AN ASSESSMENT OF THE LONG TERM FISCAL SUSTAINABILITY IN RUSSIA WITH FISCAL GAP INDICATOR

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Abstract

The gradual increase in life expectancy and decline of fertility leads to an increase in the average age of the population. Population ageing is a global and persistent process which is present not only in advanced economies but also in emerging ones. Eventually this leads to a steady increase in government spending for social needs and therefore puts long run sustainability of government finance under question. Russia is not an exception in that sense. Even though current state of government budget looks quite solid there is significant risk of fiscal balance weakening during the next several decades. If the main structural characteristics of the fiscal policy are preserved the following increase in pension and healthcare expenditures would widen budget deficit and would lead to government debt crisis. In order to address this problem either expenditures should be cut or revenues should be raised.

Some steps have been done already. Recently VAT rate has been increased and the schedule of retirement age increase has been approved. However in the view of the decline in oil revenues due to extraction stagnation these measures might not be enough to fix then problem of the long run fiscal imbalances. In this research we study long run fiscal sustainability of Russian budget taking into account the described demographic trends and expected oil sector developments. To evaluate sustainability we use fiscal gap indicator which values has natural economic interpretation. It is also possible to use fiscal gap indicator to assess whether various changes in fiscal policy are enough to close the long run deficits. We also apply it to determine the sources of budget imbalances.

In the paper we only study the Russian budget sustainability from long run perspective. Debt crises in Russia may well be triggered by a sizeable fall in oil prices, political unrest or by some other exogenous shocks. We do not consider such risks and focus on the long run fiscal trends driven by demographics and developments in the energy sector. In other words, we apply fiscal gap methodology to check if the fiscal policy with current structural parameters is able to provide stability of government finance but put aside all sorts of vulnerabilities of the Russian budget with respect to exogenous macroeconomic shocks.

The cornerstone of the debt sustainability analysis is the theoretical concept of fiscal sustainability. The concept implies that fiscal sustainability is entirely represented by the equality

of present values of the future budget receipts on the one hand and the sum of current government debt and present value of the future government budget outlays excluding debt payments on the other hand. If this equality holds then the flow of expected revenues is just enough to cover expected expenditures and debt repayment. The equality which is called the government intertemporal budget constraint can be used as a natural instrument for sustainability assessment. For that purpose one should project both future budget expenditures and revenues and then check if the flows are consistent with the intertemporal government budget constraint. In the case if it is not the difference between the present value of revenues and the present value of expenditures together with the value of current net debt gives quantitative assessment of the long term fiscal imbalances.

The value of fiscal gap is defined as the described difference and the larger is fiscal gap the more underfinanced are future government expenditures. Dividing the value of fiscal gap by the present value of GDP allows to get a sustainability indicator with clear economic interpretation. It shows what permanent increase in fiscal balance in terms of share of GDP is needed to bring budget to sustainable path. To get the indicator value one should also project the output flow.

In the paper we build detailed projections of government expenditures and revenues taking into account age-related spending and linking it to the demographic projections. While projecting revenues we assume that oil and gas reserves deplete in the future. All projections are essentially an accurate extrapolation of the official long term macroeconomic projections prepared by the Ministry of economic development and the demographic projections of the Rosstat.

Several groups of scenarios are considered. The estimated fiscal gap value is between 9,4 and 12,4% of present value of GDP which documents significant fiscal imbalances. In all scenarios we get positive fiscal gap therefore we conclude that the absence of sustainability is a result which is robust to underlying assumption choice.

There are two main sources of long term unsustainability. First of all age related spending increases in subsequence decades. Pension expenditures are going to rise even if the retirement age is increased according to the recently adopted schedule. Healthcare expenditures also increase. Weak demographic performance widens fiscal imbalances. We also show that increase in the retirement age does sharply strengthen fiscal stance of Russia in the long run. The second factor standing behind large fiscal gap is a decrease in energy revenues which is not due to depletion but rather a result of projected oil and gas production stagnation. Alternative scenario with infinite reserves assumption does not give the fiscal gap value that is significantly lower.

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