

War is the top priority: Russia is facing increasingly serious budget problems

Iwona Wiśniewska

Public funds became the most important lever of economic activity in the Russian Federation when it invaded Ukraine and due to Western sanctions. According to the Russian finance ministry's estimates, the total value of budget support for the economy in 2022–2023 reached almost 10% of GDP. Most of these funds are used to finance the war, which is the top budget priority, and contribute to a limited extent to the country's economic development.

Despite increasing fiscal burdens, the devaluation of the rouble and continuously growing inflation, the government is unable to finance the growing budget expenditures from current revenues, which undermines the financial stability of the Russian Federation. For now, the government is providing funds to cover the deficit, but this is becoming increasingly difficult. It is impossible to estimate how long the Kremlin will be able to finance the economy from public funds. The budget policy is unlikely to change until the presidential elections scheduled for March 2024, but the government will probably adopt some austerity measures after Vladimir Putin's victory. War expenses will remain a priority (estimated at around 40% of the budget), but the costs linked to the war will be increasingly transferred to the Russian public and business. This, in turn, will negatively affect the economic situation.

Barriers to the further growth of macroeconomic indicators

Since Russia invaded Ukraine in February 2022, the financial needs of the Russian army have grown, and the country's economy has lost access to Western capital and technologies. As a consequence, public funds started playing a greater role in stabilising the domestic situation. The so-called 'budgetary impulse', which has been the main support for the Russian economy since spring 2022, is based on both additional budget and quasi-budget funds, including export loans and investments from the National Wealth Fund (NWF). In 2023, the impulse is expected to reach an all-time high level of 5% of GDP (around 8.3 trillion roubles or roughly \$83 billion) and will also remain high in 2024, according to the government's plans. This money is helping the Russian economy adapt to the deteriorating economic conditions.

The priority areas for public funds set by the Kremlin are mainly: the sectors that are used for war needs, supporting the occupied territories of Ukraine, and also stimulating domestic demand through a loan policy (for example, preferential mortgage loans) or the payment of salaries to soldiers fighting on the front. This allocation has had a positive impact on the macroeconomic indicators. According to official data, Russia managed to limit its GDP decline in 2022 to 2.1% and will most likely be able to move out of recession already this

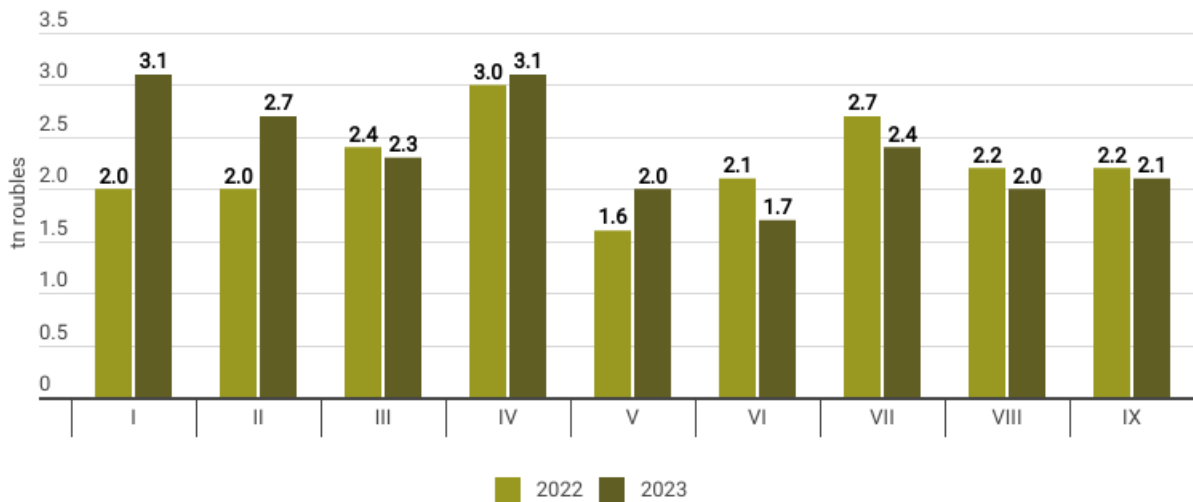
year (according to government estimates, GDP is expected to increase by approximately 2.8% this year, and international organisations also forecast an increase of 0.5–2.2%). In 2024, the GDP of the Russian Federation is expected to return to pre-invasion levels.

Nevertheless, the structure of the Russian economy is changing significantly: the share of arms production is growing, giving rise to more and more problems. Resources (financial, production and human) have been accumulated in the defence sector at the expense of the civilian sector, which is finding it increasingly difficult to satisfy the growing consumer demand. All this has led to a rise in inflation, which is additionally stoked by the depreciation of the rouble and rising import prices. To curb inflation and monetary devaluation, the government has been raising interest rates (over the past three months the base interest rate has increased from 7.5% to 13%) and has returned to partial currency controls, which in turn increases the operating costs of entrepreneurs and motivates them to continue transferring capital out of Russia. As a result, the high budget expenditures translate less and less into an improvement of economic indicators (according to Rosstat data, industrial production, taking into account seasonality, has not increased since May this year; in turn, the central bank has announced a slowdown in the GDP growth rate since Q4 this year). A possible reduction in public expenditure will, however, result in a decline in production, since business is not willing to invest its own capital in the present conditions.

Fiscal stimulation of the economy

Since Russia waged a full-scale war on Ukraine, its budget spending has been rapidly increasing. Last year it went up 20% y/y, and it is still unknown what the actual level will be this year, because so far the funds have been spent very unevenly. Initially, the government intended to cut expenses compared to last year, which was reflected in the 2023 budget act. However, the results for the first months of this year revealed a change in the Kremlin's plans. A dynamic increase in spending was seen, especially on public procurement, most of which was allocated to the defence sector. However, the expenditure was reduced in the middle of the year. As a result, in the first nine months of 2023, budget expenditure reached 21.4 trillion roubles and was 10% higher than last year, and the entire amount allocated for public procurement in 2023 had in fact already been used (almost 5 trillion roubles or around \$50 billion). According to the finance ministry's assumptions, the government intends to spend over 10 trillion roubles this year, which would mean a strong increase in spending in the fourth quarter.

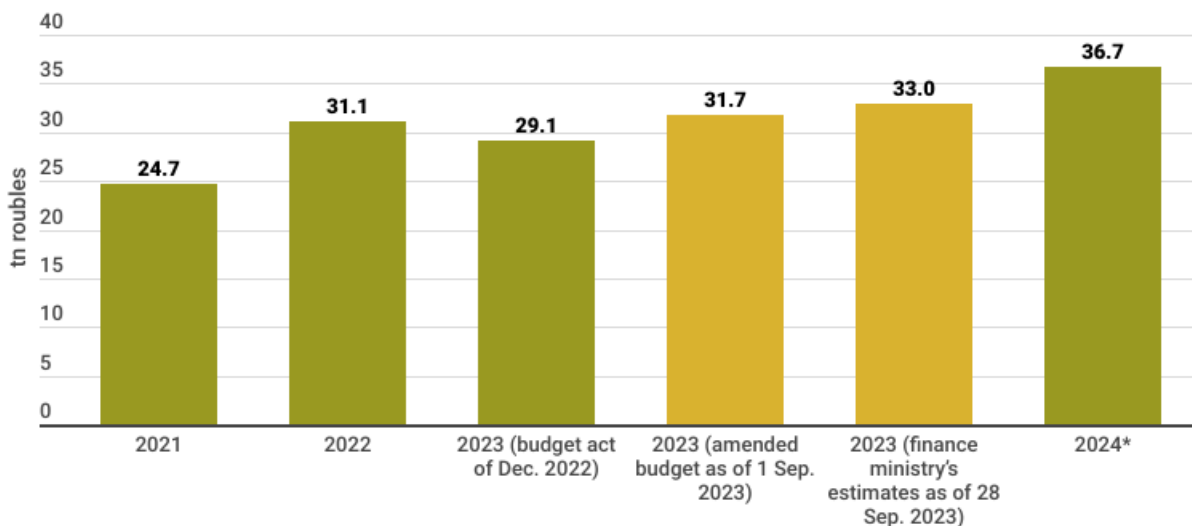
Chart 1. Budget expenditure from January to September 2022 and 2023



Source: Ministry of Finance of the Russian Federation.

Based on the budget parameters updated by the Ministry of Finance in September this year, expenditure in the entire 2023 may exceed 33 trillion roubles or around \$330 billion (around 10% more than stipulated in the act). Next year, it is expected to increase by another 10%; according to the government draft budget already submitted to parliament, it is expected to reach over 36.5 trillion roubles. However, its actual level in both 2023 and 2024 will depend primarily on the needs of the army and the financial capabilities of the state. The Kremlin will also have more room for manoeuvre after the presidential elections scheduled for next March. For example, the government will be able to announce another wave of mobilisation, which military officials have been insisting upon, and continue to shift the costs of the war onto citizens and entrepreneurs, which will probably result in a modification of the budget parameters. It is also worth mentioning that in Russia, a budget act is not typically something that can constrain the government's actions, and its provisions are unrestrictedly modified in the course of its implementation, without the need to seek parliamentary approval.

Chart 2. Budget expenditure in 2021–2024



* governmental draft budget for 2024

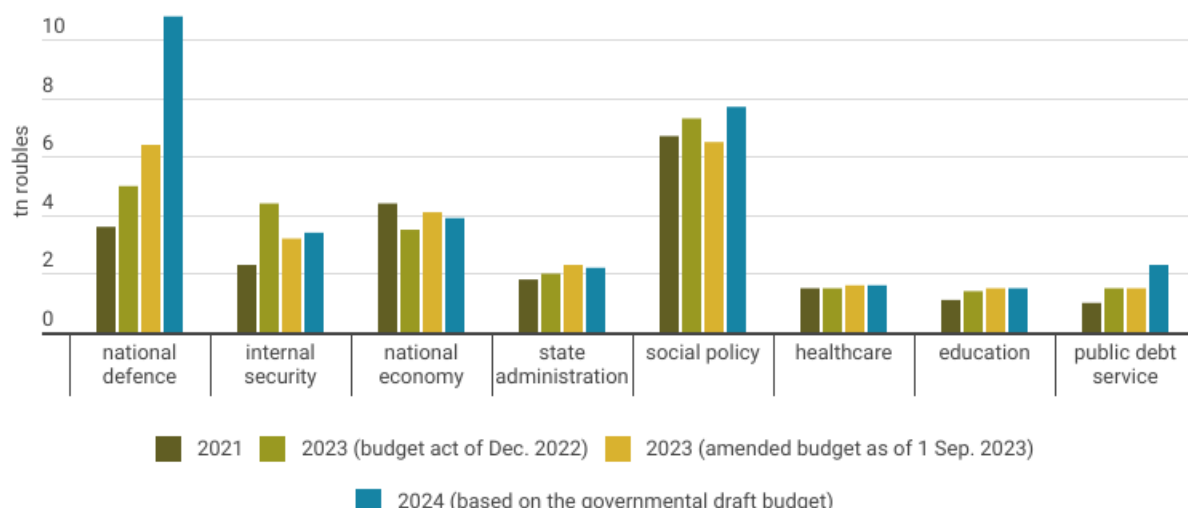
Source: Ministry of Finance of the Russian Federation.

The driving force behind the increase in Russia's budget spending is the expenses allocated to the Ukraine war, although it is principally impossible to determine their value. This is mainly because the government has not published detailed information concerning budget expenditure since last year. In the so-called governmental Electronic Budget, which continuously records the operations involving the public funds, around 25% of the funds have not been allocated to specific chapters in 2023. The vast majority of the budget's so-called 'secret part' concerns military expenditure (over 70% of national defence expenditure is classified), but it also contains information on funds allotted for other purposes. The documents from the Ministry of Finance accompanying the budget bill for the next year have been the main source of data on the distribution of public money for two years.^[1]

Furthermore, military spending is not a consolidated item in the Russian budget. Although most of it is concentrated in the 'National Defence' section, army finances are also hidden away in other chapters. For example, 'National Economy' funds are partly allocated for subsidising defence sector and research and development companies and those in the construction and modernisation of infrastructure, including municipal, road and defence infrastructure in the occupied regions of Ukraine and frontier regions of the Russian Federation. Moreover, Russian law enforcement agencies, including the Federal Security Service and the National Guard, which are in charge of controlling the occupied Ukrainian territories, are financed from 'Internal Security' funds. Most likely, these funds were also used to pay the Wagner Group, who fought in Ukraine. Thus, expenses linked to the Ukraine war may constitute around 40% of the Russian budget. According to the latest budget amendment, the nominal value of expenditure on 'National Defence' in 2023 will be 80% higher than in 2021 (data for 2022 is unavailable) and will be 6.4 trillion roubles, or around \$64 billion. However, the actual expenses may turn out to be much higher and, like the expenses in 2022, will certainly not be made public. Reuters, citing insider documents leaked from the Russian government, reported in August 2023 that the government estimated that the actual military spending this year would be 9.7 trillion roubles (around 6% of GDP).^[2] If these reports are true, the increase in military spending to 10.8 trillion roubles

planned for 2024 is no longer as impressive as it originally seemed. As a result, official expenditure on the army alone may consume as much as 30% of the total budget for 2023 and 2024 (compared to 15% in 2021). While in the first months of the full-scale invasion the Russian army was supplied with equipment and ammunition that had been stored in warehouses for many years, since the end of last year it has been increasingly dependent on the current production of the defence sector.

Chart 3. Structure of the federal budget expenditure



Source: Ministry of Finance of the Russian Federation.

The 2023 budget spending update published by the Ministry of Finance in September this year is an illustration of the Kremlin's current priorities. First of all, military expenses are rapidly growing. More funds have also been allocated to internal security, although the government limited the scale of the increase in 2023 to 40% (from a planned 100%) compared to 2021, which was probably linked to the disbanding of the Wagner Group. These funds might be shifted to the Ministry of Defence. In turn, human capital is marginalised: real budget spending (taking into account inflation) on social policy, healthcare and education has been falling. Instead of this, the government generously rewards those who are willing to fight Ukraine, and as a result, the money paid to soldiers and their families (distributed mainly by the Ministry of Defence) is becoming an important source of income for the Russian public.

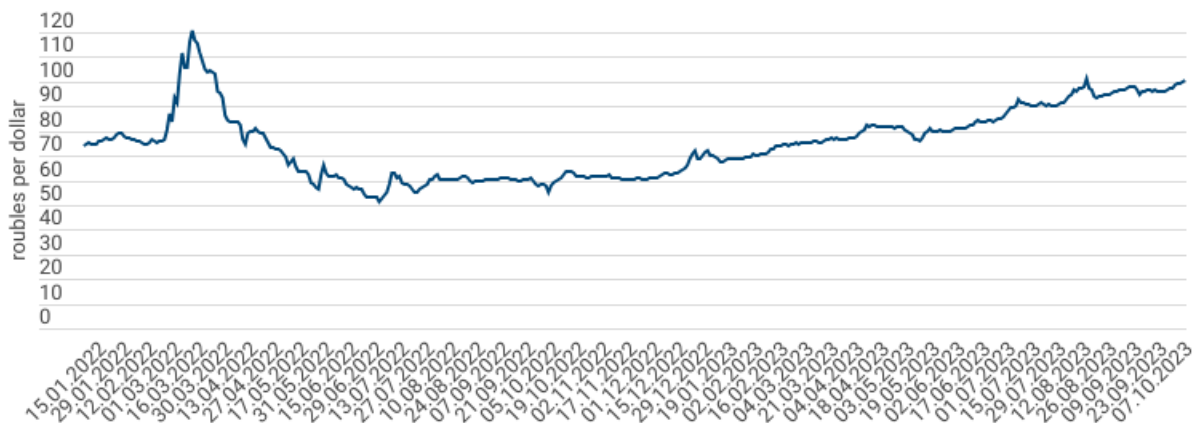
The revenue growth that defies development

Since the middle of last year, the government has been clearly making efforts to find new sources to cover its growing expenses. In 2022, the inflow of funds to the budget was ensured by high prices of exported raw materials, especially crude oil, and the large profits generated by Gazprom in 2021 and the first half of 2022, which the company *de facto* transferred to the treasury. However, the new sources of financing created by the government this year have become a serious challenge for the economy.

For example, the devaluation of the Russian currency continuing since last December means significant support for the Russian Federation's budget which relies heavily on the

export of raw materials. Economists' calculations reveal that, if the dollar value increases by 1 rouble, annual budget revenues are around 150 billion roubles higher. The government assumed in the 2023 budget that the average exchange rate of the US dollar would be below 70 roubles, while in fact in the first nine months of this year it was around 84 roubles, and since the end of August the value of the dollar has fluctuated around 100 roubles.

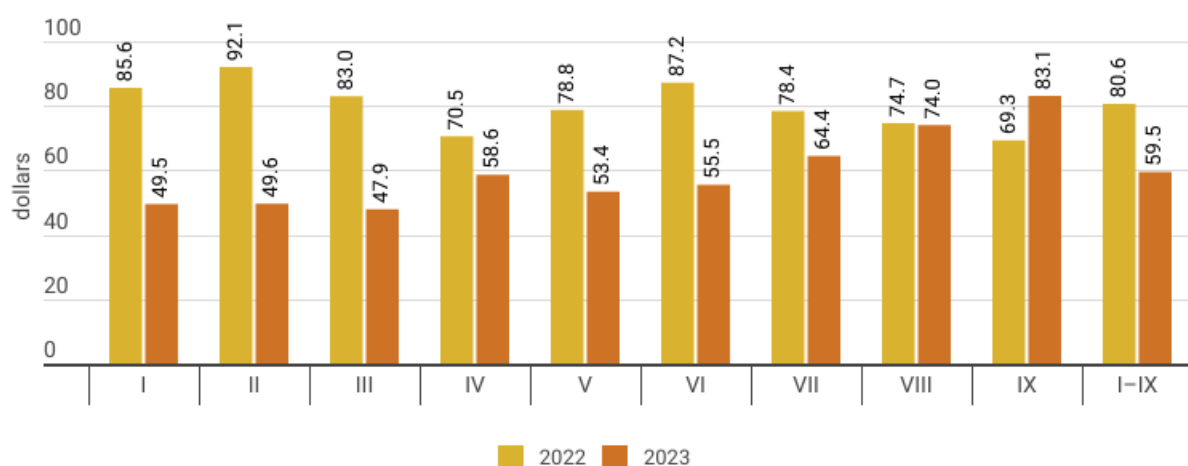
Chart 4. Dollar exchange rate in roubles



Source: Central Bank of the Russian Federation.

On the one hand, the devaluation of the rouble allows, first of all, to reduce budget losses resulting from the imposition of Western sanctions on the export of Russian oil, which led to a decline in both the volumes and the price of oil sold (taxes for the sector are calculated based on the export price).^[3] Despite the decreasing value of the rouble and the increase in export prices in recent months (in September this year they exceeded \$80 per barrel), the revenues generated by the oil and gas sector were growing to a limited extent, which was mainly due to internal regulations that apply on the fuel market. The government had to pay oil companies very high compensation (around 0.3 trillion roubles in September and 0.2 trillion roubles in August) for supplying fuel to the domestic market at lower prices. In order to increase budget revenues, the government unsuccessfully tried to stop providing the oil sector with this money in the following months.^[4] In fact, it already added these funds as potential revenue, so it is necessary to amend the budget acts for both 2023 and 2024 once again.

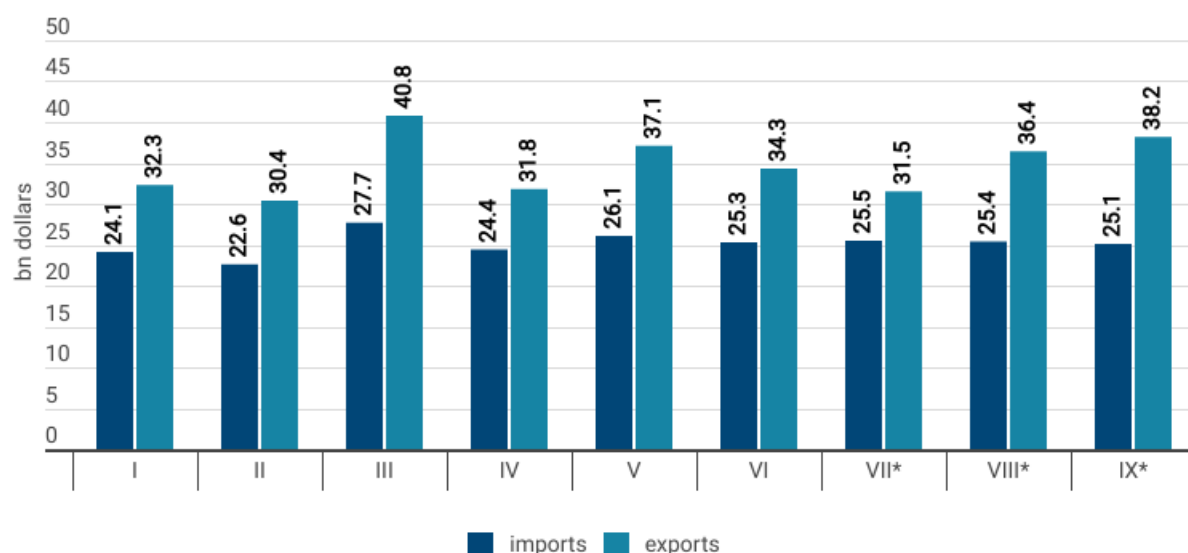
Chart 5. Average price per barrel of Urals oil



Source: Ministry of Finance of the Russian Federation.

On the other hand, the depreciation of the rouble means higher import prices and the need to tighten the loan policy. Additionally, it undermines the Russian public's confidence in their national currency and in the government's policy. Therefore, the government is trying to slow down this process and use market regulations (including raising interest rates or forcing exporters to sell foreign currency revenue on the stock market) to counteract the decline in the value of the Russian currency. The devaluation is largely caused by objective factors linked to Russia's balance of payments. The balance on the Russian Federation's current account in the first nine months of 2023 was \$39.6 billion as compared to \$196 billion a year earlier. The value of exports has fallen, but imports remain high. In addition, the shortage of Western currencies causes problems during the implementation of financial transactions. While most exports payments are received in roubles or in the currencies of countries considered friendly by the Kremlin (yuan, rupees, dirhams) and are deferred for many months, import payments usually have to be cleared in convertible currencies. Moreover, Russia typically has a negative trade balance in services, and the uncertain political and economic situation contributes to capital outflow. Nearly \$30 billion net was exported from the country in the first eight months of this year (over \$240 billion in the entire 2022). As a result, the effects of the government's efforts to stop the devaluation of the rouble are short-lived, and the trend cannot be reversed.

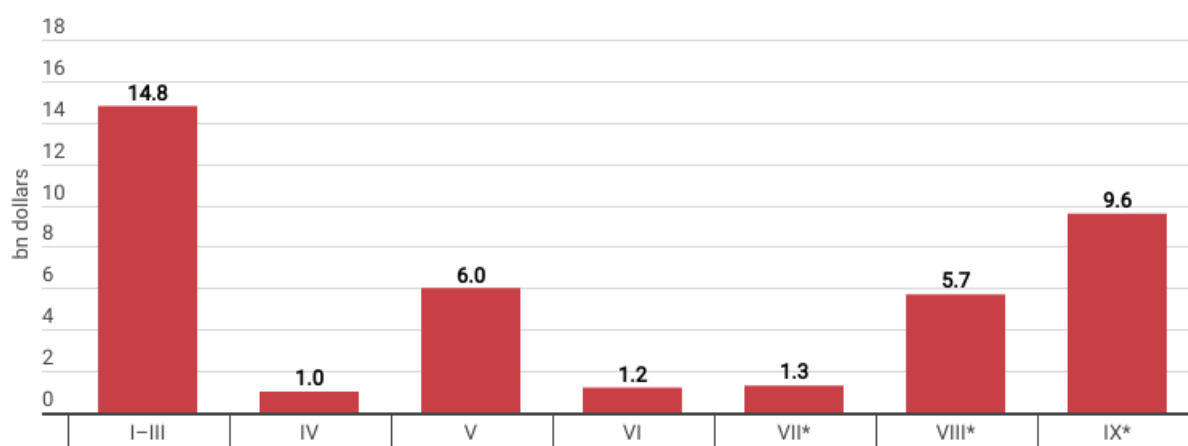
Chart 6. Value of imports and exports of goods in 2023



* estimates

Source: Central Bank of the Russian Federation.

Chart 7. Russia's current account balance in 2023



* estimates

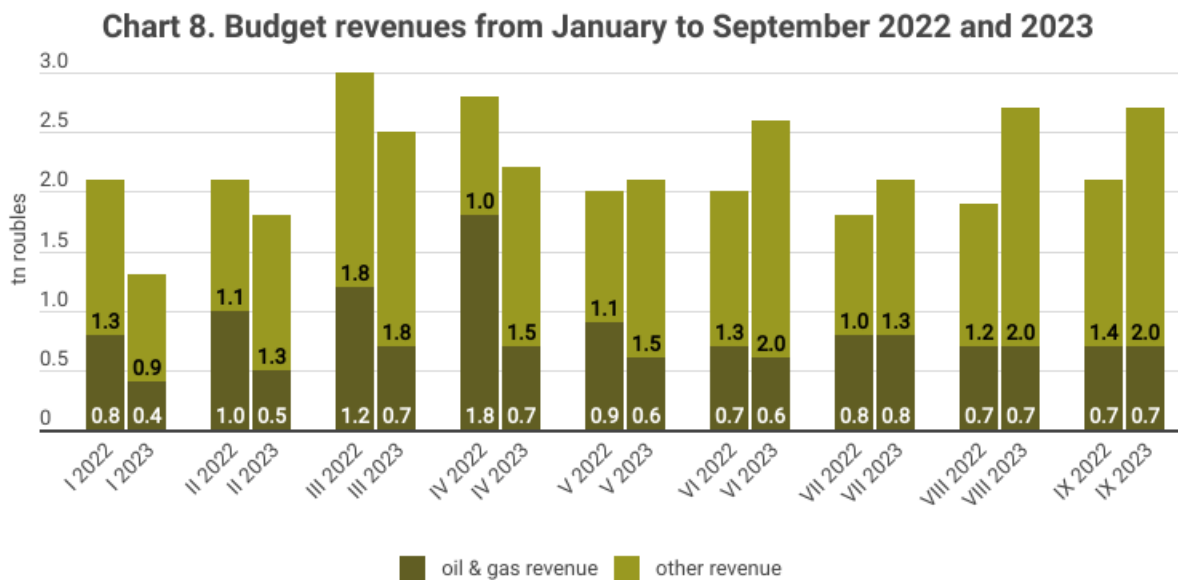
Source: Central Bank of the Russian Federation.

The continuously rising prices are another important factor that contributes to a boost in revenues (for example, from VAT). According to Rosstat's official report, annual inflation in September this year was 6% (this rate is used as the benchmark for the indexation of social welfare paid from the state budget), but the inflation really felt by citizens is much higher. The monitoring conducted by the Russian research company Romir has revealed that the prices of basic consumer goods went up almost 20% y/y in August this year. Rising inflation has a negative impact on people's income and consumer demand.

The government is trying to boost budget revenues also by increasing the fiscal burden on businesses and citizens. In 2023, it raised excise duty on cigarettes and cars, increased the taxation of Gazprom, introduced the so-called 'windfall tax' for 2021–2022 (it will be paid mainly by the metallurgical and mineral fertiliser sectors), and also taxed the income resulting from the sale of Russian assets by foreign investors withdrawing from Russia.

Moreover, starting from 1 October, flexible export duties were introduced for a number of goods (except crude oil, gas and grain), which depend on the rouble exchange rate (in doing so the government intends to strip exporters of part of the profits they are achieving due to the weakness of the rouble). All these moves increase the costs of doing business in Russia and discourage investment.

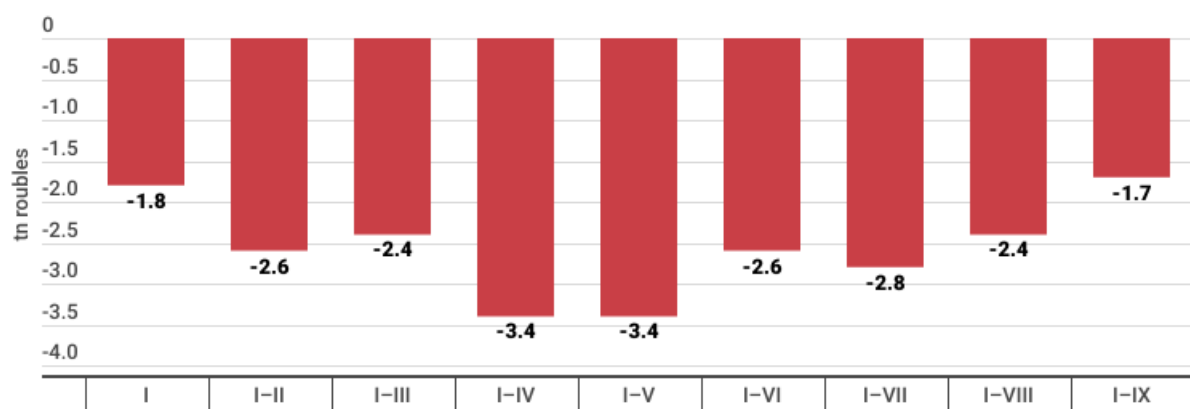
In the first nine months of 2023, Russia's total budget revenues stood at 19.7 trillion roubles and were at a similar level as a year before. However, according to the government's estimates, their total value in 2023 may be circa 10% higher than assumed in the budget act and ultimately reach around 28.7 trillion roubles. The driving force behind this growth are revenues from outside the oil and gas sector, which were 25% higher y/y in the first three quarters of this year. The primary sector, however, has performed much poorer, despite the revenue of 0.6 trillion roubles generated by the additional taxes imposed on Gazprom in 2023. In the first nine months of this year they were 35% lower y/y and stood at 5.5 trillion roubles. Therefore, the revenues from the oil and gas sector are unlikely to reach 8.9 trillion roubles, the level planned in the 2023 budget.



Source: Ministry of Finance of the Russian Federation.

Since the beginning of the full-scale invasion of Ukraine, the Russian government has been unable to cover the rapidly growing expenses with current budget revenues. The planned budget gap in 2023 will be 3 trillion roubles or less than 2% of GDP. Half of this sum was used in the first nine months. However, the real deficit will be known at the end of the year, because the Russian government usually intensifies spending in December (for example, the entire deficit in 2022 was generated in the last month alone).

Chart 9. Budget deficit dynamics in 2023



Source: Ministry of Finance of the Russian Federation.

According to the assumptions, two thirds of the deficit (2 trillion) will be financed from the National Wealth Fund (NWF), and the remaining part from the issuance of treasury bonds.

As of 1 October this year, the liquid funds at the NWF's disposal were over 7 trillion roubles, which was equivalent to \$73 billion (currently in yuan and gold, and a small part in euros and roubles), as compared to 6.1 trillion roubles or \$87 billion at the beginning of the year. The change in the value of the dollar equivalent is mainly the result of the devaluation of the Russian currency. The remaining funds were invested in state-owned companies (Sberbank) and projects implemented in Russia: in fact, they are an additional source of financing for the economy. This year the government intends to allocate around 1.6 trillion roubles from the NWF to such projects.

It is clear from available information that the Kremlin is increasing its debt in 2023 much more intensively than planned. At the end of the year, the state debt is expected to increase to 29 trillion roubles (compared to the previously planned 25 trillion roubles) or 17.5% of GDP (15% a year earlier), which is still a safe level for the country's financial stability. However, most government bonds are purchased by state-owned banks, which receive high interest rates (around 12%). As a consequence, the debt service burden on the budget is growing dynamically.

Conclusions

The Kremlin has promised to maintain the budgetary impulse at a high level in 2024 as well, but it is becoming increasingly difficult to find funds for this. Since the beginning of the invasion, the government has been intensively looking for new sources of financing to cover the growing expenses, hence the higher fiscal burdens on companies. The government does not want to run out of financial reserves, which were seriously depleted already in 2022. Although the devaluation of the rouble has been beneficial for the NWF, the financial needs of a country which is engaged in a war are huge and, since President Putin is determined to continue it, the reserves must last for a longer period. Domestic debt may increase further only to a certain limit, as borrowing funds is becoming increasingly expensive.

It is difficult to say to what extent the funds the Kremlin has at its disposal will suffice to stimulate the economy at the current level. It is clear that the government will want to change its policy after the presidential elections in March 2024. For example, the mortgage

subsidy program, which has been the driving force of the construction industry in recent years, is to be withdrawn in July 2024. A significant increase (10%) in utility tariffs, rents and fees for gas supplies to households has also been announced for next year (90% of the additional revenues generated this way will go directly to the budget). Business taxes are also set to increase further.

After the election, the Kremlin will most likely stop protecting the value of the rouble and let the market regulate its price. Currently, the central bank, mainly for propaganda reasons, is trying to prevent the domestic currency from crossing the psychological barrier of 100 roubles per dollar. However, it is likely to continue weakening, given the fact that the central bank's instruments are limited and the pressure from the balance of payments is enormous.

Moreover, inflation is expected to continue to increase, which is primarily due to the labour shortage in Russia. It contributes to rising wages, which in turn translates into higher prices of manufactured goods. Moreover, in the current conditions, it is increasingly difficult for the civilian sector to compete for employees with the defence sector, which has an adverse impact on its effectiveness.

Nevertheless, no change in budget priorities is expected. The government's key task in the near future will still be to finance the needs of the army fighting on the Ukrainian front. Paradoxically, the deteriorating living standards may additionally motivate young men to join the army and finance their families with high wages and benefits. The patience manifested by the Russian public so far suggests that no public protests should be expected that could force the government to change its policy, especially given the fact that the Kremlin wields a well-developed repressive apparatus.

In the current situation, however, it is not certain how business circles will react, as they have to pay an increasingly large part of their profits into the state budget. So far, Russian entrepreneurs have successfully used their experience in circumventing administrative barriers to supply the market with needed goods despite sanctions, which greatly helped the government stabilise the economy after the invasion of Ukraine. However, as the Kremlin continues to increase fiscal burdens and barriers to doing business, they will most likely be more prone to hide their profits, which may lead to an intensified outflow of capital from Russia. One example of this is the operation of the (Kremlin-controlled) oil sector, which has successfully defied the government's plans to impose further levies on it.^[5]

[1] The Ministry of Finance did not include 2022 at all in the table illustrating the distribution of budget expenditure in the document published in 2023. See [Основные направления бюджетной, налоговой и таможенно-тарифной политики на 2024 год и на плановый период 2025 и 2026 годов](#), Ministry of Finance of the Russian Federation, September 2023, minfin.gov.ru.

[2] ['Russia doubles 2023 defense spending plan as war costs soar'](#), Reuters, 4 August 2023, reuters.com.

[3] F. Rudnik, ['Partial success: Russia's oil sector adapts to sanctions'](#), OSW Commentary, no. 528, 9 August 2023, osw.waw.pl.

[4] *Idem*, ['Fanning the flames: crisis on the Russian fuel market'](#), OSW Commentary, no. 548, 18 October 2023, osw.waw.pl.

[5] ['Fanning the flames...'](#), *op. cit.*