

Economic Survey of the Russian Federation, 2006

Can current strong growth be sustained over the long term?

Why is fiscal policy the key to macroeconomic balance?

What might an appropriate rules-based fiscal policy look like?

Where is structural policy headed?

How can the quality of public administration be improved?

What needs to be done to enable Russia to realise its innovation potential?

What should be the main priorities for reform of the healthcare system?

For further information

For further reading

Where to contact us?

Summary

The Russian economy has been enjoying a period of robust growth, thanks largely to steadily rising terms of trade. The challenge confronting policy-makers is to facilitate Russia's transition into a period of self-sustaining, investment- and innovation-led growth. This will require a sound macroeconomic policy framework to manage the economy's adjustment to sustained high oil prices and a range of structural reforms aimed at creating better framework conditions for business.

Fiscal discipline is critical to managing the adjustment to high oil prices. The efficient and prudent management of commodity windfalls is the principal macroeconomic policy challenge facing Russia today. An uncontrolled surge of windfall revenues into the economy would drive up inflation and undermine competitiveness. While monetary policy can play a supporting role, fiscal policy will remain the primary instrument for reducing inflation while avoiding excessively rapid exchange-rate appreciation. *Policy should be based on a clear, credible fiscal rule, aimed at insulating the economy from commodity-price volatility. This basic fiscal rule could be operationalised by strengthening the legislative framework governing the Stabilisation Fund.*

Public administration reform would benefit citizens, entrepreneurs and policy-makers. The inefficiency and corruption of the state administration impose a heavy burden on business and limit the government's ability to implement any policies that make significant demands on the state's administrative or regulatory capacities. Effective, consistent implementation of the government's plans for administrative reform should therefore be a first-order priority. Russia needs to:

- *improve the institutional environment within which the bureaucracy operates by strengthening the rule of law, adopting freedom of information legislation and enhancing parliamentary oversight of the executive;*
- *empower citizens by adopting clear, accessible public service standards and creating an effective system of administrative redress for complaints;*

This Policy Brief presents the assessment and recommendations of the 2006 OECD Economic Survey of the Russian Federation. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

- *fight corruption by strengthening enforcement and adopting whistleblower protection legislation; and*
- *reduce state control and bureaucratic interference in business.*

Russia can do much to make innovation policies more effective. Russia's innovation potential is considerable but its innovation performance remains disappointing. Realising this potential will require further steps to create a healthy, open business environment, as well as steps to stimulate greater private R&D and strengthen the domestic IPR regime. Reform of the large but inefficient public science sector could make it more responsive to business needs and more dynamic as an engine of knowledge creation. Specific innovation-promotion schemes, like special zones or technoparks, should be limited in scope, carefully targeted and rigorously assessed in order to avoid deadweight losses and market distortions.

Healthcare reform is needed to achieve better care, increased efficiency and greater equity. Russia's healthcare system today is characterised by a number of fundamental imbalances that need to be addressed in order to ensure that rising healthcare expenditure is used to best effect. The major priorities for reform include closing the gap between formal commitments to the population and available resources; shifting the structure of provision towards greater reliance on integrated primary care; adopting payment schemes in the healthcare sector that encourage more cost-effective therapeutic choices; and modernising the system of mandatory medical insurance. ■

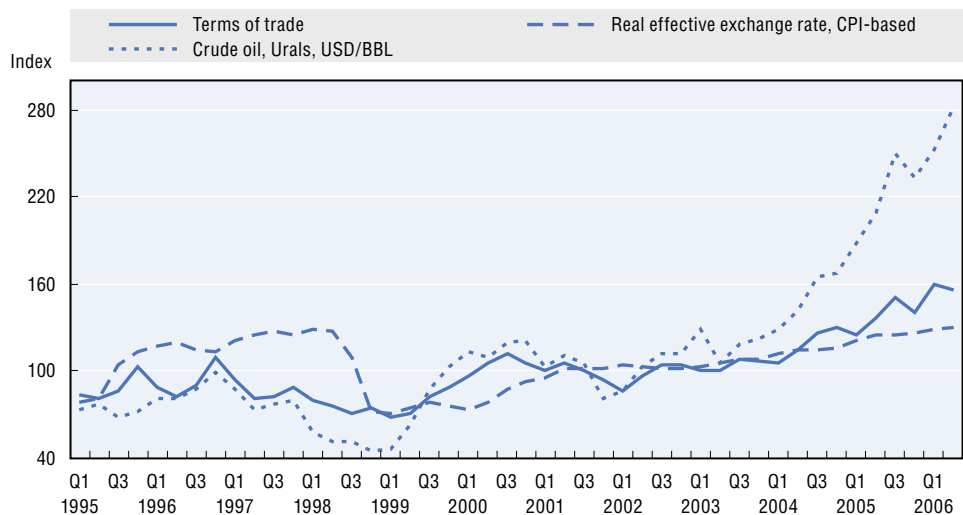
Can current strong growth be sustained over the long term?

Recent economic performance has been impressive. Real GDP growth during 1999-2005 averaged 6.7%. Initially driven by a rebound from the 1998 financial crisis, recent growth has been underpinned by large terms-of-trade gains that have translated, on the demand side, into a surge in domestic consumption. However, booming consumption has coincided with weakening export performance and surging imports. Investment is growing strongly but investment rates remain relatively low and will need to rise substantially if Russia is to sustain strong growth over the longer term. Already, there are indications that growth in many sectors is supply-constrained, and growth since 2003 has been driven increasingly by non-tradables. The growth of oil production, which was the major driver of growth during 2000-03, has slowed markedly.

Although Russia continues to grow at relatively high rates, the main factors underpinning current growth are transitory. The gains in competitiveness that Russian producers enjoyed after the 1998 financial crisis have now largely disappeared. Moreover, there appears to be little scope left for Russian industry to go on raising output by increasing capacity utilisation without substantially greater investment. Finally, the impact on growth of commodity price increases will inevitably attenuate even if oil prices remain high, as the economy will adjust to the new terms of trade.

The overarching economic challenge facing the Russian Federation, therefore, is to create the conditions needed to sustain economic growth over the long run at rates that will permit relatively rapid convergence with the advanced OECD economies. The government is well aware of the need to make the transition to a pattern of self-sustaining investment-driven growth that can be maintained over the long term. To do this, Russia needs to press ahead with a range of structural reforms aimed at increasing potential output, while maintaining sound macroeconomic management, in order to ensure that fluctuations in the terms of trade do not result in significant imbalances between domestic supply and demand. ■

Figure 1.
URALS EXPORT PRICE,
TERMS OF TRADE AND
REER
Index 2001 = 100



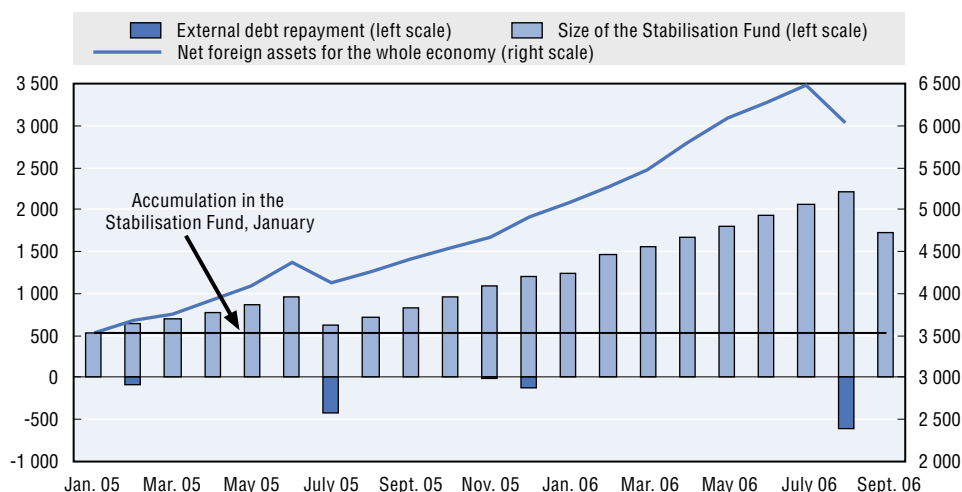
Source: Federal Service for State Statistics, Datastream, IMF, *International Financial Statistics*, OECD calculations.

Why is fiscal policy the key to macroeconomic balance?

Russia needs to devise a macroeconomic strategy for a world of sustained high oil prices. Macroeconomic – particularly fiscal – policy has remained prudent. Despite some slippage in 2005-06, the authorities have largely resisted the temptation to use commodity windfalls to finance a spending spree. However, the events of the last two years have necessitated a reconsideration of the basic assumptions underlying policy. From the first recovery of oil prices in 1999 until the end of 2004, Russia’s broadly successful macroeconomic strategy rested on the assumption that high oil prices were a temporary phenomenon. This may yet prove to be the case, but expectations have shifted. It is important to recognise that the adjustment to sustained high oil prices creates problems of its own, with respect to both monetary and fiscal policy. The first is the loss of competitiveness that arises from rapid real exchange-rate appreciation. The second is the inflationary pressure that Russia’s ballooning external surpluses generate, given the authorities’ determination to limit the pace of nominal exchange-rate appreciation. Success in addressing these issues will depend above all on the efficient and prudent management of rapidly accumulating commodity windfalls. This must be seen as the principal macroeconomic policy challenge facing Russia today.

Over the long term, real appreciation in a catching-up economy is both inevitable and desirable. However, the *pace* of appreciation may cause problems, particularly if it is driven by abrupt terms-of-trade shifts rather than relative productivity dynamics. While labour market adjustment has so far allowed a smooth reallocation of labour from industry to services in Russia and thus limited the risk of “Dutch disease”, overly rapid real appreciation will significantly impede efforts to diversify its production and export structure. At the same time, efforts to limit the rate of nominal rouble appreciation make it harder to reduce inflation. The Bank of Russia has struggled to pursue these two goals simultaneously. So far, inflation has continued on a gradual downward trajectory, but it remains stubbornly

Figure 2.
GROWTH OF NET FOREIGN ASSETS AND OF THE STABILISATION FUND
RUB billion



Source: Central Bank of Russia, Institute for the Economy in Transition.

persistent. Keeping the nominal effective exchange rate roughly stable has meant that real appreciation has come about mainly *via* high – and only slowly declining – inflation.

The authorities aim to reduce inflation to around 4.5-5.0% per annum by the end of the decade. In present circumstances, however, the Bank of Russia's policy options are limited, given the weakness of both the interest-rate channel and exchange-rate pass-through. A relatively tight fiscal stance, on the other hand, can reduce both inflation *and* exchange-rate pressures, thereby mitigating the competitiveness-inflation trade-off facing the Bank. Moreover, fiscal policy could play a critical role in sustaining not only budgetary expenditure but also growth and exchange-rate stability in the event of a negative terms-of-trade shock. Over time, financial deepening should allow the Bank to pursue a more effective anti-inflation strategy, relying on a wider range of policy instruments than at present, but fiscal policy remains the best instrument for managing the adjustment to the new terms of trade while achieving substantially lower inflation. ■

What might an appropriate rules-based fiscal policy look like?

Fiscal policy should be based on a clear, credible fiscal rule, aimed at insulating the economy from commodity-price volatility. In particular, it is critical that the budget capture a larger share of commodity windfalls than at present, so as to avoid boom-and-bust cycles, but the resulting fluctuations in fiscal revenues should not lead to pro-cyclical fluctuations in expenditure. *Such a rule should thus define a medium-term fiscal balance target, based on an assessment of the non-oil fiscal stance and long-run sustainability.* This basic fiscal rule could be operationalised via certain changes in the legislative framework governing the Stabilisation Fund:

- The revenue base of the Fund could be broadened to include all oil-price related revenue windfalls (including surplus revenues from natural gas exports). A clearer set of rules is needed to govern the division of oil-related revenues between the Fund and the current budget.
- The first RUB 500 bn in the Stabilisation Fund can only be spent if oil prices fall below the threshold price of \$27/bbl for Urals crude. This sum is actually rather small compared to the potential revenue losses that might arise in the event of such a sustained oil-price drop. *It would therefore be prudent to increase the minimum size of this reserve and to index it either to GDP or to budgetary spending.*
- Nevertheless, the size of the Fund is, or soon will be, larger than is needed to insure the budget against an oil-price drop. The government should therefore design a framework for investing excess Stabilisation Fund reserves in a wider range of income-generating assets than is permitted for those funds that are set aside for “fiscal insurance”.
- This *de facto* division of the Fund into its “insurance” and “income-generating” components points to *the need for clearer criteria for determining when and how the Fund's reserves may be spent.* These criteria should reflect the requirements of the basic fiscal rule, since it is the underlying rule that matters most, not the specific mechanisms for operationalising it. ■

Where is structural policy headed?

Realising Russia's long-term growth potential will require more than just disciplined macroeconomic management. Russia still faces daunting challenges with respect to a wide range of structural reforms aimed at improving framework conditions for business and enhancing productivity growth. Unfortunately, the pace of structural reform has decelerated significantly since early 2004. The achievements of the last two years have been modest, despite a favourable economic and political context. In general, the implementation of measures legislated during 2002-03 has continued, albeit at uneven rates, but little has been done to advance the remaining major items on the government's structural policy agenda. The ambitious and wide-ranging medium-term programme adopted by the government in late 2005 signals its renewed commitment to reform and its awareness of the need to press ahead with a broad structural reform agenda aimed at strengthening the financial system, reforming infrastructure monopolies, enhancing competition and strengthening property rights. However, progress in most areas is still very slow. The present Survey focuses on three particular reform challenges that now confront the authorities: reforming public administration, improving the national innovation system, and restructuring the healthcare system.

While market-oriented reforms have been de-emphasised somewhat, the government has undertaken a number of initiatives aimed at defining a rather more active direct role for the state in economic development, investing and intervening on its own and in partnership with business. Many of these initiatives entail greater state activism in spheres like health, education and infrastructure, where the case for public intervention is clear. However, there has also been a marked trend towards expanding state ownership and direct intervention in "strategic" sectors such as oil, aviation, power-generation equipment, automobiles and finance. Of particular concern is the state-owned gas monopolist OAO Gazprom's seemingly insatiable appetite for asset acquisitions, often at the expense of a focus on its core business. At the same time, the absence of any significant steps to restructure the gas industry as a whole constrains the growth of other producers even as concern about the sustainability of Russian gas supply is growing.

The expansion of state ownership overall must be regarded as a step back. The Russian state's track record as an owner of industrial and financial companies is poor. The corporate governance of many state-controlled companies is problematic and state interference in the operations of such companies often distorts the development of the companies themselves and the markets in which they operate. The expansion of state ownership in important sectors will probably contribute to more rent-seeking, less efficiency and slower growth. *The trend towards greater state ownership should be reversed in order to improve performance and reduce opportunities for corruption and rent-seeking. At the same time, more needs to be done to strengthen the corporate governance of those companies that remain in state ownership, especially as regards transparency, and to provide for a clearer separation between the state's roles as owner and regulator in those sectors in which it fulfils both roles. ■*

How can the quality of public administration be improved?

Effective implementation of the government's new administrative reform *Concept*, adopted in October 2005, would also help curtail corruption. Russia badly needs an honest, effective public administration with an appropriate incentive structure. The state bureaucracy is inefficient, largely unresponsive to either the public or its political masters, and often corrupt. It is cited by foreign and domestic investors alike as one of the principal obstacles to investment in Russia today. It poses a particularly heavy burden on small and medium-sized enterprises, which are often less able to defend themselves against the bureaucracy than are large companies. Moreover, the poor quality of the state administration impinges on structural reforms in almost every other field, since it limits the government's ability to implement any policies that require administrative or regulatory capacities of a high order. It also imposes significant costs on citizens engaged in such routine tasks as registering property transactions.

The *Concept* emphasises, among other things, the implementation of public service standards, further de-regulation, rationalisation of the functions of state bodies, and measures to increase transparency. *The government's main priority should be to ensure its consistent, systematic implementation.* In addition, the authorities may want to consider a number of measures that are either outside the scope of the *Concept* or receive relatively little attention in it:

- Reform will achieve little in the absence of improvements in the broader institutional environment within which the state bureaucracy operates. *Steps to strengthen the rule of law, civil society institutions – including an independent press – and political accountability will all be critical. There is a need for stronger mechanisms for ensuring legislative oversight of the executive, whether via parliamentary committees or institutions like the Accounts Chamber.*
- Greater openness is essential to monitoring, accountability and anti-corruption efforts. Freedom of information legislation should be adopted, along with other measures to establish a norm of transparency in public bodies. The government should also ensure that arrangements for adopting public service standards and the related standing rules are open and consultative, and result in documents that are clear and accessible to ordinary citizens.
- Service standards and similar innovations will mean little in the absence of effective non-judicial means of redress for citizens wishing to challenge bureaucratic decisions. The *Concept* refers repeatedly to non-judicial redress but contains no specifics. This is a major omission. *Providing effective non-judicial mechanisms for individuals and organisations to defend their interests in conflict with public bureaucracies should be a first-order priority. An ombudsman or similar institution should also be created.*

Greater transparency combined with more effective non-judicial redress for citizens should do much to reduce corruption, particularly in connection with public procurements and fire, sanitation and other inspections. However, more can be done to combat corruption. *Anti-corruption efforts would be facilitated by increasing the use of information and communication technologies (ICT) in interactions between officials and businesses or private citizens, especially in*

fields such as licensing or public procurement. There is also much to be done to bring Russia's anti-corruption legislation into line with international standards. Adoption and implementation of the OECD Convention on Combating Bribery of Foreign Public Officials would provide a further signal of the authorities' determination to crack down on corruption in all its forms. "Whistleblower protection" legislation and a law on lobbying are also needed. Nevertheless, neither technology nor new legislation will achieve significant results in the absence of more effective and consistent law enforcement. ■

What needs to be done to enable Russia to realise its innovation potential?

The quality of public administration will impinge directly on the success of recent initiatives aimed at fostering innovation. Russia's innovation potential is probably greater than that of most countries at comparable levels of per capita GDP, given its large science base and human capital endowments. There is also considerable scope for innovation, in view of the need to modernise Russian industry and to make it cleaner and more energy-efficient. Yet there is a striking imbalance between the substantial public resources devoted to knowledge creation and the rather disappointing outputs in terms of innovation. Closing this gap is the first major challenge for Russian innovation policy. The second is to stimulate greater private-sector involvement in R&D.

A healthy, open business environment may be considered an essential precondition for any successful innovation policy. In addition to macroeconomic stability and a generally sound contracting environment, policy-makers wishing to stimulate innovation should pay particular attention to reducing barriers to market entry, facilitating the diffusion of new technologies and know-how, and stimulating competition. Reforms to strengthen the financial system should also help foster innovation: enterprise surveys consistently highlight the shortage of own funds and the cost of borrowing as major barriers to investment and innovation. The dearth of venture capital in Russia – a reflection of the overall under-development of financial markets – is part of the problem here.

The government's emerging innovation strategy lays considerable stress on two key priorities: reforming the state science sector and strengthening the intellectual property rights (IPR) regime. These are the right priorities. The public science sector is large, fragmented and largely cut off from the enterprise sector. Its potential as an engine of knowledge creation is enormous, but realising that potential will require major reform. *Of cardinal importance will be steps to rationalise the organisational structure of the sector, reduce the number of direct recipients of budgetary R&D funds and shift to greater reliance on project-based rather than institutional financing of state-funded research. At the same time, it will be necessary to enhance both the independence and responsibility of managers of public R&D organisations and to broaden the opportunities and incentives for universities and institutes to pursue the commercialisation of the results of their research via the creation of technology transfer offices and/or spin-off companies.*

With respect to IPR, there is a need to improve not only IPR protection but also the specification and allocation of IPR. The recent liberalisation of the regime for

assigning IPR to the results of publicly funded research is thus an important step forward. *It would also be desirable to increase the penalties for IPR violations and reduce the scope for relying on “copycat” patents. Increased judicial understanding of IPR issues will be important, especially in the regions.*

Private-sector R&D is too low, and stimulating it must be regarded as a major priority. However, the effectiveness of fiscal incentives to promote R&D appears to be highly sensitive both to the institutional environment and to the specific design of the instruments themselves. They should therefore be approached with caution. That said, *it would be desirable in the Russian case to begin by reducing the fiscal disincentives to R&D, in particular by allowing accelerated amortisation of R&D expenditures for all firms, not only those in special economic zones. Beyond that, it will be important to ensure that fiscal incentives for private-sector R&D are relatively simple, universal, and neutral between sectors. Except in the cases of start-ups and small firms, such incentives should generally rely on tax breaks rather than subsidies, as empirical work suggests that the former are likely to be more efficient.*

There may also be scope for targeted initiatives like the creation of special economic zones, technoparks and schemes to support innovative start-ups. *However, the government should proceed with caution in expanding such programmes, especially before the results of early ventures are known. The empirical evidence on the effectiveness of such measures is mixed, and there may be considerable value in the (positive and negative) learning yielded by pilot projects. Regular, rigorous, monitoring and evaluation of these programmes are therefore critical, as are mechanisms for winding up programmes whose benefits do not justify the costs involved. Interventions should be targeted at specific innovation bottlenecks arising from market failures; they should maintain ex ante neutrality between sectors; and they should preserve risk-sharing with private investors and profit incentives for entrepreneurs. They should also be limited in both scope and duration, aiming to spur new activities, not to sustain old ones. ■*

What should be the main priorities for reform of the healthcare system?

The deterioration in basic indicators of health and human welfare that began in the 1970s and accelerated in the 1990s has yet to be overcome. While some indicators suggest that the economic recovery and rising healthcare expenditure are having a positive impact on healthcare provision, the overall picture remains extremely grim: life expectancy at birth in 2004, at 65.3 years, was almost 5 years below its late-Soviet peak. It should be emphasised that this is a *health crisis* and not only a *healthcare crisis*: problems with access to quality healthcare are by no means the sole causes of very high rates of morbidity and mortality, which are largely a reflection of environmental degradation, poor living conditions and lifestyles, high levels of road deaths, and, increasingly, the spread of HIV-AIDS. Indeed, the success of healthcare reform will depend to a great extent on the success of policies aimed at tackling these larger problems. Nevertheless, healthcare reform must play a role in addressing this health crisis. It is clear that Russia needs to spend more on healthcare than at present and that it needs to spend more efficiently. Healthcare reform will be critical if planned increases in healthcare spending are to achieve the intended results.

The Russian healthcare system today is the product of an unfinished reform. A number of early reforms were launched in 1991-93, but little was done in the decade that followed to bring them to completion, and many of the problems that afflict Russia's healthcare system today are a product of its half-reformed state. The government has recently been working to press ahead with healthcare reform, but progress has been slow and many of the measures required will meet considerable resistance from stakeholders. The major reform priorities include:

- **Bringing formal commitments to the population into line with available resources.** This will require both increased public healthcare spending and some revision of the package of medical services guaranteed to the population free of charge. *If package reform is to establish a real guarantee of care, the government will need not only to limit coverage to what is feasible but also to enable citizens to take action if the commitments in the revised package are not met. Regular, transparent review and revision of the guaranteed package will also be needed in order to take account of medical, technological and economic change.*
- **Shifting the structure of provision away from over-reliance on specialist/hospital care and towards more integrated primary care.** The current push to increase spending on primary care is welcome, but it is unlikely to achieve much unless the quantity, quality and reputation of primary-care providers improve. *There needs to be a long-term, coordinated effort to strengthen the training of primary care physicians and to provide them with practice settings which favour the provision of integrated primary care.*
- **Adopting payment schemes that encourage cost-effective therapeutic choices.** There is a need to shift away from cost-reimbursement or capacity-based methods of paying hospitals in favour of more efficient methods, such as cost-and-volume contracts. Fundholding and other methods of remuneration for primary care providers should also be explored in an effort to enhance their incentives to keep patients healthy or to treat them on an outpatient basis. Incentives for uneconomic hospitalisation could be further reduced by eliminating the inpatient-outpatient distinction in determining eligibility for free medicines.

Russia's system of mandatory medical insurance (OMS) is intended to allow patients to benefit from competition among participating private insurers. However, there is little real competition among insurers, and creating such competition will require substantial up-front investment in rules, institutions and information. It will make significant demands on the state's still limited administrative and regulatory capacities – a fact which underscores the broader importance of reforming public administration – and it will require sustained high-level commitment. If competition turns out to be weak, the benefits may be correspondingly limited, and the costs may then outweigh the benefits. *It is critical, therefore, that the regulatory framework governing the activities of medical insurers in the OMS system be strengthened, imposing greater demands on insurers to play an active purchasing role, while simultaneously expanding their freedom to compete with one another. The authorities also need to develop mechanisms that will make it easier for individuals to assess the performance*

of medical insurers and to choose their own insurers. Given variations in regional conditions and in the administrative capacities of regional administrations, there is a good case for experimentation in different regions and a degree of regional differentiation with respect to OMS reform. Some regions may prefer to opt for a less complex, single-payer model, at least as an interim solution. In any case, steps to foster greater competition among healthcare providers could increase the efficiency of resource use and the quality of care regardless of the specific model of financing adopted. ■

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Economic Outlook No. 80, November 2006.

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