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Evolution of Oil Resource Management in Russia

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The oil and gas sector has traditionally played a highly important role not only in the Russian mineral complex, but also in the domestic economy. Currently, the hydrocarbon sector accounts for 60 % of Russian export revenues and contributes over 45 % to the federal budget. As a result, this sector has been a driving force behind the economic development of the entire country and especially the oil and gas producing regions.

The evolution of the Russian resource management system reveals a complex picture in terms of already adopted decisions and future strategies in relation to resource development and revenue utilisation. During the 1992–2009 period, Russia failed to create an effective model of hydrocarbon resource management – both in terms of exploration and development of oil and gas resources, and in terms of adequate use of oil and gas revenues for the diversification of the national economy.

Keywords: oil, resource management, taxation, special funds

Introduction

The oil and gas sector has traditionally played a highly important role not only in the Russian mineral complex, but also in the domestic economy. Currently, the hydrocarbon sector accounts for 60 % of Russian export revenues and contributes over 45 % to the federal budget. As a result, this sector has been a driving force behind the economic development of the entire country and especially the oil and gas producing regions.

Since the collapse of the Soviet Union in 1991, Russian policies and legislative efforts in relation to natural resource management have been at the cornerstone of domestic political and economic processes. Unfortunately, the Russian government has been unable to promote a system of adequate mechanisms for motivating oil and gas companies to develop hydrocarbon resources in a socially effective way. This is result not only of complexity to create modern hydrocarbon resource management system, but rather result of clash of diverse interests of within the federal centre, regions, oil and gas companies and their owners.

This article seeks to examine decision-making processes and procedures in relation to the natural resource management and the use of hydrocarbon revenues in Russia in the 1990s and the 2000s. Since Russia is a federal state, relations between the federal government and the resource-rich regions have played the main role in shaping a system of resource management, licensing and taxation.

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In this respect, Russia has gone through two stages of development:

- 1992 – 2001 – formation of a decentralised model, based on the active participation of the resource-rich regions and non-governmental organisations (NGOs), representing diverse interest groups; emergence of new private corporate entities;
- 2002 – present – transition to a highly centralised bureaucratic model of resource management in the oil and gas sector dominated by the federal government; partial restoration of the state property in the oil and gas sector ownership as a form of additional securing of the state priorities (as in political as in fiscal spheres – including state-related business groups).

The first period was characterised by the substantial control of hydrocarbon rents by certain individuals, as well as newly formed independent financial-industrial groups. The subsequent period has been characterised by the strong will of government (primarily at the federal level) to establish a basis for the modern system of resource management and publicly and economically efficient use of hydrocarbon revenues.

In the 1990s, the main government agenda was to implement policy reforms vital for the establishment of a new resource management system in Russia. In the government's opinion, the main task of the new system was to ensure the accumulation of a bulk of resource rents in the state budget (as at the federal as at the regional level). The World Bank and the International Monetary Fund also proposed similar policies to the Russian government. The essence of these proposals were to consolidate the largest part of oil and gas revenues in the state budget, which could then be used to promote social stability and to support uncompetitive sectors of the national economy. The idea was through heavy taxation of the oil-and-gas sector to give a chance to uncompetitive sectors to use state money to overcome the transition period to market economy, while the oil-and-gas sector could be financed through loans provided by the above-mentioned international financial institutions (as well as the European Bank for Reconstruction and Development).

Since 2002 the federal centre started to implement a policy of strengthening its role in the accumulation of hydrocarbon revenues, including the enlargement of its direct presence in the oil and gas sector. Simultaneously though, further development of a resource management system intended to ensure economic and long term efficiency has been curtailed.

Overall, this period saw a notable attempt by the government to promote a highly centralised system of planning, adoption and implementation of decisions regarding the natural resource sector. As part of this process, the federal centre effectively curtailed the excesses of the previous period, associated with the decisive role of regional authorities and financial-industrial groups in Russia's political and economic system.[1] However, though the current system has managed to correct the excesses of the 1990s, it has failed to form a modern and effective model of resource management.

1. Evolution of natural resource management in Russia

1.1. Decision-making processes in the development of natural resources

Since the collapse of the Soviet Union in 1991, oil, gas, diamonds, precious metals, nickel,

[1] Kryukov V., Tokarev A. Oil-and-gas resources in a transitional economy: comparing realized and potential social value of mineral wealth (theory, practice, analysis, and estimates). – Novosibirsk: Science-Centre, 2007. – 588 p.

and aluminium have been the main commodities generating considerable economic rents during the transitive period of the Russian economy. In the 1990s, oil was contested by the federal centre and the regions as the main commodity generating considerable rents under volatile economic conditions, thus ensuring a certain degree of social stability and the political survival of the ruling elites.

The division of authority rights over the mineral resources in Russia has been one of the main outcomes of the centre-periphery bargaining game of the early 1990s. For example, in 1990–1991 the Parliaments of Russia's ethnic republics (including oil-rich Tatarstan, Bashkortostan, Komi and Udmurtia) adopted Declarations on State Sovereignty, proclaiming their sole jurisdiction over local natural resources. The Federation Treaty of 31 March 1992 also declared all natural resources the property of local populations. Although the Russian Constitution of December 1993 abolished this principle, four ethnic republics (Tatarstan, Bashkortostan, Udmurtia and Yakutia) continued to assert their 'sovereign' authority over local natural resources. In response, the federal legislation on natural resources vaguely defined federal and regional authority over resources in this field in order to pacify the separatist regions. Thus, divergent views on the role and place of the federal centre and the regions in the resource management system found their way into the legislation.

On one hand, the legislation established the principle of joint jurisdiction over natural resources (the "two-keys" system) while on the other hand it envisaged the division of ownership rights over natural resources in accordance with the administrative-territorial state hierarchy. The main legal act on the subject, the 1992 federal law "On Subsoil", introduced the concept of the division of all natural resources into three categories: federal, regional and municipal.

The result of this "spontaneous" arrangement regarding rights over subsoil use (which concerned not only oil and gas, but also other mineral resources, such as diamonds, gold and iron ore) was the reinforcement of the joint jurisdiction principle by the legislation. This principle asserted the existence of equal rights for both the federal government and a given region in their dealings with subsoil issues. It is important to note that this principle ensured that a given resource-rich region would receive a portion of resource rents.[1]

Therefore, the law "On subsoil" served as the foundation for legislative principles regarding resource management. This normative legal base was founded on the principles of:

- fee-based subsoil use;
- equal access to fields for all overseeing subjects;
- licensed rights to the subsoil use;
- transparent distribution of rents. Particularly important is that until 2001 the law "On subsoil" defined not only the methods of collection of rent income, but also the proportion of their distribution between the federal government and the resource-rich regions (where the mineral resources were produced). The federal government received 40 % and the regions 60 %, of which half was set aside for the municipal government and half for the regional budget;
- joint jurisdiction between the federal government and a given resource-rich region.

[1] Kryukov V., Seliverstov V., Tokarev A. Federalism and Regional Policy in Russia: Problems of Socio-Economic Development of Resource Territories and Subsoil Use in The Dynamics "Real Federalism": Law, Economic Development, and Indigenous Communities in Russia and Canada / Ed. by P.H. Solomon. Toronto: Centre for Russian and East European Studies, Univ. of Toronto, 2004, p. 96–127.

In the 1990s, in addition to the formation of the new resource management system, the Russian oil and gas sector experienced major institutional changes with the formation of a completely new institutional environment in the oil and gas sector. During this period, assets of old state enterprises, responsible for exploration, production, refining and distribution of refined products were consolidated under an umbrella of newly established vertically-integrated companies. The new oil conglomerates made sure to secure under their control the key industrial assets essential for incorporating the entire technologically-linked chain of oil production, refining and petroleum product sales. Several companies were established on this principle, including private corporate entities, such as Lukoil, Surgutneftegaz, and Yukos as well as the state oil company, Rosneft, which managed a large share of the state's oil industrial assets. At the same time, the assets of the state pipeline system were transferred under the control of the state company, Transneft, whereas the assets of the Ministry of Gas Industry were incorporated under the umbrella of the newly-established state gas concern, Gazprom. Apart from these vertically-integrated companies, several other (partially integrated) regional companies were established, such as Tatneft, Bashneft, and KomiTEK. The formation of these regional oil companies without federal involvement was possible due to the political weakness of the federal centre at this time, as well as the growing strength of regional elites in some key resource-rich Russian provinces, such as Bashkortostan, Tatarstan, Udmurtia, and Komi Republic.

The economic and financial potential of the large vertically-integrated oil companies were considerably higher than that of many regions, making them also highly influential at the federal level. At the same time, partially integrated regional oil companies were fully controlled by regional administrations and local governors.

As soon as all regional heads began to be elected by popular vote, federal companies began to experience the full scale control of provincial authorities over new oil fields which the companies sought to develop and of the existent oil resources which they had initially received. The regions flexed the power afforded to them under the "two-keys" system to extract concessions from the oil companies operating in their territories in the form of various social, financial, constructional and environmental projects. The oil giants provided credit to local agricultural and industrial producers, established grants to educational organisations, built roads, hospitals and houses, and sold petroleum products to local consumers at discounted prices. In other words, regional elites used the "two-keys" system to extract resources from federal oil companies to maintain local socio-economic stability and thus voter satisfaction.

Since the federal government was not directly involved in the management of Russia's natural resources in the 1990s, resource-rich regions became the driving force behind the development of a joint jurisdiction system. In this respect, the legislative and executive bodies in these regions adopted relevant laws and administrative procedures, and also set up relevant regional executive power bodies to envisage the subsoil use.

Legislators in some resource-rich territories sought to transform the fundamental principles of natural resource use. A few pre-existent norms and procedures were abolished, namely the free-of-charge access to resources, the anonymity of the owner, and the lack of control systems and effective administration in the regions' efforts to promote efficient use of natural resources. For example, in the Tyumen region, legislators and

the majority of oil and gas companies facilitated intensive discussions on the following issues:[1]

- the use of regional authority over allocation and control procedures in the oil and gas sector to ensure stable revenues to local and regional budgets;
- implementation of strict environmental regulations for areas of oil and gas production;
- establishment of legal limits on the development and expansion of oil and gas operations in regions where traditional forms of economic management were practiced by indigenous peoples of the North;[2]
- participation in the decision-making processes involving the examination and implementation of development plans for new oil and gas fields.

A lack of detailed procedures on conflict resolution between the centre and the regions over resource management issues and the absence of a civil system of social norms and legal procedures in general led to the inefficiency of the joint jurisdiction system in Russia in the 1990s. In 2001, the federal government introduced new administrative reforms aimed at the "harmonisation" of regional and federal laws, and the centralisation of decision-making regarding resource management.

However, the highly centralised system of resource management introduced after 2001, rather than tackling the deficiencies and excesses of the previous period, led to an over-bureaucratisation of the decision-making processes and of the coordination efforts between administrative institutions. As a result, the resource-rich regions became sidelined from active participation in mineral resource management, and are currently being excluded from the distribution of rents from the extraction of hydrocarbon resources. If in the 1990s the share of rents reached approximately 50–60 % of the budget of Khanty-Mansiysk autonomous okrug (KMAO, the largest oil producer in Russia), by 2008 this share decreased to 2–3 % and by 2010 to zero level.

The abolition of the "two-keys" principle within the subsoil legislation, which is still in Russian Constitution, resulted in a significant reduction of opportunities for the regions, and therefore the population, to participate in the creation of policy regarding the use of natural resources and, thus, the way of the socio-economic development of their territories.

Since 2004, the Russian legislation has completely altered the regulatory authority of the centre and the regions in relation to subsoil use. A more democratic and transparent system of resources management of the 1990s was replaced by a highly centralised and bureaucratic system. In this respect, the regional authority became limited only to fields of local significance (as opposed to those of federal or strategic significance) which contain commonly occurring minerals. At the same time, regions began to play a "static" role in implementing the federal guidelines for subsoil use. The federal administrative powers increased substantially while the role of the regions, along with the municipalities and NGOs, were limited to the work of commissions charged with supervising whether the guidelines for subsoil use were adhered to. At the moment, these commissions do not have clear legislative status or authority. A given region's authority over resource management depends on the bargaining power of its governor vis-à-vis the federal centre.

A further step in the bureaucratisation of decision-making with regard to subsoil usage was taken in April 2008, when the definition

[1] Kryukov V., Shafranik Yu. Zapadno-Sibirskii phenomen. Tyumen na styke vekov: mezhdu legendarnym proshlym i neyasnym budushim? [Western Siberian oil in 1990s]. – M.: Polteks. 2000, 240 p.

[2] Kryukov V., Tokarev A. Indigenous peoples and oil: Russian case study. – M.: Tsentr sodeistviia korennykh narodov Severa, 2005, 172 p.

of "strategic" resources was introduced into the Russian legislation. The exploration and extraction of natural resources from federal fields have gained strategic importance in the protection of the country and the government. The fields bearing federal significance include fields that:

- contain natural resources in excess of 70 million tonnes of oil; in excess of 50 billion cubic metres of gas; in excess of 50 tonnes of vein gold; in excess of 500 thousand tons of copper;
- are located in the inland sea water, territorial seawater, and the continental shelf of the Russian Federation.

Fields that fit the following categories are transferred to state companies (or companies with governmental stakes) on a sole source basis. As a result of these measures introduced in 2008, the principle of bureaucratic administration, in dealing with issues of resource management, became dominant.

1.2. Licensing policy in oil and gas sector

Licensing policy is an important aspect of resource management. Licensing policy can significantly reduce monopolistic tendencies with regard to mineral resources, and can also create conditions for the optimisation of expenditures and the development of an effective institutional structure.[1]

The difficult financial conditions of the 1990s led regional authorities to hold as many natural resource auctions and tenders as possible. When dealing with resources under joint jurisdiction, regions resorted to applying their exclusive ownership rights over local natural resources or employed the "two-keys" principle. The main intention behind sales of licences (access rights) was not necessarily to provide solutions to the vast spectrum of socio-economic issues of the time, but rather to receive one-time payments (bonuses). In order to garner larger bonuses, regions auctioned off their best possessions, such as the Priobsk oil field (KMAO), the Yurobcheno-Takhomsk oil field (Evenkiisky autonomous okrug), the Talakan oil field (Yakutia), and the Kovyktinsk gas field (Irkutsk region). As a result of such practices, the regions lessened their opportunities to address future socio-economic issues within an improved resource management system, which could have come about from the use of access rights as strategic levers.[2]

Despite the large number of successfully completed resources licensing auctions and tenders, many licenses were not used by the companies which had won them. The number of unused licenses, or licenses with multiple violations, attests to the underdeveloped conditions which were present within the administrative institutions at differing levels of power. For example the fundamental by-law, "Resolution on licensing procedures" (1992), did not establish supervisory powers for Russian regions, implying that the norms set out in the federal law "On subsoil" were not developed. Regions did not have clear legislative authority over early termination, suspension or limitation of subsoil licences: the licensing procedures resolution states that subsoil licences can be terminated early, suspended and limited only by the Russian Ministry of Natural Resources or its respected regional branches. Therefore, the procedures for regional participation in this process were not clearly defined.

[1] Kryukov V., Sevastyanova A., Tokarev A., Shmat V. Evolutional approach to formation of oil and gas resource management system. – Novosibirsk: Institute of Economics. 2002, 168 p.

[2] Kryukov V. Instituttsional'naya struktura neftegazovogo sektora: problemy i napravleniya transformatsii [Institutional structure of oil and gas sector: problems and transformations]. – Novosibirsk: Institute of Economics. 1998, 280 p.

Throughout the 1990s and early 2000s, the federal centre and the regions held many resource licensing auctions in order to secure auction bonuses and subsequent tax payments to their respective budgets, which were vital for ensuring socio-economic stability. While regional administrations were more interested in using these budgetary funds for solving pressing socio-economic problems, the federal centre was solely interested in securing tax payments from oil and gas production. Regions began to promote company-region licensing agreements, which contained additional company obligations in relation to urgent socio-economic projects of the region, soon after the regional rents share decreased in favour of the federal centre.

During the 2000s, the strengthening role of the state became the main impetus behind the changes to the Russian oil and gas sector's regulatory regime. As power became more concentrated at the federal level, improving the "manageability" of subsoil usage became a governmental priority. The government hence obtained practically all rents from the oil and gas companies and gained direct control over key industry assets (such as Gazprom and Rosneft) in what can be considered the government's hard answer to the soft oil and gas sector business practices of the 1990s. Having thus restored relative control over the sector, the government's most important task at hand now became the fine-tuning of the resource management system, including the mobilisation of investment into new projects and districts, along with strengthening monitoring and oversight over field development.

Overall, the unfavourable conditions surrounding the licensing policy can be attributed to the following components:

- the fiscal orientation of the national economic policy concerning the oil and gas sector;
- the ambiguity and contradictions of the principle of joint jurisdicton in practice;
- competition among different governmental institutions;
- underdeveloped and unclear regulatory measures concerning the role of licensing agreements in subsoil use; this results in a weak legal basis for claims against oil companies;
- lack of recourse regulations, including the termination of licenses due to violation of the agreement.

The main consequences of an ineffective licensing system for the use of hydrocarbon fields in Russia are:

- a significant number of unused licenses (or licenses that are being violated);
- lack of opportunity for efficient utilisation of extracted hydrocarbon materials, as in the case of associated gas;
- lack of a stable and functioning financing system for general geological surveys of the territories.

1.3. The changing nature of mineral resource management in Russia

The increased role of the federal government through centralisation has definitively shaped Russian legislation on subsoil. Table 1 presents the most important changes made to the principal subsoil-use legislation in Russia, and the state policy in the oil-and-gas sector.

As a result of the changes made to hydrocarbon regulations over time, the following significant developments took place in Russia as of 2001:

- A shift of the government's "negotiating powers" vis-à-vis parties involved within the oil and gas sector, resulting in a strengthened role of the federal

Table 1. Legislation on subsoil usage and government policy

Issues regarding subsoil use	First versions of the law on subsoil (since 1992)	Current legislation and policy on subsoil use passed after 2001
Subsoil ownership	State (federal-regional) ownership	State (federal) ownership
Oil and gas resource management	Joint jurisdiction between the Federation and the regions	Federal control
The role of oil- and gas-rich regions in the licensing	"Two-keys" principle	Regional approval with the federal centre adopting the main decision
Distribution of rents*	Regulated by the law on subsoil use	Regulated by the tax and budget legislation
Regional share of hydrocarbon rental incomes	60 % of the royalty	0–5 % of the oil production tax, 0 % – of the gas production tax
Monitoring and oversight of subsoil development	Weak federal control	Conditions implemented for the strengthening of the federal role
The role of local authorities in subsoil management	Weak role	Practically absent
Recourse/Turnover for the subsoil use rights	No provision	No formal provision, but exists in practice
Access rights for subsoil use	Licensing through auctions and tenders	Licensing through auctions and tenders
Access to subsoil	Equal access principle	Limited access to subsoil for foreign companies

* In this case, rents imply royalty and/or production tax, excluding export duties and excise taxes

centre through administrative reforms and a consolidation of the "power vertical";

- Revenues from the oil and gas sector became the "nuclei" of the country's entire financial system as a result of the rising oil prices and subsequent increase in the volume of rents. This, in turn, had a direct impact on the norms and regulations associated with rental tax collection and distribution.

2. How effective is the tax policy?

The basic characteristics of oil and gas taxation system include: flexibility of norms and regulations; tax optimisation opportunities for companies, and an inclusive role for oil and gas producing regions in implementing tax policies. On the basis of these characteristics, one could divide the evolution of Russia's taxation system into the following stages.

Stage I. Formation of a fee-based system for subsoil usage (1992–2001):

- 1992–1995 – Creation of a new taxation system, based on the Russian law "On subsoil"; this period of political and economic transition was characterised by the widespread use of non-market mechanisms for the collection and distribution of rents, including price control measures;
- 1995–1999 – Resource-producing regions implement active tax policies combined with limited use of differentiated (flexible) taxation. Low oil prices in external markets are partially responsible for active application of transfer pricing policies by oil and gas producers as well as tax optimisation strategies aimed at maintaining minimum profitability in times of volatile economic conditions;

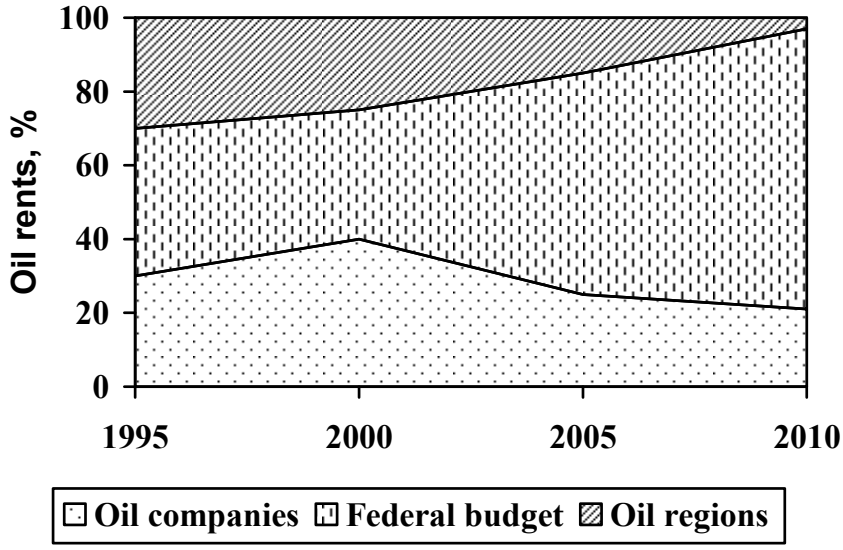

Fig. 1. Distribution of oil rents in Russia

- 2000–2001 – Widespread use of tax optimisation strategies by oil and gas producers; a gradual withdrawal of governmental policies on differentiated taxation also takes place.

Stage II. Development of a new taxation system:

- 2002–2006 – The role of regions in resource management is weakened; introduction of the mineral production tax becomes an effective solution to the problem of transfer pricing; absence of flexible approaches towards the collection of rental incomes;
- 2007 – present – Increased use of flexible taxation in oil production; a monitoring and oversight system for subsoil use is gradually developing.

As result distribution of oil rents in Russia changed drastically (See Fig. 1).

Improvement of the taxation system is a vital component of effective oil and gas resource management, along with an efficient regulation of hydrocarbon development and production, licensing system, and access to transport infrastructures. Such improvements are best made in stages and in sync with the reform of other elements of the resource management system.

2.1. Tax policy in the oil and gas sector from 1992 to 2001

The taxation of oil and gas production has great significance for the Russian federal budget, as well as the budgets of oil and gas producing regions. The foundations for a new system of taxation in the oil and gas sector were established in 1992 when special taxes, designed to accumulate rents for the state budget, were introduced alongside regular taxes. The main mechanisms for the acquisition of rents from 1992 to 2001 involved the mineral resource reproduction tax (MRRT), oil and gas excise taxes, royalties, and export duties.

The MRRT comprised up to 10 % of marketable oil and gas production, and was absorbed by the federal and regional budgets. From 1992 to 2001, the primary purpose of the MRRT was to finance and support geological explorations, and was justified as a measure of transitional economics. However, a significant portion of the MRRT was diverted to other areas

which had no direct relation to the oil and gas exploration.

From 1992 to 2001, the excise duties on oil served as one of the mechanisms for the acquisition of rents. This tax was forwarded to the federal budget in its entirety. From the perspective of oil and gas producing regions, excise duties helped shape the main regional tax bases. The increase in excise duty rates led to a reduction in the tax base, calculated on the basis of marketable production, including the redistribution of tax payments between the federal budget and the oil and gas producing regions.

A significant part of oil and gas taxes, which went to the government prior to 2002, came from royalty. The share of royalties comprised 6 % to 16 % of gross revenue / the value of marketable production (oil and gas). The average royalty rate was 8 % for oil and 14 % for gas. The dependency of royalties on the market price of hydrocarbons resulted in considerable state transactional costs during the time of economic transformation, due to oil and gas companies' practice of transfer pricing.[1]

An important feature of royalty was its distribution between the different levels of the state hierarchy. The federal government received 40 % and the regions 60 %, of which half was set aside for the municipal government and half for the regional budget. As the greater part of royalty payments was sent to the regional budgets during the 1992–2001 period, the federal government did not initially address the problem of transfer pricing in the oil and gas sector.

From 1995 to 2001, oil and gas producing regions placed additional conditions for the exemption of certain categories of fields from royalty. Exemptions from royalty gained greater emphasis during the later stages of development of both fields and the oil and gas producing provinces.

Hydrocarbon taxation policy has shown that in order to build a rental-oriented taxation system which, from the government's point of view, is effective, it is necessary to have a number of pre-existing conditions such as:

- transparency of the hydrocarbon sector or government involvement (both regional and federal) within oil and gas company ownership;
- existence of a competitive environment at the regional level;
- development of a resource management system and also the presence of adequate monitoring and field development supervision systems;
- presence of a meaningful tax policy at the regional level.

During the 1990s, large-scale transformations occurred within the oil and gas sector in Russia. Vertically-integrated oil companies responsible for the entire production process (from geological exploration and extraction to marketing of processed products for consumers), were established during this time. Such companies had great influence on the effectiveness of the acquisition mechanisms for mineral rent.

The volume of payable hydrocarbon taxes (special and general taxes for all economic sectors) is mainly determined by the market price of oil and gas. Oil prices, used to determine the tax base, develop primarily within the framework of vertically-integrated oil companies. In order to lower tax payments (especially royalties and the MRRT prior to 2001), companies broadly applied lowered transfer prices. Another important aspect of transfer pricing is that it allows the transfer of the tax base from producing regions to other regions and to optimise the general level of the tax burden.

[1] Tokarev A. Nalogovoe regulirovaniie neftegazovogo sektora: regional'nye aspekty [Tax policy in oil sector: regional aspects]. – Novosibirsk: Institute of Economics. 2000. – 256 p.

From 1998 to 2000, inter-corporate pricing had a real negative effect on KMAO's budget – a territory that accounts for more than 55 % of Russian oil production. According to the Russian Accounts Chamber, the tax burden across different enterprises varied by a factor of 2 or 3. As a result of the use of transfer pricing by oil companies, the KMAO budget sustained losses of $0.2 billion and $0.96 billion in 1999 and 2000 respectively.

Russian Institute for Financial Studies estimates reveal the scale of tax optimisation in the oil sector.[1] In 2000, one of the most "successful" years in terms of tax optimisation in hydrocarbon sector, tax evasion resulted in the loss of $4.9 billion. Throughout the period of 2000–2002, the consolidated Russian budget lost $3–5 billion annually (depending on price levels and volumes of production).[2] Experts estimate that, at the same time, rents in the oil sector comprised around $25–30 billion in 2000–2001.

The abovementioned weaknesses of the tax policy necessitated various modifications. This resulted in the development of a new system of taxation for the oil and gas sector starting in 2002.

2.2. Development of the special tax system in 2000s

Significant changes occurred in the oil and gas taxation system when a production tax on mineral resources was introduced in 2002. The MRRT, excise duties and royalties were replaced with the production tax. A specific tax base rate (roubles per tonne) was introduced. The base rate is adjusted according to movements in global oil prices.

The creation of a specific **production tax** for hydrocarbons was an indication of government's inability to establish norms and regulations which could have helped limit transfer pricing opportunities for oil and gas companies.[3]

The key advantages of the production tax include the simplicity of its operation both in terms of methods used for its calculation as well as the administrative costs involved. Another benefit of the production tax was its efficiency in counteracting transfer pricing practices previously employed by domestic oil companies. For example, the production tax (until 2007) applied a uniform rate for all hydrocarbon fields, regardless of their specific conditions, whereas the previously used royalty took into account the geological or economic diversity of different fields.

Under the new framework, 80 % of the production tax went to the federal budget, while the hydrocarbon producing regions received 20 %. Subsequently, the regional share of the production tax for oil was reduced to 5 %, while the entire tax for gas production was retained by the federal budget. In September 2009, the government adopted new amendments to the Budgetary Code which intends to abolish the regional oil tax share starting in 2010 when the federal centre will collect the 5 % share currently retained by the regions. As a result, the new taxation has further lowered incomes for hydrocarbon producing provinces.

The production tax immediately became the object of harsh criticism as it failed to take into account the diverse levels of development among hydrocarbon fields, since the degree

[1] Vygon G. Otsenka nalogovoi nagruzki na rossiiskie neftyanye kompanii v 2000 godu. – Moscow: Institute for Financial Studies. 2002, 29 p.

[2] Tokarev A. Analyz struktury dokhodov rentnogo kharaktera v neftyanom sectore Rossii: uchet interesov syr'evykh regionov [Russian oil rents: interests of resource-rich regions] in Neftegazovyi sector Rossii v teorii i na praktike [Russian oil and gas sector: theory and practice]. Ed. by Kryukov V., Sevastyanova A. – Novosibirsk: Institute of Economics. 2003, p. 73–105.

[3] Kryukov V., Tokarev A. Investitsionnyi klimat v neftegazovom sektore Rossii [Investment climate in Russian oil and gas sector]. Novosibirsk: Vestnik NGU. Seriia: Sotsial'no-ekonomicheskie nauki. 2006. Vol. 6, p. 84–97.

of the field depletion determines the level of production expenditures. In view of this, in 2007, a more flexible and differentiated approach to the production tax was introduced which focused on:

- the level of field depletion when estimating the production tax. For example, if depletion exceeds 80 %, it is possible to apply a reduction coefficient when calculating the production tax. "Mature" oil and gas producing regions, such as Tatarstan and Bashkortostan, benefited especially from these new rules;
- the use of a zero tax rate for Eastern Siberian oil fields (applicable until production reach 25 million tonnes in certain fields).

In addition to the production tax, **export duties on hydrocarbons** also play an important role in generating revenues for the federal budget. In 2002, Russian oil export duties began to be determined by a flexible scale system based on global oil prices.[1] Although, this new approach significantly increased the tax burden for oil companies, it established clearer and more predictable rules for investors. If in the past the system of rates was regulated by governmental decrees, the new clearly defined system of export duties is based on a federal law. This new formula for collecting export duties is also more flexible in nature, helping to avoid drastic fluctuations which tended to occur under the pre-2001 gradual scale system.

In the current context, the tax burden levied on oil companies has become considerably high. This leads to lower geological exploration activities, slow development of new oil and gas areas, and an increase in the number of abandoned wells in mature fields. For example, when oil prices soared above USD 60 per barrel the government used the taxation system to collect more than 80 % of companies' additional revenues (Fig. 2). At the same time, oil companies faced a significant increase in oil extraction expenditures. For instance, 2006–2007 witnessed a near 50 % rise in pipeline costs for the hydrocarbon sector. During this period, domestic oil companies also experienced rising costs due to the strengthening of the rouble in relation to the US dollar (used in Russian export contracts).

Since 2007 the government has been more responsive and efficient to changes in the oil industry taxation. For instance, it initiated a number of changes in the taxation system aimed at resolving specific problems, such as the reduction of the tax burden, stimulation of oil development in new areas, and the modification of the preferential tax regime for developed "old" fields (Table 2).

Another important challenge facing the hydrocarbon sector is improvement of the taxation system for the gas industry.[2] At the moment, there is a uniform production tax in place for all fields regardless of field depletion (maturity), absence of mechanisms to stimulate the development of new gas areas, as well as a lack of any correlation between gas prices in external markets and gas export duties.

Overall, production tax and export duties currently remain the principal mechanisms for collection of rents in the oil and gas sector (Fig. 3).

3. To spend or to save? Issues confronting resource rents and special funds

Special financial funds (known as sovereign wealth funds or reserve funds) seek to facilitate

[1] The tax was not levied if prices fell below $109.5 per tonne.

[2] Kryukov V., Silkin V., Shmat V., Tokarev A. Podkhody k differentsiatsii nalogooblozheniia v gazovoi promyshlennosti [Flexible taxation in gas sector]. – Novosibirsk: Institute of Economics. 2006. – 169 p.

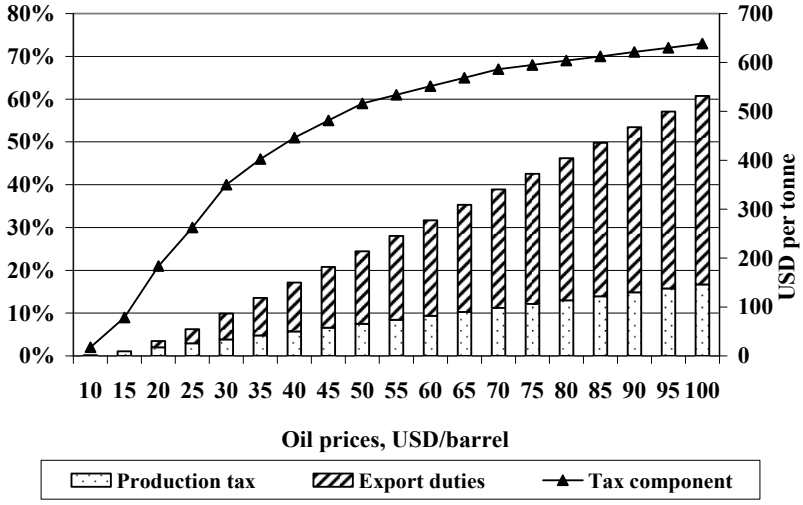

Fig. 2. Production tax and export duties in relation to oil prices

Note. The tax component – the level of the production tax and export duties in the price of exported oil (%).

Table 2. Tax policy in the Russian oil and gas sector

Taxation problems within the oil and gas sector	Solutions
High tax burden levels for oil production	Modifications to the production tax formula, resulting in lower tax levels
Inadequate taxation system for the development of new oil areas	Introduction of a preferential tax regime (tax benefits) for oil production in specific new areas
Lack of a preferential tax regime (tax benefits) for mature fields	Changes to the way hydrocarbon production is valued during mature stages of field development
Lack of flexible taxation for the gas sector	Discussions continue with no real decisions reached as of yet

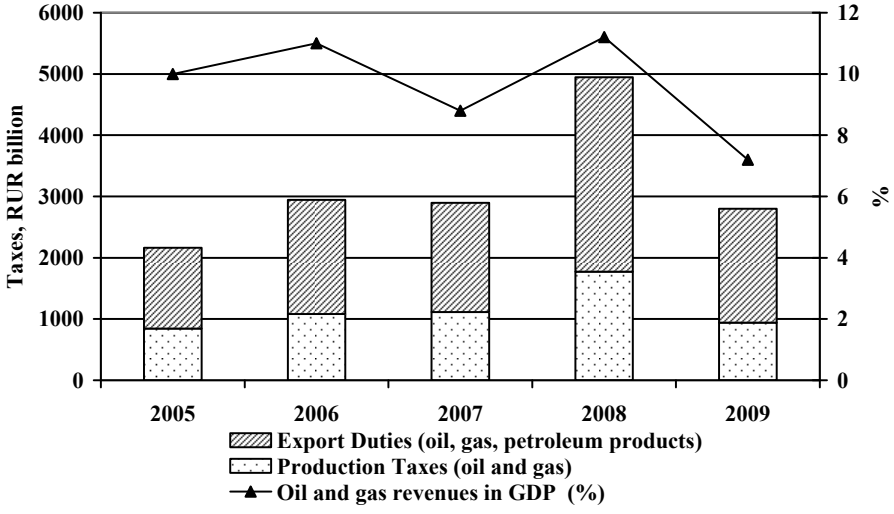

Fig. 3. Russian Federal Budget Oil and Gas Revenues, RUR billion

Note. Source: Russian Ministry of Finance.

sustainable socio-economic development of resource-rich countries, by:

- promoting the accumulation of resource rents, which would otherwise be spent;
- prolonging the impact of lucrative resource-rich periods on the domestic economy and society for many generations to come;
- providing an additional source of income for the country and its regions;
- stimulating the diversification of the economy.[1]

At the regional level, special financial funds are primarily intended to ensure the sustainable development as hydrocarbon fields reach their production peak and maturity. At the national level, these funds also function as stabilising mechanisms, ensuring the maintenance of a reasonable exchange rate, especially during periods of high oil prices. In this sense, the Russian Stabilisation Fund was designed in 2004 along the same principles utilised in Norway and Chile, where special financial funds have played, and continue to play, such an important role.

In the Russian case, the level of investment functions of special funds is often seen as being linked to the level of inflation. However, direct investment into industrial fixed assets does not make a negative impact on inflation or the exchange balance. In fact, new real investments create new industrial assets, which promote reduced inflation levels (due to the growth of commodities relative to financial resources). These considerations led to the formation of the Russian Investment Fund which aimed to boost Russia's economic development by promoting new investment projects. Practical realisation of such projects through these special funds requires not only an adequate economic and industrial base, but also a developed civil society, political accountability and transparency of financial institutions.

3.1. Special financial funds in the 1990s: discussions at the federal level, real steps at the regional level

The development of natural resources has been widely perceived in modern Russian history as both a solution to pressing socio-economic problems, as well as a source for the formation of a modern economy that would ensure the stable, long-term development of the country. Russia is a resource-rich economy primarily based upon the extraction, primary processing and sales of natural resources. Hence, Russia's economy faces problems similar to those of other resource-rich countries. Russia's biggest challenge is to transform its economy in order to make it less dependent on the raw materials sector. The successful development of high-tech and innovative (value-added) products and services could address these issues. A portion of rents from the extraction of raw materials can serve as a financial base for the diversification of the economy: discussions in Russia have focused on different ideas and approaches towards achieving such an "appropriate" utilisation of resource rents. Since the collapse of the USSR, the main discussions have revolved around the following topics:

- Should the rents from raw materials development be saved or spent?
- What role should the federal centre and the resource-rich regions play in the utilisation of resource rents?

[1] Kryukov V., Sevastyanova A., Shmat V. Utopicheskaya ideya ili real'naya nadezhda? Otsenka vozmozhnostei sozdaniya i deyatel'nosti spetsial'nykh finansovykh fondov syr'evykh territorii v Rossii i analiz zarubezhnogo opyta [Special financial funds in resource-rich regions]. – Novosibirsk: Assotsiatsiya Banki Sibiri, 1996. Warrack A., Keddie R. Alberta Heritage Funds vs Alaska Permanent Fund: A Comparative Analysis. – Faculty of Business, University of Alberta, Edmonton, 1999. – 19 p. Fasano U. Review of the Experience with Oil Stabilization and Savings Funds in Selected Countries. – International Monetary Fund, IMF Working Paper, 2000. No. 12. – 20 p.

- Should the resource rents go towards addressing urgent social issues or towards the modernization and diversification of the economy?
- What kind of legal frameworks and mechanisms should guide the use of funds drawn from resource rents?

There have been several approaches toward the accumulation and utilisation of resource rents in Russia, namely the formation of the Development Budget and special funds at the federal level and the creation of regional-based development funds (such as the Future Generations funds).

The economic development of **oil and gas producing regions** is traditionally linked with key stages in the development of the local oil and gas sector. For instance, a newly discovered oil field and its subsequent development is likely to lead to intensive economic activity, including an influx of labour, rapid development of the relevant infrastructure, and an emergence of new settlements for oil workers and personnel involved in support services. Conversely, with field depletion or unfavourable economic circumstances in external markets (such as low oil prices), there is bound to be a reduction in traditional economic activity. This leads to a number of socio-economic problems, such as growing unemployment and the lack of financial resources for the maintenance of vital local infrastructure. Therefore, the biggest challenge for oil and gas producing territories is how to establish and maintain stable conditions for their long-term socio-economic development.[1]

After the collapse of the USSR and during the subsequent economic transition in Russia, there were widespread attempts to form various development funds aimed at solving economic problems and facilitating economic and social stability specifically in resource-rich regions.

In the 1990s, the federal government did not have adequate financial resources to address vital socio-economic problems within the Russian regions, including the adequate maintenance of the social safety net, the healthcare and pension systems and the vital regional infrastructure. As a result, the federal centre granted regional administrations considerable rights and responsibilities in relation to natural resource management and the formation of their own financial funds by using a portion of the royalty. Thus, Moscow allowed regions to form institutions which would facilitate the creation of conditions conducive to the stable, long-term socio-economic development of the periphery.[2]

For example, the KMAO Future Generations Fund was established in accordance with the local law on generation funds, in December 1994. It was aimed to diversify the region's economy and to create supplementary budgetary sources while hydrocarbons depleted. Until 2001, 15 % of regional royalties were transferred to the fund. From 2002, the KMAO Future Generations Fund received up to 15 % of the regional budget's share of the mineral production tax. In 1990s and 2000s around 15 % of regional rents (royalties and production tax) was saving in main oil-rich regions.

The KMAO fund illustrates a balanced and well thought-out approach to solving future problems of resource-rich territories. The money is being invested not only into financial and fixed assets, but also into the development of human potential.[3]

[1] Kryukov V. Strategiia ustoichivogo razvitiia [Strategy of sustainable development for resource-rich regions]. – Neftegazovaya vertikal'. No. 3. 2001. p. 92–95.

[2] Kryukov V. Zhadnost' "bogov": komu idut na pol'zu "fondy razvitiia" – obshestvu ili otdel'nym grazhdanam? [Problems of special oil fund use]. – EKO. No. 9. 2001, p. 23–51.

[3] http://www.fphmao.ru. 2009.

Today, the fund allocates money for investment:

- in commercially efficient enterprises in the agro-industrial complex;
- into the creation of infrastructure for the forestry and wood-processing industries;
- into the creation of a social infrastructure, including a Winter Sports Centre, a children's physical education school, a state library and art gallery, and a community centre "Gostinny Dvor";
- in shareholdings of enterprises and banks;
- in property.

The Future Generations Fund aims to provide a material base for the region's socio-economic development. The Fund's assets comprise renewable fixed and financial resources, which supplement, and will eventually replace, tax payments from the production of oil and gas. The implementation of this approach should eliminate KMAO's one-sided dependency on oil development and should create guarantees for the provision of a high level of living standards and employment.

3.2. Special funds in the 2000s: changes at the federal level

In 2000–2003, the Russian government planned federal budgetary expenditures based on budget revenues generated under an oil price level of $20 per barrel. Although additional revenues accumulated during higher oil prices (of more than $20 per barrel) were utilised to pay off Russia's external debt, no special financial institution (such as a stabilisation fund) was established for this purpose. Since 2000, the federal government has primarily used oil and gas revenues to ensure the stability of its fiscal system. From 2000 to 2003, the Russian government focused on restoring macroeconomic stability, solving sovereign debt issues, and protecting the budget and the entire economy from external price fluctuations. The ensuing fiscal policies proved relatively effective and prevented the economy from operating under a deficit.

Starting in 2004, the Russian government declared a transition to an "active fiscal policy", directed at the creation of favourable conditions for economic development, resolution of the most urgent social problems, and improvement in the efficiency of the public sector. As part of the tax reform measures addressed by these policies, rents from the production of mineral resources increased and were allocated to the federal budget, while the tax burden for other sectors of the economy was reduced.

Currently, one of the most contentious debates in Russian economic policy concerns the problems and implementation issues associated with the use of oil and gas government revenues. The Russian Ministry of Finance has taken a resilient stance on the necessity of creating state special funds. Its experts are aware of the fundamental issues, such as the "the Dutch Disease".

Opponents to the concept of Russian special funds, those who are opposed to the application of these funds by the Ministry of Finance, posit the following concerns:[1]

- funds allocated from budget revenues, which are then invested into foreign stocks, can be considered a removal of resource rents from the country, thus benefiting foreign interests. As a result, the refinancing of the national economy is carried through foreign entities which receive Russian funds at nearly no cost. At the same time, these financial resources are later reintroduced through the private sector

[1] Voronin Yu. Neneftegazovyi budzhet: dovody i kontrdovody [Non-oil budget: pro and contra]. – Ekonomist. No. 8. 2007, p. 62–69.

in the form of foreign bank loans, at higher interest rates;

- by collecting oil and gas revenues, the government impedes inter-sectoral capital flows and can hinder domestic economic activity, especially in the oil and gas sector;
- by contrast, investing oil and gas revenues into the national economy could benefit several issues, such as incurring high returns on currently "frozen" governmental reserves, modernising the economy through the development of high-technology sectors, helping to resolve issues regarding GDP growth, boosting living standards, and lowering inflation.

However, according to the Russian Ministry of Finance, fiscal stability is most susceptible to a high budgetary dependence on oil and gas revenues. For instance, of particular concern are structural shifts due to the relatively slow growth of the oil and gas sector which, along with an increase in the real exchange rate of the rouble, have led to a decrease in the market share of this economic sector. In particular, when the tax burden for this sector considerably exceeds the tax burden in other sectors, a significant decrease in budgetary incomes could result. This can be exacerbated by any price fluctuations for hydrocarbons, since it would directly influence income from the oil and gas sector.

Therefore, the main features introduced by the federal government to improve the utilisation of rents (government resource revenue) are:

- the accumulation of all rents into the federal budget;
- an emphasis on stabilizing the financial system, at the expense of infrastructure and production expenditures;
- establishment of simple and transparent institutional arrangements to handle oil and gas revenues and improve resource management.

Nevertheless, during this period the decision-making process becomes bureaucratic without any participation of regional authorities and NGOs.

The significant exposure of the Russian economy and financial system to price fluctuations in the global oil markets was the core reason behind the formation of the Stabilisation Fund. The Stabilisation Fund was established in 2004, in accordance with the new Budget Code, with the intention of allocating revenues from hydrocarbon export duties and mineral resource production taxes into the Fund. The Stabilisation Fund was designed to accumulate revenues from oil prices that exceeded the cut-off price set at $20 per barrel (increased to $27 per barrel in 2006) in order to balance the federal budget should oil prices fall below the cut-off level. In 2004–2007 the Russian government used the Stabilisation Fund to accumulate any additional hydrocarbon revenues. The Stabilisation Fund secured around ¾ of additional revenues due to high oil prices in external markets. The Fund's resources were then invested into foreign assets, converted into foreign currency or deposited into foreign banks.

Therefore, the Stabilisation Fund was created to protect the national economy from negative consequences in the case of falling oil prices and to provide stabilisation to the national currency in times of higher prices. The Stabilisation Fund also played an important role as a mechanism to prevent inflation surges and to ensure currency stabilisation during periods of trade surplus. By early 2008, the Russian national debt dropped to 7 % of its GDP due to a severe restriction on domestic borrowing, with almost a complete halt on external borrowing (in combination with preterm repayment of a considerable part of the national debt using Stabilisation Fund resources). In effect, the Russian national debt, as a percentage

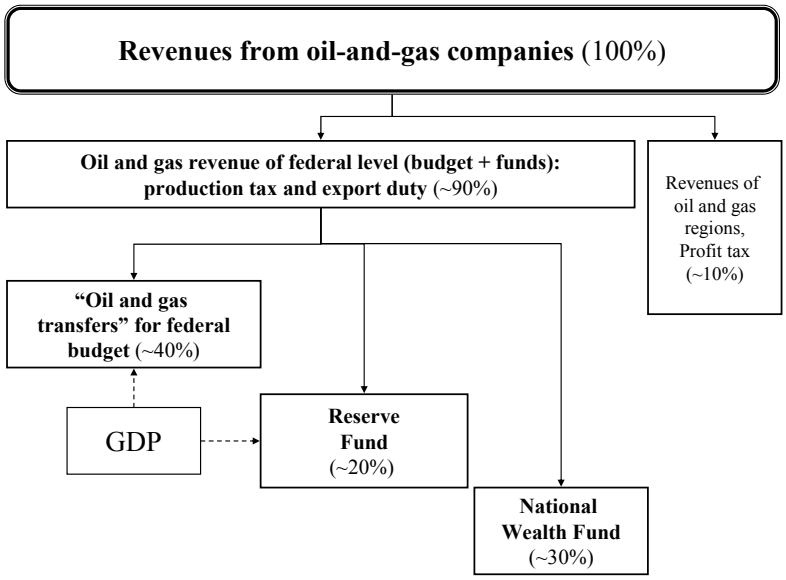

Fig. 4. Oil and gas government revenues and special funds

Note. Estimated on the basis of Russian Ministry of Finance data for 2008.

of its GDP, became lower than its counterparts in other developed and transitional countries.

In January 2008, the Ministry of Finance split the Stabilisation Fund into the Reserve Fund and the National Welfare Fund. The foreign currency reserves of each fund are denominated in US dollars (45 %), Euros (45 %) and GB pounds (10 %). As of 2008, oil and gas government revenues have been calculated separately from other federal budget revenues based upon: the production tax for oil and gas resources; export duties on oil, natural gas and petroleum products.

A portion of oil and gas revenues defined as an "oil and gas transfers" are used annually to finance federal budget expenditures. The volume of the oil and gas transfers is outlined in the law "On the Federal Budget" for each upcoming fiscal year and planning period (Fig. 4).

The proportion of "oil and gas transfers" are determined according to the percentage of the predicted GDP amount for the year: 6.1 % in 2008; 5.5 % in 2009; 4.5 % in 2010; and 3.7 % in 2011. Once the amount of the oil and gas transfers is determined, the remainder of the hydrocarbon revenues is channelled into the Reserve Fund. The size of the Reserve Fund is defined by the "Law on the Federal Budget" as a 10 % share of the predicted annual GDP. After the set limit for the Reserve Fund is reached, the remainder of the hydrocarbon revenues is collected into the National Welfare Fund (NWF).[1]

Revenues garnered from hydrocarbon development (in framework of state budget) are used for different purposes, such as the implementation of high-priority national projects and Federal Target Programmes, as well as contributing to the Russian Investment Fund. However, oil and gas revenues were only accumulated into the Stabilisation Fund (until January 2008), and subsequently (from February 2008) shared between the Reserve Fund and the National Welfare Fund.

The Reserve Fund serves as one of the financial sources for the federal budget. Created to provide stability in case of reduced oil and gas revenues, the Reserve Fund helps decrease

[1] Russian Ministry of Finance. Official Website: www.minfin.ru. 2009.

inflationary pressures and a national economic dependency on potentially volatile hydrocarbon export revenues. Thus, the Reserve Fund serves as an integral source and pillar of the federal budget.

The Russian government establishes the limits for authorised financial assets in the total volume of invested financial resources of the Reserve Fund. As mentioned earlier, Reserve Fund resources were intended to finance the oil and gas transfer and the preterm repayment of the external national debt. It was also designed to finance the oil and gas transfer should oil and gas revenues from the federal budget come short in a given financial year. Such utilisation of Reserve Fund resources would allow for the maintenance of a balanced budgetary policy during years when global prices for energy resources might be low, thereby reducing the budget's exposure to fluctuations in energy market prices.

The Reserve Fund is also utilized to make preterm repayments of the external national debt, hence reducing the federal budget tax burden which may result from unplanned federal budget revenues, and also helping preserve federal budget resources by reducing debt service expenditures.

The **National Welfare Fund** (NWF), along with the Reserve Fund, was created from the split of the Stabilisation Fund. It was designed primarily as a stabilising mechanism for the long-term provision of pensions for Russian citizens. The Fund's main aims were: (1) to contribute to the voluntary pension savings of Russian citizens, and (2) to help balance the budget and resolve the deficit of the Russian Pension Fund.

The NWF is managed similarly to the Reserve Fund, with the long-term aim of ensuring security of the Fund's financial resources and maintaining a stable level of revenues from investments. The Russian government has also established that NWF funds can be invested into the same financial assets as those of the Reserve Fund. According to the Russian Budget Code, NWF resources can be converted into foreign currency or invested into financial assets denominated in foreign currencies, similar to the Reserve Fund.

3.3. Oil and gas revenues and state investment: how efficient are they from a public perspective?

As oil and gas revenues accumulate within the federal budget, in the form of an oil and gas transfers, they are used for other projects including the implementation of Federal Target Programmes, high-priority national projects, and the accumulation of funds into the Russian Investment Fund.

Improvement of the living standards of Russian citizens has become one of the main priorities of Russia's national policy. Russia's improved economic circumstances allowed it to more tangibly enhance general standards of living whilst maintaining microeconomic stability and suppressing inflation. The improved economic conditions thus created an environment conducive to the implementation of **high-priority national projects** focusing on healthcare, education, agriculture and housing. Such sectors determine the quality of life and social development, and are thus integral to the concept of "human capital development".[1] Therefore, the implementation of national projects is in many ways related to human capital investment.

And yet, from 2006–2008, direct investment into these "human capital development" areas (not accounting for the federal budget social expenditures in other sectors) comprised only 6–9 % of the federal budget's share of oil and gas revenues (Table 3). In 2008, when financing for national projects exceed RUR 330 billon, this figure amounted to 6.7 %.

[1] Prioritetnye natsional'nye proekty [High-priority national projects]. Official website: www.rost.ru.

Table 3. High-priority national projects and oil and gas government revenues (OGR), RUR billion

National Projects	2006	2007
Healthcare	91.2	131.3
Education	29.3	48.9
Affordable housing	33.8	50.9
Agriculture	21.9	25.4
Total	176.2	256.5
Total as share of OGR	6.0 %	8.9 %

The sufficiency of this amount for "human capital development" is debatable, particularly considering the current lack of development within these areas (such as healthcare and housing) compared to world standards.

The Russian Investment Fund and Federal Target Programmes have become vitally important for the enactment of Russia's investment policies. The **Federal Target Programmes** are intended to help alleviate the most pressing socio-economic problems of the Russian economy, such as regional development and the development of various branches of the Russian economy in general. According to the Russian Ministry for Economic Development, 46 Federal Target Programmes and 36 auxiliary programmes are currently being implemented.

The **Investment Fund**'s primary purpose is to provide governmental support for investment projects of the federal significance. This can take the form of:

- co-financing based on specific investment project requirements;
- transfer of funds to authorised corporate bodies;
- provision of governmental guarantees for investment projects.

As demonstrated by 85 % of the applications submitted to the Ministry for Economic Development requesting governmental support from the Investment Fund, co-financing is apparently the most popular option among investment project sponsors. This implies that the majority of investment projects use state funds to create federal infrastructure objects, thus stimulating large-scale investment from the private sector.

Since all federal budget natural resource payments have been centralised, major oil and gas producing regions have now become the recipients of the Investment Fund's monetary resources whereas, up to 2004, these same regions would have been independently financed or self-financed. For instance, in mid-2008, the Ministry for Regional Development allocated RUR 80 billion for regional investment projects to resource-rich regions such as Yakutia, Bashkortostan, Krasnoyarsk region, and Tatarstan.[1]

A substantial problem related to the Investment Fund concerns the substantial length of time taken to consider and negotiate the projects – a process which normally takes a year to a year and a half. This is likely due to an overwhelming concentration of decision-making authority within the federal government and the relative exclusion of regions from this process.

According to the Federal State Statistics Service, the portion of budgetary funds within the fixed capital formation framework for the period of 2000–2007 was at a relatively high level (around 20 %). In 2007, the share of budgetary financing of fixed capital formation comprised 21.2 %. The share of the federal budget funds in-

[1] Shpigel M., Kaz'min D. Raspredilili den'gi [Using of Investment Fund]. Vedomosti. July 21, 2008.

creased within the total volume of investments. The increase for this period comprised 2.4 percentage points (from 6.0 % in 2000 to 8.4 % in 2007).

However, the increased governmental efforts to promote and sustain economic growth through such projects simultaneously made apparent the lack of developed and effective institutions. For instance, during a June 2008 session of the Russian government Presidium, it was noted that out of RUR 218 billion allocated for high priority national projects, nearly a fifth – 17.7 % – remained unimplemented.[1] During an international investment forum in Sochi, the head of the Ministry of Regional Development at that time, Dmitry Kozak, acknowledged that the Investment Fund and other institutes for development were utilising only 10–15 % of their potential. Overbureaucratisation of the state apparatus has been responsible for such inefficiency, as well as the lack of clearly defined procedures for replenishing the Investment Fund. Previously, the size of the Investment Fund was directly correlated to the volume of the Stabilisation Fund. However, following the split of the Stabilisation Fund into the Reserve and National Welfare Funds, this link disappeared. Currently, there is an agreement with the Ministry of Finance that the Fund should receive RUR 100 billion on an annual basis.[2]

3.4. Oil funds in crisis: the financial reserves have proven to be too small

The 2008–2009 financial crisis has led to a new wave of capital flight from Russia. As a result, the entire banking system, the financial markets, as well as budgetary social payments were brought under threat. In October 2008, the Russian government decided to change the way hydrocarbon revenues were utilised. In particular, the government aimed to use the resources of the Reserve Fund and the National Welfare Future to stabilise Russian financial markets, to reduce the budget deficit, and to provide financial aid to specific projects. In March-April 2009, the government used 1 trillion roubles from the Reserve Fund to finance budgetary expenditures.

At the same time, the government deposited the National Welfare Fund reserves (625 billion roubles) into the state corporation "Bank for Development and Foreign Economic Affairs" (Vnesheconombank). These resources were used to stabilise the financial markets and were also invested into portfolio shares in the sum of 168 billion roubles. In November-December 2008, the Vnesheconombank invested the deposited reserves of the National Welfare Bank into shares of key Russian corporate entities: LUKoil, Rosneft, Gazprom, Russian Savings Bank, Norilsk Nickel, and the Bank for Foreign Trade (VTB).

In November 2008 the total reserves of the National Welfare Fund were estimated at 1667.48 billion roubles, reaching 2863.08 billion roubles on 1st September 2009 whereas the reserves of the Reserve Fund declined from 3572.78 billion roubles on 1st November 2008 down to 2238.6 billion roubles on 1st December 2009.

In 2009 all hydrocarbon revenues, instead of being sent to the Reserve Fund and the National Welfare Fund, were directly incorporated into the budgetary revenues to cover day-to-day expenditures of the federal budget.

In recent circumstances (as of 2009), the deficit of the Russian Budget is supposed to remain at around 6 % of GDP. At the same time however, budgetary expenditures are not being reduced but, on the contrary, are increasing. The government assumes that the reduction of social

[1] Netreba P. Dlya uspekha natsproektov ne nuzhny den'gi. – Kommersant. June 10, 2008.

[2] Kukol E. Den'gi iz "odnogo okna". Minregion razrabotal novye pravila dlya Investfonda. – Rossiiskaiia gazeta. September 24, 2008.

and investment expenditures could undermine the future potential of the Russian economy.

There has not been a drastic decline of world oil prices in comparison to the 2003–2004 period (when the Russian Stabilisation Fund was formed). Although external market conditions have not changed the domestic budgetary situation has changed dramatically: instead of a budget surplus, the government now has limited financial resources at its disposal. The current situation with the Russian budget evolved from the 2004–2009 period when the government expanded the scope of budgetary expenditures.

It was initially assumed that the Stabilisation Fund's primary objective was to stabilise the financial situation in the country: i.e. by withdrawing parts of hydrocarbon revenues from the domestic market, inflation could be curtailed. However, this governmental objective was achieved only once (just before the formation of the Stabilisation Fund) when inflation remained at the planned annual level of 12 %. However, before the current crisis period, the government failed to keep inflation at bay when it increased to over 13 % per annum.

Capital flight, decline of oil and gas prices, and an increase in budgetary expenditures has forced the government to change the way the Russian Budget was formed. In September 2009 the Russian State Duma passed amendments to the Budget Code, allowing the government to increase budgetary expenditures in 2010 and up to 2012. The amended legislation promotes centralisation of the following payments which are allocated into the Federal Budget:

- Revenues from the mineral resource production tax (for oil and gas condensate). At the moment 5 % of this tax goes to the producing regions. This means that Tyumen oblast in particular, being the main source of Russia's hydrocarbon outputs, will lose a large share of its regional budgetary revenues.
- All revenues of the Reserve Fund and the National Welfare Fund. This implies that such revenues will remain in the Federal Budget without being transferred to the regional level.
- Additionally, in 2010–2012, profits payable by the Central Bank of Russia to the Federal Budget will increase from 50 % to 75 %.

The decline of Reserve Fund resources and growing budgetary expenditures are likely to lead to a situation whereby Russia will use accumulated hydrocarbon revenues faster than previously envisioned. The Reserve Fund could be spent almost entirely by 2010.

According to Russian government's estimates in 2010 the Russian budgetary deficit will be covered mainly by the Reserve Fund (1.83 trillion roubles), as well as the National Welfare Fund (413.5 billion roubles). In addition, the government plans to borrow 429.6 billion roubles in external markets and 261.5 billion in internal markets. In 2011 the government will continue to borrow funds in external markets (514.4 billion roubles) and domestically (657.3 billion roubles) as well as tap into the the National Welfare Fund (762.4 billion roubles). According to official estimates, by the end of 2011 the Russian reserve fund will contain only 48.8 billion roubles whereas the National Welfare Fund will decline from 2.81 trillion roubles down to 1.8 trillion in 2011 (Fig. 5). At the same time, the Russian public debt is projected to increase from 12.7 % of GDP in 2010 up to 15.4 % in 2012.

3.5. Economic diversification plans: never implemented

During the 1992–2009 period, Russia failed to create an effective model of resource management – both in terms of exploration and

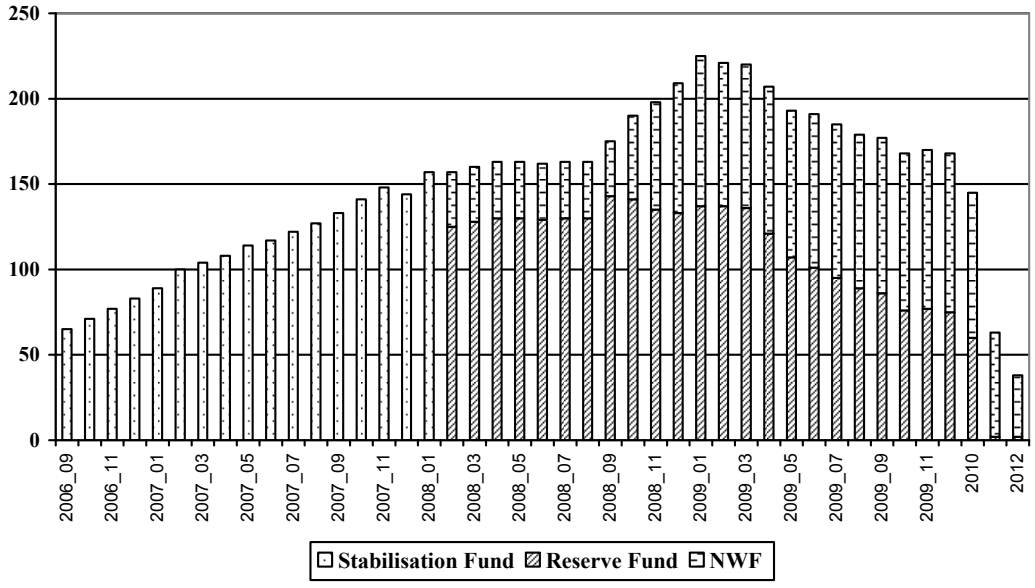

Fig. 5. Dynamics of special oil funds in Russia (billion US dollars)
Source: Russian Ministry of Finance.

development of oil and gas resources, and in terms of adequate use of oil and gas revenues for the diversification of the national economy in order to curtail its "resource curse" symptoms (Fig. 6).

Russia has failed to develop adequate methods and procedure for effective accumulation of oil and gas revenues for purposes of economic diversification. An example of such a failure can be illustrated by the government's decision, in 2007, to set up state corporations with the intended aim of promoting economic diversification. The seven established state corporations – including Rostechnologia (Russian Technologies), Rosatom (Russian Atomic Industries), Olimpstroi (Olympic Games Construction), RosNano (Russian Nano Technologies) and ZhKKH Development Fund (Fund for the Development of Housing Support Services) – were granted special rights and authorities, similar to those of state bodies, while retaining many features and capabilities of large commercial entities. The government also transferred 2 trillion roubles worth of assets to these companies in addition to the 640 billion roubles derived from the state budget (which constitutes nearly 20 % of the annual budgetary expenditures). Due to their official status as non-commercial entities, the main agenda of these corporations was to deal with specific state goals, and not to generate profit. However, once state assets and financial resources have been transferred under the control of these corporations, the state ceased to be their owner. Hence, in 2009, questions were raised about the legality of such utilisation of state finances.

The influx of oil and gas revenues, associated with high oil prices in external markets, was used by the government to solve pressing social problems mainly by increasing levels of pension payments and basic salaries. In 2000–2006, the per capita income of Russian citizens increased four-fold from $80 to $370, whereas the standard pension level tripled from $25 to $90. Astoundingly, over the past eight years, gross revenues of oil companies surpassed $1 trillion, whereas their net income reached $150 billion, of which $50–$70 billion were invested. During this period the state received over $700 billion in oil

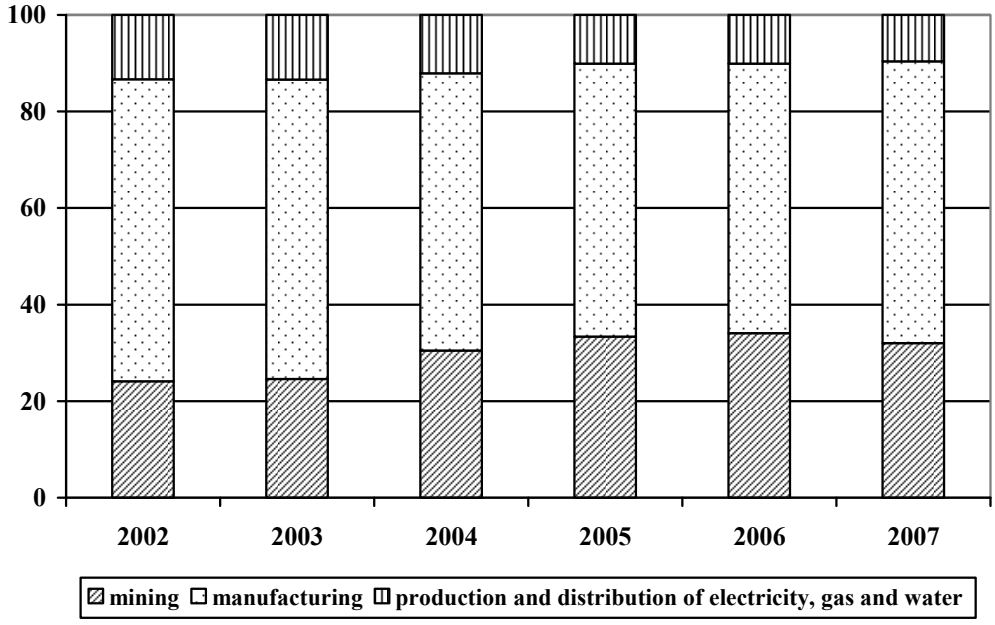

Fig. 6. Structure of value added (%)

and gas taxes and duties. However, these large oil and gas revenues did not increase the workforce in the Russian economy: if in 2006 the Russian workforce was estimated at 51 million, by 2008 this figure fell to 48 million.

In the 2000s the dependence of the Russian economy and the society on the domestic oil and gas sector increased dramatically. This could explain why, in the second half of 2008 through the first half of 2009, Russia surprisingly showed the biggest decline in GDP and industrial production among all the countries of the former Soviet Union.

In future situation could be very complex, because:

- absence of an effective model of oil and gas resource management coupled with increasingly challenging conditions for the exploration and development of new fields located in difficult-to-reach territories with severe climates and complex geology;
- lack of incentives for private investors (both foreign and domestic) to develop new fields under the existing legal framework, in a sector dominated by state-controlled companies (which determine whether a given independent company gains access to vital infrastructure and key export routes);
- the substantial tax burden recently imposed on the oil and gas sector, coupled with the dominance of state-controlled oil and gas companies, impedes the facilitation of exploration and development of new oil and gas fields. Various tax exemptions and privileges granted by the government in 2008-2009 to companies operating in new fields could not compensate for the high expenditures incurred during their industrial development;
- the growing economic dependence upon the resource sector over the past eight years with a very limited role for the hi-tech and other modern industrial sectors in facilitating economic growth and budgetary revenues;

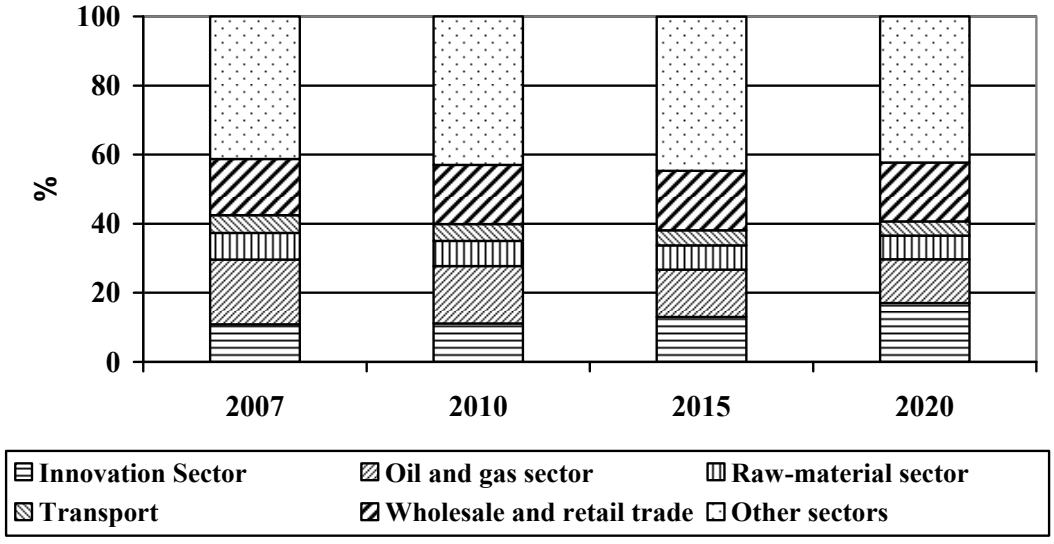

Fig. 7. Structure of value added by major sectors of the economy (in 2007 prices)

Source: Concept of long-term socio-economic development of the Russian Federation until 2020.

- successful transformation of the Russian economy from resource dependent into hi-tech and innovative will depend on a successful promotion of incentives for investors and greater opportunities for entrepreneurs, not only in the oil and gas sector but also in other sectors of the economy. In the 2000s, the growing tax burden forced Russian companies to compensate their diminishing revenues by borrowing in external markets. This resulted in an accelerated economic decline in Russia during the crisis period.

But the Ministry of Economy predicts a substantial increase in the share of innovation sector by 2020 (Fig. 7).

Conclusion

The evolution of the Russian resource management system reveals a complex picture in terms of already adopted decisions and future strategies in relation to resource development and revenue utilisation. At the same time, it is essential to take into account the overall socio-economic and political problems of the post-Soviet transition in Russia when assessing the factors behind certain key decisions which have shaped the development of the oil and gas sector.

1) During the 1990s, the post-Soviet centre-periphery bargaining game in Russia and ambiguous legal reforms pertaining to subsoil utilisation resulted in a spontaneous system guiding field usage at the regional and local (municipal) levels. The weakness of the federal government in light of mounting socio-economic problems in the resource-rich regions resulted in provincial administrations expanding their authority over subsoil use and actively seeking to resolve the problems associated with the exploration and production of hydrocarbons within their domains.

At the same time, during this period, the decision-making system was mostly democratic with a well functioning “two-keys” approach, whereby regions took a very active role in resource management. The involvement of NGOs (such as local associations of indigenous peoples) in the decision-making processes at the regional level was a very positive trend of the resource

management system which existed in Russia in the 1990s. Unfortunately, this period was also characterised by a tendency to view the resource licensing process primarily as an ultimate solution to pressing socio-economic problems of resource-rich regions.

2) In the 2000s, a new trend developed in Russia whereby the federal centre concentrated most of the authority over mineral resource management into its hands. As a result, the role of the bureaucratic administration over issues of subsoil use increased at the expense of regions and NGOs.

This reduced regional and societal role in resource management has led to a situation whereby oil and gas companies no longer see it as their priority to promote stable socio-economic development of the specific resource-rich regions within which they operate. Hence, active regional participation in the resource management is an important precondition for sustainable development since:

- environmental and social benefits and costs are primarily felt at the regional level;
- unlike the federal centre, regional administrations and NGOs are closer to the actual locations of hydrocarbon production and, therefore, could be more effective in adopting more appropriate administrative mechanisms;
- the impact of the oil and gas sector on the Russian society is increasing especially in regions with mature and depleting hydrocarbon fields;
- effective monitoring and oversight of subsoil development by the federal centre is difficult to manage without active regional participation, due to the large areas to be monitored.

3) Starting in 2001, the government began using revenues from the development of mineral resources to stabilise the budget. The following steps were thus taken:

- all oil and gas revenues were accumulated into the federal budget and special funds;
- emphasis was placed on the stability of the financial system, at the expense of implementing new infrastructure and re-investment projects;
- focus was placed on designing simple and transparent procedures for mineral resources management, as well as resource revenues;
- strengthening of the federal bureaucratic administration at the expense of the regions, NGOs, in addressing all abovementioned issues.

4) During the 1992–2009 period, Russia failed to create an effective model of hydrocarbon resource management – both in terms of exploration and development of oil and gas resources, and in terms of adequate use of oil and gas revenues for the diversification of the national economy in order to curtail its "resource curse" symptoms.

Эволюция системы управления нефтяными ресурсами в России

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Нефтегазовый сектор традиционно играл очень важную роль не только для минерально-сырьевого комплекса России, но и для местной экономики. В настоящий момент углеводородный сектор дает более 60 % российского экспортного дохода и наполняет до 45 % федерального бюджета. В результате данный сектор стал движущей силой экономического развития страны в целом и, в особенности, — нефте- и газопроизводящих регионов.

Эволюция системы управления нефтяными ресурсами России демонстрирует сложную картину уже действующих решений и будущих стратегий разработки ресурсов и использования доходов сектора. В течение 1992—2009 гг. России не удалось создать эффективную модель управления ресурсами углеводородного сектора как с точки зрения разведки и разработки нефтяных и газовых ресурсов, но и в смысле адекватного использования нефтяных и газовых доходов для диверсификации национальной экономики.

Ключевые слова: нефть, управление ресурсами, налогообложение, специальные фонды.