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RUSSIAN FEDERATION
ENHANCING THE IMPACT OF PUBLIC SUPPORT TO AGRICULTURE AND RURAL SECTORS

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CURRENCY EQUVALENTS

(Exchange Rate Effective February 8, 2006)

Currency Unit	=	Russian Rubble (RR)
RR 1.00	=	US$ 0.036
US$ 1.00	=	RR 28.25

WEIGHTS AND MEASURES
Metric System

FISCAL YEAR
January 1 to December 31

ABBREVIATIONS AND ACRONYMS

AMS	Aggregate Measures of Support
EU	European Union
FDI	Foreign Direct Investment
OECD	Organization for Economic Cooperation and Development
PPBS	Performance Based Budgeting System
PSE	Producer Subsidy Equivalent
SOE	State Owned Enterprise
SUE	State Unitary Enterprise
WTO	World Trade Organization

Vice President	Shigeo Katsu
Country Director	Kristalina Georgieva
Sector Manager	Marjory-Anne Bromhead
Task Team Leader	Iain Shuker and Bekzod Shamsiev

Tables, Figures and Boxes:

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This study was prepared as a contribution to the policy dialogue of the World Bank with the Russian Federation Ministry of Agriculture (RF MOA). The Ministry wanted to receive Bank's recommendation on the budget support to agriculture on the Federal, regional and local levels. Five pilot regions were selected by the RF MOA (Belgorod Oblast, Rostov Oblast, Oryol Oblast, Leningrad Oblast, and Republic of Mordovia) to analyze the current practice of budget support, discuss the findings with the regional authorities and provide guidance to make this support more efficient.

The Report was prepared by the WB's team comprising of Bekzod Shamsiev (TTL), Iain Shuker (former TTL), and Vera Matusevich (who was primary in charge of pilots). The Sector Leader responsible for the task is Marjory-Anne Bromhead. The study was compiled on the basis of information and findings assembled with the assistance of the RF MOA, leadership of pilot regions and Russian scientific community. Background information was provided by the Center for Fiscal Policy and the Institute for the Economy in Transition (special thanks to Ms. Serova and Ms. Shick).

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Executive Summary

Much has been achieved in recent years, especially by the Federal government, in promoting polices that will underpin in a sustainable manner the development of Russia's agricultural and rural sectors. This report is designed to build on these achievements and to support the further reforms that are necessary. Taken together, the report's recommendations offer a multi-faceted response that is needed for an effective public support structure for agriculture and rural area development in Russia. On the policy side, a concerted effort of the Ministries of Agriculture and Economic Development and Trade is needed to design more efficient support systems, underpinned by more effective provision of public services and an appropriate division of federal-regional and public-private responsibilities. Within the public sector continued efforts are needed to improve budget processes and classification, including a gradual shift towards performance-based budgeting. Greater attention to a broad array of factors that affect the profitability of primary agriculture, continued rationalization of public institutions and transfer of social responsibilities from agricultural enterprises to local municipalities will all contribute to this process.

Challenges of Agriculture and Rural Sector Support

Russian agricultural output grew strongly after the devaluation of 1998, with annual growth rates of 7%-8% in 2000 and 2001. Slower growth (2%-3% per annum) then characterized performance from 2002-2005 as underlying structural constraints re-asserted their influence. The production of grains, sugar beet and sunflower have expanded significantly since 2000, driving most of the aggregate growth in agriculture despite a reduction in the acreage devoted to these crops. Crop production accounted for 55% of total output in 2004 and grew in aggregate. Oilseeds and cereals are bulk commodities in which Russia appears to have a comparative advantage. The livestock sector continued to decline, however, particularly in cattle, pig and sheep production. These trends are consistent with the low and/or negative levels of profitability of livestock production, limited comparative advantage and the predominance of livestock farms among loss-making agricultural enterprises.

Russia faces unique challenges in framing appropriate agriculture and rural sector policies. Russia is unique amongst transition economies because of its large size, its federal structure, its large variation in agro-ecological conditions and hence agricultural production conditions and patterns. Another important feature of the Russian transition has been the persistent structural inefficiencies which have had an adverse impact on farm level profitability. These include: an under-developed banking sector; a highly deficient marketing system; and a slow pace of re-structuring of large farm enterprises. In particular, the traditional requirement for agricultural enterprises to provide social services in rural areas hinders their ability to perform their commercial mandate in the transition. As agricultural enterprises are run on a more commercial basis, they are expected to shed labor and reduce the provision of these social services. These conditions create important social challenges during the transition.

While the objectives the Ministry of Economic Development and Trade and the Ministry of Agriculture constitute an enlightened departure from older positions, the perspectives of both ministries conflict on certain fundamentals. While the broad goals of these two mentioned programs are similar, the objectives of the Ministry of Economic Development and Trade emphasize market development, the provision of support to the poor, the funding of human and institutional development programs and the protection of property rights. Until quite recently, the programs of the Ministry of Agriculture focused almost exclusively on supporting agricultural production. It is much welcomed that more recent publications of the Ministry of Agriculture, while still being highly

focused on production issues, do raise strategic issues concerning rural development. The challenge now will be to ensure that this important and significant change in strategic direction translates into increased budget allocations for rural development with an associated reduced emphasis on direct production support, and increased coordination with the programs of the Ministry of Economy.

Public expenditure on the agricultural and rural sectors is roughly in line with OECD levels and trends, therefore the main focus in the medium term should be on the nature or structure of policy interventions rather than on the level of public expenditure. When account is taken of extensive off-budget expenditures and generous tax exemptions, the level of public expenditure support in agriculture in Russia is in line with the level of expenditure that prevails internationally. However, new measures need to be devised to address the serious structural deficiencies that afflict the development of the agricultural sector. Priority should be assigned to developing a modern and efficient marketing system; the development of a competitive credit-supply industry; the enhancement of farm re-structuring; and the attraction of capital investment into the sector. The balance of program expenditures should progressively move away from market-distorting measures (those which directly subsidize input use and output production) towards measures that underpin the long-run productivity and competitiveness of the sector and rural development programs. These include support for investments in both public goods (e.g., research, infrastructure, social and environmental services), and in some cases direct farm investments through transparently managed, competitive programs. The need for reforms of this character has been well appreciated by the federal administration; however, the same appreciation is not apparent at the oblast level.

There is substantial scope for improving the efficiency of public expenditures and improving the design of individual support programs. Changes in the budgeting and expenditure system will bring about significant improvement in budget discipline. A greater emphasis on public-good-type subsidies coupled with stronger management of public resources can enhance the value obtained for public funds and will release much needed resources that can address aspects of the public policy agenda that are presently only being inadequately funded and in some cases, not at all. The scope for such improvements is substantial, especially at regional level.

Bolstering Support Programs Most Relevant to the Objectives of Public Support

A. Enhancing Delivery of Public Goods

An important thrust of policy in the future should be support for the economic and social development of rural areas, as opposed to the current focus on production subsidies. While important reforms have taken place along these lines at the federal level, the reform agenda has not yet been completed, and in the case of some regional policy, much remains to be done. Subsidies on inputs and outputs are generally not very cost-effective means of increasing rural incomes. A study of these policies in OECD countries indicated that of every dollar given in this kind of subsidy, only about $0.25 ends up in farmers' pockets, with the rest going to administrative costs, input providers, and increased land rents. They also encourage farmers to over-use subsidized inputs (sometimes with adverse environmental consequences) and to focus too much on producing things they cannot produce competitively and too little on those products they can produce more efficiently. The priority should instead be investment in public infrastructure with some positive externalities such as transport, telecommunications and energy supplies. These investments increase competitiveness of agricultural production and create an enabling environment for private-sector investment to thrive and create employment. The Federal Targeted Program for the Social Development of Rural Areas until 2010 provides direct support for public investments in rural areas that is not tied to agricultural enterprises. However, given the large number of critical social and service issues in rural areas the

extent of program expenditure should be expanded, especially on expenditures linked to employment creation.

Enhancing the research and training function is justified on both efficiency and value for money grounds. Basic research creates benefits for all, the full value of which cannot be captured by the researcher, and so is deserving of public support. Extension services can have positive externalities through their demonstration effect for other farmers. International evidence strongly emphasizes the contribution that an effective research and training function can make in underpinning long-run productivity and competitiveness. An overview of many studies of the impact of agricultural research expenditures in developing and developed countries estimated a median rate of return on investments of around 45%. Russia's agricultural research and education systems have excess capacity in terms of physical infrastructure, land and research staff relative to their operational budgets. As a result, the quantity and quality of research and training being produced is low relative to the public expenditure outlays. The efficiency of the research and training system could be enhanced by minimizing the level of core budget transfers to educational and research institutions and increasing the extent of competitive grant programs. Successful competitive grant programs for agricultural research and extension services have been established in many former Soviet countries, as well as other industrialized and developing countries. .

OECD countries that have comparable public expenditure outlays on agriculture and rural development tend to devote more public resources to areas aimed at specific policy objectives, such as environmental measures, food safety and hygiene and general information provision. Other programs, such as some types of animal health services (especially those aimed at preventing epidemics), other than measures that subsidize current inputs, are justifiable as public-good interventions and the real level of spending should be increased in Russia.

B. Reforming Market Intervention Instruments

Minimal Federal grain market stabilization programs are justifiable; however, improvements in implementation are needed to enhance efficiency. Given the current underdevelopment of the markets and resulting large variations in both inter-seasonal and intra-seasonal farm gate prices for grain and the extensive regional differences in grain markets, the existence of a temporary federal management stabilization program may in principle be justifiable in the short run, at least when markets are subject to substantial disequilibria. However, despite positive developments at federal level, there is room for improvement in the implementation of the program, especially at the regional level. The efficiency of the federal price-stabilization program would benefit considerably from the implementation of a number of features designed to enhance both the transparency and predictability of the system. Furthermore, in order for Federal market interventions to work effectively, it is important that regional price intervention programs, which range from creation of regional grain purchasing monopolies to grain export bans, should be outlawed or strongly regulated. It is also important to recognize that the long-run solution to price instability is development of a private market for storage. Experience suggests that operations of government-run stabilization schemes tends to discourage the development of this market when the government programs are unpredictable and when they stabilize prices too much. Operation of the Russia system should be carried out under clear rules designed to avoid these pitfalls.

While interest rate subsidy programs are preferable to traditional forms of credit support, a greater attention should be given to the development of alternative mechanisms for provision of rural credit. Under the current circumstances in Russia, where the banking sector is under developed and the agricultural sector is undercapitalized, the subsidization of interest rates through the commercial banking system is probably the most efficient approach to recapitalizing agriculture

and encouraging commercial bank lending to the sector. In the longer run, however, interest rate subsidies will lead to overcapitalization of the sector. The longer-term solution should be to focus on increasing the supply of credit by developing lending institutions that lend to agriculture and, more broadly, provide a range of financial services to rural areas. The proposed World Bank Project on Rural Microfinance will assist the Ministries of Agriculture and Finance to establish a financially integrated (multi-tier) system of financial cooperatives through technical assistance, institution building, various financial services, and infrastructure support; and to integrate the microfinance industry into the overall financial system of the country, through fostering links with partner banks, insurance companies and/or municipal funds.

Programs supporting the leasing of agricultural machinery and equipment require urgent reform. In the absence of a well-developed banking sector a variety of *ad hoc* responses that facilitate the fulfillment of the sector's capital needs have understandably emerged. Among the more significant, and unfortunately most worrisome of these on efficiency grounds, have involved leasing arrangements for agricultural machinery and equipment. The principal beneficiaries of this scheme have been the producers of machinery and equipment rather than agricultural producers who were the intended beneficiaries of the policy. Moreover, the allocation process for machinery leases is not transparent and is open to corruption. The Federal government should phase out this program and allow more competition in agricultural machinery leasing and distribution businesses. Improving the country's leasing laws together with circumscribing the role of the regions in leasing arrangements would also improve the viability of commercial leasing.

The Federal program for subsidizing agricultural insurance requires fundamental reform. Most developed countries subsidize agricultural insurance. Governments consider subsidies on insurance premia to have some public good characteristics because they reduce both the private and public cost of bankruptcy. There is also a sound fiscal reason for supporting premium rate subsidies because they encourage the wider use of insurance, and as a result reduce the government cost of disaster relief. However, despite the best efforts of the federal government, and notwithstanding the significant and growing amounts that have been spent on subsidizing premia, it is still faced with high levels of emergency payments, and there is a low level of insurance coverage. Russia can benefit from a number of successful international practices that offer a more sustainable alternative to the traditional multiple-peril crop insurance, which compensates each farmer for his individual losses. This type of insurance is expensive to administer and undermines farmers' incentives to take sufficient care to minimize losses. It also provides easy excuses to insurance companies to avoid payouts. Better practices include weather index insurance schemes, through which a simple pay-out is made to all policy-holders based on measurements of weather parameters or area-based yields.

C. Strengthening Budget Discipline

Non-transparent tax expenditures are significant in scale and distortionary in their impact. Both Federal and Regional Governments provide significant amounts of indirect support to the agricultural sector through the application of differential tax rates for agricultural enterprises. Some of these tax expenditures could be justified as transitional measures to encourage capital investment in the agriculture sector which has suffered from years of under capitalization. However, tax expenditures lack transparency and impair sound budgetary discipline. Rather than the State provide tax breaks to agriculture on a blanket basis, it would be more efficient to allow cost deductions for specific capital investments rather than all expenditures. In time the tax rates that apply in the sector should be adjusted in line with other industries.

Periodic debt restructuring have resulted in looser financial discipline and created substantial contingent claims on the Budget. A major source of effective subsidy with consequential significant public expenditure implications in Russia in the past has been the periodic bailout of bankrupt agricultural enterprises. The build-up of debt at the farm level therefore creates a contingent liability for the Government that is not reflected in the regular budgetary process. This periodic debt restructuring typically rewarded the worst defaulters. The Federal Law "On Financial Recovery of Agricultural Commodity Producers" that came into effect in June 2002 is a welcome and significant improvement over earlier debt write-off programs in that it required that the debtors to undertake some financial restructuring before becoming eligible for debt relief. Period debt restructuring, while essential in crisis situations, should be used only in the most exceptional of circumstances. In order to avoid unsustainable debt accumulation at the farm level and the contingent liability that this creates for both Federal and Regional governments, the underlying problem of the financial vulnerability of many agricultural enterprises should be addressed in a more fundamental way by addressing those factors that adversely affect the profitability of the agricultural sector, and large corporate farms in particular.

Strengthening the Management of Support Programs

A. Revising Functional Responsibilities between Federal and Regional Governments is Required

Contrary to best international practice Russia has opted to decentralize the operation of producer supports and to centralize the delivery of general services. The policy of the Federal government is to decentralize both the funding and management of producer supports to regional governments and to centralize the funding and management of general services support, such as veterinary services, etc. This is counter to trends in most OECD countries. Agricultural market support programs, such as grain support programs, are usually managed and financed centrally to ensure policy uniformity at the producer level. Otherwise, subsidies tend to create large price differences (inputs or outputs) among regions. This in turn creates incentives for the inputs and outputs to be taken from the regions in which they are cheap (subsidized) and re-sold in other regions. The government of the region providing the subsidies may react by trying to control the purchase or transport of these products, which fragments the national market. The federal government has a clear interest in seeing that the national market remains unified, and one element in its strategy to meet this objective should be to prohibit or strongly discourage subsidy programs on the regional level. On the other hand, the implementation of general services support, such as veterinary controls, is normally decentralized in order to bring the management of these services closer– and thereby make them more responsive -- to the service recipients. (Funding may or may not remain centralized. Under the non-centralized funding model, some form of compensation – preferably as a lump sum "block grant" -- can be transferred to the regions from the federal budget.) The recent reform of the EU's Common Agricultural Policy contains a framework for the determination of the roles of the centre and individual member states in both the funding and implementation of policy. A similar framework could be adopted in the context of the Russian Federation.

As a result, positive developments in the structure of producer supports at Federal level are offset by negative tendencies at regional level. The Federal government has made important strides in rationalizing the application of policy interventions that interfere with the performance of markets. In contrast with the broadly positive trends at federal government level, however, regional governments retain many highly distorting policies. Evidence suggests that as a result of these policies, trade is highly distorted both across regions and products because of input subsidies, in particular, and regional trade barriers. Policy making and funding for agricultural producer support

programs should be the exclusive responsibility of the federal government. For general services provision, the implementation should be decentralized, under clear national standards and earmarked federal level funding. The autonomy that regional and local governments currently enjoy in policy formulation and implementation needs to be gradually eliminated. Regional and local governments should eventually have no role in the design or implementation of measures that could potentially distort the performance of markets and prevent the emergence of a common single market. The delivery of key services such as education, training, marketing supports should, however, be confined to regional and local government agencies, with perhaps some general guidelines and budget support provided from the center. In determining the appropriate balance between the roles of the Federal and regional governments much can be learned from other countries with federal systems such as the USA, Canada and also the EU.

B. Improving Budget Processes and Classification

The policy-making process should be more closely tied to the budgeting process. This could be achieved by moving to a multi-year budget planning process and by making the budgets for Federal Targeted Programs binding on the annual budget process. This alignment of policy with budget commitments should be a key feature of the proposed Agriculture Law. The current budget classification system should be revised to provide a more balanced and inclusive set of line items that better match the Government's current policy instruments, and which allow easy classification for WTO purposes. In order to meet the requirements of WTO and achieve better coordination of Regional and Federal policies and expenditures, the same budgeting and monitoring system and system of budget classification should be used at both the Federal and Regional level. A comprehensive study should be carried out at both the Federal and Regional level to develop a new set of classifiers.

The basic budgeting, accounting and monitoring system should be overhauled before a PBBS can be successfully implemented. The successful implementation of PBBS in Russia will involve fundamental changes in the entire budgeting and expenditure system. The main lessons from the international experience are that PBBS requires a high level of public disclosure and transparency for it to work effectively. Implementation of a full-blown PBBS is a very-long term objective. In the immediate and short term, focus should be on the implementation of more basic improvements in information gathering and reporting. The current budget management and reporting system does not yield the level of information or controls required to measure the efficiency or effectiveness of public expenditure. The budget allocation process and the resulting allocation are also not transparent. Finally, improvements are needed in the auditing system and, in accordance with best-international auditing practice, all reports should be made available for public scrutiny.

C. Improving Efficiency of Public Good Provision

The Federal Government has reorganized, or is in the process of reorganizing, many of the subordinate organizations that are responsible for the provision of public services with a view to rendering their delivery more efficient and effective. It is particularly to be commended that the Federal government has privatized many commercial functions that were formally managed by government, but further improvements along these promising lines are still needed. Further enhanced efficiencies and effectiveness in the delivery of public programs will require a clear determination of whether the services provided are of a public-good nature or whether they could just as effectively be provided by the private sector. This determination should be made keeping in mind that even goods and services with externalities or some public goods character may be most efficiently produced by

the private sector, but with government subsidies or on a contract basis. Conflicts between commercial and regulatory mandates will thus need to be clarified. Commercial activities of government agencies that conflict with their regulatory functions should be curtailed. Commercial activities that do not provide a public service should be removed from the mandates of government agencies and consideration should be given to their ultimate privatization.

The following key elements are recommended in the restructuring of public institutions that supply public services: i) clearly defined performance standards for the provision of public services should be developed and agreed as part of the annual budget review process and in order to inform the justification for budgets provided; and ii) annual audits of the financial and service standards should also be carried out. Where appropriate, in the case of those agencies that provide public services or implement policies on behalf of the government, legislation should be developed to enhance reporting requirements, conduct independent audit and to ensure public disclosure of financial information and services provided.

The concern at present is that very little information on revenues, expenditures and the services provided by government agencies that collect fees for providing public services is reported back to government, and almost nothing is available for public review. In general, the quality of services that are supplied by agencies, which are part funded by revenues generated from their fee-collecting activities, should be subject to the same level of regulation and monitoring as directly-budgeted expenditures. An appropriate arrangement would involve the accumulation of all fee revenues in a treasury account, accounted for by the Ministry of Finance. All or part of the funds would be released back to the agencies to cover expenditures based on agreed arrangements with the Ministry. The government should regulate both the fee structure and the service standards for public services. Regulation should involve *inter alia*: an annual operating budget and schedule of fees approved by the responsible government agency on an annual basis; the development and enforcement of a standard procedure that requires that agencies report all fee income and expenditures to the Ministry of Finance and the Main Budget Agency to which they are subordinated; that the financial operation and performance of standards should be audited by an independent auditor; and, all information concerning these agencies should be made public.

Issues for the Next Decade

Russia could benefit from the enactment of a general agriculture law that would frame the broad policy agenda and ensure a clear connectivity with its funding. This legislative framework should define the government's intentions, with a particular focus on parameters under which regional Governments could set agricultural policy and delineate the areas of responsibility appropriate to the Federal and regional governments and rationalize public service delivery. This should inform the tenor of policy measures to be enshrined in the Strategic Plan that would incorporate a 10-year Public Infrastructure Investment Plan for rural areas. Some policy reforms can be introduced now such as the phased removal of all policies that distort markets and development of programs which support delivery of rural public goods and which enhance on-farm competitiveness. This process can begin in the next marketing year. Developing a modern marketing system is a priority but it will take several years to implement. Leasing and credit market reforms are also essential medium-term reforms which should be realized before all market support measures are removed. Government may wish to consider a range of options for responsibility for development of rural areas, which take into account social, economic and environmental management responsibilities, as well as the broader directions for administrative

reform. Sequencing of these administrative reforms should go in hand with divesting the burden of delivery of social services in rural areas from agricultural enterprises.

CHAPTER 1

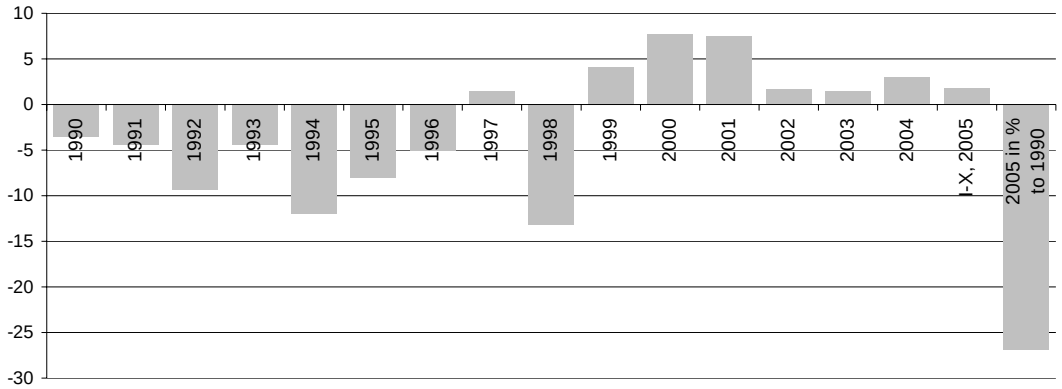
I. Recent Trends in Russian Agricultural Production and Policy

Russian agricultural output grew strongly after the devaluation of 1998, with annual growth rates of 7%-8% in 2000 and 2001. Slower growth (2%-3% per annum) then characterized performance from 2002-2005 as underlying structural constraints re-asserted their influence. Trade, price and subsidy policies created major distortions and impeded sector growth. Agricultural enterprises grew slightly faster than private farms from 2000 to 2004 due possibly to the slow but continuous liquidation of unprofitable farms and the transfer of their assets to more efficient enterprises. The composition of budget support has changed steadily since 2000, with regional governments' now funding more than half of total budget expenditure. This exacerbates regional policy differences. Together with numerous regional barriers to trade, these differences lead to distorted patterns of regional production and trade – to the detriment of the overall performance of the sector.

1.1 Trends in Agricultural Output

Between 1990 and 1998, with the exception of 1997, gross agricultural output fell each year (Figure 1). Over the period of the 1990s agricultural production in Russia fell by almost 40%, whereas employment in agricultural sector remained practically unchanged. For the vast majority of rural workers adjustment to the strictures of transition has been through reduced labor utilization and wages rather than through unemployment. Consequently a great swathe of the rural population is effectively underemployed, labor productivity suffered significantly, translating into falling wages . The reduction in wages has been offset by the intensive cultivation of their household plots. Following the 1998 crisis output became to grow again and reached an annual rate of increase of about 8% in 2000 and 2001. However, since then output growth has fallen to less than 2% per annum.

Figure 1: Annual Rate of Change in Gross Agricultural Output (%) in Russia, 1990-2005



Source: RosStat, www.gks.ru

The production of grains, sugar beet and sunflower have expanded significantly since 2000, driving most of the aggregate growth in agriculture despite a reduction in the acreage devoted to these crops. Crop production accounted for 55% of total output in 2004 and grew in aggregate. Oilseeds and cereals are bulk commodities in which Russia appears to have a comparative advantage. The livestock sector continued to decline, however, particularly in cattle, pig and sheep production. These trends are consistent with the low and/or negative levels of profitability

of livestock production, limited comparative advantage and the predominance of livestock farms among loss-making agricultural enterprises.

1.2 The Food Industry

The trends in the main sectors of food production largely track the performance of the corresponding primary sectors. Production of more processed foods (sausages, vegetable oil, macaroni) has increased rapidly since 2000 with slower increases in dairy and cereal products and a fall in sugar production. This may reflect continued growth in consumer incomes and a consequent shift to more highly-processed food products. Meat and dairy production has also been affected by declining domestic production and increased reliance on more expensive imported raw materials. Trade policies have compounded this problem, for example for meat processors when a tariff quota regime on raw meat in 2001 was imposed which left processed meat unprotected.

The recovery in incomes from 1999 onwards has led to a slower increasing demand for food staples and faster growing demand for foods with relatively higher income-demand elasticity such as meat and dairy products. On the supply side, there would appear to have been an improvement in the overall level of efficiency as the growth in production has been significantly in excess of the growth in employment. Increased productivity in agro-processing appears to be a combined result of improved capacity utilization in existing plants and recent (domestic and foreign) investments in modern, efficient firms. On the other hand, in the aggregate the level of underinvestment is still quite high as evidenced by the rate of depreciation that has remained virtually unchanged since the mid 1990s.

The food-processing sector appears to be undergoing a gradual transformation in response to the increasing competition caused by a relatively open trade policy and FDI policy, changing patterns of consumer demand, and changes in the prices and sources of raw materials. Privatization was largely completed by 2000, and state ownership accounted for only 1.4% of the industry in 2005. The number of functioning enterprises fell slightly (by 8%) from 2000 to 2004, and employment by 5%; but it is unclear what impact this has had on productivity.

1.3 Foreign Trade

In recent years the process of Russia's food sector integration in the global economy has intensified and the country is becoming an active player on a number of food markets. The volume of food exports has expanded significantly in the case of wheat, bread products and chocolate items. Exports of sunflower oil, which were depressed in 2002 and 2003, have recovered since and now stand at about their 2000 levels. Food imports have increased in many areas but especially in meat products and butter. Imports of wheat and sugar have fallen substantially between 2000 and 2005. Imports of sunflower oil have been relatively unchanged over the same period.

Tariffs are relatively moderate, 10%-20%, but a plethora of import and export licenses create more severe barriers to trade. The most severe current tariff restrictions are a tariff quota regime imposed on raw meat in 2001, as noted above; and a 20% export tariff imposed on sunflower seed in 2003. Both are regressive policies. The meat tariff quotas represent a desire to promote import-substitution for a commodity in which Russia has no clear comparative advantage while the

export tariff on sunflower seed is a disincentive to export a commodity in which Russia does have a comparative advantage.
Overall trade protection is likely to increase as a result of Russia's request for WTO membership. Like many candidates, measures are already being considered to raise current protection in order to establish a higher base for the assessment of bound tariff levels. The ultimate impact of any increase in protection is unclear however. Analysis shows that for many commodities and many regions, Russia's huge expanse and high consequent transport and transactions costs, account for a far greater proportion of the gap between domestic and border prices than tariff levels.

II. An Overview of Agriculture in Russia's Regions

Russia's enormous scale and diversity of soil and climatic conditions, together with a great diversity of historical experience and achievement means that there are wide contrasts in the nature of agriculture, food and rural development across its regions. Here we present a synopsis of the features of the Agri-Industrial Complex (AIC) in five selected regions: Belgorod, Leningrad, Mordovia, Oryol and Rostov. In Annex 2 we look in some detail at the role, performance and policy environment of the AIC in these regions.

2.1 Belgorod Oblast

Agriculture accounts for about 14 percent of the gross regional product and accounts for 20 percent of jobs in the region. The structure of production comprises 346 agricultural enterprises and 2,007 private household farms. Over 60% of the region's agricultural land is devoted to crop production. The region produces 15 percent of Russia's sugar supply, 10 percent of its vegetable oil, 4 percent of its butter output and a large share of the Federation's milk and meat. The physical volume of agricultural output for both crop and livestock production grew significantly between 1999 and 2003.

Private farms account for 2.8% of agricultural output enterprises, household plots for 43% and agricultural associations account for about 54%. The number and share of loss-making agricultural organizations has been diminishing in recent years and the overall sector was in profit in 2004. Only the production of cattle was loss making. The production of sunflower seed, grain and eggs remained highly profitable.

2.2 Leningrad Oblast

The Leningrad Oblast is one of the leading agricultural regions of Russia. Agriculture accounts for about 12 percent of the gross regional product compared with the average share for Russia of 5.2 percent (2003). The agricultural population decreased steadily throughout the 1990s down to 557,000 in 2004. The share of employment in agriculture is half that in industry.

Poultry and dairy production are the leading agricultural sectors. In terms of the productivity level of egg farming (307 eggs per laying fowl) the Leningrad Oblast has caught up with developed economies, and in terms of cow milk productivity (about 6 tons per cow) it is getting close. Potato and vegetable production is declining. The grain harvest is not growing and the sector's development trends are unstable. Milk production has also been decreasing in recent years, while eggs production remains at roughly the same level.

Large agricultural organizations are the principal producers of farm produce in the region. In 2004 they accounted for 63.6 percent of gross agricultural output. During the first years of reforms their share in gross production decreased from 76 percent in 1991 to 43 percent in 1997, but then recovered. Agricultural organizations use 77.4 percent of the farmland and are the main producers of grain (over 90 percent); they also account for a major part of livestock production. The more profitable sectors in the oblast are eggs and milk production. All meat production is loss-making, with the worst losers being beef (profit margins of - 45 percent) and poultry (profit margin of - 10 percent).

2.3 Republic of Mordovia

The share of agriculture in GDP stands 21%. The proportion of the rural population in the Republic of Mordovia is 40.6%. Both the proportion and numbers of rural population in the Republic are steadily declining. a Gross *per capita* regional product is almost twice lower than the average for the Federation. Growth rates for this indicator are also below the national average. The level and growth rate of the average monthly wage in the Republic lags behind national performance.

The volume of agricultural produce has been rising at a relatively modest rate over the last few years. Private farms and household plots account for nearly two-thirds of total agricultural output. In 2002 94% of the grain output came from agricultural enterprises, while 97% of potatoes and 58% of livestock and poultry from private plots. In 2004 agricultural enterprises produced 44% of all meat and 46% of milk. Notably, agricultural enterprises produce less milk and livestock and poultry meat than do the private plots. Yet the bulk of support from the oblast budget is funneled into the agricultural enterprises. The number of loss-making agricultural enterprises in the last few years has been decreasing (from 172 in 2002 to 150 in 2004), but their proportion (37%) remains high, considering the significant level of support for agricultural production in the region. Their indebtedness stood at 4.7 billion rubles in 2004.

2.4 Oryol Oblast

The AIC accounts for over 30 percent of the gross regional product and about 33 percent of the total work force. The main agricultural products are grains, sugar beet, potatoes, vegetables, oilseeds, meat, milk, pedigree seeds and cattle. While all production organizations have experienced a reduction in output between 2000 and 2003, the best growth performance was achieved by household plots. With the exception of grains and vegetables the output of crops has been in decline between 2000 and 2004. The output performance of livestock products is similarly unimpressive with only poultry production exhibiting upward growth over the same period.

In excess of 50% of total agricultural output is produced on household plots. The contribution of agricultural organizations has been in steady decline since 2000 and while private farms only accounted for 9% of total output in 2000, this was a trebling of the production share relative to 2000.

2.5 Rostov Oblast

The share of agriculture in the region's GDP is 16 percent (2003). The numbers employed in the sector have more than halved between 1990 and 2003. The region's rich black soils results in crops accounting for more than 60 percent of gross product of agriculture in the region. Rostov is Russia's second biggest grain-producing region. Sunflower is the leading industrial crop and the region accounts for more than 20 percent of Russia's total sunflower seed output. This makes Rostov the premier sunflower-growing region in the country. Production volumes have grown steadily since 1999, except for 2003 which was an exceptionally poor year for grain production, on all farms. However the most outstanding production trends were achieved by agricultural organizations and household plots. The production trends for individual crops have all been outstanding (ranging from 150% for grains to 70% for vegetables between 1999 and 2004) while livestock production has been relatively static in contrast (ranging from 34% for eggs to 14% for milk).

Private farms accounted for 11 percent of agricultural output in 2004 which is higher than the country's average. The number of private farms has tended to decrease, while the average size of their land plots has tended to grow. Household plots contributed about 40% of total output in 2004, although this represents a significant decline since 1999 when it stood at over 57%. Household plots tend to concentrate on the intensive activities such as potatoes, milk and poultry while the large agricultural organizations tend to be dominant in the production of grain. On the whole, agricultural production in the Rostov Oblast has been profitable, mostly due to crop growing, while sales of livestock produce in the region have been unprofitable, notwithstanding subsidies from the budget. Agricultural enterprises in the region tend to be more financially robust with fewer loss-making entities than in Russia as a whole.

III. Overview of Key Agricultural Policy Developments

At the federal level there has been no administrative regulation of prices on agricultural products and foods, although proposals to limit distribution markups on bread have been repeatedly submitted to the State Duma. At regional level, however, such regulation is widespread. The control of food prices is driven by price, margin and distribution controls on numerous food commodities. As these policies are imposed at regional level, with varying degrees of effectiveness, it is unclear what their overall impact is on price transmission and consumer demand. Regional producer and consumer prices are further distorted by regional government acquisition and disposal of agricultural commodities for food stocks. Milk production appears to be the major focus of producer subsidies, consistent with government’s apparent desire to support a weakly competitive dairy sector. Input subsidies are paid for fertilizer, credit (interest rates), and machinery - although the credit and machinery subsidies are typically off-budget funded items that are transferred via state and regionally-owned financial institutions. Further implicit subsidies are incurred through publicly-funded loans to loss-making agricultural enterprises -and eventual write-off of these loans.

In the Republic of Kalmykia, for example, limitation on a distribution markup is set for the sales of majority of domestically-produced food items (meat products, dairy products, butter and sunflower oil, eggs, sugar, bread, groats and macaroni, fruit and vegetables). Similar measures prevail in Kurskaya Oblast, and in the Northern Osetia. In the Ivanovskaya Oblast profit caps control prices for organizations using agricultural commodities provided from the regional food fund to produce dairy foods, meat products, margarine, eggs, flour, groats and macaroni. In Krasnodarskiy Krai, through limiting the distribution markup, setting marginal retail prices and capping profitability, prices on selected varieties of loaf bread made of grade one flour were regulated. Tambovskaya Oblast has set a limitation on a distribution markup, as well as on

profitability level for local enterprises that produce dairy products, sunflower oil, eggs, sugar, flour, bread, macaroni and semolina.

3.1 Import Quotas

In 1998 the country introduced a sugar import quota and in 2003 this has been replaced with tariff regulation. In 2003, Russia introduced import quotas on meat (a tariff quota on beef and pork and an absolute quota on poultry meat). At the same time a decline in raw meat imports was accompanied by increasing imports of finished meat products, especially from the CIS.

3.2 Export Licensing

Devaluation of the ruble in August 1998 created favorable conditions for Russian exporters and led to the re-introduction of export duties on key traditional food exports by the authorities to stem a rapid expansion of food exports. Prior to 2002, licensing existed for the export of sunflower seeds, rapeseed and soy beans and at present licenses are required for exports of fish, crustaceans and spirituous liquor. In early 2004, for the first time since the beginning of reforms, the Government introduced temporary export duties on rye and wheat in an attempt to contain exports and increases in domestic bread prices.

3.3 Food Stock Procurement

The formation of regional food stocks also often results in the disruption of a single market and thus distorts inter-regional trade. The stocks are created and managed by state-controlled organizations and usually known as "Regional Food Funds" (RFFs) or "Food Corporations". These organizations invariably receive interest-free loans from the regional budget from budget lines that are not directly linked to their activities. Hence, their existence also impairs the efficiency of the public expenditure system. The procurement of food supplies is often associated with commodity-based lending and distortions in both the in-kind prices paid for products and charged for inputs are pervasive.

3.4 Administrative Barriers to Regional Trade

Non-tariff internal trade barriers that are highly non-transparent comprise internal taxes and charges, public procurement and product component requirements. In recent years the use of technical barriers has intensified. In 1999 and 2000 the government identified a list of ports and customs points through which poultry meat imports were permitted. In addition, Russia has introduced bans on meat imports, and more recently wine and mineral water, from other countries on health grounds. Trade is also disrupted by unfair competitive practices in some of the regions. An example is in the Tomskaya Oblast, which as a donor region, can afford higher subsidies for its poultry farming and consequently virtually all major producers of poultry products in Siberia are effectively insulated from competitive forces.

3.5 Poorly Developed Market Infrastructure

The emergence of a competitive and effective market infrastructure is hampered by the existence of government-supported institutions. At federal level organizations such as, RosAgroLeasing and RosSelKhozBank, have been created, which receive free resources from the budget to intervene on the market and can crowd-out the development of the private sector. Similar organizations operate at the regional level and engage in such activities as machinery leasing, consulting, procurement of supplies for RFFs, etc. These organizations also are subject to only

minimal regulation. It is encouraging, however, that, albeit at a very slow pace, market-based trading mechanisms are being developed. These exchanges are being developed in many cases by the RFF's organizations.

IV. The Structure of Agriculture and Land Reform

Russia's agricultural production is highly concentrated. Ten percent of agricultural enterprises account for more than half of the sector's grain production. The ten largest agricultural enterprises account for almost 3% of total sales. Prior to the 1998 crisis, the top hundred grain-producing companies supplied 4% of total sales; after the crisis they contributed 8%. In the case of sugar beet, the corresponding concentration rates are 15% before the crisis and 20% afterwards. Concentration is even more pronounced in the case of livestock production. In poultry production the top 50 companies produced 15% of total sales before 1998 but today they produce more than half. Similarly the top 100 pig producers supplied 22% of total sales and today their contribution is over 50%. These enterprises are generally financially stable and economically efficient. At the same time there is a large group of highly unprofitable and inefficient enterprises that are maintained in existence by state support for political and social reasons. This group is however gradually shrinking in size as market forces come to increasingly dictate the adjustment process.

Key features of structural adjustment in the sector are shown in Table 1.1. As with all of the transition countries the most striking structural characteristic is the apparent exceptional productivity levels of the household farm sector. The latter accounts for over 51% of the output of the Federation but only a little over 5% of the land area. The average farm size is only about quarter of a hectare. Agricultural organizations, on the other hand, account for just over 43% of the output of the entire sector but 84% of the land area. The average farm size of this sub-sector has declined from about 5,700 hectares in 2000 to about 5,200 in 2004. This level of farm operation is exceptional and on the face of it highly inefficient. The private farm sector, while still only of marginal significance in terms of its contribution to output, has been the most dynamic of the sub-sectors, both in terms of its increased contribution to output and the growth in its average farm size.

Numerous subsidies have slowed the shedding of loss-making enterprises from the sector and impeded growth in output and productivity. Although the proportion of loss-making enterprises is falling slowly, 37% of agricultural enterprises are still loss-making 15 years after reform began. This indicates both the limited progress made with bankruptcy and foreclosure operations, consistent with the social costs of higher levels of rural unemployment. This latter view is supported by the observation that farm employment has fallen more slowly than agricultural output (relative to 1990), in contrast to most transition economies.

Table 1: Trends in Key Sectors Indicators in the Russian Farm Sector, 2000-2004

Type of farm	**2000**	**2004**	**2000**	**2004**	**2004**	**2005**
	% land area		% output		Average farm size ha	
Private	8.0	10.8	3.0	5.9	55	69
Household plots	4.4	5.1	53.6	51.3	0.22	0.25
Agricultural organizations	87.6	84.0	43.4	42.8	5710	5205
Total	100.0	100.0	100.0	100.0	---	---

Source: RosStat. www.gks.ru

V. The Input Supply Sector

The distribution of agricultural machinery such as tractors and harvesters is highly concentrated. In 1999-2000 RosAgroSnab together with regional administrations accounted for over three quarters of heavy machinery sales. The balance of sales was mainly accounted for by commercial firms. Since 2000 the share of state-financed organizations has fallen to about 55%. Due to rather rigid attachment to the distribution system of RosAgroSnab in the recent past, the development of own commercial and dealer network and the network of own service centers has begun only since 2000. The top three producers – *John Deere*, *Case Corp.* and *Klaas* – are extremely interested in promoting their products in Russia. However, even timid attempts to establish their own production in Russia, even for screwdriver technology, were unsuccessful. By the end of 1990s the share of imports in the country's annual tractor market was 67%.

Russia is a world leader in the production and export of all kinds of mineral fertilizers. The country is the fifth largest exporter of potash fertilizers; the second largest exporter of phosphate fertilizers; and the largest exporter of nitrate fertilizers. About 80-85% of fertilizer output is exported and this enabled the sector to grow following the devaluation of the ruble in 1998. All mineral fertilizer plants are privatized, with the exception of plants in Bashkiria and Tatarstan.

Since 1990 there has been a steady decline in the usage of heavy machinery and fertilizers. Increased input prices in the course of reforms have resulted on the one hand in a de-capitalization of the sector, but on the other it has led to the more rational use of purchased inputs. After 1998, vertically integrated holding companies began to rapidly develop in the agricultural sector. These holding companies have become new mass buyers of agricultural machinery and other inputs for agricultural production. Gradually a growing market has emerged for the supply of contract machinery services to agricultural producers. These services have allowed the more efficient use of machinery in contrast to the traditional system that required all enterprises to hold their own machinery stock which tended to be used less intensively. This change in the agricultural machinery utilization paradigm reduces the demand for new equipment quite dramatically.

CHAPTER 2

I. Policy Challenges and Priorities for Russia's Agriculture and Rural Sectors

The Russian Federation faces several challenges that color the nature of public policy intervention. It is a huge economic space with an internationally large agriculture and rural sector. Its agricultural systems vary hugely across its regions. It faces the legacies of its past governance structures as well as unique challenges confronted during the transition to a market economy. Fiscal supports to the AIC in the Russian Federation are broadly in line with the levels observed in OECD countries. Several OECD countries, and in particular the EU, have responded to the mounting fiscal, economic and external (WTO) pressures by gradually moving agricultural support policies from market support to direct income support and "green box" measures. The Russian Federation can learn from these trends, especially by avoiding the political and policy risks of getting locked into inefficient market-support policies.

Russia faces unique challenges in framing and implementing appropriate agriculture and rural sector policies. Russia is unique amongst transition economies because of its large size, its Federal structure, its large variation in agro-ecological conditions and hence agricultural production conditions and patterns. The combination of Federal and Regional interventions need to cater for diverse local circumstances and at the same time they must avoid fragmenting and distorting national agricultural and food markets. Russia has about 27 percent of its population living in rural areas, which is high by developed country standards (Table 2.1). In addition a high proportion of the rural population is engaged in agriculture compared to other developed countries. These conditions create important social challenges during the transition.

Table 2: Relative Importance of Rural and Agricultural Population, 2003

	Total population	**Relative share of**	
	(thousand)	Rural population	Agricultural population
Russian Federation	143,246	26.9	9.7
OECD	1,150,038	24.0	7.2
EU-15	380,051	21.7	3.8
USA	294,043	19.8	2.0

Source: FAOStat

Primary agriculture suffers from a number of severe structural burdens. An important feature of the Russian transition has been the persistent structural inefficiencies that have had an adverse impact on farm level profitability. In recent years policy makers have confronted these challenges in a forthright manner but there is still a further distance to be traveled. The banking system is under developed and cannot meet the credit needs of the agricultural sector resulting in low levels of access to credit and high real interest rates. The agricultural marketing system for both agricultural inputs and outputs is still not as efficient as it could be, resulting in high costs for inputs and low farm gate prices for outputs. Many primary agricultural enterprises are still not restructured into efficient operations, in part because many still carry the burden of providing social services and employment obligations for local communities. Many have not become more technically or economically efficient because large government subsidies or bailouts have allowed inefficient operators to remain in business.

In particular, the traditional requirement for agricultural enterprises to provide social services in rural areas hinders their ability to perform their commercial mandate in the transition. Under the centrally planned system, collective farms were the primary provider of

social services. As a result, subsidies to agriculture trickled down to the rural population as support for public social services and a social safety net for the very poor. As agricultural enterprises are run on a more commercial basis, they are expected to shed labor and reduce the provision of these social services. This is an important consideration in developing policy instruments and subsidy policies for agriculture and rural areas. The historical pattern of granting subsidies to agricultural enterprises with the expectation that they will maintain high levels of employment and social services is therefore no longer valid. In the future, subsidies will need to be targeted directly to rural municipalities and service providers, or as direct income support to poorer segments of the farming population. This is a strong justification for reallocating rural subsidies from production support to general service support for rural areas. As noted below, in recent years this lesson has been well learned and implemented through a variety of policy actions on the Federal level.

The current policy framework for the agriculture and rural sectors encompasses the perspectives of the Ministry of Economic Development and Trade and the Ministry of Agriculture. The current policy framework for agriculture and rural development is set by the *National Development Strategy until 2010* (the Gref Program), managed by the Ministry of Economic Development and Trade and by a policy document on the *Main Components of Agro-Industrial Policy until 2010*, managed by the Ministry of Agriculture. The overarching goals of these two programs are:

- The development of an effective and competitive agro-industrial complex that promotes national security in food products and serves as a basis for integrating Russia into agricultural production and food markets;

- To increase the living standards of the rural population and the development of social service infrastructure in rural areas;

- The production of ecologically safe food products and the preservation of natural resources for agricultural-production by improving agricultural technologies, and introducing resource saving technologies.

While these objectives constitute an enlightened departure from older positions, the perspectives of both ministries conflict on certain fundamentals. While the broad goals of these two mentioned programs are similar, the National Program emphasizes market development, the provision of support to the poor, the funding of human and institutional development programs and the protection of property rights. Until quite recently, the Ministry of Agriculture's program focused almost exclusively on supporting agricultural production. In the latter policy document, only brief mention was made of support to agricultural education and to the transfer of social service assets from agricultural enterprises to local municipalities and the program largely ignored broader rural development issues. It is much welcomed that more recent publications of the Ministry of Agriculture, while still being highly focused on production issues, do raise strategic issues concerning rural development. The challenge now will be to ensure that this important and significant change in strategic direction translates into increased budget allocations for rural development with an associated reduced emphasis on direct production support, and increased coordination with the programs of the Ministry of Economy.

II. Federal and Regional Budgets for Agriculture and Rural Development

In recent years there has been a considerable improvement in and rationalization of the agricultural and rural development budget. The overall level of State support for the agricultural and rural sectors in Russia is now well in line with the level of expenditure that prevails internationally. The consolidated budgetary expenditures for agriculture and rural development accounted for less than one percent of GDP in 2003. The current level of budget expenditure is similar to that found in many OECD countries. For example US total budget expenditures are estimated to be 0.73 percent of GDP, EU countries average 0.68 percent. (Table 2.2) This is a commendable achievement by any standard.

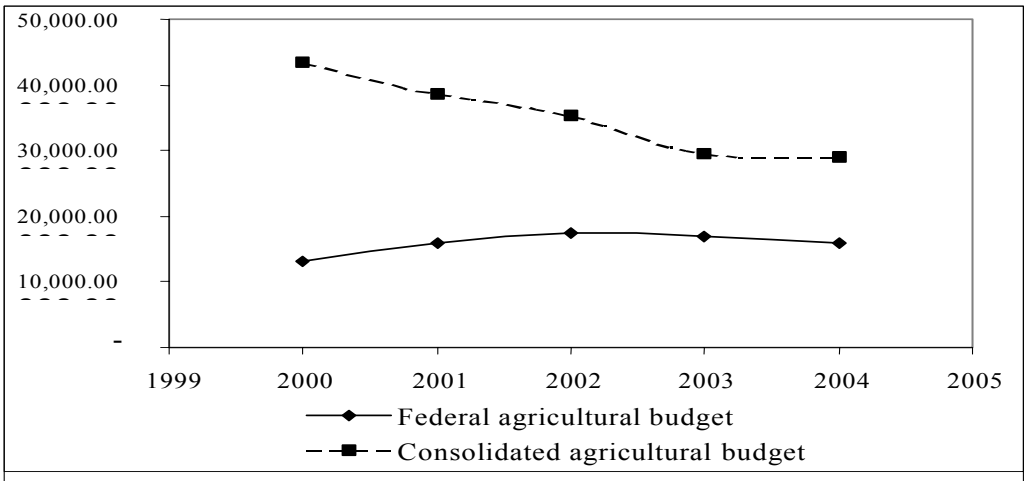
Table 3: Selected International Indicators of Budget Support to Agriculture, 2003

	Per agricultural worker	**Relative share of**	
	(USD)	Value of production (at farm gate)	GDP
Russian Federation	300	14%	0.95%
OECD	2,309	27%	0.65%
EU-15	4,852	26%	0.68%
USA	13,498	41%	0.73%

Source: OECD

Despite the impressive progress of recent years there is still room for improvement. While the overall budget on a per worker or as a share of value of production is lower than in other countries, it is not possible to conclude from these figures alone that the level of support to agricultural and the rural sector in Russia is unambiguously low. First, there is widespread use of "off-budget" expenditures in the Russian Federation (especially at Regional Government level as discussed below) that are not reflected in these data. Second, large tax concessions are provided to agriculture. While this is not an uncommon feature in other countries, the degree of tax concessions for the agricultural sector in Russia amounts to almost complete tax exemption for agricultural producers. Although it is difficult to estimate the value of these tax expenditures, they are possibly at least as high as the value of all budget expenditures for the agricultural and rural sectors. Therefore, while the overall recorded budget allocation for the agriculture and rural sectors falls within an acceptable international range, the effective level of public support is much greater. Thus when we compare the total level of fiscal support (including tax expenditures and "off budget" support) the Russian Federation's level of expenditure relative to the value of agricultural output for instance is in line with many OECD countries. However, when market supports are included the comparative position is much poorer. Effectively much of the fiscal support to agriculture in Russia goes to offset the implicit taxation of its agricultural sector through inefficient market policies. Given the success of the Federal Government in reining-in excessive expenditure in recent years there is every hope that the authorities will also get on top of these outstanding matters.

Figure 2: Expenditures of the consolidated and federal budgets for the agricultural sector, million rubles in fixed prices 1999 (2004 estimate)



Source: Ministry of Finance of the Russian Federation

Prior to 1998, Federal Budget resources comprised about 40 percent of all expenditure for agriculture and rural development. In 1998 this declined to 25 percent (as a result of the financial crises) but increased again as the Federal budget situation improved. In 2002, the share of Federal budget increased sharply because several regional administrative organizations, such as the seed inspection and veterinary inspection services, were transferred from the Regional to the Federal level budgets. However, since 2002 the Federal share has continued to decline as more responsibilities for agricultural support programs were transferred to the Regional level (Figure 2).

Despite its recent increase, regional budget expenditures in real terms have declined faster than real Federal expenditures. This could be explained partly by declining budget availability and partly by the declining use of high-cost support policies, such as government input-supply programs and directed-government credit. However, it is also likely to be partly as a result of the categorization of agricultural expenditures in non-agricultural budget lines, and the moving of more expenditure "off budget". Regional Governments have an incentive to "hide" expenditure support to agriculture and rural development under other budget headings because they are required to remain below pre-identified thresholds for agricultural sector budget support in order to qualify for Federal equalization transfers. For example, there is anecdotal evidence, from the regional case studies carried out for this Report, that a substantial share of agricultural interest rate support and credit support is recorded as "credit programs" rather than being correctly identified as support to the agriculture and rural sectors. The high "miscellaneous" expenditure category that arises in some Regions also raises the possibility that transfers to these sectors are inappropriately classified under this heading. Examples of expenditures that are financed "off budget" include the transfer of support functions to "off-budget" enterprises, which in many cases are given special privileges, such as state-sanctioned monopolies in regional markets, government credit guarantees or access to budget subsidies for favored enterprises in order to keep them profitable. Many also receive substantial grants from the State as start-up capital (e.g., the so-called "food funds").

III. The Functional Allocation of Expenditures on Agriculture and Rural Development

A very positive feature of expenditure developments in Russia has been the shift in recent years towards less-market-distorting support measures. The breakdown of Federal expenditure Agricultural and Rural Development since 2000 by program area reveals a number of positive features. Among the positive developments we can note the following. Expenditures on General Services have remained constant over time, while Production Support measures have been declining. Crop subsidies (including flax and hemp production support) have been discontinued. Likewise, some of the less efficient livestock programs (such as wool subsidies, northern reindeer breeding programs and support for livestock feed concentrates) have been discontinued. The seasonal loan program has been discontinued in favor of a more efficient interest rate subsidy program. These developments clearly underscore the commitment of the Russian Government to set its agricultural policies on a more market-oriented and sustainable path. There are a few negative aspects however that would require equally decisive action. Environmental protection programs are under funded, especially relative to the levels prevailing in EU-15 where about 60% of expenditures under the Rural Development or "Second Pillar" of the CAP[1] are earmarked for environmental and land-management measures. Expenditures for broad-based rural development, including rural infrastructure and health and social services, have been increasing but are still under-funded. (Table 4)

The shift in supports towards less-market-distorting measures in Russia is strongly in line with international developments. In the 1980's many OECD governments recognized that the level and nature of agricultural subsidies were not sustainable and began a process of reversing this trend. Apart from reductions in the level of support a process is now well in train in most OECD members of dismantling market-distorting measures in favor of direct income and general service supports.[2] Despite the high levels of Producer Supports that persist, a declining overall trend is evident as well as an increasing share of General Budget Supports and Direct Supports to producers. Producer Supports have declined from 90 percent of Total Supports in 1986-88 to 74 percent at present, while General Services Supports have increased from 13 to 18 percent in 2002-2004.[3] Despite this progress, the level of producer support is still too high and underlines the political difficulties of removing supports once they have become embedded in the system and indeed capitalized into the value of many agricultural assets. During the past ten years, the importance of general services has increased in almost all OECD countries. This trend reflects a growing recognition of the contribution made to sustainable competitiveness of investment in services such as research, extension and training. In addition such expenditures are non-market distorting and hence are exempt from reduction commitments under WTO.

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[1] See Chapter 3 and 4 for more details.

[2] In the discussion in the text we employ the OECD breakdown of Total Supports into Producer Supports, Consumer Supports and General Budget Supports. Producer Supports are further broken down into Price Supports (market-based instruments) and Direct Supports (budget-based instruments) to producers. Producer Supports comprise 74 percent of Total Supports in all OECD countries except, US, Australia and New Zealand, which have 50, 69 and 41 percent respectively. In most OECD countries, market-distorting price supports make up more than 50 percent of the so-called Producer Subsidy Equivalent (PSE) with the exception of the US, Australia, and Slovakia where direct budgetary payments to producers serve as the main form of their producer support. In the OECD General Service Supports as a share of total supports range from 69% in New Zealand to 6% in Norway.

[3] OECD, 2004

Table 4: Structure of the Federal Budget for the Agricultural and Rural Sector, 2000-2005, million 2005 Rubles

	2000	2005
General Services	26,390	25,482
Interest Rate Subsidies	0	5,370
Federal Targeted Program "Soil Fertility Improvement"	167	3,567
Crop Sector Support	450	2,670
Capital Investments	1,434	2,435
Land Resources	13,512	2,209
Livestock Sector Support	1,216	745
Public Administration Expenditures	0	518
Food Grain Market Interventions	0	250
Public Support of Bread Inspection	83	0
Equity Contribution to Rosselkhozbank	0	0
Support for Private Farmers	4	0
Expenditures on Environmental Activities	0	0
Other Expenditures	6,249	1,834
Total Agricultural Expenditures	49,505	45,080

Source: Ministry of Finance of the Russian Federation, International Financial Statistics, IMF
2000 data inflated by CPI as of III quarter of 2005

Positive developments in the structure of producer supports at Federal level are offset by negative tendencies at Regional level. Most of the positive developments have been confined to the Federal Budget. The problems of agricultural policies predominantly arise at regional level. These diverging patterns are partly the result of more rapid reforms at the Federal level and partly the delegation of the responsibility for producer support to Regional Governments in 2004. The latter decision, while well motivated, has unfortunately led to increased trade distortions between regions, increased use of inefficient and distorting policy interventions, and increased policy uncertainty.

As a result, regional level expenditures are still primarily focused on inefficient production support measures and there are wide variations between Regional governments on the levels of expenditure and the types of instruments used for agricultural producer support and rural development interventions. Evidence suggests that as a result of these policies, trade is highly distorted both across regions and products because of input subsidies, in particular, and regional trade barriers. The policy instruments used by the regions are diverse, ranging from instruments that support highly centralized government grain procurement and state machinery procurement to market oriented interventions of a public good nature, such as, rural public infrastructure, science and education, environmental protection and food safety (Table 5).

Table 5: Agricultural support programs financed from sub-federal budgets, 2003

	Number of regions including relevant line item into their budgets	Expenditures under line item, mln Rubles	% of total agricultural expenditures on relevant line item
Other Expenditures	87	11,023	30.4
Support for animal husbandry	85	7,011	19.4
Land resources	87	5,634	15.5
Support for crops	71	3,638	10
Subsidized interest rates	47	1,902	5.3
Food funds	48	1,440	4
Capital expenditures on land amelioration	56	1,102	3
Seasonal credits	50	765	2.1
Social infrastructure	45	228	0.6
Fishery	26	225	0.6
Support of private farmers	59	116	0.3
Leasing of equipment and cattle	12	101	0.3
Heating of housing and hothouses	25	91	0.2

Source: calculated using regional budgetary database (municipal budgets included)

Regional-level agriculture and rural sector expenditures as a share of regional agricultural output are variable, indicating very different policies and expenditure patterns. In 2003 the share of spending on agriculture and rural development as a percentage of total regional expenditures ranged from 0.1 percent to 7 percent. This variation reflects both the wide variation in the tax base of the Regional governments and also the wide variation in agricultural policies. For example, the Republic of Mordovia and Oryol Oblasts, which have a high degree of government involvement in agricultural markets, spend 3.5 and 3.9 percent of total expenditures on agriculture and rural development, respectively, while Rostov and Belgorod Oblasts, which have more free market policies, spend 0.8 and 1.1 percent, respectively.

CHAPTER 3

I. Bolstering Support Programs Most Relevant to the Objectives of Public Support

A continuation of recent policy reforms that emphasizes more effective and efficient use of public resources can be achieved by a greater focus on the effective provision of public goods and services; improvements in budget discipline and a reduction in a number of market-distorting policy interventions. In many respects the Russian Federation has suffered from a "first mover disadvantage" in processing reforms. With the benefit of hindsight Russia probably eliminated many of its market support mechanisms somewhat precipitously in that a number of key structural impediments to the sector's development had not been addressed. Rather than achieve increased efficiency in agriculture, these partial reforms lead to the bankruptcy of the primary agricultural sector. Support measures that followed such as input subsidies, directed credit programs and large debt write offs, in many cases slowed the pace of structural reforms. Successful programs of policy reform in the transition economies in Easter Europe, in particular the Czech and Slovak Republics, Hungary and Poland have managed to tackle structural inefficiencies such as weak banking structures, obsolete infrastructure and technology, and inefficient marketing systems.

II. More Effective Provision of Public Goods and Services

A new rural development program represents a very positive and encouraging development but there are under-funding problems. The Federal Targeted Program for the Social Development of Rural Areas until 2010 is an important addition to Russia's agriculture and rural policy agenda. This program underlines a welcome move away by the Federal government from reliance on producer subsidies to large agricultural enterprises, with the expectation that these entities would in turn provide social services. This new program provides direct support for public investments in rural areas that are not tied to agricultural enterprises, and could prove quite effective in facilitating and supporting the restructuring of the farm enterprises. Expenditures under this program are exempt from Aggregate Measure Support (AMS) reduction commitments under WTO. Another attractive characteristic of the program is that because it requires co-financing by Regional governments (at a rate of about 80% of the total) it creates an opportunity that the program will assume a high priority for the Regions. However in practice, despite the best efforts of the Federal Government, matching expenditures from the Regions are not always forthcoming at the committed amounts resulting in severe funding shortfalls which the Federal government must make good.

The most pressing problem in rural areas is the high level of unemployment, or under-employment. This program could be expanded to directly address some of these issues by supporting the creation of alternative employment in rural areas. This could include specific training programs for small-scale rural businesses, start-up grants for small businesses and small to medium sized farms, improving access to markets, promoting consumer and producer organizations.

To facilitate a speedier re-structuring of agricultural enterprises, the responsibility that these enterprises traditionally assumed for the provision of a wide variety of social services should be divested to local governments on an appropriately phased basis. Unburdened of these social responsibilities, agricultural enterprises can focus on the pursuit of their commercial mandate. With the Law on Municipal Governments, which came into effect on January 1, 2006, large amounts of public financing will be required to train and equip new Municipal Authorities with the needed capacity to assume their newly acquired responsibilities and deliver their mandated

social services. Specific programs should include training programs for small-scale rural businesses, start-up grants for small businesses and small to medium sized farms, improving access to markets, promoting consumer and producer organizations, etc. This could be followed by a system of block grants for public works' projects. A series of successful World Bank financed Rural Development projects in Poland, that integrated rural training programs to local governments and rural dwellers and the development of rural infrastructure, could provide an interesting model for expanding the rural development program in Russia. And there is positive experience also with support programs to help farmers introduce environmentally friendly approaches to land management, and management of animal waste.

The Russian Federation may well find lessons worth adopting from the EU's recently adopted new direction for its rural development policy. Since September 2005 the EU has embarked on a new framework for its rural development policy (the so-called "Second Pillar" of the CAP) for the period 2007-2013. The sustainable development of rural areas will focus on three policy objectives: competitiveness of agriculture and forestry (axis 1), land management and environment (axis 2) and quality of life and diversification of economic activities (axis 3). Future policy will be built around the three thematic axes.

Measures under axis 1 involve means of improving the economic performance of agriculture by, for example, reducing production costs, increasing the economic size of holdings, promoting innovation and more orientation towards the market. Specific support measures include physical and human capital (early retirement, young farmers, training and advisory services).

Measures under axis 2 aim at ensuring the delivery of environmental services by agri-environment measures in rural areas, and preserving land management (including in areas with physical and natural handicaps).

The aim of axis 3 is to have a 'living countryside' and to help maintain and improve the social and economic fabric of rural areas. Measures designed to make rural areas more attractive as places to work and live will involve improving access to basic services and infrastructure and the creation of a better environment. The aim is to promote sustainable growth and employment and to facilitate enhanced access to up-to-date information and communication technologies. Specific measures include support for on-farm diversification towards non-agricultural activities, assistance for off-farm activities, and the enhancement of the links between agriculture and other sectors of the rural economy.

The EU authorities aim to ensure the territorial application of this axis by promoting implementation through sub-regional entities, either developed in close collaboration between national, regional and local authorities or by using the novel LEADER bottom up approach (see Box 1).

Agricultural enterprises need to be divested of their social responsibilities to rural communities and these should be transferred instead to Local Municipalities. Despite much progress in recent years, agricultural enterprises in many instances still bear an unreasonable set of social burdens. This has several undesirable consequences. There is a blurring of the commercial and social mandate of these entities. This can frustrate the profitable enterprise by curtailing its growth by requiring it to take decisions on how resources should be allocated on non-economic grounds. It does at the same time protect the inefficient enterprise by supporting its survival on purely social grounds. This climate can create a type of "moral hazard" problem in that the inefficient enterprise will have little or no incentive to improve its performance when it feels that the State will always stand ready to supply a safety net.

Box 1: The EU LEADER Initiative for Rural Areas

Since the early 1990s the EU has devised an innovative program in support of the development of rural areas. LEADER is designed by the EU Commission for application in selected areas of the Community. Unlike the "Structural" or "Cohesion" funds, the design of LEADER is very much at the behest of the Commission (Directorate General for Agriculture and Rural Development), albeit influenced by experience in the application of the measures in the Member States.

The LEADER initiative is now in its third generation. The current initiative is known as "LEADER +", the previous initiative was known as "LEADER II" and the initial one was known as "LEADER I". LEADER provides funding to local action groups (LAGs) and these in turn are empowered to allocate these funds for local development projects and are given a wide level of discretion in how the funds are allocated. The projects that are supported range from rural tourism to small businesses with an agricultural orientation. At one level LEADER might appear as simply another mechanism for the allocation of public funds. However, this would to miss the several innovative features of the LEADER model which are:

Its area-based approach. Traditionally within the EU most state-funded activities are structured on a sectoral basis. The challenge of rural development is the development of specific areas. Sectoral policies have a role to play but they need to be harnessed to promote the development of specific areas.

Its integrated approach. The development of rural areas requires that policies and agencies that operate in rural areas mesh well together in furtherance of the objective of the development of the given area.

Its bottom up approach. It is well recognized that centrally-planned interventions reinforce a dependency culture among the recipients of state funds and hence undermine initiative. LEADER has extolled the virtues of the "bottom up" approach from its inception and has in many instances identified development opportunities that might not otherwise have arisen.

Its partnership approach. Several agencies, both public and private, impact on the lives and livelihoods of people in rural areas. LEADER has facilitated the emergence of a partnership approach among these diverse agencies that has led to a more concerted and effective identification and implementation of opportunities for development.

Its commitment to innovation. The various generations of the LEADER model have evolved in their approach to the promotion of innovation in support of rural development. The organizational structure of LEADER aims to create the conditions that may allow innovative solutions to emerge at local level.

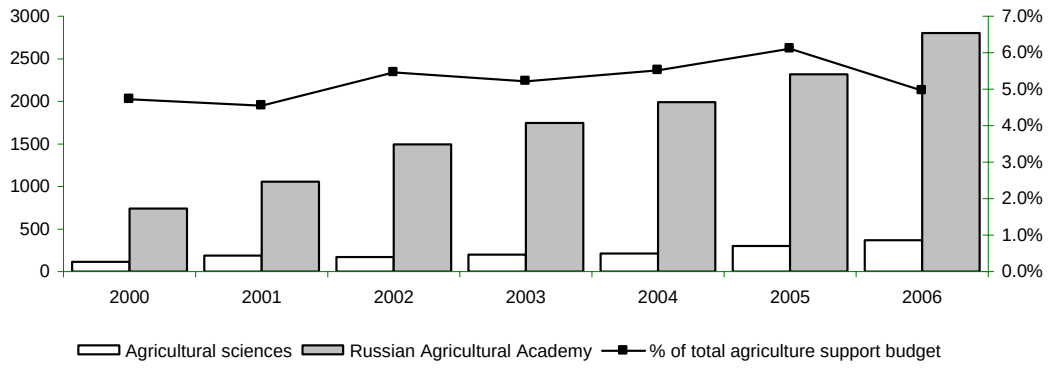
Its support for networking and cooperation among LAGs. Several LEADER-based local-action groups operate within each member state. The structure of LEADER allows for and promotes mutual learning through networking and cooperation both within and between Member States. Though this system models of "best practice" can be successfully transferred from one area to another.

Its reliance on local finance and management. Highly centralized financing agencies may lack the local knowledge both to avoid potential defaulters and to recognize good development propositions. The LEADER approach can result in a more efficient and effective local-financing model. Likewise the model relies on local management to deliver the program outcomes.

Enhancing the Research and Training function would represent good value for public money. Conscious of the imperative of maintaining high level of agricultural productivity, Russia has maintained reasonable levels of public expenditures for agricultural research and training (Figure 3). International evidence shows that returns to public investments in agricultural research are very high (Box 2). There are opportunities for further enhancement of the volume of

expenditure on research in Russia, as well as for improving its quality to provide for better returns. Russia's agricultural research and education systems have excess capacity in terms of physical infrastructure, land and research staff relative to operational budgets for these institutions. As a result, the quantity and quality of research and training being produced is low relative to the public expenditure outlays. The efficiency of the research and training system could be enhanced by minimizing the level of core budget transfers to educational and research institutions, introducing and gradually expanding the reliance on competitive grant programs. Successful competitive grant programs for agricultural research and extension services have been established in many former Soviet countries.

Figure 3: Funding for Agricultural Science from the Federal Budget (mln. Rubles)



Source: Ministry of Finance of the RF

Box 2: Economic Returns to Agricultural R&D

International Estimates of the Returns to Agricultural R&D

The most authoritative, comprehensive and up-to-date survey of rates of return to agricultural R&D is provided by Alston *et al* (2000). This study examined some 292 publications dealing with research returns over the period 1957 to 1996 with the following results:

International Estimates of Internal Rates of Return (IRR%) to Agricultural R&D

	Number of studies	Average	Mode	Median
All studies	**1708**	**82**	**49**	**38**
Field crops	**916**	**74**	**40**	**44**
Livestock	**233**	**121**	**14**	**53**

Source: Alston *et al* (2000)

These rate of return estimates are 8 to 10 times higher than what might be considered an "acceptable" real rate of return on an "ordinary" capital investment.

Source: Alston, J.M., C. Chan-Kang, M.C. Marra, P.G. Pardey and T.J. Wyatt (2000), *A Meta-Analysis of Rates of Return to Agricultural R&D – Ex Pede Herculem*, International Food Policy Research Institute (IFPRI), Research Report No. 113, Washington DC.

Federal crop and livestock and support programs are being reformed. The Federal Government implements a large number of acreage or livestock number based programs to support specific crops and livestock types. However, it is phasing out many of these programs. The only remaining programs are supports to pedigree cattle breeding and seed production. Since there is a public good associated with both improving the genetic pool for livestock and in the

production on non-hybrid seeds, both of these programs are justifiable public expenditures. In fact they could be viewed more as a general service provided by the Federal government rather than a subsidy program. In time these services could be streamlined and should be increasingly commercialized.

Consideration needs to be given to other public goods and services that are under-provided at present. OECD countries that have comparable public expenditure outlays on agriculture and rural development tend to devote relatively more public resources to areas such as environmental measures, food safety and hygiene and general information provision.

III. Reform of Market-Distorting Policy Interventions

Market support is endemic in many Regions and requires reform. Many regional governments also have their own market intervention programs. These are usually managed through "Food Funds," "Food Agencies" or "Food Corporations" (Box 3). These interventions are effectively non-cash procurement schemes commonly known as "commodity credits" and: are highly injurious to the development of an integrated well functioning national market for grain; discriminate in favor of the large farm enterprises; adversely affect the emergence of a more vibrant private-farming sector; and impede the emergence of an efficient marketing system. The degree of government participation in markets varies widely between Oblasts.

Some regional governments procure the minimum food needs for public institutions, such as hospitals and schools, while other Regional governments monopolize grain purchases in the Oblast causing severe distortions in local and national markets. In many cases these interventions are financed "off budget" through state-owned enterprises. These enterprises are often given privileges which other companies do not have, such as access to government credit or grants, or, they act as agents for the delivery of credit to farmers by Regional governments. Their privileged position discourages the development of private trading and causes the fragmentation of the national market. Moreover, there is not enough reliable information on Regional "food funds" to meet the reporting requirements of WTO.

In the long term price support programs are fiscally and economically expensive and a move towards measures that underpin the long-run productivity and competitiveness of the sector would be preferable. Ultimately in order for Federal grain market interventions to work effectively, it is important that regional price intervention programs, which range from creating regional grain purchasing monopolies to grain export bans from the region, be phased-out and eventually outlawed. In the long term, price intervention programs are fiscally costly and carry large economic costs such as agricultural surpluses, an increasing disconnect from market demand, reduced competitiveness, adverse environmental impacts and consumer welfare losses. If there is a need to support farm incomes it would be preferable to move directly to income-based support programs or programs that promote competitiveness-enhancing investments at the farm, marketing or agro-processing levels, rather than repeat the expensive lessons learned by many OECD countries in their implementation of price-support programs.

Fertilizer subsidies have been eliminated at Federal level but they still apply in many Regions. In a bold step, the Federal price subsidy on mineral fertilizers was eliminated in 2004, after it was demonstrated that the program was ineffective. Because of strong international demand for fertilizer, and almost no new investment in plant and equipment, Russia's fertilizer factories have been operating at near capacity. As a result, increased demand resulting from the subsidy on fertilizer led to an increase in domestic fertilizer prices. Consequently, most of the

fertilizer subsidy was captured by the fertilizer manufacturing sector and not by the farms that it was intended to support.

Many regional governments, however, still supply agricultural inputs directly to agricultural enterprises, usually on credit or through a barter/credit arrangement. This is often done by a single agent selected to administer the fertilizer supply and subsidy program for the Region. The international experience has shown that direct input subsidies are inefficient as a policy instrument for agricultural sector support and in effect are equivalent to output price support measures, especially in the grain sector. These programs should be eliminated in line with the Federal-level initiative.

Box 3: Examples of Regional Market Intervention Programs

Leningrad Oblast, in 2005, financed 146.6 million Rubles for procurement of products for the "Regional Food Fund." This amount was not reflected in the regional agricultural budget, but is equal to 50 percent of the amount allocated for the agricultural budget. Most funds are provided to producers under a commodity credit arrangement for delivery of produce at the end of the agricultural season. This program is one of the least transparent budget programs in the Oblast.

Oryol Oblast, in 2004, allocated about 130 million rubles, from the budget for support to "Reserve Food Fund," under a line item "other expenditures." This amount is equal to 50 % of the agricultural budget. With this funding the "Reserve Food Fund" procured 130,000 tons of food grain. It did this by providing commodity credits to agricultural enterprises and establishing quotas for the Regional Food Fund. Regional agri-holdings act as intermediaries between producers and the Food Fund.

Republic of Mordovia: The agricultural policy in Mordovia is driven by a policy of self sufficiency and the maintenance of low prices for food products in the belief that this preserves social stability. In order to achieve this objective the Government has maintained many of the features of a centrally planned economy. The Government controls almost all aspects of the agricultural production and marketing chain. The Regional government uses two state owned entities, Mordovian Food Corporation and Rural Development Corporation, to supply input to agricultural producers on credit and collect agricultural output as repayment for these credits. Almost all agricultural production is marketed through this public procurement system. Only 2 % of all milk is sold on the free market, 12% of cattle and poultry and 5% of eggs. The Mordovian Food Corporation markets 30 percent of all grains. Most of these transactions are made on a barter basis, e.g., exchanging inputs for the future delivery of agricultural output.

Chelyabinsk Oblast. The "Food Corporation" SUE has been established and completely replaces the functions of agricultural markets in the Oblast. The Corporation provides inputs, on a quota basis, to producers for credit. Producers are required to repay the credit with agricultural produce at the end of the season. Input suppliers and Food corporations receive Regional government budget support to finance this operation.

Grain market stabilization programs are justifiable but improvements in implementation are needed to enhance efficiency. Given the large variations in both inter-seasonal and intra-seasonal farm gate prices for grain and the extensive regional differences in grain markets the existence of a Federal management stabilization program is in principle justifiable on market failure grounds. However, its implementation leaves much to be desired. Interventions tend to be *ad hoc*; limits were set on both total budget expenditures and volumes available for intervention that were lower than could credibly support the announced prices; public information was not made available on prices, stocks or intervention procurements, and intervention target prices were announced after the farmers had made planting decisions. The program also lacked the appropriate delivery and controls on storage and on stocks. Delays in budget disbursements have

lead to poor timing of interventions, resulting in most of the benefits going to traders rather than farmers, who were the intended beneficiaries.

It is also important to recognize that the long-run solution to price instability is development of a private market for storage. Experience suggests that operations of government-run stabilization schemes tends to discourage the development of this market when the government programs are unpredictable and when they stabilize prices too much. Operation of the Russia system should be carried out under clear rules designed to avoid these pitfalls. The efficiency of the Federal price-stabilization program would benefit considerably from the implementation of the following principles:

- Market interventions should be rule-based and transparent, and rules should be implemented on a timely basis.

- Programs should not be limited by a predefined volume or budget ceiling, at a level that are lower than can credibly support prices under all conditions.

- Foreign trade policies, including tariffs, should be matched to the price intervention program in order to avoid an inflow of imports which would dilute the effect of the program.

- Information on stocks, prices and government purchases should be publicly available.

- Support prices should be available to farmers at the outset of the production cycle so that production decisions can be made on the basis of the floor prices.

- In addition to the pricing rules that trigger procurements and sales, the government should be required by law to publish all information on government procurements and prices paid as well as information on grain stocks and crop forecasts.

- Price support policies at the regional level should be phased out.

While interest rate subsidy programs are preferable to traditional forms of credit support they are distortionary. Under the interest rate subsidy program the Federal government pays up to 95 percent of interest paid to commercial banks by agricultural enterprises. Given the current circumstances in Russia, where the banking sector is under developed and the agricultural sector is undercapitalized, the subsidization of interest rates through commercial banking system is probably the most efficient approach to recapitalizing agriculture and encouraging commercial bank lending to the sector. This program is a significant improvement over earlier credit programs for agriculture where the Government provided loans or guarantees on loans directly to agricultural enterprises or banks lending to agricultural enterprises, thus assuming significant risk. Under the current banking environment there is no need for the government to provide liquidity to the banking system, and assume the risk of default on funds lent to banks or agricultural enterprises. The risk under the interest rate subsidy program is therefore substantially less than if the government were lending funds or providing guarantees. The number of borrowers and the amounts of funds borrowed have been increasing steadily since the program was introduced.

In 2003 the program enabled to bring 46.2 billion Rubles of credit resources into the sector, of which about 8 billion rubles were investment credits; in 2004 the figure was 44.2 billion rubles. The lever to bring the resources (ratio of debt credit amount to expended budget resources) is

very big (although it was slightly lower in 2004), the number of organizations participating in the program is growing; i.e., the program greatly enhances the accessibility of credit resources to the agriculture and food sector (Table 6).

Since 2002 there runs a program to compensate part of interest on three-year credits, which was later expanded to include five-year credits, and under the National "APC Development" Project 8-year credits are subsidized too. The terms of this program are much more profitable for agricultural producers, compared to the state-run leasing program, and it was the former that became the source of funds for technical revamp in the sector.

Table 6: Results of Implementing the Interest Rate Subsidy Program

	2002	2003	2004	2005 (target)	2006 (target)
Number of organizations that received credits	10,188	12,241	13,490		
Amount of debt credit resources in agricultural organizations, million rubles	29,338.4	46,202.1	44,200		
Budget expenditures to subsidize interest on debt credits	2,017	3,200	3,200	5,370	13,780
Lever (ratio of debt credit amount to expended budget resources)	14.5	14.4	13.8		

Source: Ministry of Agriculture of the RF, Ministry of Finance of the RF

In the longer run, however, interest-rate subsidies will be distortionary and will lead to overcapitalization of the sector. The longer-term solution is to move to market interest rates and to focus on increasing the supply of credit by developing the capacity of lending institutions that lend to agriculture. This will require that the Federal Government develop a comprehensive program for strengthening the legal and institutional framework so as to encourage the emergence of alternative lending institutions dedicated to the sector. In the interim, the implementation of the program could be improved by encouraging lending to smaller farms rather than only to large commercial, former collective, farms. Better co-ordination is also required with Regional Government subsidy programs which in some cases also provide additional interest rate subsidies for the same loans. The proposed World Bank Project on Rural Microfinance will assist the Ministries of Agriculture and Finance to establish a financially integrated (multi-tier) system of financial cooperatives through technical assistance, institution building, various financial services, and infrastructure support; and to integrate the microfinance industry into the overall financial system of the country, through fostering links with partner banks, insurance companies and/or municipal funds.

Positive lessons can be learned from some regions in the much-needed reform of the leasing of agricultural equipment. This is currently the least efficient policy instrument used by the Federal Government in the agricultural sector. The program was designed to encourage private investment in agriculture and facilitate the establishment of modern, competitive farms. Central to this development program are measures to expand and modernize the sector's capital base by encouraging producer investment in farm machinery and high performing livestock, through subsidized leasing programs. Large budgetary transfers have been made to a Government-owned monopoly (RosAgroleasing) to purchase farm machinery from Russian agricultural machinery producers and leased on to farms.

A review of these programs on the regional level suggests that the federal program is highly inefficient, and that the regional programs vary in effectiveness according to the number of leasing enterprises receiving public support. RosAgroLeasing's operating margins and fees are well above the industry average, despite its access to subsidized funds, which raises the costs of leasing and insurance for lessees. High non-repayment rates (approximately two-thirds of lessees) undoubtedly contribute to this situation. Its monopoly over subsidized funds allows it to continue however, without any improvement in efficiency. Higher machinery prices have further negated the impact of subsidized support for leasing. Producers have thus not benefited significantly from this program; demand for RosAgroLeasing services is low, and available public funds are not used in full. Indeed the major beneficiaries have probably been RosAgroleasing itself, the farm machinery manufacturers whose equipment is purchased, and the farmers who default on their payments. Rather than introduce measures to improve RosAgroleasing's efficiency, government has further lowered the cost of subsidized capital under the recently approved national project in the agro-industrial complex.

Leasing is an important alternative to credit for people unable to offer fixed assets (i.e. land and buildings) as collateral for loans. In the absence of fixed collateral, leasing enterprises secure their "credit" by retaining ownership of the machine (or other asset) being transferred until the lease contract has been paid. Any default quickly results in re-possession of the machine by the leasing enterprise, and so the ability to recover its capital. Strangely, this fundamental aspect of leasing appears to have been abandoned under the subsidized leasing programs currently in operation. In order to minimize their tax obligations (and costs), leasing enterprises appear to be transferring the ownership of leased farm machinery directly to producers (the lessors), because producers are exempt from property tax while leasing companies are not. But while this practice minimizes lessor taxes, and so their costs and the level of leasing payments, it also removes their major source of collateral and seriously undermines repayment discipline. No leasing company can operate viably under these circumstances, and the leasing industry itself cannot be sustainable. Public subsidies are the only means to keep the industry operating under these circumstances.

While the underlying objectives of current government programs to support machinery leasing are legitimate and appropriate, the policies and measures being used to achieve these objectives are not. Indeed, in the case of RosAgroLeasing, producer access to farm machinery has been reduced rather than enhanced; and the increased private sector activity needed to facilitate greater machinery acquisition (suppliers, commercial banks, leasing enterprises) is being constrained by government intervention in both federal and regional programs. Current government practices associated with leasing and credit impede the creation of a level playing field for competition, rather than support it.

Specific issues in this regard include:

- ***Inadequate clarity as to the intended outcomes and beneficiaries of the current leasing programs.*** In principle, producers should be the main beneficiaries, but there should be an associated expansion of private sector activity in the areas of machinery supply and leasing. Instead, a small group of machinery suppliers and leasing companies appear to have benefited substantially from the current programs, producer benefits have been minimal and private sector activity has been inhibited rather than enhanced.

- ***Weak, inefficient use of the public resources directed to support machinery leasing.*** RosAgroLeasing's monopoly of federal support has allowed it to operate inefficiently for a sustained period of time, by absorbing the funds designated for machinery acquisition

to meet its operating costs; low demand for its services results in an underuse of available funds; and unviable machinery suppliers are being sustained through program support, contributing to the increase in farm machinery prices.

- ***Government intervention in the current leasing programs is highly inappropriate.*** First, producer demand should dictate the type of machinery leased, the number of machines leased, and the suppliers who meet this demand. Second, the eligibility of leasing companies for subsidies should be expanded with a view to enhancing rather than reducing competition among them. The same principle applies to banks participating in the subsidized credit program.

- ***Current leasing and credit programs distort capital markets*** (credit, leasing, and insurance) by artificially lowering the cost of capital, creating an uneven playing field that favors inefficient enterprises and inhibits the entry and expansion of efficient enterprises. Public rather than private determination of the demand for farm machinery also distorts the farm machinery market by reducing its ability to clear, and its consequent ability to set prices. Significant annual variations in the level of public subsidies for leasing and credit accentuates these distortions, by increasing the volatility of demand, and making it more difficult for machinery manufacturers to gauge future levels and patterns of demand.

- ***Current tax laws should be reviewed and amended*** to avoid the current odd situation in which leasing companies transfer ownership of the machinery (i.e. their security) to lessees at the beginning of the contract. This leaves them with no security for their lending, and so precludes the development of a viable leasing industry.

- ***The marked contrast between the effectiveness of different regional programs provides valuable insight into how the overall program of leasing and credit can be made more effective.*** An increase in the number of participating institutions is critical in this regard, as it results in wider participation by the private sector and more competition between banks and leasing enterprises; which together results in increased access to capital at lower costs.

Suggested Policy and Program Responses**:**

- Terminate the monopoly access of RosAgroLeasing to federal subsidies, and ensure that this support is allocated to numerous institutions which will compete. The same principle should be applied to support for the two banks participating in the subsidized credit programs.

- Terminate government determination of the number of machines to be supported, the type of machines, and the machinery suppliers. Supply and demand should be driven by the market.

- Amend current property tax laws to remove the current "incentive" of lessors to transfer asset ownership at the beginning of the lease, rather than the end.

- Review the more successful regional leasing and credit programs to determine what lessons can be transferred to other regions.

The Federal program for subsidizing agricultural insurance requires fundamental reform. Most developed countries subsidize agricultural insurance. Governments consider subsidies on insurance premiums to be a public good because they reduce both the private and public cost of bankruptcy. However, there is also a sound fiscal reason for supporting premium rate subsidies because they encourage wider use of insurance, and as a result reduce the government cost of disaster relief. This helps to smooth the time-profile of government expenditures, by paying a predictable subsidy on insurance premiums rather than erratic expenditures on disaster relief. Federal Government expenditures for agricultural insurance have increased rapidly from 220 million Rubles in 2001 to 1.9 billion Rubles in 2004. In 2006 it is expected to increase to 3 billion rubles. Despite these high levels of expenditure on agricultural insurance, the government is still faced with high levels of emergency payments, and there is a low level of insurance coverage. The inability of crop insurance to reduce the need for disaster assistance is consistent with the experience of the US crop insurance program which expanded significantly during the 80s and 90s, covering 75 to 80% of eligible acreage (equivalent to about 40% of crop value), as the US government boosted significantly the insurance premium subsidy (by 2004, premium subsidies reached close to US$ 2.5 billion, accounting for almost 60% of total preium costs). Despite extensive area coverage under the crop insurance programs, ad-hoc disaster assistance measures –totaling about US$ 10 billion since 2000—in response to droughts and other adverse events continue to prevail.

The current Federal agricultural insurance program subsidizes 50 percent of the cost of agricultural insurance premiums. Insurance companies that participate in the program need to be licensed to provide agricultural insurance. Payments are made directly to the companies that issue the insurance coverage rather than to the purchaser as would be the norm in most other countries, an arrangement that is prone to abuse. The industry is also highly concentrated; with one company "Poderzhka Garant" controlling about 35 percent of the national crop insurance industry and in some regions concentration exceeds 90 percent. This leads to monopoly pricing behavior. The insurance industry itself is plagued by a weak legal framework, a weak culture of contract enforcement and pervasive fraud. This program should be completely overhauled.

Positive and negative examples of crop insurance are available in other countries, and the Russian Federation could benefit from these experiences when designing a new and sustainable program for crop risk insurance. Key lessons learned from around the world include:

- Traditional multiple-peril (yield-based) crop insurance offered to individual farmers has proved fiscally expensive as a result of high administrative costs, perverse incentives in the insurance process (moral hazard), and insurance uptake only by the highest risk farmers (adverse selection), resulting in permanent, high subsidy costs and adverse underwriting results;

- Catastrophic perils (affecting multiple farmers simultaneously such as hail, drought or floods) provide huge aggregate claims in adverse years, which are very difficult to manage without access to the international reinsurance market or other *ex-ante* contingency funding arrangements.

- The insurance offered must allow that there is a technical and objective measurement of losses in the field, based on well-planned procedures. In practice, it has proved difficult to separate insured losses from other contributions to lower yield (for example, poor management standards by the farmer; i.e., the moral hazard problem);

- Independence of the organization and management of loss assessment is essential, and needs to be carried out by individuals following clear and transparent technical rules and without vested interests;

- Private sector insurance principles and experience (for example, transparency, communication, prompt and fair claims settlement), are necessary to undertake crop insurance underwriting, even if subsidies are offered by government, and the process must be distanced from any state intervention or influence.

For the reasons outlined above, for catastrophe exposures (notably drought and frost), an alternative approach of weather index insurance is now being developed in some countries. This approach allows that a simplified payout is made to policy-holders based on measurements of a weather parameter (for example, shortage of rainfall in a defined period and area, or temperature below a specified level) which is independent of the insurer's behavior (i.e., eliminates the moral hazard problem) and avoids the adverse selection problems which plague the traditional, multi-peril crop insurance programs. All policy holders within the defined region are paid according a weather measurement made at an official weather station. Such indexes are designed so that the payout is an approximation of the expected loss of crop value, but is not based on individual-farmer crop measurement. Accordingly, index based insurance programs reduce significantly the administrative costs of insurance programs. One modification of Weather Index is to base payout on an Area Yield Index. This approach requires that there is an objective measurement of actual yield in the defined geographical area. Index insurance can also open the possibility of access to the international reinsurance market, which would be generally unwilling to insure traditional multiple peril insurance programs.

V. Improving Budget Discipline

Non-transparent tax expenditures are significant in scale and distortionary in their impact. Federal and Regional Governments provide significant amounts of indirect support to the agricultural sector through the application of differential tax rates for agricultural enterprises. A revised tax code introduced in 1992, relieved agricultural producers from several taxes (e.g., profits tax for marketed agricultural produce, including farm processed goods; tax on property held by organizations; road user taxes; vehicle owner taxes and vehicle purchase taxes (currently the transport tax)). Agriculture also does not pay for the use of water resources. Private farms are exempt from land tax for five years from the date the farms are established. Agriculture also enjoys benefits on deductions for payments to the social insurance fund, medical insurance fund, and pension fund. In 2003, Part II of the Tax Code introduced a single agricultural tax to replace most of the taxes that still applied to agricultural enterprises. This is essentially an imputed income tax, which is typically used for taxing small businesses. Changeover to this tax is voluntary. The tax rate is set at 6 percent of net income which will provide even higher levels of subsidy to the sector compared with the older system. It is estimated that by the end of 2004, around 15,000 farms (55% of total) chose to use Single Agricultural Tax since then. In addition to the Federal level tax exemptions, Regional governments also provide various tax breaks.

Some of these tax expenditures could be justified as a transitional measure to encourage capital investment in the agriculture sector that has suffered from years of capital outflow. However, rather than provide tax breaks to agriculture on a blanket basis, it may be more efficient to allow cost deductions for capital investments rather than all expenditures. In time that these highly differential tax rates will need to be changed in line with other industries, or they will result in long-term investment distortions in the economy.

Periodic debt write-offs by the Federal Government have resulted in slacker financial discipline and created substantial contingent claims on the Budget. A major source of effective subsidy with consequential significant public expenditure implications in Russia in the past has been the periodic bailout of bankrupt agricultural enterprises. Because the government has bailed out agricultural enterprises in 1994-95 and again 2003-04 there is an expectation that the Government may repeat this process again. About 1.5 billion Rubles worth of penalties on overdue debt were written off in 2003 and 25 billion Rubles of the same in 2004. The build-up of debt at the farm level therefore creates a contingent liability for the Government that is not reflected in the regular budgetary process. If debts are owed to the Government, such as loans issued by the Government or accumulated tax liabilities, these periodic write-offs are also generally not reflected in current budget expenditures.

The debt write-off in 1994-95, was largely a write off of accumulated debt issued by the Federal Government. This was a blanket write-off of all Government owed debt, and as a result rewarded the worst defaulters. This program largely failed as a restructuring exercise, but led instead to increased defaults following the write-off and reduced financial discipline at the farm level. The lack of a hard budget constraint also allowed many agricultural enterprises to continue operating inefficiently. In addition, the State was slow to transfer the responsibly for social services from agricultural enterprises to the government budget. This added to the cost burden of collective farms and added to the expectation at the agricultural enterprise level that the Government was ultimately responsible for covering farm debt. As a result, after the 1994-95 write-off of debts, farms continued to accumulate large debts and tax arrears to the State as well as penalties on these overdue loans and tax arrears. Accumulated debts were again written-off for the period 1999-2002.

The Federal Government adopted a new program for debt relief at the farm level that was put into effect in June 2002 under the Federal Law "On Financial Recovery of Agricultural Commodity Producers". This law is a considerable improvement over earlier debt write-off programs in that it required that the debtors undertake some financial restructuring before becoming eligible for debt relief. The Law envisages the setting up of a special commission at Federal and Regional levels to work out conditions for the restructuring of debts and to which farms such a restructuring could be granted. In addition, a Presidential Order was issued in June 2003 writing off fines and penalties on debts to the Federal budget by April 1, 2004 with recommendations to regional administrations to take a similar step.

Table 7: Volume of Farm Debt Restructuring, 2003-2004

	2003	2004
Total volume of farm debt restructuring (thousand Rubles)	38,203,638	23,403,770
Including under the Federal Law "On Financial Recovery of Agricultural Commodity Producers"	35,336,076	17,550,342

Source: Ministry of Finance of the RF

In order to avoid unsustainable debt accumulation at the farm level and the contingent liability that this creates for both Federal and Regional governments, the underlying problem of the financial vulnerability of many agricultural enterprises needs to be addressed in a more fundamental way. While periodic debt write-offs may have been necessary during the transition period to save the agriculture sector from complete collapse, debt write-offs are not a sustainable policy instrument for supporting agricultural development as it creates the expectation of repeated write-offs and rewards the inefficient.

A more sustainable approach lies in addressing the broad array of factors that affect the profitability of primary agriculture. Some specific measures include, reducing the social pressure at the farm level to employ large numbers of staff by developing programs that support employment generation outside of agriculture. This can be achieved by facilitating the transfer of social assets from farm enterprises and ensuring adequate funding mechanisms for supporting these services. It also includes support to small business development in rural areas and small towns. More general measures include improving, the stability of the agricultural policy environment; the efficiency of market and supply chains for agricultural products and inputs, respectively; the availability of credit; management training at agricultural colleges, and the other less distorting government interventions discussed in more detail in other parts of the report.

CHAPTER 4

I. Strengthening the Management of Support Programs

Several reforms in the management of public resources can enhance the value obtained for public monies that are invested. Traditional modes of expenditure management have yet to completely adjust to the emergence of a market-based model of resource allocation. The management of public expenditure can be enhanced considerably through ensuring coherence between Federal and Regional policy design and implementation; reform of the budget process; and by addressing the issues created by "off–budget" expenditures and the functioning of State Owned Enterprises (SOEs) and State Unitary Enterprises (SUEs). In order to meet the requirements of WTO and achieve better coordination of Regional and Federal policies and expenditures, the same budgeting and monitoring system and system of budget classification should be used at both the Federal and Regional level. The successful implementation of these reforms will release much needed resources that can address aspects of the public policy agenda that are presently only being inadequately funded and in some cases, not at all. Many of these reforms are not specific to the agriculture and rural sectors.

II. Ensuring Greater Coherence between Federal and Regional Policy Design and Implementation

Contrary to best international practice Russia has opted to decentralize the operation of producer supports and to centralize the delivery of general services. The policy of the Federal Government is to decentralize both the funding and management of producer supports to Regional Governments and to centralize the funding and management of general services support, such as veterinary services, etc. This is counter to trends in several OECD countries. Agricultural support programs are usually managed and financed centrally to ensure uniformity of delivery at the producer level. On the other hand, the implementation of general services support is normally decentralized in order to bring the management of these services closer to the service recipients. Policy making and funding for agricultural producer support programs should be the exclusive responsibility of the Federal Government. For general services provision implementation should be decentralized, under clear national standards and earmarked Federal level funding.

In determining the appropriate balance between the roles of the Federal and Regional Governments much can be learned from other countries and the EU in particular. The framework of the latest manifestation of the EU CAP reforms may provide some guidelines for the rationalization of Federal and Regional policy coordination. The CAP is structured into two Pillars: the Market Pillar (the "First Pillar") and the Rural Development Pillar (the "Second Pillar").

The aim of the "First Pillar" is to create a unitary market by defining a uniform set of rules at central level that are implemented at country level but subject to monitoring and scrutiny by the center. The Market Pillar comprises an EU-wide harmonized set of rules and regulations embracing: food safety; phytosanitary, veterinary measures and standards; agricultural statistics and information systems; producers associations; and farm advisory services, etc. and a common market organization covering grading, market intervention and promotion. The third element of the "First Pillar" is the recently devised Single Area Payments Scheme which will gradually come to dominate the CAP budget. This framework creates the optimum conditions for the operation of markets.

The "Second Pillar" is focused on three axes: competitiveness of agriculture and forestry (axis 1), land management and environment (axis 2) and quality of life and diversification of economic activities (axis 3). Each of these axes contains a set of indicative measures from which individual member states have considerable flexibility in choosing the menu of measures that best suits their particular circumstances and needs. This outcome will be assured by the implementation of a co-financing and minima axes expenditure requirements between the EU and the Member States that ensures each Member State will focus on commonly agreed EU priorities for the three policy axes, while leaving sufficient flexibility at Member State and regional level to find a balance between the sectoral dimension (agricultural restructuring) and the territorial dimension (land management and socio-economic development of rural areas). EU co-financing rates is determined at the axis level, with a minimum of 20 % and a maximum of 50 % (75 % for those regions – the "convergence regions" - whose GDP per capita is less than 75% of the EU average). For axis 2 (and also the LEADER initiative) the maximum rate is 55 % (80 % in the "convergence regions"), expressing the EU priority attached to these axes. To ensure a balanced strategy a minimum funding for each thematic axis will be required. The proposed minimum funding percentages of 10 %, 25 % and 10 % for respectively axis 1, 2 and 3 are a safeguard to ensure that each Member State's program reflects at least the three main policy objectives, but the percentages are set sufficiently low to leave Member States or regions a high margin of flexibility (55 % of EU funding) to emphasize the policy axis they wish in function of their situation and needs.

This framework would appear, on the face of it, to be well worth considering as a template for rationalizing the distribution of functional responsibilities between federal and state/oblast governments within the Russian Federation. A unitary market is a sine qua non for a resurgence of the agricultural sector but the implementation of a successful rural development policy will require an approach that adheres to a common framework while at the same time allowing a diversity of responses at regional level that reflects differential circumstances and requirements.

Rural development programs could be sponsored by the federal government under co-financing grants to oblast governments that, for example, promote public-private partnerships between federally-sponsored programs and agribusiness enterprises that enter into marketing contracts, supply chain arrangements with restructured farms and so on. As in the EU the financing arrangements between the federal and oblast governments could allow for minima expenditure levels and differential co-financing rates for designated measures. Allowing higher rates of central funding for the poorer agricultural regions can also encourage the principle of convergence that has been central to EU regional and cohesion policies.

Based on the EU experience, for this system to work effectively and efficiently it would be essential to establish a strong monitoring, evaluation and reporting system based on a common federal framework agreed with the oblast governments so as to ensure transparency and accountability for the use of public resources. These processes again ensure transparency but also allow oblasts to learn from best practice implementation.

Russia can also learn much from the experience of the US and Canada on how to structure an appropriate balance between Federal and regional policy management and funding. In the US, the agriculture and rural sectors receive 90% of its support from the Federal budget. Canada lies at the other extreme, where, like Russia, about 50% of supports come from the Federal budget. However, unlike Russia, regional Governments fund and manage interventions on rural infrastructure and the like, rather than producer supports. Canada only managed the

rationalization of the respective roles of the Federal and Provincial governments in 2003 through its "Agricultural Policy Framework" (Box 4).

In attempting to achieve more effective coordination of policy between Federal and Regional levels and a greater degree of policy certainty, the Federal Government has devised a number of so-called Federal Targeted Programs. This is a very welcome initiative and in line with developments in other countries (e.g., the EU as outlined earlier).: The agriculture and rural sectors have two such programs, namely, *Social Development of Rural Areas* and *Enhancement of Soil Fertility in Russia*. These programs have specific medium to long-term goals, medium-term implementation plans of about three to ten years, and indicative budget allocations for the implementation period. Some of these programs require joint financing from both the Federal and Regional governments, which has the potential to improve coordination between Federal and Regional policies. Unfortunately, these programs account for only a small part of total support to agriculture and the rural sector and the indicative medium term budget allocations established when these programs are initiated are not binding on the annual budget process. As a result, these programs are often under funded. Regional programs tied to the Federal Target Programs suffer from the same problems and the level of under-funding is even more severe.

Box 4: Extracts from the Canada's Agricultural Policy Framework

Purpose
To set out an integrated and comprehensive policy framework to enhance the profitability of the agriculture and agri-food sector, that respects the jurisdiction of each of the Parties (Federal and Provincial/Regional Governments) and the international obligations of Canada.
To identify common goals and mechanisms for implementation to ensure progress towards these common goals over the course of the Implementation Period, and to provide a foundation for further Implementation Periods
To provide a framework for Implementation Agreements that will set out the precise measures that each Party will take and the timing of those measures
To establish funding arrangements between the Parties; and
To establish a mechanism for the Parties to report to citizens on progress on all elements of the Framework Agreement, in a manner that is measurable and meaningful

Key Themes
The key themes include i) Business Risk Management; ii) Food Safety and Quality; iii) Environment; iv) Science and Innovation; and v) Renewal.

Implementation
The Provinces and the Federal Government have agreed and signed a Framework Agreement, which stipulates a set of principles for government interventions in the agricultural sector, including a delineation of responsibilities between Federal and Provincial Governments, fundamental principles and limitations on government intervention, and broad areas of government support.

The detailed programs for each Province are agreed in signed Implementation Agreements, which provide specific information on policy instruments and budget allocations for each policy instrument. It also provides timelines for phase out of existing programs that do not comply with the Framework Agreement.
Funding arrangements are reviewed on a four-year cycle allowing medium term planning.
Source: Agriculture and Agri-food Canada, www.agr.gc.ca/cb/apf

There would be considerable merit in demarcating the appropriate roles of the Federal and Regional Governments in legislation. Russia could benefit from the enactment of a general agriculture law that would frame the broad policy agenda and ensure a clear connectivity with its funding. This legislative framework should define the parameters under which Regional Governments could set agricultural policy and delineate the areas of responsibility appropriate to

the Federal and Regional governments. Similar laws exist in the USA, the European Union, Germany, Latvia, Hungary and the Czech Republic.[4] The draft law, "On Agricultural Development and Agrifood Markets", which is currently under internal Government review, has many features that are compatible with what we consider to be appropriate and when enacted would ensure considerable coherence between Federal and Regional Government policy development and implementation.

III. Reform of the Budget Process

3.1 Scope for Improvements in Budget Discipline

Budget discipline would be improved significantly if considerably more detail and information were available on the structure of General Government Services. In 2004 General Services constituted about 55 percent of the total Federal budget allocation for agriculture and rural development. About 45 percent of this allocation is classified as "General administration and maintenance of subordinated agencies" (Table 8). Another large share, 33 percent, is allocated to "education", and "science" is also prominent with a share of 9 percent. Based on the nature of the budget data that are available, it is very difficult to determine how efficiently these expenditures are being employed, except in broad terms. First, it is not possible to differentiate between capital expenditures, operating costs and personnel expenditures. Second, information on the extra budgetary fees collected by many of the organizations providing these services is not available. Third, it is not possible to map these expenditures to the quality and quantity of the services provided.

Table 8: Structure of Expenditures for General Services in the Federal Budget, (%)

	2000	2001	2002	2003	2004
Financing of general services, including:	100	100	100	100	100
Government administration and maintenance of subordinated agencies	33	31	41	47	45
Education	38	33	32	31	33
Science	10	10	9	9	9
Social development of rural areas	0	0	0	0	6
Measures for improving land management	11	7	4	3	3
Miscellaneous	7	15	13	2	3
Environmental protection measures	0	1	1	0	0
Support of private farming	0	0	0	0	0
Investment in the development of infrastructure	0	3	0	8	0
Memo Item:					
General Services as % of Total Federal Level Expenditure	36	31	44	52	55

Source: Calculated according to Ministry of Finance data

[4] The **EU** ag-related legislation is available a at http://europa.eu.int/eurlex/en/lif/ind/en_analytical_index_03.html\
The **German** Law at http://bundesrecht.juris.de/bundesrecht/lwg/inhalt.html
The **US** Law at http://www.nationalaglawcenter.org/farmbills/

The Budget process is not meeting the needs of the agriculture and rural sectors in that there is a marked lack of coherence between the determination of strategic policy interventions and their funding. The current budget process is not meeting the needs of the agricultural and rural sectors and is outdated and inflexible. A key deficiency is the failure to synchronize the annual budget allocations to the agriculture and rural sectors with medium term strategy for their development. Another deficiency is that the current budget classification system renders it very difficult for administrators, at all levels of Government, to prepare budgets that reflect policy goals. Many of the proposed new policy instruments are not covered and many of the existing expenditure categories are no longer relevant. The current system thus encourages budget requests that fit the existing budget classifications, regardless of whether they support current policies. Moreover the existing system does not provide an appropriate system for purposes of WTO monitoring. WTO requires better differentiation of budget categories in order to clearly identify and separate budget expenditures that are highly distorting from those that are considered to be less distorting.

A move to a multi-year Budget would provide greater policy certainty. The policy-making process should be more closely tied to the budgeting process. This could be achieved by moving to a multi-year budget planning process and to make the budgets for Federal Targeted Programs binding on the annual budget process.

The Budget classification system needs urgent reform. In order to meet the requirements of WTO and achieve better coordination of Regional and Federal policies and expenditures, it is important that the same budgeting and monitoring system and system of budget classification be used at both the Federal and Regional level. In order to develop a system of budget classifiers that capture the large variety of different programs at the Regional level, a comprehensive study will need to be carried out at both the Federal and Regional level to develop a new set of classifiers. The current budget classification system should be revised to provide a more balanced and inclusive set of line items that better match the Government's current policy instruments, and which allow easy classification for WTO purposes. Ideally the same budget classification system should be adopted at the Federal and Regional Government levels.

The monitoring of the efficiency and effectiveness of expenditures is highly deficient. An additional deficiency is that the budget management and reporting system does not yield the level of information or controls required to measure the efficiency or effectiveness of public expenditure. The budget allocation process and the resulting allocation are not transparent. Budget allocation is implemented in a very top down manner at each level of the bureaucracy with weak feedback systems. Feedback to the Ministry of Finance and to the Ministry of Agriculture on actual budget use is generalized into a few broad categories, making it almost impossible to monitor the performance of expenditures. Reporting of Regional budgets is particularly bad. Some regions report over 50 percent of their expenditures under the category of "other uses," with no further explanation. There seems to be an increasing trend toward categorization of agricultural expenditures under non-agricultural categories of the budget, perhaps because these expenditures become harder to track, and also Federal transfers depend on maintaining agricultural expenditures below certain limits.

Finally, improvements are needed in the auditing system. The Accounting Chambers of the both Federal and Regional governments are responsible for the audit of budget use. For all entities that receive budget funds, partial audits of randomly selected budget line items are done on a quarterly basis. However, comprehensive annual audits are not required. State owned enterprises that do not receive budget funds are not required to be audited by the Accounting Chamber. Enterprises that do not receive budget funds are subject to the same accounting rules as private

companies, which require and independent audit every three years. A fundamental safeguard of the integrity of an auditing system is that its reports are available for effective public scrutiny. In Russia, only highly aggregated audit information is available to the public.

The intent to implement a Performance Based Budgeting System (PBBS) across the full gamut of public expenditure would be a comprehensive solution but implementation will be exceptionally difficult and more modest initial reforms may reap a greater dividend. The Ministry of Agriculture is the first Federal Ministry to begin designing a Performance Based Budgeting System (PBBS), but full implementation of this system is still many years away. The successful implementation of PBBS in Russia will involve fundamental changes in the entire budgeting and expenditure system, but will place the public finance system in the Russian Federation among the top tier of countries in terms of best practice.

Box 5: The UK's Performance Based Budget System (PBBS)

At the core of the PBBS are the so-called Public Service Agreements (PSAs) that all spending agencies enter into with the Treasury (Finance) Ministry. These PSAs effectively amount to a series of quantifiable outcomes relating to Government policy objectives that spending ministries commit to delivering in return for their three-year Department Expenditure Limit (DEL). Each PSA has a value for money (VFM) target and also includes a statement of who is responsible for the delivery of the targets. The Treasury advises that PSAs should be SMART (Specific, Measurable, Achievable, Relevant, and Timed), and "should not create perverse incentives or encourage staff to massage or misrepresent performance data; encourage staff to focus on easy-win cases above more problematic and important cases; or lead people to compromise quality in order to achieve a measured target". All ministries also enter into so-called Service Delivery Agreements (SDAs) with the Treasury. SDAs comprise the menu of policy programs that government departments agree to deliver so as to achieve their associated PSAs. Ministries must commit to efficiency improvements and provide details of their administrative budgets. Failure to achieve agreed outcomes will adversely affect future DELs. Each spending unit's performance against its PSA is available for public scrutiny twice each year.

An example: Department for Environment, Food and Rural Affairs (DEFRA) Public Service Agreements (PSAs)

PSA 1. To promote sustainable development across Government and in the UK and internationally, as measured by:

- the achievement of positive trends in the Government's headline indicators of sustainable development;
- the UK's progress towards delivering the World Summit on Sustainable Development commitments, notably in the areas of sustainable consumption and production, chemicals, biodiversity, oceans, fisheries and agriculture; and
- progress towards internationally agreed commitments to tackle climate change.

PSA 2. To reduce greenhouse gas emissions to 12.5% below 1990 levels in line with our Kyoto commitment and move towards a 20% reduction in carbon dioxide emissions below 1990 levels by 2010, through measures including energy efficiency and renewables. Joint with DTI and DFT.

PSA 3. Care for our natural heritage, make the countryside attractive and enjoyable for all and preserve biological diversity by:

- Reversing the long-term decline in the number of farmland birds by 2020, as measured annually against underlying trends;
- Bringing into favourable condition by 2010 95 per cent of all nationally important wildlife sites.

PSA 4. Reduce the gap in productivity between the least well performing quartile of rural areas and the English Median by 2008, demonstrating progress by 2006, and improve the accessibility of services for people in rural areas.

PSA 5. Deliver more customer-focused, competitive and sustainable farming and food industries and secure further progress via CAP and WTO negotiations in reducing CAP trade-distorting support.

PSA 6. To enable at least 25% of household waste to be recycled or composted by 2005-06, with further improvement by 2008.
PSA 7. Eliminate fuel poverty in vulnerable households in England by 2010 in line with the Government's Fuel Poverty Strategy Objective.
PSA 8. Improve air quality by meeting the Air Quality Strategy targets for carbon monoxide, lead, nitrogen dioxide, particles, sulphur dioxide, benzene and 1,3 butadiene. Joint target with DFT.
PSA 9. To improve the health and welfare of kept animals, and protect society from the impact of animal diseases, through sharing the management of risk with industry, including:

- a reduction of 40% in the prevalence of scrapie infection (from 0.33% to 0.20%) by 2010;
- a reduction in the number of cases of BSE detected by both passive and active surveillance to less than 60 in 2006, with the disease being eradicated by 2010;
- a reduction in the spread of Bovine TB to new parishes to below the incremental trend of 17.5 confirmed new incidents per annum by the end of 2008.

Source: www.hm-treasury.gov.uk

The international experience with PBBSs is that they are extremely difficult to implement and require very sophisticated management systems to yield positive results.[5] In the United States 47 of 50 states claim to use some form of PBBS for managing public expenditures and delivery of government services (World Bank, 2003). More recently, the UK has become a leader in PBBSs. Even with their relatively high level of management training, accounting systems and transparency, these governments have found that there are limitations to PBBS. The primary benefit of these systems has been in the improved management and monitoring of government service delivery. However, as a feedback mechanism for the annual budget process, PBBS has had more limited use than was originally anticipated. The main lesson from the international experience is that PBBS is not a mechanical process and requires a high level of public disclosure and transparency for it to work effectively. (Box 5).

Implementing a performance based budgeting system in Russia will require considerably more than simply establishing broad goals, assigning budgets to these goals and monitoring outcomes. The entire budgeting and expenditure system will need to be changed. As discussed above, the budget classification and accounting system will need to be upgraded to provide more accurate feedback to decision makers. Public disclosure of information will need to become an integral part of the budget system, a fundamental shift from the current disclosure procedures. In summary, the basic budgeting, accounting and monitoring system will need to overhauled before a performance based management system can be successfully implemented.

Experience in other countries has shown that performance based budgeting approaches are most effective for improving the efficiency of government service providing organizations. Agencies that provide public services would be a good place to start implementing government's new performance based management system.

3.2 "Off-Budget" Expenditures and Controls on SOEs and SUEs

Considerable additional scope exists to improve the efficiency of provision of General Services. In a highly welcome move, the Federal Government has reorganized, or is in the process of reorganizing, many of the subordinate organizations that are responsible for the provision of

[5] For more information on performance based budgeting see http://www.odi.org.uk/publications/working_papers/wp203.pdf . Chapter 4 for examples from OECD countries and Chapter 5 for examples from developing countries.

General Services with a view to rendering their delivery more efficient and effective. The key improvements required in the restructuring of these institutions are as follows: i) these institutions should only provide public goods that cannot or ought not to be provided by the private sector; ii) they should not be engaged in commercial activities, particularly those that compromise their ability to carry out regulatory functions; iii) clearly defined performance standards for provision of public services should be developed and agreed as part of the annual budget review process and form the justification for budgets provided; and iv) annual audits of the financial and service standards should also be carried out.

"Off-Budget" expenditures are significant in scale, non-transparent and potentially highly distorting. A major problem that needs to be tackled urgently is the high level of "off-budget" expenditures, much of which is not reported at all. What tentative evidence there exists on the scale of expenditures that could be involved suggests that "off-budget" funded activities could amount to a substantial fraction of budget expenditures. There are three types of entities in Russia that work with "off-budget" expenditures and revenues. There are government departments which collect fees for services provided; State Unitary Enterprises (SUEs) and State Owned Enterprises (SOEs).[6] Allowing Government agencies to collect fees for providing public services, and having SOEs or SUEs provide public services on behalf of the government are not in themselves bad practices. However, the quality of services that these sources of revenue help finance need to be subject to the same level of regulation and monitoring as directly-budgeted expenditures. During the chaos of the 1990's a pattern of loose controls on SOEs and SUEs has lead to a deficiency in the control and monitoring of these agencies. Of most concern is that very little information on revenues, expenditures and the services provided by these organizations is reported back to government, and almost nothing is available for public review. Since most government agencies receive government budget funds they are subject to tighter financial control and audit requirements than SOEs or SUEs.

A related issue of serious concern is that some regions create SOEs and SUEs, such as food funds, which are not viable commercial entities. After running for a few years the assets of these enterprises are transferred to a new enterprise and the "shell" company is left with the debt which creates a contingent liability on the Federal or Regional budget. The legal framework for controlling fee revenues collected by Government Agencies is clear. Agencies are required to deposit all fee revenue in a treasury account that is earmarked for the use of that agency. There are also procedures for setting fees and government standards for services. The key issue in managing non-budget revenue collection and use of these funds is primarily one of implementation. In practice is that there is no standard approach to managing these funds. For some agencies, the fee revenues are accumulated in a treasury account, accounted for by the Ministry of Finance, and all or part of the funds are released back to the agency to cover expenditures based on agreed arrangements with the Ministry. This is the appropriate arrangement. In other cases, government agencies retain all or part of their fee revenue in private accounts that are drawn on to cover expenditures. These expenditures are not necessarily reported to the Ministry of Finance. These agencies are sometimes involved in commercial activities, either sanctioned or not sanctioned by government, and these funds are mixed with the fee revenue and expenditures for public services. This makes it very difficult for the Ministry of Finance or implementing agencies to match expenditures with public service delivery.

[6] State Unitary Enterprises are wholly owned by the Federal, Regional or Municipal governments and have not been converted into joint stock companies. State Owned Enterprises are joint stock companies which are wholly or partly owned by the Federal, Regional or Municipal government.

Tighter regulation of SOEs and SUEs that impact on the agriculture and rural sectors is required. For public services that are provided for a fee by a government agency, SUE or SOE, the government should regulate both the fee structure and the service standards. An annual operating budget and schedule of fees should be approved the responsible government agency on an annual basis. For Government agencies that collect fees, the Government should develop and enforce a standard procedure that requires that they account for all fee income and expenditures, and report all financial activity to the Ministry of Finance and the Main Budget Agency to which they are subordinated. Financial operation and performance of standards should be audited by independent auditors, and the information should be made public. Audit requirements and public disclosure reduce the inefficient use of resources and the potential for corruption. For SOEs and SUEs that provide public services or implement policies on behalf of the Government new legislation is required to enhance reporting requirements, independent audit and public disclosure of financial information and services provided.

Agencies engaged in commercial activity should be earmarked for privatization. The Federal Government is already in the process of reviewing and reorienting the functions of many Government agencies. It has privatized many commercial functions that were formally managed by Government, but further improvements are still needed. Continued developments along these lines are to be encouraged. In particular, commercial activities of the Government agencies that conflict with their regulatory functions should be curtailed. Commercial activities that do not provide a public service should be removed from the mandates of SOEs and SUEs and consideration should be given to their ultimate privatization. In restructuring SOEs and SUEs, the sequencing of commercialization or privatization of enterprises is however important. Many SOEs and SUE are monopolies, commercializing or privatizing these entities without first curtailing the extent of monopoly power through regulation can have a worse effect on competition than simply having an SOE or SUE.

A clear demarcation between Government functions and commercial activity is required more generally. The lack of the clear separation between Government functions and business activities has also made Government policy making in Russia during the transition extremely difficult. The inherent conflict of interest created by having Government setting the rules for business and at the same time participating in business activities, has led to distortions that are detrimental to development. Once established, State-owned enterprises, which have strong connections to Government, especially at Regional level, tend to be effective in lobbying to maintain their privileged positions. The creation of Rosargroleasing, with monopoly rights and large Government subsidies, is an example of Government involvement in markets that has had a negative effect on the development of a private agricultural machinery leasing market. At the Regional Government level there are many regionally owned or controlled grain marketing companies that have had the effect of distorting markets and slowing the development of private grain markets.

Annex 1: Issues for the Next Decade and Suggested Sequencing for Their Implementation

Recommendations	Suggested Sequencing of Implementation
Policy Goals and Overall Policy Direction	
Policy goals The **goals of agricultural policy** should be defined considering that the rural development policy is an inherent part of the state policy in agrarian sector. The goals of agricultural and rural development policies should be well coordinated. Agricultural policy and rural development policy should continue to be the preserve of the Ministry of Agriculture but the strategic direction should be consistent with the general economic development goals defined by the Ministry of Economic Development and Trade. The broad focus of policy should be to underpin the long-run productivity and competitiveness of the sector and to improve the living standards of rural population.	Approval of the Framework Document (the Law on Agriculture) in which all these issues are clearly defined should be accelerated
Overall policy direction The main focus in the medium term should be on **the nature of policy interventions** rather than on the level of public expenditure on agriculture and rural policies. The balance of program expenditures should continue to be moved away from **market-distorting measures** towards measures that underpin the long-run productivity and competitiveness of the sector. New measures need to be devised to address the **serious structural deficiencies** that afflict the development of the agricultural sector. Priority should be assigned to developing a modern and efficient marketing system; the development of a competitive credit–supply and agricultural equipment leasing sector; the enhancement of farm re-structuring; and the attraction of capital investment into the sector. The autonomy that **Regional and Local Governments** currently enjoy in policy formulation and implementation needs to be gradually reduced.	This should inform the tenor of policy measures to be enshrined in the Strategic Plan. This process should begin in the next marketing year and be linked to a phased withdrawal of all market-intervention measures. Targets should be set out in the Strategic Plan. Developing a modern marketing system is a priority but it will take several years to implement. Leasing and credit market reforms are also essential medium-term reforms which should be realized before all market support measures are removed. The desired demarcation should be set out in the proposed Framework Document and a schedule for its implementation should be drawn up in the Strategic Plan.

An important thrust of national policy in the future should be support for the **economic and social development of rural areas as well as for sustainable land management**. The priority should be investment in public infrastructure such as transport, telecommunications and energy supplies, and in soil protection programs, so as to enable private-sector investment to thrive and create employment. Over time, the Ministry of Agriculture's intervention should focus on improving agricultural competitiveness and land management, while other agencies should have responsibility for social and infrastructure services.	Eventually, agricultural enterprises should be divested of the burden of providing social services in rural areas.

Bolstering Support Programs Most Relevant to the Objectives of Public Support	
A. More Effective Provision of Public Goods and Services	
The following key elements are recommended in the restructuring of public institutions that supply **"General Services"**: i) these institutions should only provide public goods that cannot or ought not to be provided by the private sector; ii) they should not be engaged in commercial activities, particularly those that compromise their ability to carry out regulatory functions; iii) clearly defined performance standards for provision of public services should be developed and agreed as part of the annual budget review process and form the justification for budgets provided; and iv) annual audits of the financial and service standards should also be carried out.	These protocols should be drawn up as part of the proposed Framework Document.
The **research and training** budget has been reasonably well maintained but as in other countries additional expenditure would generate value for public money. However, certain efficiency issues with the current system of resource allocation need to be addressed first.	The Research and Training budget should only be significantly increased once the structural issues have been rectified.
The efficiency of the research and training system could be enhanced by minimizing the level of core budget transfers to educational and research institutions and increasing the extent of competitive grant programs. Successful competitive grant programs for agricultural research and extension services have been established in many former Soviet countries and some have been implemented with World Bank financing.	A lead-time of about 1-2 years would be needed to implement these measures.
Livestock and crop improvement programs, other than measures that subsidize current inputs, are justifiable as public-good interventions and the real level of spending should be increased.	These measures should gradually replace current fertilizer, feed and seed subsidies.
More resources should be directed towards **employment creation** by private initiative in **rural areas**. Specific measures should include training programs for small-scale rural businesses, start-up grants for small businesses and small to medium sized farms, improving access to financial services, improving access to markets, promoting consumer and producer organizations, etc. The EU LEADER initiative is an excellent example of a highly successful rural-development program that might provide lessons that could be adapted to the Russian case. This will need to be followed by a system of **block grants to public works' projects**. A series of Successful World Bank Financed Rural Development projects in Poland, that integrated rural training programs and the development of rural infrastructure, could provide an interesting model for expanding the rural development program in Russia.	These measures should only be implemented following divestiture of responsibility for infrastructure and social services delivery from agricultural enterprises to Local Municipalities. In addition these measures should only be rolled out in conjunction with the proposed long-term Public Infrastructure Plan.

OECD countries that have comparable public expenditure outlays on agriculture and rural development tend to devote more public resources to areas such as **environmental measures, food safety and hygiene and general information provision.**	This process would be a key component of the above-mentioned Plan.

B. Reform of Market-Distorting Policy Interventions	
The efficiency of the **Federal price-stabilization program** would benefit considerably from the implementation of the following features: • Market interventions should be rule based and transparent, and rules should be implemented on a timely basis. • Programs should not be limited by a predefined volume or budget ceiling, at a level that are lower than can credibly support prices under all conditions. • Foreign trade regulations should be matched to the price intervention program in order to avoid an inflow of imports which would dilute the effect of the program. • Information on stocks, prices and government purchases should be publicly available. • Support prices should be available to farmers at the outset of the production cycle so that production decisions can be made on the basis of the floor prices. • In addition to the pricing rules that trigger procurements and sales, the government should be required by law to publish all information on government procurements and prices paid as well as information on grain stocks and crop forecasts. • **Price support programs at the Regional level** should be phased out.	This should be implemented in time for implementation in the next marketing year. These protocols would remain in place as market-support arrangements at Federal and Regional level are gradually phased out.
In the **longer term interest subsidies** should be phased out and the focus should be on increasing the supply of credit by developing lending institutions that lend to agriculture. This will require that the Federal Government develop a comprehensive program for strengthening the legal and institutional framework so as to encourage the emergence of alternative lending institutions dedicated to the sector.	The proposed Framework Document should set out the intent of Government to promote an effective and competitive credit market. This will require the encouragement of new providers and the breaking up of the existing monopoly suppliers. The credibility of Government's commitment to this objective would be reinforced by the phased removal of interest-rate subsidies.

The Federal government should phase out its **agricultural equipment leasing program** and allow more competition in the sector. Improving the country's leasing laws together with circumscribing the role of the Regions in leasing arrangements would also improve the viability of commercial leasing. The **insurance-subsidy program** should be completely overhauled. Templates for successful program design are available from other countries. Schemes through which a simplified pay-out is made to all policy-holders based on weather-based biometrics provide good models. However, a first step would be to revise the payment method for subsidies so that subsidies are paid to the purchasers of insurance and not the insurance companies. The **Federal Fertilizer program** was discontinued in 2004 and should not be re-installed. Resources would be better utilized if they were spent on measures that would enhance long-run productivity such as investments in soil conservation and land improvement and restoration measures.	Immediate measures need to be put in place to enable a viable leasing sector to emerge. The incentive in the property tax system that encourages the transfer of the ownership of leased assets to the lessee needs to be first addressed. Competition must be encouraged through breaking up the existing monopoly and a clear plan laid out as to how the Government envisaged the progression of the market.

C. Improving Budget Discipline Budget discipline would be improved significantly if considerably more detail and information were available on the structure of **General Government Services.** Rather than the State provide **tax breaks to agriculture** on a blanket basis, it would be more efficient to allow cost deductions for specific capital investments rather than all expenditures. In time the tax rates that apply in the sector should be adjusted in line with other industries, or they will result in long-term investment distortions in the economy.	The Framework Document should set down the detail required and a mechanism for the speedy implementation of the recommendation. The impact of all tax breaks to the sector should be the subject of an urgent study. Pending their gradual elimination, tax breaks should be designed to achieve more specific objectives, such as capital investment.
Period **debt restructuring**, while essential in crisis situations, should be used only in the most exceptional of circumstances.	The proposed Framework Document and the follow-on Strategic Plan needs to set out a clear plan to ensure the sustainability of the agricultural sector.

Strengthening the Management of Support Programs	
A. Ensuring Greater Coherence Between Federal and Regional Policy Design and Implementation	
Policy making and funding for agricultural **producer support programs** should be the exclusive responsibility of the Federal Government. For **general services provision** implementation should be decentralized, under clear national standards and earmarked funding.	The proposed Framework Documents should set out a clear demarcation between Federal and Regional spheres of competence and responsibility.
To facilitate a speedier re-structuring of agricultural enterprises, the responsibility that these enterprises traditionally assumed for the provision of a wide variety of **social services** should be divested to Local Governments on an appropriately phased basis. Unburdened of these social responsibilities, agricultural enterprises can focus on the pursuit of their commercial mandate.	A clear signal in the proposed Framework Document of the Government's intent in this regard needs to be made. A schedule for its implementation can then be incorporated in the strategic plan.
In determining the appropriate balance between the roles of the **Federal and Regional** Governments the recently devised EU model for the CAP provides a model that should be examined as a possible template.	A study should be undertaken on the feasibility of different models of federal-governance to inform the construction of the proposed Framework Document.
Russia could benefit from the enactment of a **general agriculture law** that would frame the broad policy agenda and ensure a clear connectivity with its funding. This legislative framework should define the parameters under which Regional Governments could set agricultural policy and delineate the areas of responsibility appropriate to the Federal and Regional governments.	The enactment of legislation should follow the outline of the relationships between the different levels of government in the proposed Framework Document.

B. Reform of the Budget process	
There is a need for a much greater degree of coherence between the determination of strategic **policy interventions and their funding** as reflected in the Budget.	The alignment of policy with budget commitments should be a key feature of the proposed Strategic Plan.
In order to meet the requirements of WTO and achieve better coordination of Regional and Federal policies and expenditures, the same **budgeting and monitoring system and system of budget classification should be used at both the Federal and Regional level**.	This measure can be outlined in the proposed Framework Document and a schedule for implementation set out in the Strategic Plan.
In order to develop a system of **budget classifiers** that capture the large variety of different programs at the Regional level, a comprehensive study should be carried out at both the Federal and Regional level to develop a new set of classifiers.	This study should be commissioned immediately and any recommendations should be incorporated in the proposed Framework Document and subsequent Strategic Plan.
The current budget **classification system** should be revised to provide a more balanced and inclusive set of line items that better match the Government's current policy instruments, and which allow easy classification for WTO purposes.	
The successful **implementation of PBBS** in Russia will involve fundamental changes in the entire budgeting and expenditure system. The basic budgeting, accounting and monitoring system should be overhauled before a PBBS can be successfully implemented.	Implementation of a full-blown PBBS is a very-long term objective. In the immediate and short term, focus should be on the implementation of more basic improvements in information gathering and reporting.
The policy-making process should be more closely tied to the budgeting process. This could be achieved by moving to a **multi-year budget planning** process and by making the budgets for Federal Targeted Programs binding on the annual budget process.	This is a long-term objective and logically follows the implementation of several other basic reform measures.

C. "Off-Budget" Expenditures and Controls on SOEs and SUEs In general, **the quality of services that are supplied by agencies, which are part funded by revenues generated from their fee-collecting activities**, should be subject to the same level of regulation and monitoring as directly-budgeted expenditures. The Government should **regulate both the fee structure and the service standards for public services that are provided for a fee by government agencies.** Regulation should involve *inter alia*: an annual operating budget and schedule of fees approved by the responsible government agency on an annual basis; the development and enforcement of a standard procedure that requires that agencies report all fee income and expenditures to the Ministry of Finance and the Main Budget Agency to which they are subordinated; that the financial operation and performance of standards should be audited by an independent auditor; and, all information concerning these agencies should be made public. **Commercial activities that do not provide a public service** should be removed from the mandates of Government agencies and consideration should be given to their ultimate privatization. In restructuring Government agencies, the **sequencing of commercialization** or privatization should be given careful consideration. Many of these agencies are monopolies and commercializing or privatizing these entities without first curtailing the extent of monopoly power through regulation could worsen the environment for competition.	The entire role and operation of these agencies needs to be reviewed in accordance with the principles set out here and enshrined in the proposed Framework Document.

Annex 2: Review of the Selected Regions

Belogorod Oblast

Overview of Agriculture in the Belgorod Oblast

Agriculture accounts for about 14 percent of the gross regional product and accounts for 20 percent of jobs in the region. The structure of production comprises 346 agricultural enterprises and 2,007 private household farms as well as household plots. Over 60% of the region's agricultural land is devoted to crop production. The region produces 15 percent of Russia's sugar supply, 10 percent of its vegetable oil, 4 percent of its butter output and a large share of the Federation's milk and meat. The physical volume of agricultural output for both crop and livestock production grew significantly between 1999 and 2003.

Private farms account for 2.8% of agricultural output, household plots for 43% and agricultural associations account for about 54%.

The number and share of loss-making agricultural organizations has been diminishing in recent years and the overall sector was in profit in 2004. Only the production of cattle was loss making. The production of sunflower seed, grain and eggs remained highly profitable.

Review of agricultural policies in the Belgorod Oblast

In recent years the Belgorod Oblast has adopted a number of policies aimed at supporting agricultural producers by creating the organizational and economic conditions for their effective operation; improving management capability; devising credit policies and guaranteed payment of wages in agriculture. These policies included the creation of vertically integrated agricultural organizations in order assist insolvent agricultural enterprises in strengthening their finances and enabling them to raise funds to acquire the means of production.

In 2004, the oblast adopted a Strategy of the Development of Agricultural Production and Improvement of Agricultural Management aimed at further increasing agricultural output, making agriculture more competitive and ensuring a higher quality of life for rural dwellers. The Strategy provides for increased production of competitive goods, including the creation of new capacity for the production of the main livestock products, poultry, eggs, meat, and the development of pedigree cattle with higher levels of productivity. The strategy also envisages modernization of existing grain storage enterprises, elevators, combined fodder production enterprises and the development of programs for pig-breeding and dairy farming.

To encourage investment in dairy farming, poultry and pig breeding the oblast introduced in 2004 a variety of highly attractive tax breaks.

In 2003 oblast adopted a targeted program for the social development of rural areas.

Budget Spending on Agriculture

Federal direct spending on the AIC increased from 47 million rubles in 2000 to 445 million rubles in 2004. The most rapid elements of spending include program administration and interest subsidies and the establishment of the aforementioned program of social development of rural areas.

The spending on some programs (e.g., programs such as the enhancement of soil fertility and the social development of rural areas) are funded to a significant extent from sources other than direct AIC budget expenditure.

The share of direct AIC spending in the oblast budget is less than 2%. Oblast direct spending on the AIC increased from 133 m. rubles in 2000 to about 170 m. rubles in 2004. The administration costs of the Agricultural Ministry bring the total direct AIC expenditure to just over 192 m. rubles. The two single most important expenditure items are support for research and development and interest-rate subsidies.

However, this level of expenditure is dwarfed by spending on agricultural and rural development that is financed from other budget lines and “off budget”. Various tax benefits and fuel subsidies amounted to transfers to the AIC of over 115 m. rubles in 2004. State loan guarantees for a number of agri-enterprises totaled about 270 m. rubles. However, by far the greatest level of expenditure of this nature comprised rural development outlays (housing, roads, wage subsidies for local agencies, etc.) which are estimated at about 1.2 b. rubles in 2004. In addition the AIC benefits from a series of targeted regional programs (e.g., "Belgorod Children", "Development of a Common Educational and Information Environment in the Belgorod Oblast", "Development and Protection of Culture and Arts and the Belgorod Oblast in 2001-2005", etc.). It is very difficult, however, to quantify the impact of these programs in the region. Overall our estimate is that the consolidated budget of the Belgorod Oblast spent about 2 billion rubles to support agriculture and rural development in 2004. If we include spending from the federal budget the total level of expenditure on the AIC in the region emerged at about 3 b. rubles in 2004.

The local direct budget expenditure on the AIC is only about 21 m. rubles.

Reforms in the oblast’s budget support for the AIC

The set of agricultural and rural development support policies in the Belgorod oblast in the period under review has changed substantially and for the better. Expenditure on rural infrastructure and social development are growing. Substantial amounts are spent on public goods such as agricultural science, education and innovation technologies. At the same time the regional authorities have largely abandoned specific output subsidies and programs that create and support state or (quasi-state) structures which channel resources from the oblast into such programs as the formation of regional food funds, the provision of machinery and equipment under leasing schemes and commodity credit schemes.

Overall, the policy of support of agriculture and the agri-industrial complex in the Belogorod oblast involves measures that do not obstruct the development of market relations in the agri-industrial complex to an undue extent. The results of the current stance of agricultural and rural support policy have been positive in respect of several indicators, e.g.: a steady reduction of the number and share of loss-making agricultural organizations; the profitable operation of plant and livestock breeding; increased yields of grain, sugar beet, vegetables, fruits and berries. In macro terms the real incomes and savings of households are growing rapidly and the share of population below the poverty line is falling.

Notwithstanding these highly positive developments, there are further opportunities for improvement in areas such as science and technology, crop insurance, enhanced support of private farms, credit support for small-scale agricultural organizations, more effective control, monitoring and evaluation of effective agricultural and rural development expenditure.

Leningrad Oblast

Overview of agriculture in the Leningrad oblast

The Leningrad Oblast is one of the leading agricultural regions of Russia. Agriculture accounts for about 12 percent of the gross regional product compared with the average share for Russia of 5.2 percent (2003). The agricultural population decreased steadily throughout the 1990s down to 557,000 in 2004. The share of employment in agriculture is half that in industry.

Poultry and dairy breeding are the leading agricultural sectors. In terms of the productivity level of egg farming (307 eggs per laying fowl) the Leningrad Oblast has caught up with developed economies, and in terms of cow milk productivity (about 6 tons per cow) it is getting close.

Potato and vegetable production is declining. The grain harvest is not growing and the sector's development trends are unstable. Milk production has also been decreasing in recent years, while eggs production remains at roughly the same level.

Large agricultural organizations are the principal producers of farm produce in the region. In 2004 they accounted for 63.6 percent of gross agricultural output. During the first years of reforms their share in gross production decreased from 76 percent in 1991 to 43 percent in 1997, but then recovered. Agricultural organizations use 77.4 percent of the farmland and are the main producers of grain (over 90 percent); they also account for a major part of livestock production.

The more profitable sectors in the oblast are eggs and milk production.

All meat production is loss-making, with the worst losers being beef (profit margin of - 45 percent) and poultry (profit margin of - 10 percent).

Leningrad Oblast Regulatory and Legal Acts on Agricultural Policy

In late 2000 the **regional targeted program Development of Agro-Industrial Complex of Leningrad Oblast in 2001-2005** was approved by a resolution of the oblast government, setting out the goal of boosting the complex by making its output more competitive. The program sets out policies on land usage, the restructuring of agricultural organizations, staff training, the development of private farms and household plots, improving access to St. Petersburg markets, raising soil fertility, preserving the gene pool, development of individual sectors of the agro-industrial complex, agro-industrial integration, rural social development, scientific support and financial support for the agro-industrial complex. The budget of the program is estimated at 1.4 billion rubles to be provided from the oblast budget.

According to this comprehensive program, at least 5 percent of the oblast's annual expenditures will be used to provide government support for the agro-industrial complex. The program defines key targets for financial assistance: development of targeted regional programs, subsidies for the production of certain types of produce, compensation of expenditures on certain inputs, leasing, subsidies for interest rates on loans, issue of loans against produce, debt restructuring, and support for model farms, competitions, shows, international projects, regional microcredit funds and depressive regions in the north-eastern area of the oblast.

The federal targeted program **Rural Social Development to the Year 2010** was launched in the oblast in 2003, and in 2004 a similar regional program was approved. The goal of this program is to develop social and engineering infrastructures in rural areas and support sustainable rural development. The regional program was drawn up on the basis of the respective federal program. The planned budget for the program in 2005-2010 is 2.4 billion rubles, including 618.4 million rubles from the federal budget, 964.1 million rubles from the oblast budget, 110 million rubles from local budgets and 641.4 million rubles from off-budget sources. The program sets out concrete goals for supporting housing construction, personnel training and retention, developing a network of recreational facilities, telecommunications, roads, gas supply, etc.

The regional targeted program **Preservation of Gene Pool in Crop Growing in the Leningrad Oblast for 2001-2005** was approved in 2002. The program provides for measures to support the production and acquisition of elite seeds. On top of federal budget subsidies the oblast budget provides subsidies for the acquisition of seeds of grain and grain legumes in the amount of 2,000 rubles per ton; vegetable seeds – 4,000 rubles per ton; and perennial herbs – 20,000 rubles per ton.

Just like the federal government, the Leningrad Oblast government annually passes resolutions on spring sowing and crop harvesting campaigns that are mainly designed to improve labor efficiency. Legal regulations cover all areas of agrarian production such as the financial restructuring of agricultural enterprises.

The oblast budget for the agriculture complex covers a wide range of interventions. For instance in the 2004 budget some 14 different programs and measures are identified:

1. Regional targeted program (RTP) for the Preservation of Agricultural Land Fertility in the Leningrad Oblast in 2002-2005.
2. RTP for the Preservation of Gene Pool in Crop Growing in the Leningrad Oblast in 2001-2005.
3. Subsidies for the production of certain types of produce (grain, cattle meat, pork, milk, young cattle stock for fattening, breeding sows, honey-bee colonies).
4. Support for pedigree livestock breeding.
5. Partial reimbursement of expenses on electric and thermal power and gas for greenhouses.
6. Partial reimbursement of interest rates on loans to agro-industrial enterprises, private farms and private subsidiary plots.
7. Partial reimbursement of crop insurance to agricultural producers.
8. Support for farm producers in the north-east of the Leningrad Oblast.
9. Subsidies for unforeseen expenses.
10. Scientific and information support for the agro-industrial complex of the oblast.
11. Government support for private farms and private subsidiary plots of the oblast.
12. Funding for erosion control measures.
13. Support for the HR pool of agricultural production;
14. Funding for other measures to develop the agro-industrial complex.

RTP Fertility

In total 321.3 million rubles were spent on this program in 2003. About 60 percent came from enterprises and organizations, but the budgets of various government levels also invested heavily in this program. About one-third of local government expenditures on agriculture was invested in the program in 2003, while the program's share in the oblast agrarian budget was 14 percent.

Land improvement measures (repairs and new construction), acquisition of mineral fertilizer, calcium fertilizer and peat, agro-clinical studies and experiments are financed under the Fertility Program. Land improvement measures are financed primarily from various budgets but principally from the federal budget. In 2003 all the oblast budget appropriations for the purpose were made available to one recipient, the federal government entity Lenmeliovodkhoz, without any competition.

Acquisition of mineral fertilizer and peat is financed primarily by farm producers, with budget subsidies covering about 25 percent of total fertilizer costs. However, mineral fertilizer procurement is subsidized mainly from the federal and local budgets and peat from the oblast and local budgets (no federal funds are allocated for peat). Lime treatment for acid soils is mainly financed from the oblast budget.

RTP Crop Farming Gene Pool

This program provides funds for six main areas: Support for Selection Work, Primary Seed Growing, Testing New Varieties, Improvement of Varietal Energy-Saving Technologies, and Strengthening of the Material and Technical Base of Seed Growing.

The program does not stipulate how seed providers are selected or how subsidized procedures are to be verified.

Production subsidies

In 2004 the main production subsidies were as follows:

Grain. A number of grain producers are selected and each is assigned a grain production target (in tons). The order of the Committee for the Agro-Industrial Complex sets the rates of 250 rubles per ton of grain within the target and 700 rubles per above-target ton. The producer receives a 50 percent advance payment. If the target is not achieved, the producer forfeits the right to any subsidy and returns the advance payment.

Beef. The subsidy rate per ton of live weight is 1,400 rubles for all producers, except for the CJSC Iskra and JSC Rassvet (fattening farms), which get 2,400 rubles per ton. Individual subsidy rates (even though justified by the high quality of the meat produced in fattening farms) are in conflict with the principles of the Russian legislation that proclaims the equality of all producers. The subsidy is conditional on maintaining the cattle population at the level as of 01/01/2004. Subsidies are not paid for the months in which the population is below the level.

Pork. The subsidy rate is set at 870 rubles per ton (live weight) and on condition that the pig population is not below that as of 01/01/2004.

Milk. The subsidy rate is set at 150 rubles per ton of milk sold to Leningrad Oblast dairy factories or processed on site. The subsidy is paid on condition that the animal population is not below the level as of 01/01/2004.

Young cattle. The subsidy is in the amount of 4,000 rubles per ton of live weight is paid on animals below 60kg per animal and on condition that the animals are delivered to the fattening farms (CJSC Iskra or JSC Rassvet). Also these two farms receive a subsidy of 4,000 rubles per ton of accepted cattle.

Primary breeding sows. The subsidy is 600 rubles per breeding sow payable under the condition that the sow population in each quarter is not lower than that on 01/01/2004.

Bees. A subsidy of 500,000 rubles was paid to the government enterprise Leningrad Division of the Beekeeping Agency under contracts with the oblast Committee for the Agro-Industrial Complex. The Agency registers apiary sites and honey-bee colonies and supports breeding activities, technical control and veterinary and sanitary supervision.

Support of Pedigree Livestock Breeding

Additional subsidies are paid highly productive milk cattle; pedigree fowl; pedigree bull semen; and pedigree young beef animals. Recipients of the first two categories of subsidy are based on at an oblast approved list of farms while the latter two categories of subsidy are conferred exclusively on the Federal State Unitary Enterprise Nevskoye.

Subsidies on greenhouse production costs

These subsidies are paid to farms, subject to a maximum of 20% of total farm expenses, that are approved by the oblast Committee for the Agro-Industrial Complex. In 2004 six farms were deemed eligible for these subsidies.

Credit subsidies

Subsidy recipients include farm producers, logistics and agricultural equipment service organizations, feed-processing plants, dairy and meat processing plants, fish-processing factories, fish farms and fishing companies. Both highly and marginally profitable entities are in receipt of subsidies. There is a high level of bureaucracy involved in processing applications for these subsidies which may effectively restrict the number of eligible applicants.

Crop insurance subsidies

The procedures for the payment of the subsidy and its (up to 50 percent of the insurance premium) are the same as under the federal laws. The principal insurer is the Podderzhka-Garant insurance company, which has a 35 pre cent share of the national crop insurance market.

Producer subsidies applying in the north-east of the Leningrad Oblast

Seven districts of the oblast belong to this area. Subsidies are paid to partially (up to 70 percent) reimburse their expenses on seeds, fodder, mineral fertilizer, pesticides, peat, oil and lubricants, spare parts and other inputs. The total amount of subsidies is set in the oblast budget law and the funds are distributed between districts of the north-eastern area by an order of the oblast Committee for the Agri-Industrial Complex.

Subsidies for scientific and informational services

The topics and expenditure are determined on the basis of applications submitted by research institutions. These applications are reviewed by different departments of the oblast Committee for the Agri-Industrial Complex and then approved by a task group. Contracts are signed with the parties performing work on the approved topics.

The distribution of budget funds is not competitive. It is not uncommon for the allocation process to take many months, often up to September or October of the year in question. Since funds are provided from the annual budget, application reports are to be filed in November or December. As a result, funds are often used very irrationally.

In 2004, almost 900,000 rubles of budget money went into supporting the work of the state-owned Leningrad Oblast Agrarian Consulting Agency, and in 2005 it is to get 730,000 rubles. In effect, budget funds are the primary source of income for this for-profit organization (in 2004 it sold 205,000 rubles worth of services). According to its Charter the Agency popularizes advanced management methods and techniques by providing paid and free informational and consultation services; participates in the establishment of model farms, in the publication and distribution of informational materials, ads and analytical products; develops software and hardware and computer telecommunications technology; and organizes agro-industrial shows and trade fairs.

Funding for Federal Programs in the Region

There are a number of regulations that govern the joint work of the federal and regional authorities in implementing federal programs in the region. One of these regulations is the agreement between the RF Agriculture Ministry and the Committee for the Agro-Industrial Complex of the Leningrad Oblast.

The RF Agriculture Ministry undertakes to transfer the budget funds for executing the agreement in a timely manner to the accounts of the oblast Committee for the Agro-Industrial Complex with the Federal Treasury Office in the Leningrad Oblast. The oblast committee undertakes to disburse federal funds according to the rules for transferring funds to budget transfer recipients and to report to the RF Agriculture Ministry on the application of federal budget funds in the oblast.

Analysis of federal, regional and local budget expenditures for support to Leningrad Region AIC (2000-2004)

The consolidated agricultural budget of the Leningrad Region is formed from federal, regional and local budget resources. Key sources of finance are the federal and regional budgets. In the years under review budgetary expenditures for agriculture (out of the budgets at all levels) increased two fold; the share of federal resources grew almost three fold, while receipts from municipal budgets rose only slightly.

The overall level of financial support to the farm sector in the Leningrad Region is lower than the average for Russia as a whole, notwithstanding the fact while the structure of the region's farm budget is fairly similar to the overall budget of Russia.

The farm budget is spent on farm production, land improvement schemes, produce purchases and storage, fisheries and other needs. Federal spending goes mostly on farm production, local budgets are mainly spent on land improvement schemes, and regional – preeminently on other efforts, land improvement and on farm production.

The years under review saw a rise in the share of farm budget spending on farm production and a drop in the share of spending on land improvement schemes.

Subsidizing a part of the rate of interest on credits of banks

There were 174 large and medium-sized agricultural enterprises in the Leningrad Region in 2003, and only 134 of them, or 77%, received credits from banks. And it was only 97 farms that got subsidies to reimburse their credit interest payments; i.e., 72% of the farms receiving credits. The rest either had not applied for subsidies at all or had been refused due to untimely completion of documents or because of the exhaustion of the limit for subsidies.

Nine farms there, or 5% of the total number, accounted for 51.3% of all the payments from the federal, regional and local budgets to large and medium-sized agricultural enterprises of the region. Thus, far from all the agricultural enterprises had access to subsidized credits – and subsidies were so distributed that only a small number of the largest producers received them.

Access for small farm businesses (peasant private farms, private plots, individual entrepreneurs) to interest-rate subsidies is severely restricted due to the paucity of banks at local district level, the high cost to banks of dealing with these small units and the prohibition in the Budget Code on the subsidization of private plots.

In 1999-2003 in the Leningrad Region with the backing of the Regional Government and the UK Department for International Development a pilot small-farm credit project was initiated. The pilot proved to highly effective. In 2004 the regional administration independently, without sponsors' support, extended the pilot project to another three districts of the Leningrad Region.

Fertilizer subsidies

The actual distribution of subsidies for mineral fertilizers among the large and medium-sized agricultural enterprises is shown in Table 4. About 20% of the agricultural enterprises in the region applied no fertilizers at all; another 15% did apply fertilizers, but got no subsidies. For farms in receipt of subsidies the average subsidy rate was 21% of fertilizer costs.

But the distribution of subsidies within the region is very lopsided. A single farm received 5.3 % of all the fertilizer subsidies and 5% of the large and medium-sized agricultural enterprises of the region (a total of nine farms) received 21% of all subsidies in 2003, accounting for nearly 65% of their total fertilizer costs.

Milk Subsidies

The Leningrad Region had 135 large and medium-sized agricultural enterprises producing and selling milk in 2003. But only 83 farms (61%) of them received subsidies. The rest did not get subsidies, because payments are only available when a farm sells milk to a factory (or has its own processing shop). In addition to these regional-based subsidies many municipalities also pay supplementary subsidies. It is mainly large milk producers that receive subsidies and the rate of subsidy for these farms is almost five times higher than the regional average.

Meat subsidies

There were 158 agricultural enterprises producing and selling meat in the Leningrad Region in 2003 and most of these were in receipt of subsidies. The average subsidy per ton of meat was 265 rubles but some farms received much higher levels, e.g., OAO Rassvet received a subsidy of 2,143 rubles per ton which is eight times higher than the regional average. Eight farms accounted for 30.4% of all subsidies.

Equipment and pedigree cattle and poultry leasing

Considerable budgetary resources are accumulated in the leasing fund of the region. As of 1 January 2005, the total amount of resources in the leasing fund to provide the agro-industrial complex of the Leningrad Region with equipment was 141m rubles and as of 1 January 2006 it increased to 181m rubles. In addition, 1.5m rubles in budgetary credits are earmarked in the 2005 regional budget for the leasing of highly productive pedigree cattle and poultry.

The resources of the leasing fund are used to provide budgetary credits to authorized leasing companies on a competitive basis. Based on the results of a competitive selection, in May 1998 OAO Lenoblagrosnab received the status of authorized leasing company of the Regional Government and spending resources on engineering products has been occurring through it since then. In addition, since 2002 Lenoblsnab has been acting as a sublessor under sublease contracts through the state leasing company Rosagroleasing.

The federal leasing program is well over two and a half times as expensive as the regional program. Even the original price of equipment, for example a same-model tractor, tended to be higher under the federal program.

Especially since farmers are forced to rely on leasing services due to the shortage of working capital, the effectiveness of operations for the lessor is low, and indebtedness to the leasing fund is substantial at up to 30%. A clear question marks hangs over efficiency and effectiveness of this form of support for agricultural producers.

The regional food fund

In accordance with the Regional Food Fund (RFF) Regulations of 2003, this fund is meant to provide the Leningrad Region with food, forage grain and its processing products; that is, it is a targeted budgetary fund. At 1 January 2005, the resources of the RFF amounted to 146.6m rubles (this is about half of the regional farm budget). The steward of the fund's resources is the region's Governor, and the provision of resources to users is done by the Regional Finance Committee (RFC) in the form of an interest rate credit for a term of up to one year at 1/3 of the Central Bank rate.

In accordance with the Fund Regulations, the Agri-Industrial Complex (AIC) Committee must exercise control over the intended and rational utilization of budgetary credits from the RFF. But it does not conduct this work. Moreover, the officials of the Committee obviously do not wish to interfere in sphere of influence of the Governor or the RFC. They know nothing about the fate of their recommendations. The effectiveness of resource spending under this program is not analyzed by the AIC Committee.

Grain, fuel and lubricant purchases through the Food Market Regulatory Agency

The Leningrad Region Food Market Regulatory Agency (LR FMRA) was set up to ensure the repayment of funds by indebted agricultural enterprises which had received budgetary loans in the period 1994-99, along with the payment of an interest charge for use of the borrowed funds. It was envisaged that all of the funds that came in as debt repayments would be used for the purchase of grain, mixed feeds, fuel and lubricants and for the supply of these goods to the agricultural enterprises of the Leningrad Region.

Actually the rights were handed over to the Agency to recover a debt in the amount of about 25m rubles. By 2004 the Agency had recovered about 15m rubles. Of the 15m rubles only 8m rubles is currently used for procurement activities. In 2003 the Agency received a loan of 10m rubles at a rate equal to 1/3 of the Central Bank refinancing rate.

Funds received from debtors, as well as loans made it possible to increase the goods turnover volume significantly. In 2002 it stood at 94.6m rubles, and in 2003 at 111.8m rubles. Supplies of grain, oil-seed meal, cake, and sunflower seed oil amounted in 2003 to 99m rubles (88.6%), and supplies of diesel fuel and gasoline 12.8m rubles (11.4%). In 2005 supplies of fuel and lubricants went up significantly, because under the arrangement between the region's Governor and Lukoil the prices of gasoline and diesel fuel were markedly reduced. Thus, in May the Agency (LR FMRA) supplied gasoline to agricultural producers at 9.6 rubles per liter (including 2.5% commission), and the ex-factory prices of the Kirish Plant were 10.8 rubles.

Purchases for the regional food stock

Food purchases for the regional stock which are made to provide for social sector institutions and organizations financed from the regional budget, play an important role in the agrofood policy of the region. Resources are available from the regional budget to supply the institutions and organizations of the social sector with food. Those resources are used to extend to agricultural producers a commodity loan in the form of fuel, lubricants, fertilizers, and so on. Contracts are entered into between agricultural producers and processing plants, on the one hand, and social sector institutions and organizations on the other. Since the resources for food purchases are not allotted for the purpose of supporting the price of agricultural produce, but of supplying budget-financed institutions, these expenditures do not feature in the Agriculture section, but in the sections that refer to the relevant institutions.

Conclusions and recommendations

The Leningrad Oblast is one of the leading agricultural regions of Russia. Agriculture accounts for about 12 percent of the gross regional product compared with the average share for Russia of 5.2 percent (2003). Poultry and dairy breeding are the leading agricultural sectors. The more profitable sectors in the oblast are eggs and milk production. All meat production is loss-making, with the worst losers being beef.

1. The overall level of financial support for the agricultural sector in the Leningrad Region is slightly lower than the national average.
2. The region is clearly striving to be self-sufficient on a large range of farm products. In 2004, for example, subsidies were provided for the production of grain, beef, pig meat, milk, young cattle for fattening and beekeeping.
3. Subsidy payments are invariably tied to the fulfillment of certain targets. These targets are often unrealistic in the case of grain, for example, and an enterprise failing to fulfill the target must return a 50% advance, which may substantially affect its financial position. Milk production subsidies are supposed to be paid on condition that the cow population is maintained in fact the cow population has been steadily decreasing.
4. Several aspects of the administration of the subsidies raise issues of equity and efficiency:

    a. The principle of the equality of all commodity producers is violated in the course of the payment of subsidies for the production of individual types of output.
    b. It is mostly the largest agricultural enterprises that receive support.
    c. Frequently credit subsidies are provided to highly profitable industries

5. The principal AIC support programs of the Leningrad Region coincide with federal support programs: soil fertility program; the preservation of the crop gene pool; pedigree livestock breeding; the reimbursement of an interest rate; crop insurance; and social countryside development. Participation in the same programs by federal as well as regional bodies often leads confusion, both in use of these subsidies (for example, owing to the various rates) and in their accounting. Now that matching finance is a condition of the provision to regions of subsidies from the federal budget, regularizing the allocation and accounting of subsidies is of more acute great importance.
6. So called miscellaneous items amount to a significant portion in the farm budget. The transparency of the allocation, use and accounting of these outlays needs to be considerably enhanced.

7. Financial support from the regional budget for the Farm Consulting Agency needs to be examined. The Agency currently carries out market kinds of information and consultation activity for which it should be charging an economic cost. If the Agency were to supply more "public" goods such as the collection, processing and dissemination of market information (on the region's farm policy, the condition of markets, including prices, and so on) then a better case for federal budget support could be made.
8. The efficacy and efficiency of the considerable amount of budgetary resources that are allocated towards the subvention of leasing can be questioned. A preferable approach would be to provide interest subsidies for the purchase of farm equipment through the lending institutions.
9. Little attention in the region is paid to the program of crop insurance, even though it is in this region of high-risk production of grain, potatoes and other crops that it is very relevant. In 2004 only 15 farms participated in the crop insurance program. The AIC Committee needs to analyze the factors influencing the participation of agricultural producers in this program and to act to remove the obstacles that are identified.
10. The regional farm budget does not reflect all of the outlays for agriculture. A very substantial part of the outlays arises from other sections of the regional budget (e.g., the regional order, the regional food fund, the Food Market Regulatory Agency, social and other programs) runs under other sections of the regional budget. In addition, 70m rubles is the "concealed' support due to lower electricity tariffs.
11. Considerable sums not included in the farm budget (making up about 40% of the farm budget of the region) are allocated in the regional budget for food purchases for the regional food stock (the regional state order). For the most part these resources are provided to agricultural producers under tied-credit schemes, and the AIC Committee effectively does not participate in this process. It is thus almost impossible to assess the effectiveness of this scheme.
12. A significant portion of the budgetary funds (146.6m rubles), which constitutes nearly half of the regional farm budget, is alienated under the Regional Food Fund program. This appears to be one of the least transparent programs of the budget. Although in accordance with the Fund Regulations the AIC Committee ought to exercise control over the intended and rational use of the budgetary credits from the RFF, it conducts no such work.
13. The management of about 15m rubles in budgetary funds generated from the recovered debts of agricultural producers has been transferred to the Food Market Regulatory Agency. With these resources the Agency purchases grain, mixed feeds, fuel and lubricants and supplies these goods to the agricultural enterprises of the region. The functions performed by the Agency do not reflect any systemic approach towards market regulation. It is not clear why the purchase and supply activities of this Agency should not be undertaken by wholly private agencies. This would free up the Agency to undertake functions that solely concern regulatory matters.
14. Only a small portion of the outlays for social countryside development is reflected in the farm budget. The AIC Committee should monitor and analyze all these "extra-budgetary," including social, expenditures.
15. There is reluctance in many instances to hold a genuine tender for the supply of public services. Also there is a widespread practice of government entities avoiding open tenders for the use of budgetary funds by ensuring that contracts are so allocated than the value of no single contract exceeds a level of cost that requires competitive tendering. A renewed commitment by all levels of government to the principle of competitive tendering will help not only to fund activities of the greatest priority, but also to raise both the transparency and effectiveness in spending budgetary funds.

The Republic of Mordovia

Overview of agriculture in the Republic of Mordovia

The share of agriculture in GDP stands 21% against the national average value of 5.2% (2003). The proportion of rural population in the Republic of Mordovia is 40.6%. Both the proportion and numbers of rural population in the republic are steadily declining. Per capita gross regional product is almost twice lower than the average for the Federation. Growth rates for this indicator are also below the national average. The level and growth rate of the average monthly wage in the republic lags behind national performance.

The volume of agricultural produce has been rising at a relatively modest rate over the last few years. Private farms and household plots account for nearly two-thirds of total agricultural output. In 2002 94% of the grain output came from agricultural enterprises, while 97% of potatoes and 58% of livestock and poultry from private plots. In 2004 agricultural enterprises produced 44% of all meat (in live weight) and 46% of milk. Notably, agricultural enterprises produce less milk and livestock and poultry meat than do the private plots. Yet the bulk of support from the republic budget is funneled into the agricultural enterprises.

The number of loss making agricultural enterprises in the last few years has been decreasing (from 172 in 2002 to 150 in 2004), but their proportion (37%) remains high, considering the significant level of support for agricultural production in the region. Their indebtedness stood at 4.7 billion rubles in 2004.

Subsidies expended from the regional budget

The most recent statement of sectoral policy is set out in the **Program of Economic and Social Development of the Republic of Mordovia for the Years 2003 to 2007**. Farm policy is to be directed to forming "effective and sustained production of agricultural products, improving the financial and economic position of the AIC enterprises, raising the level of rural population incomes, preserving and reproducing natural resources for subsequent production"[7].

The document targets an annual growth in production of 7 - 8 percent. That aim is declared as the basis for improving the financial and economic position of the AIC enterprises and improving the quality of life for the rural population. Policy is aimed at detailed regulation of agricultural production in Mordovia, which is at odds with the development of a market-oriented AIC.

Provision is made for the following types of subsidies in the republic:

1. Subsidies for pedigree livestock raising support

These payments cover part of the animal purchase and maintenance costs and of the reproduction and selling costs of pedigree cattle if sold to legal entities and peasant farms registered within the territory of the RM.

2. Subsidies to maintain and increase the cattle stock

These payments cover part of the costs borne in the keeping, reproduction and sale of young cattle to fattening farms and to partly compensate for the purchase costs of animal feed and feed additives.

3. Support subsidies for the production of livestock products

Livestock products (including farmed fish) and the sale of these products to procurement and processing organizations are in receipt of subsidies.

4. Support subsidies for high-quality seed varieties

5. Subsidies for the improvement of soil fertility

These subsidies embrace both fertilizer subsidies and supports for commodities that are produced on poor-quality soils.

[7] Republic of Mordovia Law No. 62-Z of 8 December 2003 concerning Approval of the Program of Economic and Social Development of the Republic of Mordovia for the Years 2003 to 2007.

6. Credit subsidies

Interest-rate subsidies are paid on condition that the loans are used for the purchase of pedigree livestock, agricultural raw materials for industrial processing, fuel and lubricants, mineral fertilizers, plant protection agents and other material resources for the conduct of seasonal operations.

7. Subsidies to private farmers

A variety of subsidies are involved, including, the purchase of grain forage; livestock insemination; veterinary livestock care costs, etc.

8. Other subsidies

Subsidies are also granted to the State Unitary Enterprise (SUE), Countryside Development.

It should be noted that the payment of subsidies to enterprises and individuals for livestock products is made only for products sold to the processing industry, consumer cooperative societies and Countryside Development, as well as for direct contracts to schools, kindergartens and other social sector institutions located within the Republic of Mordovia, and outside of the republic – in accordance with intergovernmental agreements.

The regional budget also supplements state grants in certain cases, e.g., monthly cash allowances are provided for young farming specialists and grants are also available for individuals moving to the countryside.

Subsidies from local budgets

The following types of subsidies are being extended *from local budgets* of the Republic of Mordovia to legal entities and peasant (private) farms:

- a subsidy to compensate for a part of the costs of keeping, reproducing and selling young cattle for fattening;
- a subsidy to compensate for a part of the expenses on the keeping of young heifers;
- a subsidy to compensate for a part of the buying costs for mixed feeds.

The Government of the RM annually resolves on the list of legal entities and peasant farms having the right to get subsidies to compensate for a part of the production and selling costs for agricultural products coming from lands with relatively worse natural characteristics. The resolution approves a list of legal entities and peasant farms having the right to get subsidies, the size of the subsidies as well as the output standards for aggregate crop production.

Apart from the Ministry of Agriculture and Food and the food corporation, food supplies for state needs come from the Ministry of Social Protection, Ministry of Education, the Ministry of Health, the Ministry of Culture and the Ministry of Internal Affairs of the republic. These ministries as government customers resort for the most part to the services of Countryside Development to get produce (whole milk products, meat products, potatoes, vegetables, eggs, vegetable oil, sugar, flour, groats, and pulses) under a tied credit scheme. The volume of this activity is hard to isolate from the total volume of purchases and supplies of these ministries.

Leasing subsidies

The SUE Countryside Development arranges for the leasing of Housing Construction, the Conversion of Rural Settlements to Gas, Farm Equipment, Mineral Fertilizers and Plant Protection Agents. In 2004 the share of lease payments in the form of cash was 28% with the remained being disbursed in the form of products that are supplied to Countryside Development.

State enterprises and institutions servicing the AIC

SUEs and other state institutions are financed out of the budget of the republic. The main recipients are Countryside Development, the Mordovian Food Corporation, and the government enterprise Directorate for Implementing the Republican Target Program for the Development of the Republic of Mordovia for the Years 2001 to 2005. Countryside Development receives support in connection with its leasing activities, credit advances, loan repayments and interest-rate subsidies for the purchase of equipment and fertilizers.

The Mordovian Food Corporation performs functions as a state customer for procurement and supply for state needs of grain, sugar beets, potatoes, vegetables, milk, livestock and poultry and other products, for which a government order is placed, as well as organizing export and import operations with food goods. Under current law, the corporation is independent in the utilization of its own funds and acts as a separate business entity: engages in entrepreneurial activities, buys and sells securities, participates in the capital of other organizations, and sells farm products. Neither Countryside Development or the Mordovian Food Corporation report directly to the Agriculture and Food Ministry but they are accountable to the Government of the Republic.

The Directorate for Implementing the 2001-2005 Republican Target Development Program of the Republic of Mordovia finances a variety of undertakings in the agro-industrial complex, although the major part of its activities (5.3 billion rubles in budgetary funds was put to use under the Program in 2004 alone) lies outside the sector.

Expenditure on the Agri-Industrial Complex

The AIC regional budget has declined from 14.4% of the total in 2000 to only 3% in 2004. The main reason for this decline is due to a greater level of support to the sector coming from district and local budgets. Moreover agricultural support was also channelled through other sections of the budget, most notably, "Miscellaneous Costs". A more important point is that the AIC budget (458 m rubles in 2004) is only a small fraction (about 11%) of the total level of expenditure accruing to the sector. In addition the SUE Countryside Development receives about 1.9 b. rubles (46%) and the Target Program about another 1.6 b. rubles (38%). This amount was channelled in the form of interest-free loans to Countryside Development. Overall regional transfers to the AIC come to over 4 b. rubles. Taking into account support from the federal and local budgets, as well as regional expenditure on social countryside development, effective support to the sector is considerably greater in excess of 4 b. rubles.

The main measures in terms of direct-budgeted expenditure on the AIC over the period 2000 to 2002 are:

- Livestock and seed breeding programs
- Improvements in soil fertility
- Support of the regional food fund
- Agricultural disaster cleanups
- Interest rate subsidies

The role of inter-budget transfers in AIC support

District, town and city budgets are 30-40% dependent on RM budget grants. Transfers from the republic's budget to local budgets are performed via several channels:

1. Performance based grants to budgets of municipal entities. These grants are available to low-income municipalities (in fact, all of the municipalities fall into this category, except Saransk and Ruzeyevka) and get distributed according to a performance-based formula. These transfers amounted to about 500 million rubles in 2004 which was well over twice the direct regional budget to the AIC.
2. Grants to municipalities for budgetary provision equalization (about 200 m rubles).
3. Other transfers, including subventions to implement federal laws and to compensate for the costs of performing delegated powers, among them subsidies to rural producers.

Findings and recommendations

Much of the support activity to the AIC is non-monetized and based on commodity-based transactions. This practice militates against the emergence of a market-oriented agriculture.

1. Virtually all of the commercial animal production is purchased for delivery to the regional food fund (RFF). Farms almost have no milk, meat or eggs left to sell in a "free market." Agricultural producers' lack working capital which forces many of them to enter into inefficient tied-credit arrangements for the purchase of material and technical resources. This system of state patronage generates an undesirable dependency culture among producers. Even the produce of private plots is supplied through state-controlled channels. Local administrators have a strong incentive to sustain this inefficient system as their salaries depend to a significant extent depends on the fulfillment of production and sales' targets.

2. In Mordovia the system of production, sales and marketing has all the characteristics of a centrally planned economy. The centralization of supply and marketing has led to net inefficiency in the production and sale of food products which is compounded by the presence of strong trade barriers.
3. The implementation of policies also gives rise to equity issues in the treatment of producers. For example, compensation for a part of the costs of keeping, reproducing and selling young cattle for fattening is paid only if the fattening farm gets in on the list determined by the RM Government; animal production subsidies are paid only if the products were sold to plants of the processing industry, consumers' cooperative societies, Countryside Development, as well as under direct contracts to social sector institutions within the territory of the republic.
4. Indebtedness of entities to the state-managed agencies Countryside Development and the and the Mordovian Food Corporation nearly amounted to the entire direct regional AIC budget in 2004. These bodies, while on the face of it under state control, behave as if they were private entities with problems such as a lack of transparency in decision-making and insufficient accountability being prominent. With the shrinking of direct budget support for the sector agricultural policy has to a substantial extent slipped outside of the influence of Government.
5. A market infrastructure is lacking in the region; neither is there any informational support of agricultural producers, who depend on state intermediaries which act as monopolies and are largely independent of state control. The role of the Agriculture Ministry appears to have become marginalized.
6. Direct budget expenditure on the AIC substantially underemphasizes the extent of support to the sector. Support is mainly channeled via special state enterprises and institutions that are mainly funded through tied-credit arrangements. Apart from the Agriculture and Food Ministry, the Ministry of Economics performs important functions as a state regulator of the AIC, and relevant expenditures (about 500 million rubles) are reflected not in the line item entitled "Agriculture," but in the line item entitled "Financial Support of the Budgets at Other Levels." Thus, despite the fact that the Republic of Mordovia's agricultural budget proper is relatively small, the effective level of expenditure on the region's AIC support is much greater. Agricultural support from the regional budget exceeds 4 billion rubles. However, when we add support from the federal, district and local budgets, total support comes to just less than 9 b. rubles.
7. Despite the highly centralized support system and the effective level of support that is involve the performance of the region's AIC has been unimpressive in respect of all indicators, both in terms of trend performance and especially relative to neighboring regions.
8. The overriding requirements for reform in the region's agricultural policy are: (i) transactions should progressively become monetized and the monopoly control of key intermediaries should be dismantled; (ii) the Agriculture and Food Ministry's role in farm policy design and implementation needs to be re-established; (iii) market-based support mechanisms (such as crop insurance, and subsidizing the interest rate) should be adopted; (iv) local authorities should be divested of responsibilities that pertain to the operations of the AIC, except for all normal regulatory functions; and (v) the budget process and system needs to be aligned with best practice in the Federation.

9. These reforms, however, need to be gradually phased in, given the deep-seated commitment in the region to the traditional highly centralized centrally planned economic model. The underdevelopment of financial and marketing institutions; the fragile financial circumstances of many agricultural enterprises and their lack of access to working capital do not make it possible to quickly break the existing link between the state and agricultural producers. A precipitous and complete severing of these links would result in a sharp deterioration of the financial position of a large number of agricultural with consequential adverse implications for employment and the rural economy. But a progressive and ordered transition needs to be set in train.

Oryol Oblast

Overview of agriculture in the Oryol oblast

The AIC accounts for over 30 percent of the gross regional product and about 33 percent of the total work force. The main agricultural products are grains, sugar beet, potatoes, vegetables, oilseeds, meat, milk, pedigree seeds and cattle. While all production organizations have experienced a reduction in output between 2000 and 2003, the best growth performance was experienced by household plots. With the exception of grains and vegetables the output of crops has been in decline between 2000 and 2004. The output performance of livestock products is similarly unimpressive with only poultry production exhibiting upward growth over the same period.

In excess of 50% of total agricultural output is produced on household plots. The contribution of agricultural organizations has been in steady decline since 2000 and while private farms only accounted for 9% of total output in 2000, this was a trebling of the production share relative to 2000.

Agricultural policy in the Oryol Oblast

The evolution of agricultural policy in the Oryol Oblast can be divided into three phases.

Phase 1 (1992-1996). This phase involved the privatization of collective farms. The majority of enterprises (about 47 percent) were transformed into agricultural production cooperatives. Less than 3 percent of the enterprises remained in state ownership.

Phase 2 (1997-2002). The phase saw the creation of large entities by bringing together agricultural firms, service, trading and processing organizations. Among the major entities created in the oblast were OAO APK Orlovskaya Niva, OAO Orlovshchina, OAO Orlovsky Agrokombinat, OAO Oryolagropromsnab ("Wheat-2000 Oryol" program) which brought together as many as 130 agricultural organizations.

Phase 3 (2003-). The attraction of investors through the privatization of agri-industrial entities.

Specific agricultural policies comprise the following:

Land tenure measures

Administrative activities involve establishing an inventory of land; determining the rates of the land tax; allocating plots of land; streamlining of land transactions; adjusting the size of land shares of shareholders; measures to support gardening; reform and support of agricultural producers and agricultural shareholders.

Regional Food Fund

To support agricultural producers in the establishment of a food fund, the oblast administration issues credits, typically in form of commodities, to enterprises in the agri-industrial complex. Products for regional food funds are purchased through authorized agro-holdings.

Investment support

The Oryol Oblast has several arrangements in place to promote investment in the AIC. Both Russian and foreign investors enjoy considerable tax benefits (including reduced corporation and property taxes), interest subsidies and loan guarantees. These initiatives do appear to have stimulated significant investment activity in primary agriculture and in processing.

Regional Programs

Apart from programs that directly support the AIC, a number of measures have also been implemented in the broad sphere of rural development, e.g. the “Slavic Roots” rural housing construction program, the

federal Chernobyl clean-up program and measures (mainly interest-rate subsidies) to upgrade the farm machinery stock in the region.

Agriculture Programs

These involve measures that are funded through the Agriculture and Food Directorate and do not include budget-based credit support or the financing of the AIC through non-agricultural programs or compensation of damage from natural disasters, etc.

In 2004 the following specific agricultural measures were supported:

Purchase of pedigree cattle. Subsidies are paid to buyers of pedigree cattle at the rate of 30 rubles per 1 kg of live weight.

Support of pedigree cattle breeding. Subsidies are paid for pedigree cattle breeding for producers that do not benefit from federal budget financing provided certain conditions are observed. The annual rate of a subsidy is 700 rubles per head.

Artificial insemination of animals. Subsidies are paid to agricultural producers to finance the purchase of semen of stud stock in licensed organizations in the Oryol Oblast.

Quality seed breeding. Subsidies are paid to agricultural producers and private farmers who buy high-quality or original seed of agricultural plants for reproduction, plant rotation, renewal of crops, etc.

Interest-rate subsidies. Subsidies are granted to agricultural producers on bank loans subject to a limit of one third of the interest cost, but not more than one third of the Central Bank refinancing rate, provided borrowers pay accrued interest in a timely manner in accordance with loan agreements.

S*oil fertility assessment.* Subsidies are paid to agricultural producers for the fertility assessment of soils to ensure more effective use of fertilizers. The rate of subsidy is not more than 15 rubles per hectare of the area study.

Activities to enhance soil fertility. Subsidies are paid to agricultural producers to purchase and use humite in plant-growing in an amount of 75 rubles per 1 liter.

Consolidated Agricultural Budget of the Oryol Oblast

Over the period since 2000 the financing of support to the AIC sector from the federal budget has been increasing while support from the local and regional budgets has been diminishing.

Fertilizer subsidies

The main expenditure items are fertilizer and plant protection subsidies, interest-rate subsidies and support in response to natural disasters.

Loans to support seasonal employment

Since 2001 these loans have formed a substantial part of the AIC budget. Between 2001 and 2004 1.7 billion rubles have been issued in loans from regional and local budgets and less than half of this amount has been repaid. The problem of non-payment of budgetary loans in the Oryol Oblast is very acute. Repayments are mainly in the form of commodities and sometimes, in order to expedite repayments, the price of products delivered to the regional food fund is sometimes set at a higher rate than the market price.

Leasing of Machinery

In 2000 and 2001 the regional administration bought machinery and handed the stock over to producers. Commencing in 2002, a program of federal leasing via ZAO Oryolagrolizing, a subsidiary of Rosagrolizing,

has been in operation. The direct financial contribution of the oblast consisted in making the first payment. As of the beginning of 2005, agricultural producers owed 100 million rubles for leased machinery and some debts for machinery supplied in 2000-2001 have not been paid.

Rural Social Development

Starting from 2003, the oblast has been implementing a federal and oblast rural social development program. The expenditures under this program are comparable in amount to the direct support for the AIC sector. The main expenditure items are the construction of housing, educational facilities and roads.

Analysis of Agricultural Policy Spending of Municipalities

According to the data for 2003, municipal agricultural budgets allocated 7.1 million rubles (34.2 percent of the agrarian budget) to maintain social and cultural amenities, 6.3 million rubles (30.4 percent) land tenure, use and improvement, 1.1 million rubles (5.1 percent) to maintain the state cadastre, monitor lands and land tenure, with other spending at 6.0 million rubles (28.5 percent). The practice of granting loans to the sector from municipal budgets is widespread. In 2000-2003, loans worth 14.3 million rubles were issued but only 2.0 million rubles were repaid.

Distribution of AIC Budget Spending between Recipients

Agricultural producers received 32.7 percent of total subsidies from the regional budget, private farms 2.1 percent, processing, service enterprises and other entities 35.2 percent. The amounts received from the federal budget were respectively 44.8 percent, 1.0 percent and 54.2 percent. Private and household farms receive few subsidies despite accounting for half of the agricultural produce in the oblast. Agricultural producers received nearly 90% of their subsidies from the federal budget.

About 31% of all monies allocated to agricultural producers comprised interest-rate subsides, mainly from the federal budget. Another 41% of all subsidies is accounted for by transfers under the Federal Targeted Program Plodorodiye.

Most subsidies are received by the most efficient and profitable of strong farms. These have ties with large agricultural structures to which they sell their products at regulated prices. In so far as subsidies are at all justified they should be targeted to those farms that are struggling with efficiency and profitability challenges.

The Size and Structure of Oblast Budget Expenditures

There has been a dramatic reduction in the regional AIC budget since 2000 for a number of reasons. First, part of the previously issued budget loans had been repaid, and second, the crisis in the agri-industrial sector had on the whole been overcome as evidenced by the appearance of serious investors in the Oryol Oblast's agriculture. The oblast administration has intentionally rejected some of the support mechanisms and decided to attract off-budgetary resources, including foreign and domestic investments. Also some agricultural measures have been funded from non-agricultural sections of the budget, and more funds are committed to social programs in rural areas.

In 2004 funds provided by the Department of Agriculture and Food amounted to 254.7 million rubles and when we add compensation payments for natural disasters, the oblast's AIC budget exceeds 371 million rubles. To this total we can add the cost of the regional food fund (about 130 m. rubles); expenditure from the regional development fund in rural areas (about 9.4 m. rubles) and expenditures on the social development of rural areas (about 225 m. rubles). The latter measures do not come within the influence of the agricultural ministry, yet they clearly encompass a significant range of agricultural and rural development policy measures. In total the effective level of expenditure on the AIC is over 735 m. Rubles.

Conclusions and Recommendations

The AIC accounts for more than 30 percent of the gross regional product and about 33 percent of regional employment. The main agricultural products are: grain (rye, wheat, buckwheat, barley, peas), sugar beet, potatoes, vegetables, oilseeds, milk, pedigree seeds and cattle. The Oryol Oblast is characterized by a relatively high level of per capita production and consumption of major agricultural products, even though growth in the agrarian sector in 2003-2004 was quite moderate (1 percent), and there was even a decline in animal husbandry. Livestock breeding in agricultural organizations remains a loss-making business, despite subsidies from different budgets.

One of the specific features of the AIC sector in the oblast is the creation of vertically integrated structures - agricultural holdings and agricultural firms - through which the oblast administration channeled budget funds. In 2004, vertically integrated structures had one-third of the oblast's cattle and one-fourth of all pigs.

Another feature of the AIC sector in the Oryol Oblast is the encouragement of outside investors. In 2001-2005 alone, investment in officially endorsed projects in the agri-industrial sector increased ten-fold (from 800 million to 8,334 million rubles). This policy reduces considerably the "pressure" on the oblast budget in terms of agricultural support.

Agricultural expenditures from the oblast budget in 2001-2004 decreased three-fold. More desirable expenditure measures, including interest-rate subsidies, soil fertility enhancement and social measures increased over the same period. There was also a big decrease in the amount of budget-financed loans for machinery, the purchase of agricultural products and leasing operations. In total the effective level of expenditure on the AIC is over 735 m. rubles when we include expenditures on agricultural and rural development policies that are funded from other budget lines which lie beyond the direct control of the agricultural ministry.

There are a number of undesirable features of agricultural policy support that should be noted, e.g. compensation for damage from natural and loans for the hiring of seasonal labour. A small number of large agricultural organizations and processing enterprises get most of the support. Private farms receive 1-2 percent of all subsidies, mainly as interest-rate subsidies. The bulk of the subsidies go mainly to profitable agricultural organizations that have firm ties with managing agricultural structures.

The regional food fund although characterized as an insurance or safety net fund is very expensive and amounts to over 50% of the region's AIC budget. This system is characteristic of the old-style centralized planning. It is welcome that the scale of purchases has been in decline in recent years but there is an incontrovertible case for substantially reducing the level of purchases to at most a small reserve fund for social needs that is acquired through the market. There is no case however for the fund being used to supply raw materials to processing enterprises.

The coordinating role of the Department of Agriculture and Food in the agribusiness area (market regulation, new partnership relations with private sector, including foreign investors) should be considerably increased. The Department should have oversight over all budget expenditures that concern the AIC sector, including rural development. This initiative would ensure greater transparency for those agricultural expenditures that come within the purview of other regional programs.

Rostov Oblast

Overview of agriculture in the Rostov oblast

The share of agriculture in the region's GDP is 16 percent (2003). The numbers employed in the sector have more than halved between 1990 and 2003. The region's rich black soils results in crops accounting for more than 60 percent of gross product of agriculture in the region. Rostov is Russia's second biggest grain producing region. Sunflower is the leading industrial crop and the region accounts for more than 20 percent of Russia's total sunflower seed output. This makes Rostov the premier sunflower-growing region in the country.

Production volumes have grown steadily since 1999, except for 2003 which was an exceptionally poor year for grain production, on all farms. However, in 2004, the most outstanding production trends were achieved by agricultural organizations and household plots. The production trends for individual crops have all been outstanding (ranging from 150% for grains to 70% for vegetables between 1999 and 2004) while livestock production has been relatively static in contrast (ranging from 34% for eggs to 14% for milk).

Private farms accounted for 11 percent of agricultural output in 2004 which is higher than the country's average. The number of private farms has tended to decrease, while the average size of their land plots has tended to grow. Household plots contributed about 40% of total output in 2004, although this represents a significant decline since 1999 when it stood at over 57%. Household plots tend to concentrate on the intensive activities such as potatoes, milk and poultry while the large agricultural organizations tend to be dominant in the production of grain.

On the whole, agricultural production in the Rostov Oblast has been profitable, mostly due to crop growing, while sales of livestock produce in the region have been unprofitable, notwithstanding subsidies from the budget. Agricultural enterprises in the region tend to be more financially robust with fewer loss-making entities than in Russia as a whole.

Principal features of Rostov's agricultural policies

The main goal of AIC policy in the region is the creation of modern food processing industries whose goal is to produce and products that meet world standards. The instruments comprise measures of a regulatory or institutional-support nature that do not require significant budget commitments and more regular budget measures. The general thrust of policy tends to prioritize the creation of a favorable institutional environment for the development of agriculture rather than the subsidization of agricultural producers.

The main budget-based measures comprise the following:

1. State guarantees for loans.
2. Investment tax credits.
3. Tax breaks;
4. Interest subsidies and
5. Budget-based loans.

The main forms of support are budget-financed loans interest-rate subsidies on loans for investment projects and replenishing working capital. The interest rate for budget-financed loans amounts to 1/3 of the Central Bank's rate.

Rostov Oblast's AIC budget

Between 2000 and 2004 the contribution of regional and local budgets has declined steadily while the share of the federal budget has correspondingly increased. The share of agricultural expenditures in the consolidated AIC budget (regional plus local budgets) has also steadily declined.

Spending on most items from the local budget, with the exception of measures that support land improvement and “other” expenditures, have dwindled in recent years.

Spending out of federal transfers is dominated by interest-rate subsidies on working and fixed capital (from 2003). Natural disaster relief has also been a significant item and crop insurance support has acquired a prominence since 2004. Budget-financed loans are also outstanding as is expenditure on rural housing. Apart from these measures there is also support for the breeding of pedigree livestock, the planting of vineyards and orchards and the purchase of fertilizers and pesticides.

The regional budget only contained six items: subsidies for animal breeding, interest-rate subsidies, support for private farmers, other expenditures on agricultural production, maintenance of veterinary institutions, maintenance of other related institutions and other expenditures. Unfortunately the available budget information on regional expenditures provides us with only a partial impression of the nature of spending as the main items comprise the "maintenance of institutions" and "other spending".

Measures that support they AIC sector that are funded from non-agriculture budget lines are also highly significant. In fact they dwarf the direct AIC budget support of about 0.1 b. rubles. The vast bulk of support from these other sources is allocated to rural social housing (over 1.1 b. rubles) out of a total allocation of over 1.5 b. rubles. In addition to this amount we need to add energy subsidies amounting to an estimated 0.5 b. rubles. Federal transfers to the AIC total to about 1 b. rubles which gives an overall level of expenditure on the sector of around 3 b. rubles.

Budgetary support instruments used in the region

Interest-rate subsidies

Interest-rate subsidies are one of the main instruments employed in support of the AIC in the region. The Agriculture Ministry is responsible for the allocation of these subsidies which represents a positive change as the Ministry of the Economy had previously held this responsibility. The scope of eligibility for these subsidies in terms of producer and capital category has been expanded in recent years which may be construed as a positive development.

Budget loans

These loans are predominantly used for the purchase of agricultural machinery and spare parts. Budget loans in general are a poor substitute for a properly developed banking system. The administration of these loans, however, also raises specific problems. First, the producers of agricultural machinery, rather than agricultural producers, invariably reap the benefit of these loans in the form of higher machinery prices. This outcome is assured by the practice of transferring the loans to the machinery suppliers. One consequence of this system has been that the available monies for this purpose have not been fully utilized. Second, uniquely the Rostov Oblast is the only region where these loans are under the control of the Finance Ministry. It would be preferable for such loans to be administered through the appropriate sectoral ministry. Also the Finance Ministry provides poor information on the scale and destination of loans to the AIC sector which restricts the extent which analysis of this instrument is possible.

Tax Breaks

From 2001 through 2005 property and profit tax breaks were provided to three enterprises in the oblast: the Baltika Rostov brewery, the Rostov branch of the Moskva Efes brewery and Primary Don.

The Regional Food Fund

In 1994 228 million rubles were handed to OAO Donkhleboprodukt as a budget-based loan and the latter used this transfer to provide loans agricultural producers and other enterprises and organizations for the purpose of ensuring food security in the oblast and to meet the demands of socially vulnerable groups of the population. The food fund still exists but in recent years transfers from the budget have been restricted, apart

from a substantial write off of Donkhleboprodukt's debt to the oblast by about 90 million rubles that occurred in 2002. Since 2003 relations between the Agriculture Ministry and Donkhleboprodukt have been on a strictly commercial basis. Budget transfers to Donkhleboprodukt are on a strict repayable basis that includes interest charges. Donkhleboprodukt are also obliged to ensure that all advances are repaid and that the funds transferred to it are used efficiently. The Agriculture Ministry oversees the determination of the list of suppliers to the fund and the local district administration s no longer have any influence in this matter. Local districts also legislate for the formation of local food funds. These are administered in the form of an in-kind (commodity) tax on enterprises by obliging them to hold relatively small amounts of grain in a local food fund.

Leasing support

Two regional lease programs are in operation for agricultural machinery and pedigree livestock These operate alongside the federal program which has not been too popular because machinery prices have grown substantially. The local firm OAO Rostovagrosnabservis has acted as a sublessor for Rosagrolizing as well as for the local lease programs. The scale of resources absorbed by this measure has gradually diminished as machinery buyers prefer to avail of the federal interest-rate subsidy scheme which provides similar financial conditions to the leasing scheme but allows buyers to exercise a much greater degree of choice of machinery suppliers. Machinery prices also tend to be more expensive under the operation of the leasing scheme.

Livestock Breeding Support Program

Subsidies for crop growing are not been provided from the Rostov Oblast budget. Subsidies for animal breeding do exist, but they are limited to support of pedigree livestock breeding and fish farming. This program also embraces institutional measures such as support for the formation of district-based livestock breeding services; the promotion and development of informational support for animal breeding and measures for the development of agricultural cooperatives. In addition measures also support the promotion and development of quality animal breeding by district agriculture departments.

Financial rehabilitation of agricultural enterprises

The region has launched a program of financial rehabilitation of agricultural producers, which has been implemented through debt rescheduling in line with federal legislation. Nonetheless the indebtedness of agricultural enterprises remains a big problem. The financial rehabilitation measures are only at the very early stage of implementation. The growing extent of bankruptcy has been due to the fact that since June 2004, when the federal service for bankruptcy was disbanded, the Rostov Oblast Agriculture Ministry no longer can intervene effectively and in a timely manner to prevent bankruptcy.

Support for private farms

The need for state support for the provision of credit to private farms justified by the fact that private farmers effectively lack access to bank credit as banks prefer not to deal with these small entities. In 2002 a Commission for the provision of financial support for enterprises and organizations from the oblast budget was formed. The Commission draws up recommendations for the governor on the provision of budget loans to enterprises and organizations, including private farms. In 2003 the region adopted a small business support program which *inter alia* also supports private farming, mostly in the form of credit cooperatives.

Interest-rate subsidies, in formal terms, apply to private farmers but in reality, only major agricultural organizations can get bank loans. Private farmers' access to financial lease schemes is limited as they lack acceptable collateral as far as banks are concerned.

The development of consulting centers has been another form of support for private farms in the region. Private farms and household plots also get state support via indirect channels through advantageous arrangements with large neighboring agricultural organizations. In the absence of this indirect support, which is unrecorded in any formal way, many of these small enterprises would be unprofitable.

Support for land improvement

In the Rostov Oblast land improvement measures are funded as part of the federal program on land fertility in Russia over the period, 2002-2005. There is no regional land-improvement program but local measures are in place.

Targeted program Social Development of Rural Areas in the Rostov Oblast until 2008

The targeted program was adopted in July 2004. It is similar to the federal program and focues on support rural housing, sports facilities, educational institutions, roads, etc. Total expenditures under the program amounted to 8 billion rubles, including 1 billion rubles to come from the federal budget, 3.2 billion rubles from the oblast budget, 1.7 billion rubles from local budgets, and 2 billion rubles from extra-budgetary sources. The program's first phase is to be implemented from 2004 through 2006, while the second one in 2007 and 2008. About one-third of the funds to be provided for the development of a network of educational institutions; about 17% is earmarked for improvements in rural water supply and the remained will be spent on roads, healthcare and cultural institutions.

Conclusions and Recommendations

The share of agriculture in the region's GDP is 16 percent, while Russia's average is 5.2 percent. Crop (main grain) production accounts for in excess of 60 percent of the gross product of agriculture in the region. Rostov is Russia's second biggest grain-producing region. Sunflower is the leading industrial crop. The oblast accounts for more than 20 percent of Russia's total sunflower seed output, making it the premier producing region in Russia.

The Rostov Oblast's budgetary expenditures under the Agriculture and Fisheries expenditure item are relatively modest. In 2004 they amounted to 196 million rubles, or less than 0.8 percent of the oblast total budget expenditure. The bulk of oblast expenditures on agriculture, however, was in the form of budget-financed loans that come under other sections of the budget. In 2004 these loans exceeded 277 million rubles. Tax breaks are estimated at an additional 65.6 million rubles. In 2004 the oblast budget's expenditures on social development of the agro-industrial sector totaled 1.1 billion rubles, which is five times the amount of the oblast agricultural budget. When we add the costs of administration together with energy subsidies and federal transfers the aggregate level of expenditure on the AIC sector exceeds 3 b. rubles. This is a relatively substantial amount of resources that if they were effectively spent should lead to higher efficiency of the agro-industrial sector and to improvements in living standards of the rural population.

Much improvement has been made in the nature of financial support for the AIC sector. Interest-rate subsides rather than loans are being increasing used and the eligibility criteria in terms of producer and capital categories have been broadened.

Substantial reform has been implemented in the operation of the regional food fund since 2002. In particular, the extent of commodity-based transaction has been substantially eliminated.

The region, however, needs to develop its financial sector. Budget loans still constitute a significant source of public expenditure. This system obstructs the development of a commercial lending sector. Moreover the scope of these loans tends to be confined to purchases of agricultural machinery that tend to support the suppliers of machinery rather than agricultural producers. The allocation of funds has been in the form of transfers into the accounts of agricultural machinery suppliers (the Rostselmash Trade House, the Taganrog Combine Harvester Plant, and others), and thus agricultural producers have no chance to purchase machinery in the "free" market. Quite frequently producers have not availed of the resources made available under the scheme because of the restriction of choice and inflated prices.

The Agriculture and Food Ministry has not been involved sufficiently in the identification of effective strategies to provide appropriate financial support for the AIC sector. In fact, the ministry only plays a full role in the provision of interest subsidies on working capital. Budget-financed loans come within the remit of the Finance Ministry, while the Ministry of Economy, Trade, International and External Economic

Relations has been in charge of other instruments. This system of administration results in the provision of information in a form that is not optimal for analysis of the impact on the AIC of the loans that come from these diverse sources. More importantly, the ministry with the greatest knowledge of the funding needs of the AIC sector is in effect removed from an effective role in the provision of these laons.

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