



WORLD BANK GROUP

# MODEST GROWTH; FOCUS ON INFORMALITY

**41** RUSSIA ECONOMIC REPORT  
JUNE 2019







# MODEST GROWTH; FOCUS ON INFORMALITY

---

**41** RUSSIA ECONOMIC REPORT  
JUNE 2019

---

This report is produced twice a year by World Bank economists in the Macroeconomics, Trade and Investment (MTI) Global Practice. The team that prepared this edition was led by Apurva Sanghi (Lead Economist for the Russian Federation, [asanghi@worldbank.org](mailto:asanghi@worldbank.org)) and consisted of Olga Emelyanova (Economist, GMTE2), Mikhail Matytsin (Research Analyst, GPV03), Irina Rostovtseva (Research Analyst, GMTE2), Katerina Levitanskaya (Senior Financial Sector Specialist, GFCE1), Eva Gutierrez (Lead Financial Sector Specialist, GFCEE), Yoki Okawa (Economist, MTI), Peter Stephen Oliver Nagle (Economist, MTI) and Collette Mari Wheeler (Economist, MTI). The focus note was produced by Apurva Sanghi based on a report “Stemming Russia’s Informality: Unearthing Causes and Developing Solutions” by Apurva Sanghi, Samuel Freije-Rodriguez, and Aleksandra Posarac (all World Bank). Peer reviewers included Yaroslav Lissovlik (Chief Managing Director, Head of Analytical Department of Global Markets, Sberbank) and Bakyt Dubashov (Senior Economist, MTI). The report was edited by Christopher Pala (Consultant), and the graphic designer was Robert Waiharo (Consultant). The team would like to thank Andras Horvai (Country Director for Russia) and Sandeep Mahajan (Practice Manager, MTI Global Practice) for their advice and support. The team also would like to express their gratitude to the Department for Research and Forecasting of the Central Bank, Department for Macroeconomic Forecasting of the Ministry of Economic Development, Department for the budget policy and strategic planning of the Ministry of Finance, Gabriel Di Bella (Resident Representative, IMF) and Sergei Ulatov (Director for coordination, Eurasian Development Bank) for the collaboration. This report went to press on June 10, 2019.

# TABLE OF CONTENTS

<b>ACRONYMS AND ABBREVIATIONS</b> .....	<b>i</b>
<b>EXECUTIVE SUMMARY</b> .....	<b>iii</b>
<b>I. RECENT ECONOMIC DEVELOPMENTS</b> .....	<b>1</b>
1.1 Global growth: As growth stabilizes, oil prices recover .....	2
1.2 Russia: growth slows down in the first quarter of 2019 .....	4
1.3 Balance of payments: a flexible exchange rate regime and the continued accumulation of buffers help Russia weather external shocks.....	6
1.4 Labor Market and Poverty Trends: unemployment declines, wages increase, but disposable incomes are not growing .....	7
1.5 Monetary Policy: the CBR keeps it relatively tight, but some relaxation is expected in the second or third quarter of 2019.....	9
1.6 The Banking Sector: relatively stable but weak, with uneven growth across different segments.....	11
1.7 Fiscal policy: After the fiscal stance improved in 2018, the focus turned to national projects.....	13
<b>II. RUSSIAN ECONOMIC GROWTH IS EXPECTED TO SLOW DOWN AFTER TEMPORARY ACCELERATION IN 2018</b> .....	<b>19</b>
<b>III. CURBING RUSSIA’S INFORMAL SECTOR: UNEARTHING CAUSES AND DEVELOPING SOLUTIONS</b> .....	<b>25</b>

## LIST OF FIGURES

Figure 1: Global industrial production growth and manufacturing PMI has picked up .....	2
Figure 2: Volume Growth in the goods trade continues to soften .....	2
Figure 3: Commodity market developments: .....	4
Figure 4: Growth momentum picked up in the first quarter of 2018.....	5
Figure 5: Net exports became main growth driver in the second half of 2018.....	5
Figure 6: Economic growth weakened in the first quarter of 2019 .....	5
Figure 7: Higher commodity prices widened the current account surplus in 2018.....	6
Figure 8: Imports by value decreased in the second half of 2018 (y/y) .....	6
Figure 9: Labor force and employment started to decline .....	8
Figure 10: Unemployment rate remains low .....	8
Figure 11: Real wages by sector decelerated in all sectors .....	8
Figure 12: Real incomes dynamics remains slow .....	8
Figure 13: The CBR keeps its key policy rate unchanged in the first five months of 2019 .....	9
Figure 14: In 2019, inflation rose above the CBR’s target.....	10
Figure 15: Inflation expectations are elevated .....	10
Figure 16: Credit growth continued in both the retail and corporate segments .....	11
Figure 17: Overall financial sector indicators remained stable .....	11
Figure 18: The government pursues a policy of fiscal consolidation .....	15
Figure 19: Federal Budget (FB) non-oil and gas revenues grew .....	17
Figure 20: FB expenditures dropped .....	17
Figure 21: FB non-oil/gas primary deficit improved .....	17
Figure 22: FB spending as a share of GDP decreased for national economy, public management, national security, social policy .....	17
Figure 23: National projects and financing.....	17
Figure 24: National projects and financing.....	18
Figure 25: The growth forecast for Russia suggests modest growth .....	21

Figure 26: Russia’s informal employment is on the rise, ranging between 15.1 and 21.2 percent .....	26
Figure 27: Russia’s share of informal employment is not that high when compared to other middle-income countries (2012- 2017) .....	26
Figure 28: Net formal job creation in Russia’s medium and large enterprises has been close to zero.....	28
Figure 29: Russia’s minimum to average wage ratio is among the lowest .....	30
Figure 30: Russia’s effective tax rate on entering employment is comparatively low .....	32
Figure 31: Russia’s marginal effective tax rate on increasing working hours is comparatively low .....	33
Figure 32: The rate of informal employment varies between 3.6% in Moscow to 64% in the Chechen Republic .....	35

#### LIST OF TABLES

Table 1: Poverty .....	9
Table 2: Government fiscal stance strengthened in 2018 .....	14
Table 3: Global growth is expected to hover around 2.8 percent .....	21
Table 4: Projected growth rates are modest .....	21
Table 5: The moderate poverty rate is expected to continue to decline in 2018 and through 2021 .....	22
Table 6: Russia’s Employment Protection Legislation is strict by OECD standards.....	31

#### LIST OF BOXES

Box 1: In Russia, the shares of the education and health sectors in GDP are small compared to in advanced economies. ....	15
Box 2: Labor market regulations in Russia are broad and mandatory.....	28
Box 3: By OECD standards, regulations on redundancy dismissal in Russia are overly rigid and discourage formal employment.....	32
Box 4: Russia’s benefit schemes do not confer commensurate gains compared to those of other countries .....	34
Box 5: Reducing the cost of formality for employers only has a small impact on informality.....	36
Box 6: Certain labor market regulations can be eased to incentivize formal employment.....	38
Box 7: The role of well-functioning labor inspection systems goes beyond mere enforcement.....	39
Box 8: Russia’s Federal Tax Service has made admirable progress in implementing a risk-prioritization approach..	40

## ACRONYMS AND ABBREVIATIONS

---

<b>APB</b>	Asian-Pacific Bank
<b>Bbl</b>	Oil Barrel
<b>BSCF</b>	Banking Sector Consolidation Fund
<b>CBR</b>	Central Bank of the Russian Federation
<b>CPI</b>	Consumer Price Index
<b>EEG</b>	Economic Expert Group
<b>EM</b>	Emerging Markets
<b>EMDEs</b>	Emerging Markets and Developing Economies
<b>EPL</b>	Employment Protection Legislation
<b>ETRL</b>	Effective Tax on Labor
<b>EU</b>	European Union
<b>FB</b>	Federal Budget
<b>FDI</b>	Foreign Direct Investment
<b>FIFA</b>	Fédération Internationale de Football Association
<b>FLI</b>	Federal Labor Inspectorate
<b>FTS</b>	Federal Tax Service of Russia
<b>FX</b>	Foreign Exchange
<b>GDP</b>	Gross Domestic Product
<b>GNFS</b>	General Number Field Sieve
<b>GRP</b>	Gross Regional Product
<b>ICT</b>	Information and Communications Technology
<b>ILO</b>	International Labor Organization
<b>ILOSTAT</b>	International Labour Office (ILO) database on Labour Statistics
<b>Mb/d</b>	Millions of Barrels per day
<b>METR</b>	Marginal Effective Tax Rate
<b>NGO</b>	Non-Governmental Organization
<b>NIFI</b>	National Research Institute of the Ministry of Finance of the Russian Federation
<b>NRR</b>	Net Replacement Rate
<b>NWF</b>	National Welfare Fund
<b>OECD</b>	Organization for Economic Co-operation and Development
<b>OFZ</b>	Federal Loan Bonds
<b>OIS</b>	Overnight index swaps
<b>OPEC</b>	Organization of the Petroleum Exporting Countries
<b>OS&amp;H</b>	Occupational Safety and Health
<b>PIT</b>	Personal Income Tax
<b>PMI</b>	Purchasing Managers' Index
<b>PP</b>	Percentage Point
<b>PTI</b>	Payment-to-Income
<b>PTR</b>	Participation Tax Rate
<b>Q</b>	Quarter
<b>R&amp;D</b>	Research and Development
<b>REER</b>	Real Effective Exchange Rate

<b>RLMS</b>	Russia Longitudinal Monitoring Survey
<b>Rosstat</b>	Russian Federal State Statistics Service
<b>RUB</b>	Russian Ruble
<b>SIB</b>	Systemically Important Banks
<b>SIC</b>	Social Insurance Contribution Rate
<b>SMEs</b>	Small and Medium-Sized Enterprises
<b>TAXBEN</b>	IFS (Institute for Fiscal Studies)'s Tax and Benefit Microsimulation Model
<b>TJTC</b>	Targeted Jobs Tax Credit
<b>USD</b>	United States Dollar
<b>VAT</b>	Value-Added Tax
<b>WB</b>	The World Bank
<b>WIEGO</b>	Women in Informal Employment: Globalizing and Organizing
<b>WTI</b>	West Texas Intermediate
<b>y-o-y; y/y</b>	Year-on-year



## EXECUTIVE SUMMARY

---

*Real GDP growth in Russia surpassed expectations in 2018, reaching 2.3 percent, mostly due to one-off effects of energy construction. Forecasted growth of 1.2 percent in 2019 and 1.8 percent in 2020 and 2021 reflects a more modest outlook.*

*Russia's macro-fiscal buffers remain strong, with fiscal surpluses across all tiers of government and low public-debt levels. When compared to advanced economies, Russia spends less on health and education. Rebalancing in favor of these categories could improve the overall efficiency of public spending. Short-term inflationary risks have abated, with the Bank of Russia signaling a return to a neutral policy rate. Lending activity is recovering, but the banking sector remains afflicted with high concentration and state dominance. Having eased slightly, the poverty rate remains in double digits with many households close to the poverty line and lacking formal employment. Informal employment is rising in the face of close-to-zero net job creation by medium-sized and large formal enterprises.*

*Key risks to medium-term growth include the expansion of economic sanctions, renewed financial turmoil in EMDEs, a dramatic drop in oil prices, and souring of the global trade environment. The recent double-digit expansion in household credit may also pose a risk to financial stability in the case of a deterioration in the macroeconomic environment.*

### Recent developments

**Supported by favorable global growth, higher oil prices, one-off construction projects, and Russia's hosting of the FIFA World Cup, GDP growth accelerated to 2.3 percent in 2018 from 1.6 percent in 2017.** It was the highest reading since 2013. From the supply side, the growth acceleration largely happened on the back of the completion of one-off energy construction projects in the Tyumen region. From the demand side, both domestic demand and net exports were important sources of growth. However, a VAT rate increase, a relatively tight monetary policy, a higher base of 2018 and a dip in oil production in the first quarter of 2019 slowed the GDP growth rate to 0.5 percent, y/y.

**Relatively high levels of international reserves, a relatively low external debt and a flexible exchange rate regime helped Russia limit exposure to external volatility and absorb external shocks.** A new fiscal rule, which ushered in a stronger non-oil/gas current account, also strengthened Russia's external position. Supported by higher commodity prices and a robust export volume growth, the

current account surplus strengthened to 6.9 percent of GDP in 2018. Difficult external financial conditions for emerging markets and elevated geopolitical tensions boosted net capital outflows to USD 67.8 billion (about 4.1 percent of GDP) in 2018 and led to a depreciation of the real effective exchange rate of 7.7 percent. At USD 487.9 billion (or 15.9 months of import cover), international reserves stand at a comfortable level. In the first quarter of 2019, the current account surplus strengthened compared to the same period last year on the back of lower import values and lower debt payments, reaching USD 32.8 billion (8.7 percent of GDP) compared to USD 30 billion (7.6 percent of GDP) in the same period last year.

**Consumer price inflation, at 5.1 percent in May, exceeded the CBR's target of 4 percent in annual terms since the beginning of 2019, when it experienced the most intense VAT pass-through effect.** A relatively tight monetary policy, together with a softening of financial conditions for emerging markets, helped curb inflationary pressures; inflation appears to have peaked in

March. However, household inflation expectations and corporate price expectations remain elevated. Higher oil prices, combined with a weaker ruble, better tax administration, and a conservative fiscal policy further improved fiscal balances at all levels of the budget system in 2018. The general, federal, and regional governments registered surpluses of 2.9, 2.6, and 0.5 percent of GDP, respectively. Overall public debt, at 14.3 percent of GDP, remains low. The non-oil/gas general government primary deficit fell to 5 percent of GDP from 7 percent in 2017. The fiscal surplus is expected to roll over to 2019-2021.

**New development goals announced by the President in May 2018 have led to the shaping of 13 national projects, which total 25.7 trillion rubles (about USD 390 billion, or about 2.8 to 3.2 percent of GDP annually) for 2019-2024.** The 13 projects are divided into three specific areas: human capital (5.7 trillion rubles or 86.2 billion USD), quality of life (9.9 trillion rubles or USD 149.9 billion), and economic growth (10.1 trillion rubles or USD 152.8 billion). They are mostly financed from the federal budget. The liquid part of the National Welfare Fund could exceed 7 percent of GDP by the end of 2019, giving the government the ability to invest part of it in domestic infrastructure projects. But while Russia's infrastructure gaps are large, substantial investment in domestic infrastructure projects from the liquid part of the fund could reverse the achievements of the fiscal rule.

**In January 2019, the government adopted measures to increase the efficiency of public expenditures for the period of 2019-2024.** Such measures include regularly reviewing public expenditures for their efficiency, managing tax expenditures, and improving public procurement procedures. These are important steps in the right direction. However, the shares of the education and health sectors are small compared to advanced economies and rebalancing spending towards these sectors could further improve overall effectiveness and efficiency of public spending.

**Despite recent bailouts, Russia's banking sector remains relatively weak, with a lower capital adequacy ratio (12.2% as of April 2019) and a higher ratio of non-performing loans (10.4%) than in other emerging markets.** The recent double-digit expansion in household credit may pose a risk to financial stability in case of a deterioration in the macroeconomic environment, although consumer lending risks appear to be contained owing to tightening prudential regulations aimed at slowing unsecured consumer lending. The state continues to dominate the banking sector. As of April 1, 2019, the top five banks generated 57 % of all banking sector profits, and state-owned banks accounted for 62% of all banking assets. These figures are skewed upwards by the positive results of Sberbank, which accounts for about 30% of total system assets, generating more than 37% of system-wide profits.

**Unemployment declined further in the first quarter of 2019 to a current 4.8 percent.** Real wage growth in 2018 was above the rate of inflation in both tradable and non-tradable sectors; it was highest in the public sector. However, real-income dynamics worsened toward the end of 2018 and beginning of 2019, suggesting a contraction in real terms of some unobserved components (informal earnings, for example). The poverty rate under the national definition (population share with incomes below 10,287 rubles/month in 2018) declined slightly to 12.9 percent in 2018, from 13.3 percent in 2017. This reduction was driven by growth in the main sources of income, wages and pensions.

### Outlook, risks and challenges

**Russia's overall growth prospects for 2019-21 remain modest at 1.2 to 1.8 percent in 2019-2021, in line with its current potential growth trends.** GDP growth in 2019 is projected to be 1.2 percent. Continued oil production cuts and deterioration in the external environment (which affects export growth) are factors weighing down on GDP growth in the second quarter on top of subdued domestic demand. A less tight monetary stance and acceleration in the implementation of national

projects weigh in favor of growth acceleration in the second half. Yet, weak growth dynamics in the first half are expected to affect the annual growth number through the carry over effect. GDP growth is expected to accelerate to 1.8 percent in 2020 and 2021. Household consumption growth is expected to rebound after its 2019 deceleration, and implementation of national projects is expected to support investment demand.

**The outlook is subject to risks.** Downside risks to Russia's growth outlook stem from the potential expansion of sanctions, deterioration of financial market sentiment, souring global trade environment and a dramatic drop in oil prices. The recent expansion in household credit may pose a risk to financial stability in the case of a deterioration in the macroeconomic environment. Public investment growth is subject to the successful and efficient implementation of government infrastructure investment initiatives. On the upside, national projects, aimed at strengthening human capital and increasing productivity, could positively affect Russia's potential growth in the medium-term, depending on how well they are implemented.

### Special topic: Informal employment in Russia

**Stable economic growth, wage growth in the private sector, and the indexation of pensions to inflation should support disposable incomes and contribute to a gradual decline in the poverty rate in 2019-21.** However, many Russians lack formal employment. This edition's special topic (Part 3) focuses on the spread of informal employment in Russia and possible measures to address it.

**The share of informal employment, a pervasive phenomenon in Russia, is estimated to range between 15.1 and 21.2 percent.** The fiscal loss of underpayment by informal workers is estimated to between 1 to 2.3 percent of GDP. However, stemming Russia's informal labor tide does not lend itself to an obvious single fix. For example, policies that reduce payroll taxes to lower the cost of formal labor are not enough. Instead, the findings point to a three-pronged policy mix that would lead to (i) more-flexible labor legislation in certain areas, backed by more-effective enforcement; (ii) a stronger safety net with better unemployment benefits; and (iii) a more -workforce. Specifically, Russia's labor code and regulations could be adjusted in the areas of labor contracts, minimum wages, and redundancy dismissal. Labor inspection services are also an important line of defense against informality, and a more client-focused and risk prioritization approach, which the Federal Labor Inspectorate is moving towards, works better to decrease informal employment. A well-designed unemployment insurance system and consolidating small and fragmented benefits programs into larger income/means-tested benefits could provide incentives to register as unemployed and to subsequently seek formal work. However, informality can only be partially alleviated with specific fiscal or labor market measures. Systemic solutions to reduce informality will require broader policies. The antidote to reducing informality is the faster creation of more formal-sector jobs: In both 2017 and 2018, net job creation by medium and large enterprises was close to zero.



PART I

---

# RECENT ECONOMIC DEVELOPMENTS



## 1.1 Global growth: As growth stabilizes, oil prices recover

Global growth remains subdued after losing momentum in late 2018 and early 2019. The slowdown in industrial activity has accompanied a deceleration in the growth of the global trade of goods, especially in exports of EMDEs. After recovering over the first quarter of 2019, crude oil prices sharply declined in late May and early June, with Brent falling to roughly USD 60/bbl. Oil production surged in the United States, while output in Saudi Arabia and Russia fluctuated on production agreements

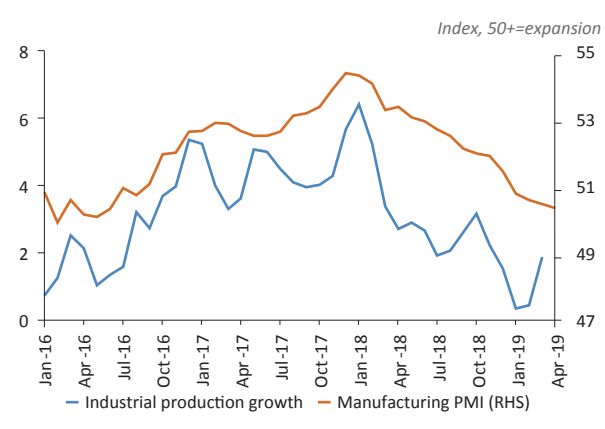
**Global growth remains subdued after losing considerable momentum in late 2018 and early 2019.** Growth in industrial production and manufacturing under the Purchasing Managers' Index (PMIs) continued to weaken in early 2019 (Figure 1). Major central banks continued supporting activity with accommodative policy rates amid soft inflation. In Emerging Market and Developing Economies (EMDEs), however, inflation accelerated on the back of rising energy and food prices towards the beginning of the year. Global trade continued to soften, with new export orders falling throughout early 2019 (Figure 2). The slowdown in trade has been particularly acute in Asia, especially with respect to imports. The increase in tariffs by the United States and retaliatory actions by China in May have re-escalated trade tensions, with the potential costs cascading across value chains and amplifying policy uncertainty.

**Global financing conditions continue to ease, with rising equity valuations and falling borrowing costs.** Market expectations for central banks' policy rates have been pushed further into the future—the European Central Bank is not expected to increase rates until 2021, while markets expect the Federal Reserve to lower them as soon as late-2019 (based on an OIS curve analysis on Bloomberg). Most EMDEs continue to enjoy benign financing conditions, with rising equity prices and falling yield spreads. Following substantial outflows in the second half of 2018, capital flows to EMDEs were essentially flat for 2019Q1. Recently released data show that EMDE foreign exchange-denominated debt in several countries rose substantially in 2018.

**Amid slowing exports, industrial activity in the Euro Area, Russia's largest trading partner, remains notably weak, while the services sector is**

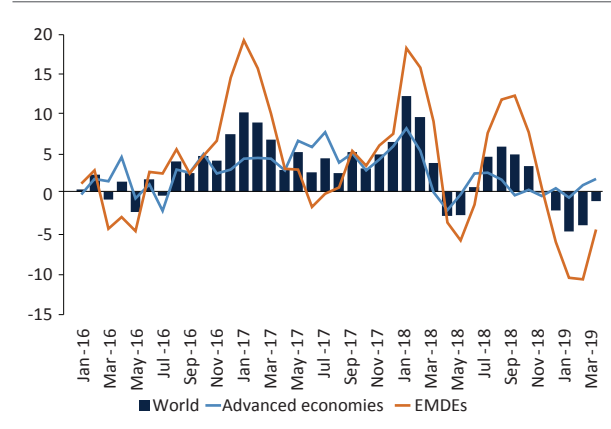
**Figure 1: Global industrial production growth and manufacturing PMI has picked up**

(Percent, 3m-on-3m saar)



**Figure 2: Volume Growth in the goods trade continues to soften**

(Percent, 3m-on-3m saar)



Source: CPB Netherlands Bureau of Economic Analysis, Haver Analytics, World Bank.

A. PMI stands for Purchasing Managers' Index (PMI). Readings above 50 indicate expansion, readings below indicate contraction.

The last observations were in February 2019 for industrial production and March 2019 for manufacturing PMI.

B. EMDEs = emerging market and developing economies. Last observation was January 2019.

**relatively resilient.** The external environment has become more challenging as uncertainty regarding the United Kingdom's exit from the European Union continues, with the deadline extended to October 31, 2019 as the government and the opposition negotiate a compromise deal, which has been complicated by Prime Minister May's resignation. Activity indicators in Japan rebounded slightly at the end of the first quarter of 2019 but have not fully recovered from significant weakness in previous months. Meanwhile, growth in China, Russia's second-largest trading partner, stabilized at 6.4 percent (y/y) in 2019Q1, on the back of monetary and fiscal stimuli. Despite signs of improving activity, China's policy uncertainty index remains near an all-time high.

**Crude oil prices fell sharply, by 15 percent, in the second half of the second quarter after rising nearly 40 percent in early 2019 (Figure 3A).** In late April, Brent reached USD 75/bbl, and the West Texas Intermediate (WTI) rose to USD 66/bbl, driven primarily by supply developments, with demand remaining robust. Since late April, prices have once again slid, by roughly 15 percent, on the back of concerns over weaker global demand and a re-escalation of trade tensions between major economies. The earlier sharp fall in prices in the last quarter of 2018 was triggered by the United States decision in November to grant waivers to its sanctions against Iran to eight countries. This coincided with a sharp increase in supply among OPEC countries, primarily Saudi Arabia (in anticipation of a shortfall arising from the sanctions), as well as surging production in the United States. It resulted in an increase of oil production (Figure 3B).

**In response, OPEC and its coalition partners, including Russia, agreed to implement production cuts of 1.2 mb/d starting in 2019.** Output among these countries has fallen sharply, particularly in Saudi Arabia, where production is down more

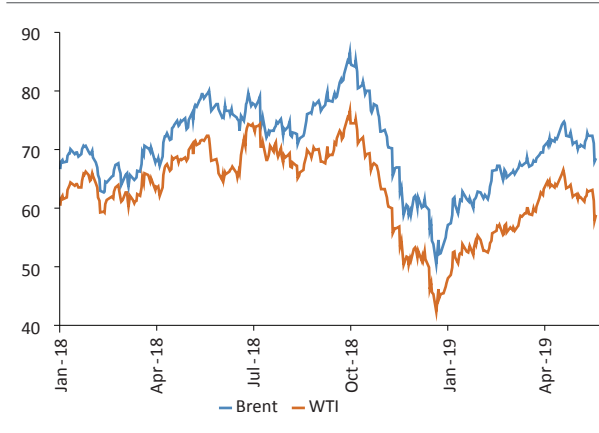
than 1 mb/d relative to its November peak. Non-OPEC countries were slower to adhere to the reduction, with Russia projected to reach its initial target in April. OPEC and its coalition partners are slated to meet in late June to decide whether to extend the oil production cuts given recent volatility in oil prices amid heightened uncertainty regarding global demand and a re-escalation of trade tensions. Production has also fallen in Iran and Venezuela, which are exempt from the OPEC agreement. Crude oil production fell by a third in Venezuela since September to 0.9 mb/d in March 2019. In Iran, the impact of U.S. sanctions on production has been substantial, despite the waivers. Output has fallen 1.1 mb/d relative to its peak in the second quarter of 2018, comparable to the impact of previous sanctions in 2014. The announcement by the U.S. that it would not renew waivers to the sanctions on Iran when they expire at the start of May boosted oil prices in late April.

**The prices of metals and some agricultural products also staged a partial recovery in the first quarter of 2019, following drops in the second half of 2018 (Figure 3C).** The recovery in metal prices reflected improving growth prospects for China – which accounts for half of global consumption – as well as a series of supply bottlenecks and concerns, such as the Vale dam accident in Brazil (iron ore, nickel) and heavy floods in Chile (copper). Similarly, supply factors helped boost some agricultural commodity prices. These included weather-related planting delays for U.S. wheat and corn as well as lower expectations for U.S. soybean plantings on concerns about trade tensions. In contrast, natural-gas prices have fallen sharply, with price differentials between the three main price benchmarks shrinking (Figure 3D). The fall in prices was due to a combination of weak demand resulting from a warmer-than-expected winter and the restarting of nuclear power plants in Japan, together with rising supply, particularly from liquefied natural gas.

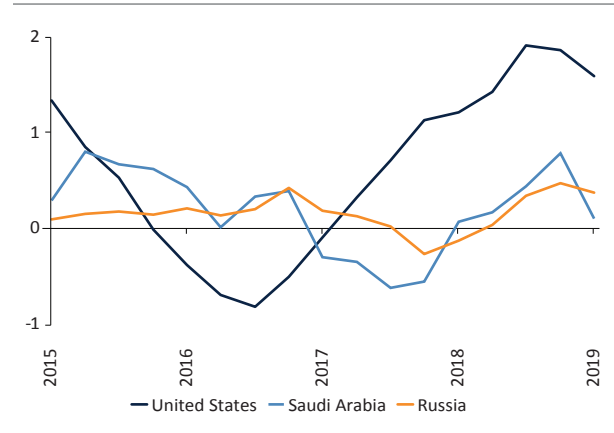


**Figure 3: Commodity market developments:****A. Crude oil prices recovered over the first quarter of 2019**

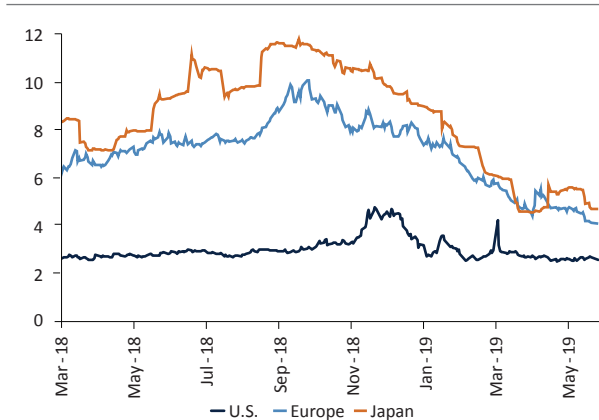
(US\$/bbl)

**B. Oil production surged in the United States, while output in Saudi Arabia and Russia fluctuated on production agreements**

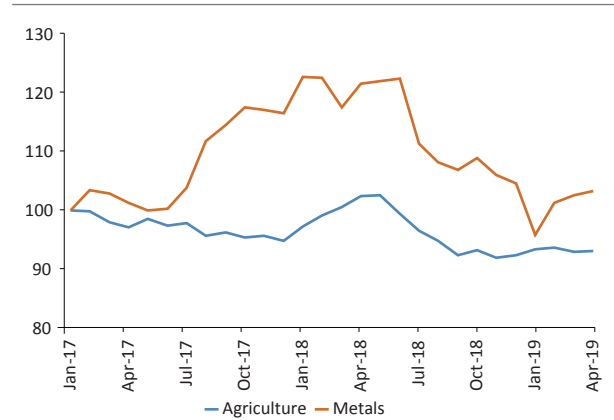
(Mb/d, y/y)

**C. Agriculture and metal price indices recovered in the first quarter of 2019**

(US\$/mmbtu)

**D. Natural gas prices have fallen in 2019**

(US\$/bbl)



Source: Bloomberg, International Energy Agency, World Bank.

**1.2 Russia: growth slows down in the first quarter of 2019**

Supported by favorable global growth, higher oil prices, one-off construction projects, and Russia's hosting of the FIFA World Cup, GDP growth accelerated to 2.3 percent in 2018 (the highest reading since 2013) from 1.6 percent in 2017. Domestic demand continued to be an important growth driver. Meanwhile, deceleration of import growth made net exports emerge as another important growth driver. In the first quarter of 2019, however, GDP growth slowed down to 0.5 percent, y/y, from 2.7, y/y, in the fourth quarter of 2018 on the back of a VAT rate increase, relatively tight monetary policy, higher base of the last year and a slowdown in oil production.

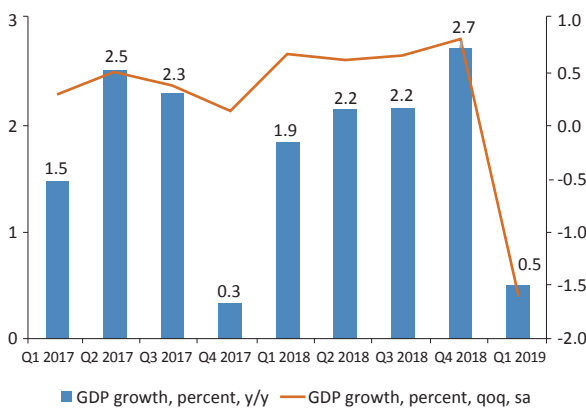
**In 2018, GDP growth totaled 2.3 percent, y/y, exceeding expectations and growth rates for the previous five years.** Growth momentum picked up in the first quarter of 2018 and stayed at about the

same level during the year, slightly accelerating in the fourth quarter (Figure 4). On the supply side, growth acceleration largely happened on the back of the completion of construction projects – a one-



**Figure 4: Growth momentum picked up in the first quarter of 2018**

(Percent)



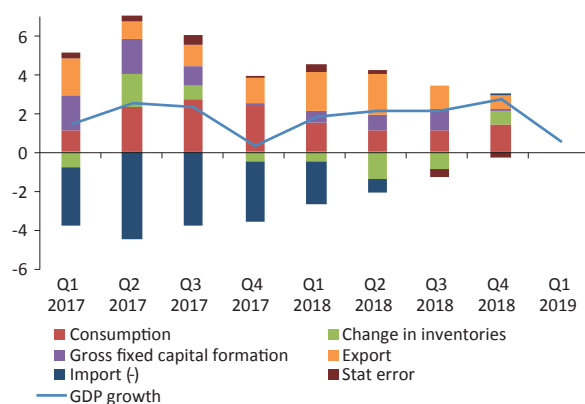
Source: Rosstat.

off effect of energy sector projects in the Tyumen region. Other sectors that contributed to GDP growth acceleration were finance (on the back of continued credit expansion), transport (benefiting from the FIFA World Cup hosted by Russia and higher growth in mineral resource extraction), hotels and restaurants (also helped by the cup).

**Both domestic demand and net exports were important sources of growth in 2018.** Even with a decline in its contribution, domestic demand remained an important driver of GDP growth. Weak growth in real disposable incomes and REER depreciation led to a slowdown of household consumption growth in 2018. Conservative

**Figure 5: Net exports became main growth driver in the second half of 2018**

(Percentage point)



Source: Rosstat.

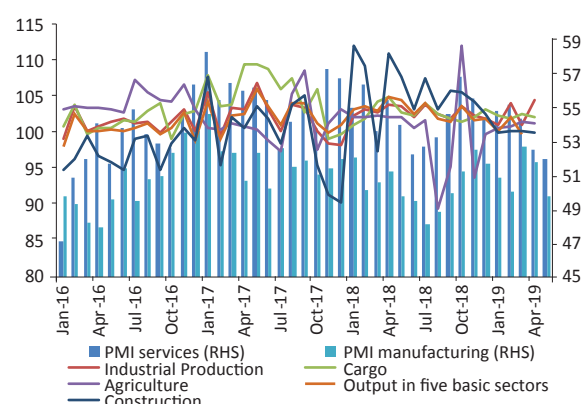
fiscal policy weighed on public consumption and investment growth. Despite support from the completion of one-off construction projects in 2018, fixed capital investment growth slowed down to 2.9 percent, y/y, from 5.2 percent, y/y, in 2017. Favorable global growth and the World Cup supported the acceleration of export growth in 2018. Inventory destocking and a weaker ruble resulted in the considerable deceleration of import growth, making net exports an important growth driver.

**Economic growth weakened significantly in the first quarter of 2019 (Figure 6).**

Flash GDP growth estimates suggests growth slowed down to 0.5 percent, y/y, (-1.6 percent, q/q adjusted for seasonality). While deceleration was expected on the back of a rise in the VAT rate, a relatively tight monetary policy, high base of the last year, some skewness of public spending to the second half of the year, and the OPEC+ agreement, the slowdown exceeded expectations: 0.8 percent growth by the Ministry of Economic Development, 1 to 1.5 percent growth from the Central Bank. Details on the supply or demand side are not available yet. High-frequency statistics point to weaker growth in industrial production in the first quarter of 2019 (with a pickup in April), on the back of OPEC+ agreement and modest growth in manufacturing. The slowdown of retail trade and market services indicate subdued consumer demand. Investment

**Figure 6: Economic growth weakened in the first quarter of 2019**

(Percent)



Source: Rosstat, HSBC.

demand growth weakened as well: fixed capital investment growth slowed down to 0.5 percent of GDP, y/y, compared to 2.9 percent, y/y, in the fourth quarter of 2018. A slump in wholesale trade: -7.4 percent, y/y, could reflect inventory

destocking (Figure 8). Preliminary statistics from Russian customs reveals a drop in the exports of base metals, oil products and machines, suggesting lower export

### 1.3 Balance of payments: a flexible exchange rate regime and the continued accumulation of buffers help Russia weather external shocks

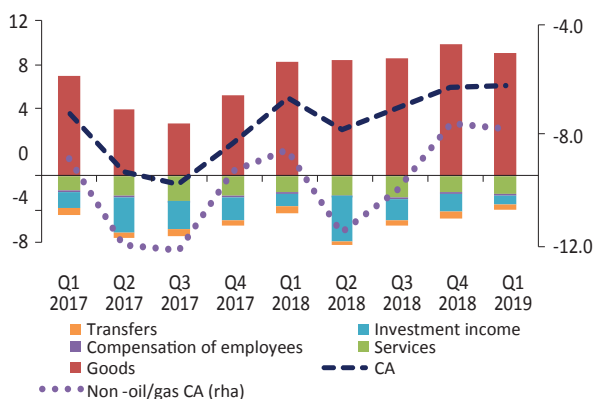
*Relatively high levels of international reserves, a relatively low external debt and a flexible exchange rate regime helped Russia limit exposure to external volatility and absorb external shocks. The new fiscal rule, which ushered in a stronger non-oil/gas current account, also strengthened Russia's external position.*

**H**igher energy prices for major commodities exported by Russia as well as robust export volume growth widened the current account surplus to about 6.9 percent of GDP (USD 113.8 billion) in 2018 from 2.1 percent of GDP (USD 33.2 billion) in 2017 (Figure 7 and Figure 8); net capital outflows increased substantially in 2018 compared to 2017. A stronger trade balance (11.7 percent of GDP in 2018 vs 7.3 percent of GDP in 2017) was the main factor behind a growing current account surplus. Net capital outflows increased substantially in 2018 compared to 2017: net capital inflows turned into net capital outflows in the government sector from the second quarter of 2018, mainly through the sell-off of OFZ bonds. Increased geopolitical tension and a tightening of monetary policy in the advanced economies were the main reasons for

this. Increased geopolitical tensions and uncertainty cut FDI inflows to Russia from 1.8 percent of GDP in 2017 to 0.5 percent of GDP in 2018. Net capital outflow in the private sector grew from 2.0 percent of GDP in 2017 to 4.1 percent of GDP in 2018 as a result of an increase in the acquisition of foreign assets amidst increased uncertainty and difficult external conditions for emerging markets. Net external liabilities decreased while banks continued debt payments. Pressure on the financial account resulted in a REER depreciation by 7.7 percent in 2018, y/y. The non-oil/gas current account deficit improved to 8.9 percent of GDP in 2018 from 10.2 percent of GDP in 2017, largely reflecting gains in the non-oil/gas fiscal balance on the back of the new fiscal rule.

**Figure 7: Higher commodity prices widened the current account surplus in 2018**

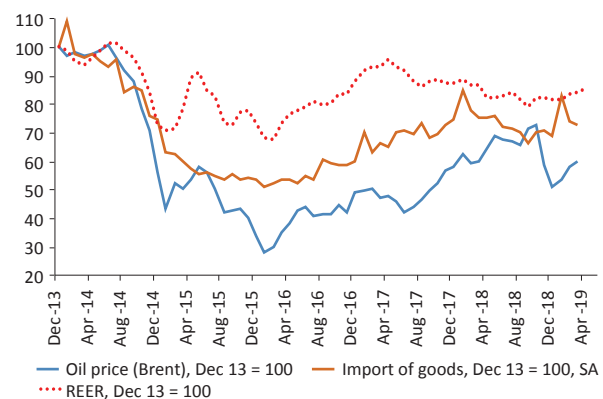
(Percentage point)



Source: CBR.

**Figure 8: Imports by value decreased in the second half of 2018 (y/y)**

(Percent)



Source: CBR.

**In the first quarter of 2019, the current account strengthened compared to the same period last year on the back of lower import values and lower debt payments.** According to preliminary data, in January-March 2019, the current account surplus reached USD 32.8 billion (8.7 percent of GDP) compared to USD 30 billion (7.6 percent of GDP) in the same period last year. The value of exported goods dropped to USD 101.2 billion from USD 101.7 billion in the same period last year, reflecting somewhat lower oil prices compared to the same period last year, a reduced grain harvest in 2018, and lower exports of machines, equipment and transport vehicles. REER depreciation (-5 percent, y/y) weighed down on import values, somewhat strengthening the trade balance. Lower debt levels combined with a weaker ruble supported the investment-income balance. As global financial conditions eased somewhat in the beginning of 2019, the government sector registered a net inflow of portfolio investment (mainly in OFZ bonds). FDI inflow increased to 3 percent of GDP from 1.6 percent of GDP in the first quarter of 2018. Yet, overall net capital outflows from the private sector grew to USD 25.6 billion (6.8 percent of GDP) from USD 20.6 billion (5.2 percent of GDP) in the same

period last year, driven mainly by the acquisition of foreign assets by the banking sector.

**International reserves gained USD 18.1 billion in the first quarter of 2019 and stand at a comfortable USD 487.8 billion.** This gain was largely because of the resumed foreign currency purchases under the fiscal rule framework. Growth in international reserves had stalled in September 2018, when the Central Bank suspended FX interventions in the fiscal rule framework to stabilize financial markets. Reserves amounted to USD 468.5 billion in the end of 2018 and increased to USD 487.8 billion in the first quarter of 2019, compared to USD 432.7 in the end of 2017. The import cover stayed at a comfortable level, slightly higher than at the end 2017 (17.1 months of goods and services in the end of March 2019, compared to 15.9 months at the end of 2017). The Central Bank refrained from intervening on its own, in line with its flexible exchange-rate regime. Relatively high levels of international reserves, a relatively low external debt (27.3 percent of GDP at the end of 2018), and the recently established macroeconomic framework helped Russia to limit exposure to external volatility and absorb external shocks.

#### 1.4 Labor Market and Poverty Trends: unemployment declines, wages increase, but disposable incomes are not growing

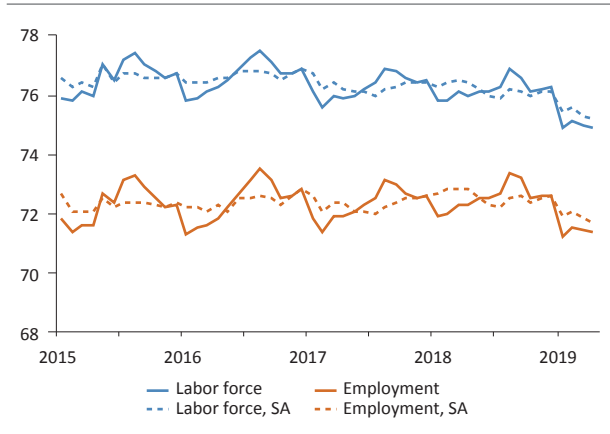
*Unemployment declined further in the first quarter of 2019 to a current 4.8 percent while real wages increased. In 2018, real wage growth was positive in both tradable and non-tradable sectors and was highest in the public sector. However, real income dynamics worsened toward the end of 2018. The poverty rate under the national definition decreased in 2018, driven by a rebound in household incomes.*

**The employment and labor-force participation rates declined slightly while unemployment was close to a minimum.** The absolute number of employed people decreased by 700,000 to 71.4 million in the first quarter of 2019, compared to the levels of a year earlier (Figure 9). The labor force decreased during the same period even more, by 900,000 people, to 75.0 million. Employment and labor force participation rates declined in the first quarter of 2019 compared to the same period a year ago by 0.4 and 0.6 percentage points respectively.

These rates were at 59 and 62 percent. The decline in economic activity was partly driven by the aging of the population and the increased shares of older cohorts, which on average have lower participation rates. The effect of the increased retirement age has not translated to the labor force participation rates yet. Lower labor supply also that led to decrease of unemployment rates by another 0.3 percentage points in the first quarter of 2019 (to 4.8 percent) (Figure 10).

**Figure 9: Labor force and employment started to decline**

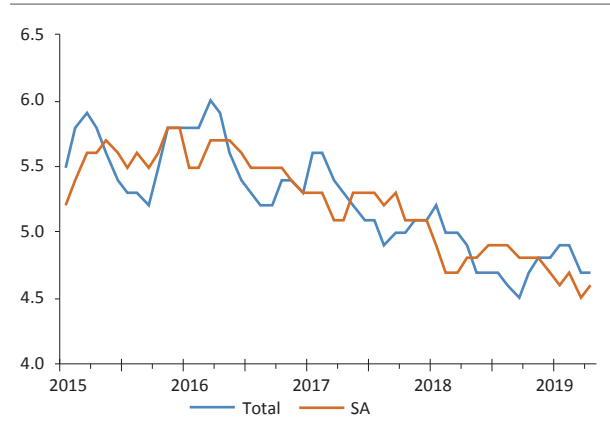
(Million people)



Source: Rosstat and Haver Analytics.

**Figure 10: Unemployment rate remains low**

(Percent)



Source: Rosstat and Haver Analytics.

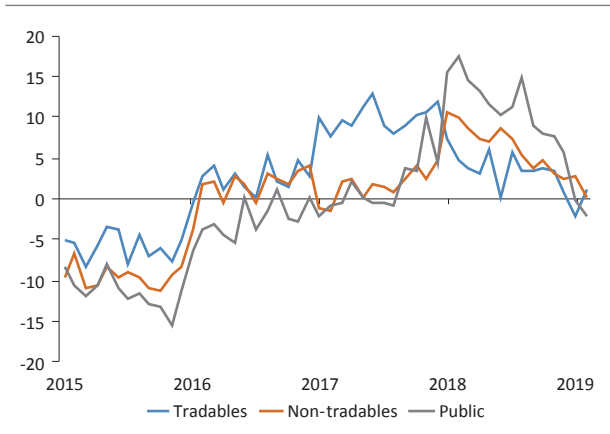
**Real wage growth decelerated in all sectors.** Real wage growth in the last quarter of 2018 and in the first quarter of 2019 was much slower than in the beginning of 2018. This can partly be explained by the effect of a high base a year ago (Figure 11). The fastest real wage growth was in the public sector: health (10.6 percent in the September 2018 - February 2019 period compared to the same period a year ago) and R&D (7.1 percent). Real wages grew robustly in agriculture (6.3 percent). Real wage growth in other tradable sectors was much lower: 1.4 percent on average (3.7 percent in mining, and a decline of 0.4 percent in

manufacturing). Among non-tradables, the highest real wage growth rates were in the wholesale and retail trade (4.5 percent), while wages in construction increased only by 2.1 percent.

**Real disposable income dynamics remains volatile.** In the last quarter of 2018, real disposable income growth was minus 1.4 percent (Figure 12). The decline is partly explained by increases in the effective tax burden and obligatory payments including loan services and repayments. Rosstat took the decision of not reporting this indicator monthly anymore. It will be reported only quarterly

**Figure 11: Real wages by sector decelerated in all sectors**

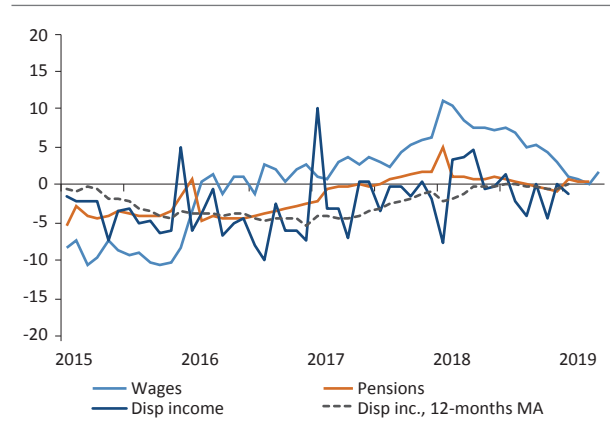
(Percent, year on year)



Source: Rosstat and World Bank staff estimates.

**Figure 12: Real incomes dynamics remains slow**

(Percent, year on year)



Note: Pension and disposable income dynamics adjusted for January 2017's one-time payment  
Source: Rosstat and World Bank staff estimates.

starting from 2019, with a slightly different methodology.<sup>1</sup> The dynamics in the first quarter of 2019 was negative (contraction of 2.3 percent to the same period of last year) according to the new methodology. Labor pensions were indexed at 7.05 percent in January 2019 – above the current rate of inflation – and social pensions were indexed by 2 percent in April 2019. This should support the level of pensions and keep it growing in real terms.

**The official poverty rate declined slightly in 2018.** Driven by growth in the main sources of income, wages and pensions, the poverty rates in Russia decreased in 2018 compared to 2017. The poverty rate dropped from 13.2 percent in 2017 to 12.9 percent in 2018 (Table 1).

**Table 1: Poverty**  
(Cumulative)

	2010	2011	2012	2013	2014	2015	2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Poverty rate, percent	12.5	12.7	10.7	10.8	11.2	13.3	13.3	15.0	14.4	13.8	13.2	14.2	13.6	13.3	12.9

Source: Rosstat.

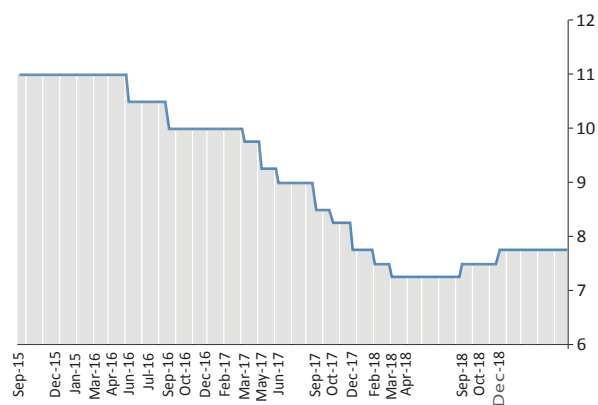
### 1.5 Monetary Policy: the CBR keeps it relatively tight, but some relaxation is expected in the second or third quarter of 2019

In the beginning of 2019, the CBR’s monetary policy remained consistent with the inflation-targeting regime. A relatively tight monetary policy, together with a softening of financial conditions for emerging markets, helped curb inflationary pressures. Inflation appears to have peaked in March and reached xx percent in May. However, household inflation expectations and corporate price expectations remained elevated.

**The Central Bank of Russia kept the policy rate unchanged at 7.75 percent as inflationary risks decreased.** In January-May 2019, the CBR kept the key policy rate unchanged since its increase by a cumulative 50 basis points in the second half of 2018, thus bringing it up to 7.75 percent in annual terms, which is above the neutral rate<sup>2</sup> of 6 to 7 percent (Figure 13). The 2018 increase was sufficient to curb the effects of one-off inflationary factors, such as the ruble depreciation, turbulence in emerging markets and the value added tax (VAT) rate increase in January 2019.

**Figure 13: The CBR keeps its key policy rate unchanged in the first five months of 2019**

(Key policy rate, percent)



Source: CBR.

**In the first quarter of 2019, the annual consumer price inflation significantly increased, exceeding the target of 4 percent, while still remaining below the CBR’s expectations (Figure 14).** The short-term inflationary risks softened: the foreign financial

and commodity markets stabilized and the VAT pass-through to prices was quite moderate. Thus, after its peak in March, when the annual consumer

<sup>1</sup> Among the most important differences are the decreased share of unobserved incomes (from 26 to 11 percent) and changes in the accounting for foreign currency operations.  
<sup>2</sup> A neutral key rate would not either decelerate or accelerate inflation, relative to the target level of 4 percent.

inflation edged up to 5.3 percent, y/y, from 4.3 percent in December 2018 and marked the highest reading since December 2016, it started to ease in April, decelerating to 5.2 percent, y/y. The inflation is expected to return to the 4 percent target in the first half of 2020. The CBR also signaled that if the situation developed in line with their baseline forecast, it may renew its movement to a 6-to-7-percent neutral rate in Q2-Q3 of 2019, but needs to proceed at a slower pace, given continuing upside risks to the inflation outlook. One is that despite the reduction in short-term risks, the overall balance of medium-term risks remains tilted towards pro-inflationary ones. Among the key risks are geopolitical factors, renewal of volatility in financial markets, acceleration of household credit growth, which puts upward pressure on prices, and a rise in inflation expectations.

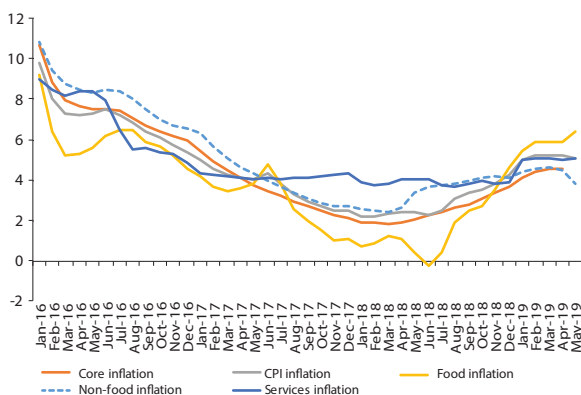
**Household inflation expectations and corporate price expectations remained elevated.** Household inflation expectations for twelve months ahead rose starting May 2018 after an increase in gasoline prices. They continued their upward trend till the beginning of 2019, influenced by the weakening of the ruble, an increase in the prices of selected consumer goods and a VAT hike (Figure 15). Corporate-sector inflation expectations also rose for three months ahead. In February-March 2019, both household and corporate expectations fell

substantially. Among the key factors that contributed to this decline were a stabilization of gasoline prices, a stronger ruble exchange rate and an adaptation to the VAT rate increase. The most significant decline in corporate price expectations was registered in trade. This may indicate that companies viewed the process of the VAT hike's pass-through to prices as mostly complete. However, in April - May 2019, the dynamics of inflation expectations of economic agents was mixed. Corporate price expectations continued to decline to the level of 9.5 percent, while household inflation expectations slightly increased to 9.3 percent.

**Elevated geopolitical tensions and difficult external financial conditions for emerging markets resulted in the ruble's depreciation in 2018.** However, in the beginning of 2019, the ruble exchange rate strengthened. For the period of January-May 2019, the currency appreciated about 4 percent against US dollar, supported by an easing of global financing conditions, higher oil prices and lower risk perceptions. The situation in the foreign exchange (FX) market stabilized after a period of volatility in the second half of 2018.<sup>3</sup> Starting January 2019, the CBR resumed its forex interventions in the fiscal rule framework. In the first four months of 2019, the CBR's FX purchases amounted of about USD 17.4 million, compared to USD 16.2 million in the same period of 2018.

**Figure 14: In 2019, inflation rose above the CBR's target**

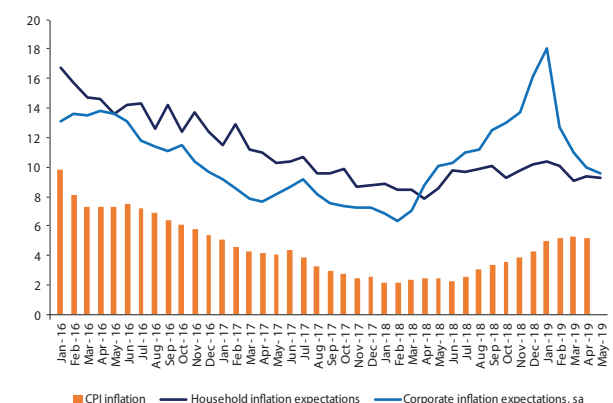
(CPI index and its components, percent, y-o-y)



Source: CBR and Haver Analytics.

**Figure 15: Inflation expectations are elevated**

(Percent)



Source: CBR.



## 1.6 The Banking Sector: relatively stable but weak, with uneven growth across different segments

The Russian banking sector has been relatively stable, supported by modest economic growth and the proactive position of the regulator. The CBR has been taking timely steps to address the risks of the accelerated consumer-lending growth, and it continued its sector clean-up by revoking the licenses of some smaller banks and focusing on the financial rehabilitation of large financial institutions. However, the continuing fast-paced expansion in household credit may pose a risk to financial stability in the case of a deterioration in the macroeconomic environment.

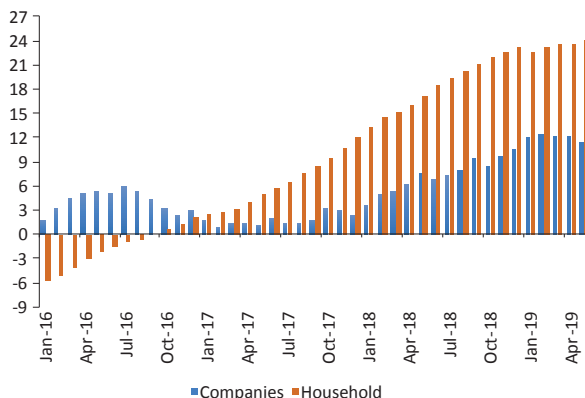
**The Russian banking sector is stabilizing as the modest economic growth supports lending growth, though dynamics vary from segment to segment, and credit risk and sector performance indicators remain stable.** Corporate demand for new loans strengthened as credit to the corporate sector in Rubles grew by 11.4 percent, y/y, as of May 1, 2019 (Figure 16). Lending to households in Rubles continues to grow in double digits – at 24.0 percent, y/y, at the same time. Lending to SMEs has been stagnating despite various government support measures. While earlier recapitalization of some large banks negatively affected banking-sector profitability, the latter continued to improve, supported by lending growth and stable NPLs. As of May 2019, banking-sector profits totaled RUB 750 billion (USD 11.4 billion), compared to RUB 537 billion in the same period of 2018. Return on

assets and return on equity have been growing steadily, reaching 1.8 percent and 15.9 percent respectively as of April 1, 2019 (Figure 17). These figures are skewed upwards by the positive results demonstrated by Sberbank, which accounts for about 30 percent of total system assets, generating more than 37 percent of system-wide profits. As of April 1, 2019, the top 5 banks generate 57 percent of all banking sector profits, and the state-owned banks account for 62 percent of all sector assets.

**System-wide capital adequacy ratio remained largely unchanged for the past six months at 12.2 percent as of April 1, 2019.** The continuing fast-paced expansion in household credit may pose a risk to financial stability in case of deterioration in the macroeconomic environment, but consumer lending risks appear to be contained by tightening

**Figure 16: Credit growth continued in both the retail and corporate segments**

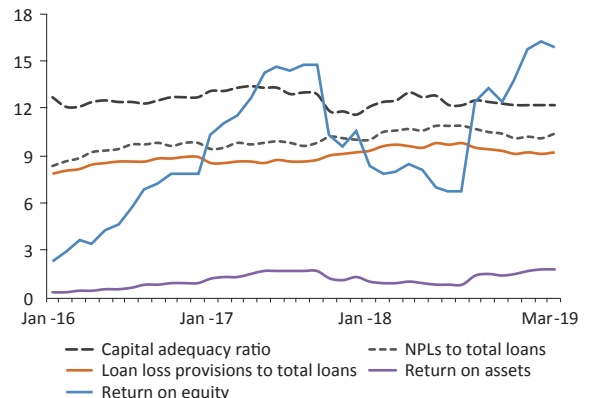
(y-o-y, percent)



Source: CBR, World Bank staff calculations.

**Figure 17: Overall financial sector indicators remained stable**

(Key credit and performance indicators, percent)



Source: CBR.

<sup>3</sup> In order to reduce the volatility in the FX market, the CBR suspended FX interventions from August to December 2018.

regulations. The CBR has taken timely steps to address the risks linked to the accelerated consumer lending growth by adjusting risk weights on unsecured retail loans three times in 2018 (the latest increase became effective on April 1, 2019). Additionally, the CBR is considering implementing payment-to-income (PTI) limits, with the first step being obligatory reporting of the ratio to the CBR by banks and microfinance organizations starting October 1, 2019. The Parliament is drafting a law to prohibit lending to borrowers whose monthly loan instalments exceed 50% of their family income.

**Despite rapid growth in Russian retail loans, the current situation is different from the one that led to the 2014 retail-loan crisis.** Current retail-loan growth in Russia is slower than in 2012-13, and there are no signs of nonperforming loans picking up. The system-wide retail nonperforming loan ratio has held largely steady since the beginning of the year, with some signs of decline – notably a drop of 5.1 percent as of April 1, 2019. Interest rates are also lower than in the past, which means households’ debt-servicing capacity has improved even as their debt burdens have increased. In addition, bank retail loan portfolios are now almost entirely denominated in the local currency (only 0.7 percent of retail loans are forex-denominated), shielding them from currency risks. However, extended loan durations may indicate that the banks have extended repayment periods to make loans affordable, without considering the underlying purpose of the loan, which may be short-term by its nature. Extended loan repayments enable borrowers to “borrow long-term and spend short-term.” The core risk is that the borrower will need to renew such expenditures (domestic consumption, health, education) whilst existing loan repayments continue – and will, therefore, need to seek additional loans, resulting in additional financial pressure.

**In 2019, the government put in place a massive, subsidized program to increase lending to SMEs.**

**Credit to SMEs had declined during the 2015-2016 recession.** This trend was reversed only recently, but SME lending volumes are still below the pre-crisis level (RUB 6.8 trillion in 2018), and the outstanding SME loan portfolio remained flat in 2017-2018 at RUB 4.2 billion (13 percent of total outstanding business loans and 4.1 percent of GDP). The National Project on SME and Individual Entrepreneurship Support (National SME Project) envisions provision of RUB 261.8 billion (USD 4 billion) public funds for improving SME access to finance, with a significant portion going to subsidized bank lending. It is planned that the volume of subsidies under the new program administered by the Ministry of Economic Development and SME Corporation since 2019 (“Program 8.5”) will increase lending manifold. Under this program, the participating banks (currently 70 banks) are compensated for the difference between the interest rate at which they lend to SMEs (capped at 8.5 percent) and the market rate, with compensation limited to no more than 1.5-2.75 percent differential. For this purpose, the federal budget in 2019 allocated RUB 9.2 billion (USD 142 million), which is expected to generate RUB 1 trillion (USD 15.4 billion) in subsidized SME loan issuance in 2019 (or 15 percent of the 2018 SME loan issuance volume). Overall, it is planned that the banks will issue RUB 10 trillion in subsidized SME loans in 2019-2024, with the federal budget subsidies for this purpose reaching RUB 56 billion (USD 862 million) in 2019-2021.

**The CBR’s license-revocation activities have slowed as the regulator has focused on the financial rehabilitation of several large financial institutions, including SIBs.** As of May 1, 2019, there were 469 banks in Russia, compared to 499 six months earlier. Following a series of bailouts of large and Systemically Important Banks (SIBs) in 2017-2018, in January 2019, the CBR bailed out the Moscow Industrial Bank (33<sup>rd</sup> by assets) via its Banking Sector Consolidation Fund (BSCF) and provided liquidity support in the amount of RUB 40 billion (USD 615 million). Capital shortfall





is estimated at RUB 60-100 billion (USD 0.9-1.5 billion). Since the BSCF was established by the CBR in 2017, ten banks were bailed out under its new resolution mechanism, with RUB 2,3 trillion spent on bank recapitalization and provision of liquidity. In March 2019, the regulator tested its first attempt to privatize a bank that had been recapitalized by BSCF by putting up for sale the Asian-Pacific Bank (APB) for RUB 9.86 billion (USD 152 million) in an open auction. But ultimately, the CBR had to cancel the auction given the lack of investor interest due to the complexity of the procedure. The central bank will postpone APB's privatization until the next year, in the meantime considering changing its auction format to allow for a broader set of options for privatizing resolved banks.

**Amendments to Russian banking laws introduced proportionate regulation starting from January 1<sup>st</sup>, 2019.** In line with the new regulatory regime, there are now three types of banks in Russia: SIBs, a category in effect since 2015), banks with a universal license and banks with a basic license. The CBR publicly designates 11 SIBs (accounting for

approximately 75 percent of the banking-system assets), which are subject to stricter prudential requirements. Banks with a total capital exceeding RUB 3 billion (USD 46 million) receive a “universal” license, which allows them to run a full scope of banking operations but forces them to comply with a wide range of regulatory requirements. Banks with total capital of less than RUB 1 billion receive a “basic” license and are subject to a simplified regulatory regime, but their operations are also limited in terms of the types, currencies and counterparts. Banks with a total capital of more than RUB1 billion, but less than RUB3 billion, may opt for either a basic or a universal license. As of April 2019, there were 144 banks with basic licenses in Russia, accounting for less than 0.5 percent of total banking system assets.

**Customer deposits remain the primary funding source for Russian banks.** The sector's reliance on wholesale market funding is low, with customer deposits (almost equally split between corporate and retail) comprising 80 percent of liabilities.

## 1.7 Fiscal policy: After the fiscal stance improved in 2018, the focus turned to national projects

*In 2018, the general government fiscal balance improved on the back of higher oil prices and the government's commitment to the new fiscal rule<sup>5</sup>. The general government registered surplus of 2.9 percent of GDP, the federal, 2.6 percent and the regional, 0.5 percent. The debt burden continued to decrease, both at the federal and the regional level. The government has put significant effort into shaping national projects, which total 25.7 trillion rubles (about USD 390 billion or between 2.8 to 3.2 percent of GDP annually) for 2019-2024. These projects are aimed at reaching goals set in the President's May Decree. The liquid part of the National Welfare Fund (NWF), currently at about 3.6 percent of GDP, could exceed 7 percent of GDP by the end of 2019, giving the government the ability to invest part of it in domestic infrastructure projects. But while Russia's infrastructure gaps are large, substantial investment in domestic infrastructure projects from the fund could reverse the achievements of the fiscal rule, which reduced the economy's dependence on energy prices.*

**In 2018, the general government fiscal balance improved on the back of higher oil prices and the government's commitment to the new fiscal rule.** The general government deficit of 1.5 percent of

GDP turned into a surplus of 2.9 percent of GDP in 2019 as general government revenues increased by 2.2 percent of GDP to 35.9 percent of GDP (Table 2) and general government expenditures dropped

<sup>5</sup> The fiscal rule limits federal budget expenditures targeting federal budget primary deficit of 0.5 percent of GDP at the benchmark oil price of USD 40 per barrel in 2017 prices.

<sup>6</sup> Cash basis, preliminary information.

by 2.2 percent of GDP to 33.0 percent of GDP. Higher oil prices, combined with a weaker ruble, resulted in higher oil/gas revenues (+2.2 percent of GDP, compared to 2017). Certain non-oil/gas tax revenues grew as a share of GDP (corporate income tax, VAT), reflecting the weaker ruble, higher prices for exported commodities and improved tax administration. Still, overall non-oil/gas revenues remained flat, largely because of shrinking revenues from social taxes (-0.2 percent of GDP), the base for which shrank as a share of GDP. General government primary expenditures decreased as a share of GDP by 2.2 percent of

GDP, as the federal government stayed committed to the path of fiscal adjustment for the new fiscal rule. The decrease in spending occurred mostly at the federal level: federal government spending on defense and national economy fell by 0.4 percent of GDP and social expenditures dropped by 1 percent of GDP. Social expenditures indexed mostly by the CPI shrank as a share of GDP as the GDP deflator was higher than the CPI. Another reason was a high-base effect for 2017, when the government conducted a one-time payment to pensioners. The non-oil/gas general government primary deficit improved to 4.9 percent of GDP in 2018 from 7.1

**Table 2: Government fiscal stance strengthened in 2018**

<b>General government (% of GDP)<sup>7</sup></b>	<b>2017</b>	<b>2018</b>
Revenues	33.7	35.9
Expenditures	35.2	33.0
Interest payments	0.9	0.9
Primary expenditures	34.3	32.1
Balance	-1.5	2.9
Primary balance	-0.6	3.8
<b>Federal government* (% of GDP)</b>	<b>2017</b>	<b>2018</b>
Revenues	16.4	18.7
Oil and gas revenues	6.5	8.7
Non-oil/gas revenues	9.9	10.0
Expenditures	17.8	16.1
Primary expenditures	17.1	15.3
Interest payments	0.8	0.8
Primary balance	-0.7	3.4
Non-oil/gas primary balance	-7.1	-5.3
Balance	-1.4	2.6
<b>Consolidated regional government (% of GDP)</b>	<b>2017</b>	<b>2018</b>
Revenues	11.7	11.9
Expenditures	11.7	11.4
Primary expenditures	11.6	11.3
Interest payments	0.15	0.1
Balance	0.0	0.5
Primary balance	0.1	0.6
<b>Extrabudgetary funds (% of GDP)</b>	<b>2017</b>	<b>2018</b>
Revenues	11.6	10.5
Expenditures	11.6	10.7
Balance	0.0	-0.2

Source: EEG.

<sup>7</sup> Due to consolidation, the sum of revenues (expenditures) at different levels does not equal revenues (expenditures) of the general government.

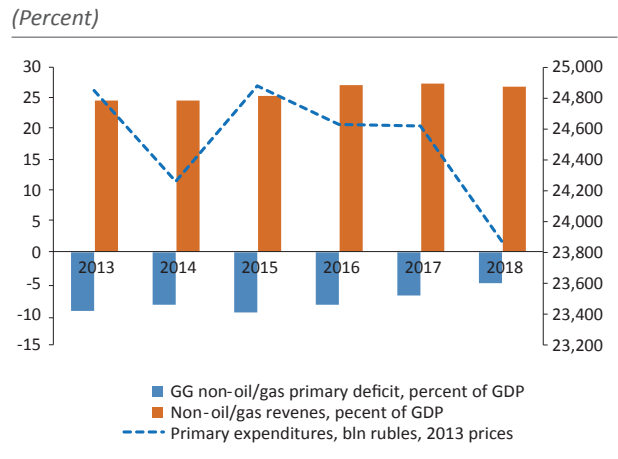
Higher energy prices and the federal government’s commitment to the new fiscal rule turned the federal budget deficit of 1.4 percent of GDP in 2017 into a federal government surplus of 2.6 percent of GDP in 2018.

The consolidated regional budget primary surplus, 0.1 percent of GDP in 2017, widened to 0.6 of GDP in 2018 as tax revenues increased and expenditures dropped as a share of GDP (national economy, social policy, -0.1 percent of GDP each).

**Overall, the general government primary non-oil/gas fiscal deficit improved from 9.5 percent of GDP in 2013 to 7 percent of GDP in 2017 and 5 percent of GDP in 2018<sup>8</sup> (Figure 18).** This was largely supported by a new macroeconomic framework established by the government and its commitment to fiscal consolidation. The government used revenue from improved tax administration and expenditure cuts. General government expenditures decreased in real terms

compared to 2013. Government spending on health and education decreased more than average as the share of expenditures for health and education decreased in 2017 compared to 2013 (Box 1). Thus, government national projects, increasing expenditures for education by about 0.1 percent of GDP per year and for health by 0.2-0.3 percent of GDP per year, are steps in the right direction.

**Figure 18: The government pursues a policy of fiscal consolidation**



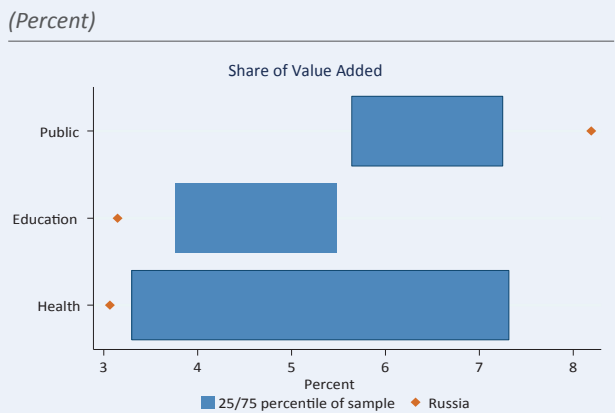
Source: Ministry of Finance of the RF.

**Box 1 In Russia, the shares of the education and health sectors in GDP are small compared to in advanced economies**

The shares of the education and health sectors in GDP are small compared to advanced economies, while the share of the public sector exceeds that of advanced economies. Shares of spending on national economy (which includes state support to various sectors of the economy, including roads construction and maintenance) in total public spending exceeds that of the advanced economies (Figures B1 and B3).

Certain health and education sectors outcomes also lag those in advanced economics. While Russia’s education system shows good performance in Harmonized Learning Outcomes, there are areas where more government focus is needed, for example, in socio-emotional skills (Figure B2). Expected increased investment in health and education from the national projects, if spent effectively and efficiently, can help improve productivity.

**Figure B1: State management sector is large while educational and health sectors are small**



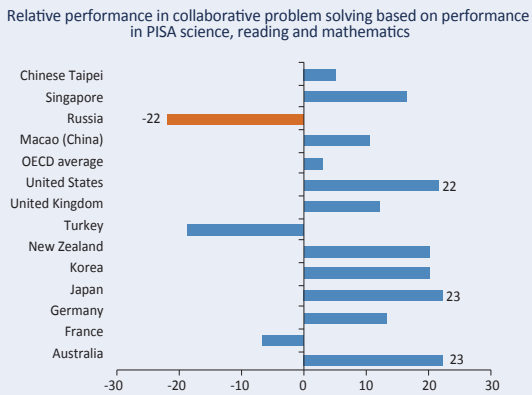
Russia data is from 2018. Other countries are latest values, usually 2015. Samples include 23 EU countries and US, Japan, Canada and China.

Source: World Bank.

<sup>8</sup> Preliminary information.

**Figure B2: The socio-emotional skills require more attention of the government**

(Percent)

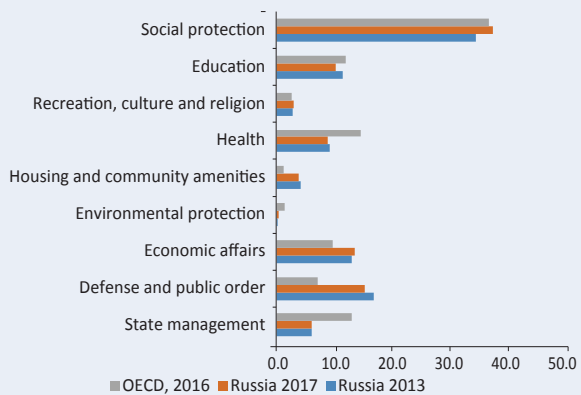


Source: World Bank, World Economic Forum.

Collaborative problem solving is part of the PISA 2015 test which shows the ability of 15 years old students to collaborate in solving learning the problems, lead the team, and agree on solutions (the task example is available by this link - <http://www.oecd.org/pisa/test/other-languages/xandarurireplacementtest.htm>).

**Figure B3: The share of expenditures for health and education in Russia is lower than in OECD countries**

(Percent)



Source: Federal Treasury of the RF, OECD.

**The debt burden continued to decrease both at the federal and the regional levels in 2018.** That year, external debt payments and capital outflow from emerging markets resulted in a lower federal government external debt. Total federal government debt reached 12.2 percent of GDP compared to 12.6 percent of GDP in 2017. Regional debt decreased to 2.1 percent of GDP from 2.5 percent of GDP in 2017, with a stronger fiscal position. The number of regions with debt volumes exceeding revenues fell from seven in 2017 to two in 2018 (Republic of Mordovia and Kostromskaya oblast).

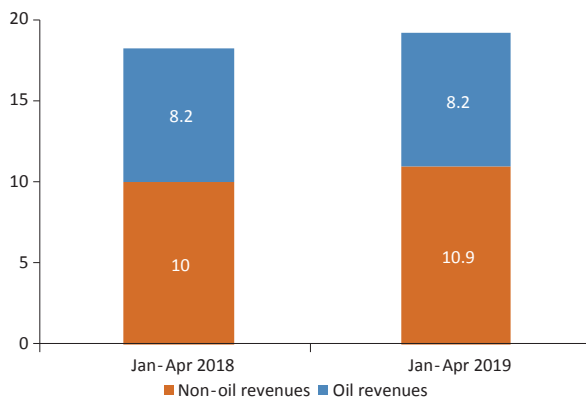
**The National Welfare Fund (NWF) reached USD 58.1 billion (3.8 percent of GDP) by the end of 2018.** In line with the fiscal rule, about USD 65 billion of foreign currency purchased by the Ministry Finance in 2018 will be channeled to the NWF in 2019. The liquid part of NWF could exceed 7 percent of GDP by the end of 2019, giving the government the ability to invest part of the NWF in domestic infrastructure projects. Currently, the government is also considering other opportunities for the fund's investment, notably export financing and export services development.

**On the back of stronger non-oil revenues, the federal budget surplus improved to 2.1 percent of GDP in the first four months of 2019, up from 0.9 percent of GDP in the same period last year.** In January - April 2019, non-oil and gas revenues grew, compared to the same period last year (Figure 19). This was largely the result of a VAT rate increase<sup>9</sup> and a weaker ruble in the four months of 2019, compared to the same period in 2018. Weaker ruble and higher energy goods production and export compensated for lower prices, keeping oil and gas revenues at the same level (as a share of GDP) as in January – April 2018. Primary expenditures edged down by 0.1 pp. Spending on national economy dropped by 0.2 percent of GDP and shrank in nominal terms (Figure 20 and 22). Lower primary expenditures and higher non-oil/gas revenue led to an improvement of the non-oil/gas federal budget primary deficit (Figure 21). In January-March 2019, the general government balance improved to 5.4 percent of GDP from 3.2 percent of GDP in the same period last year. This was largely the result of lower spending on social policy, national economy, interest.

<sup>9</sup> Base VAT rate increased from 18 to 20 percent since January 1, 2019.

**Figure 19: Federal Budget (FB) non-oil and gas revenues grew**

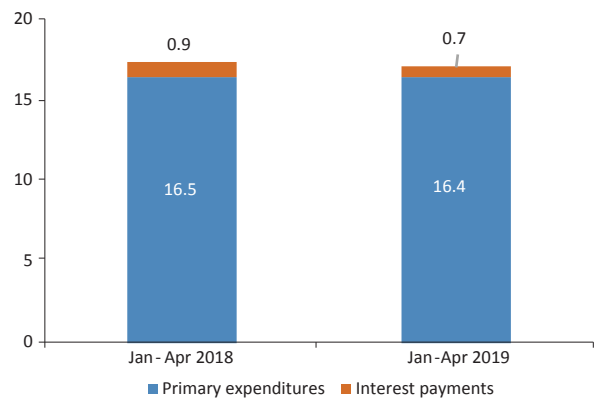
(Percent)



Source: EEG.

**Figure 20: FB expenditures dropped**

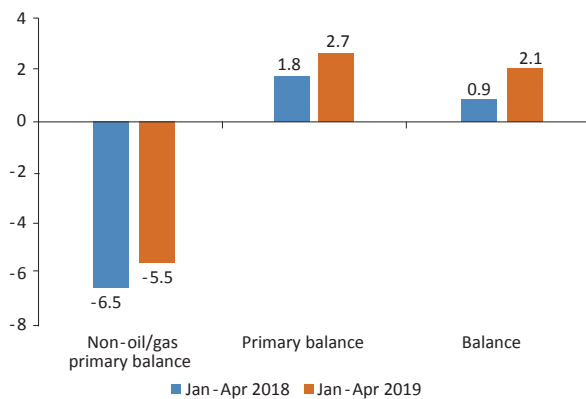
(Percent)



Source: EEG.

**Figure 21: FB non-oil/gas primary deficit improved**

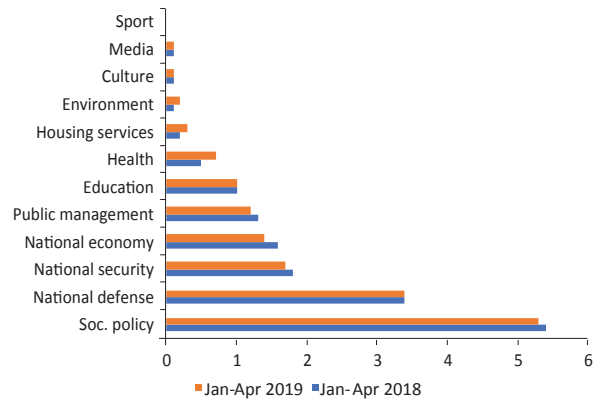
(Percent)



Source: EEG.

**Figure 22: FB spending as a share of GDP decreased for national economy, public management, national security, social policy**

(Percent)

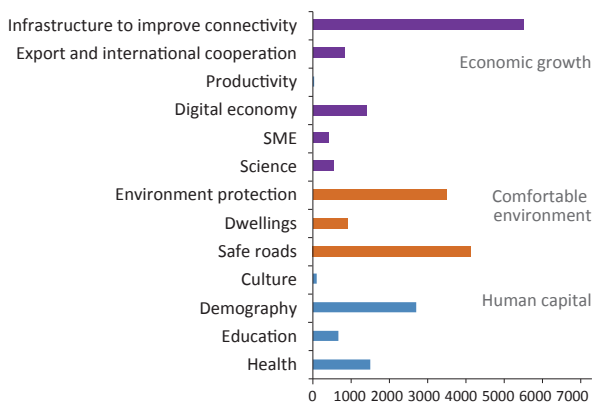


Source: EEG.

**The government continues shaping the national projects aimed at reaching the goals stated in the May Decree.** In February 2019, the government approved the main indicators to be reached by the national projects. The 13 projects are divided into 3 specific areas: human capital (5.7 trillion rubles or USD 86.2 billion), quality of life (9.9 trillion rubles or USD 149.9 billion), and economic growth (10.1 trillion rubles or USD 152.8 billion). They are mostly financed from the federal budget (Figure 23 and Figure 24). The projects address Russia’s need for higher human-capital financing. About 25 percent of the funds would go to infrastructure aimed at increasing connectivity.

**Figure 23: National projects and financing**

(Billion rubles)

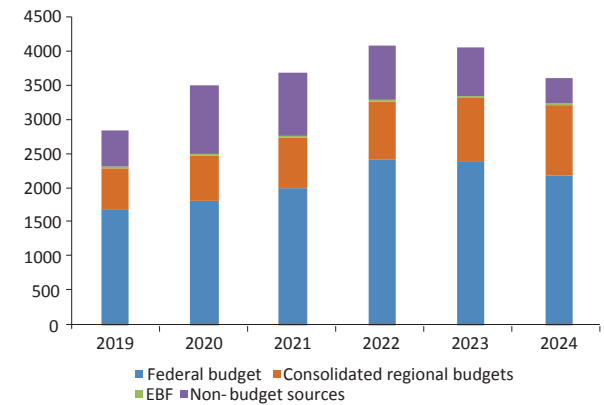


Source: Ministry of Finance.

In January 2019, the government adopted measures to increase the efficiency of public expenditures in 2019-2024. Such measures included regularly reviewing public expenditures for their efficiency, managing tax expenditures, and improving public procurement procedures. These are important steps in the right direction. The government intends to complete a full cycle of budget expenditures review every six years, and it also plans on implementing its findings regarding expenditure efficiency. The introduction of tax expenditure management would provide for a complex assessment of the efficiency of the current system of tax expenditures, currently estimated at 3.3 percent of GDP. These initiatives could create additional fiscal space and positively affect the business environment.


**Figure 24: National projects and financing**

(Billion rubles)



Source: Ministry of Finance.

**RUSSIAN ECONOMIC  
GROWTH IS EXPECTED  
TO SLOW DOWN  
AFTER TEMPORARY  
ACCELERATION IN 2018**





*Global growth is expected to slow down to 2.8 percent by 2021. Downside risks to the global projection remain elevated, with forecasts predicated on no further escalation in trade tensions, stable commodity prices and diminishing headwinds from earlier disruptive financial market developments. Crude oil prices (defined as an average of Brent, West Texas Intermediate, and Dubai) are expected to rise somewhat from their current levels and average USD 66/bbl in 2019 and USD 65/bbl in 2020-21. Russia's growth is forecasted at 1.2-1.8 percent in 2019-2021. If ongoing national projects are implemented effectively and efficiently, they could contribute to an increase in the potential growth, but only after 2021.*

## **G**lobal growth is expected to reach 2.8 percent by the 2021 horizon (Table 3).

Tepid growth in major commodity exporters, as well as a modest recovery in economies previously affected by acute financial pressure, are expected to offset decelerating activity in major economies. Sustained weakness in global investment is anticipated to weigh on growth amid elevated economic policy uncertainty. Downside risks to the global projection remain elevated, with forecasts predicated on no further escalation in trade tensions between the United States and China (as well as other major partners), stable commodity prices and diminishing headwinds from both policy uncertainty and disruptive financial market developments. A sharper-than-expected slowdown in major economies, such as the United States, China, and the Euro Area, could also dampen global prospects.

### **Price forecasts and risks**

**The price of crude oil (an average of Brent, WTI, and Dubai) is expected to rise somewhat from current levels and reach USD 66/bbl in 2019 and USD 65/bbl in 2020-21.** This is a downward revision from the previous forecast and reflects weaker-than-expected global growth and a much larger increase in U.S. production than anticipated in 2018. Risks to the oil price outlook relate primarily to policy decisions by major oil-producing countries. The United States decision on April 22 to terminate waivers to its sanctions on Iran could put upward pressure on oil prices by reducing Iranian oil exports, which are currently around

1.4 mb/d. However, other major oil-producing countries, such as Saudi Arabia and the United Arab Emirates, could increase production to compensate for any shortfall as OPEC currently has around 3.5 mb/d of spare capacity. But it is unclear how rapidly these countries will be willing to respond to a reduction in Iranian exports. OPEC is due to meet in June to discuss whether to extend production cuts, especially in light of recent oil price volatility, or to respond to any shortfall in production. As such, prices could stabilize from recent lows before rising in the second half of 2019. Other risks include conflict-related disruptions in Libya and further deterioration in Venezuela. On the downside, global demand could turn out to be weaker than expected, while U.S. shale production could surprise on the upside again.

**Non-energy commodity prices are expected to be broadly flat over the next two years.** Metal prices are expected to continue their partial recovery in 2019 but decline modestly overall, before picking up in 2020. Supply concerns (especially in copper, iron ore and zinc), and China's fiscal stimulus are expected to provide support. Risks are broadly balanced. Agricultural prices are expected to fall 2.6 percent in 2019, on average, amid ample stocks. In 2020, prices are expected to rise 1.7 percent on expected cuts in U.S. crop plantings and higher costs of energy and fertilizers. Risks to the agriculture price outlook are to the upside. Higher-than-expected energy costs could lift the prices of crops such as grains and oilseeds.



**Table 3: Global growth is expected to hover around 2.8 percent**

(GDP growth projections, percent)

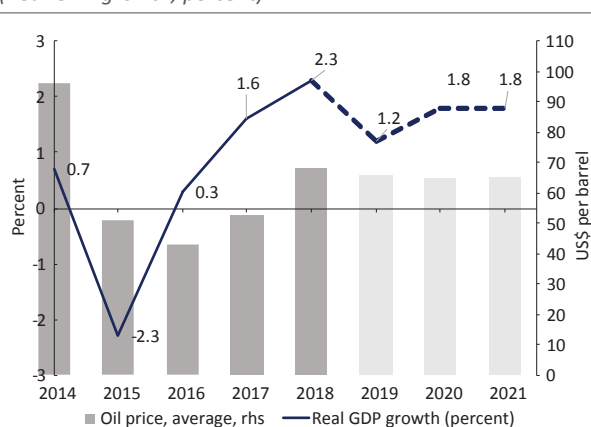
	2016	2017	2018	2019f	2020f	2021f
World	2.4	3.1	3.0	2.9	2.8	2.8
Advanced economies	1.7	2.3	2.2	2.0	1.6	1.5
United States	1.6	2.2	2.9	2.5	1.7	1.6
Euro Area	1.9	2.4	1.9	1.6	1.5	1.3
Emerging and developing economies	3.7	4.3	4.2	4.2	4.5	4.6
China	6.7	6.9	6.5	6.2	6.2	6
Russia	0.3	1.6	2.3	1.2	1.8	1.8
Crude oil (Brent, WTI and Dubai average, USD/bbl)	42.8	52.8	68.3	66	65	65.5

Source: WDI, World Bank staff projections.

Russia's overall growth prospects for 2019-21 remain modest at 1.2 to 1.8 percent in 2019-2021, in line with its current potential growth trends (Figure 25 and Table 4). GDP growth in 2019 is projected to be 1.2 percent. Continued oil production cuts and deterioration in the external environment (which affects export growth) are factors weighing down on GDP growth in the second quarter on top of subdued domestic demand. A less tight monetary stance and acceleration in the implementation of national projects weigh in favor of growth acceleration in the second half. Yet, weak growth dynamics in the first half are expected to affect the annual growth number through

**Figure 25: The growth forecast for Russia suggests modest growth**

(Real GDP growth, percent)



Source: Rosstat, World Bank.

**Table 4: Projected growth rates are modest**

(Major macroeconomic indicators)

	2017	2018	2019	2020	2021
GDP growth, percent	1.6	2.3	1.2	1.8	1.8
Consumption growth, percent	3.1	1.8	0.9	1.3	1.4
Gross fixed capital formation growth, percent	5.2	2.9	1.6	3.3	3.7
General government balance, percent of GDP	-1.5	2.9	1.7	1.6	1.5
Current account (US\$ billions)	33.3	114.9	86.3	82.3	80.1
Current account, percent of GDP	2.1	6.9	5.1	4.7	4.4
Exports (GNFS), bln USD	411.3	508.7	493.5	504.5	521.0
Imports (GNFS), bln USD	326.9	344.5	354.9	369.4	386.0
Trade balance (GNFS), bln USD	84.3	164.2	138.6	135.1	135.0
Trade balance (GNFS), percent of GDP	5.3	11.7	8.2	7.7	7.4
Capital and financial account (US\$ billions)	-19.6	-65.6	-36.1	-30.5	-26.3
Capital and financial account, percent of GDP	-1.2	-4	-2.1	-1.7	-1.4
CPI inflation (average)	3.7	2.9	5	4	4

Source: WB staff calculations.

the carry over effect. GDP growth is expected to accelerate to 1.8 percent in 2020 and 2021. Household consumption growth is expected to rebound after its 2019 deceleration, and implementation of national projects is expected to support investment demand.

**Supported by relatively high oil prices, the general government budget is expected to remain in surplus in 2019-2021.** CPI inflation peaked in March 2019. It is expected to decelerate for the rest of 2019, averaging 5.0 percent, y/y. The CPI inflation is expected to return to the central bank's target of 4 percent in 2020-21. The forecast of a narrower external surplus reflects lower oil prices and a pick-up in import spending. Net capital outflow is expected to decrease gradually with lower debt payments.

**The moderate poverty rate is expected to continue to decline in 2019 and through 2021, although social vulnerability needs to be monitored.** Continued growth of the economy, wage growth in the private sector, and the indexation of pensions to inflation will support disposable incomes and contribute to a gradual decline in the poverty rate (Table 5). However, many individuals lack formal employment and many households remain close to the poverty line, suggesting a level of social vulnerability that will continue to require close monitoring.

### Risks and challenges

**Russia faces risks both external and domestic.** Downside risks to Russia's growth outlook stem from the potential expansion of sanctions, renewed financial turmoil in EMDEs, and a

dramatic drop in oil prices. The recent expansion in household credit may pose a risk to financial stability in the case of a deterioration in the macroeconomic environment. Investment growth is subject to the successful and efficient implementation of government infrastructure investment initiatives.

**Low potential growth remains a challenge for Russia.** Currently potential growth is estimated at about 1.5 percent of GDP. Accumulated structural and institutional challenges (low productivity growth, weak institutional quality, lack of competition) and demographic pressures weigh on potential growth. The national projects, which target such important areas as human capital, public infrastructure, and demography, could positively affect Russia's potential growth in the medium-term.

**Improvements in public financial management, which provide for level playing field, are crucial for efficient implementation of the national projects.** While there were many advances in public financial management, more remains to be done to improve the public procurement framework<sup>10</sup>. This includes efforts to make it more transparent and efficient, and leveling the playing field to enable firms to better compete for government contracts. For instance, in the road sector, significant efficiency gains from current spending patterns can be realized by (1) reviewing the procurement methods for civil works; (2) introducing performance-based management contracts; (3) introducing improved asset-management techniques and ensuring that the programming of road works

**Table 5: The moderate poverty rate is expected to continue to decline in 2018 and through 2021**

	2011	2012	2013	2014	2015	2016	2017	2018	2019 f	2020 f	2021 f
Poverty rate, percent	12.7	10.7	10.8	11.2	13.3	13.3	13.2	12.9	12.6	12.1	11.5

Source: Rosstat, WB staff calculations.

<sup>10</sup> Systematic Country Diagnostic for the Russian Federation: Pathways to Inclusive Growth, World Bank, 2016.

incorporates economic principles; (4) creating a more commercially oriented national road agency; and (5) improving strategic planning. In the railway sector, the key challenges are to improve efficiency, operations and maintenance, and to finance a technically and economically sound expansion program to keep up with rising demand.



# CURBING RUSSIA'S INFORMAL SECTOR: UNEARTHING CAUSES AND DEVELOPING SOLUTIONS\*

\* This section is based on a new report "Stemming Russia's Informality: Unearthing Causes and Developing Solutions" by Apurva Sanghi, Samuel Freije-Rodriguez, and Aleksandra Posarac (all World Bank). The interested reader is referred to this report for more in depth discussion and technical analysis, including a list of references.

Growing informal employment in Russia raises concerns about fiscal sustainability, productivity, and social protection. This part of the Russia Economic Report summarizes the most recent analysis on the size of the informal sector by employment, its determinants, and emerging policy directions to stem Russia’s rising tide of informality.

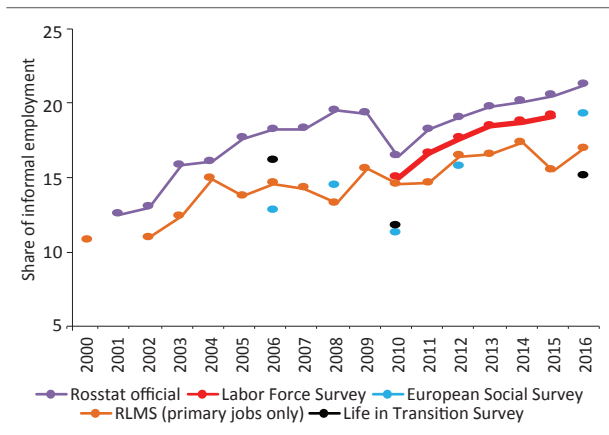
**A. How do Russia’s informality trends compare over time and with other countries?**

**How large is informal employment in Russia?** It increased from 12.5 percent in 2001 to 21.2 percent in 2016. It is defined as follows: workers are considered formal if they have a contract in their main job, regardless of the duration of contract; otherwise they are considered informal. Using various data sources, as shown in Figure 26, informal employment is on the rise in Russia. There is a long-term increase in informality from the early 2000s (and even before that, based on RLMS data) through to 2016 (with a short period of stagnation or even a decrease in the second half of the 2000s). Encouragingly, these trends and estimates are consistent across different data sources, including the official measure of informal employment monitored by Rosstat. Informality is estimated to range between 15.1 and 21.2 percent, or between

10.9 to 15 million people (with the share of self-employed estimated to be between 25 and 50 percent).

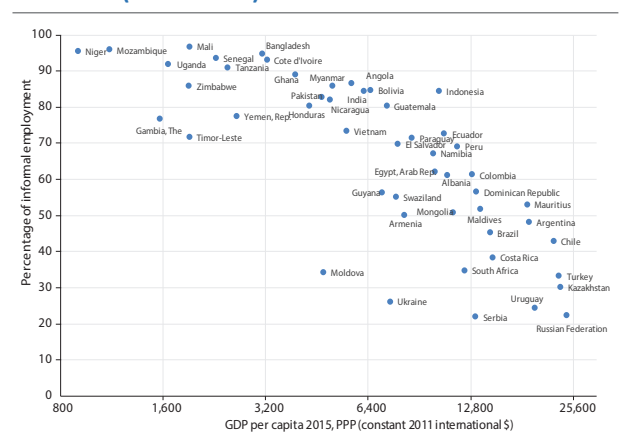
**How does informality in Russia compare to other countries?** It is worth noting that the nature of informality in Russia is different than that in most other countries. This is because of Russia’s high education level, the economy’s non-agrarian structure, and its reliance on hired labor (versus self-employment). This is apparent in Figure 27, which shows high informal employment rates in low-income countries – upwards of 90 percent in African countries – versus Russia’s 22 percent. However, middle-income countries such as Kazakhstan and Turkey, who have a similar GDPs per capita as Russia, show similar if not higher informal employment rates – 30 and 33 percent, respectively. Thus, compared to this set of middle-income countries, Russia’s share of informal employment is not high.

**Figure 26: Russia’s informal employment is on the rise, ranging between 15.1 and 21.2 percent (Percent)**



Source: Rosstat, RLMS, Labor Force Survey, European Social Survey, Life in Transition Survey.

**Figure 27: Russia’s share of informal employment is not that high when compared to other middle-income countries (2012-2017)**



Source: ILO-WIEGO informal employment database and ILOSTAT informal employment harmonized series, [www.ilo.org/ilostat](http://www.ilo.org/ilostat) (accessed June 4, 2018); and World Development Indicators for GDP data.

Note: Data corresponds to the most recent estimates of the informal employment rate within the period 2012-2017.

**Is informality rising or falling in Russia?** By global comparisons at least, Russia's share of informal employment does not appear too different. However, over time, the Russian economy has been characterized by a steady, long-term increase in informality from the early 2000s through to 2016. Informal employment increased in the first half of the 2000s, then briefly leveled off or even fell, but it continued to increase afterward. Specifically, Rosstat estimates that the country's informal employment increased from 12.5 percent in 2001 to 17.6 percent in 2005, with a slight dip to 16.4 percent in 2010 followed by a further significant increase in 2016, when it reached 21.2 percent. It is this continued increase over the past two decades that warrants further attention. It is worth noting that the fall in informal employment in the second half of the 2000s coincided with the global financial crisis. One plausible reason for why informality decreased during the crisis years is that labor demand for using informal workers shrank.

### **B. What Lies Beneath Russia's Rising Informality?**

**De-industrialization, changing demographics, and increased migration are often factors associated with rising informality.** De-industrialization, with its sectoral shift from manufacturing to services, could indeed be a factor, since services tend to attract more informal labor. Changes in the composition of demographics could also be associated with an increase in informality. For example, if women are on average more likely to be employed informally, a higher share of women among all employed would thus be associated with higher informality. Finally, migrant workers are often perceived to be more likely to be informal.

**De-industrialization cannot explain recent changes in Russia's informal employment.** The change in informality is driven by a higher incidence of informal employment across all sectors and not by shifts in employment towards

high-incidence sectors typically thought of as attracting informality such as construction or agriculture.

**Changes in demographic characteristics also play a small role.** One common trend across all surveys is that the probability of being informal in Russia has increased among those with only basic education. Interestingly, one of the few demographic characteristics to have changed rapidly over the period is the proportion of workers with tertiary education, and this has partially compensated for the growing probability of informal employment among those without this level of education. In other words, had the share in tertiary education not increased, the rate of informality would have grown even more. In 2010 for instance, according to RLMS data, on average and after controlling for other personal characteristics, people with higher education were 15.7 percentage points less likely to be informal than those with basic education. By 2016, those with some tertiary education were 24.2 percentage points less likely to be informal than those with basic education.

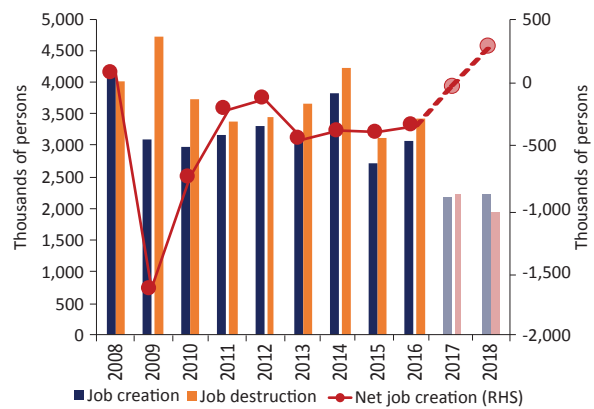
**Although migrants tend to be more informal, the overall impact of migration on informality is indeterminate.** Based on RLMS data for 2016, the share of informal migrant workers in Russia's informal labor force is higher (26.2 percent versus 15.7 percent of Russian workers). On average, migrants are not too different from Russian workers in terms of their age and gender composition. However, they are significantly less schooled, less likely to reside in urban areas, more likely to work in market services and to work longer hours. Migrant workers also get paid less per hour and have a higher likelihood of receiving part or all their wages unofficially (29 percent versus 19 percent for Russian workers). However, an important limitation is that traditional surveys do not capture illegal migrants. Thus, the share of migrants is likely to be underestimated in survey data. Another factor to consider is

causality: does informality pull more migrants or do migrants cause informality? Even so, though prima facie the share of informal migrant workers is relatively higher, the extent to which migrants thus contribute to informality is difficult to ascertain.

**Informality is driven by a lack of formal jobs. In Russia, formal net job creation has been woefully low.** Rosstat reported that the number of jobs created and destroyed for medium and large enterprises in 2018 were 2.22 million and 1.93 million, respectively. In 2017, these numbers were 2.18 million and 2.21 million, respectively. In other words, net job creation in Russia, at least in recent years, was close to zero. Figure 28 shows formal net job creation for medium and large enterprises in Russia. Sub-nationally, the relationship between informality and Gross Regional Product (GRP) is also found to be negative, with a Pearson

correlation coefficient of 0.41. That is, poorer regions are associated with higher informality, reinforcing the need for robust, formal job creation in such regions.

**Figure 28: Net formal job creation in Russia's medium and large enterprises has been close to zero**



Source: Authors' estimations based on Rosstat.  
 Note: Data for 2017-2018 are not consistent with the previous years due to methodological changes.

**Box 2 Labor market regulations in Russia are broad and mandatory**

On December 21, 2001, the State Duma in Russia adopted the Labor Code, the main legislative framework for labor regulations. The Code entered into force on February 1, 2002 and has been amended numerous times.

The following separate pieces of legislation supplement provisions of the Labor Code:

- The Employment of Population Act, 1991;
- The Collective Agreements and Accords Act, 1992;
- The Settlement of Collective Labor Disputes Act, 1995;
- The Trade Union Act, 1996;
- The Russian Tripartite Commission for Regulation of the Socio-Labor Relations Act, 1999;
- The Fundamentals of Health and Safety Act, 1999;
- The Compulsory Social Insurance Against Occupational Accidents and Diseases Act, 1998;
- The Fundamentals of Public Service Act, 1995;
- The Minimum Wage Act, 2000.

Other important sources of labor law in the Russian Federation are decrees and orders issued by the Government, notably normative documents issued by the Ministry of Labor and Social Protection with a view to implementing labor legislation. Several other federal executive bodies are also empowered to issue normative acts within the powers given to them by federal legislation, decrees, and orders of the President or Government of the Russian Federation.

According to Article 11 of the Labor Code, its application and that of other labor laws and regulations is mandatory in the entire territory of the Russian Federation for all enterprises (legal and physical entities), irrespective of their legal status and form of ownership. The labor contract should be in writing.



### C. Are Labor Market Rigidities Driving Informality?

**A well-functioning labor market is desirable for many reasons.** From an informality perspective, labor market rigidities can increase informal employment as they prevent formal firms from being able to hire or retrench workers according to their economic needs. Three aspects of the Russian labor market were analyzed: (i) Russia's labor legislation, including how it compares to other countries; (ii) Russia's tax-benefits system, and whether it creates disincentives to seek formal work; and (iii) Russia's labor mobility, both intersectoral and inter-regional.

#### *(i) How stringent are Russia's labor market regulations?*

Overly stringent rules and regulations in the labor code, such as restrictions on employment contracts, hiring and firing, and high minimum wages, may make labor markets less flexible. If so, employers could be pushed to rely on informal employment to bypass these restrictive regulations. Box 2 summarizes Russia's labor market regulations.

**Labor legislation in Russia is found to be broadly in line with internationally accepted labor standards and norms, in particular, with those of the ILO.** Indeed, out of the 77 conventions and 2 protocols ratified by the Russian Federation, 56 are in force, 18 conventions and one protocol have been denounced, one instrument abrogated and three have been ratified in the past 12 months. However, labor market regulations in Russia retain certain aspects that could be improved upon, particularly in the areas of the employment contracts, minimum wages, and employee dismissals. Small firms, in particular, bear a heavy burden in these areas, thereby exacerbating informality.

**On the employment contract:** There is some room for improvement in the type of employment contracts:

- Open-ended contracts are the prevailing form of employment contracts in Russia, accounting for 91 percent of all contracts for hired employees. This is on the high side when compared to the average of 59 percent in EU countries. Only 8 percent of all contracts are fixed-term (compared to 28 percent in Poland and 26 percent in Spain), where the end of the employment contract or relationship is determined by a definite period, and less than 1 percent of contracts are for the completion of a specific task. Russia could therefore consider more flexible forms of labor contracts. Specifically, the country may consider expanding the list of circumstances under which fixed-term/temporary contracts are allowed, including for permanent tasks, and extend their maximum duration. Most fixed-term contracts are held by those who are young, formerly unemployed, informally employed, or those with lower education levels, namely, those with the weakest bargaining power. For these workers, fixed-term work can provide a pathway into formal employment and an opportunity to gain experience and skills.
- Despite the requirement to have a written contract, 4 percent of salaried workers in Russia (about 2.7 million individuals) work based on an oral contract. Russia could thus formalize such practices and allow oral labor contracts in the case of short-term/casual employment – i.e., for a duration of up to two months.
- On many occasions, workers would like to work overtime in excess of a standard work week or on days off and public holidays in order to earn extra income. However, due to high wage premiums (50 to 100 percent for overtime work and double the rate for

work on days off and public holidays), it is costly for employers, especially in small establishments, to arrange for such work. Moreover, in Russia, working on off days and public holidays is prohibited (except for the few cases envisaged by the Labor Code). Russia could therefore consider lowering statutory wage premiums, allowing for amounts of compensation to be determined by a collective agreement, local normative act, or a labor contract. Regulations related to working on off-days and public holidays could also be revisited.

### On minimum wages

Minimum wages can exacerbate unemployment and informality if the minimum wage is above the market-clearing level, thereby reducing formal labor demand. High minimum wages are typically more damaging for small and medium-sized enterprises (SMEs) because these enterprises tend to be more labor intensive and financially weaker.

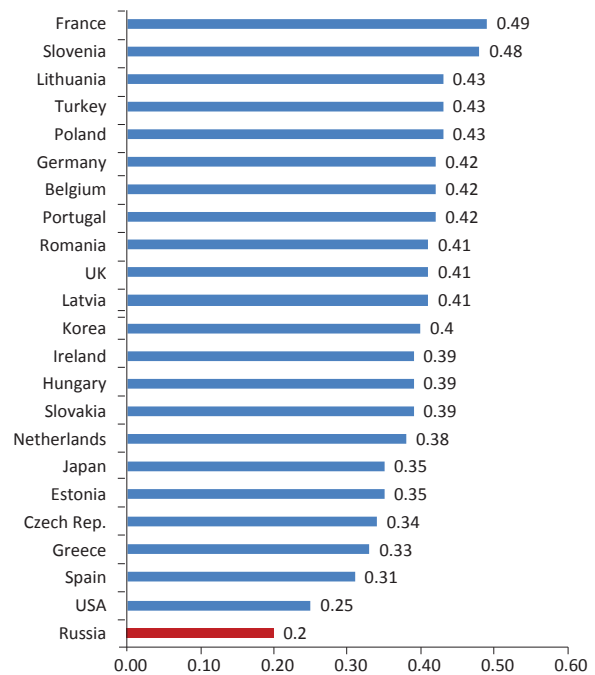
**The minimum wage setting was decentralized in Russia in September 2007, which gave regions the power to set their own regional minimum above the federal floor.** Workers employed by federal establishments and enterprises are exempt from regional minimum wage legislation. In some regions, regional and municipal employees are also excluded from regional regulation, and the regional wage floor applies only to private-sector workers. On average, the ratio of the minimum to average wage in Russia was 20 percent in 2017, relatively lower than the 35 to 60 percent in developed countries (Figure 29). Whether the minimum wage is a major impediment to job creation, however, is unclear. The estimated correlation between minimum wage and informal employment rate is minus 0.40: negative, but not strong.

### On redundancy dismissal

Overly stringent dismissal procedures can limit new job creation in the formal sector

**Figure 29: Russia's minimum to average wage ratio is among the lowest**

(Real GDP growth, percent)



Source: OECD online.

Note: Data for selected countries is from 2016; Data for Russia is from mid-2017

and increase unemployment and informality. Labor rules governing dismissals therefore need to strike a balance between flexibility for businesses and job security for workers. Compared to prime-age workers, older and younger workers are at greater risk of dismissal. Others at higher risk include workers in small firms and those employed on fixed-term and temporary contracts whose contracts might not be renewed.

**Employment protection legislation in Russia is quite strict by international standards.** As far as the protection of permanent workers against individual and collective dismissals is concerned, comparing Russian legislation to that of 34 OECD countries reveals that only nine OECD countries had more rigid legislation than Russia: Belgium, the Czech Republic, France, Germany, Italy, Luxembourg, Mexico, Portugal, and Sweden (Table 6). To address this, Russia's legislation could be restricted to focus on core and enforceable labor standards with the

**Table 6: Russia's Employment Protection Legislation is strict by OECD standards**

Country	Year	Protection of permanent workers against individual and collective dismissals	Protection of permanent workers against (individual) dismissal	Specific requirements for collective dismissal	Regulation on temporary forms of employment
Austria	2013	2.44	2.12	3.25	2.17
Belgium	2013	2.99	2.14	5.13	2.42
Czech Republic	2013	2.66	2.87	2.13	2.13
Denmark	2013	2.32	2.10	2.88	1.79
Estonia	2013	2.07	1.74	2.88	3.04
Finland	2013	2.17	2.38	1.63	1.88
France	2013	2.82	2.60	3.38	3.75
Germany	2013	2.84	2.53	3.63	1.75
Greece	2013	2.41	2.07	3.25	2.92
Hungary	2013	2.07	1.45	3.63	2.00
Latvia	2013	2.91	2.57	3.75	1.79
Lithuania	2015	2.42	2.23	2.88	3.33
Netherlands	2013	2.94	2.84	3.19	1.17
New Zealand	2013	1.01	1.41	0.00	0.92
Norway	2013	2.31	2.23	2.50	3.42
Poland	2013	2.39	2.20	2.88	2.33
Portugal	2013	2.69	3.01	1.88	2.33
Slovak Republic	2013	2.26	1.81	3.38	2.42
Slovenia	2014	2.39	1.99	3.38	2.13
Spain	2013	2.36	1.95	3.38	3.17
Sweden	2013	2.52	2.52	2.50	1.17
United Kingdom	2014	1.59	1.18	2.63	0.54
Russia	2012	2.47	2.86	1.50	1.25
Kazakhstan	2015	2.29	3.20	0.00	...
Serbia	2015	2.23	1.67	3.63	...

Note: The OECD indicators of employment protection are synthetic indicators of the strictness of regulation on dismissals and the use of temporary contracts. Data range from 0 to 6, with higher scores representing stricter regulation. The OECD has an elaborated scoring methodology for assessing and ranking countries.

Source: OECD: <https://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm>

aims of finding a balance between flexibility and security and providing a greater role for trade unions and employers associations to determine employment relations through collective bargaining. In addition, introducing an adequate unemployment insurance system would contribute to finding a better balance between flexibility and security.

**The Russian Labor Code allows for a worker to be dismissed in the case of insufficient qualification, but this needs to be proven by internal attestation.** The latter requires a special internal regulation on the attestation,

informing workers that they will be attested and establishing an attestation committee. Even if a worker is found to be unsuitable for a job during attestation, the employer has to offer him another job. In Russia, another obstacle for employers to adjust their workforce is the requirement to provide (re)training to redundant workers. Sometimes there is also a reassignment obligation before an employer can lay off a worker. This obligation is more common in high and upper-middle income countries. These requirements serve as an additional burden, especially to small firms, and could be reconsidered (Box 3).

**Box 3** By OECD standards, regulations on redundancy dismissal in Russia are overly rigid and discourage formal employment

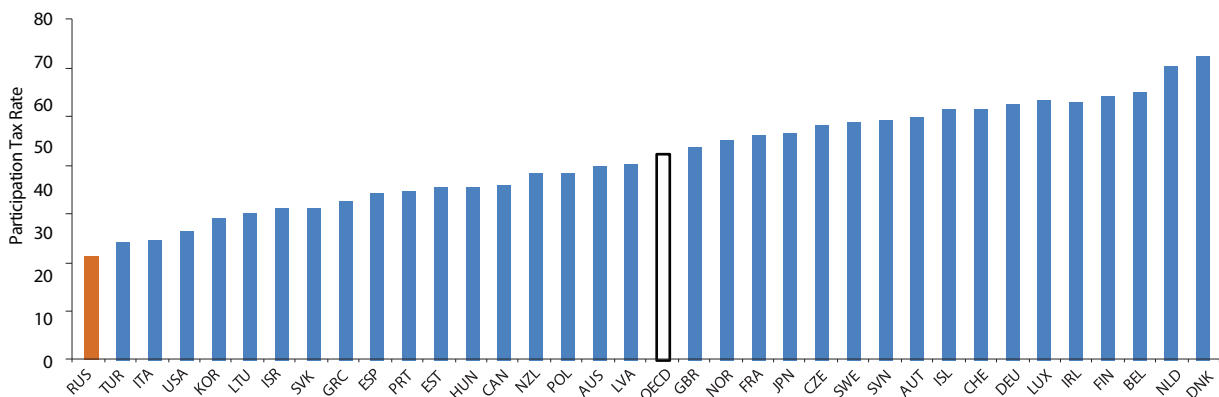
Stringent regulations affect most small and medium firms, thus disincentivizing formal employment. Many OECD countries exempt small firms from some or all employment protection requirements. Most commonly, small firms are exempt from additional notification or procedural requirements when undertaking collective dismissals. In addition, several OECD countries reduce or remove severance payments, notice periods, or the risk of being accused of unfair dismissal for small firms. For example, in Austria, Belgium, Denmark, Hungary, Ireland, and Switzerland, firms with 20 employees or less are exempt from requirements for collective dismissals. In Germany, establishments employing 10 or fewer employees are exempt from regular employment protection legislation. In Italy, firms with less than 15 employees are not required to disburse back pay or reinstate workers who are found to be unfairly dismissed. In Slovenia, employers with 10 workers or less can, by collective agreement, conclude fixed-term contracts irrespective of substantive limitations applying to fixed-term contracts and with longer duration. When terminating contracts in Slovenia, small employers do not have to verify the possibility of redeployment or retraining. Shorter statutory notice periods are allowed for small employers by collective agreement. Replacing severance pay with unemployment benefits in small firms may also contribute to flexible work arrangements, especially in cash-strapped small firms.

**(ii) Does Russia’s tax-benefits system discourage formal work?**

**Benefits and taxes affect the take-home incomes of workers, thereby influencing their incentive to participate in the labor market.** Overly generous benefits and excessively high taxes could reduce incentives of individuals to participate in the labor force. However, overly low benefits can also discourage participation in the labor force by reducing incentives for people to register as being unemployed, and subsequently to seek formal work, for example. This section assesses how Russia’s tax-benefit system compares with EU/OECD countries. Specifically, using the OECD tax-benefits model, the analysis estimates various metrics of tax-benefits schemes in Russia.

- A. The Participation Tax Rate (PTR),** which measures the extent to which taxes and benefits reduce the financial gain from moving into work, is lower in Russia than in any comparator country. This is consistent across most family composition cases (single member family; single with children; one-earner couple, one-earner couple with children; two-earner couple; and two-earner couple with children). Figure 30 illustrates the PTR results for a single person without children; compared to the OECD average of almost 50 percent, Russia’s is less than 25 percent.
- B. Russia’s Marginal Effective Tax Rate (METR),** which measures the extent to which taxes

**Figure 30: Russia’s effective tax rate on entering employment is comparatively low**  
(Percent)



Source: OECD TAXBEN model for the Russian Federation.  
Note: Fraction of additional gross earnings lost to either taxes or lower benefits when a jobless person takes up employment (for a single person without children, at 100% of average wage)

and benefits reduce the financial gain of increasing work effort, is also comparatively low. Figure 31 presents METR results for a single person without children for Russia and EU/OECD countries. Compared to other countries, Russia’s rate is the lowest, which suggests that high marginal tax rates should not discourage increasing work, at least compared to other countries.

**C. The Net Replacement Rate (NRR)**, which measures the fraction of net income in work that is maintained when unemployed, is lower in Russia than in any comparator country, irrespective of the duration of unemployment. This suggests that in Russia, high incomes, when employed, are not a factor that discourage re-entry into the work force, at least compared to other countries.

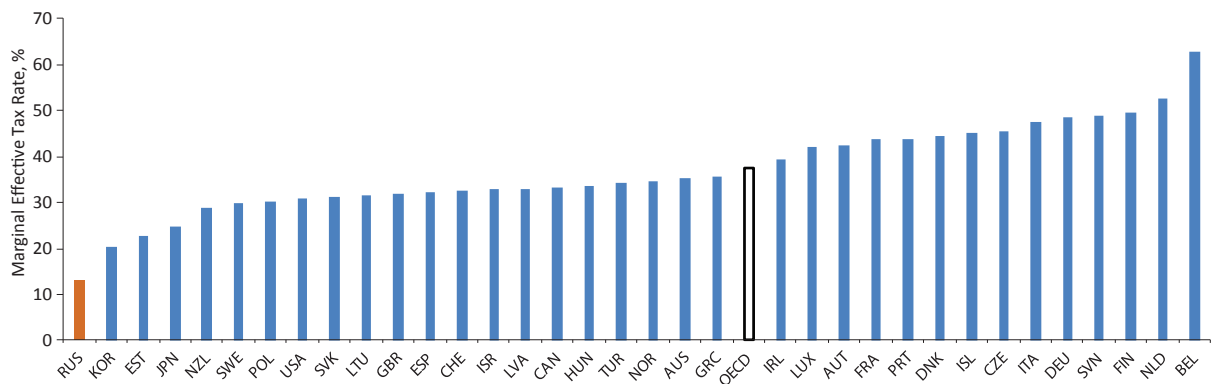
**For example, in Russia, the estimated NRR in 2018 for a single person previously earning the average wage was around 25 percent for the first 12 months of unemployment compared to the OECD average of 41 percent.** For those unemployed over the long-term (over 12 months), the NRR drops to an even lower

13 percent for 60 months of unemployment – among the lowest among the countries in the above table. Box 4 discusses the reasons behind the low NRR in Russia.

**D. The Effective Tax on Labor (ETRL)**, which measures net taxes as a percentage of the total labor cost for the employer, is also lower in Russia than in many other comparator countries. Irrespective of the family composition, the ETRL for Russia hovers at about one third of the total labor cost for the employer. In the case of the single member family (around 33 percent), it ranks 9<sup>th</sup> from the bottom and is significantly lower than the OECD average of around 40 percent.

The above findings show that relative to other OECD/EU countries, Russian tax and benefits policies should not create major disincentives to seek employment or work more formal hours. Indeed, in some cases, net benefits in Russia may be too low, thereby discouraging participation in the labor force by reducing incentives to register as unemployed, and subsequently to seek formal work.

**Figure 31: Russia’s marginal effective tax rate on increasing working hours is comparatively low**  
(Percent)



Source: OECD TAXBEN model for the Russian Federation.  
Note: Fraction of additional gross earnings lost to either higher taxes or lower benefits when an employed person increases their working hours (for a single person without children, at 100% of average wage, moving from part-time to full-time).

**Box 4** Russia's benefit schemes do not confer commensurate gains compared to those of other countries

Low NRRs in Russia are a result of the low benefits in the unemployment benefit system. At the maximum, the benefit replaces 14 percent of the average wage for 12 months. However, most of the unemployment benefit claimants received the minimum payment, which equals about 2.6 percent of the average wage in 2017. These rates have remained unchanged since 2009. This suggests that Russia may consider introducing a well-designed unemployment insurance system that would allow for more effective support to the unemployed. This could also provide incentives to register as unemployed, and to subsequently seek formal work.

Housing and utility allowances, in addition to the unemployment benefit, are conferred to unemployed citizens under certain eligibility requirements that apply to other households as well. This allowance is an important component of the NRR. However, only 6 percent of all households in Russia receive a housing and utilities allowance, and as such it affects NRR (and METR) only in a limited number of cases.

Child allowances are also extremely low in Russia, equivalent to a mere 2.5 percent of the minimum subsistence level. Consolidation of various small and fragmented child and family benefits into a larger income/means-tested family benefit would help (NIFI and Posarac, A., 2017).

Maternity allowances for the first 18 months of a child's life, together with sizable maternity capital benefits given to families at the birth of the second child, are social policy measures aimed primarily at demographic renewal of Russia; i.e., at incentivizing families to have more children. However, such assistance is "front-loaded" during the period from birth to 18 months. Stronger child protection requires a better policy, programming, and resource balance between the first 18 months and the rest of childhood.

As such, it is difficult to consider unemployment benefits as having a negative influence on recipients' decision to participate in the labor market. In fact, introducing a well-designed unemployment insurance system and consolidating small and fragmented benefits programs into larger, income/means-tested benefits could provide incentives to register as unemployed, and to subsequently seek formal work.

### (iii) *How severe are sectoral and spatial market labor rigidities in Russia?*

The analysis reveals that while intersectoral mobility in Russia is comparable to most advanced economies, inter-regional mobility, however, is low. For example, registered internal migrants (both inter-regional and intraregional) accounted for only 1.4 percent of Russia's population in 2002-2010, a rather small share. In contrast, their average share in the U.S. was 13.7 percent of the population in 2000-2006, while in Canada and Japan it was 14.6 and 4.6 percent, respectively. The fact that the Russian population is not mobile in an inter-regional manner is not surprising, given Russia's sheer size. The main implication for informality is that low inter-regional mobility translates into high inter-regional differences in informality (Figure 32).

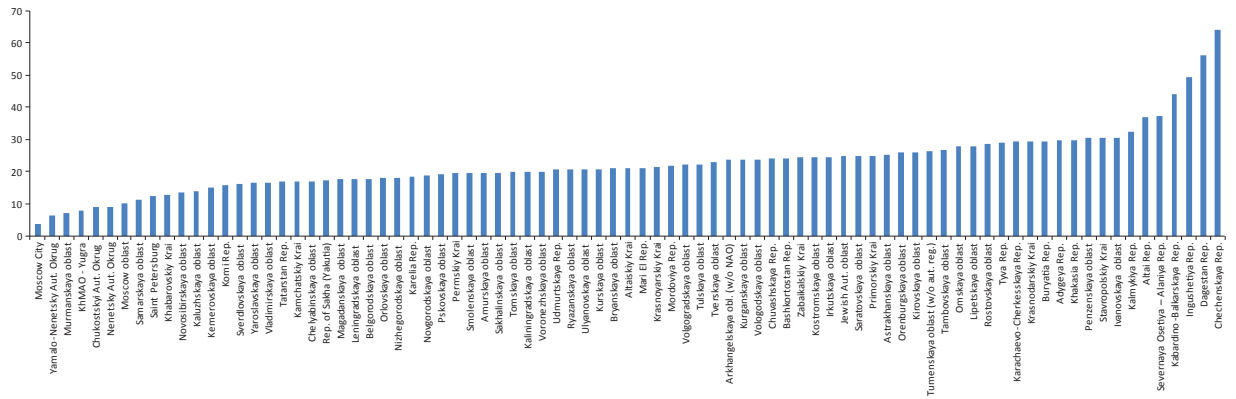
### D. Stemming Russia's Informality Tide: No single fix, but multiple policy levers

**Policy levers for reducing informal employment in Russia revolve around three areas:** direct intervention; removing labor-market rigidities; and enhancing skills training. However, informality can only be partially alleviated with specific fiscal or labor market measures. There are no quick fixes. Systemic solutions to reduce informality will require broader policies. In particular, and although it may sound tautological, the best antidote to high informal employment is the faster creation of more formal jobs. A healthy economy is characterized by the entry of young companies that boost its productivity. Dynamic firms, whether new or established, are the source of formal jobs when conditions are favorable.





**Figure 32: The rate of informal employment varies between 3.6% in Moscow to 64% in the Chechen Republic (Percent)**



Source: Authors’ estimates based on Rosstat, Labor Force Survey, 2017.

**A. Directly intervening to lower the cost of formal labor:** One policy proposal implemented with some success in other countries has been to reduce the employers’ Social Insurance Contribution rate (SIC). To make up for the loss in fiscal revenues from reducing the SIC rate (although some of it would be made from a higher tax base because of lower informality), taxes may need to be increased elsewhere. Typically, countries have maintained budget neutrality of such policies by increasing the Value Added Tax rate (VAT). In principle, such tax maneuvers ought to increase incentives for firms to hire formal labor by lowering its cost, as well as be budget-neutral. Examples of such policies in other countries are presented below:

- *North Macedonia* implemented across-the-board labor tax reforms around 2010 that led to significant growth in formal employment. Specifically, a 1 percent decrease in the tax wedge led to a 0.9 to 3.1 percent increase in the employment rate.
- *Turkey*, in the early 2000s, introduced legislation under which firms could obtain (i) a subsidy on the social security contributions due at the minimum contribution base, and (ii) an income tax subsidy for the amount due at

the minimum wage. Establishments located within industrial zones were fully subsidized for their calculated social security contributions and income taxes, whereas establishments outside industrial zones received compensation for only 80 percent of such amounts. Findings suggest that these subsidy programs led to significant net increases in registered jobs in eligible provinces: between 5 and 13 percent for the first program and between 11 and 15 percent for the second.

- In the *United States*, the Targeted Jobs Tax Credit (TJTC) program – which offered in-work benefits staggered over a few years – was found to have a net employment effect of 7.7 percent.
- In *Argentina*, a random assignment wage-subsidy scheme targeting workers in temporary employment subsidized 50 percent of the first 18 months of wages for workers employed in permanent, regular jobs. Findings indicate that the program aided low-wage workers in finding regular wage employment. However, these effects were only statistically significant among women and youth.

Such tax maneuvers have been under consideration in Russia, but for reasons discussed in Box 5, they would have a limited impact on reducing informality in the Russian context.

Why is it that similar tax maneuvers that have been successful in other countries have not yielded such results in Russia? There are at least three possible reasons for the muted results in the case of Russia:

#### Box 5 Reducing the cost of formality for employers only has a small impact on informality

In 2017, Russia's Ministry of Finance proposed a comprehensive reform of the tax system aimed at shifting the tax burden from labor to consumption taxes, referred to as the Tax Maneuver 22/22. The reform suggests reducing the employers' SIC rate from 30 to 22 percent, while simultaneously increasing the VAT rate from 18 to 22 percent. To assess the impact of this tax maneuver on inducing formality and budget neutrality, we constructed a detailed microsimulation model and calibrated it to the Russia context based on RUSMOD. RUSMOD is the first full-scale model in Russia that simulates most of the existing monetary tax-transfer policies implemented at federal and regional levels for a nationally representative sample of the population.

In addition, we made certain assumptions: (a) workers and their employers would enter as contributors to social security ("payroll taxes") and workers would start paying personal income tax on their earnings; (b) consumers would bear the burden of the VAT increase; (c) the economic incidence of SIC and Personal Income Tax (PIT) would fall on employees rather than employers. That is, workers would have to accept a lower take-home pay and employers would not have to accept higher labor costs to pay for SIC. Consequently, the tax maneuver would involve higher take-home pay for workers, but also higher VAT expenses for consumers; (d) we relaxed our legalistic definition of informal employment used so far. In other words, our analysis of the tax maneuver explicitly accounts for workers who work for a firm and either have no contract (about 6.7 percent of the employed as of 2016) or have a contract but receive envelope wages (about 8 percent of the employed). The self-employed (about 10.3 percent of total employment) are not included in this exercise because they are subject to a different tax regime. Based on these assumptions and various simulations, the key findings that emerge are:

- a. Such a tax maneuver would be fiscally neutral only if at least 50 percent of informal workers, i.e., around 7.5 percent of total employment (about 5 million workers), formalize. This is a high and unlikely transition rate from informal to formal employment. The increase in VAT, on the other hand, would partly compensate gains in take-home pay, leading to a slight increase in real incomes at the bottom of the distribution (0.1 percent). Both poverty and inequality would remain stable.
- b. Moreover, a behavioral micro-simulation exercise renders that only 6 percent of the informals would formalize as a reaction to the tax maneuver (i.e., around 600,000 workers) and the tax maneuver would not be fiscally neutral, leading to an additional fiscal deficit of 0.7 percent of GDP. In this scenario, real incomes of the first decile would increase by 1 percent, and poverty would decline slightly.
- c. The results are robust even with differing assumptions. If employers bear the incidence of PIT and SIC, then reductions in these taxes would accrue to employers and not to workers. Consequently, the tax maneuver would lead to lower real incomes among workers (because of no increase in take-home pay but higher VAT payments in consumption). Our micro-simulations show a decline in real incomes among the bottom decile of the distribution and slight increase in poverty rates. This can be partially offset by job creation (which we do not model in our exercise) because in such cases, any reduction in total labor costs could increase demand for formal labor. Targeting labor tax reductions to the low-skilled sector (where employers have more bargaining power and tax incidence is more likely to fall upon the employer rather than the employee) could thus incentivize formality in this segment of the workforce.

These results indicate that such a tax maneuver, i.e., the reduction in SIC rates and increase in the VAT rate, is unlikely to have a major impact on reducing informal employment or attaining fiscal neutrality. A larger SIC reduction could do better strictly in terms of reducing informal employment but would come with higher fiscal costs.





*One*, the above findings are only first-order approximations of the full impact of such tax maneuvers. A more complete analysis of wage and labor productivity changes after a tax maneuver is also needed to know if there would be net wage gains to formalization (i.e., not only due to changes in tax and transfers, but also due to productivity gains).

*Two*, the analysis specifically includes only the impact of formalization upon current net wages, VAT, and some social security benefits. However, it can be argued that long-term benefits — particularly in terms of pensions and health insurance — should also play a role in the worker's decision to formalize. But workers may suffer from myopia (for example, being unable to gauge the long-term impact of not contributing to social security).

*Three*, and more rationally, workers may indulge in moral hazard (i.e., free-riding on other people's contributions to enjoy some social security benefits without contributing themselves). This is because in the current environment, informal workers enjoy benefits such as social pensions and medical treatment with scant contributions. In principle, taking away such benefits from informal workers could increase the cost of being informal. However, attempting to reduce such "free-riding" may risk upsetting the already tenuous social contract between the state and citizens and reducing society-wide benefits of widespread coverage of pensions and medical treatment. Another factor to consider is managing unintended consequences. For example, the impact of reducing the SIC is likely to be felt on the contributory pillar of the pensions system in Russia, which could be adversely affected in favor of a move towards general budget financing of pensions (from the proceeds of the higher VAT rate, for example). This may have the rational but adverse effect of discouraging workers to become formal since such a de-linking of contributions from

pensions could mean that the returns to their formal contributions are discounted even further.

**The implication in the Russian context is that changes in payroll taxes and consumption rates will reduce informal employment little or not at all.** In addition, there need to be concerted efforts to increase information about the benefits of becoming formal, and as discussed earlier, and to improve some of these benefits, many of which are comparatively low. Doing so would help workers better gauge the long-term impact of their contributions.

**B. Removing labor market rigidities.** This involves action on three fronts: (a) bringing certain aspects of labor market regulations in line with global best practice; (b) consolidating certain aspects of the tax-benefits system to provide more rational incentives to participate in the labor market; and (c) increasing inter-regional mobility.

- *Bringing labor market regulations in line with global good practice:* As discussed earlier, Russia's labor code and related regulations are particularly biting on SMEs, which are a source of informal employment. Policy actions are summarized in Box 6.

**However, existing legislation is only one side of the coin; the other is how well laws and regulations are enforced.** Indeed, in many countries, even state-of-the-art labor codes and EPLs are often ineffective because of evasion, weak enforcement, and failure to reach the informal sector. Achieving greater labor market flexibility through non-enforcement of laws is a sub-optimal choice because it undermines the rule of law, exposes firms to costly uncertainty, impedes decent formal employment growth, and leaves workers without adequate protection. This is where labor inspection plays

**Box 6** Certain labor market regulations can be eased to incentivize formal employment

This box summarizes the recommendations on adjusting Russia's labor code and its regulations on labor contracts, minimum wages, and redundancy dismissal.

- More flexible forms of labor contracts could be considered. Specifically, Russia could consider expanding the list of circumstances under which fixed-term/temporary contracts are allowed, including for permanent tasks, and extend their maximum duration. Most fixed-term contracts are held by young people, those who were formerly unemployed, informally employed, or those with lower education levels, namely, those with the weakest bargaining power. For these workers, fixed-term work can provide a pathway into formal employment and an opportunity to gain experience and skills.
- Oral labor contracts, especially in case of short-term/casual employment for a duration of up to two months could be allowed and formalized.
- Lowering statutory wage premiums could be considered, allowing for amounts of compensation to be determined by a collective agreement, local normative act, or a labor contract. Regulations related to working on off-days and public holidays could be also revisited.
- Even though the minimum wage may not be a major impediment to job creation, there is a negative correlation between minimum wage and informality in Russian regions. In any case, working out benchmarks other than the subsistence minimum could be considered.
- Employment Protection Legislation (EPL) could be restricted to focus on core and enforceable labor standards, and with the aim to finding a balance between flexibility and security, provide a greater role for trade unions and employers' associations to determine employment relations through collective bargaining. In addition, introducing an adequate unemployment insurance system would contribute to finding a better balance between flexibility and security.
- Regulations on redundancy dismissal in Russia are overly rigid by OECD standards, discouraging formal employment, and could be reconsidered. For example, when terminating contracts, small employers may not need to verify the possibility of redeployment or retraining. Shorter statutory notice periods could be allowed for small employers by collective agreement. Replacing severance pay with unemployment benefits in small firms may also contribute to flexible work arrangements, especially in cash-strapped small firms.

an important role in monitoring compliance with labor standards. Box 7 highlights the characteristics of high-quality, well-functioning labor inspection services.

**In Russia, the Federal Labor Inspectorate (FLI) is a unified, centralized system composed of the federal executive governmental body charged with state supervision and control of observance of labor law and other legal regulatory acts containing labor law norms and its territorial bodies.** In conjunction with the Prosecutor's Office, the FLI has the right to carry out investigations and make binding decisions, including reinstating an employee who was wrongfully dismissed and awarding the employee wages in arrears. Even more so, these authoritative branches can initiate proceedings against the employer and its administrators for violating labor legislation.

**The ILO considers that the number of labor inspectors in relation to workers should approach the following:** for industrial market economies, 1/10,000; for rapidly industrializing economies, 1/15,000; for transition economies, 1/20,000; and for least-developed countries, 1/40,000. However, in Russia, the ratio was 1/34,400 employed in 2016, closest to the least-developed country benchmark.<sup>12</sup> Current capacity of the FLI allows, on average, for the conduct of one inspection in 28 years, while the ILO recommends at least one every five years.

**In Russia, the institutional capacity to enforce laws, and the culture of law compliance vary significantly across regions and sub-populations.** All this may result in actual enforcement being close to non-existent in some sectors of the economy, and close to

<sup>12</sup> In 2016, there were 72.4 million employees in Russia while the total number of staff of the Federal Labor Inspectorate was 2,438, including the number of labor inspectors. For comparison, in Latvia, there were 8,300 workers per one inspector.

**Box 7** The role of well-functioning labor inspection systems goes beyond mere enforcement

The institution of labor inspection has a two-fold nature. On one hand, labor inspectors enforce legal provisions dealing with labor regulations, occupational health and safety, social services, migrant workers, vocational training, social security, and other matters. On the other hand, labor inspection provides information, advice and training. Specifically, labor inspection services cover a set of five operational functions:

1. **Promotion:** Raising awareness of standards and national regulations that give effect to them, as well as disseminating best national and international practices.
2. **Advice and information:** Putting their knowledge and expertise to use in helping resolve specific issues during on-site inspections or, in a more prevention-oriented manner, in their contacts with duty-holders and their organizations.
3. **Education:** Often exercised in training for employers and workers, labor court officials, other government agencies, and NGOs.
4. **Monitoring:** Observing, keeping track of, and reporting on compliance levels in enterprises, economic sectors, and the country as a whole.
5. **Enforcement:** Ensuring compliance with the law.

Modern inspectorates aim for 60 percent proactive inspections and 40 percent reactive inspections (accidents, complaints) based on an application of risk prioritization towards highest-risk workplaces. Advice to and stimulation of employers to implement legal requirements is the modern approach to compliance. Labor inspectors are obliged to first and foremost advise employers and employees to fulfill their obligations while leaving the option of punishing grave and consistent violations open.

International studies of best practices highlight many characteristics of high-quality, well-functioning labor inspection services. These include adequate resources (both staff and infrastructure); recruitment and training policies designed to attract and retain high quality inspectors; central administration to improve consistency and reduce duplication; preventive targeting of firms based on risk; integration of different types of inspections to reduce the inspection burden on business; and a focus on prevention and education as well as enforcement. In particular, good cooperation is required between the labor inspectorate and other agencies, social partners, institutions, and NGOs. Detection and enforcement measures applied in OECD countries include information exchanges (linking computer files) using unique social security numbers; cooperation between labor, social security, and tax inspectorates; administrative requirements for the immediate declaration of new hires; making contractors responsible for the tax compliance of their subcontractors; encouraging employer and trade union denunciation of unfair competition; enforcing employees' rights, such as protection against unfair dismissal, even within undeclared relationships; and strict sanctions.

Lack of public awareness on legal rights associated with employment has also impaired law enforcement in several countries. Workers should know their legal rights and how to get them enforced. The evidence suggests that public opinion is often ill-informed in Russia. Running campaigns to inform individuals of their legal labor-related rights is thus crucial.

In high-performance labor inspection systems, social dialogue provides the foundation for effective labor inspection work. In the Netherlands, Germany, the Nordic countries, and the UK, the Labor Inspection consults social partner organizations at national and sector levels on where problems exist, and they agree upon targets, projects, campaigns, etc., on an annual or even quarterly basis. This consultation process creates transparency, higher levels of acceptance, and "ownership" of the compliance process among duty-holders. Further, labor inspectorates in many countries have an obligation to stimulate (Netherlands) or animate (France) cooperation and dialogue among parties in enterprises. Measures must be designed to develop such social dialogue on labor inspection and occupational safety and health (OS&H) at all suitable levels.

Furthermore, improved law-enforcement and the application of sanctions can be achieved through (i) better cooperation between relevant authorities (inter alia tax offices, police, labor and social inspectorates); (ii) reinforcement of the number of labor inspectors, better working conditions, and performance-based remuneration systems; and (iii) investment in training to update knowledge and develop skills in relevant areas of expertise.

complete in others. For example, in 2016, only 0.9 percent of enterprises in Dagestan were found to be without violations, and in Arkhangelsk oblast, this was only 3 percent. On the other end, no violations were observed during inspections in the Republic of Komi in 82.5 percent of cases; in Krasnodar Krai, in 66.1 percent of cases; in Moscow in 62.7 percent of cases; in Primorsky Krai in 61.8 percent of cases and in Novgorod oblast in 60.7 percent of inspected enterprises.

**Summary judiciary statistics basically tell the same story, showing significant inter-regional variation in enforcement of the labor regulations.** The Far Eastern Magadan region, with 200 legal cases per 1,000 employees filed to courts, took the leading place. It was followed by a few other Northern and Far Eastern regions, ranging between 30 and 70 legal cases. In contrast, in mostly urban and densely populated regions like Moscow, St. Petersburg and Nizhny Novgorod oblasts, of every 1,000 employees, only 1 to 4 were involved in legal conflicts with their former or current employers in regional or local courts.

**Labor inspection services are an important line of defense against informality.** While a detailed analysis of the labor inspectorate and its effectiveness is beyond the scope of this report, international evidence suggests that a law-and-order approach that focuses only on penalties and sanctions is

not helpful to combat informal employment, especially in environments with inadequate governance. Rather, a more client-focused and risk-prioritization approach, which the FLI is moving towards, and that supports firms to comply with regulations and only uses penalties and sanctions as a last resort, works better to decrease informal employment. The Baltic countries implemented successful reforms along these lines in the 1990s. Box 8 summarizes Russia's Federal Tax Service's experience and progress in adopting a risk-prioritization approach.

- *Consolidating certain aspects of the tax-benefits system to provide more rational incentives to participate in the labor market:* The earlier discussion of Russia's tax-benefits system points to several benchmarks that are below comparator countries. An assessment of various taxes yields the conclusion that by global standards at least, Russia's effective taxes are low and should not provide disincentives to seek formal work. Benefits such as unemployment compensation, housing and utility allowances, and child allowances are also low by global standards. Maternity allowances, though generous, are front-loaded. As such, it is difficult to consider benefits to the unemployed as having a negative influence on their decision to participate in the labor market.

#### Box 8 Russia's Federal Tax Service has made admirable progress in implementing a risk-prioritization approach

On the issue of mainstreaming risk prioritization in their daily work, Russia's Federal Tax Service (FTS) may offer useful lessons. The FTS has made admirable progress by adopting a self-assessment of risk approach. The numbers of field tax audits have steadily declined, and efficiency has improved.

Russia's FTS no longer uses the 100 percent audits principle and it applies a risk-based approach to tax audits. Tax audit planning is an open process based on selecting taxpayers for field audits with the use of 12 publicly available criteria. Self-assessment of risk based on financial and operational performance helps enable the taxpayer to assess tax risks in a timely fashion. This approach has helped reduce the administrative burden for businesses and improve FTS performance. The numbers of field tax audits have steadily declined, and efficiency has improved. On average, only two out of 1,000 taxpayers, or 0.2 percent, have undergone a tax audit in the first nine months of 2018

The main policy lever that thus emerges is on the benefit side of the equation: Russia could consider introducing a well-designed unemployment insurance system and consolidating small and fragmented benefits programs into larger means-tested benefits. This could provide incentives to register as unemployed and to subsequently seek formal work.

- *Increasing inter-regional mobility:* As discussed earlier, while intersectoral mobility in Russia is not a major concern, inter-regional mobility emerges as a key rigidity in the Russian labor market. This has implications for the ease with which formal firms can hire or retrench workers. Inter-regional mobility could be increased by putting in place connective infrastructure, making real estate markets (homes and land) more liquid, and addressing social barriers to internal migration, especially for youth and women.

**C. Enhancing skills training:** Even though a key finding of this report is that the growing informality in Russia cannot be attributed

to demographic factors per se, the one exception and consistent finding across all surveys and databases is that it has increased among those with only basic education. By 2016, those with some tertiary education were 24.2 percentage points less likely to be informal than those with basic education. Other surveys show qualitatively similar results regarding education. Having a post-secondary education seems to have prevented workers from becoming informal. In other words, had the share in tertiary education not increased, the rate of informality in Russia would have grown even more. This suggests that a longer-term objective to reduce informality could be to enhance skills training in areas connected to the modern economy. And given the reported shortages of skilled workers faced by Russian employers, improvements and adjustments to Russia's vocational education and training system could also be considered. Equipping the workforce with necessary skills is likely to yield economy-wide benefits that will go beyond reducing informality.

Russia Economic Report #41, June 2019

## MODEST GROWTH; FOCUS ON INFORMALITY

© 2019 International Bank for Reconstruction  
and Development / The World Bank  
Some rights reserved

1818 H Street NW, Washington, DC 20433  
Telephone: 202-473-1000  
Internet: [www.worldbank.org](http://www.worldbank.org)



This work is available under the  
Creative Commons Attribution 3.0  
IGO license (CCBY 3.0 IGO)  
[http://creativecommons.org  
license/by/3.0/igo](http://creativecommons.org/licenses/by/3.0/igo)



**WORLD BANK GROUP**