On 16 May 2007, the OECD Council decided to open discussions with the Russian Federation on accession to the Organisation and, on 30 November 2007, an Accession Roadmap, setting out the terms, conditions and process for accession was adopted (C(2007)103/PINAL). In the Roadmap, the OECD Council requested a number of OECD Committees to provide it with a formal opinion. The Economic and Development Review Committee was requested to review overall economic policies of the Russian Federation in order to provide a formal opinion on the degree of coherence of policies of the Russian Federation with those of OECD member countries. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council will decide whether to invite the Russian Federation to become a member of the Organisation.

The present Economic Survey of the Russian Federation was prepared for the purposes of the accession review of the Russian Federation. The draft report was discussed by the Economic and Development Review Committee on 29 October 2013, revised in the light of the discussions and finalised on 9 December 2013. The draft report was prepared for the Committee by Artur Radziwill and Lilas Demmou under the supervision of Andreas Wörgötter. Wide-ranging background research was provided by Yana Vaziakova with more specific inputs by John Earle, Maria Godunova, Alexander Kolik, George Kopits, Anna Kurguzova, Hartmut Lehmann and Natalia Tourdyeva. Excellent research assistance was provided by Corinne Chanteloup. Efficient secretarial support was provided by Josiane Gutierrez and Mikel Iiarritu.

This is the ninth OECD Economic Survey of the Russian Federation. The previous one was issued in December 2011. Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at www.oecd.org/eco/surveys. This Survey is published on the responsibility of the Secretary-General of the OECD.
Summary
Main findings

Structural reforms to improve the business climate are key to raising potential growth and economic resilience. As energy prices stagnate and labour and capital become fully utilised, growth is falling behind pre-crisis rates. Making the economy stronger, more balanced, and less dependent on rents from natural resource extraction is therefore a key challenge. This requires higher productivity growth and greater energy efficiency, both driven by competition, stronger investment and better matching of skills and jobs. The sequencing, political economy and implementation of structural reforms are all important.

Strengthening the macroeconomic framework

The strong macroeconomic framework needs further improvements. The new fiscal rule has anchored budgetary policies, but there are loopholes due to the possibility of tapping into oil funds, providing guarantees and shifting unfunded spending obligations on regions. Increasing attention is being paid to public sector efficiency. The monetary policy framework benefits from the transition to inflation targeting and a flexible exchange rate regime, although the importance of administered and food prices in inflation increase transparency requirements. The banking sector is stable but a consumer credit boom poses risks.

Establishing a transparent, coherent and predictable business climate

Improving the business climate is most urgent. The authorities seem to have become more energetic on fighting corruption and strengthening the legal protection of businesses. However, capital outflows and the low market valuation of Russian companies suggest that business is not yet fully convinced. Law enforcement appears to be uneven, whistleblower protection is weak, and civil society organisations and non-aligned media face constraints. Red tape has been reduced, and recently adopted federal initiatives tackle many administrative barriers. There has been less progress on the regional level. Governance of state-owned enterprises has improved somewhat, but privatisation plans were recently downsized. Notwithstanding WTO accession in 2012, market opening is meeting resistance. Transport system bottlenecks pose barriers to more geographically balanced growth.

Strengthening skills and innovation

Stronger and more sustainable growth is not possible without better use of skills and stronger innovation. Considerable resources are employed in low-productivity activities. Lifelong learning, activation programmes and temporary income support remain underdeveloped. Excessive labour turnover undermines on the job learning and contributes to the low level of innovation activities. Social partner institutions are weak and the enforcement of collective agreements is limited. While education enrolment rates are very high, insufficient quality and poor links with the business sector limit the supply of employable skills. Public spending on education is low and the high inequality of educational opportunities adds to the problem. Despite a long tradition of scientific excellence, Russia performs worse than most OECD countries in term of scientific output and patents, which is partly linked to the unfinished reform of the public R&D sector. Firms rarely see innovation as part of their business model. Innovation policies have recently become more focused at firms but results are not yet visible.
Key recommendations

Strengthening the macroeconomic policy framework

- Further strengthen the medium-term fiscal framework by stricter control of guarantees, regional spending and the use of oil funds. To reduce ageing-related spending increases, raise women’s retirement age to men’s and increase both in line with rising life expectancy, while implementing other measure to increase the effective retirement age.
- Continue transition to inflation targeting, while improving transparency of monetary policy decisions. Develop macro-prudential instruments to rein in excessive growth of consumer loans as part of regulatory and supervisory reforms. Improve monitoring and processing of non-performing loans. Resolve the potential conflict of interest at the central bank, which is the majority owner and supervisor of the largest Russian commercial bank.

Establishing a transparent, coherent and predictable business climate

- Continue the current anti-corruption campaign with stronger focus on transparency and accountability mechanisms in the public sector. Improve legal protection of whistleblowers and do not restrict the scope for media or civil society organisations to publicise violations of the law.
- Strengthen judicial independence through greater transparency in appointment and promotion processes, better pay and rotation of judges, while avoiding even the appearance of political interference in court cases. Make law-enforcement agencies more transparent and accountable.
- Continue reducing administrative barriers, and widen federal initiatives to regional and local levels. Extend regulatory impact assessments to legislative draft considered by the State Duma. Push ahead with privatisation of state-owned banks and other state-owned enterprises (SOEs). Further improve governance of SOEs and foster a level playing field between public and private companies.
- To strengthen the impact of WTO accession, refrain from introducing entry barriers. Shorten the list of strategic sectors with prior approval required for foreign investment and streamline the approval process.
- Tackle transport bottlenecks by improving the efficiency of infrastructure spending, promoting competition in the transport sector and ensuring better policy coordination to address urban transport challenges.

Strengthening skills and innovation

- Strengthen life-long learning through incentive for firms and workers, such as training vouchers. Increase spending on active labour market programmes and temporary income support to unemployed. Widen the scope for negotiating collective agreements on the enterprise level.
- Increase overall education funding, in particular in poor regions, while continuing to restructure education institutions. Link remuneration of teachers with their performance. Strengthen the co-operation between education institutions, business and trade unions and continue updating professional standards for vocational education. Reconsider school fees for optional courses in primary and secondary education to reduce access inequalities.
- Continue broad-based support for innovation and the adoption of new technologies, in particular to improve energy efficiency. Finalise the reform of public R&D by shifting more research from the Academy of Science to universities, increasing the share of competitive grant funding and streamlining state-owned branch research institutes. Evaluate innovation policies more systematically.
Assessment and recommendations

Russia made major strides in the decade before the 2008 crisis, helped significantly by oil and gas revenues. But productivity and living standards are still well below those of the most advanced market-oriented countries, and the speed of convergence since the crisis was lower than in most BRICs countries (Figure 1). Moreover, growth has slowed since 2012, partly for cyclical factors but mainly because potential output growth has slowed. The Ministry of Economic Development slashed in November 2013 its projected long-term average growth to just 2.5% down from 4.3% projected in April, warning that Russian growth until 2030 would lag behind the global average. Making further sustainable advances and fulfilling the presidential decree of May 2012 to increase labour productivity by 50% by 2018 and create 25 million highly productive jobs by 2020 will require a new pace of reforms.

The key long-term challenge is to reduce dependence on the volatile revenues from exhaustible natural resources, and strengthen sustainable, productivity-driven, regionally balanced and broad-based growth, as discussed in the 2011 Economic Survey of the Russian Federation. Meeting this challenge requires: i) further strengthening macroeconomic policy settings; ii) substantial improvement in the business climate, and iii) greater investment in infrastructure, human capital and innovation. Among those, structural reforms improving the business climate, in particular strengthening the rule of law and fighting corruption, are the most crucial but also most difficult to implement. The current growth slowdown has however contributed to the increasing support for such reforms both among policy-makers and larger public.

Figure 1. Gap in GDP per capita

A. Percentage GDP per capita difference compared with the upper half of OECD countries¹, 2012

B. GDP per capita growth, 2007-2012, percentage change

1. Compared to the average of the highest 17 OECD countries in terms of GDP per capita in 2012, based on 2012 purchasing power parities (PPPs). The OECD average is based on a simple average of the 34 member countries.

Source: OECD estimates and World Bank, WDI online database.
The slowdown is of both temporary and structural nature

Broad-based weakness appeared in late 2012 and into 2013 (Figure 2), triggered by stagnant terms of trade, the end of some temporary factors that had boosted growth in 2012, and uncertainty related to the world economy and domestic political developments. Investment growth came to a halt, driven mostly by natural resource related sectors and public infrastructure spending, and mining output declined. Private consumption growth is partly financed by increasing household debt.

Nevertheless, employment and capacity utilisation rates are near their pre-crisis boom records. The unemployment rate is still close to record lows because of employment gains, a shrinking labour force, high wage flexibility and extremely low unemployment benefits. Inflation rose above the central bank target range of 5-6%. Although this rapid rise was driven mostly by high food prices due to the poor 2012 harvest and headline inflation in the second half of 2013 was on a downward trend, core inflation and inflation expectations are sticky. These factors suggest the slowdown reflects to some extent structural limits to growth. Indeed, potential growth seems to have slowed to below 3%, which is reflected in the latest long-term projection by the Ministry of Economic Development. This is well below the average growth of 7% achieved between 1999 and 2008 and the 5% medium-term growth objective set by the authorities. Growth is projected to gradually strengthen in 2014 beyond the temporary boost from the good harvest as a moderate recovery in the euro area improves the outlook for exports and investment in extractive sectors. Inflation is likely to decline towards the policy target range as the impact of administrative price increases fade and a good harvest will reduce food prices. The current account surplus will continue to diminish (Table 1).

There are important risks to the projection. A resurfacing euro area crisis, a further slowdown in emerging market economies, particularly in China, and rising non-conventional oil and gas supply could put downward pressure on oil and gas prices. This would hurt exports and budget revenues, as well as investment in new extraction projects. The impact would spill over into other sectors of the economy through reduced incomes. Even though the strong fiscal position, current account surplus and low corporate leverage make Russia less exposed than most other emerging economies to increases in global interest rates, a sudden deterioration in financial market sentiment and a global flight to quality could lead to much larger capital outflows, tightening financial conditions in Russia. Uncertainty about domestic policy priorities could also prevent the projected investment recovery. The excessive consumer credit growth is another risk to the outlook, in the context of increasing household indebtedness.

<table>
<thead>
<tr>
<th>Table 1. Macroeconomic indicators and projections</th>
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<tbody>
<tr>
<td>2010</td>
</tr>
<tr>
<td>Real GDP growth</td>
</tr>
<tr>
<td>Inflation, period average</td>
</tr>
<tr>
<td>General government fiscal balance (per cent of GDP)</td>
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<tr>
<td>Current account balance (per cent of GDP)</td>
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Source: Economic Outlook 94 projections.
Figure 2. Key macroeconomic indicators

A. Current account, GDP and Urals crude oil price

B. Consumption, investment and exports growth (% year-on-year)

C. Real and nominal effective exchange rate (Jan 10=100)

D. CPI growth (% year-on-year)

E. Labour market (seasonally adjusted)

F. Credit extended to the private sector

1. Higher values correspond to appreciation.
Source: Rosstat, Datastream and Central Bank of Russia.
Stable and sustainable growth requires a stronger macroeconomic policy framework

The new budget rule strengthens the fiscal policy framework

The fiscal rule introduced in December 2012 limits the projected budgetary use of oil revenues to that calculated at a benchmark five-year average of past oil prices (to be gradually increased to a ten-year average by 2018), which is currently USD 91 per barrel. The medium-term federal expenditure envelope is then determined on a rolling basis for three following years as the sum of these oil revenues, projected non-oil revenues and a maximum budget deficit of 1% of GDP. The introduction of the rule follows a surge in the non-oil deficit during the crisis, which has so far been only partly reversed (Figure 3), and it increases the predictability and reduces the volatility of aggregate spending. The rule does not control for investment lending out of oil and extra-budgetary funds, for shifts of spending to fiscally weak regions without providing additional resources, and for the use of guarantees. But it does impose a fiscal spending envelope that implies some gradual medium-term fiscal tightening. Therefore, hard choices will have to be made, especially given large spending commitments in the context of the presidential elections, including social expenditure, infrastructure investment and army modernisation. It is important that pro-growth spending, including on investments in human capital and infrastructure, is prioritised. Currently, the country spends less than the OECD average on health and education, and more than the OECD average on defence and subsidies.

Oil revenues above the benchmark prices are directed to the Reserve Fund until it reaches 7% of GDP, and then at least half are directed to the National Welfare Fund, while the rest can be spent on infrastructure investment. The Reserve Fund cushions the effect of oil price fluctuations on the budget. The impact on budgetary revenues in roubles is further reduced because a decline in oil prices is usually associated with depreciation. Automatic stabilisers are allowed to work, as under-performing non-oil revenues can be compensated by reduced within-the-year transfers to the Reserve Fund. So, given the minimum expenditure commitments already predetermined in the medium-term fiscal framework for 2014 and 2015, a continued economic slowdown would imply higher deficits and little accumulation in the Reserve Fund. While justifiable, it has to be seen in the context of the projected fall of overall oil revenues as a share of GDP in medium-to-long run.

The National Welfare Fund is accumulating funds to cover future pension spending. However, a stimulus package announced in July 2013 envisages using money already accumulated for profitable infrastructure investment projects and for bank lending programmes for small businesses. This creates a potential risk for net public sector financial assets, which may undermine funding for future pension payments. Appropriate governance and control mechanisms are therefore needed to secure the expected returns, as the inefficiencies of public investments are well-known (McKinsey & Company, 2009).
Figure 3. Overall and non-oil general government balance

Within the fiscal spending envelope of the rule, increasing the efficiency of public spending will be of paramount importance. The successful introduction of programme-based budgeting within two years, as planned, will be an essential step forward. It requires careful analysis of problems encountered with some existing pilot schemes, including an appropriate choice of monitored indicators. There are also plans to streamline government agencies, outsource activities and decrease the number of civil servants by 20%. This is a particularly good time for such reforms, as the private sector needs skilled workers. A recently adopted law on public procurement offers more transparency throughout the entire project cycle, and implementation should be carefully monitored to allow for corrections as necessary.

The pension age in Russia, at 60 years for men and 55 years for women, is very low in international comparison, and life expectancy at retirement will rise further, responding positively to higher incomes and lifestyle improvements. Raising women’s retirement age to men’s and increasing both gradually along with life expectancy would be the most effective way to contain future pension spending increases, although such changes have been explicitly ruled out by the current administration.

A number of changes are planned to increase the effective retirement age and improve the sustainability of the pension system: recalibrating the pension benefit formula, including by introducing a points-based system, lengthening required service periods; reducing early retirement opportunities; tightening indexation with a closer link to the revenues of the pension system; and increasing the contribution of the self-employed. The financing burden of special pensions is to be partly shouldered by employers, providing them with incentives for improvements in working conditions. The planned reforms are an opportunity to address the need to diversify risks in retirement saving and performance problems of the defined-contribution pillar, including high administration fees, by strengthening regulation and supervision. However, contributions to the defined contribution pillar are now planned to be, by default, diverted to the defined benefit pillar, which will weaken the diversification of retirement incomes.

Russia has made major improvements to its taxation structure: tax bases have been broadened, rates cut, and compliance enhanced. Nonetheless, oil and gas taxation could better capture economic rents and promote exploration and investment by improved accounting for legitimate exploration, development and production costs of individual projects and fields. Alcohol taxes are relatively low and tobacco taxes are lower than in any OECD or major emerging country, even as high alcohol and tobacco consumption contribute to excessive mortality in Russia (OECD, 2012c). Russia also has scope to increase property
taxes, and raising green taxes holds the promise of raising revenue and promoting the transition to cleaner and sustainable production and consumption patterns.

**The transition to inflation targeting is proceeding**

Inflation targeting is to be introduced in 2015. For the transition, the main goal of monetary policy is currently stated in terms of end-of-year inflation declining from 5-6% in 2013 to 5% in 2014, 4.5% in 2015 and 4% in 2016. The transition is made difficult by the large share of volatile food prices and of regulated prices in Russia. High pass-through from exchange rate to inflation in the commodity-based economy could also be a complicating factor. Reflecting concerns about inflation volatility, the Central Bank of Russia (CBR) decided to state an inflation target with a relatively wide acceptance band of 1.5 percentage point in both directions. But high inflation volatility could raise communication challenges in building the credibility of the inflation targeting regime.

Exchange rate interventions have been significantly reduced and are now guided by clear rules aimed at preventing excessive exchange rate volatility but without an explicit or implicit exchange rate target. This allows the exchange rate to play its role as a shock absorber, notably by facilitating import substitution and supporting budgetary revenues when oil prices decline. Recent studies show that the adoption of inflation targeting tends to offset the increase of exchange rate volatility associated with floating by reducing unexpected monetary shocks and the pass-through (Floerkemeier, 2013).

The move to inflation targeting involves prerequisites, including central bank independence and transparency. Establishing a Monetary Policy Committee could more clearly separate various CBR’s functions and therefore strengthen monetary policy independence, accountability, and credibility. To explain the basis for its monetary policy decisions, the CBR publishes press releases following each policy meeting and, starting in 2013, quarterly monetary policy reports outlining its key policy considerations. The CBR should regularly publish information about inflation expectations and its macroeconomic projections, especially in inflation outlook. The transparency of the decision making process would be enhanced if the CBR published its policy meeting minutes, as many central banks now do. In another positive step in line with recommendations from the previous Economic Survey, credit instruments were streamlined, and the interest rate on one-week liquidity provision and absorption was clearly indicated as the key interest rate.

**The banking sector is financially solid while structural changes are ongoing**

The banking sector is stable and well capitalised and has solid profit margins, a manageable stock of non-performing loans and adequate provisioning (Figure 4). But better alignment with international standards of measuring non-performing loans, in particular through including doubtful loans, would instil additional confidence in the financial system and greater stability in the long-term. Large commercial banks are financed mostly through deposits, but the small stock of market collateral leads to a segmented inter-bank market, so auctions for provisions of loans at floating rates secured by non-market assets, which were introduced in 2013, will continue to play a significant role in providing liquidity. Recent CBR stress tests, which assume a major decline in oil prices and a 5% decline of GDP, suggest no immediate systemic risks.
The sector is dominated by state-owned banks (Figure 5). The CBR is the majority shareholder in Sberbank, which accounts for nearly half of retail deposits and almost one third of bank assets, although its share is declining. This unusual situation exposes the CBR to conflicts of interest, even though the regulatory and ownership roles are separated within the CBR. This situation needs to be resolved, also because it discourages new players, including foreign banks, from entering the market. While the authorities frequently confirm their commitment to privatise banks and have already sold shares of Sberbank and diluted state ownership of VTB, the second largest Russian bank, the most recent medium-term privatisation programmes retains majority state control of these two banks until at least 2016.

Consumer credit grew at an annual rate of over 40% through most of 2012, driven mainly by unsecured consumer loans, rather than mortgages or car loans. The refinancing of consumer loans through international wholesale financing is currently very profitable, but may develop into a systemic risk. The CBR has recently implemented measures, such as higher provisions and higher risk weights attached to consumer lending, to slow credit growth, and indeed it did slow marginally to 35% in the first three quarters of 2013. The CBR has also proposed the introduction of a cap for effective interest rate on consumer loans. However, despite ongoing discussions, the CBR toolkit still does not allow it to limit loan-to-value and debt-to-income ratios. The planned wider agenda of regulatory changes should include such measures. The Russian Banking Sector Development Strategy stipulates legislative amendments to implement the Financial Stability Board and Basel recommendations for capital adequacy, leverage, liquidity requirements and management of systemic risks. In particular, a new capital definition and adequacy ratios will come into force in January 2014.
Box 1. Recommendations for strengthening the macroeconomic policy framework

- Further strengthen the medium-term fiscal framework by stricter control of guarantees, regional spending and the use of oil funds. To reduce ageing-related spending increases, raise women’s retirement age to men’s and increase both in line with rising life expectancy, while implementing other measures to increase the effective retirement age.

- Continue transition to inflation targeting, while improving transparency of monetary policy decisions. Develop macro-prudential instruments to rein in excessive growth of consumer loans as part of regulatory and supervisory reforms. Improve monitoring of non-performing loans. Resolve the potential conflict of interest at the central bank, which is both the majority owner and the supervisor of the largest Russian bank.

Low growth is linked to distortions, low energy efficiency, demography and regional barriers

Enhancing sustainable growth is the most important medium-run policy challenge. High GDP growth from 1998 to 2008 resulted in some catching up with top economic performers (Figure 6), but was driven by rapidly increasing oil and gas revenues and mining investment. Terms-of-trade gains also led to rapid expansion in the non-tradable sector. This growth burst was possible because of the large unused capacity that emerged in the aftermath of the post-transition recession, the removal of bottlenecks inherited from Soviet times, and the adoption of modern managerial and technological practices. However, these factors appear to have run their course.
Table 2. GDP decomposition (1995-2008)

<table>
<thead>
<tr>
<th></th>
<th>Value added share (current prices)</th>
<th>Annual real growth rates (%)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>1995</td>
<td>2008</td>
</tr>
<tr>
<td>Total Economy</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Market economy</td>
<td>86.1</td>
<td>84.0</td>
</tr>
<tr>
<td>Goods</td>
<td>25.6</td>
<td>18.3</td>
</tr>
<tr>
<td>High Skill-Intensive</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Low Skill-Intensive</td>
<td>22.0</td>
<td>14.8</td>
</tr>
<tr>
<td>Services</td>
<td>40.4</td>
<td>41.0</td>
</tr>
<tr>
<td>High Skill-Intensive</td>
<td>5.1</td>
<td>11.2</td>
</tr>
<tr>
<td>Low Skill-Intensive</td>
<td>35.3</td>
<td>29.8</td>
</tr>
<tr>
<td>Extended mining</td>
<td>20.1</td>
<td>24.7</td>
</tr>
<tr>
<td>Non-market economy</td>
<td>13.9</td>
<td>16.0</td>
</tr>
</tbody>
</table>


Productivity growth varies substantially across sectors (Table 2) and, according to an in-depth micro study of labour productivity at the level of specific sectors, inefficiencies are driving these large productivity gaps (McKinsey & Company, 2009). Inefficient business processes, obsolete capacity and production methods seem to play a primary role, and they are linked to the intensity of competition, the burden of regulation, problems with availability of skilled managers and specialists, and credit constraints for modernisation. Productivity dispersion among firms is rising (Bukowski and Earle, 2014), while inefficient companies manage to avoid exit mostly by forming defensive networks (Huber and Wörgötter, 1998) and therefore prevent resources from moving to more productive uses (Brown and Earle, 2008).
*Energy efficiency is very low*

Despite substantial progress since the start of the transition, Russia remains one of the most energy-intensive economies in the world (Figure 7). As the country is dependent on carbon-intensive energy sources, it is also the world’s fourth largest emitter of greenhouse gases. Energy inefficiency contributes to local air pollution and the rate of premature mortality attributable to low air quality is among the highest in the world (WHO, 2013). Saved energy is also a valuable economic asset: if Russia used energy as efficiently as its OECD peers, it could save 30% of consumed energy which could then be exported or saved for future generations (IEA, 2011).

Improving energy efficiency is therefore rightly among the top government priorities. In 2008, the authorities set a strategic goal to reduce energy intensity of GDP by 40% by 2020 through energy saving, improving efficiency and eliminating regulatory constraints, to be complemented later by specific targets for energy-intensive industries. The main policy instruments adopted in subsequent federal and regional programmes included tax credits, state subsidies and loan guarantees for efficiency improvement projects. However, implementation of these initiatives was uneven and delayed. Effective mechanisms to monitor achievement of programme objectives were also absent, partly because target indicators were often not well-specified (Zaytsev and Saykina, 2013).

Fuel production and consumption subsidies in Russia, which are evaluated at more than 2% of GDP (IEA, 2012a; OECD, 2013a), should be gradually reduced. The Chapter on energy efficiency of the 2011 *Economic Survey* identified a disparity between domestic energy prices and marginal social cost of energy consumption as the most important challenge for improving energy efficiency, and this remains a missing element of the existing policy framework. In the wake of the economic slowdown, the government seems to be reconsidering its earlier plans to reduce cross-subsidisation reflected in the gap between low domestic and higher export gas prices. Indeed, domestic prices of utilities, including electricity, are to be either frozen or increased more slowly than inflation in the next three years. On the other hand, a new government decision foresees an increase in prices above newly introduced consumption norms for households. This initiative was launched in pilot regions and is to be expanded to all regions in 2014. While energy consumption meters are legally required, only 40% of residential houses and 20-25% of apartments have them installed so far. Non-metered consumption is to be subject to higher tariffs starting in 2015.

The 2011 *Economic Survey* recommended measures to improve efficiency in transport, housing and industry. In transport, mandatory fuel efficiency standards for cars and trucks and improving traffic management were recommended. After several delays, more ambitious efficiency standards have been introduced, but the motor fuel quality monitoring system remains ineffective. Tax changes to encourage the use of natural gas in transport are being discussed, but have not yet been adopted. Progress is slow in introducing traffic management, partly due to popular opposition against road charges. The renovation of the housing stock remains challenging, as owners do not always have the right incentives to improve efficiency and projects with the financial support for regional governments are rare. Although the Housing and Public Utilities Fund has recently become responsible for accelerating this process, public financial support for the construction of energy efficient housing is still under discussion. To facilitate efficiency improvements, the 2011 Survey recommended removing obstacles to the development of energy service companies (ESCs). Newly adopted legislation addresses some obstacles, but the rights of the contractual partners are still not defined clearly enough and ESCs continue to face difficulties in obtaining bank financing (Garbuzova and Madlener, 2012).
Figure 7. Energy intensity

A. Energy consumption per unit of GDP, 2011
Tonnes of oil equivalent (toe) per thousand 2005 US dollars of GDP calculated using PPPs

B. Total greenhouse gas emissions per unit of GDP, 2011
Kg of CO2 equivalent/2005 US$ PPP

Note: Data for GHG emissions are excluding emissions/removals from LULUCF (Land Use, Land-Use Change and Forestry).

Regional disparities signal low hanging fruits for growth

Another unused growth opportunity is linked to high inter-regional inequality, which contributes to overall inequality (Figure 8). Regional inequality hardly changed during the last decade, despite increased labour and capital market integration and several programmes directed at convergence. Social, education and health services still do not have the expected equalizing impact on regional income (Lehmann and Silvagni, 2013). This is mainly due to barriers to convergence that include large differences in natural resource endowments, the legacy of Soviet production location choices, poor transport, weak infrastructure in many regions, and remaining barriers to interregional mobility. Business surveys increasingly also point to regional differences in the quality of institutions and the business environment (EBRD, 2012). Therefore, increasing attention is needed on local implementation of structural reforms, and regions should be more strongly encouraged to experiment with local business improvement initiatives, for example as part of the National Entrepreneurial Initiative.
A. Inequality of GDP per capita across regions

Gini coefficient across TL3 regions, 2010, scale from 0 "perfect equality" to 1 "perfect inequality"

B. Individual income inequality

Gini coefficient¹, late 2000s, scale from 0 "perfect equality" to 1 "perfect inequality"

1. For non OECD countries, Gini coefficients are not strictly comparable with OECD countries as they are based on per capita incomes except India and Indonesia for which per capita consumption was used.

Source: OECD (2011), Divided We Stand: Why Inequality Keeps Rising, Table A1.1, Figure 0.2; OECD estimates.

Demographic changes play an important role

Low fertility rates, high premature mortality rates, particularly among males, and early retirement all contribute to the long-term decline in the labour supply. The government has put in place programmes providing significant incentives for families to have more children. The success of these measures should be closely monitored, but OECD experience suggests that the impact on fertility of support provided around the time of birth is most likely temporary, as it only accelerates but does not increase the number of childbirths (OECD, 2011c). But demographic changes with two large demographic waves (indicated by the two ovals in Figure 9) also offer an opportunity to promote structural change, because employment in the low-productivity enterprises dating from the Soviet era is concentrated in those born in the large post-war demographic boom (upper oval). They will retire in the next 10 years and be gradually replaced by the large generation (lower oval) with record-high educational attainment (Belanovsky et al., 2011). It is of vital importance to
create conditions for these entrants to find their way into sectors and enterprises that can productively use their skills, or to encourage entrepreneurship by launching own firms.

**Figure 9. Population by age and sex**

*January 2012*

Source: Rosstat, *The population of the Russian Federation, by sex and age.*

**Improving the business climate**

*Corruption and rule of law are still a big problem*

Endemic corruption is considered to be one of the main obstacles to market entry and sustainable growth (Mauro, 1995), including in Russian regions (Pushkarev, 2007). Particularly worrying is corruption in law enforcement, which accounted for a quarter of all corruption cases brought to the courts in 2012. According to the Transparency International, corruption perception is very high (Figure 10), although the international ranking of Russia improved since 2010. The survey of the Institute of Contemporary Development (2013) identifies corruption as the second biggest problem for Russians (after housing but ahead of bad roads), although the survey by Public Opinion Foundation (2013) reports that bribes have become less frequent since 2005. Only 10% of entrepreneurs have never come across corruption, although the cost of bribes has apparently fallen in recent years (OPORA, 2012). In a number of regions, corruption is so widespread that firms consider it a convenient alternative to legal and administrative compliance (EBRD, 2012).
Figure 10. Transparency International Corruption Perceptions Index

Corruption Perception Index 2013 Score, scale from 0 (highly corrupt) to 100 (very clean)

Note: CPI 2013 Score relates to the degree to which corruption is perceived to exist among public officials and politicians by business people and country analysts. Score ranges between 100 (highly clean) and 0 (highly corrupt).

Source: Transparency International, Corruption Perceptions Index 2013

Responses to these challenges include the ambitious National Anti-Corruption Action Plan for 2012-13, and the introduction of amendments on combating corruption to the Criminal Code of Russia and the Code on Administrative Violations. Russia also ratified the OECD Anti-Bribery Convention, banning bribes to foreign officials. The review by the OECD Working Group on Bribery in October 2013 revealed progress, but also urged strengthening legislation, law enforcement and awareness campaign against foreign bribery. The new law on public procurement adopted in April 2013 aims at increasing transparency and openness at all stages of the procurement process. A working group headed by the Minister of Economic Development and bringing together business and public authorities was established in October 2011 to develop anti-corruption measures in business and investment areas leading to the implementation of the Anti-Corruption Charter of Russian Business.

Commissions to consider cases of violation of the provisions of the Code of Ethics and conflict of interest regulations are being established in every public institution and state owned enterprise. A presidencial decree ordered a catalogue of government positions associated with corruption risks. Several awareness campaigns directed at civil servants were launched. Compulsory disclosure of income, expenditures, assets and property by public officials, their spouses and children was strengthened. A separate law obliges senior officials and close family members to close foreign bank accounts and repatriate financial assets abroad by September 2013. Some measures protecting whistleblowers were introduced, although there is no specific legal protection of public servants and perceived legal protection has been undermined by the handling of high profile "business crime" cases in provincial courts and by unpunished assaults against investigative journalists.

Corruption prosecution has accelerated. The Prosecutor General’s office recorded almost 50,000 corruption-related cases in 2012, a 25% increase over 2011. Several high-level corruption scandals have recently come to light, including investigations of corruption and embezzlement in state corporations, ministries and the prison service, and fraud in public procurement, including contracts for the 2014 Sochi Winter Olympic Games. However, according to opinion polls the general public is sceptical about the long-term success of the campaign and 77% of Russians think government efforts to fight graft are ineffective (Transparency International, 2013). Moreover, some corruption cases are sometimes perceived as politically motivated. Nevertheless, the scale and high status of those exposed, as well as associated legislative changes, suggest that the intent to fight corruption is genuine. The latest compliance report of the Council of Europe’s Group of States against
Corruption (GRECO, 2012) concluded that Russia implemented 15 out of its 26 wide-ranging recommendations, with remaining eleven being partly implemented. It is important to maintain and build on this momentum.

The Russian authorities have taken a number of steps to strengthen the judicial system with visible progress in the efficiency and competence of the economic courts (Granville, 2013). The share of firms considering courts a major obstacle in their business activity is falling strongly (World Bank, 2013). A new programme for “Development of the judicial system in 2013-20” foresees increasing transparency, accessibility and openness, including audio-video recordings of proceedings and broadcasting sessions on the Internet. Judicial salaries were substantially increased in 2012, although no attempt was made to introduce a rotation of judges or other measures to increase judicial independence as recommended in the 2011 Economic Survey. Greater transparency in appointment and promotion processes would also be an important step forward. Another initiative to improve the quality of judiciary decisions is the introduction of a new criminal appeal procedure. The State Duma currently considers a draft law to establish administrative justice chambers in general jurisdiction courts and a new draft code on administrative court procedure, which should improve the ability of citizens to protect their rights against state action or inaction. On the other hand, the merger of the highest economic court with the Supreme Court of general jurisdiction, which intends to eliminate the possibility of different interpretations, led to concerns by key stakeholders about the impact on perceived efficiency and independence of economic courts. It is also important to make law-enforcement agencies, including the Investigative Committee and Prosecutor’s Office, more transparent and accountable to limit room for undue influence.

The position of a Federal Business Ombudsman was created in June 2012 to protect business people from administrative and legal abuse by the government. Regional ombudsmen have been already established in 62 regions. The State Duma adopted in July 2013 an amnesty for businessmen who were criminally convicted only once and on lesser economic crimes, who agreed to pay damages, or who were still in pre-trial detentions. Article 159 of the Russian Criminal Code was amended in December 2012 clarifying the definition of “swindling”, which was so broadly interpreted as to contribute to legal uncertainty. Measures directed at shortening the length of pre-trial detention should also be considered, as cases considered by the European Court of Human Rights, where detainees had been held for four to six years in remand (OSJI, 2011), are only extreme examples of the broader problem.

Promoting a strong civil society is essential for strengthening transparency, accountability and trust in public institutions. Recent progress in this area is mixed. On the one hand, it was decreed that all legislative initiatives that gathered 100,000 signatures should be discussed by the State Duma. Stakeholder consultations were strengthened at all levels of the government and the process of registration of non-governmental organisations (NGOs) was simplified. Business representatives certainly have more structured opportunities to have their say when legislation is being drafted. On the other hand, the media are not becoming more independent and Russia is ranked in 146th place out of 179 countries according to Press Freedom Index published by Reporters Without Borders. The new law on assembly put in place much tighter restrictions on participation in public debate. A 2012 law requires any NGO involved in broadly defined political activities and receives financing from abroad to register as a “foreign agent”, a label that is highly stigmatising in Russia. This law and its heavy-handed enforcement attracted criticism from the Council of Europe and several human rights groups. At a minimum, clarifying the definition of political activity and foreign financing, and replacing the “foreign agent” label would send a very positive signal about the authorities’ commitment to civil society activities.

More broadly, the continuous flow of unsettling news regarding interactions of politics, business and law enforcement, at least as it is presented by leading business media, for example CNBC (2013), FT (2013) might contribute to capital outflows, the low market valuation of Russian companies and sluggish private investment.
The role of the state in economy is large

State-owned enterprises (SOEs) play an unusually high role in the economy (Figure 11). Their share of output has grown with large acquisitions by SOEs, like Rosneft and VTB, even as some small SOEs are disappearing. SOEs occupy the dominant position in a number of important sectors (Figure 12), including banking, transport and energy. Their dominance poses a severe challenge to market entry and competition and preserves pockets of inefficiency.

Figure 11. Product market regulation indicator: public ownership

2008, index scale of 0-6 from least to most restrictive

Note: The reference year is 2008 for all countries. The PMR indicator for Russia for 2013 is preliminary, and for purposes of comparability is calculated on the basis of the 2008 methodology. For more details, see the document prepared for discussions at the October 2013 meeting of the Working Party No. 1 of the Economic Policy Committee (ECO/CPE/WP1(2013)14). The document also provides the 2013 indicators with a revised methodology.


The privatisation plan adopted in 2010 foresaw privatisation of 1500 enterprises, including several largest companies in key sectors, such as banking, energy, telecoms and transport. But while many stakes have been sold, the majority of large transactions were delayed because of, according to official sources, an unfavourable market situation. The original privatisation plan for 2014-16 aimed at the withdrawal of the state from all companies, except for natural monopolies and oil and defence sectors. However, this plan was substantially scaled down in June 2013.

State ownership comes in great variety, which reduces transparency and accountability, while complicating management and the unbundling of commercial and non-commercial roles. A management model respecting competitive neutrality in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises could help to address these problems. The official plan reducing the number of state unitary enterprises by 2016 is a step in this direction. As the quality of governance of SOEs is highly dependent on the autonomy of directors, the gradual withdrawal of top level public officials from the board of directors of SOEs that started in 2011 is a positive change. Professional directors were established instead in a number of enterprises (RZD, VTB, Rosneft, Gazprom), but the process is rather slow. The professionalisation of SOE management has also been encouraged by the introduction of the special committee on the selection of directors. Board member remuneration is also increasingly linked to achieving key performance indicators.

Nevertheless, the “system of instructions”, under which some state-appointed directors are still required to vote at SOE board meetings according to the state’s preferences on a set of issues, should be revised in line with the OECD Guidelines. The quality of governance in SOEs could also be improved by obliging them to increase the level of their stock exchange
listing. Now, most of the largest public companies are traded at the lowest listing levels of the Moscow Exchange, which minimises corporate governance requirements, such as information disclosure and the number of independent directors.

Governance problems are not only limited to SOEs. In the private sector, the ability of minority shareholders to monitor and seek redress is constrained by low transparency of business groups and scant information on ultimate beneficial ownership, and some loophole-ridden laws, such as on takeovers. The corporate governance problems add to other risks of investing in Russia, thereby contributing to high risk premium assigned to Russian companies, with a price/earnings (P/E) ratio that is two to three times lower than the same index for other BRICS. Among other consequences, these low valuations have an impact on the size of potential privatisation proceeds.

Figure 12. State-owned enterprises shares among countries’ top ten firms

Note: Unweighted average of SOE shares of sales, assets and market values among country’s top ten companies. It ranges from 0 (no state ownership) to 100 (all sales, assets and market value of country’s ten largest companies are accounted for by SOEs). Only countries with shares above 10% are shown.
Source: Kowalski, P. et al., 2013.

Reforms address administrative burdens

Only 25% of Russian employment is in small and medium size enterprises (SMEs), compared to 50% on average in OECD countries. This difference reflects the dominant role of large state-owned enterprises, the poor business climate and poor access to financing. Attitudes towards entrepreneurship also matter. The latest Global Entrepreneurship Monitoring review puts Russia last among 69 countries in terms of willingness to start a business (GEM, 2012). On a positive note, restrictions and red tape have been reduced in recent years, as reflected in a better PMR score on barrier to entrepreneurship (Figure 13). Russia also improved its World Bank Doing Business rank in terms of the ease of opening business from 111th in 2011 to 88th most recently. Similarly, a much lower share of firms reported that licencing, tax and courts administrations were significant obstacles to their business in 2011 compared to 2008 (World Bank, 2013).
Several measures to reduce administrative costs have been introduced: one-stop shops, reductions in licencing requirements, and streamlined claims for the zero VAT rate. However, there was no progress introducing a “deemed clearance” regime. The Ministry of Economic Development (MED) is currently working on simplifying the registration process for legal entities and sole proprietors. The National Entrepreneurial Initiative “Improvement of Business Climate”, initiated at end-2011, includes 13 roadmaps to make business processes simpler, faster and cheaper. Work on preparing 10 roadmaps has finished and the process of implementation in pilot regions has started. The early success of the project was reflected in Russia being named one of the top three reformers in the 2014 World Bank Doing Business ranking, with the overall rank improved from 92nd from 120th in 2011. The Regional Investment Standard to be implemented by all regions in 2013 contains best practice measures to make the relationship between business and the regional authorities more transparent and efficient.

A regulatory impact assessment (RIA) procedure has been introduced since 2010 to review all new and, progressively, existing government laws and regulations for excessive costs to entrepreneurs. RIA procedure will be further strengthened and will be extended to customs and tax regulations and to the regional (2014) and municipal level (2015), where many barriers to business entrepreneurship originate (EBRD, 2012). Since August 2010 MED has already carried out more than 1,800 assessments. RIA could be extended to systematically reviewing legislative amendments under consideration by the State Duma.

**Competition remains weak**

Recent PMR results indicate that the barriers to competition have fallen slightly lower, but also that competition is still hampered by the dominance of large state-owned enterprises and barriers to foreign trade and investment (Figure 14). On the other hand, the Federal Antimonopoly Agency (FAS) is a strong and effective institution with a solid track record. However, it is overwhelmed with many insignificant cases. The recent “Third anti-monopoly package” should decrease the number of cases concerning small repetitive abuse of dominance, introduces the definition of cartel in both Competition Law and Criminal Code, and clarifies of the determination of a monopolistically high price.
Remaining priorities for competition policy include further improving the quality and relevance of economic analysis of competition issues, enhancing conformity between the competition law and the criminal code, developing merger control mechanisms, and removing legal obstacles to effective cooperation between FAS and its foreign counterparts. Development of competition was strongly emphasised in the National Entrepreneurial Initiative, which gives priority to reducing the role of the state in the economy and establishing clear “rules of the game” regarding competition policy. In particular, a draft “Fourth anti-monopoly package” currently considered by the State Duma requires any new state owned enterprise be approved by FAS. Competition promotion was also recently introduced as a task shared across all government institutions. More effective progress with regulatory reform promoting competition and removing entry barriers is also essential for generating a significant impact of policies supporting innovation spending.

Figure 14. Product market regulation indicator: barriers to trade and investment

2008, index scale of 0-6 from least to most restrictive

Note: The reference year is 2008 for all countries. The PMR indicator for Russia for 2013 is preliminary, and for purposes of comparability is calculated on the basis of the 2008 methodology. For more details, see the document prepared for discussions at the October 2013 meeting of the Working Party No. 1 of the Economic Policy Committee (ECO/CPE/WP1(2013)14). The document also provides the 2013 indicators with a revised methodology.


Barriers to trade and FDI remain high

Russia acceded to the WTO in 2012. The WTO membership will sharpen competitive pressures via tariff reductions and liberalised access in services, provided it is not compensated with commensurate increases in non-tariff barriers to trade. Potentially protectionist measures, notably food-safety related restrictions and the introduction of a recycling fee on imported vehicles, as well as certain implementation capacity problems suggest that further action is needed to take full advantage of the WTO process (Russian Accounts Chamber, 2013).

Inward foreign direct investment (FDI), at 1.6% of GDP in 2012, is close to the OECD average. However, round-trip investment via off-shore jurisdictions accounts for close to 60% of the total. This investment tends to be attracted to resource-rich regions and regions with a high perception of corruption, and is less technologically advanced than other FDI (Ledyaeva, 2013). Important barriers to FDI include restrictions on foreign investments in several sectors, including quotas and limitations on the scope of operations for licences granted to foreign investors in financial services. The usefulness of these restrictions should be regularly examined.
Attraction and support of FDI is a government priority, and steps to improve the FDI climate have been taken at both the federal and regional level. The State Duma is discussing simplifications of the approval procedures for foreign investors who want to acquire a significant stake in a sector deemed as strategic and fine tuning the list of strategic sectors. The removal of the application of reciprocity in the Banking Law for all OECD investors in October 2013 was an important step, expressing commitment to the principle of non-discrimination. The Russian Direct Investment Fund, created in 2011 to operate with long-term financial and strategic foreign investors, has become an anchor investor for a large number of projects. The road maps to improve the investment climate in critical areas, such as customs, construction and public procurement, have been developed at the federal level and some measures are now being tested at the regional level. The systematic implementation of these initiatives would be necessary for realising Russia’s potential for attracting FDI.

**Tackling transport bottlenecks**

Russia ranks low in quality of transport and competitiveness (Figure 15). Estimates suggest that a 10% improvement in transport efficiency could increase GDP by 0.8% (Annex 1.A1). The modernisation challenge is huge as the Russian transport system is one of the largest in the world, with a well-developed railway network but a poor road system. Improving the quality of railway services is particularly important because of its role for freight (Figure 16) and long-haul passenger transport. Spending on transport infrastructure has risen in the last decade, but the needs remain substantial, as according to the World Economic Forum Russia’s roads rank 136 (out of 148 countries), its railways 31, its ports 88 and its air transport 102 (World Economic Forum, 2013). Also repairs are not sufficient to prevent infrastructure degradation (IER, 2012).

Problems with infrastructure quality are aggravated by unfinished institutional reform. Despite a large number of players in wagon operation, RZD maintains an effective monopoly in railway freight, being the owner of both infrastructure and all locomotives. This has resulted in the ineffective use of the available infrastructure, increasing prices, excessively long shipping times and even denial of service. In long-haul passenger transport, RZD faces competition only on the route between Moscow and St. Petersburg. Improving efficiency of railway transport requires a long-awaited decision about targeted model of railway competition followed by regulatory reform and strengthened competition rules enforcement by FAS.

While road transport has been growing rapidly, the network density and quality have not kept pace despite the growing attention of the government to its development. The majority of roads are not adequate for heavy vehicles, and deficient standards and enforcement have led to safety and environmental concerns (HSE, 2013). While the system is most dense in the European part of Russia, some areas in Siberia and the Far East still lack regular connections with the main transport network, hindering economic activity.
Figure 15. Competitiveness and quality of transport infrastructure

1. Simple average of four quality indicators (roads, railroad infrastructure, port infrastructure, air transport infrastructure). The responses are to the questions: "In your country, how would you assess the following aspects of transport infrastructure? (a) Roads (b) Railroad system (c) Air transport infrastructure (d) Seaport facilities [1 = extremely underdeveloped—among the worst in the world; 7 = extensive and efficient—among the best in the world].


Figure 16. Railway share of freight transport
2010, % in total inland freight tonne-km

Note: Excluding oil pipelines. 2009 data for Canada, China, Greece, Luxembourg, Switzerland. 2008 for Australia, Korea, New Zealand, United Kingdom.

Transport problems in big Russian cities have become a particularly important constraint on economic development, as it is increasingly difficult to attract new investment and workers to these areas. The situation is most complicated in Moscow and St. Petersburg, where hours-long traffic jams have become the norm and public transport is inadequate (Figure 17). But congestion is an increasing challenge in most bigger cities (Donchenko, 2013). Improved local planning, including congestion charges, and further progress in local railway reform would be particularly important to enable an adequate response to the needs of commuters. The federal government should support cities more strongly by providing targeted aid, developing model urban and region transport plans and removing existing legal barriers.

Figure 17. Average traffic speed in peak hours in selected cities


The revised “Transport Strategy of the Russian Federation until 2030”, which was approved by the government in August 2013, lays out the principles of transport system development. The authorities are now rightly placing the revised Strategy at the centre of decision making. This should link investments with long-term priorities more strongly than in the past, and minimise the influence of short-term political and budgetary considerations, bringing more coherence and prioritisation to policy making. The various modes of transport should be also developed in a more consistent way. Large scale infrastructure projects, which will be needed to resolve transportation shortcomings, would also benefit from more rigorous cost and benefit analysis, improvements in public procurement, project evaluation, public-private partnerships, and the fight against corruption.
Box 2. Recommendations for establishing a transparent, coherent and predictable business climate

- Continue the current anti-corruption campaign with stronger focus on transparency and accountability mechanisms in the public sector. Improve legal protection of whistleblowers and do not restrict the scope for media or civil society organisations to publicise violations of the law.

- Strengthen judicial independence through greater transparency in appointment and promotion processes, better pay and rotation of judges, while avoiding even the appearance of political interference in court cases. Make law-enforcement agencies more transparent and accountable.

- Continue reducing administrative barriers, and widen federal initiatives to regional and local levels. Extend regulatory impact assessments to legislative draft considered by the State Duma.

- Push ahead with privatisation of state-owned banks and other state-owned enterprises (SOEs). Further improve governance of SOEs and foster a level playing field between public and private companies.

- To strengthen the positive impact of WTO accession, refrain from introducing entry barriers. Shorten the list of strategic sectors with prior approval required for foreign investment and streamline the approval process.

- Tackle transport bottlenecks by improving the efficiency of infrastructure spending, promoting competition in the transport sector and ensuring better policy coordination to address urban transport challenges.

Skills and innovation are essential for shaping future growth

Achieving high sustainable growth requires improving human capital and the innovation capability of the economy, and continued labour reallocation towards more productive and better paying enterprises. Lifelong learning, activation programmes and stronger income support to the unemployed could contribute to that reallocation by better matching skills with jobs. Also much needs to be done regarding the supply of the right mix of skills by continuing to reform the education system.

Better matching skills and jobs will require more active labour policies

With an employment rate of 69%, against 65% in the OECD, the Russian labour market performs relatively well. Employment also appears quite stable over time: Russia’s GDP declined by almost 8% in 2009, compared with less than 4% on average in OECD countries, but the unemployment rate rose by 2.2 percentage points, similar to the OECD average. This stability is due mainly to the high degree of wage flexibility (Figure 18; Lokshin et al., 2012).

However, this wage flexibility has resulted in a large share of employees with incomes less than the subsistence level (14% in 2009) and a high level of wage inequality as measured by the Gini coefficient (Denisova, 2012). Low wages and poor working conditions allowed least productive firms to survive but reduced job attachment, resulting in high turnover, with about 30% of workers leaving their jobs each year since 2000 (Gimpelson and Lippoldt, 2001; OECD, 2011b). The strong increase in the share of the informal sector in global employment, also added to the problem (Lehmann and Zaiceva, 2013).
High labour turnover, informality and low wages reduce incentives to invest in human capital (Commander and Denisova, 2012). This results in difficulties for firms to meet their skill needs and lowers the engagement of workers in lifelong learning (EBRD, 2012; Figure 19). The ability to apply knowledge in a technology-rich environment seems to be a relative weakness among adults. Preliminary results from the OECD Survey of Adult Skills (PIAAC) suggest that Russians perform better than the OECD average in terms of literacy, similar to the OECD in terms of numeracy, but they lag behind in terms of the ability to use ICT tools efficiently (OECD, 2013c). Brain drain adds also to the problem; 80% of emigrants in 2010 were highly skilled whereas most of immigrants were low skilled or unskilled (ILO, 2011; EBRD, 2012).
Figure 19. Skill mismatch and life-long learning

A. Availability of skilled personnel
Share of SMEs that have experienced a lack of skilled personnel in the last two years

B. Participation in lifelong learning¹
25-64 year-olds, % of total respondents, 2011²

¹ Lifelong learning refers to formal and non formal education.

Lifelong learning could contribute more strongly to improving and matching skills and facilitate the adoption of new technologies (OECD, 2005). While some programmes exist to train specific qualified personnel, for instance for engineers, broader schemes to boost lifelong learning are underdeveloped. Low qualified workers in Russia tend to engage less in learning (Tan et al., 2007), while international studies find positive effect for this group of workers. But incentives for training them need strengthening as required investment in general and transferable skills is less profitable to firms (Ok and Tergeist, 2003; Bassanini et al., 2005). The engagement of SMEs in lifelong learning is also weak which may reflect financial and organisational difficulties faced by small firms or the lack of customised training (OECD, 2012d). In that context, overall productivity could be raised by providing specific support to firms and workers who tend to under-invest.
Balanced industrial relationships between workers and employers could also limit the vicious circle of low wage, low productivity, high turnover and low human capital investment. Despite relatively high trade union membership and the provisions in Russian law, the enforcement of collective bargaining is de facto very limited, in particular at the firm level (OECD, 2011b; Box 2.6). Nonetheless, collective bargaining plays an important role in ensuring the improvement of working conditions, stable employment and the access to training for all categories of workers (Keogh, 2009). Freedom to express collective interests is also an important building block of civil society (Hayter, 2011) and effective enforcement of workers’ rights and binding agreements is part of the rule of law. Authorities should therefore widen the scope for negotiating collective bargaining on the enterprise level and ensure enforcement by following the recommendations made by experts in the context of the OECD review on labour market and the ILO Commissions on Freedom of Association and Collective Bargaining (OECD, 2011b; ILO, 2013).

Moving towards human capital-led growth will require changes in the structure of the economy and, in particular, of employment. Strong active labour market measures could support the transition of workers to new jobs (Meager, 2009; Martin and Grubb; 2001; Berger et al., 2001) and to target services to those who will need it most, such as the low skilled (Benus et al., 2005; Nivorozhkin and Nivorozhkin, 2006; Akhmedov et al., 2003). However, spending in that area remains far below the OECD average (Figure 20). There is also a need to reorient spending from public works and wage subsidies towards programmes to address skills mismatches, such as training. Federal transfers to the 15 regions with the highest levels of unemployment, targeted support to regional mobility and requalification in mono-industrial cities should be continued and indeed strengthened. The efficiency of the public employment services could be improved by reducing the caseload and developing further IT intermediation tools. More generally, the efficiency of active labour programmes should be more systematically evaluated through ex post studies.

Figure 20. Expenditures on labour market policies

Public expenditure on labour market policies per unemployed (% of GDP per capita), 2010

![Expenditures on labour market policies](image)

1. 2009 for United Kingdom and Russia.

Source: Russian authorities; OECD Public expenditure and participant stocks on LMP database, OECD Economic Outlook database and OECD Annual National accounts database.

The current level of passive labour market spending in Russia is also low, with unemployment benefits that do not cover even subsistence living costs. This may force financially constrained individuals to accept a poor job offer, creating mismatch problems and low productivity. It also reduces incentives to register in employment services and gain new qualifications. In that context, a twofold reform should be considered: increasing the level of active labour market spending and the level of unemployment benefits while reinforcing job search requirement for all recipients including those only entitled to the
minimum benefits. An adequate level of unemployment benefits will also support the transition from the informal to formal economy (OECD, 2004).

**Education enrolment is high but quality and equality of opportunities need to be improved**

Russia has one of the highest shares of tertiary educated population in the world, but the educational system has encountered difficulties in supplying the right mix of skills for employers (Figure 21). Weaknesses can be identified at all levels: secondary general, secondary vocational and tertiary education institutions.

Increased spending in the area of education should therefore be a priority in Russia. Overall spending should be brought closer to OECD levels especially in secondary education where the gap is highest (OECD, 2013b), while continuing efforts for improving the system’s efficiency, notably through the ongoing process of restructuring the network of educational institutions and the allocation of funds in higher education institutions on a competitive basis. The authorities should also increase the funding to modernise secondary vocational education institutions that currently suffer from a general obsolescence and under-financing (Nikolaev and Chugunov, 2012) and ensure that federal transfers allow supporting schools with a high number of students in need. The planned OECD review of Russian education spending efficiency should provide useful guidance in that area.

**Figure 21. Quality of the education system**

2012-13, score (1-7 scale)

![Bar chart showing quality of education system](image)

Note: The responses are to the question "How well does the educational system in your country meet the needs of a competitive economy? [1 = not well at all; 7 = extremely well]."

1. Simple average of Brazil, India, Indonesia, China and South Africa.


Results of international tests on educational performance are mixed. Russia belongs to the group of leading countries for PIRLS test (Progress in International Reading Literacy Study), and TIMMS test (Trends in International Mathematics and Science Study) which reflects good academic learning outcomes. However, the average performance of Russia in PISA is relatively poor reflecting a lower ability when it comes to apply knowledge in unfamiliar situations (Figure 22). There is also a high percentage of low performers, who do not reach the baseline proficiency in reading (OECD, 2013c). Many steps have already been taken to improve the quality of teaching including in the new Law on Education, which came to force in September 2013, the new federal state education standards for primary and secondary education, the development of pre-school education, and an increase in wages. To attract good students to careers in teaching, the authorities should also consider generalizing the use of a performance-based bonus if current regional experiences with this tool prove successful.
The vocational education system, which is partly inherited from the Soviet period, mainly trains students for narrowly specialised jobs rather than core transferable skills. The cooperation of firms with vocational education institutions is weak (HSE, 2012). As a result, most firms have to retrain workers hired directly out of school (Survey from Centre for Human Resources, RANEPA). Including business representatives on governance boards of vocational institutions and revising the system of specialisation in vocational schools on the basis of currently updated professional standards, would reduce this gap. A dual system of vocational education with at least 25% of time spent in firms, which is currently being considered by the authorities, should also better align training with firms’ needs and improve the school to work transition.

Figure 22. Education spending and PISA scores

Source: OECD (2013), PISA 2012 Results: What Students Know and Can Do – Student Performance in Mathematics, Reading and Science (Volume I), Table I.A; and OECD (2013), Education at a glance, Table B.1.1.

To improve the matching of higher education with local labour market needs, the new law on education allows universities to establish academic departments providing practical learning in close co-operation with employers. The role of regions has been strengthened since 2013, but the authorities still directly determine the distribution of state-subsidised places among study fields. Universities should be given stronger say in order to avoid creating career traps. The positive impact of such change would be reinforced by strengthening the governance boards and allowing more influence of employers in decision making. Also, the share of students paying fees has also increased substantially over the last 20 years. While this sharpens incentives, it also increasingly risks excluding the poor, so introducing means-tested grants and loans with repayment contingent on income would improve equity. The government should consider revising the criteria for the allocation of free student places, which currently depend solely on academic scores, thereby indirectly favouring students with better socio-economic backgrounds.

Primary and secondary education is decentralised, which provides greater flexibility and responsiveness but also makes its provision fully dependent on regional and municipal budgets. The result is that public expenditures on general education currently varies considerably by region, with per student spending ranging from RUB 31 000 to 164 000 (Rosstat and Ministry of Education). Increasing federal transfers for education would narrow this disparity and help to equalise educational opportunities across the country. Fees for
optional courses are also widespread and increase the dualism between schools financed by richer parents and schools with poorer parents, where only the compulsory subjects are taught (Andrushchak et al., 2010). Better resourced schools have also the possibility to attract better qualified teachers which adds to the problem. This practice should be reconsidered, and additional courses funded from the public budget.

**Strengthening innovation in Russian firms**

Further growth in Russia will have to be driven by improvements in productivity and energy efficiency. Such improvements are possible either by adapting best-practice technologies and business processes, or by innovating. Unfortunately, the number of innovative firms remains very small (Figure 23) and business funded just 26% of spending on R&D in 2010. This important “innovation gap”, which is also reflected in a low number of patents, is particularly worrying when considering Russia’s very rich science and engineering tradition, a large base of state-owned branch research institutes, and its high level of education attainment. Moreover, despite a rise in public R&D spending, Russia dropped out recently from the group of best performing upper-middle-income countries in terms of the Global Innovation Index (Cornell University et al., 2013).

**Figure 23. Innovation in the manufacturing sector by category**

<table>
<thead>
<tr>
<th>2008-10, as a percentage of all manufacturing firms</th>
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Source: OECD (2013), *Science, Technology and Industry Scoreboard 2013*, Figure 5.1.2.

Publicly-owned research and design institutions still perform almost 75% of all R&D in Russia (HSE, 2013), and the role of private organisations is marginalised. The “Innovative Russia 2020” strategy adopted in 2011 puts business more at the centre of innovation policies, including through promoting innovation at state-owned enterprises, creating innovation clusters and technology platforms, and involving business more systematically in innovation policy planning. However existing programmes still tend to be excessively focusing on high-tech innovation, which is at odds with the importance of innovations in low-technology and service sectors (OECD, 2012b). Such bias tends to disadvantage small and medium-sized enterprises, which make a remarkably small contribution to R&D spending in Russia, despite recent initiatives directed at promoting innovation cooperation between SOEs and small firms. It would also be essential to very carefully evaluate top-down programmes, such as the “Innovation Enforcement Initiative” directed at the largest SOEs, to avoid innovation “window dressing”. More broadly, one structural problem with innovation policy in Russia is that new initiatives are launched without a systematic evaluation of previous actions (Kuzyk and Simachev, 2012).
Russia performs worse than most OECD countries in terms of academic output, as measured for example by publications in peer-reviewed journals. Improving the efficiency of public research spending is therefore essential, while too much funding is still allocated without adequate accountability or reference to performance (OECD, 2012b). Remaining state-owned branch research institutes continue to be largely disconnected from both firms and universities, and should be streamlined, for instance by encouraging their merger with production-oriented enterprises (OECD, 2012a). Improving the governance of the Russian Academy of Sciences, with its myriad specialised institutes and questionable preservation strategies, and which accounts for a significant share of publicly performed research, is particularly important. The share of competitive funding should be increased and underperforming institutes should be downsized. There is also a need to further strengthen research capabilities of higher education institutes, which account for less than 10% of total research spending. Recent initiatives have been directed at establishing an elite cadre of national research and federal universities. This is in line with OECD best practice but the effectiveness and cost efficiency of supporting programmes need to be carefully evaluated.

To strengthen the contribution of the Academy and universities to economic development, more needs to be done to open channels of knowledge diffusion beyond academic publications, including through direct cooperation with businesses. A series of federal laws and programmes encourage the creation of spin-offs, development of technology platforms and regional clusters, but it is still too early to assess the results of these initiatives.

**Box 3. Recommendations for strengthening skills and innovation**

- Strengthen life-long learning through incentive for firms and workers, such as training vouchers. Increase spending on active labour market programmes and temporary income support to unemployed. Widen the scope for negotiating collective agreements on the enterprise level.

- Increase overall education funding, in particular in poor regions, while continuing to restructure education institutions. Link remuneration of teachers with their performance. Strengthen the co-operation between education institutions, business and trade unions and continue efforts to develop updated professional standards for vocational education. Reconsider school fees for optional courses in primary and secondary education to reduce access inequalities.

- Continue broad-based support for innovation, and for the adoption of new technologies, in particular to improve energy efficiency. Finalise the reform of the public R&D sector; in particular by shifting more research from the reformed Academy of Science to universities, increasing the share of competitive grant funding and streamlining state-owned branch research institutes. Evaluate innovation policies more systematically.
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Chapter summaries

Chapter 1. Improving the business climate and transport infrastructure in Russia

Economic growth is below what would be needed to resume rapid convergence to average OECD living standards. On-going efforts to improve the business climate are laudable, but need to be widened and strengthened. Much progress has been achieved in reducing red tape, but it is only recently that the authorities have visibly become more energetic in fighting corruption. Adverse interactions between politics, business and law enforcement generate obstacles for the rule of law and remain a major risk for potential investors. High entry barriers lead to weak competition. Reducing the role of the state in the economy and WTO membership should be viewed as opportunities to strengthen competition, and hence provide incentives for productivity improvements, which are urgently required to ensure stronger growth in Russia because of a shrinking labour force.

Transport can play an important role in promoting growth, diversification and regional convergence. However, with insufficient investment and incomplete structural reforms, Russia faces very large challenges in modernising its large transport system. Urban transport problems are intensifying, because of weak policy coordination and inadequate traffic management. Promoting competition in the transport sector is essential, in particular by effectively opening the railway freight market to independent operators.

Chapter 2. Boosting productivity: skills, education and innovation

The labour market in Russia is very flexible. Firms adjust to economic shocks through wage cuts, working hour reductions and minimisation of non-wage labour costs. Workers react by changing jobs. This results in a high and stable overall employment rate, but also high wage inequality, informality and labour turnover, which limits incentives for firms to invest in human capital and productivity improvements.

While educational attainment is very high, the education system needs to be strengthened to respond to the needs of a skill-based economy. School-employer cooperation is low and opportunities for higher education are unequally distributed. Adequate funding for education institutions is not assured everywhere while at the same time inefficiencies persist.

Private spending on innovation is very low and Russia underperforms in terms of scientific outputs and patents. Support for low-tech innovation and technology adoption, especially among SMEs is narrow because of a bias towards large and high-tech projects, which however are only loosely related to Russian manufacturing capacity. Reform of the public R&D sector is incomplete, notably with respect to strengthening funding on a competitive basis.
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