

2 Long-term Fiscal Sustainability of the Russian Federation¹

Russia faces major long-term fiscal risks: uncertain, volatile oil and gas revenues and rising spending on pensions, health, and education. Unless solutions are put in place in the short to medium term, Russia's strong fiscal position will unwind. That would imperil its ongoing economic expansion.

To deal with the risks, the new government should take four actions: make fiscal sustainability a top priority, expand the tax base outside oil and gas to substitute when oil revenues decline, identify possible savings to create room for spending priorities, and consider a fiscal "permanent income" rule—keeping the nonoil primary fiscal deficit below what can be financed safely from oil revenues—to keep fiscal policy on an automatically sustainable trajectory.

Over the past nine years, Russia's fiscal policy was prudently conservative, but the future fiscal risks are significant. Russia has wisely chosen to reduce spending volatility by diverting a stable flow of oil revenues to the budget and allocating the rest to a stabilization fund. This reduced the adverse impact on the domestic economy and its competitiveness. Solid fiscal management created the foundation for nine years of strong economic growth. But fiscal prudence should not be taken for granted: Russia faces serious risks in the long term, which threaten to unwind the hard-won gains from reforms. This section elaborates the implications of three risks that threaten Russia's fiscal position—from oil price volatility, from expenditure pressures linked to pensions, education, and health spending, and from the renewed debt that could ensue. It argues that

the new government should make preserving fiscal prudence and sustainability its key policy objective, proposing a fiscal rule—the permanent income rule—that could ensure long-term fiscal sustainability automatically.

Three fiscal challenges—uncertain revenues, rising expenditures, and the specter of renewed debt

Issue 1: Oil revenues, booming today, could become a drag on economic performance

The strong recovery of oil prices since 2000 increased Russia's dependence on oil and gas revenue, making it more vulnerable to price declines. The share of oil revenue in total fiscal revenue increased substantially—from 10 percent of GDP to about 30 percent. Instead of diversifying, Russia has specialized in oil, which now accounts for about 60 percent of exports (figures 2.1 and 2.2). Higher oil revenues create more room for spending, but they also complicate macroeconomic management and foster dependence on a volatile, uncertain source of income. This has not been a problem in the face of high oil prices, but it could become a major vulnerability if oil prices begin a rapid descent.

Issue 2: Russia will confront major public spending on pensions, health, and education in the medium to long term

Russia's well-documented demographic trends are key drivers of major social spending. A declining, aging population, higher demand for pension and health services, and a changing demand structure for education will mean that public spending on these areas is likely to increase significantly. Main social expenditures are likely to increase by 3.5 percentage points of GDP—from 14.1 percent of GDP in 2008–10 to about 17.3 percent in 2016–20. This estimate is in line with recent comments by the finance minister. If, as assumed, long-term fiscal revenues remain stable

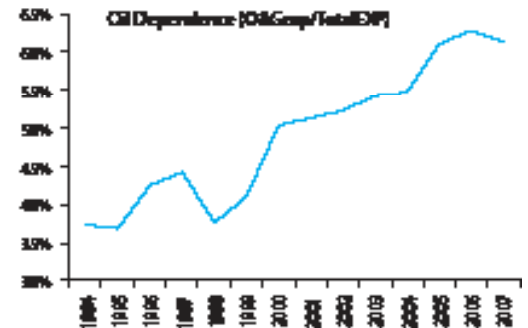
¹ Prepared by Zeljko Bogetic, Lead Economist for Russia and PREM Country Sector Coordinator. The note draws on a series of technical notes prepared by the World Bank for the Ministry of Finance in February 2008 and the paper "Oil Revenues, Expenditure Pressures, and Fiscal Sustainability in Russia," with S. van Wijnbergen and N. Budina, presented at Higher School of Economics Conference in Moscow, April 1-3, 2008. This research is part of a larger, on-going World Bank's project Russia: Long-Term Fiscal Study.

Figure 2.1: Oil's share in government revenues increases with rising prices



Source: Government of Russia.

Figure 2.2: Oil and gas making up a rising share of total exports



and total public spending remains at about 31 percent of GDP, this would mean that long-term spending in other categories would need to adjust to avoid growth in total public spending (table 2.1).

Total revenues are anticipated to stabilize around 34 percent of GDP over the long term as oil revenues and prices moderate. Expenditures, meanwhile, are likely to increase during 2008–10, reflecting the three-year budget plan, but are then projected to remain broadly constant at about 31.3 percent of GDP until 2020. This scenario would mean that the government

to 13.5 percent in 2020. This adjustment should be feasible, still allowing for real growth in other spending. In a baseline scenario with 5.8 percent average real GDP growth over 2008–2020, other spending would grow at 3.7 percent a year in real terms.

Issue 3: Unless the government undertakes fiscal measures to ensure sustainability, Russia will once again become a net debtor in the long term.

Under a baseline fiscal scenario—the scenario underlying today's macroeconomic framework and the 2008–10 budget—Russia saves and dis-saves at the same time.² Resources are added to the Reserve Fund, but meanwhile the transfers from the National Welfare Fund are not enough to cover the nonoil primary (noninterest) fiscal deficit. So, gross debt increases as a share of GDP. Continuing passively on this path, Russia could consume its oil fund assets and its other foreign exchange assets by the end of

the planning horizon in 2040, reaching zero net debt. After that, Russia could again fall into debt. With gross debt increasing, oil funds will begin to shrink—budget transfers will exceed oil revenues (figures 2.3 and 2.4).

Table 2.1: Russia's general government expenditures—an emphasis on social expenditures (percentage of GDP)

	2008–10	2011–15	2016–20
Total expenditures	31.1	31.3	31.3
Total noninterest expenditures	30.7	31.1	31.0
Education	4.7	5.5	6.0
Health	4.5	5.5	6.0
PAYGO Pensions	4.9	5.2	5.3
All other functions	16.7	14.9	13.7
Interest	0.4	0.3	0.3

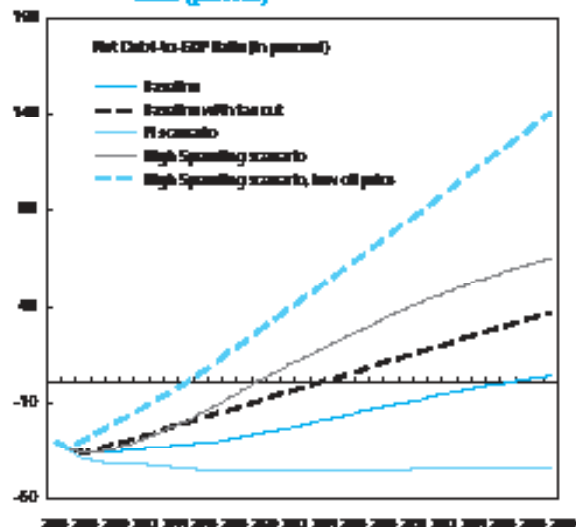
Source: Preliminary calculations; ongoing Russia: Long-Term Fiscal Study, World Bank.

maintained fiscal prudence and kept some surpluses, if substantially less than in recent years.

The long-term increases in social spending, combined with estimates for total expenditures, will put significant downward pressure on all other public spending categories. Spending on all other functions would have to decline from 17.2 percent of GDP in 2008

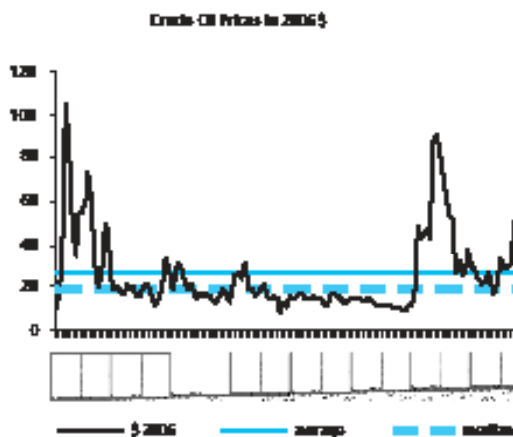
² All scenarios assume that oil prices fall back to about USD 60 per barrel but remain constant in real terms thereafter, as assumed by the government.

Figure 2.3: Five scenarios for Russia's net debt-to-GDP ratio (percent)



Source: The World Bank staff authors' calculations.

Figure 2.4: Crude oil prices in 2006 dollars per barrel



If spending is higher—say, if social spending pushes the expenditure-to-GDP ratio up by 4 percentage points, without offsetting cuts in other spending or revenue gains—net assets would deteriorate much faster. In that case, Russia could become a debtor country after 2018, with net debt reaching 61 percent by 2040. That shows the cost of not responding to spending pressures.

Cutting taxes—say, reducing the VAT rate by 4 percentage points—could raise the nonoil primary fiscal deficit by at least 1.5 percent of GDP against the base case. Russia would be able to finance this deficit with oil fund assets for only the next 20 years. From 2025 the country would start accumulating net debt again, reaching 37 percent of GDP by 2040. That shows the cost of a hasty tax cut while revenues are booming.

But if Russia adopts a “permanent income” rule—keeping the nonoil primary fiscal deficit below an estimated 4.7 percent of GDP—sustainability would not face a threat. This deficit could be fully financed from the permanent income from Russia’s oil assets. The net debt position would remain more or less unchanged over the planning horizon.

Four policy implications

1. *The new government could prepare for the possible decline in oil and gas prices and revenues by expanding its nonoil tax base and revenues.*

This would require reviewing the nonoil tax bases, beginning with major tax instruments such as the VAT, excise, and income taxes, to identify the losses from exemptions and other features that narrow the tax base. That review should yield recommendations to eliminate nonoil tax exemptions, along with the estimated revenue impact. This could be done during the ongoing preparations for the 2010–12 federal budget. Any cuts in key tax rates (e.g., VAT) should be delayed after the tax base is expanded in order to avoid precipitous revenue losses.

2. *The government could identify specific functional categories of unproductive spending to target for cuts in the medium term, to create room for rising priority expenditures—social spending and infrastructure investment.* This would require a systematic, annual review of public spending categories, in the context of the annual budget reviews, to identify the scope for cuts without affecting the desired service delivery.
3. *The government should keep fiscal sus-*

tainability a high priority. The government should return the nonoil primary fiscal deficit to a level consistent with fiscal sustainability—about 4.7 percent of GDP—and keep it there. This would be broadly in line with the government's own fiscal rule already in place for 2010 and later, but higher deficits are planned for 2008–09. But the actual nonoil primary fiscal balance now exceeds that required for the permanent income rule to function. And the 2008–10 budget plans further increases.

4. ***One way to establish automatic fiscal sustainability is to put in place a permanent income rule for fiscal policy.*** The rule says that Russia should spend only as much from oil assets as it earns on them in the long run. In practice, this would mean limiting the nonoil primary fiscal deficit to what can be financed from the permanent income from oil assets—an estimated 4.7 percent of GDP—leaving the overall oil assets (in financial terms) intact for future

generations. Today, the nonoil primary fiscal deficit is about 5 percent of GDP, so relatively small adjustments could return it to a permanently sustainable level. But unless the rule is implemented systematically, the nonoil primary fiscal deficit will likely increase and begin depleting oil assets, using them for current consumption and leaving less—or nothing—to future generations.

Russia could also ensure long-term fiscal sustainability with prudent discretionary fiscal policy, with adjustments through its annual and three-year budget reviews—as it has done in the past nine years. But applying the permanent income rule would eliminate uncertainty and make fiscal policy less vulnerable to political pressures. It would also likely lower external borrowing costs, thanks to greater certainty about the stance and direction of fiscal policy, and dampen economic volatility, given the more stable fiscal position.