

TAXATION OF THE RUSSIAN OIL INDUSTRY: A SYSTEMIC APPROACH TO REFORM

Material for consideration

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SUMMARY

At present, the taxation of the Russian oil industry is based on two taxes: mineral extraction tax (MET) and export duties on oil and petroleum products. The mineral extraction tax is purely the collection of revenue, whilst the export duties on oil and petroleum products play both a distributional role and a fiscal one. The very existence of export duties leads to a decrease of the domestic market prices for oil and petroleum products by the duties value, and the difference in the rates of export duties for oil and its products plays a significant role in the marginality of Russian refineries. In other words, the current system of oil export duties serves as an instrument of indirect revenue subsidy for both Russian consumers of petroleum products and the domestic petroleum refining industry.

The basic features of the system of taxation of the oil industry and that of the distribution of withdrawn funds were first developed in the mid-2000s. The current system of taxation has three main disadvantages:

- The first of these is the almost complete dependence of mineral extraction tax rates and oil export duties on the export price of Urals oil and, at the same time, the lack of connectivity of the taxes and duties to the actual financial results of the producing enterprise. Within the framework of such a system, the development of hard-to-reach deposits and those involving high-costs is unprofitable. As a result, the risks of a drop in oil production and a concomitant decrease in the amount of revenue received by the state from the oil industry inevitably increase with time. In order to avoid this, the state uses the targeted tax benefits tool of mineral extraction tax and/or export duties, which currently apply to many of the deposits. Although the introduction of targeted tax incentives have had a positive effect on the dynamics of oil production, the tax system itself has lost its universality and integrity, as well as become more difficult to administer and less predictable for investors.
- The second drawback is the revenue subsidisation of the Russian petroleum processing industry, which allows the continued operation of refineries, which are both technologically backward and unprofitable for the country's economy. Ideally, the operation of such refineries should be discontinued: they should either be modernised or shutdown.
- The third drawback is the positive dependence of the duty subsidy received by oil refineries on the price of Urals oil on foreign markets: the subsidy increases or decreases depending on whether the export price of the oil goes up or down. The unpredictability of the dynamics of oil prices, the possibility of their falling in value and consequently reducing subsidies create risks for investors in the petroleum processing industry and also influence the effectiveness of the industry tax reforming.

In this paper, it is demonstrated that the way to eliminate these defects and optimise the existing tax system of the industry is determined by the answers to two key questions:

- firstly – how should oil production be taxed, in order to maximize the amount of natural resource revenue “produced” by the industry over a reasonably long period of time;
- secondly – how is it best to manage that part of the revenue that today goes to oil refining sector and the consumers of petroleum products.

The general answer to the first question is as follows. Firstly, the desired tax system must satisfy those principles of integrity and universality, which are not being respected at present. Secondly, the new system must be flexible and adaptive to the specific conditions of oil production, which requires the introduction of a tax related to the financial result of the operation of the producing enterprise, and not one of existing revenue payments, tied to the volume of oil production and export. The need to fulfil both conditions is obvious: under the current taxation system, part of the oil revenue is not withdrawn by the state either because of unprofitable production (in which case, it “remains in the ground”), or because the tax burden on it is too low (in which case, it goes to the producing enterprise). Research by the state to develop concrete solutions in these areas has been going on for quite some time, but the results have not yet been shaped into legislation.

As for the fate of revenue subsidies, this issue found meaning during the process of developing two concepts for reforming the taxation system of the Russian oil industry – the concepts of IEF RAS, Ernst & Young, IHS CERA and the concept of the Gaidar Institute. The first of these was proposed in 2011, the second – in 2012, and it was these which provided the ideological basis for all the recent tax reforms affecting the industry. Reform “60-66-90” grew out of the IEF RAS, Ernst & Young and IHS CERA concepts, in which emphasis was placed on the first two problems; the reforms known as the “large” and “small” “tax manoeuvres” grew out of the concept of the Gaidar Institute, in which emphasis was put on the second problem.

Despite the obvious recognition that the above concepts have received within the industry, the ideas on which they are based are far from irrefutable, which calls into question their suitability as a basis for optimising the country’s economy by means of tax reform.

- Both concepts were aimed at stimulating the early closure of technologically backward refineries by reducing (in the first case) or completely abandoning (in the second) the revenue subsidisation of the Russian oil refining industry. The reasonableness of these measures was justified by the fact that most of the refineries were doomed to loss-making even had they been the subject of large-scale modernisation. However, as a more accurate analysis of the economics of Russian

refineries has revealed, these assumptions are not in fact valid. Allegedly, unpromising enterprises can, after having received extensive technical modernisation, still become profitable, even in the absence of a duty subsidy.

- In addition to removing the duty subsidy from oil refining, the Gaidar Institute's concept provided for complete curtailment of the practice of subsidising Russian consumers of petroleum products. Here, the authors proceeded from theoretical ideas that the increase in prices for petroleum products, which will inevitably follow abolition of the export duties on crude oil and petroleum products proposed in the work, will create incentives for the economic use of the latter. However, these theoretical assumptions were not supported by estimates of the magnitude of the expected effect. In fact, rising oil prices do not create significant incentives for their economic use. The calculations performed in this work suggest that the accumulated effect for the entire period of time after the abolition of duties amounts to a negligible 0.03–0.04% of Russian GDP in 2014, or about 140–220 roubles per head of population.
- Both concepts managed to ignore the important issue of effectiveness of the state in spending the revenues it collects. Apparently, it was immediately assumed that the state was able to best manage the duty subsidies taken from petroleum processors and the consumers of petroleum products within the framework of the regular budgetary process. But this hypothesis is incorrect. As shown in this study, Russia is characterised by its poor use of the oil revenues received by the state. Moreover, that use is so poor that the policy of increasing the state's share of total natural resource revenue from oil refining and petroleum product consumption, which has been a feature of all the tax reforms of the industry in recent years (and which has become an embodiment of the reform concepts discussed here), has led to negative consequences for the economic growth of the country. If the losses caused to the Russian economy by existing revenue subsidies account for 0.22% of Russian GDP (losses generated by Russian oil refining account for 0.18% of GDP, and losses from the non-energy-intensive consumption of petroleum products – 0.04% of GDP), then the full abolition of these subsidies with the associated transfer of funds released to the state will increase these losses to 0.57% of GDP.

In the present work, an attempt is made to find and substantiate a truly optimal solution to the problem of distributing natural resource revenue. Conceptually, the solution looks like this:

- The share of the state in the total volume of oil revenue, which it has at its disposal today, should remain unchanged. The meaning of this restriction is obvious – the reform should not lead to a reduction in budget revenues, which serve as a source of financing social welfare and public good, such as education, healthcare, national defence, etc. It must

be emphasised that we are talking here about minimum share, and not about the absolute value of the income revenue of the state, which may vary depending on the changing circumstances of the global oil market.

- The share of oil revenue that currently goes to the oil refining industry and to consumers of petroleum products should be fully transferred in cash to the Russian population. In this work, it is demonstrated that given the effectiveness of the state in spending the income revenue it receives, this is the only reasonable option among all those which assume the zeroing of export duties on oil and petroleum products – and thus eliminate the possibility of sustaining the operation of economically unprofitable enterprises in the areas of the production and consumption of petroleum products. Moreover, such a solution would allow:
 - equality of the rights of all citizens to benefit from natural resource revenue to be observed. Unlike fuel subsidies, the benefits of which, as shown in the study, are received to a greater extent by the richer segments of the population, with this option, all the citizens of Russia would on an equal basis be able to claim that part of the resource income that would be directed by the state to directly subsidise the population. The obvious justice of this option could make this reform popular (and even, in a good way, populist), given how strongly the phenomenon of “resource nationalism” is manifesting itself in Russia;
 - reduce poverty and the income inequality of the population. A fairer redistribution of part of the revenue that is currently being handed over to the population (in the form of fuel subsidies), with the addition of the revenue that is currently being received by the oil refining and petroleum product consuming industries, would be a way of reducing poverty and at the same time income inequality. Among other things, it could contribute to the economic growth of the country.

In order to achieve these objectives, export duties on oil and petroleum products should be abolished. That part of the natural resource income released as a result of such a manoeuvre migrates to oil production, from where it can already be withdrawn by the state (staying within the framework of the existing oil production paradigm, this can be done, for example, by increasing the mineral extraction tax by an amount equal to the abolished export duty on oil and transferring the existing oil production tax benefits to a “new” mineral extraction tax). The state would then redistribute the additional income revenue received to the direct benefit of the entire population.

Any transition to a new tax system should occur gradually. The key question here is how to minimize the negative effects for the country’s economy arising from the withdrawal of revenue subsidies from those sectors currently consuming and producing petroleum products.

- With regard to oil refining, the following circumstances must be taken into account. Those Russian refineries which are currently unprofitable should, as mentioned above, be modernised and then be given the opportunity to become profitable in the absence of any subsidy. This being said, the modernisation of unprofitable enterprises, which would be beneficial for the Russian economy as a whole, might be considered by business to be too precarious investment project. If the strategic objectives of the reform – the abolition of export duties on oil and petroleum products – are carried out simultaneously and without the creation of any additional incentive for the investor, it is more than likely that, instead of the enterprise being modernised, it will be shutdown and taken out of service.
- The extraction of petroleum natural resource income in those sectors of the economy consuming petroleum products should be carried out as cautiously as in the oil refining industry. When selecting the withdrawal tactics, it is essential to have a clear idea of how termination of the revenue subsidies can affect the development of these industries and the Russian economy as a whole

Strategies for achieving tax reform objectives involve timing, the setting of deadlines for each stage of the reform, the tax parameters to be used at each stage of the reform, arranging government support measures for the most vulnerable sectors of the economy, etc. In particular, it is essential:

- to select a methodology and tooling which will stimulate refinery modernisation;
- to carry out research on the need for temporary subsidies (revenue or other) for those sectors of the economy consuming petroleum products and, where such needs are identified, develop specific subsidisation mechanisms;
- to develop the mechanisms by which part of the revenue from oil is to be transferred to the population and determine the period during which such mechanisms will be introduced.

These are tasks that can and should be solved if the concept of reforming the system of collection and distribution of oil revenue proposed in this work is accepted and the reforms are to be taken from the realm of the theoretical to that of the practical.



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