

## **The new russian public policy : labour market perspective**

**Dr. Liana Lakunina**  
**Dr. Tatyana Chetvernina**  
(Centre for Labour Market Studies)

Government policies are always hard to design and painful to implement with nobody exempt from mistakes and unforeseen consequences. Naturally, in the period of sweeping political, economical and social change the process becomes still more complex and imposes higher responsibility on those who carry the policies out.

This paper presents an analysis of the Russian experience in designing policies aimed at labour market regulation and employment promotion, and of the measures the government undertook to resolve the problems of implementing them.

It is a well-known fact, that radical changes of the political and economic systems of Russia brought about phenomena new for its labour market which, in their turn, necessitated creating a corresponding institutional labour market infrastructure and a system to regulate it.

Setting up of an employment promotion system began as soon as the presence of unemployment in Russia had been officially recognized. Its foundation was laid down with adoption in 1991 of the "Employment Law of the Russian Federation" and establishing the Federal Employment Service and the State Employment Fund. The latter was defined as an extra-budgetary fund by the law and the "Provisional Regulations on the State Employment Fund" dated July 4, 1991. The Fund was intended, first of all, to finance development and implementation of the state employment programme (Article 22 of the Employment Law). The Federal Employment Services and its regional (republican, oblast, city) employment offices were given the power to administer the Fund's resources.

Structurally, the Fund included the federal fund and the territorial funds set up in the republics, krais, oblasts, autonomous okrugs, cities and districts (not in cities' districts). However, the Fund's resources were not part of the regional (republican) or local budgets.

The Employment Law defined the following revenue sources for the Fund:

- Insurance contributions by employers in the amounts set by the State Duma (Parliament) resolutions (2% and 1,5% of the payroll fund, before 1996 and in the period from 1996 to 2001 correspondingly);
- Mandatory insurance contributions by employees;
- Allocations (whenever necessary) from the federal budget, budgets of the constituent regions of the Russian Federation, and local budgets;
- Voluntary contributions by legal entities and physical persons;
- Fines paid by employers for violations of provisions of the Employment Law.

## I. Specific features of the Employment Fund.

**Mandatory insurance contributions by employers formed the main part of the Employment Fund,** accounting for 90% of its revenues in the years of crisis and for 74-75% in the “crisis-free” years

Other sources of the Employment Fund revenues in the years of crisis were negligible and supported regional funds. The only exception were the resources under the “miscellaneous revenues” item, part of them being income from investment in securities. In the mid-1990s, some regions were actively involved in this type of economic activities, but later on the practice was abolished. Regions characterized by a relatively stable economic situation registered such sources of revenue as “voluntary contributions”, “receipts from local budgets” while in the deficit regions they were “transfers from the federal part of the Fund”, i.e. grants-in-aid. *Mandatory insurance contributions by employees envisaged by the law and supposed to be of paramount importance do not exist as a source of revenues in real life.*

Thus, plurality of revenue sources for the Employment Fund in Russia existed on paper only (as a clause in the Employment Law) while insurance contributions paid by employers were the only real source of finance.

### **Impractical plans of collecting contributions to the Employment Fund**

The plans were based on economic forecasts by the Ministry of Economics and relevant estimates of the overall pay-roll fund for the next year. They couldn't but be overoptimistic as the people who made them proceeding from unfounded assumptions that:

- all the enterprises were operational;
- all the employees worked full-time throughout the calendar;
- all the employees received wages on time;
- all the employer paid regularly mandatory contributions to the extra-budgetary funds;
- investments would be growing and the number of jobs would rise or at least not fall during the forecast period.

For example, the Federal Targeted Employment Promotion Programme for 1998-2000 adopted on July 24, 1998 envisaged a 2% increase of investments in 1998 against 1997, the highest increase in numbers of jobs in the finance, credit and insurance sectors, and only a moderate increase of the number of employees in the energy and fuels sectors. Assuming that the Programme designers could not foresee the coming financial crisis, is hard to explain why they forecast an increase in employment if the financial sector (the world financial crisis could not but affect the sector's labour market), and even more so in the energy and fuels sector, considering the situation in the coal industry and the slump of oil prices in the world market.<sup>1</sup>

<sup>1</sup> The Federal Targeted Employment Promotion Programme for 1998-2000, pp. 13, 15.

Impracticability of forecasts resulted in collection of contributions falling short of the planned figures and in the Employment Fund being in the red. However the Fund had no other means of reducing the deficit except for cutting expenses and receding from its obligations. For this reason, in 1996-1999, a number of regions with critical situations in the labour market had years-long unemployment benefit arrears, cut down on their active employment promotion programmes, did not have enough resources to modernize or re-equip their employment offices, and faced other financial difficulties.

### **Mismatch between the “at the workplace” principle of formation of the Fund and the “at the place of living” principle of spending its resources**

The principles of formation of the Fund and of unemployment benefits payment did not take into consideration the inter-regional migration. As a result, regions with a relatively high level of unemployment and low average wage were placed at a disadvantage, as the Fund revenues were becoming increasingly limited due to the high incidence of enterprise insolvencies, while expenditures on all the programmes (the programme of material support for the unemployed, in particular) were growing. The system “benefited” only regions with low level of registered unemployment, active labour markets, high average wages and virtually no chances for labour migrants to buy their own housing (high housing costs, high rents, residence registration/propiska problems).

Moscow is a case history of an intensive use of labour force from other regions (such labour force is characterized by lower price, lower level of social benefits, and is less demanding than the local labour force). To a large extent, the Moscow Employment Fund was formed at the expense of transient migrants from other regions (lack of statistical data makes it difficult to evaluate their contribution). At the same time, the resources of the Fund were accessible only to the unemployed having a permanent address in the city (propiska).

The above factors were making inter-regional disproportions still more pronounced.

### **Lack of strict governmental control over formation of the Employment Fund and over observance of financial discipline by employers**

Estimates show that *the real level of insurance contributions paid to the Fund by employers were always below that stipulated by the law*. That is true both for the “crisis-free” years of the Fund (1.42% in 1993, 1.51% in 1995, instead of 2% prescribed by the law), and for the years of crisis (0.99% in 1997, 0.98% in 1998, instead of 1.5%). Even in the most favourable years for the Fund and the employment services, financial discipline was lax as far as payments of insurance contributions were concerned. Small wonder that insurance contributions arrears increased further during the crisis period that followed – to 34-35% in 1997-1998.

In the early 1990s, the Fund was all-sufficient, which made it possible for the government control over payment of insurance contributions and fines for delayed payments to be lax. As a result, employers became absolutely convinced that insurance contributions were second in importance not only to payments to the Pension Fund, the Roads Fund, but even to replenishing their own working capital. Of course, the government imposed stiff penalty in the form of fines for non-payment or insufficient payment of insurance contributions to the Employment Fund. Unfortunately, they remained on paper only and were never enforced. At the same time, there was always hope (not groundless) that after a

number of years the debts would be either written off or restructured. Therefore “wise” enterprise directors not only dragged payments to the Employment Fund, but somehow contrived to receive financial assistance (interest-free loans or low-interest credits) from the same Fund to replenish working capital.

It would be unfair to say that the idea of a stricter financial discipline was alien to local authorities. In 1997, when the situation with the Employment Fund changed radically, employment services had to tighten their control over contributions payments by employers. *However, financial discipline cannot be introduced at the regional level – it cannot come into being across the country without changes in the policies of the Centre.* That is why employers’ attitudes towards payments to the Employment Fund held practically till 2000, when the employment services were ordered to eliminate benefit arrears and to switch to paying unemployment benefits invariably in the monetary form. During that year, and partially in 1999, control over financial discipline began to be exercised not by the state but by employment services that used every means to recover debts to the Employment Fund.

The problem of financial discipline was most pressing in the regions where employment funds have enough resources to implement active employment programmes. By 1995 such regions operated funds having in some cases a surplus as large as 30%, which, however, dwindled to 19% by the year-end.

Thereupon, it one can assume that the decision by the State Duma to lower the pay-roll tax rate (i.e. payments to the extra-budgetary Employment Fund) from 2 to 1.5% was dictated by:

- low level of registered unemployment;
- real 1.5% (not 2% as prescribed by the law) level of insurance contributions paid by employers that was sufficient to finance operating costs of the Employment Fund;
- considerable Employment Fund surplus under the de-facto 1.5% level of insurance contributions.

Under the situation where political circles had an increasingly widespread opinion that the problem of unemployment in Russia is not as pressing as it was in, for example, European countries, easing of the taxes paid by employers who shoulder the total burden of financing labour market policies almost unassisted looked as absolutely justified.

However, some hard facts were ignored at that moment:

- the registered unemployment level did not reflect the real situation in the Russian labour market;
- signs of economic revival had not yet emerged and, moreover, financial problems faced by enterprises (non-payments, mutual offsetting of debts) began to aggravate;
- the Employment Fund was replenished with contributions collected in the regions having low unemployment rates and high numbers of workers. For example, in the regions having the level of unemployment of 3% the number of workers amounted to 971 000, while in the regions with the

unemployment level above 3% it amounted to 475 000;

- there was neither financial discipline nor control by the Centre over payment of contributions to the Fund. Financial documents essential for regulating the process, such as “Regulations on Tax Base for Contributions Paid to the Employment Fund” were not available and regions had to apply the “Mandatory Health Insurance Hand-Book”, which complicated the procedure and even resulted in smaller amounts collected.

Thus, we believe that the government decision to reduce the pay-roll tax from 2 to 1.5% did not reflect the real situation in the labour market and was based on a superficial assessment of the complex processes.

## **II. Evolution of the Employment Fund**

Three stages can be differentiated in the evolution of the Employment Fund from the moment of its establishing to making the decision on its abolishment from 2001.

*Stage one (1991 - 1993):* regional structures of the Federal Employment Service were developing fast, rather low level of registered unemployment was maintained, The Employment Fund revenues exceed its expenditures, large surplus was accumulated by many regional employment funds. However, by the end of that period pockets of unemployment emerged in some depressed single-industry districts with a high share of light and defense industry enterprises (certain districts in the Vladimir, Ivanovo and Yaroslavl oblasts, the Republic of Udmurtia, and some others).

*Stage two (1994 - 1995):* the level of registered unemployment increased more than three times from 1992; registered unemployment was growing particularly fast in depressed oblasts that could be clearly identified as subsidized ones (12 regions). Nevertheless, as the average all-Russia level of registered unemployment was merely 2.8%, accumulation of resources for regional employment funds and the Employment Fund did not present a serious problem and the number of donor regions by far exceeds that of the subsidized ones. At the same time, by the end of 1995 there were registered first benefit arrears.

*Stage three (1996 - 1999):* signs of the coming all-Russia crisis were becoming more numerous and obvious. The number of regions in need of financial assistance increased tenfold, while the number of donor regions dropped to two.

## **III. Government regulation of the interregional unemployment differentials**

Under the conditions of such a large country as Russia that has 89 constituent regions characterized by strongly different level of social and economic development it would be only natural to design a mechanism of re-distribution of part of the Employment Fund resources between the regions in accordance with their labour market situations and real needs. In this way the government took upon itself responsibility for regulating the labour market across the country, and for resolving problems faced by labour markets of the depressed regions.

That was the rationale for setting up the federal (centralized) part of the Employment Fund comprising 20% (starting from 1995) the amounts collected by regional employment funds as contributions by employers (other revenues of regional funds remained under control of regional authorities and were not transferred to the centre).

The system envisaged a uniform standard of financial participation for all the regions irrespective of their labour market situations, no government involvement, and low level of contributions by the regions (10%). As the policy had been developed in the period of a relatively favourable situation in the labour market, the system of collecting and re-distribution of the federal part of the Employment Fund functioned rather smoothly over the first few years. That was the result of availability of sufficient financial resources and a significant surplus registered by the regional funds. What was more, the average across-Russia level of registered unemployment was rather low and characterized by insignificant inter-regional differentials. The number of donor regions was by far higher than that of recipients. Although contributions were regularly underpaid (being 0.5% below the statutory level), regional employment funds could easily finance any programmes, even those not related directly to employment promotion.

By 1995, first signs of loss of control over the processes, of lack of correspondence between the system of formation of the federal (centralized) part of the Employment Fund built in the first years of market reforms and the new realities began to emerge:

- expenditures by the regional employment funds became practically as high as their revenues;
- the number of regions where the level of registered unemployment exceeded 4% was growing rapidly (estimates demonstrated that regions with unemployment rate above 3.5% invariably found themselves in the “subsidized” category);
- there was an increase in the number of subsidized regions receiving not only direct but also indirect subsidies from the federal part of the Fund.

It became clear that the federal Centre lacked any effective mechanism of formation and re-distribution of the federal part of the Fund, that it had lost control over collecting and spending of its resources. At the same time, the regions did not consider themselves responsible for non-observance of their financial obligations to the Centre.

The available data on the Employment Fund revenues and expenditures demonstrate a sharp drop in the amounts of contributions collected by the federal part of the Fund in 1997 in absolute terms and against the relatively “successful” 1995. Of course, law abidance had never been a strong feature of the Russian regional employment funds. Nevertheless, before 1995 there was only a small group of them not paying taxes. By contrast, in 1997, most of the regions reduced many times the contributions they paid to the federal part of the Employment Fund.

Under the circumstances, the Centre tolerated considerable underpayments of the statutory contributions by the donor regions. One quarter of such regions fell into the category of tax defaulters. Among them, the Republic of Sakha-Yakutia, the Belgorod oblast, and the Aginsko-Buryatski autonomous okrug transferred less than 5% (instead of 15% prescribed by the law) of their revenues to the federal part of the Employment Fund

Lack of criteria of allocating federal resources to the regions quite often resulted in their spontaneous and unjustified spending.

*The following facts give an insight into the situation:*

- *The donor regions took advantage of the opportunity transferring to the centralized part of the Employment Fund a smaller part of their revenues than prescribed by the law while going on receiving subsidies from the Centre.*

In 1995, over three thirds of potential donors were getting subsidies from the federal part of the Employment Fund. For example, subsidies to the Belgorod oblast (a 0.9% unemployment level and a 5.3% level of transfers to the Centre) accounted for 14% of all the expenditures of the regional employment fund, and subsidies to the Aginski-Buryatski autonomous okrug (a 1.7% unemployment level and a 6.5% level of transfers to the Centre) accounted for 84% of its employment fund.

- *Subsidies were provided to regions, which invested their resources into securities.*

In 1995, the Republic of Mari-El (unemployment rate of 3.9%), spent 19.4% of its fund on buying securities while getting not only direct financial assistance that amounted to 35.9% of all the expenditures of its employment fund, but indirect subsidies as well. At the same time the Republic was transferring to the consolidated fund 5 times less resources than prescribed by the law.

- *In some regions resources of the employment funds were spent on implementing ineffective programmes of financial support for enterprises.*

An analysis of expenditures of employment funds in three regions that received large subsidies from the Centre in 1995 (The Orel, the Novgorod and the Republic of North Ossetia) demonstrated that from 24% to 56.6% of all the expenditures were related to providing a mass-scale assistance to enterprises. It is safe to assume that the subsidies from the Centre were, to a large degree if not fully, used to fund those projects. In two years, all the above mentioned regions still enjoying low unemployment levels practically stopped transferring any resources to the federal part of the Employment Fund and became indirect (the Orel oblast) or full (the Novgorod oblast and the Republic of North Ossetia) recipients).

In 1995, the growing number of subsidized regions and the related pressure on the federal part of the Employment Fund brought about the need to change the principle of formation of the system and a gradual increase of the share of resources consolidated at the federal level.

The first step in that direction was made in the same year when a decision was made to double the rate of transfers to the federal part of the Employment Fund from 10 to 20%. Later attempts to increase the share of consolidated resources to 50% failed as leaders of a number of affluent regions, Moscow first of all, who by that time get used to the idea that regional employment funds were just parts of their regional budget, opposed the move. One more reason why many heads of regional employment services were very cautious about the idea of a stronger centralization of the Employment Fund was lack of a single law-based mechanism of redistribution of its resources thus making the way open for subjectivism and arbitrary decisions by the Ministry of Labour and Social Development. Besides, the system of allocation of resources received as subsidies was extremely inefficient and lacked any control mechanism.

Thus, in 1995, an opportunity was lost to endure a smooth transition towards a centralized system of formation of the Employment Fund and obtaining by the Centre of an effective financial lever of managing labour market policies through the employment services system.

In 1997-1998, a totally different situation emerged, that called into question the very existence of the federal part of the Employment Fund.

- The average level of transfers to the federal part of the Employment Fund dropped from 12% in

1995 (data for 9 months) to 6.8% in 1997 and 5.6% in 1998. As a result, the amount of resources accumulated by the federal part was reduced almost by half. That made the freedom of financial maneuver by the Centre still more restricted. In other words, the Centre went on losing its control over the situation in the regions.

- The amount of resources re-distributed by the Centre to the regions-recipients dropped from 365 billion roubles in 1995 to 132 billion roubles in 1997 and 130 billion roubles in 1998<sup>2</sup>. As a result, in absolute terms, subsidies to 46 regions were reduced significantly.
- In 1997-1998, arrears of the donor-regions accounted for almost half of the planned resources of the federal part of the Employment Fund.
- In 1997, the balance between regions-donors and regions-recipients changed dramatically.

**First**, the group of regions-donors practically ceased to exist. As far as the indicator of registered unemployment was concerned, only 23 of the 41 regions in the group could be still classified as such. Judging by the level of transfers to the federal part of the Employment Fund, the number of regions qualifying as donors dropped 20 (!) times (from 40 to 2). In 1997, only Moscow and the Orenburg oblast remained full donors. The number of regions qualified as full recipients increased over three times (from 12 to 43).

**Second**, *32 regions retained donor characteristics in semblance rather than in fact, becoming for all intents and purposes subsidized.* Transfers to the federal part of the Employment Fund by most of them were much below the statutory level of 20%, the highest being by the Khanty-Mansiyski autonomous okrug - 8.7%, and the lowest by the Stavropol and the Altai krais, Sant-Petersburg, the Novosibirsk, the Chelyabinsk, the Sverdlovsk, the Belgorod, the Omsk, the Moscow, and the Irkutsk oblasts – below 2%; *8 more regions* with levels of unemployment qualifying them as donors (not exceeding the average across-Russia level) fully stopped transfers to the federal part, thus moving into the group of indirect recipients. Among them: the Smolensk, the Orel, the Saratov, and the Kaluga oblasts, the Republic of Adygeia, the Jewish autonomous oblast.

**Third**, 5 regions that qualified as donors in 1995 by the level of their transfers to the federal part, had become full recipients by stopping the payments completely and going on receiving subsidies from the Centre. Among them: the Ust-Ordynski Buryatski and the Taymyr autonomous okrugs, the Republic of Tyva, and the Nizhni-Novgorod oblast. It should be noted that while in 1995, the first two regions were in the group of full donors on the strength of both of the above-mentioned indicators in 1997 they could qualify as such by one indicator only as their level of unemployment remained below 2.2%.

The above facts demonstrate that in 1997-1998 the Centre was not in a position to keep under control formation of the federal part of the Employment Fund.

The growing crisis of regional employment funds made the Centre (the Ministry of Labour and Social Development) to take steps to improve the situation. They resulted in adoption, in the late 1997, of a “Regulation on Distribution of Consolidated Resources of the Federal Employment Fund of the

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<sup>2</sup> The 20% offset between regions and the Centre was not taken into consideration



Russian Federation”<sup>3</sup>. The document was aimed at “improving the mechanism of distribution of resources of the Federal Employment Fund for the purpose of providing financial assistance to the regional offices of the Ministry of Labour and Social Development” (regional employment services).

What kind of improvement was envisaged by the Regulation? First, in accordance with its provisions, subsidies were defined as “targeted financial assistance”. Second, the forms of such subsidies were defined as direct financial transfers from resources consolidated at the federal level of the Employment Fund; mutual offsetting of funds scheduled to be transferred to the federal level (20% of insurance contributions collected from employers in the regions; direct financial payments and mutual offsetting of funds).

From the point of view of the previous experience of relations between the Centre and the regions, the regulation did not offer anything new. However, if one assumes that the regulation was intended to streamline those relations and to introduce certain objective criteria of allocating funds to the regions, one has to admit that the Ministry of Labour and Social Development failed to achieve the aim.

The fact is indisputably proved by the data on formation of the centralized part of the Employment Fund and transfers from it to the regions in 1998.

- The largest share of the centralized part of the Employment Fund – 87.3% was formed by insurance contributions transferred from 10 regions, first of all, from Moscow, as mentioned above. Ten more regions made purely nominal transfers with their share not exceeding meager 2%.
- As before, levels of unemployment did not influence much the regions meeting their financial obligations to the Centre. For example, subsidies were transferred to 9 regions with low levels of unemployment. In 3 of them (the Orel and the Saratov oblasts, the Republic of Karachaevo-Cherkessia) unemployment was twice below the average across-Russia level, while transfers to the federal part of the Employment Fund were 0%. However, while the Orel oblast was allocated an indirect subsidy (in the form of offsetting the 20% transfer to the federal part), the other two were given direct financial injections. At the same time, 10 regions with unemployment exceeding the average across-Russia level by 50% were not getting any financial assistance at all in spite of the fact that four of them made payments, although small ones, to the federal part of the Employment Fund.
- Two regions only retained the status of “full donors” (in accordance with the criterion of meeting the statutory requirements concerning transfers to the federal part of the Employment Fund). One more region (the Lipetsk oblast) could be included in the group with reservations only.
- Six regions (the Rostov, the Perm, the Chelyabinsk, and the Irkutsk oblasts; the Altai kray and the Republic of Sakha-Yakutia) stopped paying contributions to the Centre altogether, i.e. became indirect recipients of the federal transfers.
- Five regions moved the category of indirect to the category of full recipients, as apart from the mutual offsetting of the 20% contributions they began receiving direct subsidies (see the table). It is worth noting that in three of them the rate of unemployment was much lower than the average across-Russia figure.

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<sup>3</sup> Resolution by the Ministry of Labour and Social Development of the RF N 59 dated November 25, 1997 “On Approval of the Regulation on Distribution of Consolidated Resources of the Federal Employment Fund of the Russian Federation”.

- Subsidy size was not directly related to the labour market situation in the region. The largest subsidies (after those to the Republic of Ingushetia) were allocated to the Republic of Mari-El (the level of unemployment there was 0.2% below the average across-Russia level), where they accounted for 33% of all the expenditures of its employment fund. At the same time the Republic of Udmurtia received only half of that amount although it belonged to the category of the regions with the highest level of unemployment. The Kaluga oblast never having its unemployment level higher than the average one was, nevertheless, regularly receiving financial assistance (even if small) from the Centre, and had not paid a rouble into the federal part of the Employment Fund over the last three years.

Thus, the government could not set going the mechanism of regulating inter-regional employment differentials as most of the regions failed to discharge their financial obligations to the federal part of the Employment Fund. Besides, there were no clear-cut principles of financial relations between the center and the regions. That is why on the strength of the available data subsidies to a number of regions looked both unjustified and ineffective.

The practice of “loose” financial relations between the Centre and the regions that has emerged over the last 5 years has resulted in virtual self-liquidation of the established mechanism of formation and re-distribution of the federal part of the Employment Fund. In 1995, a staged transition to centralization of the Employment Fund resources was on the agenda, but later on full centralization became possible only as a result of a single act. It was necessary to synchronize increasing the share of centralized resources with developing a system of criteria for their re-distribution and with passing a corresponding legislation, which was possible only through overcoming the existing trend towards subjectivism and the “individual” approach to funds allocation.

The 1998 crisis exacerbated further the difficult situation of the Employment Fund. Impossibility for the system to go on functioning in its present form became quite obvious, and a decision was made to change it radically as of 1.1.2001:

- to abolish altogether the 1.5% pay-roll tax;
- to switch to financing employment promotion programmes (both active and passive) directly from the central budget on the basis of forecasting information on the labour market presented by regional employment departments to the central government.

It is too early yet to try to evaluate efficiency of the new system. At present its implementation is hindered by lack of legislative framework that would allow to regulate the newly emerging situation.

However, the upward trend in the registered unemployment is already visible, which might be the result (leaving aside social and economic reasons) regional departments of employment losing to some extent their “interest” in underreporting registered unemployment for the purpose of saving resources allocated for unemployment benefit payments. It is safe to assume that subjectivism of decision making might be replaced by that of forecasting the labour market situation.

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**Authors**

Dr. Tatiana Chetvernina  
Director of the Centre for Labour Market Studies,  
Institute of Economics Russian Academy of Sciences

Dr. Liana Lakunina  
Senior researcher of the Centre for Labour Market Studies,  
Institute of Economics Russian Academy of Sciences

Sphere of our professional interests:

- Russian Labour Market situation in comparison with eastern and western European countries;
- dynamics of the unemployment on federal and regional levels in 1990-s;
- unemployment benefit system in RF in 1991-2000, incomes and expenditures of regional employment funds, Employment Act;
- active labour market program, carried out by Employment service on Federal and regional levels;
- labour relations in public and new private sectors in Russia;
- enterprise restructuring;
- aspects of the formation of the social partnership in Russia;

- current social protection system in Russia, elaboration of unemployment insurance concept for Russia and policy paper for its implementation;
- gender aspects of labour market policy making.