table was added to the initial text of the FTP in accordance with the RF Government's Decree, of 07. 09. 2006, No. 549, in connection with the switchover to the principles of performance-based budgeting (PBB).

*Table 27*

**The Target Indicators and the Indices of Effectiveness of the Program**

Indicator	Financing of federal executive bodies	2004–2007, total	Including				Comments on the results of FTP
			2004	2005	2006	2007	
1. The number of servicemen enlisted for military service under contracts in the military units being switched over to the new system of manning	Ministry of Defense	125,359	18,215	40,842	24,405	41,897	In the interests of society, where the desire to minimize the scope of the draft and the economic costs shouldered by the families and the civil economy of the country is rather widespread, this indicator should have been augmented by stating the number of servicemen enlisted for military service under contracts and those drafted to the ranks
	Ministry of Internal Affairs	9,729	3,880	3,881	992	976	
	FSB	3,634	–	–	990	2,644	
	Total	138,722	22,095	44,723	26,387	45,517	
2. Number of places for housing servicemen enlisted for military service under contracts in hostels with housing cells of simplified type	Ministry of Defense	115,636	22,004	27,267	26,390	45,517	From the point of view of citizens and society, it is no less important to know the number of servicemen, especially of those with families, who are not provided with housing, and to be informed on the methods and the timelines for their housing problems to be solved
	Ministry of Internal Affairs	9,764	2,048	2,582	3,871	1,263	
	FSB	1,180	–	–	660	520	
	Total	126,580	24,052	29,849	30,921	41,758	
3. Number of places reserved for training servicemen enlisted for military service under contracts	Ministry of Defense	25,478	502	2,562	4,377	18,037	In the interests of society it would be no less important to know that all the servicemen (both drafted and enlisted for military service under contracts) are actually provided, at the places of their service, with adequate facilities for combat training and for the fulfillment of their duties, and that all the prescribed safety measures are duly observed in the process
	Ministry of Internal Affairs	860	–	–	763	97	
	FSB	571	–	–	200	371	
	Total	26,909	502	2,562	5,340	18,505	

From the table it follows that there are no indices of effectiveness as such. At the same time, there indeed exist certain methods for assessing the combat ability of armed forces as an indicator of the FTP's military effectiveness<sup>119</sup>.

If one makes use of these methods, it would become clear that the fighting efficiency of military units of permanent readiness grows in parallel with its decline in all the other military

<sup>119</sup> *Tsymbal V., Kardashevskii N.* Mnogourovnevnyi analiz problem prizyva na voennuiu sluzhbu v Rossii ( A multi-level analysis of the problems related to military draft in Russia) // *Voprosy Ekonomiki* (Issues of Economics). 2006. No. 1. Pp.70–85.



units, because they have already been remanned with citizens drafted not for 2 years but for 1.5 year, and from the year 2008 onward they will be remanned with those drafted for 1 year. The fighting efficiency of this category of regular forces will diminish, due to the insufficient level of training received by the servicemen, as well as the absence of incentives to serve efficiently, to master modern weaponry and to take care of it. It is estimated<sup>120</sup> that the fighting efficiency of the RF contingent of privates and noncommissioned officers as a whole will also decrease.

Thus, the implementation of the FTP appears to be distorted not only with regard to the needs of society and its citizens, but also to the military-political guidelines formulated by the President. The lowering (by comparison with the plan) of the number of contractees, whereas the total number of positions which should be filled by privates and NCOs remains unchanged, will lead to an increase in the number of persons being drafted, while the simultaneously introduced cancellation of deferrals will increase the number of citizens who are eager to pay the “ransom” and have the means to do this, because from now on the persons to be drafted will be, in the main, graduates of higher educational establishments who have acquired professions in demand on the labor market. Such a completion of the FTP will be profitable only to corrupt officials.

As regards the other aspects of the military personnel policy, several acts aimed at actually improving the situation were adopted last year. The RF President’s Edict No. 1495, of 10. November 2007, has approved and put into force the new standard regulations of the RF Armed Forces: the Disciplinary Regulations; the Routine Duty Regulations; and the Garrison and Guard Duty Regulations. The following decisions were adopted: on accelerating the increase, in 2008, of the money allowance of servicemen; on repaying the arrears, dating back to 1995, to military pensioners; and on the cancellation of the drafting to officers’ positions of graduates of higher educational establishments with military chairs. There are some evident successes in the provision of housing to those servicemen who have received the right to the ownership of housing, and to those who are in need of service housing.

However, so far as the contingent of privates and sergeants is concerned, the planned increase of their pay will not raise their money allowance above the average national wage level, and therefore will not enhance the attractiveness of military service under contracts. The new additional payments introduced by the Minister of Defense’s Order, of 01. 11. 2007, No. 450 will merely increase the money allowance of servicemen who serve in the central apparatus of the Ministry of Defense, and not of those who are in the greatest need of this.

#### 5.5.2. The Provision of Technical Equipment and the Ensuring of Functioning of the RF Military Organization

Russia’s arms policy was expressed in the classified State Weapons Program (SWP) for the period until the year 2015.

According to the unclassified materials of the year 2007, one could only surmise that the implementation of the Program is snagged by the already well-known problems: the higher is the degree of monopolization (vertical integration being fraught precisely with this), and the

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<sup>120</sup> Vorob’ev E., Tsymbal V. Sistema komplektovaniia voennoi organizatsii gosudarstva (The system of manning the military establishment of a State) // Mirovaia ekonomika i mezhdunarodnye otnosheniia (The world economy and international relations). 2007. No. 3. Pp. 85–93.

weaker is competition, the more costly is production. The system of orders for weapons and for war and special equipment (WWSE), as well as the operation of enterprises in the defense-industrial complex have offered numerous examples in proof of this rule. Here are some of them. During the past three years, the cost of the strategic ballistic missile (BM) "Topol" – M" increased more than two-fold, or well above the general level of inflation. Therefore, the rise in expenses on purchasing the BM will not increase the volumes of purchases. The actual rate of innovating the land-based offensive strategic means will remain at the same level of 7 missile complexes per year, which does not correspond to the existing agreements with the USA concerning the levels of strategic weapons. The transmission of the order for the development of the sea-based BM "Bulava" to the traditional developer of land-based BMs resulted not in the promised economy of the funds (due to unification), but in their being overspent, and in a failure to timely commission new naval missile-carriers.

The second military-economic thesis, repeatedly mentioned in the programs of modernization of the DIC, that the DIC is the "locomotive" that will virtually haul the kindred sectors of civilian machine-building to the world level of high technologies, is by no means absolutely correct, either. For this "locomotive" to be operable, it would be necessary for the rules of competition to be observed and for independent civil control to be implemented; also, the thesis needs a scientific substantiation.

In conclusion of this sub-section, we should like to note that the problems of military production development have been aggravated by the deficiencies of military personnel policy, referred to in the previous sub-section. At a special conference, which took place under the chairmanship of First Vice-Premier D. Medvedev, Head of the State Corporation "Russian Technologies" S. Chemezov presented a very grim picture of Russia's defense industry. According to him, the rise in sales of Russian weapons on the external market (by the results of 2007 – 8 billion USD), and in sales within the framework of state defense order, has revealed one of the most acute problems – the lack of regular work force. Today, the average age of a worker is 45 years, while that of a highly qualified worker – 53 years. Despite having enormous funds at their disposal, enterprises simply cannot cope, in a timely and adequate manner, with the tasks assigned to them. For example, the Severodvinsk Machine-Building Enterprise has failed to fulfill India's order for the re-equipment of the aircraft carrier "Admiral Gorshkov". The reason was trivial – the plant did not have enough welders.

In order to improve the situation, it is suggested that the system of vocational training schools and specialized secondary schools should be resurrected under the aegis of the State; besides, incentives should be created for graduates of technological higher educational establishments to go to work, at the DIC's enterprises. Their attractiveness could be achieved, for example, by the provision of these graduates with housing by the employer. But there are other suggestions as well: either to restore the deferral for DIC's workers, or to equate work at these enterprises with alternative civilian service (ACS). The State Duma of the new convocation will consider the corresponding draft law as early as spring 2008<sup>121</sup>.

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121 *Litovkin D.* Opiat' tebe broniu daet rodnoi zavod "Kompessor"! Kvalifitsirovnykh rabochikh budut osvobozhdat' ot armii (And once again our dear plant "Compressor" gives you a draft deferral! Skilled workers will be exempted from military service) // *Izvestiia*. 12 July 2007.

### 5.5.3. The Military Expenditures of the Federal Budget

The 2007 federal budget<sup>122</sup> envisaged the spending of 822,036 million rubles, which amounted to 2.63% of GDP, or 15% of the federal budget's expenditure under Section 02 "National Defense". Although it seemed that the May adjustment of the federal budget<sup>123</sup> did not openly interfere with military expenditures, as early as February the reports of the Federal Treasury<sup>124</sup> began to assert that the allocations under this sections had been set, by the Law, in the amount of 825,169 million rubles; by November, they had grown, without the Law having been formally altered, to 833,978 million rubles. After the 2007 federal budget's acquiring its final shape in November<sup>125</sup>, with the expenditures under Section 02 being fixed at the level of 839,103 million rubles, the discretionary growth of expenditures, nevertheless, continued. Thus, the Government's adjusted budget revenue and expenditure<sup>126</sup> authorized the spending, under this section, of as much as 840,623 million rubles in November, and of 843,222 million rubles in December.

In the final version of the federal budget, expenditure rose from 5,463 billion rubles to 6,531 billion rubles, or by 19.6% by comparison with the version dated as of the end of 2006. At the same time, the expenditures under Section 02 "National Defense" grew by 2.1% to 839,103 million rubles, or 2.61% of GDP, or 12.9% of the federal budget's expenditure. It should be noted that the expenditures under the other sections of the budget increased more considerably (with the exception of Section 03 "National Security and Law-Enforcement Activity", where the rise in expenditures amounted to 1.8%).

Due to a more significant growth of expenditures under the unclassified sections of the final version of the federal budget, there was a certain decrease in the degree of its general secretiveness, by comparison with both the initial version (from 12.2% to 10.3%) and the two previous federal budgets (see *Table 28*). However, the secret expenditures of the 2007 federal budget did increase in absolute terms from 669,025 million rubles in the initial version to 674,747 million rubles in the final version.

The 2007 federal budget was the first one where some of the allocations were classified, namely those under Section 11 "Interbudgetary Transfers" and Sub-section 0410 "Applied Scientific Research in the Sphere of the National Economy" of the functional classification of the federal budget's expenditures. And although it is very tempting to believe that the declassification, in 2007, of the allocations under subsection 0806 "Other Issues in the Sphere of Culture, Cinematography and Mass Media" would set a good example for all the developers of the Russian federal budgets, an analysis of the federal budget for the year 2008 and for the 2009–2010 planning period 2008 indicates<sup>127</sup> that the tendency toward a steady decrease in the transparency of the main financial document of this country is very much alive.

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<sup>122</sup> Federal Law "On the 2007 Federal Budget", No. 238-FZ.

<sup>123</sup> Federal Law "On the Introduction of Alterations in the Federal Law "On the 2007 Federal Budget", No. 74-FZ, of 15. 05. 2007.

<sup>124</sup> Reports on the implementation of the Federal Budget (see <http://www.roskazna.ru/reports/fb.html>).

<sup>125</sup> Federal Law "On the Introduction of Alterations in the 2007 Federal Budget", No. 267-FZ, of 23. 11. 2007.

<sup>126</sup> See the Federal Treasury's data on the implementation of the Federal Budget.

<sup>127</sup> See *Ekonomiko-politicheskaia situatsiia v Rossii. 2007. August*. (The economical and political situation in Russia. 2007. August). Pp. 44–48.

Table 28

The Share of the Classified Expenditures of the 2003–2007 Federal Budgets, in %

Code and name of item (or sub-item) that contains classified expenditures	2003	2004	2005	2006	2007
Total expenditure of federal budget	9.73	9.83	11.33	11.80	10.33
01 ISSUES OF NATIONAL IMPORTANCE	No data <sup>128</sup>	No data	3.67	6.28	5.52
0108 International relations and international cooperation	31.88	18.04	–	0.01	< 0.01
0110 State material reserve	97.73	93.33	82.86	89.23	92.18
0111 Fundamental research	–	–	2.13	1.22	1.12
0115 Other issues of national importance	No data	No data	0.05	0.72	0.28
02 NATIONAL DEFENSE	37.22	38.40	42.06	42.77	45.33
0201 Armed Forces of Russian Federation	35.39	36.11	33.07	35.59	37.11
0203 Preparation of economy for mobilization	100.0	100.0	100.0	100.0	100.0
0204 Preparation for and participation in ensuring collective security and peace-keeping activity	–	–	100.0	100.0	100.0
0205 Nuclear weapons complex	100.0	100.0	100.0	100.0	100.0
0206 Implementation of international obligations in sphere of national defense	100.0	41.05	45.22	46.90	50.65
0207 Applied scientific research in sphere of national defense	No data	No data	98.37	93.94	93.69
0208 Other issues in sphere of national defense	No data	No data	2.49	8.79	24.38
03 NATIONAL SECURITY AND LAW-ENFORCEMENT ACTIVITY	23.33	20.79	28.52	31.64	31.07
0302 Internal security agencies	3.40	3.01	4.76	6.31	5.16
0303 Internal service troops	13.21	11.10	11.76	10.31	9.80
0306 Security agencies	100.00	98.91	97.80	95.49	97.31
0307 Frontier service agencies	19.73	22.88	100.00	98.97	97.62
0309 Prevention and liquidation of consequences of emergency situations and natural disasters, civil defense	43.69	41.74	59.02	62.39	50.65
0311 Applied scientific research in sphere of national security and law-enforcement activity	No data	No data	73.95	66.41	64.43
0313 Other issues in sphere of national security and law-enforcement activity	No data	No data	8.26	50.71	39.95
04 NATIONAL ECONOMY	No data	No data	0.05	0.02	0.44
0402 Fuel and power engineering	No data	No data	–	–	5.23
0411 Other issues in sphere of national economy	No data	No data	0.12	0.06	< 0.01
05 HOUSING AND UTILITIES SECTOR	No data	No data	–	3.42	0.85
0501 Housing sector	No data	No data	–	4.22	5.69
07 EDUCATION	–	–	2.76	2.69	2.39
0701 Pre-school education	–	–	2.03	2.17	2.44
0702 General education	–	–	1.51	1.91	2.14
0704 Secondary vocational education	–	–	1.06	1.03	1.02
0705 Retraining and advanced training	–	–	16.85	15.78	17.22
0706 Higher vocational education	–	–	3.15	2.93	2.53
0709 Other issues in sphere of education	–	–	0.30	0.33	0.28
08 CULTURE, CINEMATOGRAPHY AND MASS MEDIA	–	–	0.17	0.17	0.21
0801 Culture	–	–	0.14	0.10	0.16
0804 Periodical press and publishing houses	–	–	13.46	7.45	2.57
0806 Other issues in sphere of culture, cinematography and means of mass communication	–	–	0.02	0.15	–
09 PUBLIC HEALTH CARE AND SPORT	–	–	4.30	3.99	2.57
0901 Public health care	–	–	5.61	4.66	2.94
0902 Sport and physical culture	–	–	0.28	0.26	0.24
Total expenditure of federal budget	–	–	–	–	0.16
01 ISSUES OF NATIONAL IMPORTANCE	–	–	–	–	0.50

Source: IET estimates based on the data of the 2003–07 federal budgets (the data for the years 2003–04 are presented under the corresponding items and subitems of the existing budget classification).

The absolute and relative values of the major components of the RF's military expenditures, and their change by comparison with the year 2006 in accordance with the final version of the 2007 federal budget, are shown in *Table 29* (recalculation into 2006 prices has been

<sup>128</sup> Can not be applied due to changes in the budget classification's structure.

performed on the basis of Rosstat's first estimation of the GDP deflator index for the year 2007<sup>129</sup>).

*Table 29*

**Direct Military Expenditures of the Federal Budget under the Section  
“National Defense”**

Sections and subsections	2007 mil- lion rubles / same in 2006 prices	Change in 2007, by com- parison with 2006, mil- lion rubles / growth in %	Share of 2007 budget expendi- tures, in % / change by com- parison with 2006, in p.p.	Expenditures as percentage of GDP / change by comparison with 2006, in p.p. of GDP
NATIONAL DEFENSE	<u>839,103</u>	<u>53,149</u>	<u>12.85</u>	<u>2.54</u>
	739,297	7.75	-2.64	-0.01
Armed Forces of Russian Federation	<u>606,163</u>	<u>18,701</u>	<u>9.28</u>	<u>1.84</u>
	534,064	3.63	-2.35	-0.08
Mobilization-related and military train- ing for civilians	<u>4,157</u>	<u>146</u>	<u>0.06</u>	<u>0.01</u>
	3,662	4.14	-0.02	-
Preparation of economy for mobiliza- tion	<u>4,736</u>	<u>672</u>	<u>0.07</u>	<u>0.01</u>
	4,172	19.21	-0.01	-
Preparation of and participation in en- suring collective security and peace- keeping activity	<u>117</u>	<u>43</u>	<u>0.00</u>	<u>0.00</u>
	103	71.,92	-	-
Nuclear weapons complex	<u>12,099</u>	<u>-770</u>	<u>0.19</u>	<u>0.04</u>
	10,659	-6.74	-0.07	-
Implementation of international obliga- tions in sphere of military-technological cooperation	<u>6,665</u>	<u>-71</u>	<u>0.10</u>	<u>0.02</u>
	5,872	-1.20	-0.03	-
Applied research in sphere of national defense	<u>122,759</u>	<u>14,887</u>	<u>1.88</u>	<u>0.37</u>
	108,158	15.96	-0.23	0.03
Other items in sphere of national de- fense	<u>82,408</u>	<u>19,542</u>	<u>1.26</u>	<u>0.26</u>
	72,606	36.83	0.06	0.05

*Source:* IET estimates based on the data of Federal Laws No. 238-FZ, of 19 December 2006, and No. 267-FZ, of 23 November 2007.

One further part of military expenditures incurred at the expense of other sections of the Russian federal budget is presented in *Table 30*. In contrast to previous years, it now includes the estimates of the low bound of the military establishment's expenditures incurred under such traditionally civilian budget sections as 04 “The National Economy”, 05 “The Housing and Utilities Sector”, 07 “Education”, 08 “Culture, Cinematography, and Mass Media”, 09 “Healthcare and Sports”, and 11 “Interbudgetary Transfers”.

The indirect military expenditures related to previous defense activity are presented in *Table 31*, while the aggregate indices of the RF's military expenditures in the year 2007 are presented in *Table 32*. The observed unprecedented rise in expenditures on pensions was caused by the October decision<sup>130</sup> to repay the State's liabilities, dating back to 1995–98, to pensioners of the Ministry of Defense and of the Frontier Service. The corresponding funds in the amount of 42.615 billion rubles were allocated, in due course, to the RF Ministry of Finance. Without taking this sum into consideration, the Ministry of Defense's pension expenditures in 2007 declined by 2% in real terms.

<sup>129</sup> Sotsial'no-ekonomicheskoe polozhenie Rossii: Doklad. (The socio-economic situation in Russia: a report). Moscow: Rosstat, 8 February 2008.

<sup>130</sup> Edict of the RF President of 18.10.2007, No. 1373s “On some measures designed to guarantee the social protection of individual categories of pensioners”.

Table 30

**Direct and Indirect Military Expenditures under Other Items of the Federal Budget**

Sections and subsections, or character of expenditures	2007, million rubles / same in 2006 prices	Change in 2007, by comparison with 2006, million rubles / growth in %	Share of 2007 budget expenditure, in % / change by comparison with 2006, in p.p.	Expenditures as percentage of GDP / change by comparison with 2006, in p.p. of GDP
<b>Expenditures on military establishment under Section "National security and Law-Enforcement Activity"</b>				
Internal service troops	46,394	2,451	0.71	0.14
	40,876	6.38	-0.16	-
Security agencies	115,955	9,345	1.78	0.35
	102,163	10.07	-0.32	0.01
Frontier-service agencies	56,927	-682	0.87	0.17
	50,156	-1.34	-0.28	-0.02
<i>Units of Ministry for Emergency Situations' forces, and civil defense</i>	24,457	-421	0.37	0.07
	21,548	-1.92	-0.12	-0.01
<b>Expenditures on military establishment under Section "National Economy"</b>				
Military types <sup>131</sup> of expenditures	10,410	4,134	0.16	0.03
	9,172	82.07	0.05	0.01
Classified expenditures	3,187	2,753	0.05	0.01
	2,808	5,004.34	0.05	0.01
<b>Expenditures on military establishment under Section "Housing and Utilities Sector"</b>				
Military types of expenditures	15,452	-7,591	0.24	0.05
	13,614	-35.80	-0.24	-0.03
Classified expenditures	2,511	353	0.04	0.01
	2,213	18.99	0.01	-
<b>Expenditures on military establishment under Section "Education"</b>				
Expenditures of Ministry of Defense	27,971	-5,131	0.43	0.08
	24,644	-17.23	-0.24	-0.03
Classified expenditures	6,862	336	0.11	0.02
	6,045	5.89	-0.02	-
<b>Expenditures on military establishment under Section "Culture, Cinematography, and Mass Media"</b>				
Expenditures of Ministry of Defense	2,429	376	0.04	0.01
	2,140	21.34	-	-
Classified expenditures	148	37	0.00	0.00
	131	39.05	-	-
<b>Expenditures on military establishment under Section "Healthcare and Sports"</b>				
Expenditures of Ministry of Defense	21,434	-2,414	0.33	0.06
	18,884	-11.33	-0.15	-0.01
Classified expenditures	7,112	-125	0.11	0.02
	6,266	-1.97	-0.04	-
<b>Expenditures on military establishment under Section "Interbudgetary Transfers"</b>				
Federal subsidies, subventions and interbudgetary transfers to closed administrative and territorial units	19,842	1,645	0.30	0.06
	17,482	10.39	-0.05	-
Subventions to budgets to finance the exercise of powers with regard to initial registration for military service	1,189	48	0.02	0.00
	1,048	4.79	-	-

Source: IET estimates based on the data of Federal Laws No. 238-FZ, of 19 December 2006, and No. 267-FZ, of 23 November 2007.

<sup>131</sup> Items 145, 215, 220–252, 256 and 472 of the current budget classification.

*Table 31*

### The Indirect Military Expenditures Related to Previous Defense Activity

Sections (subsections) or items	2007, million rubles / same in 2006 prices	Change in 2007 by comparison with 2006, million rubles / growth in %	Share of 2007 budget expenditure, in % / change by comparison with 2006, in p.p.	Expenditures as percentage of GDP / change by compari- son with 2006, in p.p. of GDP
Pension provision (Ministry of Defense)	<u>129,967</u> 114,509	<u>36,025</u> 31.46	<u>1.99</u> 0.22	<u>0.39</u> 0.10
Material support for employees of nuclear weapons complex	<u>1,845</u> 1,625	<u>208</u> 12.79	<u>0.03</u> –	<u>0.01</u> –
Housing subsidies for servicemen already discharged or being dis- charged from service	<u>29,381</u> 25,886	<u>9,908</u> 38.28	<u>0.45</u> 0.09	<u>0.09</u> 0.03

*Source:* IET estimates based on the data of Federal Laws No. 238-FZ, of 19. 12. 2006, and No. 267-FZ, of 23. 11. 2007.

*Table 32*

### The Aggregate Indices of Military and Associated Expenditures

Type of expenditures	Total expenditure, million rubles	Share of 2007 budget expenditure, in % / change by comparison with 2006, in p.p.	Expenditure as per- centage of GDP / change by comparison with 2006, in p.p. of GDP
Aggregate direct military expenditures	1,201,383	<u>18.39</u> –4.18	<u>3.64</u> 0.08
Aggregate direct and indirect military expenditures related to current and previous defense activity	1,362,576	<u>20.86</u> –3.87	<u>4.13</u> 0.05
Total expenditure on national defense, law – enforce- ment activity, and state security	1,513,893	<u>23.18</u> –4.86	<u>4.59</u> –0.03
Total direct and indirect federal expenditure related to current and previous defense, law – enforcement activ- ity, and state security	1,842,542	<u>28.21</u> –5.39	<u>5.59</u> 0.05

*Source:* IET estimates based on the data of Federal Laws No. 238-FZ, of 19. 12. 2006, and No. 267-FZ, of 23. 11. 2007.

The data on the month-by-month implementation of the 2007 federal budget's military and associated expenditures are presented in *Table 33*.

The results of a comparison, by means of *Figures 8–10*, of the implementation of federal budget expenditures, by each of the major components of direct military expenditures listed in Section 02 “National Defense”, have provided no grounds to suggest that the change of the Ministry of Defense's leadership in February 2007 have indeed had any impact on the implementation of expenditures.

On the whole, the dynamics of Russia's military expenditures in the post-crisis period of 1999–2007, reflected in *Table 34*, lend credence to the views of those<sup>132</sup> who eight years ago were warning us about the futility of increasing military expenditures without reforming the institutions inherited by Russia from its Soviet past.

<sup>132</sup> *Shlykov, V.* Neizbyvnyi kompleks (The indelible complex) // *Ъ-Vlast*?, 5 May 2000 (№ 19).

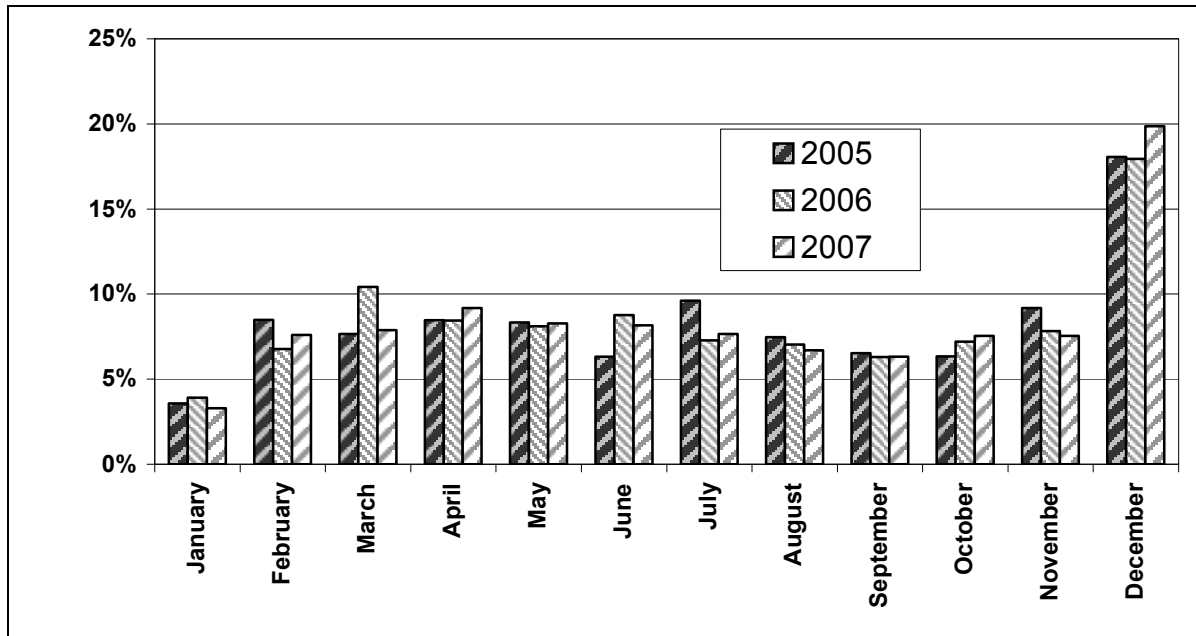
Table 33

**Implementation of Military and Associated Expenditures of the  
Federal Budget 2007, by month, billion rubles**

Expenditure items	Envisaged in FB - 2007	FB - 2007, amended.	January	February	March	April	May	June	July	August	September	October	November	December	Economy (overspending)
<b>National defense</b>	<b>822.0</b>	<b>839.1</b>	<b>22.5</b>	<b>61.1</b>	<b>66.5</b>	<b>72.6</b>	<b>68.5</b>	<b>65.9</b>	<b>67.4</b>	<b>52.9</b>	<b>50.1</b>	<b>60.9</b>	<b>63.8</b>	<b>181.7</b>	<b>7.2</b>
RF Armed Forces	549.9	606.2	20.0	46.2	47.8	55.7	50.2	49.6	46.5	40.6	38.4	45.8	46.4	116.0	4.0
Mobilization-related and military training for civilians	5.9	4.2	0.0	0.1	0.4	0.2	0.2	0.8	0.2	0.2	0.2	0.2	0.4	1.0	0.3
Preparation of economy for mobilization	3.5	4.7	0.0	0.1	0.1	0.6	0.4	0.4	0.6	0.3	1.5	0.5	0.9	0.3	(0.9)
Preparation of and participation in ensuring collective security and peace-keeping activity	0.1	0.1	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
Nuclear weapons complex	12.1	12.1	0.8	3.3	1.5	0.6	1.1	0.4	0.7	0.6	0.8	0.9	0.9	1.2	-
Implementation of international obligations in sphere of military-technological cooperation	6.0	6.7	0.8	0.1	0.2	0.8	0.0	0.2	0.8	0.1	0.1	0.7	1.4	0.6	0.3
Applied research in sphere of national defense	120.5	122.8	0.6	10.8	13.1	7.3	10.9	6.5	13.1	5.5	4.3	6.0	4.9	38.5	1.9
Other items in sphere of national defense	79.1	82.4	0.2	0.6	3.4	7.4	5.6	8.1	5.6	5.5	4.9	6.8	8.8	24.1	1.7
<b>National security and Law-Enforcement Activity</b>	<b>662.9</b>	<b>674.8</b>	<b>27.9</b>	<b>42.7</b>	<b>48.4</b>	<b>53.0</b>	<b>49.1</b>	<b>55.7</b>	<b>50.2</b>	<b>51.2</b>	<b>52.6</b>	<b>55.0</b>	<b>60.9</b>	<b>116.5</b>	<b>7.8</b>
Internal service troops	45.9	46.4	1.3	2.5	2.9	3.8	3.8	3.6	3.8	3.8	3.8	3.7	5.0	8.3	(0.4)
Security agencies	113.2	116.0	5.1	6.9	7.8	10.3	7.7	9.1	9.8	9.8	9.3	9.2	9.6	21.5	(0.9)
Frontier-service agencies	55.3	56.9	1.7	3.2	3.1	4.0	3.6	4.1	4.6	4.2	4.1	4.5	5.5	10.1	3.1
Prevention and liquidation of consequences of emergency situations and natural disasters, civil defense	40.3	42.0	1.6	3.8	4.0	3.8	2.8	3.2	2.6	2.8	2.5	5.2	3.3	6.2	(0.4)
Applied research in sphere of national security and law-enforcement activity	4.7	5.1	0.2	0.3	0.3	0.3	0.3	0.5	0.3	0.3	0.4	0.3	0.5	1.3	0.1
Other issues in sphere of national security and law-enforcement activity	11.2	5.92	0.2	0.5	0.2	0.5	0.2	0.1	0.4	0.2	0.2	0.3	0.2	0.5	2.4

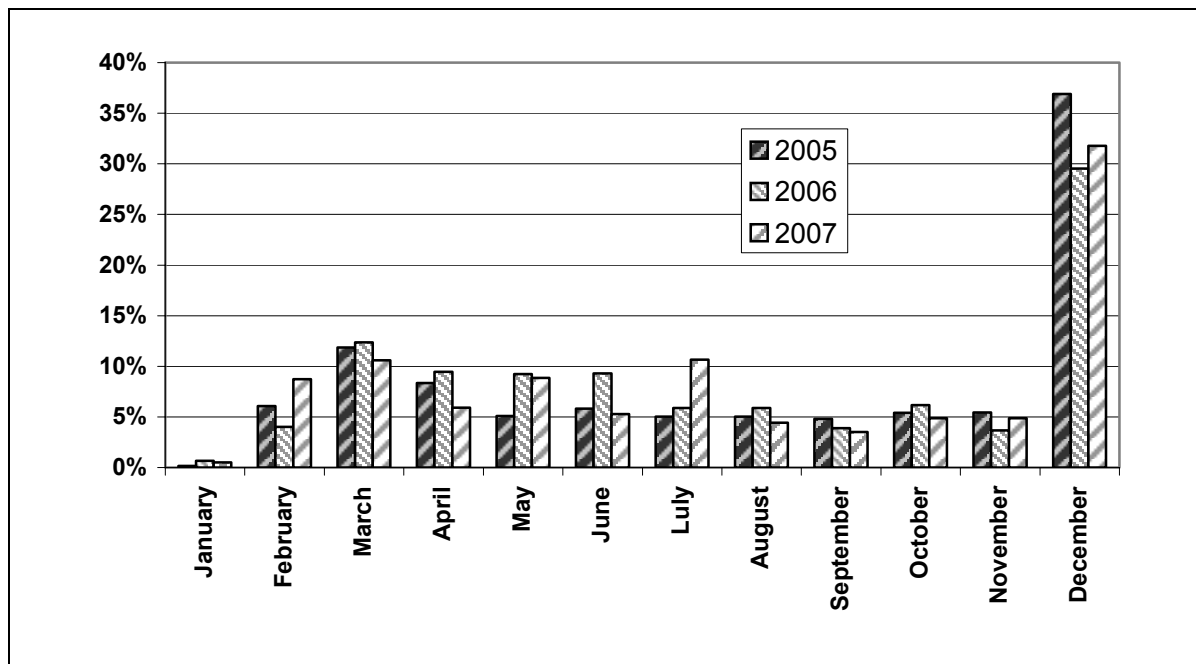
Source: IET estimates based on the data of the Federal Treasury.





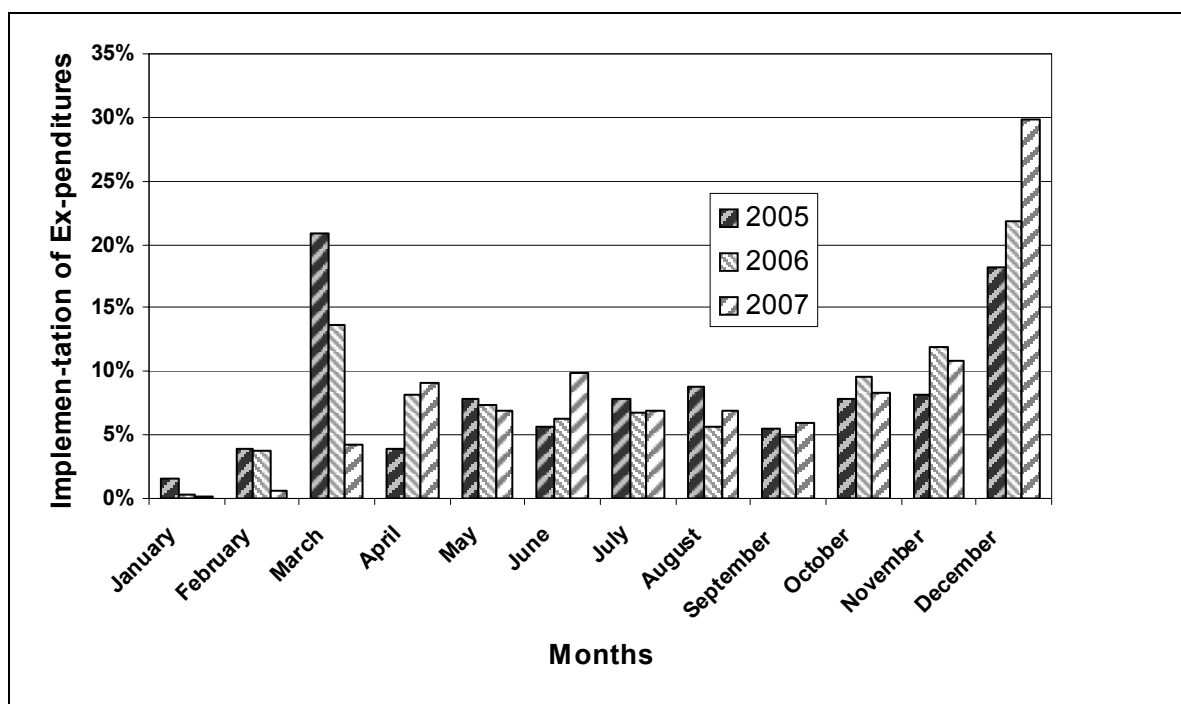
Source: IET estimates based on the data of the Federal Treasury.

Fig. 8. The Implementation of the Federal Budget's Expenditures under Subsection 0201 "The Armed Forces of the Russian Federation" in the Years 2005–07



Source: IET estimates based on the data of the Federal Treasury.

Fig. 9. The Implementation of the Federal Budget's Expenditures under Subsection 0207 "Applied Scientific Research in the Sphere of National Defense" in the Years 2005–07



Source: IET estimates based on the data of the Federal Treasury.

Fig. 10. The Implementation of the Federal Budget's Expenditures under Subsection 0208 "Other Issues in the Sphere of National Defense" in the Years 2005–07

Table 34

**The Basic Indicators of the Russian Federation's Military Expenditures  
in 1999–2007**

	1999	2000	2001	2002	2003	2004	2005	2006	2007
1	2	3	4	5	6	7	8	9	10
<b>1. In nominal terms (current prices), billion rubles</b>									
Execution of FB's expenditures under Section "National Defense", in current budget classification <sup>a</sup>	115.6	191.7	247.7	295.4	355.7	430.0	581.1	681.8	831.9
FB's allocations under Section "National Defense":	93.7	209.4	214.7	284.2	354.9	427.4	578.4	686.1	839.1
in current budget classification									
withdrawn to other sections of budget classification <sup>b</sup>	–	–	–	–	–	–	44.3	77.7	91.3
in a comparable budget classification	93.7	209.4	214.7	284.2	354.9	427.4	622.6	763.9	930.4
Military expenditures, according to UNO <sup>c</sup>	–	202.6	294.4	325.9	447.0	499.0	665.0	822.1	–
Overall direct military expenditures <sup>d</sup>	128.9	270.4	283.4	353.1	456.5	544.5	759.6	992.5	1,201.4
Overall direct and indirect military expenditures related to current and previous military activities <sup>e</sup>	144.0	304.6	329.6	455.6	594.6	630.7	844.4	1,079.0	1,362.6

*Table 34 (continued)*

1	2	3	4	5	6	7	8	9	10
<b>2. In real terms (in the 2007 prices)<sup>f</sup>, billion rubles</b>									
Execution of FB's expenditures under Section "National Defense" in current budget classification	926.8	1,109.9	933.5	828.3	786.0	797.1	900.0	854.3	831.9
FB's allocations under Section "National Defense": in current budget classification	751.3	1,212.4	809.1	796.8	784.2	792.3	895.7	859.7	839.1
withdrawn to other sections of budget classification	–	–	–	–	–	–	68.6	97.4	91.3
In comparable budget classification	751.3	1,212.4	809.1	796.8	784.2	792.3	964.2	957.1	930.4
Military expenditures, according to UNO	–	1,173.1	1,109.6	913.9	987.8	925.0	1,029.8	1,030.1	–
Direct military expenditures	1,033.5	1,565.5	1,068.1	990.2	1,008.8	1,009.3	1,176.4	1,243.6	1,201.4
Overall direct and indirect military expenditures related to current and previous military activities	1,154.7	1,763.5	1,242.1	1,277.7	1,313.9	1,169.1	1,307.8	1,352.0	1,362.6
<b>3. In real terms (in 1999 prices), billion rubles</b>									
Execution of FB's expenditures under Section "National Defense" in current budget classification	115.6	124.8	120.0	112.8	113.9	115.0	125.8	117.8	114.7
FB's allocations under Section "National Defense": in current budget classification	93.7	136.4	104.0	108.5	113.7	114.3	125.2	118.5	115.7
withdrawn to other sections of budget classification	–	–	–	–	–	–	9.6	13.4	12.6
in comparable budget classification	93.7	136.4	104.0	108.5	113.7	114.3	134.8	132.0	128.3
Military expenditures, according to UNO	–	131.9	142.6	124.4	143.1	133.5	143.9	142.0	–
Overall direct military expenditures	128.9	176.1	137.3	134.8	146.2	145.7	164.4	171.5	165.6
Overall direct and indirect military expenditures related to current and previous military activities	144.0	198.3	159.6	173.9	190.4	168.7	182.8	186.4	187.9
<b>4. Military burden borne by national economy, as % of GDP</b>									
Execution of FB's expenditures under Section "National Defense" in current budget classification	2.40	2.62	2.77	2.73	2.69	2.52	2.69	2.54	2.52
FB's allocations under Section "National Defense": in current budget classification	1.94	2.87	2.40	2.62	2.68	2.51	2.67	2.55	2.54
withdrawn to other sections of budget classification	–	–	–	–	–	–	0.20	0.29	0.28
in a comparable budget classification	1.94	2.87	2.40	2.62	2.68	2.51	2.88	2.84	2.82
Military expenditures, according to UNO	–	2.77	3.29	3.01	3.38	2.93	3.08	3.06	–

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*Table 34 (continued)*

	1	2	3	4	5	6	7	8	9	10
Overall direct military expenditures		2.67	3.70	3.17	3.26	3.45	3.19	3.51	3.69	3.64
Overall direct and indirect military expenditures related to current and previous military activities		2.99	4.17	3.69	4.21	4.49	3.70	3.91	4.01	4.13
<b>5. By parity of purchasing capacity (current prices), billion USD</b>										
Execution of FB's expenditures under Section "National Defense" in current budget classification		21.9	26.8	30.2	31.9	34.2	36.2	44.4	47.5	53.4
FB's allocations under Section "National Defense" in current budget classification		17.7	29.3	26.2	30.7	34.1	35.9	44.2	47.9	53.8
withdrawn to other sections of budget classification		–	–	–	–	–	–	3.4	5.4	5.9
in comparable budget classification		17.7	29.3	26.2	30.7	34.1	35.9	47.6	53.3	59.7
Military expenditures, according to UNO		–	28.3	35.9	35.2	42.9	42.0	50.8	57.3	–
Overall direct military expenditures		24.4	37.8	34.6	38.1	43.9	45.8	58.0	69.2	77.0
Overall direct and indirect military expenditures related to current and previous military activities		27.2	42.6	40.2	49.2	57.1	53.0	64.5	75.2	87.4
<i>For reference</i>										
Deflator of GDP, as % of a previous year		172.5	137.6	116.5	115.5	114.0	120.1	119.2	115.7	113.5
Deflator of expenditures on final consumption of state administration <sup>g</sup> as % of previous year		138.5	153.6	134.4	126.9	119.2	119.7	123.6	125.3	125.3
Parity of purchasing capacity <sup>h</sup> , rub / USD		5.29	7.15	8.19	9.27	10.41	11.89	13.09	14.34	15.59

<sup>a</sup> For 2006–2007 – the preliminary data on the execution of federal budgets, released by the Federal Treasury.

<sup>b</sup> The aggregate expenditures of the Ministry of Defense plus the classified expenditures under sections 04-09 and 11 of the 2005–07 federal budgets.

<sup>c</sup> The data for 1999 were not submitted by the RF Government to the UNO; the data for 2007 will be submitted in 2008, including the expenditures on the upkeep of the Internal Service Forces, frontier guards and civil defense.

<sup>d</sup> Including on the upkeep of Internal Service Forces, frontier guards, civil defense, and other elements of the military organization.

<sup>e</sup> Including pensions paid to ex-servicemen.

<sup>f</sup> Deflated by applying final consumption deflator to state administration expenditures.

<sup>g</sup> For 2007 – the IET's estimates.

<sup>h</sup> For 2005–2007 – the linear trend of values for previous years (the IET's estimates).

*Sources:* The Federal Laws on the 1999–2007 Federal Budgets and on the execution of the 1999–2005 Federal Budgets; Natsional'nye shcheta Rossii v 1997–2006 godakh. Statisticheskii sbornik. [Russia's national accounts in 1997–2006. Collection of Essays on Statistics]. Moscow: Rosstat, 2005–2007; Ob'ektivnaia informatsiia po voennym voprosam, vkluchaiia transparentnost' voennykh raskhodov. Doklady General'nogo sekretaria OON 2001–2007 [Objective information on military issues including the transparency of military expenditures. The reports of the UNO Secretary General, 2001–2007]; Rosstat; the Federal Treasury.

#### 5.5.4. The Trends and Outlooks of Development of Russia's Military Economy

Although the implementation of the FTP “The Switchover of a Number of Formations and Military Units to the System of Manning by Servicemen Enlisted for Military Service under Contracts”, adopted in 2003, was formally completed in December 2007, in fact, the plan for its implementation has been foiled. From time to time the mass media publish information<sup>133</sup> that the Program should be “supplementarily” implemented in 2008, after which it would become possible to initiate, in 2009, a new FTP aimed at the switchover of the whole NCO component of the RF military organization to the system of manning by volunteers enlisted for military service under contracts.

The undisputed successes achieved in recent years have confirmed once again, especially in the struggle against terrorists and armed bands in the North Caucasus, that the military security of this country should be ensured by professionals. The most successful changes have taken place in the Border Service of the FSB, where the draft was completely discarded, while some lesser, although still very substantial, changes occurred in the Interior troops of the Ministry of Internal Affairs. The worst situation is observed in the RF Armed Forces.

However, due to the outflow of contractees from the military units not included in the list of military units of permanent readiness and their replacement with draftees, the overall capability of the RF Armed Forces will decline, this being the result of the lower combat efficiency of the present-day draftees, and especially of those draftees who will serve one year only.

The attractiveness of military service under contracts will not increase either, as proved by the attitude towards it displayed by the Ministry of Defense's leadership during the FTP's implementation. Over that period, the program was adjusted four times. The expenditures on the FTP rose by almost 20 billion rubles in the 2003 prices. The number of positions to be filled by contractees diminished by almost 9 thousand. Not a single penny of the additional (with respect to the initial plan) allocations was spent on increasing the increment to money allowance, although it is this increment that largely determines the attractiveness of military service under contracts. Despite the fact that the overall rise in expenditure amounted to 20%, the expenditures on capital construction and repairs grew by 44% against the initially set amount; the expenditures on scientific research increased by 15%; and the other expenditures – by 7%, the increment to money allowance introduced in order to increase the attractiveness of military service under contracts has not been indexed since 2003. As inflation rose to more than 46% over the past four years, this increment has by now been depreciated by almost 75%. Neither the 15% rise in payments from 1 December 2007, nor their increase in 2008 promised by the President will be able to change the situation.

The socially significant results expected from the FTP, which are more important for society than for the army, cannot be considered to have been fully implemented either. The case in point is the following task of the FTP, declared in its certificate: “the reduction of society's dissatisfaction with the existing system of manning the RF Armed Forces and other troops, military formations and organs, and with these servicemen being dispatched for military service in the “hot spots”. The cancellation of the socially significant draft deferrals (car-

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<sup>133</sup> See *Iuzbashev, V.* Intellect staviat pod ruzh'e. [Intellect under arms] // *Nezavisimoe voennoe obozrenie* [The independent military review], 2007, 21–27 December (No. 45), p. 3.

ried out simultaneously with the reduction of the term of service”) will produce a reverse effect – the growth of society’s dissatisfaction; or, to be more specific, it will result:

- in undermining the tentative achievements in the State’s demographic policy (because of the drafting of young fathers), as it is absolutely clear to everybody that a compensation in the amount of 6 thousand rubles / month per every child whose father will be drafted cannot be considered as adequate, bearing in mind that the average wage in the country approaches 14 thousand rubles per month;
- in reducing the personnel potential of defense industry (because of the drafting of the young workers with the most sought after specialties, who used to be granted deferrals, and the drafting of young engineers who have oriented themselves to work in the DIC;
- in increasing the intensity of the “brain drain” (because of the drafting of the majority of graduates from higher educational establishments irrespective of their specialties, who are afraid of army service as such, in addition to the potential resulting loss of qualification and career prospects).

There is one real achievement among the socially significant results of the FTP: according to the assurances of high-rank officers, no draftees are serving in Chechnya. However, the legal possibility of servicemen enlisted for compulsory military service being used in combat action in time of peace had not been eliminated. At least in the existing Military Service, Item 3 of its Article 2 still reads: “Servicemen enlisted for compulsory military service can be dispatched (including within a subunit, unit, or formation) to perform tasks in conditions of armed conflicts (or for taking part in combat action) after their having served for no less than six months and after their having been trained in military occupation specialties”.

A similar situation exists with regard to many other factors determining society’s dissatisfaction not only with the current system of manning, but also with the general state of affairs in military units. The reasons for citizens’ discontent and the facts of violation of their rights are as numerous as ever. It is typical that in the period after the year 1999, the number of servicemen who perished outside of the zones of combat activity (“non-combat casualties”) was approximately equal to that of combat casualties.

Thus, the military personnel policy, already demonstrated in the period of the FTP’s implementation, could be beneficial only to criminal structures who profit on the deficiencies of the system of manning the army and on the citizens’ fear of military service.

After the year 2007, it could lead the country to a social explosion.

There is no need for any new recommendations to be invented in this connection. One has simply to recall some of the existing ones:

1. To discuss the results of the FTP at an open joint meeting of the Interdepartmental Commission, created to analyze the FTP’s progress, and representatives of all non-governmental organizations who capable of presenting independent estimates of the FTP’s results and of the state of affairs in regard to compulsory and contractual military service. It is important that the participants should be on a timely basis provided with complete financial and economic information on the FTP and its previous substantiation. Only after all the deficiencies of the previous FTP are taken into consideration, a new one can be initiated.

2. To urgently increase the level of money allowance of all contractees, from soldier and sailor upwards (and not only in military units of permanent readiness), to a level by 20% higher than the average wage in the country. This level should be then sustained on the annual basis. It should be noted that the afore-said level has remained stable since the 2001 survey

conducted by the All-Russian Center for Public Opinion Studies and referred to in the IET's previous publications. The results of surveys carried out by the Russian State Insurance Company have confirmed this conclusion<sup>134</sup>. The size of a "just" wage for workers of budget-funded institutions is estimated in accordance with the age and the level of well-being of the respondents. Young people aged up to 26 years are sure that private contractees should get the highest wages (23,400 rubles). Female respondents also "voted" for contractees (26,300 rubles). The most generous wages were suggested by Muscovites (up to 35,000 rubles), while the lowest (from 13,000 rubles upwards) ones – by residents of small towns.

The money allowance of officers, warrant officers and midshipmen should also be accordingly increased. It should be necessary to simultaneously reduce the number of troops, mainly in those military units that are not included in the category of "permanent readiness" or are not on stand-by duty.

3. It is necessary to urgently revise (in cooperation with non-governmental organizations, which is absolutely essential) the legislative base of military service, and to eradicate its defects concerning the draft procedure and the procedure for the enrollment of contractees, as well as the terms of contractual and compulsory military service. It should be laid down in a law that the only purpose of military service in time of peace should be the acquisition, by a serviceman or woman, of a military occupation specialty necessary for his or her further service in regular forces and for his or her being included in military-trained manpower resources (or reserve), if the military-political situation in the world would require it to be sustained at a corresponding level.

4. It is equally crucial to lose no time in initiating an open discussion of the main directions of RF military-technological policy in the part concerning the rational use of know-how and dual-purpose technologies in the interests of the development of the civil economy and for the sake of achieving all types of beneficial economic effects, including the military, economic, and commercial ones.

5. The recommendations regarding the problems faced by the military budget also remain unchanged.

It is high time to coordinate the RF budget classification with the mission, objectives and tasks of the RF military organization's activity, and to establish a strict correlation between the indices characterizing this activity and the amounts being spent on their implementation. Without this, as far as the prospects for the future are concerned, RF military expenditures will be implemented without any control – at least during the period until the year 2010.

RF military expenditures will continue to be overclassified in excess of any reasonable norms and, most importantly, this will be done with violation of the federal law on State secrets. This corruption-generating defect of Russian budgetary system will surely exert a very negative influence not only of the military economy of the Russian Federation, but also on its national economy as a whole.

Of course, the actual military expenditures of the RF, if estimated by the international standards of military expenditures of states (it is not without interest that they are acknowledged by Russia), indeed exceed the level, in percentage points, of GDP as shown in the budget and as declared by the military-political leadership of the RF. This situation by no means improves the image of the State in anybody's eyes.

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<sup>134</sup> *Vedomosti*. 2007. 19 December (No. 240).

So far as the issue of manning is concerned, equally detrimental is the fact that among all G-8 countries, compulsory military service is preserved only in the RF and Germany, although the term of service in Germany is only 9 months, while the level of support for every serviceman, including those who are enlisted for compulsory military service, is better than that enjoyed by the Russian contractee. The same is true of the conditions of military service.

As regards the declared advantages of the three-year planning of the budget, especially that established for the military organization, the results already visible at end of 2007 (after the final approval and the subsequent publication of the budget) has shown that the budget needed adjustment even for 2008, the first of the three years under consideration. And this indeed happened in early 2008 with regard to the expenditures on combat training, the money allowance of servicemen, and, correspondingly, the pensions of former servicemen.

## **5.6. Municipal Reform: Accumulation of Problems and Search for Solutions**

### **5.6.1. Changes in the Federal Legislation in 2007**

In 2007, the process of revision of the federal legislation on local self-government continued. In sum, there were adopted 9 federal laws, which introduced amendments to Federal law No. 131 FZ of October 6, 2003, "On the general principles of the organization of local self-government in the Russian Federation" and to certain articles of sector specific laws regulating the powers vested in the bodies of local self-government. At the same time, it should be noted that the majority of amendments aimed at the division of powers between different levels of government was adopted in the last quarter of 2007. This development was in line with the tradition, in accordance with which the most significant amendments pertaining to this sphere were adopted at the very end of each year, already after the budgets had been approved, thus creating substantial difficulties for regions and municipal entities as concerned their plans pertaining to the financing of powers newly vested in them.

The major avenues of development of the federal legislation concerning local self-government in 2007 were the following:

- The settlement of the issues pertaining to the division of powers and
- Introduction of changes in the economic and financial principles of local self-government.

Besides, some updates were made to the territorial and organizational principles of local self-government, as well as the laws regulating the functioning of local self-government in the territories with special status.

In the sphere of division of powers, the most significant changes and updates were aimed, on the one hand, at a more precise determination of powers vested in the bodies of local self-government and related to the settlement of issues of local importance already vested in municipal entities, and, on the other hand, at the expansion of the sphere of competence of municipal authorities.

There were more precisely determined the powers of local governments relating to four issues of local importance vested in the municipal tier by law No. 131-FZ, i. e. the following issues:



- Organization of delivery of health care to the population<sup>135</sup>;
- Implementation of primary measures aimed at fire protection of the population centers being parts of settlements and city okrugs<sup>136</sup>;
- Creation of conditions facilitating development of small and medium sized businesses<sup>137</sup>;
- Carrying out of road related activities as concerns motor roads of local importance<sup>138</sup>.

The sphere of competence of municipal entities was enhanced via the introduction of additional rights and powers of the bodies of local self-government. For instance, in the sphere of public health care bodies of local self-government were granted the right to create emergency medical services with the structure of health care institutions at the expense of the revenues flowing in local budgets. Besides, there was introduced the power of the bodies of local self-government to organize training, retraining, and professional development of elected officials of local self-government, members of elected bodies of local self-government, deputies of representative bodies of municipal entities, as well as municipal officers and municipal employees<sup>139</sup>. There were also enhanced the possibilities to delegate state powers to the municipal level.

In the sphere of territorial principles of local self-government, there were elaborated certain issues, which previously had not been regulated by federal laws. For instance, there were envisaged certain procedures governing the alteration of limits of city okrugs by the way of inclusion into them of urban and rural settlements, as well as the procedures related to the liquidation of municipal entities in the territories characterized by low density of the population and hard to reach areas. In the process of settlement of the issues related to the inclusion of settlements in the composition of city okrugs there was streamlined the procedure permitting to take into account public opinion: it was manifested via decisions of representative bodies, whereas with respect to the majority of other types of transformations concerning settlements and the limits thereof public opinion should be manifested via voting or at the meetings of citizens.

In the sphere of organizational principles, the amendments, introduced in 2007, limited the opportunities of the heads of local administrations, deputies, exercising their powers on an ongoing basis, members of elected bodies of local self-government, and elected officials to engage in paid activities<sup>140</sup>.

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<sup>135</sup> The amendments to the sector specific laws were introduced by article 6 of federal law No. 230-FZ of October 18, 2007, “On the introduction of amendments to certain legislative acts of the Russian Federation in relation to the improvement of division of powers” (hereinafter referred to as law No. 230-FZ).

<sup>136</sup> The amendments to the sector specific laws were introduced by article 7 of law No. 230-FZ.

<sup>137</sup> The list of powers vested in the bodies of local importance was set by federal law No. 209-FZ of July 24, 2007, “On development of small and medium sized businesses in the Russian Federation” (entered into force on January 1, 2008).

<sup>138</sup> The list of powers vested in the bodies of local self-government was set by federal law No. 257-FZ of November 8, 2007, “On motor roads and road related activities in the Russian Federation and the introduction of amendments to certain legislative acts of the Russian Federation.” The same law has changed the definition of the issue of local importance, which had been earlier defined as “the maintenance and construction of motor roads for public access, bridges and other transport engineering facilities within the limits of populated centers of the settlement...”.

<sup>139</sup> The amendments to article 17 of federal law No. 131-FZ introduced by article 26 of law No. 230-FZ.

<sup>140</sup> Federal law No. 24-FZ of March 2, 2007, “On the introduction of amendments to certain legislative acts of the Russian Federation as concerns the elaboration of requirements to the persons holding state or municipal offices, as well as state or municipal public servants”.

Besides, the federal legislation determined the requirements to the activities of representative bodies of local self-government and penalties for the failure to meet these requirements, including the dissolution of respective representative bodies by decisions of subjects of the Russian Federation<sup>141</sup>. It should be noted that control over the activities of representative bodies of local self-government was introduced not only at the municipal, but also at the regional level.

The reforming of financial and economic principles of local self-government was also carried out across several avenues. In the sphere of property relations there were adopted amendments aimed at the expansion of the list of permitted types of properties for municipal entities<sup>142</sup>. Municipalities of all types may now have the property designated for the development of small and medium sized businesses. There was also elaborated the issue related to the ownership of objects created at the expense of government investments and aimed at the development of the social and engineering infrastructure of municipal entities, which, since that moment, should, on compulsory basis, be transferred in the municipal ownership<sup>143</sup>.

In 2007, there was significantly altered the budgetary legislation. Federal law No. 63-FZ<sup>144</sup> introduced significant amendments to the RF Budget Code, such as:

- Alteration of the requirement criteria pertaining to the distribution of revenues generated by lease and sale of the plots of lands, the state ownership of which was not divided, among municipal budgets. More specifically, 50 per cent of revenues derived from the use of the plots of land were transferred to the budgets of municipal districts in stead of the budgets of settlements, as it had been the case earlier;
- More precise determination of the sources of non-tax revenues of local budgets;
- Introduction of tighter control measures with respect to the activities of the bodies of local self-government in recipient municipal entities;
- Alteration of the mechanisms, governing the provision of targeted transfers aimed at the resolution of the issues of local importance, more specifically, the merger of the funds of municipal development and co-financing of social expenditures into the regional fund of co-financing of expenditures;
- Introduction of an opportunity to provide grants from the regional funds of financial support of settlements proceeding not only from the number of residents, but also fiscal capacity of the settlement<sup>145</sup>;

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<sup>141</sup> Federal law No. 101-FZ of June 18, 2007, "On the introduction of amendments to certain legislative acts of the Russian Federation as concerns the issue of activities carried out by legislative (representative) bodies of state power of the subjects of the Russian Federation and representative bodies of municipal entities".

<sup>142</sup> Item 20 of article 26 of law No. 230-FZ.

<sup>143</sup> Article 19 of law No. 230-FZ.

<sup>144</sup> Federal law No. 63-FZ of April 26, "On the introduction of amendments to the Budget Code of the Russian Federation as concerns the regulation of the budgetary process and harmonization of certain legislative acts of the Russian Federation with the budgetary legislation of the Russian Federation".

<sup>145</sup> It should be noted that the amendments permitting to equalize the fiscal capacity of settlements were introduced only to the first part of article 137. In the third part of the analyzed article there was retained the stipulation of the law being previously in force that "the amount of the said grant should be determined for each subject of the Russian Federation eligible for the reception of the grant proceeding from the number of residents of the settlement on per capita basis". As a result, the issue, which of the two provisions of the law should use regions determining their policies towards settlements, remained unregulated.

- Granting of the right to delegate certain budgetary powers of the financial bodies of settlements to the financial body of the municipal district on the basis of agreements;
- Change of the official term for the “negative transfer” from “subvention” to “subsidy.”

Among other changes introduced to the federal legislation concerning local self-government there should be also noted the resolving of the issues related to the organization of local self-government in the territories with special status. In particular, there was expanded the list of territories, for which there were established specific features of organization of local self-government. Such a status was granted to the territories situated in the areas of the Far North and the territories with the similar status characterized by limited time of delivery of goods (products). For such territories, it was established that the powers related to the ensuring of deliveries of certain goods (fuel and energy resources, food products and goods for production and technical purposes), which should be delivered on the centralized basis, should be exercised by the executive authorities of the RF subjects<sup>146</sup>. Significant changes were also made with respect to federal law No. 3297-1 of July 14, 1992, “On the closed administrative and territorial entity<sup>147</sup>”.

The introduction of article 18.1 on the assessment of the effectiveness of activities of the bodies of local self-government, which envisaged that at the expense of the financial resources of the subject of the Russian Federation to municipal entities there should be provided grants aimed at the facilitation and (or) encouragement of attainment of the best values of the indicators of efficiency, in law No. 131-FZ, may be seen as the continuation of the trend towards the centralization of power. It should be noted that the list of indicators is approved in accordance with the procedures determined by the President of the Russian Federation. In fact, this article envisaged that the federal and regional authorities should assess the activities of municipal authorities, which, in accordance with the RF Constitution, are separated from the system of state authorities in the Russian Federation.

### 5.6.2. Changes in the Regional Legislation

In accordance with federal law No. 129-FZ of October 12, 2005, the deadline for the full scale implementation of the municipal reform was put off until January 1 of 2009. Prior to that date there should be in force a transition period, during which regions should annually adopt laws setting the procedures governing the resolution of local issues by newly created settlements, including the amount of powers vested in such settlements, organization of funding of resolution of local issues, and so on.

An analysis of the regional legislation in this sphere in 2006 based on the rates and scale of implementation of the municipal reform permitted to identify four groups of regions:

- Those, where, in accordance with the regional legislation, the municipal reform should be implemented in full since January of 2006. According to the official data presented by the RF Ministry of Regional Development, in 2006 47 regions implemented the municipal reform in full; however, basing on the research carried out by IET, it may be concluded that the number of such regions was somewhat less and amounted to 45<sup>148</sup>;

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<sup>146</sup> Item 21 of article 26 of law No. 230-FZ.

<sup>147</sup> Article 36 of law No. 230-FZ.

<sup>148</sup> According to the data obtained in the course of a study conducted by IET, in 2006 such regions as Moscow, St. Petersburg, the Tyumen oblast and the Sakhalin oblast were removed from, while the Astrakhan oblast and the Leningrad oblast were added to the list of the RF Ministry of Regional Development, since the latter introduced

- Those, in which some issues of local importance in all newly created settlements, were assigned to municipal districts. This group included 26 regions. It should be noted that in 2006 from 3 to 24 issues of local importance were transferred to newly created settlements;
- Those, which had set different rates of implementation of the municipal reform for different groups of newly created settlements. This group included 9 regions;
- Those, which in fact failed to start the implementation of the municipal reform in 2006 and delegated all issues of local importance to the level of municipal districts. Such a policy was pursued by 3 regions.

In 2007, the regional legislation concerning this issue changed rather significantly. Among major changes, there should be noted the following:

- 1) The number of regions, where the municipal reform was implemented in full, has increased;
- 2) As concerns the regions, where the municipal reform had not yet been fully implemented, a typical feature of such regions was an expanded list of local issues delegated to the level of settlements;
- 3) In the regions failing to fully implement the municipal reform there was observed a trend towards singling out of certain territories, where the municipal reform is implemented in full as an experiment;
- 4) Regional laws on the procedures governing the resolution of local issues paid more attention to the problems of distribution of municipal property between municipal districts and settlements.

The distribution of regions across the four groups as registered in 2006 changed as follows.

According to the information presented by the RF Ministry of Regional Development, in 2007 the number of regions comprising the *first group*, i.e. the regions, where the municipal reform was implemented in full, made 57 subjects of the Russian Federation. In comparison with the data for year 2006, 11 regions were added to the list and the Sakhalin oblast was removed from it. Taking into account the merger of the Taimyr (Dolgano-Nenets) and the Evenk autonomous okrugs with the Krasnoyarsk krai, it may be said that the group of regions, where the municipal reform was implemented in full, amounted to 55 regions. The authors deem that this group consists of 55 regions (taking into account the territorial transformations in the Krasnoyarsk krai this group is comprised of 53 regions); it should be noted that some of them were included in this group with certain reservations<sup>149</sup>. The authors of the survey be-

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limitations on the independence of an insignificant number of newly created settlements. The factors behind the differences in the list of regions, which implemented the municipal reform in full, are described in detail in “Munitsipalnaya reforma v 2007 g.: osobennosti realizatsii” [Municipal reform in 2007: the specifics of implementation] (to be published). However, on the whole it may be said that the RF Ministry of Regional Development primarily oriented towards the “letter” of the law, whereas the authors proceeded from the “spirit” of the law.

<sup>149</sup> The authors still insist that the cities of Moscow and St. Petersburg, as well as the Tyumen oblast, should not be included in the first group and can not agree with the inclusion of the Republic of Karelia, where the regional legislation delegated 2 key issues of local importance to the district level, in the first group. At the same time, the Leningrad and Tomsk oblasts are viewed as those, where the municipal reform was implemented in full, on the basis of the fact that there limitations on the independence were imposed on only an insignificant number of newly created settlements. It should be also noted that the inclusion of the Republic of Komi, where some tax and

lieve that the number of regions belonging to this group increased by 10 in comparison with the data for year 2006. It should be noted that 4 regions of the second group and 6 regions of the third groups joined the first group.

In 2007, the *second group* of regions, where some local issues to be resolved by newly created settlements were vested in municipal districts, comprised 19 regions. Since 2006, this group has diminished by four regions, which were entered in the first group, and by six regions now being in the third group; however, two regions from the fourth group were entered in the first group that year (the Yaroslavl and Magadan oblasts). In 2007, the settlements newly created in the regions of this group were vested with the resolution of 3 to 32 local issues. A significant number of regions have substantially expanded the list of local issues vested in the newly created settlements. Such regions included, among other subjects of the Russian Federation, the Nizhny Novgorod, Novgorod, Pskov, and Ryazan oblasts, the Republic of Karelia, the Republic of Khakassia, and the Udmurt Republic.

At the same time, the fact that although the list of local issues assigned to settlements expands, the ratio between the regions, which finance newly created settlements on the basis of budgets and financial estimates remains practically the same, gives rise to serious concerns. In 2007, only 9 out of 19 regions comprising the second group transferred budget powers to the newly created settlements. It should be noted that in the Samara and Yaroslavl oblasts it was done only partially: the powers concerning the approval of budgets and control over the administration thereof, whereas the municipal district were vested with the powers related to the formation and administration of budgets. In the Republic of Bashkortostan it was legislatively established that settlements should exercise tax and budgetary powers in the full amount. At the same time, the legislation envisaged that bodies of local self-government of settlements should have the right to delegate these powers to municipal districts on the basis of agreements.

As concerns the *third group* of regions, which set different rates of implementation of the municipal reform for different groups of newly created settlements, 6 regions of this group moved to the first group. At the same time, this group grew by 5 regions at the expense of the second group of regions (the Kemerovo, Murmansk, Saratov, Tver oblasts and the Khanty-Mansi autonomous okrug (KhMAO)). Therefore, in 2007 this group comprised 8 regions.

The most typical trend observed in the third group of regions was the setting of pilot sites, where the provisions of federal law No. 131-FZ were implemented in full as an experiment. Thus, in the Kemerovo oblast it was envisaged to fully introduce the municipal reform in nine municipal districts, in the Tver and Saratov oblasts – in two municipal districts, whereas in the Khanty Mansi Autonomous Okrug it was planned to implement the municipal reform in full in 11 settlements of three districts. It is of interest to analyze the terms of such an experiment conducted in the Tver oblast, where, according to the available information, in the pilot territories the practice of delegation of powers from settlements to municipal districts on the basis of respective agreements had been significantly limited and the municipal reform was implemented in its “pure form”. In the regions belonging to this group, where test sites were organized, different rates of transition to the full scale implementation of the municipal reform were set depending on the status of the settlement – was it urban or rural one (the Vladimir oblast), or was in the jurisdiction of a certain municipal district (the Novgorod

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budgetary powers were retained at the level of municipal districts, in the list of regions, which had fully implemented the municipal reform, is also open to questions.

oblast). In certain regions belonging to this group the division of powers was carried out taking into account the individual specifics of settlements, their economic and human resources capacities.

At last, in 2007 only the Sakhalin oblast could be defined as a region belonging to the *fourth group* of regions, i.e. of those, which failed even to launch the implementation of the municipal reform. The Sakhalin oblast chose to create urban okrugs on the basis of rural districts, and at the moment in its territory there exist only three urban and three rural settlements. All local issues in these settlements were delegated to municipal districts.

The analysis of the regional legislation on the procedures governing the resolution of local issues in newly created settlements, which were used in 2007, permitted to arrive to the conclusion that there was achieved a certain progress as concerns the scale of implementation of the municipal reform in the territory of the Russian Federation as compared with 2006; however, it should be taken into account that the real depth of the transformations depended not only on the stipulations of the regional legislation. There was sufficient number of tools, both within and outside the legal framework, which permitted to impose limitations on the independence of municipal entities even in the case all rights and powers envisaged by the federal legislation were assigned to them.

### 5.6.3. Need to Change Approaches to the Territorial Organization of Local Self-Government

#### *General Description*

A component of the implementation of the municipal reform in the Russian Federation was significant transformation of the territorial organization of local self-government. The base concept of the reform in this sphere was the mass transition to a two tier model – it was envisaged that across the whole territory of the country with the exception of large cities and sparsely populated territories local self-government should exist both at the level of municipal districts and rural and urban settlements. The practical implementation of this approach resulted in the fact that the number of municipal entities increased almost twofold<sup>150</sup>; it should be noted that rural settlements accounted for the bulk of the total growth. In the course of implementation of the reform of the territorial organization, the legislation on local self-government failed to take into account the financial capacities of newly created municipal entities, as well as existing engineering and social infrastructure. As a result, the majority of rural settlements were being organized within the limits, where there had previously existed rural councils; it should be also noted that there was not taken into account the existence of prerequisites necessary to resolve the issues of local importance as it was envisaged by federal law No. 131-FZ “On the general principles of the organization of local self-government in the Russian Federation”<sup>151</sup>. Such an approach was inevitably fraught with inevitable problems and conflicts, what was indeed observed in the course of the practical implementation of the municipal reform.

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<sup>150</sup> According to the data presented by the RF Ministry of Regional Development, as on January 1, 2007, in the Russian Federation there existed 24.2 thousand municipal entities, whereas prior to the launch of the reform this number made 12.6 thousand.

<sup>151</sup> In a number of regions, for instance, in the Tver and Vologda oblasts, as well as in the Khabarovsk krai, in the course of transformation of the territorial structure there were adopted more balanced approaches.

The start of the practical implementation of the municipal reform revealed a need to introduce changes in the approaches to the territorial organization of local self-government. In 2007, these processes affected many regions and were implemented along different avenues. It should be noted that there were observed the following changes in the territorial organization:

- Attempts to merge rural settlements, envisaging first of all incorporation of financially unviable municipal entities into those with more developed economic base;
- Continuation of the processes facilitating the withdrawal of the status of city okrugs from towns and incorporation thereof in the composition of municipal districts;
- A tendency towards creation of city okrugs on the basis of municipal districts;
- Registration of precedents of initiatives aimed at the division of artificially formed city okrugs and recreation of the two tier system of local government in the respective territories;
- The beginning of processes of enlargement of municipal districts;
- A search for mechanisms of administration of city agglomerations.

The intensification of processes of the territorial transformations revealed the following inconsistencies and problems related to these reforms:

- High proneness to conflicts of the processes of transformation of the territorial organization of local self-government;
- Lack of regulation of many avenues of territorial transformations in the legislation resulting in the fact that they fully or partially developed outside the legal framework;
- Public consciousness (including the consciousness of regional legislators) was dominated by the concept of legitimate nature of any decision adopted by referendum regardless of the fact if the respective issue was in the terms of reference of the respective tier of government and if an expression of the popular will was envisaged as a mechanism governing the resolution of this issue.

Such a situation resulted in a significant differentiation of approaches to the implementation of the territorial transformations in different regions and different interpretations of the federal legislation and its adaptation to local needs, as well as significant difficulties concerning the transformation of the territorial organization of local self-government in different subjects of the Russian Federation.

#### *Enlargement of Settlements and Municipal Districts*

In different regions, the processes of amalgamation of settlements developed with the different degrees of success. According to the information presented by the RF Ministry of Regional Development, a rather large scale enlargement of rural settlements was registered in the Kirov oblast, where this process affected 12 municipal districts, whereas the number of rural settlements in the oblast declined by 33 settlements<sup>152</sup>. At the same time, in a number of other regions large scale initiatives in this sphere remained unimplemented.

In this respect, an illustrious example was the situation observed in the Chelyabinsk oblast, where there was advanced one of the most large scale initiative aimed at the transfor-

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<sup>152</sup> Itogi realizatsii Federalnogo zakona ot 6 oktyabrya 2003 g. No. 131-FZ “Ob obshchikh printsipakh organizatsii mestnogo samoupravleniya v Rossiyskoi Federatsii v 2007 g. [The results of implementation of federal law No. 131-FZ of October 6, 2003, “On the general principles of the organization of local self-government in the Russian Federation” in 2007] / D. R. Khromov, Ed. – M.: ID “Yurisprudentsiya”, 2007. – p. 24.

mation of the territorial organization of local self-government. In the summer of 2007, the oblast administration made a list of 67 settlements to be liquidated due to their financial dependence by the way of merging them with more financially independent territories<sup>153</sup>. As a criterion, there was used the amount of tax and non-tax revenues, which in the settlements planned for liquidation was below 200 thousand rubles a year, what was insufficient even to maintain their administrative staffs. This initiative encountered an active opposition on the part of the municipal community of the oblast. On August 14, 2007, in Chelyabinsk in order to discuss this issue there was held a round table organized by the Association of rural settlements of the Russian Federation and the Association of rural municipal entities of the Chelyabinsk oblast<sup>154</sup>. In the course of the meeting, the heads of settlements and the associations representing them voiced their resentment of the idea of amalgamation stating that too little time had passed since the moment of the launch of the reform for the local self-government could realize its potential and defended the right for the equalization of fiscal capacities at the level of the subject of the Russian Federation, what should ensure that each settlement could resolve the issues of local importance.

After the encounter with the resentment of the ideas they advanced, the regional authorities did not insist on the planned large scale amalgamation. Already by the time of organization of the round table the number of settlements entered in the list was reduced to about two dozens. Later, by the date of the vote timed to coincide with the date of elections to the RF State Duma on December 2, 2007, only 8 projects of amalgamation of settlements remained on the list<sup>155</sup>. In the course of the voting, such projects were rejected in the overwhelming majority of settlements. It should be noted that the turnout of the voters made from 66 per cent to almost 75 per cent, i. e. this ballot reflected the real will of the population. Only in one case the population voted for enlargement: residents of the Babarykinsky and Spassky rural settlements situated in the territory of the Verkhneural'sk district supported the initiative aimed at the merger of settlements. The turnout in these settlements amounted to 83 per cent and 66 per cent and 52 per cent and 82 per cent of the citizens participating in the ballot cast their votes for the enlargement. However, on the whole it may be acknowledged that the initiative of the regional authorities aimed at the enlargement of settlements has failed, at least for now<sup>156</sup>.

A similar situation was also observed in the Amur oblast. In this region, the voting on the issue of amalgamation of municipal settlements was held in 23 settlements. Similarly to the situation in the Chelyabinsk oblast, the turnout of voters was rather high. However, the decision on enlargement was taken only in two cases. It should be noted that against this decision voted mostly the residents of economically weak municipal entities to be included in other municipalities.

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<sup>153</sup> In total, there were 274 settlements in the territory of the Chelyabinsk oblast.

<sup>154</sup> As concerns the range of problems relating to the municipal entities lacking the sufficient tax base and recommended to be merged with other municipal entities, see the verbatim report of the round table "Mestnoye samoupravleniye kak resurs razvitiya strany" [Local self-government as a resource for the development of the country], Chelyabinsk, August 14, 2007.

<sup>155</sup> The information on the results of the voting is presented as published by the local press. See, for instance, Alexander Polozov, Alexander Panan, "URA.Ru", August 7, 2007, an interview of a deputy of the Governor of the Chelyabinsk oblast, "Guberniya", September 5–11, 2007.

<sup>156</sup> However, attempts to merge settlements continue – a new stage of the voting on this issue is to be held on March 2, 2008.



As concerns the processes of enlargement of municipal districts, at present this issue in the majority of regions is less urgent than the problem of amalgamation of settlements. Nevertheless, in certain subjects of the Russian Federation the regional authorities are planning large scale reforms along this avenue justifying them, in particular, by the need to create favorable conditions for the implementation of regional strategies.

#### *The Change of the Status of Municipal Entities*

The legal framework concerning local self-government contains only one variant of changes as concerns the change of the status of urban settlements in connection to the granting to it of the status of a city okrug or withdrawal of the status of a city okrug. In 2007, transformations of this kind were a characteristic feature, for instance, in the Krasnodar krai. In this krai, there were underway the process of withdrawal of status of city okrug from towns and inclusion of them into the composition of municipal districts. Thus, law No. 1254-KZ the town of Yeisk was deprived of the status of a city okrug and granted the status of an urban settlement included in the composition of the Yeisk municipal district. Similar procedures were launched with respect to the city okrugs Tikhoretsk and Tuapse.

Along with the legitimate (although not always positive) processes of change of the status of the city okrug, in 2007 the transformations of this type were characterized by two other processes, none of which was regulated by the federal legislation. On the one hand, in a number of regions there began apparent the tendency to grant the status of city okrugs to municipal districts. On the other hand, there were observed precedents of the advancing of initiatives aimed at the division of artificially created city okrugs and recreation of the two tier system of local self-governance in the respective territories.

Since the legislation did not directly envisage the process of creation of city okrugs on the base of municipal districts, in this case there were used the mechanisms permitting to achieve such results by making a certain series of steps aimed at the transformation of municipal entities. It should be noted that different algorithms were used in different regions.

Thus, in the Belgorod oblast, for instance, on the base of municipal entities there were created two city okrugs – Gubkin and Sary Oskol. The process of transformation was implemented on the base of the following steps: 1) development and approval of the general plan of an urban settlement – a district center embracing the whole territory of the district; 2) organization of the voting of the population on the issue of agreement to amalgamate all settlements situated in the territory of the municipal district thus creating a new municipal entity, which should be granted the status of a city okrug and in which the territories of settlements should be granted the status of administrative entities of the city okrug; 3) adoption of a regional law on the change of the territorial organization of local self-government.

A different variant was envisaged as concerned the amalgamation of the Odintsovo district of the Moscow oblast initiated by the head of the district. In this case, the proposed transformation clearly was politically motivated and was aimed at the retaining of the right to dispose of land and other valuable resources in this territory by the municipal district. The initiative on this transformation include neither the working out of an integrated general plan of development of the territory as an urban settlement, neither a program of development of the territory of the district as a single urban territory. It should be noted that in the territory of the district there were situated independent city okrugs, the destiny of which in the course of the transformation was also not determined.

The algorithm of the transformation planned in this case included the following stages: 1) organization of local referendums on the change of the administrative and territorial structure of the district aimed at the transformation of six towns and urban type settlements into rural settlements; 2) amalgamation of new rural settlements with the urban settlement Odintsovo resulting in the creation of a single urban settlement; 3) granting of the status of a city okrug to the urban settlement created within the extended boundaries.

In the course of this process there emerged numerous scandals and conflicts. In spite of an unprecedented administrative pressure, in one of the urban settlements the local referendum held on December 2, 2007, rejected the transformation. At present, the combination of the high proneness to conflicts of the processes of transformation, an active opposition on the part of the expert community and the interest of international organizations in the outcome of the confrontation resulted in the halt of the implementation of plans aimed at the amalgamation of the Odintsovo district.

Even more complicated situation develops in the case the regional authorities attempt to liquidate the distortions of the federal legislation and recreate the two tier model of local self-government in the territories of the artificially created city okrugs. For instance, such a problem was encountered by the authorities of the Kaliningrad oblast. The first step towards the resolution of this problem was the claims submitted by the Governor of the oblast to the regional Charter Court; with respect to these claims the court passed the judgment that a number of laws on the territorial organization of local self-government in the Kaliningrad oblast was not in conformity with the Charter of the Kaliningrad oblast. In the autumn of 2007, there was adopted a number of legislative acts of the Kaliningrad oblast aimed at the change of the territorial organization of local self-government. Primarily, these acts concerned the Baltiysk and Svetlogorsk city okrugs.

However, the laws concerning the transformation of the Baltiysk city okrug were disputed in the regional court on the basis that they were adopted without taking into account the opinion of its residents. The RF Supreme Court upheld the ruling of the Kaliningrad oblast court<sup>157</sup>. At present, the legislation of the Kaliningrad oblast concerning the territorial transformation of the Baltiysk city okrug is reviewed by the RF Constitutional Court. The ruling of the RF Constitutional Court concerning this case will be of the principal importance for further reforms both in the Kaliningrad oblast and other regions of Russia.

### *Urban Agglomerations*

Quite new processes of the transformation of the territorial organization of local self-government were related to the creation of urban agglomerations. The legal framework of the Russian Federation contains no definition of agglomeration. However, since the spring of 2007 this problem was more actively discussed. By all appearances, this problem had attracted attention due to the implementation of the project "Affordable Housing". However, the immediate impulse to such a discussion came from the RF Ministry of Regional Development, which announced the creation of urban agglomeration centers with multimillion populations as one of the strategic avenues of spatial development of Russian territories permitting to create the basic structure of the system of administration and modernization of the national econ-

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<sup>157</sup> See: <http://www.regnum.ru/news/923610.html> report of November 29, 2007, "Verkhovny sud otkazalsya uprazdnyat Baltiyskiy gorodskoi okrug v Kaliningradskoi oblasti" [The Supreme Court refused to liquidate the Baltiysk city okrug in the Kaliningrad oblast].

omy. As a priorities there are reviewed projects “Greater Rostov” (the amalgamation of Rostov-On-Don, Novocherkassk, Taganrog, Aksai, Bataisk, Azov), agglomeration “Irkutsk – Angarsk – Shelekhov”, “Vladivostok – Nakhodka – Ussuriysk – Artem”, “Samara – Togliatti”, “Tomsk – Seversk” and some others.

In 2007, the major processes related to the formation of urban agglomerations developed along two avenues.

On the one hand, there was started the elaboration of a number of projects envisaging the creation of polycentric agglomerations with several city nucleuses on the basis of the ideology developed by the RF Ministry of Regional Development. As concerns these projects, the most intensively there develops the situation around the project “Irkutsk – Angarsk – Shelekhov.” With the help of experts, there were determined the limits of the agglomeration. There was started the elaboration of specific projects permitting to ensure a dynamic development of the agglomeration in such spheres as transport, water supply, utilization of solid household waste, and so on. There were discussed the variants of specialization of territories within agglomerations, as well as projects of creation of new development centers (for instance, the move of the administrative center outside the limits of the city of Irkutsk). In the structure of administration of the Irkutsk oblast there was established the office of a deputy of the Governor responsible for the creation of a free economic zone of recreational nature at the Baikal and formation of the Irkutsk urban agglomeration.

However, the example of the Irkutsk agglomeration helps to understand the conflicts inevitably related to the processes of amalgamation. While the authorities of the towns of Angarsk and Shelekhov actively supported this process since they hoped to benefit because of it both in economic and political aspects, the authorities of Irkutsk oppose such an initiative. The major concerns related to the political consequences of this process are also clear – the creation of the agglomeration may result in the continuation of centralization of political power at the regional level and formation of a mechanism permitting to further limit rights and powers of the bodies of local self-government.

The processes of agglomeration also intensified in the Chuvash Republic. In this region there were in fact made first steps towards the reformation of the Cheboksary agglomeration on the base of amalgamation of the cities of Cheboksary and Novocherkassk situated 15 kilometers from each other and a part of the Cheboksary district. It should be noted that in this case there was chosen the toughest form of amalgamation – the full merger of different municipal entities. Such an approach, in the case it is used, would result in rather serious problems relating to the ensuring of manageability of new municipal entities, which, as the international experience demonstrates, require significant efforts to be resolved.

On the other hand, there develop natural processes of formation of monocentric agglomerations around large cities reflecting the intensification of interrelations of the city nucleus with surrounding territories on the basis of push pull migrations, economic ties, processes of suburbanization, and so on. In this case, the inter-municipal cooperation in different forms is an organizational mechanism of agglomeration. A certain experience of such activities was obtained in the city of Tver, where there was organized cooperation with the bodies of local self-government of the Kalininsky and Rameshkovsky districts. In order to ensure the implementation of the agreement on cooperation between the administrations of the city of Tver, the Kalininsky and Rameshkovsky districts, the Tver City Duma had approved the city targeted program “Inter-municipal cooperation in 2006 through 2008”. Similar programs aimed

at the fulfillment of common tasks of inter-municipal cooperation were adopted also in both suburban districts.

Similar processes were observed in the framework of the Chelyabinsk agglomeration. There was organized cooperation between the city and suburban municipalities as concerns the issues relating to production and sale of agricultural produce. There were also elaborated the opportunities of cooperation along some other avenues, for instance, water supply and utilization of solid household waste. There had started to function a working group consisting of chief architects of the municipalities comprising the agglomeration of municipalities and deputies of the heads of municipal entities responsible for economic issues. The work carried out by this group was aimed at the coordination of general plans of development of municipal entities. There was underway the preparation for the creation of the Agglomeration Council.

Since urban agglomerations are a new and actively developing element of the territorial structure, special attention should be paid to the experience relating to the organization of cooperation among municipal entities and within them.

#### 5.6.4. Ways of Efficient Resolution of Issues of Local Importance of Settlements

Traditionally, the discussion on the ways of resolution of local issues at the level of settlements has been focused on the question if settlements have sufficient resources to exercise the powers vested in them. This survey focuses on the issues, what factors determine the efficiency of the resolution of local issues at the level of settlements (and, therefore, the amount of necessary resources), and to what extent settlement use the resources available for the enhancement of efficiency.

Creation of numerous small municipal entities has made more urgent the problem of losses resulting from the insufficient scale as concerned the resolution of issues of local importance. However, in the course of the reform it was expected that such losses could be compensated as a result of:

- The powers related to the organization of provision of services ensuring the maximum economy of scale will be concentrated at the level of municipal districts;
- At the level of settlements, there will be introduced additional mechanisms of mobilization of the potential of local communities permitting to compensate losses;
- Settlements will use the mechanisms of inter-municipal cooperation in order to enhance the efficiency of their activities.

The two year experience of implementation of the municipal reform permits to arrive to some preliminary conclusions on the extent to which these expectations were fulfilled. A research concerning the current situation permitted to reveal the following specific features of the resolution of issues of local importance at the level of settlements.

*First*, it has turned out that the division of issues of local importance between municipal districts and settlements failed to fully prevent losses resulting from insufficient scale of activities. It was caused not only by mistakes in the division of powers between the two tiers of the local self-government, but also the underestimation of such a factor that the uniform division of the jurisdictions of the bodies of local self-government notwithstanding the density and dispersion of the population, as well as the prevalence of urban or rural territories in any case results in inevitable losses. At present, this problem is especially apparent in the sphere of collection, removal and utilization of household waste. The legal framework of local self-

government assigns the issues related to collection and removal of waste to settlements, whereas the issues of utilization of waste were assigned to municipal districts. In the case the density of the population is high, settlements are not far from each other, and the road network is developed, it is really more feasible to concentrate utilization and processing of household waste at higher tiers of municipal administration both in economic and social terms. However, as concerns territories characterized by low density of the population and significant territorial dispersion of settlements all these positive effects are brought to naught. In the situation, where a transport haul to the solid waste landfill makes several dozens kilometers, it turns out that transportation of waste to the official landfills is economically unjustified. At the same time, the bodies of local self-government of a municipal district have no incentives to take into account the interests of settlements as concerns this issue<sup>158</sup>. As a result, in the best case settlements organize own landfills without any official supervision, and in the worst case the waste is unloaded outside special landfills: in forests, on the sides of motor roads, and so on. It has significant harmful environmental consequences and negatively affects the attractiveness of territories, particularly their recreational capacities.

*Second*, there became apparent the major avenues of the use of internal reserves becoming available due to the fact that authorities draw nearer to the population. Among the respective positive effects of the reform are the following.

1) The bodies of local self-government of settlements get incentives to mobilize the revenues generated by local taxes. At the level of settlements there is carried out the work aimed at the inventory of properties subject to taxation; work on the issues of registration of properties and prompt paying of taxes as concerns the population; delivery of tax demand notifications to tax payers; work with tax evaders. However, the current legal, normative and organizational system of tax administration fails to create adequate conditions for participation of settlement administrations in this process. As a result, activities carried out by different authorities overlap; spheres of responsibility of participants of this process and sanctions imposed in the case of the failure to exercise their functions are not clearly determined; there are not also organized information flows. Municipal entities lack the data needed to mobilize own revenues, as a result they are forced to keep their own registers of taxpayers, gather information on tax arrears and so on, in other words, they have in fact to carry out same activities as the tax authorities, which poorly cope with the administration of local taxes. At the same time, the tax authorities actually force upon local administration the exercise of some of their functions, for instance, the delivery of tax demand notifications.

2) Possibility to concentrate resources for the priority avenues of municipal development in the situation of the switch over from the estimate based financing to the budget based financing. A study of the budgets at the level of settlements reveals that the structure of expenditures significantly differs; it should be noted that whereas in some cases the priority is provision of urban amenities, in other cases it is culture. However, in the situation of a significant limitation of the independence of settlements in the budgetary sphere, the source of implementation of priorities is mainly the above-plan revenues generated primarily by local taxes, as well as better outreach with respect to land holders.

3) Possibility to use the potential of mobilization of resources being at the disposal of the local community for the resolution of issues of local importance. The use of these possi-

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<sup>158</sup> It should be noted that by no means all municipal districts have official landfills at all; however, it is a different problem not discussed in this study.

bilities is affected both by objective and subjective factors. The subjective factors relate to the strategies of administration implemented in municipal entities. Basing on the results of the study, from this standpoint all municipal entities may be classified into four groups:

- Settlements trying to copy the methods of organization of administration characteristic of much larger structures: municipal districts, regions, and so on. It means the introduction of the administrative machinery, in the framework of which the activities of each municipal officer should be clearly specialized; there should be provided the full funding of the resolution of local issues from the budget of the settlement; in each settlement there should be organized own municipal enterprises, and so on. Apparently, such a system should inevitably bear significant losses resulting from insufficient scale of activities and experience permanent deficit of budget resources allocated for the resolution of issues of local importance, as well as bear a significant burden of administrative costs and other negative consequences.
- Settlements oriented towards the minimization of own powers and responsibilities to the population, as well as delegation of the overwhelming number of powers to the level of municipal districts.
- Settlements, carrying out primarily politically motivated mobilization of the local communities. The main goal is to struggle with district authorities, obtain the maximum amount of powers, properties, and financial resources, often notwithstanding the fact if the settlement is actually able to resolve all issues of local importance and if it is economically feasible.
- Settlements, where mobilization of the local communities is primarily carried out in order to ensure the resolution of issues of local importance and improvement of living standards in the settlements. Although political motives are also present, they are primarily related to the need to create conditions facilitating the improvement of living standards. By all appearances, this group of settlements is the least numerous one. It should be noted that this model of self-government could result only from a combination of rather unique conditions, for instance such as:
  - Existence of a charismatic municipal leader;
  - High level of education of the settlement administration;
  - Existence of the economic basis and prospects of the economic growth;
  - Existence of a structured local community comprising different groups of interests.

As concerns the objective conditions, they are determined by the existence of legislative prerequisites enabling municipal authorities to use the resources of local communities. It should be noted that such conditions are not favorable for municipal entities. The federal legislation either does not envisage certain mechanisms of mobilization of such resources at all (for instance, the involvement of businesspersons in the resolution of issues important for local communities), or over-regulates such mechanisms, what results in the fact that to be used in practice they require significant time and financial expenditures (for instance, self-taxation and labor duty). As a consequence, such mechanisms do not disappear, but used in non-legal forms. Thus, in spite of the absence of local taxes on businesses, in practice businesspersons have to finance vital activities of local communities; however, this financing is outside the legal framework and may acquire the form of “municipal racket”, what has a significant negative effect on business interests. Such a method as self-taxation is still used, but rather in the

traditional, customary for local communities forms than in the forms envisaged by the legislation<sup>159</sup>.

Therefore, there may be drawn the conclusion that the municipal reform resulted in certain positive consequences as concerns the organization of resolution of issues of local importance at the level of settlements. However, these consequences could manifest themselves only partially and in a limited number of municipal entities. The main factors limiting the positive effect of the reforms may be reduced to the following:

- Financially stable settlements disposing of economic bases and organizational capacities, primarily created prior to the launch of the municipal reform, are the main source of best practices;
- The share of such settlements is rather low, whereas the mechanisms governing the dissimilation of best practices practically do not work due both to the lack of sufficiently favorable conditions facilitating better awareness thereof, and the absence of the institutional framework of this process;
- The federal legislation fails to create favorable conditions for the implementation of best practices; moreover, they are rather often implemented in the forms not fully answering the provisions of the law.

*Third*, as concerns the inter-municipal cooperation with respect to the resolution of issues of local importance, these tools remained underdeveloped. It is not surprising in the situation, where the mechanisms aimed to ensure contract enforcement in the country are not sufficiently efficient and the risks of inability to resolve issues of local importance arising as a result of a failure to fulfill obligations on the part of a side of an agreement of inter-municipal cooperation are rather high.

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Our study revealed that in 2007, as compared with the situation observed in 2006, both positive and negative processes relating to the implementation of the municipal reform were more apparent.

As positive trends, there may be indicated the following:

- A greater number of regions implement the reform in full or show progress as concerns its implementation;
- There have begun to manifest themselves positive consequences of enhanced independence of settlements; as the major effects there may be listed the tendency of settlements to mobilize revenues generated by local taxes, use the possibilities to implement the priorities of municipal policies as a result of switching from the estimate based financing to the budget based financing, and attract of resources available to local communities for resolution of issues of local importance;

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<sup>159</sup> In this situation it is apparent that the amount and the structure of local budgets not always adequately reflect the actual amounts of financial resources used for the resolution of issues of local importance. It should be noted that without carrying out a special study, it is impossible to determine the size of discrepancies: according to the results of the study it may make from 20 per cent to 25 per cent. Such a situation is characteristic exactly for the relations with the business community, which may be characterized as “municipal racket”, i. e. the expenditures related to provision of amenities in the territories of settlements, as well as a significant amount of investments in the infrastructure, social and cultural facilities and so on are shifted on local businesses.

- Urban problems have begun to play a more active (although clearly not sufficient) role in the sphere of municipal policies; there have started processes of formation of urban agglomerations of both monocentric and polycentric nature; the issues related to the ensuring of competitive capacities of urbanized territories both domestically and in the international arena gather in importance.

At the same time, the problems emerged due to the launch of the municipal reform or becoming more urgent in the process of its implementation manifest themselves more actively. As concerns this issue, there may be pointed out the following negative effects:

- In the course of the reform of the territorial organization of local self-government insufficient attention was paid to the objective processes underway in the system of population patterns in the territory of the Russian Federation, what resulted in the creation in the territory of the country of numerous unviable settlements, the potential of which does not permit to ensure the resolution of issues of local importance. In all probability, it may be assumed that over time this problem will rather become more urgent than mitigate.
- In the course of implementation of the reform there was registered the impact of certain factors resulting in economic losses in the process of resolution of local issues due to the impossibility to ensure the economies of scale at the level of settlements on the one hand and the underestimation of the transport factor as concerns the organization of provision of municipal services on the other hand. The uniform division of issues of local importance between municipal districts and settlements notwithstanding the density and pattern of the population results in inevitable losses. This trend intensifies even more due to the fact that many settlements try to copy the methods of organization of administration characteristic of much larger administrative units and are applied at the level of municipal districts or city orkugs. At the same time, possible compensation mechanisms relating to the development of inter-municipal cooperation and utilization of the capacities of local communities are underdeveloped and not always function efficiently.
- Many processes, the necessity of which is felt in the course of implementation of the municipal reform, have no adequate legal mechanisms of actualization. In particular, it concerns changes in the territorial organization of local self-government. As a result, the processes not clearly formalized in legal terms are implemented with apparent infringements on the legislation currently in force, and the common law begins to play a more important role in this sphere. Thus, the decisions approved by the population at referendums are assumed to be legitimate regardless of the fact if they were in compliance with the law and if an expression of the popular will was in principle envisaged as a mechanism governing the resolution of the respective issue. Due to the absence of local taxes on businesses, the participation of businesspersons in the resolution of issues of local importance in the territories of municipal entities is also to a significant degree carried out outside the legal framework and in many places acquires the form of “municipal racket”, what has a significant negative impact on business interests.

Certain barriers on the way of more efficient implementation of the municipal reform can be overcome in the framework of the current adjustment of the existing federal legislation. These problems have been many times discussed in the municipal expert community; however, the respective amendments have been never introduced. Among these amendments are, in particular, the following:

- Simplification of the mechanisms of self-taxation of the population;



- Extension of the legislative mechanism governing the distribution of municipal property between newly created settlements and municipal districts the municipal entities, which existed prior to the launch of the municipal reform;
- Introduction of the possibility to assign to municipal entities individual standards of tax rates at the expense of grants, which would be fixed for the medium term period, and without limitations on the composition of taxes<sup>160</sup>;
- A tighter regulation with respect to the provision of transfers from the budgets of municipal districts to the budgets of settlements or exclusion of such issue as the “equalization of the levels of fiscal capacities of the settlements being in the composition of the municipal district at the expense of the financial resources of the budget of the municipal district” from the list of issues of local importance for municipal districts;
- The return of the full amount of powers relating to the disposal of land and revenues generated by the lease of land to the level of settlements.

Other problems require a rather serious adjustment of the current approaches to the organization of functioning of local authorities and introduction of significant changes in the legislation, what should be a subject of a serious and comprehensive discussion. Among such problems there may be indicated the following:

- Organization of administration of local taxes;
- Determination of the composition of local taxes and the extent of independence of municipal entities as concerns the imposition thereof.

At the same time, there is a number of problems, the mechanisms of settlement of which are in principle not apparent, since such problems are originated by the conceptual approaches to the transformations in the sphere of local self-government, for instance:

- Significant differentiation of the economic situation, financial and human resources capacities, and the prospects of development of settlements in the situation they are assigned the single list of issues of local importance;
- Impossibility to ensure the division of issues of local importance between municipal districts and settlements, which would be efficient regardless of the conditions, under which this division would exist (density and pattern of the population, types of buildings and so on);
- Inevitable losses relating to the insufficient scale as concerns the resolution of issues of local importance at the level of settlements in the framework of the exiting system of population patterns, and the further deterioration of the quality and affordability of municipal services in the case it is attempted to administratively limit the expenditures for these purposes.

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<sup>160</sup> The limitation of tax revenues to the income tax exclusively was removed for the transition period until January 1, 2009; however, it remained in force for the period of full implementation of the municipal reform. The setting of tax rates for the medium term outlook is possible in the framework of the three year budget; however, it is not apparent that these rates will not be differentiated across years, what, from the standpoint of creation of incentives for mobilization of taxes, is undesirable.

### 5.7. Legal Aspects of the Functioning of Development Institutions

The year 2007 became a key period in the development of the financial and normative-legal base of development institutions, since it is then that they began to receive substantial financing. Besides, that year a number of fundamental federal laws were adopted, which were designed to regulate the procedure for their formation and functioning. Among these new laws, the following are noteworthy:

- Federal Law of 17 May 2007 No. 82-FZ “On the Bank for Development”;
- Federal Law of 19 July 2007 No. 139-FZ “On the Russian nanotechnologies corporation”;
- Federal Law of 23 November 2007 No. 270-FZ “On the public corporation “Rostekhnologia”; and other normative legal acts regulating the operation of such organizations;
- Article 179.2 of the RF Budget Code (BC) “The Investment Fund of the Russian Federation”, which augmented the RF BC on the basis of Federal Law of 26 April 2007, No. 63-FZ, “On the introduction of changes into the Budget Code of the Russian Federation in the part of budgeting process regulation, and on bringing individual legislative acts of the Russian Federation in conformity with budgetary legislation of the Russian Federation”.

Although the notion itself of “development institutions” received no legislative definition, this term has been widely applied in literature on economics and law<sup>161</sup>. It seems that, as the distinctive features of development institutions, the following specific attributes of their operation should be pointed out:

- Investment-oriented activity;
- performance-based results of their operation;
- an institution’s functioning in the form of a juridical person;
- an institution’s activity related to the socioeconomic policy of the Russian Federation;
- part of their funding being received from the federal budget of the Russian Federation;
- absence of the status of a budget-funded institutions, and operation on a basis other than budget.

These criteria are fully complied with by the following entities:

- the Bank for Development (Vneshekonombank – VEB);
- the RF Investment Fund;
- the Russian Venture Company (RVC);
- the Russian Nanotechnologies Corporation (Rosnanotekh);
- the Public Corporation “Rostekhnologia”;
- the Agency for Housing Mortgage Crediting (AHMC).

The afore-listed development institutions should be distinguished from those development instruments that include various forms of direct financing and financial support of investment projects, which can be described as follows:

- federal and departmental target programs;
- a targeted investment program;
- concession agreements;
- non-program budget investments; and other instruments.

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<sup>161</sup> See, e.g., the approach to the term’s definition applied by the Center for Strategic Research [http://www.csr.ru/document/original\\_452.stm](http://www.csr.ru/document/original_452.stm); Kudrin: 640 billion rubles will be allocated to development institutions. <http://business.restate.ru/news/35607.html>.

Special economic zones (SEZ), from the point of view of law, are also an instrument rather than an institution for development, since they create conditions for improving investment climate. However, they do not act in their own name as public investors.

These development instruments can be used by applying the following forms of budget support for investment projects:

- subsidies;
- credits;
- guarantees;
- participation in the capital of juridical persons (investors), etc.

Below we are going to discuss briefly the main peculiarities and problems inherent in the functioning of each of these *development institutions*, established in 2007.

The Bank for Development (Vneshekonombank). At present, the main issues of the Bank's functioning are regulated by the following normative acts:

1. Federal Law of 17 May 2007 No. 82-FZ "On the Bank for Development";
2. The memorandum on the financial policy of the public corporation "The Bank for Development and Foreign Economic Activity (Vneshekonombank)", approved by Regulation of the Government of the Russian Federation as of 27 July 2007, No. 1007-r;
3. The provision on the Supervisory Board of the public corporation "The Bank for Development and Foreign Economic Activity (Vneshekonombank)".

As the Federal Law "On the Bank for Development" was adopted only as late as May 2007, the normative base for its operation is still being elaborated and therefore does not contain *all* the necessary normative and local acts.

With the enactment of the new law, Vneshekonombank changed both its organizational-legal form and the directions of its activity. While previously it had had the status of an ordinary credit institution, from the year 2007 onward it acquires that of a public corporation, while its operation was, in fact, placed outside of the sphere of control of the RF Central Bank. In particular, now its activity is not subject to regulation by legislation on banks and banking activity, which established the following procedures:

1. state registration of credit institutions;
2. licensing of banking operations;
3. liquidation and reorganization of credit institutions;
4. disclosure of information concerning the activity of credit institutions;
5. compliance with the requirements to stability and financial reliability of credit institutions, as well as compliance with other mandatory requirements and normative standards.

Besides, the activity of Vneshekonombank, after it acquired the status of a not-for-profit organization (NPO), is no more subject to the provisions regulating the procedure for effectuating control over the operation of NPO stipulated in Items 3, 5, 7, 10, and 14 of Article 32 of Federal Law of 12 January 1996, No. 7-FZ, "On Not-For-Profit Organizations".

Thus, Vneshekonombank is not subordinated directly to the Central Bank and financial control agencies, and its activity is controlled only by the RF President and the Government of the Russian Federation. And, since neither legislation on banks, nor legislation on the securities market, let alone budget legislation, apply in full to the Bank for Development's activity, each of the Bank's powers listed in the Law and Memorandum require, in fact, some additional regulation to be introduced. Thus, further elaboration is needed for:

- the mechanisms for internal and external control over Vneshekonombank's activity;

- the procedure for its interaction with federal and regional bodies of state authority, and with bodies of local self-government;
- the mechanisms for its interaction with other development institutions, credit institutions, and insurance organizations;
- the procedure for opening its affiliations in the territory of the Russian Federation and abroad, as well as other directions of its activity.

Besides, no distinct definition has been offered for the terms of which the projects to be granted financial support from Vneshekonombank are to be selected, or for the guarantees of “absence of competition” on the part of Vneshekonombank in respect of credit institutions<sup>162</sup>. From a comprehensive interpretation of the Law’s and Memorandum’s texts it follows that the projects receiving such support must be, on the one hand, profitable, and on the other, no other banks must aspire to be the source of their financing (the no competition principle). It is unclear, however, how these two conditions are expected to be complied with.

One more task requiring lawmakers’ attention is that of delineating more distinctly the areas of the Bank for Development’s activity and those of the other development institutions functioning in the Russian Federation; of mapping the prospects for their interaction; and of finding a solution to the issue as to which directions of the national economy’s by branch development may be allocated support backed by the Bank’s resources (innovative only, or any). In accordance with Item 7 of the Memorandum, “the main branch priorities of the Bank for Development’s activity in the years 2007–2010” are as follows:

- a) rocketry and space-systems complex;
- b) shipbuilding;
- c) electronics industry;
- d) nuclear power industry, including nuclear power engineering;
- e) machine-building for transport, special purposes and power engineering;
- f) metallurgy (production of steels for special purposes);
- g) woodwork industry;
- h) the defense-industrial complex.

In this connection, it is not quite clear as to which individual branch development projects being implemented in the afore-listed areas can be covered by VEB’s activity: only those involving support of innovative research and development, or the financial support of projects aimed at promoting a given branch as such.

The Public Nanotechnologies Corporation (Rosnanotekh). The procedure for the Corporation’s functioning is determined by:

1. Federal Law of 19 July 2007, No. 139-FZ, “On the Russian Nanotechnologies Corporation”;
2. Decree of the RF Government of 2 August 2007, No. 498, “On the Federal Target Program “Development of infrastructure for the nanoindustry in the Russian Federation for the years 2008–2010”;

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<sup>162</sup> A comprehensive interpretation of the norms stipulated in the Law and Memorandum has led to the conclusion that the granting of financial support from the Bank for Development’s resources should be based on the results of a contest between projects and organizations. However, no terms of such a contest have been clearly defines for any of the areas to be supported.

3. Regulation of the RF Government of 25 August 2006, No. 1188-r, “On the program for coordinating works in the field of nanotechnologies and nanometaterials in the Russian Federation”;
4. Regulation of the RF Government of 07 September 2007, No. 1175-r, “On the composition of the Supervisory Board of the Russian Nanotechnologies Corporation”;
5. Order of the RF Chief State Sanitary Physician of 23 July 2007, No. 54, “On the supervision over the products obtained with the use of nanotechnologies and containing nanomaterials”.

The Corporation, similarly to the other development institutions, has been created in order to support and promote primarily innovative infrastructures. However, in contrast to VEB, the Investment Fund and the SC “Rostekhnologia”, the Corporation, just as the RVC, has been assigned a relatively “narrow” field for investing in science and technologies – the sphere of nanotechnologies.

On the whole, the Corporation’s organizational form and the forms of its activity resemble those of the other development institutions established in the form of a public corporation. Similarly to the other development institutions, with the exception of the Investment Fund, the Corporation enjoys a broad range of rights and a high degree of independence in dealing with its day-to-day issues, including those relating to the investment of its funds<sup>163</sup>.

In particular, the Corporation may engage in entrepreneurial activity, since in Article 5 of Law No. 139-FZ it is stipulated that the Corporation’s property “shall be formed by a contribution of property by the Russian Federation, *incomes received from the Corporation’s activity*; voluntary contributions and donations, and by other legal receipts, and shall be owned by the Corporation”. Besides, the Corporation has the right, at the expense of its property, “*to create other not-for-profit organizations and enter in associations and unions on conditions determined by the Supervisory Board of the Corporation*”. As for not-for-profit organizations, these are not, in fact, in any way restricted by existing legislation in their right to engage in commercial activity, either.

In addition, Law No. 139-FZ establishes the Corporation’s right “*to form target funds*” (that is, to create target capital for achieving the goals of its activity in the procedure envisaged by Federal Law of 30 December 2006, No. 275-FZ, “On the procedure for forming and using target capital by not-for-profit organizations”).

In this connection, some of the norms stipulated in Law No. 275-FZ may be regarded as contradictory to Law No. 139-FZ. The essence of the problem is that Law No. 275-FZ imposes rigid restrictions on the range of NPOs empowered to create their target capital. In accordance with this Law, target capital may be formed exclusively by the following entities:

- funds;
- autonomous not-for-profit organizations;
- nongovernmental organizations;
- nongovernmental funds;

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<sup>163</sup> Its property is to be formed by a contribution from the Russian Federation; incomes from the Corporation’s activity; voluntary contributions and donations; and by other legal receipts. The Corporation is the owner of this property.

– religious organizations<sup>164</sup>.

A “public corporation”, while being a form of an NPO, does not belong to the category of organizations with the right to create target capital. And, since the Law “On the Russian Nanotechnologies Corporation” does not elaborate on the procedure for applying the norms stipulated in Federal Law No. 275-FZ to the Corporation’s activity, this may be interpreted as a ban on the formation of target capital by the Nanotechnologies Corporation.

The procedure and terms for its formation by the Corporation have been, in fact, left largely unregulated. Even if it is assumed that the Corporation, with time, will indeed become able to create own target funds, it will still be necessary to solve the problem of selection of asset managers to be assigned with the task of trust management of the Nanotechnologies Corporation’s funds, since it is envisaged in the Law “On the procedure for forming and using the target capital of not-for-profit organizations” that an external manager must be attracted for carrying out the operations with target capital.

In accordance with Article 2 of the Law, the target capital of a not-for-profit organization represents “part of property of a not-for-profit organization” formed “by the donations contributed by donor(s) in the form of monies, transferred by the not-for-profit organization into trust management to an asset manager in order to generate income to be used for financing the charter activity of the not-for-profit organization, or of other not-for-profit organizations, in the procedure envisaged by the Federal Law”.

No special norms designed to regulate the terms for selecting companies to be entrusted with the management of the Corporation’s target funds could be found either in Law No. 139-FZ or in the normative acts adopted as by-laws. By way of comparison, it should be noted that the other development institutions transfer public funds to assets managers on a more transparent basis. Thus, the criteria for selecting venture companies to act as asset managers, at least in a general form, have indeed been established by the Russian Venture Company (RVC).

As a result, it can be concluded that if the norms stipulated in the Law “On the procedure for forming and using the target capital of not-for-profit organizations” will be applied to the Corporation’s target funds without any reservations, there will be only limited areas for investing its target capital.

Besides, the Corporation’s activity in some respects differs from that of other development institutions. In addition to a more “narrow” sphere for investing resources, lawmakers have also specified some conditions for their placement. Thus, while Vneshekonombank and RVC are orientated towards ensuring at least a minimum level of profitability of the projects they choose to finance, the Corporation is orientated more toward *subsidizing* innovative developments, while not being required to ensure their profitability.

It should be noted that at least in the sphere of subsidizing nanotechnologies the Corporation is not competing with other development institutions, while its activity, from the point of view of goals, is to a large extent duplicated by that of the bodies of state authority engaged in the implementation of the Federal Target Program “Development of infrastructure for the nanoindustry in the Russian Federation for the years 2008–2010”<sup>165</sup>. Among the state agencies

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<sup>164</sup> In accordance with Article 2 of Law No. 275-FZ, the target capital’s owner may be only a not-for-profit organization created in the organizational-legal form of a fund, an autonomous not-for-profit organization, a non-governmental organization, a nongovernmental fund, or a religious organization.

<sup>165</sup> See the RF Government’s decree of 2 August 2007, No. 498.

acting as the Program's customers, the following have been designated: the Federal Agency for Science and Innovations, the Federal Agency for Public Education, the Federal Agency for Nuclear Power, the Federal Outer Space Agency, the Federal Agency for Industry, the Federal Agency for Technical Regulation and Metrology, and the Federal Service for Technical and Expert's Control. The role of customer and coordinator has been assigned to the Ministry of Public Education and Science of the Russian Federation.

It is also noteworthy that the Russian Nanotechnologies Corporation is not mentioned among the recipients of budget funding under the Target Program, and therefore it is unclear how it interacts with the state customers for the Program.

The funding channeled through the Program, similarly to Rosnanotekh's funding, is allocated to the elaboration and marketing of nanotechnologies.

The Public Corporation "Rostekhnologia". In November 2007 Federal law of 23 November 2007, No. 270-FZ, "On the Public Corporation "Rostekhnologia" was adopted, which provided the basis for creating yet another state structure, to be allocated substantial funding from the federal budget for the promotion of innovations and hi-tech industries.

In accordance with Article 3 of this Law, the goal of the Public Corporation "Rostekhnologia" is to "promote the development, manufacture and export of hi-tech industrial products through providing support, on the domestic and foreign markets, to Russian organizations – developers and manufacturers of hi-tech industrial products, attracting investments to organizations belonging to different branches of industry, *including the defense-industrial complex*".

Thus, the new corporation's activity, in addition to "civilian" innovations, also encompasses the commercialization of military and dual-purpose products. It should be noted that the Corporation's creation at the stage of developing the law designed to regulate its activity<sup>166</sup> was substantiated not so much by the need to make the trade in military hi-tech products more profitable, but by the general necessity to develop the hi-tech sector of exports as such. The establishment of the SC "Rostekhnologia" was preceded by a comprehensive analysis of Russia's position on the international hi-tech market<sup>167</sup>, which pointed to its very low market share (no more than 0.5%), as well as to the problems faced by the export of *civil* machine-building. However, as a result, the Law on the SC "Rostekhnologia" was adjusted in the main to regulate the defense-industrial sector. The SC "Rostekhnologia"'s operation, in its currently existing form, can hardly be conducive, in our opinion, to improving the situation in the sphere of *civil machine-building and export of non-military technologies*, since nothing is said either in Law No. 270-FZ or in any official plans and programs about investments in this sphere to be channeled through "Rostekhnologia".

The directions of the Corporation's activity are in many ways overlapping with those of Vneshekonombank, RVC and the Nanotechnologies Corporation. Thus, the purpose of "Rostekhnologia", as well as of other development institutions, is to promote the export of hi-tech products; both "Rostekhnologia" and Vneshekonombank enjoy the right to carry out "works associated with the use of information classified as State secret". As a consequence, the Bank for Development, alongside "Rostekhnologia", can participate in projects implemented in the defense - industrial branch.

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<sup>166</sup> See, e.g., [http://www.gosrf.ru/print\\_1486.htm](http://www.gosrf.ru/print_1486.htm).

<sup>167</sup> Ibid.

However, as compared to other development institutions, the activity of “Rostekhnologia” is the least transparent. Thus, the directions of activity assigned to Vneshekonombank, RVC, and even to the Nanotechnologies Corporation are formulated with greater precision than those assigned to the SC “Rostekhnologia”.

For example, its basic functions are described in Law No. 270-FZ as follows: “*aid* to organizations belonging to different branches of industry, including the defense-industrial complex, in the development and production of hi-tech industrial products”; “*ensuring the promotion* on the domestic and foreign markets and the realization on the domestic and foreign markets of hi-tech industrial products, as well as the commodities associated with the creation of these products and the results of intellectual activity”, etc. In this connection, it is totally unclear what was meant by lawmakers as “aid to” and “participation in the implementation of state policy”. Thus the question arises as to whether the performance of these functions of the Corporation could be ensured through granting not-for-profit subsidies? Or by granting credits, guarantees, or by participating in concession agreements, etc.?

Thus, the principal problem associated with “Rostekhnologia”’s operation is presented by its very broad powers, coupled with extremely vague goals, tasks and actual procedures envisaged for it. The problem is further aggravated by the fact that, in contrast to other development institutions, “Rostekhnologia” deals with military and dual-purpose technologies, which, due to secrecy, makes the task of “external” control even more difficult.

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While summing up the analysis of the legal base for the functioning of some of the development institutions created in 2007, it should be said that they all are characterized by certain common problems. The most important, in our opinion, is the insufficiently developed legal base of their activity.

The Laws adopted in 2007 – “On the Bank for Development”, “On the Russian Nanotechnologies Corporation”, and “On the Public Corporation “Rostekhnologia” – are designed to regulate the financial activity of development institutions only in most general terms, granting to the leadership of the newly established public corporations broad opportunities for spending budget funds, without creating any adequate system of control over the efficiency of their spending.

Thus, the common problem of these development institutions is that they are independent of the specialized agencies for financial control. For example, the financial operations of Vneshekonombank, after it has traded its status of a credit institution for that of a public corporation, are now beyond the sphere of financial control exercised by the RF Central Bank.

The activity of all the other newly created corporations cannot, in any practical terms, be controlled by state agencies like Rosfinnadzor and the Federal Treasury, because they are not recipients and executors of budget funds, since the allocations from the federal budget were transferred to them not as regular budget financing but as contributions to their charter capital, or in other forms which are not subject to control over targeted use of financial resources.

For this purpose, even parliamentary control exercised in the process of consideration and approval of a law on the federal budget does not apply to the activity of such corporations.

In this connection, the direct reporting by these development institutions to the RF President and Government cannot, in our opinion, ensure the necessary level of transparency



of their financial operations, since neither the President and nor the Government, as bodies of state authority, possess an apparatus adequate to effectuating detailed financial audits.

Control over the activity of such development institutions could be in part ensured by annual auditor's control, which is mandatory for Vneshekonombank, as well as for "Rostekhnologia" and Rosnanotekh.

However, in all the three cases it is the leadership of a corporation, and not any "external" agencies, who is authorized to select the auditors. In this connection, the experience of audits conducted in respect of such big clients (e.g., the audits of "Yukos") has demonstrated that auditors are not always prepared to generate objective conclusions, which can be contrary to their clients' interests. Thus, problem of transparent functioning of the newly created development institutions remains open.

Equally common for all the development institutions created in 2007 has been the problem presented by overlapping areas of activity. The laws determining the range of projects to be supported by other development institutions have, in fact, duplicated one another by pointing out that the highest priority is assigned to the sphere of "innovations".

Firstly, nowhere have the lawmakers specified what exactly is understood by "innovations" for purposes of allocating budget support (all the attempts made so far to offer a clear definition of this sphere have not been very successful).

Secondly, no clearly defined procedure has been established, in respect of the selection of projects to be implemented with the participation of development institutions, for expert's estimation aimed at determining their "novelty" and "prospects" as a commodity tradable on the domestic and international markets, which is also fraught with certain risks.

Thirdly, the overlapping goals and areas of activity of some development institutions gives rise to a kind of competition for supporting high-tech products in the phase of their completion. This problem, despite being quite predictable, has proved to be unexpected by the State. Thus, according to Deputy Director of Rosnauka's Administration for Innovative Development and Infrastructure G. V. Shepelev<sup>168</sup>, in the last 20 years, due to shortages in the financing of research and development projects, the number of those actually reaching the phase of practical implementation has dramatically diminished. There are no business plans, estimations of potential markets for trading high-tech products, or other necessary documentation even for the developed products. Most of the Russian innovative products, which potentially can be funded by development institutions, have not yet undergone the phase of testing. As a result, the newly created development institutions and innovative funds quite often are unable to put together the needed "package" of large-scale hi-tech projects, while those projects that are relatively ready for implementation are becoming considerably more expensive because of competition among investors. This results in lower efficiency of spending budget resources allocated to the support of the sphere of innovations.

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<sup>168</sup> The related materials were presented in a report delivered at the MPTI's conference in 2007.

## **Annex.**

### **Review of the Law in the Area of Tax Regulation and Civil Legislation<sup>1</sup>**

The year of 2007 saw the continuation of reforming of the tax legislation aimed at its regulation and improvement. Practically all the chapters of Section Two of the Tax Code of the Russian Federation underwent amending during the year.

Let us briefly consider what the taxpayer should expect in 2008 and comment on the most substantial amendments.

#### **Main Amendments to the Tax Code of RF**

##### **Value-Added Tax (VAT)<sup>2</sup>**

In compliance with p.6 Art. 145 of the Tax Code, the eligibility for exemption (extension of the term of exemption) from execution of the taxpayer's responsibilities with respect to VAT should be proved by the following documents: an excerpt from the corporation's balance-sheet statement (submitted by the organization itself); an excerpt from the sales book; an excerpt from the revenue and expenditure and economic operations book (submitted by the self-employed individual (*aka* individual entrepreneur)); and a copy of the received and made out invoices book. Meanwhile, both corporations and self-employed individuals that had switched from the simplified taxation regime to the general one failed to submit the sales book, a copy of the received and made out invoices book, or an excerpt from balance-sheet statement. Since January 1, 2008, it will be an excerpt from the revenue and expenditure and economic operations book to be submitted by corporations and self-employed individuals that use the simplified taxation system. This document should complement the aforementioned ones that prove the eligibility for ax exemption.

Since January 1, 2008 , it will be only sales of the non-ferrous scrap that will be exempted from VAT (as introduced by sp. 25 p. 2 art. 149 of the Tax Code). This benefit will be applied in the mandatory order, while in 2007 it was also effective with regard to sales of ferrous metal scrap, while taxpayers enjoyed the right to refuse the benefit (as per p. 5 art. 149 of TC of RF).

Since 2008 exempted from taxation will become sales of goods, works and services produced and sold by public unitary enterprises under anti-TBC, psychiatric and psycho-neurological institutions, those of social protection or the population social rehabilitation, while until recently this benefit was granted solely to medical-production (labor) workshops under the noted institutions.

Since January 1, 2008, sales of medicines designated to the conduct of clinical research has become subject to the 10% VAT rate (p. 2 of art. 164 of TC of RF), and the same tax rate is applied to a concrete lot of unregistered medicines imported to the RF territory and designated for the conduct of the clinical research (p. 2 of art. 164 of TC of RF). Meanwhile, in compliance with sp. 4 p. 2 of art. 164 of TC of RF, codes of kinds of the noted products are to

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<sup>1</sup> This section was drafted using Consultant Plus.

<sup>2</sup> The respective amendments were introduced by Federal Act of 17 May 2007 No. 85-FZ "On introducing amendments to chapters 21, 26, 26.2 and 26.3 of Section Two of the Tax Code of the Russian Federation".

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be set by the RF Government according to the National Products Classifier (NPS)<sup>3</sup> and the Foreign Trade Commodity Classification (FTCC).

In the past (since 2006), there was no 180-day deadline for collecting documents with respect to services rendered by national taxpayers on transportation of goods imported in or exported from Russia and, basing on this, the RF Ministry of Finance demanded to identify the moment of setting the tax base in compliance with p.1 art. 167 of TC of RF, i.e. at the moment the respective service was provided<sup>4</sup>. Accordingly, the taxpayer was to submit to the tax office the documents, as per p.4 art. 167 of TC of RF, not later than on the 20<sup>th</sup> day of the month that followed the tax period when the services had been provided<sup>5</sup>.

The novelties also imply a substantial amendment in favor of taxpayers in p. 9 art. 165 of TC of RF and p.9 art. 167 of TC of RF that became effective as of January 1, 2008 and remain equally effective on relations started since January 1, 2007. Now in the event the taxpayer fails to submit to the customs agency a customs declaration (or its copy) to justify for the application of zero tax rate to his works (services), he should submit the documents no later than within 180 calendar days since the date of the mark that proves the exportation of the goods from (or the importation of the goods in) the territory of the Russian Federation made by the customs border offices on the carriage documents. In the event of the failure to submit the noted documents within the 180 calendar days, his operations on sales of works (services) are subject to the 18% tax rate. Meanwhile, in the event the taxpayer submits to the tax office at a later date documents that justify for the application of the zero tax rate, the earlier paid amounts of the tax are subject to refund, following the procedures and under terms, as per art 176 of TC of RF.

From the list of events when VAT should be restored excluded became the property transfer to the participant in the particular partnership (joint adventure agreement) or his successor in the event of allotment of his share from the property jointly owned by participants in the agreement or division of such property (sp. 2 p.3 art 170 of TC of RF).

Art 171 of TC of RF also underwent amending. Provisions of p. 5 art. 171 of TC of RF regulate application of rebates in the event the goods are returned to the seller (including the guarantee term in particular), refusal from them, change in conditions or dissolution of the respective agreement, and refund of the respective amounts of the partial payment only by sellers, rather than tax agents. Since 2008 the VAT rebates in such cases can equally be employed by the tax agents that exercise the duty of the tax agents, as per p.2 art 161 of TC of RF, and become payers of the tax.

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<sup>3</sup> The RF Government has failed so far to pass the respective resolution, but as per p. 2 of the Letter by the RF State Customs Committee of June 4, 2003, No. 01-06/22880 “On collecting VAT under importation of goods into the customs territory of RF”, the decision on collection of the 10% VAT rate with regard to medicines and other medical articles can be taken by the customs office on the basis of documents submitted at the moment of the customs clearance, which prove that a given medicine or medical article has passed the state registration as such.

<sup>4</sup> See the Minfin’s Letter of 12.03.2007 No. 03-07-08/34.

<sup>5</sup> See the Minfin’s Letter of 30.08.2006 No. 03-04-08/183.

### *Personal Income Tax (PIT)*<sup>6</sup>

Chapter 23 of the Tax Code of RF saw a great number of various amendments introduced therein. Those were both technical modifications and amendments that introduced critical changes in the taxation procedures.

To cite a particular example, the term “permanent representative offices” will be substituted by “separate divisions” (art. 208, 226 of TC of RF). Consequently, should they pay remuneration to private individuals, separate divisions of foreign organizations that do not operate in RF via a permanent representative office will have to exercise the tax agent’s functions, so far as PIT is concerned.

An amendment was introduced to procedures of identification of the tax base on incomes received in kind, as per p.1 art. 211 of TC of RF. Under this category will fall partly paid for goods, works and services received by a private individual. In this case, while computing the PIT tax base, the market value of goods, works and services received by the private individual should be reduced by the amount he has paid for them.

Since 2008 incomes in the form of the material benefit received from saving on interest on the use of targeted loans (credits), which the taxpayer received and de-facto spent on construction or purchase in the RF territory of a house, apartment or shares in them, as well as a room (s), will not be included in the PIT tax base, provided, however, the private individual is eligible for a property rebate on construction or purchase of housing (sb. 1 p. 1 art. 212 and p. 2 art 224 of TC of RF).

The sums taxpayers receive to refund costs (a part of costs) they incur in regard to interest payments on loans (credits) (p. 35 art. 217 of TC of RF), as well as the sums of subsidies on purchase and/or construction of housing (p. 36 art. 217 of TC of RF) are no longer subject to PIT taxation, providing such subsidies were paid from the federal budget or the RF Subject’s budget or a local budget.

While computing the amount of PIT on the material benefit in the form of a saved interest, the tax agency will now employ the refinancing rate effective as of the date when the private individual received the respective income. Sp. 2 p. 2 art. 212 of TC of RF has been amended in such a manner so that it bears a direct reference to the tax agent’s responsibility for identification of the tax base with respect to the material benefit and computation, withholding and transferring PIT to the budget following the procedures as per TC of RF. An analogous responsibility is imposed on the credit institution with which the private individual concluded a deposit agreement.

The Tax Code of RF was complemented by art. 214.2, which concerns peculiarities of identification of the tax base in the event of receipt of income in the form of interest on bank deposits, while analogous provisions were taken off from p.2 art. 224. Since 2008 the private individual’s taxable income will no longer comprise interest on Rb.-denominated deposits, which, as of the date of conclusion or extension of an agreement, were set at a rate not higher than the Bank of Russia’s effective refinancing rate. This implies observance with two conditions: namely, the interest rate on such deposits has not been raised and the moment when the interest rate was greater than the refinancing rate occurred not later than 3 years ago.

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<sup>6</sup> As amended by Federal Statute of 24.07.2007 No. 216-FZ “On introducing amendments to Section Two of the Tax Code of the Russian Federation and some other acts of the Russian Federation”.

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The procedures of taxation of some payments in favor of private individuals likewise underwent some changes.

More specifically, as per p. 3 art. 217 of TC of RF, per diem amounting to Rb. 700 (for each day of a business trip across the RF territory) and 2,500 (for each day of a business trip overseas) will no longer be subject to PIT.

As well, exempted from PIT (p.8 art. 217 of TC of RF) will become amounts of material relief payable both to a private individual who suffered from a natural calamity or other emergency situations and members of the family of an individual who died due to such disasters. Paying a material relief in such cases will not require a decision by the legislative or executive power, or by representative local self-governance bodies. In addition, exempted from PIT will be humanitarian and charity relief provided by charities to family members of individuals who died because of acts of terror in the RF territory.

An amendment was also introduced to p. 9 art. 217 of TC of RF, which consequently reads that exempted from PIT are amounts of compensations disbursed at the expense of funds received from operations that are subject to special tax regimes. Amounts of a full or partial compensation (payment) for rehabilitation vouchers the employer buys for his former employees who have retired due to disability or because of the retirement age are exempted from taxation.

In addition, now there exists a list of objects that fall under the category of sanatorium-resort and rehabilitation institutions (p. 9 art 217 of TC of RF), which includes sanatoriums, rehabilitation centers, resorts, medical-rehabilitation centers, health centers and children's sport camps, among others.

Since 2008 the procedures of granting benefits with regard to insurance compensations on voluntary insurance contracts will be modified, as per sp 3 p. 1. art. 213 of TC of RF. This particular benefit will also become available by voluntary personal insurance contracts that provide for compensations in the event of infliction of harm to one's health.

As concerns the voluntary life insurance contracts, the procedure of taxation of indemnities will no longer depend on their term, be that 5 years or less (sp. 2 p. 1 art. 213 of TC of RF). The tax will be withheld only from the amount that appears in excess of the sum of insurance contributions made over the whole period of effect of the contract, with account of incomes computed proceeding from the Bank of Russia's average annual refinancing rate. In the event of an early termination of such a contract, the insurance company is bound to calculate and withhold PIT, with the tax base being computed as a diff between the insurance indemnity due to the insured individual and the amount of insurance contributions made as per the agreement.

A specification was introduced to sp 4 p.1 art 213 of TC of RF, which now reads that insurance claims by voluntary pension insurance contracts upon the appearance of the grounds for pension will be exempted from PIT only if a private individual concluded such a contract in his own behalf. Plus, subpoint 4 sets procedures of taxation of payments in the event of an early termination of pension insurance contracts, except for dissolution of an insurance contract because of causes beyond the parties' control. While refunding the sum by such a contract to the private individual, an insurance company is bound to withhold PIT from the payment. An analogous procedure of taxation of payments is set with regard to cases of an early dissolution of non-government pension provision contracts (p. 2 art. 2131 of TC of RF).

In compliance with p. 3 art. 213 of TC of RF, should the employer pay amounts of insurance premiums by insurance contracts on other private individual's behalf, such amounts are taken into account while identifying the tax base, except for the cases when the employer insures private individual by the following contracts: compulsory insurance of private individuals and voluntary insurance contracts that provide for compensation for harm caused to the private individuals' life and health and/or medical costs they incurred. Since 2008 the list of contracts has comprised all other kinds of voluntary personal insurance contracts, as well as voluntary pension insurance ones.

Now PIT will also be withheld from sums paid by insurance contracts on private individuals' behalf by organizations or individual entrepreneurs, which (who) are not employers to the noted individuals (p. 3 art. 213 of TC of RF).

Another amendment was introduced to sp 3 p.1 art. 219 of TC of RF<sup>7</sup>. Now the social rebate on rehabilitation is granted in the amount of insurance premiums the taxpayer paid on his family members' (spouse, parents and children under 18) voluntary insurance contracts. In addition, in compliance with the newly introduced sp. 4 p.1 art. 219 of TC of RF, taxpayers will become eligible for a social tax rebate from the amount of the following payments made over a given tax period: pension contributions by a non-government pension provision contracts and insurance premiums by a voluntary pension insurance contract. The taxpayers can conclude such contracts in his, as well as on his family members' (spouse, parents or adoptive parents, disabled children, including adopted ones, or under guardianship) behalf.

While filing the 2007 tax returns, the social tax rebate will be granted to the taxpayer according to new procedures. The previous version of art. 219 provides for the capping of the maximum amount of social rebates. In compliance with the latest amendments, the uniform maximum capping of the amount of social rebates in conjunction with expenses on the taxpayer's education, his medical treatment and expenses on non-government pension provision contracts and voluntary pension insurance has now been increased up to Rb. 100,000. So, the taxpayer will have to make a choice on his own as to which kinds of his expenses, and at which amounts, will be accounted within the limits of the maximum value of the social tax rebate.

Since 2008 (sb. 1 p.1 art. 220 of TC of RF)<sup>8</sup> taxpayers will be able to reduce incomes under assignment of right of demand with regard to contracts on participation in the so-called shared construction, those on investing in the shared construction or other contract in conjunction with the shared construction by the sum of expenses conditioned by receipt of the noted incomes, providing that such costs have been actually incurred and proved by documents.

The property tax rebate will no longer be available in the event the housing construction or purchase costs were paid for at the expense of subsidies allocated from the federal budget or an RF Subject's budget or a local budget. As concerns receipt of an income in the form of labor compensation, the date of the taxpayer's actual receipt of the income is recognized as the last day of the month for which the income was accrued to him for the completed labor duties, as per the labor contract (p.2 art. 223 of TC of RF). The new version of this particular provision specifies as follows: in the event an employee resigns prior to the last day of the calendar month, the date of the actual receipt of income is recognized as the last day of the work for which his income was accrued. So, the employer will have to calculate, withhold and

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<sup>7</sup> In the new version, this provision embraces legal relations emerged since 2007.

<sup>8</sup> Applicable to legal relations emerged since 2007.

transfer to the budget PIT from the sum of the employee's salary no later than on the date of his resignation.

The list of private individuals that must independently calculate and pay to the budget PIT from the amount of their incomes, as well as to file the PIT return, and submit it to the local tax office has been complemented. In 2007, in particular, this category included private individuals that received remuneration from other individuals that were not tax agents on the grounds of civil contracts and housing rental contracts in particular (sp. 1 p. 1 art. 228 of TC of RF). Since 2008 under this category have also fallen private individuals that receive remuneration by such agreements from organizations that are not tax agents, for instance, credit institutions that pay a private individual an income by their promissory notes or in conjunction with dealer transactions that involve financial instruments. Whereas private individuals can enter into civil, as well as labor, contracts with other private individuals, there was introduced an amendment according to which the private individual that received a remuneration from other private individual should on his own calculate and pay PIT and file and submit his tax return to the tax office.

Since 2008 incomes received in the form of gift and succession are subject to filing, while it is heirs (successors) to authors of works of science, literature, arts, as well as of inventions, useful models and industrial samples, who will have to pay PIT on them (sp. 6 p.1. art. 228 of TC of RF); as well, private individuals that receive incomes in cash and in kind, except for cases stipulated in p. 181 art 217 of TC of RF<sup>9</sup> (sp. 7 p.1 art 228 of TC of RF) will likewise have to follow the same procedure.

Russian military personnel stationed overseas are recognized as the RF residents, regardless of the actual length of stationing in the RF territory (p.3 art. 207 of TC of RF). Now they are relieved from the obligation to file on their own their incomes received from sources outside RF and to pay PIT from them (sp. 3 p.1 art. 228 of TC of RF)<sup>10</sup>.

### ***Uniform Social Tax (UST)***<sup>11</sup>.

A number of amendments concerning the uniform social tax were introduced to Chapter 24 of the Tax Code of RF.

Specifically, an amendment was introduced to p.1 art. 236 of TC of RF<sup>12</sup>, which now reads that payments to foreign citizens and stateless individuals made by labor contracts and civil contracts whose subject is execution of works, provision of services, providing such individuals operate outside the RF territory, are exempt from UST.

It was earlier provided for in sp. 5 p. 1 art. 238 of TC of RF that incomes of members of the peasant (farmer) company received from production and sales of agricultural products, their processing and sales are exempt from UST for the term of 5 years beginning the year of the company's registration, while since 2008 the benefit became applicable only to the company's head. In compliance with amendments introduced to p.2 art 236 of TC of RF, while

<sup>9</sup> Incomes in cash and in kind received from private individuals as a gift, except for cases of giving real estate, means of transportation, shares and stock, unless provided for otherwise in the Code.

<sup>10</sup> Applicable to legal relations emerged since 2007.

<sup>11</sup> The respective amendments were introduced by Federal Act of 24.07.2007 No. 216-FZ "On introducing amendments to Section Tow of the Tax Code of the Russian Federation and some other legal acts of the Russian Federation".

<sup>12</sup> Applicable to legal relations emerged since 2007.

identifying the object of levying UST, actually incurred and proved by documents operational costs should be excluded from incomes earned by heads of such companies.

Since 2008 by civil contracts it is only the subcontractor's remuneration, rather than all the payments, that became subject to UST (sp. 2 p. 1. art. 238), while payments to compensate for costs are not subjected to taxation.

According to the version of sp.1 p. 1 art. 239 of TC of RF effective until 2007, corporations of any organizational and legal form were exempt from UST as long as amounts of payments and other compensations do not exceed Rb. 100,000 over a given tax period per each disabled private individual. Since 2008 this benefit became equally available for individual entrepreneurs and private individuals that are not recognized as individual entrepreneurs.

According to amendments introduced to art. 242 of TC of RF, the date of the actual receipt of income for legal counselors that exercise their professional activity at the Bar, bureau or legal consultation offices is the day the respective establishment pays the income to them, including in particular the day the income is transferred to the counselor's bank account.

Tax office on its own sets the amount of monthly forward payments individual entrepreneurs, counselors and notaries should transfer. The calculation is made on the basis of data over the prior tax period (p.1 art 244 of TC of RF). Should the noted individuals' incomes grow by more than 50% in the current tax period, they are to file and submit a revised tax return and provide therein sums of the supposed income over the current tax period (p.3 art 244 of TC of RF), and this should be done within a month upon the fact of such a rise in their income has been established.

Procedures of calculation and payment of UST on incomes of counselors that receive those through the Bar, bureaus and legal consultation offices are set by p. 6 art 244 of TC of RF, while procedures of calculation and payment of UST by counselors that have established their own offices has not been set so far. This gap was bridged by an amendment to this particular point, which reads that the noted individuals are bound on their own to calculate and pay UST on incomes generated by their professional activity, less costs associated with income generation, following procedures set for self-employed individuals. Meanwhile, along with their UST tax return, counselors submit to the tax authority a note<sup>13</sup> by the Bar, bureau or legal consultation office on amounts of the tax paid on their behalf in the last tax period (p.7 art 244 of TC of RF).

In compliance with a new version of p.3 art 243 of TC of RF, monthly forward payments are to be accrued not only during reporting periods (between January and September), but over the whole tax period, including October, November, and December in particular. A revision was introduced to p. 4 art 243 of TC of RF, according to which, the amount of monthly forward payments due to the budget of extrabudgetary funds is set in even Rb, with standard rounding rules in effect: that is, amounts under 50 Kopecks are taken off, while 50-plus ones are rounded to the nearest Rb.

Yet another amendment worth paying attention to was introduced to p.8 art. 243 of TC of RF. The novelty sets procedures of payment of UST and filing forms of the tax return by separate divisions of Russian companies beyond the RF territory. While running their balance sheets and cash clearing accounts, they may not be registered by the national tax authorities,

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<sup>13</sup> The form of which has not been approved by the Federal Tax Service as yet.



which is why UST on behalf of private individuals employed in such separate divisions will be payable by the head organization's domicile.

### ***Corporate Profit Tax***<sup>14</sup>

Chapter 25 of the Tax Code of RF also underwent serious modifications. Let us center on the most substantial amendments.

More specifically, the legislature introduced amendments to Art. 251 of TC of RF that concerns revenues not accounted in the course of identification of the respective tax base.

Until 2008, while identifying the corporate profit tax base, one did not consider incomes in the form of assets, property rights or non-property rights which had monetary value and which were received in the form of contributions to the authorized (joint-stock) capital (fund) of an organization (including the income in the form of the excess of the cost for stock (shares) placement over their face value). An amendment was introduced into p. 1 art. 251 of TC of RF (which consequently became p. 3.1.), which reads that amounts of VAT due to a tax rebate available for the receiving organization, as per Chapter 21 of TC of RF, in the course of assignment of assets, non-material assets and property rights as a contribution to the authorized capital of organizations or installments in shared funds of cooperatives may not be included in the composition of the receiving party's taxable revenues. This novelty is applied with account of provisions of art. 170, 171 and 277 of TC of RF. Thus, in compliance with p.3 art. 170 of the Code, in the event of a transfer of assets (non-material assets, property rights) as a contribution to the authorized (joint-stock) capital of economic companies (as well as installments in shared funds of cooperatives), the granter is bound to restore VAT, while the grantee enjoys the right of receiving the respective amounts of the tax (which are consequently reflected in concomitant documents) for a further rebate (p.11.art. 171 of TC of RF). The new sp. 3.1 p. 1 art 251 of TC of RF specifies that the grantee should not include such VAT amounts due to further rebate in the composition of his revenues.

Amendments introduced to p. 21 art.251 of TC of RF emphasize that the taxpayer has a right not to include in the composition of his revenues amounts of accounts payable with regard to taxes and levies, penalties and fines before budgets of different tiers, as well as contributions, penalties and fines before budgets of the state extrabudgetary funds, which have been written off and/or reduced in any other way, as per the RF law or following an RF Government's ruling<sup>15</sup>.

As dictated by sp.1 p.2 art. 251 of TC RF, while calculating the corporate profit tax, one traditionally should not consider targeted receipts, that is, admission, membership fees, joint-stock contributions, charity donations to/in favor of non-for-the-profit organizations for the sake of maintenance of their authorized operations. The benefit is applicable to the housing owners' companies, housing, agricultural, garage-housing, housing-construction cooperatives and other specialized consumer cooperatives. Such non-for-the-profit organizations can form their reserve for the sake of holding repair operations, capital refurbishment of the common property in a manner, as per art. 234 of TC of RF. Such reserves can be completed by means of special contributions by members of a given cooperative, rather than by contributions and

<sup>14</sup> The respective amendments were introduced by Federal Act of 24.07.2007 No. 216-FZ "On introducing amendments to Section Tow of the Tax Code of the Russian Federation and some other legal acts of the Russian Federation".

<sup>15</sup> Interestingly, the effect of this provision covers regal relations emerged since January 2005.

donations. For the purpose of taxation such contributions are recognized as targeted ones and they should not be included in the CPT tax base (sb. 1 p. 2 art. 251 of TC of RF)<sup>16</sup>. This novelty is particularly important, as referring to the closed list of revenues, which p. 2 art. 251 of TC of RF attributes to targeted receipts, the Minifin of RF earlier refused to attribute to targeted contributions compulsory payments for repairs of the housing owners companies' common property.

Since 2008 there has become effective yet another condition for the possibility for accounting in the composition of expenditures on labor compensation of amounts of payments by long-term life insurance agreements a company concludes in favor of its staff: Such a contract should be concluded with a Russian corporation that has a license to conduct the respective kind of operations. Besides, the voluntary life insurance contract can provide for indemnity in the event the insured individual's health suffered from harm.

In compliance with an amendment introduced into par. 4 p. 16 art. 255 of TC of RF, a non-government pension contract can provide for a life payment of pension, and an organization can include insurance premiums by such contracts in their labor compensation expenditures<sup>17</sup>.

Since 2008 the company can complement its list of expenditures on insuring its staff with premiums to voluntary personal insurance agreements, which are concluded exclusively for the case of death of the insured employee or his disablement resulting from his exercising labor obligations (par. 6 p. 16 art. 255 of TC of RF).

Since 2008 the maximum annual amount of premiums by such contracts was increased from Rb. 10,000 up to 15,000, and that is the amount an organization can include in the composition of its expenditures while calculating its corporate profit tax over a given tax period (par. 10 p. 16 art. 255 of TC of RF).

Since 2008 the assets, results of an intellectual activity and other intellectual property objects with the length of the useful exploitation over 12 months and the original value of over Rb. 20,000 will be recognized as depreciated assets.

The original cost of means of transportation by which the application of a decreasing coefficient has now doubled, while prior to 2008, while calculating depreciation by passenger cars and minivans with the initial value of over Rb. 300,000 and 400,000, respectively, organizations had to employ a special decreasing coefficient equaling 0.5 (p. 9 art. 259 of TC of RF). By contrast, since January 2008 the said coefficient is applicable solely to passenger cars (minivans) with the initial value of over Rb. 600,000 (800,000).

Chapter 25 of the Tax Code was complemented with a new article (268.1) which specifies peculiarities of recognition, for taxation purposes, of revenues and expenditures in the event of the purchase of an enterprise as a property complex.

Yet another amendment is aimed at the legal fixation of the timeline of notification of the decision making regarding which of separate divisions will become the payer of corporate profit tax. Thus, organizations that have several separate divisions within the territory of a given RF Subject, have the right not to distribute profits across them, but to pay the tax to the RF Subject's budget through one of them. To do this, a corporation should notify of the decision of a local tax office in the separate divisions' locations and identify the one responsible for paying the tax (par. 2 p.2. art 2888 of TC of RF).

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<sup>16</sup> Applicable to legal relations emerged since 2007.

<sup>17</sup> Applicable to legal relations emerged since January 2005.

Should a Russian corporation have separate divisions located outside Russia, the corporation should transfer corporate profit tax and file tax returns in its domicile, as per amendments made to p.4. art. 311 of TC of RF.

Taxpayers enjoy the right to establish in the tax accounting a reserve to pay for employees' holidays. Now there have been established the reserve adjustment procedures: if the amount of the reserve proves to be smaller than the amount of holidays payments plus UST with regard to unused vacations, the corporation should increase the reserve at the expense of labor compensation expenditures on. Should the amount of the reserve appear greater than the amount of holidays payments plus UST by unused holidays, it should be cut down, while the amount of the diff should be included in the composition of non-operating gains (p.4 art. 324.1 of TC of RF).

### ***State Duties***<sup>18</sup>

Since 2008 the amount of the state duty for the state registration of means of transportation coupled with the issuance of state registration plates, as well as the issuance of metal state registration plates "Transit" for tractors, road-construction and other self-propelled units is down from the previous Rb. 400 to 200 (pp. 29 and 32 p.1. art. 333.33 of TC of RF).

As well, the amount of the state duty for the issuance of the tractor driver's certificate was set, with the hard copy in paper worth Rb. 100 and the plastic one – 200 (sp. 36 p.1 art. 333.33 of TC of RF), and another 30 Rb. should be paid for the certificate that proves the granting of those (sp. 38 p.1 art. 333.33 of TC of RF).

The Rb. 500 state duty was set for the granting of educational institutions with certificates of their equipment's consistency with requirements of the educational process for consideration by the respective agencies of the matter of accreditation and issuance of licenses to them to train tractor drivers and operators of other self-propelled units.

### ***The Simplified Taxation System (STS)***<sup>19</sup>

The list of taxpayers not eligible for employment of STS was set by p.3. art. 346.12 of TC of RF and comprised foreign organizations that have their subsidiaries, representative offices and other separate divisions in the RF territory (sp. 18 p.3 art 346.12 of TC of RF). Since 2008 any foreign organization may not resort to STS, regardless of whether or not it has subsidiaries.

Organizations and self-employed individuals transferred to the single presumptive tax system, as per art. 26.3 of TC of RF, by one or several kinds of entrepreneurial activities, enjoy the right for employment of the simplified taxation system in regard to other kinds of their entrepreneurial activities (p.4 art 346.12 of TC of RF), while caps on the number of employees and value of capital assets and non-material assets in respect to such organizations and individual entrepreneurs are identified proceeding from all the types of their operations. Caps on the amount of their gains were abrogated in 2006, while in 2007 the value of their receipts was regulated and identified by kinds of operations that are taxed in compliance with the gen-

<sup>18</sup> The respective amendments were introduced by Federal Act of 24.07.2007 No. 216-FZ "On introducing amendments to Section Two of the Tax Code of the Russian Federation and some other legal acts of the Russian Federation".

<sup>19</sup> The respective amendments were introduced by Federal Act of 17 May 2007 No. 85-FZ "On introducing amendments to chapters 21, 26, 26.2 and 26.3 of Section Two of the Tax Code of the Russian Federation".

eral taxation regime. So, if organizations already transferred to SPT decide to employ STS by individual kinds of their operations, their gains over 9 months of 2007 should account for less than Rb. 15 m (with account of application of the deflator coefficient).

A number of amendments were introduced in the list of expenditures which taxpayers that have opted for “revenues less the amount of expenditures” as an object of taxation can take into account while identifying their tax base by STS.

Specifically, it is allowed to take into account expenditures on completion, equipping, reconstruction, modernization and technical rearmament of capital assets in the period of employment of the simplified taxation system (sp.1 p. 1 of art. 346.16 of TC of RF), which are found with account of provisions of p.2 art. 257 of TC of RF and take effect since the moment of placement of capital assets in operation (p.3 and p.4 art. 346.16 of TC of RF).

Taxpayers may not include the costs incurred in conjunction with voluntary insurance in expenditures accounted while calculating the tax payable due to application of the simplified system of taxation, but it is now allowed to consider all kinds of costs associated with the compulsory insurance of employees and property (sp. 7 p.1 art 346.16 of TC of RF).

In compliance with sp. 23 p.1 art. 346.16 of TC of RF, the taxpayers that have employed STS could, beginning January 2006, consider expenditures on payments for the value of goods purchased for their further sale, including costs of storing, servicing and transporting goods for sale, providing they observe with two conditions: namely, such goods should be sold, while expenditures associated with their sales should be paid for. The newly introduced amendments have taken off the former requirement, and taxpayers now can recognize the noted expenditures on purchased goods upon an actual payment for them, regardless of the sale of the said goods.

The list of expenditures was complemented by those on servicing the control and cashier's equipment (CCE) and on disposal of solid household waste (pp. 35 and 36 p.1 art 346.16 of TC of RF). The expenditures on servicing CCE should be regarded as a positive step, as it is chiefly trade organizations that employ STS and the servicing of CCE for them is directly associated with their profile operations.

The novelties also directly state (sp. 22 p.1 art 346.16 of TC of RF) that expenditures presently comprise amounts of taxes and levies paid in compliance with the RF law on taxes and levies, except for the amount of the tax paid as per art. 26.6 of TC of RF.

While accepting a forward payment from buyers, the vendor organization includes thus received amounts in the tax base in the reported (tax) period of their receipt. Meanwhile, TC of RF earlier failed to give an answer to the question as to how the tax base should be corrected in the event the vendor returns earlier received forward payments. At the same time, the RF Minfin<sup>20</sup> specified that in the event taxpayers return earlier received down payments, the revision of the tax base on the tax paid in conjunction with the use of STS is made over the reporting period in which the said amounts were received. Since 2008 such a procedure of return of earlier received forward payments has been set by the law (p.1 art. 346.17 of TC of RF).

Peculiarities of calculation of the tax base in the event of the taxpayer's switching to STS from other taxation regimes and vice versa (art. 346.25 of TC of RF) have been specified by the respective amendments.

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<sup>20</sup> See letters of Minfin of 11 April 2007 No. 03-11-04/2/98 and of 09 April 2007 No. 03-11-04/2/96.

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In its new version, p. 2 art. 356.25 of TC of RF completes the earlier existed legislative lacuna, as it was required to recognize revenues as of the date of the transition to calculation of the tax base of corporate profit tax using the accrual method, with the revenues being understood as amounts of payments (debt repayment).

Also, modifications were introduced into provisions that regulate matters of employment of STS by individual entrepreneurs who operated using a patent. The list of kinds of entrepreneurial activities exercise of which grants the right for employment of the patent-based STS has been brought in conformity with the General Russian Nomenclator of Kinds of Economic Activities (GRNKEA).

Another novelty became a limitation of the term during which one can switch from the patent-based STS to the general procedure of employment of STS and vice versa. Such a transition is now possible only upon expiration of the period on which the patent was granted (p.3 art. 346.25.1 of TC of RF). Having breached the conditions of employment of the patent-based STS, the individual entrepreneur loses the right to employ the patent-based STS in the period on which it was granted, and in such a situation only transition to the general taxation regime will be possible (p.9 art. 346.25.1 of TC of RF).

According to the general rule, the patent is effective only in the territory of the RF Subject wherein it was issued. Presently, having such a patent, the taxpayer has the right to apply for another one in the jurisdiction of another Subject of RF (p. 5 art. 346.25.1 of TC of RF).

In compliance with amendments to p.9 art. 346.25.1. of TC of RF, an individual entrepreneur is bound to advise the tax office of the loss of rights to employ the patent-based STS and transition to another taxation regime within 15 calendar days from the beginning of employment of the another regime of taxation; he will once again obtain the right to switch to the patent-based STS not earlier than in 3 years after he has lost the respective right.

In compliance with art. 346.21 of TC of RF, individual entrepreneurs enjoy the right to cut down the cost of the patent by the amount of insurance premiums on the compulsory pension insurance payable over the respective period of time, as per the RF law, however, as stipulated in the noted article, the value of the patent cannot be reduced by more than 50%.

The reduction in the value of the patent by the amount of insurance premiums is made in compliance with p. 10 art. 346.21 of TC of RF, when one pays the residual cost of the patent upon the end of the period on which it was granted. An addition to the procedure reads that the residual part of the cost of the patent is subject to reduction by the amount of insurance premiums on the compulsory pension insurance, while there is no cap on the amount of such premiums.

As well, amendments were introduced to p. 10 art. 346.25.1 of TC of RF, which reads that taxpayers have to conduct the accounting of revenues and expenditures for the purpose of calculation of the tax base by the tax in the Revenue and Expenditure Accounting Book of organizations and self-employed individuals that employ STS, the form and procedures of completion of which are subject to Minfin's approval.

### *Presumptive Tax (PT)<sup>21</sup>*

Since January 2008 procedures of application of PT have changed: the greater fraction of new provisions have now directly concerned trade and public catering organizations. As well, they specify kinds of entrepreneurial activities to certain kinds of which the system of taxation in the form of PT can be applied.

Specifically, so far as the public catering services are concerned, such services rendered by educational, health care and social network institutions may not be transferred under the PT regime.

Since 2006 it became possible to employ PT to provision of temporary stay services (in the event the total dormitory area in each object that renders such services was under 500 sq.m.) (sp. 12 p.2 art. 346.26 of TC of RF). The amendments introduced since 2008 specify that it is the area of temporary residence facilities, rather than dormitory facilities, that is used for calculation of areas in each object.

The definition is given of the temporary residence facility, which is now understood as a facility used for the temporary stay of private individuals (an apartment, a room in an apartment, a private house, cottage (or their parts), a hotel room, a room in a hostel, and other facilities). The total area of facilities designated for temporary stay is found on the basis of inventory records and property documents on objects of provision of the temporary stay services (agreement of purchase and sale, rental (sub-lease) contract, technical passport, plan, explication, among others).

While calculating the total area of temporary-stay facilities of hotel-type objects (hotels, campings, hostels, etc.), one should not consider the public space areas (lobbies, corridors, stairways, shared bathrooms, saunas and showers, restaurants, bars, canteens, among others), as well as the area occupied by administrative and operational facilities.

Since 2008 services on lease of trade locations are split into two separate kinds of activities that can be transferred under the PT regime:

1). Provision of services on the assignment under temporary ownership and/or use of trade locations (sp. 13. p.2 art. 346.26 of TC of RF):

- points of trade located in the objects of a stationary trade network without trade halls;
- objects of a non-stationary trade network;
- objects of organization of public catering without a hall designated for servicing customers;
- a basic rate of return has been set depending on the area of thus assigned trade locations.

2). provision of services on the assignment under temporary ownership and/or use of land lots for organization of trade spots in the stationary trade network, as well as for placement of objects of a non-stationary trade network (counters, kiosks, containers, and other objects) and objects of organization of public catering that do not have indoor customer service facilities (sp.14. p.2 art. 346.26 of TC of RF).

- a basic rate of return has been set depending on the area of thus assigned trade locations.

An additional restriction has been introduced with regard to employment of PT by corporations in the event they exercise their operations in the framework of a trust agreement, as

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<sup>21</sup> The respective amendments were introduced by Federal Act of 17 May 2007 No. 85-FZ “On introducing amendments to chapters 21, 26, 26.2 and 26.3 of Section Two of the Tax Code of the Russian Federation”.

well as, a situation when the taxpayer may fall under category of the largest taxpayers (p.2.1 art. 346.26 of TC of RF).

The article has been complemented with new items (pp. 8 and 9 of art. 346.26 of TC of RF) which set transitional provisions with respect to application of VAT rebates. Overall, they appear analogous to those set for organizations and entrepreneurs that employ PT. Once they opt for transition to PT, they have the right to apply for the rebate of the amounts of VAT they have paid from down payments prior to the transition to PT, providing they are in possession of documents that prove that the buyer has returned the amount of the tax due to the taxpayer's transition to PT (p.8 art. 346.26 of TC of RF).

Once the taxpayer returns to the general taxation regime, he has the right to apply for VAT rebates with regard to amounts of payments made in his favor by goods (works, services, property rights) that have not been used in operations subject to PT in the general order, as per Chapter 21 of TC of RF (p.9 art. 346.26 of TC of RF).

Revisions introduced into art. 346.27 of TC of RF imply that, while finding the value of the K2 coefficient, one does not consider the actual period of conducting a given activity. Meanwhile, it was set that the adjusting K2 coefficient can be applied for at least one calendar year. In the event a representative body fails to pass the K2 value with a legal act until the start of next calendar year and/or the documents did not come into effect, in next calendar year the value of the K2 coefficient remains unchanged and equals the one effective in the prior calendar year (p.7 art. 346.29 of TC of RF).

In the new version of par. 9 art. 346.27 of TC of RF, services associated with the intermediate maintenance of cars do not fall in the group of services on maintenance and repair of means of transportation for the purpose of PT. Accordingly, PT is not applicable to such services and the respective taxes should be paid according to the general taxation regime or the STS one.

The concept of "retail trade" was modified, and the following operations may not become subject to transition to PT: sales of gas in cylinders; sales of trucks and special vehicles, trailers, semitrailers, buses of any types; goods by samples and catalogues outside the stationary trade network (including those delivered by post), as well as through teleshops and computer networks); and delivery of medicines by beneficial (free) prescriptions.

Changes made in par. 15 of art. 346.27 of TC of RF read that slot machines falls into the category of objects of the stationary trade network that has no floor; at the same time these objects are excluded from the list of objects of organization of public catering that do not have trading area for customers (par. 21 art. 346.27 of TC of RF). Meanwhile, culinary shops (departments, counters) were equally included in the list of objects of public catering organizations that do not have a trading floor.

Prior to the most recent amendments the trade spot was defined as a location used for exercising purchase and sale transactions, while since 2008 the concept of trade spot has become different from that of stationary trade spot and their basic return rates are set individually.

Trade spots include buildings, structures, facilities (their parts) and/or land sites used to conclude purchase and sale transactions, as well as objects of retail trade and public catering organizations that do not have a trade floor and customer service areas (such as kiosks, among others, which can be located within buildings, structures, and facilities), counters, and tables (including those located on land sites), land sites used to place objects of retail trade (public

catering) organizations that do not have trade areas (customer service facilities), counters, tables, and other objects (par. 30 art. 346.27 of TC of RF).

By contrast, stationary trade spot is a location used to conclude purchase and sale transactions within a stationary trade network objects. They also include land lots leased to organizations or individual entrepreneurs for the sake of organization of a stationary trade network (par. 31 art. 346.27 of TC of RF).

Yet another modification concerns automobile transportation services. As concerns such services, the amount of PT will be set depending on kinds of transportation services, that is, passenger or cargo ones. In the latter case the physical indicator remains the number of vehicles used to transport cargo, while in the former – the amount of PT will depend on the number of seats in a given vehicle. The basic profitability per seat is set at the amount of Rb. 1,500 (p.3 art. 346.29 of TC of RF).

### ***Corporate Property Tax***<sup>22</sup>

The object of levying this particular tax for Russian corporations remains movable and immovable property which is accounted on their balance sheet as objects of capital assets, as per the set accounting procedures (p.1 art. 374 of TC of RF). As p.1 art. 374 of TC of RF has been amended, now the aforementioned provision no longer concerns trusted property or the one acquired under trust, and it is the trust founder that is taxed in such a situation. Meanwhile, the responsibility to pay taxes with regard to property of a mutual fund that was trusted to its management company since 2008 was laid upon the latter, rather than the founder of the trust (art. 378 of TC of RF).

While identifying the tax base (art. 376 of TC of RF), the average value of the property, recognized as an object, over the reporting period will be found as quotient from the division of the amount received resulting from the addition of values of the residual cost of the property as of the first date of each month of the reporting period and the 1<sup>st</sup> date of the month following the reporting period by the number of month in the given reporting period plus 1. The average annual value of the property recognized as an object of taxation over the tax period is calculated as quotient from the division of the amount found resulting from the addition of values of the residual cost of property as of the 1<sup>st</sup> date of each month of the tax period and the last date of the tax period by the number of months in the tax period plus 1.

Novelties were also introduced to art. 381 of TC of RF: now there has been introduced the third condition upon observance with which residents of a special economic zone (CEZ) can enjoy a corporate property tax benefit: that is, their main assets should be used within a SEZ territory in the framework of agreements on creation of the SEZ.

The amount of an advance payment of the property tax with regard to the foreign organization's real estate object is calculated after the end of the reporting period as a product of the tax rate by  $\frac{1}{4}$  of the inventory value as of the beginning of the tax period (p.5 art. 382 of TC of RF). This item was complemented by a new provision which sets procedures of calculation of the amount of the corporate property tax and the respective advanced payments in a

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<sup>22</sup> The respective amendments were introduced by Federal Act of 24.07.2007 No. 216-FZ "On introducing amendments to Section Tow of the Tax Code of the Russian Federation and some other legal acts of the Russian Federation".



situation(s) the foreign organization purchased or sold the real estate object during the tax period.

To bring the procedures of payment of advances in conformity with art. 382 of TC of RF, the respective amendments were introduced to art. 384 and 385 of TC of RF: while calculating the tax by domicile of organizations' separate divisions or with regard to immovable property objects located outside the organization or its separate divisions' domicile, the tax base is set as  $\frac{1}{4}$  of the average value of the said property.

There was introduced a new article, 368.1, which deals with elimination of double taxation in regard to corporate profit tax. A Russian organization can offset its property tax due with the amount it paid outside the RF territory, in compliance with another state's legislation, on its property located in the said state's territory within the limits of the amounts due in the RF territory. To obtain such an offset, the organization has to submit to the tax authorities in its domicile a respective application and a document which proves that the tax was paid overseas, which should be duly verified by the respective foreign state's tax authorities. Both documents should be appended to the corporate profit tax return for the year in which the tax was paid outside the RF territory.

### ***Land Tax***

The following modifications were introduced with regard to the land tax.

The amendments set procedures of identification of the tax base in respect to land sites located in the territory of several municipal entities (art. 391 of TC of RF). In this case the tax is calculated individually by each municipal entity, and the tax base by each part of the land site is set as a fraction of its cadastre value calculated in proportion to the share of the area in the territory of the municipal entity which the site occupies.

The reporting periods by the tax shall be the 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> quarters of the calendar year.

Since 2008 the procedures of informing taxpayers of the cadastre value of land sites is to be set by the RF Government (p.14 art. 396 of TC of RF).

In the event the land site is used for construction of housing, increasing coefficients should be employed to calculate the land tax. Organizations and entrepreneurs that have completed construction of housing (except for individual construction operations) within 3 years become eligible for a partial refund of the earlier paid land tax. To calculate the amount of the tax refund due, one should recalculate the land tax paid during the construction period using coefficient 1. The amount of the land tax resulting from such a calculation remains in the budget, while the rest will be recognized as an excessive payment and as such is due to be refunded to the taxpayer.

In compliance with amendments introduced to the said points, the noted 3- and 10-year periods start from the date of the state registration of the right for land lots wherein the housing construction is in progress (pp. 15 and 16 of art. 396 of TC of RF).

Modifications were also introduced in p.1 art. 397 of TC of RF: the timelines for advance payments of the land tax may not be set earlier than the calculation by advance payments is presented, i.e. the final date of the transfer of the advance payment of the land tax to the budget may not be earlier than the final date of the month that follows the reporting period.

## *Modifications in the Sphere of Civil Legislation*

### *Autonomous Institutions*

Federal Act of 03.11.2006 No. 174-FZ “On autonomous institutions” came into effect since 2007. The act set a new type of the public (municipal) entity, namely, autonomous institution.

As a reminder, autonomous institution is a non-for-the-profit organization established by the Russian Federation, its Subject or municipal entity<sup>23</sup> for the purpose of conducting works, providing services in order to exercise powers of government and local self-governance agencies in the areas of research, education, health care, social protection, the population’s employment, and physical culture and sports. Autonomous institution is a legal entity and as such can acquire and exercise property and personal non-property rights, incur obligations, and become plaintiff or defendant in the court of law.

What were the 2007 novelties in this respect?

First, it is worth noting that, in compliance with p. 2 art. 3 of the Act, the autonomous institution may not, without its founder’s consent, control immovable property or especially valuable movable property assigned to it by the founder or purchased by the autonomous institution at the expense of funds the founder allocated to it to purchase such property. As for other property, including immovable property, the autonomous institution holds the right for an independent control of that. The RF Government adopted Resolution of 31 May 2007 No. 337 “On procedures of identification of kinds of particularly valuable movable property of an autonomous institution”. The document reads that kinds of particularly valuable movable property of federal autonomous institutions are identified using a number of criteria (as per p. 2 of the Resolution) by the joint ruling of the respective federal body of executive power that exercises functions on legal regulation in the areas of science, education, health care, social protection, employment of the population, physical culture and sports and the federal body of executive power mandated to manage the federal property<sup>24</sup>. Specifically, while identifying kinds of particularly valuable movable property of the federal autonomous institutions, the following property is due to be included in its composition:

- movable property whose balance-sheet value is in excess of Rb. 50,000;
- other movable property whose balance-sheet value accounts for less than Rb. 50,000, but without which the federal autonomous institution would find it substantially hard to exercise its profile activity;
- as well as the property, alienation of which is carried out following a special procedure set by law and other legal acts of the Russian Federation, including museum collections and items owned by the Federation and included in the contingent of the state-owned part of the Museum Fund of the Russian Federation, library funds attributed, in a due order, to

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<sup>23</sup> A joint founding of autonomous institutions (particularly by different government or local self-governance agencies) is not allowed by the law.

<sup>24</sup> Procedures of identification of kinds of particularly valuable movable property of autonomous institutions established on the basis of property owned by an RF Subject and on the basis of property owned by a municipality are set, accordingly, by the supreme executive body of the state power of the RF Subject or a local self-governance body with account of requirements of the Resolution in the part of identification of kinds of particularly valuable movable property of the federal autonomous institutions.

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monuments of culture and arts, and documents of the Archive Fund of the Russian Federation.

Meanwhile, it is noted that property, which is not designated for exercise by the federal autonomous institution of its principal activity, as well as property the federal autonomous institution purchased at the expense of gains from its operations as per its Charter may not be attributed to the particularly valuable movable property. The federal bodies of executive power that exercise functions and powers of the founder of a federal autonomous institution make decision on attribution of the federal autonomous institutions' property to the category of the particularly valuable movable property (or on exclusion of such property from the category of the particularly valuable movable property) basing on the list of certain kinds of particularly valuable movable property as agreed upon with the federal body of executive power commissioned to manage the federal property.

In the autumn 2007, the RF Government adopted new documents associated with the autonomous institutions' operations: the Statute on exercise by the federal bodies of executive power of functions and powers of the founder of the federal autonomous institution (of October 10, 2007, No. 662) and Regulations of publicizing reports of autonomous institutions' performance and on their usage of the property fixed with them (of October 18, 2007, No. 684). Let us briefly consider these documents.

The Statute on exercise by the federal bodies of executive power of functions and powers of the founder of the federal autonomous institution regulates procedures of exercise by the federal bodies of executive power of functions and powers of the founder of a federal autonomous institution established following the RF Government's decision on the basis of the property owned by the Federation. Specifically, if not stated otherwise by federal law or other legal acts, the federal body of executive power that exercises functions and powers of the founder of the federal autonomous institution:

- approves, as agreed upon with the federal body of executive power mandated to manage the federal property, the federal autonomous institution's Charter and amendments to it;
- assigns tasks to the federal autonomous institution according to its profile activity, as per its Charter;
- considers proposals by the federal autonomous institution head on creation or liquidation of the federal autonomous institution's subsidiaries, opening or closure of its representative offices;
- submits for the Supervisory Council's consideration various proposals by the federal autonomous institutions (on introducing amendments to the federal autonomous institution's Charter, on creation or liquidation of the federal autonomous institution's subsidiaries, on its reorganization or liquidation, on withdrawal of property fixed with the federal autonomous institution on the basis of the right for operative management);
- makes decisions, on the basis of the list of kinds of the federal autonomous institution's particularly valuable movable property, as agreed upon with the federal body of executive power mandated to manage the federal property, on attribution of the federal autonomous institution's property to the particularly valuable one and on withdrawal of property of objects fixed with the federal autonomous institution which discontinue to fall under kinds of particularly valuable movable property;
- grants its consent, as agreed upon with the federal body of executive power mandated to manage the federal property, to the federal autonomous institution to its management of

immovable property fixed with it by the founder or purchased at the expense of funds the founder has allocated for this purpose;

- grants its consent to the contribution by the federal autonomous institution with cash and other property to the authorized (joint-stock) capital of other legal entities or its otherwise property transfer to other legal entities, while acting in the capacity of their founder or participant (in the part of contribution with immovable property – as agreed upon with the federal body of executive power mandated to manage the federal property);
- and solve other numerous matters, as per the Federal Act “On autonomous institutions”.

The federal body of executive power that exercises functions and powers of the founder of the federal autonomous institution notifies the federal autonomous institution of its decisions in writing within 7 days upon the date of their adoption.

As concerns the Procedures of publication of the autonomous institution’s performance reports, it should be noted that reports on the autonomous institution’s performance and use of the property fixed with it are due to be published in the media identified by the autonomous institution’s founder and available for consumers of the autonomous institution’s services not later than on June 1 of the year that follows the reporting one. There has been set the list of data which should be included in the noted reports, such as, in particular:

- information of completion of the founder’s task;
- information of carrying out activities associated with completion of works and services according to obligations before the insurer by the compulsory social insurance;
- the overall number of consumers that consumed the autonomous institution’s services (works), including the number of consumers that used free, partly remunerated and completely remunerated for them services (works), with a breakdown by kinds of services (works);
- the average cost for consumers of receipt of partly remunerated and completely remunerated services (works), with a breakdown by kinds of services (works);
- the average annual number of the autonomous institution’s employees;
- the average labor compensation payable to the autonomous institution’s employees;
- the volume of the funding of a task by the founder;
- the volume of the funding of operations associated with completion of works or delivery of services according to obligations before the insurer by the compulsory social insurance;
- the overall amount of the autonomous institution’s post-tax profits in the reporting period generated by the provision by the autonomous institution of partly remunerated and completely remunerated services (works);
- the list of kinds of operations by the autonomous institution;
- the list of permits (along with specification of their numbers, date of issuance and term of validity), on the basis of which the autonomous institution carries out its operations;
- the composition of the Supervisory Board (along with positions held, names and patronymics).

The report on the use of the property fixed with the autonomous institution should comprise the following data:

- the overall balance-sheet value of the autonomous institution’s property, including the balance-sheet value of the property fixed with the autonomous institution with specifica-

tion of the value of immovable property, as of the beginning and the end of the reporting period;

- the number of the immovable property objects fixed with the autonomous institution (buildings, structures, facilities), as of the beginning and the end of the reporting period;
- the overall area of the immovable property objects fixed with the autonomous institution, as of the beginning and the end of the reporting period, including the area of leased immovable property, as of the beginning and the end of the reporting period.

The noted reports may also comprise other data, which do not constitute compulsory ones.

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Editors: Glavatskaya N., Mezentseva K., Serianova S.  
Computer design: Yudichev V.  
Information support: Avralov V., Pashlova O.

5, Gazetny per., Moscow, 125993 Russia  
Tel. (495) 629–6413, FAX (495) 203–8816  
E-MAIL – [info@iet.ru](mailto:info@iet.ru), WEB Site – <http://www.iet.ru>