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DEBT AND DISCONTENT

THE COLLAPSE OF THE PUTIN CONSENSUS?



RUSSIA POLITICAL ECONOMY PROJECT



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FOREIGN POLICY RESEARCH INSTITUTE

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EXECUTIVE SUMMARY

Christopher Jarmas

For the vast majority of Russians, the *vlast'*—regime—they encounter is neither the Kremlin nor the Duma. It is considerably more local: regional governors, mayors, municipal bureaucrats, local ministry representatives, and their proxies. Although the Kremlin projects a centralized vision of the Russian Federation, in which Moscow's writ is executed evenly throughout the country, this image is not the reality of center-periphery politics in Russia. This report analyzes the Kremlin's handling of a subnational debt crisis, which its own policies sparked in 2012. Rather than managing the situation on a technocratic basis, the Kremlin has prioritized politically or strategically sensitive regions, while allowing fiscal problems to mount in others. The result is a paradox well known to observers of Russian politics: although the formal institutions that codify the center's relations with its periphery treat the regions on an equal basis, informal power dynamics play a much greater role. The Kremlin has also opted at each turn to delay painful repayments of subnational debts, pursuing an ad-hoc policy of immediate survival rather than a long-term strategy.

When a financial crisis crippled the Russian economy in 1998, it surprised many foreign investors and even Russia watchers. Conditions in the regions beyond Moscow and Saint Petersburg, however, would have made clear that the status quo was not sustainable. Today, Russia watchers are again walking blindly. Center-periphery politics in Russia are not dead, but hidden. If the "Putin consensus" begins to break down in Vladimir Putin's fourth term, its cracks will not initially form in the country's formal institutions; they will appear first in the informal relationships that define Moscow's interactions with its periphery.

FISCAL TENSIONS IN RUSSIA

“**T**hey’ve stolen everything.”¹ This attitude towards central policymakers is gaining momentum in Moscow’s periphery as the Russian Federation trudges toward its 20th year with Vladimir Putin at the helm. A plan to reform Russia’s pension system—specifically to raise the retirement age from 60 to 65 for men and from 55 to 60 for women (revised down from an initial proposal of 63)—has fueled public ire, particularly in the provinces, since the changes were first introduced in June 2018.

Political backlash is hitting the Kremlin, even in Russia’s heavily managed political system. The gubernatorial elections in September 2018 revealed a ruling party on the defensive, as several Kremlin-backed incumbents were unable to beat their disadvantaged opponents. In Primorskiy Krai, in Russia’s Far East, ballot-stuffing in the final hours of the runoff election was so brazen that the results were thrown out and a rerun was ordered—the first time this had happened since the 1990s. In Khakassia, it seems the only way the incumbent government can keep the Communist candidate, Valentin Konovalov, from winning is to repeatedly delay the election.² Putin himself has suffered

a 10-percent drop in his approval rating since plans to reform Russia’s pension system were proposed.

It may seem as if Putin’s political problems came out of nowhere. But if one looks more closely at the regions, it is evident that while center-periphery tensions are only now making headlines, they have been mounting for several years. In September 2016, Russia’s central government adopted a plan to expand the federal budget’s share of Russia’s 20 percent profit tax from two to three percent. That the central government would attempt to seize a larger slice of Russia’s shrinking tax-revenue pie was hardly surprising; it was unexpected, however, that many of Russia’s regions would publicly denounce the gambit. Tatarstan’s President Rustam Minnikhanov ridiculed the plan, calling it “stupidity” and “an extremely dangerous move.”³ At Moscow’s Gaidar Forum the following January, Kaluga’s Governor Anatoly Artamonov griped, “God forbid if you manage to grow your budget revenues – you will immediately be removed from federal budget programs.”⁴ Nor were donor regions—that is, regions that send more tax revenue to Moscow than they receive in transfers—alone in their critiques

1 Matthew Luxmoore, “‘They’ve Stolen Everything’: In Russia’s Far East, Dreams Deferred Amid Grim Mood Over Pension Reform,” *RFERL*, October 14, 2018. <https://www.rferl.org/a/in-russia-s-far-east-dreams-deferred-amid-grim-mood-over-pension-reform/29542683.html>.

2 Andrew Roth, “Communist Challenger Exposes Cracks in Putin’s Grip on Power,” *Guardian*, October 13, 2018. <https://www.theguardian.com/world/2018/oct/13/communist-challenge-exposes-cracks-putins-power>.

3 Robert Coalson and Alsu Kurmasheva, “Where is this Country Going? Debt Crisis Tugs at Russian Federation’s Seams,” *RFERL Tatar-Bashkir Service*, January 2, 2017. <https://www.rferl.org/a/tatarstan-russia-debt-crisis-war-of-words/28209393.html>.

4 Mikhail Ryabov, “*Kaluzhskii gubernator pozhalovalsya na diskriminatsiyu Minfina* [Kaluga’s Governor Complains About Discrimination by Ministry of Finance],” January 12, 2017. <http://www.politnavigator.net/kaluzhskijj-gubernator-pozhalovalsya-na-diskriminatsiyu-minfina.html>

of the Kremlin: even before the government announced its tax proposal, in August 2016 Samara Oblast's then-Governor Nikolai Merkushkin warned citizens that the region would soon need "to fight for every ruble from the federal budget."⁵

Under challenging economic circumstances, with oil prices near five-year lows and Western sanctions contributing external shocks to a sputtering domestic economy, the central government's plan was designed to transfer rubles from well-off regions to cash-strapped regions. But since just 14 of Russia's 83 regions are net-donors to the federal budget, this move threatened the country's wealthiest regions with narrow but deep losses.

The regional reaction to the Russian government's 2016 tax proposal demonstrates that center-periphery politics may be marginalized, but they are far from dead. While the Kremlin relies on a meticulously constructed appearance of formal uniformity, policy is often hotly contested—albeit via informal channels rather than formal mechanisms. Even in the Duma, where ruling party United Russia dominates, legislative bargaining still exists; rather than debated as bills on the floor, policy is hammered out in weekly Presidium meetings, where deputies, representatives from the ministries, and lobbyists all fight for their interests behind closed doors. Officially, bills often pass unanimously or nearly unanimously—but the teeth of Russian legislation lies in language bitterly fought over by informal powerbrokers.

Informal agreements, rather than institutionalized power structures, also play a key role in Russia's center-periphery fiscal relations. In Russia, the regions are

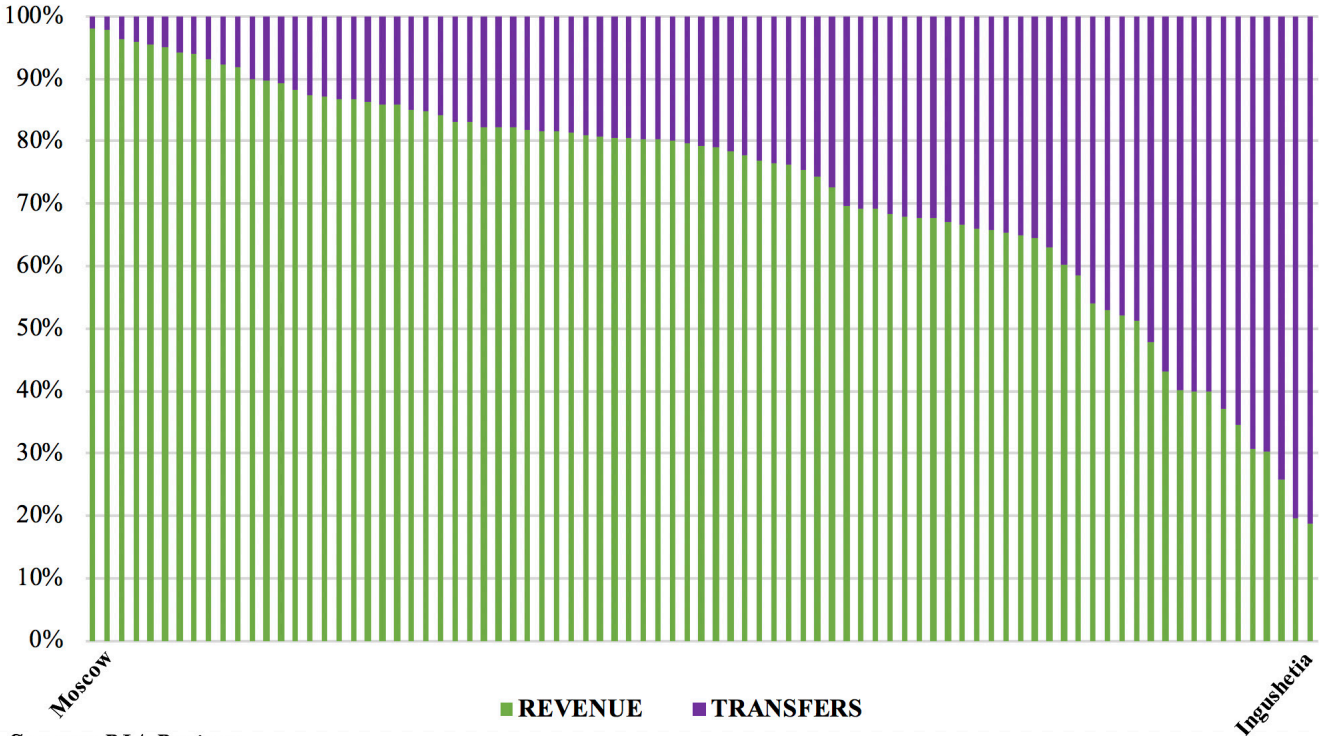
formally responsible, together with the federal government, for education, health, and infrastructure spending. The country's Budget Code states that all three levels of government—federal, regional, and local—are "autonomous" and should be financially self-sufficient. Russia's Budget Code has even included some form of a fiscal rule since 2008.⁶ In reality, however, the regions are anything but autonomous and financially self-sufficient—and the parameters of the Budget Code's fiscal rule were frequently amended, and its implementation was often suspended.

This report focuses on Russia's center-periphery politics since Putin's "return" to the Kremlin in 2012 and, in particular, the Kremlin's handling of a debt crisis in the regions—a crisis which its own policies set in motion. The picture that emerges from this analysis hardly reflects the well-worn tropes of Russian governance familiar to Western observers of the country's politics, which typically cast Putin as a strategic "chess master" whose writ is dutifully and efficiently executed throughout Russia. In reality, the center's policies towards its periphery consistently favor ad-hoc decision-making over common approaches and short-term stability over long-term solutions. The Kremlin crafts regional fiscal policy primarily to mitigate immediate challenges while assuming that future economic growth will eliminate the need for difficult choices. In its management of regional debts, the Kremlin has staked a great deal on future budgetary flexibility—flexibility which it may not have.

⁵ "Merkushkin priravnal vybory k voennoi mobilizatsii [Merkushkin Equates Elections to Military Mobilization]," *Zasekin.ru*, August 18, 2016. <https://zasekin.ru/days/22582>.

⁶ Gabriel Di Bella, Oksana Dynnikova, and Francesco Grigoli, "Fiscal Federalism and Regional Performance," *IMF Working Paper*, 2017. <https://www.imf.org/en/Publications/WP/Issues/2017/11/22/Fiscal-Federalism-and-Regional-Performance-45430>.

**Regional Budget Dependence on Federal Transfers
(December 31, 2017)**



Source: RIA Ratings

RUSSIA'S SUBNATIONAL DEBT DEBACLE

While foreign policy—and more recently, pension reform—seizes headlines, a debt crisis has gripped many of Russia's regions since late 2012. Whereas aggregate subnational debt obligations amounted to 26 percent of total regional revenues in 2012, this figure had ballooned to 37 percent by 2016.⁷ Barring unprecedented economic growth in Russia's most debt-laden regions, repaying these accrued debts will eventually require regions to cut their expenditures—and in Russia, that typically means cuts to healthcare and education spending. Federal interventions, discussed in this report, have since temporarily eased the regions' pain, but offer no long-term solutions.

Aggregate figures, however, fail to fully capture the fiscal realities of Moscow's periphery. Center-periphery relations in Russia are defined by massive fiscal inequalities. While Moscow, Saint Petersburg, and resource-rich regions are fiscally self-sufficient, most others depend on subsidies and transfers from the federal budget for, in the most extreme cases, up to 80 percent of their revenues.⁸ In terms of standard of living, measured by per capita gross domestic product (purchasing power parity, PPP), Russia's regions range from Tyumen Oblast (equivalent to Norway) to Ingushetia (equivalent to Iraq).

7 RIA Ratings, http://vid1.rian.ru/ig/ratings/rating_regions_2018.pdf.

8 RIA Ratings, http://vid1.rian.ru/ig/ratings/rating_regions_2018.pdf.

Inequality has also exacerbated Russia's subnational debt crisis. While well-off regions, and those heavily subsidized by the central government like Crimea, Chechnya, and Kaliningrad have maintained healthy balance sheets despite Russia's challenging macroeconomic environment, fiscal woes have ballooned for the country's bottom-of-the-barrel debtors. In 2013, for instance, the Republic of Mordovia held debt equal to 172 percent of the region's annual revenue—while *nationwide* figures have since improved, Mordovia's debt was equal to nearly 250 percent of its annual revenue by July 2018.⁹ How did this situation come to pass in a country whose leadership prizes stability at all costs?

The roots of Russia's subnational debt debacle can be traced to 2012, as Putin campaigned for his third term as Russia's president amidst an atmosphere of protests in major cities and widespread dissatisfaction with the ruling party United Russia. Opposition to Putin's regime, which coalesced into protests after blatantly fraudulent Duma elections in 2011, did not call into question that Putin would likely win the election, but did threaten his margin of victory—and thereby his ability to claim an electoral mandate.

As a countermeasure, Putin relied on a populist message to garner support, particularly among the middle-class employees of the state bureaucracy, and he published a series

9 Russia Ministry of Finance.



Russian President Vladimir Putin meets with elected regional governors, September 2018. (Source: kremlin.ru)

of manifestos promising everything from massive infrastructure projects to 50-percent raises for teachers, healthcare workers, and government officials. Within hours of his inauguration on May 7, Putin codified these campaign promises into presidential decrees and tasked the regions with fulfilling them. With limited funding from the central government, the burden on regional governments proved massive, even more so given that public-sector employees—whose salaries, according to one decree, would be raised by 50 percent within six years—accounted for approximately a quarter of Russia’s workforce. No official cost estimate accompanied the decrees, but analysts speculated the price tag could be as high as \$43 billion.¹⁰ Natalya Zubarevich, an expert on Russian regional economics, estimated that 70 percent of the necessary financing

would come directly from regional budgets.¹¹

Not only are presidential decrees “obligatory for fulfillment” according to Russia’s 1993 constitution, but the Kremlin evaluates Russia’s regional governors on two main criteria: their ability to deliver votes in election years and their ability to ensure political stability in the others. While governors are elected by the populations of the regions they govern, the Kremlin retains the right to dismiss a governor at any time. Zubarevich writes, “Governors who lack the confidence of the public and who are at odds with regional elites are dismissed.”¹² Economic factors can play a critical role: the dismissal of the governor of the oil-rich Nenets Autonomous Okrug in 2017 was linked to austerity measures, which saved the regional budget, but were

10 William Pomeranz and Kathleen Smith, “Commentary: Putin’s Domestic Strategy: Counting the Trees, Missing the Forest,” *Reuters*, May 30, 2016. <https://www.reuters.com/article/us-russia-putin-domestic-commentary/commentary-putins-domestic-strategy-counting-the-trees-missing-the-forest-idUSKCN0YM08V>.

11 Arnold Khachaturov, “*Mayskie ukazy tyanut regiony v defolt* [May Decrees Drive the Regions Towards Default],” *Novaya Gazeta*, June 13, 2015. <https://www.novayagazeta.ru/articles/2015/06/13/64511-mayskie-ukazy-tyanut-regi-ony-v-defolt>.

12 Natalya Zubarevich, “The Fall of Russia’s Regional Governors,” *Carnegie Moscow Center*, December 10, 2017. <https://carnegie.ru/commentary/73369>.

unpopular with the population and regional elites. This incentive structure prompted regional leaders to react to the May decrees not by raising requisite revenues to cover the newly mandated expenditures—regions have limited authority to adjust tax rates anyway—but by borrowing on a massive scale.

As debts mounted and macroeconomic circumstances deteriorated, the Kremlin remained focused on fulfilling Putin's so-called "May decrees." In fact, the very pressures that were choking the Russian economy—low global oil prices, economic stagnation, inflation, and recession—also meant that in 2018, Putin would, for the first time in his tenure, be unable to run on a record of economic growth.

In May 2016, Kremlin spokesperson Dmitry Peskov stressed the importance of the decrees: "The president has regularly been holding meetings with the regions' leadership and each governor individually to discuss in detail the process of implementing the decrees."¹³ Meanwhile, the popular newspaper *Moskovsky Komsomolets* declared that the Duma elected in October 2016 would be "the State Duma of fulfilling the May decrees" and blamed "negligent ministers" and "obstinate governors" for their slow implementation.¹⁴ In reality, the federal government itself had slashed its own spending on implementing the May decrees by 153 billion rubles in 2015. But for regional leaders, the message from Moscow was clear: remaining in the Kremlin's good graces still meant fulfilling the May

decrees—even if that meant accumulating a mountain of debt.

At the same time, however, Moscow was growing concerned about subnational borrowing. Prime Minister Dmitry Medvedev urged regions towards "balance and self-sufficiency" in their budgets, while the Kremlin's first efforts at subnational debt restructuring stipulated that regions with growing debt-to-revenue ratios would be ineligible for federal assistance in the form of zero-interest "budget credits" or "budget loans."¹⁵ In other words, the initial federal response managed to exclude precisely those regions which needed fiscal intervention most.

¹³ Interfax, "Overwhelming Majority of Russian Regions Mobilize resources, Implement Putin's May 2012 Decrees – Peskov," *Russia & CIS Presidential Bulletin*, May 6, 2016.

¹⁴ Mikhail Zubov, "Eksperty: Eta Gosduma budet voevat' s neradivymi chlenami pravitelstva [Experts: This Duma Will Fight With Negligent Members of the Government]," *Moskovsky Komsomolets*, October 5, 2016. <http://www.mk.ru/politics/2016/10/05/eksperty-eta-gosduma-budet-voevat-s-neradivymi-chlenami-pravitelstva.html>.

¹⁵ TASS, "Medvedev: Regiony prodolzhat poluchat' subsidii po osnovnym sotsialnym napravleniyam [Medvedev: Regions Will Continue to Receive Subsidies in Major Social Areas]," July 29, 2016. <http://tass.ru/ekonomika/3496416>.

HOW DID THE KREMLIN RESPOND?

If there was a silver lining to Russia's regional debt crisis in 2015, it was that the growth rate of consolidated regional liabilities decelerated. With promising results, the central government expanded its program of replacing high-interest commercial loans—issued by banks, often at unfavorable rates—with effectively zero-interest budget loans, redistributed from other parts of the federal budget. In terms of debt structure, as respective proportions of total consolidated regional debt, budget loans increased by 7.3 percent, and commercial loans decreased by 5.6 percent. Improvement in *consolidated* figures, however, masked deepening inequality between regions.

First, the central government dictated that in order for a region to remain eligible to receive budget loans, its commercial debt could not exceed 70 percent of fiscal revenues. At the time, the Russian bond-rating agency ACRA identified six highly indebted regions that would fail altogether to meet this requirement, barring them from federal debt restructuring and thereby forcing them to continue to increase their commercial debt.¹⁶

The central government's response to Russia's burgeoning subnational debt has taken place under the guise of a technocratic process, but a closer look at changes in regional debt structures suggests that the central

government was more concerned with ensuring short-term political stability than it was with remedying the deteriorating fiscal health of the regions. The data indicate that the initial phase of the central government's debt restructuring program did not aim to equitably help regions according to need, but according to the Kremlin's own priorities. Among Russia's 20 most indebted regions, there was hardly any correlation between the severity of a region's debt burden and the conversion of its commercial debt into budget loans. While financial need was not of primary concern to the central government's debt restructuring program, politics appear to have been essential.

The Kremlin has long understood the link between fiscal policy and maintaining power in the regions. Daniel Treisman has described 1990s inter-budgetary transfers as a strategy of "fiscal appeasement" in which regions that expressed opposition to Boris Yeltsin were more likely to receive higher levels of transfers from the federal budget.¹⁷ In turn, higher levels of regional government spending yielded better electoral outcomes for the Kremlin. By contrast, Treisman concludes, "fiscal neglect of regions led to growing discontent with central incumbents."¹⁸

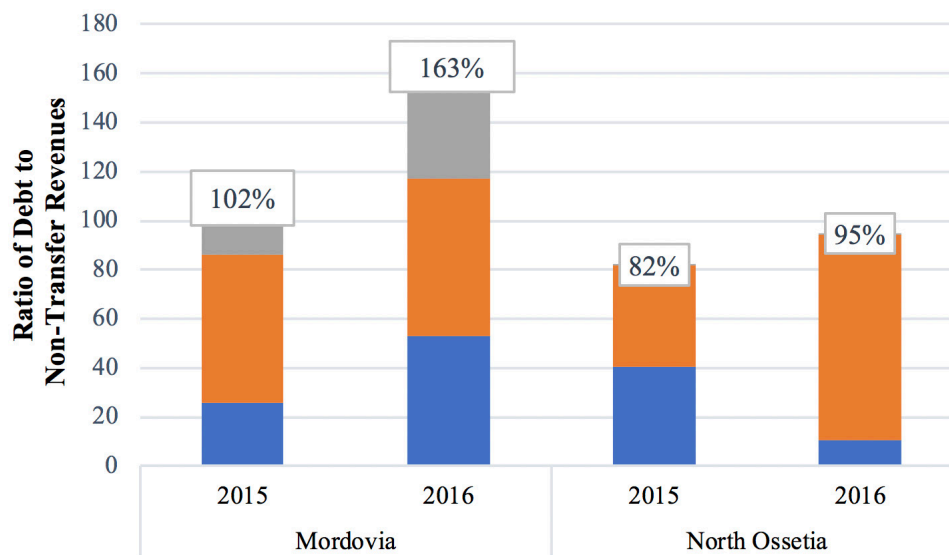
In the Putin era, ensuring political loyalty has

¹⁷ Daniel Treisman, *After the Deluge: Regional Crises and Political Consolidation in Russia*, (University of Michigan Press, 2001), p. 75.

¹⁸ Treisman, *After the Deluge*, p. 136.

¹⁶ The six regions identified by ACRA are Ivanovo, Kostroma, Omsk, Khakassia, Mordovia, and Mari-El.

Comparative Debt Structures in Mordovia & North Ossetia (2015-2016)



Source: Ministry of Finance

■ Commercial ■ Budget Loans ■ Other

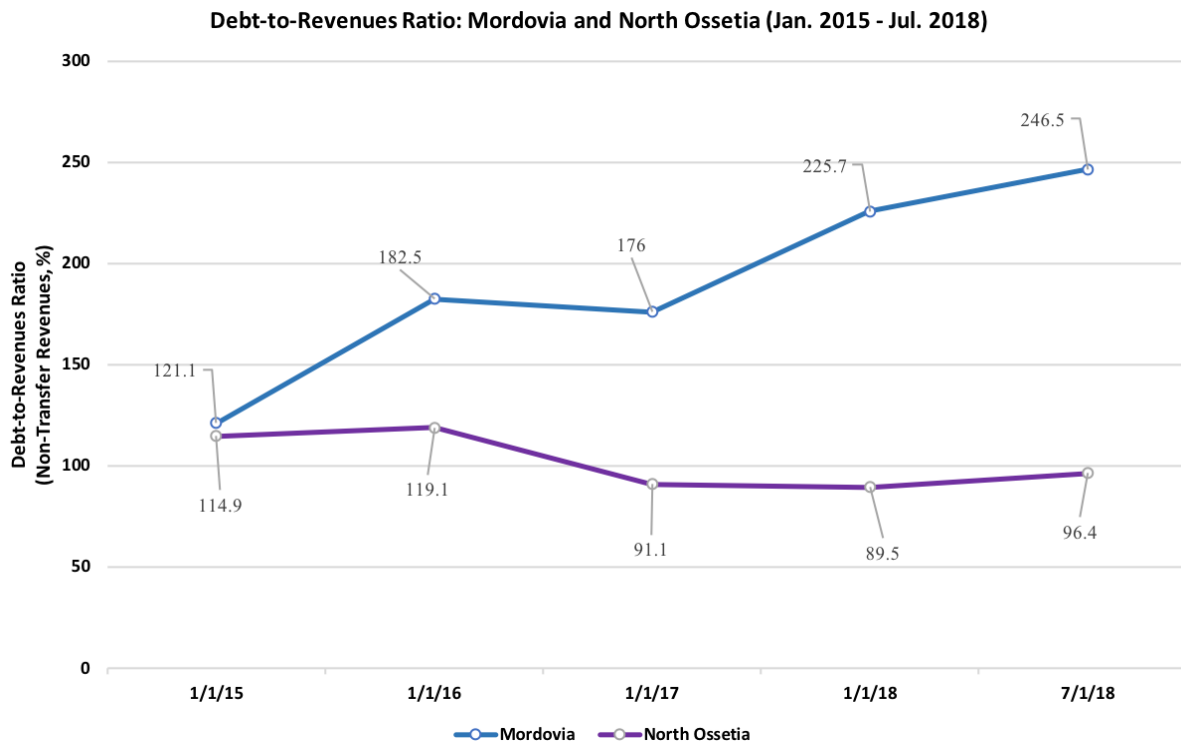
remained a primary driver of the Kremlin's entire regional policy. Along with illegally annexed Crimea, Chechnya and Ingushetia are the regions most dependent on fiscal transfers; they are also among Russia's most politically and strategically sensitive, and massive fiscal transfers and subsidies form a key part of Moscow's social contract with the historically restive North Caucasus. Such regions form a category which Anton Tabakh and Daria Andreeva label "non-market"—high levels of subsidies and targeted investment activity eliminate the need for taking on debt altogether.

At the start of the current crisis, it was Russia's "middling" regions, characterized by their narrow revenue bases and lower shares of transfers that were in the most difficult position. Once again, a region's political risk appears to have influenced its place in line for early federally funded debt restructuring. Among highly indebted regions, those which had higher turnout in the 2016 Duma election tended to receive fewer budget

loans. Those with higher vote totals for the ruling party United Russia also tended to see less attention from Moscow.

Strategic considerations may also help explain the central government's prioritization of certain regions over others. For the six North Caucasus regions with debt-to-revenues ratios over 50 percent by September 2017, budget loans accounted for an average 77 percent of regional debts; the average share of budget loans for *all* Russian regions with debt-to-revenue ratios over 50 percent was just 53 percent.

The divergent trajectories of Mordovia and North Ossetia exemplify the significance of early federal intervention through budget loans—and reflect the strategic orientation of the Kremlin's initial debt-restructuring campaign. Both regions reliably turn out overwhelming support for Kremlin-backed candidates, but they represent dramatically different security environments. Mordovia is situated in Russia's European heartland



between Moscow, Nizhny Novgorod, and Saratov. North Ossetia, on the other hand, borders Ingushetia and Chechnya, and the geopolitically significant disputed territory of South Ossetia. The region has been a persistent security concern for policymakers in Moscow since the 1990s and when it faced a crippling debt situation, North Ossetia was among the first in line for federal intervention. Meanwhile, regions such as Mordovia remain stuck in line.

The effect of the May decrees on Mordovia's budget was clear by 2013, when the rating agency Moody's warned, "The region's high deficits are attributable to substantial local infrastructure spending made recently, as well as growing social payments and public salaries, with the latter adding to already inflexible operating expenditure."¹⁹ North Ossetia was in an equally difficult position:

in 2015, Astemir Tsomaev, the director of a North Ossetian organization dedicated to the implementation of the May decrees, warned that the region may become the first in Russia to formally default.²⁰

Over the course of 2016, however, the two regions diverged dramatically: Mordovia's debt-to-revenues ratio increased by 60 percent, in comparison with just a 15 percent increase for North Ossetia. Mordovia's worsening position vis-à-vis North Ossetia was not a product of internal mismanagement—both regions cut expenditures by approximately the same level between 2015 and 2016—but a result of neglect by the central authorities.

Specifically, changes in the respective debt structures of Mordovia and North Ossetia were responsible for the divergence. While Mordovia *increased* its level of high-interest

¹⁹ Moody's, "Moody's Interfax Assigns A1 Rating to Mordovia Republic," February 21, 2013. https://www.moody.com/research/Moodys-Interfax-assigns-A1ru-rating-to-Mordovia-Republic--PR_266573.

²⁰ Astemir Tsomaev, "Regiony-bankrotы могут стать реальностью в РФ [Bankrupt Regions May Become a Reality in the Russian Federation,]" *Echo Moskvy*, November 12, 2015. <https://echo.msk.ru/blog/astemir-tsomaev-v/1657248-echo/>.

commercial debt, the central government converted virtually all of North Ossetia's commercial debt into budget loans. Mordovia's continued reliance on commercial debt meant that its debt-servicing costs continued to rise through 2016, keeping the region ineligible for federal refinancing. Early intervention in North Ossetia, on the other hand, ensured the region's eligibility for future refinancing maneuvers. By October 2017, the divergence in the two regions' indebtedness was even more dramatic, the result of a conscious choice in Moscow to launch an early intervention on behalf of North Ossetia while leaving Mordovia out in the cold.

KICKING THE CAN DOWN THE ROAD

The central government's distribution of budget loans from 2015 through 2016 was uneven, ad hoc, and politically and strategically motivated. But on a macro level, by the end of 2017, Russia's Ministry of Finance could claim to have successfully deleveraged subnational debt structures in aggregate.

High-interest commercial loans accounted for 44.6 percent of regional debts in 2014; by the end of 2017, that figure had been cut to 31.6 percent. The central government's dispersion of budget loans was responsible for the shift. In 2014, budget loans had comprised just 30.8 percent of regional debts, yet by the end of 2017, their share reached 45.9 percent. In simpler terms, the federal budget now directly owned 45.9 percent of regional liabilities.

By the end of 2017, the Russian economy remained in stagnation—under pressure from internal factors, low oil prices, and sanctions—and the Ministry of Finance sought to reduce expenditures. According to the approved budget for 2018-2020, new budget loans would no longer be issued.²¹ But for the regions, the problem of repaying existing budget loans remained. Budget loans were never designed as a permanent solution and

held a maximum maturity of three years—meaning that repayments on their principal would start to come due in 2018.

Expiring budget loans left the Kremlin with an important decision: to allow regions to default, thereby risking social stability and the provision of public goods, or to forgive the debts of regions in technical default and force the federal balance sheet to absorb the cost. A mid-2015 *Bloomberg News* headline labeled the situation “The \$42 Billion Debt Trap that Putin has Three Years to Escape.” In 2017, the Kremlin chose a third path: to effectively kick the can down the road. That September, Putin announced a new restructuring program, which would begin in 2018 and would offer regions an additional seven years to fully repay the principal on their quickly expiring budget loans.²² For an unspecified number of “certain regions,” Putin added, the pain of repayment could be delayed for up to twelve years.²³

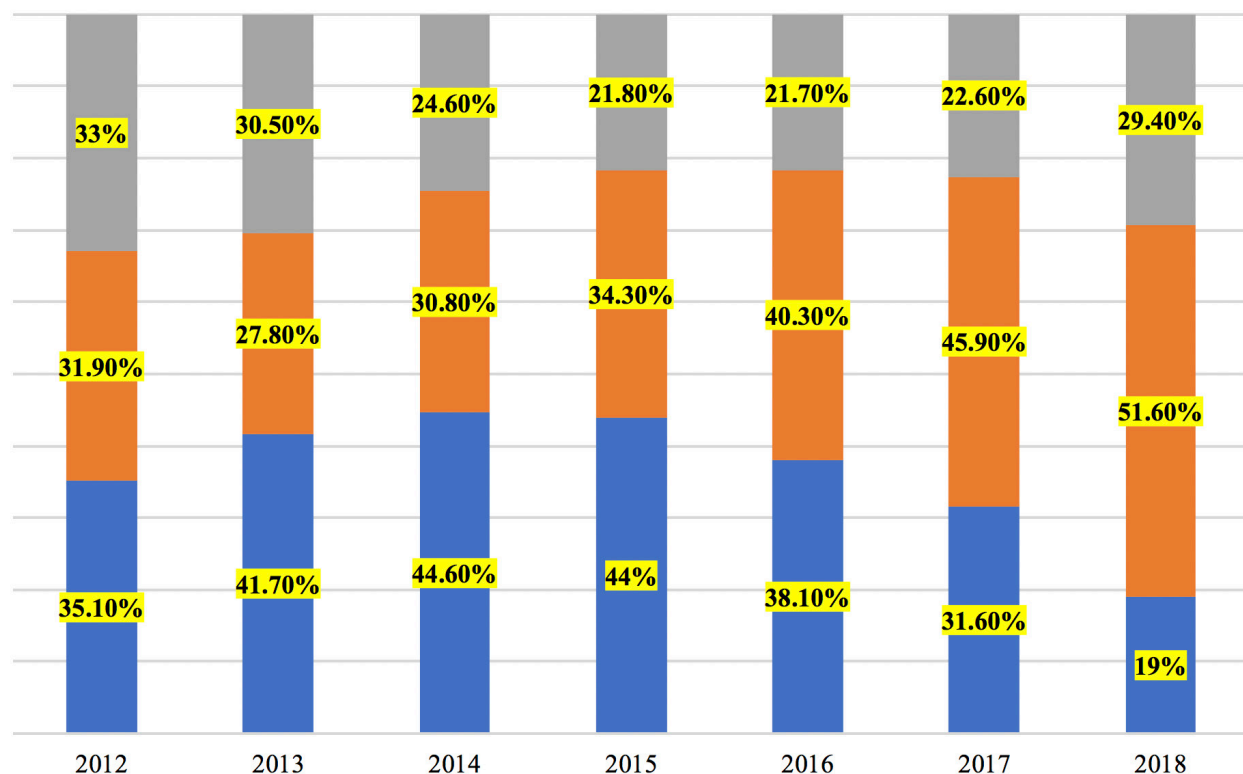
The new restructuring program is also heavily backloaded, saving the worst for last. In 2018 and 2019, participating regions will only be required to repay their debt to the federal government at a rate of 5 percent per year—

21 Elizaveta Bazanova, “Vместо новых бюджетных кредитов, регионы получат отсрочку по старым [Instead of New Budget Loans, Regions Will Receive Delays on Old Loans],” *Vedomosti*, September 25, 2017. <https://www.vedomosti.ru/economics/articles/2017/09/25/735128-byudzheth-nih-kreditov-regioni>.

22 “Putin анонсировал реструктуризацию бюджетных кредитов регионов [Putin Announced a Restructuring of Regional Budget Credits],” *RBC*, September 22, 2017.

23 “Putin анонсировал реструктуризацию бюджетных кредитов регионов [Putin Announced a Restructuring of Regional Budget Credits],” *RBC*, September 22, 2017. <https://www.rbc.ru/rbcfreenews/59c5542b9a79477b81e649c9>.

Consolidated Regional Debt Structures 2012-2018



Source: Ministry of Finance

■ Commercial Loans ■ Budget Loans ■ Other

but in 2020, repayment requirements increase to 10 percent, then double again to 20 percent per year from 2021 onward. In other words, take a region with a debt-to-revenue ratio of 100 percent, and whose entire debt consisted of budget loans. Beginning in 2021, the region would be saddled with repaying the central government an amount equal to 20 percent of its total budget, until the budget loans are fully repaid—an impossible proposition for Russia's most indebted regions. Moreover, this case is hardly a hypothetical; as of July 2017, North Ossetia had a debt-to-revenues ratio of nearly 90 percent, 88 percent of which consisted of budget loans.

In November 2017, Russia's Ministry of Finance announced rules that would govern the program, chiefly sanctions for regions that fail to uphold their repayment requirements. Once again, examining the details reveals a process less likely to be governed by formal

rules than by ad-hoc political considerations. According to the new rules, regions that miss interest payments—highly unlikely to occur due to the budget loans' symbolic 0.1 percent interest rate—or miss a payment on principal would be compelled to repay the entirety of their remaining obligations to Moscow at once, resulting in default.²⁴ But even these formal rules leave room for the Kremlin to maneuver. Failure to complete payments on time would be acceptable under two conditions: vaguely defined "circumstances outside of a region's control" (*obstoyatel'stva nepreodolimoj sily*) and the replacement of a region's governor.

"Above all," Moody's credit analyst Vladlen Kuznetsov remarked, "the Ministry of Finance will take a rather flexible stance in these cases

²⁴ Christopher Jarman, "MinFin Impossible: Russia's Self-Inflicted Regional-Debt Crisis," *BNE IntelliNews*, November 29, 2017. <http://www.intellinews.com/fpri-bear-market-brief-minfin-impossible-russia-s-self-inflicted-regional-debt-crisis-133265/?source=russia>.

to avoid regional defaults,” adding that the Kremlin would be less likely to force potentially destabilizing defaults than it would be to provide additional inter-budgetary transfers, introduce further refinancing options, and take regional expenditures under central control.²⁵

A second condition of the budget-loan restructuring program limits the regions’ maneuverability. Indebted regions taking part in the program would be prohibited from seeking new commercial loans at interest rates higher than a formula of “key rate plus 1 percent” beginning in 2018. This rule represents a major limitation on commercial credit available to Russia’s most heavily indebted regions. Mordovia, for example, had borrowed at an 11.5 percent rate in September 2017, despite a key rate of just 8.5 percent. Thus, observed Natalya Zubarevich, “Some regions will simply cut down all expenditures on the national economy, where possible, and not invest in development at all – but they will fulfill the [May] decrees.”²⁶ The process once again hardly reflected a system based on universal rules, in which orders were effectively transmitted by the Kremlin and faithfully executed by actors in the regions. Instead, the central government favored a strategy destined to favor certain indebted regions over others, according to opaque criteria designed to mitigate political and strategic risks.

25 Anton Feinberg, “*Minfin nazval potentsialnykh sanktsii dlya regionov-dolznikov* [Ministry of Finance Named Potential Sanctions for Debtor Regions],” *RBC*, November 14, 2017. <https://www.rbc.ru/economics/14/11/2017/5a09abe69a7947becc37f375>.

26 Natalya Zubarevich, “*Regiony-dolzchnik: Mezhdru Stsilloy I Kharibdoi* [Debtor Regions: Between a Rock and a Hard Place],” *Polit.ru*, November 14, 2017. <http://polit.ru/article/2017/11/14/regions/>.

MANUAL CONTROL (RUCHNOE UPRAVLENIE)

In early 2018, the central authorities took a drastic step to hem in regional budgets: for the first time in the Russian Federation's history, the Federal Treasury took under its direct control the expenditures of Kostroma Oblast and Khakassia in an effort to stave off technical defaults. In a January 2018 interview with TASS, the head of the Federal Treasury, Roman Artyukhin, outlined the plan:²⁷

TASS: In essence, the Treasury will control the financial flows of the region?

RA: We will use budget instruments which are used at the federal level. These are the mechanisms of treasury support, mechanisms for tabulating budget obligations, for preventing regions from adopting obligations exceeding limits established in the budget law and preventing hidden accounts payable...

TASS: Are any regions already candidates for this innovation?

RA: A decision has already been made in regard to certain federal subjects. These are the Republic of Khakassia and Kostroma Oblast.

Officially, federal policy threatened defaults for regions that failed to repay their obligations to Moscow; in practice, the Kremlin bypassed

²⁷ Dar'ya Karamysheva, "Roman Artyukhin: Kazhdyi gosudarstvennyi rubl' dolzhen rabotat' [Roman Artyukhin: Every State Ruble Must Work]," TASS, January 19, 2018. <http://tass.ru/opinions/interviews/4887485>.

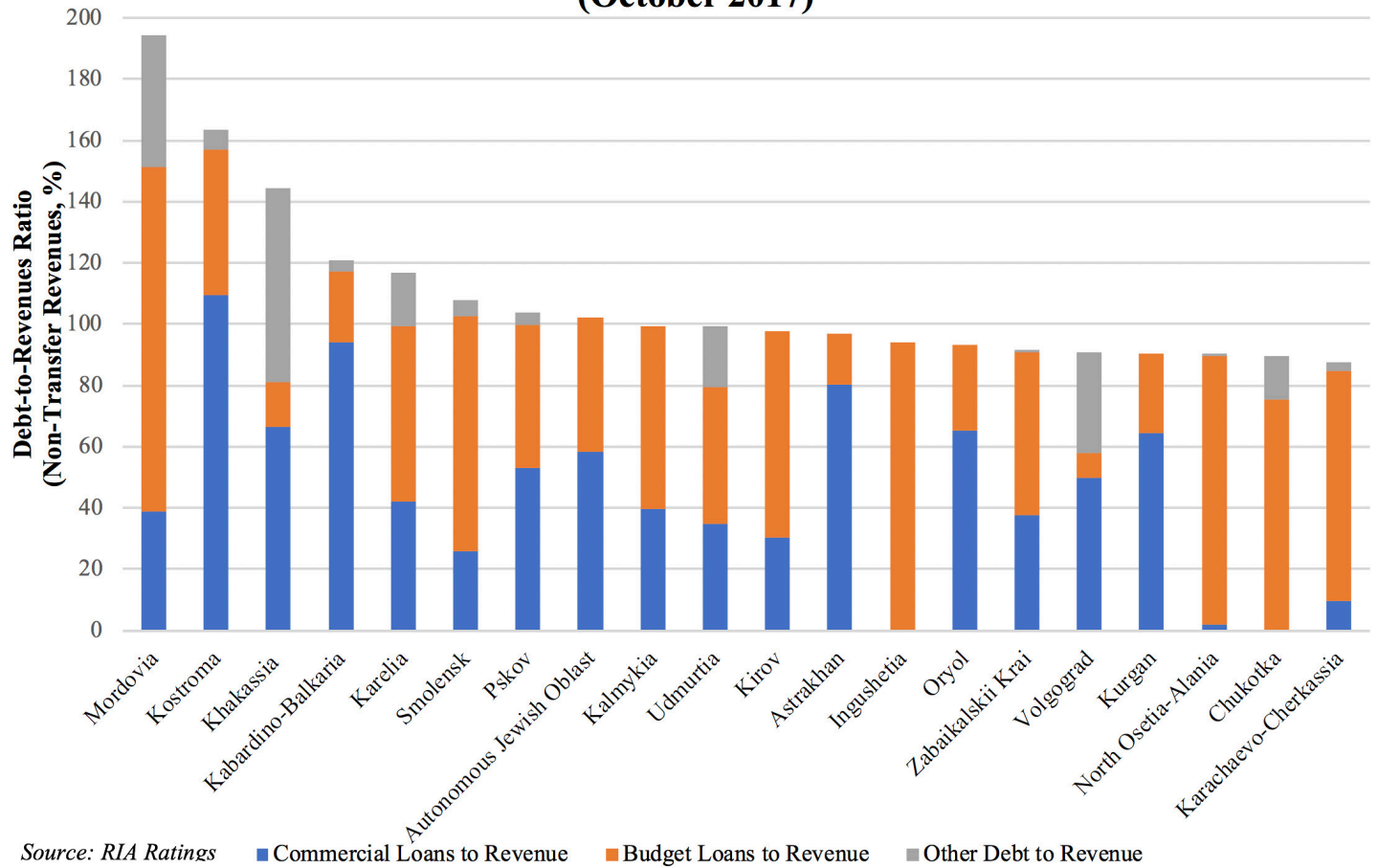
its own rules and exerted manual control over regions close to missing budget loan repayments. Kostroma Oblast and Khakassia were among Russia's most heavily indebted regions, but were hardly exceptional in their level of indebtedness, suggesting that this same fate awaits additional Russian regions.

As 2018 began, it was widely recognized that Kostroma Oblast and Khakassia would not be singled out for long. Kabardino-Balkaria, Smolensk, the Autonomous Jewish Oblast, Udmurtia, and Pskov all risked losing control over their expenditures. As for Mordovia, one analyst suggested, the Kremlin was awaiting the conclusion of the World Cup—in which the regional capital Saransk was a host city—before making determinations about seizing control of the region's spending and borrowing.²⁸

The Kremlin's deepening involvement in regional finances is not a sign of the center's strength—it is an indication of a breakdown in normal center-periphery politics and a worrying trend for central policymakers.

²⁸ Sergei Markelov, "Intervyu: Esli prisooedinyat'sya, tak uzh srazu k Moskvu! [Interview: If You Are Annexed, Then Go Immediately to Moscow!]," *Novaya Gazeta*, February 8, 2018. <https://www.novayagazeta.ru/articles/2018/02/09/75446-esli-prisooedinyat-sya-tak-uzh-srazu-k-moskve>.

Debt-to-Revenues Ratio and Regional Debt-Structures (October 2017)



RUSSIA'S REGIONAL-DEBT CRISIS IN CONTEXT

As this report has demonstrated, the formal structure of Russian fiscal federalism hardly reflects reality. The saga of Russia's regional debt spiral underscores that center-periphery fiscal relations in Putin's Russia remain ad hoc and informal, and frequently circumvent institutionalized rules, despite the Kremlin's projection of order and control. As of this writing, Russia's subnational debt worries have eased—thanks in part to a recovery in regional revenues—but they have not disappeared. The central government has merely delayed the day of reckoning, betting on unprecedented growth in regional revenue bases to save the day before repayment becomes necessary.

The Kremlin today projects a simple but persuasive narrative: Putin is a modern-day Prince Pozharsky, the Russian nobleman who rallied his forces against Polish occupiers in 1611. Putin, we are told, imposed order on Russia's obstreperous regional elites and saved the nation from the hapless "Tsar Boris"—only this time it was Yeltsin, rather than Godunov. But beyond the Kremlin's self-serving narrative, center-periphery politics in today's Russia remain grounded in informal calculations and favor short-term stability over long-term viability.

Assessing the future development of Russia's center-periphery relations in a 2000 interview, Putin remarked, "You can't please everybody, but you can find common approaches." The Russian state has codified the structures

of common approaches—from the *polpredy* who oversee Russia's Federal Districts to the imposition of general fiscal rules that theoretically manage the central government's current subnational debt-restructuring efforts. However, center-periphery relations still largely operate according to the rules of the 1990s, when short-term stabilization took precedence over adherence to formalized rules.

This analysis supports two main conclusions. The first concerns Putin's new batch of May decrees, signed in May 2018 on the day of his re-inauguration. Once again, the Kremlin's goals are ambitious and expensive; one section says that "the Russian Federation should join the group of the world's five largest economies, ensure economic growth rates above the world's level while keeping macroeconomic stability, including inflation at no more than 4 percent."²⁹ If the regions are tasked with fulfilling significant parts of the decrees, particularly those concerning boosting investment for the modernization of Russia's economy, the Kremlin risks once again breaking the backs of the regions.

Second, this report supports the conclusion that if the "Putin consensus" begins to break down in Putin's fourth term, its cracks will not initially form in the country's formal institutions; they will first appear in the informal relationships that continue to govern

²⁹ Kremlin.ru, May 7, 2018. <http://kremlin.ru/events/president/news/57425>.

Moscow's relations with its periphery. Warning signs are already cropping up in the regions. Outcry over pension reform was particularly acute in Moscow's periphery—in part because the proposed retirement age for men is higher than male life expectancy in 15 regions. Political blowback may already be affecting electoral outcomes, even in Russia's highly managed political system. In this September's gubernatorial elections, unexpected losses for Kremlin-backed candidates in Vladimir Oblast—120 miles east of Moscow—and the Far East suggest that the tethers between Moscow and the regions are fraying.

The Kremlin has declared “mission accomplished” on much of the socioeconomic agenda outlined in Putin's original May decrees—but it has yet to absorb the cost of implementing the decrees. Since 2015, the federal government has taken an increasingly interventionist approach in the finances of the regions, particularly by replacing regional obligations to commercial banks with regional obligations to the federal budget itself. How the Kremlin manages the future of center-periphery fiscal relations will depend on Russia's macroeconomic standing. The ultimate risk to the Kremlin's management of the regions is not that incremental policy decisions—such as pension reform—will chip away at Putin's popularity; it is that Russia's economy may falter, and if it does, Moscow will no longer be able to uphold its side of the informal contract that has governed Russian center-periphery relations since the tsarist period. 🌐





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