Briefing

REVENUE WATCH INSTITUTE

The Potemkin Complex

Russia's Management of Oil and Gas

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"Should a primitive economy based on raw materials and endemic corruption accompany us into the future?"

– President Dimitri Medvedev, 2009

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Summary

If the winner of Russia's presidential election wants to create a more diversified and stable economy, he will have to change how the government manages the enormous profits it earns from oil and gas. The money is central to the country's finances, accounting for a quarter of GDP, half of the federal budget revenues and three-quarters of all exports. Russia is also the world's largest oil and gas producer. Between 2003 and 2008, the country's oil revenues grew tenfold to over $200 billion a year.

But as Russia has grown more dependent on this money, the government has failed to use it to reform the nation's economy. Russia's economic success is a Potemkin façade, the last decade a lost opportunity for urgently needed economic modernization. Demonstrators in Moscow and other major cities sense it, as the focus of their protests have expanded from the parliamentary elections to corruption and the lack of government transparency and accountability.

Without reforms that diversify Russia's economy, and without greater transparency in the management of the country's oil and gas, Russia will suffer another lost decade.

From a Potemkin economy...

From 2000-2009, the government earned nearly $700 billion from oil and gas, thanks in part to rising prices. It used the revenues to reduce its debt below 10 percent of GDP—a favorable figure compared to the debt of most industrialized nations. It also saved roughly 45 percent of its hydrocarbon revenues, and beginning in 2004 established special savings funds to protect the federal budget from volatility in prices and to help meet the cost of future pensions. The Kremlin automatically diverts oil and gas revenues in excess of 3.7 percent of GDP to its Reserve Fund, until it reaches a ceiling of 10 percent of GDP. All additional oil and gas revenues go to its National Welfare Fund.

For the government to balance its budget, however, the break-even oil price has nearly doubled in five years, to about $120 a barrel in 2012 from $60 in 2007.[1] Money from oil and gas increased Russia's vulnerability to swings in the price of oil and other external shocks.

The vulnerabilities were subtle and deepened slowly. The Kremlin's use of oil and gas revenues to reduce debt and increase public saving attracted foreign investment, but 80 percent of the foreign

Contents

Briefing

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capital went into Russia's stock market. Only a meager portion was invested in infrastructure (fixed assets). In 2000-2009, public investment stagnated at less than 5 percent of GDP. Public spending on roads, for example, declined to 1.5 percent of GDP in 2009, compared to 2.8 percent in 2000—the period when Russia had the greatest revenues to invest. China, in comparison, during the 1990s invested an average of 3.5 percent of GPD a year on roads. Between 2000 and 2008, Russia doubled real spending on education, health and social security. Yet health expenditures as a percent of GDP remained below the OECD average, and the mortality rate stayed high—30 to 40 percent higher than in other countries with similar health spending. Russia's shrinking population increases the pressure on the federal budget, by adding pensions costs. At the same time, energy subsidies have increased to about $40 billion a year. The growth in recurrent expenditures and social transfers raises significant sustainability issues and undermines Russia's capacity to invest a larger share of oil and gas revenues in ways that strengthen the economy.

Oil money temporarily masked some of the problems it created. It helped reduce interest rates, encouraging a surge in private borrowing. In 2007 foreign loans grew by $100 billion, to a total of $280 billion. When the world financial crisis hit, however, money began leaving the country and banks faced severe strain. In the fourth quarter of 2008, net capital outflows reached $130.5 billion. To rescue the banks as well as major corporations, the government spent most of the special savings funds. Government finances deteriorated, with the federal budget showing a 4.1 percent surplus in 2008 but a 5.9 percent deficit in 2009. The anti-crisis measures cost nearly 7 percent of GDP in 2009—about three times the average economic stimulus in other G20 economies. Meanwhile, total investment fell to 19 percent of GDP from 26 percent. By shifting public expenditure away from investment, the economic crisis further undermined prospects for economic diversification.

The new government will have few options for addressing the country's economic vulnerability. According to the World Bank, a drop in oil prices to $80 would cut Russia's economic growth by half, to 2 percent. A fall to $60 a barrel (as in 2009) would put Russia in recession. The current government took an important, positive step in January 2012, by accumulating new savings in the Reserve Fund for the first time in two years. As a result the Reserve Fund balance has jumped from $25 billion at the end of 2011 to $61.4 billion as of February 1, 2012. These new savings will be critical protection against a potential fall in the Urals oil price (Russia's main export blend), trading at about $110 dollar a barrel as of February 1, 2012.

According to the International Energy Agency, the country's oil production will level off over the next 20 years. Anticipated increases in gas production are unlikely to generate enough revenues to ease the government's budget constraints. If the country is to be sheltered from changes in oil prices, the next president will need to develop a credible plan for creating new sources of growth.

...to a Potemkin mutiny?

Prime Minister Putin recently acknowledged that a poor business climate and "system-wide corruption" were threats to the country's economic and political future.[2] By many measures, he understated the problem: Russia ranks 154 out of 178 countries on the Transparency International corruption perception index. According to the Association of European Business, bribes account for 20 percent of the cost of doing business, with the lack of transparency costing the equivalent of 4 per cent of GDP a year in lost foreign investment. Lack of transparency in access to resources and weak property rights represent another significant deterrent to investment in Russia. For instance BP and Shell were forced to divest from the Sakhalin and Kovytka gas fields in favor of Gazprom, the state-controlled gas giant.

Briefing

The government's recent endorsement of the OECD Anti-Bribery Convention is a step forward, but the business climate will not significantly improve without greater transparency in the oil and gas sector.[3] Gazprom and Lukoil—the state-controlled oil company—do not provide even basic information about any corporate anti-corruption measures, and thus rank at the bottom of the Transparency International/Revenue Watch companies transparency index. The government only provides limited information about its gas and oil contracts. And access to natural resources is too often granted on a political rather than competitive basis, creating more opportunities for corruption. Even when information is available, political constraints on civil society organizations and citizens limit their ability to hold their governments to account.

Large profits from oil and gas combined with limited public scrutiny and accountability offer lucrative opportunities for corruption and few incentives for reform and innovation. Pervasive corruption hinders to private sector investment into the non-oil sector and jeopardizes economic diversification. Inefficient public investment creates bottlenecks to infrastructure provision and impedes economic modernization.

Similar conditions existed in the Middle East and North Africa, where public discontent with corruption, mismanagement of natural resources and economic inequality helped spark the Arab Spring. In Russia, restoring political trust and improving economic outcomes will require significant reforms, starting with greater transparency and accountability in the management of oil and gas.

Solving the problems

Russia's next president will have an opportunity to reform the oil and gas sector in ways that could improve the country's economic prospects. As soon as possible after the election, the government should:

- Publish in full all oil and gas contracts, to allow public scrutiny of the management of public assets and limit corruption in the procurement of natural resources. Public disclosure is simple and does not require legislative approval.
- Commit to implementing the Extractive Industries Transparency Initiative, an international transparency standard followed by over 35 resource rich countries.
- Put into effect immediately fiscal rules limiting the budget's reliance on oil revenues, rules otherwise not scheduled to go into effect until 2014.
- Reallocate spending towards productive investment, and continue to build up the Reserve Fund to a minimum of 5 percent of GDP, to lessen the effects of oil price volatility.
- Increase government openness and guarantee civil society freedom and ability to use available information to hold government to account. As a politically thinkable first step, Russia should take steps to qualify for the Open Government Partnership—a global effort to improve government accountability by empowering citizens and increasing responsiveness to their aspirations.
- Increase transparency and accountability about the use of oil and gas revenues at the state and local level, to improve the effective use of this money.
- Gazprom and Lukoil should strengthen and publish their anti-corruption programs in line with international best practice.

Over the medium-term, Russia needs a credible strategy for diversifying its economy. The Natural Resource Charter offers practical guidance for addressing the challenges of resource dependency and managing money from oil and gas. Since Russia's oil production will stagnate over the next five years, radical reforms will be necessary to sustain Russia's economic development. The government should:

Briefing

- Develop an inclusive, long-term plan to create broad political consensus about the proper the role of oil and gas in the country's economic development.
- Take advantage of low debt and attractive interest rates to finance public investment targeting at modernizing the economy
- Stop ad hoc changes to the budget and ensure that public spending supports Russia's medium and long-term development strategy.
- Consider sharing a larger share of oil and gas revenues with state and local governments to stimulate productive investment.
- Develop a cash distribution system to increase citizens' interest and scrutiny over oil and gas money and strengthen the social contract.
- Reform the National Welfare Fund, to allow the government to invest the assets to support long-term economic diversification.

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REVENUE WATCH INSTITUTE

The Revenue Watch Institute promotes the effective, transparent and accountable management of oil, gas and mineral resources for the public good. Through capacity building, technical assistance, research, funding and advocacy, we help countries to realize the development benefits of their natural resource wealth.

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