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## **Reduction in Budgetary Expenditure on Social Services as one of the Russian Economy Stabilization Plan Direction**

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**Abstract:**

*This article discusses the problem of reduction in budgetary expenditure as one of the priority directions in economic development and social stability of the Russian Federation being in an unfavorable geopolitical situation. The dynamics and structure of expenditures of the Russian Federation federal budget are being analyzed as well as budgetary expenditure control specifics against the background of budget deficit. The article highlights the Russian regions social burden and provides the social sphere optimization results. According to the research results, the author proposes a set of measures to reduce the social spending in the Russian Federation, including the pension reform improvement; better targeting of social transfers and subsidies; social institutions network optimization.*

**Key Words:** *Budgetary Resources, Social Spending, Federal Budget, Reserve Fund, Social Burden, Social Sphere Optimization*

**JEL Classification :** *D7, E6, P2*

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## **1. Introduction**

Double external shock, which the Russian economy experienced in the second half of 2014, gave rise to aggravated expectations of an economic crisis (Minakir, 2015). Along with financial and currency crisis, a budget crisis has become the most real danger for the Russian economy. Geopolitical tensions have led to a slowdown in economic growth, the budget replenishment rate reduced, resulting in the need to counter the growing demands in the area of spending and look for ways to optimize budget spending in order to meet the important needs of infrastructure projects financing.

Therefore, during the unfavorable situation in Russian national economy due to the world oil prices dropping and sanctions of the West, the economic development and social stability problems are of particular relevance. In January 2015, the Government of the Russian Federation approved a plan of anti-crisis measures ("Order of the Government of the Russian Federation dated January 27, 2015 No. 98-r", 2015), which aims to cut government spending by 5% annually over the next three years to achieve a balanced budget.

A significant reserve of budgetary resources saving lies in the optimization of budgetary expenditure in the social sphere (health, education, science and culture). This optimization of social spending does not necessarily mean their reduction, but rather the reduction in inefficient spending by suppressing waste of resources and abuse. The aim of this study is to determine the reserves of reduction in budgetary expenditure while maintaining and/or improving the quality and accessibility of public services in social spheres.

## **2. Methodology**

Information research base includes the statistics of the Federal State Statistics Service of the Russian Federation, the official documents of the Ministry of Finance of the Russian Federation, analytical and reporting materials of the Accounting Chamber of the Russian Federation, the Department of the Federal Tax Service of Russia, the Federal Treasury.

This research used a variety of methods and tools of scientific knowledge, including methods of system and statistical analysis, analogies, comparative analysis, monographic research, graphical method, and others. The state budgetary strategy comprises the budgetary expenditures, each of which has at least three parameters (Sukharev, 2015):

- The value of government spending on a specific budget item (area, sectors, etc.);

- time of investment, which would lead to a return (or another effect), with a breakdown of finance by the stages of receipt and use of budget funds;
- Total income generated by the results of the budget funds distribution (government spending), as well as income (result) for each specific area of expenditure.

## **2.1 Dynamics and Structure of the Russian Federation Federal Budget Expenditure**

Due to the negative effect of geopolitical tensions related to the events in Ukraine, Russia's economic growth in 2014 almost stopped. Dynamics of the Russian federal budget key figures in 2009-2014 are presented in Table 1.

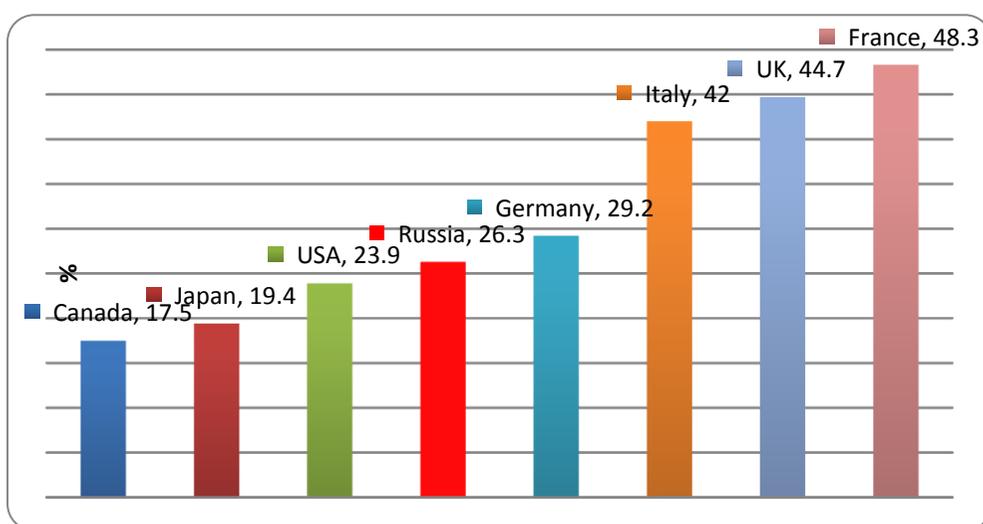
**Table 1. Key Figures of the Federal Budget of the Russian Federation in 2009-2014**

Indicator	2010	2011	2012	2013	2014
GDP, RUB bn. (Federal State Statistics Service of the Russian Federation, <a href="http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/">http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/</a> )	46,308.5	55,967.2	62,176.5	66,190.1	71,406.4
GDP growth, %	4.5	4.3	3.4	1.3	0.6
Inflation per year, %	8.8	6.1	6.6	6.5	7.5
Income, RUB bn. ("Electronic Budget", <a href="http://budget.gov.ru/epbs/fac">http://budget.gov.ru/epbs/fac</a> )	8,305	11,368	12,855	13,020	14,082
in % from GDP	17.9%	20.3%	20.7%	19.7%	19.7%
Expenditure, RUB bn.	10,115.6	10,935.2	12,890.8	13,342.9	14,830.6
in % from GDP	21.8%	19.5%	20.7%	20.2%	20.8%
Deficit (surplus) in RUB bn.	-1,810.6	432.8	-35.8	-322.9	-748.6
in % from GDP	-3.9%	0.8%	-0.1%	-0.5%	-1.0%

The volume of budget expenditure mainly reflects the preferences of the country in relation to the desired size of the government and the scope of its services. Over the past few years, the Russian Federation has seen a clear upward trend in public spending: the Russian Federation federal budget expenditures increased by 46.6% over five years. It should be noted that the actual social and economic situation of the Russian Federation differs significantly from the forecast evaluation, in which most decisions led to an increase in expenditure obligations of the state.

In the last few decades, the expenditure of most developed and developing countries were growing to meet the increasing needs of the public in education, science, healthcare, infrastructure, etc. Toughening competition between countries required large budgetary expenditure, especially in science, education, transport, energy (Knobel, 2013). As a result, in the most developed OECD countries, the consolidated budget expenditure began to exceed one half of the national GDP (Figure 1). Currently, total public social spending in Russia is 26.3% of the gross domestic product of the country.

**Figure 1. Level of budget expenditure relative to GDP of Russia and some developed countries, % ("Comparison of Russia and the countries of the world", 2013)**



Expenditure structure analysis of budget systems in Russia compared with other countries shows that the Russian Federation is a country with relatively low level of total public expenditure given the scope of the national economy (United Nations, 2014), but at the same time it exceeds the level of public funding in developed countries such as the United States, Canada and Japan.

Social policy expenditure steadily becomes the largest share in the structure of federal budget total expenditure as well as in the structure of expenditure in relation to GDP (Table 2).

**Table 2. The Russian Federation Structure of Federal Budget Expenditure in 2010-2014 (Federal Treasury of the Russian Federation, 2014)**

Indicator	2010		2011		2012		2013		2014.	
	RUB bn	%	RU B bn.	%	RU B bn	%	RU B bn	%	RU B bn	%
Social policy	1509	14.9	3,12	28.6	3,85	29.9	3,83	28.7	4,98	39.5
National economy	1,222.	12.1	1,79	16.4	1,96	15.3	1,84	13.9	2,95	23.4
National defense	1,276	12.6	1,51	13.9	1,84	14.3	2,10	15.8	1,08	8.6
National security and law enforcement	1,085	10.7	1,25	11.5	1,81	14.1	2,06	15.5	1,52	12.0
National Issues	886	8.8	787	7.2	806	6.3	850	6.4	841	6.7
Other expenses	4,136	40.9	2,45	22.4	2,60	20.2	2,64	19.8	1,23	9.8
<b>TOTAL</b>	<b>10,11</b>	<b>100</b>	<b>10,9</b>	<b>100</b>	<b>12,8</b>	<b>100</b>	<b>13,3</b>	<b>100</b>	<b>12,6</b>	<b>100</b>

Thus, the federal budget has focused resources on social obligations, strengthening the country's defense, and financial provision of the issues in the national economy.

### **3. Budgetary Expenditure State Regulation**

Currently, the Russian government has a tight fiscal policy, which aims to reduce budget expenditure.

The budget process in Russia is comprehensively regulated by the Budget Code of the Russian Federation, which dictates the rules and procedures for the preparation, approval and execution of federal, regional and municipal budgets. This comprehensive legal framework provides a consistent classification and accounting of expenses and revenues, and allows strict control over the public finances by the center (the International Monetary Fund, 2014).

Russian authorities have strengthened their macroeconomic framework through the introduction of a new fiscal rule in 2013, which restricts the growth of federal budget expenditure in the Russian Federation on both sides.

Firstly, oil and gas revenues of the federal budget are based on a new approach of calculating the base oil price. Base oil price is the average annual oil price in USD over a certain period of time (in 2014 – over 6 years, 94 USD per barrel), which increases annually by one year until it reaches ten years. Due to low oil prices during

2008-2009 crisis, the base budgeted price for oil was at a level below the actual price until August 2014 (Musayev and Malakhov, 2014).

Secondly, the spending cut on the level of the basic revenues plus 1% GDP would limit the budget deficit calculated at the base oil price. Thus, rated consumption consists of the estimated oil and gas revenue, actual non-oil revenue and limited budget deficit. Therefore, the nominal growth of federal budget expenditure is constrained.

In 2008, the Stabilization Fund was reorganized and divided into the National Welfare Fund (NWF) and the Reserve Fund. National Welfare Fund is the fund for savings of future generations, designed to finance the future costs of pensions. It is formed from the additional oil and gas revenue of the federal budget, provided that the accumulated amount of resources to the reserve fund reaches the regulated amount. Creating National Welfare Fund was reasonably required, but its potential is still not fully used.

The Reserve Fund is formed from additional oil and gas revenues of the federal budget. With the oil price below the reference price, the Reserve Fund can be used as a financial source of the federal budget. In reality, the creation of the Reserve Fund of the Russian Federation pursues the aim of not complete, but only partial smoothing of macroeconomic indicators and the dynamics of the real costs of the federal budget. It is assumed that the Russian Federation Reserve Fund should be strong enough to cover the spending during the state economic policy transformation due to oil prices drop. In this regard, the Russian Federation Reserve Fund is not considered as a universal mean of economic security in Russia, but only as a "safety cushion", which should alleviate the economic shock (Sukharev, 2014).

As of 01.05.2015, the value of the Reserve Fund is 5.4% of GDP, below the target of official bodies established at the level of 7% of GDP and designed to ensure the support of public spending at the same level in the case of oil prices falling to 60 USD per barrel in two years. After reaching the target, the law requires that 50% of all revenues that exceed prediction to be forwarded to the National Welfare Fund. The remaining 50% can be used for investment in internal infrastructure or other various projects of national significance.

Considering that in 2015 the Reserve Fund is predicted to reduce to 1.5 RUB bn., the sustainable development of the economy requires restricting its use and seeking for reserves to reduce the amount of budgetary expenditure.

### **3.1 Analysis of the Social Burden on Regions of the Russian Federation**

Over 2010-2014, spending on social policies increased 3.3 times (in nominal terms) to the level of 2010, being significantly ahead of the overall growth in federal

budget spending of the Russian Federation. The advancing growth of social expenditures is observed at the level of regional budgets. The increase in social spending slowed only in 2014. For comparison, the spending of the regions on the national economy (support for industries, transport and road sector) since the crisis drop in 2009-2010 rose by 2014 to a level comparable with the dynamics of the total budget expenditure.

Such a policy against the backdrop of economic stagnation led in 2013 to a crisis of regional budgets. In 2014, debt exceeded half revenues in 47 regions; the budget deficit almost exceeded the regional average of 5% in half of them. Because of a sharp rise in social burden with insufficient income, the regions had to triple the debt and cut other expenditure items (Zubarevich and Gorina, 2015).

Only the richest regions – Moscow, Sakhalin, Tyumen region, Yamalo-Nenets district – retained the reduced share of social spending (less than 50%). Social spending reached the maximum share (up to 70% of spending) at highly subsidized budgets of the Caucasian republics, as well as in the most developed regions, which had to choose between supporting the economy and the public sector employees.

The regions can be divided into five groups by the level of debt load, deficit, fiscal capacity, subsidization and the share of commercial loans in the debt: "rich" – oil-producing and federal cities (9 regions); "more responsible" – 12 regions with a relatively low debt; "average" – 33 regions with large debt and deficit. Nine economically underdeveloped regions with a high proportion of federal transfers in the revenues are attributed to the "highly subsidized". Other 20 regions have defaulted.

As a result of regions faster growth in social spending and their reduction in the federal budget (by 9% over the last two years), there was redistribution of the social load between the levels of the budget system: while in 2012 the regions financed 45% of all social spending, in 2014 they financed 51%.

In 2011-2012, the regions were still able to combine the increase in social spending and spending on the national economy, but in 2013 the support of the economy declined sharply because of the plight of the budgets in most regions, the growth of deficits and debt. Caught in a budget crisis, the regions not only increased the debt and deficit, but also reduced other spending, especially on housing and utilities (from 16% to 10% over 2008-2014), and then – on the national economy. In 2014, it was the turn of social spending: nine regions reduced spending on education, eight – on social policy, two – on healthcare (Mordovia and Chukotka, having a maximum debt load).

By the current moment, the social orientation of regional budgets increased to the extreme and has led to an imbalance of revenues and expenditure of the budgets in most regions. The extensive growth of social obligations of the regional budgets in 2015 is not possible, the trend will be reversed.

#### **4. The Results of the Social Sphere Optimization**

The need to optimize spending in the social sphere was noted by the President in his decrees dated back May 2012. The federal Ministries of Culture, Science, Healthcare and Labor developed the lists of targets to optimize the network of institutions and signed agreements with government agencies in the regions that the latter must meet the targets of optimization in order to implement the "roadmaps" in 2014. This had to lead to the development of the social sphere from a regional perspective, as well as to raise funds to increase wages.

In April 2015, the Accounts Chamber of the Russian Federation presented a report on the results of optimization of healthcare, culture, education and social services. Auditors concluded that, despite the fact that "optimization" proposed actions achieving the best possible state of the system as a whole, the set of conducted activities was mainly limited by measures to reduce objects, their reorganization or reduction in the number of employees (Press Center of the Accounting Chamber of the Russian Federation, 2014).

In general, the research shows that the optimization in the present form does not lead to the intended results. As a result, network of social institutions reduction and the number of public sector employees' cut-off had led to a decrease in the availability of services and a decline in the performance of state and local government organizations.

Thus, during the optimization of the healthcare system, the bed capacity of district hospitals is actively reduced; specialized departments in rural hospitals are primarily eliminated. This leads to an imbalance of the bed capacity and a significant reduction in the availability of medical care, especially primary healthcare to rural residents. Currently, 17.5K localities in Russia do not have the medical infrastructure, of which more than 11K is located at a distance of over 20 km from the nearest health facility (Korchagina, Migranova and Ivashinenko, 2013). 61 regions of the country saw an increase in in-hospital mortality: in the whole country, this indicator increased by 2.6%.

The number of unsuccessful calls to emergency medical care significantly increased, as well as cases of non-assistance (from 2.1 ml to 2.25 ml) and refusal to call an ambulance (from 1.16 ml to 1.43 ml calls). But most importantly, as a result of the measures, the targets for the reduction in mortality were not achieved: as the results of 2014, the mortality rate was 13.1 deaths per 1 thousand people at the planned index of 12.8 deaths per 1 thousand people.

As a result of reducing the educational institutions network, inequality in access to quality educational services for rural residents increased in 2014. About 9.5 thousand of settlements with a population from 300 people to 1.5 thousand people

do not have kindergartens. 877 of them are located at a distance of over 25 km to the nearest kindergarten.

At the year-end 2014, due to optimization measures, 25.7 RUB bn. was released, of which 22.9 RUB bn. is forwarded to workers' wages. However, this amount of money released during optimization has no significant effect on the financial support of the organizations and the wages of these employees. Overall, the funds obtained in 2014 amounted to less than 1% of the payroll of these employees (more than 3.8 RUB ml).

At the year-end 2014, the wages of public sector employees have increased in absolute terms. According to Rosstat data, doctors average salary in 2014 compared to 2013 has increased by 4.0 RUB thousand, the average medical (pharmaceutical) staff – by 2.2K RUB, nurses – 1.8K RUB, teachers of preschool educational institutions – by 2.2K RUB, teachers of general education – by 2.5K RUB, teachers of higher education – 6.8K RUB, social workers – by 3.5K RUB, employees of cultural institutions – by 2.8K RUB.

#### **4.1 Fiscal Policy Measures to Reduce Social Spending**

To stabilize the current situation it is necessary to constrain social spending and the payroll in the public sector, which together make up a large part of public spending. The necessary fiscal adjustment must be accompanied by long-term measures of fiscal policy, which could include:

- Improvement of the pension reform
- Improvement of the targeting of social transfers and subsidies
- Optimization of the network of public institutions

##### **a) Pension Reform**

The viability of the budget of the Russian public pension system is a concern. The main problem relates to the early retirement age (60 for men and 55 for women) in terms of the expected demographic developments and a number of benefits, which result in even earlier actual retirement. The reform held in December 2013 has not risen the retirement age established in the legislation.

Pension system itself continues to be sufficiently ineffective and highly dependent on transfers from the federal budget. In the coming decades Russian pension system will have to exist under the conditions of the population sharp aging, increased macroeconomic instability and reduced possibilities of budget financing. Since the Pension Fund deficit is one of the main social policy challenges even further exacerbated under the conditions of change in the pattern of economic growth, a new round of changes to the pension system has already begun. The state has three

unused resources remained in the arsenal (Kuzminov, Ovcharova and Yacobson, (ed.), 2015)

- First and the simplest one include restrictions on the pension payment to working retirees, which is likely to be enacted as of January 2016. According to the Minister of Labour Mr. Topilin, restrictions on the payment of pensions to retirees with large annual income would save about 145 RUB bn. over three years.
- Second – comprehensible, but associated with political risks – is raising the retirement age.

Since 2015, people included in the pension system will have conditional pension points accrued over their employee tenure. The cost of conditional points will be assessed annually based on revenues of the pension system (including the volume of government transfers, decisions on which will be taken each year), divided by the sum of all conditional points awarded to pensioners.

Other changes to the system include:

- Creating financial incentives for later retirement;
- Raising standard deductions for self-employed and those occupied in any hazardous jobs;
- Increasing the minimum work experience from 6 to 15 years needed to qualify for a pension;
- Introduction of a threshold amount of conditional points giving the right to a pension.

These changes will lead to an increase in the effective retirement age. A person receiving the minimum wage will need 40 years to accumulate the minimum number of conditional points required to qualify for a pension under this system. As the authorities indicated, gradual decrease of the system ‘generosity’ degree is expected (measured by the ratio of the average value of pensions to average wages) by about 10 percentage points relative to the current level of 37 percent. Under the new system, transfers from the federal government are expected to reduce by about 1 percent of GDP by 2030.

- Third and the most difficult is increase in revenues of the pension system due to the legalization of the informal sector of the economy.

b) Better Targeting of Social Transfers and Subsidies

Duplication of federal and regional measures prevents increase in the social assistance targeting. There is a huge variation between regions in the pace and extent

of reforms. Inequality manifests itself in the low human development indicators in rural areas (The World Bank, 2011).

Improving the targeting of federal support for social programs can solve part of the problem. Better targeting of social transfers and their effectiveness in terms of increased public spending can play an important role in ensuring the sustainable reduction of the budget deficit. The combination of targeted assistance may be used for a variety of special programs and, given the existing grand amount of earmarked funds, allows optimizing costs, ensuring maximum efficiency by eliminating from the number of welfare recipients those on welfare and members of their families whose wealth meets the minimum requirements. In order to determine who really needs state support; it is required to establish a detailed and qualified assessment system of the social subsidies recipients' material state.

No-purpose benefits such as energy subsidies should be replaced by more targeted programs (appropriate strategies are discussed in the recently published IMF book). In developed economies, linking the social benefits to participation in the labor force (including through subsidies to childcare and tax credits on children) can strengthen the incentives to enter the labor market and reduce dependence on social benefits.

#### c) Optimization of the Network of Social Institutions

Optimization, i.e. consolidation of social institutions, resources concentration (both human and technological) in them is aimed at more efficient budgetary funds use. But it must be carried out without compromising the quality and accessibility of social services for the population.

In view of the above, it is necessary to amend the Federal Laws "On the basis of public health in the Russian Federation", "On education", "Fundamentals of the legislation on culture" and other concerning the improvement of decision-making procedures for the reorganization and liquidation of public institutions.

It should be established at the legislative level that the decision on reorganization or liquidation of the state or municipal institution can only be taken on the basis of the positive conclusion of a special commission to assess the impact of such a decision. In addition, the decision on reorganization or liquidation of the municipal medical organization located in rural areas should be taken considering the opinion of the residents of the settlement. The order to assess the impact of reorganization or liquidation of the federal government institution will be established by the Government of Russia, and when it comes to the institution under the authority of the Federation or a municipality – the authorized body of state power in the region.

## **5. Conclusion**

In response to external challenges related to the fall in oil prices and the imposition of sanctions by the US and the EU, the Russian Federation faces an urgent need for fiscal consolidation in order to reduce the public deficit.

Despite the fact that over time, according to forecasts, the non-oil deficit is expected to decline, it will remain relatively high and lead to a significant Reserve Fund reduction. The necessary fiscal adjustment should ensure productive spending, such as spending on public investment and education, and should be fixed through the budget rules revision.

Opportunities to optimize non-social expenditure are close to exhaustion, a significant reserve lies in reducing social spending. The following determinants of success and direction of the budget policy of the Russian Federation in addressing the containment of social spending can potentially be identified: improvement of the pension reform; better targeting of social transfers and subsidies; optimization of the network of social institutions.

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