

## **CAN RUSSIA BECOME AN OIL PARADISE?**

**The idea that natural resources are the single, irreplaceable source of national prosperity is taking hold of society**

**By Vladimir Milov**

The recent actions of Russian authorities seemingly indicate they have chosen to make Russia a “petrostate.” This term describes hydrocarbon-rich states in which the way of life and government policy are heavily subject to the influence of oil and gas.

Several years of stable high prices for oil and gas on international markets have had their effect, changing the priorities of Russian policy. The economic reforms declared as the main agenda item for President Vladimir Putin’s first term are practically dead, having given way to the so-called “national projects.” These are initiatives of a primarily redistributive character, connected with either direct or indirect state support for several sectors of the economy and social life, and funded with the proceeds from oil and gas exports.

The dominance of energy is also increasing in foreign policy questions—from its active use in relationships with the former socialist countries and post-Soviet republics to its inclusion in the agenda for the G8 summit. The authorities, first of all Putin personally, devote heightened attention to various oil and gas problems: strengthening the market and political status of state energy companies like Gazprom and Rosneft, the initiation of new oil and gas projects, and active state p. r. on the energy theme, particularly positive news connected to the distribution of revenue from oil and gas exports. All this indicates that the petrostate concept is transforming into a definite philosophical (akin to a national) idea and becoming the main vector of Russian foreign and domestic policy.

### **The “Petrostate” as National Idea**

To a large extent this course of events is natural. A state with many economic and social problems has suddenly got hold of gigantic revenues (steadily growing over several years) from the export of oil and gas. Recall that from 1992 to 1999 the world price for Brent crude averaged US\$22.50 in 2005 dollars (\$17.60 in nominal terms), and from 2000 to 2005 it averaged \$35.40 in 2005 dollars.

“As though Yeltsin would have introduced reforms if such prices had occurred in his time?” sadly exclaimed one politician involved in implementing the liberal reforms of the 1990s. Truly, many difficulties that earlier seemed insurmountable have been resolved without visible effort. “Remember how much we talked in our time about the 2003 peak in payments on external debt, and even frightened each other: how would it affect the life of the country, and could the government cope with its social obligations to the population? We’ve paid 17 billion dollars—the country hasn’t even noticed,” Vladimir Putin approvingly commented.<sup>1</sup> On June 2, 2006, the hard-currency reserves of the Central Bank comprised \$247 billion and the Stabilization Fund is projected to grow to \$100 billion by 2008.

For politicians it is difficult not to give in to the temptation to use Russia’s comparative advantage—enormous reserves of scarce natural resources, the value of which on world markets continuously grows—not only to resolve socio-economic

problems, but also to form a new state ideology, which holds that proceeds from hydrocarbon exports are a source of national strength and a dependable means for resolving any problem. Not by chance did Deputy Chief of the Presidential Administration Vladislav Surkov, speaking on February 7, 2006 before United Russia party activists, announce, “We need to choose that which will work for us, and simply do it better. The concept of Russia as an energy superpower, it seems to me, fully corresponds to this approach. If you have strong legs, you should compete in the long jump, not play chess.”<sup>2</sup>

The question, however, is this: does this claim have any economic basis?

### **Blessing or Curse?**

Enough has been written about the “oil curse”—the negative consequences of economic dependence on hydrocarbon exports. Likewise there has been much about “Dutch disease” (domestic industry’s loss of competitiveness as the result of flows of petrodollars into an oil-exporting country, the growth of wages and costs, and appreciation of the national currency), and the loss of political stimulus for the elite to improve economic and social policy (because it limits itself to redistribution of revenues from oil and gas exports, which requires much less effort). Russia has seen all these phenomena in recent years, accompanied by an alarming decline in the quality of government administration.

The impression arises that the tremendous possibilities opened up by the flood of petrodollars have pushed the goal of long-term growth and the risk of future difficulties into the background. One cannot exclude the possibility that oil prices will really remain high for a long time. This will allow the state (as it has done before) to hush up the problems that, in my opinion, will inevitably arise in the future as the result of the “oil curse.”

However we will look at this problem in a somewhat different way. Is it *possible in principle* to create in Russia a state, however faulty from the point of view of economic theory, but nonetheless relatively economically successful, able for a time to favor its citizens by distributing petrodollars (directly or in the form of financing for different development projects)? In the end, the arguments of those agitating for directing revenues from hydrocarbon exports “to the goals of economic development and social needs” basically converge on the thesis that, as they say, it would be stupid not to use the oil country’s oil wealth in the national interest and not to support the population, poor and weary of economic difficulties, using hydrocarbon revenues.

Supporters of the concept of an “oil blessing” invoke as examples to be imitated relatively prosperous countries, with high standards of living, that have built their success exclusively on redistribution of revenues from oil and gas exports. The conversation turns to Norway, the United Arab Emirates (UAE), Kuwait, Qatar, and Saudi Arabia. The high standard of living in these countries mostly relies on state subsidies that have an openly paternalistic character—like free stipends for their citizens and the provision of a wide spectrum of social services. So, in February of this year the chairman of the National Audit Office, Sergei Stepashin, one of the active converts to spending the income from hydrocarbon exports on social needs, invoked as an example Norway, which generously finances social programs using petrodollars. In the process Stepashin called Norway “a country of victorious developed socialism” (though he clarified that “the Norwegians don’t realize this”).<sup>3</sup>

Many populist politicians put paternalism at the center of their political programs. For example, in the program of Sergei Glaziev’s “For a Respectable Life!” party, which

bears the eloquent name “Social Justice and Economic Growth,” one reads: “Use of such significant revenues, created through exploitation of natural resources belonging to the state, in the national interest, would overcome the chronic budget crisis and provide for the fulfillment of all the state’s social obligations... The aforementioned and other instruments of returning resource rents to the coffers of the state, as the owner of natural resources, have been successfully applied around the world, and will allow the state budget to grow by a factor of at least 1.5 in the near future.”<sup>4</sup>

The figures show that announcements on the supposed possibilities for using petrodollars to resolve all Russian social problems or achieve substantial modernization of the country are nothing more than illusions. The truth is that comparisons of Russia with such “petrostates” as Norway, the UAE, Kuwait, Qatar, and Saudi Arabia, if they have in mind a model for socio-economic policy, are *systematically incorrect*. There is at least one substantial reason not to put Russia in a class with the aforementioned countries. This reason is very simple: construction of a successful petrostate, analogous to those mentioned above, is impossible because Russia’s population is *too large*.

### **Population—Enemy Number One for a Petrostate**

Surprisingly, in analyzing development problems in oil-producing countries many experts concentrate on the quality of economic policy and institutions, rather than on such an elementary factor as the quantitative sufficiency of resources for ambitious programs. The accent in an article by Moises Naim is typical. He writes, “Petrostates are oil-rich countries plagued by weak institutions, a poorly functioning public sector, and a high concentration of power and wealth. The gulf between a petrostate’s rich natural resources and the chronic poverty of its citizens often leads to political unrest and frustration.”<sup>5</sup> Yegor Gaidar strikes a similar note: “The chances of creating...reliable institutions, which allow for the limitation of corruption and arbitrariness among the authorities and civil servants, are much less in resource-rich countries than in those without such resources.”<sup>6</sup>

Of course the quality of economic policy is an important factor. However no less meaningful is the very possession of hydrocarbon resources in a quantity that provides at least the hypothetical possibility of building an effective petrostate in a country with a large population. Economists usually measure the resource base of such countries using the share of natural resources in exports or GDP. But to really assess the potential for oil and gas to facilitate a prosperous petrostate other figures are needed—the figures for hydrocarbon extraction and export per capita.

A simple comparison of petrostates by hydrocarbon extraction and export per capita yields a very illuminating picture. Such countries clearly divide into two groups. In the first are those that have really succeeded in achieving fairly high indicators of economic development based on oil and gas exports. They have per capita GDP—in 2004 dollars by purchasing power parities (PPP)—of \$20 thousand or greater (Norway, UAE, Kuwait, Qatar) or at least \$10-15 thousand (Saudi Arabia, Oman, Libya). The distinguishing feature of all these countries is that they have not more than 5 million people (the exception is Saudi Arabia with its more than 24 million residents, but its oil and gas potential, one must note, is incomparably larger than that of the others). For each citizen in the more successful petrostates there is annual extraction of more than 50 tons of hydrocarbons, in the “marginal” countries of the group 15 to 25 tons.

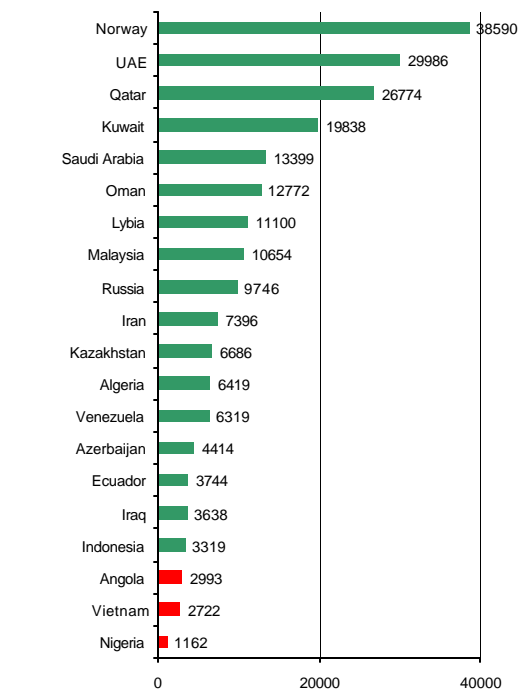
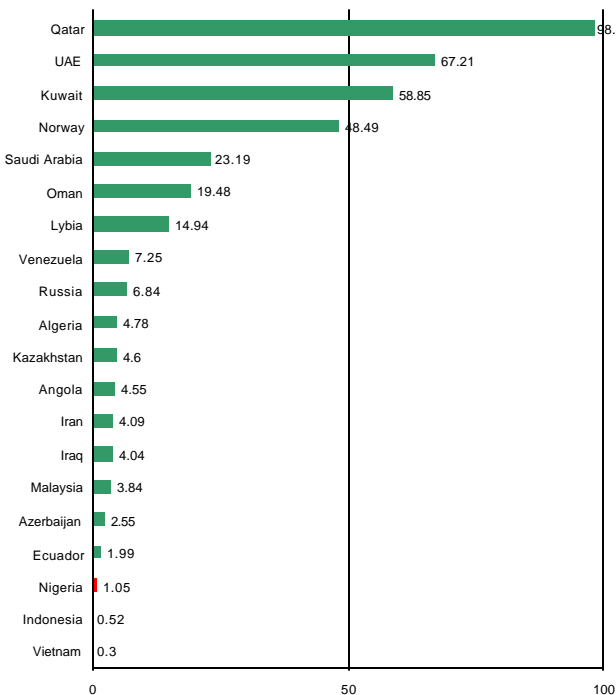
The second group lags noticeably in its level of economic development, despite the large quantities of hydrocarbons extracted in absolute terms. In such countries, like

Venezuela, Iran, Iraq, and Nigeria, despite their role on the world oil market (where each is responsible for 3-5 percent of world production), GDP per capita by PPP is stable below \$10 thousand per year. Russia is no exception, though its share of world oil production is significantly higher (almost 12 percent), not to mention that Russia, unlike other petrostates, produces not only oil, but also gas (in the aggregate approximately one billion tons of oil equivalent per year). On the charts below it is clear that the correlation between the per capita quantity of hydrocarbons extracted and per capita GDP is as direct as can be.

**Fig. 1**

***Annual Hydrocarbon Extraction and GDP per Capita in Different Petrostates***

Annual hydrocarbon extraction (in tons of oil equivalent) per capita, 2004



Sources: BP, IEA, CIA

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In other words, not one country with significantly more than 5 million people has attained an acceptable standard of living, with the exception of Saudi Arabia. That country has done so thanks to being number one in world hydrocarbon extraction and thanks to its relatively low domestic energy use. But even with those advantages Saudi Arabia's results are not among the best.

Only a few states with modest populations are really capable of resolving socio-economic problems on a national scale using only oil and gas exports. What does this mean? In the other countries, even those that produce quite a bit of oil and gas as a share of the world market, there just aren't enough resources to provide an acceptable standard of living *solely* based on oil and gas. But, as has been noted, the ease of concentrating resource rents causes the authorities to lower the quality of economic

policy, which worsens the development indicators. In this way, in the majority of oil-producing countries the “oil curse” reliably runs its course, while the “oil blessing” turns out to be an unattainable dream.

But that’s not all. Russia, unlike many Middle Eastern, African and Latin American countries, is a highly industrialized power with vast territory, which demands the maintenance of energy-consuming transport infrastructure. And this in turn facilitates the growth of domestic demand for energy. In the aggregate the Russian economy uses almost 500 million tons of hydrocarbons (oil and gas converted into oil equivalent) per year, which is the same as the total annual production of Saudi Arabia. Almost 60 percent of that is used by energy-intensive industry and transport.

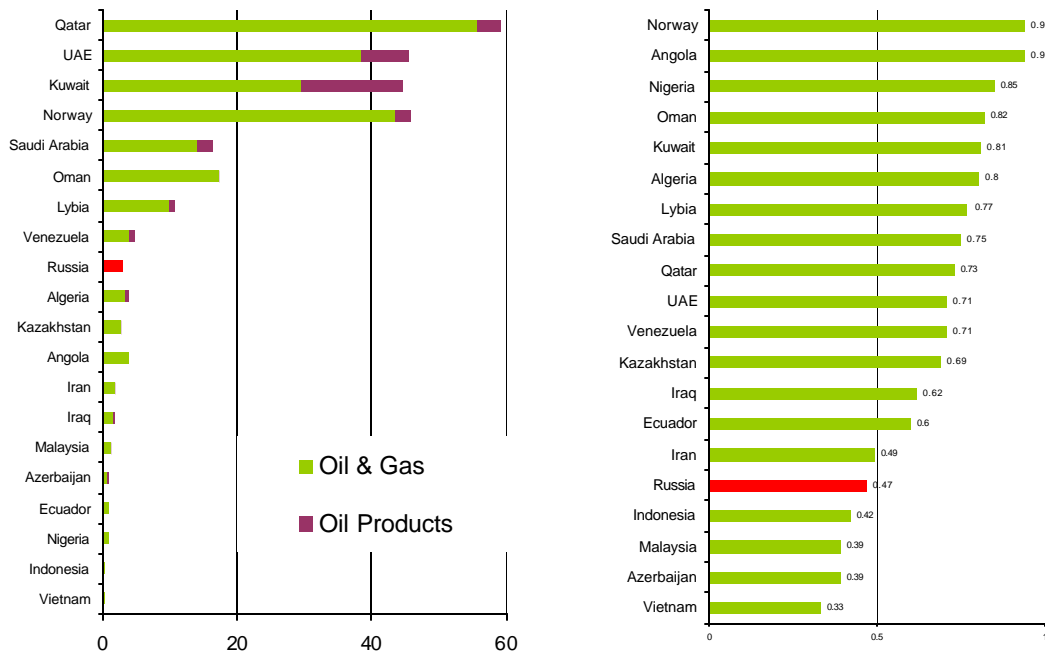
It is thus unsurprising that as a result the annual physical volume of oil and gas exports is only about 3 tons of oil equivalent per Russian (according to 2004 totals). On the list of petrostates according to the relationship between exports and domestic use Russia occupies one of the last places. This means that our ability to convert national hydrocarbon potential into national prosperity is limited.

**Fig. 2**

***Annual Hydrocarbon Exports per Capita and the Relationship of Hydrocarbon Exports to Domestic Use in Different Petrostates***

Annual hydrocarbon exports (in tons of oil equivalent) per capita, 2003

Ratio of hydrocarbon exports (in tons of oil equivalent) to domestic hydrocarbon consumption, 2003



Sources: BP, IEA, CIA

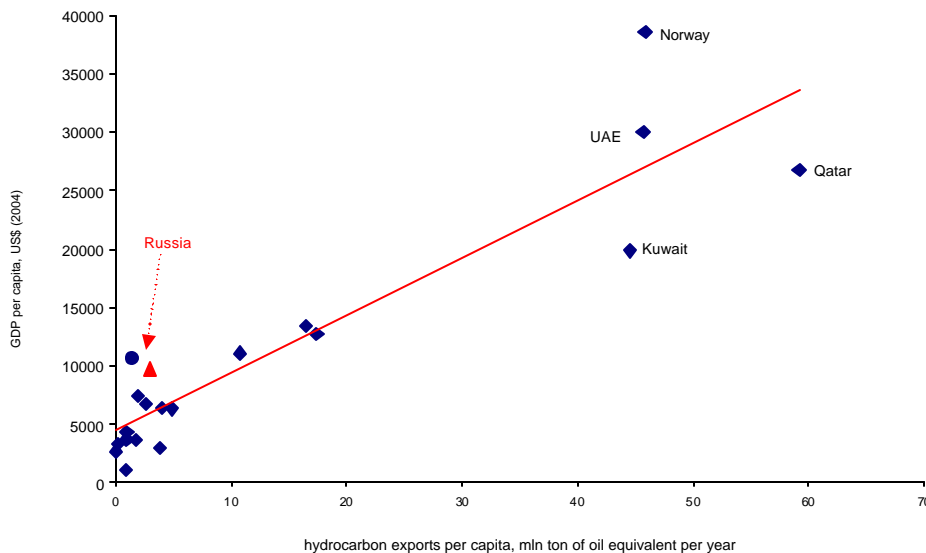
What can you do, exporting only three tons of oil equivalent per capita annually? An elementary calculation shows that even with today’s super-high world price of \$60 per barrel of Russian oil, allowing for different costs of extraction and transportation,

and including at least minimal capital expenditures (the necessity of which even such populists as Glaziev recognize), the net profit from exporting those three tons is only \$990 per year, or just over \$82 per month.

Obviously these sums are barely adequate to sustain the existing situation, but not for achieving national prosperity or fixing large-scale social problems. Moreover the withdrawal of even these relatively modest sums from the oil and gas sector will lead to it facilitating, in the best case, only replacement of basic capital, and that only for a while. Forget about qualitative development and realization of new large-scale projects—within a few years the potential of the oil and gas sector will be exhausted. An analogous picture appears in all petrostates with a population of more than 20 million. As is apparent from the chart, per capita GDP greater than \$10 thousand occurs only in petrostates that export not less than 10 to 20 tons of hydrocarbons per capita annually. For Russia such a level is unattainable.

**Fig. 3**

### **Hydrocarbon Exports per Capita and GDP per Capita in Petrostates**



The four most prosperous countries—Norway, the UAE, Kuwait, and Qatar—occupy a special place. As a rule, proponents of using petrodollars for social and investment needs invoke these four as examples. Truly, these countries can boast not only of high per capita GDP and standards of living, but also of successful investment mechanisms for hydrocarbon export revenue and attractive social benefit systems. But make no mistake: such successes are not the result of the greater effectiveness or high quality of these countries' economic policies. It's simply that their resource endowments are an order of magnitude greater than those of the other oil-producing states. This is unsurprising with such small populations (in Qatar—less than 1 million, in Kuwait—still less, in the UAE—just over 3 million, and in Norway—less than 5 million). These countries are simply bursting with resources.

Nigeria is another matter. Economists love to introduce this country as a negative example of a petrostate, in which ineffective governance and the absence of functioning institutions has for 40 years prevented growth of per capita GDP by PPP:

it has stagnated around \$1000, despite high revenues from oil exports. However, with a population of more than 130 million and moderate oil and gas potential, if government policy relies *solely* on oil, no other result is possible.

The conclusion is self-evident. If you export not more than 2 to 3 tons of hydrocarbons per capita annually, there's no point in thinking about "energy superpower" as a national idea. Revenues from the sale of that quantity of oil and gas resources do not suffice even for the elementary needs of citizens, let alone achievement of ambitious political goals. The high absolute quantities of hydrocarbon resources and revenues, expressed in millions of tons and billions of dollars, should not fool anyone.

### **The Curse is in The ir Heads**

So applying the term "petrostate" to all large oil producers is not entirely correct. Petrostates, as we have seen, clearly divide into two unequal groups: countries where low population allows the state to capitalize on high revenues from hydrocarbon exports, and countries where these revenues barely suffice for satisfying the nation's minimal current needs and the appetites of state officials.

Russia belongs to the second group. A large population and elevated domestic energy consumption practically foreclose the road to "petro-happiness." The question of whether use of hydrocarbon export revenues for certain modernization projects is justified may still be a subject of conversation (although there are more than a few partisans of a more cautious approach to the "petro-riches"). But the question of large-scale modernization of Russia using its energy potential should be considered closed. *It is impossible, and there are not enough resources for it.*

Does the Russian leadership understand the limited character of the national oil and gas potential? For now there are serious doubts on that score. There is an obvious slant toward strengthening the hydrocarbon factor in domestic and foreign policy. Moreover the appearance of symptoms of "ideological framing" of the energy superpower concept gives rise to the thought that the possibilities opened to Russia by high oil and gas prices have completely obscured other ideas and directions for state policy.

Here are Putin's words, from a December 27, 2005 speech before the Security Council of the Russian Federation, on the role of energy in the Russian economy and strengthening Russia's world position: "Energy is, at least today, the most important motive force of world economic progress. The present and future prosperity of Russia depends directly on the place we occupy in the global energy context. Claiming leadership in world energy is an ambitious task... Such a large -scale task will become a serious catalyst for the modernization and qualitative development of the entire economy of the Russian Federation."<sup>7</sup>

The growing hypertrophy of the fuel-resource complex in economic policy is also apparent in the numbers: according to data from the Ministry of Finance of the Russian Federation, the share of the tax on use of natural resources in federal tax revenues has grown from 7.8 to 16 percent, which has sharply increased the influence of the oil and gas factor on the budget balance. Also revealing is that for realization of the four priority national projects ("Modern Health Care," "Quality Education," "Affordable Housing," and "Effective Agriculture") the state promises—including non-budget sources—to spend 180 billion rubles, or \$6.4 billion at the current exchange rate. The state indirectly spent \$7.15 billion on the purchase of a controlling

interest in Gazprom, and it has allocated tens of billions of dollars in the coming years for a range of new large energy projects, like new oil and gas pipelines.

Thus oil and gas have become the most important priorities for economic policy, and the remaining spheres of national life increasingly depend on hydrocarbon exports. Basically the state has officially declared the resource orientation of the Russian economy as the foundation of its economic, social, and foreign policy, and even its state ideology. In essence, the idea that natural resources are the single, irreplaceable source of national prosperity is taking hold of society.

Such a view is obviously bankrupt, because there simply aren't enough resources for the declared development model to work. The financial resources accumulated as hard currency reserves in the Central Bank and the Stabilization Fund make an impression, leading many representatives of the state and society to concentrate on redistribution of the riches. But in the context of the urgent problems facing Russia, these sums are not so large. The country needs too much capital investment. For example, the transport strategy confirmed by the authorities in May 2005 assesses annual investment needs to 2010 at more than \$20 billion in this sphere alone.<sup>8</sup> Actually around \$10 billion is being invested annually. For this reason, if it were decided, say, to spend the Stabilization Fund on covering the funding gap in transport infrastructure, then the accumulated sums would be enough for only five years. And there are other needs like the modernization of the army and social infrastructure, the realization of the "national projects" in health care and education, and a whole lot more...

Without doubt Russia has alternatives. If the authorities introduced appropriate policies to reduce the state share in the economy and remove regulatory barriers—and this goal was supposedly declared at the outset of Putin's first term—then Russian business, denied access to petro-wealth, would be able to rapidly adapt to the conditions of global competition and provide high rates of economic growth. To this day Russia remains a fairly diversified economy, in which the share of oil and gas in GDP is only 9 percent, and even if one accepts the higher assessments, considering the influence of transfer pricing,<sup>9</sup> that share is not greater than 25 percent. Today the authorities, intensifying pressure on entrepreneurs at all levels, are practically depriving national business of this possibility, giving full economic freedom only to state energy companies.

The "resource curse" has its roots in Russian politicians' way of thinking.

One hopes Russia will break out of this vicious circle of psychological and political dependence on oil and gas, having fully understood the insufficiency of its hydrocarbon resources for successful realization of the petrostate concept. Then we will all get the chance to play chess, contrary to the desire of certain Kremlin ideologues to make us all compete in the long jump.

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#### Notes

<sup>1</sup> *Television program* "Direct Line with the President of Russia." 2003. 18 December.

<sup>2</sup> *Speech* of the Deputy Chair of the Presidential Administration V. Surkov before an audience at the Center for Party Studies and Preparation of Party Cadres of "United Russia." 2006. 7 February. (<http://www.edinros.ru/news.html?id=111148>).

<sup>3</sup> See: *Trud*. ? 20. 2006. 7 ?????. (<http://www.trud.ru/trud.php?id=200602070200103>).

<sup>4</sup> See: <http://www.zdj.ru/documents/155/>

<sup>5</sup> *Naim M.* If Geology Is Destiny, Then Russia Is in Trouble // *The New York Times*. 2003. Dec. 4 (<http://www.nytimes.com/2003/12/04/opinion/04NAIM.html?ex=1071547802&ei=1&en=ecf60aed7ef58a9a>).

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<sup>6</sup> *Gaidar Y. The Oil Curse// Gaidar Y. End of an Empire: Lessons for Contemporary Russia* (<http://ej.ru>).

<sup>7</sup> *Introduction* of Russian President V. Putin at a session of the Security Council on the question of Russia's role in providing international energy security. Moscow, 2005. 22 December.

<sup>8</sup> *Order* of the Ministry of Transport of the Russian Federation from 12 May 2005, ? 45, "On Confirmation of the Transport Strategy of the Russian Federation to 2020."

<sup>9</sup> *Riul' K., Shafer M. Potemkin GDP // Vedomosti* ? 29. 2004. 19 February. For details see Russian Economic Report. The World Bank 2004. Feb. ? 7. The idea is that because of resale of oil by subdivisions of oil companies (which buy it from the extracting subdivisions) part of the national value added falls under "trade and services." As a result the share of trade in GDP is elevated. But if the companies producing oil immediately sold it at market prices, the share of the oil and gas extraction sector in GDP would be perhaps 25 percent, rather than the 8-9 percent we see. In other words, part of the oil trade reflected in GDP is actually just resale by one subdivision of a vertically integrated oil company to other subdivisions of that same company.

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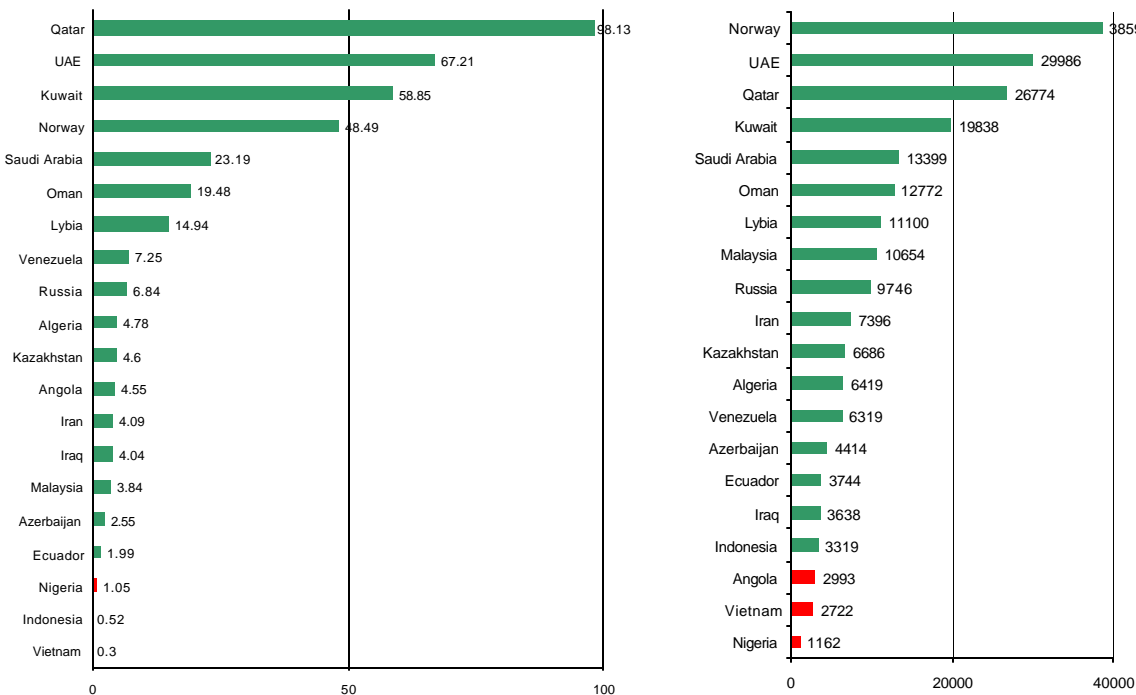
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**Fig. 1**

***Annual Hydrocarbon Extraction and GDP per Capita in Different Petrostates***

Annual hydrocarbon extraction (in tons of oil equivalent) per capita, 2004  
 GDP per capita, 2004, in 2004 dollars by PPP



Sources: BP, IEA, CIA

Sources: The World Bank, IMF, CIA

In other words, not one country with significantly more than 5 million people has attained an acceptable standard of living, with the exception of Saudi Arabia. That country has done so thanks to being number one in world hydrocarbon extraction and thanks to its relatively low domestic energy use. But even with those advantages Saudi Arabia's results are not among the best.

Only a few states with modest populations are really capable of resolving socio-economic problems on a national scale using only oil and gas exports. What does this mean? In the other countries, even those that produce quite a bit of oil and gas as a share of the world market, there just aren't enough resources to provide an acceptable standard of living *solely* based on oil and gas. But, as has been noted, the ease of concentrating resource rents causes the authorities to lower the quality of economic

policy, which worsens the development indicators. In this way, in the majority of oil-producing countries the “oil curse” reliably runs its course, while the “oil blessing” turns out to be an unattainable dream.

But that’s not all. Russia, unlike many Middle Eastern, African and Latin American countries, is a highly industrialized power with vast territory, which demands the maintenance of energy-consuming transport infrastructure. And this in turn facilitates the growth of domestic demand for energy. In the aggregate the Russian economy uses almost 500 million tons of hydrocarbons (oil and gas converted into oil equivalent) per year, which is the same as the total annual production of Saudi Arabia. Almost 60 percent of that is used by energy-intensive industry and transport.

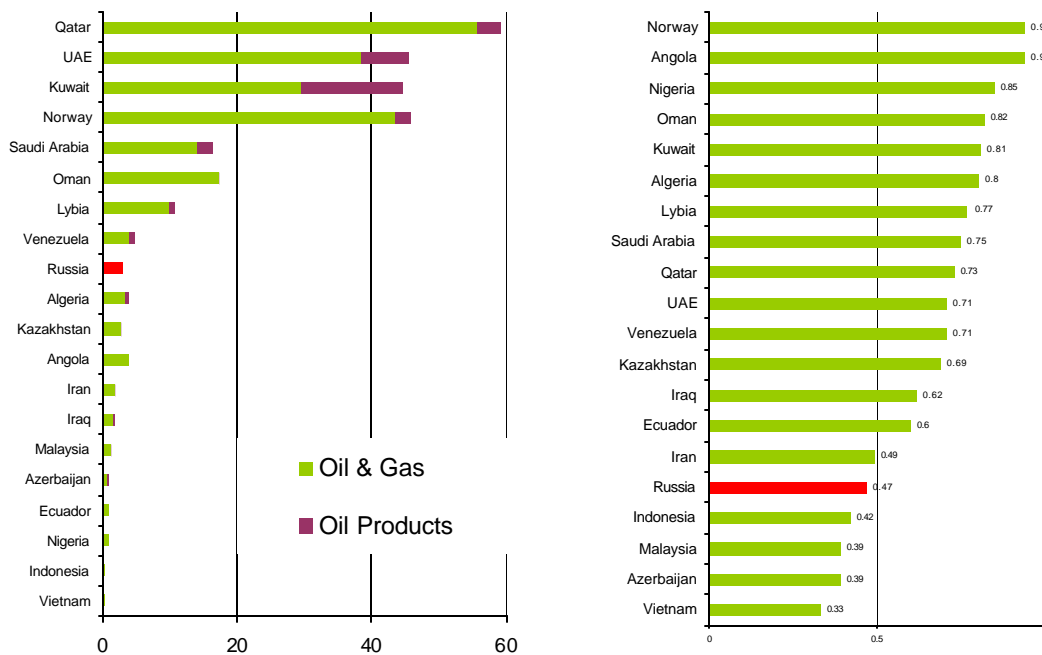
It is thus unsurprising that as a result the annual physical volume of oil and gas exports is only about 3 tons of oil equivalent per Russian (according to 2004 totals). On the list of petrostates according to the relationship between exports and domestic use Russia occupies one of the last places. This means that our ability to convert national hydrocarbon potential into national prosperity is limited.

**Fig. 2**

***Annual Hydrocarbon Exports per Capita and the Relationship of Hydrocarbon Exports to Domestic Use in Different Petrostates***

Annual hydrocarbon exports (in tons of oil equivalent) per capita, 2003

Ratio of hydrocarbon exports (in tons of oil equivalent) to domestic hydrocarbon consumption, 2003



Sources: BP, IEA, CIA

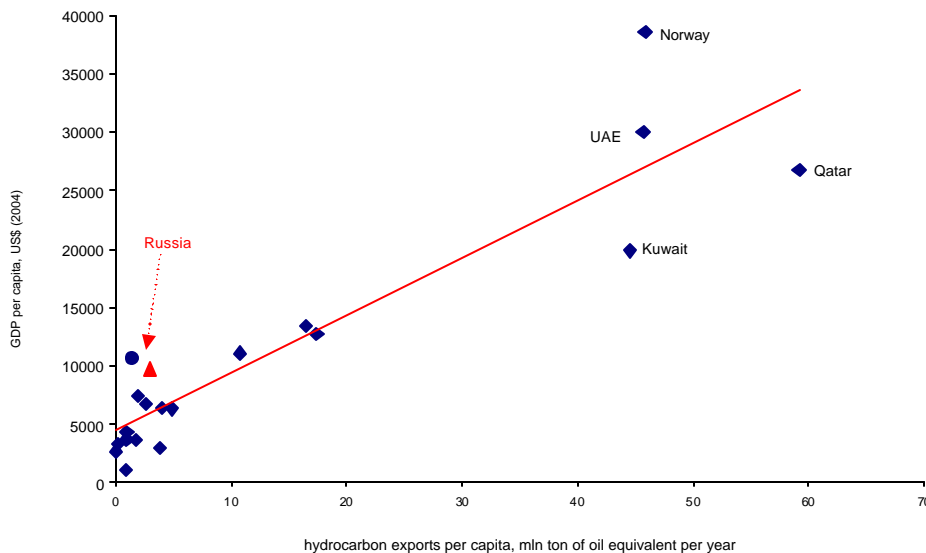
What can you do, exporting only three tons of oil equivalent per capita annually? An elementary calculation shows that even with today’s super-high world price of \$60 per barrel of Russian oil, allowing for different costs of extraction and transportation,

and including at least minimal capital expenditures (the necessity of which even such populists as Glaziev recognize), the net profit from exporting those three tons is only \$990 per year, or just over \$82 per month.

Obviously these sums are barely adequate to sustain the existing situation, but not for achieving national prosperity or fixing large-scale social problems. Moreover the withdrawal of even these relatively modest sums from the oil and gas sector will lead to it facilitating, in the best case, only replacement of basic capital, and that only for a while. Forget about qualitative development and realization of new large-scale projects—within a few years the potential of the oil and gas sector will be exhausted. An analogous picture appears in all petrostates with a population of more than 20 million. As is apparent from the chart, per capita GDP greater than \$10 thousand occurs only in petrostates that export not less than 10 to 20 tons of hydrocarbons per capita annually. For Russia such a level is unattainable.

**Fig. 3**

### Hydrocarbon Exports per Capita and GDP per Capita in Petrostates



The four most prosperous countries—Norway, the UAE, Kuwait, and Qatar—occupy a special place. As a rule, proponents of using petrodollars for social and investment needs invoke these four as examples. Truly, these countries can boast not only of high per capita GDP and standards of living, but also of successful investment mechanisms for hydrocarbon export revenue and attractive social benefit systems. But make no mistake: such successes are not the result of the greater effectiveness or high quality of these countries' economic policies. It's simply that their resource endowments are an order of magnitude greater than those of the other oil-producing states. This is unsurprising with such small populations (in Qatar—less than 1 million, in Kuwait—still less, in the UAE—just over 3 million, and in Norway—less than 5 million). These countries are simply bursting with resources.

Nigeria is another matter. Economists love to introduce this country as a negative example of a petrostate, in which ineffective governance and the absence of functioning institutions has for 40 years prevented growth of per capita GDP by PPP:

it has stagnated around \$1000, despite high revenues from oil exports. However, with a population of more than 130 million and moderate oil and gas potential, if government policy relies *solely* on oil, no other result is possible.

The conclusion is self-evident. If you export not more than 2 to 3 tons of hydrocarbons per capita annually, there's no point in thinking about "energy superpower" as a national idea. Revenues from the sale of that quantity of oil and gas resources do not suffice even for the elementary needs of citizens, let alone achievement of ambitious political goals. The high absolute quantities of hydrocarbon resources and revenues, expressed in millions of tons and billions of dollars, should not fool anyone.

### **The Curse is in The ir Heads**

So applying the term "petrostate" to all large oil producers is not entirely correct. Petrostates, as we have seen, clearly divide into two unequal groups: countries where low population allows the state to capitalize on high revenues from hydrocarbon exports, and countries where these revenues barely suffice for satisfying the nation's minimal current needs and the appetites of state officials.

Russia belongs to the second group. A large population and elevated domestic energy consumption practically foreclose the road to "petro-happiness." The question of whether use of hydrocarbon export revenues for certain modernization projects is justified may still be a subject of conversation (although there are more than a few partisans of a more cautious approach to the "petro-riches"). But the question of large-scale modernization of Russia using its energy potential should be considered closed. *It is impossible, and there are not enough resources for it.*

Does the Russian leadership understand the limited character of the national oil and gas potential? For now there are serious doubts on that score. There is an obvious slant toward strengthening the hydrocarbon factor in domestic and foreign policy. Moreover the appearance of symptoms of "ideological framing" of the energy superpower concept gives rise to the thought that the possibilities opened to Russia by high oil and gas prices have completely obscured other ideas and directions for state policy.

Here are Putin's words, from a December 27, 2005 speech before the Security Council of the Russian Federation, on the role of energy in the Russian economy and strengthening Russia's world position: "Energy is, at least today, the most important motive force of world economic progress. The present and future prosperity of Russia depends directly on the place we occupy in the global energy context. Claiming leadership in world energy is an ambitious task... Such a large-scale task will become a serious catalyst for the modernization and qualitative development of the entire economy of the Russian Federation."<sup>7</sup>

The growing hypertrophy of the fuel-resource complex in economic policy is also apparent in the numbers: according to data from the Ministry of Finance of the Russian Federation, the share of the tax on use of natural resources in federal tax revenues has grown from 7.8 to 16 percent, which has sharply increased the influence of the oil and gas factor on the budget balance. Also revealing is that for realization of the four priority national projects ("Modern Health Care," "Quality Education," "Affordable Housing," and "Effective Agriculture") the state promises—including non-budget sources—to spend 180 billion rubles, or \$6.4 billion at the current exchange rate. The state indirectly spent \$7.15 billion on the purchase of a controlling

interest in Gazprom, and it has allocated tens of billions of dollars in the coming years for a range of new large energy projects, like new oil and gas pipelines.

Thus oil and gas have become the most important priorities for economic policy, and the remaining spheres of national life increasingly depend on hydrocarbon exports. Basically the state has officially declared the resource orientation of the Russian economy as the foundation of its economic, social, and foreign policy, and even its state ideology. In essence, the idea that natural resources are the single, irreplaceable source of national prosperity is taking hold of society.

Such a view is obviously bankrupt, because there simply aren't enough resources for the declared development model to work. The financial resources accumulated as hard currency reserves in the Central Bank and the Stabilization Fund make an impression, leading many representatives of the state and society to concentrate on redistribution of the riches. But in the context of the urgent problems facing Russia, these sums are not so large. The country needs too much capital investment. For example, the transport strategy confirmed by the authorities in May 2005 assesses annual investment needs to 2010 at more than \$20 billion in this sphere alone.<sup>8</sup> Actually around \$10 billion is being invested annually. For this reason, if it were decided, say, to spend the Stabilization Fund on covering the funding gap in transport infrastructure, then the accumulated sums would be enough for only five years. And there are other needs like the modernization of the army and social infrastructure, the realization of the "national projects" in health care and education, and a whole lot more...

Without doubt Russia has alternatives. If the authorities introduced appropriate policies to reduce the state share in the economy and remove regulatory barriers—and this goal was supposedly declared at the outset of Putin's first term—then Russian business, denied access to petro-wealth, would be able to rapidly adapt to the conditions of global competition and provide high rates of economic growth. To this day Russia remains a fairly diversified economy, in which the share of oil and gas in GDP is only 9 percent, and even if one accepts the higher assessments, considering the influence of transfer pricing,<sup>9</sup> that share is not greater than 25 percent. Today the authorities, intensifying pressure on entrepreneurs at all levels, are practically depriving national business of this possibility, giving full economic freedom only to state energy companies.

The "resource curse" has its roots in Russian politicians' way of thinking.

One hopes Russia will break out of this vicious circle of psychological and political dependence on oil and gas, having fully understood the insufficiency of its hydrocarbon resources for successful realization of the petrostate concept. Then we will all get the chance to play chess, contrary to the desire of certain Kremlin ideologues to make us all compete in the long jump.

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#### Notes

<sup>1</sup> *Television program* "Direct Line with the President of Russia." 2003. 18 December.

<sup>2</sup> *Speech* of the Deputy Chair of the Presidential Administration V. Surkov before an audience at the Center for Party Studies and Preparation of Party Cadres of "United Russia." 2006. 7 February. (<http://www.edinros.ru/news.html?id=111148>).

<sup>3</sup> See: *Trud*. ? 20. 2006. 7 ?????. (<http://www.trud.ru/trud.php?id=200602070200103>).

<sup>4</sup> See: <http://www.zdj.ru/documents/155/>

<sup>5</sup> *Naim M.* If Geology Is Destiny, Then Russia Is in Trouble // *The New York Times*. 2003. Dec. 4 (<http://www.nytimes.com/2003/12/04/opinion/04NAIM.html?ex=1071547802&ei=1&en=ecf60aed7ef58a9a>).

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<sup>6</sup> *Gaidar Y. The Oil Curse// Gaidar Y. End of an Empire: Lessons for Contemporary Russia* (<http://ej.ru>).

<sup>7</sup> *Introduction* of Russian President V. Putin at a session of the Security Council on the question of Russia's role in providing international energy security. Moscow, 2005. 22 December.

<sup>8</sup> *Order* of the Ministry of Transport of the Russian Federation from 12 May 2005, ? 45, "On Confirmation of the Transport Strategy of the Russian Federation to 2020."

<sup>9</sup> *Riul' K., Shafer M. Potemkin GDP // Vedomosti* ? 29. 2004. 19 February. For details see Russian Economic Report. The World Bank 2004. Feb. ? 7. The idea is that because of resale of oil by subdivisions of oil companies (which buy it from the extracting subdivisions) part of the national value added falls under "trade and services." As a result the share of trade in GDP is elevated. But if the companies producing oil immediately sold it at market prices, the share of the oil and gas extraction sector in GDP would be perhaps 25 percent, rather than the 8-9 percent we see. In other words, part of the oil trade reflected in GDP is actually just resale by one subdivision of a vertically integrated oil company to other subdivisions of that same company.