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Debt Crisis Looms as Putin's Pledges Bankrupt Russian Regions

By Delphine d'Amora

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Three years ago, President Vladimir Putin promised the Russian people a kind of utopia: salaries would grow by up to 50 percent, average life expectancy would rise to 74 and waiting lists at kindergartens would disappear.

Conceived as electorate-pleasing proof of the state's concern for its people, these so-called "May orders" have instead become a towering testament to the reality of today's Russia: that the Kremlin's political ambitions have pushed domestic concerns into the shadows.

Russia's regional governments have fallen deeply into debt under the weight of these pledges. And with a drop in aid from the federal budget, which is increasingly tied up in such expensive projects as military rearmament and the integration of Crimea, relief is nowhere in sight.

The regions will need to cough up about 400 billion rubles ($7 billion) to service their commercial loans and bonds this year, according to ratings agency Standard & Poor's. A report issued by Moscow's Higher School of Economics (HSE) in May found that 20 of Russia's 83 regions may be technically in default already.

Default is politically impossible in Russia, the report added, but there is still a price to be paid. Dozens of regions have already axed investment in infrastructure and local industry, and more cuts are on the way, according to HSE.

In addition to pushing Russia's poorest citizens further into poverty, these cuts will in essence slash investment in Russia's human capital at a time when this investment is pivotal.

This is precisely the opposite of how developed economies reacted to the global financial crisis of 2008-09 — and the choice will have lasting consequences, said Alexander Deryugin, director of the Center for Regional Reform Studies at the Russian Presidential Academy of National Economy and Public Administration.

"In the long term, we won't have any chance of competing on equal terms with the major economies that we competed with only a short time ago. Russia will fall behind. This is what worries me the most," Deryugin said.

Putin's Orders

The roots of the regional debt crisis go back to 2012, when Vladimir Putin marked his return to the presidency by announcing a sweeping array of social reforms — the "May orders."

The orders held the federal government to a series of ambitious targets in areas ranging from health care to education to economic policy. The government was directed to raise educators' salaries to the regional average by the end of 2012, to raise the national birth rate to 1.753 by 2018, to create 25 million highly qualified jobs by 2020, and so on. While most of the orders were addressed to the federal government, the burden of funding the reforms fell disproportionately on the regions.

A year later the regions' deficit rose sharply to about 1 percent of gross domestic product as rising spending obligations collided with a fall in profit taxes — a key source of regional income — and drop in federal assistance, Deryugin said.

With 2014 came an economic whirlwind: First, Western sanctions imposed over Russia's role in the Ukraine crisis cut off investment, then the price of oil fell sharply, sending federal budget revenues and the ruble currency tumbling.

Russia's current economic crisis is expected to hit all three of the regions' key sources of income: personal income tax, corporate profit tax and aid from the federal government, which is now struggling with its own budget issues, said Karen Vartapetov, assistant director at Standard & Poor's in Russia.

The regions' revenues — which stood at 12.3 percent of GDP last year — are on track to hit a "record" low this year, Deryugin said ruefully.

Meanwhile, thanks to the May orders, the regions' spending obligations are still rising. There are some signs the requirements may be eased: Finance Minister Anton Siluanov said in March that the timeline for fulfilling the decrees could be pushed back, and Putin in May admitted that some changes might be necessary.

To date, however, the decrees remain legally intact.

Surging Debt

As spending obligations rise and incomes fall, the regions have one choice: borrow. And borrow they have.

Total regional debt, excluding federal aid, rose from 22 percent of the regions' income in 2009 (excluding federal aid) to 34 percent, or 2.4 trillion rubles ($42.3 billion), at the end of last year. Their debt could climb by around 25 percent to hit 3 trillion rubles ($52.9 billion) by the end of 2015, Vartapetov said.

Some regions are in significantly worse shape than others: 40 of Russia's 83 regions — excluding Crimea and Sevastopol — have debt exceeding 60 percent of their revenues, and 10 are nearing 100 percent, he added.

This debt load may not seem exceptionally high by international standards, but the bank loans obtained by the regions are largely short term and expensive to service, leaving the regions with huge yearly loan payments and a perilous dependence on the environment on financial markets.

This exposure to the markets came crashing down on the regions in late 2014 and early 2015, when lending rates soared after the Central Bank abruptly hiked its key rate to shore up the ruble currency.

Geopolitics Take Priority

Regional debt is rising even as the federal government shifts the burden of social spending — which includes education, health care and pensions — ever more onto the shoulders of local governments.

The regions' share of social spending rose from 45 percent in 2012 to 51 percent last year, according to the HSE report.

This is largely the result of shrinking support from the federal government. Aid to the regions has fallen from 1.7 trillion rules in 2012 (about $56 billion, by December 2012 exchange rates) to 1.6 trillion rubles ($28 billion) in 2014, according to HSE. This drop in support meant that the share of federal aid in regional revenues fell from 21 percent in 2012 to 18 percent last year, the report said.

Under the current budget, the federal government is supposed to slash support for the regions by another 15 percent this year.

But not all regions are in the same situation. Newly annexed Crimea received 125 billion rubles ($2.2 billion) from the federal budget last year, a sum so large the region was left with a 13.4 percent budget surplus for 2014, according to HSE.

Other noticeably well-funded territories included regions in the Far East, bordering China, and the tumultuous republics of Chechnya and Dagestan, all of which are of geopolitical importance to the Russian state.

To some economists, these discrepancies suggest that politics have drowned out economic concerns in the distribution of federal funds.

"Federal aid for the regions is aimed not at cushioning the budget crisis, but instead reflects the Russian authorities' geopolitical priorities," economists at HSE said in the report.

These regions are not the only political cause accused of swallowing up ever scarcer state funding. For instance, even as the Finance Ministry forecasts a federal budget deficit of 3.7 percent this year, federal spending on Putin's 20 trillion ruble ($352 billion) military rearmament program through 2020 has continued unabated.

People Bear the Brunt

The ripple effects of this burgeoning debt crisis are already visible. With hefty loan payments falling due, 53 regions last year cut spending on "national economy," a budget category that covers transport, the public road system and support for local business, according to HSE. Half of the regions also cut spending on housing and public utilities.

Further-reaching and more troubling cuts are already under way this year, according to Natalya Zubarevich, a professor at HSE and one of the authors of the report.

In the first quarter of this year, 26 regions slashed spending on education, 21 cut health care spending and 16 curtailed spending on social security, she said.

"In this situation, it's the people who suffer. Especially vulnerable people, low-income people — for whom a rise in the cost of utilities is very serious — and people who receive social subsidies," she said.

Ultimately, economists expect the government will come to some arrangement with the regions' chief creditors, state-owned lenders Sberbank and VTB. But in the meantime, regional budgets have been thoroughly destabilized, and the state's budget priorities made clear.

These priorities were not ones that the economists interviewed for this article could support.

"To develop the Northern Sea Route [shipping route in the Arctic] when there are no roads in the countryside, when people can't get to the hospital — this policy is wrong both economically and socially," said Zubarevich.

The long-term consequences, in her view, are obvious: The most competitive people will leave Russia for better opportunities abroad, while the rest will stay behind and watch their human capital wane.

"It's very sad," Zubarevich said. "But it's not the first time this has happened in Russian history."

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