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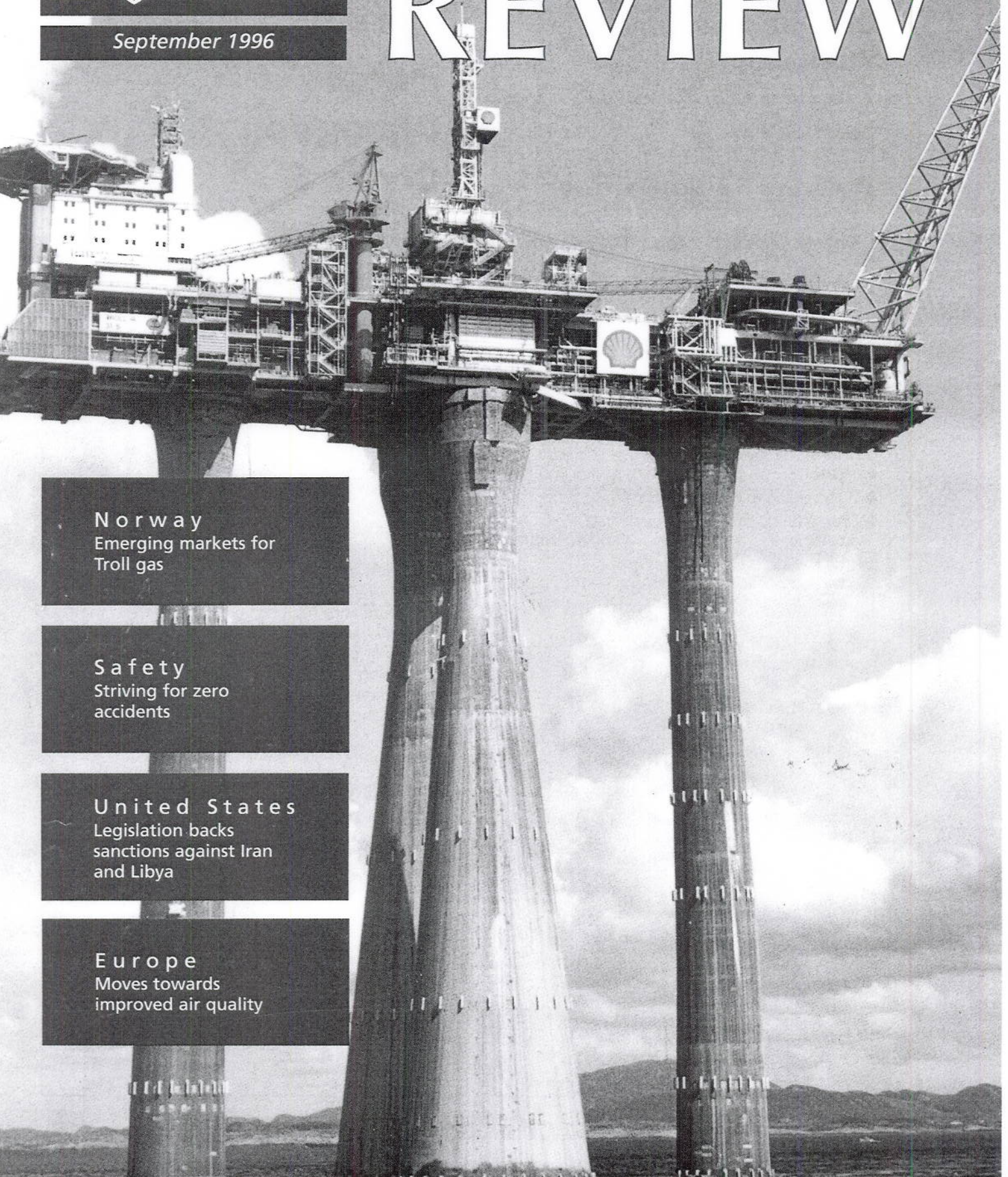
September 1996

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Striving for zero
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Consequences of IMF loan to Russian Federation

The award of a \$10.2 billion credit by the International Monetary Fund stipulated the abolition of export duties on all goods except oil from 1 April. Duties on oil were reduced from 20 to 10 Ecu per tonne and then finally abolished on 1 July. The oil industry should benefit, firstly from the general improvement to the economy as a result of the reduction of the state budget deficit, where the IMF credit resources are directed; and secondly, as the result of the abolition of export duties, which were one of the main costs for oil exporters – accounting for one-quarter of the oil export price. Since the level of export duties was set in fixed monetary terms and was the same for all exporters, irrespective of individual field characteristics, economy of scale, price fluctuations caused by market condition changes, this cost was particularly burdensome for exporters.

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Likely economic consequences

According to estimates from the Ministry of Fuel and Energy, export duties on oil currently provide 8 trillion roubles towards the annual budget revenue. Calculations by the budget subcommittee of the Budget and Economic Committee of the State Duma estimate that they account for more than 2 percent of federal budget revenues. Given the disastrous shortage of budget revenues, the crucial point was not the abolition of export duties (as the condition for granting the IMF credit) but their replacement with other ways of providing adequate, alternative budget revenues.

The government decided to increase excise duties on oil and selling prices for gasoline and electric power as the main compensatory mechanism in order to maintain the level of budget revenues. The tariffs for oil transport by pipeline were also increased.

On 1 April excise duties on oil were raised from 39,400 to 55,000 roubles per tonne and from 1 July to 70,000 roubles per tonne. The selling price for motor gasoline (less excise duty and VAT) was increased by 29 percent. Electric power selling price for the material production sphere will rise by 12 roubles per kWh and the effective tariffs for oil pumping, transshipment and filling by 73 percent.

Effect on oil companies

For Lukoil, estimates show that the abolition of export duties will result in a gain of 1,420 trillion roubles (US\$1 equals approximately 5,000 roubles). On the other hand there will be an

increase in oil excise duty (1,364 billion roubles), transport tariff for oil pumping to the company's oil refineries and for export (714 billion roubles), electric power tariffs (92 billion roubles) and gasoline tax (1,375 billion roubles). Thus, 'compensating' payments will total 3,545 billion roubles, exceeding the amount of savings of export duty payment by two and half times.

So, for Lukoil the balance from the introduction of new taxation terms initiated by the award of the IMF extended credit will be negative and totals minus 2,125 billion roubles. Thus, the abolition of export duties will not improve the economic situation of companies but will make it considerably worse.

In 'replacing' export duties with increased excise duties, two aspects should be distinguished: methodological and quantitative.

From the methodological point of view, a substitution of one 'state take' by another was done in a correct direction. Export duties with fixed absolute value, common all over the country for all commodities were replaced with 'mining excise payments', the absolute value of which is calculated for oil companies/associations individually. Thus, instead of extracting (through export duty mechanism) a price rent which is common to all producers and is calculated as the difference between export and domestic price and thus does not take into account the differential rent resulting from the individual characteristics of the deposits and the E & P projects, the 'rough' procedure of differential rent extraction was applied to the producers (through mining excise mechanism).

More not less taxes

However, the state's fiscal needs have overturned any chance of an equivalent replacement for export duties, leading to the tightening of fiscal pressure on the fuel industries.

Figure 1

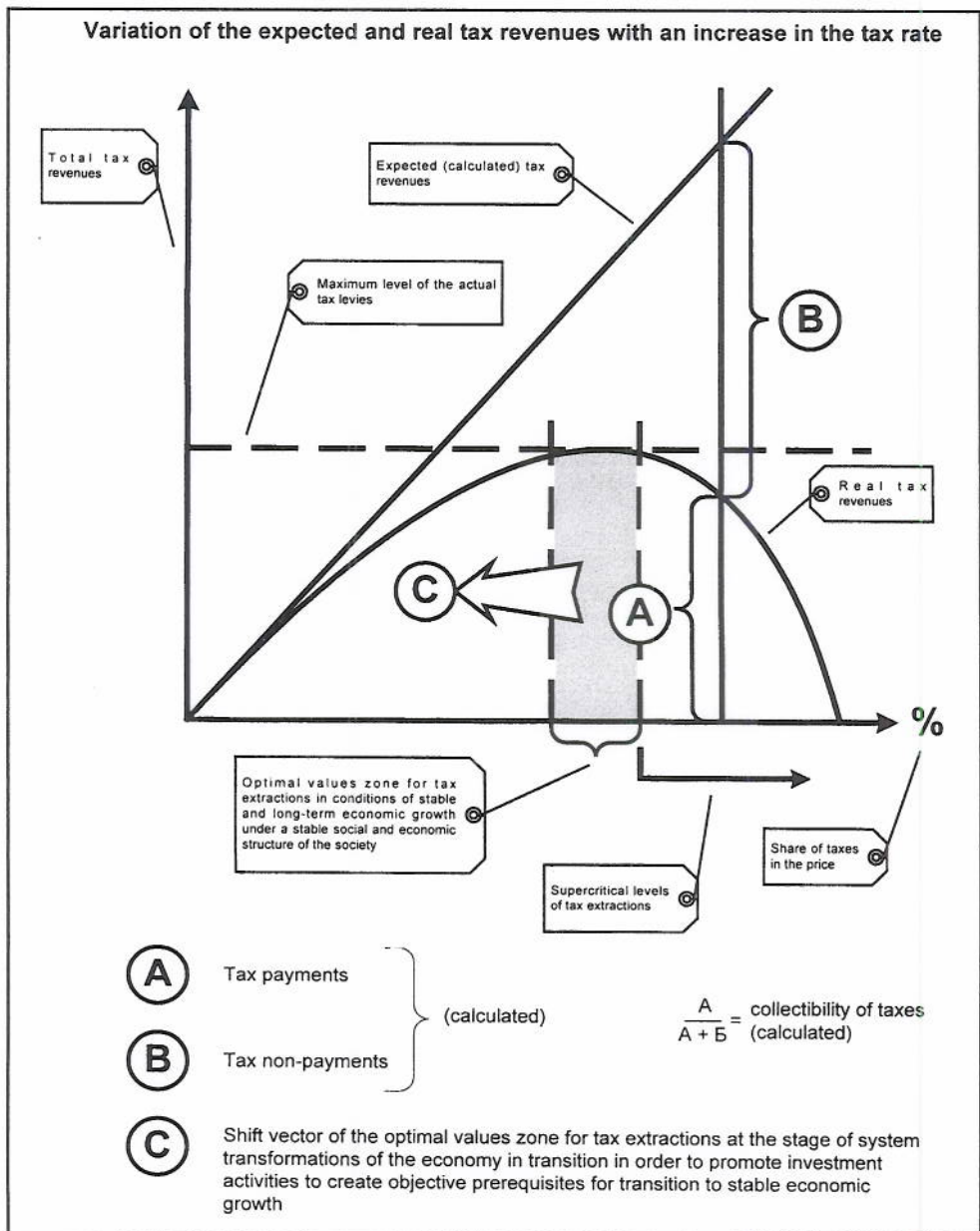
Apparently, attempts to ensure the balanced replacement of certain payments with other payments have never been made. Rather on the contrary, the terms accompanying the award of the IMF loan were used as grounds for a tightening of tax pressures on the oil industry. The incumbent administration, the only one among the election candidates, has the ability to secure economically, in some way or other, their socially oriented pre-election promises. The easiest way is to increase even further the tax load on those who are making the lion's share of payments to the budget (121 trillion roubles or around 35 percent of the total revenues of the federal budget in 1996 is estimated to come from fuel and energy enterprises).

Moreover, in the Russian government, as elsewhere, there is a natural conflict between departments. The Ministry of Finance usually stands up for increasing the tax burden on the oil industry, while the Ministry of Fuel and Energy wants to reduce it. As a result the figures and calculations of these departments frequently differ.

The Ministry of Finance calculations are unknown but, according to the estimates of the Ministry of Fuel and Energy, the additional 'tax' burden on the oil industry will be 21 trillion roubles, as the taxable base expands by three times because it applies to all oil production, not just to export deliveries.

Thus, using the IMF 'requirements' as a cover, the government is planning to obtain an additional 13 trillion roubles for budget revenue as a result of this simple manipulation. But in reality will the Russian budget receive this money?

The current tax system in Russia is already prohibitive – the percentage of tax in the wholesale oil price without VAT exceeds 60 percent (see **Table**). According to Lukoil, current taxes and charges in the sales price of the company



oil equals 67 percent, though their effective level need not exceed 25-35 percent.

Less revenue?

Under such conditions, the behaviour of tax-payers essentially differs from their behaviour under a 'favourable' tax environment. In the global economy, this effect is described by the 'Laffer's curve'

which shows that tax hikes for manufacturers and service providers first leads to an increase in tax revenues, while further rises over a certain critical point cause a totally different effect.

With taxes rising above the optimal level, many manufacturers will be either broken resulting in a reduction of the number of tax-payers, or squeezed out to the area of 'grey' busi-

ness where taxes are not paid at all. As a result, instead of tax revenue increasing, the state faces a reduction in tax collection, an increase in non-payment and consequently a reduction in budgetary revenues (see **Figure 1**).

In addition the main tax-payers are a large number of small enterprises and companies, which are very difficult to control and often able to dodge taxes. Meanwhile, large companies are always 'at the centre of attention', they are subject to permanent tax control and thus the problem of tax collection is resolved, with the main tax burden falling on such companies as Lukoil, Yukos, Surgutneftegas etc. This is why the 'excessive' tax pressure falls primarily on their shoulders.

However, on the other hand, these companies are the ones that bear the main investment load; they are the ones that implement the most capital-intensive investment projects. Thus, shouldering the main load of investment obligations, they are the ones, even if it might seem paradoxical, that may find themselves in the most difficult situation because of the so-called abolition of export duties.

The conclusions of the Budget and Finance Committee of the State Duma (budget subcommittee) on the consequences of the proposed tax changes are fairly realistic, as they correspond more to economic theory. O Dmitrieva, Chairman of the subcommittee, calculated the budget losses from export duty abolition as 17 trillion roubles. This was higher than the Ministry of Fuel and Energy's figure because the subcommittee made a comparison with the draft budget for 1996 in which it was decided to retain export duty rates and to increase gas export duty rates.

Moreover, the decision to increase excise duty rates on crude oil, gasoline prices, as well as to introduce increased tariffs for pipeline transit will result not in the growth of budget revenues but, according to Ms Dmitrieva, in the growth of non-payment and consequently in a reduction of budget revenues by 20 trillion roubles. As a result, instead of an increase of 13 trillion roubles, the budget will fall by 37 trillion roubles, which, on the basis of the subcommittee's calcula-

Major taxes paid by Russian oil companies

Type of Tax	1994	1995	1996 (Forecast)
Royalty (for the use of underground resources)	6-16% of the total proceeds (average - 8%)	6-16% of the total proceeds (average - 8%)	6-16% of the total proceeds (average - 8%)
VAT (value added tax)	23% of the total proceeds	21.5% of the total proceeds	20% of the total proceeds
Tax for rehabilitation of mineral resources	10% of the total proceeds less VAT, special tax and excise duty	10% of the total proceeds less VAT, special tax and excise duty	10% of the total proceeds less VAT, special tax and excise duty
Excise tax	0-25,000 roubles per tonne (average rate - 14,750 roubles per tonne)	20,000-50,000 per tonne (average rate - 39,200 roubles per tonne)	30,000-70,000 per tonne (average rate - 55,000 roubles per tonne); will grow after abolishment of export duty
Export duty	30 ecu per tonne	20 ecu per tonne	10 ecu per tonne; will be abolished after 1 July 1996
Property tax	up to 2% of fixed assets value	up to 2% of fixed assets value	up to 2% of fixed assets value
Profit tax (to the local budget)	up to 22% of balance profit	up to 22% of balance profit	up to 22% of balance profit
Profit tax (to the federal budget)	13% of balance of profit	13% of balance of profit	13% of balance of profit

tions, accounts for more than 10 percent of the federal budget revenues - or about 70 percent of the IMF loan.

Reduced investment?

This is the negative fiscal effect of excessive taxation pressure on producers. But there is a negative investment effect as well which implies that an increase in excise duties and tariffs for oil pumping, increasing the tax burden on producers and refiners, which becomes even higher with bigger volumes of production and refining, will lead to decreased production and refining volumes.

As a result, the oil industry might fail to reach the 301 million tonne production target forecast for 1996. This would mean that exports would also fall. As a result, prospects for budget revenue growth would be damaged at the expense of external borrowings from the IMF.

A decline in exports will reduce resources for the industry's self-financing in foreign currency and lessen its financial standing. It has already caused the appearance of comments 'in defense of the industry' aimed mostly not against the IMF credit but against the fund itself which is considered

responsible for the government's plans to replace export duties with other forms of taxation. Observers believe that the IMF proposals are aimed at undermining the Russian oil industry, weakening its competitive position and ousting its oil from the world market. The government is scarcely interested in feeding suspicions for further development of this theme, as the parallels between the government actions and the IMF requirements disclosed in these comments are too transparent.

When there is a lack of co-operation and even mutual understanding between the executive and the legislative, and especially in the situation when the majority of the State Duma consists of nationalistically-oriented opponents to the government, the charge that the government does not provide an independent economic policy but has just been following the 'obligatory demands' of the IMF does not improve the investment climate in this country and has been slowing down the transition to economic growth.

** In Russia a special 'mining excise payment' exists as a type of producer tax. This is not to be confused with the use of excise in other countries as a form of consumer tax.*

