

# **MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:**

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

**No. 16(54) September 2017**

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*Monitoring of Russia's Economic Outlook: trends and challenges of socio-economic development. 2017. No. 16 (54). September / A. Bozhechkova, N. Zubarevich, A. Kaukin, T. Malinina, E. Miller, I. Sokolov, P. Trunin, and N. Shagaida. Edited by: V. Gurevich, S. Drobyshevsky, P. Kadochnikov, A. Kolesnikov, V. Mau and S. Sinelnikov-Murylev; Gaidar Institute for Economic Policy, Russian Presidential Academy for National Economy and Public Administration. 30 p. URL: [http://www.iep.ru/files/text/crisis\\_monitoring/2017\\_16-54\\_September\\_eng.pdf](http://www.iep.ru/files/text/crisis_monitoring/2017_16-54_September_eng.pdf)*

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## MAIN TRENDS AND CONCLUSIONS

The Russian Government's adoption of a draft federal budget for 2018–2020 and a CBR's key rate cut make up most, if not all, of the recent economic agenda.

Another thing that has come into focus is a decision to raise next year's fuel excise duties, which is worth noting not because of its magnitude but because such a move towards charging more from individuals and companies could hardly be expected in the lead-up to the election. Neither was it expected that the Banking Sector Consolidation Fund would take over systematically important Binbank shortly after announcing the takeover of Bank Otkritie FC, although this process was verbally attended with an almost ideal formula: the Bank of Russia has enough money for all.

There has been nothing unexpected or surprising about the draft federal budget and the key rate. No drastic changes have been noticed, at least at first reading, with regard to expectations about the federal budget for the ensuing three years. If any serious economic (structural, budgetary, fiscal) reforms are projected beyond 2018, they are not reflected in publicly available figures. As to the key rate cut, this may just as well be recognized as the popular vote because lots of experts predicted the central bank would cut the key rate (to 8.5%).

According to our experts, lowering the key rate by 0.5 p.p. was driven by a lower-than-expected descent in inflation rate from the second half of summer and by lower inflation expectations. The price growth deceleration was led by the seasonal fall of fresh fruit and vegetable prices and by the rouble exchange rate movements. Furthermore, the inflation deceleration (not seasonal one) was seen in the non-food sector, too (since as early as February). Factors such as less predictable global oil market and domestic demand recovery (growth in real wages and in retail trade turnover) may push inflation. The experts predict that the central bank will continue to make gradual key rate cuts, with the year-end rate down to 8.0–8.25%.

Some kind of recovery of individuals' consumer activity ("the Russians are fed up of saving") has been noticed by the experts while analyzing the H1 outturns of regional economies. Seventy three of the 85 regions recorded industrial growth, with investment increasing basically in a few regions, two of which – oil and gas producing Khanty-Mansiysk and Yamalo-Nenets Autonomous Okrugs – accounted for 15% of the country's total investment, with a 5–13% growth over the period under review, and Moscow represented another 12%, with a 19% growth. Yakutia saw investment boost by 60% (owing to the construction of a gas pipeline to China, and to oil and gas production). The Republic of Crimea and the city of Sevastopol took the lead, with investment up by 2.9 and 1.9 times, respectively (however, jointly they make up just 1.3% of the country's total investment). According to the experts, the housing construction sector is an area of concern: new housing construction commissioning dropped by an overall of 10.4% in 54 regions, including in the North Caucasus, in Tyumen, and in Moscow.

Regional budgets appear to be relatively well-situated, with revenues increasing in real terms (including in Moscow, with revenues up 17% from H1 2016, accounting for one-fifth of total regional budget revenues). Furthermore, regions now have more balanced budgets (regions with a budget deficit have reduced in number, to 36 from 50) and less debts.

However, statistical data on budget revenues is mixed (and also determined by Moscow's budget spending). In any case, the data do not look inspiring enough when it comes to social spending. For example, social spending in the first half of the year increased 2% (excluding insurance payouts for non-working population that in many regions have been moved to the social expenditure item from the healthcare item). The social benefits dynamics has turned out to be zero, being reduced by half in almost 50% of the regions.

The social security framework is poor enough to encourage disputes on new forms of social safety provision for persons in the lower-income bracket. In particular, the experts have analyzed a proposed food aid programme seeking to support the most vulnerable groups of population.

First, according to the experts, the programme should cover at least 20% of the population (29m persons) rather than 13.5% of those below the subsistence minimum (Rosstat's data for 2016), that is, it should cover those who are able to afford only two-thirds of the food basket recommended by the Healthcare Ministry. Second, the fact that food ration coupons (similar to the coupons that were used under the US programme in the 1930s) only can be used for purchasing domestically manufactured foods is questionable because domestic foods often turn out to be more expensive than imported foods. Third, the idea of using the programme for supporting agricultural producers is questionable, too: retail networks will likely to become key beneficiaries. The food aid programme should be promoted indeed, but it is lower-income persons who are supposed to be the key beneficiaries, whereas supporting the agricultural sector would be more valuable through immediate support to farmers.

According to the common practice, the agricultural and other sectors, as well as regions and selected categories of population, are also supported through tax incentives. The Russian budget system is therefore faced with annual shortfalls in revenue of more than 2.5% of GDP (85% of which can be seen at the federal level). They stem basically from taxes such as profit tax, VAT, mineral extraction tax, personal income tax. Regional tax expenditures stem basically from property tax incentives.

According to our experts, there are few countries with a relatively successful tax incentives policy in place. Most countries have seen the reverse effect of tax incentives: widely used tax incentives have resulted in lower effective taxation and in tax base erosion, which in turn have become the key factors leading to downturn trends in national financial systems, particularly in countries with low-quality public administration.

The experts have made their proposals considering the fact that tax incentives in Russia are distinguished mostly by their permanent nature and by lack of targeting although they focus on accomplishing certain national policy objectives and are beyond the scope of budgetary control. In particular, they have proposed criteria to determine whether tax incentives are valid or not, as well as introduction and revocation mechanisms. They have also presented "a list of selected tax incentives that fail to meet the required efficiency criteria". In doing so, the experts have acknowledged that the effectiveness

of the criteria depends largely on the immediacy of system-wide problems such as high corruption levels, excessively volatile exchange rate, inflation, inadequate transparency and regularity of budget expenditure, inconsistency and unpredictability of public administration and other important institutional terms.

Taxation issues are also considered in Gaidar Institute's developments related to a so-called "tax manoeuvre" that is in force in the Russian petroleum industry since late in 2014. Measures have been proposed to encourage the Russian refining industry to increase its efficiency, to reduce the scope of subsidization of petroleum refiners (PRs) in Russia and in EEU (Eurasian Economic Union) countries, to raise the effectiveness of the tax system as a whole. This is planned to be achieved by cutting export and excise duties on refined products while raising the crude oil extraction tax.

According to the experts, however, the described mechanism has been seriously updated since then and has failed in practice. As a result, Despite falling crude oil prices, the economy-wide average cost of refined products manufacturing remains high enough while an implicit refining sector subsidy (setting domestic crude oil prices below the world market price) is still in place, with no effect on ultimate customers. The rates of excise duties on refined products are raised on a regular basis despite the previously announced plans of gradually cutting excise duties. In this context, the Gaidar Institute has developed a tax manoeuvre option with due regard for the aftermath of the crisis, the current economic environment, certain PRs' economies, and the achievement of expected reform outputs and outcomes. ●

## 1. INFLATION IN RUSSIA: A SHARP DECELERATION IN Q3 2017

A.Bozhechkova, P.Trunin

Russia saw inflation decelerate rapidly since July to 3.2% year-over-year in early September 2017, and a way below the central bank's target inflation rate for 2017. The Bank of Russia therefore moved toward a less rigid monetary policy: a decision to cut the key interest rate by 0.5 p.p. was made on the 18 September meeting. In the period between August and early in September 2017 the Russian economy experienced a deflation for the first time since August 2011. Prices were down owing to seasonal fall of food prices, a stronger rouble, as well as a moderately tough policy of the Bank of Russia.

On 18 September, the Bank of Russia cut the key interest rate, making the fourth reduction this year. As a result, the key rate was down 0.5 p.p. to 8.5% p.a. The decision seems to be reasonable enough amid a sharply decelerating inflation rate in July–September 2017. As a reminder, after a drastic upsurge in June to 0.6% from May (4.4% from June 2016), the growth rate of consumer prices decelerated in July to 0.1% (3.9% from July 2016) and in August to -0.5% (3.3% from August 2016) (Fig. 1). Deflationary processes continued in the first half of September, when prices over the first 11 months fell countrywide



Source: Rosstat.

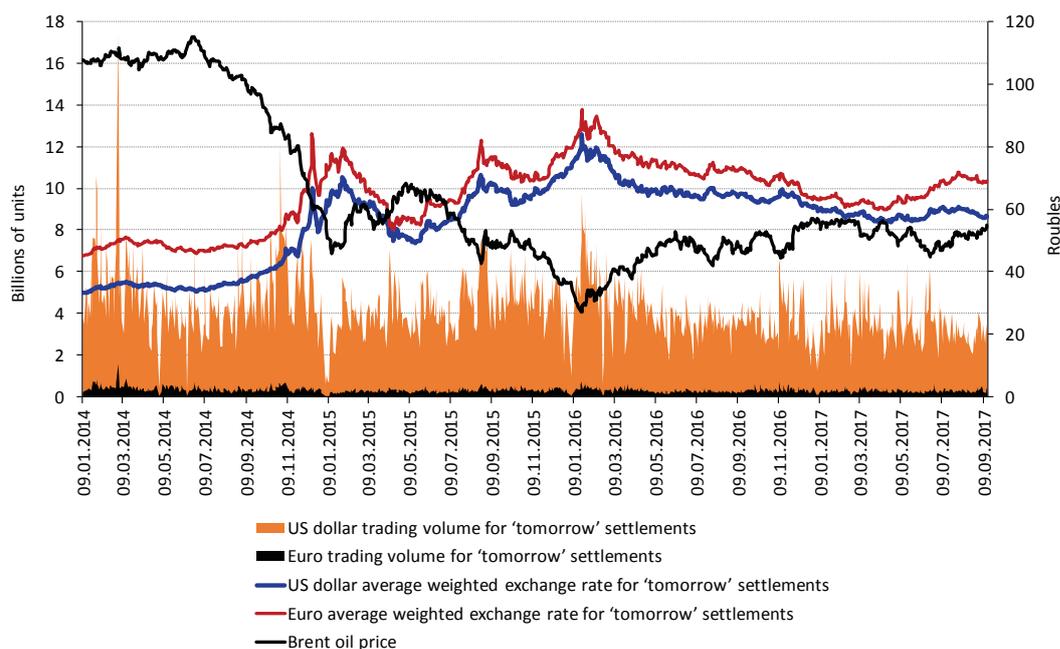
Fig. 1. CPI growth rate in 2011–2017, % change, year to year

by an average of 0.1%. The deceleration of consumer inflation was primarily driven by a seasonal food price fall that took place despite the preliminary downbeat crop assessment for 2017 as a result of adverse weather conditions. Food prices in August fell in general by 1.8% (-0.6% in August 2016), and negative growth of prices of fruits and vegetables reached 15.5% from July (-8.9% in August 2016). The last time food prices saw such a strong fall (1.7%) was August 2003, when prices of fruits and vegetables dropped 7.2%.

Non-food prices in August increased 0.1% (0.4% in August 2016). Inflation in the non-food sector continued decelerating since February 2017 (prices in February–May 2017 increased monthly by 0.2%, in June–August 2017 by 0.1%). Prices and tariffs of paid services to individuals in August 2017 rose by 0.4% (+0.3% in August 2016), driven up predominantly by seasonal appreciation of outbound tourism services and passenger transport services.

Thus, the seasonal fall of prices for fruits and vegetables was not the sole contributor to the consumer price deceleration. The underlying inflation, excluding seasonal and administrative factors, also continued decelerating since January 2017. For example, it stood 5.5% year-over-year in January,

## 1. INFLATION IN RUSSIA: A SHARP DECELERATION IN Q3 2017



Sources: Central Bank of Russia, Finam.

Fig. 2. Dynamics of the rouble's exchange rate to the US dollar and to the Euro, forex market trading volume, Brent oil price

reaching 3.0% year-over-year in August 2017. This indicates that the inflation deceleration is steady enough and driven not only by short-run factors.

Inflation expectations are also heading toward a lower inflation rate, with the median value in August, according to InFOM's survey, hitting a historical low of 9.5% from 10.7% in July this year. Bank of Russia estimations based on households' inflation expectation surveys also provide evidence of lower inflation expectations. For instance, the inflation probabilistic estimate that was obtained by "superimposing" respondents' current inflation assessments in August was 3.7%, which is 0.4–0.5% below the value recorded in July<sup>1</sup>.

Developments in the Russian foreign exchange market also seemed to reduce inflation. For example, the Russian rouble in the year to mid-September gained 4% against the US dollar, reaching 57.5 roubles per dollar (Fig. 2). The rouble appreciation was associated basically with growing energy prices, as well as with excess demand for Russian assets, particularly Russia's government and corporate bonds, by non-residents.

In our view, it is too early to say that inflation in Russia is steadily below the central bank's inflation rate target. A consumer demand recovery still remains a source that can possibly boost inflation: for instance, real household cash income in May and in June 2017 increased 0.3% and 0.2% year-over-year, respectively, after a fall during the three previous months. In addition, real wages were on the upswing since August 2016, with growth rates reaching 4.6% year-over-year in July 2017. Furthermore, retail trade turnover in April–July 2017 increased for the first time since December 2014, reaching 1.0% year-over-year in July 2017, which was most likely driven by continuing growth in consumer lending.

1 The Bank of Russia Bulletin "Inflation Expectations and Consumer Sentiment", No. 8 August 2017.

Another source that can possibly boost inflation in the coming months is persisting uncertainty about external environment for the Russian economy. In particular, the petroleum market remains extremely unstable, and there may be less demand for Russian securities if the Federal Reserve tightens its monetary policy coupled with Fed's interest rates cuts.

On the whole, given the current balance of risks, the Bank of Russia will most likely continue to lower gradually the key rate to 8–8.25% at year end. ●

## 2. REGIONS IN H1 2017: THE CRISIS IS ALMOST OVER, BUT NO GROWTH IN SIGHT

**N.Zubarevich**

*The H1 2017 results for Russian regions are ambiguous: the economy is getting out of the crisis, but the dynamics of households' income and consumption look far less optimistic. Revenues of budgets are growing ahead of the dynamics of expenditures, but in almost half of regions there are still budget imbalances. Regions' policy priorities as regards support of the economy and promotion of human capital development have become more high-profile, but positive trends are weak and localized primarily in the most competitive regions.*

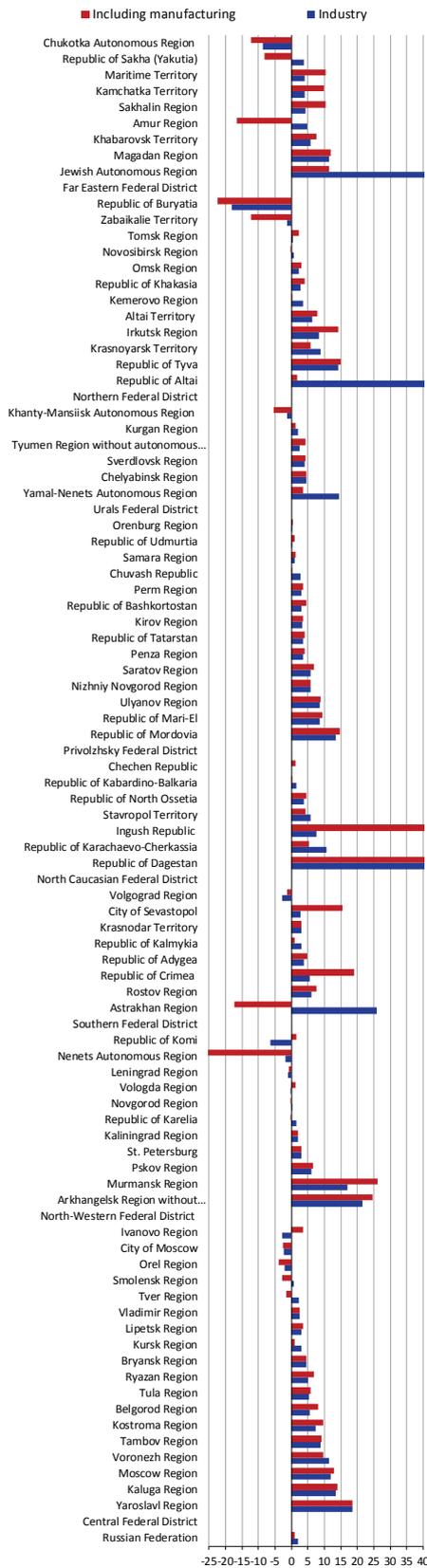
As seen from the results of the first six-seven months of 2017, the crisis recession is over not only in manufacturing, but also in investments. In January–July, industrial output growth increased by 1.9%; growth was observed in 73 regions out of 85 regions (Fig. 1) Among regions with more developed industry, growth rates were higher in the Astrakhan Region, the Arkhangelsk Region, the Yaroslavl Region and Murmansk Region (growth of 17–26%) and the Yamal-Nenets Autonomous Region (14%). However, in the two largest regions – Moscow and the Khanty-Mansiysk Autonomous Region – industrial output fell by 2.4% and 1.3%, respectively. Their contribution to the ultimate dynamics of the country's industrial output is quite high: the city of Moscow accounts for over 11%, while the Khanty-Mansiysk Autonomous Region is the area where nearly 7% of industrial production is concentrated.

### **The Industrial Output Dynamics**

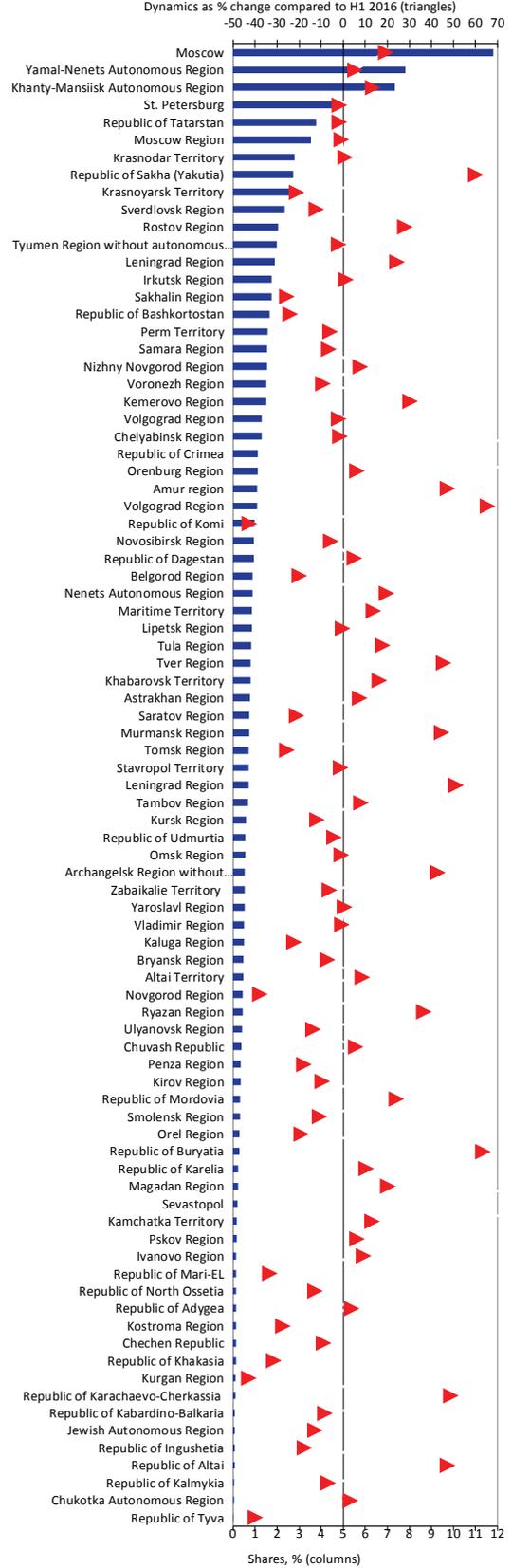
So far, there is no sustainable industrial growth due to weak dynamics of manufacturing (a 1% growth in January–July) though its growth was observed in most regions (68 regions out of 85 regions). Apart from the Arkhangelsk Region, the Murmansk Region and Yaroslavl Region, substantial growth was also observed in the Kaluga Region, the Moscow Region and the Irkutsk Region (13–14%) as a result of improvement of the situation in the non-ferrous industry, the motor industry and some other industries. Among regions with developed manufacturing, a dramatic slump was observed in the Buryat Republic (-22%), the Astrakhan Region and the Amur Region (-17%) and the Zabaikalye Territory (-12%). The regions of the Zabaikalye Territory are still the most problematic ones as regards the dynamics of industry.

### **Dynamics of Investments**

In H1 2017, investments increased by 4.8%, however, on the regional level the situation is not that optimistic: growth is observed only in half of regions (Fig. 2). As the dynamics of investments depends greatly on the base effect, it is necessary to take into account the differences in the volumes of investments across regions. In H1 2017, the share of the two leading oil and gas producing regions – the Khanty-Mansiysk Autonomous Region and the Yamal-Nenets Autonomous Region – accounted for 15% of all the investments in Russia, while the volume of investments rose by 5–13% as compared to the



Source: The Rosstat.  
 Fig. 1. Dynamics of industrial output, January–July 2017, % change compared with January–July 2016



Source: The Rosstat.  
 Fig. 2. Dynamics and share of investments in H1 2017, % (The Republic of Crimea with growth of 2.9 times and Sevastopol with growth of 1.9 times are not shown in the fig. above)

corresponding period of 2016. Moscow received nearly 12% of all the investments in Russia, while growth in their volume amounted to 19%. The share of budget investments in Moscow (29%) is twice as much as the national average (13%); one-fourth of all the investments come from the Moscow budget, including those on development of the infrastructure and public amenities. A more substantial growth is observed in Yakutia (60%) thanks to building of the gas pipeline to China and development of oil and gas production. As regards the dynamics of investments, the leaders are Crimea and Sevastopol (2.9 times and 1.9 times, respectively), but aggregately they account for only 1.3% of all the investments in Russia, while their growth was mainly ensured by means of budget investments, whose share was the maximum (71–80%). So, the positive dynamics of investments were ensured by Moscow, the main export mineral producing regions with explicit competitive advantages, as well as priority regions in terms of geopolitics at the expense of budget investments. Such investment growth can hardly be sustainable.

### **Commissioning of Housing, Labor Market and Incomes**

Housing development is still one of the most problem sectors where in January–July 2017 commissioning of new housing fell by 10.4%. A slump continued in 54 regions; it was the most severe in Chechnya (9 times over), Adygea (2 times), the Vologda Region (40%) and the Tyumen Region (40%). In this index, the base effect should be taken into account, too. The most substantial volume of housing is commissioned by the Moscow Region (over 10% of the total floorspace in Russia), as well as the Krasnodar Territory, St. Petersburg, the Leningrad Region, the Republic of Tatarstan and the Republic of Bashkortostan, the Rostov Region and Moscow. Among leader-regions, commissioning of housing increased in half of them: St. Petersburg (8%), Tatarstan (5%), the Leningrad Region (4%) and the Rostov Region (2%). In H1 2017, commissioning of housing in Moscow fell by 27%. Note that it decreased in 2016, too (14%). So, it is one of the factors behind implementation by the Moscow authorities of the renovation program aimed at underpinning the Moscow building sector.

During all the crisis years, according to the ILO methods the unemployment rate is rather low, while in summer it usually goes down (by 5.1% in May–July 2017). Regional differences are substantial and sustainable: the maximum unemployment rate is observed in republics of North Caucasus and Southern Siberia (12–27%) and depressive regions of Zabaikalie (9–11%), while the minimum one, in large federal cities (1.3–1.7%).

The dynamics of partial employment reflect problems of regional labor markets. In Q2 2017, the share of part-time workers decreased to 2.8% of the average staffing number compared to 3.1% in Q1 2017; reduction took place in most regions. The problem of partial employment is more acute in the Republic of Crimea (7.0%), Sevastopol (5.1%), the Republic of Chuvashia and the Republic of Altai (4.7–4.8%) due to a small number of new jobs created and a lamentable state of some industrial enterprises.

Households' real incomes stopped falling only in May–June 2017; H1 2017 saw negative dynamics (-1.1%) as a whole with recession still prevailing in 65 regions. The crisis is not yet over for the population. However, the Russians are tired of tightening their belts; from Q2 2017 the retail trade volume has been growing among other things on the back of consumer lending growth. In general, in January–July 2017 the retail trade stabilized (-0.2%), though recession continued in 48 regions.

### Budgets and Debts

Another positive trend consists in the fact that the state of regional budgets is changing for the better. In H1 2017, revenues of consolidated regional budgets increased by 9% as compared to the same period of 2016. Higher growth rates were observed as regards profit and income tax revenues (12%), individual income tax revenues (8%) and budget transfers (9%) as they were allocated more evenly during the year. But the situation is not homogeneous at the regional level. Moscow accounts for one in five roubles of regional budget revenues, the Moscow budget revenues rose by 17%, while profit tax revenues which are the most important income source, by 26%. In 15 regions, budget revenues fell most dramatically. In the oil-producing Sakhalin Region and the Khanty-Mansiisk Autonomous Region they decreased by -29% and -21%, respectively, due to a drop in profit tax revenues. Also, they went down in the Republics of Kabardino-Balkaria and Yakutia (-11–17%) and the Leningrad Region, the Novgorod Region and the Chukotka Autonomous Region (-9–10%).

Budget expenditures rose at a slower rate (6%), but the situation varies greatly, too, from one region to another. The maximum growth in expenditures is registered in the Kaliningrad Region (52%) thanks to a three-fold growth in budget transfers, the Republic of Crimea (28%) which received twice as much transfers and the Republics of Kalmykia and Karachaevo-Cherkassia (20–23%), Moscow, St. Petersburg, Sevastopol and the Chukotka Autonomous Region (15–16%). In 25 regions, budget expenditures fell the most: the Sakhalin Region, the Republics of Udmurtia, Kabardino-Balkaria and Yakutia (6–8%).

The pattern of regional budget expenditures is not quite typical as the major expenditures fall on the end of the year, however, it is possible to single out a few trends which can be mainly explained by the policy of the Moscow authorities.

Firstly, regions have largely increased their expenditures on the economy (9% compared to H1 2016). In Moscow, growth was even higher (17%); Moscow accounts for one-fourth of regional budgets' expenditures on the economy. St. Petersburg's budget expenditures on the economy were growing at a higher rate (19%), but their volume is four times smaller than that of Moscow.

Secondly, regional budgets' expenditures on housing and public utilities increased a great deal (14%) and again at the expense of Moscow (growth of 30%) which accounts for one-third of all the regions' expenditures. Housing and public utilities include also Moscow's spending on public amenities ("My Street" program and other); such expenditures rose by 37%. Moscow accounts for 65% of all regional budgets' expenditures on public amenities, while other regions have no funds to spend on such programs.

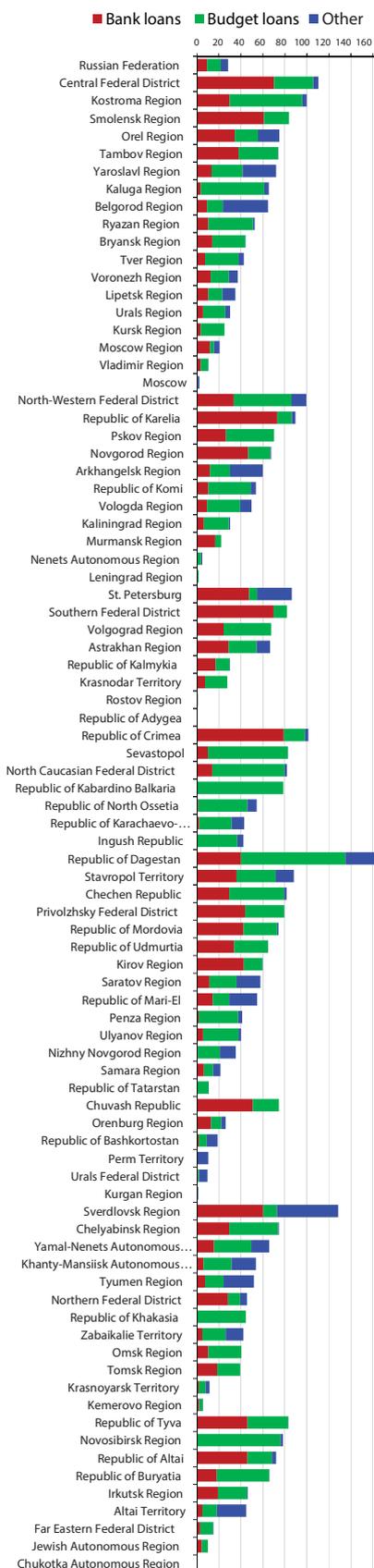
Thirdly, after the crisis optimization of the past years H1 2017 saw a more sustainable growth in regional budgets' expenditures on human capital: education (5%) and culture (11%). The dynamics of healthcare expenditures distorts statistical changes (in most regions insurance payments for non-working people were transferred from the "Healthcare" item to the "Social Policy" item); on a pro forma basis they decreased. If one recalculates the dynamics with insurance contributions taken into account, healthcare expenditures of budgets and territorial funds for mandatory medical insurance rose by 6%.

Fourthly, in H1 2017 social security expenditures increased by the mere 2% (with a transfer of insurance contributions for non-working people to the

“Social Policy” item not taken into account). The dynamics of social payments (benefits) is almost zero, while nearly in half of the regions there were cuts in benefits. There are two explanations: either it was not required to win greater loyalty of the voters by means of social payments (in H1 2017 there were no federal and regional elections), or regional authorities actually started to reform an inefficient social security system pursuing mainly fiscal purposes.

Budgets have become more balanced and the number of regions with a budget deficit decreased from 50 regions in H1 2016 to 36 regions in the same period of 2017. But among them there are some with a huge budget deficit: the Republics of Mordovia and Kabardino-Balkaria (the budget deficit amounted to 23-24% of the revenues), the Magadan Region, the Jewish Autonomous Region and Sevastopol (15%) and the Republics of Khakasia and Yakutia (10-12%). The authorities in the above constituent entities failed to cope up with optimization of expenditures, while in case of Yakutia it was a dramatic drop in budget revenues. In H1 2017, nearly a half of the aggregate surplus of regional budgets was ensured by a huge surplus of the Moscow budget (Rb 210bn out of Rb 437bn). However, this surplus may disappear after implementation of the renovation program.

Another positive trend consists in the fact that the debt of regions and municipal entities decreased by 7% from January till August 2017. The highest debt remained in the Republic of Mordovia (173% of the budget revenues) and the Republic of Khakasia (129%) (Fig. 3). The debt pattern shows growth in the share of ultra-low-cost budget loans (44%), which permitted to cut regional budget expenditures on debt servicing, however, the budget deficit remains high in the Ivanovo Region, the Astrakhan Region, the Kostroma Region, the Nizhny Novgorod Region, the Saratov Region, the Magadan Region, the Republic of Mordovia, the Republic of Udmurtia and the Republic of Khakasia (5–6% of all the budget expenditures).



Source: The RF Finance Ministry.

Fig. 3. The debt of regions and municipal entities as of August 1, 2017, % change on own (tax and non-tax) revenues of consolidated budgets in 2017 (the estimate of the revenues based on the H1 data)

### 3. FOOD AID PROGRAM: SUPPORT OF THE POPULATION OR AGRICULTURE?

N.Shagaida

*Food aid to low-income people should not be linked to Russian food products because some of them are more expensive than imported ones. The RF Ministry of Agriculture should not include food aid in the agrarian budget as such a measure creates an illusion of growth, but does not contribute to development of the agriculture.*

A decrease in households' income which started in 2014 has prompted debates on the need to introduce a food aid program<sup>1</sup>. The RF Ministry of Agriculture actively engaged in development of the program referring to the US experience (under the US federal food stamps program stamps/coupons were introduced late in the 1930s on farmers' products and that permitted to feed low-income people and create demand on farmers' products).

It is expected that funds deposited to a kind of a bank card can be spent on purchasing only specific groups of products made in Russia. Such products include bread, pasta, flour, vegetables, fruits, dried fruits, salt, fish, potable water, dairy and meat products, eggs, seeds and planting stocks and cereals. One can hardly attribute potable water to the essentials as the share of purchased water in households' water consumption is miserable, yet, it is included in the list. Also, the existence of dried fruits in the list is debatable because the share of those products in the food ration of any group of people is very small, too, while the share of Russian-produced dried fruits is even smaller.

It is declared that the program is not only aimed at supporting the population, but is a vehicle stimulating development of the agriculture by means of additional demand on food products and products of related industries (manufacturing of retail and refrigerating equipment, logistics and transport, production of agricultural equipment and building of retail, storage and production facilities).

As was declared, but not explained by the RF Ministry of Industry and Trade, additional demand will be supported only by effective producers and retailers. A few agencies are competing for the right to become a program operator. The RF Ministry of Agriculture believes that it should be the operator and the allocated funds need to be spent on support of the agriculture, while the Ministry of Industry and Trade expected that function to be assigned to the National Administrator of Programs on Support of Demand, a newly established autonomous non-profit organization (ANPO NAPSD). The declared volume of funds per person amounts either to Rb 1,400 a month<sup>2</sup>, or to Rb 10,000 a year<sup>3</sup>. The same can be said about the expected efficiency of the program. The RF Ministry of Industry and Trade calculates it either as

1 <https://lenta.ru/news/2016/09/30/foodstamp/>

2 [http://www.ng.ru/economics/2017-04-03/1\\_6964\\_karts.html](http://www.ng.ru/economics/2017-04-03/1_6964_karts.html)

3 [lenta.ru/news/2017/06/06/10tousfood](https://lenta.ru/news/2017/06/06/10tousfood)

GDP growth of Rb 1.9 per deposited rouble<sup>1</sup>, or Rb 1<sup>2</sup>, or over Rb 2<sup>3</sup>. It is expected that participants in the program may include markets, mobile shops and stores of any format provided that they are connected to the processing center. In case of a market, the management company has to ensure acceptance of cards on which subsidies are transferred to.

The declared scheme is very much alike to the US food aid program, but does not take into account the US experience in that field.

In our view, it is crucially important to introduce the program one way or another. According to the data released by Rosstat, in 2016 almost 13.5% of the population had income below the subsistence level. Should the program be aimed only at this group of the population? It is evident that the group of the under-privileged is much larger. The data on consumption across decile groups of the population (in terms of the level of the available resources) show that with 10 % of low-income people the cost of a set of food products amounts only to 52.6% of that recommended by the RF Ministry of Healthcare, while with other 10% of people, to 66% (*Table 1*).

According to the RF food security policy, “each citizen is guaranteed physical and economic availability of food products meeting the requirements of the RF legislation on technical regulation in volumes which are not below reasonable norms of consumption of food products required for active and healthy way of life”. It means that the program should be aimed not at 13.5% of the population, but, at least, 20% which can for the time being afford no more than 66% of the recommended set of nutrition which in terms of caloric value is close to the ration that needs to be improved<sup>4</sup>. So, it amounts to about 29 million people. If they proceed from the recommended set of food products<sup>5</sup> and seek to ensure nutrition for active and healthy way of life, there will be at least five decile groups of the population in terms of average per capita disposable resources. It would not be correct, however, to set such a large-scale food aid objective because huge government expenditures will be required. It is necessary to look for alternative ways of reducing economic barriers to food products (promotion of households’ incomes, reduction of prices on food products which are often more expensive than their import analogs and other). Shown below are our estimates of food aid to the two most vulnerable groups of the population in terms of average per capita disposable resources.

**The first of the key issues is who needs to be supported?** In the US, applicants have to fill in a form specifying apart from their incomes the amount of funds on bank accounts, real property and the information on family members (disability, retraining and other). In addition, different US states introduce their own amendments and regulations. So, in some states a car is taken

1 Presentation by the RF Ministry of Industry and Trade of the Program on Support of Consumer Demand on Food Products , June 2017.

2 [http://www.ng.ru/economics/2017-04-03/1\\_6964\\_karts.html](http://www.ng.ru/economics/2017-04-03/1_6964_karts.html)

3 <https://rg.ru/2016/02/05/minpromtorg-razrabotal-proekt-zapuska-produktovyh-kartochek.html>

4 People who consume 1520 kcal were attributed to the category of the starving population; people who consume 2150 kcal are on the verge of hunger and malnutrition, FAO

5 For each income group, to assess the actual and recommended sets of food products the prices at which the actual set of food products was bought were applied. It means that the recommended set of food products in terms of quantity was recalculated into the prices of the actual one. According to the data of the budget examination, purchasing prices grow from one group to another as income increases.

Table 1

## THE SHARE OF EXPENDITURES ON NUTRITION AND THE RATION CALORIC VALUE, 2016

	All households	Decile groups of the population based on the level of average per capita disposable resources										Rational norms
		1 group	2 group	3 group	4 group	5 group	6 group	7 group	8 group	9 group	10 group	
Cost of a set of food products (based on actual prices in groups) thousand roubles.	70.3	38.7	48.5	55.4	60.2	66.0	71.3	77.4	84.5	93.9	102.7	73.5
% of the cost of a reasonable set of food products	95.7	52.6	66.0	75.3	81.9	89.8	97.0	105.4	114.9	127.7	139.7	100.0
Unit weight of actual expenditures on purchasing of food products in households' consumer spending, %	32.3	49.2	45.7	45.1	42.7	40.9	38.2	35.4	32.7	28.9	19.9	
Kilocalories, total	2675	2045	2283	2480	2584	2676	2751	2832	3005	3019	3007	2850

Source: The Rosstat, budget examinations.

into account, while in others, only a portion of its value is included for assessment of a family's wealth. An apartment or house is not taken into account. In the US, numerous social workers are able to assess the actual standard of living. As regards Russia, it was only reported that the issue of taking housing into account was under discussion. However, it will give rise to numerous additional questions: housing may be expensive, but there are several family members and disabled persons who need a separate room; housing is expensive, but it is situated close to a medical institution which a disabled person often visits and other. The Russian taxation and property registration systems do not see the family as a whole; they focus on individual persons, that is, income recipients and property owners. So, it is not an easy objective to assess the actual needs of a family with its property taken into account. The approach to singling out of groups is not yet clear, though it has been debated for three years.

**The second issue is what level of support should be like?** Suppose, people from the first two groups have no savings and property what so ever which could ensure them a higher standard of living than that identified by the budget examination. It is evident that for the first group of the population to go beyond the limits of the malnutrition group and for the second group to improve its consumption it is necessary to ensure at least such a set of food products as is available to the third group of the population. To achieve that goal (proceeding from the 2016 data), Rb 346,4bn will be required: an additional payment for the first group to attain the level of the third group would amount to Rb 16,700 per person a year, while that for the next group, to Rb 6,900. It is obvious that it will not be easy to allocate such huge amounts of money on food aid.

**The third issue is whether food aid should be linked to domestic food products?** The US gave up that idea long ago because some US-produced food products were more expensive than imported ones, while "linkage" with domestic products required high budget expenditures to ensure a comparable volume of purchases. Russia will face the same situation, too.

It is necessary to address this issue because the OECD indicators (2017) point to this problem, as well. According to them, in Russia consumers of ag-

gricultural products overpaid on average 10% in 2014-2016 to producers (at a farm price) compared to the price on food products of potential importers. If most crop prices in Russia are lower than in potential importer countries, local prices on beef, milk and pork are much higher<sup>1</sup>. So, in dealing with the issue of “linking” the food aid to domestic products only it is necessary to decide whom to support: the needy or agricultural producers whose prices on some products are non-competitive. As regards competitive goods, Russian consumers will prefer Russian agricultural products without any “linkage” required.

**The fourth issue is whether demand on food products will go up?** Yes. It will, but not proportionately to the food aid allocated funds. As seen from numerous US reviews of the practice of application of a similar food aid program (earlier it was food stamps, now – the Supplemental Nutrition Assistance Program), various options are possible. According to various research, a large number of poor people used those subsidies to replace their expenditures, so the released funds were spent on other urgent family needs<sup>2</sup>. To prevent that, it would be expedient in carrying out the Russian program to introduce a payment of only a portion of the cost of each product by means of a food aid card. For example, a person may pay only 50% of the price of a milk package or a pasta pack. In such a case, the buyer will have to diversify the set of products and increase the number of packs to spend up the money.

**The fifth issue is whether agricultural producers gain any tangible advantage?** It is obvious that it will be less tangible for them than even, for example, retailers. In a retail price of a product, the share of the agriculture rarely exceeds 40%. In bread prices, the cost of grain is maximum 8%. Even if they manage to find in the budget Rb 346bn worth of aid, it will amount to the mere 3% of households’ expenditures on food (2016) and the agriculture will receive in the best case scenario only 30% of that amount, that is, Rb 93bn. In comparison with revenues of agricultural entities (with farmers’ and households’ revenues not taken into account), the sum amounts to the mere 4%. In case of Russia, the aid amount is equal only to Rb 6,900–16,700 per person a year. Undoubtedly, if the amount of the food aid was comparable with that of the US (on average \$125 per person a month) one could expect a motivating effect to be made on the agriculture, while in case of a small support the effect is going to be limited.

**The sixth issue is what multiplier effect the food aid yields?** Despite the optimistic assessment of the effect of the allocated food aid funds on GDP, that is, growth of more than Rb 2 per one invested rouble, the US has failed to achieve such results. In the US, the yield is estimated at \$1.7–1.8 per invested dollar<sup>3</sup>.

**The seventh issue is who the main beneficiary of additional demand is going to be?** It is obvious that chain stores will be the main beneficiaries, though the RF Ministry of Industry and Trade has declared democratically that retailers may include even mobile stalls and farmers, but in reality the situation will be different. The project does not envisage paper coupons/stamps which buyers could use to pay for food products at markets or mobile stalls.

1 Agricultural Policy Monitoring and Evaluation 2017. OECD

2 Rossi, Peter H. Feeding the Poor: Assessing Federal Food Aid. Washington: AEI Press, 1998. P.36.

3 Mark Zandi, Assessing the Macroeconomic Impact of Economic Impact of Fiscal Stimulus 2008, Moody’s Analytics (January 2008), P. 3–4.

It means that special devices are needed to ensure connection with a settlement center or fiscal authorities. It is estimated that a lump-sum payment on purchasing of such equipment and one-year service thereof amounts to Rb 18,000 to Rb 35,000<sup>1</sup>. The project of the RF Ministry of Industry and Trade envisages that market management companies should equip their markets with such equipment. Even if they do it, the use of such services is not going to be free for farmers. To participate in the program, each mobile stall should be equipped with such special device.

These problems are well known. In the US, for example, they allocate federal government or state grants to equip farm markets with special devices<sup>2</sup>. In addition to that, paper stamps are still used<sup>3</sup>. However, in Russia these issues – allocation of grants on equipping farm markets with special devices or use of paper stamps – are not discussed at all. It is highly likely that the *Pyaterochka* retail chain which is integrated into rural stores of the consumers cooperative society will become the beneficiary.

And finally, it would be inexpedient for the RF Ministry of Agriculture to call for implementation of the food aid program under its management. If it is done this way, the funds allocated on food aid to individuals will get into the agrarian budget (as in the US). The food aid program is very expensive and its estimated volume is close to the annual budget of the state program for support of the agriculture. If financial volumes of the state program are increased at the expense of the food aid, it will create an illusion that financing of the agriculture has become higher, while in reality the agriculture gets only a miserable amount of funds (a direct support of farmers would be far more important).

The only advantage of assigning the RF Ministry of Agriculture with the function of the operator of the food aid program is promotion of awareness with the Ministry of Agriculture of the fact that the price matters much for consumption. At present, the Ministry of Agriculture takes notice only of food output volumes without taking into account whether Russian-made food products are competitive with foreign ones in terms of price for Russian buyers. The Ministry of Agriculture still proceeds from the reality in which physical access barriers on the way to food used to prevail. At present, there are virtually no such barriers, except for economic access barriers. The Ministry of Agriculture is not yet fully aware of this new reality. If the Ministry of Agriculture is made responsible for improving nutrition of the needy and not the entire population of Russia, it will probably set before itself a new objective, that is, to reduce costs and prices and not close markets for cheaper imported products.

Thus, it is necessary to promote the food aid program, but it should be dealt with as an aid program for the poor. If the program is not linked to the agrarian budget and Russian-made products, both the side will benefit

1 According to the expert estimate by the Russian Guild of Bakers and Confectioners, revenues and profits of a kiosk amount to about Rb 0.5m–Rb 1m a year and about Rb 50,000–100,000 a year, respectively. Installation of a new type of cash register equipment (with online connection to the fiscal authorities and processing center) amounts to Rb 15,000–30,000. The cost of a year service of connection of the cash register equipment to the fiscal data operator amounts at least to Rb 3000. Annual replacement of a fiscal storage device costs Rb 8,000. So, total costs of operation of cashier register equipment during the first year will amount to Rb 18,000–35,000. Similar expenses will be required if bank cards are used.

2 <http://farmersmarketcoalition.org/education/snap/state-federal-support/>

3 <https://farmersmarketcoalition.org/education/snap/>

from t. Recipients of the aid will be able to choose products depending on the funds available to them. If Russian products happen to be less expensive, they will buy them. According to the data of the RF food security monitoring carried out by the RANEPА, the Russians are very much committed to Russian-made food products. Agricultural producers will be able to ask for additional funds to be allocated on their own support or agrarian education and science, or market promotion of their products. That will be more advantageous to them than to receive financial support – which effect is quite uncertain – through the food aid program. ●

## 4. TAX INCENTIVES: HOW TO MEASURE THE EFFECTIVENESS OF TAX INCENTIVES

I.Sokolov, T.Malinina

*Tax incentives in Russia are in wide use for stimulating certain types of economic activity and for supporting certain regions (territories) or population categories. The Russian budget system is therefore faced with annual shortfalls in revenue of more than 2.5% of GDP. However, neither systematic inventory measures nor uniform performance measurement methods for tax incentives have been introduced to date.*

The fiscal function of generating budget revenues in a country or some of its territories (regions, municipalities) is traditionally considered the tax system's primary function. Some papers highlight that the Russian tax system is efficient enough in performing this function, as was proved in the mid-2000s, when the country ran a budget surplus, and during the crises of 2008–2009 and 2014–2016, when budget deficit was relatively small<sup>1</sup>.

Many countries apply tax incentives within the fiscal policy framework to promote investment and factor productivity. Tax incentives are introduced, above all, because they are able<sup>2</sup> to increase substantially returns on investments and to send signals showing that economy is open for private investment, as well as because they are useful for capital mobility. This tool is also useful for tax competition with other jurisdictions. Tax incentives are also regarded as less sophisticated solution than budget programmes seeking to improve business environment<sup>3</sup>.

However, tax incentives tend to lead to shortfalls in budget revenues, like any other tax exemptions and preferences stipulated by the law in effect. Any tax incentives initiatives must be implemented in an extremely prudent and scrupulous manner, and countries that are faced with strong budget constraints must be extremely careful in introducing tax incentives in order to avoid the increase in fiscal risks<sup>4</sup>.

There are few countries (Costa Rica, Ireland, Malaysia, China) with a relatively successful tax incentives policy in place. Most countries have seen the

1 See, for example, Panskov V.G. Taxes and taxation: Theory and Practice: A textbook for the academic bachelor degree course / Panskov V.G. 4th edition, revised and enlarged. M. : Urait Publishing House, 2014.

2 Pursuant to Clause 1, Article 56 of the Russian Tax Code, tax and levy exemptions shall be understood to mean privileges over other taxpayers and levy payers which are provided for by tax and levy legislation and are granted to particular categories of taxpayers and levy payers, including the right not to pay a tax or levy or to pay a lesser amount thereof. Thus tax incentives constitute lower than normal tax rates for selected payers and for selected business transactions, tax base deductions, tax exemptions, exemption of taxable activities and assets, tax deferrals, tax credits, etc.

3 See for details Malinina T. Ways of improving tax incentives monitoring // Budget. 2014. No. 10 (142). Zolotareva A., Kireeva A., Malinina T. Special forms of supporting investment activity in Russia. M.: Delo, 2012.

4 Effectiveness and Economic Impact of Tax Incentives in the SADC Region – technical report // by Nathan–MSI Group TO USAID/RCSA SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment Directorate, February 2004. [https://www.nathaninc.com/sites/default/files/Effectiveness\\_and\\_Economic\\_Impact\\_of\\_Tax\\_Incentives\\_in\\_the\\_SADC\\_Region.pdf](https://www.nathaninc.com/sites/default/files/Effectiveness_and_Economic_Impact_of_Tax_Incentives_in_the_SADC_Region.pdf)

reverse effect of tax incentives: widely used tax incentives have resulted in lower effective taxation and in tax base erosion, which in turn have become the key factors leading to downturn trends in national financial systems, particularly in countries with low-quality public administration. The point to note is that tax incentives can be successful as long as the following system-wide factors are available: favourable macroeconomic environment, stable monetary and tax systems, well-developed infrastructure, mobile and transparent labour market, government agencies' willingness to cooperate (on a mutually beneficial basis) with businesses<sup>1</sup>.

Otherwise, not only tax preferences can undermine the budget revenue base and require painful tax adjustments by raising taxes on other economic agents and types of activity, by reducing expenses or increasing the reliance on debt finance, but they can lead to serious economic distortions, political manipulations and corruption.

The following three principles of an optimal tax structure have long been set forth by the theory of taxation: efficiency (as small as possible tax distortion in allocating resources according to market rules); equity (taxation based on taxable capacity); simplicity (lowest costs on administration and on tax compliance). Tax incentives – except for attempts to forestall market failures; tax competition for attracting investment projects, or tax treatment formation for the development of economic agglomerations (production clusters) – clearly fail to meet the foregoing principles of optimal taxation<sup>2</sup>. In this connection establishing fair and moderate basic tax rates is the most reasonable tax incentive.

Russia has a great number of tax incentives and preferences at the federal and regional levels, with budget revenue shortfalls making up 2.5 to 2.8% of GDP annually, according to Finance Ministry's estimates.

The bulk of tax expenditures<sup>3</sup>, about 85% of total budget revenue shortfalls (*Table 1*), can be seen at the federal level and stems basically from taxes such as profit tax, VAT, mineral extraction tax, personal income tax. Regional tax expenditures stem basically from property tax incentives.

*Table 1*

TAX EXPENDITURES ALLOCATION AMONG BUDGET SYSTEM LEVELS  
IN 2014–2017, BILLIONS OF ROUBLES

	2014	2015	2016	2017
Total tax expenditure	2190.3	2163.3	2208.8	2448.6
of which				
Federal budget tax expenditures	1886.5	1835.9	1882.6	2103.0
Consolidated budget tax expenditures of subjects of the Russian Federation	282.7	302.0	305.8	319.6

Source: based on Finance Ministry's data.

1 Nersesyan, Nariné (2013). Effectiveness of tax incentives: global experiences //Tax and Development Program CTPA, DCD OECD, February 2013. [https://www.taxcompact.net/documents/workshop-lusaka/2013-02-12\\_itc\\_Nersesyan\\_OECD.pdf](https://www.taxcompact.net/documents/workshop-lusaka/2013-02-12_itc_Nersesyan_OECD.pdf)

2 Chen, Duanjie. The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach // Paper for Workshop on Tax Incentives and Base Protection // New York, 23–24 April 2015. [http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf)

3 Tax expenditures constitute budget revenue shortfalls arising from introducing tax incentives. However, the tax incentive is not referred to tax expenditures if the respective provision is reasonable for the purpose of neutrality, equity and/or effectiveness of taxation, including the simplicity of administering and meeting the tax legislation requirements.

In terms of functionality, the prevailing trend in tax incentives focuses on the national economy (an average of 83–85% of total tax expenditures), with mineral reserves replacement and agriculture as major contributors. Moreover, the theoretical research and empirical experience of applying tax breaks indicate that investment in projects that are intimately related to a specific location in terms of implementation (e.g., natural reserves development investment projects or agro-industrial projects on specially designated lands) and have no geographic “mobility” must not be subject to special tax preferences. Budgetary subsidies is a more reasonable form of state support to this type of investment.

Another specific feature of the Russian tax incentives practice on a retail rather than corporate basis is the compensatory and stimulating nature of tax incentives. The state covers some of taxpayers' education, housing or medical expenses, thereby encouraging somehow the consumption of certain types of social services or market goods. In contrast, in most of developed countries tax incentives are introduced in the form of reducing the tax burden in exchange for simultaneously reducing the consumption of such goods, works, services. For instance, US nationals who spend most of their time during a year outside the U.S. and do not enjoy the public goods or state-funded goods that have positive external effects (e.g., social services or transport infrastructure services) may be exempt from the U.S. taxable income of just over \$100,000.

Tax incentives as a direct alternative to budget expenditures in Russia are distinguished mostly by their permanent nature and by lack of targeting although they focus on accomplishing certain national policy objectives and are beyond the scope of budgetary control. As the Russian Finance Ministry has aptly noted, this type of practice creates preconditions that may deteriorate the effectiveness of national policy measures and lead to underestimation of the actual size of support of a certain type of activity, to less than optimal allocation of limited budget resources, and eventually may cause direct losses to the social well-being<sup>1</sup>. The fiscal process should therefore include measures of regular monitoring and performance measurement of budget tax expenditures. The literature is full of research on quantitative evaluation of the effectiveness of tax incentives<sup>2</sup>, most of which, however, are not designed for comprehensive analysis of costs and benefits, but rather focus on detecting specific effects of tax incentives, or they employ an extremely sophisticated econometric modelling of all the socio-economic effects of tax incentives. Because of their complexity and labour intensity such methodological approaches cannot be reasonably recommended for regular use by public employees unless they are trained to do so. Therefore, the performance measurement of tax incentives should, on the one hand, combine the integrity and comprehensiveness of consideration of socio-economic and fiscal effects of tax incentives, and, on the other hand, the simplicity and understandability of the analytical algorithm.

In our view, the performance (effectiveness) of tax incentives should be measured on a two-stage basis, beginning with checking the compliance with

1 The Principle Parameters of the Budgetary, Fiscal, Customs and Tariff Policy for 2018 and for the Planning Period of 2019 and 2020.

2 See, for example, Brown, J. David and John S. Earle (2013). Do SBA Loans Create Jobs? // IZA Discussion Paper. P. 7544. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2205174](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205174)

the required efficiency criteria, followed by adequacy assessment of the performance indicator for their actual or expected application that describes the effects of the tax incentive.

The criteria for initial-stage analysis:

- a) the tax incentive is a part of budget tax expenditures;
- b) the tax incentive may lead to substantial losses in budget revenues (e.g., more than Rb 100m annually);
- c) the tax incentive is not designed for a special-purpose use although it is applied for limited purposes or by a small number of taxpayers after a few years from the effective date. The relevance of tax incentives is defined as the ratio of the actual number of consumers to the potentially possible number of users;
- d) the tax incentive is not complex in terms of administration and enforcement and/or cannot be misused, and/or it is targeted enough and/or requires comparable (low) administrative costs (tax expenditure administrative costs make up less than 10% of their total amount);
- e) better cost-efficient alternative options (e.g., budgetary subsidies or projects based on public-private partnership) are available for achieving the tax incentive's objectives.

Failure to meet any of the above criteria implies that the tax incentive is inefficient and therefore must be recommended for revocation or at least for the development of proposals on revising the tax incentive mechanism (e.g., for the purpose of administrative costs, increasing tax incentive demand, etc).

The Attachment below presents the findings of an analysis on whether Russian tax incentives in place meet the required criteria, including a list of tax incentives that have been "nominated" for revocation.

At the second stage (when all the required efficiency criteria are met) a supervisory body or the Finance Ministry that supervise tax incentives (for system-wide institutional tax incentives that affect the interests of various government agencies) make sure the incentives meet the efficiency criteria, in which case the dynamics of at least a single value (indicator) that is influenced by a given tax incentive should be analyzed. The tax incentive clearly can have both social objectives (e.g., to ensure that socially important goods are available for consumers, to provide support to selected groups of population, to promote employment for selected groups of population, etc.) and economic objectives (to promote investment activity, to provide support to selected types of economic activity, to scale up innovation, to stimulate economic development of certain territories, etc.). The supervisory body or the Finance Ministry should therefore select at least one indicator that is most sensitive to the target effect of the tax incentive. This, for example, can include consumption of certain goods (services), population coverage with services provided by socially important organizations, the share of individuals (or selected groups) spending on socially important goods and services, the share of population below the subsistence minimum, the share of investment expenses in organizations' total spending, the output size of certain types of products, etc.

However, assessment of the effect of tax incentives on the dynamics of the target value (indicator) is reliable as long as the following requirements are met:

- full information on the tax incentive is available;

- the legislation within the period under review has not been seriously amended with regard to the tax incentive application procedure and the tax base calculation procedure;
- the value (indicator) and respective tax expenditure is not showing extremely negative dynamics;
- the dynamics of the value (indicator) in question is not critically influenced by any factors other than the tax incentive.

The formation of a performance measurement tool for tax incentives requires a series of measures to be taken; in particular, procedures for regular monitoring and assessment of budget tax expenditures should be introduced into the budgeting process; formalizing the list of tax expenditures to be annually revised according to amendments to legal acts, to the list of state programmes/projects, including their composition, as well as other circumstances; set a revocation procedure for tax incentives that are inefficient and inconsistent with the current national goals and objectives; securing requirements for introducing new tax incentives, including requirements that allow for a more targeted application and strict compliance with goals and objectives of respective tools designed for public result-oriented and project management.

Adequate outcomes of the proposed performance measurement mechanism for tax incentives depend directly on the immediacy of system-wide problems such as high corruption levels, excessively volatile exchange rate, inflation, inadequate transparency and regularity of budget expenditure, inconsistency and unpredictability of public administration and other important institutional terms.

#### *Attachment*

#### A LIST OF SELECTED TAX INCENTIVES THAT FAIL TO MEET THE REQUIRED EFFICIENCY CRITERIA<sup>1</sup>

	Tax incentive description	Tax Code provision	Revenue shortfalls, billions of roubles <sup>1</sup>	Number of taxpayers <sup>2</sup>	Non-compliance with criteria c), d), e)
<b>Corporate profit tax</b>					
1	Income of mortgage agents and special-purpose vehicles that have been received from the statutory activities shall be deducted from the tax base	Subsec. 29, Cl.1, Art. 251	1.51	87	c)
2	Income from operation and sale of vessels registered with the Russian International Register of Vessels shall be deducted from the tax base	Subsec. 33, Cl.1, Art. 251	0.32	98	c)
3	Income from operation <sup>3</sup> and sale of vessels that were built by Russian ship-building organizations after 1 January 2010 and registered with the Russian International Register of Vessels shall be deducted from the tax base	Subsec. 33.2, Cl.1, Art. 251	0.15	24	c)
4	Income of a development bank / state-owned corporation shall be deducted from the tax base	Subsec. 34, Cl.1, Art. 251	68.52	1	c), e)
5	Multiplying co-efficient of 2 or less to the depreciation rate of fixed assets owned by residents of industrial production, tourism and recreation special economic zones and by participants of a free economic zone	Subsec. 3, Cl.1, Art. 259.3	0.28	5	c)
6	Multiplying co-efficient of 2 or less to the depreciation rate of fixed assets with high energy efficiency	Subsec. 4, Cl.1, Art. 259.3	0.57	57	c)
7	Multiplying co-efficient of 3 or less to the depreciation rate of fixed assets that are the subject matter of a financial leasing agreement	Subsec. 1, Cl.2, Art. 259.3	11.13	366	c)
8	Application of a 1.5 co-efficient to the amount of actual expenses incurred for R&D activities in accordance with the R&D list established by the Government of the Russian Federation	Cl. 7, Art. 262	0.8	64	c), d)

1 Indicated are only tax incentives that have led to budget losses, and the size of losses is known, with losses of more than Rb 100m.

#### 4. TAX INCENTIVES: HOW TO MEASURE THE EFFECTIVENESS OF TAX INCENTIVES

	Tax incentive description	Tax Code provision	Revenue shortfalls, billions of roubles <sup>1</sup>	Number of taxpayers <sup>2</sup>	Non-compliance with criteria c), d), e)
9	A reduced rate of the tax that goes to the budget of subjects of the Russian Federation, on selected categories of taxpayers	Sec. 4, Cl.1, Art. 284	88.5	11.860	-
10	A reduced rate of the tax that goes to the budget of subjects of the Russian Federation, on operations conducted by residents of special economic zones in the territory of such zones	Sec. 5, Cl.1, Art. 284	0.42	Not more than 54	c)
11	A zero tax rate on the sale of products, including processed products, manufactured by agricultural producers and fisheries	Cl. 1.3, Art. 284	55.7	4.979	d)
12	A zero tax rate on dividends of Russian organizations in the case of strategic equity participation	Subsec. 1, Cl.3, Art. 284	203.23	n/a	c), d)
<b>Value-Added Tax<sup>4</sup></b>					
13	The sale of coins of precious metals shall be exempt from taxation	Subsec. 11, Cl.2, Art. 149	0.77	452	c)
14	Services rendered involving the repair and technical servicing of goods and domestic appliances, including medical goods, within their warranty period shall be exempt from taxation	Subsec. 13, Cl.2, Art. 149	4.17	11.797	-
15	The sale of scrap and waste of ferrous and non-ferrous metals shall be exempt from taxation	Subsec. 25, Cl.2, Art. 149	42.41	56.363	c)
16	The sale of exclusive rights to the results of intellectual activity on the basis of a license agreement shall be exempt from taxation	Subsec. 26, Cl.2, Art. 149	24.88	21.579	d)
17	The performance of R&D works related to certain types of activity shall be exempt from taxation	Subsec. 16.1, Cl.3, Art. 149	7.07	1.822	c)
18	The sale of agricultural produce in kind of agricultural organizations to workers who are hired for agricultural work	Subsec. 20, Cl.3, Art. 149	0.11	600	c)
19	Tax shall be levied at the rate of 10 per cent with respect to the sale of food products, goods for children and printed publications <sup>5</sup>	Cl. 2, Art. 164	278	n/a	d), e)
<b>Personal Income Tax</b>					
20	The property-related tax deduction for the construction or acquisition of a house, an apartment, a room or a share (shares) therein <sup>6</sup>	Subsec. 3, Cl.1, Art. 220	151.1	3.479.051	d), e)
21	Income received from the sale of immovable property owned by taxpayers for three years or more shall be exempt from taxation <sup>7</sup>	Cl. 17.1, Art. 217	51.3 <sup>8</sup>	n/a	d)
22	Investment-related tax deduction for the amounts of money credited to individual investment accounts	Subsec. 2, Cl.1, Art. 219.1	10.2	n/a	d)
<b>Corporate Property Tax</b>					
23	Tax exemption with respect to assets recorded on the balance sheet of residents of special economic zones that are located and used in the territory of such special economic zones within 3 years from the date when the assets are booked	Cl. 17, Art. 381	1.0	95	c)
24	Tax exemption with respect to newly commissioned projects of high energy efficiency within 10 years from the date when the assets are booked	Cl. 21, Art. 381	0.93	321	c)
25	Tax exemption for management companies in special economic zones with respect to immovable property that is booked as fixed assets on their balance sheet and used for the implementation of agreements on the creation of such special economic zones, within 10 years from the date when the assets are booked	Cl. 23, Art. 381	0.76	22	c)

1 According to the data of statistical tax reporting forms for 2015, if not otherwise specified.

2 According to the data of statistical tax reporting forms for 2015, if not otherwise specified.

3 The meaning of "operation" differs in the provisions of Subsec. 33 and 33.2, Cl.1, Art. 251 of the Tax Code of the Russian Federation.

4 According to the 1-VAT Form dated 2016.

5 Calculated on the basis of the CSR dated 2015.

6 According to the 1-DDK Form dated 2014.

7 While retaining the tax incentive for income from the sale of residential property as the sole asset owned.

8 Calculated on the basis of the 1-DDK Form (2014) using the data released by The Federal Service for State Registration, Cadastre and Cartography (Rosreestr).

## 5. TAX MANOEUVRE IN RUSSIAN PETROLEUM INDUSTRY

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*Inefficiency issues facing Russia's refining industry should have been fixed by a so-called "tax manoeuvre" that is in force since late in 2014. However, adjustments to the initial parameters that were made within the next two years with a view to generating extra budget revenues could discourage refiners to increase the refining depth and to upgrade refining facilities. A tax manoeuvre option has been proposed based on our surveys, whereby some issues can be solved, including the issue of encouraging a transition to manufacturing a "basket" of refined products that are higher in gasoline.*

A programme was adopted late in 2014, including measures<sup>1</sup> of reforming the taxation of the Russian petroleum industry, that seeks to improve the energy efficiency of the Russian refining industry and in the economy as a whole, to reduce the scope of subsidization of petroleum refiners (PRs) in Russia and in EEU (Eurasian Economic Union) countries, as well as to enhance the effectiveness of the fiscal system<sup>2</sup>. The tax manoeuvre is above all aimed at ensuring that oil producers have equal terms of doing business in the domestic market and in external markets by cutting export and excise duties on refined products while raising the crude oil extraction tax.

The foregoing arrangement that was initially embedded in the Tax Code has been seriously updated since then (e.g., the export duty reduction in late 2015 was frozen in order to retain the same level of budget revenues amid a new macroeconomic environment), but has failed in practice<sup>3</sup>. Despite falling crude oil prices, the economy-wide average cost of refined products manufacturing remains high enough while an implicit refining sector subsidy (setting domestic crude oil prices below the world market price) is still in place, with no effect on ultimate customers. Furthermore, the rates of excise duties on refined products are raised on a regular basis despite the announced 2014 plans of gradually cutting excise duties. In rouble terms, the share of taxes per tonne of refined products for the domestic market turns out to be much bigger than the share of taxes per tonne of exported refined products<sup>4</sup>. Given a new mechanism of distributing excise payments<sup>5</sup> that are levied when selling Russian refined products and help increase substantially regional budget

1 Federal Law of 24.11.2014 No. 366-FZ 'On Amendments to Part II of the Tax Code of the Russian Federation and to Certain Legal Acts of the Russian Federation'.

2 Bobylev Yu., Idrisov G., Kaukin A., Rasenko O. Oil, budget, and tax manoeuvre // Russian Economic Developments. 2015. No. 11. P. 47–50.

3 Idrisov G., Kaukin A. Tax manoeuvre: Boosting economic growth at the expense of budget consolidation // Russian Economic Developments. 2016. No. 6. P. 7–11.

4 Gordeev D. Increasing excise duties disables the tax manoeuvre // Russian Economic Developments. 2016. No. 9. P. 49–53.

5 Federal Law of 23 May 2016, No. 145-FZ 'On Amendments to the Budget Code of the Russian Federation and to Article 6 of the Federal Law 'On Amendments to the Budget Code of the Russian Federation' and to Article 30 of the Federal Law 'On Amendments to Certain Legal Acts of the Russian Federation in the Context of Improvement of the Legal Status of Public (Municipal) Institutions'.

revenues, this hampers the implementation of a strategy of reforming the petroleum industry<sup>1</sup>.

The Gaidar Institute has developed a tax manoeuvre option with due regard for the aftermath of the crisis, the current economic environment, certain PRs' economies, and the achievement of expected reform outputs and outcomes.

Under the legislation in force<sup>2</sup>, the tax manoeuvre in 2016–2017 has the following parameters<sup>3</sup>: the calculation formula for the Russian crude oil export duty has a ratio of 0.42 for 2016 and 0.3 from 1 January 2017 onwards; the baseline rate of the crude oil extraction tax is up from 857 roubles per tonne in 2016 to 919 roubles per tonne from 1 January 2017 onwards; the rate of export duty on light refined products is 0.4 in 2016 and 0.3 from 2017 onwards; the rate of export duty on heavy refined products is 0.82 in 2016 and 1.00 from 2017 onwards. Provision is made to raise the excise duty on refined products in 2017 from 2016<sup>4</sup>.

The key parameters for the tax manoeuvre option proposed by experts of the Gaidar Institute are as follows<sup>5</sup>:

- Full and one-off scrapping of crude export customs duties while raising equivalently (US\$ per tonne in absolute terms) the crude oil extraction tax, and full scrapping of the export customs duty on refined products in 2019;
- The rate of the excise duty on refined products remains at the level of 2018;
- Introducing a lump-sum (one-off, indivisible)<sup>6</sup> subsidy to all PRs so that they can upgrade their refining facilities. The subsidy is to be cut gradually until it is fully scrapped in 2024;
- The subsidy is allocated among PRs, seeking, for the most part, to encourage a transition to manufacturing a higher-in-gasoline “basket” (including the refund for already made investments).

*Table 1* shows the dynamics of tax revenues that can be generated using the tax manoeuvre option developed by the experts of the Gaidar Institute. The Table also shows that with an exchange rate of 57.48 roubles per US dollar and with crude oil traded at \$61.70 a barrel in 2024, motor gasoline retail prices in 2019 would increase in real terms by approximately 7% from 2018 and by 16.5% in 2024, and total budget revenues in 2019 would rise 1.7 p.p. of GDP (2.5 p.p. of GDP in 2024). The net effect of the proposed tax manoeuvre option, less 1.0 p.p. in 2019 (0.0 p.p. in 2024) required for PR subsidies, and less 0.4 p.p. in 2019 (1.2 p.p. in 2024) that derive from a change in the

1 Gordeev D. Increasing excise duties disables the tax manoeuvre // Russian Economic Developments. 2016. No. 9. P. 49–53.

2 Federal Law of 24.11.2014 No. 366-FZ ‘On Amendments to Part II of the Russian Tax Code and to Certain Legal Acts of the Russian Federation’.

3 As at the date of these calculations and of this article.

4 The calculations use a numerical value of the excise duty on grade 5 motor gasoline (10 130 per tonne in 2016–2017 and 10 535 per tonne since 1 January 2018).

5 The calculation methodology for Russian refined petroleum products and crude oil is described in detail by Idrisov G.I., Sinelnikov-Murylev S.G., Crude oil export duty: Neither to be scrapped nor retained // Russian Oil Journal. No. 12, December 2011, pp. 72–77; Idrisov G.I., Sinelnikov-Murylev S.G., Modernization or conservation: The role of export duty on crude oil and refined petroleum products // Economic Policy. 2012. No. 3. P. 5–19.

6 Other types of subsidy also may be considered, like, e.g., a negative excise tax, that is, a “reversed” excise duty, a system of tax credits.

macroeconomic environment, would stay at 0.3 p.p. of GDP in 2019 and at 1.3 p.p. of GDP in 2024.

Table 1

DYNAMICS OF TAX REVENUES AS A RESULT OF FULL IMPLEMENTATION  
OF GAIDAR INSTITUTE'S TAX MANOEUVRE OPTION

		2019	2020	2021	2022	2023	2024
US dollar exchange rate	Roubles per US dollar	58.80	58.21	57.75	57.75	57.63	57.48
Crude oil price	US\$ a barrel	55.00	57.00	58.14	59.30	60.49	61.70
Crude oil export duty	as % of GDP	0.0	0.0	0.0	0.0	0.0	0.0
Refined products export duty	as % of GDP	0.0	0.0	0.0	0.0	0.0	0.0
Gasoline excise duty	as % of GDP	0.51	0.51	0.51	0.51	0.51	0.51
Crude oil extraction tax	as % of GDP	9.00	9.22	9.32	9.48	9.63	9.78
Total budget revenues	as % of GDP	9.51	9.73	9.84	9.99	10.14	10.29
Growth in total budget revenues	p.p. of GDP 2018	1.67	1.89	2.00	2.15	2.30	2.45
Change in manufacturer's tax-free oil price	% change from 2018	39.0	42.9	44.7	47.8	50.6	53.4
Change in manufacturer's tax-free gasoline price	% change from 2018	10.3	13.9	15.7	18.6	21.2	23.9
Change in gasoline retail prices	% change from 2018	7.1	9.7	10.8	12.9	14.7	16.5

**Note.** Calculations are based on 2015 prices.

*Source:* own calculations based on the data released by Central Dispatching Department of the Fuel and Energy Complex (CDU TEK), Rosstat, Russian Federal Customs Service.

Table 2

DYNAMICS OF PR SUBSIDY SIZE AND ULTIMATE IMPACT  
OF GAIDAR INSTITUTE'S TAX MANOEUVRE OPTION, BILLIONS OF ROUBLES

	2019	2020	2021	2022	2023	2024
Growth in total budget revenues, billions of roubles	1344.2	1518.7	1605.6	1731.8	1850.3	1968.6
as % of GDP	1.7	1.9	2.0	2.2	2.3	2.5
PR subsidy, billions of roubles	841.1	675.5	405.3	162.1	32.4	0.0
as % of GDP	1.0	0.8	0.5	0.2	0.0	0.0
"Evolutionary" component of growth (macro-conditions), billions of roubles	261.9	436.4	523.3	649.4	768.0	886.3
as % of GDP	0.4	0.6	0.7	0.8	1.0	1.2
Final effect of tax manoeuvre, billions of roubles	241.2	406.9	677.0	920.2	1049.9	1082.3
as % of GDP	0.3	0.5	0.8	1.2	1.3	1.3

**Note.** Calculations are based on 2015 prices.

*Source:* own calculations based on the data released by Central Dispatching Department of the Fuel and Energy Complex (CDU TEK), Rosstat, Russian Federal Customs Service.

An indicator described as the averaged value-added specific lows<sup>1</sup> of certain PRs in 2013–2015 has been introduced for the model calculation of subsidy allocation among PRs; the averaging was performed inside PR groups<sup>2</sup> that use comparable volumes of crude oil in refining (the values of PRs value added in biggest Vertically Integrated Oil Companies (VIOCs) that use more than 14,000 tonnes of crude oil annually, as well as its group-mean value,

1 Modeled as the difference between the value of the basket of manufactured refined products and the value of crude oil used..

2 The calculation is based on the 2015 commercial data released by CDU TEK.

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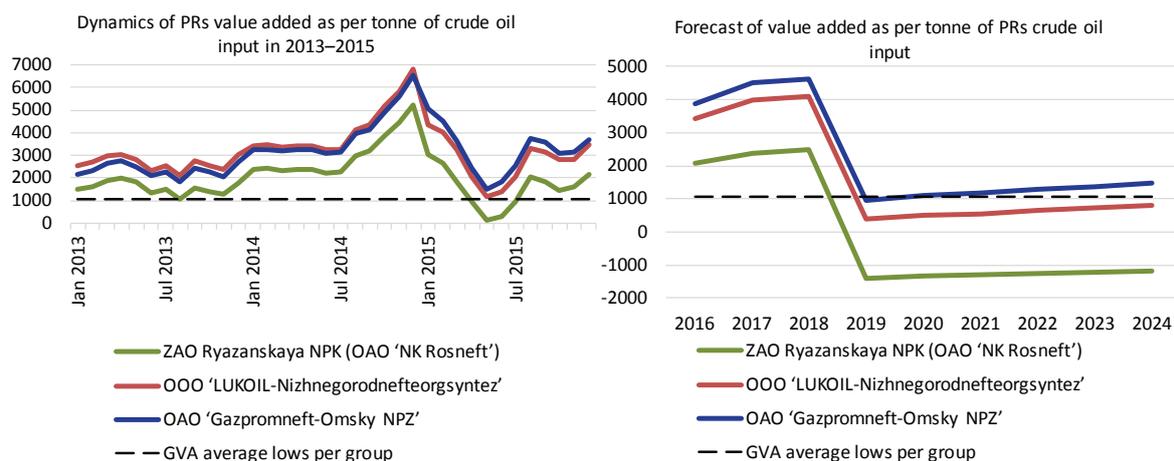


Fig. 1. Dynamics of PRs value added in 2013–2015 and the 2019–2024 forecast for proposed tax manoeuvre parameters, excluding subsidy, as per tonne of crude oil input

are presented as an example in Fig. 1). According to estimates, the value added produced by PRs that have not upgraded refining facilities while the tax manoeuvre is implemented would drop below historical lows that still enabled them to stay in business (including a possible cross-subsidization inside VIOCs). Also, Fig. 1 presents an example of value added forecasting per tonne of crude oil input produced by PRs according to the parameters of the proposed reform in 2016–2024, excluding the subsidy. It is apparent that some refineries would not be able to achieve a positive refining margin unless they upgrade their refining facilities, and therefore they will have to launch a modernization process. The subsidy for such PRs seeks to ensure that they operate in the transition period. PRs that have launched the modernization process also may be entitled to subsidy to ensure reimbursement for already made investments.

The proposed reform option will prompt PRs to upgrade, increase the oil refining depth, and expand the proportion of light fractions, or it will lead to shutting down loss making enterprises. At the same time, a lump-sum subsidy for all PRs is to be introduced to support them through the transition period after a one-off scrapping of the crude oil export duty, and to enable them to upgrade refining facilities. Even with this subsidy in place the tax manoeuvre will help generate more budget revenues from petroleum and refining industries. Another point to note is that the proposed option retains the 2018 rate of excise duty on refined products as a source of regional budget revenues. ●

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