FEDERAL BUDGET FOR 2017–2019[1]

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A draft law On Federal Budget for 2017 and the Planning Period 2018 and 2019 describes 2016 as a period of adjusting to external economic challenges. The period is planned to be followed by a period of reaching balanced economic development parameters. However, this will, among other things, require certain updates in the volume and structure of budget expenditure in order to consolidate the budget and achieve deficit size goals.

The draft law *On the Federal Budget for 2017 and the Planning Period 2018 and 2019* (hereinafter – the draft law) was considered at a meeting of the Russian government on 13 October 2016. The draft law includes preliminary assessments of the 2016 federal budget execution[2], as well as parameters of the budget system and conceptual updates therein that are scheduled for the ensuing three years.

Russia's Ministry of Finance and government are reintroducing three-year budget planning: the draft law includes parameters for 2017 and for the 2018–2019 planning period. However, the important question is whether the target parameters could be met within a three-year period and whether this could be real rather than nominal signal to individuals and businesses that the public fiscal policy is sustainable?

This year the Russian government have gotten out of the routine of considering the Guidelines of the Budget, Tax and Customs Tariff Policy in May or June, as they did before 2016. Instead, the Guidelines were considered for the first time at a government meeting that was held a week ahead of the date on which the draft federal budget and the explanatory note thereto were considered, which actually devalues their importance as documents underlining the federal budget draft law.

The draft law relies on a baseline socio-economic development forecast for the Russian Federation for 2017 and 2018 and 2019, whose key parameters are presented in *Table 1.*

Table 1

KEY PARAMETERS OF BASELINE SOCIO-ECONOMIC DEVELOPMENT FORECAST FOR THE RUSSIAN FEDERATION FOR 2017–2019

	2015	2016	2017	2018	2019
GDP, Rb billion	80804.0	82815.0	86806.0	92296.0	98860.0
GDP growth rate, year-on-year, %	-3.7	-0.6	0.6	1.7	2.1
Urals crude average price, US dollars a barrel	51.2	41.0	40.0	40.0	40.0
Rouble to US dollar average exchange rate, roubles per US dollar.	60.7	67.5	67.5	68.7	71.1
Consumer Price Index, year-on-year, %	12.9	5.8	4.0	4.0	4.0

Source: 2015 – actual values. The 2016–2019 – explanatory note to the draft law *On the Federal Budget for 2017 and the Planning Period 2018 and 2019*.

1 This paper was originally published in *Online Monitoring of Russia's Economic Outlook* No.16(34).

2 The assessment of the 2016 budget execution considers amendments to the applicable law that were made in October 2016.

External and internal factors and conditions

In terms of external conditions for the Russian economic development, global economic growth rates are projected to slow down further, as a result of which no improvement in prices and demand for Russia's exports goods is expected. In addition, sanctions against Russia are expected to stay in force throughout the entire period under review. Urals crude price is expected to average $41 a barrel in 2016 and to stay stable at $40 a barrel in 2017–2019, according to preliminary estimates.

As to internal factors, the Russian economy is expected to resume its growth following a two-year downturn: GDP growth rate is anticipated to reach 0.6% in 2017, 1.7% in 2018 and 2.1% in 2019. With a moderate nominal growth in domestic demand and relatively stable exchange rate dynamics, inflation slowdown to 4% a year should have a positive effect on economic growth. The rouble to US dollar exchange rate is expected to vary within 67,5–71,1 roubles per US dollar.

Overall, the federal budget draft law describes 2016 as a period of adjusting to the external economic challenges that emerged in 2014–2015. The period is planned to be followed by a period of reaching balanced economic development parameters.

The federal budget key characteristics rely on the baseline socio-economic development forecast (*Table 2*).

Table 2

FEDERAL BUDGET KEY CHARACTERISTICS

	Rb billion					% of GDP				
	2015 (actual)	2016* (estimated)	2017 (projected)	2018 (projected)	2019 (projected)	2015 (actual)	2016 (estimated)	2017 (projected)	2018 (projected)	2019 (projected)
Revenue	**13.659**	**13.369**	**13.437**	**13.989**	**14.825**	**16.9**	**16.1**	**15.5**	**15.2**	**15.0**
Including:										
oil and gas revenues	5863	4.778	5.029	5.133	5.370	7.3	5.8	5.8	5.5	5.4
non-oil and gas revenues	7797	8.591	8.408	8.856	9.455	9.6	10.4	9.6	9.6	9.6
Expenditure	**15.620**	**16.403**	**16.181**	**15.978**	**15.964**	**19.3**	**19.8**	**18.6**	**17.3**	**16.1**
Deficit (–) / surplus (+)	**-1.961**	**-3.034**	**-2.744**	**-1.989**	**-1.139**	**-2.4**	**-3.7**	**-3.0**	**-2.2**	**-1.2**
Non-oil and gas deficit	-7.823	-7.812	-7.773	-7.122	-6.509	-9.7	-9.4	-9.0	-7.7	-6.5

***** The presented parameters of preliminary assessment of the 2016 federal budget execution consider revenues from selling a 19.5% interest in Rosneft. The relevant transaction is expected to be closed until the end of 2016.

Source: 2015 – actual values. The 2016–2019 – explanatory note to the draft law *On the Federal Budget for 2017 and the Planning Period 2018 and 2019*.

Revenue

Federal budget revenue are anticipated to contract in 2017–2019, from 16.1% of GDP in 2016 to 15.0% by 2019, which will first of all be driven by the dynamics of oil and gas revenues that are expected to reduce from 5.8% of GDP in 2016–2017 to 5.4% by 2019. In terms of volume, non-oil and gas revenues are anticipated to be stable and they, according to budget projections, will not slide below 9.6% of GDP, which is similar to the level recorded in 2015. The marked growth in non-oil and gas revenues in 2016 (up to 10.4% of GDP) is the result of extra revenues that are expected from partial privatization of Rosneft.

The volume of all the non-oil and gas revenues (except import duties that are expected to decrease by 0.1 p.p. of GDP) in 2017–2019 is forecast to be

Table 3

FEDERAL BUDGET REVENUES IN 2017–2019

	Rb billion					% of GDP				
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Total revenues	**13659**	**13369**	**13437**	**13989**	**14825**	**16.9**	**16.1**	**15.5**	**15.2**	**15.0**
Oil and gas revenues	***5,863***	***4,778***	***5,029***	***5,133***	***5,370***	***7.3***	***5.8***	***5.8***	***5.6***	***5.4***
of which:										
mineral extraction tax	3,160	2,819	3,278	3,386	3,527	3.9	3.4	3.8	3.7	3.6
export duties	2,703	1,959	1,750	1,746	1,843	3.3	2.4	2.0	1.9	1.9
Non-oil and gas revenues	***7797***	***8,591***	***8,408***	***8,856***	***9,455***	***9.6***	***10.4***	***9.7***	***9.6***	***9.6***
of which:										
corporate profit tax	491	465	599	635	686	0.6	0.6	0.7	0.7	0.7
VAT on goods sold on the territory of the Russian Federation	2,448	2,637	2,888	3,205	3,559	3.0	3.2	3.3	3.5	3.6
VAT on goods imported in the territory of the Russian Federation	1,785	1,910	2,001	2,119	2,265	2.2	2.3	2.3	2.3	2.3
excise duties on goods manufactured on the territory of the Russian Federation	528	623	791	854	894	0.7	0.8	0.9	0.9	0.9
excise duties on goods imported in the territory of the Russian Federation	54	57	51	50	52	0.1	0.1	0.1	0.1	0.1
import duties	560	542	529	538	558	0.7	0.7	0.6	0.6	0.6

Source: 2015 – actual values. The 2016–2019 – explanatory note to the draft law On the Federal Budget for 2017 and the Planning Period 2018 and 2019.

equal or above what is estimated for 2016 (approximately 0.1 p.p. of GDP). The most visible growth, +0.4 p.p. of GDP by 2019, is expected in VAT revenues (VAT on goods sold on the territory of the Russian Federation) (*Table 3*).

Stable non-oil and gas tax revenues, as well as partial compensation for falling oil and gas revenues in the mid-term, will be supported by measures aimed to mobilizing extra budget revenue, of which the following are the most important:

- a "tax manoeuvre" that is scheduled for completion in 2018–2020. This will lift mineral extraction tax rates and abolish exports duties on oil and petroleum products and bring about updates in the system of collecting excise duties on petroleum products. In addition, a tax on added income is supposed to be introduced in a pilot mode. Overall, the tax burden on oil and gas industries is planned to be balanced with regard to taxation on oil and gas production in the mid-term;
- an increase of 25 to 50% in the lower standard for dividends on public shares and public companies;
- developing a single budget revenue administration system by introducing a unified methodological framework. This initiative is expected to improve the revenue performance rate and contribute to relaxing the administrative burden.

In our view, however, the expected effects of the third of the above listed measures are well overestimated. First, the expected improvement of imports administration through integration of the FCS (Federal Customs Service) and FTS (Federal Tax Service) information systems may increase the VAT tax base for imports, however, the overall effect of revenues from this tax may turn out to be much moderate given that most of the tax withheld in the process of customs declaration is subsequently subject to "internal" VAT credit.

Second, all other conditions being equal, an increase in the customs value will entail higher customs duties, which will eventually boost supplier costs and result in either higher prices (inflation) or lower profits (shortfall in profit tax revenues).

Third, as to ASK VAT-2 (FTS information system) that was introduced in 2015, it identifies companies that report no sales while they carry out procurement operations, which narrows the scope of FTS's control and audit activities. The fiscal effect in 2015 was estimated Rb 150bn, but considering a more complicated "cash in" procedure in general and the fact that the ASK VAT-2 has been in service since 2015, the fiscal effect was evident predominantly in the year when this system was put into service, and the same effect can hardly be seen again in the form of substantial additional annual revenues.

Expenditure and budget rules

Federal budget expenditure for 2017–2019 were developed within the budget rule framework. The budget rule mechanism is set to be reintroduced in the mid-term in order to make the budget system less sensitive to volatile global crude prices. According to preliminary projections, a new version of budget rules will take full force beginning with 2020, and 2017–2019 are announced as transition period because of the need to prevent expenditure from contracting too fast to the level provided for by the concept of new budget rules.

Russia's Finance Ministry suggests that from 2020 the maximum volume of federal budget expenditure should be defined as the sum of the following three components: 1) reference volume of oil and gas revenues that is calculated given a steady Urals crude price of $40 a barrel and reference rouble exchange rate; 2) the volume of non-oil and gas revenues that is calculated given the baseline mid-term forecast made by Russia's Ministry of Economic Development; 3) debt servicing expenses. Furthermore, if the forecast volume of the Reserve Fund falls below 5% of GDP as of January 1 during the initial year of the planning period, the maximum volume of spending the Reserve Fund may not exceed 1% of GDP in the ensuing fiscal year, and the maximum volume of spending is adjusted accordingly.

This framework of rules is intended to smoothing the effect of crude price fluctuations on internal prices and exchange rate, while the budget policy is mated with monetary regulation objectives. Obviously, there is no room whatsoever for active budget policy if the first and the third components of the formula exhibit acyclic behaviour while the second one exhibits procyclic behaviour, and if no deficit is allowed for. In addition to the points of large-scale privatization and stable tax burden, this is indicative of a course that have been set for reducing the share of government-led direct intervention in the economy.

The framework of rules by itself doesn't seem to be sustainable enough in the long term, because there is no point in pegging expenditure to crude price unless budget rules rely on a more or less plausible hypothesis that describes the crude price behaviour.[1] Otherwise, the rules may be discred-

1 Budget rules: Redundant constraint or integral tool of budget sustainability? / Gurvich E.T., Sokolov I.A. // Voprosy Ekonomiki, No. 4, 2016.

ited, which would make their revision inevitable, as was the case with the 2014 version thereof.

In addition, the budget rule provides for limiting the basic amount of fund-raising to the volume of debt servicing expenses (0.8–1.0% of GDP annually) beginning with 2020. This indeed is correct because debt servicing expenses are deemed to be considered more critical than the size of a debt. However, the following should be taken into consideration: debt servicing expenses would approach the upper limit (0.93% of GDP) as early as 2018 under the hypothesis of deficit reduction; more than Rb 1 trillion are planned to be raised domestically on an annual basis; issues of growing regional debts and disequilibrium of the Pension Fund of the Russian Federation still remain to be tackled. Collectively, all the above-mentioned aspects indicate that this limit could hardly be realistic.

The objective of shifting to new budget rules in 2020 predetermines the need for budget consolidation that is scheduled for implementation during the transition period of 2017–2019. The upcoming budget consolidation provides for further cutting on federal government spending commitments while enhancing their efficiency.

Indeed, federal budget expenditure are expected to be cut in the period under review both in nominal terms, almost Rb 0.5 trillion to the level seen in 2016, and as a percentage of GDP, almost four p.p. (from 19.8% of GDP in 2016 to 16.1% in 2019).

It is important to consider not only the total volume but also the structure of federal budget expenditure that have been deteriorating over the past few years. As a result, expenditure only have increased for three expenditure items, namely national defence, social policy, debt servicing, all of which are productive. Russia is a champion in terms of defence spending among non-belligerent states. Pension expenses have been growing steadily, and it is unlikely that this trend will reverse in the near future, until a pension reform is implemented.

A public debt issue has deteriorated at the regional level. Subjects of the Russian Federation have recently been facing a non-controllable growth in their public debt. While raising wages of public workers, regions not only have abandoned budget investment, but they also have amassed debts due to growing consolidated budget deficit. Indeed, many subjects of the Russian Federation had insignificant public debt prior to 2012. In contrast, 14 regions had a public debt accounting for more than 100% of the regional budget tax and non-tax revenues as early as 2016.

Furthermore, facing the recent economic downturn, the federal budget and regional budgets have responded to "new reality" largely by cutting on the expenditure that determine the future of the country and its regions, namely investment spending.

While the budget projections for 2017–2019 cannot reverse the previously established trends, they provide for certain positive updates in the expenditure structure (*Table 4*). In particular, military/defence spending have been cut, social spending are planned to be cut, although this is more of a sluggish motion within total budget consolidation than a conscious update in the nature of budget policy. The latter point can be illustrated by a certain decline in healthcare and education expenditure in terms of a percentage of GDP.

Table 4

FEDERAL BUDGET EXPENDITURE (FUNCTIONAL CLASSIFICATION OF EXPENDITURE) FOR 2017–2019

	Rb billion					% of GDP				
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Total expenditure including:	**15620**	**16403**	**16181**	**15978**	**15964**	**19.3**	**19.8**	**18.6**	**17.3**	**16.1**
General National Issues	1118	1098	1170	1126	1115	1.4	1.3	1.3	1.2	1.1
National Defence	3181	3889	2840	2728	2856	3.9	4.7	3.3	3.0	2.9
National Security and Law Enforcement	1966	1943	1968	1945	2007	2.4	2.3	2.3	2.1	2.0
National Economy	2324	2166	2292	2247	2054	2.9	2.6	2.6	2.4	2.1
Housing and Utilities	144	57	60	30	27	0.2	0.1	0.1	0.0	0.0
Environmental Protection	50	65	76	78	80	0.1	0.1	0.1	0.1	0.1
Education	611	558	568	589	586	0.8	0.7	0.7	0.6	0.6
Culture and Cinematography	90	92	94	88	80	0.1	0.1	0.1	0.1	0.1
Healthcare	516	466	377	394	360	0.6	0.6	0.4	0.4	0.4
Social Policy	4265	4631	5080	4962	5054	5.3	5.6	5.9	5.4	5.1
Physical Culture and Sports	73	66	86	55	34	0.1	0.1	0.1	0.1	0.0
Mass Media	82	76	74	68	67	0.1	0.1	0.1	0.1	0.1
Public Debt Servicing	519	640	729	848	870	0.6	0.8	0.8	0.9	0.9
Inter-Budget Transfers	682	656,4	768	770	776	0.8	0.8	0.9	0.8	0.8

Source: 2015 – actual values. The 2016–2019 – explanatory note to the draft law On the Federal Budget for 2017 and the Planning Period 2018 and 2019.

The reasons why budget policy may be revised

There are three prerequisites for drastic revision of the budget policy nature:

1. A budget that has long been relying on resource-based revenues has become a serious constraint, even a setback, for structural shift in the economy: guaranteed unearned income and a lack of materials sector's demand for direct budget support discourage taking measures aimed at updating the structure of economy. The volume of oil royalty reallocated via the budget has steadily been declining since 2015, thus creating conditions for shifting budget expenditure priorities.

2. Although deficit reduction was proclaimed as one of the budget policy objectives, reserves that were available in sovereign funds encouraged not seeking out responses to challenges that confront long-term budget equilibrium (population aging; sluggish and rigid expenditure structure biased towards social security and military/national security; updates in the structure of budget revenues; informal sector and low stability of the banking system). It is now apparent that the Reserve Fund will be depleted completely in 2017, and the National Wealth Fund has not enough liquid assets (that are not allocated in infrastructure projects) to run the federal budget in equilibrium during the planning period. This situation also prompts revision of budget policy approaches.

3. With "specified" figures being meticulously executed, the "self-reproducing" amount of debt owed by consolidated budgets of subjects of the Russian Federation will ultimately bring the regional budget equilibrium issue to the federal level that has no sufficient reserves to maintain the budget system as a whole and the federal budget itself at a sustainable level. The budget policy in force leads to wider fiscal gap and deterioration of long-term budget sustainability, that is to say that it will not take long before crisis developments crop up in public finance.

Deficit and budget strategy

It is expected that budget consolidation measures reduce considerably the volume of federal budget deficit at a rate of about 1% of GDP annually (*Table 2*). For instance, by the end of 2019, total deficit is to stay at about 1% of GDP against the expected 3.7% of GDP in 2016 (4.5% of GDP, excluding revenues from partial privatization of Rosneft). Non-oil and gas deficit will also be reduced markedly during the period, down to 6.5% of GDP in 2019 (almost by 3 p.p. of GDP from the level seen in 2016).

The ratio of sources of deficit financing will be changed considerably amid overall reduction of deficit during the planning period (*Table 5*). While about 70% of the deficit is financed with sovereign funds in 2016, up to 90% of the total deficit will be financed from domestic sources of deficit financing, mainly with government securities, by 2019. This structure of sources of deficit financing provides that the Reserve Fund will be depleted as early as 2017 and the National Wealth Fund will account for 3.1% of GDP by the end of 2019.

Table 5

SOURCES OF FEDERAL BUDGET DEFICIT FINANCING IN 2017–2019 (RB BN)

	2016	2017	2018	2019
Sources of deficit financing	3034	2744	1989	1139
Reserve Fund and National Wealth Fund	2144	1812	1140	137
Other than Reserve Fund and National Wealth Fund	890	932	849	1002
Domestic sources of deficit financing	897	1136	1078	1130
government securities	449	1050	1050	1050
privatization	382*	138	14	14
budget loans and credits within the country	-183	29	133	155
other sources	249	-81	-119	-89
External sources of deficit financing	-7	-203	-229	-127

* The amount includes revenues from selling an interest in Bashneft.

Source: 2016 – the Guidelines of the Budget Policy for 2017–2019, 2017–2019 – explanatory note to the draft law *On the Federal Budget for 2017 and the Planning Period 2018 and 2019*.

However, it must be acknowledged that the existing structure of budget expenditure and prevailing trends towards its changes fail to meet the requirements of budget sustainability and sustainable economic growth in the long term.

A budget manoeuvre towards productive expenditure is facing serious constraints amid falling government revenue: the manoeuvre has to be performed amid falling total budget expenditure of the general government. "Inflationary expansion" of the economy can be employed for some time to run a budget deficit of not more than 1–1.5% of GDP by 2019–2020 and to keep the maximum volume of general government budget expenditure at not more than 33–34% of GDP: productive expenditure are adjusted for inflation rate, or even higher, while non-productive expenditure are kept at the current nominal level. However, this should be followed by a "debt brake" policy (zero budget balance in real terms, over the period under review) through introducing relevant updates in the budget rules and adopting mid-term budget consolidation programmes.