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Russian Fiscal Policy: Challenges Ahead

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The period 2007 to 2010 will in many ways mark a macroeconomic turning point in Russia, witnessing a change in the external conditions of the development of the Russian economy and in the character of government policy.

First, the rapid growth of world commodity prices is expected to be replaced by their decline. The Urals oil prices, after growing by more than 2.5 times in the last three years, are expected to go down to US$50 per barrel in 2010.

Second, the production and export of hydrocarbons will be lagging behind economic growth in Russia. Nevertheless the massive inflow of foreign capital will further strengthen the ruble and thus reduce the share of export-oriented sectors in GDP. As a result, the share of the oil and gas sector in the country's GDP will plummet from 23% in 2006 to 13% in 2010. Accordingly, the size of the resource rent in the sector will drop almost by half from 19.1% of GDP in 2006 to 10.6% in 2010 (see Graph 1).

A sharp reduction of the relative weight of the oil and gas sector will significantly reduce the total budget revenue. This is due to the increased tax burden for both sectors (following the recent tax reform) and eased burden for other sectors. As a result, in 2006 the tax burden on the oil sector was twice that on the rest of the economy, and on the gas sector it was 1.5 times higher. Accordingly, the drop in oil and gas revenues cannot be compensated by other sources, so that the total federal and enlarged budget revenue will drop by 5.4% of GDP in 2007-2010.

Balanced 3-Year Budget

The drop in oil and gas budget revenue will be accompanied by tougher budgetary rules. A special regime will now be applied to all the main oil and gas taxes except the profit tax.

Moreover, the division of the oil and gas revenues into disposable and saved categories will change. Up until now the size of disposable oil and gas revenues varied depending on the prices. Under the new rules, such revenues are fixed at 3.7% of GDP and are thus constant over time and independent of oil and gas prices. On the whole, this marks a transition from short-term and partial smoothing of the use of oil and gas revenues to their full and long-term smoothing.

At the same time, while in 2006 the saved oil and gas revenues equaled 7.5% of GDP, in 2008-2010 they will not exceed 1% of GDP. A combination of growing spending and diminishing revenues will result, within just three years, in a balanced budget — quite a change from a significant surplus of 7.4% of GDP. Most of the increase in spending will be channeled to public investments, government corporations and similar goals. That reflects the state's intention to promote the development of non-extractive sectors by increasing the economic growth base.

Given the poor track record of public investments in the past, a course for private-public partnerships has been adopted. Nevertheless there is a risk that increased spending may weaken macroeconomic stability in the long term. Previous international research has revealed that public investments and other support measures are beneficial for growth only if the quality of state institutions is high enough but yield no effect if the institutional quality is low, which is the case in Russia today.

The Need for "Intensive" Spending Policy

Our estimations show that budget revenue will continue to decline beyond 2010. Based on the Energy Information Agency's forecast of the average oil price of about US$45 per barrel of Urals oil in 2011-2020, federal budget revenue may drop to

16.5% of GDP by 2020. From 2008, a cap of 4.7% of GDP will be imposed on the non-oil and gas deficit, that is, net borrowing should not exceed 1% of GDP. The predicted maximum expenditure will then level out at about 18% of GDP (see Graph 2).

Thus, after 2010 a rapid increase of budget expenditures will have to give way to their gradual reduction. Furthermore, one has to take into account the growing need to support the pension system. Estimates show that although the pension system will be able to meet its obligations in nominal terms, too big a drop in the income replacement ratio is socially unacceptable. The replacement ratio already declined from 32% in 2002 to 25.8% in 2006. To prevent a further drop, the federal budget envisages an increase of transfers for labor pensions — but further increases are need to maintain the replacement ratio at least at the 2006 level.

The above assessments highlight the need to adopt an "intensive" spending policy instead of an "extensive" one. The extensive character of recent trends is also revealed by the nature of the national projects in public health and education where the allocation of additional resources failed to deliver substantial reform progress. Meanwhile, international experience shows that additional funding without improvement of the institutional environment is not conducive to a higher quality of public service provision, while public sector reform can achieve the desired results without an increase in spending.

Challenges Ahead

If public sector performance does not improve, two equally unattractive alternatives will remain. Limits on overall spending will lead to a degradation of the social sphere. If transfers to the Pension Fund remain at the 2010 level, the income replacement ratio will drop below 19% by 2020. To prevent it, the authorities may abandon tough budgetary rules by increasing borrowing and using more of the oil and gas revenues to finance current expenditure. But such a policy will merely delay the need to implement serious reforms and keep expenditures down. Besides, continued high spending creates serious macroeconomic risks: if world prices drop suddenly, or if investors are less ready to credit the government, it will not be able to fully meet its obligations. The crisis would not just slow down the economy, but would set it far

back. The government therefore faces a serious challenge. If it succeeds, the macroeconomic and social conditions of development will remain favorable, but if it fails to improve the performance of the public sector, the prospects of further economic development will be put into question.

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