AN AUSTERITY BUDGET

Under extreme pressure from the financial markets, the new Russian government has set out to slash government borrowing in what may turn out to be the most significant reform effort since 1992. The government has proposed a package of revenue measures that shifts much of the tax burden from large manufacturing enterprises to consumers and to small businesses, many of which currently operate in the shadow economy. At the same time, recognising the failure of previous tax collection drives, the government has turned its attention to the spending side of the budget. Its “Savings Plan” aims to reduce federal expenditures by R42 bn below the level targeted in the budget, while additional cuts in defence procurement and transfers to the regions bring the total expenditure reduction to almost R75 bn, or 2.5% of projected 1998 GDP. This special report puts these spending cuts in context by analysing government spending in Russia. We argue that there is considerable scope for reduction of wasteful expenditures at all levels of government in Russia; but that more important than straightforward budget cuts are institutional improvements in the way budgets are drafted, executed, and audited.

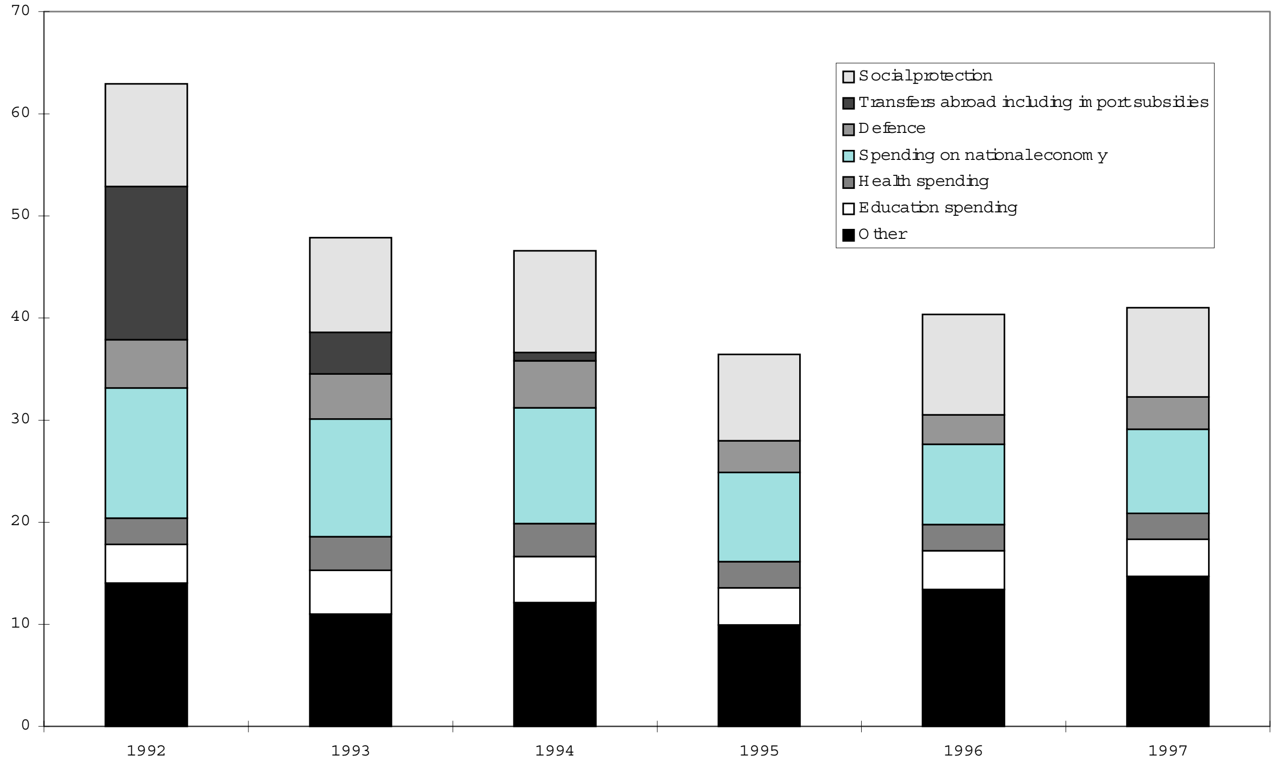
How large is the government sector in Russia?

Government spending in Russia takes place, broadly speaking, at three levels of government: federal, regional (oblast, republic, krai etc.), and local. The “consolidated budget” refers to the total of these three levels of government, less transfers among them. In 1997, total consolidated budget spending amounted to R860 bn, or 33% of GDP, which was split almost evenly between the federal budget (16% of GDP, not including transfers) and regional and local budgets (17% of GDP). In addition, a portion of government spending takes place in the large number of “off-budget” funds at the federal and regional levels. The major federal off-budget funds – the only funds for which data is available – spent a further 8% of GDP. Thus “enlarged” government spending – including both the consolidated budget and off-budget funds – was over 41%. The actual figure is probably somewhat higher, but is not known exactly since there are no complete accounts of off-budget funds at the regional level.

Since the fall of communism, general government spending in Russia has fallen sharply: as recently as 1992, general government spending amounted to 63% of GDP. But relative to GDP, the Russian general government remains quite large by international standards. The average ratio of spending to GDP for advanced industrial countries in 1997 was 39%, and for countries in transition it was just 35%, with the figure still lower for middle income countries. General government spending in OECD countries ranges from 15% of GDP in South Korea to 66% in Sweden. The United States general government spends roughly 35% of GDP each year, and the United Kingdom roughly 42%.

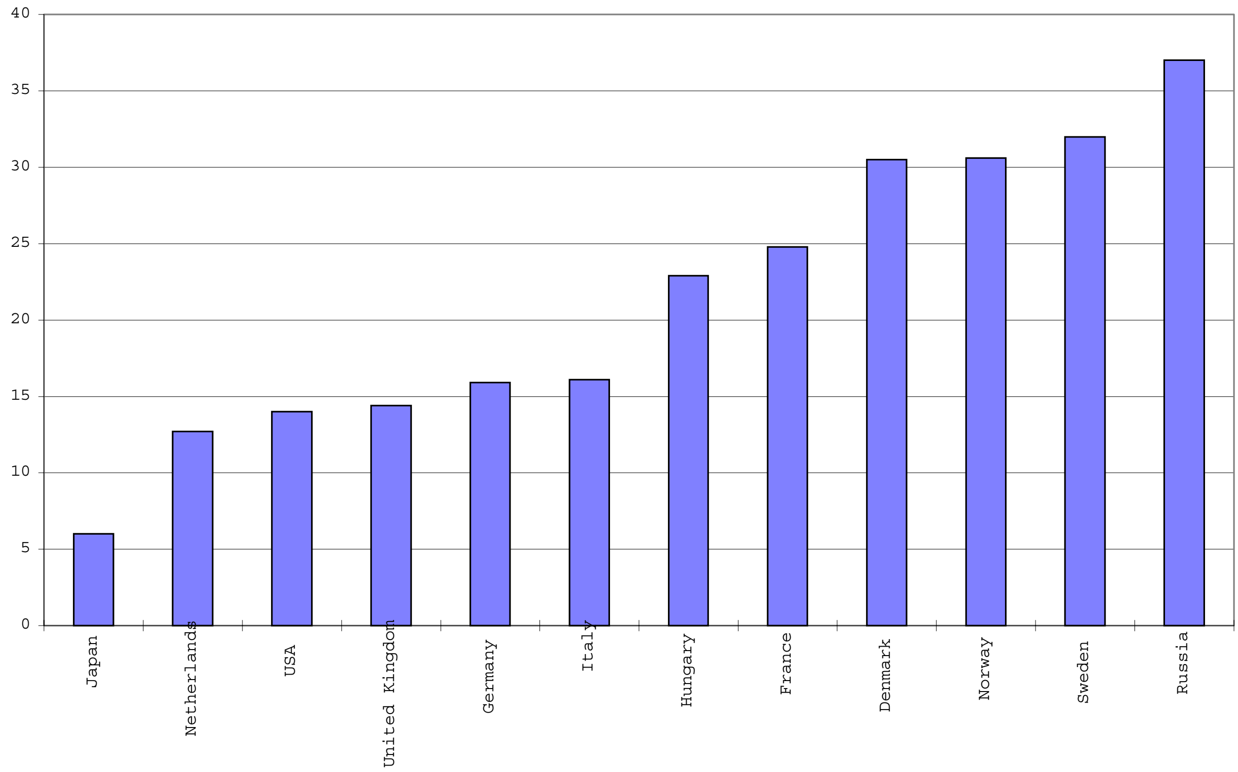
Most importantly, however, Russia spends beyond its means: the enlarged government ran a total deficit of roughly 7.5% of GDP, almost all of which was at the federal level. As in most other countries in the former Soviet Union, the contraction of government spending in Russia has been driven by an even more rapid decline in government revenue. There is no “optimal” size of government for Russia: ultimately, the choice of the mix of public and private spending is a political one. However, a closer look at Russia’s current expenditures shows that there is a lot of room for improving the efficiency of government spending; in other words, the Russian government could produce just as much in the way of public goods with a considerably smaller amount of public expenditure.

Breakdown of "enlarged government" spending, % GDP*



** 1997 figures include RECEP estimates.*
Sources: MinFin and IMF.

Share of public sector employment in total employment, %



Sources: Goskomstat and OECD.

How effective is the Russian government?

The share of government spending in GDP does not convey the efficiency of that spending. Public finance textbooks have traditionally identified three roles for government in a market economy: to stabilise macro-economic cycles, to redistribute income, and to make up for "market failures" by producing essential public goods such as roads, schools, courts and defence.

It is clear that, at present, the Russian government is failing in the first two of these tasks. Government taxation and spending, far from playing a stabilising role, has contributed to the collapse in output. The confiscatory and arbitrary tax system has discouraged new businesses from registering and has driven enterprises to use barter rather than cash. Meanwhile, spending arrears have left the government's suppliers insolvent and have fed the growth of inter-enterprise arrears in the economy as a whole. The recent crisis on financial markets was brought on by excessive government borrowing at short maturities, so that the fiscal situation now imperils the rouble's stability.

The government has also been ineffectual at redistributing income and eliminating poverty. Inequality rose sharply at the outset of the transition and continued to stay high. A ratio of income of the richest 10% of the population to the poorest 10% rose from 4.5 in 1991 to 8 in 1992 and to 13 in 1996. Governments at various levels do provide social benefits – most notably, housing subsidies – but they tend to be universal rather than targeted, so that the rich benefit from them as much or more than the poor. The real value of unemployment benefit has dwindled to the point that few people out of work bother to register for it.

The consolidated budget does provide public goods, some of which are of high quality by international standards. Though it has been starved of funds and has suffered frequent wage arrears, education in Russia remains the envy of much of the world. Health too has suffered severe declines in quality over the last few years, but remains far superior to the health systems in other countries at Russia's income level.

Defence spending has fallen steadily since the end of the Cold War from 19% of the federal budget in 1992 to 3% in 1997, but remains a source of considerable controversy. The army is overmanned, but cannot afford to retire officers, since it is obliged to provide retirees with apartments. The secrecy surrounding defence expenditure and procurement has hidden large scale embezzlement by high level officers.

While much of spending goes towards these clearly important goals, another sizeable portion continues to subsidise inefficient "sunset" industries – often located in areas unsuitable for human habitation – as well as to keep afloat defunct collective farms. The largest expenditure item in the consolidated budget is spending on the "national economy", which made up 8.2% of GDP in 1997. Roughly three quarters of this spending took place at the regional and local levels, with 4.1% of GDP going to local housing subsidies, and the remainder to assorted other regional and local subsidies. Federal spending on the national economy now makes up under 2% of GDP (down from 6% in 1992), and consists almost entirely of subsidies to the coal industry and to agriculture.

Expenditures of the consolidated government, % GDP

	1996			1997		
	Federal	*Regional and Local*	*Total*	*Federal*	*Regional and Local*	*Total*
National Economy	1.7	6.2	7.9	1.9	6.4	8.2
Industry, energy and construction	1.2	0.6	1.8	1.1	0.7	1.8
Agriculture and fisheries	0.4	0.8	1.1	0.5	0.7	1.2
Transport, roads and computers	0.0	0.7	0.8	0.2	0.7	0.9
Environment	0.1	0.0	0.1	0.1	0.1	0.2
Housing		4.0	4.0		4.1	4.1
Education	0.5	3.3	3.8	0.6	3.6	4.2
Defence	2.9		2.9	3.1		3.1
Health	0.2	2.4	2.6	0.4	2.5	2.9
Social policy	0.4	1.2	1.7	0.9	1.2	2.1
Law-enforcement	1.3	0.5	1.8	1.6	0.5	2.1
State administration	0.2	0.5	0.8	0.4	0.7	1.1
Culture and Mass Media	0.1	0.4	0.5	0.2	0.5	0.6
Basic research and science	0.3	0.0	0.3	0.4	0.0	0.4
International activity	1.2		1.2	0.3		0.3
Emergencies	0.2	0.0	0.2	0.3	0.0	0.3
Debt servicing	5.7		5.7	4.5		4.5
Internal debt	4.7		4.7	3.6		3.6
External debt	1.0		1.0	0.9		0.9
Intergovernmental transfers	2.1			2.3		
Other	1.7	1.0	2.8	3.4	1.6	5.1
Total on-budget spending	*19.0*	*15.6*	*32.4*	*18.1*	*17.2*	*33.0*

Source: MinFin

The extremity of Russia's climate mean that these subsidies cannot all be eliminated overnight: for example, miners and their families will need to be resettled from coal producing regions in Siberia and retrained for new professions. But the sooner the resettlement takes place, the quicker it will be possible to phase out the burdensome expense of supporting whole communities.

Rising debt service costs are also putting pressure on discretionary spending. Interest payments made up a quarter of total federal spending in 1997 (4.1% of GDP). With interest rates again rising, debt service reached a third of federal spending in the first quarter of 1998. The need to cut the budget deficit while servicing the growing debt is forcing the federal government to pare down spending to bare essentials. Rather than undertaking an extravagant industrial policy or trying to keep alive outdated Soviet factories, the government appears to have recognised the need to focus on its core activities – provision of basic public goods – and to live within its means.

Fiscal management

Perhaps a more serious problem than the size or composition of federal spending is the way that spending is planned, executed, and then accounted for. A combination of poor budget preparation, a tenuous legal relationship between budget laws and actual implementation, weak control by the Ministry of Finance over the behaviour of spending ministries, and little or no independent auditing of budgetary outcomes have contributed to skewed spending priorities, misappropriation and embezzlement, and spending arrears to both employees and suppliers.

Budgeting.
In a rapidly changing economic environment, budget forecasts for growth, inflation and revenues have tended to be wildly inaccurate. As a result of over-optimistic "rosy scenario" revenue forecasts, budget laws have set spending targets far above what could realistically be afforded. At times, the government has found it politically expedient to propose budgets that it knows to be unfulfillable, confident that the Ministry of Finance could subsequently make discretionary cuts as necessary to preserve macroeconomic stability and meet deficit targets agreed with the International Monetary Fund.

The situation has been exacerbated by a constitutional separation of powers that gives the Federal Assembly broad authority to shape the budget law but no recourse to ensure that the government executes its budget as intended. Hence the Duma has had little incentive to take the budget process seriously as a act of policy-making. Budget laws tend to be passed well into the year to which they apply, and parliamentary debates over the budget have become little more than opportunities for political posturing and brinkmanship.

The Duma has attempted to check the government's discretion by forcing it to account for its cuts, as yet with little success. In accordance with the terms of the 1997 Budget Law, the government had to submit a sequester bill to the Duma when revenues were less than 90% of target in the first quarter. When the Duma refused to consider the revised budget, however, the government proceeded to implement the spending cuts regardless. The 1998 budget law, in a concession to reality, permits the government to cut spending without submitting a sequester bill, as long as the spending cuts are proportional across spending items. But the government's new plan for spending reduction, with its heavy emphasis on military procurement cuts, shows no sign of heeding even this restriction. In practice, spending ministries are guided by the government's spending "limits" and pay no attention to the law passed by the Duma. The flimsy legal basis for this practice, however, means that ministers have little to fear from substituting their own priorities for the government's.

The draft Budget Code currently before the Duma would significantly increase legislative oversight of budget execution and introduce legal responsibility for failure to abide by the rules of the budget process. Passage of the Budget Code, however, is not sufficient to improve the budgetary process; in addition, the government and Federal Assembly will need to start co-operating and compromising in good faith in order to draft implementable budgets based on realistic assumptions.

Spending control.
At the implementation stage, the Ministry of Finance itself until recently had little control over how ministries – especially the "power ministries" such as the Ministries of Defence and Internal Affairs – have spent the money allocated to them. The Ministry of Finance

would transfer sums into the bank accounts of the spending ministries and receive reports ex post on where the money went. When revenues fell short, it would simply transfer less than originally planned.

There is no doubt that sequestration initially played a key role in containing the budget deficit and bringing down inflation. But as the sequestrations continued year after year, spending ministries developed strategies for protecting their allocations from the Ministry of Finance's axe. These strategies included:

Accruing wage and payment arrears. Ministries understood that if they spent their entire expenditure allocation on non-essential expenditures (such as purchases of cars or refurbishment of offices) while running up arrears on essentials (such as wages and electricity), the Ministry of Finance would then come under considerable political pressure to allocate additional funds to pay for the essentials. Similarly, they would unilaterally increase wages for their employees, knowing that the Ministry of Finance would have trouble refusing to fund the increase ex post. In many cases, ministries would deliberately understate their need for electricity and fuel, confident that the schools, hospitals or military bases, for which the ministries are responsible, would not have their supplies cut off in the middle of winter. It would appear that federal debts to suppliers, largely accumulated through such practices, currently stand at around R50 bn. This type of strategy is far from unique to Russia: it can be seen in other republics of the former Soviet Union that have attempted sequestration-based spending cuts, and also in places as distant as Zambia under similar circumstances.

Obtaining earmarked revenue sources. Many ministries lobbied for earmarked revenue sources – either user-fees for certain services or a percentage of an existing tax – to guarantee themselves an uninterrupted flow of funding. Two of the more conspicuous of these funds are the Fund for the Development of the Customs System and the Fund for the Development of the Tax System and the Tax Service, financed by a proportion of customs and tax receipts respectively. The Customs Fund alone amounted to more than a quarter of total spending on the entire federal bureaucracy in 1997. Earmarked revenues are not inherently bad budgetary practice: indeed, they can promote the sensible principle of cost-recovery in government spending. But in the context of severe spending cuts and poor budgetary control earmarking distorts spending priorities in favour of politically influential agencies and reduces the transparency of spending.

Non-cash forms of settlement. Another way for ministries to assure funding for their own spending priorities is by arranging barter deals or "offsets" between the government and suppliers to the ministries (i.e. to consumers, for which the ministries are responsible). As long as the suppliers were willing to accept payment in the form of tax write-downs, ministries could boost their spending allocation by offering the Ministry of Finance the prospect of added "revenues". The president decreed that the government should stop accepting payment in offsets as of January 1, 1998, so it appears that this particular form of strategic behaviour will no longer take place.

The key to improving central control over expenditures is to introduce a treasury system, under which all expenditures are monitored and approved by a branch of the Finance Ministry. The treasury is now in place in almost all regions of Russia, and for almost all expenditure categories (with the on-going exception of the Defence Ministry). Eventually, the treasury should approve all contracts and spending commitments as well as actual outlays, to ensure that budget organisations do not run up arrears.

The government's savings programme

The government has announced plans to cut R75 bn of budgeted spending for 1998. It simultaneously faces the task of settling arrears accumulated by the federal government during recent sequestrations. R32 bn is to be cut directly out of defence procurement and transfers to regions; the remainder will be saved by eliminating waste identified during a wholesale review of budget-funded organisations conducted over the last few months. The review identified several areas where money could be saved:

- mopping up ministerial off-budget funds (the review located over 28,000 off-budget bank accounts of budget-financed organisations) and using the money to pay off accumulated debts; eventually any remaining accounts should be serviced by the federal treasury;
- streamlining control over the flow of budget money by reducing the number of organisations receiving funds directly from the budget
- eliminating duplication in the bureaucracy, raising teaching loads in federally funded institutes, and reducing the number of military personnel
- bringing wages throughout the federal bureaucracy into line with the legally established federal pay scale (they have in some places drifted considerably higher, with the help of off-budget funds);
- control over the debts, new spending commitments, and energy usage of budget organisations;
- a thorough review of how federal property – holiday homes, administrative buildings, and so on – is being used.

Preliminary budget plans 1998-2001

	1998		*1999*		*2000*	*2001*
	law	*"savings plan" limits*	*plan (current tax laws)*	*plan (new tax code)*	*plan (new tax code)*	*plan (new tax code)*
R bn						
revenues	350.9	289.6	335.2	320.7	351.5	379.6
expenditures	493.2	432.7	448.3	433.8	430.0	456.2
interest payments	124.1	137.6	142.9	142.9	129.9	129.6
deficit (-)	-142.3	-143.1	-113.0	-113.0	-78.5	-76.6
primary deficit (-)	-18.1	-5.5	29.9	29.9	51.5	53.0
% GDP						
revenues	12.4	10.2	10.7	10.2	10.3	10.2
expenditures	17.4	15.2	14.3	13.8	12.6	12.3
interest payments	4.4	4.8	4.6	4.6	3.8	3.5
deficit (-)	-5.0	-5.0	-3.6	-3.6	-2.3	-2.1
primary deficit (-)	-0.6	-0.2	1.0	1.0	1.5	1.4
projected GDP	*2840.0*	*2840.0*	*3140.0*	*3140.0*	*3420.0*	*3720.0*

Source: MinFin

Carrying out the programme will require strong political will in the face of resistance and lobbying by bureaucrats losing out from the changes. The hardest political test will come when the government asks the Duma to approve its cuts in the 1999 budget. A slip in the government's resolve would most likely manifest itself not in a larger deficit but in a resurgence in spending arrears or a relapse to some form of non-cash settlement.

Over the medium term, the scope for savings and efficiency gains is enormous: years of ad hoc budgeting and weak control over execution have created large areas of waste and abuse. But the most important aspect of the current program is not the one-time savings but the change in institutions and procedures, which should strengthen the hand of the Finance Ministry in controlling the flow of budget money. The ban on offsets and the strengthening of the treasury system are important milestones. With the passage of the Budget Code, the Ministry of Finance itself should come under greater scrutiny, which would serve to make the budget process more transparent and government officials answerable for their decisions.

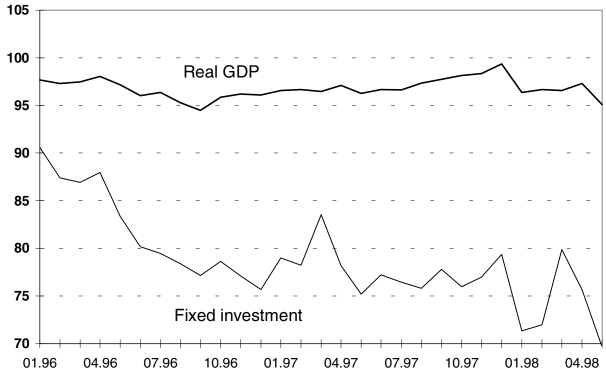
Perhaps the most challenging step of all will be to convince regional governments to implement similar reforms of their budget institutions. Over the past years, much of the reduction in federal spending has come through devolution of spending to lower levels of government, on the assumption that the latter would be better able to distinguish necessary from wasteful spending programmes. So far, regional governments have done little to make their spending more efficient, in part because the current system of federal transfers does not give them an incentive to do so. The federal government has announced a plan to make transfers conditional on good budgetary behaviour. Given the strategic importance of regional leaders, however, it will take an unprecedented show of political resolve to deny them funding on technical grounds.

ECONOMIC UPDATE

Output

May data for the first time show the serious effects of the financial crisis on the real economy. The liquidity squeeze that is at the centre of the crisis has meant that firms are having real difficulties getting hold of cash either in payment form or as credits. This is hitting both output and investment demand. Real GDP (seasonally adjusted) fell close to its all time low in May, while industrial production hits its lowest level yet. Investment lurched down to another all time low.

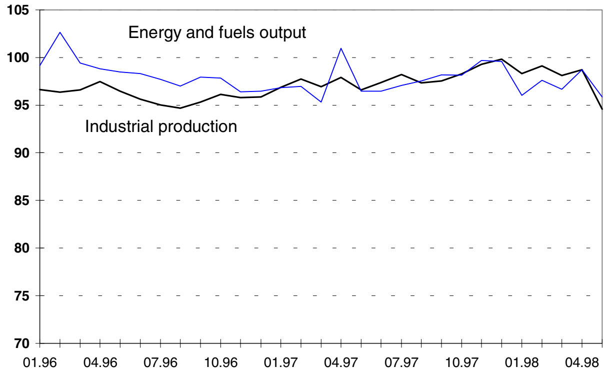
GDP and investment (1995=100, SA)



Source: Goskomstat

The slump in output has revealed that even though Russia is only just becoming a market economy, it too is effected by high interest rates and tight money. The financial crisis has been eight months now and as it has worsened so has the economy. As there is a lag involved, the best that can be hoped for is a speedy end to the crisis, followed, later, by the slow revival of the economy as markets normalise. If however the crisis were to lead to a rouble collapse and with it a collapse of the banking sector then the real economy would once more worsen.

Industry (1995=100, SA)

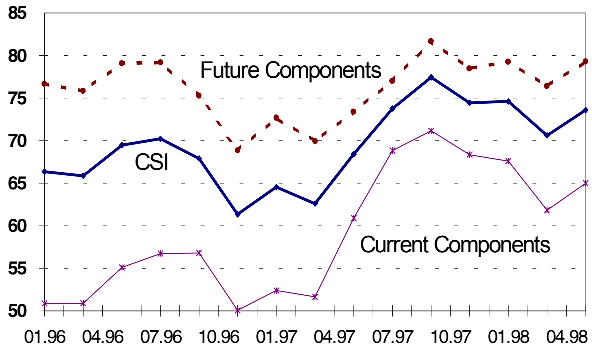


Source: Goskomstat

Aggregate demand

Consumer demand remains the only source of strength in the Russian economy. Despite a continuing fall in real personal income (in May it was 8.7% lower than a year ago) real consumer expenditures remain strong. The volume of retail trade increased over the same period by more than 3%. After a seasonal drop of consumer confidence in March the Consumer Sentiment index rose again in May. Personal savings, especially in hard currency dropped sharply. It looks like the financial crisis has forced people to run down savings made at the end of 1997.

Consumer sentiment index

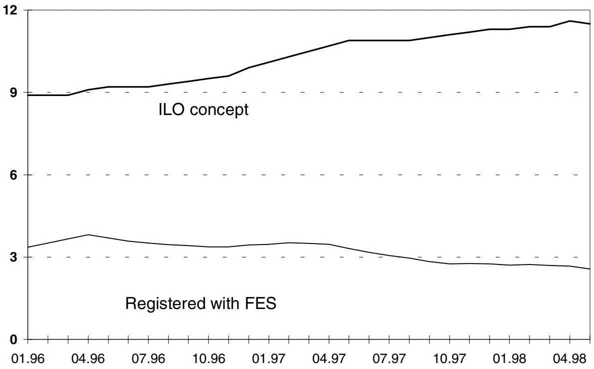


Source: VCIOM

Unemployment

Goskomstat carried out a labour force survey in October 1997. The one previous to that had been in March 1996. The results from the October survey have just been published revealing large revisions to the data. According to the old data (that extrapolated from a mixture of the old survey and the registered unemployment rates) in April 1998 the unemployment rate was 9.2%. The revisions have increased this to 11.6%. Employment has also been revised downwards by 500,000. These new numbers reveal a number of points. The labour markets are being effected much more than had been thought by the collapse in output. There are no signs of improvement (though in a perverse way lay-offs are such an improvement). And only a fraction of the unemployed are getting any benefit.

Unemployment, % labour force

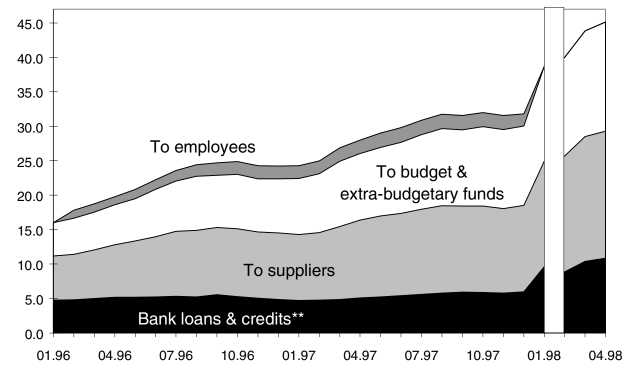


Source: Goskomstat

Arrears

Non-payments continued to rise in April at a rate close to that observed since the start of the year. Arrears to the budget and off-budget funds increased especially rapidly. In June, the government pledged to the IMF to collect tax arrears from the top 20 debtors to the budget, and promised an immediate seizure of productive assets and accelerated bankruptcy proceedings against companies which do not pay or agree to restructure their debts. Under the plan, oil companies which owe money to the state will automatically be denied access to pipelines.

Arrears and Bank Credits & Loans, % of GDP*



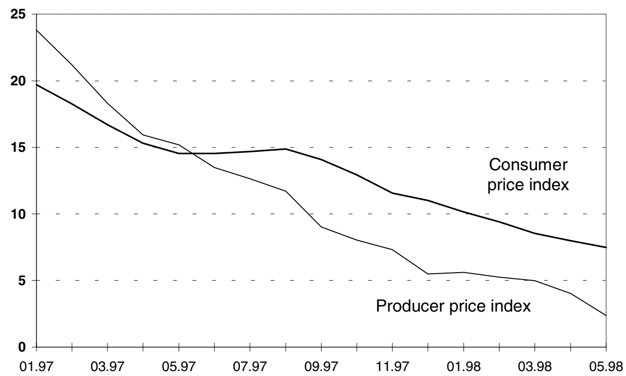
** Data is for the four sectors of the economy (industry, agriculture, transport & construction) prior to January 1998 and for the whole of the economy from January 1998*

Source: Goskomstat

Prices

Inflation rates continued to fall in May. Indeed producer prices actually fell. This latter fact is due to a mixture of effects. Domestic energy prices are now lower than they were at the same period in 1997, reflecting some of the world price fall. The government's drive to increase cash payments and drive to reduce prices to industrial consumers at the same time as increasing those paid by households has also had an effect. And finally the financial crisis is really starting to hurt the real economy, so reducing any remaining inflationary pressures.

Inflation rates, % per year

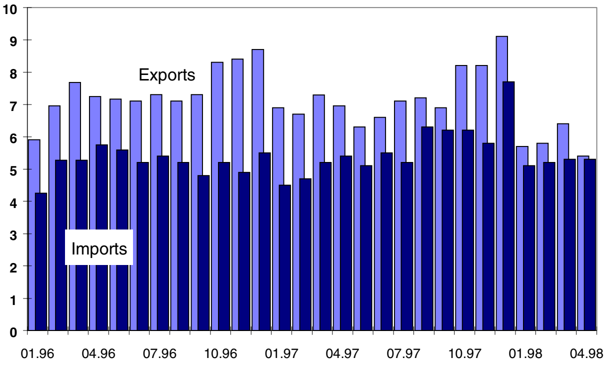


Source: Goskomstat

Foreign Trade

Further declines in the prices for oil and gas resulted in another significant slump in export revenues in April. In the month they were 22% lower than in April 1997. Imports remained at March levels, just a touch lower than in April 1997. The overall trade balance in April barely stayed positive at just $0.1 bn, while Russia ran a small deficit against the countries of the CIS.

Merchandise exports and imports ($ bn)



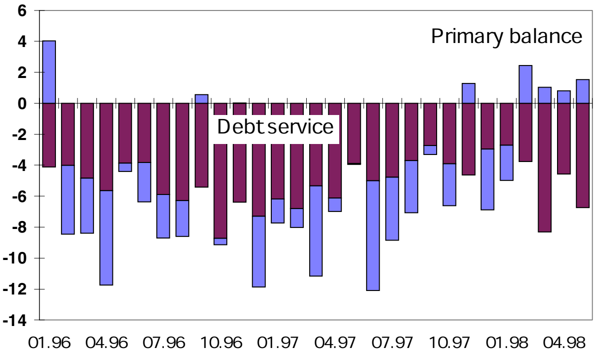
Source: Goskomstat

The budget

The federal budget deficit for the first five months of 1998 was 4.6% of GDP. The primary surplus in May was 1.5% of GDP and for the first five months as a whole was 0.7%. This is much improved on the performance in 1997. The deficit then for the first five months was 7.5% of GDP. In its austerity drive the government is planning a primary surplus of 2-2.5% of GDP in 1999, that would mean a federal deficit of 2.5% for the year as a whole.

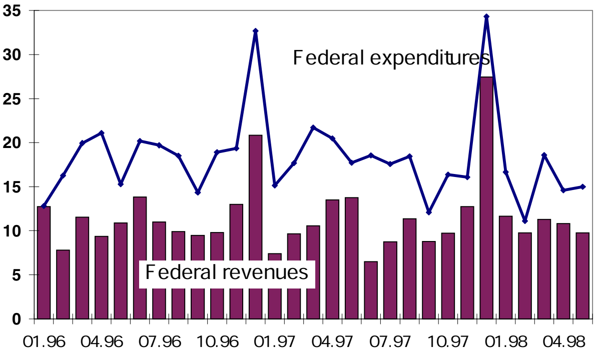
Revenues however fell back in May to R20.1 bn, bringing those for the first five months to R104.3 bn. These are down on what was intended, no doubt at least partly due to the troubles the economy is facing. As discussed above enterprises are finding it hard to garner credits and cash due to the tightness of money. Contributing to the monetary tightness is the government's push for taxes to be paid in cash. Though at first glance it looks like revenues in 1998 were lower than in 1997, this masks a significant increase in the quality of those revenues. In 1997 a good portion of them were offsets or other non-cash instruments. In 1998 it is just cash.

Federal budget deficit, % GDP



Source: Ministry of Finance

Federal revenues and expenditures, % GDP



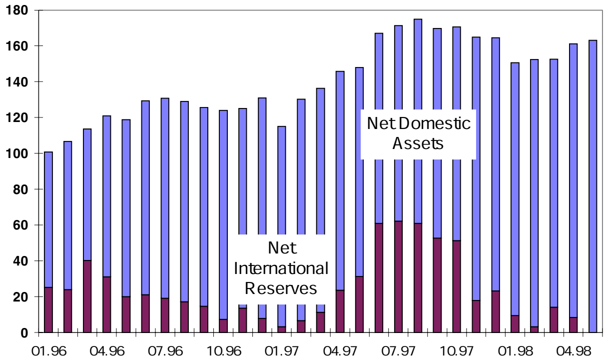
Source: Ministry of Finance

Money

As the crisis has intensified the CBR has been faced with an increasingly tough dilemma. Either to not purchase GKOs and so starve the markets of liquidity, letting interest rates climb sky high. Or to intervene in the GKO and money markets, keep some liquidity and make loans to ailing banks. The benefit of the first approach is that foreign exchange reserves are not used as much and the rouble is defended. The problem is that it starves funds from the money markets, and pushes banks into terrible liquidity problems, that might lead to bankruptcy. The second approach while helping and keeping alive the banks causes a constant drain on reserves and increases pressure on the currency. The CBR, like most central banks confronted with such a dilemma, has opted for a mix of these two policies.

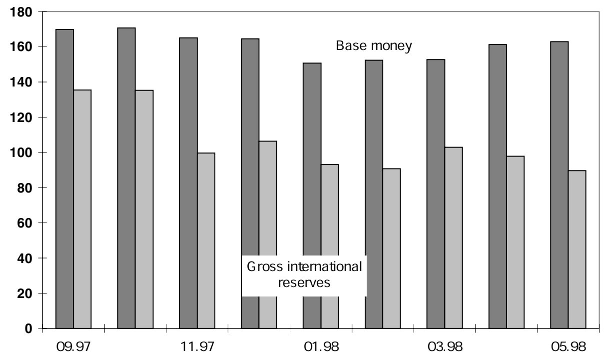
This has meant that base money has increased, reserves spent and net domestic assets (an amalgam of credits to the government, banks and others) of the CBR have increased rapidly, as the graphs shows.

Monetary base (R bn)



Source: CBR

Monetary base and gross reserves (R bn)

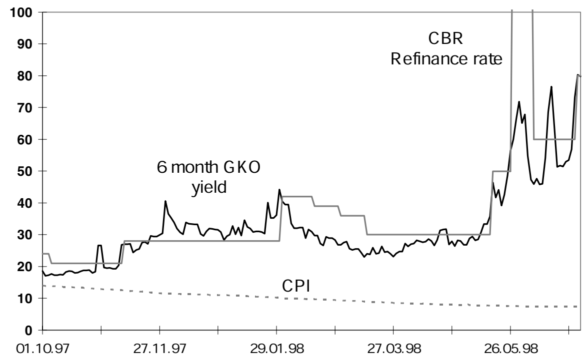


Source: CBR

Interest rates

Interest rates climbed ever higher during June. GKO rates peaked - for now - at over 80% in the last few days of the month. And the CBR was forced once more to raise the refinance and Lombard rates which it did, effective Monday 29, to 80%. Also interest rates on foreign currency Russian debt started to be seriously effected. Interest rates on the 10 year benchmark Eurobond rose to 15.6% at the end of the month from 11.8% at the beginning. This is due to a mixture of the crisis and the large new issuance of debt that the government has placed to reduce dependence on the GKO market.

Interest rates and inflation, % per year

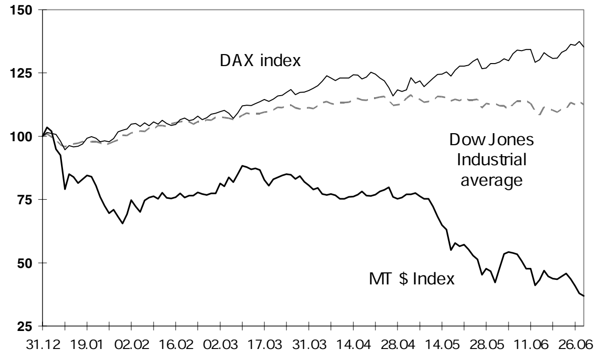


Source: Troika Dialog, CBR

Financial markets

In the wake of the crisis and the huge liquidity pressures facing domestic market operators, the stock market continued to dive. By the end of the month it was 75% below its peak, 63% below its level at the beginning of 1998 and 24% below its level of the end of June 1996 - the date of the second round of the presidential elections. This, if it is needed, shows the absolute pessimism that abounds, and perhaps more the depth of the liquidity squeeze. Russian banks have been forced to sell to keep operational in the face of no buyers, pushing the price ever downwards.

MT, DAX and Dow 1998



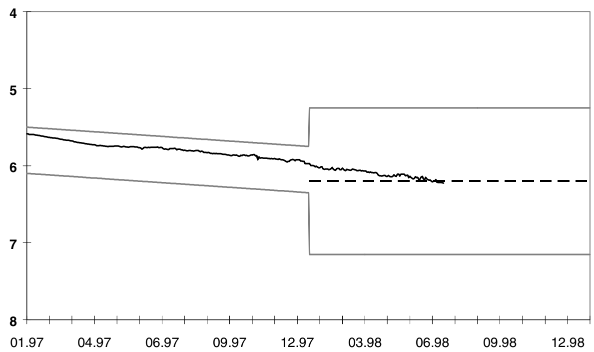
Source: Moscow Times

The exchange rate

The exchange rate did not however give way. The CBR intervened heavily in the market on an almost daily basis. The MICEX rate was right at the bottom of the daily intervention band of the CBR for much of the month. It is not clear how much was spent - but something in the region of $3 bn seems likely. Reserves however rose due to the proceeds from the two government Eurobond placements and other sources of borrowing that totalled at least $4 bn. But this rise in reserves should not be interpreted as a sign that the crisis is over.

Instead the danger of a forced, and thoroughly damaging, collapse of the rouble continually increased during the month. It is now essential that the Duma approves the government's crisis plan (or if not, that the President passes it by decree) and the government agrees with the IMF on a stabilisation fund.

The rouble exchange rate and the corridor (R/$)*



** MICEX exchange rate*
Source: CBR