Budget and tax problems and central banks: Russia's experiences

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1. Medium-term budget and tax positions of emerging market economies

The most widely used indicator of the position of the budget, and the efficiency of the budget policy as a whole, is the ratio of the fiscal deficit or surplus to GDP. It should be noted, however, that if it is necessary to determine more precisely the credibility of the fiscal policy pursued, the analysis of this ratio should be complemented by information on the structural aspects of government revenue and expenditure. In Russia, the size of a budget deficit or surplus is calculated on a cash basis or by financing method. The Central Bank of the Russian Federation (Bank of Russia) believes that one of the major preconditions for the implementation of an efficient monetary policy today is the pursuit by the federal government of a budget surplus policy, which creates conditions for optimal government debt management and makes enterprises competitive in the domestic market. In the last few years Russia has had a budget surplus: calculated according to the cash basis method, it was 1.1% of GDP in 2000, 2.6% in 2001 and 1.4% in 2002. Calculated on the basis of liabilities, the surplus has been considerably smaller owing to the constant accumulation of balances in the accounts of recipients of budget funds. The kernel of the matter is that the Federal Treasury has not yet created a single account for day-to-day management of budget resources. Budget-financed organisations are unable to gain instant access to funds to fulfil their obligations and therefore they have to keep considerable positive balances in their budget accounts. However, the main factor contributing to the budget surplus is the persistent efforts made by the federal government to reduce the country's domestic and foreign debt and create a financial reserve to compensate for peak government debt payments. As a result, such fiscal tactics of the government have a significant effect on the money supply and the monetary policy pursued by the Bank of Russia.

Owing to the country's three-tier budget structure, the federal government's budget surplus does not preclude budget deficits at the regional level. In 2000-02, the Russian government implemented a policy of centralising tax revenues at the federal level while simultaneously passing a part of regional and municipal budget liabilities to the federal budget. Specifically, it made the decision to include all value added tax revenues in the federal budget (previously 15-25% of VAT revenues went to regional budgets) and to cut the profit tax from 35% to 24%. At the same time, regional budget obligations to finance child and disability allowances have been transferred to the federal budget and transfers have been increased for regions with budget deficits. Nevertheless, a number of regions still have budget deficits.

Although under the Constitution the Russian regions are independent in managing their budgets, Russia must have a single budget concept, which should be implemented on the basis of effective budget interaction at all levels. It should be emphasised that a budget deficit is not always a bad thing. Its nature and role should be evaluated taking into consideration the causes, areas and uses of the additional financial resources mobilised and the sources and methods of financing. In recent years the government has increasingly used budget reserves as a precaution against a possible budget deficit, even though this method is not written down in the Budget Code. The 2002 Federal Budget Law provided for creating a financial reserve from the budget surplus of RUB 110 billion and free federal budget funds in the Federal Treasury accounts as of 1 January 2002. This fund can only be used as a substitute for internal and external sources of financing the federal budget deficit and government debt repayment. The Ministry of Finance manages the financial reserve in accordance with the procedures set by the federal government.

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Evaluation of the stability of the budget and tax position by central banks

One of the key indicators of stability of the budget and tax position is the amount and dynamics of government debt relative to GDP. Thanks to timely payments, by the end of 2002 Russia's government debt had contracted to 40% of GDP from 49% at end-2001. At the same time, the burden of government debt servicing remains heavy as interest payments account for (almost a third) of total expenditure in the federal budget. One of the indicators of the government's ability to fulfil its debt obligations is budget liquidity, that is, the ratio of budget revenues to government debt service expenditures. In the last two years, this ratio has gradually increased (from 6.5 in 2000 to 9.8 in 2002).

Of primary importance for a central bank is the movement of funds in its accounts opened for the budget implementing agencies and some government funds. The movement of funds in these accounts affects the monetary base. The Bank of Russia has opened accounts for the Federal Treasury and several government funds, both federal and regional. The Federal Treasury implements not only the federal budget, but also some regional budgets. Therefore, the balances of accounts opened with the Bank of Russia for the Federal Treasury and government funds are constantly monitored, and forecasts for their movement are used in drawing up the monetary programme.

The balance of budgets (fiscal position) is of interest as the budget is an instrument of the government's economic policy and influences aggregate demand.

According to the contemporary methodology of compiling budget implementation reports, the fiscal position is the difference between revenue (from taxes and the activities of government institutions) and expenditure. Therefore, it does not include revenue from the sale of state property and reserves or expenditures on debt servicing.

In recent years Russia has managed to show quite adequately the government's fiscal operations in the budget classification. The budget has also been quite clearly separated from the activities of government unitary enterprises, which pay taxes in compliance with the tax legislation and receive no subsidies from the government. Revenues from government assets are not recorded in the budget in full, as a part of them is appropriated by government and budget organisations which finance through their budgets some state or public expenditures. The government regulates tariffs on gas and electricity, rent and utility service prices and transport fares. These products and services are provided by government or municipal commercial companies. Their budgets are not transparent to government regulators, even though the government tries to analyse and set limits on their investment programmes. It should be noted that at present the existence of such quasi-fiscal interrelations does not upset tax and budget stability.

Restrictions imposed on regional and local government budget and tax positions

There are some differences between the financing of the regional and local government budget deficits and the federal budget deficit. First, the regional and local governments are barred from borrowing from external sources; second, they have no revenues from the sale of valuables, such as precious metals and gemstones. Some regions (Yakutia, Tatarstan and the Magadan region) have been granted this right under power sharing agreements with the federal government.

As the activities of some Russian regions in international capital markets in 1997-98 proved extremely inefficient owing to high insolvency risks of regional borrowers, Russia's current Budget Code allows only the federal government to use external sources for the financing of a budget deficit. Internal borrowings were banned at the regional level in the first few years after the 1998 crisis. These restrictions have been lifted, but an issue prospectus is subject to approval by the Finance Ministry, which ensures that the regions observe the 15% limit set by federal law on the total amount of their debt relative to their total revenue and the 30% limit on interest payments relative to their total expenditure.

Specifically, Russia's Budget Code contains a number of requirements that regulate the size of the budget deficit. A federal budget deficit, for example, cannot exceed the total amount of budget investments and government debt service expenditures, while a regional budget deficit cannot exceed 15% of revenue, excluding financial aid from the federal budget. The limit set on the regional budget deficit may be increased by the amount of revenues from the sale of regional government property. A local government budget deficit, approved by the corresponding local government's budget act, cannot exceed 10% of local budget revenue, excluding financial aid from the federal and regional budgets, although this limit may be raised by the amount of revenues from the sale of local government property.

Effectiveness of budget and tax rules as a means of regulating federal government balance sheets

There are some flaws in the tax and budget rules set out in the Budget Code with regard to the budget surplus. Specifically, they say nothing about the possibility of the government creating and accumulating a stabilisation or reserve fund from additional (extraordinary) incomes, which may be made necessary by the government debt service schedule or the exigencies of the macroeconomic policy.

Budget deficit correction strategies and central bank ability to maintain price stability

As countries that have a current account surplus normally do not need to take external loans, they may, in an emergency, finance a budget deficit from internal sources. The best option in this case, however, is implementing a budget surplus policy based on the principle of making a reserve from a part of extraordinary budget incomes received from exports. If the monetary authorities for some reason refrain from using a floating exchange rate as a means of reducing a large trade surplus, it is the budget that must fulfil the function of sterilising liquidity in order to maintain macroeconomic stability, and this policy brings additional revenue to the budget. Should the balance of payments deteriorate, the reduction of a budget surplus may become a source of additional money supply without creating a budget deficit and, consequently, without provoking a sharp rise in inflation.

The Russian balance of payments has been stable since the 1998 crisis and significant growth in the current account surplus and the continuing accumulation of foreign exchange reserves and reduction of capital outflow bear this out. In 2001, Russia's capital and financial account deficit (including growth in reserve assets) was one third smaller than in 2000. This deficit is mainly caused by the timely and full servicing of the government's foreign debt and partly by a net outflow of private capital from the country. At the same time, an excess of foreign exchange supply over demand has created conditions conducive to the accumulation of foreign exchange reserves.

Another kind of budget policy can be used when there is a trade deficit which is covered by a capital and financial account surplus. If balance of payments equilibrium is achieved by the government sector taking out loans, the central bank's ability to maintain macroeconomic stability depends to a great extent on the size of the government's overall debt, when it is due and the budget liquidity ratio. If these positions are maintained at reasonable levels, it is quite possible to preserve exchange rate and price stability. If the principal borrower is the corporate sector, the central bank's possibilities depend on the competitive power of the corporate sector and the efficiency of corporate governance. In that case it is possible to try to impose controls on capital operations in order to prevent the volume of non-performing loans from reaching a critical level. Russia has a poor record in this respect. Before the 1998 crisis the country's balance of payments deficit had been financed by budget and corporate sector loans, although it had a large foreign debt to GDP ratio and a vast domestic short-term debt. As loans were used with little effect, Russia had to restore the balance of payments equilibrium by significantly devaluing its currency.

2. Anticyclical policy: monetary policy or budget and tax policy or both?

Medium-term orientation of monetary and budget and tax policies

In recent years Russia's budget policy has been designed to maintain a budget surplus and reduce government debt, while the aim of its monetary policy has been to tame inflation in the medium term.

This orientation of monetary and fiscal policy implies macroeconomic stability and increased confidence of economic agents in the macroeconomic policy pursued by the monetary authorities. This policy was chosen largely because the federal budget and balance of payments were extremely sensitive to Russian export prices, especially the price of oil. It will be possible to cushion external shocks considerably if this conservative policy is continued until exports are diversified and the Russian economy becomes less dependent on oil and vulnerable to fluctuations in its price. Experience has shown that short-term responses to the economic situation by using budget policy tools is effective enough when the monetary authorities sterilise idle liquidity mainly by regulating the balances of federal budget accounts. Monetary policy tools, such as the raising of deposit interest rates, do not always lead quickly to an outflow of free capital from the money market.

The maintenance of a budget surplus requires cutting non-interest expenditures, which, in turn, restrains aggregate demand and, consequently, may contain economic growth. The emphasis on low inflation also prevents the monetary authorities from pursuing an expansionary policy. At the same time, the Russian authorities are looking for ways to shore up economic growth, preparing the ground for economic restructuring while foreign trade conditions are good, because the main problems of the Russian economy are connected with its structure rather than any particular phase of the business cycle. Now that the raw materials sector of the Russian economy is over-saturated with savings, the use of the budget deficit policy as a means of stimulating economic growth will hardly be appropriate.

The central bank and cyclically adjusted budget positions

The Bank of Russia takes into account cyclical factors when forecasting the state of government finances. It is clear that the budget surpluses of the last few years are the result of economic growth (which is no longer restricted to export sectors) and that Russia may see its budget position weaken as economic growth eases. To evaluate the budget position from the viewpoint of its structural and cyclical aspects, calculations are made on the basis of the prices of raw materials sold by Russian companies in world commodities markets. These calculations are taken into consideration in drafting the budget for the next year. It is the realisation of the difference between the structural and cyclical deficit that lies at the base of the concept of creating a federal budget financial reserve. At the same time, significant growth in budget revenues in 1999-2001, brought about by an economic upswing, allowed the Russian authorities to continue reforms aimed at alleviating the debt burden on economic agents. The government hopes that this will encourage further economic growth and allow it to preserve the budget surplus.

The inherent automatic stabilisers of the Russian budget system play too small a role today. Theoretically, the revenue side of the budget may dampen cyclical fluctuations. Budget expenditures are normally approved beforehand and hardly increase at all during the budget year, including expenditures on the socially vulnerable population groups, although the 2001 and 2002 budgets provided for contingent expenditure items that would only be implemented if more revenue was collected than planned. Moreover, a tax on the development of mineral resources was introduced, which partly protected the revenue part of the budget from oil market fluctuations.

A large budget deficit or rapidly growing government debt makes it impossible to increase budget expenditure and cut taxes in order to maintain economic growth during a recession. In the upswing, for example, the opposite measures are impossible to implement in order to suppress inflation, because such measures are not supported by the electorate. As the public may consider a cut in taxes to be a temporary measure, its more far-sighted representatives will be in no hurry to change their spending, so the deficit may increase while aggregate demand will remain unchanged. The authorities responsible for the budget may take such a long time to react (making amendments to tax and budget laws is a long process, as has been noted above) that budget measures alone may not suffice to stabilise the situation.

Coordination of monetary and budget and tax policies

An expansionary monetary policy often leads to interest rate cuts, which on the one hand should stimulate investment and on the other hand increase capital outflow, consequently undermining the national currency and encouraging growth in net exports. That is why the scale of capital outflows and the exchange rate are the yardsticks by which one can judge if the choice of an expansionary monetary policy is right.

In post-crisis Russia, macroeconomic stability, necessary for the implementation of structural reforms, has been ensured by a fairly tight budget policy, implemented amid a decline in net domestic assets. The only source of growth in the monetary base is the expansion of net international assets of the monetary authorities. The government is set to reduce its spending and retain a primary surplus (in

2001/02, a general surplus). Although actual non-interest expenditure grew relative to GDP in 2001/02, the government managed to preserve a surplus in its consolidated budget on the basis of liabilities owing to growth in revenues. A surplus budget enabled the Bank of Russia to pursue an effective and manageable floating exchange rate policy designed to preserve a trade surplus reserve as a safeguard against a steep fall in the price of oil and other Russian exports. This policy has proven effective this year from the standpoint of the implementation of the monetary programme drawn up at the beginning of the year, which set the inflation target at 14%. At the same time, the Bank of Russia practically refrained from refinancing commercial banks to avoid creating a more acute problem of sterilising excess liquidity. Its activities in the open market this year were dominated by mid-term operations (one- to three-month) to move bank liquidity to Bank of Russia deposits and short-term (overnight) refinancing of banks at market rates. Consequently, the interbank interest rate was set on the basis of the price which the Bank of Russia was prepared to pay commercial banks for their readiness to reduce liquidity.

It should be noted that budget deficit/surplus problems are often regarded mainly from the point of view of their effect on economic growth and employment. In Russian budget policy, however, a budget surplus is to a greater extent a macroeconomic shield protecting the economy from potential painful external shocks. A budget surplus allows Russia to contain the appreciation of the rouble when export earnings are high and thus makes it possible to preserve a sound balance of payments when market conditions deteriorate, by allowing a budget deficit.

What determines long-term interest rates?

Many analysts emphasise that, in general, changing interest rates to control the monetary and credit relations in the economic system is an extremely inaccurate and intangible process. As for long-term interest rates, their level and dynamics depend above all on the outlook for the development of the economy as a whole. It is clear that the central bank base rate serves as a benchmark for them. As for the federal budget deficit, research conducted by US analysts shows that its size directly affects the difference between the short-term and long-term interest rates in the economy.

In the Russian economy, just as elsewhere, the long-term interest rates depend above all on the expectations of economic agents, which in turn develop under the impact of economic processes. The more unpredictable the economic processes, the higher the risks and interest rates. When economic agents and the government establish the rules of conduct and abide by them, economic confidence is enhanced and interest rates may decline. A budget deficit is a negative signal for economic agents. Yields on Russian government bonds today are considerably lower than they were shortly before the 1998 crisis. Moreover, the real yields on outstanding government securities are minimal and the difference between interest rates on one-year and five-year papers only reflects a premium for liquidity. Central bank rates are becoming increasingly important for the short-term market, and plans are afoot to make the central bank rate on open market operations the anchor of monetary policy.

Consequences of short-term and foreign currency borrowings for monetary policy

Most of the federal bonds traded have a maturity of less than five years. Long-term government securities are not traded in the market and have always been kept by the Bank of Russia in its portfolio. At times when there is a federal budget surplus the government securities market is rather limited in terms of liquidity, although there are many investors wishing to buy securities in this market. In the last few years foreign debt has been increasingly replaced by domestic debt, while the latter's term to redemption has increased significantly. Before the 1998 crisis the Russian authorities had pursued an opposite policy: budget loans denominated in foreign currency, many of them short-term, had expanded at rapid rates, replacing residents' domestic loans, and that led to the budget and balance of payments crisis.

The conclusion is that a large share of short-term loans and foreign currency denominated loans weakens monetary policy as the balance of payments becomes vulnerable to the effect of a large-scale movement of short-term capital.

3. Balance sheets and quasi-fiscal operations of central banks

The role of seigniorage in recent years

Seigniorage as an issuance income may be divided into a net issuance income and inflation tax. The net issuance income, which is a change in the sum of real cash balances, appears when there is real economic growth or a favourable change in the demand for money. The inflation tax is equal to the inflation rate, which in this case is a “tax rate” multiplied by the real amount of cash (a taxable base). In recent years seigniorage has not only arisen from the issue of money; it has come from reserves created by commercial banks. The new bank reserves created in the process of seigniorage are becoming the principal cause of the multiple expansion of money in circulation. Moreover, while a constant moderate expansion in the money supply is entirely compatible with long-term price stability, excessively rapid growth in the amount of money in circulation provokes inflation.

Central bank resources and their use for specific budget purposes

The volume of quasi-fiscal operations conducted by central banks (credit subsidies, actions in support of the government bond market, etc) depends on the specific monetary situation and usually increases when this situation becomes slightly destabilised. The volume of Bank of Russia quasi-fiscal operations expanded significantly after the banking crisis of 1998. Although Article 22 of the Law on the Central Bank of the Russian Federation and Article 93 of the Budget Code prohibit the Bank of Russia from extending loans to finance the budget deficit by buying government securities at the time of their initial placement, the 1998/99 federal budget laws permitted using for this purpose the funds raised as a result of the purchase by the Bank of Russia of permanent coupon-income federal bonds. Although officially this was done through the Savings Bank (Sberbank), it did not change the essence of the transaction. In addition, in that period the Bank of Russia provided foreign currency to the Ministry of Finance through the Vnesheconombank (Bank for Foreign Economic Affairs) for government debt payment and service and restructured Bank of Russia-owned Finance Ministry bills and other securities, including accrued interest. As a result, the Finance Ministry’s debt to the Bank of Russia amounted to RUB 655 billion (USD 21 billion) as of 1 January 2003, of which RUB 385 billion, or 57% of Russia’s domestic government debt, were denominated in the national currency.

The structure of Russia’s domestic government debt and securities market, as at the start of 2002, will not allow the Finance Ministry to increase domestic borrowings in 2002 and the subsequent years or expand the range of debt instruments without increasing interest expenditures (with regard to domestic debt), because a large part of domestic government debt is now owned by the Bank of Russia. It should be noted that 94% of the Finance Ministry’s rouble-denominated debt to the Bank of Russia is non-marketable and illiquid owing to a low coupon interest rate (from 0 to 2%) and long maturity (up to 30 years). This debt is a drag on the Bank of Russia’s balance sheet, depriving the Bank of considerable resources and restricting the range of instruments it could otherwise have used to enhance the efficiency of its monetary policy.