"Better Policies" Series

RUSSIA

MODERNISING THE ECONOMY

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OECD

OECD "Better Policies" Series

The Organisation for Economic Co-operation and Development (OECD) aims to promote better policies for better lives by providing a forum in which governments gather to share experiences and seek solutions to common problems. We work with our 34 members, key partners and over 100 countries to better understand what drives economic, social and environmental change in order to foster the well-being of people around the world. The OECD Better Policies Series provides an overview of the key challenges faced by individual countries and our main policy recommendations to address them. Drawing on the OECD's expertise in comparing country experiences and identifying best practices, the Better Policies Series tailor the OECD's policy advice to the specific and timely priorities of member and partner countries, focusing on how governments can make reform happen.

We are grateful to the Executive Director of the International Energy Agency, Maria Van Der Hoven, for the involvement of the Agency in this project.

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Foreword

Russia has made fast progress in reducing poverty and catching up with the income level of advanced OECD countries over the past decade. However this progress has been largely supported by rising oil prices rather than the structural transformation of the economy. It has also been uneven. Regional and personal inequalities remain extremely large. Continuing the improvement in living standards requires simultaneously reducing dependence on natural resources, modernising the economy and fostering more inclusive and sustainable growth.

Russia has many assets it can rely on to succeed in this challenge, including low debt, high labour force participation and abundant energy resources. Its leading position in areas like space technology suggests an untapped potential in other segments of the economy. To reap the fruit of this potential, renewed reform efforts are indispensable. This is essential not only for Russia but also for the world at large.

Drawing on experiences in OECD countries and in our key partners, this report presents an OECD view of major policy challenges in Russia, including the fiscal framework, financial sector, competition, business climate, governance of public enterprises, innovation, trade, social policies, employment, education, health, energy, agriculture and green policies.

The OECD looks forward to deepening its relationship with Russia and to working with Russia, including through the OECD accession process, to contribute to making the Russia economy modern, vibrant and inclusive.

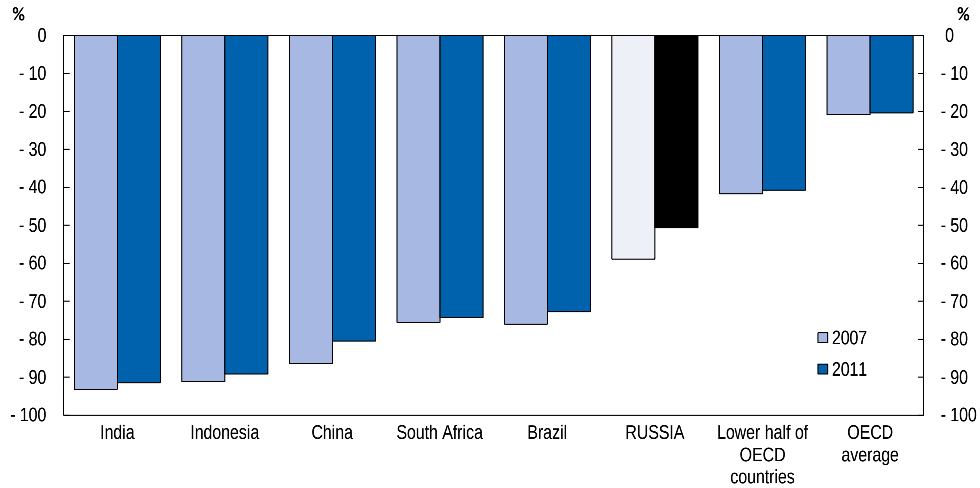
Angel Gurría

Secretary-General

Modernising the Russian Economy

Russia still has a long way to go to reach the living standards of the most advanced market-oriented countries, despite clear improvements in the past decade (Figure 1). To narrow the gap, Russia needs to modernise its economy, reduce its dependence on revenues from natural resource extraction and ensure more sustainable and broad-based growth. By making it more attractive to live, study, work, innovate and invest in Russia, the country can free the great potential of its people and ensure growth well beyond its natural resource endowment. Achieving this requires a combination of strengthened macroeconomic policy settings and decisive structural, social and institutional reforms.

Figure 1: Percentage GDP per capita gap compared with the upper half of OECD countries



Note: Compared to the unweighted average of the 17 OECD countries with highest GDP per capita in 2011 and 2007, based on 2011 and 2007 purchasing power parities (PPPs). The OECD average is based on a simple average of the 34 member countries.

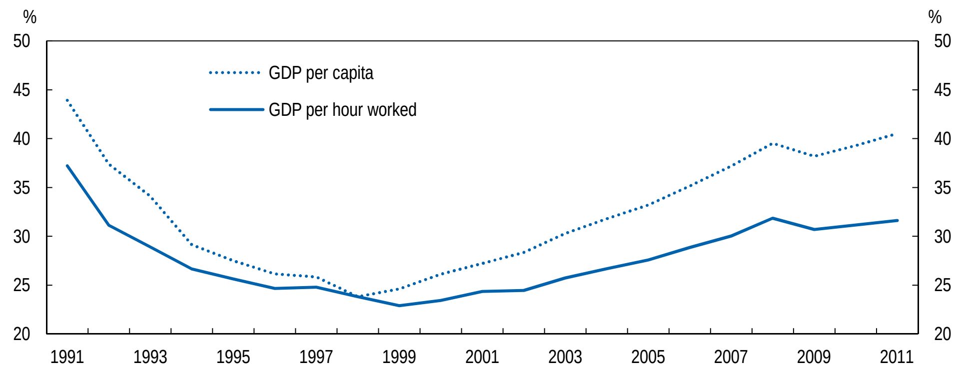
Source: OECD National Accounts Statistics (Database); World Bank (2012), World Development Indicators (WDI) (Database); India National Sample Survey (various years), annual population estimates from the Registrar General.

Unlocking high potential with structural and institutional reforms

The GDP per capita gap relative to the upper half of the OECD narrowed rapidly during the boom period of 2000-08 (Figure 2), but the impact of the global crisis was deeper and took longer to overcome than in other emerging economies. Output growth has resumed, but the trend has fallen to below 4%, and remains excessively dependent on the revenues from natural resource extraction (Figure 3). Moreover, the economy is not fully exploiting the high skill level of the Russian people.

Figure 2. GDP per capita and labour productivity

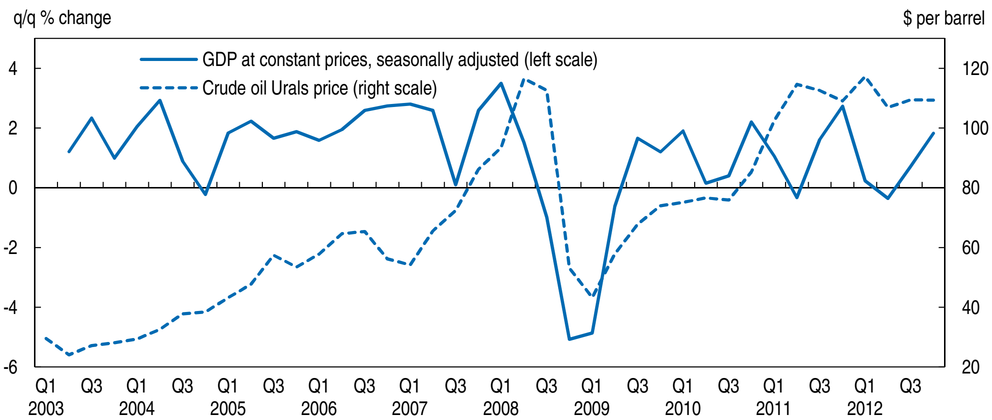
As a percentage of upper half of OECD countries[1]



1. Simple average of the top 17 OECD countries in terms of GDP per capita and GDP per hour worked (in constant 2005 PPPs).

Source: OECD, *Going for Growth 2013* (forthcoming).

Figure 3 Economic dependence on oil and gas extraction



Source: Datastream and Rosstat.

Russia's relative strengths include very low public debt, high labour force participation, and a larger proportion of high-school students going on to tertiary education than in OECD countries. In areas like space technology, Russia is a leader. On the other hand, the economy exhibits low productivity levels, extreme inequality, poor health and environment outcomes, low access to and use of ICT, and mixed educational results. The business environment is undermined by weak rule of law and corruption.

Russian leaders increasingly emphasise the importance of modernising and diversifying the economy and reducing budgetary dependence on oil and gas revenues. They have also recognised the importance of strengthening institutions. Ongoing initiatives aim notably at improving public administration efficiency, reducing corruption and stimulating innovation.

Most of the gap in living standards is associated with a low level of productivity and therefore, structural and institutional reforms can contribute significantly. Productivity enhancements are all the more important given that rapid population ageing will weigh heavily on potential employment and thus on growth potential, even if there is significant room to increase the retirement age.

The scope for improvements in the macroeconomic policy framework is also wide, in particular to better insulate the economy from oil price fluctuations. After the crisis, the budget has become increasingly vulnerable to a correction in oil prices, with the non-oil deficit expanding rapidly to above 10% of GDP. Gradual consolidation is needed, underpinned by a strengthening of the fiscal framework. This should include the consistent implementation of the new fiscal rule adopted at the end of 2012 which bases future budgets on the long-term average oil price (see chapter *Strengthening the fiscal framework*).

Monetary policy has delivered a gradual decline in inflation over the past 12 years. However, switching to a low-inflation policy, featuring more exchange rate flexibility as a main external shock absorber and increased emphasis on central bank rates, is not without difficulties. It would also depend on further financial sector deepening that would strengthen the transmission of policy rates to real activity.

Strengthening the rule of law, reducing corruption and broadening competition through less restrictive product market regulation will contribute to improve significantly the business environment and performance of the economy (see chapters *Improving the business climate* and *Strengthening competition*). The governance of public enterprises must be improved and greater openness to foreign direct investment encouraged (see chapters *Reducing the size of SOEs sector and improving its governance*, *Improving the foreign investment climate* and *Reducing trade barriers*). Ensuring access to long-term financing is also key, in particular to support SMEs. The development of the private financial sector is therefore important (see chapters *Strengthening the financial sector* and *Modernising the SME sector*).

Modernising the Russian economy also requires competent, accountable, open and dynamic public institutions with high levels of integrity (see chapter *Strengthening the effectiveness of public administration*). This also contributes to a more favourable climate for business R&D and the diffusion of innovation where performance is weak despite huge potential (see chapter *Strengthening innovation*).

The population does well in terms of the number of years of schooling, but educational performance ranks below most OECD countries in PISA and other tests, and there is a mismatch in the demand and supply of skills. There is therefore a need to invest in human capital, not only for the benefit of individuals and the labour market, but also to respond to the needs of a fast-growing and modernising economy (see chapter *Getting the right skills and competencies for a modern Russian economy*).

Promoting more-inclusive and environmentally-friendly growth

As in OECD countries and other large emerging economies, promoting higher growth in itself is not sufficient to really improve the well-being of the Russian population. The challenge is to promote inclusive growth that is also respectful of the environment.

Russia is characterised by high levels of both inter-personal and inter-regional inequality, which exceed those of most OECD countries and pose considerable challenges for social and regional policies (see chapters *Fostering regional development* and *Social policies to promote equity*). Tackling inequality requires a policy agenda that includes labour market reforms, as well as changes to the tax-benefit system to make it more effective and redistributive. Income inequalities take their roots in a very fragmented labour market where the unemployed receive little effective support (see chapter *Striking a better balance between labour market flexibility and workers' protection*). Striking such balance would reduce income inequalities and boost productivity. Gaps in health coverage and differences in quality contribute to the high levels of inequality more generally in Russia. A more efficient and better-funded healthcare system would support human capital investment and mitigate the social impact of high income inequality. Improving the quality of education outcomes would also contribute to reducing inequality while supporting productivity growth.

Regional disparities are difficult to overcome *inter alia* because of barriers to factor mobility and lack of infrastructure. Addressing them requires deep reforms to the fiscal federalism framework and effective regional policies, including the upgrading and development of key infrastructures.

Energy and resource use efficiency is essential to ensure that the current pressure on the environment does not damage Russia's growth prospects and the quality of life of its citizens. Russia has one of the most energy-intensive economies in the world (it is the fourth largest emitter of greenhouse gases, GHGs), even though energy use has declined substantially in absolute terms since the Soviet era. Low energy efficiency contributes to poor air quality, and Russia has one of the world's highest rates of premature mortality attributable to air pollution. Fairly ambitious official targets for energy efficiency gains have been established, but it is necessary to improve the policy measures to achieve them. There is also scope for Russia to modernise its large energy sector. A major reform of Russia's environmental policies has been proposed. This includes upgrading the regulatory and economic instruments for sustainable resource use in agriculture, and energy efficiency legislation (see chapters *Better policies for agriculture* and *Reforming the energy sector to modernise the economy*). If well implemented, this could constitute an important platform for a greener growth path (see chapter *Promoting a greener growth*).

The implementation challenge

Despite significant efforts to advance the structural reform agenda, as in many countries, the results are not always clearly visible and major implementation challenges remain.

First, it is essential to progress simultaneously on various fronts in order to reap synergies from the different measures and avoid bottlenecks in one area limiting the impact of key reforms in others. For example, it is essential to address major weaknesses in the business climate in order to ensure the success of privatisation programmes.

Second, the challenge of implementation and enforcement of major reforms in a large and diverse federal country is compounded by the number of recent reforms and their complexity. Thus, it is necessary to strengthen the fiscal, administrative and human capacities of the regions and to develop monitoring mechanisms which would play a key role in ensuring the implementation and success of ongoing and future reforms.

Strengthening the Fiscal Framework

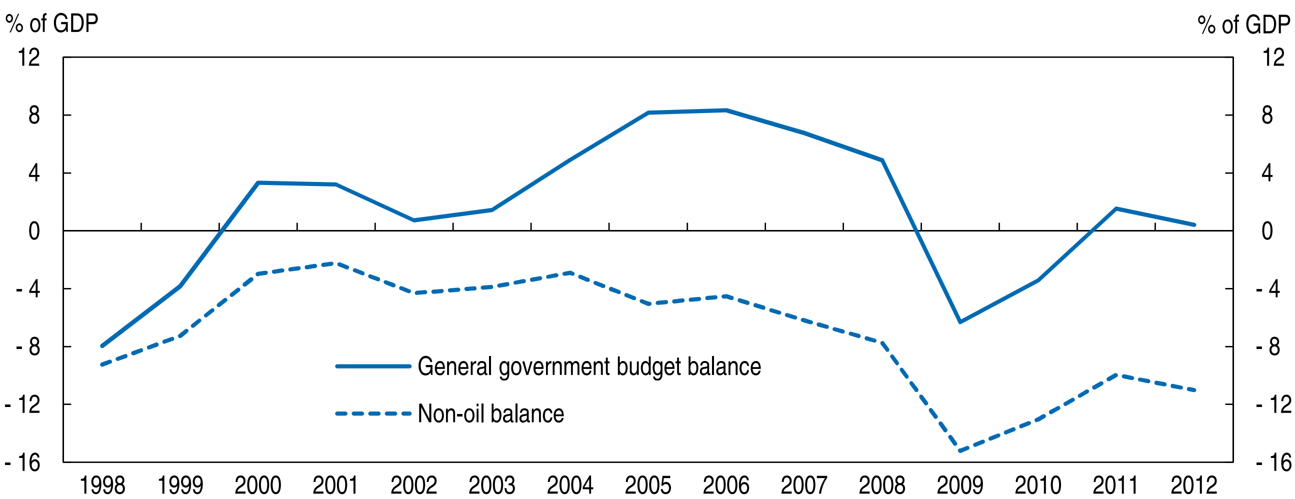
Russia has progressively built modern fiscal institutions and fundamentally reformed its tax system. Fiscal outcomes have been positive over the last twelve years and public financial assets exceed gross public debt, unlike most OECD economies. Nonetheless, fiscal policy continues to face major issues linked to Russia's natural resource wealth, notably commodity price and real exchange rate volatility. The key challenge is to find the optimal balance between fiscal stability, intergenerational equity, and pro-growth and social spending. High levels of income inequality and uneven distribution of wealth, which have moderated only slightly as a result of the tax and benefits system, present an additional challenge. At the same time, the long-term sustainability of public finances has been called into question by population ageing.

Strengthening the fiscal framework

Fiscal outcomes improved markedly in the past decade compared to the period leading to the partial government default in 1998. This reflects rising oil prices; strong output growth; and an initial commitment to restrain spending of windfall gains, supported by an institutional mechanism to manage resource wealth. Russia has developed institutions that promote fiscal discipline and the main features of budgetary formulation and execution are consistent with OECD best practice. Measures include three-year budgets; limiting the scope of the parliament's budgetary amendments; fiscal reporting; macroeconomic forecasting; and financial risk management. The government has paid off most of its debt and accumulated assets in two reserve funds.

However, the non-oil deficit deteriorated procyclically between 2004 and 2008. The budget framework then allowed the non-oil deficit to expand rapidly in 2008-09 in response to the global crisis but was then unable to refill the reserve funds. No substantial improvement in the non-oil balance was achieved. The large non-oil deficit puts upward pressure on the real exchange rate, hindering diversification of the economy. This is compounded by the long-term fiscal pressures associated with population ageing. Reducing these requires increasing women's pension age to that for men; a gradual rise in pension age in line with gains in life expectancy; and phasing out early retirement options (see chapter *Social policies to promote equity*).

Figure 4. Overall and non-oil general government balance



Note: Net of one-off tax receipts from Yukos in 2005 and 2007.

Source: IMF, World Economic Outlook database, April 2013.

More generally, there is a need for further improvements to the fiscal framework. There is significant scope to enhance budget transparency, particularly to reduce the use of "closed" or "secret" appropriations, which accounted for about 20% of the total budget in 2011. Furthermore, while the 2010 budget reform marked a clear shift to performance budgeting, the development and use of performance information remains a challenge. Future success will depend on how performance budgeting is taken on board by ministries and government agencies.

A fiscal rule which based future budgets on the long-term average oil price was adopted at the end of 2012. This rule should lead to an improvement in the overall budget balance in the next three years. Although the rule has faced significant criticism from those in the government arguing for higher spending, consistent implementation should remain a priority, especially given that recent spending promises have created uncertainty about the medium-term direction of fiscal policies. A quicker reduction in the non-oil deficit could be achieved if the fiscal rule was accompanied by binding ceilings on annual expenditure growth to reduce the risk of procyclical and inefficient expenditure increases. Finally, the efficiency of the rule-based framework could be strengthened by setting up an independent fiscal council.

Regional and local governments face a fiscal gap, leading to a reliance on transfers, which account for almost half of total revenues (see chapter *Regional policy and fiscal federalism*). The remaining deficits among about half of local governments are financed in an ad-hoc manner, hampering sustainable and rules-based policies. This problem is aggravated by frequent spending obligation increases planned centrally but that need to be implemented by regions. The tax base is limited to a personal tax on property and a land tax at the Municipal level; and to a corporate tax on property and a transport tax at the Regional level. Moreover, ceilings for local tax rates and the absence of linkages to the market value of land reduce tax revenues. This limits the fiscal autonomy of sub-national governments and increases their dependence on large incumbent enterprises in providing essential social services. Fostering the growth of sub-national revenues and promoting more rules-based federal fiscal relations is therefore important.

Reforming taxation

Russia has made major improvements to the structure of its taxation and to the efficiency of tax collection. Tax bases have been broadened, rates cut, and compliance improved. Nonetheless, further reforms are needed to speed up convergence with income levels in advanced economies. The tax burden on Russian firms is moderate, but inefficiencies remain. Oil and gas taxation should be adjusted to better capture economic rents without unduly harming incentives for exploration and development. Tax on corporate profits is already low after the recent cut to 20%, but further reductions should not be ruled out.

Indirect taxation could be increased. Alcohol taxes are relatively low and tobacco taxes are lower than in any OECD or major emerging economy, while alcohol and tobacco consumption weighs heavily on Russia's health system (see chapter *Modernising the health care system*). Russia could also increase the revenue share of property taxes and expand the use of green taxes (see chapter *Promoting a greener growth*). More redistribution would also help to alleviate poverty, which remains far more prevalent than in OECD countries (see chapter *Social policies to promote equity*).

Key OECD Recommendations

- **Increase budget transparency, avoid supplementary budgets and sustain the implementation of the performance budgeting reform.**
- **Build wider and stronger consensus around the newly established oil-price based fiscal rule** to insulate the economy from oil price related volatility.
- **Address weaknesses in the municipal and regional funding regimes** to foster accountability for economic development on the regional level. Make federal fiscal relations more rules-based.
- **Reform the tax system further** by improving taxation of rents from natural resource extraction; shifting taxation from labour income to indirect taxes; and increasing overall progressivity.

Strengthening the Financial Sector

The financial sector, supported by decisive policy action, withstood the global crisis well. Since then, credit growth has picked up strongly and its role in the economy has increased further. However, access to long-term financing remains difficult and the system faces two major challenges. First, it needs to converge on best practice in respect of prudential supervision and second, it needs to find ways, together with other countries, to develop counter-cyclical bank regulation, promote greater transparency, and deal more effectively with liquidity risk.

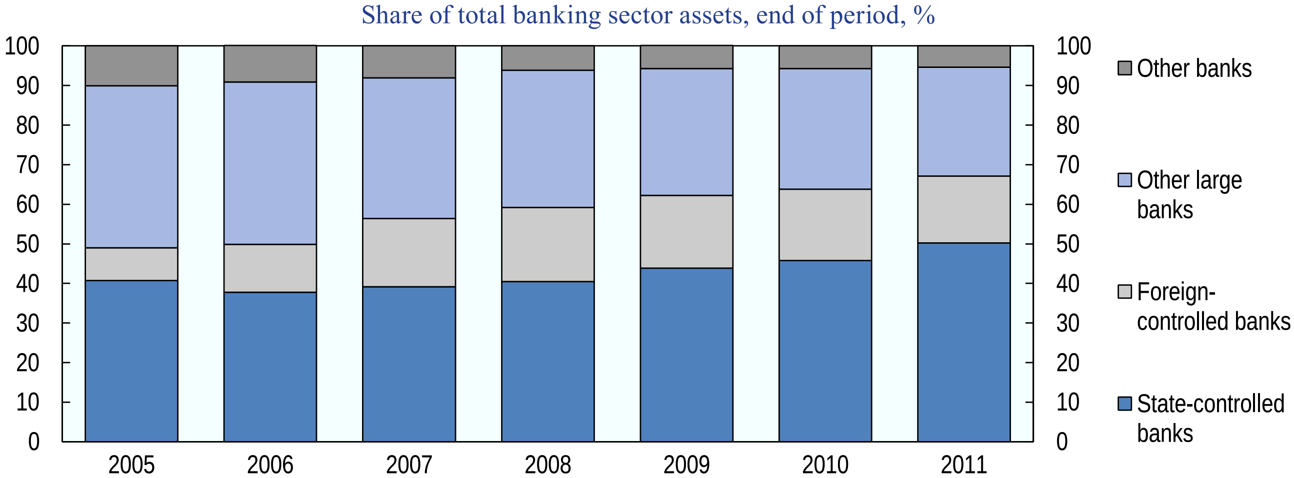
The banking system currently plays a greater role in intermediating savings and investment than ever before, with assets currently exceeding 75% of GDP compared to 60% in the end of 2007. The system has become increasingly sophisticated and integrated into global financial networks. The 2008 global financial crisis put the Russian banking system under stress, but speedy and energetic provision of liquidity by the Central Bank of Russia helped to prevent major bank failures, and credit growth has been very strong recently. Bond and equity markets have grown rapidly in the past 12 years. After being severely affected by the global financial crisis, they have rebounded strongly, while remaining volatile.

The Russian equity market is larger in relation to GDP than those of most middle-income countries, although capitalisation is dominated by a small number of natural resource extraction companies, and the main indices are highly correlated with commodity prices. The part of a company's shares that are freely traded is generally relatively small, with most major companies controlled either by the state or private majority shareholders. This exposes small shareholders to unprotected risks. Fund management and venture capital remain underdeveloped. There are regulatory impediments to long-term investment financing, in particular due to investment restrictions imposed on insurers and pension funds.

Developing the private banking sector

Figure 5: Structure of the banking system

Share of total banking sector assets, end of period, %



Note: Other banks and other large banks are private domestically-controlled banks.

Source: Central Bank of Russia, Banking Supervision Report.

The banking system is dominated by state-owned banks (Figure 5), with limited foreign ownership and an increasingly marginalised private domestic bank sector. This may inhibit the development of a sound, market-oriented financial system. State-owned banks occupy the top five rankings by size, and increased their share of total bank assets to over 50% after the onset of the crisis, although current privatisation plans envisage the sale of the second largest bank by 2017. All but one of the other top 10 banks are owned by non-residents, but foreign-owned banks' market share is only around 15%. Minimum capital requirements are being raised to encourage consolidation among the small banks, which do little genuine banking business. Rather, many were established to act largely as treasuries for non-bank corporations and as trusts for third parties.

Improving financial regulation

The authorities have made steady progress in building the regulatory framework for the development of the financial sector. The objective to develop Moscow as an international financial centre has given impetus to a number of important regulatory initiatives. Russia has also signed up to various financial sector reform initiatives in the context of its membership of the G20 and the Financial Stability Board. Among recent changes, insider trading legislation was adopted at the end of July 2010 and new laws on payments systems, central depositories and central counterparties have also come into force. International financial reporting standards were introduced in the banking system around mid-decade and have begun to be applied more recently to large listed companies.

But corporate governance, risk management, and transparency are still well short of the requirements for a competitive international financial centre. Some of these deficiencies have also been observed in banks elsewhere, but in the case of Russia they have been compounded by macroeconomic volatility and by weaknesses in the business environment. These concerns weigh on investor confidence and result in weak demand and supply of assets with longer maturity.

Steps have been taken to address weaknesses in financial oversight. In 2011, the insurance supervisor, the Federal Services of Insurance Supervision (FSIS), was integrated into the securities supervisory body, the Federal Financial Market Services (FFMS). However, the FFMS in its current form lacks the resources and the degree of independence needed to perform all its regulatory and supervisory functions. More sweeping institutional reform is on the way. In October 2012, the Russian authorities announced their intention to transfer the functions of FFMS to the Central Bank. The creation of this mega-regulator may bring benefits by consolidating oversight functions and increasing the resources available for supervision of insurance and securities markets, while extending supervision to the non-bank financial sector. Legislation establishing the merged Central Bank is due to be passed in April 2013, with the integration of the FFMS with the Central Bank to commence in June and completed by end of 2014.

Nevertheless, an open and transparent consultation process is needed before the new structure is established, to ensure: the independence of the supervisory function; clear lines of responsibility; adequate access to information; and necessary powers to act, including control over related-party lending and intra-group activities. Given the concentration of authority in this new structure, which will also include monetary policy responsibility, clear accountability mechanisms to its responsibilities will be essential.

Key OECD Recommendations

- **Proceed with announced plans to reduce state-ownership of banks** and reconsider the ownership of Sberbank.
- **Ensure effective implementation of recent legislation**, including on insider trading and financial reporting.
- **Encourage long-term investment financing** by removing restrictions on investment diversification by insurance companies and private pensions funds.
- **Establish effective consolidated supervision**, including supervision of related-party lending and the financial activity of non-financial entities.

Improving the Business Climate

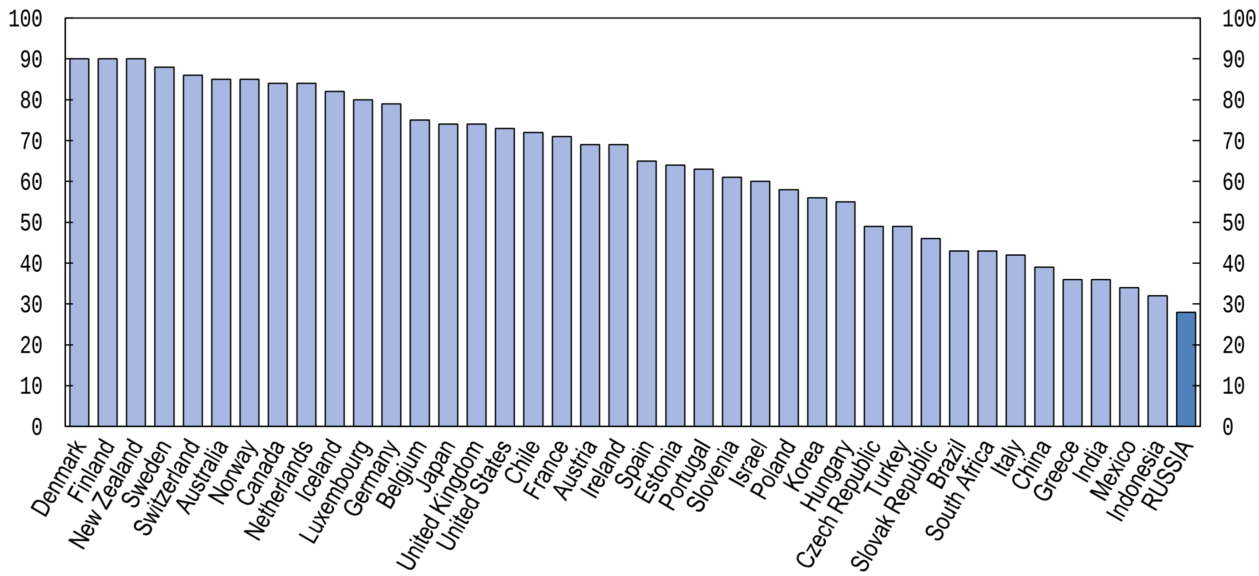
The poor business climate is a persistent handicap for the Russian economy. A range of indicators suggests that doing business in Russia is perceived as difficult and risky. Corruption is widespread, the rule of law is weak, and state involvement in the economy is pervasive. The implications are wide-ranging and serious: low levels of entrepreneurship and competition, sluggish innovation, low investment, and a growing dependence on revenues from natural resource extraction. While several aspects of the business climate have improved, more comprehensive policy action is needed to tackle corruption and improve the rule of law. Further improvement to the business climate would also require enhanced competition, a stronger financial system, a better matching of skills with labour market needs and more efficient public institutions. These issues are dealt with in other chapters.

A comprehensive approach to tackle widespread domestic corruption

Corruption is a serious burden on business in Russia. According to business surveys, it is among the main obstacles to market entry and growth. Transparency International's Corruption Perception Index scores suggest that Russia is perceived by Russians to be far more corrupt than any OECD country. The burden of corruption on Russian business has long been acknowledged by Russia's political leaders. Much has been done to address the problem, in particular in the framework of Russia's national anti-corruption plan for 2010-11, which included continued efforts to simplify licensing, registration and taxation. In March 2012, a new National Anti-Corruption Plan for 2012-13 was adopted, focusing on the need for increasing transparency for all state officials who use public funds. However, some gaps in legislation to tackle domestic corruption remain, for example on whistleblower protection and on lobbying, and little visible progress has been achieved so far. In the context of the Russian Presidency of the G20, where countries committed to enact whistleblower protection rules and have supported the implementation of principles for whistleblower protection, steps in this direction will be key.

Figure 6: Transparency International Corruption Perceptions Index 2012

Scale from 0 (highly corrupt) to 100 (very clean)



Note: CPI 2012 Score relates to the degree to which corruption is perceived to exist among public officials and politicians by business people and country analysts.

Source: Transparency International, Corruption Perceptions Index 2012.

One problem may be that the opportunity for corruption linked to the spending of natural resource rents has expanded sharply in the past twelve years. Reforms to improve public integrity are necessary, including identifying risks to integrity for particular jobs, activities and projects. Specific mechanisms to minimise those risks, while ensuring protection for whistleblowers, are required. However they may not be sufficient to ease the burden of corruption on businesses and citizens.

A broader set of policies to limit the scope for corruption in Russia is needed. Some of these policy measures would contribute to other goals as well. For example, less-restrictive product market regulation could reduce product market rents and limit the scope for rent-sharing between incumbent firms and public officials, while also spurring innovation and growth. Effective rules governing the taxation of oil and gas rents and the use of the revenues derived from it could decrease significantly rent-seeking behaviour, while helping to insulate the economy from oil price shocks. Public administration reform, by reviewing the large number of employees and reducing it when feasible, along with improved conditions and salaries of those who are retained, could reduce the motivation to seek bribes as well as the burden on business of state intervention in the economy.

How Russian individuals and companies conduct business outside Russia's borders also has a direct impact on Russia's ability to operate in the international market. Russia joined the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in April 2012; this is a sign that Russia is taking its commitments to combat corruption seriously. The Convention requires Russia to make it a crime for its individuals and companies to bribe foreign public officials for advantages in their international business dealings. The recent evaluation of Russia's implementation of the Convention by the OECD Working Group on Bribery shows that there are steps Russia can take to strengthen its anti-bribery framework. In particular, Russia should, in accordance with the Convention, explicitly and clearly ensure that the "offer" and "promise" of a bribe, as well as bribes in the form of non-pecuniary benefits, are appropriately criminalised. Russia's efforts to implement the OECD Anti-Bribery Convention would also be complemented by Russia's implementation of other OECD instruments, such as those focusing on combating corruption in procurement, lobbying, and other areas.

Improving the rule of law

International comparisons suggest that Russia lags in regard to the rule of law in several dimensions, including limitations on government powers, regulatory enforcement and open government. Moreover, regional and municipal administrations exercise very broad discretionary powers in the interpretation of regulatory requirements. This creates problems for effective and fair regulatory enforcement, often captured by vested interests. The creation of national and regional business ombudsmen in 2012 is a first step in protecting entrepreneurs' rights. The rule of law is a multi-faceted issue, and, as with combating corruption, a range of complementary measures are needed. The quality and consistency of laws and regulations need to be improved, their quantity reduced, and enforcement strengthened. Greater accountability of public institutions should also help to strengthen the business climate. In this respect, the law to strengthen controls over government officials' expenditures that came into force in January 2013 is an important step.

In addition, judicial reforms have been underway for several years and there is evidence that economic courts are performing more effectively, at least in Moscow, under the leadership of the Supreme Arbitral Court. Improved judicial independence remains critical, including better training and pay for judges. Further limiting tribunal presidents' scope for discretion would reduce their degree of influence on judges and prevent the selection of compliant judges for particular cases. Case assignments could even be randomised. Regular rotations among courts could reduce the risk of long-term informal relationships influencing legal decisions.

On the other hand, the laws adopted in 2012 on criminalisation of defamation, on protests and on foreign-funded NGOs may create additional barriers for increasing transparency and reducing corruption by imposing further restrictions on the ability of citizens and civil society to participate in the public debate and express voice. There is abundant evidence that an active and engaged civil society is critical for holding government accountable, minimising corruption, and ensuring the rule of law. It can help the authorities find innovative solutions to public governance challenges, expose corruption, give voice to the vulnerable and disadvantaged, enhance accountability to citizens, and keep people informed and engaged on the issues that matter most to them. Moreover, further steps are needed to improve media freedom. International stakeholders regularly express concerns related to the state control of the nationwide television and overall independence of the press. Russia was ranked 148th out of 179 in the 2012 Report of the Reporters Without Borders for respecting media freedom, and 172nd out of 196 countries in the 2012 Freedom of the Press Report, which considers the press as "not free" and the Internet as "partly free".

Key OECD Recommendations

- **Identify and address risks to integrity** for particular jobs, activities and projects; **strengthen protection for whistleblowers**; and **reduce opportunities for rent-seeking**.
- Strengthen the rule of law by **raising the quality and reducing the quantity of laws and regulations, and strengthening judicial independence**.
- **Improve the accountability and transparency of public institutions**, including by increasing media freedom.

Strengthening Competition

The competition framework in Russia (including markets for goods as well as for services) could be significantly overhauled. Currently, Russia has the highest barriers to competition when compared with any other OECD or emerging country. This holds back the diffusion of technology and lowers the speed at which labour productivity catches up with the level of the best performers.

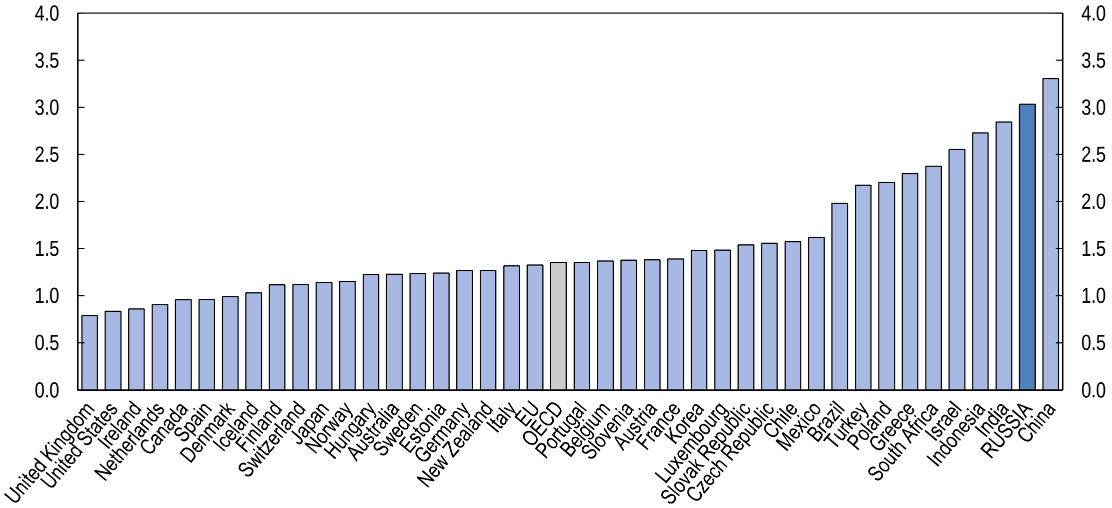
Russia's policy settings remain relatively anti-competitive, as suggested by the OECD's product market regulation (PMR) indicators. Russia's PMR is more restrictive than that of any OECD country and other economies for which the indicators have been calculated, except China. In particular, the PMR indicators reveal that state involvement in the economy is especially pervasive and administrative barriers to the development of new enterprises are high. All these problems are reflected in an underdeveloped small and medium-sized enterprise (SME) sector as well unsatisfactory innovation performance.

Reducing administrative burdens

Measures to lighten the administrative burdens for firms should include efforts to ensure that legislative or regulatory changes are preceded by sufficient consultation process, and provide for adequate transition periods to allow businesses to adjust. The government should also introduce a "deemed clearance" regime under which licenses are issued automatically if the licensing office does not act by the end of the statutory response period.

Figure 7: Overall product market regulation indicator

Index scale of 0-6 from least to most restrictive



Source: OECD, Indicators of Product Market Regulation Database

Strengthening competition policy

Russia's competition law has been amended several times in recent years, broadly in line with best international practice. The competition authority, FAS Russia, is large, well-financed and pro-active in enforcing the law. However, it is hugely overloaded. Cases are often overly formalistic, with insufficient assessment to distinguish real harm to competition from actions that could be considered to breach the letter of the law. Furthermore, FAS Russia too frequently intervenes to impose price controls. Competition is also hampered by subsidies to large firms, especially those introduced or expanded during the global crisis. The long transition period negotiated with the WTO means that relatively restrictive foreign trade and investment regimes will be maintained for quite some time. There is also room to liberalise and streamline the investment regime.

Key OECD Recommendations

- **Lighten administrative burdens for firms** by cutting red tape, introducing a "deemed clearance" regime, and systematically carrying out Regulatory Impact Analysis and stakeholder consultations.
- **Strengthen competition policy** by empowering FAS Russia to prioritise resources for the most important cases, eliminating subsidies to large firms, and liberalising foreign trade and investment regimes.
- Take WTO accession as an opportunity to **widen the scope for competition** and support concerned companies through framework measures rather than by establishing entry barriers.

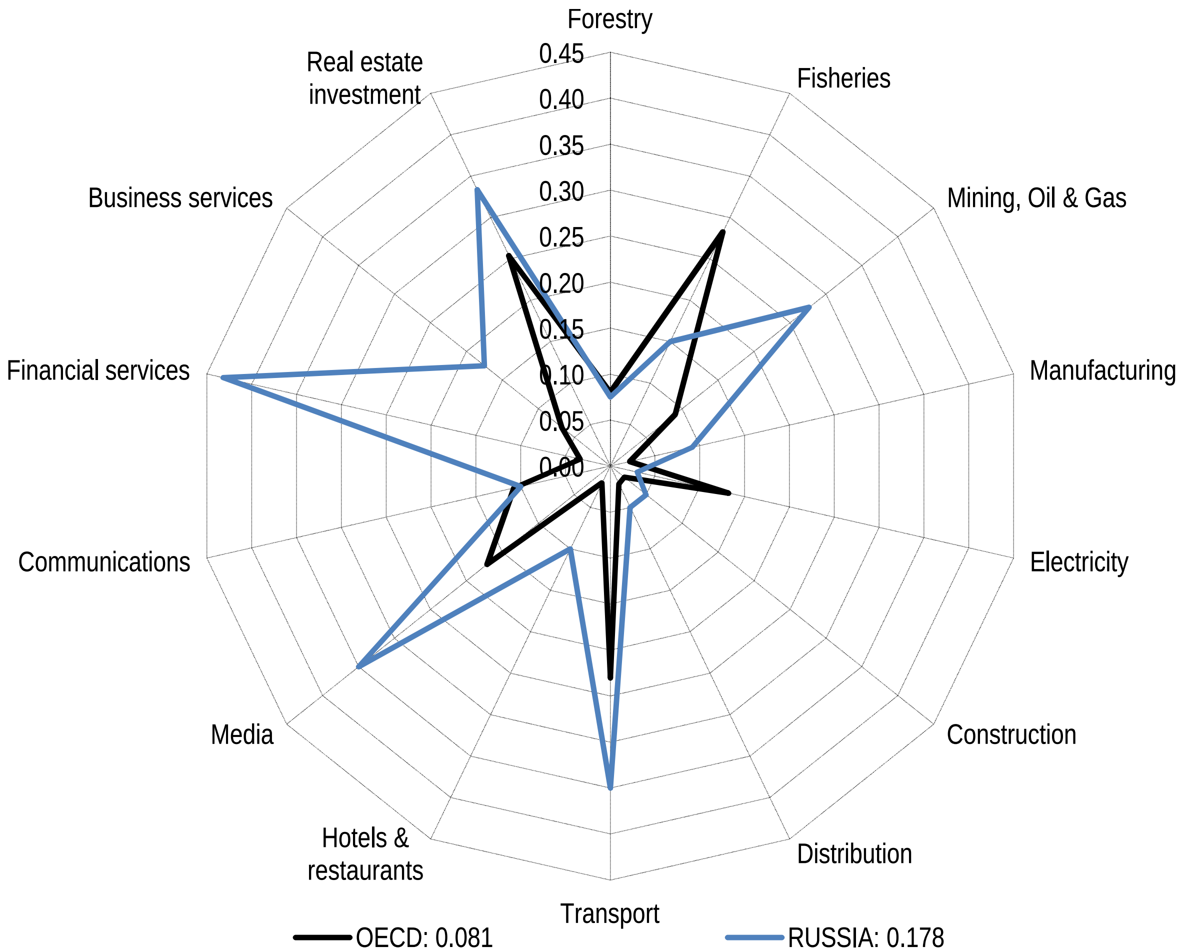
Improving the foreign investment climate

Foreign direct investment flows (FDI) do not reflect Russia's weight in the global economy. Russia's FDI abroad is lacklustre. While inflows at 3.4 % of GDP in 2006-2011 were close to the OECD average, they largely reflect investments in Russia by firms incorporated abroad (typically in offshore centres) under ultimate control of Russian investors. A more liberalised FDI regime combined with a friendlier business environment would support higher productivity growth by enhancing competition and spurring innovation.

More open and transparent FDI rules are needed.

The 1999 Foreign Investment Law (FIL) was a key step in improving the foreign investment climate, by granting right of establishment, national treatment, and protection against unfair expropriation. The 2008 Law on strategic sectors increased transparency and predictability for foreign investors. Recent efforts to relax restrictions and simplify procedures in some of these sectors are welcome but limited. Still, the legal regime for FDI as measured by the OECD FDI Restrictiveness Index is more restrictive than in most OECD countries.

Figure 8. FDI Regulatory Restrictiveness Index



Note: A higher score of the Index indicates more restrictive regulations for FDI. The Index does not account for actual enforcement of regulations or for non-discriminatory barriers to market access such as rules regarding activities reserved for the state.

Source OECD FDI Regulatory Restrictiveness Index database

More can be done to reduce the burden of approval processes for investors and ensure restrictive measures are proportionate to their stated objectives and transparent in their implementation. This is especially the case for financial services where barriers are highest, and includes quotas in banking and insurance and limitations on the scope of operations for licences granted to foreign investors. In addition, information on rules and procedures is difficult to obtain and spread across many sources, which makes for higher cost of investing in Russia, except for informed insiders.

Advancing integration into global markets

The legal regime for FDI is not the only factor behind the limited FDI inflows. As illustrated by the case of mining exploration (Box 1) the range of activities reserved to the state, or in which state owned enterprises (SOE) dominate, narrows the scope for investment. Ombudsmen to ensure that investors' rights are protected are helpful short term responses, but cannot substitute for addressing the underlying rule of law and business climate issues. Reinforcing the judiciary and reaffirming the availability of international arbitration would help build investor confidence. Implementing planned privatisation and clear rules of the game for SOEs would broaden the scope for investment.

Corporate responsibility instruments can significantly improve the welfare impact of investment and the level playing field for business but they are scantly used in Russia. Active promotion by the Russian government of the OECD Guidelines for Multinational Enterprises, a multilaterally-agreed code of business ethics addressed to companies, would be an important positive step.

To further open its economy Russia has taken steps to ensure free convertibly of the rouble, and now capital flows are largely unrestricted. However, Russia still maintains restrictions on issuing shares abroad, which increases the cost of capital for Russian businesses and encourages larger investors to incorporate abroad.

Box 1: What is Russia missing on expenditure on mining exploration?

Russia's lowest exploration density among countries with significant mining reserves reflects, in addition to broader business climate issues: more restrictive FDI rules in mining than in OECD countries on average; heavy state involvement (state control of oil and gas pipelines and all operati.ons on the continental shelf); licensing rules that do not protect property rights, notably moving from exploration to exploitation; and discriminatory rules on exploitation.

	Land area (millions of km2)	Exploration expenditures* (US$ million)	Exploration density* ($/km2)
Russia	17.0	471	28
Canada	10.0	1,778	178
China	9.6	314	33
US	9.6	704	73
Brazil	8.5	315	37
Australia	7.7	1,167	152
Mexico	2.0	570	291

Note * Indicates average 2006-2010.

Source: Foreign Investment Advisory Council and Kinross Corp. 2012. Fostering Foreign Investment in Mineral Exploration and Development in Russia

Key OECD recommendations

- **Open the legal regime for FDI** by reducing barriers to investment, in particular in financial services
- **Promote responsible business conduct** in line with the OECD standards to help level the playing field for all investors
- **Ease Russian firms' access to global financial markets** to raise capital.
- **Improve the quality of FDI statistics** to support policymaking.

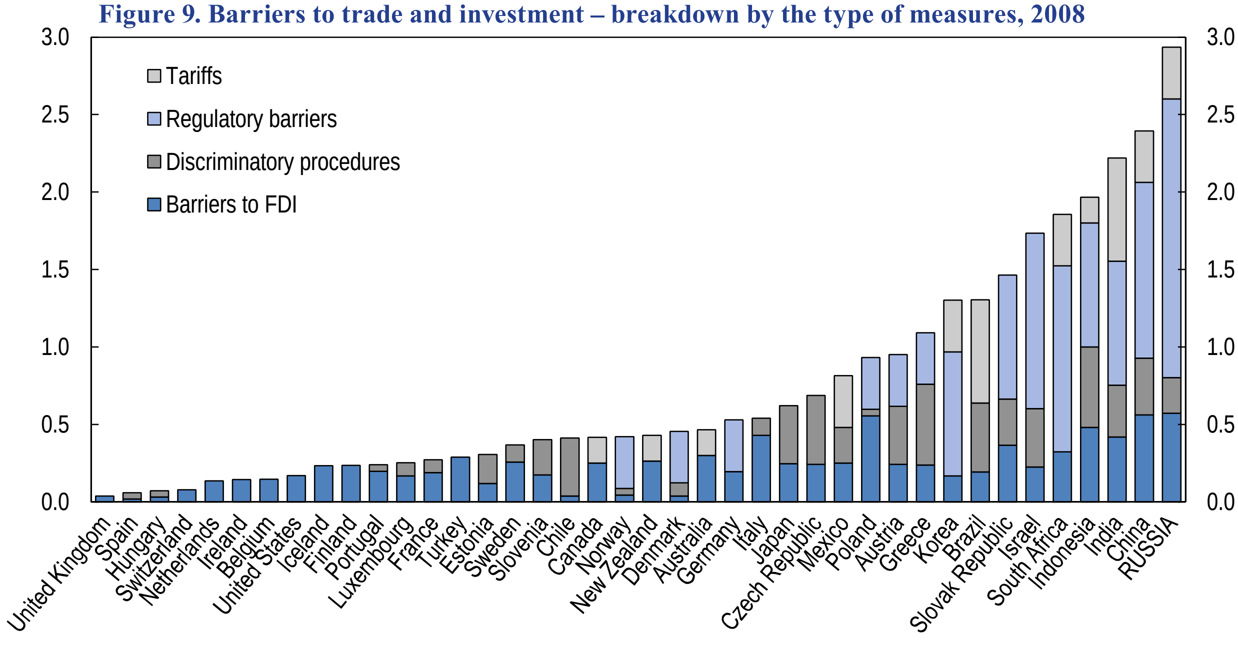
Reducing trade barriers

Russia's trade was affected by the financial crisis during 2008-09, but has since resumed growth. The country has undertaken an impressive process of economic reform, with WTO accession deepening its integration into global markets. Nonetheless, Russia continues to fall short of its economic potential with some significant barriers to trade remaining. In addition, some measures taken since acceding to the WTO have raised concerns about the policy direction.

Russia is a large trading nation: in 2011, it was the world's 6th importer and 11th exporter of merchandise (these rankings exclude intra-EU trade). Following two decades of reform, restructuring and institutional building, Russia's accession to the WTO on 22 August 2012 marked an important step in the nation's further integration into the global economy. After a phase-in period, Russia's average bound tariff will be reduced from 10% in 2011 to 7.8%. Access will also be liberalised in service sectors such as telecommunications, banking and insurance, transport and distribution, albeit some notable restrictions remain. Overall, the aggregate positive welfare effect of these reforms is estimated to amount to 3.3% of GDP, with the highest share of gains coming from removing restrictions to FDI flows (2.4%).

Still, the average trade-weighted tariff in Russia is twice as high as the OECD average (6%% versus to 2.2% on average in the OECD in 2011). Many regulatory barriers to trade and investment remain and Russia has only limited levels of integration into global production processes, or value chains. Successful integration requires a combination of low tariffs; fast and efficient border processes to facilitate imports; a vibrant services sector to support the competitiveness of manufacturing firms; and standards and certification requirements that are aligned with international norms. Public and private investment to build or upgrade supply-side capabilities and the ability to exploit new market opportunities are needed. In order to sustain the reform momentum, Russia could focus in particular on improving customs authorities' efficiency, removing economically meaningful barriers to trade in services, and improving the overall regulatory quality in the country.

Figure 9. Barriers to trade and investment – breakdown by the type of measures, 2008



Source: OECD Product Market Regulation database

Significant barriers to trade remain – including in services

The set of OECD Product Market Regulation (PMR) indicators that specifically cover barriers to trade and investment clearly shows a large scope for improvement terms of easing the flow of goods and services across borders (Figure 9). While the WTO accession has or soon will diminish some of these barriers, most notably tariffs, other measures will require sustained effort to push reforms further. In particular, increasing the efficiency of customs administration will be important, as Russia's weak performance contrasts sharply with that of OECD countries. For example, the World Bank's Trading Across Borders indicator places Russia at 162th place among 182 economies – far below OECD countries in particular regarding time, cost and documentation required for imports and exports. The on-going work at the OECD on Trade Facilitation indicators also shows that Russia lags behind the OECD and its income group, notably in the area of trade-related formalities (documents, procedures, and automation), fees and charges, and information availability.

Improving the quality of domestic regulations and reducing their undue impact on trade is another area where progress could be achieved. The use of international standards, streamlining of conformity assessment procedures, and systematic consultation of stakeholders play an important role. Further administrative simplification, including through streamlining and automation of formalities as well as the use of impact assessment procedures early in the regulation drafting process could also help ensure that domestic measures achieve their intended policy objectives in the least trade restrictive manner possible.

Finally, barriers to services trade still remain significant. This is particularly important for backbone services sectors, such as telecommunications and transport, which play a significant role in the performance of the economy at large.

Sustain the reform momentum

While the country's WTO accession has been welcome, some measures recently adopted by Russia have raised concerns about the direction of the country's trade policy. In particular, numerous bans on imports of certain agricultural and food products and the imposition of a recycling fee on imported vehicles have been heavily criticised by Russia's trading partners. These developments highlight the importance of focusing the reform agenda on remaining priorities. As the average level of tariffs in the country falls, Russian authorities will need to resist the temptation to use non-tariff barriers to restrict trade flows and international competition. While the reforms may be challenging and pose difficulties to some sectors, they will bring their rewards in a form of increased productivity and competitiveness in the medium to long run, observed in other open economies.

Key OECD recommendations

- **Improve customs and border procedures** to drive significant cost reductions for both importers and exporters.
- **Pursue the use of least trade restrictive regulations** through, among others, further administrative simplification and increased use of international standards.
- **Consider further liberalisation of the services sector** as a means to boost growth. Participation in the OECD Services Restrictiveness Index would help assess the key constraints to services trade in Russia.

Reducing the size of the SOE sector and improving governance

The state-owned enterprise (SOE) sector still accounts for around 50% of the Russian economy and this share continues to grow. Corporate governance rules and practices in the sector have improved, but still need simplification and streamlining, ideally under a single management model and respecting competitive neutrality rules.

The extent of state control in Russia is significantly above any OECD country, with the size of the state-owned sector estimated at around 50% of GDP. Many large companies are majority owned by the state, partly due to policies seeking to control "strategic" sectors of the economy and to promote "national champions." Currently SOEs exist in a variety of corporate forms, including State Corporations and Unitary Enterprises that are not totally transparent and which seem to have outlived their purpose. There are also diverse state ownership modalities, with prominent SOEs not subject to the oversight of the Federal Agency for State Property Management. This fractured ownership allows some SOEs to be included in ad hoc schemes that grant them exceptional status and limit the accountability of their senior management. The Russian authorities agree that the state-owned sector should be streamlined and governance improved to increase efficiency and reduce the drag of the state budget.

Reducing the size of the SOE sector

There is an ongoing discussion about reducing the size of the SOE sector through privatisation. Effective implementation of these initiatives would ultimately lower the extent of state control, associate private sector expertise with key SOEs, and enhance the competitiveness of the Russian economy. Privatisation plans should be complemented first with a publicly-disclosed, unified SOE ownership policy for companies remaining under state control, with additional company-specific objectives where necessary. And second, with the implementation of principles of competitive neutrality that foster a level playing field between state-owned and private companies, such as choosing the best corporate form, achieving a commercial rate of return or providing equal access to finance. The integrity of the market should also be protected by independent sector regulators.

Improving governance

The Russian state will remain a significant shareholder, with controlling or blocking stakes in several large and significant enterprises. Corporate governance of SOEs is therefore a key driver of potential economic growth and development, and the authorities have embraced an extensive corporate governance reform agenda. SOEs should operate on corporate and commercial terms, in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, and thus according to high standards of accountability and transparency.

The role of boards is paramount in improving corporate governance of SOEs, and the Russian authorities have achieved significant improvements in this area. Presidential decisions have called for the exclusion of high-level politicians from boards and the nomination of independent directors and "professional attorneys". Further reform should focus on the adoption of more transparent methods for the state to communicate with SOEs, including the development of a clear ownership policy with specific company objectives where needed, which could contribute to the formation of boards capable of objective independent judgment. This also includes revising the "system of instructions" under which some directors are currently required to vote according to the state's preferences on certain board decisions, including the selection of the CEO and Chair.

Progress will require maintaining a commitment to continuous improvement. But there seem to be contradictory forces at play. The privatisation process is conducted in parallel with expansion and control consolidation of the energy sector under Rosneftegaz, whose recent acquisition of TNK-BP will offset most of the reduction in the size of the SOE sector from recent and upcoming privatisations. Likewise, political appointees may return to some boards and SOEs' major transactions are to be placed under the direct control of the Prime Minister. Although this measure is intended to help limit the expansion of the sector, it is also likely to weaken their boards. A robust corporate governance framework relies on institutions and practices that should not depend on the Prime Minister´s power to rein in SOEs.

Table 1. Top 12 SOEs traded on the Moscow Stock Exchange

Issuer	State ownership (%)		Market cap, RUB Million	Listing level	PE ratio
	Direct	Total			
Gazprom	38.4	50.1	3,303,165	Off	2.8
Rosneft	0	75.2	2,632,056	B	6.6
Sberbank	50.1	50.1	2,018,811	A1	5.9
VTB Bank	75.5	75.5	550,852	B	6
Federal Grid Company of Unified Energy System	79.6	83.2	271,802	B	8.7
RusHydro	60.5	60.5	223,185	A1	9.7
Transneft	78.1	78.1	106,509	B	3.2
Interregional Distribution Grid Companies Holding	54.5	63.7	95,839	A1	4.5
Mosenergo	26.4	85	55,216	A1	7.3
Aeroflot	51.2	51.2	48,312	A1	10.2
United Aircraft Corporation	84.3	93.4	31,944	B	Losses
RAO Energy System of East	0.1	65.6	10,666	B	Losses

Note The PE ratio is an equity valuation measure defined as the ratio of total market capital value over the earnings of the company. Companies with higher (or more certain) forecast earnings growth will usually have a higher PE. It is also used as an indicator of investor's confidence in a given company or market.

Source: OECD using data from the Moscow Exchange, Datastream, Credit Suisse and PCM analysts' reports, December 2012.

Compliance with corporate governance rules is undoubtedly improving, but practices are not yet fully aligned with the rules. Besides, rules still contain prominent loopholes and enforcement efforts have only had moderate success. While overcoming structural challenges will take time, some relatively simple concrete actions, supported by sufficient enforcement and accountability measures, could have an immediate impact. Listed SOEs could in particular become a catalyst for improving corporate governance across Russia and set the example by meeting the more demanding corporate governance requirements for admission to the highest listing level (A1) at the Moscow Exchange. Currently, many SOEs trade at the lowest B level, subject to minimal obligations. Upgrading their listing level would force them to improve their corporate governance practices. It could also help reduce the risk premium charged by investors on Russian shares, which during 2012 traded at an average price/earnings (PE) ratio of 5.3. Improving investor confidence in the Russian capital market up to the level of other BRIC countries - with PE ratios of about 16 for India, 13 for Brazil and 10 for China according to Credit Suisse (see 2013 EEMEA regional equities outlook) could double today's valuation of the state's portfolio and revenues from future privatisation.

Key OECD recommendations:

- **Accelerate the simplification and streamlining** of the SOE sector, including by **effectively implementing privatisation plans**.
- **Develop a publicly-disclosed ownership policy** and, where necessary, SOE-specific objectives.
- **Ensure a level playing field** between state-owned and private companies.

Financing the Small and Medium-sized Enterprises Sector

The number of small and medium-sized enterprises (SME) in the Russian Federation is on par with or exceeds that of many OECD members, but employment and output is not in line with this large number of SMEs. Only 27% of all employees (19 million people) are employed by SMEs, and they generate only 23% of GDP, compared with 60% to 81% of employment and 48% to 71% of GDP in benchmark countries. Increasing the share of GDP coming from the SME sector has therefore become a government priority. To meet this objective, both SME employment and SME productivity need to rise, requiring important investments in physical, human and knowledge capital along with improvements in the business environment.

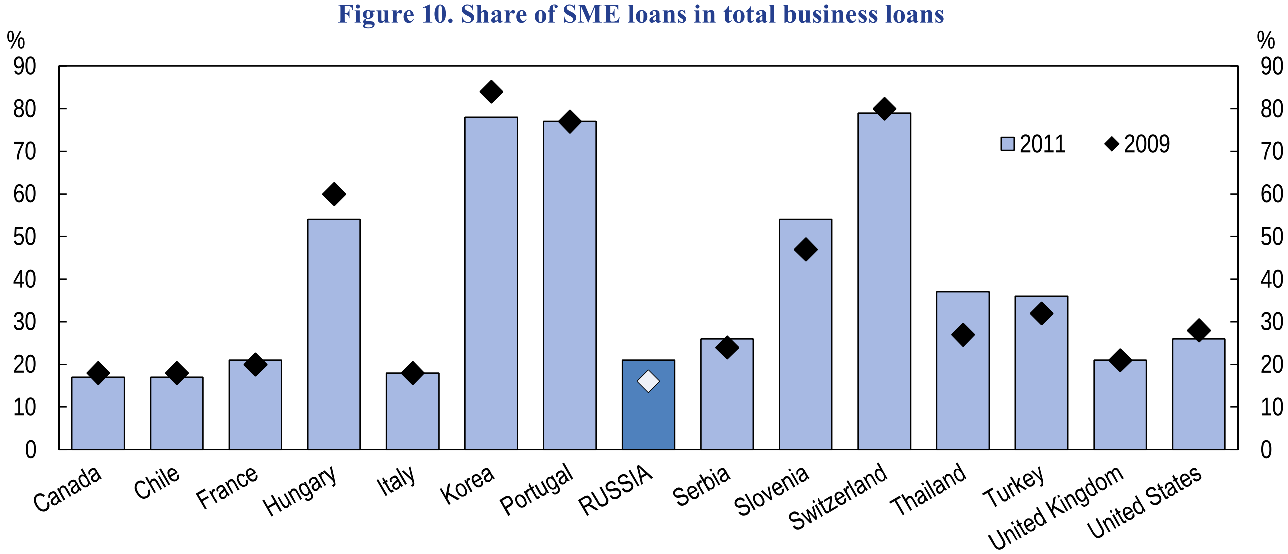
In 2011, there were 250 000 small and medium enterprises with 16 to 250 employees in Russia, amounting to 1.7 per 1 000 inhabitant, compared for example with 2.0 in Italy, 1.4 in Germany, 1.2 in Korea, 1.1 in Japan, and 0.2 in Mexico. In addition, there were some 1.6 million micro enterprises and 4.1 million self-employed.

The Government is engaged in a series of measures to develop SMEs and increase their productivity. The 2007 "SME Law" created a shared definition of SMEs for the first time and set out the arrangements for policy support. The main measures concern reduction of the administrative burden, financial support, property support, and support for innovative SMEs. The lack of a fully functioning SME finance market in Russia is a major obstacle, so the government created the "SME Bank" in 2009. The Bank provides state credit lines for SME lending to partner banks and financial institutions to encourage them to serve SMEs and finance their investments.

SME financing is still a major challenge

Government measures have clearly had an impact on SME financing. Total lending to SMEs (RUR 5.3 trillion) accounted for 21% of bank business lending in 2011, similar to the share in many key comparator countries (Figure 10). SME lending grew by about 50% between 2008 and 2011. Although this occurred in the context of growing business loan activity overall, the share of SMEs in total loans increased. The volume of equity finance also grew by 250% from 2008 to 2011.

Figure 10. Share of SME loans in total business loans



Source: Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard (forthcoming).

However, approximately 45% of SME loan applications are still rejected across the banking system. Interest rates on loans are typically very high, between 14% and 17% (compared with expected inflation of 6% to 7%), and banks commonly seek marketable collateral of up to 200% of the loan amount. These lending conditions do not necessarily reflect the real risks and profitability of SME activities. Several policy actions are required to ease the access of profitable SMEs to credit and hence improve their productivity and contribution to Russia's economic development.

First, it is essential to develop the private financial sector. The high share of state-controlled banks is not conducive to this and announced privatisations need to go forward. Furthermore, the state loans offered by the SME Bank should be replaced with loan guarantees, following international good practices such as that of Canada's Small Business Financing Programme outlined in the Box 2.

Box 2: Canada's Small Business Financing Programme

Government loan guarantees have significant advantages over loans in reducing public costs and building a private market. The Canadian government facilitates access to commercial loans for SMEs by providing guarantees of up to 80% of loan amounts of up to CAN 250 000 for businesses with annual sales of less than CAN 5 million that wish to purchase and improve their premises and equipment. Around three-quarters of the loans would not otherwise have been made. The programme has led to increases of 12% in the salaries and employment of beneficiary SMEs. Costs to the public sector are kept low by obliging the lender to pay an upfront fee of 2% and an annual fee of 1.25% for a guarantee.

Second, the short-term maturity of business loans limits the financing of long-term investment – approximately two-thirds of loans in non-state-owned banks are for less than 18 months. This reflects the lack of stability of long-term bank deposits and an insufficient regulatory and support framework for the inter-bank trading of SME loans. An example of a successful response to the latter problem is the German KfW public banking group's standardised platform (the Promise platform) helping commercial banks to securitise their SME loans. KfW acts as an intermediary by bundling small SME loan portfolios from different banks into pooled portfolios, which it sells on to other investors. In such schemes, if any risk is taken on by the public sector, the aid element should be conditional on banks' extending new loans to SMEs, rather than supporting existing loan portfolios.

Third, there is no centralised credit assessment bureau in the Russian Federation, which makes it difficult for smaller banks to assess their SME lending risks. A national credit bureau could help by gathering and disseminating SME credit information from financial institutions. For example, the Bank of France operates a company database providing data on the credit transactions and positions of individual SMEs together with an evaluation of their capacity to honour loans.

Key OECD recommendations

- **Reduce state involvement in commercial banking** by replacing SME loans with loan guarantees.
- **Improve the regulatory framework for SME lending**, focusing on reliability of deposits and securitisation of SME loans.
- **Facilitate the development of a national independent credit bureau** for risk assessment of SME borrowers.

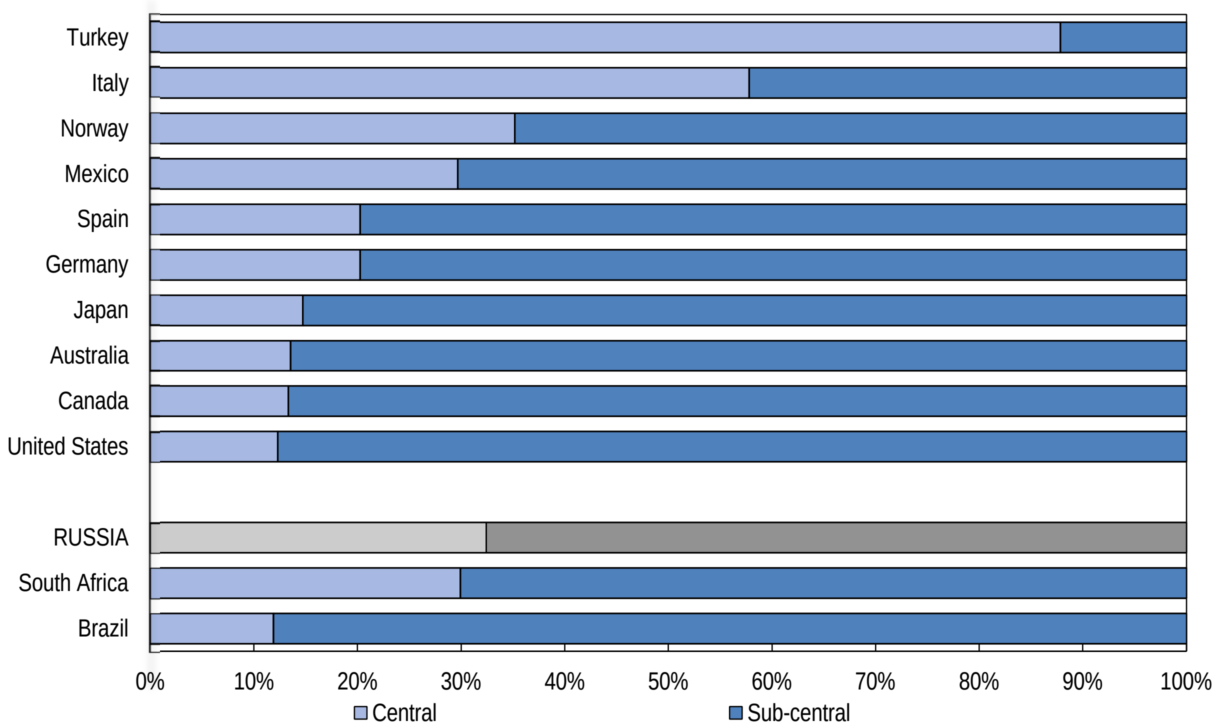
Improving the Effectiveness of Public Administration

Russia has introduced a wide range of reforms to increase the effectiveness of public administration by improving human resource management, monitoring the performance of public organisations, increasing government openness, and fighting corruption. In addition to ensuring effective implementation of the current set of reforms, further reforms are needed to build a world-class public governance system. This is essential to increasing competitiveness, strengthening business and citizen confidence, and boosting foreign and domestic investments.

Strengthening performance of the civil service

Russia has undertaken a wide range of reforms to modernise its public service, notably the 2009-2013 Civil Service Reform Programme to improve the professionalism of public employees. To advance further, Russia now needs to consolidate all ongoing reforms and fully implement relevant provisions of the legal framework. Measures should include the adoption of a competency-based framework for recruitment and promotion of public servants; the use of performance indicators for assessing senior managers' performance; and the introduction of a performance-related pay system to attract and retain talent for senior positions. The majority of public servants are employed at the sub-national level (Figure 11). It is therefore critical that modernisation, including incentives and accountability for implementation of reforms, concerns all government levels.

Figure 11. Distribution of public employment between levels of government



Source: *Government at a Glance 2011*. Data is from the International Labour Organization (ILO), LABORSTA database. Data for Turkey are from the Ministry of Finance and Turkish Statistical Institute. Data for Japan are from the Establishment and Enterprise Census.

Building an efficient public service in Russia requires not only changes to procedures and techniques but, more importantly, changes at the administrative and cultural levels to overcome remaining features of the previous regime, notably politicised appointments of senior public servants, compensation based on seniority, and limited transparency of administrative processes. Addressing these challenges calls for creating a non-fragmented community of civil servants at all levels of government with a clear understanding of performance expectations and opportunities for professional development. It also requires defining clear lines of authority and responsibility for human resources policy design and implementation; ensuring transparency, competition, and merit in the recruitment process; and clarifying the political and managerial interface. Currently, the interface between political and administrative appointments is blurred, as state civil servants in executive positions are largely appointed by discretionary means (though minimum qualifications for such positions are established by law). There are no consistent rules for recruitment, career development, training and separation from the service for senior managers. While the practice of political appointment of senior managers is common in a number of OECD countries, many of these countries tend to put in place safeguards to ensure merit-based recruitment at senior levels.

Strengthening integrity and transparency of the public sector

The fight against corruption is one priority of the authorities. The government's ambitious anti-corruption agenda includes the Federal Law of 4 May 2011, amending the Criminal Code of Russia and the Code on Administrative Violations; accession to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions; and the 2012-2013 National Anti-Corruption Action Plan. Since November 2011, members of legislative bodies have to report their incomes and assets, and banks have to provide information about public officials' accounts. Yet, gaps remain. Further strengthening of the integrity framework, notably regarding whistleblowers protection and lobbying, is necessary to ensure its consistency and effective implementation and greater transparency and accountability of public institutions. There is no specific legal protection for whistleblowers besides the general rules in the Federal Law on Counteracting Corruption. Clear and effective whistleblower protection within the public service is needed. In addition, developing mechanisms to ensure integrity and transparency of lobbying would strengthen the current integrity framework by providing guidance for policy makers on how to promote good governance principles in this important area of public concern. A comprehensive approach is also needed to reduce overall levels of corruption in regulatory and law enforcement bodies. Openness and transparency of public institutions are necessary for effective accountability and for preserving citizens' trust. The authorities have introduced a range of reforms, including the introduction of pre-trial procedures for considering complaints related to the quality of public service delivery; an "e-parliament" initiative allowing citizens to submit draft laws for consideration by the Parliament; and an "Open Government" initiative. To consolidate this momentum, stronger institutional mechanisms for citizen participation in decision making and the monitoring of public authorities' activities are essential. Further progress is also needed in the implementation of access to information provisions in all branches of power. This could be achieved through an awareness-raising campaign throughout the administration, the clarification of the types of restricted information that cannot be released to the public, and independent mechanisms to review decisions regarding access to information requests. Finally, despite steps to improve the functioning of NGOs, including provision state funding, further progress is needed to develop the capacity of civil society and foster its active involvement in policy-making processes; this will help civil society to be an effective agent in governance transformation. The recent steps, including tightened provisions of new laws on foreign-funded NGOs and the new law on protests however have a strong potential to further restrict viability of an active civil society and hence overall openness, accountability and transparency of public organisations. It would be important to ensure that the application of the newly-enacted laws on defamation, protests and foreign agents, respects the freedom of citizens and stakeholders to effectively advance their points of view and participate in robust public debate.

Enabling effective implementation of laws and policies

While Russia is introducing many reforms at the policy and legal levels, implementation and enforcement still remain a challenge. This implementation gap is due to a wide range of factors, including the recent nature and number of the reforms, the sheer size of the territory, the scope of the challenges to be addressed, and the complexity of the legislative and regulatory stock. It is also linked to shared responsibility for

implementation among the central and 83 regional governments with vastly uneven fiscal, administrative and human capacities (see chapter *Fostering regional development*). Recognising this gap, the authorities have established a legislative monitoring centre in the Council of the Federation; introduced a mandatory monitoring of legislative implementation by the Ministry of Justice; and completed a full inventory of administrative functions. Further efforts to streamline the stock of regulation, build capacities at all levels of government and develop effective implementation and monitoring mechanisms are necessary.

Key OECD Recommendations

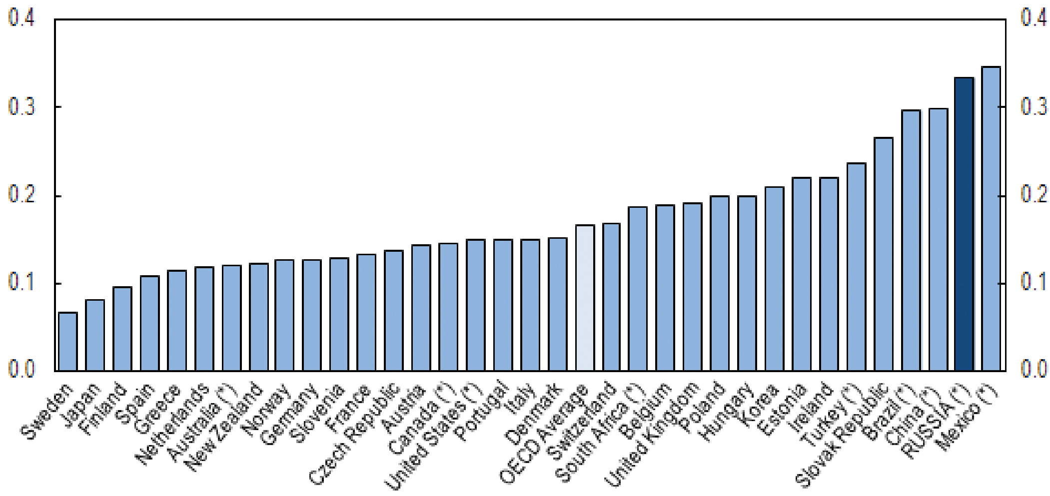
- **Advance civil service reforms**, including human resources management policy design and implementation, the recruitment process, and clarification of the political and managerial interface.
- **Strengthen the integrity framework of the public sector**, including the protection of whistleblowers, public procurement, and lobbying practices.
- **Advance the implementation of access to information provisions** and develop a **government-wide comprehensive strategy for engaging citizens in the policy process**.
- **Introduce mechanisms to enable independent oversight of programme and policy implementation** and requirements for government-wide performance evaluation and monitoring.
- **Create principles governing and constraining the exercise of discretion in public administration**.

Fostering regional development

Russia is characterised by high levels of inter-personal and inter-regional inequality. Inter-regional disparities in GDP per capita are larger than in any OECD member country and have been relatively stable for more than a decade. Such disparities are largely the product of extreme outliers at both ends of the distribution. They reflect, in part, the very fragmented structure of Russian federalism and the presence, in particular, of a belt of very poor, politically unstable regions in the North Caucasus.

Only 15 of Russia's 83 federal administrations recorded GDP per capita above the national average in 2009 (including four above twice the national average) even when adjusting for differences in regional price levels. These were mainly the country's largest agglomerations, resource-rich (mostly low-density) regions and some of the major ports. By contrast, 18 mostly small regions fell below 50% of the average, with four below 40%. Yet two-thirds of Russia's population inhabits the 50 regions in between. GDP is highly concentrated: 30% of the population lives in eight regions that generated about half of Russia's GDP. The city of Moscow and the oil-rich province of Tyumen, with 10% of the population, generate just under one-third of Russia's GDP. These disparities, though large, are comparable to those found in some other large, converging economies.

Figure 12 Inequality of GDP per capita across Regions (Gini index across TL3 regions, 2010)



Note: Data for China does not include either the special administrative regions of Hong Kong and Macao or Chinese Taipei, * indicates TL2 regions

Source: OECD Regions at a Glance 2011.

The real challenges stem not from the disparities themselves, but from the barriers to convergence confronting the great mass of regions. Low population density, barriers to factor mobility (particularly labour, see chapter *Striking a better balance between labour market flexibility and workers' protection*) and poor infrastructure handicap the great majority of regions. Neither agglomeration processes nor natural resource or location endowments favour them. Many lagging regions, particularly in the far North and East of the country, have substantially above-average price levels due to geography and infrastructure limitations.

Reforming fiscal federalism

Reforms at the end of the 1990s and in the early 2000s streamlined and clarified revenue and expenditure assignments, scrapped unfunded mandates (at least in principle) and allocated most federal transfers on the basis of clear equalisation formulae. This greatly enhanced the predictability and transparency of the system. However, the reforms left the vast majority of regions dependent on transfers, as the federal share of general government revenues rose. At the same time, expenditure autonomy at regional level remains weak. Moreover, since the reform, there has been a sustained decline in the share of formula-driven transfers, owing to the multiplication of earmarked grants of various kinds. Earmarked grants have accounted for over half of all transfers in recent years. These are allocated by central ministries and other federal bodies, often with

little co-ordination or assessment of regions' own fiscal capacities. As a result, earmarked subsidies and subventions frequently serve to counteract the effects of equalisation. They are also more likely to be allocated annually and often with little transparency. The co-financing requirements attached to some earmarked grants also reduce regions' expenditure autonomy. Finally, they are often allocated in the course of the year, so regions can use them only for a few months - a "use it or lose it" situation not conducive to good financial management. To enhance regions' expenditure autonomy, it would be useful to extend the formula-based approach to a larger share of total transfers, while reducing the number of earmarked grants, as well as the number of federal bodies allocating them. This should make it easier to align those earmarked grants that remain around federal priorities.

Reversing the erosion of the transfer is particularly important. Huge and persistent disparities in tax potential across regions mean that federal transfers have to play a large role in limiting disparities in access to key public services. For example, primary and secondary schools are now exclusively financed from regional and municipal budgets, leading to considerable regional heterogeneity in public funding. The authorities should consider implementing even stronger federal transfers, especially in the poorest regions, to help combat geographical variability in educational outcomes. A critical challenge will be to ensure that such transfers are predictable, transparent and allocated according to appropriate criteria based on efficiency indicators and outcomes.

Modernising regional policy

The transition to a modern, growth-oriented regional policy is still incomplete. During the 1990s, it was opaque, largely ad hoc and focused on supporting the poorest regions and responding to political pressure from stronger regions for fiscal privileges and greater autonomy. This changed in the early 2000s, as bilateral agreements between the centre and the regions were scrapped and the system of fiscal federalism was reformed. However, there is still a tension between the need for sustained federal support to very poor regions and the desire to foster the emergence of growth poles. While these might aid economic diversification, they could reinforce inter-regional disparities. Most regions (and citizens), moreover, fall between these two groups. Devising appropriate regional development strategies is most complex in the large number of "mono-cities" i.e. organised around a single branch or enterprise. Attempts to restructure these have met with little success.

Cluster policies are being considered, but there is a tendency to mistake Soviet-era territorial production complexes for clusters. Regional authorities often seek federal support for local "clusters" as a way of helping to sustain incumbent firms. Similarly, concepts like "smart specialisation" and "strategic planning" are often misunderstood to imply planning regions' specialisations decades in advance, chiefly on the basis of what already exists. Instead of acting as a mechanism to reveal potential new opportunities, smart specialisation can then become an exercise in picking winners among incumbent firms and sectors. In general, regional authorities often see regional development primarily in terms of receiving additional support from the centre. This means that rather than seeking to identify new niches and specialisation of their own, regions often try to align themselves with what they see as current federal priorities. Top-down thinking continues to prevail.

Key OECD Recommendations

- **Enhance regions' expenditure autonomy** by extending the formula-based approach to a larger share of total transfers, while reducing the number of earmarked grants and federal bodies allocating them.
- **Create a framework that leaves regions some scope to carry over unused balances of subsidies and subventions into the next year** to avoid autumn spending sprees.
- **Focus federal policies for regional development** on measures that encourage factor mobility, reduce the incentives for regions to mimic one another in trying to attract federal funds, and stimulate more bottom-up, independent approaches on the part of regional authorities.

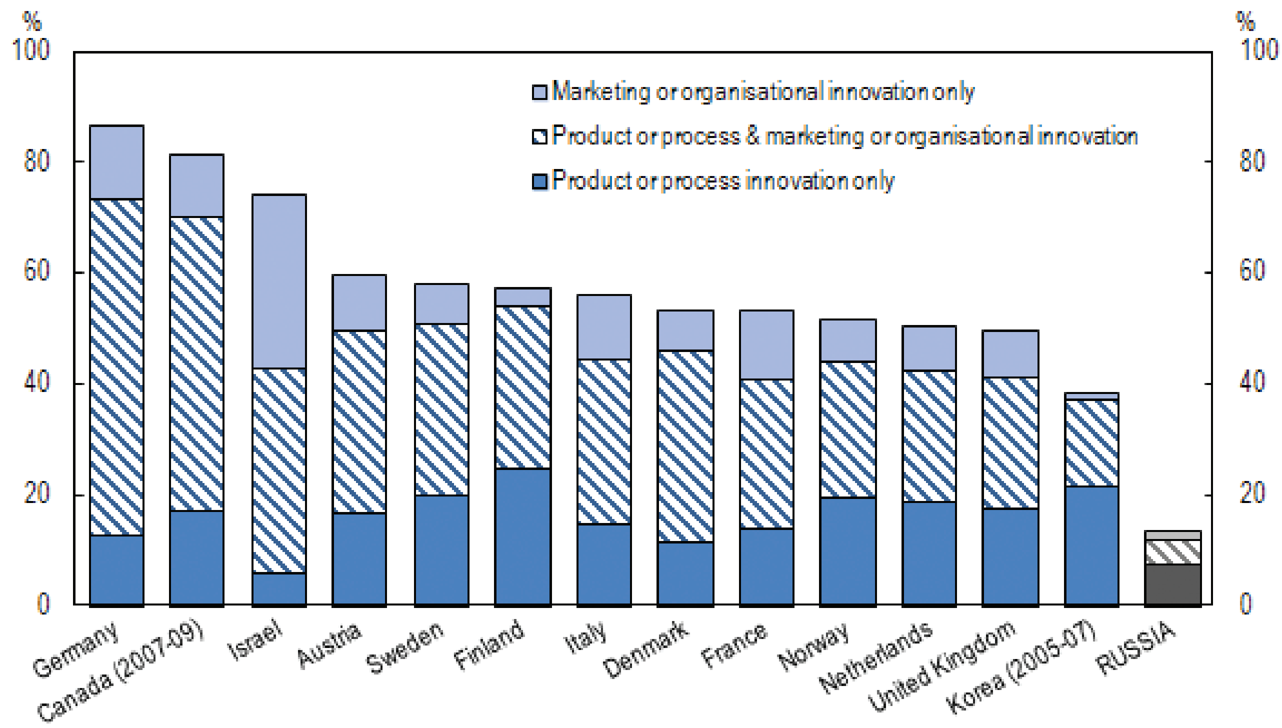
Strengthening innovation

During the last decade, Russia growth was characterised by low rates of investment and innovation and became more dependent on transitory factors, especially terms-of-trade gains reflecting world oil and gas prices. To achieve sustainable growth in the longer term, Russia needs to boost productivity growth. This will require a radical improvement in capabilities to exploit the country's significant innovation potential.

Weak innovation performance, despite a huge potential

Overall, Russia's innovation capabilities remain too low, not only considering the potential in terms of human resources and scientific tradition, but also regarding what would be needed for a sustained improvement of productivity throughout the economy. Many of the standard innovation performance indicators (R&D inputs, trade, scientific output, patents, etc.) are poor and confirm the existence of an innovation gap. Russian manufacturing firms are much less likely to engage in innovation activities than their counterparts in OECD countries (Figure 13). As pointed out in the chapters on the business climate and competition, exceptions to the rule of law, overly restrictive regulation and a lack of competition remain major disincentives to innovation and entrepreneurship. Physical and ICT infrastructures are comparatively weak, which also hinders innovation.

Figure 13. Innovation in the manufacturing sector by company category for selected countries, 2006-08
As a percentage of all manufacturing firms



Source: OECD Science, Technology and Industry Scoreboard 2011, p. 141.

Yet, Russia has some outstanding strengths on which to build. It has a longstanding science and engineering tradition and many centres of excellence, particularly in key fields such as aerospace, nuclear science and engineering, and advanced software. Its tertiary education attainment rate of 54% is well above any OECD country (see chapter *Getting the right skills and competencies for a modern Russian economy*). However, limited cooperation between science, education and industry hampers innovation. The bulk of Russian R&D is still performed in state-owned research institutes, which are mostly separate from industrial firms and universities. The institutes of the Russian Academy of Sciences also account for a significant share of publicly performed R&D and conduct the sorts of basic research carried out in universities in many OECD countries. Firms themselves have too few capabilities to innovate, little absorptive capacity for innovation, weak links to public research institutes and universities, and, above all, easy access to economic rents that provide few incentives to innovate.

Supporting innovation by a broad-based strategy

These obstacles highlight the need for a broad-based innovation policy going well beyond government support for R&D. Innovation policy is too often reduced to a focus on science and engineering inputs, without fully taking into account the broader framework conditions for innovation. This leads to an over-emphasis on the knowledge supply side with insufficient attention paid to the demand side. Instead, a broader, whole-of-government approach to innovation policy is required, involving greater levels of co-ordination between different ministries and agencies.

Government policy also needs to be balanced in several aspects. First, policy should support innovation in both large firms and SMEs, as both play a crucial, often complementary, role in innovation systems. Firms also need to be better encouraged to invest in innovation. Business firms funded just 26% of Russia's spending on R&D in 2010, well below the levels of most OECD countries. Second, there should be stronger recognition of the scope for and benefits of innovation in low-tech and services industries. Current innovation policy is overly focused on high technology, which means it neglects large parts of the Russian economy. Third, the innovation system needs to open up more extensively to foreign sources of knowledge, not as substitutes for Russian knowledge but as complements. Russian research policy is increasingly geared to greater international co-operation and a similar openness is needed in support of learning and accumulation of innovation capabilities in firms. Fourth, greater attention should be paid to the demand side of knowledge creation. So far, a technology-push philosophy has strongly influenced innovation policy and given too much emphasis to the supply side. This orientation has serious limitations in a market economy, where the knowledge of customers is critically important in shaping innovations. Finally, policy should find an appropriate balance between the need for industry competition and consolidation. Both have potential benefits for innovation, but too much of either will be inhibiting.

In carrying out these balancing acts, Russia needs to create and empower agents of change. The federal government cannot and should not try to do everything itself but should instead enable others to take the initiative through appropriate incentives. In some instances, this will mean nurturing capacity-building, for instance at the regional level, where the authorities often lack the necessary capabilities to formulate and implement a bespoke innovation policy. Too much R&D funding is still allocated without adequate accountability or reference to performance, and this leads to waste. Prioritisation and selectivity should be used to focus public R&D resources in centres with a critical mass of research excellence.

Russian innovation policy is already moving in these directions. For example, a broader concept of innovation is being promoted by the Ministry of Economic Development's Innovation Development Strategy of the Russian Federation to 2020. A number of new policies target firms, including measures that seek to lighten administrative barriers and improve framework conditions (including taxation and customs regimes). Measures that target major state-owned enterprises (SOE) notably include the Innovation Enforcement initiative (2011-12), which obliges SOE to formulate and carry out innovation development strategies. These initiatives should be fully and effectively implemented.

Key OECD Recommendations

- **Support innovation in both large firms and SMEs** and better encourage firms to invest in innovation.
- **Give stronger recognition to the scope and benefits of innovation in low-tech and services industries**.
- **Open up the innovation system more extensively to foreign sources of knowledge**.
- **Pay greater attention to the demand side of knowledge creation**.
- **Find an appropriate balance between the need for industry competition and consolidation**.

Getting the right skills and competencies for a modern Russian economy

Russia boasts one of the highest levels of educational attainment in the world: 88% of adults have attained at least upper secondary education, while 54% have a tertiary qualification. Ambitions of students are high: in the 2006 PISA assessment, 65% of 15-year-olds expected to be in highly skilled lines of employment by the time they are 30 years old. And yet, the coexistence of many graduates struggling to find jobs while employers report they cannot find workers with the skills they need suggests a significant mismatch in the demand and supply of skills.

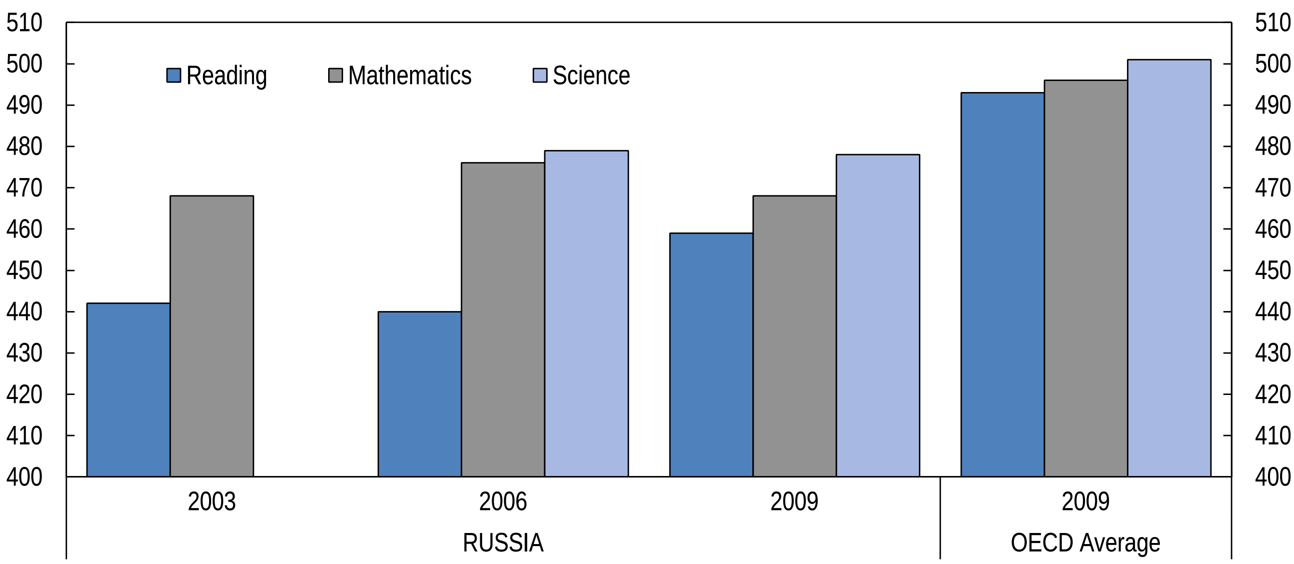
Reducing the skills mismatch

Part of the challenge lies in the highly specialised and compartmentalised nature of Russia's tertiary institutions, often closely affiliated with specific sectors of the economy. This leaves graduates with skills that have limited transferability across industries, occupations and regions. Moreover, it increases hiring costs for employers who have to fund additional workplace training. The narrow specialisation of institutions is encouraged by public subsidies for students in vocational institutions that usually no longer meet labour market needs.

The lack of engagement of employers in Russia's vocational education and training (VET) system is a further challenge. The curricula need to be updated to better respond to the skills needs of a market economy. Several OECD members have shown how the effective engagement of employers can help strengthen the VET system. In Denmark and Switzerland, more than three-quarters of VET students spend more than half of the length of their programmes in workplaces. In Australia, Austria and the Netherlands, tax deductions provide incentives for firms to engage in workplace training. In Mexico, decision-making processes in VET are underpinned by Labour Market Observatories that collect data on the labour market outcomes of VET graduates.

Russia's results in OECD's Programme for International Student Assessment (PISA) provide evidence on the skill mix developed in the education system. Russian 15-year-olds tend to do very well on tasks that relate to the reproduction of subject matter knowledge. But they tend to perform poorly on tasks requiring them to extrapolate from what they know and apply their knowledge in novel situations. This may reflect in part a greater emphasis in schools on the acquisition of encyclopaedic knowledge rather than problem-solving, innovative thinking and creativity. As a result, the average performance of 15-year-olds remains significantly below OECD averages in reading, mathematics and science (Figure 14). Moreover, Russia has a relatively high percentage of low performers. Some 36% of boys and 19% of girls do not reach PISA Level 2 of reading proficiency, considered the baseline to participate effectively and productively in life.

Figure 14. Average performance of 15-year-olds at PISA



In regard to PISA, several countries have experienced concrete improvement in the performance of students in less than a decade. Policies to promote quality improvements included curricular reform, designed not only to change the content of school education, but also to encourage the introduction of innovative teaching methods, emphasising student-centred learning.

Furthermore, the fact that Russia performs very well internationally in tests at the primary and lower secondary level of schooling suggests that the Russian education system adds less value year by year than is the case on average across OECD countries. Major actions are needed to improve the quality of the education system including curricular reform designed to shift focus from rote-learning and the reproduction of subject matter content to students' ability to apply knowledge creatively and innovatively.

Key OECD Recommendations

- **Place greater emphasis on broader and transferable competencies** and competency-based learning at all levels of education.
- **Update the curricula in the VET system** to cope with the demands of new industries and technologies and provide students with basic business skills, including those needed for self-employment.
- **Encourage greater engagement of employers in the VET system**, for example in the design of curricula and the addition of workplace components to vocational programmes.
- **Improve quality through curricular reform** promoting students ability to apply knowledge creatively and innovatively.

Striking a better balance between labour market flexibility and workers' protection

The global financial crisis halted a period of strong economic growth and significant improvements in the Russian labour market. However, compared with the large decline in output, job losses and hikes in unemployment remained modest. Much of the adjustment took the form of cuts in working hours but also in earnings, reflecting the very high wage flexibility. The labour market has now recovered to pre-crisis levels. It remains however characterised by important structural imbalances. Action is needed to improve labour market policies and institutions, strike a better balance between labour market flexibility and workers' protection, and reduce inequalities.

Important structural imbalances need to be addressed

High worker turnover points to a dynamic labour market, but employment growth has been mostly in lower quality jobs in the non-corporate sector, and the share of atypical contracts is large. Regional disparities remain wide as poverty traps hinder workers' mobility across regions. In addition, Russian workers also face large wage inequalities. The Gini coefficient on earnings was 0.41 in 2009 against 0.31 on average in the OECD, contributing to wide income inequality (see chapter *Social policies to promote equity*). Many Russian enterprises provide poor working conditions to their employees, especially in small and medium size localities in underdeveloped regions.

Much needs to be done to develop and improve labour market policies and institutions to achieve a better balance between labour market flexibility and workers' income security. Very high wage flexibility does not favour attachment to the job or appropriate investment in workers' skills, and therefore does not lead to improvements in labour productivity. There is ample room to develop the collective bargaining framework and redress the uneven bargaining power between workers and employers. At the same time, significant progress is needed to provide more effective support to the unemployed within an activation framework.

Improving the effectiveness of collective bargaining

Collective bargaining is underdeveloped in Russia and wages are fixed by managers. Despite relatively high trade union membership and a comprehensive collective bargaining framework, the extent of collective bargaining and its impact on wages and working conditions is very limited in practice. Moreover, almost half of workers' wages is variable on average, which provides employers with large freedom in setting wages. In turn, wage flexibility implies large earnings variability for workers.

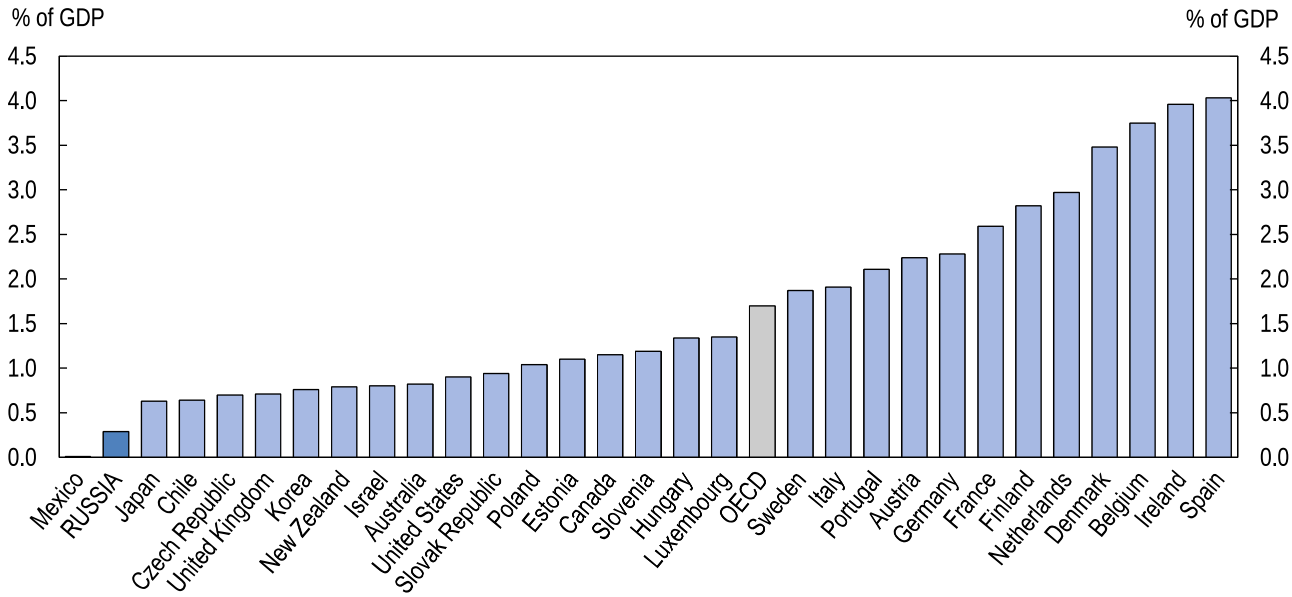
This reflects mainly the weak bargaining power of trade unions. Traditional unions have not evolved since quite some time, and act more as mediators between employers and workers than as workers' representatives. Alternative trade unions face difficulties in emerging as real social partners, in part due to restrictive legal provisions on the right to strike. Finally, the provisions guaranteeing workers' representation at the firm level are weakly enforced by government authorities.

Investing more on labour market policies

Public spending on labour market policies remains very low in spite of a strong increase during the crisis. In 2009, the Russian government tripled the budget for labour market programmes, but at 0.3% of GDP, expenditure on labour market policies remains well below that in mostly all OECD countries. Assistance provided to the unemployed is very limited. This discourages registration with the public employment services, as reflected in the large gap between registered unemployment and unemployment measured by the labour force statistics. While unemployment benefits are available to many, their level is low compared with most OECD countries. Resources available for active labour market policies are very limited (Figure 15). Personal assistance to jobseekers is scant and most time is spent on administrative procedures. The Russian public employment services function more as a social assistance service for the weakest groups of the population than as an effective intermediary between employers and jobseekers.

As agreed by social partners, there is a need to re-introduce a well-designed unemployment insurance system to provide more effective income support to the unemployed. At the same time, to avoid a significant increase in expenditures as well as in unemployment duration, proper activation services have to be developed. The authorities need to invest in a rigorous evaluation programme to identify which labour market programmes are most effective in facilitating the transition from unemployment to work.

Figure 15. Expenditures on labour market policy as a % of GDP in Russia and the OECD countries, 2009 or 2010



Note: 2009 for Russian Federation and United Kingdom, 2010 for other countries.

Source: OECD/EU Labour Market Programmes Database and Federal Service for Labour and Employment (Rostrud).

Key OECD Recommendations

- **Promote workers' representation and collective bargaining, and encourage trade-union pluralism at all negotiation levels**. In particular, ease conditions for more than one trade union to participate in the collective bargaining process at the firm-level. Better enforce the provisions guaranteeing workers' representation. Relax the very strict provisions on the right to strike.
- **Invest more in passive and active labour market policies**. Introduce a well-designed unemployment insurance scheme to provide more effective financial support to jobseekers. At the same time, develop an effective activation strategy and shift active labour market expenditure towards the most effective programmes, such as job search assistance and counselling, training and direct job creation for the most difficult to place.

Social policies to promote equity

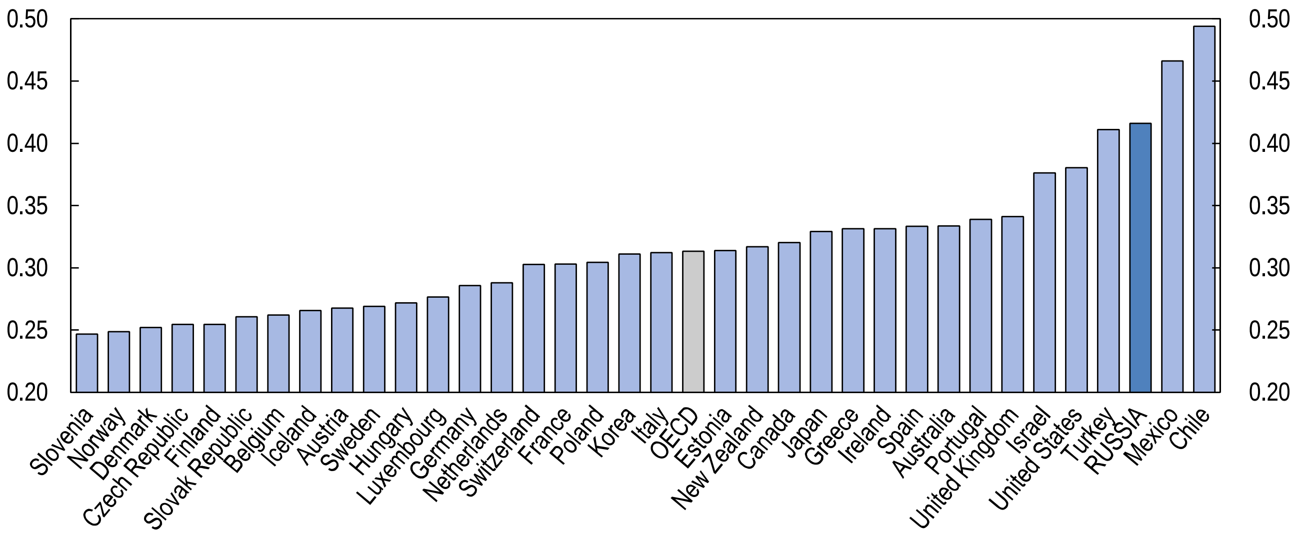
Despite progress in reducing absolute poverty, relative poverty and inequality remain important in Russia. Moreover, adverse demographic developments combined with the existing features of the pension system are putting long-term fiscal sustainability at risk. Russian social policies should focus on reducing wide income discrepancies while ensuring the financial sustainability of the pension system.

Addressing inequality

The global financial crisis interrupted a period of strong economic growth that had seen the official absolute poverty rate drop sharply from 29% in 2000 to 13.3% in 2007, but stabilise thereafter. The effect of the crisis on incomes was cushioned by labour market adjustments involving reductions in working time rather than layoffs (see chapter *Striking a better balance between labour market flexibility and workers' protection*), while the resulting significant declines in real wages were counterbalanced at the lower end of the distribution by a very large increase in the minimum wage in 2009 and significant increases in transfer payments to pensioners. However, relative poverty – measured against the standard OECD benchmark of 50% of median household income (adjusted for household size) - stood at 17% in 2008 compared with an OECD average of 11%. Income inequalities are also very high in international comparison (Figure 16) largely stemming from wage inequalities that are not smoothed by the tax and benefit system.

Figure 16. Levels of income inequality in the late-2000s

Inequality (Gini coefficient) of disposable net income, 2010-11 or latest year available



Note: Countries are ranked in increasing order of the Gini coefficient of income inequality. Data refer to the distribution of household disposable income in cash across people, with each person being attributed the income of the household where they live adjusted for household size.

Source: Preliminary data based on OECD income distribution database (www.oecd.org/social/inequality.htm) and Federal State Statistical Service for Russia

The abolition of the complicated and regressive Unified Social Tax system in January 2010 is an important step. However, the new flat-rate system of social contributions still has exemptions for certain industries, and the earnings thresholds up to which social contributions are due were reduced to about 1.5 times the average wage. The government could consider raising this threshold to twice the average wage or higher without a proportional increase in entitlements. To improve the redistributive power of the tax-benefit system, progressivity in the personal income tax scheme could be strengthened. A flat rate of 13% applies at present, apart from tax deductions for very low-income households.

Family policy is focused on increasing birth rates, which fell from 2 children per woman in 1990 to around 1.25 in 2000. In 2007, "Family Capital" was introduced, which provides families with two or more children with a certificate (worth RUB 387 640 or USD 12 850 in 2012). The certificate can be used towards improving housing conditions, alleviating the cost of education or strengthening mothers' future pension entitlement. While the birth rate rebounded to 1.6 in 2011, this policy has been ineffective in reducing family poverty. Children and young people (up 30 to years old) make up half of the poor. Family policy needs to better support families in work, including enhancing access to good quality, affordable, formal childcare for working parents with children of pre-school age, including children under 18 months.

Ensuring the financial sustainability of the pension system

Thus far, social policy has largely focused on the elderly and disabled. Recent increases in transfer payments to pensioners have helped to keep old-age poverty in check, but have worsened the imbalance between pension contributions and expenditure. Already in 2009, public pension spending amounted to about 6.5% of GDP, with pension contributions at 2.5% of GDP. Reforms are needed for the future pension system to reach financial equilibrium rather than relying on general budget transfers and the sales of natural resources. Standard pensionable ages are low: 60 for men and 55 for women, despite longer life expectancy. Most OECD countries now have the same pensionable ages for both sexes, usually 65. Thus, standard pensionable ages need to be gradually equalised among the sexes. Further increases in pensionable ages for both sexes are desirable if recent gains in life expectancy continue.

Moreover, many Russian workers retire before reaching the low standard pensionable age. A plethora of schemes grant early full pensions to specified categories of workers and professions, and are often not justified by difficult work conditions. These early pensions are paid by the Pension Fund of the Russian Federation rather than by employers' and workers' contributions, which limits incentives to restrict take-up of early pensions. The authorities have started to consider reform options which should make the corporate sector financially responsible for the cost of early pensions. This could also contribute to the development of the corporate pension sector.

For about a decade, the public pension system has included a funded component to which workers born after 1967 have to contribute 6% of their earnings (up to a defined ceiling). As the system is relatively young, the role of pension fund assets in Russia is limited by OECD standards (3.2% of Russian GDP in 2011, against 25% on average in the OECD). The contributors can choose to select a private sector asset manager for their mandatory pension savings, but only 20% do so. The vast majority of assets are managed - by default - by the State-owned asset manager. Low profitability on private pension assets has been identified as one of the main weaknesses of the system and is one reason for new legislation in December 2012 that reduces contributions to the funded part of the pension system from 6% to 2% for individuals whose assets are managed by the State. This reform thus enhances the pay-as-you-go system at the expense of the funded part. For funded pension savings to develop further, it is essential to improve the rate of return, for example, through improving the diversification of risks as well as the modernisation of regulatory and supervisory frameworks which embed trust in the system.

Key OECD Recommendations

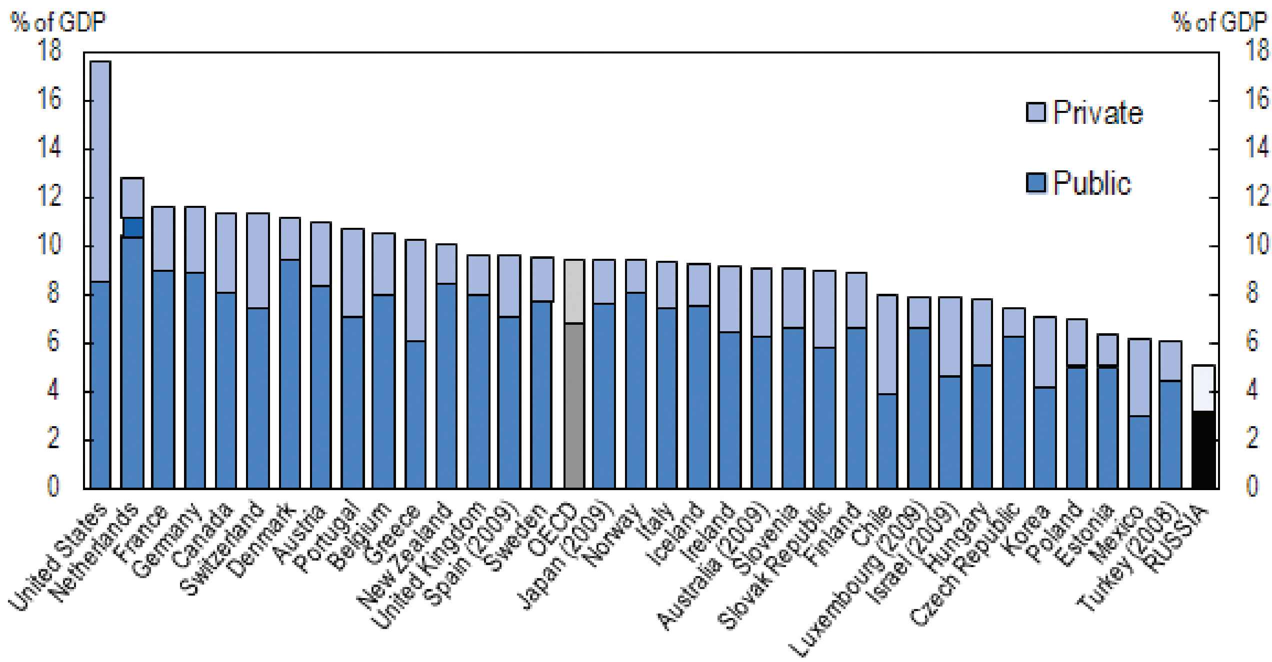
- **Ensure that the wealthiest bear a fair share of the cost of social protection** by increasing earnings levels up to which social security contributions are due and strengthening progressivity in income taxation.
- **Make family policy more effective in reducing in-work poverty** among families, for example by increasing access to good and affordable formal childcare.
- **Enhance the financial sustainability of the pension system**. Strengthen the contribution base, reduce use of early pensions, apply contribution rates equally across sectors, equalise standard pensionable ages, and raise them in line with increased life expectancy.
- **Further develop private pension savings**. Raise awareness among the public of the need for private pension savings, expand coverage among the labour force, strengthen regulatory and supervisory frameworks, and improve risk management systems of pension funds to enhance their profitability.

Modernising the health care system

Health outcomes in the Russian Federation fall well below those of OECD countries. Life expectancy at birth (69 years in 2010) lags behind the OECD average by more than ten years and is about seven years lower than in countries with a similar per capita income. While the situation has improved since 2004, premature mortality caused by non-communicable diseases (e.g. cardiovascular diseases and cancer) and external causes (injuries, road accident and suicides) is still relatively high, especially among men of working age.

Alcohol and tobacco account for a large share of the burden of disease. According to the WHO, alcohol consumption per capita (including unrecorded consumption) is above the OECD average by 40% and does not show any sign of decline. One adult in three smokes (against 22.8% in OECD countries in 2010) and this proportion has been stagnating in Russia whereas it has been declining in most OECD countries. The Russian Federation spends 5.1% of its GDP on health, in line with total spending in countries with similar income per capita. However, public spending (3.2% of GDP) is lower than in all OECD countries except Mexico (Figure 17). Russians benefit from universal coverage for health care. However, they pay 31% of health care costs out-of-pocket (OOP), well above the OECD average of 20%. In particular, patients pay high prices for "chargeable" services (services and goods that are not included in the basic benefit package) and often give informal payments to providers. This reduces access to health care services for the poorest.

Figure 17: Health spending and financing in the Russian Federation and other OECD countries (2010)



Source: OECD Health Data 2012 and WHO Database, 2012

Public spending on health also varies widely across the Russian Federation. The region which spends most per capita on health spends nearly 7 times as much as the lowest spending region. This is far higher than in federal OECD countries like Canada (where the ratio is 3.2), the United States (1.3) or Australia (1.3). Although the relationship between spending and outcomes is complex, regions with low spending tend to have worse outcomes.

On the provision side there is ample room for efficiency gains. In particular, there are too many curative care beds and the length of stay in hospital is too long – both twice the OECD average. In addition doctors and other providers have few incentives to deliver high-quality care. Russia should continue to increase public spending for health care but it also needs to ensure that new funds are spent efficiently.

Further investing in health care while allocating resources more equally and efficiently

The Russian Federation has overhauled its approach to unhealthy lifestyles, and recently implemented broad multi-year strategic plans to reduce the consumption of both alcohol and tobacco. These plans are well-structured and reflect international good practice. However, experience from other countries shows that

there is often a gap between official plans and action on the ground. To ensure that this is not the case, the government needs to develop a credible system for monitoring the implementation of the new policies, and the effects on consumption of alcohol and tobacco by different social groups.

The government should also broaden the scope of the basic benefit package to cover cost-effective services. Similarly, it should ensure access to essential and cost-effective medicines used in outpatient care to the whole population. It should also move to reduce the impact of informal payments, by combining pay increases for providers with information campaigns aimed at patients to explain that such payments are no longer necessary.

Russia has started to address inequalities between regions by reforming the financing of the system. Starting in 2013, each region will get the average amount per capita needed to finance the basic benefit package for each inhabitant, through mandatory health insurance (for the working population), regional budgets (non-working population) and federal transfers (where needed). If implemented, this reform will boost spending in poorer regions.

The government must also shift resources from hospitals to primary care. The first step should be to increase access to and the quality of outpatient medical care. Reforms in the supply of care – in particular, the three-tier system of primary care provision – should help reduce the need for hospital beds. In addition, provider payments need to include incentives for higher productivity and efficiency, and payment per case for hospitals needs to be generalised.

The recent law on mandatory health insurance includes many provisions aiming at improving competition among insurers and providers: it extends patient choice, imposes the publication of information on both types of institutions, introduces incentives for high-quality medical services, entitles patients to compensation in case of inappropriate behaviour from an insurer or a provider, etc. However, such arrangements can only improve the quality and efficiency of health care delivery if insurers and consumers can access information on the quality of health care provision. There is therefore an urgent need to improve health information systems, to compare the quality of health care between providers, but also to provide comparative information so that Russia can benchmark its performance against OECD countries.

Key OECD Recommendations

- **Increase public health care funding and ensure fair and efficient distribution of public resources**.
- **Enforce and monitor coherent population-wide prevention policies** to reduce risky behaviours and encourage healthy life-styles.
- **Extend the scope of the basic benefit package** to cost-effective outpatient pharmaceuticals and reduce out-of-pocket payments for health care services.
- **Continue to increase remuneration of health care professionals** in exchange for an end to informal payments, regular training to maintain skills, and an increased emphasis on quality.

Promoting greener growth

A major reform of Russia's environmental policies has been proposed in recent years. While the detail of this reform has yet to be finalised and implementation will be challenging, it could constitute an important platform for greener growth.

The long-term strategy in Basic Principles for State Policy in the Field of Environmental Development of the Russian Federation up to 2030, adopted in April 2012, includes the creation of a coherent system of environmental legislation, the use of economic instruments for environmental protection, the introduction of environmentally sound technological innovations, and the improvement of inter-agency coordination. To ensure successful implementation, this strategy will need to be accompanied by specific short-term plans identifying priority actions, a timetable and a process to monitor implementation, including indicators to measure progress, and sufficient financial resources. The effort is considerable as only 0.2% of the government's budget has been allocated to the environment in 2013, according to Russian officials.

Some long-term sectoral strategies have been developed in recent years, such as the 2012 Transport Strategy, the 2010 Energy Strategy and the 2009 Climate Doctrine. While these strategies integrate some environmental considerations, they are formulated as very high-level goals and the successful implementation of the environment-related aspects often remains a challenge. Russia's long-term socio-economic strategy to 2020 does not yet recognise the sustainable use of natural resources and the protection of ecosystem services as a fundamental prerequisite for long-run growth. Integrating these concerns in core elements of economic policymaking is essential for designing a coherent approach to green growth.

Energy efficiency as a powerful tool for economic and environmental benefits

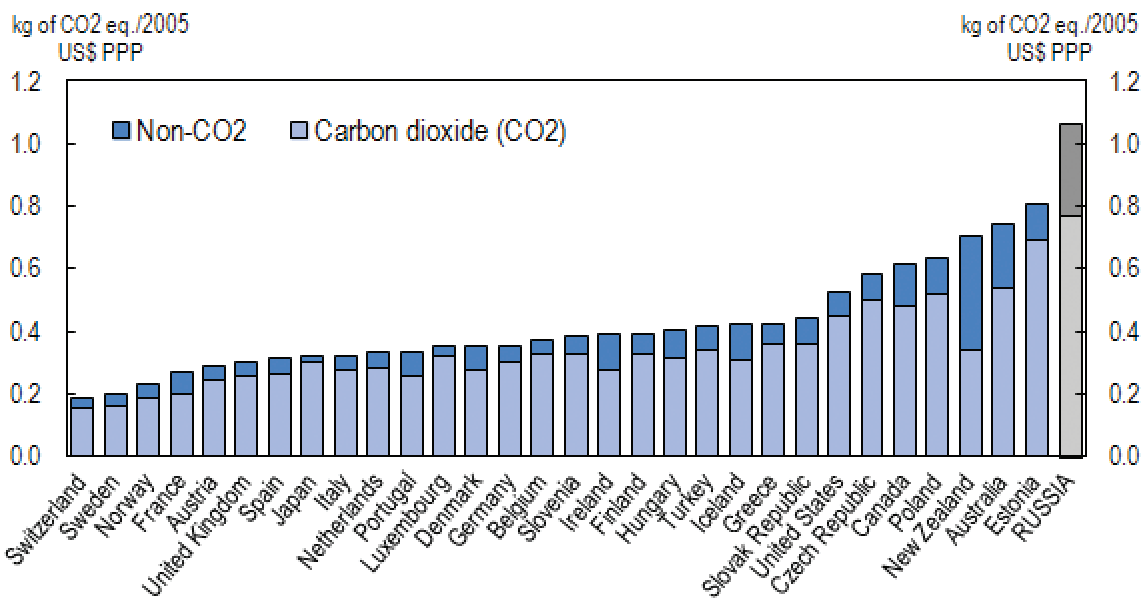
Although energy use has declined significantly in absolute terms, Russia still has one of the most energy-intensive economies in the world (see next chapter). Combined with relatively carbon-intensive energy use this makes Russia the fourth largest emitter of greenhouse gases (GHGs) (Figure 18). Low energy efficiency also contributes to poor air quality, with Russia having one of the world's highest rates of premature mortality attributable to air pollution. The maximum permissible concentration of harmful substances in the atmosphere is exceeded in 185 cities and industrial centres in which over 60 million people live.

Russia's high energy intensity is related to its industrial structure, but also to the age of its capital stock. Recent steps to increase energy efficiency include the introduction of mandatory metering of energy use, along with a large-scale information campaign to promote energy savings in households, energy efficiency labelling for buildings and appliances, and a programme on performance standards based on best available technology (BAT). To achieve its goals in energy savings and emission reductions in a cost-effective way, Russia should rely less on administrative measures and place more emphasis on financial incentives. The main objective is to ensure that the price of energy reflects the true costs for society as a whole of pollution and other externalities. In particular, this means removing government interventions that result in below-market prices (such as subsidies for domestic energy use and export taxes on energy); introducing a carbon tax or a cap-and-trade system to reflect GHG emissions; and differentiating fuel taxes according to sulphur content. The installation of meters for energy consumption – as well as for water – should be accelerated to stimulate more efficient use. Low-income households should be assisted directly via direct transfers rather than through low prices.

Improving the efficiency of the environmental tax regime

Russia was a pioneer in terms of introducing taxes on pollution. However, the system has not changed since the late 1980s and is very complex. Taxes are imposed on over 225 air pollutants, but tax rates are so low that it is often cheaper for polluting companies to pay the pollution taxes than to invest in pollution prevention and control. Administrative red tape is further weakening the effectiveness of applying the "polluter pays principle". Several environment-related laws are being revised to promote the use of BAT, diversify regulatory requirements based on environmental risk, and introduce an integrated environmental permit system. This is a good opportunity to simultaneously modernise the environmental tax regime. OECD guidelines could be used to assess the environmental effectiveness and economic efficiency of the current pollution tax system, and consider related implementation issues such as enforcement and compliance.

Figure 18. Total greenhouse gas emissions per unit of GDP (2008)



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

Source: OECD calculations based on United Nations Framework Convention on Climate Change (UNFCC), Greenhouse Gas Inventory Data, IEA database and World Bank, WDI database.

Improving resource productivity and waste management practices

Insufficient infrastructure capacity to manage industrial and municipal solid waste leads to a widespread use of environmentally harmful waste management practices. For example, there are many illegal dumping sites and on-site storage of industrial waste is common. Landfill is the predominant waste management option and only 7.8% of municipal waste is recovered in Russia (23% on average in the OECD in 2010). Russia has closed 29 000 of the 42 000 illegal dumping sites identified thus far, and some of them have been cleaned up. A main source of finance for new waste management infrastructure is expected to come from private-public partnerships and the introduction of Extended Producer Responsibility through amendments to the Federal Law on Production and Consumption Waste. Russia will need a strong engagement of the private sector in waste management activities to ensure the necessary infrastructure investments are made.

Key OECD Recommendations

- **Integrate green growth considerations in the long-term socio-economic strategy**, including specific measures and incentives for all economic sectors.
- **Improve incentives for increased energy efficiency**, including removing subsidies to energy use.
- **Ensure effective implementation** of laws, strategies and target programmes related to the environment. Allocate more resources from the federal budget for environmental expenditures.
- **Evaluate the effectiveness and economic efficiency of environmental policy instruments** and reform the tax regime.
- **Improve waste management infrastructure** and make the sector more attractive for private investors.

Reforming the energy sector to modernise the economy

The transformation of Russia's energy sector plays a key role in modernising the economy. Oil and gas account for about 24% of Russia's GDP, while the energy sector accounts for almost half of Russia's budget revenues. Energy exports represented 70% of export revenues in 2011. In October 2012, Russia's oil production reached a post-Soviet record of 10.8 mb/d. Russia is also the world's largest producer and exporter of natural gas, respectively 670 bcm and about 190 bcm in 2011. The modernisation of the energy sector is also important for global energy markets, especially as global oil and gas consumption is set to grow.

The modernisation of the energy sector requires major investments

The energy sector needs about USD 100 billion in investments per year until 2030 to modernise ageing power generation assets, develop new oil and gas production sites, and build new transmission infrastructure to accompany stronger economic growth. This will not be possible without a massive increase in investment, including foreign direct investment (FDI).

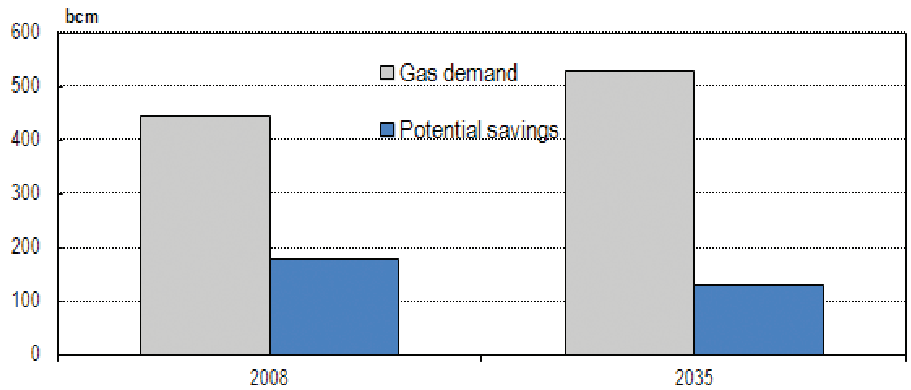
In addition to continued efforts to attract FDI in general (see chapter *Improving the foreign investment climate*) attracting higher investment in the energy sector will require the progressive removal of remaining price subsidies and cross-subsidies, the deployment of clean-coal technologies, and the completion of regulatory reforms. Important steps have already been made. Russia's electricity privatisation has for example attracted almost 1 trillion Rubbles of private capital (about USD 32 billion). The next steps will be critical in ensuring timely and efficient investment in the sector over the longer term. Recent strategic partnerships between Russian state companies and the world largest oil companies reflect a trend for the future in the development of offshore and Arctic resources, where cutting-edge technology and management will be needed.

Improving efficiency is central to energy sector modernisation. Russia is among the world's top five energy consumers and there is greater scope for more efficient energy use in Russia than in almost any other country. Russia uses twice as much energy per unit of GDP than OECD countries. According to the World Energy Outlook 2011, if Russia had used energy as efficiently as comparable OECD countries in each sector of the economy in 2008, it could have saved the equivalent of more than 200 million tonnes of oil or 180 bcm of gas, equal to 30% of its consumption that year (Figure 19). This high energy intensity stems partly from the age of the capital stock. For example, 39% of Russia's fossil fuel-based power plants were over 40 years old in 2010, compared to 28% in the United States, 22% in the EU and 12% in Japan. The electricity transmission infrastructure is also relatively old, contributing to transmission losses that are about double those in the United States. The energy losses in heating generation and distribution are even larger.

Realising the country's energy efficiency potential in the residential sector would increase purchasing power, support small and medium enterprises, free up gas resources for exports, and foster regional development and economic diversification.

To promote energy efficiency, the implementation of the State Programme for Energy Saving to 2020 is also key. In particular, in line with IEA recommendations, it is essential to continue efforts to strengthen energy building codes and enhance their coverage and enforcement as well as to implement tighter energy efficiency standards for appliances. A focus on empowering homeowner associations and building capacity in the banking and private sectors will help support a more effective financing of energy efficiency investments through mechanisms such as ESCOs (Energy Saving Companies). In industry, energy management systems and techniques should be more widely employed, especially in energy-intensive industries. Efforts to improve data and statistics collection should be also pursued, especially on the energy demand side, a complex effort which involves all sectors of the economy. Other key measures include accelerating the modernisation of district heating systems; deployment of metering and consumption-based measures, alongside "co-generation" (Combined Heat and Power); and the use of renewable sources of energy, especially biomass or waste. Last, a gradual move towards full market prices for all categories of consumers should be pursued. It should be done in a way that protects the most vulnerable households while providing sufficient price signals for the modernisation of generation assets and improvements in energy conservation (see chapter *Promoting a greener growth*).

Figure 19. Natural gas savings from raising efficiency (to levels of comparable OECD countries)



Source: World Energy Outlook 2011

Nuclear energy challenges

Nuclear power plants produce 18% of Russia's electricity supply. There are 33 nuclear reactors in operation in Russia and another 11 under construction. One of the most significant challenges facing all countries using nuclear power is to review safety in light of the lessons learnt from the Fukushima Daiichi accident. Defence-in-depth needs to be more thoroughly implemented for both existing and future reactors. Like many other countries using nuclear power, a sustainable solution needs to be put in place for managing the radioactive waste generated by nuclear power plants.

Key Recommendations

- **Pursue efforts to attract domestic and foreign investments** in the different energy sectors through predictable, attractive, competitive investment frameworks, particularly by completing the final critical phase of the electricity sector reform process.
- **Continue widespread implementation of already adopted energy efficiency legislation and targets in the building and industry sectors**.
- **Ensure a gradual move towards full market prices** for all categories of consumers, while providing support to the low-income households.
- **Continue efforts to support progress in sustainable energy technology**.
- **Ensure the safety** of Russia's nuclear reactors, and also of those being built by Rusatom overseas.

Better Policies for Agriculture

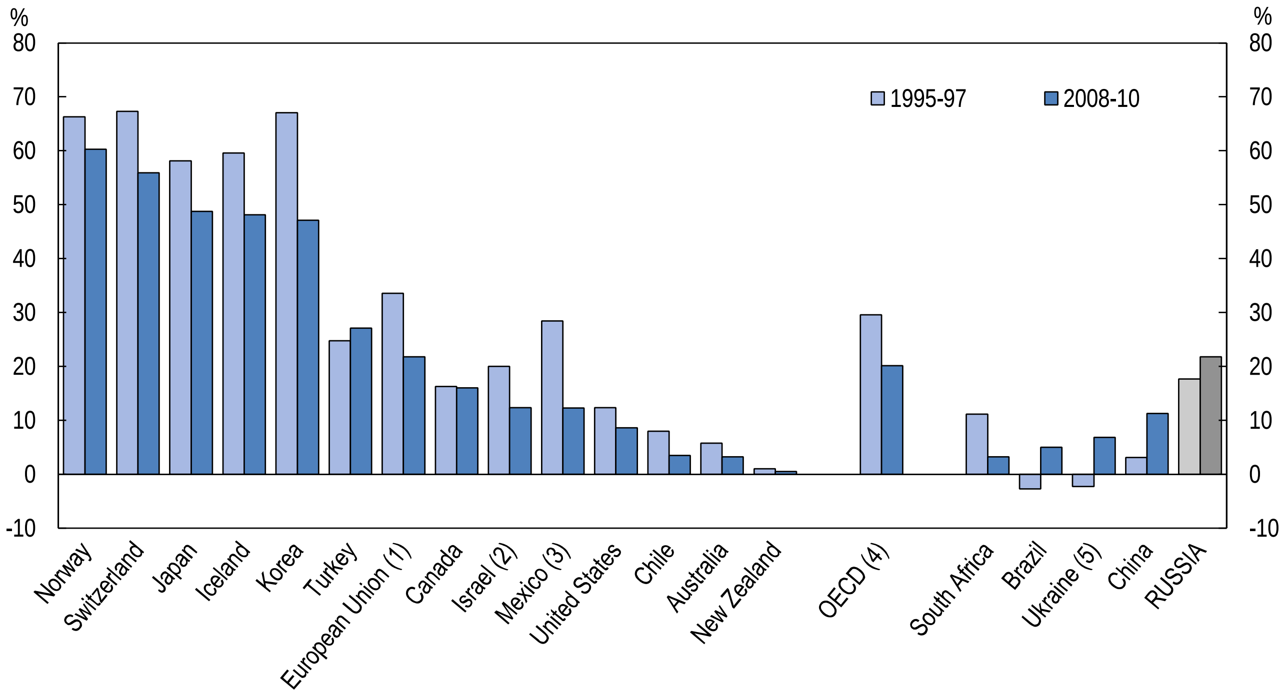
Russia's new agricultural programme sets production growth targets up to 2020, while WTO accession implies that these production increases will have to be pursued along with the gradual lowering of trade barriers and reductions in trade-distorting subsidies. Achieving the growth targets will therefore require fundamental improvements in the international competitiveness of Russian producers. Progress in this direction would benefit consumers, as a more competitive domestic food system would provide cheaper food.

A policy aimed at boosting agriculture and substituting agro-food imports

Agricultural policy has focused on increasing livestock production through border protection and budgetary support for investment. The food price surges in the late 2000s increased concerns over import dependency and reinforced the policy focus on stimulating domestic food supplies.

In 2008-10, overall support provided to the farming sector, as measured by the OECD's Producer Support Estimate (PSE) increased to 22% (Figure 20), overtaking the level of support in the European Union and on average in the OECD which had both declined. This reflects a tightening of border protection for key agricultural imports and an increase in budgetary transfers to the sector. Over one-fifth of gross receipts of agricultural producers in Russia were due to policy support. The estimate of agricultural support in 2008-10 also reflects the significant exceptional assistance related to the global economic crisis in 2009 and to local droughts, including a particularly severe one in 2010.

Figure 20. Producer Support Estimate in Russia, OECD countries and selected emerging economies 1995-97 and 2008-10; percent of gross farm receipts



Note: 1. EU12 for 1986-88 and EU27 for 2008-10.
2. See disclaimer
3. For Mexico, 1995-97 is replaced by 1991-93
4. Austria, Finland and Sweden are included in the OECD total for all years and in the EU from 1995. The Czech Republic, Hungary, Poland and the Slovak Republic are included in the OECD total for all years and in the EU from 2004. Chile and Israel are included in the OECD total from 1995. The OECD total does not include the non-OECD EU member states.
5. For Ukraine, the first average corresponds to 1996-97.

Source: OECD, PSE/CSE database, 2011.

An issue is that producer support has mainly used measures that change prices for both agricultural outputs and inputs. Such policy measures are highly market distorting and they are unlikely to bring sustained improvements in the competitiveness of the agriculture sector. For instance, this policy induces transfers from the crop to the livestock sector. Due to frequent export restrictions, domestic grain prices are below international price levels and livestock producers thus benefit from cheap feed. In addition, this form of support to agricultural growth involves a high cost to consumers and taxpayers. Consumers finance around two-thirds of support to agricultural producers by paying above international prices for some key agricultural products.

From production subsidies to investments in improving productivity and competitiveness

Russia's new agricultural programme for 2013-20 maintains an orientation favouring production growth and import substitution. However, as a new WTO member, Russia will have to gradually lower its tariff barriers, and agricultural spending will become subject to limits on trade-distorting support. Aggregate annual spending under the new agricultural programme is to increase to around USD 11.5 billion by 2020, with Russia committed to limiting distorting-support to USD 4.4 billion by 2018.

A significant shift is thus required from a subsidy-focused policy to one combining strategic public investments in improving agricultural productivity and efficient resource use. This will require major efforts. Substantial deficiencies exist in transport and service infrastructure. Public water and land management systems have also suffered from underinvestment and require major upgrading. The capacities of the plant and animal health and food safety systems are limited due to a lack of modern equipment and a lack of qualified staff. In addition, there is inadequate public investment in R&D and incentives for private investment in agricultural innovation systems are limited. A shortage of qualified labour with higher education and technical skills is increasingly limiting agricultural development. A more general improvement to the business environment to attract higher domestic and foreign private investment, and to the education system, would also contribute to improving the productivity and competitiveness of the agricultural sector (see chapters *Improving the business climate*, *Improving the foreign investment climate* and *Getting the right skills and competencies for a modern Russian economy*).

Last, over one-quarter of the population lives in rural areas, many of which face economic and social decline and depopulation. Efforts to stimulate efficient and modern agriculture must therefore be complemented by investments in better living conditions in rural areas and the creation of alternative earning opportunities outside agriculture.

Key OECD Recommendations

- **Re-orient agricultural support towards investments in strategic areas supporting agricultural productivity growth**, such as R&D, education, information and knowledge dissemination systems, market and production infrastructure, and animal and plant health systems.
- **Strengthen regulatory and economic instruments for sustainable resource use in agriculture**, including development and enforcement of agricultural environmental standards; economic disincentives to environmentally harmful farm practices based on the "polluter pays" principle; and integration of sustainable agriculture practices into education and extension programmes.
- **Enhance policies and programmes to improve living conditions in rural areas and diversify rural incomes**.

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