

Working Paper

**Russian revenue
management under
Vladimir Putin**

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Abstract

Spurred by high hydrocarbon prices, Russia's economy has experienced a boom in the 2000s. However, it is well-known that revenues from natural resources may have adverse effects on long-term economic evolution. We analyse the revenue management policy that Russia has pursued during Vladimir Putin's presidency. We conclude that efforts to decouple revenues from expenditures have been relatively successful. Nevertheless, the economy shows clear signs of under-investment and lagging productivity. Furthermore, it is unclear whether the political leadership can uphold a disciplined and transparent policy for managing revenues, or if it wishes to improve the institutional climate for economic development.

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1 Introduction

Throughout the past decade Russia has grown to become one of the world's biggest exporters of oil and gas. High levels of export volumes have coincided with high prices, thus resulting in record high export revenues for Russia. The export revenues have contributed to the substantial economic growth Russia has experienced in the 2000s. There is, however a possible downside to high export revenues. This downside has economic as well as political connotations. If revenues are managed in a sound way, natural resources may be a blessing to a country. If not, however, the blessing might be turned into a 'resource curse'.

The objective of the article is to analyse the management of revenues from natural resources – primarily oil and gas – that Russia has pursued during Vladimir Putin's presidency. The article assesses the adequacy of policy measures and discusses the possible influence of hydrocarbon domination on the development of sound economic institutions. We conclude that efforts to prevent a rapid appreciation and to decouple revenues from expenditures seem to have been relatively successful and adequate. However, the economy shows clear signs of underinvestment and lagging productivity. Furthermore, it is unclear whether the political leadership has the will or the ability to uphold a disciplined and transparent policy for managing revenues, or to improve the institutional climate for economic development.

In our assessment of revenue management, the point of view is a conventional socio-economic perspective concerned about efficiency and equity. Of course any government – not least the one studied – has additional political objectives aiming at national or federal coherence, enhancing national status and the like. Indeed, one of our conclusions is that Russian economic policy diverges from international recommendations and standard economic wisdom primarily in the political efforts to secure government control. While a centralistic policy may be compatible with some aspects of revenue management, it constrains other aspects of economic policy and development.

Section 2 of the article presents a framework describing the potential problems for economic development that revenues from natural resources may cause, and discusses possible solutions, with a focus on revenue management and stabilization funds. Section 3 provides a description of Russian economic development and revenue management since 2000. Finally, Russian revenue management is analysed within the framework described in Section 2.

2 Resource curse and revenue management

2.1 The resource curse

Natural resources may be a blessing to a country, but they may also pose a threat to the economic performance and to the political development, both in the short run and in the longer perspective.

In terms of macroeconomic development, there are at least four concerns. Firstly, the increased demand for the national currency and the resulting appreciation hurts the competitiveness of other industries for tradable goods. This is the Dutch Disease in its purest form. Secondly, as the resource sector attracts inputs (labour and capital – including human capital) from other sectors, the productivity development in other sectors tends to slow down – a more indirect form of the Dutch Disease.¹ Thirdly, since the supply of resources tend to be price inelastic the economy will be exposed to the volatility of world market commodity prices unless expenditures can be decoupled from revenues – an issue that we shall address shortly. Fourthly, short-sightedness and inefficient extraction can be especially relevant if ownership rights are unclear, or if the owner has a short time horizon. This can diminish social efficiency if the boom-and-bust behaviour drives down prices and thus revenues, while production costs are inflated. In addition, there may be distributional concerns if only the present generation is allowed to reap the benefits of the national patrimony. Finally, weaker institutions and corruption growth in the political system, as discussed below, will have direct effects on macroeconomic performance.

In terms of political development and institutions resources may cause conflict over ownership² – possibly with devastating consequences – but also cause trouble once ownership rights are established. Discussions on this part of the resource curse describe weaker democracy, slower modernization and weaker contractual institutions as the main negative effects of natural resources.³ If natural resources end up in the hands of the government, they may foster authoritarianism because the regime's need for tax revenues and thus public legitimacy is weakened, because the resource revenues and rent-seeking behaviour enhance the scope for bribes and for favouring certain interest groups,

¹ The Dutch Disease can be split in different ways. For instance, Ahrend, de Rosa & Tompson, as well as Oomes & Kalcheva (2007), quote Corden & Neary (1982), who talk about a resource movement effect and a spending effect. Both of these lead to a declining productivity in the sector for non-resource tradables and a higher real exchange rate, while the effect on the productivity in the non-tradable sector is ambiguous. For our purposes it is sufficient to talk about appreciation and slower productivity in the non-energy tradables sector.

² For an analysis, see for example Boschini, Pettersson & Roine (2003).

³ See Isham, Woolcock, Pritchett & Busby (2005)

and because the revenues directly allow for strengthening the instruments of repression.⁴ Modernization may be slowed down because there will be strong interests vested in the resource extraction industry.⁵ Finally, it has been alleged that resources requiring a centralized production (like most extracting industries) over time tend to impede the development of contractual and ownership rights.⁶ Since the institutional quality is a key factor behind long-term growth, a sustainable resource management policy needs to address these issues as well. Of course, this is the case not least for countries with weak institutions and democratic traditions at the outset of resource extraction. Since the objective of this article is to study the effect of policy on how resources are managed, rather than vice versa, we focus the present analysis on the effects on more directly economy-related institutional factors of property rights and corruption.

2.2 Revenue management as a remedy

The governmental toolbox to deal with the threat of the resource curse does not only include measures to prevent corruption and strengthen political and commercial institutions, but also measures that address and soften the potentially negative macroeconomic consequences. The latter aim primarily at dampening the real exchange rate appreciation, shield the economy from commodity price swings and preventing short-sighted extraction. The measures encompass instruments for revenue collection, revenue management and revenue distribution.⁷

In revenue collection, the government needs to create a system that ensures that the general public and future generations get a fair share of the proceeds from production, while still providing incentives for investment and efficiency, and for an adequate balance between exploration and extraction. A World Bank paper argues that a combination of corporate taxation, a progressive additional profits tax and a royalty should do a good job, but emphasizes that it is hard to achieve results without a competent administration.⁸

The overriding issues in distribution are to use revenues in an efficient and fair manner. Efficiency-wise, this means that money used for public investments are spent wisely across sectors such as education, infrastructure and other social services. Fairness considerations concern both distribution between groups and generations.

Besides maintaining good commercial institutions, managing revenues is probably the most important issue of the macroeconomic policy. The key here is to decouple expenditures from the revenue stream.⁹ This is necessary to shield the

⁴ See Ross (2001)

⁵ See Acemoglu, Johnson & Robinson (2001)

⁶ See Isham, Woolcock, Pritchett & Busby (2005), for an overview

⁷ See McPherson (2002)

⁸ McPherson (2002)

⁹ See Devlin & Lewin (2002)

economy from short-term swings in commodity prices and to distribute revenues across generations. If revenues are met by investments in foreign assets, it also prevents a rapid appreciation. This practice is called *sterilization*. By softening incentives and diminishing short-term profitability, decoupling expenditures from revenues may also mediate the problem with overinvestment and short-sightedness in the extraction industry, and possibly also help combat corruption. Of course, the holdings should be managed well in order to ensure a good return.

A central question is whether revenues should be managed like any other government income or if they should be handled in a separate fund. Proponents of separate funds suggest that the separation of fund management from the government budget can increase accountability and thereby curb corruption and overspending. Sceptics point out that a fund itself cannot guarantee fiscal responsibility, and that the funds are least likely to be transparent and on an arm's length from the rulers exactly in those states where good institutions are lacking. A possible corollary of the arguments, and a possible compromise between the proponents and the sceptics, is that the decision to establish a resource fund could be relatively more important in a democratic country than under an authoritarian regime. While the latter also has an interest in mediating the macroeconomic consequences, at least if it has a long-term perspective, it is less susceptible to short-term electoral spending pressure and is less likely to avoid corruption by delegating formal power to a fund. However, to the extent that a fund is better at sterilization – in the sense that it can invest more in foreign assets than the government budget could (or would) – it provides an additional argument also for authoritarian regimes to establish a separate revenue management regime.

3 Russian revenue management

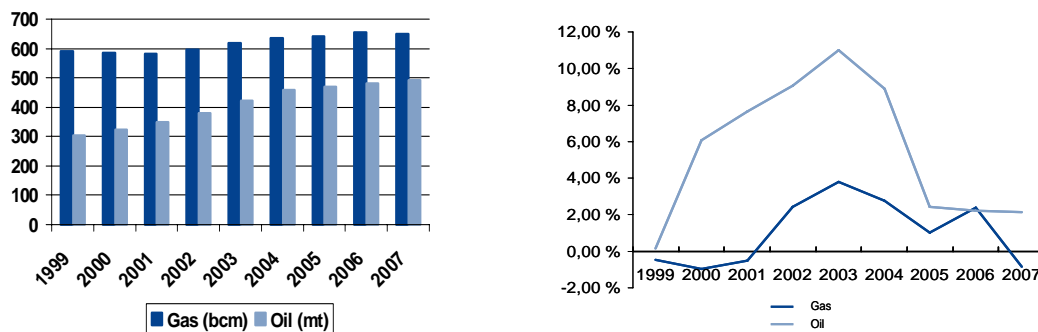
As a country that has seen a large increase in revenues from natural resource exports, Russia needs to deal with the complexity of challenges described above. In the following we will present some of the most important indicators of how Russian revenue management has performed in the 2000s.

3.1 The role of oil and gas in the Russian economy

The Russian economy has experienced substantial growth for 9 consecutive years, resulting in over 70 percent cumulative GDP growth from 1999 through 2007. The Russian economy is concentrated on resource extraction. Estimating the exact share of oil and gas extraction industries in the economy is tinged with some major uncertainties. According to the Russian Federal Statistics Service, oil and gas extraction has contributed a mere 8-9 percent of GDP so far in the 2000s and

is planned to decline to 5.35 percent in 2010.¹⁰ The real number, however, is far higher. Some of the inconsistencies are due to transfer pricing, a result of attempts by the producers to escape taxation. Adjusting for this by applying oil profit margins normal in western countries takes the oil and gas sector share up to 20-25 percent of GDP and almost 50 percent of fiscal revenues.¹¹ In addition, other sectors are of course affected by money from the extraction industry. Oil and gas production in Russia is struggling uphill (or rather, downhill). In the early 2000s, growth in oil production volumes was high. After 2004, however, growth slowed down, and has been at a moderate level since, see Figure 3.1. The slowdown coincided with the Yukos case, where Russia's biggest company was subject to enormous tax claims and in practical terms nationalized. After production results from Q1 2008 showed a 90 000 barrels/day reduction from Q1 2007, there have been speculations whether the peak in Russian oil production has already been reached. There are several possible explanations for the drop in production growth after 2005. Some claim that the main reason has been uncertain property rights leading to short-term strategies from the companies pumping as much as they could, with the easiest oil now being exhausted. Others emphasize that the tax system has resulted in a lack of incentives for investments in increased exploration and production. Other explanations point at uncertain connections between exploration licences and production licences, lack of infrastructure development and difference in company structures and strategies.¹²

Figure 3.1 Oil and gas production 1999-2007: (a) levels; (b) growth, percent year-on-year



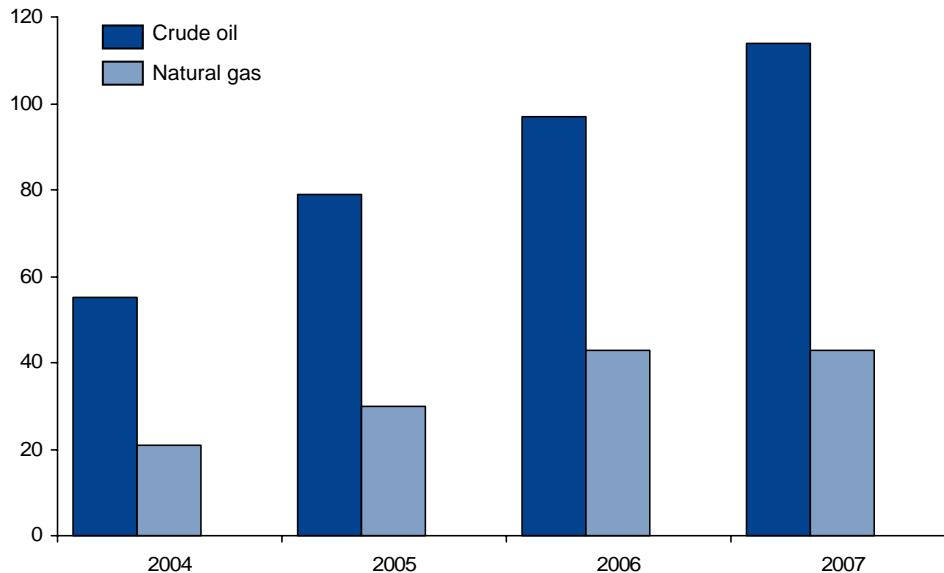
Source: BP Statistical Review of World Energy, EIA Russia brief, Ministry of Industry and Energy

In volumes, oil exports increased with 4.7 percent in 2007 after three years of decline according to the Federal Customs Service. Because of record high oil prices, the value of oil exports increased with 18 percent. Gas exports, on the other hand, are still going down. In volumes gas exports experienced a significant fall of 6 percent in 2007, and despite high prices, there was a small decline in gas

¹⁰ Oppenheimer & Maslichenko (2006), Federal Statistics Service.
¹¹ Oppenheimer & Maslichenko (2006), Oomes & Kalcheva (2007)
¹² See Kryukov & Moe (2007)

export value as well. In monetary terms, export of oil, oil products and natural gas in 2007 accounted for approximately 70 percent of total exports.¹³ Still, Russia is less dependent on the oil and gas sector in terms of per capita production and export than many other oil resource rich countries.¹⁴

Figure 3.2 Oil and gas exports from the Russian Federation, billion USD



Source: Federal Customs Service

The rest of the economy shows some signs of the Dutch Disease. The extraction-driven growth has led to higher wages and a rapid expansion of the service sector. Since 1999, real wages have grown by between 10 and 20 percent per annum. There are indications that the non-oil tradeable sector in Russia is struggling under real appreciation of the ruble and lack of sufficient productivity gains, as predicted by theory. Gianella & Chanteloup (2006) find that a 10 per cent real appreciation of the currency, has led on average to a non-fuel trade current account deterioration in Russia of around 1 per cent of GDP. Manufacturing industry output growth experienced a slowdown from 2003 to 2006. Statistics from the World Bank (2007a) show that non-energy exports are growing far less than the rapidly increasing imports and point at the low level of technology in Russian exports. World Bank estimates (2007b) show a sharp increase in unit labour costs in the manufacturing sector from 2002 onwards, suggesting that wages have grown more rapidly than productivity. While the relative slowdown in the manufacturing industry could partly be interpreted as an artefact of transition economies, the pattern of an expanding service sector, lagging productivity in

¹³ Federal Statistics Service, Federal Customs Service

¹⁴ Progunova (2006)

manufacturing and a rapid wage growth is consistent with the Dutch Disease theory. In a recent IMF publication, Oomes & Kalcheva (2007) recognize the symptoms but cannot conclude with certainty whether they are caused by Dutch Disease mechanisms or whether they are caused by other, non-pathological factors. Even if we cannot say that Russia definitely has the Dutch Disease, the symptoms pose a great challenge for the revenue management.

3.2 Russian governmental policy for managing revenues

The Russian government pursues an active policy aimed at avoiding some of the possible pitfalls of the increase in oil and gas export revenues. The tax regime makes sure that a substantial part of the revenues from the extractive sector is collected and controlled by the government, and the stabilization fund makes it possible to decouple budget expenditures from the revenue stream. In the following we will discuss some of the main tools of Russian revenue management during Vladimir Putin's presidency.

3.2.1 Fiscal policy on the revenue side

A good tax system should be able to ensure the general public and future generations – usually represented by the government – a share of the revenues from the oil and gas industries without taking away incentives for production, development and efficiency from the companies. In the 1990s the Russian oil and gas sector had a relatively modest tax pressure. Estimates suggest that in 2000, the total effective tax burden on the fuel sector amounted to just 31.8 percent of the sector's value added.¹⁵ After Vladimir Putin came to power in 2000, one of his major administrative reform achievements was reform of the tax system. Most notable has been the introduction of a flat 13 percent income tax, which together with more efficient tax collection as well as a harder line towards tax evasion (and the example of the Yukos case) has led to a manifold increase in Russian tax revenues.¹⁶ The tax reform also affected the oil and gas sector, which has seen a substantial increase in the tax burden. Some of the increase is due to the high oil prices. Business representatives claim that the tax burden increased to 60 percent of value added by 2007.¹⁷

Since 2004 the main tax revenues for the Russian government from the oil and gas sector are the mineral extraction tax (MET) and export duties. The MET was introduced in 2002 and was originally supposed to be replaced by a 16.5 percent *ad valorem* tax from January 2006. That did not happen, and instead the MET was changed. At the outset, the MET was an attempt by the authorities to fight transfer pricing within companies, a system established for tax payment evasion.

¹⁵ Ahrend & Tompson (2006)

¹⁶ It has been noted that this tax reform was planned before Putin came to power and thus should not be attributed to him, see McFaul and Stoner Weiss (2008).

¹⁷ "MET tax reduction instead of VAT reduction", *InvestExp* 26.03.2008

The taxes are calculated on a rather complex scheme.¹⁸ The mineral extraction tax is based on extraction volumes, taking both the international price on Urals oil and the exchange rate into account.¹⁹ As a consequence, the MET rate has increased notably with the increase in the international oil price level. The MET on gas is an ordinary ruble tax on the production volume. Up to 2007 the tax rate was 147 RUR/1000 m³. The export duties on oil are tied to the Urals price, with marginal rates increasing when the price increases.²⁰ From April 1 2008 the export duty was USD 46.60/barrel. Export duties on gas are ordinary *ad valorem* taxes.

Oil market analysts as well as the companies themselves have claimed that the taxation system puts too heavy a burden on the companies such that they do not benefit from the high oil prices. As oil prices have increased, government take has grown, and, as mentioned above, there are claims that high marginal tax rates are one of the causes of production growth slowdown. Because the MET and export duties do not take into account project profitability, the tax burden has been disproportionately high for new projects with high investments and low profits, thus discouraging greenfield development. As an attempt to avoid some of the negative production effects of the tax system, the system was changed in 2007. The new taxation system incorporates the level of depletion of the oil and gas fields so that old and less productive fields have a more moderate tax pressure. In the new system, a concession on mineral extraction tax may be given to fields with a depletion rate above 80 percent. In order to give some incentives for greenfield investments, undeveloped areas in Eastern Siberia have been granted 10 year tax holidays in order to stimulate green field development. However, this applies only to oil fields and not to other geographical areas. In 2008, Minister of Finance Aleksey Kudrin has suggested that new changes in the MET might come from 2009, raising the non-taxable threshold from USD 9 to USD 15 and possibly introducing new tax holidays.²¹

The tax system seems to ensure high government tax revenues when the price of crude oil is high. Most of the revenues go to the Stabilization Fund, which is estimated to absorb about 85 percent of the fluctuations in revenues when oil prices change.²²

The Stabilization Fund

As many other resource rich countries Russia has established a natural resource fund. The *Stabilization Fund* was established on 23 December 2003 and launched on 1 January 2004. The fund is the main policy instrument for the Russian

¹⁸ See Tabata (2006) for a thorough discussion on the tax system.

¹⁹ The MET formula since January 2007 is $RUR\ 419 + CD \times ((U_{exp} - 9)/\text{barrel})/261 \times RUR/USD$, where CD is a coefficient of depletion and U_{exp} the export price on Urals oil.

²⁰ Above \$25 the formula is $\$4 + (U_{exp} - 25) \times 0.65$.

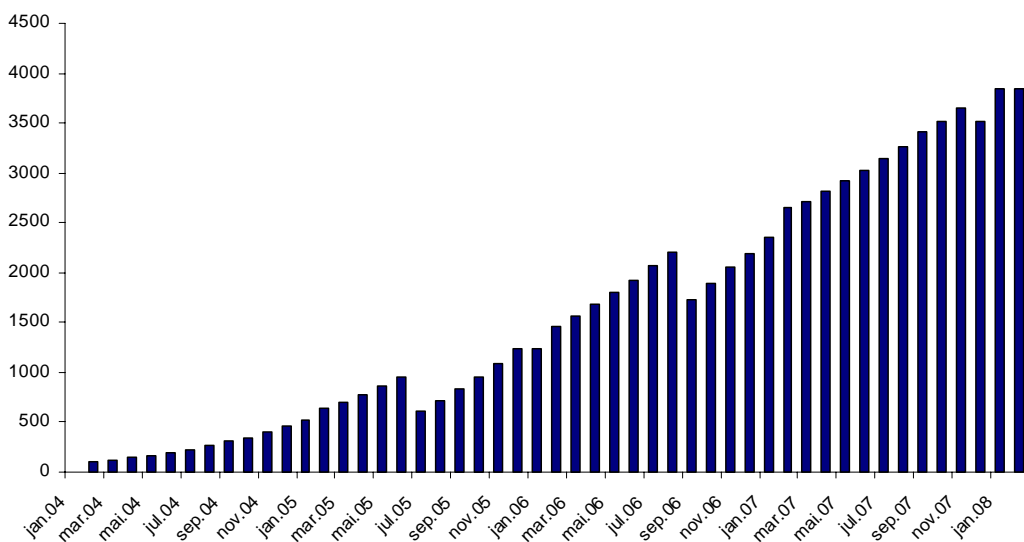
²¹ "Russian Finmin eyes oil tax burden cut from 2009", *Reuters* 25.03.2008

²² IMF (2007a)

government in terms of oil revenue management and limiting the pressures from the positive balance of payment. The fund has two main purposes. The first is to balance federal budgets in case of falling oil prices. The second is to sterilize revenue inflows and soak up excess liquidity in order to make the Russian economy and the Federal budget less vulnerable to variations in hydrocarbon prices. The investment profile has been directed at foreign sovereign debt securities.²³

The Fund has been growing steadily since it was established, and has shown month-to-month decreases only three times. In 2005 and in 2006 parts of the fund was used for down payment of foreign debt. From November to December 2007 the value of the fund also dropped, most likely due to the crisis in the international credit markets. By 1 January 2008 the Stabilization fund had reached RUR 3 850 billion (USD 157 billion). From the onset, the Fund has accumulated revenues from export duties on oil and from the mineral extraction tax when oil price is above a cut-off price. In 2006 the cut-off price was raised from USD 20 per barrel to USD 27 per barrel.

Figure 3.3 Stabilization fund 2004-2008, million rubles



Source: Ministry of Finance

From 1 February 2008 the Stabilization Fund was divided into the *Reserve Fund* and the *National Welfare Fund*. The Reserve Fund will total 10 percent of GDP. It will be invested in highly liquid securities and will cushion the federal budget in the event of a substantial oil price fall. The investment profile of the Reserve Fund seems to be similar to that of the Stabilization Fund, i.e. sovereign debt securities. The National Welfare Fund will take revenues above the limit of 10 percent of GDP and invest in longer term and riskier assets than the Reserve Fund. There has

²³ Ministry of Finance

been a debate in Russia whether the Government should open up for the Welfare Fund to invest also in Russian domestic corporate stocks. This has been endorsed by president Putin.²⁴ This would potentially seriously negate the Fund's sterilizing purpose and pour petro-money into the economy. So far, it is not publicly stated whether the Welfare Fund has actually invested in Russian stocks.

The revenue base of the funds has been broadened to include more oil-price related revenue windfalls including surplus revenues from natural gas and oil products exports.²⁵ This increases the sterilizing ability of the fund. However, the corporate income tax and dividend revenues from oil as well as the extraction tax accruing to the regional governments will remain excluded from the Funds.

The funds seem to reduce Russia's oil price vulnerability, at least in the short term. In their macroeconomic model of the Russian economy Merlevede, van Aarle and Schoors in 2004 found that the Russian economy was indeed very vulnerable to oil price changes.²⁶ However, their model was developed before the oil price surge of the last years, and before the Stabilization Fund had started to make an impact, and may not have the same explanatory value today. Later studies find that the sensitivity of GDP growth to oil price changes has declined markedly since 2000. The main reason for this is that oil revenues are now heavily taxed and saved in the Stabilization Fund.²⁷

Until spring 2006 the Stabilization Fund grew largely in parallel with foreign reserves and represented almost half of the growth in gross foreign reserves, i.e. more than half of the additional monetary expansion from the purchase of foreign reserves was effectively sterilized by the Stabilization Fund. Since this time, capital inflows, which are not absorbed into the Stabilization Fund, have become an increasingly important source of reserve accumulation. Correspondingly, the relationship between accumulation in the Stabilization Fund and reserve accumulation has become much weaker, and averaged only 33 percent between April 2006 and April 2007.²⁸ The Stabilization Fund seems to be an effective automatic stabilizer of large inflows stemming from oil revenues, but capital inflows have become an increasingly important source of reserve accumulation and money supply expansion in 2007.²⁹

²⁴ "Putin wants oil revenues to go into Russian stock market", *International Herald Tribune* 21.05.2007,

"Andrey Vavilov Vyshel na Stabfond", *Kommersant* 16.11.2007

²⁵ IMF (2007a)

²⁶ Merlevede, van Aarle and Schoors (2004)

²⁷ Deutsche Bank Research (2007)

²⁸ World Bank (2007a)

²⁹ World Bank (2007b)

As has been noted, the successful performance of a natural resource fund depends not only on the macroeconomic regulations and impact of the fund, but also on how transparent and accountable the fund is.³⁰ The public has access to information on the Reserve and Welfare Funds via the Ministry of Finance's web-site. Here, the public has access to the development of the Funds' value and their main portfolio considerations. Information about Funds' specific investments as well as the actual performance of the investments is not listed on the web site, only the Funds' cumulative value. Audits or annual reports are not available on the web site. When the authors of this article accessed the Ministry's web page in April 2008, the site for the new funds was under construction. The content outline suggested that there will be more information accessible through the site than was the case for the Stabilization Fund, but this remains to be seen. On the accountability side, the Russian Stabilization Fund is said to have some serious flaws. There is no internal or external auditing policy established for the fund.³¹ This does not seem to have changed with the division of the Fund.

The division of the Stabilization Fund and the new guiding principles are to a large degree in line with recommendations from the OECD³². The OECD recommended that the Russian government reorganized the Stabilization Fund. The OECD recommended that the revenue base was broadened to include excess revenues from export duties on oil products and natural gas, that the oil price fluctuation buffer should be indexed to nominal GDP and raised to some 10 percent of nominal GDP, while opening for riskier investments for the overshooting amount, and that transparency and accountability should be enhanced. Obviously, broadening the scope to include long-term equity investments poses additional challenges in terms of accountability and fund management performance.

3.2.2 Fiscal policy on the expenditure side

Even though the effect of the Stabilization Fund has been to keep a significant portion of oil and gas export revenues from pouring into the economy, it is clear that a natural resource fund cannot substitute for fiscal prudence. Oil prices tend to be highly volatile, changes are generally difficult to predict and it has been difficult to separate out temporary fluctuation from trend.³³ This leads to high fluctuations and uncertainty for a country's fiscal revenues. For fiscal stability it is important that the government of an oil exporting country does not fall for the

³⁰ Notably, Progunova's (2006) master's thesis claims that the Russian Stabilization Fund does not perform well in terms of transparency and accountability, factors that are important for a natural resource fund to perform adequately. She also claims that the financial effectiveness of the fund is "somewhat questionable". The foundation for this last claim seems rather vague and will not be followed further in this article.

³¹ Progunova (2006:66)

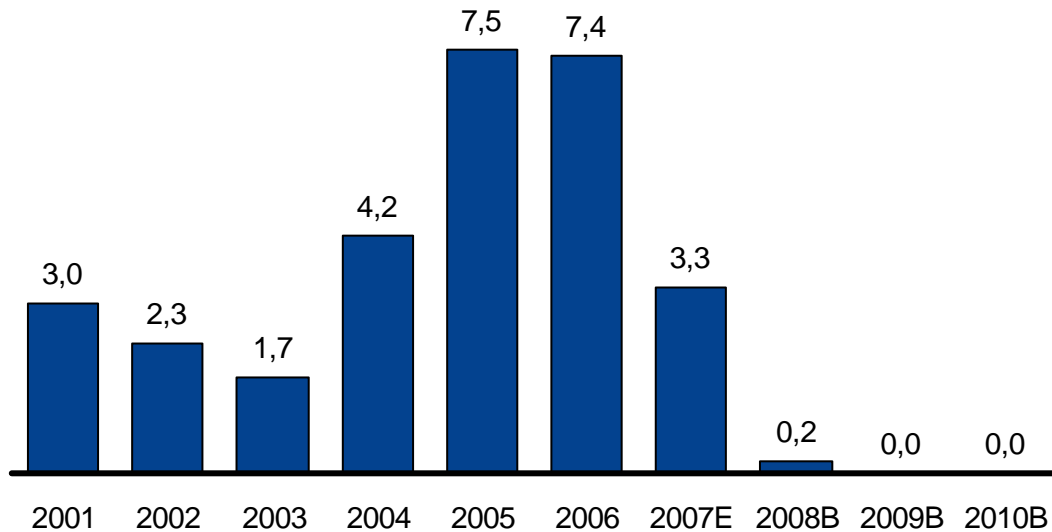
³² OECD (2006)

³³ See for instance Eifert, Gelb & Tallroth (2002)

temptation to increase spending in boom periods only to pay the price in bust periods.

Up to 2005, the Russian government resisted the temptation of running an expansive budgetary policy despite high oil export revenues. Budget policy was rather prudent, and budgets were run with solid surpluses since 2000, growing to 7.5 percent of GDP in 2005. After 2005 fiscal policy has become more expansionary, and the budget surplus has been reduced since 2006 (see Figure 3.4). The budget's non oil balance has deteriorated. The main reason for this has been increased spending in the social and security spheres. A large part of the increased spending was due to higher transfers to extrabudgetary social funds.³⁴ This has been in line with president Putin's so-called national projects, with increased budget spending in health care, education, housing and agriculture. In an attempt to streamline the country's finances and expenditures the Russian government in 2007 put forward a draft three-year budget. This could be seen as a transition to longer-term financial planning. In the three-year budget the government aims at increasing non-oil deficit by 2¼ - 3¼ percent of GDP through 2009, ending at a balanced budget in 2009 and 2010. Expenditures will be kept at 18-19 percent of GDP. This implies that Russia's twin fiscal and current account surpluses will disappear within 2-3 years. According to the government, expansive budgets would help overcome infrastructure bottlenecks and increase investments.³⁵

Figure 3.4 Federal budget balance 2002-2010, per cent of GDP



Source: World Bank 2007, Ministry of Finance (numbers for 2007 are World Bank estimate, numbers for 2008-2010 are Ministry of Finance budget numbers)

³⁴ IMF (2007a)

³⁵ IMF (2007a)

The 2007 federal budget used an assumption of USD 61 per barrel Urals. The 2008, 2009 and 2010 budgets have price assumptions of USD 53, 52 and 50 respectively. In a period where oil prices are pushing the USD 100 limit this might seem to be a moderate price assumption. That could help restrain the growth of spending in the absence of a spending rule.³⁶ However, oil prices tend to shift unexpectedly and that a fall in the oil price below the USD 50 mark cannot be regarded as totally improbable.

There are, no doubt, many sensible projects on which to spend budget money. If the government succeeds in spending revenues on projects contributing to increased productivity, like infrastructure and education, weakening the budget balance could be a good idea. The *national projects* launched in 2005, which have led to substantial increases in budget spending in the education, public health, housing and agriculture sectors, at least partly seem to have this focus. However, as the Russian economy is said to operate close to its potential, increased government spending may increase the inflationary or nominal appreciation pressure.³⁷

Furthermore, part of the increased spending goes to projects that do not necessarily increase productivity. One notable innovation is Vladimir Putin's creation of so-called *state corporations*. The state corporations concept is not perfectly clear, but the general idea seems to be that some chosen industries or companies will get budgetary support in an early phase to be built up as competitive enterprises.³⁸ One goal is to diversify the Russian economy. The state corporations are also an attempt at better control and coordination of state equity. In 2007 the state corporations received funding in the magnitude of USD 20 billion.³⁹

3.2.3 Monetary policy

The options for addressing the challenges of the revenue flow via monetary policy are limited, i.a. because of the weakness of the interest-rate channel.⁴⁰ This leaves the exchange rate the main monetary policy tool to fight inflation for the Central Bank. The Russian ruble has appreciated significantly in real terms from 1999 onwards.

³⁶ OECD (2006)

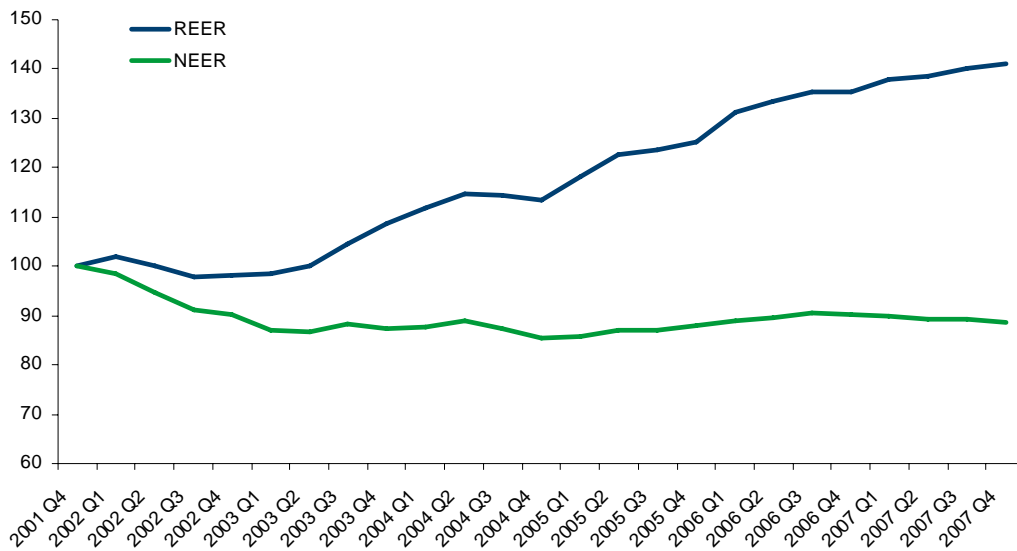
³⁷ IMF (2007a), World Bank (2007b)

³⁸ Seven state corporations have been established; Rosnanotekh, Rostekhnologii (with the defense industry's Rosoboroneksport as its main pillar), Rosatom, Olimpstroj (construction of the infrastructure of the 2014 Olympics in Sochi), the Fund for the Support of Reform of Housing Utilities, the Development Bank and the Deposit Insurance Agency.

³⁹ "Tsarevye Dary", *Kommersant* 24.12.2007

⁴⁰ OECD (2006)

Figure 3.5 *Nominal and real (CPI-based) effective exchange rate index (Q4 2001=100)*



Source: Central Bank of Russia

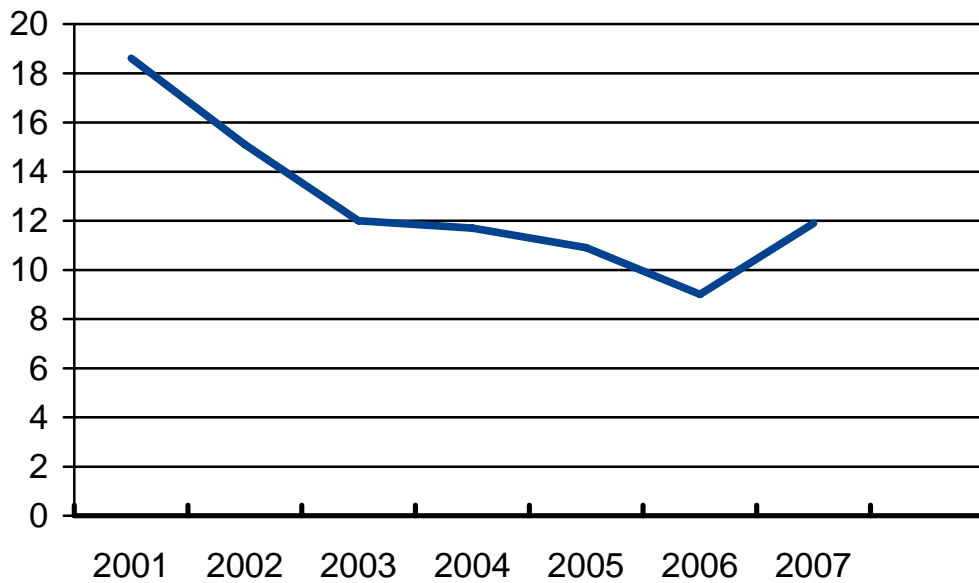
The ruble appreciation may be interpreted as a catching-up process after the 1998 devaluation. According to Gavrilenkov (2006, p. 131), the strengthening of the ruble is largely a natural result of economic growth. However, there is evidence that the high oil price itself has contributed to the real exchange rate appreciation, hurting the competitiveness of the non-energy tradable sector.⁴¹

The Russian Central Bank follows a policy of fixed nominal exchange rate, limiting the possibility for the exchange rate to dampen the effect of foreign currency inflows. The Central Bank has since 2006 aimed at keeping the ruble fixed towards a basket of Euro and USD. This has led to a rapid base money growth, as forex purchases are the primary source of monetary emissions in the economy. In 2007 the money supply (M2) increased by nearly 50 percent.⁴² One effect has been increasing inflation, and after a period with steadily decreasing inflation, the inflation rate in 2007 grew to 11.9 percent (see Figure 3.6)

⁴¹ Oomes & Kalcheva (2007)

⁴² Bank of Finland (2008).

Figure 3.6 *Inflation 2001-2007, percent*



Source: Federal Statistics Service

A study by the IMF (2007b) suggests that backward looking behaviour (where previous inflation rates strongly affect current inflation expectations) is more prevalent than forward looking behaviour in forming inflation expectations in Russia. This has been caused by the focus of the Russian Central Bank on the stabilisation of the exchange rate. It has decreased its credibility as an inflation fighter and has induced higher inflation expectations. The trend break in 2007 may thus cause increased inflation expectations. The Government insists on an inflation target of around 8 percent for 2008, but continues with the fixed nominal exchange rate policy, and it is difficult to see what main measures will be introduced to curb inflation. In the long term, a clear inflation targeting framework may well be the optimal solution to control inflation and its persistence. This will allow firms to reduce uncertainty about future inflation and result in a more forward-looking effect on inflation expectations.

3.2.4 Institutional evolution

As described in Section 2, revenues from natural resources are often believed to worsen the institutional quality for economic development in general. In principle, it is possible to use the governmental income to strengthen the integrity and independence of officials and judges, for instance by raising their salaries in order to make extraordinary payments less attractive. However, it is also possible that

the inflow of petro-money into the economy will raise the stakes in legal disputes and lead to corruption on higher bureaucratic or judicial levels.

We do not analyse the possible impact on democracy and high-level party politics, neither do we compare Putin's presidency with previous administrations that enjoyed lower revenues from oil and gas. By their very nature, measures of institutional quality are much less accurate than quantitative macroeconomic data. Nevertheless, international organisations regularly publish recognized indicators about corruption and property rights in worldwide comparisons. With these reservations, we see that Russia have performed rather poorly in terms of property rights and corruption during the Putin presidency.

Property rights

The Russian Federation has struggled with weak property rights since its inception. In Property Rights Alliance's 2008 international ranking, Russia ends up 92nd out of 115 ranked countries, with an overall score of 4.0 on a 0–10 scale. Russia is judged especially weak in the domain of legal and political rights, with a score of 3.2.⁴³

During Putin's presidency, many private players in the extractive industries have experienced a considerable pressure from Russian authorities. The mentioned *de facto* nationalization of Yukos is the most obvious example. To the extent that these governmental interventions only seek to rectify the consequences of what many consider a rash and unjust privatization process in the 1990s, this may say less about the property rights environment in general. Nevertheless, foreign-owned assets in the energy sector are not free from political interfering either. The most prominent example is probably the Sakhalin-2 Production Sharing Agreement (PSA) where the foreign partners Shell, Mitsui and Mitsubishi in 2006 were forced to sell a controlling stake in the Sakhalin Energy operating company to Gazprom. An intervention in March 2008, when employees of British Petroleum's Russian subsidiary BP-TNK were accused of espionage, has been seen as a politically motivated move, and is the latest event in a period of pressure on foreign stakeholders in Russia's oil and gas industry.⁴⁴

While it is hard to say that the weak property rights in the oil and gas sector indicate a shift relative to earlier Yeltsin administrations, it is clear that the high oil and prices coinciding with Putin's presidency has exacerbated the issues. To this extent, the energy sector may be the part of Russia's economy where private property rights are weakest. In the Property Rights Alliance report, Russia performs slightly better in the field of physical property rights, where it scores 4.9. Still, this points at low overall protection of property rights, including access to

⁴³ Property Rights Alliance (2008)

⁴⁴ "TNK-BP worker held on spying charge", *Upstreamonline* 20.03.2008

finance. Since the threat to property rights stem largely from non-neutral implementation of regulation and from biased legal enforcement, corruption in the bureaucracy and in the judicial system may today be the worst institutional problem.

Corruption

In Russia, corruption has been a problem for many years, long before the really big oil export revenues began to flow into the country. Putin stated the fight against corruption as one of his main tasks. However, it does seem to be far from stated targets to actual policy implementation and achievement of results. After two terms of Putin presidency, Russia does not perform well on the corruption target. According to Transparency International's global survey of corruption (corruption perception index), released in September 2007, Russia made a drop on the corruption ranking from 121st of 163 countries in 2006 to 143rd of 180 in 2007.⁴⁵ Part of the explanation may be ascribed to the new country entries in the list as 12 of the new entries have higher score than Russia. However, Russia falls not only on the ranking but also on the score, from 2.5 to 2.3. One should probably not make too much a point out of the score itself, as the score of 2006 is within the confidence range of 2007, but it does show a non-positive trend.

The most serious corruption related problems in Russia are listed to be public trust in politicians, burden of regulation, favouritism in government decisions and judicial independence. Bribery in various forms is also considered a problem, although not as severe as the above mentioned factors. The newly elected president Dmitriy Medvedev has stated the fight against corruption on of his main targets.⁴⁶ To what extent the endemic corruption is a result of natural resource wealth is a question that for now will remain unanswered. That the resource-rich Russia is struggling with corruption seems to be an undisputed case.

4 Discussion

In this final section, we assess the management of revenues from oil and gas under Putin's presidency. We use the framework presented in Section 2 to see how revenue management has dealt with the economic challenges natural resources may constitute.

We draw the following conclusions:

⁴⁵ Transparency International (2007)

⁴⁶ "Interview Transcript: Dmitry Medvedev" *Financial Times* 24. March 2008

- The efforts to prevent a rapid ruble appreciation seem to have been generally successful, but inflationary pressure and political wishes to invest funds domestically pose a hazard.
- Nevertheless, there are signs of Dutch Disease indicating a relative under-investment and lagging productivity in the non-energy tradable sector. Taxes and institutional factors seem to discourage some productive investments also in the energy sector.
- The design of the funds managing oil and gas revenues seems adequate, but there is uncertainty as to their actual accountability and management capacity.
- The plans to relax the fiscal policy rise concerns about the government's long-term commitment to a disciplined economic policy, but this should largely be judged by the selection and implementation of planned governmental investments.
- There are few signs that the resource revenues are being used to improve the institutional environment for business and economic development in Russia.
- Russian economic policy is guided by more nationalistic and centralistic concerns than assumed in conventional economic analysis. The policy striving for governmental control comes at the price of structural deficiencies, impeding Russian economic development.

The central measure to prevent a quick exchange rate appreciation, a drainage of resources from other sectors and an overly volatile economy is to decouple expenditures from revenues by investing the latter and letting them trickle into the whole Russian economy rather than flow into the energy sector. Sterilizing by investing in foreign assets reduces pressure on appreciation.

The Russian government and the Central Bank have tried to curb appreciation of the ruble by striving to keep a fixed exchange rate against a euro-dollar basket, and by investing the proceeds from oil and gas taxation abroad. The policy has managed to keep the nominal exchange rate relatively stable, although there are signs that the price in terms of inflation is non-negligible. The policy of sterilizing oil and gas revenues by investing the money of the Stabilization Fund in foreign assets has probably helped dampen appreciation. However, if the National Welfare Fund starts investing in Russian assets, there will be an increased demand for rubles, putting further upward pressure on the exchange rate or inflation, both of which will harm the competitiveness of the non-energy tradable sector. President Putin's support for a more domestically oriented investment policy puts the government's commitment to sterilization into question.

In addition to the disadvantage caused by the monetary factors, the non-energy tradable sector – in particular manufacturing – seems to experience productivity problems. While we cannot say for sure that these problems are due to under-investment relative to the energy and non-tradable sectors, the Dutch Disease

theory and our framework certainly suggest that it may be an explanation. This would suggest that the revenue management has not been entirely successful in preventing drainage of resources from non-energy tradable into the energy sector.

However, most of the provisions that the Russian government has made to shield the economy in general and the extraction industry from volatility caused by swings in world market commodity prices seem to be adequate. The Reserve Fund is designed to cushion from short-term price swings, in line with OECD recommendations, and there is some evidence that the oil-price sensitivity has gone down. At least in its design, the new tax system seem to have progressive elements – taxing new developments and depleted fields less than mature business – as recommended by the World Bank paper by McPherson. However, there are indications that the tax burden, combined with institutional insecurity, discourages investments also in the extraction sector.

In terms of the actual management of the Funds, it is not certain how transparent and accountable the Reserve Fund and the National Welfare Funds are, or how well they will perform. On the one hand, managing a fund of foreign sovereign bonds – like the Stabilization and the Reserve Funds – is relatively easy and risk-free. On the other hand, the Welfare Fund's equity investments call for an increased monitoring of risk-return performance. Foreign equity investment also calls attention to the international transparency of the fund and its objectives, as shown by the ongoing debate on Sovereign Wealth Funds.

Also the government's expenditure policy is a concern. The increase in the non-oil deficit and the plans for national projects and state corporations may be a consequence of lacking fiscal discipline, which weakens the decoupling of revenues from expenditures. On the other hand, the investments in social projects and perhaps also in certain industries with positive external effects (e.g. a high degree of research intensity) may not be a short-run response to high oil prices, but reflect a longer-term strategy of social investments and an attempt to bring money from the extraction industry into other sectors. While the general case for government intervention in certain industries is at best mixed, there is no doubt that Russia is in need of improvements in public health, education and infrastructure. If the money is spent wisely, the price of less decoupling and a stronger appreciation pressure may be worth paying.

Russia's endemic problem with corruption and weak property rights seem to prevail. Even if better governmental finances may help curb low-level corruption by increasing the salaries and living standards of officials and judges, it does not necessarily shield Russian and foreign citizens from bureaucratic or political pressure from higher hierarchical levels. The suggestions that bribery is less of a problem than favouritism in governmental and legal decision-making indicate that the oil and gas revenues have done little to improve the institutional environment in Russia.

Finally, an overriding conclusion is that Russian economic policy is guided by more nationalistic and centralistic concerns than usually assumed in the utilitarian welfare framework used by academic economists and international economic organisations. While fostering growth and shielding the economy from excessive hydrocarbon price swings is of interest to the Moscow leaders, only measures that could be combined with firm governmental control seem to be politically feasible. This policy comes at a price to the Russian economy. Long-term private investments – especially from abroad – and entrepreneurial efforts become less attractive. Bureaucracy and weak property rights prevent a well-functioning financial market. These structural deficiencies probably hinder the economic diversification strived for and impede Russian economic development.

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