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Russia’s Regional Debt Spiral

It all started with three regions – Udmurtia, Khakassia and Karelia – which recently sought emergency financial assistance from Moscow. Each region had already announced their inability to meet some of their core budgetary obligations. These included various salary increases for public sector employees, which had been stipulated in Putin’s “May Decrees” of 2012.

Earlier it was assumed that the regions would implement the “May Decrees” (for example, to increase salaries of doctors and teachers to an above average salary level for the region) by the end of President Vladimir Putin’s third term. But these targets can no longer be met. And not even with the use of statistical tricks: compared to May 2012, a new calculation method lowered the target level of salaries by 10-13 percent. Other strategies to make this policy viable, including job cuts in schools and hospitals, which could then free up funds to increase salaries of those who remain in employment, have still left regional governments strapped for cash and short of their targets. Most likely, the program will have to be extended for two or three years and, for the most part, it will require further federal funding.

The three regions in question are precisely the regions which were burdened with the task of implementing the president’s “Salary decrees” (from 70% in 2013 to 80% in 2016). It soon became clear these decrees are in no way justifiable from an economic perspective, and the increased salaries were nothing to do with increased productivity. However, no one foresaw that the economic downturn, which started in 2013, would aggravate due to economic sanctions and a fall in energy prices. Back in 2012, it was stated that economic growth of no less than 5% was required to reach Putin's targets. Currently, the Ministry of Economic Development optimistically anticipates a maximum growth of 2 percent next year. In 2017, Russia's economy might record its first positive growth figure since 2014.

In the face of plummeting revenues and a stagnant economy, regions sought to balance their budgets by issuing bonds and seeking more and more loans from both commercial banks and the federal state. Levels of indebtedness now vary greatly from region to region. According to the Independent Institute for Social Policy, debt levels have soared to between 80 percent and 100 percent of revenue in 12 regions, 100-125 percent in seven regions, 185 percent in Mordovia and 35 percent on average. As estimated by the Russian National Audit Office, the cost of servicing regional debts has increased twofold in the last three years. Costs of debt repayment have ballooned. Servicing debt is 3.6 times higher now; the total stands at 2.3 trillion rubles. According to the Analytical Credit Rating Agency, approximately 30 percent of regional revenue has been earmarked for servicing debt. As estimated by the "New Republic" Fund, the cumulative debt of all of the Russian regions combined has virtually increased 5-fold from 432.6 billion rubles to 2.3 trillion rubles in the last decade.

Meager consolation can be found. Regional debt owed this year as the proportion of high-interest bank loans has fallen from 44 percent to 35 percent while the share of budgetary loans has increased from 34 to 45 percent, largely thanks to the efforts of the Ministry of Finance. Earmarked funding will primarily be allocated to those whose share of commercial loans exceeds 50 percent. However, the problem is unlikely to be systematically resolved (not to mention the "negligible" amount of 60 billion rubles). Hence, regional debts will have to be restructured sooner or later. Truth be told, it will ultimately be necessary to write off the debts at the expense of the federal budget, that is, taxpayers will be expected to pony up the cash.

A 7-year budgetary debt restructuring program may be launched next year. Debtors will repay 5 percent of their debt a year from 2018 and 2019. Debt repayments will rise to 10 percent in 2020 and later to 20 percent from 2021 until 2024. Given such high levels of indebtedness, it remains unclear whether these concessions will help rescue regional economies or lead to conditions whereby it is possible to allocate funds to meet social needs and promote regional development. Moreover, given that according to Natalia Zubarevich from the Independent Institute for Social Policy, at least 52 regions are operating under a budget deficit this year. Unlike, for instance, in the US, no bankruptcy procedure exists in Russia where regions or municipalities are given a shot at a fresh start.

There is no single system for resolving debt problems in the region. Problems are addressed on an ad hoc basis, all dependent upon the political situation in a given region and the lobbying potential of local leaders. According to unofficial data, Deputy Prime Minister Dmitry Kozak is lobbying for the adoption of such a model, according to which "weak" regions, incapable of generating profits but where signs of social unrest are apparent, are bestowed greater federal support than "strong" regions, while those regions which have the potential to become catalysts for overall economic growth in the country receive less. The new buzzword here is "leveling the playing field" (reminiscent of Soviet leveling) primarily for the sake of political stability. Dagestan, the Chechen Republic, Altai Krai, Yakutia, the Kamchatka Krai and Kurgan Oblast, highly dependent on the central budget as a matter of course, are among the regions which could attract the most grants. The industrially more advanced Perm Krai and Krasnoyarsk Krai, Murmansk, Irkutsk, Lipetsk, Nizhny Novgorod and Chelyabinsk Oblasts will likely receive fewer grants. The curtailing of expenses due to reduced federal funding primarily affects long-term infrastructure investment aimed at stimulating economic growth, among other things.

To a large extent, the dire situation of indebted Russian regions stems from the centralization of budgetary processes in the country carried out in the early 21st century. This resulted in large portions of regional revenues (from taxes) being transferred to central government before being redistributed at the discretion of the federal center. Regional financial independence has largely diminished since the 1990s. In terms of budgetary processes, there is a distinct lack of federalism in the Russian Federation.

In addition to the above-mentioned agenda of presidential "May Decrees", the financial dictat of the central government (contrary to the principles of federalism) is also conspicuous in the way the state regulates the rules of the game. For instance, as estimated by Chairman of the Tax Committee of the State Duma Andrey Makarov, 79 percent of decisions concerning tax allowances for the regions were taken not at the regional level but rather centrally last year. The government decided to be more generous towards businesses and it is the regions who are feeling the pinch. This year, the federal center has decided to slash regional corporate income tax revenue by 3 percent. As a result, those who try to enhance production on the ground will suffer the most. The laggards will be supported at their expense, as was the case back in the Soviet era when underperforming collective farms were propped up.

According to the National Audit Office, 60 percent of losses due to tax allowances offered by the federal center are generated at the regional level. Moscow has just begun to develop a plan for the redistribution of taxes between the center and regions while staring down the barrel of a severe debt crisis. Moscow also intends to cancel some of the tax allowances afforded to regions and municipalities which were introduced by the central authorities.

On the other hand, the system of central provision of financial assistance is also extremely rigid and bureaucratic. Regions are afforded minimum autonomy when it comes to allocating funds. This is a typically Russian model borne out of the state's outright disdain for its citizens and any regional economic structures; maximum control must not be relinquished by the state.

Three types of federal assistance are provided to the regions: grants (without stringent criteria which stipulate how funds are to be allocated), subsidies (which involve regional co-financing) and subventions (transfers of funds to the regional level in order to finance certain federal tasks of the federal bodies represented there). According to the National Audit Office, 40 percent of inter-budgetary transfers made to the regions in order to promote budgetary potential took the form of grants. The remainder were subsidies, subventions and other transfers given the green light at the federal level. The regions have no say here. There are more than a hundred types of subsidies alone and each is purpose-specific, no "deviations to the left or to the right" are permitted. There is strict control over the execution of funds at ministerial level and through other federal agencies. Regions have zero autonomy when it comes to planning how to effectively allocate funds for, say, agriculture, healthcare or education. Consequently, the regions will never learn to generate revenues independently and will forever be reliant on Moscow for funding. Importantly, however, this does guarantee their loyalty will endure and the value of that fealty has been elevated above economic development in recent times. Needless to say, the varying pace of development across different regions of the federation is fraught with political danger.

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