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**Research Report**

## Mounting pressure on Russia's government budget: Financial and political risks of stagnation

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SWP Research Paper

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*Janis Kluge*

# Mounting Pressure on Russia's Government Budget

Financial and Political Risks of Stagnation



Stiftung Wissenschaft und Politik  
German Institute for  
International and Security Affairs

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Economic stagnation and demographic change in Russia are putting intense pressure on the government budget. Tax revenues have been declining since the late 2000s. Meanwhile, the oil dependency of Russia's budget has increased significantly. This became patently clear when the oil price plummeted in 2014. Energy revenues have since begun to recover, but the Finance Ministry's reserves have shrunk considerably and are only slowly being replenished.

To keep public budgets stable, the Russian government is forced to raise taxes and extend the retirement age in the years to come. There is a widening gap in funds required to cover the paternalistic social policies of earlier years. At the same time, the struggle for control of public resources is having a destabilizing effect on the political regime — especially in light of the ever more pressing question of Putin's successor in the Kremlin.

Up to the presidential election of 2018, the Russian leadership avoided making any budget cuts that would have hurt key clientele groups: retirees and the military-industrial complex. Additional income was generated instead through a series of smaller budgetary adjustments. Shortly after the start of Putin's fourth term, however, tax raises and a higher retirement age were announced, which lead to drastic declines in the president's approval ratings.

As a reaction to shrinking funds, budget policy is now being controlled in a more centralized way by Moscow, while public oversight of government budgets has been restricted. Shadow budgets have also emerged outside the purview of the finance administration. In this complex and politically tense situation, conflicts between elites are erupting with increasing frequency, bearing risks for Putin's fourth term in office.

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*Janis Kluge*

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## **Mounting Pressure on Russia's Government Budget: Financial and Political Risks of Stagnation**

Russian budget revenues relative to GDP have declined substantially over the last decade. The lower oil price is one reason for this, but tax revenues outside the energy sector have fallen as well. The Russian economy has been in a period of stagnation for a number of years now, placing a burden on state coffers. The government reserves that the Kremlin was still able to fall back on prior to the 2009 financial crisis have been largely exhausted in 2015 and 2016, and economic growth is expected to be slow after 2018. The Russian leadership faces ongoing financial difficulties in the years ahead, making unpopular policies such as increasing the value added tax and raising the retirement age necessary.

At the same time, the domestic political situation has become more difficult for the Kremlin to manage. Without economic growth, the Russian leadership will no longer be able to fulfill its implicit “social contract” with the population. As long as the standard of living was rising, the vast majority of Russian citizens refrained from active participation in politics. But then from 2014 to 2017, real incomes fell for four years running. The Kremlin could now be facing a crisis of legitimacy — and that in a phase of uncertainty about a possible shift of power after Putin's last term of office (2018–2024).

Will the Russian regime be able to adapt to the changing economic reality, or will dwindling resources lead to a destabilization of the political system? How is the Kremlin dealing with the increasing pressure to implement economic reforms? Are any practical ways to escape the budgetary dependence on oil revenues beginning to emerge, or will the risks increase further in the years to come?

After the oil price collapse of 2014 put the state budget under pressure, the Kremlin pursued policies aimed at maintaining the existing political and economic order. Rather than undertaking important but risky reform projects in the run-up to the 2018 presidential election, the leadership in Moscow sought to mobilize remaining reserves in the system by implementing a series of smaller budget and tax adjustments. In doing so, it sought to keep the financial



and political risks resulting from budgetary policy in check. This changed with Putin's inauguration, shortly after which tax increases and a higher retirement age were announced, which have led to drastic declines in the president's approval ratings.

To increase revenues at the height of the economic crisis in 2016, the Russian government sold shares in the oil companies Bashneft and Rosneft but without relinquishing control over them. The state pension system discontinued capital accumulation so that all premiums could be used to cover the pay-as-you-go pensions. Russia's commitment to oil output cuts, in line with the November 2016 resolution of the Organization of the Petroleum Exporting Countries (OPEC), was also aimed at increasing revenues without engaging in structural reform within the country.

On the spending side, Russia's leadership has distinguished between politically risky and less risky areas. It has passed early and significant budget cuts in policy areas that did not affect the Kremlin's core voters and supporters — areas like education, the economy (infrastructure), and health spending on the federal level. Pensions, social security, and defense, on the other hand, have long been spared from budget cuts.

Only when the 2016 budget crisis reached dangerous proportions did the Russian government decide to reduce pension inflation adjustments and eventually also raise the retirement age. The Kremlin's approach to military spending was similarly cautious: Decisions on a long-term state armament program were delayed repeatedly and finally made in fall of 2017, only after the oil price had recovered to some extent.

The increased pressure on the government budget has exacerbated conflicts over the distribution of financial resources, heightening the importance of control over the remaining funds. This has led, among other things, to a centralization and personalization of decision-making power over budgetary funds in the Kremlin. Other political actors like the State Duma have not played a significant role in the budget process for years now. The already low scope of action available to regional government administrations has been curtailed further in recent times.

The Russian leadership is not only further weakening the Russian federalist system through centralization, but also undermining the binding nature of budgetary planning itself. Budget plans have become more opaque and unspecific, and resources that lie outside the Finance Ministry's purview have increased. The big state-owned enterprises play an important

role in this: they only pay part of their profits into the state's budget, and in return, they take on direct political responsibilities in Russia and abroad. Public control over government resources is thus being gradually eroded and the directors of the state-owned enterprises are becoming influential political figures with their own agendas.

From the perspective of Germany and the EU, the vulnerability of Russia's government budgets has important political implications. In a situation of declining government revenues, the Russian regime will have a difficult time legitimizing its rule by pointing to economic successes or instituting comprehensive social programs. The regime's annexation of Crimea in 2014 garnered high approval ratings in 2015 and 2016 despite the economic slump. If a loss of legitimacy becomes an imminent threat, the Russian leadership could be tempted to build on this experience. The result would be a stronger emphasis on mobilizing patriotic sentiment and intensifying anti-Western propaganda. An improvement in relations between the EU and Russia would then be pushed off into the more distant future.

A more prolonged budget crisis or a serious destabilization of the Russian regime could also have severe immediate impacts on the EU. For Germany, it would pose risks to the energy supply and to the security of foreign direct investments in Russia. Political destabilization in Moscow would also quickly spread to neighboring countries with close economic ties to Russia. Unresolved conflicts in the region could then spin out of control.

# Diminishing Room to Manoeuvre

Russia's public budgets are comprised of the federal budget (with spending of 17.8 percent of GDP in 2017), regional and municipal budgets (11.7 percent), and the social security funds (11.6 percent).<sup>1</sup> In absolute figures, federal spending in 2017 was 16.4 trillion rubles (€249 billion<sup>2</sup>) and consolidated expenditures for all public budgets amounted to 32 trillion rubles (€485 billion). Since all of the various government budgets are interlinked through extensive transfers, total government spending (that is, the government spending ratio) adds up to 35.2 percent of GDP. In the broadest sense, government-controlled enterprises also belong to the public sector. Only estimates are available as to these companies' expenditures. Studies by the International Monetary Fund (IMF) and Russian economists estimate them at 29 to 30 percent of GDP.<sup>3</sup>

## It's not just the oil price

Oil and gas extraction taxes and export tariffs have made up around half of all federal and a quarter of total tax revenues in Russia since the mid-2000s (see Appendices A and B, p. 42 and 43). During the oil boom of 2010–2014, annual revenues from oil and gas sales amounted to 9 percent of GDP. At first glance, this does not seem to place Russia in the category of “rentier states”, which derive the lion's share<sup>4</sup> of their tax revenues from sales of oil and gas. In Saudi Arabia, the United Arab Emirates, and Iraq, energy revenues make up over 80 percent of the total government budget.<sup>5</sup> In Russia, however, non-oil tax revenues depend in part on energy exports as well. Energy companies play an important role, for instance, in corporate and individual income taxes. Taken at face value, the budget figures also conceal the fact that domestic gas supply is cross-subsidized in the Russian economy by revenues from gas exports.<sup>6</sup>

The oil price slump of 2014 had a severe negative effect on federal tax revenues. Although the floating of the ruble exchange rate absorbed some of the shock, revenues fell by more than one third up to 2016 to just 5.6 percent of GDP, which resulted in a federal budget deficit of 3.4 percent of GDP. Without two major privatizations (Rosneft and Bashneft), the deficit would have been as high as 4.6 percent of GDP in

1 All budget data are taken from the Russian Finance Ministry's official statistics, Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* [Financial and economic indicators of the Russian Federation], <https://www.minfin.ru/ru/statistics/>. Data on GDP come from: Rosstat, *Valovoj vnutrennij produkt* [Gross Domestic Product], [http://www.gks.ru/free\\_doc/new\\_site/vvp/vvp-god/tab3.htm](http://www.gks.ru/free_doc/new_site/vvp/vvp-god/tab3.htm) (both accessed 2 February 2018). See Appendices A and B, p. 42 and 43.

2 To convert ruble amounts, we used the average exchange rate for 2017 (€1 is equivalent to 65.94 rubles), “Euro (EUR) to Russian Ruble (RUB) Average Annual Exchange Rate 1999–2017”, *Statista* (online), 2018, <http://www.statista.com/statistics/412824/euro-to-ruble-average-annual-exchange-rate/> (accessed 27 March 2018).

3 International Monetary Fund (IMF), *Russian Federation: Fiscal Transparency Evaluation*, IMF Country Report 14/134 (Washington, D.C., May 2014), <https://www.imf.org/external/pubs/ft/scr/2014/cr14134.pdf> (accessed 30 December 2017); Alexander Abramov, Alexander Radygin and Maria Chernova, “State-Owned Enterprises in the Russian Market. Ownership Structure and their Role in the Economy”, *Russian Journal of Economics* 3, no. 1 (2017): 1–23.

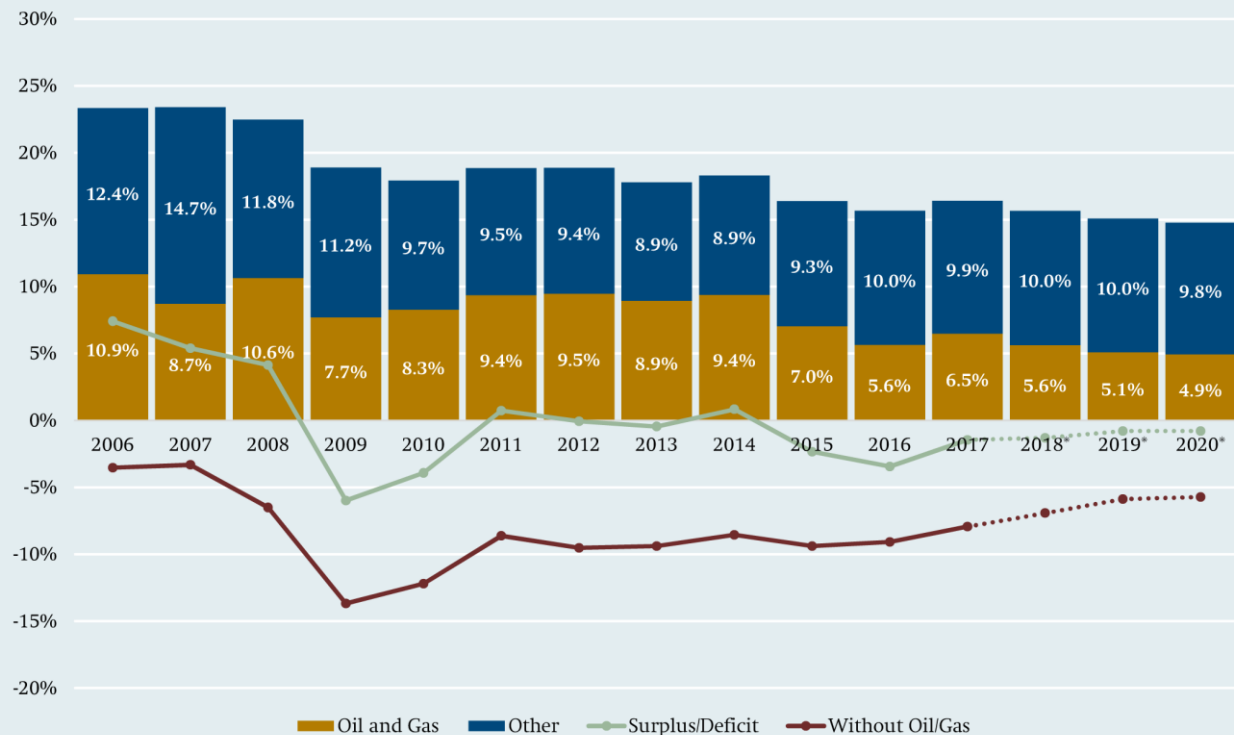
4 A frequently used threshold value in the literature is 40 percent, see Giacomo Luciani, “Allocation vs. Production States. A Theoretical Framework”, in *The Arab State*, ed. Giacomo Luciani (Berkeley, 1990), 70.

5 IMF, *Revenue Administration. Administering Revenues from Natural Resources – A Short Primer* (Washington, D.C., July 2014), 4.

6 Stefan Wagstyl, “Russia: Riding with the Rentiers”, *Financial Times*, 8 July 2011, <https://www.ft.com/content/ab44f357-5e42-3ecd-a96f-415bbd42db08> (accessed 26 March 2018).

Figure 1

## Federal budget revenues and balance (in percent of GDP) as of May 2018



Budget planning figures were used for the years 2018–2020.

At the end of May 2018, a new budget bill was introduced in the Russian Duma taking the sharply increased oil price from 2018 into account. As a result of this, revenues are 1.8 percent of GDP higher, and instead of a deficit of 1.3% percent of GDP, a surplus of 0.5 percent of GDP is expected, Gosudarstvennaya Duma Federal'nogo Sobranija Rossijskoj Federacii, *Zakonoproekt № 476242-7* [draft law no. 476242-7], 29 May 2018, <http://sozd.parliament.gov.ru/bill/476242-7>.

Source: Minfin Rossii, *Finansovo-ëkonomicheskie pokazateli Rossijskoj Federacii* [Financial and economic indicators of the Russian Federation], <https://www.minfin.ru/ru/statistics/>

2016. The average oil price in 2016 was \$41.9.<sup>7</sup> Against the backdrop of a renewed increase in oil prices in 2017 (to an average of \$53.3), the deficit fell to 1.4 percent of GDP.

The reduced revenues from oil and gas sales are responsible for just part of the current budget imbalance. Revenues from other areas have been in decline for several years now. This is true especially of corporate and individual income taxes, which

made up 10 percent of GDP in 2008 but just 6.2 percent of GDP in 2013 (before the oil price drop). Since these taxes accrue mainly to regional budgets, the regions' debts increased substantially over this period. The situation was exacerbated further in 2012 after Vladimir Putin laid out goals for his third term of office in his May Decrees that placed a heavy strain on regional budgets.<sup>8</sup> Pay increases for civil servants played a significant role in this. The risks of regional debt are ultimately borne by the federal budget. Regional debt is distributed extremely unequally across

<sup>7</sup> The price of Urals, the reference oil brand used for pricing Russian oil, Minfin Rossii, *O srednej cene nefi marki Urals po itogam janvarja – dekabrja 2017 goda* [on the average price of Urals oil from January–December 2017], 14 February 2018, [https://www.minfin.ru/ru/press-center/?id\\_4=34979](https://www.minfin.ru/ru/press-center/?id_4=34979) (accessed 12 March 2018).

<sup>8</sup> Alexander Libman, *Russische Regionen. Sichere Basis oder Quelle der Instabilität für den Kreml?*, SWP-Studie 19/2016 (Berlin: Stiftung Wissenschaft und Politik, November 2016), 13.

Russia's regions, but is low overall at just 2.4 percent of GDP.<sup>9</sup>

The decline in non-oil revenues in the remaining budget balance up to 2014 was disguised by the boom in commodity prices. It only became evident in the non-oil deficit, an indicator published by the Russian Finance Ministry for the Russian budget's oil dependence. This budget deficit is hypothetical: tax revenues from oil and gas have been deducted from it. For 2007, the non-oil deficit was still 3.3 percent of GDP; since the financial crisis, the budget deficit would have been between 9 and 10 percent of GDP without oil and gas revenues in most years.

### **Economic growth is unlikely to ease budgetary strain in the years to come.**

According to estimates by Fitch Ratings, Russia would have needed an average oil price of \$72 a barrel in 2017 to balance its budget. This places Russia in the middle among the world's major oil-exporting nations: Nigeria (\$139), Bahrain (\$84), and Angola (\$82) needed much higher prices. Kuwait (\$45), Qatar (\$51), and the United Arab Emirates (\$60) adjusted better to the lower oil price. Like Russia, Saudi Arabia was in the middle of the field in 2017, at \$74 per barrel.<sup>10</sup>

Economic growth is unlikely to ease the strain on budgets in the years to come. The Russian economy posted 1.5 percent growth in 2017,<sup>11</sup> allowing it to leave the recessions of 2015 and 2016 behind. Yet forecasts for the coming years are less optimistic: growth rates are projected to be 1.7–1.8 percent up to 2020.<sup>12</sup>

The background to Russia's current long-term economic slump is a significant decline in potential

growth since the 2000s that is rooted in structural problems. Despite high potential returns on investment, large amounts of capital are exported and too little is invested in Russia. Private businesses have a difficult time in many sectors due to the lack of reliable property rights protections. The major state-owned enterprises, whose share in the Russian economy has increased even further in recent times, are less efficient than private businesses.<sup>13</sup>

The difficult demographic situation in Russia at present is putting an additional damper on growth. Around one-third of economic growth from 1997 to 2011 came from the "demographic dividends" of a growing working-age population – an extraordinarily favorable situation.<sup>14</sup> What had once been a blessing increasingly became a curse, however: in 2017 alone, Russia's working-age population dropped from 84.2 to 83.2 million. A large cohort is currently leaving the labor market, while the cohort of young people entering the workforce is just half as large. Up to 2024, the Russian statistical office Rosstat expects a further decline to a working-age population of 77.9 million.<sup>15</sup>

Western sanctions are also having a negative impact on Russia's prospects for the future. The immediate effect of the financial market sanctions imposed by the EU and USA during the crisis in the Ukraine peaked in late 2014 and 2015, but new risks arose in the summer of 2017 with the United States' CAATS Act (Countering America's Adversaries Through Sanctions Act), which is severely affecting Russian companies with international business ties. Uncertainty about the future use of the various sanction mechanisms mentioned in the act is impeding the Russian economy's integration into international supply chains and access to Western capital markets. This in turn raises protectionist walls higher that were erected around the economy by Russian industrial policy from 2012–2018 during Putin's third term of office.<sup>16</sup>

9 At the end of 2017, regional debt was 2.1 trillion rubles (€31.8 billion). Data on regional debt are published in "Gosudarstvennyj dolg sub"ektov RF" [Public debt of Russian federal subjects], *iMonitoring*, 1 March 2018, <http://iminfin.ru/areas-of-analysis/budget/gosudarstvennyj-dolg-sub-ektov-rf?territory=14000000> (accessed 27 March 2018).

10 According to estimates by Fitch Ratings, Claudia Carpenter, "Kuwait Is Best Off, Nigeria Worst in Fitch's 2017 Oil Break-Even", *Bloomberg*, 6 April 2017, <https://www.bloomberg.com/news/articles/2017-04-06/kuwait-is-best-off-nigeria-worst-in-fitch-s-2017-oil-break-even> (accessed 20 December 2017).

11 Rosstat, *Valovoj vnutrennij produkt* (see note 1).

12 World Bank Group, *Global Economic Prospects. Broad-Based Upturn, but for How Long?*, (Washington, D.C., 2018), 4.

13 Ibid.; Abramov, Radygin and Chernova, "State-Owned Enterprises" (see note 3).

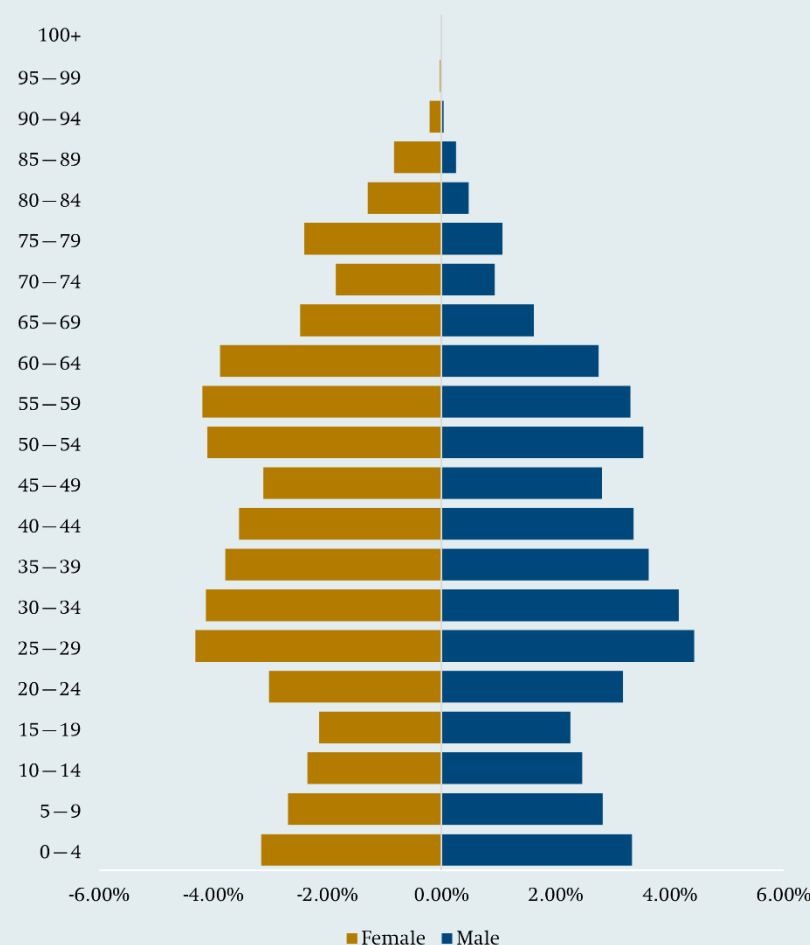
14 World Bank Group, *Searching for a New Silver Age in Russia. The Drivers and Impacts of Population Aging*, (Washington, D.C., 2015), 10.

15 Rosstat, *Demografija* [Demography], [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/population/demography/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/demography/#) (accessed 2 February 2018).

16 Vladimir Ruvinskij and Marija Zheleznova, "Krug i rossijskoj toksichnosti. Kak daleko mogut zajti posledstvija novych amerikanskich sankcij" [Ripple effects of Russian toxicity. How far the impacts of the new American sanctions

Figure 2

## Russian Population by Age Groups (2015)



Source: Diagram by author based on data from the United Nations, *World Population Prospects 2017*, <https://esa.un.org/unpd/wpp/> (accessed 5 May 2018).

The relatively low public debt (13.8 percent of GDP, including government guarantees)<sup>17</sup> currently poses no danger to Russian budgetary stability. In the near future, however, new sanctions by the USA could trigger a sell-off of government bonds (see inset box on page 11). Based on its analysis of budgetary risks in Russia, the IMF pointed out that the financial liabilities of government-controlled enterprises amounted

to at least 102 percent of GDP.<sup>18</sup> The majority of this was from government-controlled banks, whose share in the banking system had increased to 66 percent in 2017 due to the nationalization of troubled banks.<sup>19</sup> These liabilities are offset by assets, but there is no consolidated report available analyzing the fiscal risks of government-controlled enterprises for the budget, making these risks very difficult to quantify. Particu-

can go], *Vedomosti*, 29 October 2017, <https://www.vedomosti.ru/opinion/articles/2017/10/30/739760-krugi-toksichnosti> (accessed 23 January 2018).

<sup>17</sup> Minfin Rossii, *Gosudarstvennyj dolg* [Public Debt], 9 January 2018, [https://www.minfin.ru/ru/performance/public\\_debt/](https://www.minfin.ru/ru/performance/public_debt/) (accessed 26 January 2018).

<sup>18</sup> IMF, *Russian Federation: Fiscal Transparency Evaluation* (see note 3).

<sup>19</sup> Inna Grigor'eva, "Dolju gosudarstva v bankach chotjat ogranichit'" [State ownership in banks is to be limited], *Banki.ru*, 20 October 2017, <http://www.banki.ru/news/bankpress/?id=10070588> (accessed 26 January 2018).

## Effects of possible US sanctions on Russian government bonds

In the framework of the United States' Countering America's Adversaries Through Sanctions Act (CAATSA) in 2017, the Treasury Department was directed to submit a detailed report on the consequences of the United States imposing sanctions on Russian government bonds.<sup>a</sup> If the US president sanctioned existing government bonds, both eurobonds (a bond denominated in a foreign currency) and government bonds denominated in rubles (*Obligatsii Federal'nogo Zaima*, OFZ) would no longer be tradeable by foreign investors after a transitional period. The Russian government's eurobonds had a total value of \$49.8 billion in early 2018, one-third of which was held by non-resident investors (\$15.1 billion). The total value of the OFZ was 6.8 trillion rubles (€103.5 billion), although bonds with a volume of 2.3 trillion (€35.4 billion) were held by foreigners.<sup>b</sup>

If sanctions were imposed on existing Russian government bonds, many foreign investors would have to sell their holdings quickly. As a result, more capital would flow out of Russia and the ruble would come under downward pressure. Estimates suggest that the ruble would depreciate by around 10 percent,<sup>c</sup> accompanied by higher rates of inflation.<sup>d</sup> Returns on Russian government bonds would also increase, although the

Head of the Central Bank of Russia, Elvira Nabiullina, estimated that this effect would be 0.3–0.4 percent. Other estimates predict a much larger increase of 2 percent. In 2017, returns fluctuated between 7.5 and 8.5 percent.<sup>e</sup>

In its 2018 report on this sanction mechanism, the US Treasury warned of much stronger repercussions that could even go as far as destabilizing Russian financial markets. The report focused, however, on a more benign variant that would only impose sanctions on new bonds issuance. Yet even in this case, if investors reacted to the potential sanctions with preemptive caution, the results could affect current bond holdings as well.<sup>f</sup>

In the short term, the effects of the sanctions would be clearly palpable in Russia, but the potential for new domestic borrowing would not be threatened. The Central Bank has announced that in the case of a sell-off by foreign investors, it would intervene by purchasing bonds. The Finance Ministry is also working to reduce its vulnerability to sanctions by issuing its first bond on China's capital market and by issuing what are known as "people's bonds", government federal bonds for private individuals in Russia.<sup>g</sup>

**a** "Minfin Rossii ne stanet forsirovat' vypusk evrobondov iz-za sankcij SŠA" [Russia's Finance Ministry will not force the issuance of eurobonds due to US sanctions], in: *Vedomosti*, 18 December 2017, <https://www.vedomosti.ru/finance/news/2017/12/18/745646-minfin-rossii-ne-stanet-forsirovat-vipusk-evrobondov-iz-za-sanktsii-ssha> (accessed 26 January 2018).

**b** Bank Rossii, *Nominal'nyj ob'em obligacij federal'nogo zaima (OFZ), prinadlezhashchich nerezidentam, i dolja nerezidentov na rynke* [Nominal value of foreign-held OFZ and the share held by non-resident investors], [http://www.cbr.ru/statistics/credit\\_statistics/debt/table\\_ofz.xlsx](http://www.cbr.ru/statistics/credit_statistics/debt/table_ofz.xlsx); *ibid.*, *Vlozhenija nerezidentov v evroobligatii Rossijskoj Federacii* [Foreign investments in eurobonds of the Russian Federation], [http://www.cbr.ru/statistics/credit\\_statistics/debt/72\\_eurobonds.xls](http://www.cbr.ru/statistics/credit_statistics/debt/72_eurobonds.xls); Minfin Rossii, *Gosudarstvennyj vneshnij dolg Rossijskoj Federacii (2011–2018 gg.)* [Government foreign debt of the Russian Federation (2011–2018)], [https://www.minfin.ru/common/upload/library/2018/05/main/Obem\\_gos.vnesh.dolga\\_20180501.xlsx](https://www.minfin.ru/common/upload/library/2018/05/main/Obem_gos.vnesh.dolga_20180501.xlsx) (all accessed 8 June 2018).

**c** Danil Sedlov and Julija Titova, "Vozhidanii sankcij. Kak amerikancy mogut obrushit' rubl'" [In expectation of sanctions. How the Americans could cause the ruble to collapse], *Forbes*, 21 November 2017, <http://www.forbes.ru/finansy-i-investicii/353045-v-ozhidanii-sankcij-kak-amerikancy-mogut-obrushit-rubl> (accessed 2 February 2018).

**d** Tat'yana Lomskaya, "Centrobank minimal'no snizit stavku iz-za ugrozy novych sankcij" [Central Bank reduces prime interest rate minimally due to the danger of new sanctions], *Vedomosti*, 14 December 2017, <https://www.vedomosti.ru/economics/articles/2017/12/14/745198-tsntrobank-snizit-stavku> (accessed 2 February 2018).

**e** For 10-year government bonds denominated in rubles (OFZ).

**f** Erik Wasson/Saleha Mohsin, "Treasury Warns of Upheaval If U.S. Sanctions Russian Debt", *Bloomberg.com*, 2 February 2018, <https://www.bloomberg.com/amp/news/articles/2018-02-02/treasury-warns-of-widespread-effects-of-russian-debt-sanctions> (accessed 5 February 2018).

**g** *Ibid.*; Sedlov and Titova, "Vozhidanii sankcij" (see note c).

larly Russian banking supervision has proven in the past to be often inadequate.<sup>20</sup>

However, for Russia, the risk of financial insolvency is currently very low. Recent western financial

market sanctions also caused total foreign debt (government and private) to fall to \$529.1 billion. At the same time, the Central Bank's monetary reserves were around \$449.8 billion in February 2018. Russia would

**20** Andrey Movchan, "How to Fix Russia's Broken Banking System", *Financial Times*, 14 January 2018, <https://www.ft.com/content/b90754a8-f7c0-11e7-a4c9-bbdefa4f210b> (accessed 15 January 2018).



be able to use these funds to pay for its current imports for 19 months.<sup>21</sup>

## Russia's hidden liabilities

It would be short-sighted to attribute Russia's budget difficulties solely to the surprisingly sharp drop in the oil price. The budget will continue to fluctuate between deficit and surplus with the ups and downs in energy prices in the future. Long-term budget forecasts predict, however, that the surpluses will occur less often, and that the deficits will be deeper.

Of course, a number of parameters for long-term budget forecasts are uncertain, particularly future economic growth and commodity prices. Nevertheless, the high predictability of demographic developments allows for an approximate calculation of future burdens. Russian experts have long pointed out that the situation would worsen in the 2020s and beyond. As early as 2013, economists at the Gaidar Institute in Moscow warned that government revenues were likely to fall progressively further below expenditures in the long term.<sup>22</sup> According to their estimates, all taxes would have to be raised by 49 percent or all expenditures reduced by 33 percent in order to balance future public budgets. Russia's long-term "fiscal gap" of 14.6 percent of GDP per year — that is, the disparity between all future revenues and all future expenditures — is, according to the economists' estimates, even greater than that of countries that are deeply in debt today, such as Greece, Belgium, and Japan (10 percent each) as well as Germany (5 percent).<sup>23</sup> The gap is only gradually widening. Up to 2050, the forecast based on 2015 tax rates is an annual deficit of 11.7 percent of GDP (with expenditures increasing to 40.7 percent and revenues falling to 29 percent of GDP).<sup>24</sup>

21 Bank Rossii, *Vneshniy dolg Rossijskoj Federacii* [Foreign debt of the Russian Federation], [http://www.cbr.ru/statistics/credit\\_statistics/debt/debt\\_new.xlsx](http://www.cbr.ru/statistics/credit_statistics/debt/debt_new.xlsx) (accessed 6 August 2018).

22 Eugene Goryunov et al., *Russia's Fiscal Gap*, NBER Working Paper 19608 (Cambridge, MA: National Bureau of Economic Research, November 2013).

23 To calculate fiscal debt, all future government spending is deducted from all future tax revenues (at the respective current prices). For international comparability, this value is expressed as a percentage of future GDP (at current prices).

24 Evgeny Goryunov, Lawrence Kotlikoff and Sergey Sinelnikov-Murylev, "The Fiscal Gap. An Estimate for Russia", *Russian Journal of Economics* 1, no. 3 (2015): 250–51.

**As the financial room to manoeuvre diminishes, the Russian government is forced to raise taxes and make people work longer into old age.**

In comparable calculations, the World Bank estimates that Russian public debt could increase to 116 percent of GDP by 2050, although as much as 250 percent is possible depending on how productivity, demographics, and the oil price develop.<sup>25</sup> The tax rates and pension levels assumed in these studies have already changed since Putin's fourth term began in 2018. The studies do, however, clearly reveal what a comfortable situation the Russian treasury has enjoyed for the last 20 years. As the financial room to manoeuvre continues to diminish due to demographic developments, the Russian government is being forced to raise taxes and make people work longer into old age.

Demographic change is a burden on budgets because it comes with a declining rate of employment, which causes government expenditures, especially within the pension system, to increase. Russia's cumulative additional spending on pensions because of demographic change alone is estimated by the IMF to reach 97.9 percent of GDP by 2050.<sup>26</sup> A similar level of reserves (instead of the close to 5 percent in the Russian welfare funds in 2018) would be required to counterbalance the impacts of demographic change on the current tax system up to 2050.

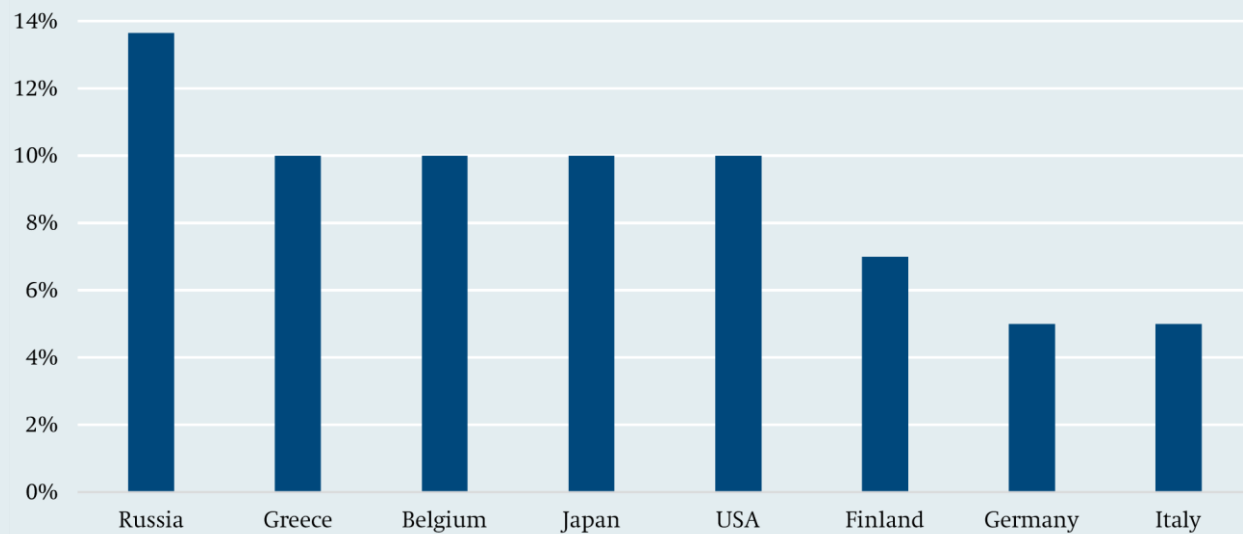
The reason for the negative forecasts is not just Russia's demographic development, but also the predicted stagnation of oil and gas production. The World Bank expects annual oil production in Russia to fall from 547.5 million tons in 2016 to 436 million tons by 2050. At the same time, gas production is expected to increase slightly, causing Russian the value of overall energy production to remain at 2017 levels up to 2050.

It is problematic for Russia that such an important economic sector — one that was responsible for over half of Russian exports in 2017 — is predicted to show no growth. For countries that face significant demographic challenges, the solution typically centers around "growing out" of the expected burdens.

25 World Bank Group, *Balancing Economic Adjustment and Transformation*, Russia Economic Report 34 (Washington, D.C., 2015), 46.

26 IMF, *Fiscal Monitor*, October 2013. *Taxing Times* (Washington, D.C., October 2013), 81.

Figure 3

**Russia's long-term fiscal gap compared to other countries (in % of GDP)**

Source: Evgeny Goryunov, Lawrence Kotlikoff and Sergey Sinelnikov-Murylev, "The Fiscal Gap. An Estimate for Russia", *Russian Journal of Economics* 1, no. 3 (2015): 254.

The dominance of resource exports is thus a stumbling block on the path out of future debt.

For the Russian economy, the best chances of long-term growth lie outside of oil and gas. Companies outside the energy sector are much more dependent, however, on the provision of public goods. They require higher public investments than gas and oil producers, for instance, in infrastructure or the educational system. Improving the neglected economic potential outside the energy sector would therefore initially require increased government expenditures.<sup>27</sup>

This reveals the dilemma currently facing the Russian leadership: on the one hand, major investments and possibly expensive structural reforms are needed to escape the long-term debt trap through growth. On the other hand, it is necessary to rapidly build reserves to pay for future pensions. Due to the current overall low percentage of government revenues (33.7 percent of GDP in 2017), Russia has to make more significant changes in relative terms than, for instance, Belgium (51.1 percent of GDP), which is confronted with a comparable increase in expen-

ditures — and these changes will have a palpable impact on the Russian population.<sup>28</sup>

### Volatile oil price putting a strain on budget discipline

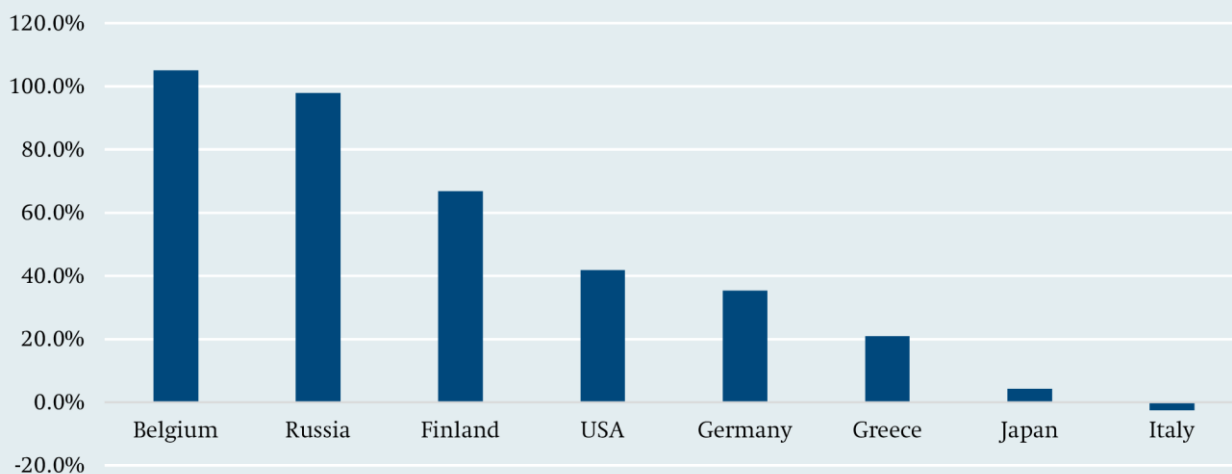
The Finance Ministry's reserves were the pride of Russian fiscal policy in the 2000s, but Russia's sovereign wealth funds were never comparable in size to those of other oil-producing countries. In the United Arab Emirates, Norway, and Saudi Arabia, reserves amount to over 100 percent of GDP. In early 2009, Russian reserves reached their highest level to date at 16 percent of GDP. In 2015, just 11 percent of GDP remained. One of the two sovereign wealth funds (the reserve fund) was then used up entirely to cover budget deficits, and at the end of 2017 it was dissolved. The reserves in the second fund (national welfare fund) still made up 3.9 percent of GDP at the end

<sup>27</sup> Ibid.; World Bank Group, *Balancing Economic Adjustment and Transformation* (see note 25).

<sup>28</sup> On Belgian government revenue, see Economist Intelligence Unit, *Belgium. Annual Data and Forecast*, <https://country.eiu.com/article.aspx?articleid=1866770970&Country=Belgium> (accessed 8 June 2018). On Russian revenue, see Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* (see note 1).



Figure 4

**Change in expenditures for the pension system up to 2050 (in % of GDP)**

Source: IMF, *Fiscal Monitor*, October 2013. *Taxing Times* (Washington, D.C., October 2013).

of 2017, but this was only partially invested in liquid assets (2.3 trillion rubles, or €35 billion) and thus could only partially be used to cover future deficits.<sup>29</sup> Although the welfare fund was designed to provide long-term protection for the pension system, some of the funds were used for high-risk financing of state-owned businesses and infrastructural projects such as the 2014 Winter Olympics in Sochi. The partial misuse and low volume of the reserve funds show the monumental political difficulties the government in Moscow is facing when it comes to sustainable management of Russia's resource wealth.

Up to now in Russia, fiscal rules have had a limited lifespan, regularly falling victim to the temptations of an expansive fiscal policy. The first fiscal rule, introduced in 2004 under then Finance Minister Alexei Kudrin, stipulated that just part of the surging oil and gas revenues could be used for current spending. This freely usable part was determined by calculating revenues based on a fictitious oil price of \$20: All revenues above this level had to be transferred to a "stabilization fund." In light of the rising oil prices, the rule was weakened in the year 2007 and a new threshold value of \$27 was set. In 2008, a new rule was established that again raised the threshold value to

\$45. This second rule was suspended in the following year to allow the additional funds to be used for a comprehensive stimulus package during the financial crisis. The third rule (\$91, introduced in 2012) already became obsolete shortly after its introduction, when the oil price fell by half in 2014.<sup>30</sup>

As of early 2018, Russia has a new fiscal rule in place, again with a low oil price of just \$40 as its threshold value. Budget plans for the years 2018 to 2020 are based on annual oil and gas revenues of only around 5 percent of GDP. The oil price in fact rose to over \$60 at the end of 2017 and to around \$70 in 2018, so revenues should be higher than estimated. Whether or not the Russian government will exercise the necessary fiscal discipline remains questionable in view of the short lifespan of past fiscal rules.

<sup>29</sup> Pravitel'stvo Rossii, *Zasedanie Pravitel'stva 7 December 2017* [Meeting of the Government, 7 December 2017], <http://government.ru/news/30441/> (accessed 26 January 2018).

<sup>30</sup> Dmitry Butrin, "Bjudzhetnoe pravilo 4.0" [Budget rule 4.0], *Kommersant*, 6 June 2017, <https://www.kommersant.ru/doc/3318593> (accessed 6 June 2017).

## Fiscal Rules

Fiscal rules are legal provisions that are designed to ensure the long-term sustainability of budget policy. A fiscal rule is also enshrined in the German constitution in the form of the “debt brake”, (Basic Law, Art. 109 and 115), which limits new structural debt to 0.35 percent of GDP.<sup>a</sup>

When a country exports a large amount of its (finite) resources, a fiscal rule can be used to establish that only a portion of the revenues will be used and the rest will be saved. This ensures that future generations will also profit from the country’s resource wealth and isolates the government budget to some extent from major commodity price fluctuations. Fiscal rules can help to reduce negative effects of commodity exports on other economic sectors, known in economic jargon as the “Dutch disease”.

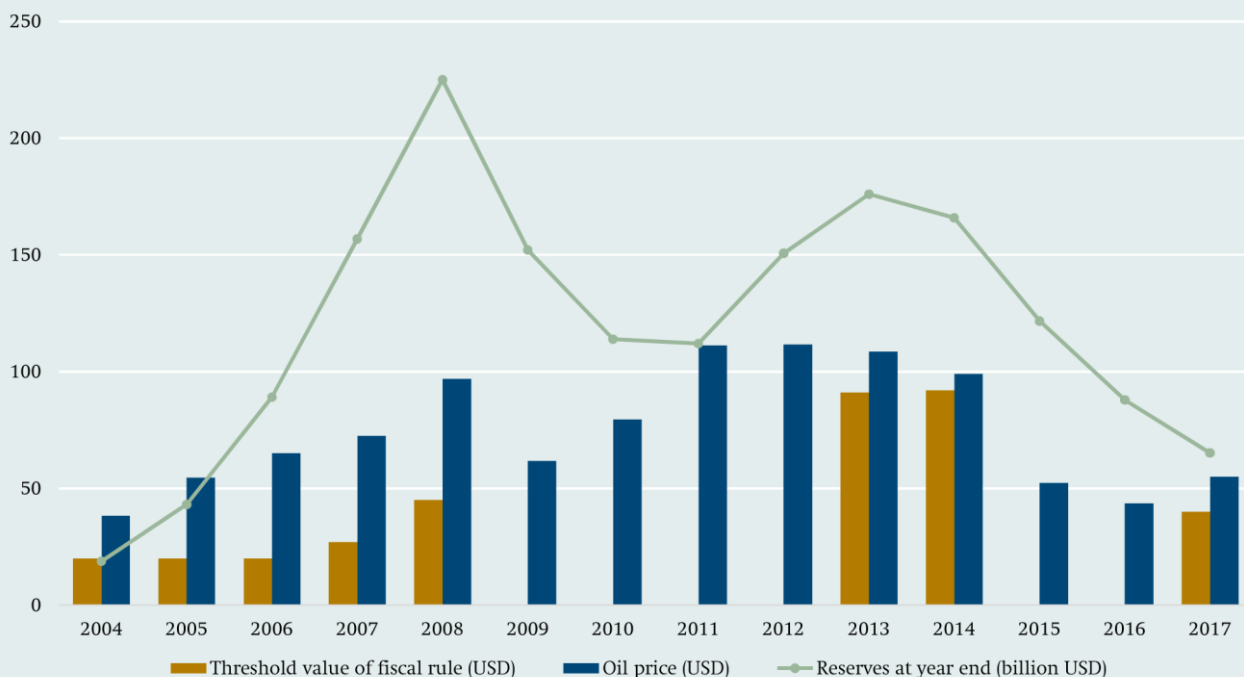
Government reserves are generally invested in low-risk foreign securities such as US or European government bonds. This prevents currency appreciation in boom periods and protects reserves from depreciation in times of crisis. If the fiscal rule is followed closely, pro-cyclical fiscal policy – that is, a fiscal policy that intensifies cyclical economic effects – becomes less likely, and the financial and political risks of fluctuating commodity prices sink. Comparative studies show, however, that fiscal rules are only effective in the long term under specific institutional conditions.<sup>b</sup> In Norway, for instance, an independent parliament, independent courts of law, and political competition would make it very difficult for the government to weaken its fiscal rule. In Russia, in contrast, there is no entity that could protect the fiscal rule from a change of priorities in the Kremlin.

**a** Christian Kastrop, Gisela Meister-Scheufelen, Margaretha Sudhof and Werner Ebert, “Konzept und Herausforderungen der Schuldenbremse” [Concept and challenges of the debt brake], *Aus Politik und Zeitgeschichte* 62, no. 13 (2012), <http://www.bpb.de/apuz/126016/konzept-und-herausforderungen-der-schuldenbremse?p=all> (accessed 9 March 2018).

**b** IMF, *The Commodities Roller Coaster. A Fiscal Framework for Uncertain Times* (Washington, D.C., October 2015), 8, <http://www.imf.org/en/Publications/FM/Issues/2016/12/31/The-Commodities-Roller-Coaster> (accessed 11 August 2017).

Figure 5

### The Finance Ministry’s fiscal rule, oil price, and reserves



Sources: Reserves and oil price: Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* (see also note 1); Fiscal rule: Dmitrij Butrin, “Bjudzhetnoe pravilo 4.0” [budget rule 4.0], *Kommersant*, 6 June 2017, <https://www.kommersant.ru/doc/3318593>.

# Obstacles in Budget Policy

Budget imbalances in recent years have significantly increased pressure on the Russian government for reforms. A second or third “2016” with oil prices around \$40 could make it necessary to implement austerity measures, which would further threaten the regime’s popularity.

Until recently, the Russian Finance Ministry has had few policy options to substantially increase revenues. At the end of 2014, President Putin announced a moratorium on tax increases that would apply up to the 2018 presidential election.<sup>31</sup> The Finance Ministry nevertheless attempted to boost federal revenues through a variety of smaller adjustments. For instance, the government sold its shares in oil producers Rosneft and Bashneft. Capital accumulation, one of the pillars of the Russian pension system, was suspended in favor of a pay-as-you-go system so that all contributions could go toward ongoing pension payments. In the case of the corporate income tax, the possibilities for companies to carry forward losses have been limited.<sup>32</sup> At the same time, a portion of the revenues from the corporate income tax has been shifted from the regional to the federal budget.<sup>33</sup> Production taxes for the oil industry were increased, while the planned reduction of export tariffs was postponed.<sup>34</sup> To balance the effects of the increased

oil production tax on the Russian fuel market, a reduction of the gasoline tax was planned,<sup>35</sup> but instead, the gasoline tax was significantly increased as well,<sup>36</sup> and like with the corporate income tax, revenues were redistributed from regional budgets to the federal budget.<sup>37</sup> The attempt to increase dividends from state-controlled joint stock companies partially failed, however, due to these companies’ resistance.<sup>38</sup>

## The Finance Ministry attempted to increase federal revenues through a series of smaller adjustments.

Part of the losses in oil revenues were absorbed in this way, but the majority of measures implemented are not sufficient to increase tax revenues on a long-term basis. Either they could only be implemented once (privatization) or they increased current tax revenues at the expense of future budget years (pensions, corporate income taxes). The redistribution of regional revenues will not ease the federal budget in the long term because Moscow will ultimately have to take the responsibility for regional debt.

Before the tax and retirement age adjustment announced in 2018, the biggest adjustments were planned on the expenditure side. General govern-

31 Sergej Titov, “Putin prizval vvesti moratorij na izmenenie nalogovoj nagruzki” [Putin called for a moratorium on the change in the tax burden], *Vedomosti*, 4 December 2014, <https://www.vedomosti.ru/finance/articles/2014/12/04/putin-prizval-vvesti-moratorij-na-izmenenie-nalogovoj> (accessed 31 December 2017).

32 “Perenos ubytkov v 2017 godu” [Loss carried forward in 2017], *Buhgalterija.ru*, 17 January 2017, <http://www.buhgalterija.ru/article/n154921> (accessed 24 August 2017).

33 Elizaveta Bazanova, “Pochti 100 mlrd rublej zarabotajut regiony na nalogovykh izmenenijach” [Regions to gain almost 100 billion rubles through tax changes], *Vedomosti*, 2 March 2017, <https://www.vedomosti.ru/economics/articles/2017/03/02/679613-zarabotajut-regioni-nalogovih-izmenenijach> (accessed 24 August 2017).

34 Fares Kil’zie, “NDPI: differencirovat’, a ne podnimat’” [NDPI (= extraction taxes): Differentiate, don’t raise], *Vedomosti*, 10 March 2016, <https://www.vedomosti.ru/opinion/articles/2016/03/10/632959-ndpi> (accessed 1 September 2017).

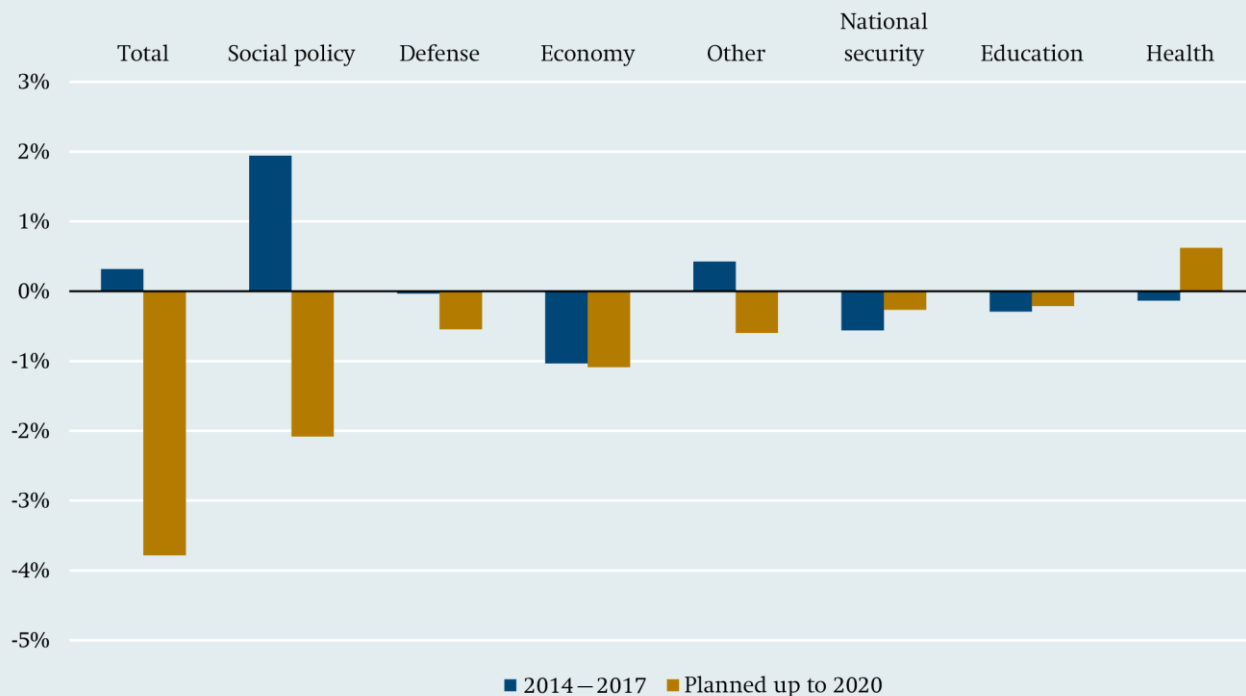
35 Yuri Barsukov, “V bjudzhet dol’jut benzina. Neftjaniki chotjat razdelit’ nalogovoe bremja s potrebiteljami” [The budget is being filled up with gas], *Kommersant*, 15 September 2016, <https://www.kommersant.ru/doc/3089123> (accessed 28 January 2018).

36 Ol’ga Mordjushenko, “Dorogie akcizy — regulirovanie rynka” [High excise taxes — market regulation], *Kommersant*, 14 April 2016, <https://www.kommersant.ru/doc/2962740> (accessed 31 August 2017).

37 Ekaterina Mereminskaya and Ol’ga Adamchuk, “1 rubl’ ot Putina” [1 ruble from Putin], *Vedomosti*, 23 June 2017, <https://www.vedomosti.ru/economics/articles/2017/06/23/695653-rubl-putina> (accessed 30 August 2017).

38 See below, p. 33.

Figure 6

**Past and planned changes in spending (in percent of GDP) as of May 2018**

Source: Calculations by author based on Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* [Financial and economic indicators of the Russian Federation], <https://www.minfin.ru/ru/statistics/>

ment spending in 2017, 35.2 percent of GDP, was unaffected by the fall in the oil price to 2014 levels (34.9 percent). The federal portion thereof fell slightly from 18.7 percent to 17.8 percent. Significantly more radical steps are planned for the years to come: the budget adopted at the end of 2017 for the period 2018–2020 envisions a reduction in federal spending to 15.6 percent of GDP.

Looking at the spending categories in detail, the political sensitivity of these planned cuts becomes apparent: Two thirds of budget cuts are planned in the categories of defense (planned cuts of 17.6 percent)<sup>39</sup> and social policy (16 percent) – areas in which virtually no cuts have been achieved up to 2017. Spending cuts in both of these areas are risky for the Russian leadership since they will affect the Kremlin's most important supporters. Under President Vladimir Putin, social policy and the defense sector were developed with the explicit aim of bolstering the regime's

legitimacy. Yet these sectors contribute little to Russian economic growth. The question of whether the Russian regime will succeed with its spending adjustments or whether a long-term destabilization of government finances is imminent will be determined above all in these two policy areas.

### Social and pension policy is becoming more expensive

According to the 2018–2020 budget plan, the largest budget cuts relative to 2017 measured in percentage of GDP will be in the area of social policy. Including regional budgets and extrabudgetary funds, a decline of 2.1 percent of GDP is planned up to 2020, including a 1.0 percent of GDP cut in the federal budget's social spending.

The social policy component of the budget is comprised largely of social benefits received by the population in the form of monetary transfers. The bulk of these (around 80 percent) consists of pension

<sup>39</sup> All relative figures refer to changes in spending relative to GDP.

Figure 7

**Russia's population below the poverty line, 2005–2016 (in millions of people)**

Source: Rosstat, *Neravenstvo i bednost'* [inequality and poverty], [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/population/poverty/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/population/poverty/#) (accessed 2 February 2018).

payments. This budget item does not provide a complete picture of all of the Russian government's social policy activities, however. Some measures that are designed to protect socially or economically disadvantaged segments of the population are financed through other budget categories such as health and education.

In many ways, Russia faces similar social policy challenges to other post-Soviet states. Rapidly increasing inequality and high poverty rates have lent increased urgency to questions of social justice and redistribution since the end of the Soviet Union. The population's expectations about what the government should provide are rooted in their experience in the Soviet welfare state. Redistribution plays a central role in the implicit social contracts within the region: citizens forego political participation in exchange for socio-economic stability. Reforms of the social system often meet with opposition from the population. Society's acceptance of government social policy is

therefore a key condition for the stability of the political system.<sup>40</sup>

### **The informal sector impedes targeted redistribution**

In Russia, over 80 percent of fiscal redistribution of income is achieved through pensions. This helps to attenuate the inequality in market incomes, which is extremely high by international comparison.<sup>41</sup> Nevertheless, 20 million Russians live in poverty according to official Russian statistics. Economic growth in the 2000s and rapidly rising pensions in the period that

<sup>40</sup> A theoretical discussion of the connection between social policy and regime stability can be found in Franziska Smolnik, *Sozialpolitik und Regimestabilität im Südkaukasus. Das Beispiel Rentenreform*, SWP-Studie 10/2017 (Berlin: Stiftung Wissenschaft und Politik, May 2017).

<sup>41</sup> The Gini coefficient of income is 0.49 for market incomes, 0.30 after redistribution, World Bank Group, *The Russian Economy Inches Forward. Will that Suffice to Turn the Tide?* Russia Economic Report 36 (Washington, D.C., November 2016).

followed caused the poverty rate to decline. Starting in 2014 with the economic crisis, poverty increased again. Pension levels are low by international comparison, at just 36 percent of average income. The majority of social transfers in Russia also do not go to the poorest sectors of the population but are distributed in a relatively indiscriminate way across income groups. This can be seen, for instance, in the basic pension: As a component of monthly pension payments, the basic pension is intended to guarantee a minimum level of social security. Pension rates are therefore differentiated into various categories of pension recipients or degrees of need. An evaluation of population census data from 2012 showed how badly this system is working: Only 20 percent of basic pensions paid ended up with the 20 percent poorest pension recipients.<sup>42</sup> The unsystematic distribution of these funds means that the Russian government has to pay more than other countries for social policy in order to achieve a comparable reduction in inequality.

An important reason for the relative lack of focus in social benefits is that the informal sector makes up a large percentage of the Russian economy. In 2015, informal income made up 26.2 percent of total private household income. According to official data, around 21.2 percent of all workers were employed informally in 2016.<sup>43</sup> Informal employment and the widespread employer practice of paying part of workers' salaries in cash without withholding taxes ("in the envelope") makes it more difficult for Russian authorities to clearly identify the actual level of benefit recipients' need. This in turn makes it very hard to provide social support to meet existing needs in a targeted way. Thus, pension recipients in informal employment receive their full government pension even though they are only eligible to receive a percentage thereof. Furthermore, workers in informal employment do not pay contributions into the social funds. Measures designed to ensure that transfers are better targeted to existing needs could have a counterproductive effect, however: if government benefits were made to depend more heavily on formal wages and salaries, there would be the risk of more pension

recipients attempting to engage in undeclared work, which would mean further growth in the informal sector.<sup>44</sup>

## Pensioners benefit from redistribution

Overall, despite low pensions, pensioners in Russia are a net beneficiary of government redistribution. The legally guaranteed minimum pension is oriented toward a subsistence level of income calculated specifically for pensioners (as of 2017: 8500 rubles per month, or €129), which is slightly below the general poverty threshold (10,300 rubles per month, or €157). The proportion of pensioners living in poverty is, at 12.2 percent, below their proportion in the total population (21.6 percent). The losers in this "horizontal" redistribution across different demographic groups are families and adults living alone, who make up an overproportional percentage of the poor population. Redistribution from rich to poor ("vertical redistribution") scarcely takes place at all through the Russian government's tax and social policy.

The World Bank suspects that political considerations could be behind the privileged position accorded to pensioners, who play an important role as active voters and supporters of the Russian regime.<sup>45</sup> Surveys confirm the importance of this group: not only is support for Vladimir Putin highest in the 60+ age group (88.8 percent of the vote); in the 2018 presidential election, expected voter participation in the 60+ age group was significantly above that in the young adult age group (18–24 years), at 86 percent and 47 percent, respectively.<sup>46</sup> Opposition leader Alexei Navalny, in contrast, is regarded with skepticism

<sup>44</sup> Tax policy faces a very similar problem: a more progressive income tax could create a fairer distribution of the tax burden. But introducing such a tax would entail the risk that the informal sector of the economy could continue to grow; see World Bank Group, *The Russian Economy Inches Forward* (see note 41), 35.

<sup>45</sup> Luis F. López-Calva, Nora Lustig, Mikhail Matytsin et al., "Who Benefits from Fiscal Redistribution in the Russian Federation?", in *The Distributional Impact of Taxes and Transfers. Evidence from Eight Low- and Middle-Income Countries*, ed. Gabriela Inchauste and Nora Lustig (Washington, D.C.: World Bank Group, 2017), 223.

<sup>46</sup> "VCIOM: 70% oproshennykh rossijan zayavili, chto namereny priyti na vybory prezidenta RF" [VCIOM: 70 percent of Russians surveyed stated that they are planning to vote in the RF presidential election], TASS, 20 December 2017, <http://tass.ru/obschestvo/4826581> (accessed 27 March 2018).

<sup>42</sup> Evsey Gurvich and Juliya Sonina, "Mikroanaliz rossijskoj pensionnoj sistemy" [Microanalysis of the Russian pension system], *Voprosy ekonomiki*, no. 2 (2012): 27–51.

<sup>43</sup> Anna Mogilevskaya, Anton Fejnberg and Ivan Tkachëv, "Neformal'naya ekonomika v Rossii vyroslo do rekordnykh razmerov" [Informal economy in Russia grew to record level], RBC, 17 April 2017, <https://www.rbc.ru/economics/17/04/2017/58f4b8789a7947c1418ff1af> (accessed 26 January 2018).

by the older generation. In the Moscow's 2013 mayoral election, where Navalny ran against Kremlin-backed candidate Sergei Sobyenin, the 60+ age group voted 70 percent for Sobyenin and just 14 percent for Navalny. In the 18–24 age group, Navalny beat Sobyenin with 53 to 35 percent of the vote.<sup>47</sup>

The pension system is becoming more expensive for Russia every year, as the percentage of the population that is dependent on government transfers grows. The proportion of pension recipients to employed people is shifting in Russia (as in many European countries), meaning that the pension fund depends on increasing transfers from the federal budget. A series of historically induced “demographic dips” in Russia have made this shift especially severe: Rosstat, the Russian statistical agency, predicts that the working-age population will shrink by 5 percent between 2018 and 2024, while the number of retired people will increase by 9.3 percent in the same period. This will require substantial transfers from the federal budget to the pension funds: In 2016, contributions to the pension funds amounted to 4.8 percent of Russian GDP, while pension payments were at 7 percent of GDP. The funding gap, which made up 2.2 percent of GDP in 2016, could rise to 3.3 percent of GDP by 2024 due to the country's changing demographics.<sup>48</sup> An increase in the retirement age in Russia — which is currently 55 for women and 60 for men — has been called for repeatedly by the Finance Ministry and economists, but was not implemented for many years due to explicit opposition from the Russian president.<sup>49</sup> Only in June 2018, after the presidential election, did Prime Minister Dmitri Medvedev announce that the government would raise the

retirement age and the value-added tax in 2019, causing Putin's popularity ratings to plummet.<sup>50</sup>

## Return to paternalism

The Kremlin's resistance to pension system reforms can be explained by the uniquely important role social policy plays in providing legitimacy to the Russian regime. While Putin pursued unpopular reforms inspired by economic liberalism in his first term of office, he embarked on a significant change of course in 2005. As a result, Russia again became a more paternalistic welfare state with a number of Soviet elements.<sup>51</sup>

This change is considered to have been triggered by the wave of protests that engulfed all of Russia in the summer of 2004. The demonstrations were against what is known as the “monetization of privilege” (*monetizatsiya lgot*). The government wanted to eliminate special benefits for specific population groups like retirees and veterans (free use of public transport, free medications, health resort stays, etc.) and replace them with means-tested financial benefits. The protests soon led to the formulation of new political demands and focused increasingly on President Putin himself.<sup>52</sup> The trust rating in the Russian president, a polling statistic compiled by the Levada Center, an independent public opinion research institute, reached a new low in 2005 at 38 percent.<sup>53</sup> The demonstrations showed the extremely high willingness of pension recipients to mobilize politically.

47 “Vyborny v Moskve i Ekaterinburge: kto planiroval i kto prishel?” [Elections in Moscow and Yekaterinburg: Who planned to come and who came?], *WCIOM* (online), 25 September 2013, <https://wciom.ru/index.php?id=236&uid=114510> (accessed 27 March 2018).

48 Calculations by author based on the budget of the pension fund, Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* (see note 1), and the evolution of employment figures: Rosstat, *Demografija* (see note 15). Assumption: pension payments and contributions develop proportionally to the population and GDP growth.

49 “Putin rasskazal o svoem soprotivlenii povysheniju pensionnogo vozrasta” [Putin expressed his resistance to the increase in the retirement age], *RBC*, 17 December 2015, <https://www.rbc.ru/rbcfreenews/56729d879a794709f72589e6> (accessed 28 January 2018).

50 Janis Kluge, *Kremlin Launches Risky Pension Reform. Plan to Raise Retirement Age Undermines Confidence in Russian Leadership*, SWP Comment 28/2018 (Berlin: Stiftung Wissenschaft und Politik, July 2018).

51 Linda J. Cook, “Russia's Welfare Regime: The Shift toward Statism”, in *Gazing at Welfare, Gender and Agency in Post-Socialist Countries*, ed. Maija Jäppinen et al. (Newcastle upon Tyne, 2011), 14–37.

52 Irina Petrakova and Vadim Biserov, “L'gotniki sozhgli Putina” [Benefit recipients burned Putin], *gazeta.ru*, 28 February 2005, [https://www.gazeta.ru/2005/02/28/oa\\_149600.shtml](https://www.gazeta.ru/2005/02/28/oa_149600.shtml) (accessed 19 December 2017).

53 “Rejting Putina upal do istoricheskogo minimuma” [Putin's approval rating fell to historic low], *Lenta.ru*, 7 July 2005, <https://lenta.ru/news/2005/07/07/rating/> (accessed 28 January 2018).



## As oil prices rose, the pension system increasingly became an instrument for the redistribution of windfall tax revenues.

The Kremlin reacted quickly: In Putin's April 2005 speech before the Russian Federal Assembly, he declared social policy to be the most important task facing all levels of government. The government drafted a series of development programs with a significantly different focus from previous liberal-oriented reform plans. New transfers and benefits were introduced without the requirement of thorough means-testing. The "maternity capital" incentive – a one-time payment of the equivalent of €17,000 (purchasing power parity in the year the incentive was introduced) to mothers on their child's third birthday – became the government's showpiece, symbolizing the new direction of its social policies.

A media campaign flanked the return to a more paternalistic social policy. According to an analysis published in the state newspaper *Rossiyskaya Gazeta* on how social problems are reported on in Russia, media coverage starting in 2005 was aimed at presenting the government as the vanquisher of social problems. During the presidential election years 2008 and 2012 in particular, praise far outweighed critique of the government's social policies in media reports on poverty, inequality, and discrimination.<sup>54</sup>

Russia's expansive spending policy continued even after Putin moved to the position of Prime Minister in 2008. Against the backdrop of rising oil prices, the pension system increasingly became a rentier-state type instrument for the redistribution of windfall tax revenues.<sup>55</sup> Inflation-adjusted pension payments in-

creased 76 percent in the period 2007–2010 through annual pension increases and a revaluation of previous years of work. This was intended mainly to shield the population from the impacts of the 2009 economic crisis. Yet in 2010, when the economy was growing again at a rate of 4.5 percent, pension payments increased further. Public transfers played an increasingly important role in the continuous increase in Russians' incomes, while private-sector wages made only a minor contribution to economic growth, especially after 2010.<sup>56</sup>

## Pensions increase oil dependence

The large volume of pension payments and social benefits posed a particular risk to Russian budget stability: On the one hand, falling oil prices reduced government revenues, which are needed to finance transfers. An added challenge was that spending on social policy increased during the oil price slump. Since the dropping oil price meant that the ruble declined in value as well, imported consumer goods in Russia became more expensive, and consumer goods prices rose overall.<sup>57</sup> Pension and social benefit recipients in Russia are legally guaranteed adjustment of their benefits for inflation. Due to this "scissors effect", with revenues and expenditures moving in opposite direction, social policy spending exacerbates the Russian budget's dependence on oil.

When federal tax revenues fell nominally by 6 percent, pensions had to be increased nominally by 11.4 percent at the same time to compensate for the previous year's inflation (additional spending amounting to 1 percent of GDP). In 2016 as well, tax revenues fell nominally, while pensioners were due another inflation adjustment of 12.9 percent. With its reserves dwindling rapidly, the Finance Ministry pressed for an exemption to this rule. The Kremlin stalled on passing the resolution: first, the 2016 inflation adjustment was split into two parts, with a first increase of 4 percent in early 2016 and a second announced for the fall. This second increase did not take place, however: It was replaced by a one-time payment of 5,000

<sup>54</sup> Elena Iarskaia-Smirnova, Daria Prisyazhnyuk and Rostislav Kononenko, "Representations of Inequality and Social Policy in the Russian Official Press, 2005–2012", *Journal of European Social Policy* 26, no. 3 (2016): 268–80.

<sup>55</sup> On Russia, see also Alfio Cerami, "Welfare State Developments in the Russian Federation. Oil-led Social Policy and 'The Russian Miracle'", *Social Policy & Administration* 43, no. 2 (2009): 105–20; Andreas Heinrich and Heiko Pleines, "Analyse: Die politischen Herausforderungen eines Erdölbooms: Ressourcenfluch und politische Stabilität in Russland" [Analysis: The political challenges of a natural gas boom: resource curse and political stability in Russia], *Russland-Analysen*, no. 240 (2016): 7–13. On regime legitimization in rentier states: Kevin M. Morrison, "Oil, Nontax Revenue, and the Redistributive Foundations of Regime Stability", *International Organization* 63, no. 1 (2009): 107–38; Uriel Abulof,

"'Can't Buy Me Legitimacy'. The Elusive Stability of Mideast Rentier Regimes", *Journal of International Relations and Development* 20, no. 1 (2017): 55–79.

<sup>56</sup> World Bank Group, *The Russian Economy Inches Forward* (see note 41).

<sup>57</sup> This effect became more pronounced with the floating of the ruble course in November 2014.



rubles (€76) to all pensioners — a symbolic amount considering the level of inflation adjustment.<sup>58</sup>

Compared to its decisions on other categories of budget spending, the Russian leadership acted very cautiously in deciding on pension inflation adjustments. While it significantly reduced spending on education and health without any major discussion in 2015 and 2016, it only intervened into pension system expenditures when the Finance Ministry's reserves were close to being exhausted. The matter was also decided only after an explicit vote by the president.<sup>59</sup>

## Regression instead of reform

While the government kept rising social policy expenditures in check by not following through with inflation adjustments, it was still not addressing fundamental problems such as the lack of focus in benefit provision and the looming risks of demographic change.

One possible way to resolve the “informal sector dilemma” in the pension system would be an approach in which individuals receive a portion of their pensions through a funded pension system. Employees who report their income officially and whose employers make payroll social security contributions could then be rewarded accordingly. If contributors have trust in the pension system, a similar effect could be achieved through a pay-as-you-go scheme. Trust is very low in Russia, however, and has declined further due to the incomplete inflation adjustment of 2016 and the “freezing” of the previously existing funded pension scheme.

A funded pillar was first introduced into the Russian pension system as part of the liberal reforms of 2002. Of the individual's pension contribution, which is currently 22 percent of gross wages, 6 percent was set aside in the name of the contributor for future pension benefits. In 2014, however, this fund was frozen, which means that the contributions are not

continuing to accumulate but are being diverted to cover ongoing pension payments. This helped to reduce transfers from the federal budget into the pension system. The savings are estimated at 342 billion rubles (€5.2 billion) for 2016, 412 billion rubles (€6.3 billion) for 2017, and 471 billion rubles (€7.1 billion) for 2018 (0.4–0.5 percent of GDP).<sup>60</sup> The decision to freeze accumulated individual pension savings has been extended multiple times already. There is currently no indication that the funded pillar will be reactivated, even in the draft budgets for the years up to 2020.<sup>61</sup> A return to a system in which pensioners are required to build up their own individual pension reserves is thus not likely.

**The burdens to the pension system are being hidden and shifted into the future. Although the budget deficit is declining, “implicit debt” is increasing.**

From the viewpoint of fiscal sustainability and transparency, the decision to freeze the funded pillar of the pension system was a step backwards. Not only does it render the burdens to the pension system invisible and shift them into the future; it means that even as the budget deficit is shrinking, “implicit debt” is on the rise. Government-guaranteed future pension payments that are not covered by reserves or future tax revenues create hidden government liabilities. Pension transfers that are saved today will have to be paid off out of the budget in the future.<sup>62</sup>

<sup>58</sup> Ol'ga Kuvshinova and Aleksandra Prokopenko, “Den'gi na razovuyu vyplatu pensioneram eshche predstoit najti” [Money still has to be found for one-time payment to pension recipients], *Vedomosti*, 24 August 2016, <https://www.vedomosti.ru/economics/articles/2016/08/24/654249-deneg-indeksatsiyu-pensii-budut-iskat-razovuyu-viplatu> (accessed 25 August 2017).

<sup>59</sup> Marina Khmel'nitskaya, “The Social Budget Policy Process in Russia at a Time of Crisis”, *Post-Communist Economies* 29, no. 4 (2017): 468.

<sup>60</sup> Natalija Bijanova, “Chastnye pensionnye fondy mogut poluchit' den'gi byvshich molchunov” [Private pension funds could receive money from the former ‘silent’ (= pension contributors who did not state which pension funds should receive their contributions)], *Vedomosti*, 8 October 2015, <https://www.vedomosti.ru/finance/articles/2015/10/08/612034-chastnie-pensionnie> (accessed 25 August 2017).

<sup>61</sup> Alina Evstigneeva, “Moratorij po umolchaniju” [Implicit moratorium], *Izvestiya*, 2 August 2017, <https://iz.ru/627023/alina-evstigneeva/moratorii-na-pensionnye-nakopleniia-prodiat-do-2021-goda> (accessed 25 August 2017).

<sup>62</sup> On implicit debt, see Ognian Hishow, *Die implizite öffentliche Schuld. Schuldenproblem “plus” der Europäischen Union*, SWP-Studie, 25/2010 (Berlin: Stiftung Wissenschaft und Politik, October 2010). The measure reduces the demand for long-term investment and increases the costs of financing investments.

## No simple solutions

In the context of the economic crisis and declining tax revenues, the Russian leadership has had few simple options for action in the field of social policy. The Kremlin had to choose between unpopular reforms and budget cuts that would jeopardize political support from important voter groups, and a more debt-financed social policy that would increase medium- to long-term budget risks. The middle course it decided to take is beset by both political and fiscal risks, but most likely poses no immediate danger to political stability.

The political costs of this strategy are difficult to estimate, either from an outside perspective or by the Kremlin itself, since there are few forums for the public expression of dissatisfaction in Russia, and credible political alternatives are quashed before they can take root. Opinion surveys show, however, that public support for government social policy had been declining even before the controversial pension reform of 2018. The social policy index of the state survey research institute WCIOM, which has been collecting data on the subject since 2007, reached a new low in mid-2017. In 2015, 38 percent of the population reported being satisfied with social policy while 27 percent reported being dissatisfied. In mid-2017, this distribution tipped in the opposite direction: just 25 percent reported being satisfied, while 43 percent were dissatisfied.<sup>63</sup> Studies by the Russian Academy of Sciences also show that the percentage of Russians who generally favor change increased dramatically in 2017 to over half of all respondents. The desire for change was less focused on political change, however. Sociologists reported a growing desire for a paternalist government that would play a stronger role in addressing the population's social problems.<sup>64</sup>

Procrastination on unpopular reforms and the increase in implicit debt that is not covered in the budget figures create new fiscal risks. The population's trust in the pension system — a key precondition for future reforms — has suffered from the government's efforts at short-term budget savings.

## Defense expenditures are top priority

The 2017 defense budget was 3.1 percent of GDP (€43.3 billion). Defense expenditures, which are paid almost completely out of the federal budget, varied widely in recent years, reaching a new peak at 4.4 percent of GDP in 2016. In 2011, the defense budget was just 2.5 percent of GDP. The budgets project that defense expenditures up to 2020 will decline to 2.6 percent of GDP.

Russia is spending more on the military than its defense budget would suggest, however. Just three quarters of Russian military expenditures, classified according to the definition of the Stockholm International Peace Research Institute (SIPRI),<sup>65</sup> actually come out of the defense budget. The rest, amounting to another 1 percent of GDP (€13.8 billion) in 2017, are paid for out of other budget categories such as social policy (military pensions), education, and health.

Since 2008, the Kremlin has been pursuing a large-scale reform and upgrade of the Russian armed forces with the aim of returning Russia to its former status as a military superpower.<sup>66</sup> The turning point in Russian arms policy came with the Georgian War of 2008, when the weaknesses of the Russian army became clearly apparent.<sup>67</sup> Part of the increase in spending went for the organizational restructuring of the military: wages in the Russian armed forces were increased significantly in 2012 to attract qualified staff for a

<sup>63</sup> Satisfaction levels increased again in 2017, but the more recent figures are difficult to compare with past figures due to a change in survey methodology. Current data can be found in "Ocenka vlastej" [Evaluation of the authorities], WCIOM (online), [https://wciom.ru/news/ratings/ocenka\\_vlastej/](https://wciom.ru/news/ratings/ocenka_vlastej/) (accessed 27 March 2018).

<sup>64</sup> Andrej Kamakin, "Novyj srok Putina budet ochen' tjazhelym dlja nego i strany" [New term of office will be difficult for Putin and for the country], *Moskovskiy Komsomolec*, 25 January 2018, <http://www.mk.ru/politics/2018/01/25/novyj-srok-putina-budet-ochen-tyazhelym-dlya-nego-i-strany.html> (accessed 28 January 2018).

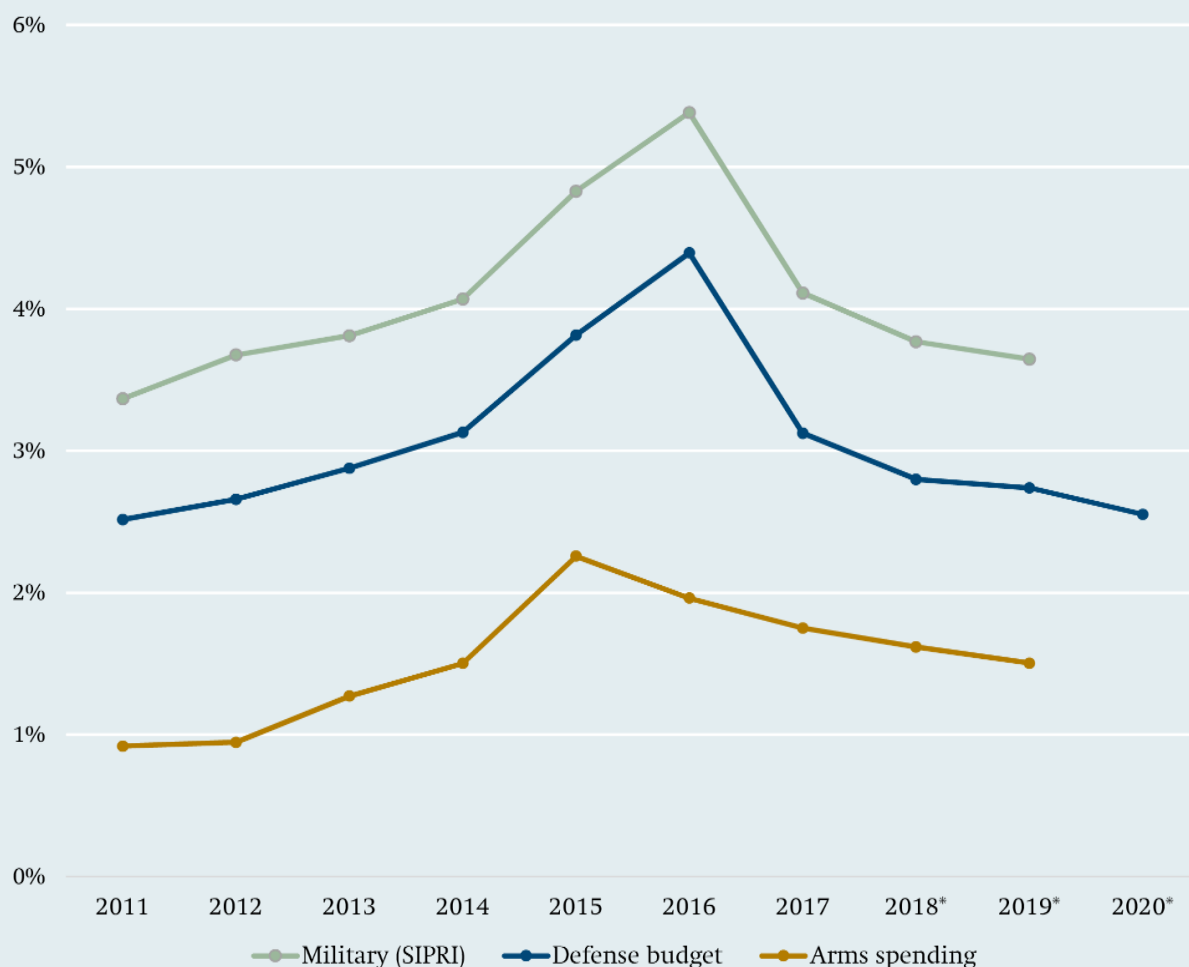
<sup>65</sup> SIPRI, *SIPRI Definition of Military Expenditure*, <https://www.sipri.org/databases/milex/definitions> (accessed 2 February 2018).

<sup>66</sup> Margarete Klein, *Russlands Militärpotential zwischen Großmachtsanspruch und Wirklichkeit. Zustand, Reformen und Entwicklungsperspektiven der russischen Streitkräfte* [Russia's military potential between superpower aspirations and reality. Condition, reforms, and development perspectives of the Russian armed forces], SWP-Studie 24/2009 (Berlin: Stiftung Wissenschaft und Politik, October 2009).

<sup>67</sup> Dmitri Trenin, "The Revival of the Russian Military. How Moscow Reloaded", *Foreign Affairs* 95, no. 3 (2016): 23–29.

Figure 8

## Defense budget, military spending, and arms (in percent of GDP) as of May 2018



\* Figures from the 2018–2020 budgets were used.

Sources: Defense budget: Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* [Financial and economic indicators of the Russian Federation], <https://www.minfin.ru/ru/statistics/>; Military and arms spending: Julian Cooper, *Prospects for Military Spending in Russia in 2017 and Beyond* (Birmingham, 2017), <https://www.birmingham.ac.uk/Documents/college-social-sciences/government-society/crees/working-papers/prospects-for-military-spending-in-Russia-in-2017-and-beyond.pdf> (accessed 2 October 2017).

professional army.<sup>68</sup> But armaments account for most of the increase in military spending.

Armament spending is planned as part of the long-term programs known as Gosprogramma vooruzheniy (GPV, “state armament program”), which have a time horizon of ten years and are generally updated at five-year intervals. The GPV-2020 program adopted in

2010 included a drastic increase in arms expenditure for the decade from 2011 to 2020. Over that time period, 19 trillion rubles were to be allocated to weapons purchases (€472 billion at the exchange rate in 2010 when the program was adopted or 41 percent of Russian GDP in 2010).<sup>69</sup> The stated primary goal of the program was to increase the percentage of modern

**68** Andrzej Wilk, “A Significant Pay Increase in the Russian Army”, *Ośrodek Studiów Wschodnich* (online), 1 February 2012, <https://www.osw.waw.pl/en/publikacje/analyses/2012-02-01/a-significant-pay-increase-russian-army> (accessed 9 October 2017).

**69** Ivan Safronov and Dmitrij Butrin, “Vooruzheniya vstu-pili v boj s vozrazheniyami” [Arms in the struggle against objections], *Kommersant*, 19 February 2015, <https://www.kommersant.ru/doc/2670562> (accessed 28 January 2018).

## Direct Spending on Military Operations in Ukraine and Syria

According to estimates, the direct costs of Russian military operations in Syria and Ukraine make up just a few percent of the Russian defense budget, which amounted to around €43.3 billion in 2017. The necessary expenditures could thus be covered entirely through reallocations, for instance from the budget for military exercises, without any added burden on the budget.

As the government provides almost no official figures, and most of the data on military exercises are classified as secret, the available sources consist either of information compiled by journalists or independent studies — for instance, those released by the opposition party Yabloko. In the case of Syria, the fact base is slightly better due the somewhat lower level of secrecy. In March 2016, President Putin stated that the first six months of the Syrian operation cost 33 billion rubles (€500 million). Russian experts estimate the costs of the operation from October 2015 to September 2017 at between 188.6 and 194.3 billion rubles (€2.9–3 billion).<sup>a</sup>

The costs of the military operation in Donbas (independent of the annexation of Crimea) are estimated at 53 billion rubles (€800 million) for the first ten months (March to December 2014).<sup>b</sup>

Russian economist Sergey Aleksashenko assumes \$2 billion for the year 2015. That just covers the direct costs of pay and provisions for the deployed soldiers, but not the provisions for refugees or economic assistance to the self-proclaimed “people’s republics” in Donbas.<sup>c</sup>

**a** Yabloko, *Rossija potratila na Siriju ot 188.6 do 194.3 mlrd rublej* [Russia spent 188.6 to 194.3 billion rubles on Syria], 2017, <http://www.yabloko.ru/news/2017/09/22> (accessed 8 June 2018).

**b** Ilya Yashin and Olga Shorina (eds.), *Putin.War. Based on Materials from Boris Nemtsov* (Moscow, May 2015), <http://4freerussia.org/putin.war/Putin.War-Eng.pdf> (accessed 3 October 2017).

**c** Reva Bhalla, “The Logic and Risks Behind Russia’s Statelet Sponsorship”, *Stratfor*, September 2015, <https://www.stratfor.com/weekly/logic-and-risks-behind-russias-statelet-sponsorship> (accessed 24 June 2017).

weapons in the Russian military arsenal to 70 percent by 2020. In September 2017, President Vladimir Putin announced that 58.3 percent of Russian military weapons had already been modernized in the previous year.<sup>70</sup> There is no clear definition of what

**70** “Putin provedet zasedanie voenno-promyshlennoj komissii” [Putin leads meeting of the military-industrial

qualifies weapons systems as “modern” or which specific weapons stock the figures refer to, but supplier figures on newly produced weapons show significant progress in production.<sup>71</sup>

The process of planning the follow-up program (GPV-2025) indicates that the tense budget situation has at least temporarily dampened the Kremlin’s arms ambitions. The new strategy for the years 2018–2027 includes spending in the amount of 19 trillion rubles (€288 billion). In nominal terms, it is similar in volume to the predecessor program, GPV-2020. As a percentage of GDP, the scope of the new arms program is just half of that (20.6 percent of GDP in the year of the program’s adoption, 2017).

The resolution on the new arms program was also postponed repeatedly. A decision on the GPV-2025 should have been made in 2015. In the light of the falling oil price and economic sanctions, this was put off again and again, as the Finance Ministry and the Defense Ministry had very different ideas about the scope of the budget, and the President chose not to exercise his authority to end the debate. In 2014, Putin had made relatively vague indications as to the overall direction it should take: he said the program should be realistic and within the government’s financial means.<sup>72</sup>

## The defense budget grew to a record high in 2016 with no direct connection to the preceding escalation of foreign policy crises in Ukraine and Syria.

In contrast to the long-term armament programs, the change in defense spending from year to year does not necessarily indicate a change in the Kremlin’s priorities. From the outset, the GPV-2020 envisioned a more dramatic increase in arms spending in the second half of the program period.<sup>73</sup> The partially inconsistent trajectory of spending from 2011 on was

commission], *RIA Novosti*, 19 September 2017, [https://ria.ru/defense\\_safety/20170919/1505029454.html](https://ria.ru/defense_safety/20170919/1505029454.html) (accessed 9 October 2017).

**71** Richard Connolly and Cecilie Sendstad, “Russian Re-armament. An Assessment of Defense-Industrial Performance”, *Problems of Post-Communism* 65, no. 3 (2018): 143–60.

**72** Safronov and Butrin, “Vooruzheniya vstupili v boj s vozrazheniyami” (see note 69).

**73** Susanne Oxenstierna, “Russia’s Defense Spending and the Economic Decline”, *Journal of Eurasian Studies* 7, no. 1 (2016): 60–70.

also due to the mode of financing military spending: armaments industries had received government guarantees for loans in the amount of around 1.2 trillion rubles (€18 billion) to start fulfilling arms contracts immediately.<sup>74</sup> These guarantees are not contained in the defense expenditures in the early years. Starting in 2016, the Finance Ministry ended the practice of using bank loans to provide co-financing, and paid off the majority of the loans (793 billion rubles, or €12 billion). A further repayment took place in 2017 (approx. 200 billion rubles, or €3 billion). These payments caused the defense budget to reach a record high for a period of 2016, with no direct connection to the preceding escalation of foreign policy crises in the Ukraine conflict and in Syria.

### Coalition for arms

The Kremlin's security policy priorities only partially explain the increase in spending on long-term Russian arms programs. The systematic implementation of the wide-ranging GPV-2020 is also rooted in a particular constellation of domestic and industrial policy factors.

The most important decisions on the state defense orders are made by the military-industrial commission, whose individual members have a military or secret service background. Significant overlapping of responsibilities makes it easier for the military to assert its particular interests in the planning of expenditures: the defense ministry not only acts as arms buyer but is also responsible for evaluating the urgency of certain purchases and for planning supply needs. There are also major overlaps in staffing between the management of arms manufacturers, the presidential administration, the security agencies, and the military.<sup>75</sup> The political weight of influential military-industrial interest groups has increased further with the expansion of defense spending. Furthermore, the Minister of Defense since 2012, Sergei Shoigu, is among the most popular politicians in Rus-

sia and has the strongest individual political profile of all of the ministers.<sup>76</sup>

In the public discourse, the drastic increase in arms spending has often been justified with industrial policy arguments. Vladimir Putin likes to present the defense industry as an engine of growth for the Russian economy, although economists cast doubt on the industry's ability to play this role. In many cities, however, arms manufacturers are among the most important and in some cases the only major employers. As a result, they play a highly significant socio-economic role.

### The risks for the arms industry

Against this backdrop, it is unsurprising that the arms sector has become one of the most important political clienteles for the Russian leadership: the arms industry employs around two million workers, whose support for the Kremlin regime is at times even instrumentalized in the state media. A prime example of this role can be seen in a television appearance by workers for the company Uralvagonzavod, which among other things is building the platform for the new combat tank Armata. During Putin's annual live television conference, in which he takes call-in questions, they offered to come to Moscow and help clear the streets of the demonstrators who were protesting against electoral fraud in Winter of 2011/2012.<sup>77</sup> According to the data from the Ministry of Industry, arms industry production more than doubled between 2010 and 2016.<sup>78</sup> The share of civilian production in the arms industry fell during the period from 33 percent (2011) to 16 percent (2015).<sup>79</sup> The compa-

<sup>74</sup> Anna Eremina, Aleksandra Prokopenko and Tat'jana Voronova, "Dosrochnye vyplaty po kreditam na oboronzakaz prinesut bankam 800 mlrd i golovnuju bol'" [Early repayment of loans for arms contracts costs banks 800 billion and causes headaches], *Vedomosti*, 14 December 2016, <https://www.vedomosti.ru/finance/articles/2016/12/14/669471-dosrochnoe-pogashenie-golovnyu-bol> (accessed 6 October 2017).

<sup>75</sup> Una Hakvåg, "Russian Defense Spending after 2010. The Interplay of Personal, Domestic, and Foreign Policy Interests", *Post-Soviet Affairs* 33, no. 6 (2017): 496–510.

<sup>76</sup> Konstantin Gaaze, *Gibrid ili diktatura – 2. Kak slozhilas' koaliciya vojny Vladimira Putina* [Hybrid or dictatorship – 2. How Putin's coalition of war emerged] (Moscow: Carnegie Moscow Center, May 2015), <http://carnegie.ru/commentary/?fa=69995> (accessed 5 June 2017).

<sup>77</sup> Margarita Ljutova, "Putin poobeshchal modernizaciju podderzhavshemu ego 'Uralvagonzavodu'" [Putin promised modernization of Uralvagonzavod, which supported him], *Vedomosti*, 10 May 2012, [http://www.vedomosti.ru/politics/articles/2012/05/10/putin\\_rasskazal\\_rabochim\\_uralvagon\\_zavoda\\_pro\\_nachalo\\_samogo](http://www.vedomosti.ru/politics/articles/2012/05/10/putin_rasskazal_rabochim_uralvagon_zavoda_pro_nachalo_samogo) (accessed 9 February 2018).

<sup>78</sup> Gaidar Institute, *Russian Economy in 2016. Trends and Outlooks* (Moscow, 2017), 468, <https://iep.ru/files/text/trends/2016-eng/Book.pdf> (accessed 1 June 2017).

<sup>79</sup> Centr ékonomicheskogo razvitiya i sertifikacii, *OPK: ternistyj put' k diversifikacii* [Military-industrial complex: Rocky path to diversification], 12 September 2016, <https://profio.k>



nies are largely oriented toward the Russian defense ministry as their main buyer.

Table 1

**Year-on-year percentage growth in production of the Russian defense industry**

2010	2011	2012	2013	2014	2015	2016
17.4	5.8	6.4	13.5	15.5	12.9	10.1

Source: Gaidar Institute, *Russian Economy in 2016. Trends and Outlooks* (Moscow, 2017).

Due to their dependence on Russian state contracts, managers and workers at the arms producers are uneasy that budget plans project a significant decline in military spending.<sup>80</sup> President Putin and then Vice President Dmitri Rogozin, who was until recently responsible for the arms industry (replaced by Yuri Borisov in May 2018), see the future of the industry in the production of goods with civilian applications and want the companies to open up new export markets.<sup>81</sup>

**The Russian defense industry is being squeezed by high-tech western companies on the one side and cheaper Chinese manufacturers on the other.**

The Russian defense industry has been successful in selling its goods abroad in recent years, with exports of around \$15 billion annually. But it is being squeezed by high-tech western companies on the one side and cheaper Chinese manufacturers on the other. For many years, China was one of the most important buyers of Russian weapons, but it has

made great progress in its own weapons manufacturing — in part through licensed production of Russian weapons systems. In recent times, Chinese providers have been penetrating markets such as Nigeria and Venezuela that were traditionally dominated by Russian arms suppliers. Given that Chinese arms producers possess the backing of a much more financially powerful state, as well as superiority in many production processes, Russian producers will have a difficult time asserting themselves against Chinese competitors in the future.<sup>82</sup> With some weapons systems such as the air defense system S-400 or the fighter jet Su-35, the Russian industry still holds the technological lead. The combat tank Armata, which is one of few weapons systems developed after the end of the Cold War, has good chances of becoming internationally competitive as well — provided Russia decides to export it.<sup>83</sup>

Whether there will be a successful and significant shift to civilian production is questionable since the arms industry's own technological developments are either useful only for weapons systems or are classified as secret.<sup>84</sup> As a result, it is being discussed whether the arms industry should be given preferential treatment in tenders by other state corporations as a kind of “start-up aid” for the sale of civilian goods.<sup>85</sup>

The sanctions imposed during the Ukraine crisis and under the US CAATS Act made it more difficult for the Russian defense industry to gain access to capital and to import goods that it needed for produc-

<sup>82</sup> Siemon Wezeman, “China, Russia and the Shifting Landscape of Arms Sales”, *SIPRI* (online), 5 July 2017, <https://www.sipri.org/commentary/topical-background/2017/china-russia-and-shifting-landscape-arms-sales> (accessed 10 October 2017).

<sup>83</sup> Ibid.; Richard Connolly and Cecilie Sendstad, *Russia's Role as an Arms Exporter. The Strategic and Economic Importance of Arms Exports for Russia* (London: Chatham House, March 2017), <https://www.chathamhouse.org/sites/files/chathamhouse/publications/research/2017-03-20-russia-arms-exporter-connolly-sendstad.pdf> (accessed 30 April 2018).

<sup>84</sup> Aleksandr Trushin, “‘Voennaya nagruzka stala tormozom’” [Defense burden became a brake], *Kommersant*, 17 October 2016, <https://www.kommersant.ru/doc/3114479> (accessed 2 February 2018).

<sup>85</sup> Svetlana Bocharova and Aleksej Nikol'skij, “Putin soobshchil o prinjatii novoj gosprogrammy vooruzhenij” [Putin reported on the adoption of the new state armament program], *Vedomosti*, 24 January 2018, <https://www.vedomosti.ru/economics/articles/2018/01/24/748864-putin-vooruzhenii> (accessed 2 February 2018).

[com/about/news/detail.php?ID=3349&sphrase\\_id=5523](http://com/about/news/detail.php?ID=3349&sphrase_id=5523) (accessed 2 February 2018).

<sup>80</sup> Roman Ryskal', “Oboronka gotovitsja k potrebleniju” [Arms industry prepares for consumption], *Kommersant*, 26 May 2017, <https://www.kommersant.ru/doc/3307198> (accessed 2 February 2018).

<sup>81</sup> Julian Cooper, *Prospects for Military Spending in Russia in 2017 and beyond* (Birmingham, March 2017), <https://www.birmingham.ac.uk/Documents/college-social-sciences/government-society/crees/working-papers/prospects-for-military-spending-in-Russia-in-2017-and-beyond.pdf> (accessed 2 October 2017).

tion.<sup>86</sup> The loss of Ukrainian suppliers had already begun negatively impacting the sector in 2014. For Russian banks with international operations, the new sanctions substantially increased the risks of doing business with the arms industry.<sup>87</sup> For this reason, Moscow created a special financial institution to support the defense industry on the foundations of Promsvyazbank, which the Russian central bank took over at the end of 2017 to prevent its collapse.<sup>88</sup>

### No change of course up to now

It is unlikely that there will be a rapid change of course from the rearmament that has been pursued up to now. During the budget crisis of 2015 and 2016, the Russian leadership showed willingness to limit military spending. Yet even if the political will to do so could be maintained despite the recent rise in oil prices, the drastic cuts planned by the Finance Ministry would be difficult to implement for structural reasons. First of all, actors from the arms industry and military have a great deal of political weight in the decision-making process. In the last few years, for instance, they have repeatedly succeeded in having defense spending levels revised upward after budgets were passed. The growing foreign policy tensions between Russia and NATO are strengthening forces within the Kremlin that focus on security policy arguments. Second, due to sanctions, demographic developments, and increasing competition, the arms industry will have to battle increasing headwinds in the years to come. A significant decline in government arms contracts would have a severe impact on arms producers and could destabilize the socio-economic situation in a number of cities.

<sup>86</sup> Madalina Sisu Vicari and Nicholas Trickett, *CAATSA Out of the Bag: Russia's Arms Exports under Threat* (Philadelphia: Foreign Policy Research Institute, 2018), <https://bearmarketbrief.com/2018/01/23/the-caatsa-out-of-the-bag-russias-arms-exports-under-threat/> (accessed 28 January 2018).

<sup>87</sup> Alina Didkovskaya, "Al'fa-bank prekratit sotrudnichestvo s oboronnymi predpriyatiyami iz-za sankcij" [Alfa Bank stops doing business with arms manufacturers due to sanctions], *Vedomosti*, 3 January 2018, <https://www.vedomosti.ru/finance/articles/2018/01/03/747066-alfa-bank> (accessed 2 February 2018).

<sup>88</sup> Max Seddon, "Moscow Creates Bank to Help It Avoid US Sanctions", *Financial Times*, 19 January 2018, <https://www.ft.com/content/90c73fe4-fd15-11e7-9b32-d7d59aace167> (accessed 28 January 2018).

Ultimately, whether or not the planned budget reductions succeed will depend on arms producers' flexibility — and this has been relatively low up to now. One can safely assume that the Kremlin will not allow these companies to fail, risking mass unemployment in many of Russia's monotowns. A newly established bank serving the arms industry and possible cross-subsidies from other state corporations will continue even if arms spending falls. This will create new risks that could materialize in future budgets, for instance, if borrowers default on loans from Promsvyazbank.

### Russian discourse: Concepts without consequences

The future of arms and social policy spending plays a central role in the Russian (expert) discourse on reform plans. On explicit instructions from the Kremlin, two reform proposals were developed starting in 2016: On the one hand, there is the proposal by a team at the Center for Strategic Research, headed by the economist and former Minister of Finance Alexei Kudrin. On the other hand, there is the "strategy of growth" developed by the Stolypin Club, now under the leadership of Russian businessman and Presidential Commissioner for Entrepreneurs' Rights Boris Titov.<sup>89</sup> Whereas Kudrin's perspective on Russian economic policy is based more on neoclassical, supply-side economics, Titov's strategy is clearly rooted in the Keynesian, demand-oriented tradition. Kudrin's plans are much more strongly rooted in current economic literature. The two sides are in agreement on the urgent need for reform of the legal system as a precondition for better protection of property rights. On questions of budget policy, however, the two strategies take opposing positions.

### Kudrin's fiscal manoeuvre

Kudrin proposes a redistribution of fiscal spending within the budget ("fiscal manoeuvre"). He distin-

<sup>89</sup> Under the internationally oriented businessman Boris Titov, the Stolypin Club has moved away from some of the nationalist ideas of previous head Sergey Glazyev, see Roland Götz, "Die Wirtschaftspolitik der belagerten Festung. Das Glasjew-Programm" [The economic policy of the besieged fortress. The Glazyev program], *Russland-Analysen*, no. 305 (2015), 6 — 11, <http://www.laender-analysen.de/russland/pdf/RusslandAnalysen305.pdf> (accessed 2 February 2018).

guishes between expenditures in productive areas (such as education, health, and infrastructure), which have a positive impact on economic growth, and expenditures in unproductive areas, which have little or even a negative impact on growth (military and security).<sup>90</sup> In the category of expenditures with a negative impact, Kudrin includes social transfers that do not reach the needy population they are targeted at but are instead distributed indiscriminately (these are not taken into consideration in the following statistical analysis, however, due to the lack of data).

Table 2

### Effect of expenditures in the amount of 1 percent of GDP on GDP and growth

Budget category	GDP	Short-term growth	Long-term growth
Government spending (total)	0.91 %		
Defense	0.22 %	−0.29 %	−0.52 %
National security	0.78 %	0.26 %	−1.45 %
Education	0.38 %	0.18 %	0.47 %
Health & sports	1.25 %	0.09 %	0.14 %
Infrastructure	1.64 %	0.26 %	−0.68 % <sup>a</sup>

a The long-term negative effect of infrastructural spending is explained by the fact that many projects are not geared toward economic needs. This is true, for instance, of the megaprojects carried out in recent years (Olympic Games, Soccer World Cup, and Kerch Bridge).

Source: Alexey Kudrin and Alexander Knobel, “Bjudzhetnaya politika kak istochnik ékonomicheskogo rosta” [Budget policy as a source of economic growth], *Voprosy ékonomiki* 26, no. 10 (2017).

An empirical analysis by Alexei Kudrin and Alexander Knobel shows that expenditures on health and infrastructure in Russia lead to a disproportionate increase in GDP (1.25 percent and 1.64 percent, respectively, for every 1 percent of GDP increase in expenditures), while defense spending increases GDP little (0.22 percent, see Table 2). Defense expenditures are even detrimental to long-term growth, while educational

spending in particular leads to positive growth effects.

Based on their analysis of these contributions to economic growth, a comparison with other countries, and the effectiveness of the various ministries, Kudrin and his colleagues recommend increasing spending on infrastructure, education, and health care, and decreasing spending on defense, security, and a number of subsidies. On the subject of social policy, Kudrin highlights the potential for savings in the area of untargeted social transfers.<sup>91</sup> His proposals thus strongly resemble those of the World Bank for Russian budget policy.<sup>92</sup>

### The Stolypin Club’s “strategy of growth”

The authors of the Stolypin Club’s alternative proposal call for a substantially more expansive monetary policy on the part of the central bank to promote private investment. At the same time, pointing to unused production capacities in Russia, they recommend boosting domestic demand through an increase in government spending to generate increased economic growth.<sup>93</sup> Their plan aims to achieve long-term budget equilibrium not through spending cuts but through the increase in tax revenues resulting from economic growth. Titov pairs his Keynesian perspective with a developmental state approach: According to this idea, active industrial policy and ongoing import substitution will lead to the emergence of leading international enterprises in a variety of technological sectors. Titov and his colleagues expect that the defense industry will make a positive contribution to growth, and warn against a decrease in defense spending.<sup>94</sup> Overall the Stolypin Club’s ap-

91 Alexey Kudrin, “Bjudzhetnyj manevr i strukturnaya perestrojka rossijskoj ékonomiki” [The budget maneuver and structural reform of the Russian economy], *Voprosy ékonomiki* 26, no. 9 (2017).

92 Andrey Ostroukh, “World Bank Urges Russia to Spend More on Healthcare, Education”, *Reuters*, 16 January 2018, <https://uk.reuters.com/article/us-worldbank-russia/world-bank-urges-russia-to-spend-more-on-healthcare-education-idUKKBN1F529F> (accessed 2 February 2018).

93 Boris Titov and Aleksandr Shirov, “Strategija rosta dlja Rossii” [Strategy of growth for Russia], *Voprosy ékonomiki* 26, no. 12 (2017).

94 Institut ékonomiki rosta im. Stolypina P.A., *Rol' voenno-promyshlennogo kompleksa v obespechenii ékonomicheskogo rosta v RF* [The role of the military-industrial complex in ensuring economic growth in the RF] (Moscow, November 2017),

90 Alexey Kudrin and Alexander Knobel, “Bjudzhetnaya politika kak istochnik ékonomicheskogo rosta” [Budget policy as a source of economic growth], *Voprosy ékonomiki* 26, no. 10 (2017).



proach is less systematic in its design and more eclectic than Kudrin's research-based recommendations.

### Low likelihood of implementation

The Kremlin has shown no clear preference for either of the plans. After a presentation of the two reform papers, Putin suggested that a joint strategy be developed combining both concepts.<sup>95</sup> In view of the contradictions between a number of the recommendations, this would be virtually impossible to carry out. Overall, the reaction on the part of the Russian leadership reveals a certain level of disinterest in the proposals for structural change.

Putin's apparent reluctance to make a decision in this regard is most likely rooted in the fact that both programs contain ideas that contradict the Kremlin's current political priorities. Kudrin calls for wide-spread cuts in areas affecting important political clientele groups that currently depend on the "unproductive expenditures" in the budget. Titov's proposal may entail too many economic risks: Above all, the dangers of inflation but also of increased government debt make a more expansive monetary and fiscal policy uninteresting to the Kremlin, which has tended to act in a more conservative way up to now. This ambivalence became clearly apparent in Putin's address to the Federal Assembly in March of 2018. The announcements in the first part of his address strongly recalled Kudrin's demands: increasing spending on education, health, and infrastructure. The second part glorified the successes of Russia's military buildup. There was no mention of any decrease in military spending.<sup>96</sup>

<http://stolypinsky.club/2017/11/22/issledovanie-instituta-ekonomiki-rosta-rol-oboronno-promyshlennogo-kompleksa-v-obespechenii-ekonomicheskogo-rosta-v-rf/> (accessed 1 February 2018).

<sup>95</sup> Vesti Finance, "Putin ocenil strategii Kudrina i Titova. Chto dal'she?" [Putin evaluated the strategies of Kudrin and Titov. Where do we go from here?], *Vesti Finance*, 31 May 2017, <http://www.vestifinance.ru/articles/86115> (accessed 5 January 2018).

<sup>96</sup> "Presidential Address to the Federal Assembly", *Kremlin.ru*, 1 March 2018, <http://en.kremlin.ru/events/president/news/56957> (accessed 30 April 2018).

# Contested Control over State Finances

Economic know-how and reform concepts can be found predominantly among the “liberals” within the Russian elite, who still hold important positions in the central bank, the Finance Ministry, and the government-owned Sberbank. In those contexts, however, they operate purely as technocrats and have only a limited scope of action. As political actors, the liberals are just as discredited in Russia as liberal political ideas themselves. This is due in part to the regime’s propaganda campaign dissociating it from the period of radical liberalization of the government and the economy in the 1990s. For the liberally inclined elite, the annexation of Crimea and the escalation of foreign policy confrontation with the West meant even further weakening of their position in the domestic political landscape.

**Instruments of long-term voluntary commitment, such as budget plans and fiscal rules, require a minimum level of transparency and separation of powers to amount to more than just good intentions.**

Sustainable fiscal policy in Russia is inhibited by problems of expenditure control. Instruments of long-term self-commitment such as budget plans and fiscal rules require a minimum level of transparency and separation of powers to amount to more than just good intentions. In reaction to the collapse of tax revenues, however, control over budget funds became more centralized and less transparent. Some of the revenues also do not make it into budgets but remain with state-owned enterprises. This increases their political clout, and since they are profiteers of the status quo, they have no interest in a reform of Russian economic policy.

## Undermining the separation of powers

By granting the parliament budgetary powers, the Russian constitution gives the State Duma and the Federation Council an effective instrument for shaping public policy. In past years, however, Russia’s parliament has barely made use of this fundamental right in the sense set out in the constitution. After the acrimonious budget debates of the 1990s, which often ended in protracted impasses and delayed budget resolutions, there have been no further disputes between parliament and the executive since the early 2000s. In the Duma today, half as much time is spent discussing budget laws as in the early 2000s. The number of changes made during the readings in the Duma have declined continuously as well.<sup>97</sup> As a result, budget planning has become very predictable.

The price being paid for this seemingly orderly process, however, is the large-scale erosion of parliamentary control. The fact that the executive branch in Russia today does not need to worry about support from Duma representatives is due above all to the successful establishment of a “party of power”, the United Russia party. Since 2016, the party has even had a large enough majority in the State Duma to change the constitution (343 of 450 seats). United Russia representatives use their Duma mandate to pursue particularistic interests,<sup>98</sup> but parliamentary budget debates always end with their parliamentary group voting to adopt budget laws in virtually unchanged form. Most representatives of the opposition groups faithful to the system use the opportunity to distinguish themselves politically from other parties

<sup>97</sup> Ben Noble, “Amending Budget Bills in the Russian State Duma”, *Post-Communist Economies* 29, no. 4 (2017): 505–22.

<sup>98</sup> Thomas Remington, “Patronage and the Party of Power. President-Parliament Relations under Vladimir Putin”, *Europe-Asia Studies* 60, no. 6 (2008): 959–87.

(although without consequences) by abstaining or voting against the budget proposals.<sup>99</sup>

Drafting budget proposals is the task of the government. At the government level, a “social bloc” and a “security bloc” can be distinguished. Vice Prime Minister Olga Golodets and the political representatives of the health, education, and labor ministry are commonly counted as part of the “social bloc”. The “security bloc” is generally considered to consist of Vice Prime Minister Dmitry Rogozin (since May 2018: Yuri Borisov), Defense Minister Sergey Shoygu and the representatives of the security agencies and national guard (Viktor Zolotov), the secret service, and the Ministry of Internal Affairs. The main opponent of both blocs in the government is the Ministry of Finance, which always takes a very restrictive position towards any spending. It is often counted as part of the “financial-economic bloc” together with the Ministry of Economic Development.<sup>100</sup>

The Kremlin sets clear boundaries on government negotiations. The president determines the scope of discussions by issuing directives with long-term impacts such as the May Decrees of 2012 or the moratorium on tax increases up to 2018.<sup>101</sup> If the president decides to pursue a concrete goal, he has the formal and informal means at his disposal to push it through at the governmental level.<sup>102</sup> Vladimir Putin likes to use television appearances to announce popular government measures, which are then implemented without controversy or public opposition.<sup>103</sup> Politically

risky decisions are not made without Putin’s explicit agreement.<sup>104</sup>

Since the beginning of the economic crisis, the President has tightened the reins further. Putin has been meeting with the government ministers on a biweekly basis since 2014 — sometimes even in the absence of the Prime Minister. In summer of 2016, when the budget situation was especially critical, the group of individuals actively involved in budget planning shrunk further, when the Kremlin and the Ministry of Finance delayed negotiations with the other ministries for several months. When the government commissions for the various ministries ultimately started working, they had to follow new, restrictive rules on the confidentiality of budget proposals. Just a month was planned for consultations within the government and for the discussion in parliament.<sup>105</sup>

## Highlights and lowlights of transparency

In addition to a functioning separation of powers, transparency of planned expenditures is generally seen as a key precondition for public control of national budgets. At the same time, an increase in transparency without checks and balances may also be a sign of strengthening authoritarian control over the use of resources in various areas of the government administrative apparatus and may thus enable the centralization of power.

Russia has been scoring high for several years in international comparisons of public budget transparency. In a ranking by the independent Institute of International Budget Partnership, Russia is on par with Germany.<sup>106</sup> For its ranking, the organization evaluates what data is published by the government and whether the point in time of publication theo-

**99** Aside from United Russia, only the nationalist “liberal-democratic party” voted in favor of the current budget law for 2018–2020, Vadim Visloguzov, “Bjudzhet povyshennoj prochnosti” [Budget of increased stability], *Kommersant*, 28 October 2017, <https://www.kommersant.ru/doc/3453712> (accessed 5 January 2018).

**100** Stephen Fortescue, “Russian Federal Budget Formation. Introduction”, *Post-Communist Economies* 29, no. 4 (2017): 453. The Russian elite is also often differentiated into the “Siloviki” (Ministry of Internal Affairs, Secret Service, and Military) and the “liberals”. This differentiation focuses on the distinguishing ideological orientation and typical career paths of each group, while the term “bloc” is used to refer to the official roles of the various government agencies.

**101** Titov, “Putin prizval vvesti moratorij na izmenenie nalogovoj nagruzki” (see note 31).

**102** Stephen Fortescue, “The Role of the Executive in Russian Budget Formation”, *Post-Communist Economies* 29, no. 4 (2017): 523–37.

**103** The most recent example was the cancellation of tax debts, new social benefits for mothers on the birth of their first child, and measures to reduce gas prices.

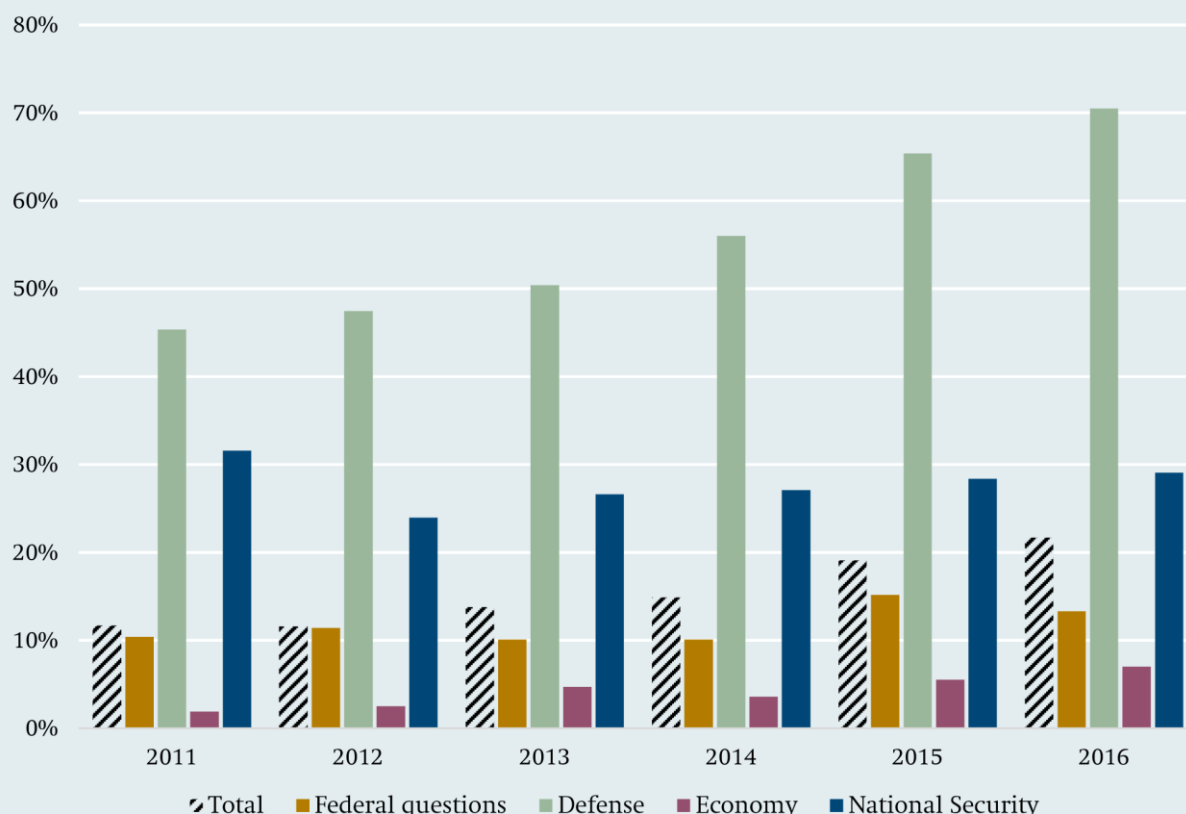
**104** An example is the discussion on the use of pension contributions, see Thomas Remington, *Pension Reform in Authoritarian Regimes: Russia and China Compared* (Atlanta, July 2015), <http://www.polisci.emory.edu/home/documents/papers/pension-reform-%20authoritarian-regimes.pdf> (accessed 9 October 2017).

**105** Aleksandra Prokopenko, “Novye pravila bjudzheta” [New budget rules], *Vedomosti* 19 October 2016, <https://www.vedomosti.ru/opinion/articles/2016/10/19/661524-novie-pravila> (accessed 21 October 2017).

**106** International Budget Partnership, *Open Budget Index 2015*, <https://www.internationalbudget.org/wp-content/uploads/OBS2015-OBIRankings-English.pdf> (accessed 2 January 2018).

Figure 9

## Percentage of classified expenditures (federal budget)



Source: Gaidar Institute, *Russian Economy in 2016. Trends and Outlooks* (Moscow, 2017).

retically enables societal budget control. It takes into account in its ranking reports from the Accounts Chamber of Russia, and the formal legal independence of this agency from the executive branch.

The Russian Ministry of Finance publishes detailed plans and projections of revenues and expenditures as well as precise and reliable data on actual budget developments. The Accounts Chamber of Russia, like the German Federal Audit Office, provides extensive and critical comments on budget laws.<sup>107</sup> The Russian Ministry of Finance occasionally seeks advice from international organizations to professionalize its expenditure planning. In 2013, on invitation from the ministry, a team from the IMF conducted a comprehensive evaluation of transparency and risks of Rus-

sian government spending. The IMF report praises the Russian government for its progress in the transparency of revenue and expenditure policies over the previous few years; its critique focuses on the unclear role of state corporations.<sup>108</sup>

The Russian case reveals the methodological limits of transparency rankings that are based on formal criteria. The Russian Ministry of Finance does not have to respond to objections from the Accounts Chamber, and it is by no means obligated to make improvements to budgets. Given the largely state-controlled media landscape, the reports published by the Accounts Chamber cannot generate any political pressure from the public at large. The transparency ranking also does not take into account what portion of the budget is considered classified information for reasons of national security.

<sup>107</sup> On Russia's individual ranking, see International Budget Partnership, *Open Budget Survey 2015 – Russia*, <https://www.internationalbudget.org/wp-content/uploads/OBS2015-CS-Russia-English.pdf> (accessed 2 January 2018).

<sup>108</sup> IMF, *Russian Federation: Fiscal Transparency Evaluation* (see note 3).

### The Russian Finance Ministry occasionally seeks advice from international organizations to professionalize expenditure planning.

The percentage of confidential budget expenditures has increased in Russia in recent years, in apparent contradiction to the improvements in its transparency rankings. In 2016, 21.7 percent of federal expenditures were classified.<sup>109</sup> This is a spectacularly high percentage: In many of the G20 countries, less than 1 percent of budget expenditures are classified.<sup>110</sup> In Russia, not only arms purchases in the defense budget are classified, but expenditures in the categories of “federal questions” (especially in the subcategory “international relations and international cooperation”) and “economy” (especially in the subcategory “other questions of the national economy”) are listed as classified to an increasing degree.<sup>111</sup>

Other less conspicuous tendencies exacerbate the lack of transparency in the budget while simultaneously creating additional flexibility for the Kremlin. There was an increase in the percentage of unspecific subcategories in budget plans such as “other expenditures” that can be allocated to specific uses later. The funds in contingency or shadow budgets such as the “presidential reserve”, introduced in 2014, or accumulated in the state holding Rosneftegaz are growing.<sup>112</sup> In budget years 2018–2020, over one billion rubles (over €15 billion) are allocated to general items like these that can be used by the executive branch at its own whims and without a supplementary budget. The percentage of these kinds of items was half that in the previous year’s budget.<sup>113</sup>

**109** Confidentiality can be used to avoid critical discussions among political actors about expenditures. For Russian civil servants, there are also strong personal incentives to expand confidentiality: Employees of Russian agencies that work with confidential information receive salary increases of as much as 75 percent; see Julian Cooper, “The Russian Budgetary Process and Defence. Finding the ‘Golden Mean’”, *Post-Communist Economies* 29, no. 4 (2017): 483.

**110** IMF, *Russian Federation: Fiscal Transparency Evaluation* (see note 3), 33.

**111** Gaidar Institute, *Russian Economy in 2016. Trends and Outlooks* (see note 78), 469.

**112** See the following section on Rosneftegaz.

**113** Ivan Tkachëv, “Oboronnyj trillion: v bjudzhet sozdadut rezerv na ‘otdel’nye meroprijatija” [Defense trillion: A reserve for “special measures” introduced into the budget],

### Bypassing the budget: Public funds in state-owned companies

State-owned enterprises in Russia serve as an important source of budget revenues from tax payments, dividends, and proceeds from privatization. In 2016 the government’s partial sale of its own shares in the oil companies Bashneft and Rosneft significantly reduced the looming budget deficit. At the same time, state-owned enterprises are being used directly by the Russian leadership to achieve their political aims. This dual role has impeded reforms of the sector and has created a breeding ground for conflicts within the Russian elite.

The Russian government controls numerous companies. Their annual expenditures make up an estimated 29–30 percent of Russian GDP.<sup>114</sup> Most of these are what are known as *unitary enterprises*, which are controlled directly by the federal, regional, and local government administrations. Well known examples include the Russian Post, Mosfilm film studio, and the Moscow Metro. A second group of government-owned enterprises are *joint stock companies*, which are partially privately owned and listed on foreign stock exchanges. These include the two largest Russian state firms in the energy sector, Gazprom and Rosneft, Russia’s pipeline monopoly Transneft, the state-owned Sberbank and VTB Bank, and service providers like the airline Aeroflot or Rostelecom. A third, very particular type of state-owned enterprise can be best compared to foundations: *state corporations*, which include the defense and industrial holding conglomerate Rostec and the development bank Vnesheconombank (VEB), are effectively owned by themselves.

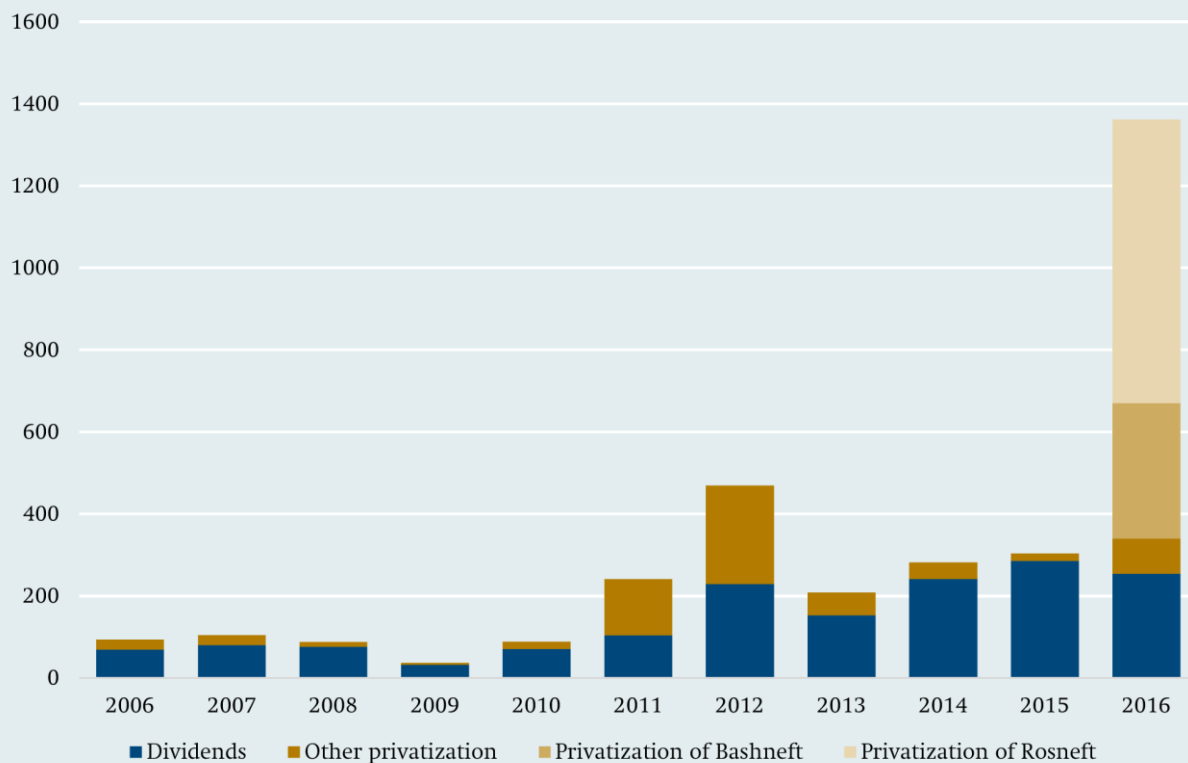
Whereas unitary enterprises have limited power to make decisions without the agreement of the respective government level, joint stock companies and state corporations have much greater formal independence. The Russian President appoints and dismisses the managing directors of state corporations, and thus holds the strongest influence over them.<sup>115</sup> Thanks to Vladimir Putin’s personal relationships to

RBC, 18 September 2017, <https://www.rbc.ru/economics/18/09/2017/59bfff3cf9a794710a9300d17> (accessed 2 February 2018).

**114** IMF, *Russian Federation: Fiscal Transparency Evaluation* (see note 3).

**115** Viktor Kessler, *Die sichtbare Hand des Staates. Eine rechts-ökonomische Analyse russischer Staatskorporationen*, Schriftenreihe zum Osteuropäischen Recht 19 (Berlin, 2013), 326.

Figure 10

**Russian budget revenues from state-owned enterprises, 2006–2016 (in billion rubles)**

Source: Gaidar Institute, *Russian Economy in 2016. Trends and Outlooks* (Moscow, 2017).

the corporate executives, the Kremlin has the possibility to exercise relative direct control and influence, independent of company structure. Putin has a shared history at KGB in Dresden with Sergey Chemezov and Nikolay Tokarev, chief executives of the state corporation Rostec and oil pipeline company Transneft. The CEO of Rosneft, Igor Sechin, has been working at Putin's side since the early 1990s.

The transparency of state-owned enterprises is determined by their legal form and whether they are listed on international capital markets. Open joint stock companies listed on foreign markets are subject to the strictest regulation and outside auditing. State corporations, in contrast, are not subject to regular outside audits of their activities.<sup>116</sup> Since they are not legally under state ownership, their revenues do not

flow into the budget.<sup>117</sup> Unitary enterprises and joint stock companies are less privileged: part of their profits have to be paid into the budget (in particular, stock companies' dividends). They also provide budget financing when they are either fully (relatively rare) or partially (more frequent) privatized.

### **Dividends: Insubordinate energy companies**

The leadership of state-owned joint stock companies prefer to keep their profits and reinvest according to their own priorities. The average amount of dividends paid by state joint stock companies to the budget is low by international comparison.<sup>118</sup> The Finance Min-

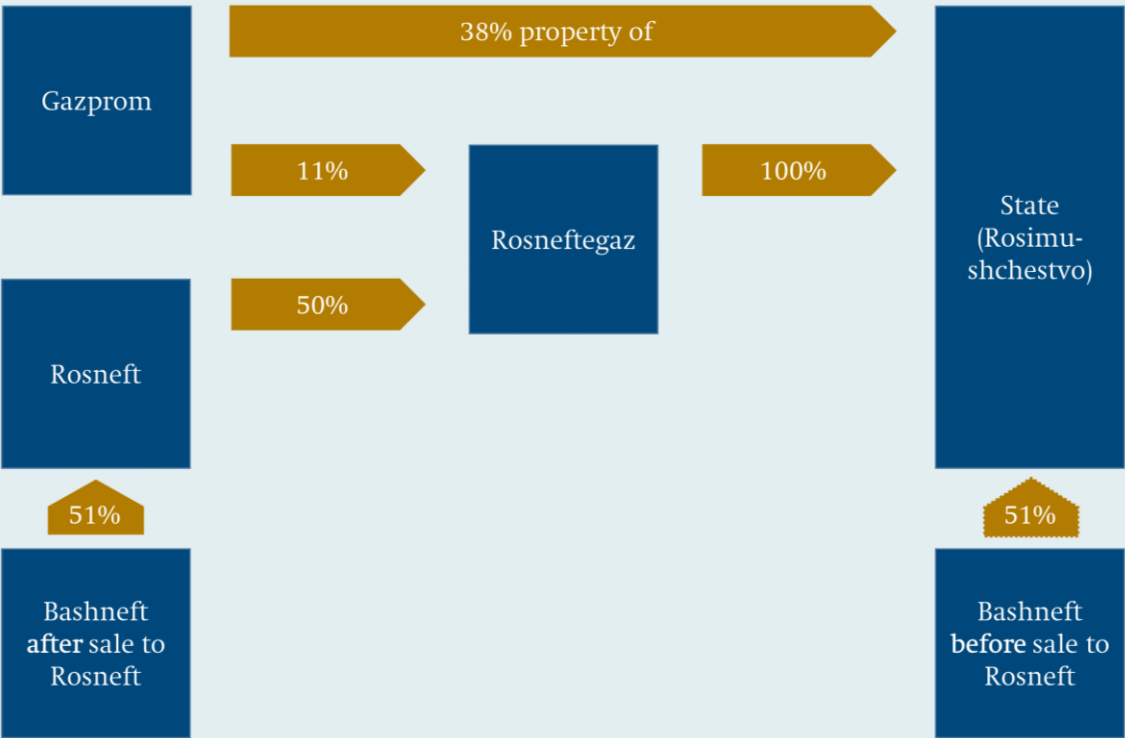
<sup>116</sup> In some cases, there are stricter laws applying to state corporations depending on the acts of incorporation and form of financing, see *ibid*.

<sup>117</sup> Carsten Sprenger, "State Ownership in the Russian Economy. Its Magnitude, Structure and Governance Problems", *Journal of Institute of Public Enterprise* 33, no. 1–2 (2010).

<sup>118</sup> Aleksandr Branis, "Otdajte dividendy!" [Pay out the dividends!], *Vedomosti*, 1 March 2017, <https://www.vedomosti.ru>.

Figure 11

Nested shareholdings in state-owned energy companies as of May 2018



Source: Diagram by author based on Margarita Papchenkova, Elizaveta Bazanova, and Ol'ga Petrova, "Minfin prodolzhaet bor'bu za dividendy goskompanij" [Finance ministry continues battle over dividends from state-owned companies], *Vedomosti*, 10 July 2017, <https://www.vedomosti.ru/economics/articles/2017/07/10/717277-minfin-dividendi> (accessed 3 January 2018).

istry therefore receives significantly less as returns on equity from the shares in state joint stock companies than what it has to spend on its own financing through sovereign bonds. This means an implicit "dividend subsidy" to state companies — independent of tax benefits and other forms of subsidies — in the amount of 386 billion rubles in 2015 and 346 billion rubles in 2016 (€5.9 and €5.2 billion, respectively).

The Finance Ministry has been working for several years to impose the same rules for dividends on all state-owned joint stock companies. This has been unsuccessful to date, however, due to exemptions that some companies have secured with support from the Kremlin.

To increase budget revenues after the drop in the oil price, Prime Minister Medvedev issued a directive

[ru/opinion/articles/2017/03/02/679573-otdaite-dividendi](http://ru/opinion/articles/2017/03/02/679573-otdaite-dividendi) (accessed 2 February 2018).

in April 2016 attempting to force higher dividend payouts. According to this directive, in 2017, state-owned joint stock companies were to pay out 50 percent of the previous year's net profits according to the International Financial Reporting Standards (IFRS). The increase in revenues was already planned into the budget law for 2017–2019. As early as Spring of 2017, however, the Russian Accounts Chamber had doubts as to whether the government would be able to overcome opposition from the corporations and push this through.<sup>119</sup>

Most of the smaller joint stock companies complied and distributed more of their profits than in

**119** Schetnaya Palata, *Zakljuchenie Schetnoj palaty Rossijskoj Federacii na proekt federal'nogo zakona № 185935-7* [Conclusions of the Russian Accounts Chamber on draft federal law no. 185935-7] (Moscow, 2017), <http://audit.gov.ru/activities/audit-of-the-federal-budget/30381/> (accessed 8 August 2017).



the previous years. In the energy sector, however, further exceptions were made with support from the Kremlin. Despite the 50 percent directive, the amount of Gazprom dividends was just 20 percent of their profits from 2016 according to the IFRS, which they justified by major investment projects (especially the construction of gas pipelines). Rosneft distributed 35 percent of its net profits. The official explanation for this was that since the company is only indirectly owned by the state, via Rosneftegaz (see figure 11), Rosneft is not, strictly speaking, state-owned and Medvedev's directive therefore does not apply to it. The pipeline company Transneft distributed just 13 percent of its IFRS profits in 2017, and justified this by arguing that a higher payout contradicted Russian accounting principles, because the profits were recorded almost entirely by the subsidiary companies and not by Transneft itself.<sup>120</sup>

A clear pattern emerges in the distribution of dividends: In the past, the three companies Gazprom, Rosneft, and Transneft fulfilled numerous political functions for the Kremlin, among other things in the construction of oil and gas pipelines and management of energy exports, in the nationalization of the media landscape (especially by Gazprom Media), or in providing financial support for public infrastructure projects or foreign allies.<sup>121</sup> In the case of these companies, the Russian leadership is less interested in having profits flow into the federal budget, since it can directly and informally influence how they are used in the companies themselves. This also means that the directors of these companies are themselves powerful figures who have no interest in reforming the public sector.

## Rosneftegaz as a shadow budget

The case of the state energy holding Rosneftegaz clearly shows how public funds are used politically in bypassing the budget. The Rosneft dividends and part

of the Gazprom dividends do not go directly into the Russian budget but are distributed to Rosneftegaz, which stands between the state and the energy companies. The holding company is the formal owner of all government Rosneft shares and is 100 percent state-owned. It originally served as a vehicle for a merger that was planned in 2004 between Rosneft, which was much smaller at the time, and Gazprom, but that was not carried out.<sup>122</sup> Today, the holding is controlled by the CEO of Rosneft, Igor Sechin, who is Rosneftegaz's board chairman. The management of Rosneftegaz also comes from Rosneft.<sup>123</sup>

Sechin had initially left his post at the head of Rosneft in 2011 under pressure from then President Medvedev. With Putin's return to the Kremlin, Sechin took over leadership of the company again. Since Sechin's return, Rosneftegaz has changed its dividend payout policy and only passes on part of the dividends it receives from Rosneft, Gazprom, and other shareholdings to the federal budget, leaving the majority of these profits in the accounts of Rosneftegaz.

Raiffeisenbank estimated the amount of dividends collected by Gazprom and Rosneft at the end of 2016 at 544 billion rubles (€8.2 billion). The actual amount is not public information because Rosneftegaz's legal status changed in 2016 from an open joint stock company (Otkrytoye aktsionernoye obshchestvo) to a closed joint stock company (Aktsionernoye obshchestvo). The last public annual report is from 2014.<sup>124</sup> Even the Russian Ministry of Economics was unsuccessful in its recent efforts to obtain information on Rosneftegaz's finances.<sup>125</sup> In response to an inquiry to this effect from Rosimushchestvo, the Russian Federal Agency for State Property Management, the director

<sup>120</sup> Margarita Papchenkova, Elizaveta Bazanova and Ol'ga Petrova, "Minfin prodolzhaet bor'bu za dividendy goskompanij" [Finance ministry continues battle over dividends in state-owned companies], *Vedomosti*, 10 July 2017, <https://www.vedomosti.ru/economics/articles/2017/07/10/717277-minfin-dividendi> (accessed 3 January 2018).

<sup>121</sup> On Rosneft, see Hans-Henning Schröder, "Der Mineral-ölkonzern 'Rosneft'. Kommerzieller Erfolg und Einsatz politischer Machtmittel" [The mineral oil corporation Rosneft. Commercial success and the use of instruments of political power], *Russland-Analysen*, no. 348 (2018): 9–16.

<sup>122</sup> "Chronika slijanija" [Timeline of the merger], *Kommersant*, 3 March 2005, <https://www.kommersant.ru/doc/551982> (accessed 2 February 2018).

<sup>123</sup> Dmitrij Kozlov, "Rukovodstvo 'Rosneftegazom' doverili eks-ministru" [Former minister entrusted with leadership of Rosneftegaz], *Kommersant*, 3 June 2016, <https://www.kommersant.ru/doc/3005490> (accessed 5 February 2019).

<sup>124</sup> "'Rosneftegaz' poluchil pravo skryvat' o sebe informaciju" [Rosneftegaz gains right to keep company information confidential], *Interfax*, 18 March 2016, <http://www.interfax.ru/business/499118> (accessed 5 January 2018).

<sup>125</sup> Margarita Papchenkova and Galina Starinskaya, "Finansy 'Rosneftegaza' zakryty poka i dlja pravitel'stva" [Rosneftegaz finances remain classified for the government], *Vedomosti*, 27 June 2017, <https://www.vedomosti.ru/economics/articles/2017/06/26/697334-finansi-rosneftegaza> (accessed 2 January 2018).



of Rosneftegaz stated that he only sends his reports directly to the Russian President.<sup>126</sup>

President Vladimir Putin has expressly supported Sechin's efforts to withhold profits retained by Rosneftegaz from the Russian budget and to use them to create a shadow budget outside of public control and beyond the reach of budget laws. In response to questions about the dividends accumulated by Rosneftegaz, he remarked: "We will use Rosneftegaz funds for things that there is no money left for after all the bickering and wrangling, but that need funding."<sup>127</sup> According to Putin, Rosneftegaz gives priority financing to research projects and the construction of aircraft and engines. The state holding also finances the Rosneft shipbuilding complex Zvezda near Vladivostok and the construction of four power plants in Kaliningrad.<sup>128</sup>

## Privatization

Through Igor Sechin, the Russian President has access to funds from Rosneftegaz to address economic and social problems that the Kremlin considers urgent. The government's informal control over these businesses also bears risks, however, because it gives those at the helm of the companies (such as Igor Sechin) personal political clout. Not just the dividend policy but also privatizations bear substantial potential for conflict: the lucrative and influential position of the corporate managers close to the Kremlin is under threat when state-owned enterprises pass over into private ownership.

This partially explains why budget revenues from privatization in Russia have been significantly lower than revenues from dividends over the last few years. The year 2016 was an exception because of two particularly large privatization projects. Without the sales of shares in the oil companies Bashneft (330 bil-

lion rubles, €5 billion) and Rosneft (692 billion rubles, €10.5 billion), the federal budget deficit would not have been 3.4 percent but 4.6 percent of GDP.

The sales of shares in Rosneft was part of a privatization program adopted in 2013, which was scarcely implemented otherwise. It was planned that smaller stakes would be sold not only in Rosneft but also in the state corporations Alrosa (diamond mining), Aeroflot (airline), Sovcomflot (shipbuilding), Transneft, Rushydro (hydropower), the national railway, and the state bank VTB.<sup>129</sup> Almost no additional revenues from privatization are part of the budget plans up to 2020.<sup>130</sup>

The Bashneft shares were renationalized in 2014. Previous to that, the mineral oil company had been majority-owned by the private holding Sistema, headed by Russian businessman Vladimir Yevtushenkov. The sale of shares to Rosneft that followed this in 2016 cannot be considered as privatization in the strict sense, because the shares in Bashneft went from the state agency Rosimushchestvo to state-owned Rosneft. Bashneft is thus still state-controlled but is now part of the company headed by Igor Sechin.

The sale of Bashneft to Rosneft was preceded by disputes over whether such pseudo-privatizations make sense. Former Minister of Economic Development Alexey Ulyukhaev and the former head of Rosneft Board of Directors, Andrey Belousov,<sup>131</sup> expressed criticism. They argued that the sales of one state-owned enterprise to another does not create additional budget revenues in the long term. Igor Sechin ultimately kept the upper hand, however, and was able to integrate Bashneft into Rosneft. The formal justification for the transaction was — as in the preceding discussion around dividend policy — that Rosneft was not a state-owned corporation in the narrow sense, as it was controlled by Rosneftegaz.

**126** Margarita Papchenkova and Galina Starinskaya, "Poluchit' dochody ot 'Rosneftegaza' v bjudzhet, vozmozhno, ne poluchitsja" [May not be possible to obtain Rosneftegaz profits for the budget], *Vedomosti*, 25 October 2016, <https://www.vedomosti.ru/economics/articles/2016/10/25/662262-dohodi-rosneftegaza> (accessed 2 January 2018).

**127** "Putin pojasnil, na kakie proekty pojduť den'gi 'Rosneftegaza'" [Putin explained which projects the Rosneftegaz money are going to], *RIA Novosti*, 23 December 2016, <https://ria.ru/economy/20161223/1484467582.html> (accessed 17 August 2017).

**128** Papchenkova, Bazanova, and Petrova, "Minfin prodolzhaet bor'bu za dividendy goskompanij" (see note 120).

**129** Part of the Alrosa shares were sold in 2016, Tat'jana Radchenko, *Gosudarstvennoe uchastie v rossijskoj ekonomike: goskompanii, zakupki, privatizacija* [Government involvement in the Russian economy: state enterprises, procurement, privatization], *Bjulleten' o razvitii konkurencii* 13 (Moscow, 2016), <http://ac.gov.ru/files/publication/a/8449.pdf> (accessed 3 August 2017).

**130** Minfin Rossii, *Osnovnye napravlenija bjudzhetnoj, nalogovoj i tamozhenno-tarifnoj politiki na 2018 god i planovyy period 2019 i 2020 godov* [Fundamental directions of the budget, tax and customs tariff policy for the year 2018 and the planning periods 2019 and 2020] (Moscow, 2017).

**131** His successor in this position is former German Chancellor Gerhard Schröder.

The reprivatization of Bashneft had politically significant legal consequences in the arrest and subsequent conviction of Minister of Economic Development Ulyukayev. The legal proceedings against Ulyukayev were the result of a covert operation initiated by Sechin and carried out by the Federal Security Service (FSB). At a meeting with Sechin, Ulyukayev had accepted a closed suitcase containing \$2 million in cash. According to Sechin, the Minister had solicited the money in exchange for agreeing to the sale of Bashneft to Rosneft, which Ulyukayev denied. In December 2017, Ulyukayev was sentenced to eight years in prison and a fine of \$2 million. The court proceedings failed to produce clear proof of Ulyukayev's guilt.<sup>132</sup>

It was the first time in the history of post-Soviet Russia that a Federal Minister was jailed. Reform-oriented politicians like Alexei Kudrin must have understood Ulyukayev's sentence as a signal to those "systemic liberals" still in the government not to interfere in the business of state-owned enterprises. Kudrin, who called the Ulyukayev sentence "terrible and unjustified", had proposed a far-reaching privatization of state-owned enterprises himself in summer of 2017.<sup>133</sup> Whether the political leadership actually wanted to send that kind of signal is unclear. The case does make it clear, however, what risks the personalized control of public resources entails for the internal stability of the political system and its capacity to undergo reforms.

**132** Roland Götz, "Ulyukayev Fall und Jewtuschenkows Niederlage. Rosnefts Expansion durch Annexion" [Ulyukayev's fall and Yevtushenkov's defeat. Rosneft's expansion by annexation], *Russland-Analysen*, no. 348 (2018): 2–4, <http://www.laender-analysen.de/russland/pdf/RusslandAnalysen348.pdf> (accessed 5 February 2018).

**133** "Kudrin prizval k privatizacii vseh neftnykh aktivov" [Kudrin called for privatization of all oil companies], *Interfax*, 1 June 2017, <http://www.interfax.ru/forumspb/564758> (accessed 5 February 2018).

# Outlook and Recommendations

A decade of economic stagnation and the oil price slump have largely exhausted the Russian Finance Ministry's reserves. With recovering energy prices, they are now only being replenished slowly. However, Russia's public debt remains low. As a result, even though the Russian leadership did not carry out structural reforms after the economic crisis, the financial stability of Russia's government budget is not in immediate danger.

The Kremlin's fiscally conservative stance may at first seem to promote stability. In recent years, the political leadership has succeeded in maintaining the status quo by further centralizing formal authority over political and economic decisions and by instituting informal controls, particularly in the case of the major state-owned enterprises. This form of crisis management promotes some processes, however, that could prove to be problematic in the long term, both for domestic policy as well as for Russia's relationship to Germany and the EU.

Moscow's handling of the fiscal pressures in 2015 and 2016 shows that Russian authoritarianism is becoming even less transparent and simultaneously more centralized. The concentration of economic and political power in the hands of Vladimir Putin and his immediate circle will exacerbate the risks to stability for the regime in the years to come, since according to the constitution, the Russian president is not allowed to stand for election in 2024. If there is indeed going to be a change of guard in the Kremlin in 2024, according to the common practice in Russia, the successor will already take office as acting President even earlier, before the presidential election takes place. The political poker for Putin's succession could begin early, and a series of measures undertaken since 2016, such as the reappointment of officials to important positions within the Kremlin administration can already be understood as part of this process. The stakes are high, and the struggles around

who will fill these positions can be expected to lead to new conflicts within the Russian elite.

Against this backdrop, there can be little hope that the Kremlin will push forward with politically difficult economic reforms that could ultimately lead to diversification and sustainable development of the Russian economy. In view of the demographic burdens and the uncertainty regarding new US sanctions, ongoing economic stagnation is more likely, which could increasingly undermine the legitimacy of the regime. The Kremlin recently dealt with this problem by increasing repression and intensifying its control over the media and social networks.

When faced with economic difficulties in the past, the Russian leadership has also used anti-Western propaganda as an alternative strategy of legitimization. If dissatisfaction within the Russian population increases, heightened foreign policy confrontation with the USA and EU could benefit the Kremlin.

The tightening in Russia's financial situation could also have negative impacts on the region's stability: If Russia discontinues its substantial subsidies to several neighboring countries (particularly Belarus), these countries could find it less appealing to maintain political and economic ties with Russia. At the same time, the Russian leadership is unlikely to relinquish its hegemonial claims. To compensate for its declining economic appeal, Russia could turn to other instruments of political power. One possibility would be the military;<sup>134</sup> others could include tough economic measures and trade sanctions or increased pressure on guest workers.

In the area of economic policy, just as in foreign policy, the Russian leadership has focused recent efforts on isolating itself to an increasing degree from

<sup>134</sup> See Margarete Klein, *Russlands Militärpolitik im post-sowjetischen Raum* [Russia's military policy in the post-Soviet space], SWP-Studie 19/2018 (Berlin: Stiftung Wissenschaft und Politik, September 2018).

the EU. The Kremlin took Western sanctions as an occasion to introduce a wide-ranging program of import substitution, including an import embargo that also affected German exports to Russia. The protectionism applies primarily to trade, however, and less to investments: The Russian government recently intensified its efforts to induce foreign manufacturers to move production to Russia. In its “special investment contracts” (“SpetsInvestKontrakt”) it promises privileges and stable long-term conditions.

Germany and the EU have few options at their disposal to influence Russian domestic and economic policy developments in the near term. This is due, on the one hand, to the current tense relationship with Russia and mutual economic sanctions, and on the other, to the Russian regime’s course of action over the last decade, which has been to systematically cut itself off from Western influences.

For this reason, above all, Germany and the EU should follow their own long-term strategic perspective. Diversification of the Russian economy, for instance, is not just in the economic but also in the security policy interest of the EU. With a diversified economy that is integrated into international supply chains, Russia is likely to develop a stronger national interest in the stability of international rules. The risks to the stability of the system would be lower in Russia if the government were less dependent on volatile oil and gas revenues.

Through targeted support for economic cooperation outside of trade in fossil energies, Germany and the EU could support diversification in Russia. The European Bank for Reconstruction and Development (EBRD) could play a central role in this. The bank has already financed investments in Russia that contribute to diversification, with a focus on small and medium-sized enterprises. According to the bank’s own figures, 90 percent of its clients are from the private sector.<sup>135</sup> For Russian entrepreneurs, cooperation with the EBRD means more than just the possibility of financing: the EBRD’s involvement is especially appealing to small and medium-sized private

enterprises because it can protect them against intrusion or expropriation by state actors.<sup>136</sup>

Due to Russia’s role in the crisis in Ukraine, the EBRD received instructions in July of 2014 not to fund any further investment projects in Russia. This decision is not part of the EU Council decisions on the Russian sectoral economic sanctions, which were tied to the implementation of the Minsk agreement.<sup>137</sup> The EBRD could thus resume its work again without the conditionality of the economic sanctions being undermined. Precisely because of the EBRD’s unique orientation, it would be beneficial to a strategic foreign policy towards Russia for the EBRD to begin funding projects in Russia again.

Furthermore, the significant interest on the part of the Russian leadership in attracting foreign manufacturers to Russia provides an opportunity to expand economic cooperation in the direction of long-term diversification. The large number of new investment projects in Russia shows that German companies are clearly interested in Russian investment agreements, despite the difficulties that import substitution creates. Although foreign investors in Russia cannot be expected to have an immediate transformative impact in the sense of “change through rapprochement”, the investments could at least help to create conditions that would allow Russia to begin moving toward a less oil-dependent future.

**135** European Bank for Reconstruction and Development (EBRD), *The EBRD in Russia: Overview*, <https://www.ebrd.com/cs/Satellite?c=Content&cid=1395238401543&pagename=EBRD%2FContent%2FContentLayout> (accessed 27 March 2018).

**136** Stanislav Markus, “Secure Property as a Bottom-Up Process. Firms, Stakeholders, and Predators in Weak States”, *World Politics* 64, no. 2 (2012): 242–77.

**137** European Commission, *European Union Restrictive Measures (Sanctions) in Force*, 2017, [https://eeas.europa.eu/sites/eeas/files/restrictive\\_measures-2017-08-04.pdf](https://eeas.europa.eu/sites/eeas/files/restrictive_measures-2017-08-04.pdf) (accessed 27 March 2018).

## Appendix A: Federal budget 2006 to 2020 (in percent of GDP) as of May 2018

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*	2019*	2020*
Revenues	23.3	23.4	22.5	18.9	17.9	18.9	18.9	17.8	18.3	16.4	15.6	16.4	15.7	15.1	14.8
Gas & oil	10.9	8.7	10.6	7.7	8.3	9.4	9.5	8.9	9.4	7.0	5.6	6.5	5.6	5.1	4.9
Other	12.4	14.7	11.8	11.2	9.7	9.5	9.4	8.9	8.9	9.4	10.0	9.9	10.0	10.0	9.8
Expenditures	15.9	18.0	18.3	24.9	21.8	18.1	18.9	18.2	18.7	18.8	19.1	17.8	17.0	15.9	15.6
Federal questions	2.0	2.5	2.0	2.2	1.9	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.2	1.1
Defense	2.5	2.5	2.5	3.1	2.8	2.5	2.7	2.9	3.1	3.8	4.4	3.1	2.8	2.7	2.5
National security	2.0	2.0	2.0	2.6	2.3	2.1	2.7	2.8	2.6	2.4	2.2	2.1	2.2	2.1	1.9
Economy	1.3	2.1	2.5	4.3	2.6	3.0	2.9	2.5	3.9	2.8	2.7	2.7	2.5	2.3	2.2
Education	0.8	0.9	0.9	1.1	1.0	0.9	0.9	0.9	0.8	0.7	0.7	0.7	0.7	0.6	0.6
Health	0.5	0.6	0.7	0.9	0.8	0.8	0.9	0.7	0.7	0.6	0.6	0.5	0.5	0.6	0.7
Sozial policy	0.7	0.6	0.7	0.8	0.7	5.2	5.7	5.2	4.4	5.1	5.3	5.4	4.8	4.6	4.4
Transfers**	5.6	5.7	6.5	9.3	8.9	1.1	0.9	0.9	1.0	0.8	0.8	0.9	0.9	0.8	0.7
Other	0.5	1.1	0.5	0.6	0.8	1.2	1.0	1.1	1.0	1.3	1.1	1.1	1.3	1.0	1.5
Surplus/Deficit	7.4	5.4	4.1	−6.0	−3.9	0.7	−0.1	−0.4	0.8	−2.4	−3.4	−1.4	−1.3	−0.8	−0.8

Note: Data on years marked with an \* are based on Russian budget planning for the period 2018–2020.

\*\*Includes federal transfers to regional budgets. Up to 2010, pension fund transfers were also included.

At the end of May 2018, a new budget bill was introduced in the Russian Duma taking the sharply increased oil price from 2018 into account.

As a result of this, revenues are 1.8 percent of GDP higher, and instead of a deficit of 1.3 percent of GDP, a surplus of 0.5 percent of GDP is expected,

Gosudarstvennaya Duma Federal'nogo Sobraniya Rossijskoj Federacii, *Zakonoproekt No. 476242-7* [draft law no. 476242-7], 29 May 2018,

<http://sozd.parliament.gov.ru/bill/476242-7>.

Source: Minfin Rossii, Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii (see note 1); Rosstat, Valovoj vnutrennij produkt (see note 1).

## Appendix B

### Consolidated budget 2006 to 2020 (in percent of GDP) as of May 2018

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*	2019*	2020*
Revenues	39.5	40.2	39.2	35.0	34.6	34.6	34.4	33.4	33.8	32.3	32.8	33.7	32.0	31.7	30.5
Gas & oil	10.9	8.7	10.6	7.7	8.3	9.4	9.5	8.9	9.4	7.0	5.6	6.5	5.6	5.1	4.9
Other	28.5	31.5	28.5	27.4	26.3	25.2	24.9	24.5	24.4	25.3	27.1	27.2	26.4	26.4	25.6
Expenditures	31.1	34.2	34.3	41.4	38.0	33.2	34.0	34.6	34.9	35.7	36.4	35.2	33.9	32.8	31.4
Federal questions	3.1	3.5	3.1	3.4	3.1	2.3	2.1	2.1	2.1	2.2	2.1	2.1	2.0	1.9	2.0
Defense	2.5	2.5	2.5	3.1	2.8	2.5	2.7	2.9	3.1	3.8	4.4	3.1	2.8	2.7	2.6
National security	2.7	2.6	2.6	3.2	2.9	2.5	2.8	3.0	2.8	2.5	2.3	2.2	2.2	2.1	1.9
Economy	3.5	4.7	5.5	7.2	5.0	4.6	4.8	4.5	5.7	4.5	4.5	4.7	4.0	3.7	3.6
Education	3.9	4.0	4.0	4.6	4.1	3.7	3.8	3.9	3.8	3.6	3.6	3.5	3.5	3.4	3.3
Health	3.6	4.2	3.7	4.3	3.7	3.2	3.3	3.2	3.2	3.4	3.6	3.1	4.0	3.8	3.7
Social policy	8.8	8.6	9.1	12.2	13.3	10.8	11.3	12.0	11.1	12.6	12.7	13.1	12.3	12.0	11.0
Other	3.0	4.1	3.8	3.4	3.1	3.6	3.2	3.0	3.1	3.1	3.2	3.4	3.1	3.2	3.3
Surplus/Deficit	8.4	6.0	4.9	-6.3	-3.4	1.4	0.4	-1.2	-1.1	-3.4	-3.7	-1.5	-1.9	-1.1	-0.9
Non-Oil Deficit	-2.6	-2.7	-5.8	-14.0	-11.7	-7.9	-9.1	-10.1	-10.5	-10.4	-9.3	-8.0	-7.5	-6.2	-5.9

Note: The consolidated budget combines the federal budget, the regional and municipal budgets, and the social insurance, but net of all transfers between levels of government. Data on years marked with an \* are based on Russian budget planning for the period 2018–2020.

At the end of May 2018, a new budget bill was introduced in the Russian Duma taking the sharply increased oil price from 2018 into account.

As a result of this, revenues are 1.8 percent of GDP higher, and instead of a deficit of 1.3 percent of GDP, a surplus of 0.5 percent of GDP is expected;

Gosudarstvennaya Duma Federal'nogo Sobraniya Rossijskoj Federacii, *Zakonoproekt No. 476242-7* [draft law no. 476242-7], 29 May 2018,

<http://sozd.parliament.gov.ru/bill/476242-7>.

Source: Minfin Rossii, *Finansovo-ekonomicheskie pokazateli Rossijskoj Federacii* (see note 1); Rosstat, *Valovoj vnutrennij produkt* (see note 1).

## Abbreviations

CAATS-Act	Countering America's Adversaries Through Sanctions Act
EBRD	European Bank for Reconstruction and Development
FSB	Federalnaya Sluzhba Besopasnosti (Federal Security Service)
GDP	Gross Domestic Product
GPV	Gosprogramma vooruzheniy (state armaments program)
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
OFZ	Obligatsii Federalnovo Zaima (Russian federal loan bonds)
OPEC	Organization of the Petroleum Exporting Countries
SIPRI	Stockholm International Peace Research Institute
VEB	Vneshekonombank





