

E. S. Avramenko^{a)}, **S. V. Vlasov**^{a), b)}, **S. A. Lukyanov**^{a), c)}, **I. M. Tyomkina**^{a)}

^{a)} Ural Federal University n.a. the First Russian President Boris Yeltsin

^{b)} Administration of the Governor of Sverdlovsk region

^{c)} Saint-Petersburg State University

REGIONAL INVESTMENT POLICY UNDER THE IMPACT OF BUDGET LIMITATIONS AND ECONOMIC SANCTIONS¹

This article presents the results of research on the impact which budget limitations and economic sanctions have had on regional investment policy. External sanctions and sluggish economic growth have affected the social and economic development of the region. Relying on the results of comparative and statistical analysis, the article demonstrates the need for altering the focus of current investment policy from quantitative growth to qualitative enhancement.

The article analyses a new trend in the investment policy related to import substitution and the way it is combined with the acceleration of innovative business developments in Sverdlovsk region.

The findings and recommendations described in this article can be applied by public authorities of the Russian Federation, by experts in the sphere of regional investment policy and development, and by organisations specializing in investment attraction and collaboration with investors in Russian regions.

Keywords: global situation, sanctions, regional investment policy, budget limitations, import substitution, Middle Urals

At their current stage of economic development, Russian regions have faced serious internal and external threats, likely to cause dramatic changes in regional investment policies. This scenario sounded particularly plausible when discussed at the XIII International Investment Forum 'Sochi – 2014' on 19 September, 2014.

During the plenary session 'Russia between Europe and Asia: New Regional Policy under Present Conditions', D. Medvedev's report [9] pointed out that 'the year of 2014 has changed many things and will be described in the history books as the watershed year not only for Russia but for the whole world. It will be marked as a starting point for a new period. Confrontation in the Ukraine, which developed into a civil war, the reunification of the Crimea and Russia, the application of sanctions against our country, and, unfortunately, the cooling of relations with our Western partners — all these events force our foreign colleagues and us to look at the world environment from a different angle'.

The whole system of European security, its basic values, and further development of the globalization process, are all under a serious threat. The sanction confrontation has a negative effect not only on Russia, but also on its Western counterparts. These factors should not however affect macroeconomic policy, which ought to remain invariable but involve the appropriate adjustments of domestic and foreign policy, both centrally and locally. Qualitative improvement of the economic management system should also be aimed for.

Russia has faced two considerable challenges at one time: the geopolitical situation has seriously deteriorated while economic cooperation with the West has actually come to a halt. However, these short-term factors are not the main problem areas. Since the old raw-export model of our economy has practically exhausted its potential, Russia is bound to face major systemic shifts.

The mechanism inhibiting economic growth was triggered in Russia in mid-2012. At year's end 2012 the reduction in the growth rate of labor efficiency spread to most of our economic sectors.

The economic growth level in Russia in the last two years (2013–2014) has fluctuated within 0–1 % of GDP annually. In 2013 the growth rates in Russia were lower than in the USA and EU, not to mention the developing countries.

Lack of investment in the technological reconstitution of production and infrastructure, and low levels of innovation in private businesses, are still considered to be the major constraints. Only 10 % of

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Basic indicators of social and economic development of the Russian Federation

Indicators	2013		2014		
	July	January – July	July	January – July	Reference June
Economic growth, % as a percentage of the relevant period of the previous year					
GDP	101.6	101.0	99.8	100.7	99.9
Industrial production index	100.8	99.9	101.5	101.5	100.4
Investment in fixed capital	102.4	99.8	98.0	97.4	100.5
Inflation, % (over the period)					
Consumer prices	100.8	104.4	100.5	105.3	100.6
Industrial producer prices	102.0	101.1	101.6	106.0	100.8
Private finances					
Average nominal monthly wages, in rubles	30.229	28.992	32.715	31.681	33.726
Actual earnings, % as a percentage of the relevant period of the previous year	106.4	105.5	101.8	103.1	102.1
Real disposable household income, % as a percentage of the relevant period of the previous year	104.1	104.3	102.3	100.2	97.1
Money and credit					
Money supply (M2) (changes over the period), %	0.8	4.8	0.1	-3.0	0.6
Exchange rate, in rubles per 1 USD (period average)	32.74	31.26	34.64	34.935	34.41
Actual exchange rate index of the ruble to the US dollar, % as a percentage of the previous year	99.4	96.4	99.8	97.8	101.9
Foreign economic activity, in billions of US dollars					
Export of goods	43.7	296.2	40.1	295.7	40.7
Import of goods	30.3	191.3	28.8	181.6	26.8
International reserves (changes over the period)	-0.938	-24.784	-9.488	-40.833	11.023

all enterprises are involved in innovative undertakings. The country spends four times less on research and development than China, and forty times less than the USA [2, p. 10; 7, p. 10].

According to leading Russian economists, it is necessary to create favourable conditions for economic growth, to build a new growth model based not only on the increases in production factors such as labour and capital, but also in enhancing the effectiveness of their use; that is, in mobilizing every aspect of production [8, p. 25; 15].

It is possible to find solutions to these problems only if we manage to develop an effective economic policy overall, and in its most important components in particular: budget and investment policy at the federal and regional levels.

Apart from the internal impediments, there is a set of measures which are necessary to take so that Russia can be reoriented towards the new markets of the Customs Union countries, and of Asia, Africa, and Latin America.

A competitive economy is essential for the development and entering of new markets. Unfortunately, the pace of development was slow in 2014. The growth factors for the first six months compared with the same period in 2013 are indicated in Table 1 [10], (data source: the Ministry of Economic Affairs of the Russian Federation).

As Table 1 clearly shows, the increase in GDP is 0.7 %, investment decreased by 2.5 %, and consumer prices rose by 1 %. The continuing growth in nominal wages is evident (31,681 rubles against 28,992 rubles) and so also is the money supply collapse (M2) and the double reduction in international reserves.

Given this situation, the Ministry of Finance has been forced to cut spending on the advancement of science, infrastructure and innovations in the 2015–2017 budget forecast. At the same time expenditures in the societal and military spheres are increasing, while the budget deficit remains moderate. All these problems are of serious concern.

The reduction of the federal budget was observed in four different sectors in the first quarter of 2014, in comparison with January – April of 2013:

- Education, 0.2 % of GDP;
- Healthcare, 0.2 % of GDP;
- Social policy, 1.1 % of GDP;
- Physical culture and sport, 0.04 % of GDP.

The government of the Russian Federation offers three methods of budget implementation: drastic cuts in spending, improvement of the taxation system and increases in the budget deficit. The most heated debates raged over the budget rule: on 18 September 2014 the Russian government passed a draft mid-term budget. But the challenges the country faces are changing the situation so dramatically that the draft budget proposed in summer does not correspond to forecasts of economic growth rates. This extreme measure was a 10 % budget reduction against the planned budget, which equaled 1.5 trillion rubles. Inefficient expenditures are the first to fall under sequestration [3].

The federal budget deficit for 2015–2017 does not go beyond the current budget ruling and is 0.6 % of GDP for each year. Federal budget revenues in 2015 will amount to 20.4 % of GDP and reduce to 18.2 % of GDP in 2017; the federal budget expenditures in 2015 are assumed to be at the level of 21.0 % of GDP and will drop to 18.8 % by the end of 2017. This version of tax and budget policy prioritizes institutional reforms in the medium term [14, p. 10].

The results of the first nine months in 2014 prove that the economic sectors and investment sectors undergo considerable transformations, affecting the situation in general. These facts are also confirmed by the analysts of the ‘Development Center’ Institute of the Higher School of Economics. They believe that, according to the September macroindices, stagnation of production continues, investment is dropping and the growth rate of trade turnover is low. These experts also pointed out that while manufacturing companies were adjusting to sanctions, inflation rates accelerated (up to 8 % from September to September) and the real value of average wages fell by 0.3 % at the end of the third quarter year-on-year. This has happened for the first time after the crisis in 2008–2009. [5, p. 10]

According to calculations of the Russian Ministry of Economic Development, in the short-term and mid-term Russia has sufficient funds to compensate for the major part of the possible losses caused by sanctions; but if tensions escalate, in 2014 however it could lead to a decline in GDP of up to 0.5 %.

The Russian Ministry of Economic Development holds a moderately optimistic view, appealing to the following data (Table 2) [12].

The object of our research is regional investment policy under severe budget constraints and multiplying economic sanctions, as exemplified by the case of Sverdlovsk region.

The peculiarity of the Middle Urals is that this region has enough resources to cope with these internal and external challenges. Proper usage of these resources demands a scientifically substantiated and effective social, economic and investment policy. These policies should be targeted at achieving precisely-defined and specified goals in the short term, mid-term and long term. To make the right choices it is necessary to determine the right priorities.

The impact analysis of the key social and economic indicators in Sverdlovsk region in 2010–2013, and in Russia overall, demonstrates the extent of stagnation in social and economic growth.

Table 2

Key factors of economic growth in 2014–2017, increase in 2013, %

	Forecast			
	2014	2015	2016	2017
GDP increase (by 2013, version 2)	1.1	4.3	8.2	12.8
Difference in GDP increase (versions 2-1)	0.6	1.8	3.2	4.3
Investment increase (version 2)	-0.1	6.0	13.8	23.0
Difference in investment increase (versions 2-1)	2.3	6.1	12.2	16.7
Non-fuel export increase	3.2	11.9	17.9	26.9
Difference in non-fuel export rates (versions 2-1)	0.0	2.7	5.2	8.4
Increase in retail trade (version 2)	2.4	5.7	10.1	14.8
Difference in retail trade increase rate (versions 2-1)	0.5	1.7	3.0	3.8

Key social and economic indicators of Sverdlovsk region

№	Indicator	2010	2011	2012	2013	the first half-year of 2014
1.	Gross regional product, mln rbs	1 046 600	1 291 019	1 484 447	1 587 000	—
2.	Gross regional product per capita, rbs	243 234	300 069	344 283	367 510	—
3.	Economic efficiency of labour (gross regional product per person employed) at current prices, thousand rbs per person	495.8	603.4	687.4	730.5	—
4.	Industrial production index (as a percentage of the previous year)	117.3	106.2	109.6	101.9	95.5
5.	Including economic spheres:					
6.	Mining	189.5	106.3	102.0	101.9	102.1
7.	Manufacturing	110.5	107.7	112.5	103.4	94.3
8.	Agriculture, bn rbs	44.5	56.6	51.4	59.0	22.4
9.	Investment in the fixed capital, as a percentage of the previous year	130.4	115.9	98.0	96.5	—
10.	Monthly per capita income, rbs	22193.8	24892.6	27851.7	31023.1	29934.9
11.	Paid services rendered to the population, bn rbs	175.5	199.7	215.0	253.3	133.9
12.	Retail trade turnover, bn rbs	646.0	764.6	858.8	954.0	470.2
13.	Foreign trade turnover in current prices, mln US dollars	11 683.8	11 347.3	11 957.1	10 028.0	3995.0

In the last five years the production index in Sverdlovsk region fell from 117.3 % in 2010 to 101.9 % in 2013. A similar trend can be observed in the investment dynamics of fixed capital: from 130.4 % in 2010 to 96.5 % in 2013 (Table 3) [6, 13].

The first half of 2014 saw continuing negative processes in the social and economic development of Sverdlovsk region. For instance, the trade turnover in the manufacturing sector was 96.3 % of the same period in 2013; retail trade turnover was 98.3 %, transportation of goods was 94.1 %. At the same time there was an increase in nominal wages, 108.6 %.

The investment policy in the previous five years (2010–2014) emphasised the quantitative investment growth of Sverdlovsk region. In 2012, however, the investment growth stopped and the index of investment in fixed capital began to decline (Table 4) [6, 13].

Changes in the economic situation of Russia and of its constituent regions requires an effective regional investment policy which must meet the challenges emanating from the reduction in the volume of federal transfers and the decrease of enterprises' own funds due to recession and decreases in profits.

Table 5 shows the dynamics of transfers from the federal budget in the last five years [4]. In total, regional transfers in Russia have fallen by approximately one half, while in Sverdlovsk region the amount of reduction has been two-and-a-half times.

The central budget support will be to a greater extent contingent upon sustained, favourable business conditions which the regions manage to create. Finding the optimal structure of regional investment sources under budget constraints is one of the priorities of any sustainable innovation policy.

Enterprises' internal funds remain as the main source of investment in the fixed capital: although their share in the general investment structure is falling gradually, they still make up one half of the total volume.

The share of the budget money is reducing, especially in terms of federal budget transfers (Table 6). [13].

The state and businesses are the key partners in investment policy implementation, which explains the changes in the investment structure as far as types of property ownership are concerned. The main trend here is the reduction in the share of state property from 33.7 % in 2000 to 9.3 % in 2013. The

Table 4

Investment in fixed capital of Sverdlovsk region

	2010	2011	2012	2013	January — June 2014
Investment in the fixed capital (in actual prices), m. rubles	264462	333451	351637	350637	101175,5
Indices of investment volume of fixed capital volume (in comparable prices), as a percentage of the previous year	130.4	115.9	98.0	96.5	98.7

Table 5

Gratuitous transfers from the federal budget, mln rbs

	2010	2011	2012	2013	As of 01.07.2014
Russian Federation	1 397 694.55	1 642 857.31	1 623 189.50	1 513 838.21	722 174.70
Ural Federal District	103 124.48	106 934.34	92 241.35	75 820.34	38 095.93
Sverdlovsk region	21 550.40	21 960.67	18 415.16	18 443.88	9 761.00
Kurgan region	13 270.41	14 775.27	14 719.81	14 298.55	7 437.86
Tyumen region	39 200.24	37 190.19	26 017.21	13 983.57	3 110.49
Chelyabinsk region	21 541.19	23 211.51	23 905.84	22 456.11	12 802.34
Khanty-Mansi autonomous area	5 301.37	6 221.70	6 853.88	4 792.81	4 132.46
Yamal-Nenets autonomous area	2 260.86	3 574.99	2 329.46	1 845.42	851.8

Table 6

The structure of investment in fixed capital from funding sources in Sverdlovsk region,1) as a percentage of the total

	2000	2009	2010	2011	2012	2013
Investment in the fixed capital — total	100	100	100	100	100	100
<i>Including funding sources:</i>						
Internal funds	62.7	41.6	49.3	55.2	54.4	46.4
including:						
profit at the disposal of the organization	—	19.9	21.7	33.5	30.6	—
depreciation	—	20.7	27.1	21.4	21.6	—
Funds attracted	37.3	58.4	50.7	44.8	45.6	53.6
<i>including:</i>						
bank loans	—	15.4	10.2	9.0	10.8	13.9
including foreign banks loans	—	2.6	1.0	0.2	0.2	0.1
borrowed assets of other organizations	—	2.9	1.7	1.7	2.7	8.6
foreign investment	—	—	—	—	—	0.4
budgetary funds	23.9	23.2	20.8	16.4	14.6	13.9
<i>including:</i>						
federal budget funds	5.7	14.3	13.7	8.8	9.1	5.8
regional budget funds	14.1	4.0	4.3	6.0	3.6	5.6
extra-budgetary funds	—	0.2	0.2	0.2	0.0	0.1
funds attracted from organizations and people for shared construction	—	1.5	3.3	2.4	3.4	5.6
other	—	15.2	14.5	15.1	14.1	11.1

same period also saw the share of private property almost double from 24.7 % in 2000 to 54.9 % in 2013. (Table 7). [13].

Recently many steps have been taken to enhance entrepreneurship in the Sverdlovsk region. A legislative package was developed in order to support investors undertaking priority investment

Table 7

The structure of investment in the fixed capital from property ownership types of the Sverdlovsk region, as a percentage of the total

	2000	2009	2010	2011	2012	2013
Investment in the fixed capital — total	100	100	100	100	100	100
including ownership types:						
Russian	79.6	83.3	79.9	76.9	80.7	85.8
including:						
state	33.7	23.0	11.9	12.5	15.2	9.3
municipal	10.2	6.6	6.7	6.4	5.0	4.8
private	24.7	48.8	50.4	38.2	35.2	54.9
social and religious organizations	0.2	0.0	0.0	0.0	0.0	0.0
customer cooperation	0.0	0.0	0.0	0.0	0.0	0.0
mixed Russian	10.8	4.9	4.6	10.6	17.4	8.4
state corporations property	6.3	9.2	7.9	8.4
Foreign	0.5	2.0	8.0	7.0	7.5	5.2
Joint Russian and foreign	19.9	14.7	12.1	16.1	11.8	9.0

projects within the strategic plan for the development of the Sverdlovsk region. The participants in these projects are granted tax rebates.

At the same time, investment in the field of the ‘knowledge economy’ is merely 1.3 % in research and development, and only 1.8 % in education. Taking this into consideration, it is hardly possible to speak of any innovation development in the regional economy (Table 8). [6].

The effect which the investment has on any enterprise from any industry is determined by the specific structure of investment in fixed capital.

In any innovation economy the biggest effect is achieved by means of investment in the active part of fixed capital, mainly in machinery, equipment, and research and development of new technologies. In Sverdlovsk region only half of all investment is spent on these areas, while almost 40 % is spent on buildings (excluding residential buildings) and construction, which is on the predominantly old-industrial heritage of the region (Table 9). [6].

The main targets and areas of innovation policy in the region should be clearly defined, especially considering the current challenges: that is, serious budget restrictions; economic sanctions; and the need to deal promptly with the problem of import substitution. Therefore, the priority is to identify the major growth points for investment.

The most important condition for investment efficiency is the strict timeline, which requires consolidated efforts from the regional administration and businesses. In all cases, it is necessary to consider the level of societal and economic development in the region, and its industrial structure.

The complicated societal and economic situation in modern Russia, and the intensification of economic sanctions, brought to the agenda the problem of import substitution. This implies solving the problem of funding, especially in agriculture and industry.

In the Middle Urals over 80 % of all industrial production comes from three branches: metallurgy, mechanical engineering (primarily heavy engineering) and the chemical industry.

Thus, the most attractive spheres for import substitution in Sverdlovsk region are: railway engineering; oil and gas equipment production; machinery construction; microelectronics; and the forest industry. This is due to the existing industrial and technological facilities, the potential of cooperative interaction and the stability of market demand. In these fields the government of the Sverdlovsk region has defined growth points and selected enterprises for further development and high-priority funding. For each of them, government experts identified their growth opportunities, the share of imported spare parts and components to be substituted, and the tentative time-limits for completing import substitution.

The selected companies include, for example, the joint stock company “Uralskiye Lokomotivy”, which is undertaking a project for production expansion. It provides orders for more than 100 Russian radio electronics enterprises; sector-based research; conducts mechanical engineering operations; and carries out metal-rolling production. It is also planning to substitute Ukrainian engines and spare

Table 8

Investment volume of fixed capital in different types of economic activity

	January–June of 2014.	
	Mln rbs	As percentage of total
Total	101175.5	100
Including such economic spheres as agriculture, hunting and forestry	2237.6	2.2
Fishing, fish farming	—	—
Mining	2411.8	2.4
Manufacturing	28462.8	28.1
Energy production and distribution of electrical energy, gas and water distribution	29039.2	28.7
Construction	548.1	0.5
Wholesale and retail trade; maintenance of motor transport, motorcycles, home and personal appliances	3223.9	3.2
Hotels and restaurants	266.1	0.3
Transport and communication	14725.6	14.6
Including communication	3822.6	3.8
Financial activities	1036.7	1.0
Real estate, renting and services	13233.6	13.1
Including research and development	1270.1	1.3
Public administration and military security; social insurance	790.0	0.8
Education	1861.5	1.8
Healthcare system and services	2387.4	2.4
Public, social and personal services	951.2	0.9

Table 9

Specific structure of investment in fixed capital

	January — June of 2014	
	Mln rbs	As percentage of total
Investment in fixed capital	101175.5	100
including: residential buildings	9294.2	9.2
Buildings (excluding residential buildings) and construction	39228.2	38.8
Machinery, transport vehicles, industrial and household equipment	50582.4	50.0
Other	2070.7	2.0

parts for “Lastochka” electric trains. At present, the level of localization is 62 %; by the end of 2017 it will be 80 %, so that more than one half of all spare parts will be produced in the Sverdlovsk region.

There are 56 enterprises engaged in the production of oil and gas equipment in the Sverdlovsk region. These embrace practically the whole range of production. Among their clients are the companies: “Gazprom Burenie”, “Rosneft”, “Surgutneftegaz”; and countries such as Belarus, Turkmenistan, and Azerbaijan.

According to the results of the expert committee’s appraisal, the share of foreign spare parts is about 40 % of the cost of the final product.

For machine-tool manufacturing the most promising sphere is the assembly of horizontal boring mills, and bridge-type and turning machine centres with programmed numerical control. The prospective import substitution level for spare parts is 72 %. It is also planned to build a full-scale plant in the region.

The general recommendation to the regional government is to conduct a theoretically-substantiated integrated questionnaire survey among enterprises. This would enable specialists to obtain comparable data and to develop more complete and reliable guidelines for the active participants in the process.

The next step was taken on 2 October, 2014 by the Ministry of Industry and Science of the Sverdlovsk region, when it prepared a draft sub-program “Cooperation Development and Import Substitution in

the Industries of Sverdlovsk Region”, as a part of the state program “Development of Industry and Science on the Territory of the Sverdlovsk Region before 2020” [11].

Its main objective is to promote a long-term strategy of regional industrial development by improving the region’s performance in the Russian and international markets, and by enhancing interregional cooperation and import substitution in the leading branches of the industries of the Sverdlovsk region.

This requires the following measures:

- to expand the interregional and intra-regional production interactions of industrial enterprises of the Sverdlovsk region;
- to support the establishment and development of enterprises specializing in import substitution production in the industrial sectors of the Sverdlovsk region;
- to raise awareness of the productive capacities of regional industrial enterprises to enhance cooperation and import substitution in the region.

The period for the subprogram implementation is from 2015 to 2020. The subprogram determines the level of cooperation and import substitution capabilities in each of the leading industrial complexes of the region. It also describes the financial and nonfinancial instruments, the organizational measures, and the necessary budgetary funds.

The draft subprogram also specifies all the available funding sources and the total volume of funding for the development of import substitution over a five-year period (28; 3 billion rubles, 86 % of which is extra-budgetary funds). The funding breakdown, by sources and years, is provided.

To take the next step it will be reasonable to provide an overall estimate of the costs of import substitution and to find the sources of funding. This task requires every serious effort since it involves an analysis of the internal and external situation; medium-term forecasts for the development of enterprises; an analysis of changes in cooperation ties and potential markets; a study of price trends, local and international tariffs; product cost calculation; and so on.

In the process of import substitution, regional industrial enterprises will be working in three directions: for themselves; for their cooperation partners; and by completing orders from other Russian regions.

This research determines the following priority areas for an investment policy of Russian regions and provides some relevant guidelines:

1) At present we observe a downward trend in the sources of investment such as federal investment, transfers, regional budget expenditures, enterprises’ internal funds and foreign investment. At the same time there is a growing need for investment to modernize the economy and organize import substitution. Under such circumstances the main target of investment policy is to cut back on expenditure and to maximize funding efficiency at all stages.

2) In the complex process of import substitution, it is essential to invest only if import substitution can be combined with the diversification and acceleration of innovative development. This is particularly important for the Sverdlovsk region, with its ageing industrial background.

3) To create the industrial structure of investment development it is vital to develop the ‘real’ economic sector and the knowledge economy; this is especially significant for the Sverdlovsk region, one of Russia’s ten leaders in innovative development.

4) Investment distribution should be based on the ‘points of economic growth’, especially when they are of regional or federal significance. In the Sverdlovsk region such a ‘point of growth’ is the special economic zone, ‘Titanium Valley’.

5) For each region it is essential to develop specific measures to realize the priority areas and provide close control over the investment process in order to prevent or minimize corruption.

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Information about the authors

Avramenko Yelena Semyonovna (Yekaterinburg, Russia) — PhD in Economics, Deputy Vice-Rector for Academic Affairs, Associate Professor at the Chair of International Economics, the Ural Federal University named after the first President of Russia B.N.Yeltsin (19, Mira St., Yekaterinburg, 620000, Russia).

Vlasov Semyon Vasilyevich (Yekaterinburg, Russia) — PhD Applicant, Chair of Financial Management, the Ural Federal University named after the first President of Russia B.N.Yeltsin, Deputy Chief of Experts Directorate of Expert and Analytical Department, Administration of the Governor of Sverdlovsk Region (21/23 Gorkogo St., Yekaterinburg, 620075, Russia, e-mail: vlasovsv81@gmail.com).

Lukyanov Sergey Aleksandrovich (Yekaterinburg, Russia) — Doctor of Economics, Professor, Head of the Chair of International Economics, (51, Lenina Av., Yekaterinburg, 620083, Russia), Professor at the Chair of World Economy, Saint Petersburg State University (62, Chaykovskogo St., Saint Petersburg, 191123, Russia, e-mail: s.lukyanov@mail.ru).

Temkina Irina Mikhaylovna (Yekaterinburg, Russia) — PhD in Economics, Professor at the Chair of Financial Management, the Ural Federal University named after the first President of Russia B. N.Yeltsin (2-7, Sverdlova St., Yekaterinburg, 620027, Russia).