

Assessment and recommendations

Macroeconomic performance and policy: encouraging trends

In recent years, the Russian economy has experienced significant growth...

Since the previous OECD *Economic Survey of 1999-2000*, the Russian economy has experienced a number of favourable trends and developments. Output, employment, consumption, and investment have grown significantly. In the two-year period of 2000-01, Russian GDP and fixed capital investment grew by close to 15 and 25 per cent, respectively. Unemployment fell from 13 per cent at the end of 1999 to an estimated 8 per cent in mid-2001. Real incomes have recovered more slowly from the 1998 crisis than output and employment, but began to increase significantly in 2000 and 2001. The recent growth has reversed years of economic decline, bringing GDP in 2001 almost back to the recorded level of 1993.

... and most other trends have been quite favourable

Since the crisis of 1998, most other trends in the Russian economy have also been quite favourable. The Russian government succeeded in eliminating the large chronic budget deficits of the past, generating substantial general government surpluses in 2000 and 2001. The Central Bank has stabilised the exchange rate and reduced inflation, although consumer prices continued to increase by close to 20 per cent annually in 2000 and 2001. The commercial banking sector has shown significant signs of recovery from the 1998 crisis. The Russian government has normalised relations with foreign creditors and boosted the international credit rating of the country. An unprecedented degree of political stability and co-operation between the federal government, the State legislature, and subnational state organs has created greater opportunities for the realisation of key economic policies and reforms.

External factors played an important role in supporting the recent favourable trends...

External factors played an important role in supporting the recent growth and other favourable macroeconomic trends. Relative prices and the terms of trade improved for many Russian firms in the period since the 1998 crisis. A four-fold depreciation of the rouble in 1998-99 gave a major boost to firms oriented toward exports or import-substitution. Real wage costs also declined sharply as a consequence of the crisis. A subsequent strengthening of oil and other commodity prices on world markets further increased the average profitability of exports, augmenting investment demand, foreign reserves, and federal budgetary revenues.

... and, although weakening, they continue to be important

Although continuing to appreciate gradually in real terms, the rouble remained 40 per cent below its pre-crisis value as of mid-2001. Real wages and the relative prices of a number of other important inputs for Russian firms have been growing in recent years, but had yet to recover completely to pre-crisis levels by 2001. Commodity prices have weakened in the context of a world economic slowdown, but still remained strong in 2001 relative to 1998. Thus, these relative price changes continue to support the profitability of many Russian firms relative to the pre-crisis period, although the strength of these factors has been weakening steadily since 2000.

The sustainability of the current positive trends depends increasingly on more permanent factors and structural reform

As these largely transitory factors weaken, the sustainability of the current positive trends depends increasingly on more permanent factors, including key structural reforms. Russia continues to suffer from a number of institutional weaknesses. A still very difficult environment for business and investment finds reflection in large net capital outflows from the country, rather low domestic investment outside of oil and gas, and relatively few small private businesses. Although household incomes have recovered, they still remained lower in 2001 than before the 1998 crisis, and poverty remains an important problem. The current mass subsidisation of households and firms through cheap gas, electricity, and transportation is both highly inefficient and unsustainable. Sustainable growth thus depends on key structural reforms to solve these and other problems. As indicated below, the Russian government has already made some important progress in structural reform, although many challenges still lie ahead.

The government and Central Bank have maintained responsible macroeconomic policies

The Russian government and Central Bank have maintained responsible macroeconomic policies in recent years, exercising the financial restraint necessary for stabilising expectations, normalising relations with foreign creditors, and improving the credibility of fiscal and monetary policy commitments. The Russian authorities had already succeeded in restoring at least some degree of macroeconomic stability in 1999 in the immediate aftermath of the crisis. But fiscal and monetary policy received an important boost from the subsequent strengthening of oil and gas prices on world markets. The taxation of export revenues brought surplus resources to the federal budget and current account inflows fuelled the rapid expansion of foreign reserves. A sharp contraction in imports following the depreciation of the rouble in 1998-99, together with a much higher value of exports, moved Russia's current account from a deficit of US\$6 billion in the first half of 1998 to a surplus of over US\$45 billion in 2000. The current account remained quite strong in 2001. In this context, the monetary authorities increased gross foreign reserves from US\$12 billion at the end of 1999 to US\$37 billion by December 2001. In the face of these inflows and surplus revenues, macroeconomic policy has nevertheless remained rather tight.

The managed float has been effective, although inflationary pressures have been significant

The previous OECD *Economic Survey* raised some concerns about confusing messages coming from the Central Bank on the goals of monetary policy. Fortunately, a number of recent documents have clarified the fundamental goals as the defence of the currency and controlling inflation. The managed float of the rouble has proved an effective mechanism for stabilising expectations and, along with the accumulation of foreign reserves, for supporting an enhanced credibility of monetary policy. Given the reluctance of the Central Bank to allow the nominal appreciation of the rouble, the strong current account inflows of recent years have generated some inflationary pressures. The Central Bank has not done much to sterilise exchange rate interventions, partly due to the remaining weakness of Russian financial markets. Two primary factors have limited the impact of a corresponding rapid growth in money supply on inflation in 2000 and 2001. First, the stabilisation of expectations and economic growth have increased money demand and the

capacity of the economy to absorb the monetary expansion. Second, the federal government has been running sizeable budgetary surpluses, and depositing surplus revenue with the Central Bank. Consumer price inflation has nevertheless exceeded targeted rates. Most of this inflation can be linked to monetary expansion from currency market interventions. Future uncertainty about the growth in money demand and the government budget suggest that the Central Bank may need to develop more active policies to absorb excess liquidity in coming years.

A tight fiscal policy has been maintained...

Even though the federal government took a decision in 2001 to resume servicing foreign debt in full, it has continued to maintain a tight fiscal policy, not allowing expenditures to increase along with significantly higher tax revenues. Federal tax revenues increased from 7.5 per cent of GDP in 1998 to projected levels of close to 16 per cent in 2001. Federal expenditures, by contrast, have remained in the range of 14 per cent of GDP throughout this period, transforming a former large federal deficit to a surplus of 2.3 per cent in 2000, and a similar expected surplus in 2001. Trends in consolidated regional tax revenue and budgetary balance have also been positive, if less dramatic.

... and an implicit stabilisation fund has been created

Given uncertainty over oil prices and exceptionally high foreign debt payments due in 2003, the Russian government has been under some pressure to generate surpluses. The government reached a decision in 2001 to create a type of implicit "stabilisation fund," committing itself not to spend surplus revenue in 2001, and planning a surplus of 1.6 per cent of GDP in the budget for 2002 that is conditional on the optimistic assumption that oil prices are in the range of US\$23-24 a barrel. Due to the strong dependence of the federal budget on oil and gas prices, this type of stabilisation fund indeed makes sense for Russia. Funds of this nature have been created in a number of other countries that face fiscal risks from commodity price fluctuations. A stabilisation fund might also relieve some pressure for the appreciation of the rouble. Nevertheless, the appropriate size of this fund should involve a careful consideration of the possible alternative uses of these resources, either as social expenditures or as an easing of the tax burden.

Yet the federal government will need to increase its role in the social policy sphere

The government is currently undertaking a number of important social policy initiatives, including the development of more targeted social assistance and a major pension reform. Poverty remains a key problem in Russia, as witnessed by continuing disturbing trends in some demographic and health statistics. Most of the responsibility for social expenditures currently rests with regional and local governments. Yet recent reforms have reallocated a significant amount of revenue from the regions to the federal government, raising the question of a possible greater involvement of the federal government in financing social expenditures. The previous OECD *Economic Survey* recommended a larger relative size of the federal budget, but also a much greater federal responsibility for financing social policy, particularly in support of poorer segments of the population. The long-term economic programme of the Russian government is consistent with this recommendation, proposing a reallocation of state investment funds toward social policy. Other than the creation of a new transfer fund to back some federal mandates with financing, however, this reallocation has not yet been realised.

Economic reforms and institutional change

Ambitious and comprehensive economic reform programmes have been developed

In 2000 and 2001, the Russian government developed quite ambitious comprehensive long and medium-term programmes for economic policy and structural reform. These programmes differ notably from previous such initiatives in placing primary emphasis on measures to improve the environment for private business and investment. While previous government programmes typically prescribed a more active role of the state in the economy, particularly in investment policy, the current programme highlights measures for “deregulation” and “debureaucratisation” that are aimed at promoting a freer business climate and enhanced competition. The economic programmes encompass virtually all of the problems examined in this and previous OECD *Surveys*. They also reflect the determination of the Russian government to obtain membership in the World Trade Organisation.

The government's two-year record in pursuing structural reform has been positive

While political processes and controversies sometimes altered or slowed the implementation of parts of the economic programme in 2000 and 2001, the Russian government's two-year record in pursuing structural reform has nevertheless been impressive. Accomplishments include important changes in government administration (including an enhanced coercive power of the federal government to enforce basic laws), tax reform, payment discipline, fiscal federalist relations, and the alleviation of some administrative barriers to business. The government has also made fundamental progress toward pension reform, reform of the electricity sector, a Land Code, and a new Labour Code. In addition, the Russian government has exhibited considerable skill in prioritising a limited number of reform initiatives at any given time as an essential condition for rallying sufficient political support for success.

In this context, the Russian economy has already experienced some important institutional change

In this context, the Russian economy has already experienced some important institutional change in recent years. External factors alone cannot completely explain all of the recent growth. An increase in cash payment discipline, consistent with a hardening of budget constraints for many firms, is one important visible institutional change. The economy has also become monetised to a much higher degree, as cash payments have replaced the formerly predominant instruments of barter, debt offsets, and bills of exchange. The previous OECD *Survey* gave particular attention to serious problems associated with the use of these money surrogates. Substantial increases in bankruptcies and outside corporate takeovers in recent years are consistent with a more active monitoring and turnover of enterprise management. The previous problematic insider control and entrenched management of Russian enterprises is finally yielding to increasingly concentrated outside ownership. This process has also been riddled with problems for the enforcement of fair competition and the rights of shareholders and creditors, however. The institution of bankruptcy, in particular, has been commonly abused for the orchestration of takeovers at the expense of some groups of shareholders or creditors. Nevertheless, relative to the past, the increase in outside acquisitions and bankruptcies may be promoting greater efficiency in many cases,

and are part of the overall trend toward greater financial discipline in the corporate sector.

Economic policies, in addition to external factors, have promoted greater cash payment discipline in the economy

By increasing profitability and liquidity for Russian firms, the favourable external factors discussed above facilitated the enforcement of cash payment discipline. But economic policies of the Russian government have also been important. First, the federal government has introduced more discipline into its own finances, maintaining a cash-only rule for budgetary operations, honouring a much higher share of expenditure obligations, and shifting the execution of major budgetary operations to the federal treasury. Regional and local administrations have also been placed under considerable pressure to follow suit. Second, pressure on the electricity and gas monopolies, RAO UES and Gazprom, to pay taxes in cash, while allowing them to reduce supplies to non-paying customers in a wider variety of circumstances, has also had an important effect on the hardening of budget constraints. Although higher average liquidity and profits have naturally contributed to the enforcement of cash payment discipline, the effect of these policies should not be underestimated. As concluded in the previous *OECD Survey*, the causes of demonetisation and non-payments went far beyond low liquidity and profits.

Tax reform is another key accomplishment of 2000 and 2001

Previous *OECD Surveys* stressed fundamental problems in the Russian tax system. Tax reform is another key accomplishment of the Russian government in 2000 and 2001. A number of changes in the tax system, many of which are codified in new chapters of the Tax Code, represent important steps toward the simplification and clarification of tax obligations. The combined effect of these changes has reduced somewhat the explicit tax burden, eliminated many excessive exemptions, and reduced incentives for tax evasion. The most important reforms include the introduction of an income tax with a single flat rate of 13 per cent, a reduction in social (wage) tax obligations, a regressive scale for marginal taxes on the wage fund, a reduction in the profit tax rate, and a narrower definition of profits that allows for the deduction of additional costs in a manner consistent with international practice. A number of problems remain in the Russian tax system, however, including remaining ambi-

givities in the division of tax authority between different levels of government and a perceived high degree of instability in tax rules.

The recovery of the banking sector

Even in the absence of major restructuring, trends in the banking sector have been encouraging...

The economic crisis of 1998 took an enormous toll on the commercial banking sector, leaving many banks poorly capitalised or insolvent. Even in the absence of major restructuring or recapitalisation, trends in the banking sector have been encouraging. The real values of aggregate assets, credit, and capital have virtually reached pre-crisis levels. Reported shares of non-performing credits are also quite low. In addition, incentives for banks to function as genuine financial intermediaries appear to be improving. In contrast to the pre-crisis period, Russian banks no longer appear to be as oriented toward working with state organs, and are more concerned with developing profitable credit portfolios.

... but quite a number of problems persist

As acknowledged in the recently announced joint strategy of the Russian government and Central Bank, however, quite a number of problems persist in the banking sector. These problems include the low capitalisation of most banks, a predominance of potentially unstable short-term deposits of juridical persons in liabilities, and limited opportunities for profits. Removing the giant state-owned Sberbank from aggregate bank balances reveals a rather low share of working assets, a less rapid expansion of credit to the non-financial sector, and a strong orientation toward relatively safe foreign investments. With the exception of Sberbank, the degree of trust of the population in banks remains low. A number of commercial banks appear to operate only in the context of a small group of firms, holding these firms' accounts, supplying them with short term loans, and (perhaps) investing surplus resources abroad.

Greater legal protection of the rights of creditors in the case of collateralised loans is needed...

A weak defence of the rights of creditors in the event of default on commercial loans has been, and remains, a central problem in the Russian banking sector and credit markets. Even the collection of collateral in the case of secured loans can be exceedingly difficult or even impossible. The recently adopted strategy of the Russian government and

Central Bank indicates an intention to pursue new legislation that would facilitate the seizure of collateral in the event of default on secured loans. Such measures could indeed be of critical importance for the further recovery of the banking sector, credit markets, and the development of corporate governance. Commercial credit to the non-financial sector remains quite low in Russia, standing at little more than 10 per cent of GDP.

... and state household deposit insurance should be limited to highly capitalised banks

The government and Central Bank have given attention to the development of an explicit system of state insurance for household deposits. Deposit insurance could indeed be important for building the confidence of the population in Russian banks and allowing other banks to compete with Sberbank on a more equal footing. It is also the case, however, that deposit insurance can seriously distort incentives in banks operating with relatively little capital. Therefore, the development of a workable system of deposit insurance is inseparable from the question of minimal capital requirements and capital adequacy. Only banks satisfying high requirements by these measures and other prudential regulations should be eligible for participation in a state deposit insurance system. The announced strategy of the Russian government and Central Bank also proposes to increase gradually capital adequacy and (perhaps) minimum capital requirements with a goal to encouraging mergers or liquidations of the still quite numerous smaller banks.

Problems of Russian entrepreneurs

Apparent slow growth in the small business sector provides a striking contrast to the overall economic expansion

The small enterprise sector in any economy offers a barometer of the overall climate for entry, exit, fair competition, and private business. This is particularly the case in transition economies, where new small private firms have grown rapidly, filling formerly neglected sectors of the economy and absorbing labour and other resources shed by loss-making industrial firms. While small private businesses exhibited quite rapid growth in the early years of economic transition in Russia, their officially recorded numbers and output have virtually stagnated since the mid-1990s. These numbers now provide a striking contrast to the overall economic expansion in 2000 and 2001. However, a business survey conducted in three regions for this *Survey*, as well as a

number of other surveys and interviews of Russian entrepreneurs, suggest that the small business sector in Russia may have recovered from the crisis to a greater degree than official statistics would suggest. In some regions and cases, the climate for small businesses appears to be more favourable than prior to the economic crisis in 1997.

Russian entrepreneurs often complain of harassment or extortion

Nevertheless, evidence suggests that conditions for entrepreneurship in Russia remain quite difficult on average. While Russian entrepreneurs struggle with many of the same problems as small businesses in other countries, one striking characteristic of Russian small business surveys is the number of complaints of harassment or extortion by various state organs. Russian small businesses are often subject to continual pressures to bribe state officials in charge of various inspections, extra-budgetary funds, or licenses. An attempt to expand a business into a different region can intensify these pressures. Recent cross-sectional studies that compare Russia with the Eastern European transition countries stress this problem in particular. Russian entrepreneurs also commonly point to a number of other problems in the enforcement of contracts and the uncertainty surrounding tax regulations, particularly in the case of the single imputed income tax.

The new strategy of the Russian government for supporting small business activity promises to be more effective than previous programmes

The current Russian government has taken a qualitatively new approach to the support of the small business sector. As opposed to previous strategies that emphasised direct state support of individual entrepreneurs, such as guaranteed or low interest loans, the current approach aims primarily at reducing the excessive interference of state organs in the functioning of small businesses. Recent legislation has simplified licensing procedures and placed limits on the activities of a number of state inspections. The new strategy of the Russian government has the potential to be much more effective than past programmes. These measures are directed at what entrepreneurs themselves identify as some of the most important obstacles to their operations. When business surveys question Russian entrepreneurs about what they feel the Russian government should do to improve their situation, the vast majority of responses stress the need to reduce, rather than increase, the involvement of state organs in their activities.

But these measures should be supplemented by other reforms

Although the strategy of the Russian government should have a positive impact on the environment for small business, the problem of extortion of entrepreneurs by state organs cannot be solved completely through greater discipline and control by the central government. Despite the well-intentioned changes in federal laws and regulations, state officials, particularly at the regional and local levels of government, will continue to possess various means for gaining leverage on small businesses for purposes of extortion. The solution of this problem requires a comprehensive approach that combines selected measures of central control with other reforms that increase the incentives for regional and local officials to promote a healthy business environment through their own initiatives. These latter measures correspond to part of the recommendations below for reform in fiscal federalist relations.

Regulation and reform in the gas and electricity sectors

The natural gas and electricity sectors occupy a central place in the Russian economy...

In size, scope, and economic importance, the natural gas and electricity sectors occupy a central place in the Russian economy. Output of gas and electricity has remained relatively stable in the transition period, in contrast to the sharp declines in a number of other sectors. Russian gas and electricity remain dominated by two large monopolies, Gazprom (gas) and RAO UES (electricity), whose significance in the Russian economy goes far beyond the production and sales of energy. These companies have functioned essentially as quasi-fiscal institutions, administering large subsidies to firms and households on the basis of rather complex relations and agreements with state organs at all levels of government.

... and have experienced some favourable trends in recent years...

As has been the case in most sectors of the Russian economy, gas and electricity have experienced some favourable trends in recent years. The strengthening of world gas prices has boosted earnings from gas exports enormously. The government appears to be playing a more active role as the dominant shareholder in Gazprom and RAO UES, and progress has been made in raising accounting standards, professional audits, and the openness of information. One of the most dramatic changes in recent years has been the remonetisation of these sectors. Domestic sales of gas and electricity had become almost completely demonetised

in 1997-98, with money surrogates such as barter, debt off-sets, and bills of exchange accounting for the vast majority of sales. Cash sales now predominate, especially in electricity. Payment arrears for energy have also declined notably. As discussed above, this remonetisation and greater payment discipline have been achieved in the context of policies that have allowed the reduction of energy supplies to delinquent consumers in a much wider variety of circumstances, even if this has sometimes been accompanied by severe social tensions and costs.

... but are the source of some of the most serious and complicated problems

Despite these strengths, the gas and electricity sectors are the source of some of the most serious and complicated problems in the Russian economy. Most experts concede that the capital infrastructure of the Russian electricity industry has deteriorated to such a degree that Russia could face the beginnings of an acute electricity shortage in the next five years. The gas industry may not be under such an immediate threat, but is also in need of significant fixed investment over the medium and longer term for the development of new fields. Thus, generating or attracting substantial resources for sufficient investment in these sectors, particularly in electrical power, must be a primary and immediate goal. An excessive and often inefficient consumption of energy in the context of highly repressed prices and payment problems represents another key problem. Subsidies channelled through the electricity and gas industries remain enormous. Based on a very conservative estimate of the appropriate domestic value of gas and electricity, this *Survey* estimated aggregate energy subsidies in 2000 to have remained close to 5 per cent of GDP. Despite the progress in recent years, non-payments also remain a serious problem in the gas and electricity sectors. Finally, a remaining lack of transparency and reliable information has complicated the effective regulation of Gazprom and RAO UES, as well as hindering the attraction of outside investment.

Fundamental regulatory reform in electricity and gas is of vital importance

Fundamental regulatory reform in electricity and gas is of vital importance. Currently, average domestic electricity and gas tariffs are too low, cross-subsidisation is too high, and regulation is too politicised and unpredictable. The health of the electricity and gas sectors, as well as the creation of conditions to support rational energy consumption,

depends on the creation of a clear and depoliticised regulatory regime that sets sufficient tariffs to cover necessary fixed investment as well as variable costs. Furthermore, in accordance with international best practice, these tariffs should be set for a fixed period of time under which additional profits from cost reduction can accrue to the regulated firm. The huge cross-subsidies in gas and electricity should also be reduced. Such a regulatory reform is critical for both promoting rational energy consumption and creating conditions under which these industries can attract sufficient investment capital to solve the looming problems mentioned above. For achieving depoliticisation, transparency, and credible commitment in regulation, the recent experience of Chile, where important regulatory practices have been codified into laws, may be of value to Russia.

The reduction in energy subsidies should be carried out in a sequence of precommitted steps

The immediate introduction of much higher average energy tariffs and much lower cross subsidies would imply a major shock to many Russian firms and raise social policy concerns for poorer households that would be difficult to meet in the short run. For this reason, increases in energy prices and reductions in cross-subsidies should be carried out in a sequence of steps. These steps should comply with a pre-committed and rigid time schedule, and not be subject to renegotiation. If commitment to this schedule can be made credible, the gas and electricity industries could hopefully attract considerable investment even before the price adjustments are completed. This credibility, in turn, will depend on the successful depoliticisation of the regulatory process, allowing regulators to function on the basis of strict laws or contracts. The exact degree to which prices need to be raised should depend on a comprehensive audit of these industries, preferably by an independent and reputable third party. During the process of raising prices and eliminating cross-subsidies, a key priority should be measures to combat and prevent a rise in non-payments. The elimination of cross-subsidies will relieve the burden of higher energy prices somewhat on industrial users, but the resulting burden on poorer households means that a fundamental part of the reform commitment should be an explicit significant programme of social assistance. As argued above, under current circumstances, much of this assistance should come from the federal government.

Transferring authority for electricity pricing to a single regulatory body would be useful

The current authority of regional energy commissions and administrations poses a particular problem for electricity pricing. The government is currently considering proposals that would transfer authority for electricity pricing to a central regulatory body, perhaps leaving heating pricing at the subnational level. Although this proposal faces some significant opposition, it could be quite an important element for supporting the feasibility of the regulatory reform described above.

Reforms to introduce competition in the gas and electricity industries could be of potentially high value...

The economic programmes of the Russian government contain proposals for major organisational reforms within the gas and electricity industries themselves. The goal of these reforms is the introduction of competition into production and supply, leaving transmission and (most likely) distribution as regulated natural monopolies with the enforcement of non-discriminatory third-party access to the networks. This builds on recent experience in OECD and many other countries. In July 2000, the government approved a general reform strategy for the electricity industry, while a similar strategy for the gas industry should be elaborated in the near future. These types of reforms could indeed be of potentially high value to Russia, particularly considering the country's size and status as such a large producer and distributor of electricity and gas over such a large territory. The primary benefit of such reforms is the avoidance of large inefficiencies deriving from information, incentive, and political problems inherent to state regulation. Competition for consumers and market shares can hopefully support a truthful revelation of costs in generation and supply, through market prices, and enhance incentives for efficiency and rational investment decisions. While the implementation of such reforms has been complicated in a number of countries, most specialists estimate world experience in this area to be positive on balance.

... but their success depends on prerequisite measures for solving the fundamental regulatory problems

The success of reforms to introduce competition into gas and electricity depends on prerequisite measures to solve the fundamental regulatory problems discussed above. Unless investors or potential entrants are confident that prices will be sufficient to cover costs, including fixed costs, competition will not induce entry, investment will remain insignificant, sales of firms as part of unbundling will not fetch appropriate market value, and new owners will

likely be more interested in shifting assets to other sectors of the economy than in developing electricity or gas. If average prices are increased but high cross subsidies remain, one of two negative results would be possible. Under one scenario, new entrants would compete to service large industrial consumers that are cheaper to supply, leaving distribution companies burdened with universal service obligations and without the former source of finance. Under another scenario, regional administrations and distributors with universal service obligations would anticipate this problem and take collective measures to prevent any real competition from developing.

The reform strategy adopted for electrical power is potentially constructive, although a number of important questions await clarification

The reform strategy adopted for electrical power represents a potentially constructive compromise between different views within the government. It breaks apart the monopoly of RAO UES and separates the high voltage grid from the rest of the industry. Under this conception, however, regional electricity companies (Energos) will continue to own local distribution as well as production and supply, raising difficult regulatory problems for enforcing fair pricing and non-discriminatory third-party access to the distribution networks. This will most likely limit potential competition between generators and leave energy markets highly regionalised. On the other hand, given the severe remaining problems in contract enforcement and payments in the energy sector, maintaining vertical integration could have greater advantages in Russia at this time than in some other countries. In Russian gas and electricity, these types of problems have been particularly serious in relations between Gazprom or RAO UES affiliates and independent local distributors or producers. Although the strategy does not oblige Energos to divest of transmission or generation at this time, such a step could potentially be taken in the future. As the experience of the United States shows, regions could become interested in introducing such measures themselves as a means of securing lower energy prices on their territories through greater competition. Many key elements of the electricity reform strategy have yet to be clarified, however, including the timing of these reforms with other measures to address the problems in regulation and social assistance emphasised above.

Fiscal federalist relations

The nature of fiscal federalist relations in Russia continues to be problematic

The previous OECD *Economic Survey* placed particular emphasis on problems in fiscal federalist relations. Inter-budgetary relations in the Russian Federation continue to suffer from an excessive degree of central control over explicit subnational budgets, together with significant *de facto* informal autonomy of regional and local administrations. Under these conditions, the incentives for officials at lower levels of government remain highly distorted. The current system of severe explicit central control effectively absolves subnational administrations from genuine budgetary responsibility, while at the same time encouraging them to create their own informal budgets. Informal fiscal policies are conducted through many devices, such as bilateral agreements with major taxpayers in the region and hidden extrabudgetary funds, often to the detriment of businesses operating on their territories. The underground nature of informal budgetary activities can be associated with high levels of corruption, a higher (formal and informal) tax burden on businesses, and favouritism toward large industrial enterprises with the capacity to finance directly public goods in the region.

OECD work has recommended a comprehensive reform of fiscal federalist relations

The previous OECD *Economic Survey* and subsequent OECD work recommends a comprehensive reform of fiscal federalist relations in Russia. The fundamental goal of such a reform is the creation of a system with a clear explicit division of autonomy and responsibility between different levels of government in a manner that is consistent with strong incentives at lower levels of government to improve the business and investment climate. Under this proposal, a larger relative size of the federal budget allows the central government to ensure macroeconomic financial control and take greater responsibility for social policy, while lower levels of government receive genuine fiscal autonomy and responsibility within well-defined bounds. The question of autonomy for local (third tier) government is complicated by the fact that Russian municipalities possess an ambiguous legal status and vary in size from large districts to small rural communities. Genuine local autonomy may therefore require the creation of an explicit third level of state power in large districts (*raiony*).

The reform strategy of the Russian government is largely consistent with OECD recommendations, and important changes have already occurred

The long-term economic programme of the Russian government, as well as the more recently announced strategy for reforming fiscal federalist relations through 2005, are largely consistent with OECD recommendations. 2000 and 2001 have already witnessed a number of important changes in interbudgetary relations. The VAT has been made a 100 per cent federal tax, while all revenue from the personal income tax is being channelled to subnational budgets, representing a step in the direction of a clearer division of tax assignments. The relative size of the federal budget has increased, while the creation of the Compensation Fund in 2001 is an important step toward backing existing federal expenditure mandates with explicit sources of finance. New laws have increased the ability of the federal government to enforce federal laws and regulations at lower levels of government, which is an important condition for the delegation of genuine budgetary responsibility. Amendments to the Budget Code have helped clarify some expenditure responsibilities and assignments. Other measures have hardened budget constraints for subnational governments and pressured regions and localities to reduce sharply the use of money surrogates in their budgetary operations.

But recent measures have not yet promoted the development of explicit subnational autonomy

While the changes described above have increased the coercive power of the federal government in the regions and, in some cases, promoted a clearer and more rational division of budgetary assignments, they have not yet expanded explicit subnational budgetary autonomy. In fact, almost all of the policy measures and reforms in the last few years have further reduced, rather than increased, the autonomy of subnational organs. In a sense, the policies of 2000-01 can be viewed as a continuation of the measures of the Russian government since the latter half of the 1990s that aimed at cracking down on informal regional finance and establishing greater central control.

Incentives in regional and local administrations will remain distorted until they are delegated clear autonomy and responsibility

The recent measures aimed at increasing central control often have understandable motivations, and in many cases they are appropriate. Nevertheless, incentives in regional and local administrations will remain fundamentally distorted until such a time that they are delegated clear autonomy and responsibility within well-defined bounds. While these issues remain controversial within the Russian government, the attention given to the develop-

ment of subnational budgetary autonomy in the recently approved programme for fiscal federalist relations through 2005 is encouraging. On the other hand, this programme does not always identify explicit policy measures in this area, together with timetables for their implementation, leaving uncertainty over what will actually be implemented.

Summing up

It is critical that the government does not allow the favourable economic trends to deflate the momentum behind the reform process

In conclusion, the Russian economy has experienced a quite successful two years since the previous OECD *Economic Survey*. Short of a major deterioration in world commodity prices, short-term prospects also appear favourable. Medium and long-term prospects depend on compensating for the probable continued weakening of external factors of growth with key structural reforms and a more hospitable overall environment for business, investment, and competition. The Russian government has so far succeeded notably in exploiting the current favourable trends for the realisation of important reforms and policies. It is now critical that the government does not allow these trends to deflate the momentum behind the reform process. Despite important progress in structural reform, many complicated problems remain to be solved. This *Survey* gives special attention to three such problematic areas, namely the climate for small private businesses, the regulation and reform of the energy sector, and fiscal federalist relations. Other recent OECD work has addressed other important areas such as foreign investment, competition policy, trade policy, social policy, corporate governance, and the environment. The effectiveness and determination of the Russian government in pursuing policies and reforms during the past two years offers hope that it will succeed in meeting the formidable challenges that lie ahead.