ANALYSIS

The Political Challenges of an Oil Boom: the Resource Curse and Political Stability in Russia[1]

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Abstract

This article discusses the political challenges arising from the Russian oil boom. It focuses on the regulation of foreign direct investment, the role of state-controlled companies and the management of resource revenues. It argues that inefficient governance allows the exploitation of resource revenues within political patronage networks, while, on the other hand, the insulation of the management of resource revenues from the patronage networks guarantees the future availability of rents. At the same time, the distribution of smaller parts of the rents to the larger population is meant to ensure that no serious political challenge to the patronage system will occur.

Common sense would predict that countries with huge oil and gas resources prosper, or at least perform better than those without such natural wealth. However, the actual performance of resource-rich countries has been meagre. Russia is often seen as a point in case. The first conceptual approaches to explain the related problems of oil and gas producing countries were the 'rentier state' and the 'Dutch disease'.

The concept of the rentier state was created in reaction to the rise of petro-states in the Middle East. The basic idea is that in the wake of a resource boom a national economy receives large external rents, i.e. considerable income (from oil exports) without the need for major capital investments (as in a boom phase the world market price for oil is much higher than production costs). This approach was pioneered in 1970 by Hossein Mahdavy's comparative study of Iran. He stressed that the large share of external rents in the state budget had important consequences for the political system: 'A government that can expand its services without resorting to heavy taxation acquires an independence from the people seldom found in other countries. However, not having developed an effective administrative machinery for the purposes of taxation, the governments of rentier states may suffer from inefficiency in any field of activity that requires extensive organizational inputs. In political terms, the power of the government to bribe pressure groups or to coerce dissidents may be greater than otherwise. By the same token, this power is highly vulnerable since the stoppage of external rents can seriously damage the government'.

The negative macro-economic impacts of a resource boom were summarized as Dutch disease, a term first coined by the British journal 'The Economist' in the 1970s in an analysis of the economic development of the Netherlands after North Sea oil had been discovered. The starting point is that oil exports lead to huge inflows of petro-dollars, which causes a rise in the exchange rate. This in turn has two major consequences: high inflation rates and reduced competitiveness of the domestic non-resource sector, which can potentially lead to de-industrialization. At the same time the oil and gas industry employs only a small number of people and does not induce major modernization or innovation processes in the national economy.

Since the late 1980s many macro-statistical studies, looking for correlations between resource booms and manifold country-level indicators, asserted that natural resource abundance increases the likelihood that countries will experience negative economic, political and social outcomes, including poor economic performance, increased income inequality, widespread poverty, low levels of democracy, high levels of corruption and a greater likelihood of civil war. In this context, the term 'resource curse' was coined by Richard Auty in a book published in 1993. This literature has been extremely influential: the idea that natural resources are bad for development is now widely accepted.

However, after more than two decades of research on the issue, there is still no conclusive evidence regarding the effects—and even less regarding the causal mechanisms—of the 'resource curse'. Contradictory results are due to differences in the quality of data, in the operationalization of variables and in the construction of statistical models. Looking into regional differences Thad Dunning (2008) comes to the conclusion that resources are bad in many regions of the world, but have a marked positive political impact on development in Latin America. Indeed, some resource-rich countries, most promi-

1 This article is based on research from the project 'The Energy Sector and the Political Stability of Regimes in the Caspian Area: A Comparison of Kazakhstan and Azerbaijan', which has been conducted by the Research Centre for East European Studies at the University of Bremen from 2009 until 2011 with financial support from the Volkswagen Foundation.

nently Norway, manage a resource boom very well, and thus mitigate or avoid the negative impacts.

The Concept of Resource Challenges

That is why there is a growing consensus in the academic literature that institutional weakness is central to the explanation of the negative effects of resource booms. That means, the negative consequences of a resource boom are by no means an inevitable 'curse', but can be mitigated through adequate policy choices. If we assume that the specific features of the resource curse can be influenced by policy choices, the political decision-making process is introduced as an important explanatory factor. For that reason we prefer to speak of resource challenges instead of a resource curse.

In this context several sets of policy challenges arising from an oil or gas boom can be identified. For the purpose of comparing the ways in which political decision-makers address the related policy issues, it makes sense to group these challenges according to policy fields and examine the development of policy responses over time. Of course, these fields are highly interconnected, and decisions in any one area certainly impact policies in the others.

- The most basic resource challenge for governments is to ensure control over the resources by guaranteeing the state's monopoly of power and its legal claim to ownership of (or income from) the natural resources concerned. This claim might be challenged by foreign powers trying to invade the resource-rich region, by separatist movements in the resource-rich region or by armed gangs using violence to extract a share in profits. In the case of offshore-fields legal ownership might be subject to international law and arbitration.
- Another major group of policy issues concerns the regulation of oil production, covering the creation and implementation of regulations, dealing with issues ranging from ownership rights over licensing, taxation and foreign direct investments to environmental safety, as well as negotiations with foreign investors and the decision on whether to establish a national oil company.
- A third challenge is the development of export infrastructure, as an oil or gas boom can only materialise if a large share of the production is exported. For most oil producing countries this task is limited to the construction of port facilities. However, if reserves are situated in landlocked areas pipelines need to be built.
- A fourth group of policy issues is related to financial flows resulting from the sale of resources. This covers the challenges summarized as Dutch disease as well as budgetary policy, as it has to be decided which part of resource revenues will be channelled into the state budget under what conditions. In authoritarian states the oil money can be used to strengthen regime stability as described in the rentier state approach.
- A fifth group of resource challenges pertains to the effective implementation of the designed policies (independently of their content). Major issues in this group are administrative reform or anti-corruption measures, as the influx of petro-dollars hugely increases the risk of bribes.
- The final two groups comprise long-term challenges of industrial policy to diversify the economy beyond the resource sector and socio-economic challenges to improve the well-being of the population.

Obviously, depending on the specific country some resource challenges are not relevant and some seem to be more pressing than others. That means every country that experiences a resource boom is confronted with a specific combination of resource challenges. Moreover, as different leaders react differently to the same challenges, policy outcomes vary. This introduces dynamic aspects into the concept of resource challenges. In the short term, a change in leadership (or even a leader's change of mind) can lead to a policy change in relation to resource challenges. In the longer term, the set of relevant or most pressing resource challenges can change.

Post-Soviet Resource Challenges

For Russia contextual factors, many of which were inherited from the Soviet system, have largely determined the set of relevant resource challenges. As the Soviet oil and gas industry was focused on onshore production in Western Siberia, it never came to acquire the requisite expertise for offshore production. In addition, the economic crisis which accompanied the break-up of the Soviet Union depleted capital for larger exploration and development activities. The resulting weak economic situation as well as the need for technology and expertise created a strong demand for foreign direct investment (FDI). At the same time, the collapse of the Soviet command economy left a regulatory void in relation to property rights and investment. The resource challenges related to the regulation of oil and gas production were, therefore, particularly acute for the post-Soviet states.

With a recent history of hyper-inflation, weak financial institutions and low international competitiveness, Russia was especially vulnerable to the Dutch disease, making resource revenue management all the more critical. In addition, the inherited Soviet-style administrative systems meant that problems related to weak administrative capacity and corruption also constituted a major challenge.

The location of oil and gas deposits far away from ports and foreign markets also means that revenues can only be received if a functioning system of export pipelines is in place. This added a foreign policy dimension to the resource challenges.

Finally, the nostalgia of large parts of the population for the Soviet welfare system had the potential to put pressure on the political leadership to deal with the resource challenge of promoting socio-economic development, or at least to maintain large parts of the Soviet-era welfare system.

Regulation of Foreign Investment

With no relevant legislation in place, all post-Soviet states saw production sharing agreements (PSAs) as the preferred means of regulating FDI in oil and gas production, because these case-specific agreements are immune to administrative and legislative changes in the host country.

Although host governments and investors may have complementary interests, as both profit from rising oil or gas production, there are limits to reciprocity. On the one hand, big multi-national companies can have an information advantage, as they often have a better understanding of the nature of deposits, the technical challenges and the amount of profits to be expected. On the other hand, oil and gas projects are characterized by large capital investments. Thus, the host government might use the (sunk) assets as 'hostages' to extract increased resource rents and/or limit foreign ownership through forced divestment and expropriation of assets.

The Russian state has been markedly indecisive concerning foreign direct investment in the oil and gas industry, swinging between a desperate need for investment in order to modernise one of the most important sectors of the Russian economy and a fear of surrendering control over this important sector to foreign interests. Which aspect dominated was influenced by general political and economic trends. Until 1992, when enthusiasm for market reforms was growing, the legal foundations for joint ventures were laid. When public sentiment against capitalism and a sell-out to foreign investors was rising, restrictions on foreign investment were tightened. When the financial crisis of 1998 made foreigners the only possible source of cash, a more attractive PSA law was enacted rather smoothly. Increased earnings, resulting from the rise in world market prices for oil, then again cooled the interest in foreign direct investment in the industry. In a turn to resource nationalism the role of state companies in the industry was increased.

This turn was in line with international developments. The allure of enormous profits prompted many resource-rich countries to seek to increase their contractual share of fossil fuel revenues often through a violation of investors' rights. Russian authorities endeavoured to boost the country's share of oil and gas monies by undermining the rights of foreign oil and gas companies, namely by accusing them of violating environmental regulations, contractual terms or taxation rules. Once contracts had been redrawn in the government's favour, however, the charges were consistently dropped. By now all oil and gas projects in Russia give a prominent role to Russian companies.

Promoting National Oil and Gas Companies

As a means of both retaining a dominant stake in resource production and developing domestic know-how and capacity in the field, national oil companies (NOCs) help governments to maintain sovereignty and control over domestic fossil fuel endowments.

While the Russian gas industry in the form of the monopolist company Gazprom remained under state control, large parts of the country's oil industry were privatised in the 1990s and neither specific fields nor deals with foreign investors were reserved exclusively for NOCs. As a result, the share of the state in oil production dropped below 15% in 2002. However, under president Putin this trend was stopped and state support for NOCs related to resource nationalism led to a threefold increase in the state's share from 2004 to 2007. An important feature in the process of increasing state ownership in the oil industry was the state's reliance on heavy pressure and legally dubious measures. The Yukos affair has become the prime example of this. As a result, the major Russian NOC in the oil industry, Rosneft, is now a leading player.

Many experts regard the dominant role of state-controlled companies as a major cause of poor resource management. However, this view assumes competitive markets. But the natural resource sector is generally characterized by the dominance of a limited number of large companies. Furthermore, extreme economics of scale within the production process hamper the entry of new companies into the sector. In his analysis of the role of the state in the oil and gas industry, Joseph Stiglitz (2007) concludes that in such an environment private companies do not necessarily operate more efficiently than state-owned ones. Instead, the institutional setting and the political attitude of the government in charge are important criteria for the efficiency of the oil and gas sector.

In Russia the commercial efficiency of NOCs has been compromised by three factors. First, the companies lack organizational stability as a result of regular structural 'reforms' and personnel reshuffles. Second, the political leadership has burdened the NOCs with tasks that do not normally fall within their scope of operation, namely regulatory functions and the provision of subsidies to industry and the social sphere. As a result of this continual interference, the NOCs are greatly hampered in performing their designated activities. Third, NOCs are partly seen as a self-service shop by political elites charged with oversight over the respective industry. A report by the Warsaw-based Centre for Eastern Studies thus concludes: "The process of Gazprom's assets being taken over by private companies and business partners from within Vladimir Putin's closest circle is underway." Next to Gazprom and Rosneft, which are controlled by the national government, Tatneft, controlled by the regional government of Tatarstan, is also a prime example for these negative features of state-owned companies.

Management of Resource Revenues

Large foreign currency inflows from exports of natural resource make the financial situation of the exporting economy highly dependent on world market prices. In order to provide a cushion for times of falling prices and also in order to sterilize the inflow of petro-dollars and to avoid symptoms of Dutch disease, sovereign wealth funds (SWFs, also called national wealth funds) have become a major instrument for managing a large share of the revenues that the state derives from resource exploitation.

Russia has successfully established a sovereign wealth fund during the first term of Putin's presidency. The fund, which was split into two in 2008, has accumulated considerable amounts of resource revenues. The funds have helped to ward off obvious symptoms of the Dutch disease, and perhaps even more importantly, they were instrumental in limiting the impact of the 2008–09 global financial crisis on the national economy.

A technocratic team has defended the revenues accumulated in the wealth funds against the demands of political interest groups. This proves that despite an inefficient and corrupt state bureaucracy, policies can be implemented successfully in Russia if they are directly supported by the president/prime minister and can be realized by a small technocratic team.

Further Resource Challenges

The resource challenges described above concern all oil and gas producing countries. They are specific for the post-Soviet countries only in so far as they were much more pressing than in other countries, because not only regulation directly related to oil and gas production, but the full legislation and state administration related to a market economy had to be created from scratch.

However, two further resource challenges are also relevant for Russia. One of these challenges is a rather unique feature of the post-Soviet region. As most oil and gas deposits are situated in land-locked areas, post-Soviet oil and gas producers are one of the very few which rely heavily on international export pipelines. This has important consequences. As export pipelines are long-term projects, they rely on strategic cooperation with both importing countries and transit countries. Accordingly, the decision on export pipelines becomes part of a country's foreign policy and geopolitical strategy.

Another important resource challenge for Russia is the promotion of socio-economic development. This aspect has gained in importance for two reasons. First, two decades after the end of the Soviet Union the regulation of the oil and gas industry is fully in place and the process of adjustment to higher world market prices (and related policies of resource nationalism) has clearly been designed. As a result the resource challenges related to regulation have become less pressing and there is now a desire to move ahead. Second, while the first oil revenues were used to compensate for investment costs and to reduce state debts, the oil boom of the 2000s has led to strong economic growth and to the accumulation of larger financial funds. This development has given risen to expectations of improved well-being among the population. Public pressure is visible in Russia, where protests are discouraged by the political leadership, but are not impossible as has been demonstrated in recent months.

This is why the Russian government has conducted some populist transfer payments to the population, but there have also been attempts to develop long-term projects aimed at socio-economic development. Already in the mid-2000s, Russia started four so-called national projects to be financed with oil revenues, which were aimed to address infrastructural problems. In addition, the Russian government tries to stimulate the modernization of the economy as a means to diversify away from the production of natural resources. However, the success of these long-term policies has so far been very limited. The major obstacle has been the lack of governance capacities due to an inefficient and corrupt state administration.

Explaining Performance: The Link to Politics

Russia has proven to be relatively efficient in addressing clearly defined, limited tasks of a technocratic nature, such as dealing with foreign investors or managing the sovereign wealth funds. As a result of this capacity, Russia has stabilized oil and gas production while managing to avoid overt symptoms of Dutch disease.

However, as soon as the political elites begin to interfere in these activities, serious governance problems ensue, resulting in decreased efficiency and reduced sustainability of policies and regulations, namely in the cases of the national oil and gas companies, as well as social policies. Governance issues also harm the country's relationship with foreign investors.

Based on the standard academic benchmark of a successful public policy, that is, one that aims to promote the public good, Russia is showing strong deficits. However, for the Russian elites, the relevant criterion often seems to be political stability and increased personal power and wealth.

A relatively stable political environment under Putin has enabled the evolution of larger elite networks, often referred to as oligarchic and secret service camps, although their composition is more diverse. It seem that vast, multi-layer patronage networks have emerged which help to stabilize political leadership, as they can be used to co-opt potential rivals. These networks, which transcend the constitutional institutions of the state and are based on a logic of mostly bilateral exchange between patrons and clients, thus play a vital role for regime stability. Although resource revenues are obviously not a precondition for the formation of patron-client relations in politics, large revenues arising from oil and gas booms nevertheless serve to make these networks more attractive, more sustainable and more capable of broadening their scope to include more societal segments.

It is not clear how much these networks have been actively created by the top leadership or how far the top leadership has failed to fend off asset-grabbing from lower ranking elite groups, but this does not change their nature. And although the many distinct groups that make up these networks are frequently in competition with each other, they all regard the president/prime minister as their patron and willingly exchange loyalty and support for access to public offices and state funds.

Accordingly, the governance failure described above with reference to the public good is exactly the outcome the patrons might be aiming at. On the one hand, the inefficient governance and regular political interference into the management of the national oil and gas companies allow the exploitation of resource revenues within the patronage networks. On the other hand, the insulation of the management of resource revenues from the patronage networks guarantees the future availability of rents. At the same time, the distribution of smaller parts of the rents to the larger population is meant to ensure that no serious political challenge to the patronage system will occur.

This assessment has two important implications. First, the real challenge for post-Soviet rentier states is not the lack of governance capacities, as the public good view would suggest. The real challenge is the patronage system, which intentionally supports weak governance so that elites can exploit the loopholes for their own benefit. Second, the argument that the current governance system is not sustainable because it is inefficient and wastes financial resources on a large scale is simply not tenable: the political leadership in the post-Soviet rentier states has in fact made extremely efficient use of resources to create vast, sustainable patronage networks that have the capacity to guarantee political stability.

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Further reading

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