No Easy Solution as Russia's Budgetary Troubles Mount

By The Moscow Times

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The oil price collapse and Ukraine sanctions have punched a hole in Russia's finances, but the government is fudging its response so far because the solutions could hurt President Vladimir Putin's popularity.

In the absence of a clear way out of this bind, Putin's government can only bicker about how best to respond, and play for time.

Divisions within the government have been highlighted in recent days by public disagreements over proposals to raise taxes on oil companies, part of the departmental battles over the national budget that must be finalized in the coming month.

A year ago, Russia based its budget plans on the oil price remaining at $100 per barrel for the coming three years. With the price now below $50, and not expected to recover much in the years ahead, Russia faces an annual tax shortfall of around $50 billion compared with previous plans.

At a meeting to discuss the budget last week, Putin said the economic situation "was difficult, but not critical."

He ordered that the deficit should not exceed 3 percent of gross domestic product (GDP) in 2016, a figure that sounds manageable by Western standards but which is hard to finance in Russia without tapping diminishing fiscal reserves.

What is especially awkward for Putin is that on current trends Russia will run out of money in around two to three years — coinciding with the next presidential elections in 2018.

Although Putin's popularity remains high, he has shown little appetite for spending cuts that might dent it.

"This year they were promising a significant fiscal squeeze. So far we're not seeing what was promised," said Liza Yermolenko, emerging market economist at consultancy Capital Economics.

Half-measures and short-term fixes may enable Russia to muddle through beyond the 2018 election — after which the hard choices cannot be put off any longer.

"They are going to do the minimum necessary," said Christopher Granville, managing director of emerging markets consultancy Trusted Sources in London, "but not enough to have a fully sustainable trajectory of the public finances."

Pensions Deadline

At least some tough decisions will need to be made by Oct. 25, when the government has to submit the 2016 budget to parliament.

Pensions are central to the debate because they account for over a quarter of the federal budget — not helped by a relatively low retirement age of 60 for men and 55 for women.

Their burden has been exacerbated by Putin's decisions to double pensions during the last economic crisis in 2009, to rule out increasing the retirement age for the next few years, and to index pensions in line with inflation this year.

Pensioners currently make up about 30 percent of an aging population and are more likely to vote than younger Russians.

"The only way to achieve spending cuts that will move the needle will be to attack these favored areas of spending — which is pensions first and foremost," said Granville.

Next year, the Finance Ministry wants to limit the increase in pensions to just 4 percent — well below inflation seen at 12-13 percent this year.

That would be an unlikely about-face. Last week Putin again ordered that social obligations be a priority.

A compromise seems likely, raising pensions by more than the Finance Ministry wants but below inflation.

The ministry is therefore also now training its sights on big corporate taxpayers — notwithstanding repeated government promises.

It wants to squeeze an extra 600 billion rubles ($9.15 billion) out of oil companies next year by changing the formula used to calculate an extraction tax.

Putin appears attracted to the idea of targeting big companies rather than ordinary voters. "The government needs to work out the question of directing to the budget additional incomes, received by our exporters as a result of the ruble's devaluation," he said.

But Russia's oil sector has already been damaged by falling prices and Western sanctions, and the tax plan is already under fire from several senior officials and businesses.

Russia may keep ducking decisions for now because reserves still allow it to spend beyond its means.

The deficit is being financed largely by running down a $70 billion fiscal Reserve Fund. If Russia carries on tapping this at the present rate of 200 billion rubles a month, it will run out in two years.

Russia may also be able to put off the crunch for another year by using what will be left in a second sovereign fund, the $70 billion National Wealth Fund, although this is already facing heavy demands to fund off-budget support to cash-starved companies and banks.

"My prediction would be that both the funds would be fully drawn down between now and the 2018 election — leaving Russia at the mercy [after that] of the markets," said Granville.

"That will require another round of yet more painful decisions. But they will face those over the hump of the political cycle, with no more elections."

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