ANALYSIS

A New Step in Russia's Budget Policy

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Abstract

Russia's state revenues grew considerably during the 2000s, fell sharply during the international financial crisis, and have since recovered. Looking forward, revenues are likely to remain steady or fall as Russia's physical oil output plateaus. While the president plans to honor the promises he made during his campaign, Russia will impose budget discipline beginning in 2013. Some critics of Russia's budget policy complain that cutting budget expenditures will hurt economic growth. Others complain that saving oil profits in a Reserve Fund deprives the economy of infrastructure investment. While macro parameters of Russia's fiscal strategy may be on track, currently the expenditure structure is deteriorating with less money spent on infrastructure and human capital and more going to defense and security. Russia can improve the effectiveness of its budget expenditures, but only if it make this goal a top government priority.

From Surplus to Deficit and Back

The fiscal policy of the 2000s was for a long time determined by memories of the painful crisis of 1998, when the drop in the price of oil to $12/barrel led to a sharp debt and currency crisis. After that event, the government significantly cut its expenditures and introduced new fiscal rules that required saving part of the oil revenues during times when oil prices were high so that the state could cover losses to the budget when oil prices fell. The consistent rise in oil and gas prices to the record levels of mid-2008 meant that the budget was typically in surplus for most of the decade (during 2004–2008, the surplus was 4–8 percent of GDP).

In 2009 the international financial crisis sharply curtailed Russia's budget revenues. The accumulated petrodollars in the Reserve Fund made it possible not only to compensate for the losses to the budget, but also to increase expenditures to stimulate demand. Support for the banking system and the labor market combined with high social expenditures facilitated relatively low unemployment and an almost unchanged level of income for the population, despite the sharp fall in production.

As in other countries, in the extraordinary conditions of the global crisis, the existing fiscal rules were put on hold. This "natural experiment" demonstrated the importance of placing limits on adopting more spending obligations—without strict checks, the government sharply increased such obligations. Unfortunately, the growing spending was not always focused on overcoming the crisis. Thus, a significant number of the expenditures were not one-off outlays (as an anti-crisis program would suggest), but long-term commitments. For example, the expenses of the pension system grew by more than 3 percent of GDP.

In the years since the crisis, income grew in parallel with the reduction of expenditures and, as a result, in 2011 the budget again returned to the black.

Future Budgeting Priorities

The fiscal policy of the upcoming next few years will largely be determined by the conditions in which the Russian economy develops. First, one cannot overlook the possibility of a new international financial crisis. There is a significant possibility that Greece will leave the Eurozone within the next year, which would have a serious impact on the European and world economies, as well as on the international financial system.

The next factor which must be taken into account is the long-term reduction, starting in 2013, in state revenues as a percent of GDP. This reduction results from the fact that the physical output of oil in Russia is reaching a plateau, and, as the government projects, will remain at its current level for the foreseeable future. In previous years, this decline was balanced by a rapid rise in the price of oil. However, as soon as the price drops or stabilizes (as budget forecasts expect), the overall share of the oil sector in the economy (which continues to grow) will begin to shrink. This contraction will automatically lead to a reduction in budget revenues, since the tax burden in the oil sector is 2.5 times higher than in the rest of the economy. Since hydrocarbon revenues are concentrated in the federal budget, it will suffer the main losses. The income of the federal government will fall from 21 percent of GDP to less than 19 percent of GDP in 2014–2015. Finally, over the next three years, there will be a continuation in the growth of expenditures for defense as part of the government's large-scale rearmament program. Another driver of increased expenditures is connected to promised higher salaries for doctors, teachers and other public sector workers. President Vladimir Putin signed decrees mandating such raises after his inauguration in May this year. Regional and local budgets will finance most of these new outlays.

In a situation in which revenues are dropping and the state faces additional expenses, the government can either raise taxes or increase the budget deficit. However, both options harm economic growth since they both deprive economy of resources for growth and reduce stimuli for investment in the private sector. In this light, a decision was made to reject both of these "easy" options. In the president's budget address, he promised not to raise taxes on the non-raw material sector of the economy before 2018. This pledge provides transparency and predictability in the state's tax policy, increases the competitiveness of the tax system, and improves the investment climate in general. The second principled decision was that beginning in 2013, fiscal rules will be restored (in a modified version as compared to the pre-crisis period); in other words, we will return to strict budget discipline. Budget expenditures will no longer be based on the anticipated price of oil, but on the average price for several past years. This approach significantly reduces the dependence of the budget and the entire economy on the fluctuations in the oil market, since expenditures will not depend on the current oil price. Saving money in the Reserve Fund during period of high energy prices will guarantee the budget's integrity at times when oil prices fall.

Enforcing budget discipline and simultaneously carrying out promises already made is not a simple task. The upcoming two years will be particularly difficult as expenditures will stay at the same real level and increase only at the rate of inflation. These years will be transitional, and then, beginning in 2015, we will carry out the budget rules in full measure. At that point, we will return to a balanced federal budget. Overall between 2013 and 2015, federal budget expenditures will drop by more than 2 percent of GDP.

Criticism from All Sides

Critics of all persuasions complain about recent budget decisions. Some economists argue that budget consolidation measures planned for upcoming years will undermine economic growth. This supposition would be correct if the volume of production in the Russian economy was much less than its potential level. However, our economy now is growing close to the level of its potential growth—we have practically full use of competitive capacities combined with low and dropping unemployment. Therefore, at present, the main task is not to support demand through additional budget expenditures, as in the majority of developed countries, but to enhance investment (primarily private investment). But, now Russia is experiencing an outflow of capital—financial resources which could go to investments are leaving the country—and it is necessary to end this process. Otherwise we will not secure even the current pace of growth in the economy. To resolve this problem, a prudent macroeconomic policy is the top priority.

The other criticism is that saving hydrocarbon income in the Reserve Fund deprives the economy of resources for development. However, no one denies the need to have a "rainy day fund" in case of negative external shocks. The government outlined a compromise course: rents from the hydrocarbon sector will be directed to the Reserve Fund as long as the money there does not reach 7 percent of GDP. Beyond that level, natural rents may be used to finance infrastructure projects.

With hard budget constraints in place, the general approach should be to spend budget funds more effectively. There are significant reserves for doing this. For example, there is so much waste in state purchases that experts estimate that Russia loses up to one trillion rubles a year. Now the government is considering plans to overhaul the system of public procurement. In comparison with other countries, Russia is much less efficient in building roads and other state investments. To address all such issues, the government adopted a program to increase the efficiency of its expenditures by providing new incentives for those who receive funds from the budget. One of the main points is the transition to a "program budget," which provides a framework so that any expenditure will be linked to the result which should be achieved as a result of the expenditure. This will create serious stimulants to increase efficiency in public sectors and among individual recipients of budgetary funds.

Additionally, regional budgets will have to end their current practice of inefficient expenditures. The difference from the federal budget is that the need to improve efficiency comes for the latter from the reduction of revenues while regional budgets face higher labor costs in the spheres of education and healthcare. The regions will have to improve efficiency and tap internal reserves by cutting low priority expenditures. But this task will take more than one year. It is necessary to change the mechanisms for financing sectors and specific organizations and create incentives so that the high pay matches the level of qualifications of the specialists and their work.

It is necessary to guarantee that the increased pay in the public sector is matched by increased worker productivity. Now, in terms of the number of people employed in the public sector per thousand in the population, Russia surpasses both developed countries and emerging markets. At the same time, the size of the labor supply will shrink beginning in the new year by about 300,000 to 400,000 people per year. So that the shortage of workers does not become a factor holding up the development of the economy, it is possible to use such reserves as reducing loss-making employment in the public sphere.

Fixing State Expenditures

While budget policy is on the right path from the point of view of general strategy, the structure of state expenditures is deteriorating. During the pre-crisis period, the most quickly growing category of expenditure was directed toward development of the economy (including investment in infrastructure) and the expansion of human capital (education, health-care). During the crisis itself, the top priority was social expenditures, especially pensions. Now, the leaders are military expenditures and police and security outlays. Such shifts are not justified for two reasons. First, by increasing pensions to 9 percent of GDP and expenditures on defense and security to 6 percent of GDP, we have significantly exceeded what is characteristic for countries of the OECD (which Russia is planning to join), where 7.5 percent of GDP is typical for pensions and 3.5 percent is usual for defense and security. Additionally, Russian expenditures on health-care—3.5 percent of GDP—are significantly less than the OECD average of 5.8 percent. Second, according to cross-national research, "productive" state expenditures focus on developing physical and human capital, which facilitates the long-term growth of the economy, while other types of expenditures do not affect development.

A key problem of budget policy is the fate of the social safety net system. In 2002 Russia adopted reforms that created a contemporary pension system with three principle components: basic pensions were designed to provide a minimum social guarantee to pensioners; insurance pensions, which were built on the notional accounts principle (similar to the Swedish model), and a funded pillar. However, recent steps have pushed the pension system from its original design. The decision to reduce the level of pension contributions in 2005 and the increase in the size of the pensions in 2009–2010 led to a result under which more than half of pensions are now financed from general budget funds rather than pension contributions. In 2010, the government cancelled the basic pensions, and now the government is discussing the proposal of the Ministry of Labor and Social Development to significantly redistribute income from the funded pillar to the pay-as-you go pillar. This is necessary, in part, because the state agency (that is managing a bulk of pension funds), until recently, did not succeed in earning positive real returns, and partly due to the need to carry out a fiscal consolidation. Anyway, the draft of the new reform does not include proposals making it possible to define a new strategy to address the looming demographic reality that the old-age dependency ratio is rapidly going up. Russia is not unique in facing this problem, which is also looming for Europe and other developed countries. This means that we must return to the issue of pension reform and sooner or later adopt unpopular, but necessary, changes: increasing the pension age, lengthening the minimum term a person must work before gaining access to a pension, limiting the receipt of pensions by people who continue to work, using smaller pensions in payment indexation, etc. By all these parameters, the Russian pension system is one of the most "generous." Women can receive a pension at age 55, while men can start at age 60, as long as they have worked for 5 years. Additionally, almost one third of workers, for one reason or another, have the right to receive their pensions at an earlier age. There are no limits on people currently working also receiving a pension, with about a third of pension-aged people working.

Of course, it is easy to understand why the authorities do not want to take responsibility for unpopular measures. However, of the 15 former Soviet republics, 12 have already increased their pension age, with Belarus, Russia, and Uzbekistan being the only exceptions. The average pension age in post-Soviet countries is 58 for women and 62 for men. This year Ukraine has gradually begun to increase the pension age for women. That experience just provides further evidence of the natural and inevitable character of such policies and efforts to reject them will only make the future increases in the pension age more difficult from the economic and political points of view.

Conclusion

Overall, it is clear that the decision to restore implementation of fiscal rules was an important step in returning to a prudent budget policy. The key step now is to compensate for the consequences of the deterioration in the structure of state expenditures by increasing their effectiveness. This is not a simple task, but one that is, in principle, possible to implement as long as it becomes a priority for the government, which it should. In parallel, it is necessary to make economic policy more consistent, removing those elements that contradict announced general principles prioritizing long-term budget stability.

About the Author
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