ANALYSIS

The Russian Budget: Why So Much Fuss?

By Philip Hanson, London

Abstract
Disagreements among policy-makers over budget plans have become unusually open. They reflect profound differences of view within the elite over Russia's future development. Those who seek rapid fiscal consolidation have little faith in state intervention and also seek fundamental reforms in the state pension system and in the state's control over energy assets. Such disagreements will not be quietly resolved.

A Budget Storm…
In September 2012 the Russian government was preparing and presenting a draft budget plan for 2013–15. On the 18th President Putin publicly castigated his ministers for failing to make provision for spending promises he had made in May. These were particularly about raises in public-sector pay. In early October Andrei Klepach, a deputy minister of economic development, spoke of adjusting the draft plan to allow for more expenditure on healthcare and education. Nonetheless the existing plan—primarily the work of the Ministry of Finance (MinFin)—went forward pretty much unchanged. The budgetary committee of the Duma (parliament) then announced that it was going to spend four days scrutinising this draft for the first reading, an unusually intensive procedure at this stage. Yet again, as over several other matters lately, the political elite were embroiled in a public spat. What is at stake?

The answer is: more than you might suppose. Budgetary policy in Russia is linked to the fundamental economic challenges the country faces: a medium-term decline in the workforce, an abrupt slowdown in supplies of credit from abroad, insecure property rights, weak domestic competition and vulnerability to volatile oil prices.

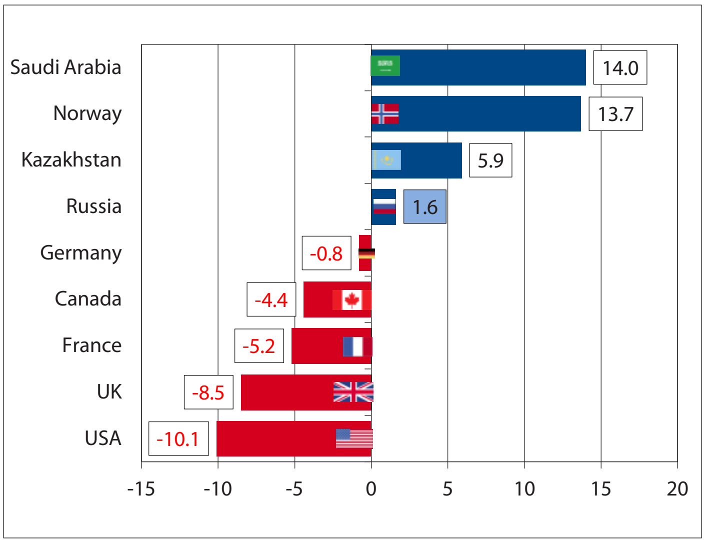
…in a Teacup?
At first sight, the issues at stake do not seem fundamental. The fiscal plan in question is only for the federal-level budget. Russia's recent budgetary balance has been much healthier than those of the Western world, and its public debt is, by OECD standards, laughably small. Couldn't a bit more be spent without any harm being done?

First, the matter of multiple Russian budgets: it is true that the federal budget accounts for only about four sevenths of general government spending, and has latterly been around 20–21% of GDP. However, transfers from it prop up regional budgets. Regional and municipal officials have almost no independence in the choice of tax bases and tax rates. Federal transfers also plug a very large hole (about 2% of GDP) in the state pension fund. The overall balance of government revenue and spending depends on the federal budget.

Second, Russia's fiscal health is currently good. Figures 1 and 2 present a picture that is, by OECD standards, one of glowing fiscal health. This applies not only to Russia but to several other large oil-and-gas exporters as well. In 2011 Russia, Kazakhstan, Saudi Arabia and Norway all had positive fiscal balances. The first three had comparatively very low public debt levels; Norway, with a highly developed welfare system, had an intermediate debt level.

Recent Russian experience, however, points to a serious downside risk. When oil prices fell steeply in 2008–09, its GDP fell by 7.8% (2009 over 2008). This was the largest percentage fall among G-20 nations. Strikingly, other major oil exporters, such as Saudi Arabia, experienced only a slowing of growth, not an outright decline.

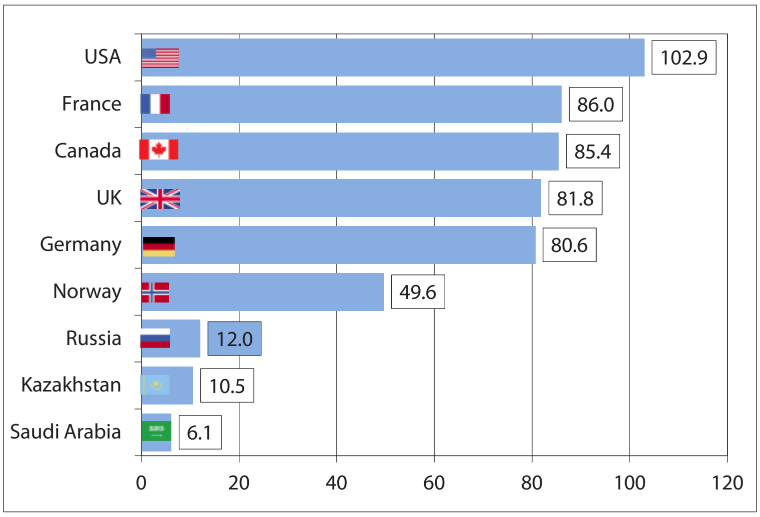
Figure 1: General government balance (surplus +, deficit -) in 2011 in selected hydro-carbon-exporting and advanced economies, % of GDP



Source: IMF World Economic Outlook database, October 2012

This sensitivity is not easily explained. It may stem from a particularly severe lack of confidence in Russia's ability to cope with lower oil prices, on the part of both Russian business and global markets. It may therefore be the

Figure 2: Gross government debt as % GDP, end-2011, selected hydrocarbons-exporting and advanced economies



Source: IMF World Economic Outlook database, October 2012

outcome of a self-fulfilling prophecy. Aleksey Kudrin, the much-admired, long-serving finance minister who resigned last September, has argued that Russia could not easily, at short notice, borrow to plug a budgetary deficit of 3% of GDP. In the same vein, he has consistently maintained that Russia could not allow itself the luxury of a public debt much above 30% of GDP. Figure 2 illustrates the vastly more luxurious debt ratios that leading western nations have allowed themselves.

Two Views of Russia's Way Ahead

For most of the 21st century so far, Russian policymakers have seen the petrodollars flooding in. There have been two opposed reactions to this inflow: spend it, and save it. That is, of course, simplifying things, but not by much. Revenue from the mineral resources tax and the export duties on oil and gas has been providing around half of federal budget income. For most of his decade as minister of finance, Kudrin resisted the would-be spenders. From 2004 he built up a stabilisation fund—subsequently split into the Reserve Fund and the Fund of National Prosperity. In 2008–09 it propped up state spending when hydrocarbon revenues fell. It allowed Russia to cope with a sharp recession without running up major debts.

This stance has been maintained by Kudrin's successor, Anton Siluanov. However, both Siluanov and Kudrin have been unable to stop the rise in spending. In 2007 the Urals oil price at which the budget would have exactly balanced was $29 per barrel. In 2012 it is $117 per barrel.

Part of the pressure to spend more comes from officials with their own plans to siphon off funds from state projects. Accordingly, one of Kudrin's objections to more spending was that in Russian conditions much of it simply did not go where it was supposed to go. But there is also a school of thought that favours more spending on healthcare, education and science as part of a strategy to develop and diversify the Russian economy. This view has in recent times been represented, departmentally speaking, by the Ministry of Economic Development (MinEkon). It was espoused by the large army of economists who have presented proposals to revise an existing national economic strategy to 2020.

One view therefore is that of the Ministry of Finance, counselling fiscal consolidation: a return to budgetary balance by 2015 and to building up the Reserve Fund and the FNB. Their priority is that Russia must be seen to be in good shape to cope with another drop in oil prices. On the other side there are two constituencies. There are the big spenders with dubious motives, and there are also those who espouse liberal views on the need for more privatisation and for the establishment of an independent judiciary—in short, for millions of hectares of level playing fields—but who at the same time advocate more state spending on infrastructure, education and health for the sake of long-run growth.

The Danger of a Fall in Oil Prices

In the first nine months of 2012 oil and gas revenues, as officially defined, accounted for fractionally over a half of federal budget revenue. The real budgetary impact of oil revenues is greater than this. 'Oil and gas revenues' in the MinFin sense do not include profits-tax revenues, which are split between federal and sub-national budgets. Moreover, the flow of oil and gas revenues, even though part of it is 'sterilised' (removed from the circulation of domestic income) by diversion into the Reserve Fund and the FNB, affects incomes and thereby demand, and therefore levels of economic activity more generally in Russia. That means that changes in oil prices have a secondary effect on the state's revenues from non-oil-and-gas activities.

The risks from lower oil prices are not immediately obvious from recent federal budget numbers.

On the face of it, Table 1 overleaf displays a sound initial state of affairs in 2012 and then projections of the Urals oil price over the next few years that are rather conservative, in a scenario in which a very modest deficit is smoothly reduced. It should however be pointed out that federal budget spending regularly surges in December, so that this year's outcome will be less benign than the current figures suggest. Also, the projected oil price over 2013–15 could indeed prove to be unduly modest, but it could also prove to be not modest enough. One

Table 1: Average annual Urals oil prices and the balance of the federal budget ($/barrel and % of GDP), 2010 Actual—2015 Plan

	Oil price	Fiscal balance
2010A	78.9	-4.0
2011A	109.6	0.8
2012J–O	111.2	1.5 (Jan–Sept)
2013P	97	-1.5
2014P	101	-0.6
2015P	104	-0.1

Notes: A = Actual. J–O = January–October Actual; P = draft MinFin plan. Sources: Central Bank of Russia; Vedomosti.

thing we know about oil prices is that they move around a bit. MinFin's aim is to reduce Russia's vulnerability to sharp movements in the oil price, in part by curbing spending so that the federal budget will balance at just over $90/barrel, from $117 this year.

Given the disarray and (on a good day) stagnation in Europe, the prospects of a 'fiscal cliff' in the US and the slowdown in China and some other emerging economies, horror stories (from Moscow's point of view) of oil at less than $80 or even $60 are not wholly implausible. The Kudrinist view is that Russia should be prepared for such eventualities. That view also carries the implication that additional government spending is not going to transform Russia's prospects for the better.

Guns, Pensions and Rosneftegaz

The basic disagreement about budgetary policy is linked also with conflicts of views about defence spending, the reform of the state pension system and the control of energy-sector assets. For reasons of space I shall not try to describe those here. A few points will, I hope, suffice.

This year public spending on defence and security is rising faster than GDP or budget revenue. Kudrin now, like MinEkon's Klepach, criticises the draft budget for neglecting infrastructure, healthcare and education, but implies that spending on defence should be cut to accommodate them.

The Ministry of Labour's proposed 'reform' of the pension system would leave it still subsidised from the federal budget in 2030.

The struggle over the privatisation of some major state electricity assets is tilting towards eventual control of those assets by Igor Sechin's state holding company, Rosneftegaz.

None of this is good news for reformers, but *la lutta continua*.

Conclusions

Current disputes among policy-makers over fiscal policy are important in their own right. The downside risks of protracted global recession, as far as Russia is concerned, support the case for curbs on public spending.

Suppose, however, that fundamental economic reforms were to be put in place. A Russia that had independent courts, a rule of law and secure property rights would be a country in which the rate of investment was higher, competition was more powerful and the manipulation of oil-and-gas rents was no longer at the centre of political life. It would therefore be a country that could support a larger burden of public debt without causing investor panic, and in which public spending on infrastructure and education had a chance of generating benefits for the wider public.

Then the downside risks of a fall in oil prices, that loom so large at present, would be much less. Choices in macro-economic policy would be different because the rules of the micro-economic game had changed. As things are at present, however, it is hard to argue against the Russian Ministry of Finance's view of the options.

Equally, it is hard to see the current public disagreements over the budget and related matters as simply part of the routine friction to be found in any government. More to the point, they do not seem to conform to the normal functioning of the Putinist order as we have known it since the early 2000s. The disputes are too numerous, too public and have too much bearing on the competence and legitimacy of different parts of the state system. In the words of a Polish analyst, there may be turbulence ahead.

About the Author

Philip Hanson is an Associate Fellow of the Russia and Eurasia Programme at Chatham House and an Emeritus Professor of the University of Birmingham. His books include *The Rise and Fall of the Soviet Economy* (2003) and (co-edited with Michael Bradshaw) *Regional Economic Change in Russia* (2000),

Further Reading

- Hanson, Philip, James Nixey, Lilia Shevtsova and Andrew Wood, *Putin Again. Implications for Russia and the West*, London: Chatham House, 2012 (www.chathamhouse.org/publications/papers/view/182351)
- Rogoza, Jadwiga, 'Turbulence ahead: disputes within the Russian ruling elite are gathering force,' (www.osw.waw.pl/en/publikacje/osw-commentary/2012-09-27/)
- Sutela, Pekka, *The Political Economy of Putin's Russia,* London: Routledge, 2012.