

Part 3.

GOVERNMENT FINANCES

The main trend in government financing in 2007 was the adoption of the first three year budget. This budget calls for unprecedented government expenditures for long-term investment programs.

The State of the budget and the idea of stretching it out over three years

The main author of the three year budget was the head of the Ministry of Finance, Aleksey Kudrin.

The preparation for presenting the three year budget to the parliament began a year ago. First, the project received the approval of the president who included its main points into his budgetary presentation to the Federal Assembly. Then the parliament passed the law “about making changes to the budgetary code” that stipulated Russia’s transition to a three year budget. The law removed the last restrictions on having a three year budget. According to the law, the executive branch now has the right to form a three year financial plan. Moreover, the government of the Russian Federation is now obligated to use the three year model. At that, the three year budget must include macroeconomic forecasts for the next three years. This includes the level of inflation, the rise in GDP, and the receipts and expenditures of the government.

The key point for Aleksey Kudrin was for the parliament to keep the mentioned forecasts during the passage of the budget. These forecasts could be described as “moderately pessimistic”.

Thus, according to the forecasts of the Ministry of Finance, at the beginning of May, 2007 the price of Urals brand oil was supposed to fall from \$61 per barrel in 2006 to \$55 per barrel in 2007 and to \$50 per barrel in 2010. According to the ministry data, the stable macroeconomic situation, the reduction of the government debt burden, and the high level of foreign currency reserves will help keep the favorable investment climate. The main factor in economic growth for 2008-2010 will be the increase in consumer and investment demand. However the increase in consumer demand will be slower than in the current year. The factor of the

situation in the foreign markets, which to a large degree determined the high rate of growth in the previous years, will noticeably decrease: from 2.7% (out of 7.2% GDP growth) in 2004 and 2.6% in 2005 to 1% in 2008. During the course of the next two years (2009 and 2010) foreign market factors will stabilize and account for 1-1.5% of GDP growth. As a result, the yearly GDP growth will be 6-6.2% compared to the forecasted 6.5% for the current year. Investments in fixed capital will have a yearly growth rate of 10-12%. In 2008-2010 the increase in people's incomes will continue and should be around 7.5-9% per year. The average salary in the economy will increase from 13.1 thousand rubles in 2007 to 20.8 thousand rubles in 2010. Pensions will increase from 3.1 thousand to 5 thousand rubles. This will help decrease the poverty level in the country. The percentage of people whose income is less than the minimum living wage will fall from 16% in 2006 to 10.7% in 2010.

Keeping these figures was of principle importance for the Ministry of Finance since the reduction in budgetary receipts and energy prices was one of the main arguments for establishing "nonoil and gas funds" and for the reduction in government expenditures.

However, German Gref came out against understating the forecasts. The former head of MEDT insisted that they be increased. The confrontation between these two departments became a fierce battle in the government, the winner of which was Aleksey Kudrin.

Nevertheless, notwithstanding the major preparation, the budget couldn't pass the parliament without the support of United Russia. This was the reason for the meeting between the head of the Ministry of Finance and the party's representatives.

He had to pay a high price for getting the support of parliament. The election season started in the fall and United Russia needed to find financing for its many social projects. The source of this financing became the federal budget of the Russian Federation²⁸.

The increase in government expenditures is traditionally one of the more painful subjects for Aleksey Kudrin especially against the background of low government revenue. The rise in government expenditures will significantly increase rubles money supply and which then in its own right increase the inflation rate in the Russian Federation – the containment of which, Aleksey Kudrin personally answers for.

²⁸ Sokolovskaya M. A budget that pleases everyone //Gazeta. 2007. May 16.

In the end, Kudrin met United Russia halfway and the budget successfully passed the parliament and Federation Council.

The priorities of budgetary policy (government expenditures)

The final version of the budget was signed by the president on July 26, 2007.

According to the final version Russia's GDP in 2008 will be 35 trillion rubles with an inflation rate of 7%, in 2009 GDP will be 39.69 trillion rubles with inflation at 6.5% and in 2010 GDP will be 44.8 trillion rubles with inflation at 6%.

Federal budget revenues in 2008 will be 6 trillion 644.4 billion rubles (20% of GDP), including oil and gas revenues of 2 trillion 383.1 billion rubles (6.8% of GDP). Oil and gas transfers in 2008 will total 2 trillion 135 billion rubles (6.1% of GDP). Budgetary expenditures in 2008 are planned to be 6 trillion 570.3 billion rubles (18.8% of GDP). Budget revenues in 2009 will be 7 trillion 465.4 billion rubles (18.8% of GDP), including oil and gas revenues of 2 trillion 351.9 billion rubles (5.9% of GDP). Oil and gas transfers in 2009 will total 2 trillion 103.6 billion rubles (5.3 % of GDP). Budget expenditures in 2009 are planned to be 7 trillion 451.2 billion rubles (18.8% of GDP), including tentatively confirmed expenditures of 186.3 billion rubles (. 5% of GDP). Federal budget revenues in 2010 will be 8 trillion 089.9 billion rubles (18.1% of GDP), including oil and gas revenues of 2 trillion 348.3 billion rubles (5.2% of GDP). The oil and gas transfer in 2010 will be 2 trillion 016.0 billion rubles (4.5% of GDP). Budgetary expenditures in 2010 are planned to 8 trillion 089.9 billion rubles (18.1% of GDP), including tentatively confirmed expenditures of 404.5 billion rubles (. 9% of GDP).

The budget surplus in nominal terms in 2008 is planned to be 74.1 billion rubles (. 2% of GDP), in 2009 – 14.2 billion rubles (. 04% of GDP), and in 2010 there will no longer be a surplus. The nominal value of Russia's GDP in 2008 is expected to be 35 trillion rubles, in 2009 – 39 trillion 690 billion rubles, in 2010 – 44 trillion 800 billion rubles. The maximum level of internal government debt as of January 1, 2009 is set at 1 trillion 824.7 billion rubles, as of January 1, 2010 – 2 trillion 275.8 billion rubles, as of January 1, 2011 – 2 trillion 856.8 billion rubles. The maximum level of government foreign debt as of January 1, 2009 is set at 1 trillion, 132.4 billion rubles, as of January 1, 2010 – 1 trillion 164.5 billion rubles and as of January 1, 2011 – 1 trillion 232.9 billion rubles.

Expenditures will gradually increase in most of the segments of the budget. For example, in 2008 the “National Defense segment is set to get 509.1 billion rubles, while in 2010 its supposed to get 600 billion rubles. At the same time, expenditures for the housing and public utilities segment and the culture, cinematography and media segment will decrease.

3 firm trends can be singled out which manifested themselves within the framework of the 3 year budget.

First of all, there will be a decrease in the financing of the national projects. This was caused by a number of complications that came up in their realization. The national project Affordable and Comfortable Housing for Russian Citizens is traditionally considered the most problematic. The rise in housing prices in the capital and in the regional centers, the deficit in construction materials and the ineffective mortgage system were the main restraining factors in 2006. The president stated in January of 2008 that the national projects in their current form will come to an end. Then Vladimir Putin stated that it was necessary to transform them into long-term investment programs.

Secondly, there will be a change in the mechanism of the formation and the structure of the Stabilization Fund. According to the three year budget there will be a change in the way oil and gas revenues are administered. A Reserve Fund (to substitute for falling income in the budget if there were to be a fall in energy prices) and a Fund of National Wellbeing will be created on the base of the Stabilization Fund. Part of the oil and gas revenues will go towards covering the budget deficit, which in 2008 will be 6.6% of GDP, in 2009 – 5.9% of GDP and in 2010 – 5.3 % of GDP. The size of the oil and gas transfer to cover the budget deficit in 2008 will be 6.1 % of GDP, in 2009 – 5.3% of GDP, and in 2010 – 4.5%.

As a result of the establishment of the Fund of National Wellbeing, the total value of the Stabilization Fund will significantly decrease. Part of its cash will go to the Investment Fund, the Russian Venture Company, and the Development Bank.

We will note that previously there was a proposal to buy securities of Russian companies in order to support the stock market. The Fund for National Wellbeing was looked at as the most likely source of funds for this government investment. However this idea was later disavowed. Vnesheconombank (VEB), which administers part of the pension fund, was then offered up as the strategic investor. To be more precise, VEB administers the pension fund of the “undecided” pensioners – those who haven’t chosen a management company yet.

Thirdly, the budget stipulates for long-term investment programs which were proposed by the largest government companies (Gazprom, RAO EES Russia, RZhD) and also separate departments.

Practically the budget is being put together within the framework of a project to weaken the successor. Its main point is to distribute the financial flows between the main pressure groups while at the same time not allowing any one group or person to consolidate them. This is the very reason for the long-term government expenditures.

Three groups can be singled out as major recipients of government investment. The first one is the regions. Regional FTPs (Federal Target Programs) as a rule are controlled by the Ministry for Regional Development which is run by Dmitri Kozak. The second group is state employees. Social expenditures until the fall of last year were controlled by the Ministry of Finance. However, after Kudrin's deputy, Tatyana Golikova became the Minister for Health and Social Development the financial levers returned to the specialized department.

Finally, the third and largest recipient of government investments are the government companies. First of all, this is the state corporations (USC, UAC, Rosnanotech, the Development Bank, Olympstroï, Rostechnology, Rosatom, HPU and others) and the OAOs (Gazprom, RAO EES Russia, GidroOGK, RZhD and others). As a rule, here, government financing takes the form of an FTP to aid separate branches of the economy.

The largest Federal Target Programs that were announced in 2007 are:

FTP Development of Maritime Machinery. The main recipient of funds within the framework of this program is USC (United Ship Building Corporation). The program's initiator is the business structure of Sergey Pugachev²⁹. According to the FTP the production of civil maritime machinery, for which there will be demand in the market is supposed to increase 2.5 times by 2016. At the same time the government is planning to increase the productivity of these factories by 3 times. Also the government has calculated that by 2015 the market will demand 116 ships, 70 icebreakers and other service ships, 117 riverboats and river-sea class boats, 180 harvesting vessels and 35 technical facilities for shelf development (platforms). The total cost of all this is valued at \$22 billion. Because of this at a meeting of the cabinet a decision was made that the Federal Target Program for the development of civil maritime machinery between 2009 and 2016 would be financed to the tune of 140 billion rubles.

²⁹ The bearing is taken // Expert C-3. 2007. April 2.

93 billion is supposed to come from the federal budget while 47 billion is supposed to come from non-budgetary sources.

FTP Development of the Domestic Auto Industry. This program foresees the expenditure 146.6 billion rubles till 2015³⁰. The FTP is still being discussed in the government. The main lobbyist for the program is the head of Rostechology, Sergey Chemezov. The point is that a lion's share of these funds will go to the development of Avtovaz, which is under the control of Rostechology. These government investments will be absolutely enormous for Avtovaz, considering its modest financial showing in 2007. The attraction of funds is necessary to modernize the plant's production and retain its share of the domestic auto market³¹.

FTP Development of Rial Road Transportation. The main lobbyist for this project is the president of RZhD Vladimir Yakunin. This document first came to light in the spring of 2007. On April 10, Vladimir Putin held a meeting about the long term development of rail road transportation. The former prime minister, Mikhail Fradkov, the head of the presidential administration, Sergey Sobyenin, the former minister for economic development, German Gref, the head of the Ministry of Transportation Igor Levitin and the president of RZhD Vladimir Yakunin all took part in this meeting. Immediately after the meeting, the head of the transportation monopoly said that according to the "Strategy for the development of rail road transportation in the Russian Federation until 2030" overall investments in this industry could total 10 trillion rubles. At that, according to Vladimir Yakunin, OAO RZhD would be able to supply more than half that sum. However, already in the fall, this number increased to 13.7 trillion rubles³². At that, the government's share will be 2.7 trillion rubles and the constituent entities of the Russian Federation will pay out 672.8 billion rubles. The share of private investments in general rail road transportation is set at 7.2 trillion rubles (from that, RZhD will provide 5.9 trillion rubles), while their share in industrial transportation is 3.1 trillion rubles.

FTP "the Development of the City of Sochi as a mountain resort till 2014". The main initiator of this project is the governor of the Krasnodar region, Alexander Tkachev, Basil and Interros. Oleg Deripaska has been actively investing in the region over the past couple of years and is pretty well prepared for 2014³³.

³⁰ Kolobkov C., Samatorova A. Billions for Avtovaz. // PBC daily (Moscow).- 11.20. 2007

³¹ Kvasov D. Internet Lucky charm. // Expert (Moscow).- 11.26. 2007

³² Haymov I. Putin remembered the XIX century. // Nezavisimaya Gazeta (Moscow).- 10.25. 2007

³³ Samarina N. Make it in time to 2014 // Vedomosti (Moscow).- 12.10. 2007

This took different forms. Basil began the construction of a number of cement factories in different regions (including the southern federal district). Moreover, Deripaska sped up the development of transportation projects within the framework of the Aeroporti Yuga holding. This business structure operates the airports in Anapa, Krasnodar, Sochi, Avialiniyi Kubani, and is participating in the construction of the airport in Geledgik. In 2006 these airports served 3.1 million passengers. For the development of this project Deripaska even bought a small share in German Hochtief AG, which specializes in the reconstruction and exploitation of airports. Finally, Basil began the project Imeritinskaya Riviera³⁴. As a counterweight to Deripaska, another heavyweight from the Russian business world, Vladimir Potanin decided to concentrate on the construction of the Rosa Khotour complex in Krasnaya Polyana. The calculation that the head of Interros made was a rather easy one: the government itself will build practically all of the transport and social infrastructure and this in turn will increase the project's profitability. According to the FTP, Sochi's infrastructure is supposed to get \$313.9 billion rubles (around \$12 billion) of investment. The federal budget will contribute 185.8 billion rubles, the Krasnodar region and the city administration will contribute 9.2 billion rubles while the other 118.8 billion rubles will be contributed from non-budgetary sources. This much money has never been allotted for the Olympics. For example the games in Nagano cost \$2 billion, the ones in Salt Lake City cost \$1.32 billion and the ones in Turin cost \$2.7 billion. According to experts, the Olympic games themselves won't be able to cover these costs – the maximum is around 20%. According to experts the time that it will take to recoup these costs will be 7-10 years.

FTP Development of Nanotechnology in the Russian Federation from 2008-2010. Its main initiator is the head of the Kurchatov Institute³⁵. It was thanks to Mikhail Kovalchuk and his brother Yuri that this project was lobbied through and received the necessary financing. The FTP was approved by the former head of the government Mikhail Fradkov on August 9, 2007. This projects finances will include 24 billion 944 million rubles from the federal budget and 2 billion 788 million rubles from non-budgetary sources. These funds will be geared towards developing nanotechnology infrastructure in 8 thematic directions. In particular, the Lukin R&D physics institute was chosen as the lead organization for the

³⁴ Akopyan A. Destination Sochi and every station after that. // Kommersant (Moscow).- 11.22. 2007

³⁵ Taratuta U. Election nanotechnology // Kommersant (Moscow).- 06.26. 2007

development of nano-electronics, the Moscow State for Electronic Machinery – nano-engineering, the Bochvar All-Russian R&D institute for inorganic materials – functional nano-materials for use in the energy sector, the Keldish R&D institute – functional nano-materials for use in the space sector, VGUP Russian scientific center Kurchatovskii Institute – nano-biotechnologies, the Prometei VGUP Central R&D institute of construction materials and the federal state institution Technological Institute of super-hard and new carbonic materials – nano-materials for the construction industry. VGUP All-Russian R&D institute for aviation materials – composite nano-materials, and VGUP Central R&D institute of chemistry and mechanics – nano-technology for security purposes.

Trends in tax policy

The main trend of the tax policy in the Russian Federation was the battle over the size of the tax burden between the business structures and the Ministry of Finance. As of the beginning of 2008, the winner was Aleksey Kudrin.

In December of 2007, the Ministry of Finance stated that it could review the tax rate for gas drilling companies. The project for increasing the tax burden on these business structures has been in effect since the spring of last year and was Kudrin's answer to ***a proposal put forth by a number of businessmen to lower the VAT.*** The authors of the latter initiative included the Russian Union of Industrialists and Entrepreneurs (RUIE), Delovaya Rossiya, and Opora Rossiya. The representatives of the business world were forced to turn directly to the president because of Aleksey Kudrin's firm position on this matter. The head of the Ministry of Finance has repeatedly torpedoed their initiatives to lower the VAT.

On February 13, 2007 at a meeting of the cabinet, the Finance Minister announced a plan about the possible lowering of the value added tax (VAT) to 15%³⁶.

Aleksey Kudrin's statement looked very puzzling against the backdrop of the passage of the January document "The main direction for tax policy in 2008-2010". He, besides everything else, recommended keeping all the main tax rates the same. At that, according to the Ministry of finance, the main aim of tax policy should be the improving the collection rate of the VAT.

So, the VAT in 2006 was the only tax that the FTS had trouble meeting their collection targets for. The increase in the collection rate for the VAT was only 4%

³⁶ Visloguzov V, Butrin D, The golden rate. // Kommersant (Moscow).- 02.14. 2007

across the country while in Moscow and the Moscow region the collection rate increased by 43%. The FTS in 2006 didn't fulfill its collection plans for the VAT – instead of 1.124 trillion rubles the actual collection hit 924 billion. This was connected with the rise in returns for export VAT and the simplification of its administration. The VAT made up 31% of the 2006 budget. Its collection plan for 2007 is 1.379 trillion rubles, however the Ministry of Finance is already forecasting that because of the new quarterly format for the payment of the VAT and the establishment of a single VAT declaration for domestic and foreign operations for exporters, the budget will lose 150-170 billion rubles.

The major change in the Finance Minister's position is connected with the consolidated pressure put on Aleksey Kudrin by the members of the RUIE, who were able to receive the support of the head of state. The main lobbyists for this project were the head of the RUIE, Alexander Shokhin and the owner of Bazovii Element, Oleg Deripaska.

At the above mentioned meeting, one of Shokhin's main topics of discussion was tax administration³⁷. Later, on February 14 of last year, Oleg Deripaska made his own presentation on the RUIE website about lowering the VAT. Oleg Deripaska has a significant departmental resource, which, most likely, played an important role in changing the position of the Ministry of Finance.

However, while agreeing to lower the VAT, Kudrin made some of his own demands. In order to compensate for the loss that the budget will take, the ***Finance Minister proposed to cancel the preferential VAT rate and to increase the tax on the extraction of mineral deposits (TEMD)***³⁸.

Previously the president had initiated the process of establishing preferential TEMD rates for oil companies that develop technically challenging oil fields. Thus, the biggest losses from Kudrin's proposal would be suffered by gas drilling companies.

According to Kudrin, in a year, the rate should increase to 480 rubles and in 2010 to 735 rubles. In this way, The Ministry of Finance is planning on taking away Gazprom's super-profit that it will receive from the price hikes (to a European level) on the domestic market.

In November of 2006, the government approved the gas supply program till 2010³⁹. According to this program, gas prices will rise by \$13 for one thousand

³⁷ About the meeting between president Putin and representatives from the RUIE – top managers from the largest Russian companies // RUIE, - 02.06. 2007

³⁸ Piggybank conversations // Vedomosti.- 02.15. 2007

³⁹ Grivach A. Shared with the budget // Vremya novostei.- 04.26. 2007

cubic meters in 2008. In the following year they are supposed to rise by \$18.1 and in 2010 by more than \$21. Because of these price increases the revenues of gas companies will also increase. According to the Ministry of Finance, Gazprom's extra profit will total \$4 billion a year while independent companies \$1.3 billion. Officials are proposing that all this money be taken for the budget by way of increasing the TEMD rate.

This couldn't have pleased the pressure group that controlled Gazprom. The latter is actively consolidating gas drilling assets and it isn't planning on losing margin and profitability because of tax losses. As a result, the members of the Government who were close to the Gazprom group criticized Kudrin's initiative. The deputy minister for economic development Andrei Sharonov, the former prime minister Mikhail Fradkov, and the deputy premier Alexander Zhukov all came out against Kudrin's proposal. As a result of this combined effort the project was sent back for revision.

The second tax that may be increased in 2008 is the Unified Social Tax (UST). This idea belongs to the Minister of Health and Social Services, Tatyana Golikova. This proposal can conditionally be divided into two parts⁴⁰.

First of all the minister is proposing to change the current UST rate system. Currently in Russia there is a regressive scale for the tax – 26%, 10% and 2%. The Ministry of Health and Social Services is offering establish a system of two rates (26% and 0%) and essentially eliminate its regressive feature. For the first 50 thousand rubles that a worker makes, the company would pay a UST rate of 26%. If the worker makes more than 50 thousand then the rate becomes fixed at 13 thousand rubles (additionally). The result of Tatyana Golikova's proposals would significantly increase the tax burden on businesses. This will especially be true for companies whose workers make more than 23 thousand rubles a month.

At the same time the Ministry of Health and Social Development is proposing that 6% of the UTS from the 26% bypass the federal budget – increasing the pension fund payment from 14% to 20%. In this way, the whole UST will go into the funds of the Ministry of Health and Social Development: 20% – to the Russian Pension Fund (RPF) and 6% – to the Fund for Obligatory Medical Insurance (FOMI) and Social Insurance Fund (SIF).

⁴⁰ Grozovskii B. Ivanitskaya N., Shpigel M, Sterkin F. Payment from honesty // Vedomosti, - 01.14. 2008

The reason for these harsh measures from the Ministry of Health and Social Development is the deficit that the government non-budgetary funds are facing – most of all, the RPF.

And this is at the time that the effectiveness of administering the VAT has decreased, especially in the third and fourth quarters of 2007.

VAT liabilities as of November 1, 2007 compared with October 1, 2007 have increased by 7.6%. Since January 1, 2007, the debt for tax penalties decreased by only 0.1% and as of November 1, 2007 was 45.9 billion rubles, which is about half of the total UST debt (49.9%). In comparison with the beginning of 2007 it decreased by 4.4%. The debt on contributions to the mandatory pension insurance program and payments to the government non-budgetary funds on November 1, 2007 compared with October 1, 2007 increased by 10.1%, and with January 1, 2007, decreased by 1.5%. The debt on tax penalties as of November 1, 2007 was 151.5 billion rubles and was 1.4 times bigger than that debt on contributions to the mandatory pension insurance program and payments to the government non-budgetary funds. Compared to January 1, 2007 it decreased by 23.8%⁴¹.

Notwithstanding the fact that the project to increase the UST and to redistribute where this money goes was done with the direct involvement of Aleksey Kudrin, it faced fierce resistance from businesses and from factions within the parliament.

The backbone of the opposition to the Kudrin-Golikova tandem was *Delovaya Rossiya* and *Opora Rossiya*. Social organizations that represented the interests of small and medium sized businesses also came out against increasing the tax burden. The RUIE also supported this opposition.

What is more, these organizations were able to get the support of United Russia. Boris Grislov came out against changing the tax code including the way that the income tax is calculated. The speaker of parliament stated that United Russia is not interested in “changing the approach to calculating the income tax”. However, his sharpest comments were about the UST. As an alternative to the initiatives from the Ministry of Finance and the Ministry of Health and Social Development, Grislov proposed to stimulate voluntary citizen contributions to the accumulative part of the pension fund. It is easy to understand the speaker’s position. The Kudrin-Golikova project proposes to give the Ministry of Health and Social Services full control over the UST and thus bypassing the parliament in the process of redistributing the budgetary income.

⁴¹ Tax statistics for January-October 2007 // The Federal Service for Government Statistics