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**R95 Russian Economy in 2014. Trends and Outlooks.**

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The review provides a detailed analysis of main trends in Russia's economy in 2014. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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## **2.2. Russia's State Budget in 2014**

In 2014, Russia's budgetary sphere was operating under the cumulative influence of several negative factors. A further slowdown in the national economy's growth rate to 0.6% (vs. 1.3% in 2013) occurred due to the declining prices of oil in the second half-year of 2014. The average annual price of Urals in 2014 dropped to \$ 97.6 vs. \$ 107.9 per barrel in 2013. At the same time, it is necessary to emphasize that the slowdown in the Russian economy had first been noted during an earlier period, while oil prices had been even higher, and so this was by no means a decisive factor of economic development. However, for the budgetary system, and primarily from the point of view of the 'oil and gas' component of federal budget revenue, it was the price of oil that became the key determining parameter. As for the negative factors that the economy has been faced with, it is also necessary to point to the economic sanctions introduced against Russia from the spring of 2014 by the West, as a result of which investment activity declined and borrowed funds became far less easily obtainable. All these factors produced a negative effect on the growth rate of revenue inflow in the RF budgetary system. As estimated by the RF Ministry of Finance, Russia's loss of federal budget revenue in 2014 amounted to \$ 150bn as a result of the downward movement of prices for oil, and to about \$ 50bn due to the economic sanctions.<sup>1</sup> It is only thanks to the relatively high prices for energy carriers in the international raw materials markets over the period of January–June 2014, when the price of Urals never dropped below \$ 106 per barrel, that the execution of budget revenue resulted in no shrinkage in the volume of receipts, neither in absolute nor in relative terms. Besides, another factor that conduced to increasing receipts was the decline of the ruble's foreign exchange rate, which in part compensated for the downward movement of oil prices over the second half of the year. On the whole over that year, the ruble-to-USD exchange rate rose from 33.5 in January to 55.5 in December 2014.

While the federal budget targets for 2014 were being planned, it was decided that the Pension Fund's retirement savings should be frozen, to be redistributed in favor of the fund current retirees' pensions, as a result of which the amount of federal budget transfers to the Pension Fund could be reduced. On the one hand, this measure helped to more economically spend the federal budget resources, while on the other the reliance on that mechanism further undermined the population's already feeble trust in pension reform and deprived the financial system of a new inflow of funds from one of the principal sources of 'long money'. The decision, taken in the autumn of 2014, that this measure should be prolonged into 2015, cast doubts as to the ultimate success of one of the major directions of pension reform, thus also significantly increasing the long-term risks for the budgetary system in view of the ongoing population ageing.

In late 2014, the federal government launched its antirecession package designed to support the national economy; the most impressive undertaking, in terms of volume of

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<sup>1</sup> <http://1prime.ru/energy/20150129/801293885.html>

financing, was the measure aimed at recapitalization of the banking system, in the form of issue of new OFZ bonds to the total value of Rb 1 trillion, to be transferred to the Deposit Insurance Agency.

### 2.2.1. The Main Parameters of the Budgetary System of the Russian Federation in 2014

According to data released by the RF Federal Treasury, the RF budgetary system's revenue for 2014 rose on 2013, both in absolute and in relative terms, to 37.2% of GDP (or Rb 26,371.1bn) vs. 36.1% of GDP (or 24,082.4bn) a year earlier (see *Table 6*). General government budget expenditure increased to 38.3% of GDP (or Rb 27,215.9bn), whereas in 2013 its volume had amounted to 37.3% of GDP (or Rb 24,931.1bn). As a result, in spite of the rising revenue, in 2014 the general government budget was executed with a deficit of 1.2% of GDP, which is only 0.1 pp. below the corresponding index for 2013.

*Table 6*

#### The Movement of the Budgetary System's Revenue and Expenditure in 2010–2014

	2010		2011		2012		2013		2014		Deviation, pp. of GDP, 2014 on 2013
	bn Rb	% of GDP	bn Rb	% of GDP	bn Rb	% of GDP	bn Rb	% of GDP	bn Rb	% of GDP	
<b>Federal budget</b>											
Revenue	8,305	17.9	11,366	20.3	12,854	20.7	13,020	19.5	14,497	20.4	0.9
Expenditure	10,117	21.8	10,935	19.5	12,891	20.7	13,343	20.0	14,831	20.9	0.9
Deficit (-)/ Surplus (+)	-1,812	-3.9	431	0.77	-37.0	-0.06	-322.9	-0.5	-333.8	-0.5	0.0
<b>Consolidated budget of RF subjects</b>											
Revenue	6,537	14.5	7,644	13.7	8,064	13.0	8,165	12.2	8,906	12.5	0.3
Including interbudgetary transfers	1,399	3.1	1,644	2.9	1,680	2.6	1,577	2.3	1,728	2.4	0.1
Expenditure	6,637	14.7	7,679	13.7	8,343	13.4	8,807	13.2	9,353	13.2	0.0
Deficit (-)/ Surplus (+)	-99.6	-0.2	-35.4	-0.06	-278.4	-0.5	-642	-1.0	-447.8	-0.6	0.4
<b>General government budget</b>											
Revenue	15,716	33.9	20,853	37.2	23,089	37.1	24,082	36.1	26,371	37.2	1.1
Expenditure	17,301	37.4	20,005	35.7	22,826	36.7	24,931	37.3	27,216	38.3	1.0
Deficit (-)/ Surplus (+)	-1585	-3.4	849	1.5	262.9	0.4	-848.7	-1.3	-844.8	-1.2	0.1
<i>For reference: GDP, bn Rb</i>	66,755		62,218		55,967		66,755		70,976		-

Source: Rosstat; RF Ministry of Finance; IEP's calculations.

Over the course of the year 2014, the volume of federal budget revenue and expenditure increased by approximately the same amount: their growth in relative terms on 2013 amounted to 0.9 pp. of GDP. Federal budget deficit in 2014 remained at its 2013 level of 0.5% of GDP. According to preliminary estimates, the federal budget was expected to be executed with a surplus of approximately 0.4% of GDP. However, towards the year's end the government made the decision of a 1-trillion ruble recapitalization of the banking system (for further detail concerning this operation, see the sections on the budgetary system's expenditures and the RF government debt later in the text). The launch of this measure resulted in a 'technical' deficit in the year-end federal budget for 2014 (in view of the respective increase in the amount of expenditure by Rb 1 trillion).

In accordance with the initial budget targets stipulated in the Federal Law ‘On the Federal Budget for 2014 and Planning Period 2015 and 2016’, the amount of federal budget revenue was to be reduced by 1 pp. of GDP, with a simultaneous cut in expenditure by 1 pp. of GDP being planned for the year 2014. The approval of this cut in budget expenditure was effectuated in compliance with the budget rule whereby the budget deficit should be capped at 1% of GDP above the amount of revenue, provided that the price of oil stayed at its basic level. Throughout the course of 2014, the discussion was underway as to the feasibility of softening the budget rule, to allow for the possibility to spend the surplus oil and gas revenues. Besides, that year saw the fundamental decision to the effect that part of the National Welfare Fund (NWF) should be spent on the infrastructure projects designed to boost economic growth. However, there remain certain issues relating to the choice of most efficient procedures for selecting such projects and assessing their real long-term effects on economic growth.

In late May 2014, the RF submitted to the State Duma a draft law whereby an adjustment of the main parameters of the federal budget for 2014 was envisaged.<sup>1</sup> Thus, in particular, the planned volume of GDP was to be reduced from Rb 73,315bn to Rb 71,493bn. At the same time, the increasing amount of oil and gas revenues produced by the relatively high prices of oil in early 2014 (over January–May 2014, oil prices never dropped below \$ 106.7 per barrel) resulted in an upward adjustment of federal budget revenue from 18.5% of GDP to 19.9% of GDP. However, as early as July, the prices of oil went down to \$ 95.6 per barrel, thus also bringing down the amount of budget revenue. The volume of federal budget expenditure was not revised, but due to the altered GDP index, the volume of expenditure amounted to 19.5% of GDP. As a result of these adjustments to budget parameters, the initially planned deficit gave way to a surplus of 0.4% of GDP. However, as noted earlier, after the issuance of new OFZ bonds this surplus once again gave way to a ‘technical deficit’.

The Reserve Fund in 2014 increased by 72.9% to Rb 4,945.5bn, an equivalent of \$ 87.9bn; the National Welfare Fund – by 51.3% to Rb 4,388.1bn, or \$ 78bn. Such an impressive growth of Russia’s sovereign funds can largely be explained by the downward movement of the national currency’s foreign exchange rate, which had been observed since the autumn of 2014. As a result of foreign exchange rate adjustments over the period from 1 January through 31 December 2014, the growth in value of the Reserve Fund residuals denominated in foreign currencies, kept on its accounts with the Bank of Russia, amounted to Rb 1.9 trillion, and that of the NWF residuals – to Rb 1.5 trillion.

The consolidated budget revenue of RF subjects increased by 0.3% of GDP. At the same time, in early 2014 this index somewhat declined due to interbudgetary transfers. Thus, in particular, in January 2014, the amount of regional budget revenue shrank not only as a result of lower gratis receipts from other budgets of the RF budgetary system – by 0.7 pp. of GDP on January 2013, but also due to the back transfer, in the amount of Rb 187bn, of the residual amounts of subsidies, subventions and other targeted interbudgetary transfers received over the past years by the consolidated budgets of RF regions; later on, towards the end of 2014, this index shrank to Rb 74bn. From this fact it follows that, as far as the procedure of allocation of targeted interbudgetary transfers is concerned, the system of interbudgetary relations between the federal center and regions is still less than perfect. The volume of expenditure in the

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<sup>1</sup> Federal Law of 28 June 2014, No 201-FZ ‘On Introducing Alterations to the Federal Law “On the Federal Budget for 2014 and Planning Period 2015 and 2016”’.

consolidated budget of RF subjects remained at its 2013 level of 13.2% of GDP. The consolidated budget deficit of RF subjects in 2014 shrank by 0.4 pp. of GDP – to 0.6% of GDP<sup>1</sup>.

### 2.2.2. Analysis of the Receipts of Main Taxes in the Federal Budgetary System

In 2014, the amount of tax burden shouldered by Russia's economy rose on 2013 by 0.4 pp. of GDP; however when taken in real terms, the amount of tax-generated revenues shrank by 2.7%<sup>2</sup> (see *Table 7*). This fact points to the increasing risks associated with the revenue sustainability of Russia's budgetary system. As for revenue growth in terms of share of GDP, this index reflects only the varying elasticity of revenue components with regard to the growth rate of GDP.

*Table 7*

**Receipts of the Main Taxes in the General Government Budget of the Russian Federation in 2008–2014, % of GDP**

	2008	2009	2010	2011	2012	2013	2014	Change in 2014 on 2013	
								pp. of GDP	in 2013 prices, %
Tax burden index	35.7	30.8	31.1	34.9	34.6	34.3	34.7	0.4	-2.7
Profits tax	6.1	3.3	3.8	4.1	3.8	3.1	3.3	0.2	2.9
Personal income tax	4	4.3	3.9	3.6	3.7	3.8	3.8	0.0	-3.0
SST / insurance contributions *	5.1	5.5	4.9	6.3	6.3	6.7	6.7	0.0	-3.8
VAT	5.1	5.3	5.4	5.8	5.7	5.3	5.6	0.2	-0.1
Excises	0.8	0.9	1.0	1.2	1.4	1.5	1.5	0.0	-5.3
Tax on mineral resources extraction	4.1	2.7	3.0	3.7	4.0	3.9	4.1	0.2	1.2
Customs duties and levies	8.6	6.8	6.8	8.3	8.0	7.6	7.7	0.1	-2.5

\* from 2010 onwards, single social tax (SST) is transformed into insurance contributions, to be transferred directly to off-budget funds.

Sources: RF Ministry of Finance; *Rosstat*; IEP's calculations.

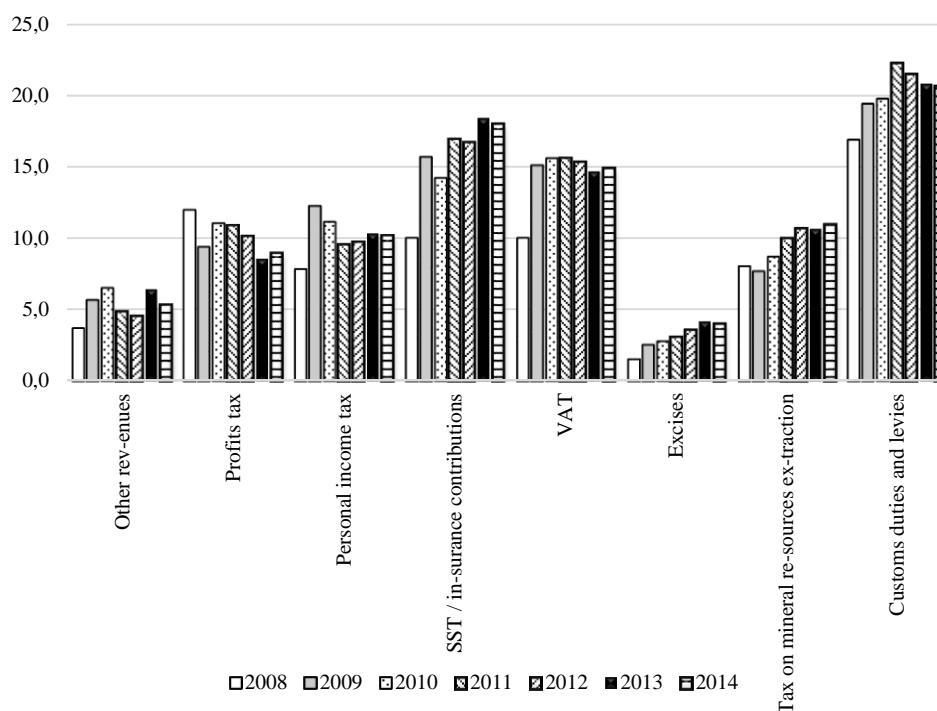
From the general government budget revenue statistics presented in the table it follows that, in 2014, the tax burden in terms of percentage points of GDP increased on 2013 as follows: profits tax – 3.3 pp. vs. 3.1 pp.; VAT – 5.6 pp. vs. 5.3 pp.; tax on mineral resources extraction – 4.1 pp. vs. 3.9 pp.; and customs duties and levies – 7.7 pp. vs. 7.6 pp. of respectively. As for the other taxes, their burden in terms of share in GDP remained unchanged. However, when the movement of tax receipts is reviewed in real terms (with an adjustment by CPI), it becomes clear that all the relevant tax receipts declined in real terms, with the exception of tax on mineral resources extraction (growth by 1.2%) and profits tax (growth by 2.9%).

The structure of tax-generated revenues in the general government budget is shown in *Fig. 13*. In this connection, two circumstances are noteworthy. Firstly, personal income tax (PIT) retained its priority over profits tax as a major revenue source for the general government budget. Secondly, excise receipts, which since 2009 had been demonstrating a steady growth due to the indexation of their rates ahead of the inflation rate, in 2014 dropped in terms of share in GDP, while in real terms they were leaders in decline among all the other types of receipts (decline by 5.3%).

The receipts of PIT, as well as the index of their 'macro-base' – money income of the population less social benefits – in 2014 remained almost at the same level as in the previous year (see *Fig. 14*).

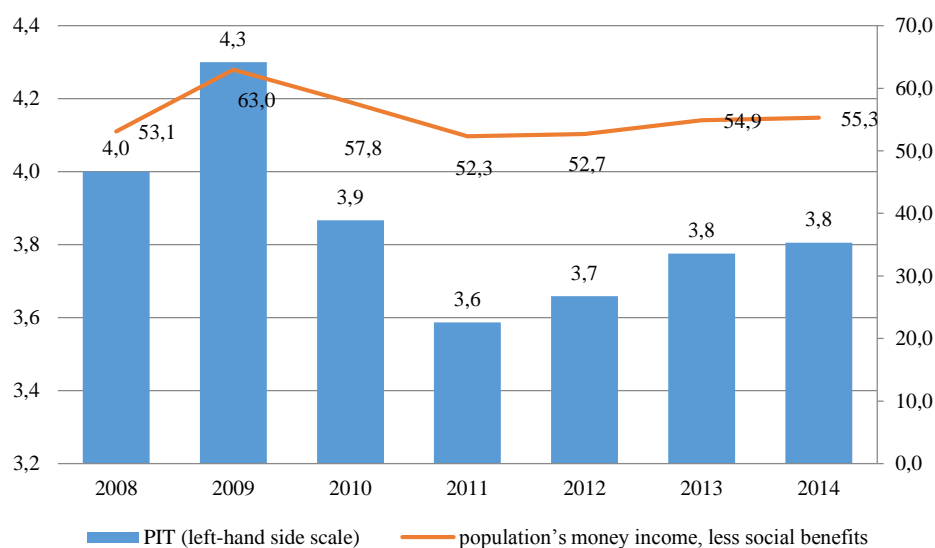
<sup>1</sup> For further detail on the situation in the sphere of regional budgets, see the corresponding section.

<sup>2</sup> In 2013 prices, adjusted by CPI.



Source: RF Federal Treasury.

Fig. 13. The Share of Tax Receipts in Aggregate General Government Budget Revenue in 2008–2014, as %



Source: RF Federal Tax Service; Rosstat.

Fig. 14. The Comparative Movement of PIT Receipts and Money Income of the Population less Social Benefits in 2008–2014, as % of GDP

The amount of oil and gas revenues in the federal budget in 2014 returned to their previous level of 10.6 pp. of GDP (see Table 8). Their first component – tax on mineral resources

extraction levied on hydrocarbons increased by 0.2 pp. of GDP. A sharp drop of price for oil occurred in Q4 2014, as a result of which the average supply price for crude oil amounted to \$ 93.9 (according to customs statistics). The negative effect of the decline of the average price by nearly \$ 14 was compensated for by the decline of the ruble-to-USD exchange rate from Rb 31.2 in 2013 to Rb 38.6 in 2014<sup>1</sup>.

Table 8

**The Receipts of Oil and Gas Revenue and Tax on Mineral Resources Extraction in 2008–2014**

	2008	2009	2010	2011	2012	2013	2014
Oil and gas revenues, as % of GDP	10.9	7.9	8.4	10.3	10.6	10.0	10.6
Tax on mineral resources extraction, as % of GDP	4.1	2.7	3.0	3.7	4.0	3.9	4.1
Oil extraction, including gas condensate, m tons	488	494	506	512	519	522	525
Average annual price of Urals, USD per barrel <sup>2</sup>	90.7	60.7	76.2	107.3	109.7	108.4	93.9
RF Central Bank's official average annual exchange rate of USD, Rb/USD	24.78	31.90	30.37	29.31	31.05	31.20	38.6

Source: Rosstat; RF Central Bank; RF Federal Tax Service; IEP's calculations.

The movement of the second component – the export customs duties on hydrocarbons – played an even greater role in pushing up the index of oil and gas revenues in terms of share in GDP (approximately 6.5% of GDP in 2014 vs. 6.1% in 2013). Importantly, growth of receipts occurred due to the increasing exports of crude oil and petroleum products (see Table 9). The plummeting foreign exchange rate of the ruble obliterated not only the effect of declining oil prices, but also the shrinkage of crude oil export by 5.6% in terms of physical volume (according to data released by Rosstat).

Table 9

**The Receipts of Customs Duties in 2008–2014, % of GDP**

	2008	2009	2010	2011	2012	2013	2014
Export duties on energy carriers	6.8	5.2	5.3	6.6	6.6	6.1	6.5
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5	3.7
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7	0.7
- on petroleum products	1.3	1.0	1.3	1.7	1.8	1.8	2.1
<b>Customs duties and levies, total</b>	<b>8.6</b>	<b>6.8</b>	<b>7.0</b>	<b>8.4</b>	<b>8.0</b>	<b>7.6</b>	<b>7.7</b>

Sources: Rosstat; RF Federal Treasury; IEP's calculations.

Value added tax (VAT) is the only significant component of budget receipts that remained practically unchanged in real terms (-0.1%), and even somewhat increased in terms of share in GDP (see Table 10). VAT receipts were pushed up by the increased receipts of VAT on goods sold in RF territory ('domestic VAT'), while the corresponding index for goods imported into RF territory demonstrated no noticeable change in terms of share in GDP. It should be noted that, for Russia, a typical phenomenon has always been the higher amount of receipts of VAT on imports by comparison with VAT on domestic products. However, the data for recent years

<sup>1</sup> The rate of tax on mineral resources extraction levied on oil includes the coefficient of the movement of world oil prices (Ct) pegged to the average USD exchange rate for a given tax period.

<sup>2</sup> Ratio of crude oil exports in money terms to crude oil exports in terms of physical volume (according to data released by the Federal Customs Service).



point to the emergence of a new downward trend displayed by the effective rate of VAT on imported goods.

Table 10

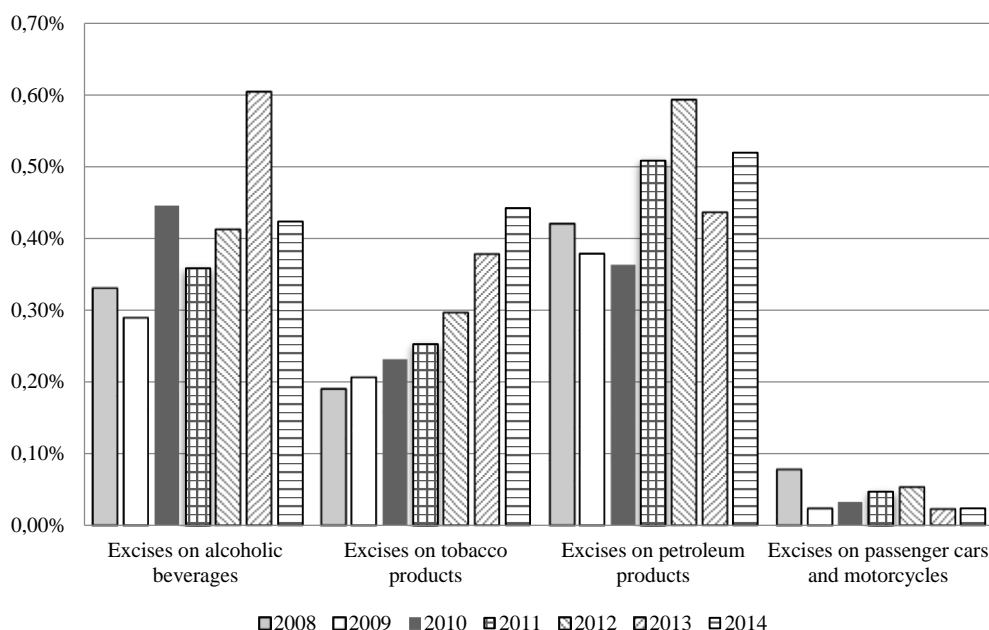
**The Movement of End-use Consumption, Imports and VAT Receipts in the RF Budgetary System in 2008–2014, % of GDP**

	2008	2009	2010	2011	2012	2013	2014
VAT, total	5.2	5.3	5.4	5.8	5.7	5.3	5.6
VAT on goods sold in RF territory	2.4	3.0	2.9	3.1	3.0	2.8	3.1
VAT on goods imported into RF territory	2.8	2.3	2.5	2.7	2.7	2.5	2.5
Effective rate of VAT <sup>1</sup> , %	8.4	7.6	8.2	9.3	8.3	7.4	7.5
Effective rate of VAT on goods sold in RF territory <sup>2</sup>	5.4	5.5	5.8	6.9	6.4	5.7	6.1
Effective rate of VAT on goods imported into RF territory <sup>3</sup>	12.5	11.0	11.9	12.3	12.1	11.1	10.7
Imports*	22.1	20.5	21.1	21.9	22.4	22.7	23.0

\* The share of imports in GDP was determined as the ratios of imports indices (based on Rosstat's data) to GDP.

Sources: Rosstat; RF Ministry of Finance; IEP's calculations.

As seen from Fig. 15, the year 2014 saw increasing receipts, in terms of share in GDP, of excises on tobacco and petroleum products: from 0.38% and 0.44% in 2013 to 0.44% and 0.52% in 2014 respectively. In 2014, the excises on petroleum products once again became leaders among excises. It is noteworthy that the receipts of domestic excises increased, while those of excises on imported petroleum products declined. As before, the excises on sold passenger cars and motorcycles accounted only for a negligible part of this type of budget revenue.



Source: RF Federal Treasury.

<sup>1</sup> The VAT receipts to end-use consumption ratio.

<sup>2</sup> The ratio of the receipts of VAT on goods sold in RF territory to end-use consumption, less imports in money terms.

<sup>3</sup> The ratio of the receipts of VAT on goods imported into RF territory to imports in money terms.

*Fig. 15. The Receipts of Excises for the Period 2008–2014, by Group of Excisable Goods, as % of GDP*

At the same time, the decline in the amount of receipts of excises on alcoholic beverages was so steep that the index of ‘alcohol-generated’ excises fell below not only that of the excises on petroleum products, but also the excises on tobacco products. In *Table 11* one can see that the consumption rates declined with regard to practically every type of alcoholic beverage. The most impressive decline was observed with regard to the retail turnover of vodka and liquors – from 133.6 to 124.7 m dal. The retail turnover of wines and cognacs also somewhat shrank, but the sales volumes of beer and sparkling wines slightly increased.

*Table 11*

**Consumption of Alcoholic Beverages and Tobacco Products  
in the RF in 2008–2014, m dal**

Product type	2008	2009	2010	2011	2012	2013	2014
vodka and liquors	177.2	166.1	157.8	156.4	153.0	133.6	124.7
wines (less champagnes and sparkling wines) <sup>1)</sup>	102.9	102.5	103.4	97.1	93.6	83.6	83.3
cognacs, cognac products (including brandy, calvados)	10.8	10.6	11.1	11.6	12.4	12.1	11.9
champagnes and sparkling wines	26.0	25.5	27.3	28.5	28.3	27.7	28.6
beer	1,138.2	1,024.7	1,004.0	1,011.5	1,017.5	984.2	1,001.2
Cigarettes (including with cardboard mouthpieces), bn items	393.6	398.7	382.4	395.0	391.8	384.0	362.1

<sup>1)</sup> Prior to 2012: ‘Grape wines and fruit wines’.

Source: Rosstat.

### 2.2.3. The Expenditure of Russia’s Budgetary System in 2014

The expenditure side of the RF budgetary system in 2014 amounted to 38.3% of GDP, which is 1 pp. above the corresponding index for 2013 (see *Table 12*).

*Table 12*

**General Government Budget Expenditure in 2009–2014, % of GDP**

	2009	2010	2011	2012	2013	2014	Deviation for 2014 on 2013
Expenditure, total	40.8	37.4	35.7	36.7	37.3	38.3	1.0
Nationwide issues	2.7	2.5	2.4	2.3	2.3	2.3	0.0
Government and municipal debt servicing	0.6	0.6	0.6	0.6	0.7	0.7	0.0
National defense	3.1	2.8	2.7	2.9	3.2	3.5	0.3
National security and law-enforcement activity	3.2	2.9	2.7	3.1	3.2	3.1	-0.1
National economy	7.2	5.0	5.0	5.3	4.9	6.4	1.5
Housing and utilities sector	2.6	2.3	2.1	1.7	1.6	1.4	-0.2
Environment protection	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Education	4.6	4.1	4.0	4.1	4.3	4.3	0.0
Culture, cinematography and mass media	0.8	0.8	0.7	0.7	0.7	0.7	0.0
Healthcare and sports	4.3	3.7	3.8	4.0	3.8	3.9	0.1
Social policy	11.7	12.7	11.6	11.9	12.6	11.8	-0.8

Source: RF Federal Treasury; IEP’s calculations.

The amount of allocations to the majority of expenditure items for 2014 changed on 2013 by no more than 0.1-0.3 pp. of GDP. The most substantial shrinkage in the amount of expenditure occurred under the item *Social Policy* (-0.8 pp. of GDP). This happened first of all due to the redistribution of accumulated pension contributions to the funded component of the pension system in favor of the current retirees’ pensions, so as to bring down the amount of transfers from the federal budget to the Pension Fund. On the one hand, this resulted in more

economical spending of federal budget funds, while on the other, the introduction of this particular mechanism further undermined the population's already feeble trust in pension reform and deprived the financial system of the inflow of funds from one of the major sources of 'long money'.

At the same time, government spending under the item *National Economy* increased at a record rate to 6.4% of GDP (+1.5 pp. of GDP). A higher value of 7.2% of GDP had been observed only back in 2009; it was associated with the implementation of anti-crisis measures designed to support the national economy. The significant growth in expenditure under the item *National Economy* observed in 2014 was also associated with the launch of a new anti-recession package in support of the financial sector of the economy. Thus, in December 2014, a total of Rb 1 trillion was transferred from the federal budget as a property contribution to the Deposit Insurance Agency (DIA), in the form of a new issue of OFZ bonds. With this contribution, the DIA was granted the right to recapitalize the banks considered to be systemically important — with equity to the value of no less than Rb 100bn. If this transfer had not taken place, the amount of expenditure allocated to *National Economy* in 2014 would have amounted to 5% of GDP.

The budget allocations to *National Defense* continued to be on the rise, demonstrating growth by 0.3 pp. of GDP on 2013. The allocations to defense had been increasing consistently since 2012 (when their amount increased from 2.7% to 2.9% of GDP), with a subsequent surge to 3.5% of GDP in 2014. The boost to army expenditures is associated with the launch of the government armaments program for the period 2011-2020, as well as with the introduction of a new system of money allowance for military servicemen and army retiree pensions.

The amount of expenditure under the item *Healthcare and Sports* in the general government budget for 2014 increased by 0.1% of GDP on 2013 due to the allocation of funding through off-budget funds (compulsory medical insurance system CMI). At the same time, the amount of federal budget expenditure and the budget expenditure of RF subjects remained at its 2013 level. For many years already, gradual reform has been underway in the healthcare funding system that included, among other things, the switchover to a 'one-channel' allocation of CMI funds.

On the whole, in recent years there has emerged a distinct trend towards increasing the amount of government spending obligations, which takes place notwithstanding the existing constraints on the growth of resources (the revenue part) of the budgetary system. In 2012, the budget expenditure index began to increase, moving from 35.7% of GDP in 2011 to 38.3% of GDP in 2014. At the same time, the amount of the budgetary system's revenue over the same period fluctuated around 37% of GDP (with a marked drop, in 2013, to 36.1% of GDP). It should be noted however, that the changes occurring in the structure of expenditures are rather controversial. On the one hand, the amount of expenditure allocated to education was increased over the period 2013-2014, primarily in compliance with the May 2012 Presidential Executive Orders, while the expenditures on healthcare and sports in terms of share in GDP were reduced. In other words, on the whole the 'productive expenditures' (that is, those intended to boost long-term economic growth) and targeted investments in human capital rose on 2012 by only 0.1 pp. of GDP. Over the same period, the amount of expenditure allocated to defense ('nonproductive expenditures' in excess of the necessary minimum) increased by 0.6 pp. of GDP (on 2012). So, the structure of the budgetary system's expenditure is becoming less effective from the point of view of long-term socioeconomic development.

#### 2.2.4. Government Debt of the Russian Federation in 2014

As of 1 January 2015, the volume of Russia's government domestic debt amounted to Rb 7241bn, or approximately to 10% of GDP, having increased over the previous year by Rb 1519bn. The volume of government domestic debt increased in the main over the month of December (+Rb 1 482bn), due to the RF Government's decision to recapitalize Russian banks by issuing a federal bond issue to the value of Rb 1 trillion (federal loan bonds with variable coupon rate – OFZ-PK). Over the same period, the volume of government guarantees increased by Rb 433bn. As of 1 January 2015, the share of government guarantees in the total government domestic debt volume amounted to 24.4%.

The year-end results of 2014 for the first time demonstrated a shrinkage in the volume of market debt in nominal terms, represented by exchange-traded federal loan bonds with fixed coupon rate (OFZ-PD), federal loan bonds with debt amortization (OFZ-AD), and the new market instrument launched in December – zero coupon federal loan bonds (BOFZ). In face of the deteriorating international political situation, mounting pressure produced by the economic sanctions, and declining economic growth rate, only 20 out of the 48 auctions on placement of OFZ bonds planned for 2014 were actually held. The aggregate face value of placed bonds amounted to Rb 158bn, or 21% of the planned bond offer volume (see *Table 13*).

*Table 13*

#### The Final Results of Auctions on Placement of OFZ Bonds

bn Rb	Q1 2014	Q2 2014	Q3 2014	Q4 2014	2014
1. Aggregate planned OFZ bond offer volume	275	150	140	200	765
2. OFZ bond offer volume at auctions that actually took place	90	90	45	40	265
3. OFZ bond placement volume, face value	38	65	40	16	158
4. Bond placement coefficient, as % of bond offer at auctions that actually took place (3/2)	42	72	88	40	60
5. Bond placement coefficient, as % of planned aggregate offer volume (3/1)	14	43	28	8	21

Source: RF Ministry of Finance.

The proceeds from the placement of OFZ bonds by the RF Ministry of Finance in 2014 amounted to Rb 146bn, or approximately to 93% of the placed volume of bonds at face value. It should be pointed out that, in Q4, the placement was less successful due to the plummeting bond prices – the proceeds amounted to only 85.5% of the face value of bonds vs. 96.4% in Q1.<sup>1</sup>

As shown by the year-end results of 2014, the RF Ministry of Finance had not managed to properly refinance market debt<sup>2</sup>: the net sum yielded by OFZ-PD, OFZ-AD and BOFZ amounted to Rb 60bn<sup>3</sup>, and if the cost of their servicing is added up – to Rb 318bn.

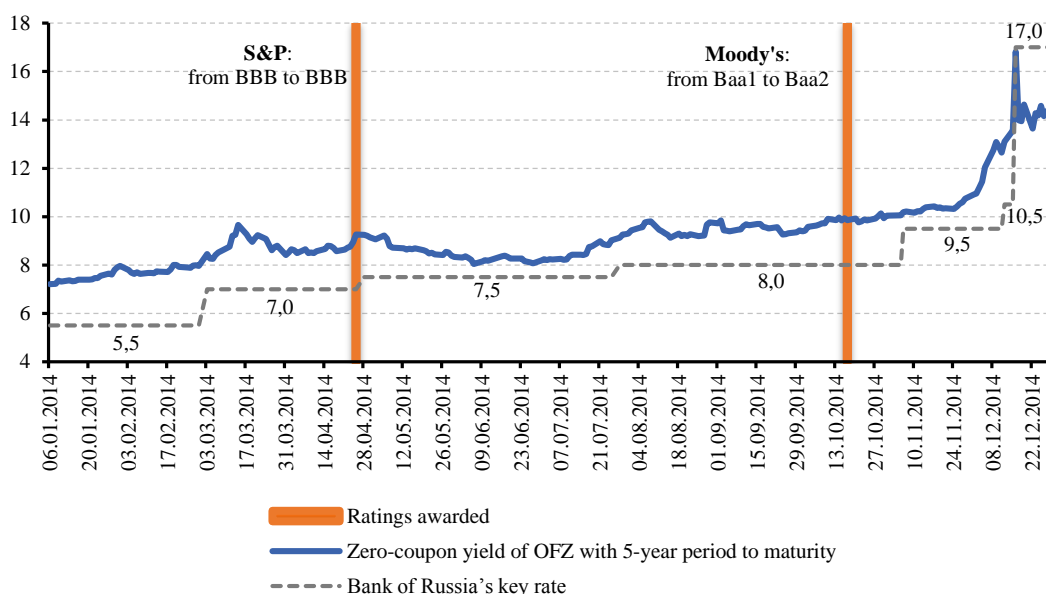
In 2014, two international rating agencies (Standard&Poor's and Moody's) downgraded Russia's sovereign credit ratings one notch from BBB to BBB- (25 April 2014) and from Baa1 to Baa2 (17 October 2014) respectively. The new rating assigned to Russia by S&P came close to speculative status (BB+); Moody's rating still stood one notch above the non-investment grade (Baa3). The knocking-down of Russia's sovereign rating came as no surprise for market participants – the zero-coupon yield curve of OFZ showed no 'jerks and starts' on the rating reduction dates (see *Fig. 16*). The movement of yields on government bonds was determined by the worsening international political situation as a result of sanctions levied against Russia, and

<sup>1</sup> For reference: in Q2 and Q3 2014 – 92.3% and 92.5% respectively.

<sup>2</sup> Less the new OFZ-PK issue to the value of Rb 1 trillion for recapitalization of Russian banks.

<sup>3</sup> Net borrowing is the amount of attracted market loans less the amount of market debt redemption.

Russia's retaliatory measures (the introduction of an embargo on certain imported foodstuffs), as well as by the rising recession trends in the Russian economy.



Source: data released by the Bank of Russia; Standard&Poor's; Moody's.

Fig. 16. The Movement of OFZ Yields in 2014

Thus, if the tense economic and international political situation should persist throughout the course of 2015, the federal budget may be weighed down with an additional burden due to the impossibility to refinance government debt in full through the issuance of new bond loans on the domestic market (the redemption of government securities in 2015 should amount to approximately Rb 627bn<sup>1</sup>).

As of 1 January 2015, Russia's foreign debt amounted to \$ 54.4bn, having shrunk over the past year by \$ 1.5bn. However, if taken in terms of the ruble's foreign exchange rate (which markedly declined in 2014), the amount of foreign debt rose by more than 1 trillion Rb: from Rb 1.8 trillion (as estimated on the basis of the Bank of Russia's exchange rate as of 1 January 2014) to Rb 3.1 trillion (as estimated on the basis of the Bank of Russia's exchange rate as of 1 January 2015). The reduction in the amount of foreign debt denominated in USD was noted with regard to all items except government guarantees, which demonstrated growth by nearly \$ 700bn. The absence, in 2014, of foreign loans in the form of Eurobonds can be explained by the tricky international political situation and the reassessment, by foreign investors, of the risks associated with investing in Russia's government bonds. The cost of servicing and redemption of Eurobonds in 2014 amounted to \$ 1.4bn. On the whole, it can be concluded that foreign loans cannot become a major source of funding to cover federal budget deficit in 2015.

#### 2.2.5. The Prospects for Medium-term Budget Policy

Thanks to the relatively high oil prices in the first half year of 2014 and the ruble's depreciation over the second half year, it became possible to avoid the shrinkage of oil and gas revenues, which had been largely determining the availability of resources in the budgetary

<sup>1</sup> Based on data released by the RF Ministry of Finance. The debt redemption volume is calculated as of 1 February 2015.

system. However, in the medium-term perspective the decline of oil prices may acquire a critical momentum. In absence of opportunities for attracting foreign loans, and given the limited domestic resources available for borrowing, the Reserve Fund may be fully spent, by way of covering federal budget deficit, within the next two years. In view of these grim prospects, it will be necessary to exercise an even greater caution when making decisions concerning the launch of ‘mega-projects’ funded from the NWF, to prevent rapid evaporation of Russia’s sovereign funds.

Under the conditions of limited economic growth sources, both domestic and foreign ones, it will be necessary to boost budget spending efficiency. Part of budget expenditure could be redistributed in favor of items representing investment in human capital (education, healthcare) or fixed assets (infrastructure), while correspondingly reducing the allocations to the upkeep of the government apparatus and the power structures (the so-called *budget maneuver*). Another important goal is to boost the efficiency of ‘anti-recession’ budget expenditures. Thus, for example, it may be feasible to create incentives for the recapitalized banks to use their resources as corporate and individual loans, and not as a source of funding for speculations in the foreign exchange or stock market.

Besides, it is necessary to take into consideration the fact that the federal budget is ‘the budget of last resort’, and that the problems arising throughout the budgetary system will, sooner or later, but inevitably be translated into an additional burden shifted onto it. This effect can be further enhanced by the significant shortcomings of Russia’s federalism model where, in spite of the formal division of powers between the Federation and regions, the federal government is the principal decision-maker on issues that directly influence the actual volume of subnational budget expenditure (one example being the May 2012 Presidential Executive Orders). The attempt to solve the problems faced by subnational budgets by applying the instrument of budget loans can only delay the ultimate solution – the achievement of a well-balanced budget status. In the medium term, this policy will either necessitate the issuance of new loans in order to redeem the old ones, or make inevitable the writing-off (or restructuring) of part of outstanding debt to the federal budget. Both scenarios imply a very negative course of events, because the fiscal incentives for regional administrations will become even more distorted, and the issues relating to the soft budget constraints imposed on subnational authorities will become still more complicated.

Another important precondition for maintaining well-balanced federal budget over a long-term period is the solution to the pension reform issue, including the issue of raising the retirement age. Instead of putting forth strategic initiatives in this sphere, the government has chosen to ‘freeze’ the accumulated insurance contributions to the funded pension component for a second year in a row (2014 and 2015), thus increasing the risk that this direction of pension reform may ultimately result in a failure. In the long run, this will inevitably become translated into an increasing burden on the budgetary system, which will become responsible for providing funding to the solidarity (distributive) pension component under the conditions of population ageing.