

Chapter 3

Strengthening the fiscal framework to enhance resilience to external shocks and safeguard sustainability

Since the beginning of the transition process, Russia has progressively built modern fiscal institutions and fundamentally reformed its tax system and fiscal framework. Moreover, fiscal outcomes improved markedly in the past dozen years, reflecting rising oil prices, strong output growth and a commitment to restrain spending of windfall gains, supported by an institutional mechanism to manage resource wealth. The government paid off most of its debt and accumulated assets in two oil funds, which financed the large fiscal stimulus during the global crisis. However, fiscal policy has not sufficiently insulated the economy from oil price fluctuations. The surge in expenditure during the boom preceding the crisis, coupled with the fiscal stimulus during the crisis, left Russia with a large non-oil deficit, making it vulnerable to a sharp fall in oil prices. Moreover, the large non-oil deficit implies sub-optimal saving from oil revenues and puts upward pressure on the real exchange rate, hindering diversification of the economy. There is therefore a need for medium-term consolidation, even though the budget will record a small surplus this year, with only moderate deficits foreseen over the next three years. To reduce the procyclical bias of fiscal policy that is re-emerging in the current high-oil-price environment, and to assist in the consolidation of the budget position, the non-oil deficit target in the Budget Code that was suspended during the crisis should be restored and complemented with binding ceilings on the annual growth in expenditures. Long-term fiscal pressures arising from demographic trends should be addressed in the first instance by equalising the pensionable ages for men and women and gradually raising the pensionable age in line with gains in longevity.

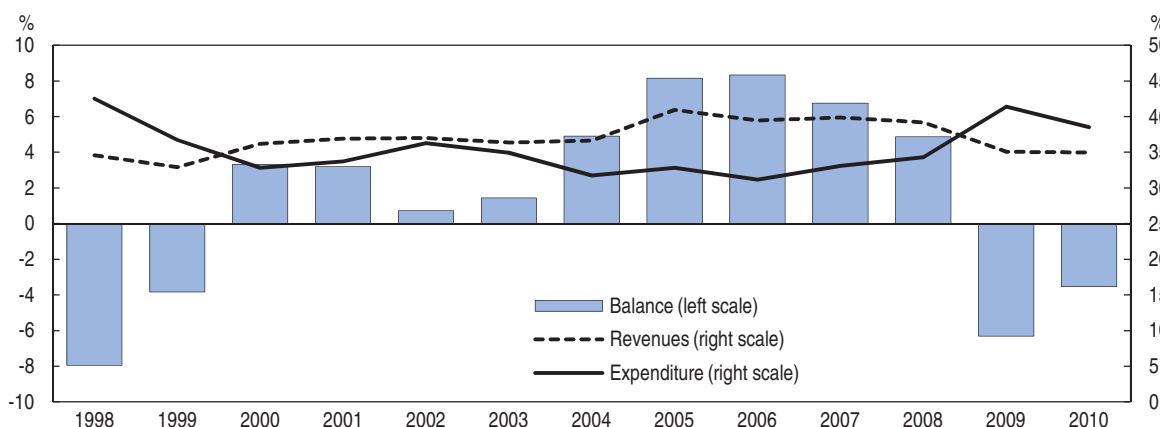
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Overview of fiscal policy trends and the sustainability outlook


Fiscal outcomes have improved markedly in the past twelve years and have been very favourable in international comparison...

Russia has come a long way since the beginning of transition to establish and maintain sound public finances. Over the past two decades the country has built modern fiscal institutions and fundamentally reformed its tax system and budgetary practices. According to preliminary findings of the OECD accession review of the Russian Federation on public governance and regulatory policy, in most areas, including medium-term budgeting, fiscal reporting and macroeconomic forecasting underpinning the budget, Russia's budgeting procedures are quite advanced and comparable to those in many OECD countries. Fiscal initiatives in the 2000s, including wide-ranging tax reforms and reforms of the fiscal framework, laid the foundation for a marked improvement in fiscal outcomes, from persistent budget deficits of the-1990s to a series of budget surpluses that lasted almost a decade and was interrupted only by the onset of the global crisis (Figure 3.1).

Figure 3.1. **Government finances**
General government, as a percentage of GDP



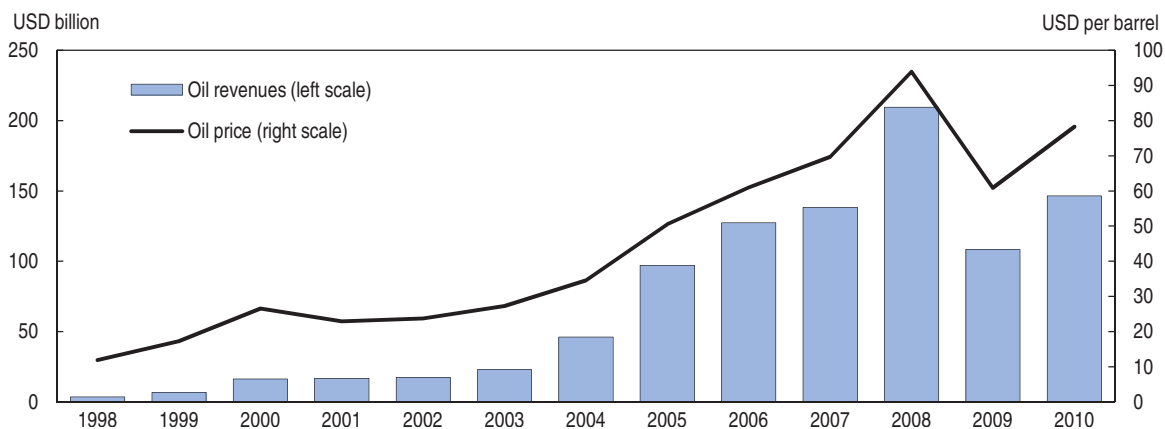
Source: IMF, WEO Database, September 2011.

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Strong output growth and soaring prices for natural resources exported by Russia, in particular oil and gas, facilitated these favourable outcomes. Due to rising energy prices and the tax reforms of the first half of the 2000s which increased the share of natural resource rents accruing to the state, general government revenues from the oil and gas sector rose almost tenfold in US dollar terms between 2003 and 2008, exceeding USD 200 billion in 2008 (Figure 3.2), about one third of all general government revenues and close to a half of federal budget revenues.

As a share of GDP oil¹ revenues more than doubled between 2003 and 2005, but were capped afterwards at below 13% of GDP (Figure 3.3), as output rose very fast in US dollar terms over this period. This rapid rise in dollar GDP reflected a combination of strong output growth and substantial real appreciation of the rouble, itself linked to rising terms of trade (Figure 3.4). The tax burden on the non-oil sector was reduced following the tax reforms of the 2000s that simplified the tax structure and broadened the tax base while reducing marginal rates. Critical for the turnaround in the fiscal situation was the government's resolve to restrain spending of windfall gains, supported by an institutional mechanism for managing resource wealth.

Figure 3.2. Oil price and oil revenues

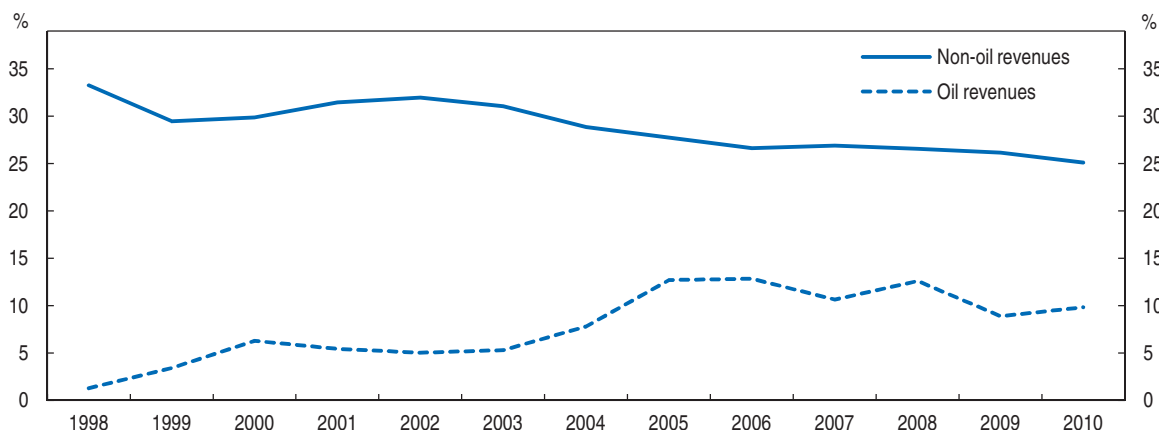


Source: Datastream and IMF, WEO Database, September 2011.

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Figure 3.3. Oil and non-oil revenues

Percentage of GDP

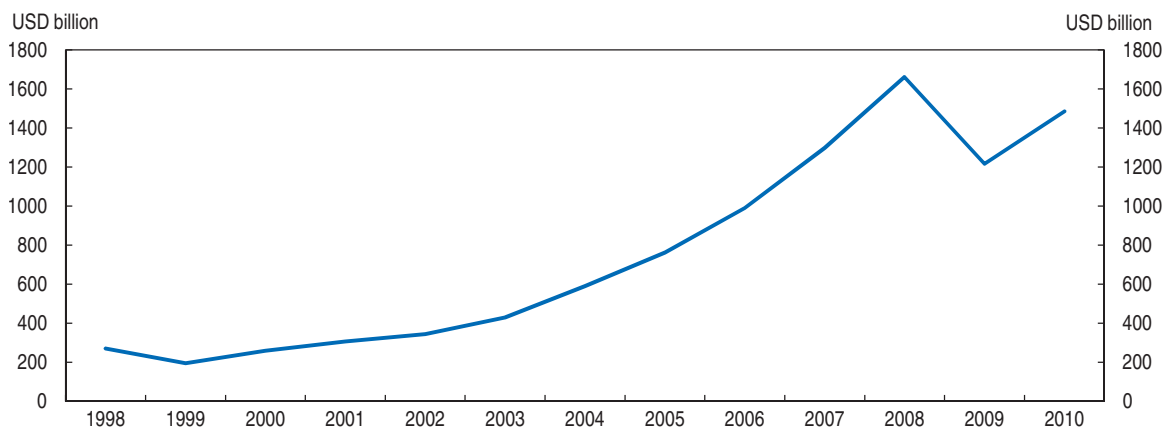


Note: Net of one-off tax receipts from Yukos in 2005 and 2007.

Source: IMF, WEO Database, September 2011.

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Figure 3.4. Evolution of GDP in US dollar terms

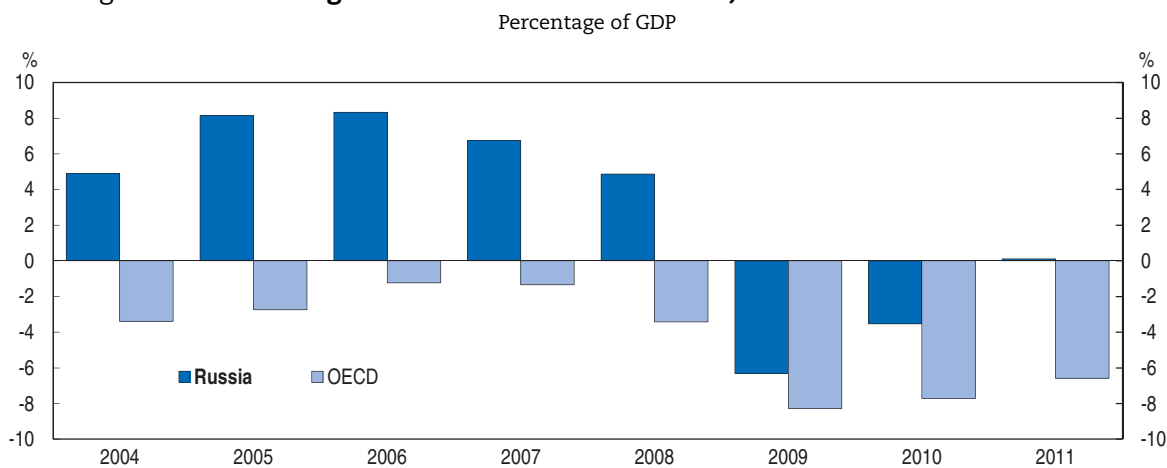


Source: Rosstat and Central Bank of Russia.

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Russia's strong fiscal outcomes over the last decade are notable, both against the backdrop of its own performance in the first years of transition and in international comparison. The headline budget surpluses of the boom years preceding the crisis contrast with the average deficits of OECD economies over that period (Figure 3.5). Russia's fiscal surpluses during the pre-crisis commodity boom were also above the average for oil-exporting countries, although a number of oil exporters, for example Norway and Saudi Arabia, had much larger surpluses during that time. The transformation of the government debt position in less than a decade from one of the weakest compared to the OECD and a number of emerging economies to one of the strongest among this group is particularly remarkable (Figure 3.6).

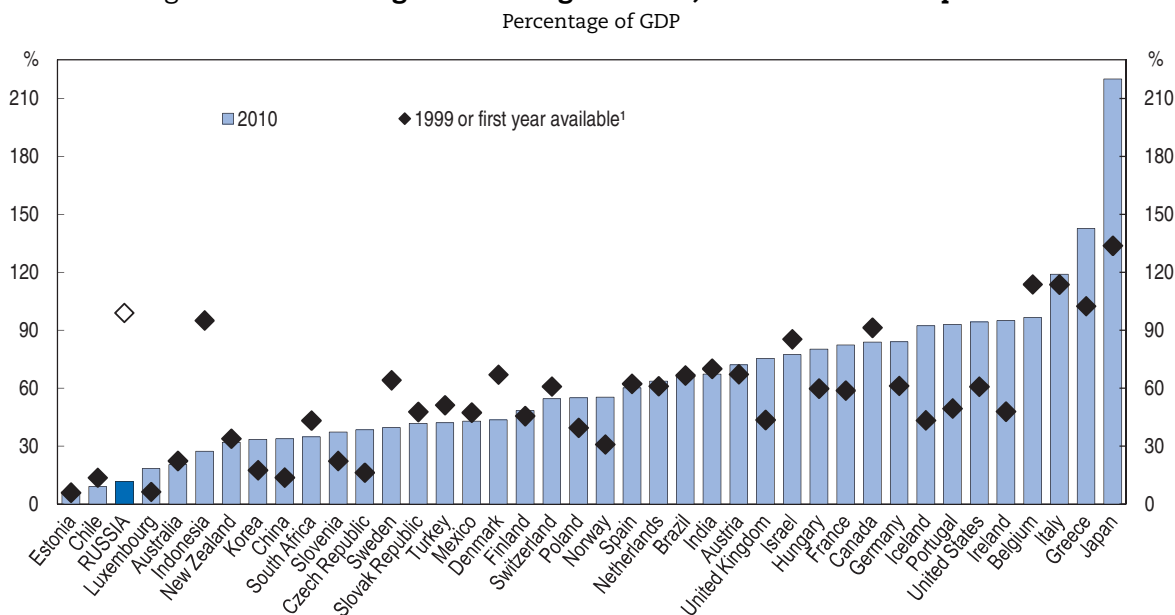
Figure 3.5. **General government financial balances, Russia and OECD countries**



Source: OECD Economic Outlook 90 Database and IMF, WEO Database, September 2011

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Figure 3.6. **General government gross debt, international comparison**



1. 2000 for Brazil, Indonesia, Israel, South Africa and Turkey.

Source: IMF, WEO Database, September 2011.

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The sovereign debt burden was already high at the beginning of transition as Russia assumed the obligations on Soviet debt after the dissolution of the USSR in 1991.² External debt repayments aggravated the already dire fiscal situation of the early transition years, brought about by a fall in output and a collapse of the old system of tax collection, and prolonged by the lack of political consensus on the need to reform large social obligations and significantly reduce budget subsidies. The need to finance chronic large deficits led to the accumulation of the so-called “new Russian debt”, which consisted of loans from international financial institutions, Eurobonds and, beginning in 1995, rouble-denominated government bonds. The latter debt grew quickly, and, while debt-to-GDP ratios were not particularly high in international perspective, the rouble-denominated instruments were issued at extremely short maturities and at relatively high interest rates. In the absence of the needed fiscal adjustment, the situation quickly became unsustainable, and in August 1998, Russia defaulted on its domestic currency-denominated debt.³ The debt burden was still extremely heavy at the end of 1999; while the ratio of rouble-denominated debt to GDP shrank as domestic prices grew by 80% in 1999, the share of foreign debt soared due to the sharp devaluation beginning in August 1998. As the fiscal situation improved, the government made debt reduction a priority, and used windfall revenues to make early repayment of external debt, in addition to building up assets in an oil stabilisation fund (later split into two, designated the Reserve Fund and the National Welfare Fund).

Reflecting this and other factors, such as the already mentioned fast rise in GDP in US dollar terms since 1999, the Russian government virtually eliminated its gross debt and became a net creditor in 2006. The country’s relative debt position looks even stronger in the aftermath of the crisis: gross public debt rose only slightly in Russia over the crisis, as the budget deficits that arose were largely financed by drawing on the resources accumulated in the Reserve Fund, while public debt levels rose significantly in many OECD economies. Russia’s position *vis-à-vis* OECD countries in terms of net debt is also very favourable. Even after the use of government financial assets to cover the budget deficits during the crisis, the Russian government has remained a net creditor; only a few OECD countries have had negative net public debt before and after the crisis, Norway being the leader.

... but fiscal policy showed clear features of pro-cyclicality over the last few years...

At the same time, fiscal policy has not sufficiently insulated the economy from energy price fluctuations. Given the country’s dependence on volatile oil prices which drive the business cycle, and limited effectiveness of monetary policy instruments (see Chapter 4), fiscal policy is the principal stabilisation tool in Russia. Taxing and saving a large proportion of windfall revenues dampens excess demand during commodity booms, alleviating inflationary pressures and counteracting other signs of overheating, such as asset price bubbles. It can also provide at least partial protection against “Dutch disease” by mitigating the upward pressure on the exchange rate caused by surging foreign currency inflows from export proceeds. Spending the accumulated resources during a period of low commodity prices should in turn support domestic demand.

In the first half of the 2000s, the government maintained a prudent fiscal stance in the environment of large windfall revenues (OECD, 2004, 2006, 2009a; Bogetic *et al.*, 2010). However, as oil prices continued to soar, pressures for fiscal expansion mounted, especially in the context of the 2007-08 electoral calendar. While estimating the underlying fiscal

trends in Russia is methodologically complicated (Box 3.1), various indicators point to a significant fiscal relaxation during the boom preceding the crisis. Expenditure ratcheted upwards, adding a stimulus to the already overheated economy (Table 3.1). The non-oil primary balance, an indicator often used as a proxy for the fiscal stance (Box 3.1), deteriorated in 2005 and then again in 2007 and 2008 (Table 3.1). The picture is slightly altered if the cyclical dividend from non-oil revenues is taken into account; for example, Vlasov (2011) suggests that fiscal policy was counter-cyclical until 2005, but then turned pro-cyclical in 2006. This also implies that fiscal policy provided insufficient protection against Dutch disease pressures, which manifested themselves in the sizeable real appreciation of the rouble and the rapid growth of imports.

Table 3.1. **Fiscal stance (general government)**

	2004	2005	2006	2007	2008	2009	2010
	In per cent of GDP						
Budget balance	4.9	8.2	8.3	6.8	4.9	-6.3	-3.5
Non-oil primary balance ¹	-1.8	-4.2	-4.0	-6.2	-7.5	-14.9	-13.1
Change in non-oil primary balance	0.6	-2.4	0.2	-2.2	-1.3	-7.4	1.8
<i>Memorandum items</i>							
Oil price, URALS, USD/barrel	34.6	50.5	61.0	69.7	93.9	60.9	78.3
Nominal GDP growth, per cent	28.9	26.9	24.6	23.5	24.2	-6.0	15.9
Nominal expenditure growth, per cent	17.2	31.1	18.3	31.3	28.6	13.4	7.8
Inflation, annual average, per cent	10.9	12.7	9.7	9.0	14.1	11.7	6.9

1. Net of one-off tax receipts from Yukos in 2005 and 2007.

Source: Datastream; IMF, *WEO Database*, September 2011; and OECD calculations.

Box 3.1. **Methodological issues in assessing the underlying fiscal indicators in Russia**

The OECD regularly computes and publishes the underlying fiscal indicators for its member countries. Eliminating cyclical fluctuations and non-recurrent operations from the headline indicators helps to assess the effectiveness of fiscal policy in stabilising the cycle, as well as its sustainability. The standard OECD methodology adjusts headline revenues and expenditures to the output gap, i.e. the deviation of actual output from its potential level, which reflects in particular the cyclical movement of tax revenues. The cyclically adjusted balance (CAB), which is the difference between cyclically adjusted revenues and expenditures measured as a percentage of potential GDP, indicates what the budget balance would have been achieved if output were at its potential level (Girouard and André, 2005). Excluding large non-recurrent fiscal operations, or one-offs, from the CAB yields the measure of the underlying fiscal balance* (Joumard et al., 2008). An improvement in the underlying (primary, i.e. net of interest payments) balance indicates consolidation.

For the purpose of fiscal analysis of commodity-exporting countries, total revenues are often separated into commodity-related revenues and other revenues. One way to estimate the underlying balance is to adjust commodity revenues to the deviation of actual commodity prices from their long-term trends, and non-commodity revenues to the business cycle.

Box 3.1. Methodological issues in assessing the underlying fiscal indicators in Russia (cont.)

In the case of Russia, “commodity revenues” usually refer to oil and gas revenues, even though Russia exports other commodities as well, such as non-ferrous and ferrous metals, coal and timber. However, revenues from these commodities are not clearly identified and are usually included in the category “other revenues”. The Budget Code stipulates that “oil and gas revenues” include the mineral extraction tax on oil and gas and export duties on oil, gas and oil products. In principle, corporate income tax on profits of mining companies should also be considered as part of “commodity revenues” and is usually included into commodity-related revenues in other countries, for example in Chile and Norway. Other government revenues from the commodity sector, such as personal income taxes or social security contributions of those working in that sector, are usually not included.

Adjusting oil- and gas revenues to the deviation from their long-run trends requires estimating the long-term “equilibrium” oil price, which is notoriously difficult. As such, any assessment of sustainability linked to long-term oil prices in Russia should be done in a scenario form, rather than as a definitive statement. For the purpose of measuring the fiscal stance, it is more convenient to exclude oil revenues completely and trace the developments in the underlying non-oil balance (or the non-oil primary balance), *i.e.* the difference between non-oil structural revenues and expenditures (minus net interest payments). A deterioration of the underlying non-oil primary balance indicates fiscal expansion, while an improvement indicates consolidation.

Adjusting non-commodity revenues to the business cycle in Russia is not straightforward, as the relatively short time series and ongoing structural changes make it difficult to estimate the output gap and the magnitude of automatic stabilisers, which is essential to decompose the headline balance into cyclical and structural components. Therefore, the non-oil balance is often used in the assessment of fiscal trends in Russia, without adjusting non-oil revenues to the cycle. One of the fiscal rules in the Budget Code sets the target for the non-oil balance.

Taking into account the difficulties associated with assessing the fiscal stance in commodity-exporting countries, it might be more informative to look at the correlation between government expenditure and the business cycle to assess the pro-cyclicality of fiscal policy. Such an approach is sometimes implemented in studies assessing the cyclicality of fiscal policy in developing countries. Significant increases in public spending when commodity prices are rising is perhaps the simplest and clearest indicator suggesting that windfall revenues are being overspent.

* The term “structural balance” is often used in the literature as a substitute for either the cyclically adjusted balance, if one-offs are not excluded, or the underlying balance.

This box draws on Vladkova-Hollar and Zettelmeyer (2008); Medas and Zakharova (2009); Villafuerte and Lopez-Murphy (2010).

Fiscal policy became counter-cyclical from the second quarter of 2009. The non-oil deficit rose sharply between 2008 and 2009, mainly due to higher expenditure. This rise in public spending was not only due to a stimulus package; the three-year budget approved before the crisis already showed a significant increase in spending in 2009 in anticipation of high oil prices and robust growth. Even without a stimulus, the deterioration in the underlying fiscal position would have been quite significant. In fact, large increases in social transfers, approved before and during the crisis (Table 3.2), are not temporary and their subsequent withdrawal is not planned. Another item that increased significantly

during both the boom and the crisis was spending on the “national economy”, which to a large extent represents subsidies. This item increased by two percentage points of GDP between 2006 and 2008, and jumped to 7.1% of GDP in 2009, as many crisis-response measures were directed towards supporting enterprises.

Table 3.2. **Structure of government expenditure**
Percentage of GDP

	2006	2007	2008	2009	2010
Total expenditure, general government	31.1	34.2	33.9	40.9	38.5
Interest	0.8	0.5	0.5	0.6	0.6
State administration	2.3	3.0	2.7	2.7	2.6
Defence, law and order	5.2	5.1	5.2	6.3	5.8
National economy	3.5	4.7	5.5	7.2	5.2
Housing and utilities	2.3	3.3	2.8	2.6	2.4
Education	3.9	4.0	4.0	4.6	4.2
Health and sport	3.6	4.2	3.8	4.3	3.8
Social policy	8.8	8.6	8.7	11.7	13.0
Pensions ¹	6.2	5.9	6.2	8.3	9.9
Other	0.8	0.8	0.8	0.9	0.8

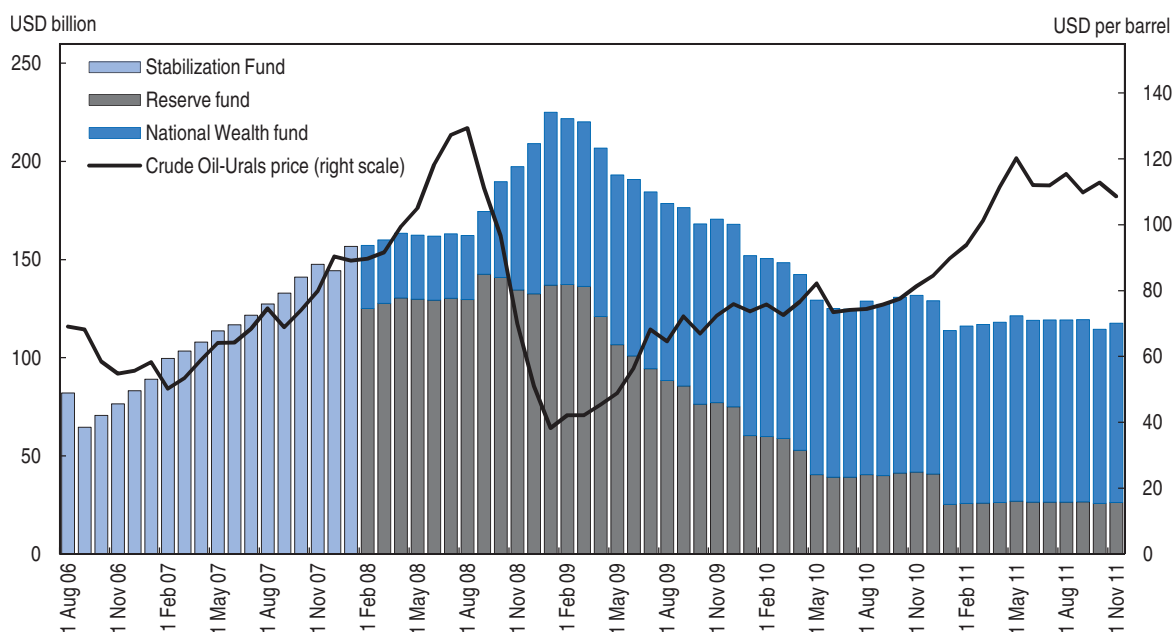
1. Including expenditure of the State Pension Fund other than pension benefits.

Source: Ministry of Finance.

... and the non-oil deficit has risen to excessive levels

Although the federal budget is expected to record a small surplus in 2011, aided by high oil prices, the non-oil deficit that rose during the boom and then expanded rapidly during the crisis remains very high at about 10% of GDP for the federal budget, well above the government’s own medium-term target of 4.7% of GDP. The large non-oil deficit makes the fiscal position vulnerable to a sharp reduction in the oil price. As of October 2011, the assets in the Reserve Fund were below 2% of GDP (Figure 3.7) which means they would be exhausted very quickly should the need to cover a large fiscal gap arise. The assets in the National Welfare Fund (NWF) are not supposed to be used to finance the budget deficit, although they may be used to cover the deficit of the Pension Fund. In any case, the NWF’s assets were relatively modest at about 5% of GDP as of October 2011. The government appears to have ample room for borrowing, given the low level of debt and the relatively low level of Russia’s sovereign spreads currently. If oil prices were to fall sharply, however, it is far from certain whether it would be possible for the Russian government to borrow on reasonable terms to cover the (potentially large) deficit. Financial markets’ assessment of the sustainability of Russian public finances could be quickly downgraded in such a situation, which could lead to a higher risk premium and a shortening of maturities. Moreover, should the fall in the oil price reflect problems in the world economy, such financing might be difficult to obtain. This suggests that any sharp reduction in oil prices would strain the capacity of the government to finance its deficits without being forced into a pro-cyclical reduction of expenditure. A more rapid reduction in the non-oil deficit and a speedy refill of government coffers is therefore needed for self-insurance reasons.

Moreover, the large non-oil deficit implies sub-optimal saving from oil revenues and puts upward pressure on the real exchange rate, hindering diversification of the economy. There is therefore a case for a medium-term consolidation, even if public debt is low and the budget is expected to be in surplus this year. The medium-term plan for the federal

Figure 3.7. **The Reserve Fund and the National Welfare Fund**

Source: Ministry of Finance and Datastream.

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budget envisages deficits over the next three years and little reduction in the non-oil deficit (Table 3.3). As fiscal outcomes in Russia are shaped by the federal budget (budgets of other levels of government and of extra-budgetary funds are close to balance after transfers from the federal budget), and as oil revenues accrue mostly to the federal government, federal fiscal plans determine the path for the overall and non-oil general government deficits. These plans look insufficiently ambitious. In particular, a more than 8% real increase in spending in 2012, when the budgeted oil price is expected to remain high, risks becoming pro-cyclical.

As the deterioration in the non-oil balance occurred mainly due to a jump in spending before and during the crisis, reversing this fiscal expansion would be needed to reduce the non-oil deficit. Partial scaling back of support to enterprises in 2010 and 2011 already improved the underlying fiscal position. Further removal of subsidies by bringing spending on “national economy” programmes back down to 2006 levels as a percentage of GDP would reduce the non-oil deficit by about two percentage points of GDP. The increase in spending on the “national economy” was largely geared towards support for inefficient enterprises and did not promote development and modernisation of the Russian economy (Kudrin and Sergienko, 2011). There may be legitimate reasons for additional social spending, although such increases should be implemented in the context of reforms of the system of social protection (OECD, 2011a). At the same time, there seems to be considerable scope in Russia for raising the efficiency of public spending in education and health (OECD, 2006; Word Bank, 2011). The Russian government adopted a comprehensive programme to increase the efficiency of government expenditure in 2010, which is a welcome step. These efforts need to be continued alongside the strengthening of the fiscal framework that provides a better protection against pro-cyclical policy, so that efficiency gains in some areas are not cancelled out by an increase in inefficient spending in others, triggered by the

Table 3.3. **The medium-term budget plan for the federal budget**

	2011(f)	2012(f)	2013(f)	2014(f)
<i>In trillions of roubles</i>				
Revenues	11.1	11.8	12.7	14.1
Oil revenues	5.5	5.6	5.6	6.1
Non-oil revenues	5.7	6.2	7.1	8.0
Expenditure	11.1	12.7	13.7	14.6
Balance	0.0	-0.9	-1.0	-0.5
Non-oil balance	-5.5	-6.5	-6.7	-6.6
<i>In per cent of GDP</i>				
Revenues	20.9	20.1	19.6	19.4
Oil revenues	10.3	9.5	8.7	8.5
Non-oil revenues	10.6	10.6	10.9	11.0
Expenditure	20.9	21.6	21.2	20.1
Balance	0.0	-1.5	-1.6	-0.7
Non-oil balance	-10.3	-11.0	-10.3	-9.1
<i>Memorandum items</i>				
Urals oil price, USD/barrel	110	100	97	101
Real GDP, % change	4.1	3.7	4.0	4.6
CPI inflation, %	6.5-7.0	5.0-6.0	4.5-5.5	4.0-5.0
Nominal growth in expenditure (%)	9.9	13.8	8.5	6.2

Note: Components may not add up to totals due to rounding.

Source: Ministry of Finance.

availability of windfall revenues. It is also notable that the increase in spending in the 2012-14 budget is disproportionately oriented to unproductive expenditures such as military spending. This both hinders the pace of fiscal consolidation and squeezes other areas that are of high priority in economic terms, such as infrastructure investment, health and education.

Demographic trends will put increasing pressure on public finances

An ageing and shrinking population (Chapter 1) will impose an increasing burden on the pension system, which poses a risk to the long-term sustainability of the public finances. The increase over the next two decades in the old-age dependency ratio measured as the ratio of the population over 65 to the population aged 15-64 is about average compared to the OECD and a group of selected emerging countries. If, however, old age dependency is measured as the ratio of the population eligible for retirement to the working age population, it would stand at 33%, and is expected to rise to 52% by 2030, higher than all but a few OECD countries. This is explained by a relatively low pensionable age in Russia, 55 for women and 60 for men. Most OECD countries have unified pensionable ages for men and women, usually at 65, although the effective retirement age is often somewhat lower in many OECD economies (see OECD, 2011b).

Public expenditure on pensions amounted to about 8% of GDP in 2010, following large increases in 2009-10 in the value of basic pensions in particular. This resulted in a rapid increase in relative earnings of pensioners compared to the working population, with the ratio of the average pension to average gross earnings increasing from 24% in 2008 to 36% in 2010. If the current level is to be maintained or increased, pressures on public finances will intensify substantially under unchanged policies with respect to the pension age. Gurvich (2011) estimates that maintaining the current ratio of the average pension to average

earnings would increase public spending on pensions by 8 percentage points of GDP by 2050.

Various reforms of the pension system have been implemented over the last decade, establishing a three-pillar pension system (OECD, 2011a). The reforms have been incomplete, however, and further policy actions are required (Chapter 1). In the first instance, pressure on future pension liabilities should be addressed by equalising the pensionable ages for men and women and gradually raising the pensionable age in line with gains in longevity. Implementation of such a reform is complicated by strong public opposition to raising the pensionable age. While it would be difficult to achieve wide support for this measure, it is important to devote greater efforts to communicating the rationale for these decisions and addressing some popular misconceptions. In particular, it is perceived to be extremely unfair to raise the pensionable age for men to 65, above life expectancy for men which stood at 63 in 2009. It is important to clarify that what matters is life expectancy at the age of 65, which in 2008 was estimated at 11.7 years for men – still below the level in all OECD countries except Turkey, but a less pronounced difference than on the life expectancy at birth indicator. Moreover, life expectancy at the age of 65 for women is higher than for men on both measures (life expectancy at birth for women was 75 in 2009, and life expectancy at the age of 65 was 16.1 years in 2008), while women’s pensionable age is lower. The trade-off between the replacement rate and pensionable age should also be clearly explained.

Strengthening the fiscal framework

A rule-based fiscal framework has been developed over the last decade

Since 1999 the Russian fiscal framework has been significantly reformed.⁴ The Budget Code, adopted in 1998, came into force in 2000, modernising budgeting procedures and laying the foundation for greater transparency and an improved quality of fiscal policy-making. All government activities were put on a Single Treasury Account in 2000, and since then, considerable progress has been achieved in constraining off-budget operations. Most extra-budgetary funds were eliminated and the boundaries between the government and the market sector clarified. Several issues remain to be resolved, such as the unclear status of some public institutions. Efforts have been devoted to develop performance budgeting, with the aim of using performance information in managerial and budgetary decision-making and shifting the emphasis from administering budget resources (expenses) to “performance management”, in line with trends in OECD countries. A framework for programme budgeting was developed, re-classifying the budget according to programmatic areas, as has been done in several OECD countries. The framework has not yet become fully operational, but the new 2010 reform optimising budget expenditures marked a clear shift to programme classification and budgeting. Three-year budgets were introduced, starting from 2008. The revisions for the out-years, as well as for the current year, require parliamentary approval.

Creating an institutional mechanism to address macroeconomic and fiscal challenges resulting from resource dependence was part of the government strategy. Since oil revenues accrue largely to the federal budget, and given the general trend to centralisation of fiscal relations at the beginning of the last decade, such a mechanism was developed at the federal level. The establishment at the end of 2003 of the “Stabilisation Fund of the Russian Federation” (“the Fund”), together with a rule governing accumulation and

spending of its resources based on a reference oil price, was an important milestone. The Fund can be viewed as an example of a strong fiscal institution due to its full integration into the budget and a high degree of transparency about its objectives, operations and investment strategies. The establishment of the Fund brought the need to insulate the budget and the economy from the fluctuations in commodity prices to the centre of the fiscal policy debate, which helped to restrain spending during times of high oil prices. The presence of an oil fund has been regularly cited by rating agencies as an essential positive factor underpinning an investment grade rating that Russia has enjoyed since late 2003.⁵ At the same time, the mechanism governing accumulation and particularly spending of resources from the Fund proved not to be well-suited to the environment of high and rising oil prices (OECD, 2006). As soon as the Fund reached the level of RUB 500 billion (about 2% of 2006 GDP), spending was allowed for “unspecified purposes”. As long as the assets were used to repay external debt, this did not create any tensions with the objective to mitigate Dutch disease effects. However, after the debt repayment was largely completed, and as the actual oil price significantly overshot the reference oil price of USD 27 per barrel, pressures mounted for spending the Stabilisation Fund’s resources. The narrow revenue base of the Fund, which included only taxes and export duties from the oil sector, was another issue.

In an attempt to address these challenges, the government initiated further reforms of the fiscal framework in 2007. The Stabilisation Fund was split into two oil funds, the Reserve Fund and the Future Generation Fund, which was soon renamed the National Welfare Fund (Box 3.2), and a number of fiscal rules were introduced. Spending out of oil revenues was restricted to 3.7% of GDP. The limit on the non-oil balance was set at a slightly higher level, 4.7% of GDP, to allow some borrowing up to 1% of GDP (even if the budget was in surplus) to pursue different objectives such as the development of financial markets. In the event of oil revenues falling below 3.7% of GDP, the government would be allowed to finance the deficit with the assets accumulated in the Reserve Fund, but other sources of financing could not exceed 1% of GDP. The rules at the federal level were complemented by the rules for sub-national governments, which put numerical constraints on the deficit, total annual borrowing, debt and debt service.

The framework was weakened during the crisis

The changes to the fiscal framework, which were broadly in line with OECD recommendations (OECD, 2006; see also Annex 1.A.1) were expected to come into effect in 2011. The 2008-10 budget, which was the first three-year budget, outlined a path for gradual convergence of the non-oil deficit to the target of 4.7% of GDP. The timing of the transition to new fiscal rules proved unfortunate. The old framework had been dismantled, but the new one had not yet become operational when the fiscal situation changed radically. As expenditure soared, the 4.7% of GDP limit on the non-oil deficit began to look unrealistic. In this difficult and uncertain environment, the authorities decided to push back the entry into force of the new fiscal rules to 2013.

Russia was far from alone in deciding to postpone its fiscal rules in the context of the crisis: many other countries breached their fiscal rules during this period and some amended the targets or suspended the rules until the situation became more stable (Schick, 2010). While Russia’s rule was not yet operational, the 2011 date for the coming into force of the rule had been set with a gradual consolidation path in mind, which was superseded by events. In September 2010, the date was pushed even further out to 2014.

Box 3.2. The Reserve Fund and the National Welfare Fund

Following the amendments to the Budget Code approved in April 2007, two oil funds were established at the beginning of 2008 in place of the Stabilisation Fund of the Russian Federation, which had been created in 2004. Their revenue base was expanded to include the mineral extraction tax on natural gas and export duties on natural gas and oil products. The Reserve Fund assumed the role of the original Stabilisation Fund: its main statutory objective is to insulate the federal budget from oil price volatility. The Reserve Fund also has a wider purpose of promoting economic stability by mitigating inflationary pressures and reducing dependence of the economy on fluctuations in oil prices. Oil and gas revenues in excess of 3.7% of GDP are automatically accumulated in the Reserve Fund until it reaches 10% of GDP, at which point any additional oil and gas revenues are used to accumulate assets the National Welfare Fund (NWF). Assets accumulated in the Reserve Fund can be used to cover the budget deficit if oil and gas revenues are below 3.7% of GDP, or to repay external debt.

The NWF's main objective is to co-finance voluntary pension savings and to cover the deficit of the State Pension Fund. Initially, as its original name the *Future Generation Fund* attests, the fund's role was defined more broadly as saving part of the income from current exploitation of non-renewable resources for the benefit of future generations (Ministry of Finance, 2007).

On 1 February 2008, assets of the Stabilisation Fund amounting to USD 135 billion, or 10% of 2007 GDP, were transferred to the Reserve Fund. The remaining USD 25 billion, about 1.5% of GDP, were transferred to the NWF. Over 2008, the Reserve Fund's assets rose slightly to keep its statutory limit at 10% of GDP in line with nominal GDP growth, while the NWF's assets increased by USD 56 billion. Assets accumulated in two funds reached USD 225 billion (more than 13% of 2008 GDP) at their peak at the end of 2008. The Reserve Fund's assets were used to finance the deficits which emerged during 2009-10. More than USD 100 billion was used for that purpose. By end-2010, the Reserve Fund's assets stood at USD 25 billion, less than 2% of 2010 GDP. The NWF's funds remained intact and at end-2010 were just above USD 90 billion (6% of 2010 GDP). During the first ten months of 2011 the two funds were neither drawn on nor built up, as the federal budget was in surplus but the expectation was that all oil revenues would be spent by the end of the year.

The rules governing the NWF's asset allocation were relaxed to allow investment in rouble-denominated assets. This was used during the crisis as a measure to provide support for domestic banks and companies.

This appears less justifiable, as the economic situation had stabilised and the recovery was underway by that time, also supported by a strong recovery in oil prices. Moreover, the three-year budget plan for 2012-14 (Table 3.3) envisages the non-oil deficit widening in 2012 and declining only slowly to 9% of GDP by 2014. This suggested that the entry into force of the rules was to be pushed further back in October 2011 and indeed this was confirmed when the Budget Code was again amended to get a new date of 1 January 2015. The government is also considering whether to return to the mechanism of the cut-off oil price.

Fiscal rules should be quickly restored

Russia would benefit from a prompt reinstatement of fiscal rules that could help reduce a pro-cyclical bias of fiscal policy that is re-emerging in the current environment of high oil prices, and assist in the reduction of the non-oil deficit. The country's own

experience attests to the fact that institutional constraints on fiscal policy can enhance the management of public finances and lead to better fiscal outcomes. Restoring such constraints would assist the Ministry of Finance in its continued efforts to restrict pro-cyclical overspending of windfall revenues and ensure sustainable consolidation.

There is no one-size-fits-all fiscal rule, either in general or for commodity exporters. For example, three commodity-exporting OECD countries – Chile, Mexico and Norway – have all adopted a fiscal rule, but with different designs (Box 3.3). Generally, the checklist for a well designed fiscal rule should include the criteria of simplicity and transparency, flexibility in the response to shocks, and a stable link between the targets and ultimate policy objectives (Kopits and Symansky, 1998; IMF, 2009; Schick, 2010). The major objective for Russia can be defined as reducing the pro-cyclical bias of fiscal policy, in particular during commodity booms, which would help mitigate the impact of fluctuations in the commodity prices on economic performance. A specific aspect that needs to be considered in connection with the country's natural resource endowment is intergenerational equity, i.e. how Russia's non-renewable natural resource wealth, and in particular its oil and gas wealth, should be shared between current and future generations. In a catching-up economy like Russia, future generations are expected to be significantly wealthier, which makes a case for spending a larger part of resource wealth by current generations (OECD, 2006). Nevertheless, the Russian government itself set a goal of saving part of the income from resource exploitation for future generations via a gradual build-up of assets in the National Welfare Fund, which is expected to generate significant investment income in the future. This objective remains valid, especially taking into account unfavourable demographic trends.

The current rules in the Budget Code score well on many dimensions and should be restored. This has the potential advantage of preventing yet another overhaul of the budget legislation, as the rules are already in place and need only to be reactivated. The non-oil balance target is easy to monitor, although it has proved at times difficult to communicate to parliament and the public. Limiting spending out of oil revenues insulates to a large extent the budget and the economy from oil price fluctuations and allows for a gradual build-up of assets in the NWF, in line with an objective to save part of the income from exploitation of non-renewable resources and generate investment income. An advantage of this rule is that it does not require an explicit assumption about long-term equilibrium oil prices. At the same time, quantification of the target implicitly assumes some "equilibrium" level of oil revenues (as a percentage of GDP) that will cover the non-oil deficit on a sustainable basis, and lead to a gradual accumulation of assets. The 4.7% of GDP target for the non-oil deficit does not look unreasonable in the medium term, as the ratio of oil revenues to GDP, now about 10%, is expected to decline with economic growth and a diversification of the economy, but the gradual build-up of the NWF should generate investment income that could be used to finance future non-oil deficits. This would move Russia closer to the Norwegian model, which requires all oil revenues to be transferred to the oil fund and allows the use only of a notional long-term investment return (4%) on the fund's assets to finance the non-oil deficit. However, as oil revenues are much higher now, this would currently imply a substantial saving rate out of oil income. It may take some time to reduce the non-oil deficit to the level of 4.7% of GDP specified in the Budget Code. Moreover, oil prices may continue to trend upward, in which case limiting the non-oil deficit to 4.7% of GDP would be too strict as this would imply more saving out of oil revenues than would be desirable. One way to overcome this difficulty is to allow for a

Box 3.3. Fiscal guidelines in commodity-exporting OECD countries

Chile: the structural balance target for the central government budget

Chile's fiscal policy is guided by a structural balance target, defined as the central government budget balance that would have been achieved if output were at its potential, prices of copper and molybdenum were at their long-term levels, and the return on financial assets corresponded to the long-term interest rate. In practice, as expenditures are not cyclically sensitive, commodity-related revenues (*i.e.* revenues from the state-owned copper company CODELCO and tax revenues from private mining companies) are adjusted to the gap between long-term and actual prices of copper and molybdenum, while non-commodity revenues are adjusted to the deviation of output from trend. A panel of independent experts estimates the long-term copper price every year, while another panel assists with the estimates of potential output.

Surpluses generated by the structural balance rule are accumulated in several sovereign wealth funds, such as the Economic and Social Stabilisation Fund and the Pension Reserve Fund. The former can be used to finance headline deficits.

Major aspects of the framework are institutionalised in the Fiscal Responsibility Law, but the legislation does not define a particular target for the structural balance. The target was set in 2001 as a surplus of 1% of GDP and reduced to 0.5% of GDP in 2008. In 2009, it was further reduced to zero to allow for a fiscal stimulus in the context of the crisis. The rule was *de facto* suspended in 2010 due to the earthquake in February. The government now targets a structural deficit of -1% of GDP by 2014.

Norway: the structural balance target for the non-oil central government budget deficit linked to a long-run real return on the oil fund's assets

In Norway, all oil and gas revenues are saved in the Government Pension Fund Global (GPF). The fiscal guidelines established in 2001 state that the non-oil structural central government budget deficit should normally be 4% of the GPF's value, which is assumed to be the long-run real return on the Fund's assets. GPF's assets are invested solely in foreign assets. The purpose of this framework is to insulate the economy and public finances from oil price fluctuations, spend the income generated by the petroleum wealth while saving the wealth itself for future generations, and mitigate Dutch disease effects.

The rule allows for deviations from the 4% target in the event of exogenous shocks or abrupt changes in the GPF's value. The 4% non-oil deficit path can therefore be undershot during periods of strong economic growth, and overshot during downturns, allowing a discretionary counter-cyclical response. Since the inception of the fiscal guidelines in 2001, the structural non-oil central government deficit has on average only slightly exceeded 4% of the GPF. However, the strong counter-cyclical fiscal response in 2009 led to a significant overshooting of the 4% target.

Mexico: a balanced budget rule and a rule for excess revenues based on a reference price for oil

Since 2006, the key element of Mexico's fiscal framework has been the balanced budget rule applied to part of the budget balance. The rule covers the "budgetary public sector" (central government and public enterprises) and includes non-oil revenues and expenditures, oil revenues (royalties and revenues from the state-owned oil company PEMEX), and current PEMEX spending. It does not apply to the government's net lending operations or to PEMEX investment.

The balanced budget rule is complemented by a rule requiring some of excess oil revenues to be transferred to three oil stabilisation funds (for the federal government, PEMEX and state governments). The Fiscal Responsibility Law requires that 90% of excess revenues (estimated on a basis of a reference oil price) be transferred to the oil funds, with the remaining 10% allocated to the states for investment. The balances in the funds are capped at relatively low levels and once the limits are reached, 75% of extra revenues are allocated to investment and 25% to support of the pension system. At end-2008, the assets accumulated in the oil funds stood at 1.2% of GDP.

Source: This box draws on Dabán (2011), IMF (2009), OECD (2009b), OECD (2010b), OECD (2010c), OECD (2011c).

periodic revision of the non-oil deficit target. For example, if the size of the National Wealth Fund is judged to be too big or too small, the target can be reviewed to reflect sustained changes in the oil prices.

Having a target for the non-oil deficit expressed as a ratio to GDP can substantially reduce, if not completely eliminate, the pro-cyclicality of fiscal policy. The rule still has some pro-cyclical bias. First, the target is expressed as a share of actual GDP. As the GDP deflator tends to rise faster than consumer price inflation during a positive terms-of-trade shock, the ratio of expenditures to GDP (and therefore the ratio of the non-oil balance to GDP) may look stable even though real expenditures are rising fast, as happened in 2006-08. Second, a sufficiently counter-cyclical fiscal policy should save all cyclical revenues during an upturn, not just windfall gains from oil and gas revenues. Such cyclical dividends in the case of Russia come from revenues from other commodities (non-ferrous and ferrous metals, coal and timber metals, coal and forest products) and non-commodity revenues. In principle, Russia should identify windfall gains from other commodity-related revenues, and estimate a cyclical component of non-commodity revenues by adjusting them for the business cycle. Finally, it is important to eliminate one-offs (large non-recurrent fiscal operations) to get a clear understanding of underlying trends (Box 3.1). Admittedly, these conceptually attractive improvements can prove difficult to implement in practice. The process of cyclical adjustment has many limitations, especially in a middle-income transition economy like Russia. Having a fiscal rule based on a target in structural terms is probably not advisable at this point, as it could just add to the uncertainty in formulating fiscal policy. Nevertheless, developing and refining such estimates would be useful as a means to enhance understanding of fiscal developments. Moreover, as the share of oil and gas revenues is expected to decline with economic growth and diversification of the economy, the impact of the business cycle on government revenues will become more pronounced, and the concept of structural balance will gain in importance. In that context, it is important to develop the necessary expertise on the cyclical adjustment of non-oil revenues. Work on such estimates has already started and should be advanced, and information on cyclical indicators should be published in budgetary documents, while highlighting the associated uncertainties.

The government is considering the idea of returning to a cut-off oil price concept, aiming at a 1% federal budget deficit at the reference oil price, which would be set every year at the average level over the previous 10 years. The concept of a cut-off price is relatively intuitive for the public, although the rule is in fact less transparent than it may appear, as it requires assumptions about the behaviour of non-oil revenues. During a period when commodity prices are trending upwards the rule may again turn pro-cyclical. OECD estimates suggest that while in 2002-04 the application of the reference price rule would have resulted in a non-oil deficit close to 4.7% of GDP (i.e. virtually the same as the suspended rule currently enshrined in the Budget Code), between 2004 and 2008, the non-oil deficit would have been significantly larger and the government would have saved less of windfall gains than would have been the case with the implementation of the existing non-oil deficit rule.

Designing an expenditure rule

As noted earlier, the non-oil deficit target may not be sufficient to prevent overspending of windfall revenues, particularly when commodity prices are rising. To further reduce the pro-cyclical bias of fiscal policy, a non-oil balance rule may be usefully

supplemented by a public expenditure rule. An expenditure rule sets a limit on aggregate spending, expressed either in nominal terms (in which case, they are called expenditure ceilings; see Ljungman, 2008), or in growth rates. The limits can also be defined as a percentage of GDP, but especially in the case of Russia, this risks building in a degree of pro-cyclicality, as discussed above. Expenditure rules are transparent, easy to communicate, and have counter-cyclical features by allowing full working of automatic stabilisers (Anderson and Minarik, 2006), at least in a country like Russia where automatic stabilisers on the revenue side are strong but spending is not cyclically sensitive. Evidence suggests that rules with expenditure targets are associated with longer-lasting consolidation (Guichard *et al.*, 2007).

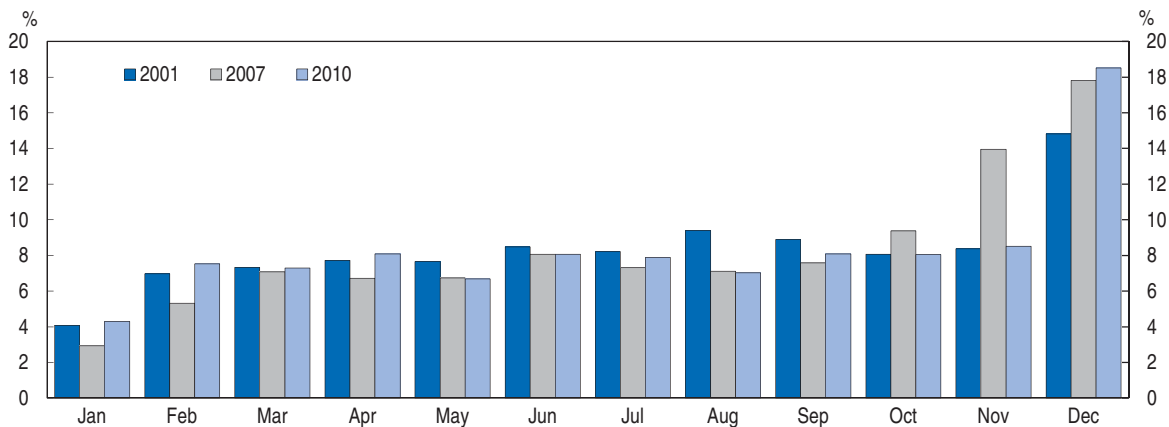
Multi-year expenditure ceilings have been adopted in several OECD countries, including the Netherlands and Sweden, and the experience has been generally positive. The main idea of these ceilings is that by setting *ex ante* spending limits in a multi-year framework, usually for three or four years, the government explicitly pre-commits not to exceed this level, no matter how revenues perform. Such pre-commitment helps to restrain pressures for fiscal expansion during periods of revenue buoyancy caused by transitory factors. For Russia, such a rule has the potential to constrain spending when oil prices are soaring. The ceilings may then be reviewed in the next three-year cycle and raised if necessary, for example in line with the changes in the average level of the oil price for that period.

In fact, since 2008 Russia has set expenditure targets in the three-year budget plans adopted by parliament. This could be viewed as an expenditure rule with a strong institutional basis, as parliamentary approval is required to amend the ceilings. However, supplementary budgets adopted every year since 1998, and often more than once a year, have undermined the discipline such a framework might provide. Such amendments have often been triggered by the deviation of the actual oil price from the one that was budgeted. As a recent example, the supplementary budget adopted in April 2011 pushed expenditure for 2011 and the two out-years upwards compared with the three-year budget plan approved in November 2010, and 2011 expenditures were raised again in a further budget amendment tabled in October. A commitment to expenditure targets, by treating them as firm ceilings, would help to make fiscal policy more counter-cyclical. A still stronger commitment would be achieved by setting up a rule limiting the annual increase in total expenditure in real terms to some ceiling.


This tendency to adopt supplementary budgets also exacerbated the very uneven and inefficient pattern of expenditure within the year, with large December spending peaks (Figure 3.8). One measure that could help reduce the frequency of supplemental budgets, while imparting a pro-consolidation bias to fiscal outcomes, would be the inclusion in each annual budget of a significant contingency reserve controlled by the Ministry of Finance, to accommodate underestimated needs in some areas without having to reduce allocations in others. Importantly, the contingency reserve should not be used to finance new policy initiatives. Such a mechanism was successfully implemented, for example, in Canada, supporting the effectiveness of the budget process (Blöndal, 2001).

It is probably not possible for any set of rules to be appropriate under all circumstances. An effective rule should also contain a well-defined escape clause (Kopits and Symansky, 1998; IMF, 2009) to provide clear guidance regarding the circumstances

Figure 3.8. **Within-year expenditure pattern**
General government expenditure, percentage of each month in the year



Source: Economic Expert Group.

StatLink  <http://dx.doi.org/10.1787/888932539821>

under which the rule can be suspended, and for what period. This is preferable to an *ad hoc* suspension of a rule that can be put on hold for an unspecified period of time, as happened in Russia. An exceptional circumstances clause should therefore be added to the Budget Code.

As discussed above, intergenerational fairness calls for saving at least part of oil income for the benefit of future generations, beyond saving for the purpose of smoothing cyclical fluctuations. The establishment of the NWF (Box 3.2) had this objective in mind. The redefining of the NWF's objective as contributing to the sustainability of the pension system is a reasonable approach, as this is a more focused goal that has a better chance of surviving the inevitable demands of various interest groups than the more abstract goal of benefiting future generations. At the same time, it serves the same purpose, given the demographic burden that future generations will encounter. The accumulation of NWF assets could be accelerated by transferring privatisation proceeds to the fund. Currently, the legislation is silent on what to do with these revenues.

Russia should also consider enhancing its rule-based framework by setting up an independent fiscal agency, as has been done in several OECD countries, including Sweden and the United Kingdom (Hagemann, 2010). An independent group of experts providing input into policy decisions, including on fiscal policy, would not be something entirely new for Russia. The government has long drawn on the expertise of think-tanks and research institutes, as well as renowned economic experts. Creating a specialised agency would formalise such arrangements with regard to input into fiscal policy decisions. Such a "fiscal council" can usefully assume a number of important advisory tasks, for example, providing estimates of short-term macroeconomic variables and trend growth. An independent panel of experts can also help build expertise on the cyclical adjustment of non-oil revenues, and can also perform independent analysis of fiscal issues, for example as regards the sustainability of pension arrangements, or estimate the cost of various fiscal initiatives. It can also help communicating fiscal issues to the public, for example, as regards the rationale for increasing the pensionable age.

Box 3.4. Recommendations on fiscal policy

Fiscal rules and council

- In the Budget Code, restore a rule governing management of oil and gas revenues and limiting the non-oil deficit, along with a well defined escape clause regarding the circumstances in which the rule can be breached.
- Supplement the non-oil deficit limit by a rule restricting the annual increase in total expenditure in real terms to some ceiling.
- Develop the necessary expertise on the cyclical adjustment of non-oil revenues. Publish more detailed information on the underlying fiscal position, highlighting uncertainties.
- Set up an independent fiscal council to perform a number of advisory tasks such as providing estimates of short-term macroeconomic variables and trend growth. An independent panel of experts can also help build expertise on the cyclical adjustment of non-oil revenues.

Budgeting and spending reforms

- Consider including in each annual budget a significant contingency reserve controlled by the Ministry of Finance, to accommodate underestimated needs in some areas without having to reduce allocations in others.
- Consider transferring privatisation proceeds to the National Welfare Fund.
- Equalise pensionable age for men and women and gradually raise the pensionable age in line with gains in longevity.

Notes

1. Henceforth, “oil revenues” will be used as a short form for “oil and gas revenues”. General government oil and gas revenues include the mineral extraction tax on oil and gas; export duties on oil, gas and oil products; and corporate income tax on the companies operating in the oil and gas sector. The Budget Code definition used by the authorities refers to the federal budget only and does not include corporate income tax on the companies operating in the oil and gas sector.
2. Russia took on both the financial assets and liabilities of the Soviet Union. The former were on paper substantial, but mostly consisted of claims on developing countries that were eventually written off entirely or in large part.
3. The situation was aggravated by the external shocks, namely a fall in oil prices and a wave of capital outflows from emerging markets induced by the Asian crisis, but at the centre of it were domestic macroeconomic weaknesses. See Gilman (2010) for a comprehensive discussion of Russia’s 1998 default.
4. This paragraph draws on preliminary findings and recommendations of the OECD accession review on public governance and regulatory policy as well as Kraan et al. (2008).
5. Moody’s awarded an investment grade to Russia in October 2003, shortly before the Stabilisation Fund became operational. Fitch assigned an investment grade to Russia in 2004, and Standard & Poor’s in 2005.

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