February 22, 2018

Corporate sector to drive surpluses of regional budgets, and federal center to save overleveraged regions

2017 regional budgets execution overview

- **Growing regional revenues resulted in more surplus budgets**. 45 regions finished the year of 2017 with a surplus. Corporate income tax contributed one third of budget revenue growth.

- **Capped losses carried forward have driven up corporate income tax.** Corporate income tax revenues grew irrespective of a change in corporate income tax distribution shares between federal and regional budgets. The reason is a temporary restriction on the ability of taxpayers to reduce their tax bases by the amount of previous losses, which will remain effective until 2020.

- **Total debt of the Russian regions has decreased for the first time ever** recording a 2% decline year-on-year, or RUB 37.8 bln. Its structure has also changed: the amount of bank loans contracted by RUB 141.6 bln, or 18% with concurrent bond offerings being in full swing (a 20% gain, or plus RUB 91 bln). The total bond debt of the regions reached RUB 547 bln representing an all-time record, while many first-time issuers tapped the bond market.

- **The federal center provided aid to some over-indebted regions.** In 2017, many regions with heavy debt load (Mordovia, Khakassia, Kostroma and Ivanovo Regions) managed to secure substantial fiscal loans. However, not all of them used the funds provided to refinance their debt.

- **Regions might continue breaching their agreements with the Ministry of Finance.** Some regions increased their debt more than their fiscal loan agreements with the Ministry of Finance allowed. As fiscal loan restructuring is subject to performance of agreements that were in force in 2017, such regions stand for early repayment of newly restructured loans.

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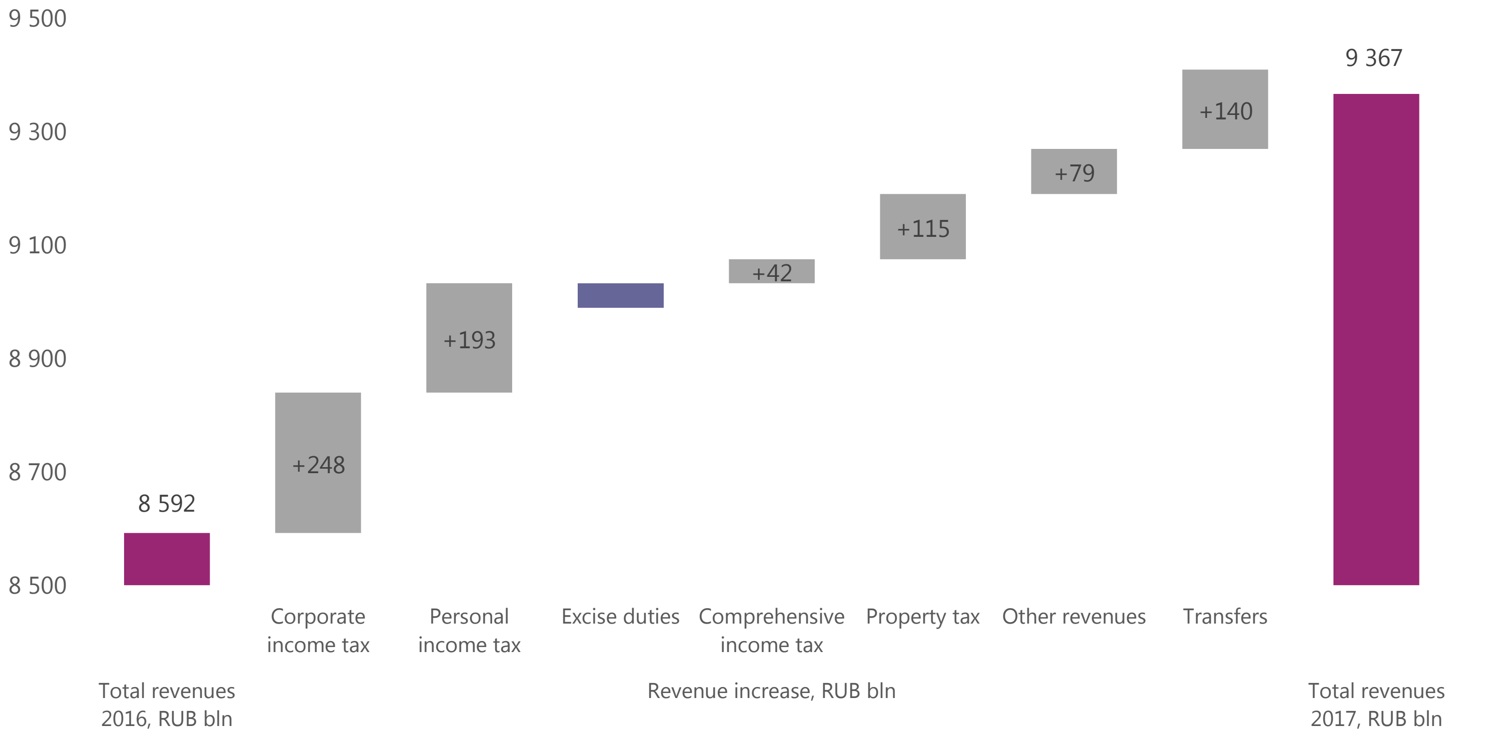
Growing regional revenues resulted in more surplus budgets

The year of 2017 was successful for Russian regions: the aggregate deficit of regional budgets increased slightly and amounted to only RUB 15.5 bln. For comparison: the deficit was RUB 2.4 bln in 2016 and RUB 108.2 bln in 2015. The total revenues of the regions increased by 9% or RUB 775 bln.

Figure 1. A third of regional revenues came from corporate income tax (2017)



Source: Federal Treasury, ACRA estimates

One third of the increase came from corporate tax (+ RUB 248 bln, or +11%), a quarter came from personal income tax (+RUB 193 bln, or +8%), and 15% of the increase was generated by property taxes (+RUB 115 bln, or +12%). The reduction in rates of taxes on goods and services caused by a temporary change in the distribution of excise taxes on fuel led to a RUB 80 bln decline in regional revenues.

Amid growing tax revenues, more than a half (45 out of 85) of Russian regions reached a surplus budget, while such share was one third in late 2016 and 16% in late 2015.

Table 1. Regions with budget surplus (2017)

	Deficit '16	Surplus '17		Deficit '16	Surplus '17
Belgorod Region	-2 782	1 410	Mari El Republic	-318	71
Voronezh Region	-2 143	7 336	Republic of Tatarstan	-1 992	13 179
Ivanovo Region	-1 201	14	Udmurt Republic	-7 151	431
Kaluga Region	-2 188	584	Nizhny Novgorod Region	-4 419	304
Kursk Region	-2 041	780	Kirov Region	-2 479	674
Lipetsk Region	-482	1 659	Samara Region	-5 841	2 321
Smolensk Region	-1 837	828	Perm Territory	-1 042	708
Republic of Komi	-5 442	3 340	Chelyabinsk Region	-166	7 035
Novgorod Region	-18	116	Yamal-Nenets Autonomous District	-671	15 798
Nenets Autonomous Okrug	-2 895	888	Kemerovo Region	-3 889	22 586
Astrakhan Region	-1 529	2 074	Novosibirsk Region	-1 211	3 395
Stavropol Krai	-3 188	1 968	Republic of Altai	-90	264
Karachay-Cherkess Republic	-575	30	Kamchatka Region	-1 650	458

Source: Federal Treasury, ACRA estimates

Capped losses carried forward have driven up corporate income tax

The growth in corporate income tax revenues—the primary revenue source for regions which comprises a third of their own revenues—occurred despite a change in the proportion of its distribution between the federal and regional budgets. In 2017–2020, inclusive, the federal budget will get the corporate income tax at a rate of 3% (previously 2%), while regions will receive 17% unless a lower rate is applied (earlier 18%). As a result of such redistribution, the federal budget revenues based on corporate income tax increased by 55% (RUB 271 bln) in 2017 vs 2016.

The Government of the Russian Federation plans to return withdrawn funds to regional budgets as transfers. However, transfers are not categorized as own budget revenues and do not contribute to the ratio of debt to own revenues ratio (regions must maintain such ratio as set forth in the relevant agreements with the Russian Ministry of Finance).

A positive effect of changes in the loss carry forward scheme was noted by ACRA in its rating press release on the Kemerovo Region dated August 29, 2017.

This effect negative for the regions was offset by a temporary change in the loss carry forward scheme, according to which in 2017-2020, the taxable base for a current tax period may not be reduced by more than 50% of losses in previous periods.

Table 2. Decreasing budget losses amid restricted loss carry forward, RUB bln

	9M 2016	9M 2017	Change, %
Taxable base	12,015	10,727	-11%
Loss reducing taxable base	2,769	620	-78%
Taxable base for tax calculation	9,301	10,107	9%
Assessed corporate income tax	1,818	1,984	9%
Tax shortfall due to taxable base decrease by the amount of loss	553	124	-78%

Source: FTS of Russia, ACRA estimates

Thus, despite the withdrawal of 1% of the corporate income tax into the federal budget as well as the reduction in the taxable base (by 11%, data for 9M2017), the corporate income tax revenues of regional budgets have grown.

At the same time, the amount of loss that reduces the taxable base and the amount of shortfall in corporate income tax caused by the reduction in the taxable base by the loss received decreased 4.5 times in the 9 months of 2017 as compared to the same period of 2016 (by RUB 2,150 bln and RUB 430 bln, respectively).

In 9M2017, the taxable base increased only in 29 regions, but the corporate income tax grew in 65 regions, therefore, in 36 regions, revenues increased due to a change in the legislation.

The most significant increase in corporate income tax revenues occurred in mineral extraction-intensive and financially secure regions. The shortfall of tax revenues in their budgets connected with the reduction of taxable base by taxpayers at the expense of losses from previous periods became noticeably lower.

Table 3. Corporate income tax trends after the change in the loss carry forward scheme (2017)

	Tax gains, RUB bln	Tax shortfall*, 9 month 2016	Tax shortfall*, 9 month 2017
Moscow	98 060	255 935	50 599
Kemerovo Region	24 673	9 670	6 164
Yamal-Nenets Autonomous District	16 926	13 057	2 057
Saint-Petersburg	15 844	63 284	4 551
Moscow Region	14 695	26 155	5 427
Tyumen Region	13 280	6 021	933
Republic of Crimea	12 584	1 607	219
Sverdlovsk Region	12 113	15 028	1 741
Belgorod Region	11 981	10 808	306
Republic of Tatarstan	9 676	10 866	1 783
Chelyabinsk Region	8 100	4 742	1 739
Irkutsk Region	6 650	1 897	292
Republic of Komi	6 467	1 370	269
Perm Krai	6 249	1 832	699
Republic of Bashkortostan	5 718	2 178	453
Krasnodar Krai	5 617	28 867	7 036
Krasnoyarsk Krai	5 377	5 935	1 446
Kaluga Region	5 281	2 640	1 698
Astrakhan Region	5 228	1 025	125
Samara Region	4 818	3 268	841
Other regions	57 376	-	-

* Tax shortfall caused by the reduction of tax base by losses carried forward.

Source: FTS of Russia, Federal Treasury, ACRA estimates

In 20 regions, the corporate income tax decreased. The most noticeable decrease was in the Sakhalin Region—by RUB 37.4 bln against the backdrop of 5% decrease in the corporate income tax distribution proportion in the performance of product-sharing agreements in 2017 and fluctuations in the liquefied natural gas prices. Budget revenues also declined significantly in the Khanty-Mansiysk Autonomous Okrug - Ugra (by RUB 20.3 bln), which is explained by the effect of the high base of 2016, and in fact, the tax has returned to its stable level.

According to ACRA estimates, the share of organic growth on account of tax base before losses in the total increase of corporate income tax revenues (about RUB 0.5 trillion) amounted to mere one fifth. The rest is a result of other factors including temporary changes in the legislation with respect to tax accounting of losses.

The total debt of regions has decreased for the first time ever

Owing to increase of surplus budgets the total debt of the regions decreased by 2% year-on-year (by RUB 37.8 bln) in 2017, which has never happened before. This is a success for regional authorities, as the policy of the Ministry of Finance pursued in the regions by entering into loan agreements, and now by restructuring these loans, is aimed at lowering debt of the budgets (tied to own revenues).

Figure 2. The total debt of regions has decreased for the first time ever in 2017

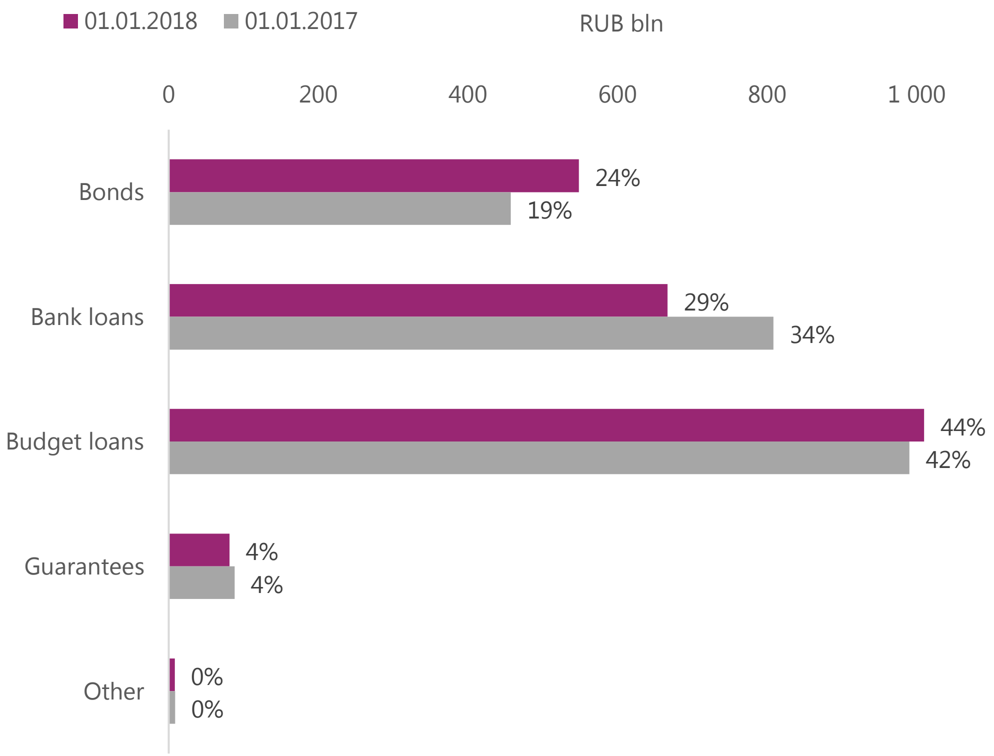
Source: Ministry of Finance, ACRA estimates

The debt decreased by virtue of reduction of bank loan amount (by RUB 141.6 bln, or 18%), with concurrent bond offerings being in full swing (a 20% gain, or plus RUB 91 bln) and fiscal loans amount increasing slightly (by 2%, or RUB 19.8 bln).

ACRA projected this scenario in its research titled Russian regions to favor bonds published on February 14, 2017.

Bonds issued in 2017 totaled RUB 199.3 bln – one third higher than in the previous year, and the total bond debt of the regions reached RUB 547 bln - an all-time record. Owing to lower interest rates in the market and the regions rushing to fix cheap debt for a long period, the regions that have never placed bonds before or those that made a bond offering a long time ago tapped the bond market: Karachay-Cherkess Republic, Yamalo-Nenets Autonomous Okrug, Kursk, Oryol, Saratov, and Ulyanovsk Regions, and St.Petersburg. The above secured a substantial increase in offerings.

Figure 3. Debt structure rearrangement towards bonds



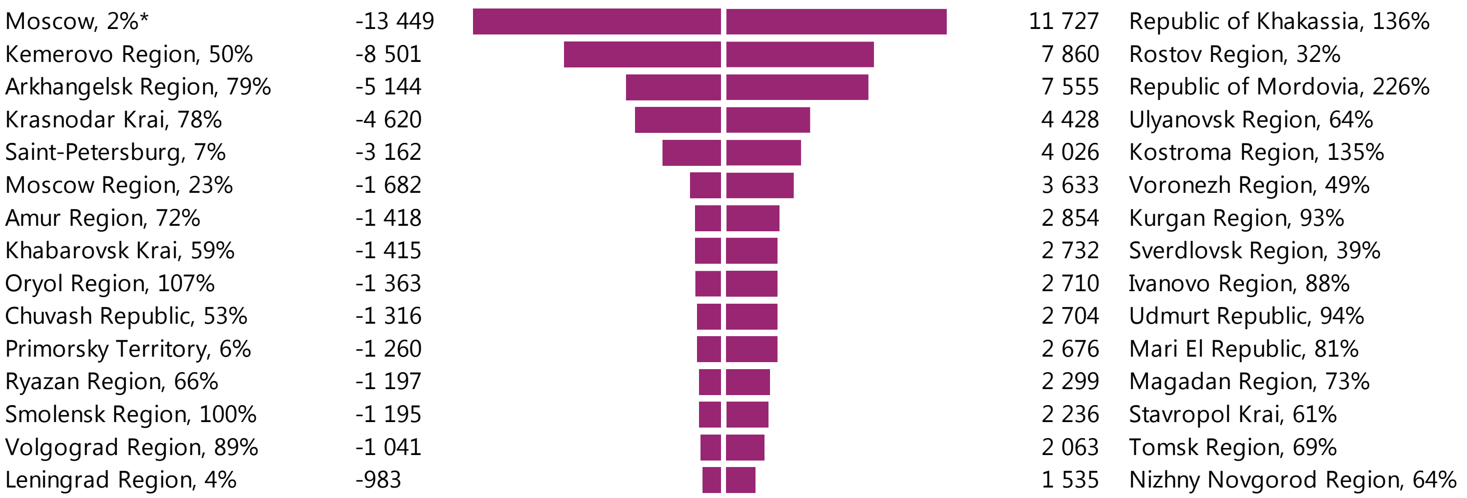
Source: Russian Ministry of Finance, ACRA estimates

The federal center provided aid to some over-indebted regions

According to the interim report on federal budget performance, the regions obtained RUB 333.8 bln in loans in 2017. That said the initial plan was to provide RUB 200 bln in loans. The bulk of that difference are fiscal loans repaid by the regions early in the above-stated year due to violations of their obligations assumed in compliance with contracts with the Ministry of Finance. Last year these funds returned to the regions, but this time in form of new loans with a five-year maturity and further repayment rescheduling.

As a result, restructuring of fiscal loans in many regions with high debt load would stretch over seven years, which would partially release them from both refinancing risk and interest burden.

Figure 4. Many over-indebted regions obtained more funds from the budget in 2017



*debt to own revenues ratio

Source: Ministry of Finance, ACRA estimates

The largest share of budget funds was provided to Khakassia (used primarily to refinance bank loans), Rostov Region (used for the same purpose), Mordovia (the region has substantially increased its debt), Ulyanovsk Region (that spent funds to replace a portion of the bank loans), and Kostroma Region (replacement of bank loans). Some of the regions repaid their fiscal loans. The largest fiscal loan repayments came from Moscow and the Kemerovo Region (by virtue of higher corporate income tax revenues driven by high coal prices the region managed to significantly reduce its debt).

Regions are likely to continue breaching agreements with the Ministry of Finance

In the context of loss offsets, the regions have the opportunity to significantly improve their financial standing in the period to 2021. Distributing 1% of the corporate income tax to be collected in 2017-2020 among the regions that are the most in need would also help with the above. The restructuring of fiscal loans coupled with distribution of fiscal loans among regions in 2017 enables a significant portion of regions to save on interest expenses and mitigate refinancing risks. However, the debt load of specific regions continues increasing despite the overall positive trend.

The regions are forced to comply with fiscal loans agreements entered into with the Ministry of Finance. Breaching the covenants led to early fiscal loan repayments in the past (however, experience has shown that early repayments are often followed by issue of new equable loans). Now a region would have to return a portion (below 20%) of the total debt.

As a result, some regions that saw their respective ratios rise (excluding those allowed to grow their debt within the 50% limit) could have breached the covenants as set forth in fiscal loan agreements as at end-2017.

New terms for fiscal loan restructuring are coming into force in 2018; however, one should have observed the current agreement terms in 2017 in order to qualify for restructuring.

Covenants that the regions are obliged to comply with include controlling debt to tax and non-tax revenues ratio (own revenues). Those regions the debt to own revenues ratios of which was below 50% as at January 1, 2016 were not allowed to have that ratio above 50% the next year. Other regions undertook an obligation to avoid increasing the above ratio over the next year. The experience shows that agreements often set forth conditions for lowering the debt to own revenues ratio by 1% to 3% or more a year.

As a result, some regions that saw their respective ratios rise (excluding those allowed to grow their debt within the 50% limit) could have breached the covenants as set forth in fiscal loan agreements as at end-2017.

Table 4. Regions with debt to own revenues above 50%

	Debt to own revenues, January 1, 2017	Debt to own revenues target values, January 1, 2018*	Debt to own revenues, January 1, 2018
Republic of Mordovia	176%	140%	226%
Republic of Karelia	115%	100%	124%
Pskov Region	99%	99%	102%
Oryol Region	95%	95%	107%
Kurgan Region	87%	87%	93%
Karachay-Cherkess Republic	86%	86%	91%
Kabardino-Balkar Republic	84%	84%	124%
Chukotka Autonomous Okrug	76%	76%	97%
Novgorod Region	69%	69%	75%
Ulyanovsk Region	63%	63%	64%
Tambov Region**	61%	61%	77%
Magadan Region	60%	60%	73%
Tomsk Region	56%	56%	69%
Khabarovsk Krai	55%	55%	59%

* According to the rules for fiscal loans provision in 2017.
** Constitutes no violation of the current restructuring agreement.

Source: Federal Treasury, Ministry of Finance, ACRA estimates

As fiscal loan restructuring took place in December 2017 (when annual budget performance could already be assessed) ACRA does not include that debt covenants may be changed in restructuring agreements with those regions that increased their debt.

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