

Guest Opinion

Petroleum And Pensions

Long-Term Problems Of Russia's Fiscal System

The past year or so has been marked by changes in some key Russian macroeconomic indicators and important economic policy initiatives. In 2006, for the first time, there was a large net inflow of foreign capital in the private sector (\$40 billion). This accounted for 4.1% of GDP, consisting mostly of direct foreign investment, and went on to more than double over the nine months to Sept. 30, 2007 year on year. By September 2007 the growth rate of fixed investments reached 20%. Growing investment demand and low macroeconomic risks are likely to continue to attract large capital inflows.

Most Russian economic indicators look impressive. GDP growth reached 7.9% in the first half of 2007, while the federal budget fiscal surplus was a large 7.5% of GDP for the first eight months of 2007. The current account balance was positive at \$57 billion and external debt was less than 4% of estimated annual GDP in mid-2007. The Stabilization Fund, established by the government in 2004 to help protect the federal budget from oil price volatility, had accumulated about \$140 billion at Sept. 30, 2007, three times Russia's external debt.

Nevertheless, the Russian economy faces several major problems that the federal government is trying to tackle through economic reforms. The most fundamental reforms have recently been initiated in the area of fiscal policy. For example, in July 2007 the federal budget was for the first time passed for

three years instead of one, helping to link the amount of the government's spending mandates with the increase of fiscal revenues anticipated in the medium term. This reduces macroeconomic risks, and lays the foundations for the strategic distribution of resources. Moreover, incremental budgeting based on the indexation of expenditure items is being replaced with the allocation of funds for public priorities.

Perhaps the two most important issues that Russia needs to address are the management of oil and gas revenues, and the reform of its state pension system. These two subjects are closely linked, as the government plans to use some oil and gas revenues to support the ailing pension system. But Russia's oil and gas sector is expected to shrink over time relative to GDP, while the problem of funding pensions will only grow due to negative demographic

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trends. Recent reforms in both these areas appear encouraging, but further major changes are vital for the future health of Russia's economy.

Managing Oil And Gas Revenues

The management of the oil and gas fiscal revenues is a key area of reform. From 2008, the government will subject five oil taxes (natural resources extraction tax on both oil and gas, and export duties on crude oil, oil products and gas) to a special management regime, instead of the previous two main oil taxes (natural resources extraction tax on oil and export duties on crude oil). In other words, a special regime will apply to all main oil and gas taxes, with the exception of profit tax, for which it is difficult to separate the natural resource rent and economic profit. In addition, the principle of what share of oil and gas revenues the government should save is to be changed. The government has so far saved windfall revenues (in contrast to revenues on the base oil price) from the two main taxes. The size of the revenues from oil and

National Welfare Fund (NWF) is intended for long-term priority spending. The NWF is likely to be used to support the state pension system by mitigating the anticipated fall in the replacement rate (the ratio of the average retirement pension to the average wage).

The reform of the management of oil and gas revenues is a major new step in the same direction as that taken by the establishment of the Stabilization Fund. The Stabilization Fund mechanism was introduced to cushion the government's budget from short-term fluctuations in the oil price, like those that triggered the 1998 financial crisis. The time has come to address a more difficult and comprehensive task: to protect the economy from long-term fluctuations of oil and gas prices and outputs. Price hikes and drops may be equally dangerous, albeit in different ways. The completed reform will mean a transition to much stricter budget rules that will make the Russian economy less vulnerable to external shocks.

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gas to be spent by the government have therefore varied, depending on oil and gas prices (in 2006 they varied by \$0.7 billion for every \$1 per barrel change in the price of Urals crude oil). The new rules, however, fix the amount allocated for government spending (the so-called 'oil transfer') as a percentage of GDP (it is set at 3.7% of GDP from 2011).

The government's revenues from oil and gas sales are divided into two funds: the Reserve Fund aims to cover possible fiscal losses if the international oil and gas market deteriorates; the

Russia's Looming Pension Problem

Russia's state pension system is the country's greatest long-term macroeconomic problem. It stems from the unfavorable demographic trends that are typical for most developed countries, with the number of workers contributing to the pension scheme set to fall significantly and the number of pensioners set to rise.

Russia faces even greater problems than more developed economies. According to some estimates, the share

of the retirement-age population in Russia will increase to 31% (compared with 26% for the U.K. and 26% for the U.S) in 2050 from 20% (20% and 12%, respectively) in 2006, while the share of the working-age population will decline to 51% (59% and 62%) in 2050 from 63% (66% and 67%) in 2006. (This data is taken from the Standard & Poor's Ratings Services article "Global Graying: Aging Societies and Sovereign Ratings—Methodological and Data Supplement", published June 27, 2006, on RatingsDirect, the real-time, Web-based source for Standard & Poor's credit ratings, research, and risk analysis.)

Projections for the period through 2050 show that, in its current form, Russia's state pension system can fully meet its obligations (as formally defined in nominal terms) and, moreover, can increase benefits at least in line with inflation. However, pension levels will increasingly lag behind wages, and will therefore likely lead to major social policy concerns. The costs of addressing this problem are high: long-term projections show that pension benefits need to be increased by more than 2% of GDP over the period 2020-2041 if the replacement rate is to be maintained at the 2006 level, while the highest projection of a shortfall in resources amounts to almost 3% of GDP.

Future Shrinking Hydrocarbons Sector Demands Fiscal Rethink

Russia also faces the major long-term challenge of a shrinking of its oil and gas sector relative to GDP in the future. The slowdown of oil and gas production and export growth in combination with an appreciation of the ruble will result in the sector's share in GDP falling when world oil and gas prices stop rising. This will reduce fiscal revenues, because the tax burden in the hydrocarbon sector is twice as high as in the rest of the economy. Combined with the planned increase of federal government spending in 2008-2010, this is likely to result in balanced (zero surplus) budgets in the coming years.

This situation requires a major change in fiscal policy. Some adjustment has already been made through the reform of the Stabilization Fund. Coupled with a restriction on net borrowings by the federal government (now capped at 1% of GDP), this measure will prevent inflation of government spending and provide for the replacement of the current oil and gas revenues when their share of GDP falls. Nevertheless, this still leaves the acute problem of supporting the pension system and improving the quality of public education and healthcare services when the government is no longer able to increase allocations to these areas as a share of GDP.

It is high time for the government to modify its approach, moving from an extensive fiscal policy (based on increasing spending) in the public sector (typical for the period of implementing the ‘national priority projects’) to an intensive policy (based on institutional reforms). The cornerstone of the intensive fiscal policy should not be the growth of financing but rather the reform of mechanisms in the public sector, particularly health care and education.

Pensions Dilemma Requires Multiple Solutions

The government has proposed that it co-finance employees’ additional voluntary contributions to the funded system. However, implementation of this proposal—even if most employees were to use it—might take effect only after 2030.

Economist and former acting Prime Minister of Russia Yegor Gaidar has proposed that the proceeds from the privatization of state-controlled companies and banks be used to solve the problems of the pension system. This seems an excellent idea, but discussions are needed on exactly how the proceeds should be used. To address the pension system’s most acute and important problems, the fund should perhaps be channeled into the so called “insurance” component rather than the funded component to finance current, rather than future, pensions.

Russia’s pension problems are too fundamental to be solved by any single

action, however. Multiple approaches will be required, in particular by:

- Increasing the role of private pension insurance, which plays the leading role in most developed countries.
- Using revenues from high oil prices and the sale of the state-owned companies to increase allocations to the pension system.
- Using more selective pension eligibility criteria (for example, paying the basic pension only to the lowest-income citizens and retaining state pensions only for those working pensioners who are paid low salaries (in Russia, pensioners are eligible for the state pension even if they continue working after reaching retirement age)).
- Raising the retirement age, a measure that several factors make inevitable. First, Russia has the lowest pension age among countries with high and medium incomes, at 55 for women and 60 for men. Second, an expected long period of acute labor shortage is beginning in Russia. Third, women retire earlier and live longer than men. To close the gap between the pensions paid to men and women, the government should reduce the gender differences in the retirement age. Many countries have the same retirement age for men and women (for example, 62), and such a change is worth considering.

Only a set of such measures can lead to an acceptable level of pensions and the long-term financial viability of the pension system and the public finance system. Russia still has the time to implement these reforms, as pension problems may become severe in five to seven years’ time, but it needs to start preparing now. **CW**

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