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**Taxing the Golden Goose: The Politics of Reforming
Taxation of the Oil Sector in Putin's Russia**

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Keywords:	Russia, oil, tax reform, institutions, centralisation of power

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3 **Taxing the Golden Goose: The Politics of Reforming Taxation of the**
4 **Oil Sector in Putin’s Russia**
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11 **Abstract:** There has been one defining characteristic of Russia’s approach to
12 taxing the oil sector during the Putin era. Successive governments have illustrated
13 an inbuilt resistance against adopting a comprehensive tax regime that would take
14 into account the sector’s costs and profitability. This has defied international
15 trends among a growing number of oil-rich countries. This article centers on three
16 explanations. The concentration of power around the executive branch, the
17 organisational setup of the oil industry and “path dependence” have all made
18 Russia less likely to shift away from its adherence to more traditional means of
19 taxation, and ad hoc policy solutions.
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28 **Keywords:** Russia; oil; tax reform; institutions; centralisation of power.
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31 **Introduction**
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36 Reviewing Levi’s seminal book *Of Rule and Revenue*, Curtis (1989, p. 1424)
37 observed that taxation was ‘one of the most significant political phenomenon that
38 political scientists had left relatively unexplored’. Nearly three decades later, taxation
39 presents plenty of questions that are unanswered.
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45 This article analyzes Russia’s journey in reforming taxation in the oil sector.
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47 No other sector has been more important for the Russian economy. Its significance
48 has been particularly pronounced during the Putin era: oil exports alone brought
49 Russia nearly 3 trillion USD between Putin’s appointment as prime minister in 1999
50 and his re-election as president in 2018.¹ Successive governments in Russia have
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¹ Calculation based on data from the Central Bank of the Russian Federation.

recognised this reality, adopting a series of tax reforms to capture a fair share of the sector's revenues.

There has been one defining characteristic of Russia's approach to taxing the oil sector during the Putin era. Successive governments have illustrated an inbuilt resistance against adopting a comprehensive tax regime that would take into account the sector's costs and profitability. Instead, the preference has been in favour of a simplistic approach to taxation that targets gross revenues, and a penchant for ad hoc solutions in response to mounting difficulties in the industry. By adopting such an approach, Russia has defied international trends marked by a growing reliance of oil-rich countries on tax regimes that prioritise costs and profits rather than revenues. Furthermore, it is remarkable that fundamental shifts in ownership in Russia's oil industry in the past two decades did not alter the authorities' stern resistance to a modernized and profit-based taxation.

Why, unlike in many other parts of the world, profit-based taxation failed to gain ground in Putin's Russia? Answering this question is critical for understanding the politics of reform in one of the most fundamental economic policy areas in contemporary Russia. The paper does not have the objective to explore the short-term or longer-term implications of Russia's tax approach for investments in the oil sector.

It is surprising that scholarly work on the evolution of Russia's oil tax regime remains scarce despite the essential role of the oil sector for the Russian economy and its political establishment. A few studies that have explored how Russia reformed taxation in the oil sector have been fairly technical in nature, focusing predominantly on the implications of tax measures for oil production (Alexeev & Conrad 2009; Goldsworthy & Zakharova 2010; Fjaertoft & Lunden 2015). Luong and Weinthal's (2004) work on Russia's oil tax reform presents an exception, though their analysis is

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2
3 limited to the early years of Putin's presidency. Gustafson (2012) provides a historical
4 narrative of Russia's subsequent efforts at reforming taxation for oil, but is less
5 concerned with the politics behind the government's ultimate resistance to profit-
6 based taxation.
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12 This study fills a significant gap by presenting explanations about the way
13 Russia's oil tax regime evolved under Putin. At the core of its analysis stands Russia's
14 broader political context. Namely, looking through the lenses of the 'veto players'
15 theory, the paper illustrates how the rising concentration of power around the
16 executive had significant repercussions for the evolution of the oil tax regime. This
17 political context made it much less likely for Russia to adopt a tax regime that
18 accounts for costs and profits in the oil sector. The paper recognises two additional
19 explanations. It argues that the organisational setup of Russia's oil sector empowered
20 the state in shaping the tax design in accordance with its own preference.
21 Additionally, it acknowledges "path dependency" as well, suggesting that some of the
22 earlier policy choices of the Russian government have continued to shape recurring
23 reform efforts.
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40 The paper is based on an extensive analysis of tax reform policies in Russia's
41 oil sector in the past two decades. It starts with a brief overview of how fiscal regimes
42 vary across countries, and how Russia has increasingly found itself defying
43 international trends. This is followed by a concise review of three periods of oil tax
44 reform in Russia: the 1990s, when the first experiment with establishing a tax regime
45 was undertaken; the period between 1999 and 2001, when a distinctly new regime
46 was set up shortly before parts of the oil industry were re-nationalised; and the
47 subsequent years when the Russian government sought to modify this tax model in
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3 response to growing pressures for reform. The paper proceeds with explanations on
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5 the Russian government's ultimate choices for an oil tax regime.
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10 11 12 **What to tax—revenues or profits? Russia defying the trend** 13 14

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16 While fiscal regimes in the petroleum sector vary widely across countries (Blake &
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18 Roberts 2006; Daniel et al 2010), one particular dimension provides a helpful
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20 distinction: they differ in terms of what predominantly constitutes their 'tax base'. In
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22 some tax regimes it is mainly the *revenues* of the oil sector that form the tax base,
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24 while in others the emphasis is overwhelmingly on the *profits* associated with
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26 individual oil fields and oil companies.
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31 A government's choice of a fiscal regime involves major trade-offs with
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33 significant repercussions. Taxation that targets oil revenues as the tax base ensures tax
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35 receipts for the government regardless whether the oil sector is making profits. Apart
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37 from providing greater predictability in tax receipts for the state, revenue-based
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39 taxation is also generally easier to administer. It relies principally on monitoring the
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41 quantity of oil production and its price. Yet, as this type of taxation is not sensitive to
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43 costs in the oil industry, it can distort investment and production decisions. It runs the
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45 risk of not providing sufficient incentive for oil companies to undertake exploration
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47 and development, therefore threatening the flow of tax receipts in the longer-run. By
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49 contrast, profit-based taxation, by definition, takes into account both revenues and
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51 costs in the oil industry. It is less distortionary for investors and provides incentives to
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53 invest in more costly fields. In a profit-based tax regime, the government accepts a
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55 greater risk as its tax receipts are conditioned on the profitability of oil projects. The
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government may also need to wait before it starts receiving revenues until the project becomes profitable (Tordo 2007). Taxation based on profits is also more complex to manage. It requires the state to develop substantial administrative capacity to monitor costs (Goldsworthy & Zakharova 2010, p. 7). Failure to monitor costs is likely to lead companies to report inflated costs, resulting in potential loss of tax receipts for the government.

The general trend among oil producing countries in the past four decades has been a gradual shift towards profit-based taxation (Vygon et al 2017, p. 8). Many governments still employ a combination of tax instruments targeting both revenues and profits as the tax base. Yet, for many countries, the preference has been increasingly in favour tax measures tailored to account for profits. Some countries such as the United Kingdom and Norway have made a complete move away from revenue-focused taxes (so-called royalties). Developing countries such as Nigeria and Brazil have also shifted towards profit-based taxation, retaining taxes on revenue only as a very minor component in their tax regimes (Vygon et al 2017, p. 9). More emphasis on profit-based taxation has been observed in the United States, Canada and Australia as well (Hogan & Goldsworthy 2010, p. 127). Among the major oil producers in the former Soviet space, Kazakhstan has also enhanced the emphasis on costs and profitability through tax reforms in the past decade (Beer & Loeprick 2017, p. 190). It is noteworthy that the increasing prevalence of profit-based taxation has affected countries that differ widely in many respects such as their level of development, the significance of oil in their economy or the type of ownership in their oil sector.

Putin's Russia has defied this trend. In the early 2000s, following an overhaul of the tax regime, it moved in the opposite direction by eliminating several tax

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3 instruments which, at least in theory, had aimed to account for company costs and
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5 profits. Since then, its oil tax regime has remained overwhelmingly focused on gross
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7 revenues. Oil companies are required to pay corporate profit tax as well. But, this
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9 profit-based component in the tax regime remains among the lowest worldwide, as the
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11 bulk of the tax burden on the oil sector derives from tax instruments targeting
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13 revenues (Vygon et al 2015, p. 12).
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22 **Transforming the tax regime for oil in post-Soviet Russia**

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26 The evolution of Russia's oil tax regime has gone through three phases. The first steps
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28 for establishing rules on taxation for the oil sector were taken in the early 1990s.
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30 Right after Putin's ascent to power, the tax regime went through a major overhaul. By
31
32 the middle of the 2000s, however, growing signs of difficulties in the oil sector
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34 prompted lively debates for once again reforming how oil was taxed. The debates
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36 have continued to date along a series of new tax measures adopted by the Russian
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38 government.
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42 This brief review of Russia's experience with taxing its oil sector reveals the
43
44 continuous struggle of the Russian government to collect revenues from the oil sector.
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46 What has changed over time is its success in collecting these revenues and its selected
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48 method to respond to industry pressures to reform taxation.
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54 *The 1990s: the failed trial with profit-based taxation*
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Russia's initial efforts to establish a tax regime for the oil sector were largely shaped by the broader economic and political context in the aftermath of the collapse of the USSR. The 1990s was a decade marked with a drastic economic decline. The Russian government faced an immense challenge in collecting taxes, prompting chronic budgetary deficits. Uncollected tax revenues had reached from about \$3.3 billion in 1993 to \$31.3 billion in 1997 (Easter 2006, p. 26). What made Russia's fiscal predicament even worse was the prevalence of various tax exemptions granted throughout the economy. In 1996, the Russian state lost nearly \$30 billion of potential tax revenues due to such exemptions.²

The oil sector was a natural candidate for the Russian state to turn to in order to meet its tax collection targets. It had only a handful of several large players, which made them relatively visible and easier tax targets. And despite a drastic decline in production³, the sector was generating sizable amount of rents. Thus, some of the highest statutory tax rates in the Russian economy were set on the oil sector (Ivanenko 2005).

Yet, the government's tax efforts ended up with a major disappointment. Russian oil majors, like many other players in the economy, continued to pay much less than what the government expected. They managed to minimise their tax bill by underpaying or evading taxes. Intensive lobbying also helped to get special exemptions and reduce the amount paid to the government. Despite numerous efforts to employ coercive measures as a means to enhance collection of taxes from the oil companies, this did not yield the result desired by the government.⁴

² This constituted about a third of all the revenues going to the consolidated budget, and over two-thirds of the federal government revenues. (Easter 2006, p. 36)

³ Production dropped from 10.3 million barrels a day (mbd) in 1990 to 6.1 mbd in 1999. British Petroleum 2016.

⁴ According to one estimate, the Russian government was able to collect only 22% of the windfall from oil and gas exports in 2000. (Luong & Weinthal 2004, p. 141)

At the core of the government's challenge was the design of the tax system itself. What was peculiar about the tax regime of the 1990s was its openness to account for different costs and profitability across Russia's oil fields and companies. This, however, created extensive opportunities for the oil majors to minimise their tax bill. As the government often stepped back and accommodate demands to revise existing tax rules, this further curbed its ability to collect revenues from the sector.

The 1990s tax regime was based on three major taxes specific to the oil sector: royalty tax, mineral resource replacement tax (*VMSB* in the Russian acronym), and excise tax. In addition, oil companies were subject to the typical taxes affecting the rest of the Russian economy, such as VAT and corporate profit taxes. Each of the three oil-sector-specific taxes was open to manipulation by the oil companies, while also susceptible to arbitrariness and corruption on the part of the tax authorities.

The royalty tax, introduced in 1992, was set as a *percentage*, ranging from 6 to 16 percent, of the sales value of the extracted oil. This range would presumably account for the different costs associated with Russia's oil fields. However, the presence of such a range created opportunities for oil companies to significantly reduce their royalty tax payments. As there were no clear criteria for determining when oil companies should pay the maximum instead of the lower royalty rate, they were often successful in securing a lower tax rate for themselves. Russia's Ministry of Finance observed that the royalty tax failed to be enforced as intended. It was quite common for some older and nearly depleted fields to pay a higher royalty tax than newer and much more profitable fields (Kimel'man 2001). There was a further flaw in the design of this tax: the sales value of the extracted oil was calculated on the basis of domestic crude prices. This presented Russia's vertically integrated oil companies the possibility to benefit from a practice known as transfer pricing: to

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3 minimise their tax bill, they set deliberately low prices for the crude oil they produced
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5 and sold the oil to affiliated trading companies based in tax havens.
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8 The *VMSB* had also been subject to misuse and manipulation. It was
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10 introduced in 1993 with the goal of financing geological exploration. It was also set in
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12 relation to Russia's domestic crude prices which let oil companies minimise their tax
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14 burden by presenting their accounts based on artificially low prices. Unlike royalty,
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16 the *VMSB* was set as a fixed percentage (10 percent) of the domestic sales price of the
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18 extracted crude. However, in order to take into account varying costs and profitability
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20 in the industry, the legislation related to the *VMSB* granted oil companies certain
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22 deductions and refunds depending on the attributes of their respective oil fields
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24 (Bosquet 2002). In practice, these deductions and refunds were often misused. Rather
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26 than channelling the funds into geological exploration, companies often preferred to
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28 invest them in production.⁵
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33 Unlike the royalty tax and the *VMSB*, excise tax on crude oil was set in
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35 relation to the quantity of the extracted oil rather than its value, which limited the
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37 opportunities for tax minimisation. However, in order to reflect economic and
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39 geographic conditions of each oil deposit, the excise tax was set as a specific range of
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41 rubles per ton of oil (Reznik 1999).⁶ The mere presence of a range prompted
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43 continuous negotiations between the oil companies and tax officials. Thus, in practice,
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45 the actual rate paid by a company reflected its lobbying capabilities rather than the
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47 attributes of its deposits.⁷
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51 Overall, the design of the oil tax regime in the 1990s reflected an attempt on
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53 part of the Russian government to take into account company costs and profits. All
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57 ⁵ 'Neftianiki Zaplatiat za Pravitel'stvo', *Kommersant Daily*, No 24, February 15, 2000.

58 ⁶ As one of the first significant tax reform measures under Putin, the range was eliminated in January
59 2000. Oil companies were required to pay the same amount irrespective of the quality of their deposits.

60 ⁷ 'Obshchestvo Ravnykh Vozmozhnostey – Neftianiki Vystupaiut za Izmenenie Aktsizov', *Finansovye Izvestia*, 4 March 1999

three taxes specific to the oil sector had an inbuilt measure for this purpose. In addition, corporate profit tax constituted a significant part of the tax regime. Oil majors found various means to minimise their profit tax payments as well.⁸

Putin's 'tax revolution'—the overhaul of the oil tax regime

Failures in enforcing the oil tax regime during the 1990s prompted the Russian government to undertake a major overhaul. The reform came through introducing two measures that fundamentally altered the tax landscape: an export duty on oil and mineral resource extraction tax (*NDPI* in the Russian acronym) that replaced the three existing oil-sector specific taxes. There was a clear pattern in the resulting new tax regime. It reflected an urge for simplicity as a means to enhance the government's ability to successfully administer the collection of taxes. It also represented a drastic shift away from tax instruments that accounted for costs and profitability.

The first major step for tax reform came at the beginning of 1999 in response to growing fiscal pressure on the government in the aftermath of the August 1998 financial crisis. The Russian government under Prime Minister Primakov decided to re-introduce export duties on crude oil and petroleum products.⁹ Earlier in the 1990s, this tax instrument had never been a major part of Russia's oil tax regime. This was about to change with Putin's arrival to the helm of Russian politics, as the government discovered that export duties were a convenient instrument to collect revenues.

Raising the export duty was one of Putin's first acts after becoming the new prime

⁸ Companies benefited from international or domestic 'tax havens', and were also able to get various deductions from regional governments when operating within their jurisdiction.

⁹ Such duties had been introduced in January 1992, but were completely phased out in 1997 following IMF pressure to liberalise Russia's export regime.

minister.¹⁰ A further step was taken in April 2000, when the government adopted a relatively clear scheme tying the export tariff to the international price of oil.¹¹ The initial formula used for calculating the tariff reflected primarily the dominant concern of the period – the possibility of another collapse of the world oil prices (as had recently occurred in 1998). Thus, as oil prices kept rising in the following months, the existing mechanism was not yet successful in adequately capturing the bulk of the rent generated in the sector (Budberg 2001). Putin's administration managed to address this gap through introducing new rules for export duties effective as of 2002. Steeper tax intervals subject to periodic revision helped to establish a more solid link with international prices for crude oil.¹²

Another fundamental step was taken in 2001 when the government introduced the *NDPI* tax. This tax replaced royalties, the *VMSB* and the excise tax on crude oil. As in the case of the export duty, the initial design of the *NDPI* let oil companies benefit proportionately more from rapidly rising oil prices. However, through several consecutive steps by 2004, the government calibrated it and established a steeper tax rate for the oil companies (Skliarova 2004).

There were three major implications of this tax overhaul. First, it allowed the government to drastically increase its revenues from the oil sector. Furthermore, as oil prices and the oil sector's revenues kept growing, the state managed to expand its share in the total revenues generated by the oil industry. Thus, as the sector's gross revenues increased fivefold between 1999 and 2005, the surge in the government's oil tax receipts was far more robust—they rose nearly fifteen fold (Berezinskaya &

¹⁰ Export duties on crude oil were raised from 5 euros/ton to 7.5 euros/ton in mid-September 1999. 'Poshlina na Nedt' Budet Uvelichena do 7,5 Evro za Tonnu', *Segodnia*, 9 September 1999. Before the end of 1999, the export duty was raised once again—from 7.5 euros/tonne to 15 euros/tonne. 'Russia Raises Oil Export Duty to 15 Euros per Tonnes', *Interfax Petroleum Report*, 10-16 December 1999.

¹¹ 'Vvodiatsia Novye Eksportnye Poshliny', *Kortes—Oil and Gas Complex*, 25 March 2000.

¹² In the case of export duties for petroleum products, the rules remained less straightforward and were subject to frequent fluctuations that were not always directly related to oil prices.

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3 Mironov 2006, p. 143).¹³ The oil sector continued to expand its after-tax profits. But
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5 in a rapid reversal, the government started to receive a disproportionately larger share
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7 of the rents. With the tax overhaul accomplished by 2002, the state was acquiring
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9 about 70 percent of the oil sector's rents—up from 45 percent in 1999. By 2005, the
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11 state's share rose to 84 percent.¹⁴ Importantly, the state managed to effectively
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13 capture the majority of the oil industry's rents already before it launched a process of
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15 nationalisation when state-owned Rosneft took over the largest private oil company,
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17 Yukos, in 2004. The Russian government did not stop there, however, further
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19 calibrating the tax regime to secure even more revenues along rising oil prices. In
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21 2005, it was estimated that for every one dollar increase in the price of oil (above 25
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23 \$/barrel), the state received 65 cents through its export duty and an additional 21 cents
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25 through the *NDPI* (Ahrend & Thompson 2006, p. 59).
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31 Second, taxation in the oil sector was fundamentally simplified, which
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33 explains to a large extent the government's success in raising the tax burden on the oil
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35 sector. This simplification resulted from the method by which the export tax on crude
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37 oil and the *NDPI* were deliberately formulated. Both taxes were set in a way that was
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39 relatively easy to administer and left no room for manipulation by oil companies.
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41 They were based on two criteria that were highly straightforward. One was the
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43 quantity of the oil produced by companies (in the case of *NDPI*) and the amount
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45 shipped abroad (in the case of export duties). The other was the price of crude oil
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47 linked to a simple formula that triggered a higher rate as prices rose. Importantly, the
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56 ¹³ The oil sector's revenues during this period rose from \$26.9 billion to \$143.6 billion. The
57 government's tax receipts from the sector jumped from merely \$5.6 billion to \$83.2 billion.

58 ¹⁴ Defined as the difference between the oil sector's total revenues and costs, oil rents were split in
59 favour of the oil sector in 1999: while the government collected \$5.6 billion worth of taxes, the oil
60 sector received \$6.8 billion as after-tax profits. By 2005, industry's after-tax profits stood at \$16.1
billion, whereas the state's tax receipts rose to \$83.2 billion. (Berezinskaya & Mironov 2006)

reference price for oil was the world price rather than domestic prices, which had led to tax underpayment during the 1990s.

Third, the tax reforms heralded the demise of Russia's experiment with profit-based taxation. The two new taxes were in complete disregard of oil companies' profitability and the costs associated with their individual deposits. Oil from low-cost fields acquired as a legacy from the Soviet era and oil from yet to be discovered or harder to develop deposits were all subject to the exact same export duty and *NDPI*. The government did not abandon the corporate profit tax in the oil sector. It remained as an additional tax instrument, though its relative importance in the receipts from the oil industry declined sharply. Accordingly, in 2000, corporate profit tax was accounting for about 41 percent of all taxes paid in the oil sector. By 2005, its share dropped to merely 7.4 percent of the sector's tax liabilities. Nearly all of the rest was paid in the form of export duties and the *NDPI*.¹⁵

Furthermore, despite the declining importance of the corporate profit tax in the oil industry, the Russian government undertook additional measures to enhance its capacity to collect this tax. It took several incremental steps. As early as in 2001, it sharply reduced the profit tax rate (from 35 % to 24 %) to facilitate its payment by companies across the economy. But to compensate for lost revenues, the government abolished a large range of investment allowances and incentives, which had turned costly for the budget. Oil companies had been among the chief beneficiaries of such allowances.¹⁶ The net effect of the reformed profit tax depended on each company's prior ability to engage in various tax minimisation schemes (Vyhuloeva 2004).

¹⁵ In 2005, export duties and the *NDPI* accounted for 50% and 33.5% of the oil sector's tax payments, respectively. Oil companies also had to pay a relatively small amount of VAT, property and other taxes. (Institute for the Economy in Transition 2006, pp. 210-225).

¹⁶ 'German Gref: Politicheskaya Elita Ustala ot Stabil'nosti', *Vedomosti*, 21 August 2002.

It took several more years for the Russian authorities to compel oil companies to abstain from various tax minimisation initiatives related to the corporate profit tax, albeit this tax instrument lost its former significance with the tax overhaul of the 1999-2001 period. Companies still managed to use various tax optimisation schemes due to the continued presence of 'tax havens' located within the Russian Federation. They continued to benefit through operating in specially designated 'free economic zones' and so-called Closed Administrative Territorial Formations (*ZATO* in the Russian acronym).¹⁷ Such zones allowed them a free hand to continue with transfer pricing, and created additional opportunities for acquiring tax exemptions from regional governments.¹⁸ Yet, shortly before the 2003 Duma elections, amendments to the Tax Code almost fully eliminated tax exemptions granted under regional or municipal laws.¹⁹ Meanwhile, with the lawsuits brought against Russia's then largest oil company Yukos and the imprisonment of its chief owner Mikhail Khodorkovsky, companies felt compelled to voluntarily renounce the use of internal tax havens.²⁰

Responding to pressures for reform: the government's resistance to profit-based taxation

The new tax regime established under Putin was undoubtedly successful in capturing most of the rents generated in the oil sector, but it was only a matter of time until the

¹⁷ *ZATOs* had been created during the Soviet period. In 1992, a federal law was enacted defining a special tax regime for such localities. The administrators of *ZATOs* were allowed to grant tax privileges to businesses registered in their territories.

¹⁸ There were three internal tax havens where most companies concentrated their tax minimisation activities: Chukotka, Mordavia and Kalmykia. Russia's Accounts Chamber estimated the size of lost government revenues at about 100 bn rubles in 2002 (Sapsay 2004).

¹⁹ As a minor exception, regions were allowed to reduce their share of the profit tax up to four percentage points. This amendment ended all investment agreements formalised under regional laws between investors and local governments offering arrangements involving special tax treatment (Samoylenko 2004).

²⁰ Personal interview with Igor Nikolaev, FBK, Partner and Director of Strategic Analysis. 15 June 2007, Moscow.

Russian government would confront demands for reforming it. The government had established a highly simplistic tax regime that left little room for tax evasion and manipulation. But with its simplicity, the existing tax regime created little incentive for oil companies to invest in new or costly fields to sustain growth. As the industry's pressures for reforming taxation grew, the question was how the government would respond. What could be done in response to oil companies' pleas that taxation should take into account the vast differences in costs and profitability across Russia's oil deposits? Would the government opt for another tax overhaul or a piecemeal approach?

By 2005, the oil sector was showing signs of difficulties, sparking debates on the tax regime itself. The preceding five years had witnessed a rapid growth in oil production, driven by rising oil prices, unused productive capacity from the 1990s and the devaluation of the ruble. Known as the period of the 'West Siberian miracle', Russia's oil output had grown at the annual average of 8.8 percent between 2000 and 2004. But suddenly, the growth rate slowed down to 2.5 percent in 2005 (British Petroleum 2016). Oil companies flooded the Russian government with demands for some tax relief. They warned that further growth in the oil sector was in danger, and the imminent decline of oil production, and consequently state revenues was on the horizon.

The government's response was cautious. It brought together the oil companies and engaged them in regular discussions on reforming the tax regime. In the end, the government's choice was in favour of a limited tax relief instead of a new tax overhaul. Recognising that some fields were more costly to develop, it agreed to provide a series of special exemptions for select projects and fields. Legislative changes were approved in the Duma in 2006, providing tax relief with respect to the

NDPI. 'Greenfield' projects that were yet to start production in East Siberia and highly depleted fields, which typically operate at higher costs, were the selected winners (Shokhina et al 2006).

The oil majors continued to press for reforming the tax regime in the aftermath of the 2006 legislation for tax relief. On numerous occasions they presented proposals for a more comprehensive tax reform—one that would take into account the costs and profitability of individual fields. But simultaneously, they continued to argue for new exemptions for other categories of oil deposits.²¹ Subsequent developments in the oil sector strengthened their position. Despite a historic peak in international oil prices by mid-2008, Russia's oil sector was witnessing its first output contraction for a decade (Titushkin 2008).²² Then, a sudden drop in oil prices magnified the oil sector's pleas for new relief measures. The government responded with a new wave of tax exemptions: this time it extended the relief to export duties as well. This tax instrument had become responsible for the largest share of the tax burden on the oil sector. Several East Siberian fields acquired this new benefit.

Yet, just as the oil majors were preparing to enjoy the new tax relief measures, the government shifted its approach. Oil prices had surprised observers once again, rising quicker than many expected. This prompted the Ministry of Finance to object to approved measures, considering them as 'too generous'. The ministry argued that East Siberia in particular had turned into a new 'tax paradise' for Russian oilmen (Malkova 2010). As a result, tax relief was partly rolled back in the summer of 2010.²³ The government's shifting tax approach turned out to be the new rule rather than an

²¹ Limited exemptions were provided with respect to NDPI in new selected regions (Timan Pechora and Yamal) and for offshore fields. (Zateychuk & Sterkin 2008).

²² The decline in the first four months of 2008 was 0.3%.

²³ After the roll back, export duties for a handful of fields in East Siberia were raised. However, these fields were still allowed to pay less than those with no tax relief. 'Stavka na Neft', *Vedomosti*, 18 June 2010.

exception. For instance, between 2009 and 2011, Russian legislation on export duties and the NDPI was revised 12 times and 16 times, respectively (Lunden 2014).²⁴

As rules for taxation changed frequently, several oil majors, backed by the Ministry of Energy called for the introduction of a profit-based tax titled as ‘tax on supplementary income’. Evidently, oil companies could not take their tax relief victories from granted. However, the Russian government continued to prefer piecemeal reform measures, followed by rolling some of them back when it deemed necessary. It adopted a new major piece of legislation in 2011, aiming to encourage more investment in oil development and refinery modernisation²⁵. The existing tax regime had created some distortions, and this measure aimed to correct them.²⁶ Tax relief was also provided for several unconventional oil fields in Russia, including the largest one—the Bazhenov field. Producers of extra heavy oil were also given some tax breaks.²⁷ Additionally, a handful of comparatively small fields (less than 5 million tons of reserves) were granted a discount rate for *NDPI*.²⁸ In 2013, the government opted for what it described as a major ‘tax manoeuvre’ (Kalyukov 2014). It launched a multi-year plan for reducing the export duty on crude oil to foster more investment in production. The potential foregone revenues for the state were to be compensated through an across the board increase of the *NDPI* for oil. But, while implementing these measures, the Ministry of Finance selectively rolled back some of the resulting relief. For instance, a government decree in July 2011 eliminated tax relief on the

²⁴ The figures refer to all changes including tax rollbacks.

²⁵ Known as the ‘60-66-90-100 reform’, the government calibrated the export duties by lowering them for crude oil and raising them for petroleum products (Kondrashov, 2011).

²⁶ Namely, oil companies were focusing excessively on fuel oil exports, which faced lower duties, and even selling the product abroad at a price lower than for crude oil. While a rational response to the tax regime, it represented value destruction (Vatansever 2010).

²⁷ ‘Putin Podpisal Zakon O L’gotakh pri Dobyche Trudnoizvlekaemoi Nefti’, *Ria Novosti*, 4 December 2012.

²⁸ ‘Vstupaiut v Silu L’goty po NDPI na Neft’ s Malykh Mestorozhdenii’, *Ria Novosti*, 1 January 2012.

export duty for several fields.²⁹ Later, as the oil sector benefited from the devaluation of the ruble in the aftermath of the crisis in Crimea, some of the benefits secured through the ‘tax manoeuvre’ were also rolled back (Papchenkova & Starinskaya 2015).

Russia’s experimenting with piecemeal reform measures has had multiple outcomes. To an extent, these measures helped to meet a widely shared objective in Russia about avoiding a contraction in the oil sector. Thanks to various tax breaks, it was possible for the oil companies to bring on line many new fields, and turn profit from some older and largely depleted fields. This let the oil sector expand its output with nearly no interruption through 2018.³⁰

The reforms have also been in line with the government’s expectations to maintain its high tax take from the oil sector. The cost of various tax cuts has risen over time and reached about 350 billion rubles in 2015 (Vygon et al 2017, p. 20). However, the Russian government succeeded in maintaining the tax burden on the oil sector fairly high based on international comparisons.³¹ While sacrificing some tax revenues through new exemptions or tax rules, the government did not allow the tax burden on the oil sector to drop in a substantial way.

Yet, Russia’s piecemeal approach to reforming the oil tax regime also brought numerous major challenges. Contrary to the government’s objectives, the tax regime became highly complicated to administer with the proliferation of ad hoc

²⁹ Prior to this decree, the number of fields benefiting from export tax relief were 24 (22 projects in East Siberia and 2 projects in the Caspian). Their number was cut to 15 as of August 2011 (Gavshina 2011).

³⁰ The two exceptions for the Putin era are 2008 and 2017. In the latter case, oil output witnessed a minor decline as Russia adhered to voluntary production cuts along OPEC.

³¹ On the relative tax rate on the oil sector across countries, see: ‘Taxation in the Russian Oil Sector: Learning from Global Fiscal Perspectives’, Presentation by Alexey Kondrashov, EY Consulting, July 2015 ([http://www.ey.com/Publication/vwLUAssets/ey-taxation-in-the-russian-oil-sector-learning-from-global-fiscal-perspectives/\\$FILE/ey-taxation-in-the-russian-oil-sector-learning-from-global-fiscal-perspectives.pdf](http://www.ey.com/Publication/vwLUAssets/ey-taxation-in-the-russian-oil-sector-learning-from-global-fiscal-perspectives/$FILE/ey-taxation-in-the-russian-oil-sector-learning-from-global-fiscal-perspectives.pdf) - Accessed on May 21, 2017). Russian oil companies have also continued to face a relatively higher tax burden compared to international majors in other countries (Zhavarionkova 2015).

arrangements for tax relief. By 2014 there were already over 200 licensees that benefited from some form of tax relief (Petlevoi & Starinskaya, 2014). By 2015, nearly a third of oil was produced with the help of various tax reduction measures. Determining whether they should be kept, abandoned or revised has relentlessly preoccupied Russian government officials. In effect, instead of letting a profit-based tax regime respond to different levels of costs and profitability in the oil sector, the Finance Ministry acquired a manual control over taxing distinct oil projects—a highly cumbersome task.

As an additional challenge, the Russian government has had difficulty in ensuring the effectiveness of the adopted tax relief measures. Without a clear yardstick, government officials have lacked the confidence that the tax relief provided to individual projects is commensurate with their needs. Frequent rollbacks of tax relief measures have been illustrative of the government's difficulties in assessing their effectiveness in advance. For the oil sector, this context has bred uncertainty about the future of tax burden on their existing and upcoming projects.

After over a decade of a resistance to profit-based taxation, the Russian government agreed in 2016 to experiment with new a tax instrument that would account for costs and profitability. The Ministry of Finance, recognising the difficulties associated with manually supervising an extensive number of cases involving tax relief, tentatively expressed its consent to introduce pilot projects whereby oil companies would be taxed via a newly proposed measure titled 'tax on supplementary income' (*NDD* in the Russian acronym).³² The government's preference to apply this new method to only a few pilot projects has been yet another indication of its cautious approach.

³² 'Dvorkovich: Zakonoproekt of NDD v Neftianoi Otrastli Gotov k Rassmotreniu Pravitel'stvom', *Tass*, 21 April 2017 (<http://tass.ru/ekonomika/4199942> - accessed May 21, 2017).

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3 In 2018, the Russian government took one further step to modify the tax
4 regime. This time, it approved a sharp schedule to completely phase out its export
5 duties on oil by 2024, while compensating for its foregone revenues through an
6 equivalent hike in the NDPI tax (Yashunskii 2018). This has been a clear step to alter
7 the existing tax setup, yet it has once again fallen short of a shift towards a
8 comprehensive tax reform that has well-defined criteria targeting costs and profits.
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10 Instead, Russia has opted in favour of turning the NDPI tax along with its numerous
11 ad hoc tax holidays as the single most important instrument to collect revenues from
12 oil. Furthermore, the majority of Russia's oil production, namely oil coming from
13 mature fields, has remained immune to tax holidays. This further highlights Russia's
14 lack of a comprehensive approach to reform that could take into costs and profitability
15 across the entire oil industry.
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35 **Explaining the transformations of the oil tax regime:**

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40 This study provides three broad explanations on what shaped Russia's oil tax reform.
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42 First, it examines the tax policy reform process through Tsebelis's (1995) 'veto
43 players' theory. It explains how the growing concentration of decision-making around
44 the executive affected the evolution of the tax regime. Next, it considers two
45 additional explanations. It examines how the organisational setup of Russia's oil
46 industry mattered for the chosen tax reform path. Finally, the paper recognises the
47 impact of 'path dependency' on reforming Russia's oil tax. In each case, the
48 objective is to focus on what hampered the possibility for Russia to make a transition
49 towards a profit-based tax regime.
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The impact of growing concentration of power around the executive

President Putin fundamentally altered Russia's political landscape following his ascent to power in 1999. Compared to the 1990s, more power became concentrated in the hands of the executive branch, while the role of the other institutional veto players in the policy process got substantially weaker.³³ The two branches of the legislature, the Duma and the Federation Council, and regional governments became less capable over time to shape policies of national significance (Haspel et al 2006). The weakening of Russia's other veto players, along with the demise of its independent media has prompted a widespread discourse on the authoritarian traits of Russia's political regime.

Putin's initial oil tax reforms were conducted within this context of growing concentration of power around the executive and the concurrent weakening of Russia's other institutional veto players. Subsequent efforts for tax reform by the middle of the 2000s faced a political landscape characterised by decision-making heavily concentrated within the executive branch. A key question is how Russia's transformed political context affected the evolution of its oil tax reform. This study argues there were three key implications. First, decision-making on taxation for oil, which had been dispersed in the 1990s, moved nearly exclusively within the domain of the executive. Any meaningful attempt by the oil sector to revise the terms of taxation would have to go through the executive. This limited the oil companies' opportunities to minimise their tax burden, and let the Russian government finally establish a higher tax burden on the sector. Second, within the increasingly centralised

³³ Based on Tsebelis, one can define four institutional veto players in Russia: the executive branch, the lower chamber of the legislature (Duma), the upper chamber (Federation Council) and regional governments (Tsebelis 1995).

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3 decision-making process on taxing oil, the Ministry of Finance carved itself the key
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5 role of negotiating and drafting reforms for the oil sector. Its risk-averse approach has
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7 fundamentally shaped the design of tax reforms implemented since the middle of the
8
9 2000s. Third, as the veto player theory would predict, the weakening of Russia's veto
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11 players (outside the executive) compromised policy stability. In other words, the
12
13 ability of the government to commit to a given tax policy was weakened (Tsebelis
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15 2002, p. 2). Facing little resistance, the Ministry of Finance opted for measures that
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17 were inherently unstable and likely to be revised at its own will. The flexibility
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19 brought by this policy choice had a major appeal for the ministry. As illustrated
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21 below, overall, the concentration of power within the executive made a transition
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23 towards profit-based tax regime much less likely.
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31 *The rise of the executive as the sole decision-maker on taxation for oil*

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35 Following Putin's rise to the presidency, the veto players, outside the executive, were
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37 substantially weakened. The Duma, which had provided a major access point for oil
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39 companies to lobby for lower taxes, was significantly less effective over time. The
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41 same was true for the Federation Council and regional governors who had served as
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43 additional targets in oil companies' lobbying efforts during the 1990s. New federal
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45 and budgetary legislation enacted during Putin's early years as president effectively
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47 limited the role of regional governments and local administrations on issues pertinent
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49 to the hydrocarbon sector (Henry et al 2016, p. 1346). Decision-making on taxing the
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51 oil sector gradually moved within the domain of the executive branch. But the
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53 executive branch was also transformed. President Putin was able to secure a more
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cohesive executive that was in stark contrast to the Yeltsin period, when different parts of the government continued to grant various tax relief to the oil majors.

Yet, the rising concentration of power around the executive branch was a gradual process and its impact on Russia's oil tax reform became more apparent only over time. Thus, the establishment of the new oil tax regime between 1999-2001 still involved significant input from the Duma.³⁴ As examined by Luong and Weinthal, through various incremental steps, oil companies were also effective in shaping the new rules. The choice against profit-based taxation was a mutual compromise between the government and leading oil companies. For the government, a shift towards a revenue-based simpler tax model reflected hopes to end rampant tax underpayment prevalent during the 1990s. In the case of the oil sector, there was no consensus on what would best serve the industry's interests. Yet, several large private oil companies led by Yukos clearly aligned with the government's preference for a simple revenue-based tax regime. Such a regime was conducive to their investment profiles, in the short-term at least, while they hoped it would bring greater stability in the tax rules as well (Jones-Luong & Weinthal 2004, p. 144). Furthermore, oil companies maintained their ability to shape tax rules for some time after the new tax regime was fully in force after 2001. Arguably, this made the proponents of this simple revenue-based regime less worried about its longer-term implications on investments. Thus, in 2002, oil companies were still capable to lobby for measures that reduced their tax payments. For instance, a legislation known as the Yukos Amendment was approved by the Duma in 2002, granting oil companies a special tax relief with respect to petroleum product exports.³⁵

³⁴ For instance, in 2001, there was an 'energy faction' within the Duma, which generally supported the oil sector's proposals (Khamraev 2001).

³⁵ The amendment set an upper limit on the export tax for petroleum products (Visloguzov 2003).

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3 In the subsequent years, however, with the emergence of a stronger pro-
4
5 Kremlin majority in the Duma, it was no longer possible for the oil sector to secure
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7 legislation that was at odds with the executive's preferences. The government
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9 established a dominant role in steering the direction of oil tax reform and it was able
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11 to ensure that any measures pertaining to tax relief would require its consent.
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15 The rise of the executive as the sole decision-maker on taxation had several
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17 important implications. First, it helped the government to eliminate some of the key
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19 deficiencies of the tax regime of the 1990s, which had allowed oil majors to underpay
20
21 their taxes. While the new tax regime established by 2001 was a first step towards
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23 fewer loopholes, further steps were soon taken to eliminate the other remaining
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25 opportunities for tax minimisation. Thus, internal tax havens were gradually
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27 eliminated. Second, the rise of the executive as the sole decision-maker closed
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29 another pathway for tax minimisation. During the 1990s, oil companies had been able
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31 to acquire numerous special tax relief measures in the form of tax rates that were
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33 lower than what was legislated. The political context under President Yeltsin had been
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35 conducive to get such help through lobbying efforts directed at Russia's various
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37 institutional veto players. Distinct parts of the federal government, the legislature and
38
39 regional authorities were all capable to reward them with tax benefits (Jones-Luong &
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41 Weinthal 2004). This pathway was finally closed. Third, the executive acquired the
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43 growing ability to revise the rules of taxation. The earliest example of this newly
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45 acquired power was in the form of calibrating the *NDPI* tax and the export duties in
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47 2003 and 2004. The calibrated rates made sure that the state would be the main
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49 beneficiary of the rising international oil prices.
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56 Nonetheless, as the Russian executive branch gradually emerged as the sole
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58 decision-maker and got increasingly successful in capturing the rents from the oil
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sector, why did it opt against profit-based taxation? This question is particularly valid because with the growing concentration of power around the executive branch, the Russian leadership also acquired the liberty to adopt more comprehensive approach to oil tax reform instead of the easier to enact ad hoc measures. It did not opt for this path, however. The rest of the paper provides several answers.

The rising role of the risk-averse Ministry of Finance in oil tax reform

As President Putin consolidated power, policy-making on reforming the taxation in the oil sector also became more cohesive within the executive branch itself.³⁶ While multiple agencies within the government vied for influence to shape the oil tax reforms in the 1999-2001 period³⁷, it was the Ministry of Finance's that eventually gained the upper hand. The ministry's central role was particularly evident after the middle of the decade when the Russian government came under increasing pressures to modify the tax regime.³⁸ This substantially affected the course of reform in the following years, explaining to a large extent the failure of proposals on profit-based taxation to gain traction.

As Russia's new oil tax regime came under pressure for reform by the middle of the 2000s, the Ministry of Finance faced a crucial choice: should it support a transition to profit-based taxation as proposed by many in the oil industry and the banking community, or should it adopt piecemeal solutions that would still preserve

³⁶ The executive branch used to be highly disunited during the administration of Putin's predecessor Boris Yeltsin (Sokolowski 2003, pp. 422-426).

³⁷ Apart from the Ministry of Finance, the Ministry of Economic Development, the Ministry of Natural Resources and the Ministry of Energy all provided various proposals for reforming the oil tax regime during the 1999-2001 period.

³⁸ This observation was consistently confirmed through multiple interviews conducted in Moscow in 2007 and 2017, and through personal experience as energy consultant advising the Russian government on oil tax reform in 2009.

the existing tax regime? The Ministry of Finance opted in favour of the latter, providing ad hoc solutions in the form of reduced rates of the *NDPI* tax and export duties for select oil fields.

The Ministry of Finance was principally driven by a highly risk-averse approach to reforming taxation in the oil sector. As an institution in charge of the health of Russia's budget, its primary concern was the ability of the Russian government to maintain the high tax burden on the oil sector. According to Igor Nikolaev, a leading Russian economist, 'oil revenues have been too important for Russia, and the government has deemed experimenting with a new tax regime as too risky'.³⁹ Indeed, as oil prices went up and Russia collected more taxes from the oil sector, the federal budget became increasingly dependent on the revenues from the oil sector.⁴⁰ By contrast, the Ministry of Economic Development, the Ministry of Natural Resources, and particularly the Ministry of Energy which was concerned mainly about a potential decline in the oil output, adhered to a position that was closer to the one of the oil sector. They were more favourable to the sector's demands for a lower tax burden.⁴¹ However, their role in shaping tax reform had faded by the middle of the 2000s, and the adopted tax measures overwhelmingly reflected the position of the Ministry of Finance.⁴² Importantly, Putin's preferences consistently reflected the cautiousness of the Ministry of Finance. He has been warning about the pitfalls of profit-based taxation, arguing that a transition to such a regime would reopen the

³⁹ Personal interview with Igor Nikolaev, FBK, Partner and Director of Strategic Analysis. April 2017, Moscow.

⁴⁰ According to the Ministry of Finance, the share of oil and gas revenues in the federal budget rose from 17.9% in 2002 to 51.3% in 2014. (Ministry of Finance of the Russian Federation website: <https://www.minfin.ru/ru/>).

⁴¹ Personal interview with Vladimir Drebenstov, British Petroleum, Head of Russia and CIS Economics, April 2017, Moscow; Personal interview with Vladimir Milov, former Deputy Minister of Energy of the Russian Federation, April 2017, Moscow.

⁴² Personal interview with Vladimir Feigin, Institute for Energy and Finance, President, April 2017, Moscow.

opportunities for oil companies to underpay taxes (Starinskaya and Papchenkova 2014).

What also prompted the Ministry of Finance's risk averse approach was Russia's continuing lack of administrative capacity to handle a more complicated oil tax regime. As Vladimir Feigin, the President of the Institute of Energy and Finance described, from the standpoint of the ministry, the tax rules established during the 1999-2001 period were ideal, as they simplified tax collection to the utmost extent, necessitating no significant administrative resources. The ministry was intent to continue with this regime as long as it could, and it approached proposals on profit-based taxation with scepticism.⁴³ Its position reflected its lack of trust in the willingness of oil companies to pay their dues should a profit-based tax regime be established. Indeed, such a regime would require building an extensive administrative capacity to monitor costs and profitability across the industry. Lacking such a capacity, the ministry had no assurance that oil companies would not artificially and selectively inflate their costs to pay fewer taxes. According to Milov, what has also made cost inflation likely in Russia's context is that Russian oil majors, both state-owned and private, have not generally faced shareholder pressure to keep costs down, unlike many of their international peers.⁴⁴

Russia's lack of an administrative capacity to handle a more complicated tax regime for oil is partly associated with the growing concentration of authority around the Ministry of Finance. It is a common practice for oil-rich countries to divide the responsibility to collect taxes across multiple agencies. Often, both the ministry of finance and a sectoral ministry (such as the ministry in charge of energy or natural resources) have responsibilities for different types of taxation within the resource

⁴³ Personal interviews with Feigin and Drebenstov, April 2017.

⁴⁴ What has really prompted them to lower their costs since the early 2000s has been the harsh nature of the tax regime that disregards costs altogether. Personal interview with Milov, April 2017.

sector. Assigning a role to a sectoral ministry in tax administration aims to leverage their technical expertise in auditing and regulating resource companies. Occasionally, politically more influential ministries, such as a ministry in charge of economic development, have also undertaken some tax duties. This has allowed complementing but also counterbalancing the role of a finance ministry (Calder 2010, p. 356-7).⁴⁵

By contrast, in Russia's context, branch ministries, such as the Ministry of Energy and the Ministry of Natural Resources were assigned no role in tax collection as the process was centralised around the Ministry of Finance.⁴⁶ Administering a profit-based tax regime, however, requires various forms of expertise, including in geology and engineering, which has been lacking in Russia's Ministry of Finance.

In sum, as power became increasingly concentration around the executive following Putin's ascent to the Kremlin, the Ministry of Finance gradually emerged as the dominant authority to shape the oil tax regime. Unlike during the early stages of legislating the new tax regime between 1999 and 2001, the oil tax reform in the subsequent period occurred within the boundaries set by the risk-averse and administratively poor Ministry of Finance. This made a shift to a profit-based tax regime less likely.

The appeal of ad hoc solutions to the Ministry of Finance

Apart from providing a more risk-averse solution, the ad hoc approach to tax reform had an additional appeal for the Ministry of Finance. To a large extent this approach

⁴⁵ Such a division of labour has often been a product of ministerial infighting, rather than a careful planning to enhance effectiveness of taxation. While it reduces the potential for serious errors and collusion, it has also been accompanied by some disadvantages, such as lack of clarity about responsibilities and weakened accountability.

⁴⁶ The role of the Ministry of Natural Resources, for instance, declined in line with the introduction of the NDPI. The royalty and the VSMB had been determined through license agreements signed by the ministry.

ensured that the ministry would maintain a steering role in oil tax reform, while, in the meantime, granting it a substantial room for manoeuvring. In each adopted measure, the ministry retained the leading role in determining its parameters and duration. It proceeded with periodic reviews about the need to continue with each of these tax relief measures, which granted it significant leverage when dealing with oil companies. On numerous occasions, the ministry was also able to roll them back *unilaterally*, arguing that it found them to be excessive.⁴⁷ By contrast, a comprehensive tax reform on the principle of profit-based taxation, would set new rules, and establish a new 'contract' between the state and the oil sector. Typically, profit-based taxation includes an inbuilt flexibility that responds to the needs of oil majors with respect to changing costs and profits. A new profit-based tax regime bore some uncertainties about the ministry's role, particularly about its capabilities to quickly adjust the rules, when it considers that the state was not getting its due share.

The ability of the Ministry of Finance to frequently roll back its ad hoc tax measures is not surprising in the context of Russia's growing concentration of power around the executive. As Russia's other veto players were weakened, the oil companies found it more difficult to find allies to support them, including against the occasional roll backs of tax relief. The stability of the oil tax policy was compromised in favour of the government's capability to change the rules when it deemed it necessary.

Importantly, the tax breaks for the oil sector in the past decade have differed significantly from those during the 1990s. To an extent, this has enhanced their appeal for the Russian government. Thus, unlike in the 1990s, these new tax breaks have been preceded by a thorough and fairly open discussion with government officials,

⁴⁷ Personal interview with Maria Belova, Vygon Consulting, Head of Research, April 2017, Moscow.

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3 where the Ministry of Finance takes the lead. Long justification have been provided
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5 for granting tax relief, while each proposed measure has been related to relatively
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7 clearer criteria such as the geographic location of the oil field and its level of
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9 depletion. During the 1990s, the criteria for acquiring a tax break remained fuzzy,
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11 reflecting mainly oil companies' capabilities to lobby through various distinct
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13 channels.
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17 Overall, the new tax regime set during the early 2000s constituted a significant
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19 step in institutionalising the relationship between the state and the oil sector. It was an
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21 attempt to create more predictability both for the government and for the oil sector.
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23 However, it did not take long for this arrangement to change. As pressures for
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25 reforming taxation in the oil sector increased, the government, led by the Ministry of
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27 Finance was able to adopt new rules. The ad hoc nature of these new rules, while
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29 helping investors in their designated oil fields, further empowered the state and raised
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31 the unpredictability for the oil majors.
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37 *The organisational setup of Russia's oil sector*

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42 Putin inherited an oil sector that had a rather unique character in terms of ownership.
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44 By the late 1990s, it was neither international oil majors (IOCs) nor national oil
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46 companies (NOCs) that dominated the oil industry. Instead, several "home-grown"
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48 private companies had acquired control over the sector's assets. The missing role of
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50 foreign majors was particularly striking. At the start of the 1990s, many IOC
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52 managers had viewed Russia as the next frontier—a land of vast opportunities that
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54 was finally open for business (Yergin 2011, pp. 21-42). By the end of the decade oil
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56 companies with some foreign ownership were accounting for merely 6 percent of
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Russia's oil output (Infotek 2000). In another disappointment, with the exception of three relatively minor projects, foreign investors failed to sign Production Sharing Agreements (PSAs) to develop Russia's oil resources. Meanwhile, even though Russian private companies established their dominant role in the oil industry, the state remained heavily involved. In Anders Aslund's words, its role remained "both greater and more arbitrary than the Anglo-American model would permit" (Aslund 2005, p. 612).

The oil industry's organisational setup went through a major transformation after 2004. The state reasserted its role as the owner of Russia's oil resources in several waves of nationalisation of private companies. And yet, some unique aspects of Russia's oil industry remained. Far from being fully nationalised, the oil sector could best be characterised in terms of the coexistence of several private and state-owned oil companies. Though the number of large vertically integrated oil majors has been reduced from twelve to six between 1999 and 2018, a semblance of competition has been maintained in the industry. Furthermore, state-owned Rosneft, the closest equivalent to a NOC, has also gone through several phases of partial privatisation though the state has retained its controlling stake.

Looking at the organisational setup of Russia's oil sector provides an additional explanation about Russia's chosen tax reform path. It is possible to argue that the sector's organisational setup has affected the oil tax reform twofold. First, the failure of foreign investors to emerge as major players in Russia's oil industry has set Russia apart from many developing countries. With their limited involvement in Russia, foreign oil majors never emerged as effective players that could shape the evolution of the country's oil tax regime. Faced with stricter reporting requirements for costs and profits in their home base along with shareholders' oversight, foreign oil

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3 majors could have emerged as strong proponents for a profit-based tax regime
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5 particularly in a context where PSAs never became a truly viable alternative.
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8 Second, this organisational setup has hampered the possibility for effective
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10 collective action among Russia's oil majors. Such collective action, if targeted at
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12 getting a profit-based tax regime, could have provided the impetus for a very different
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14 tax model than Russia has had. It is important to acknowledge, however, that weak
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16 collective action in the oil sector could be linked to a range of additional factors such
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18 as the growing concentration of power around Russia's executive branch examined
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20 above, the divergent investment concerns of oil companies and the government's
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22 policy choice in response to these concerns.
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26 Collective action in Russia's oil sector could be examined in two periods. The
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28 first period refers to the years of oil tax reforms between 1999 and 2001, and its
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30 immediate aftermath. This is the period when Russia managed to entirely overhaul its
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32 tax regime. It is also a period when private oil companies still dominated the oil
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34 industry with little signs about a possible reversal in ownership in the future. The
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36 second period starts in the mid-2000s when the existing tax regime came under
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38 pressure for reform.
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42 By the end of the 1990s, Russia's newly emerging oil companies had gone
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44 through cutthroat competition over the industry's assets. There were fewer assets left
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46 for acquisition and the process of consolidation within the industry had finally slowed
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48 down. Unlike during the preceding decade, this made Russian oil majors more
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50 capable to engage jointly in negotiating tax reform with the government (Jones-Luong
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52 & Weinthal 2004, pp. 144-7). Yet, significant differences among them remained. For
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54 instance, the new bill introducing the flat *NDPI* tax in 2001, reflected mainly the
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56 position of Yukos and Sibneft, whereas the rest of the sector demanded a tax regime
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that would be more sensitive to various factors affecting costs and profits (Liapunova & Reznik 2001).

When debates on reforming the tax regime reappeared by the mid-2000s, if there were any expectations for effective collective action, they were clearly not met. Russia had transitioned towards a high concentration of power around the executive branch—a setting hardly conducive for collective action. Allowing Russia's most economically significant sector to organise independently and lobby jointly to defend its interests could not be in line with the presidency's determination to limiting autonomous sources of power. Interestingly, on the surface, oil sector representatives have continued to have regular opportunities to get together and meet government officials. Yet, such meetings have not been preceded by independent efforts to coalesce and prepare joint proposals. As an oil sector executive recalls, the industry never prepared an elaborate joint statement or action plan on tax reform.⁴⁸ Instead, their joint meetings have reflected the preference of the Kremlin to engage with the oil sector in a corporatist structure, whereby a ministry within the executive, namely the Ministry of Finance, would take the lead.

What has also impeded collective action is the persistent divisions within the oil industry, which reflect its rather unique organisational setup. The oil industry has remained divided on reforming the tax regime, and the government's position on tax reform has played a significant role in this outcome. When faced with the choice to defend a transition to profit-based taxation versus ad hoc solutions, there has never been a consensus among oil companies. In fact, they have typically favoured both paths of reform simultaneously—calling for tax relief measures while continuing to express support for more comprehensive reform that focuses on costs and profits. In

⁴⁸ Personal interview with Drebentsov, April 2017.

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3 their efforts to acquire tax relief, oil majors have lobbied mostly individually rather
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5 than collectively.⁴⁹ This has been in large part due to their different needs reflecting
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7 differences in their resource base. For some oil majors, the urgent concern has been
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9 about getting tax relief for highly depleted fields. For others, the priority has been on
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11 new fields, which have also varied significantly in terms of investment needs due to
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13 location.⁵⁰ With multiple large players such diversity in interests and preferences
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15 could be considered an expected outcome.
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19 The government's choice in favour of ad hoc tax relief measures has further
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21 weakened the possibility for collective action. Once the Ministry of Finance opted for
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23 this path of reform in the second half of the 2000s, the immediate reaction of oil
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25 companies was to magnify efforts to benefit from tax relief. As more and more oil
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27 majors acquired tax relief, this weakened their incentive to collectively pursue a more
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29 comprehensive profit-based tax reform. With ad hoc solutions on the table, oil
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31 companies maintained a sceptical stance on a potential transition to profit-based
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33 taxation. As oil prices remained high between 2011 and 2014, rising costs within the
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35 industry prompted the oil majors to once again revive proposals for profit-based
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37 taxation.⁵¹ However, similarly to the Ministry of Finance, they maintained a cautious
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39 approach, though for a different reason. Their major concern has been losing the
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41 already acquired tax breaks in case of a transition to a new tax regime. Oil majors
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43 have also been concerned that profit-based taxation is likely to emerge as a constant
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45 source of tensions with tax authorities who disagree with their reported costs and
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47 profits.⁵²
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55 ⁴⁹ Personal interview with Belova, April 2017.

56 ⁵⁰ For instance, East Siberian oil fields and West Siberia's unconventional oil fields face different
57 investment challenges. Personal interview with Sergey Drobyshevsky, Gaidar Institute for Economic
58 Policy, Academic Director, April 2017, Moscow.

59 ⁵¹ Personal interview with Drebensov, April 2017.

60 ⁵² Personal interview with Milov, April 2017.

The trend towards nationalisation that shifted the organisational setup of the oil sector after 2004 has also weakened the possibility for an organised collective action in two additional ways. A shifting paradigm towards nationalisation of the sector created a continuous credible threat for property rights of the oil majors. As noted by Catherine Locatelli, the oil sector's privatisation in the 1990s had created low legitimacy in the eyes of the public and policy-makers (Locatelli & Rossiaud 2011, p 5591). Oil companies' private owners were never given an assurance about the future ownership of their assets. In this context, defying the government through an independent collective action on taxation could hardly emerge as a company priority.

The potential for an effective collective action was also weakened as a result of the rise of Rosneft as a national champion for the oil sector. While oil majors have jointly attended numerous meetings to discuss tax reform with the Ministry of Finance, Rosneft has maintained a privileged and direct access to Kremlin in voicing its concerns.⁵³ Being the largest oil company, Rosneft has acquired the most extensive tax relief measures in the sector, though there is no evidence that this has been due to discrimination in its favour.⁵⁴ Despite being the company likely to benefit the most from tax relief, thanks to its privileged channels of communication, Rosneft has lacked the incentive to take the lead in collective action.

In sum, with weak collective action in the oil sector, any voices favoring profit-based taxation have been bound to remain ineffective as long as oil tax reformers, the Ministry of Finance in particular, have not perceived this model as their preferred choice to collect revenues from this economically critical sector. The lack of

⁵³ Personal interview with a leading Russian advisor to the energy industry. May 2017, London.

⁵⁴ Rosneft has acquired the bulk of tax relief measures in part due to legislation that grants state-owned companies exclusive rights in a range of potential new fields. Personal interviews with Feigin, Drebenstov, Nikolaev, April 2017.

foreign oil majors as effective players has also impeded the possibility for having a profit-based taxation. Overall, looking at the oil sector's organisational setup featuring a high degree of diversity along limited involvement of IOCs provides an additional explanation about Russia's oil tax reform path. This organisational setup has empowered the state authorities in shaping oil tax reform.

It is also highly remarkable that a revenue-based tax regime in Russia has endured through two vastly different ownership models in the sector. The existing tax regime was set up between 1999 and 2001 when private oil companies had established a clearly dominant role in the industry. Subsequently, Russia shifted to a new ownership model characterised by the resurgence of state-owned oil majors amidst coexisting private oil companies. Yet, the state retained its preference for a revenue-based tax regime, albeit with some ad hoc modifications.

Path dependency

It is also important to recognise the potential impact of path dependency on the design of the oil tax regime and its evolution. In retrospect, two choices with respect to tax reform had significant long-term repercussions. First, the Russian government consistently postponed efforts to develop administrative capacity to monitor costs and profitability in the oil sector. During the 1990s, there were little efforts to build such a capacity. Instead the Russian government preferred to rely on coercive measures to collect taxes from oil companies (Easter 2006). Subsequently, when the oil tax regime was overhauled at the turn of the century, the government opted in favour of a tax regime that would not necessitate building any significant administrative capacity.

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3 The two main tax instruments, export duties and the *NDPI* were very simple to
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5 enforce and required no extensive state apparatus in charge of monitoring costs in the
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7 oil sector. This lack of urgency also explains the delay in adopting a new legislation
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9 on transfer pricing that would bring Russia closer to OECD standards. Such
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11 legislation was considered essential for any transition towards a profit-based tax
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13 regime as it targets internal costs of companies and their subsidiaries (Ahrend &
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The two main tax instruments, export duties and the *NDPI* were very simple to enforce and required no extensive state apparatus in charge of monitoring costs in the oil sector. This lack of urgency also explains the delay in adopting a new legislation on transfer pricing that would bring Russia closer to OECD standards. Such legislation was considered essential for any transition towards a profit-based tax regime as it targets internal costs of companies and their subsidiaries (Ahrend & Thompson 2006, pp. 70-2). A legislation aimed at limiting transfer pricing was adopted as late as 2011 (Kulikov 2011).

Once the new tax regime was under pressure for reform, this lack of an administrative capacity constrained the ability of the Russian government to a more comprehensive profit-based tax reform. Instead, it adopted an ad hoc approach that further postponed the need to build such a capacity. Eventually, with the massive proliferation of ad hoc tax relief measures, the tax regime became overly cumbersome to manage. The Ministry of Finance's administrative limitations are best epitomised by its ongoing need to rely overwhelmingly on data provided by oil majors (Vygon et al 2015, pp. 33-5). This has weakened its ability to monitor the effectiveness of the tax relief measures it approves. In effect, the Russian government has found itself in a vicious cycle: lack of administrative capacity has limited its options to reform the tax regime, and avoiding a major step towards profit-based taxation has further weakened the urgency to build such a capacity. Arguably, as noted above, the emergence of the Ministry of Finance as the single most important authority in further tax reform for the oil industry has contributed to this vicious cycle.

Another choice that ultimately shaped how Russia's oil tax regime evolved was the decision to introduce export duties at the end of the 1990s. Alexeev & Conrad (2009) note that export duties are unusual for oil-rich countries, making Russia's tax

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3 regime distinctive. Once introduced, removing export duties and replacing them with
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5 new measures was likely to be challenging. In part this was due to the fact that export
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7 duties rapidly evolved into the most substantial component of taxation in the oil
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9 sector—export duties started to bring more revenues than the NDPI tax after 2003.
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11 Furthermore, export duties were set to accrue exclusively to the federal government in
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13 line with the growing centralisation of power in Russia's politics. Given the simple
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15 nature of this tax instrument that made it easy to enforce, along with its role in
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17 centralising the oil revenues, replacing export duties bore significant risks.
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21 The challenge, however, was further magnified by the fact that export duties
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23 have substantial repercussions on the domestic oil sector. They create a wedge
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25 between international and domestic prices, suppressing artificially the latter. Thus,
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27 Russia's export duties transformed into a means for the government to regulate
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29 domestic oil prices, subsidise the economy with lower-priced petroleum products and
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31 encourage the modernisation of the refining sector that operated with cheap crude oil
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33 (Vatansever 2010). The mere presence of export duties in Russia's tax regime has
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35 considerably complicated prospects for a more comprehensive tax reform that involve
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37 their abandonment. By comparison, in neighbouring Kazakhstan, export duties on oil
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39 never achieved a similarly important status for government finances and its regulatory
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41 policy, which provided the authorities more flexibility to experiment with new
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43 measures (Wolreich 2010).
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Conclusions

Taxation in Russia's oil sector has confronted an inbuilt resistance against adopting more modern and sophisticated methods. The oil tax regime has remained overwhelmingly focused on traditional means of taxation whereby the state targets primarily company revenues while widely disregarding profitability and costs.

Examining about two decades of tax reform in Russia's oil sector, this study provides three explanations about this enduring resistance to profit-based taxation. First, it puts Russia's politics of taxation in the oil sector in its broader political context, arguing that the growing concentration of political power under Putin has significantly shaped the reform process. As decision-making on taxing the oil companies moved solely within the executive branch, the risk-averse Ministry of Finance set the priorities and the limits of the tax reform efforts. The ministry adopted an approach that further empowered the state in its relationship with the oil sector, as its approach offered an ample room to adjust, and when necessary, roll back the tax rules. Second, the rather unique organisational setup of Russia's oil industry has further helped to empower the state in charting its preferred path for oil tax reform. Highly diverse and weak collectively, along with a fairly modest presence of foreign oil majors, Russia's oil sector has been unable to push for a more comprehensive profit-based tax reform. Third, a "path dependency" also needs to be recognised to account for the evolution of Russia's oil tax reform. Early policy choices have had repercussions long into the future. The tax regime established at the turn of the century created no urgency to build administrative capacity for a more sophisticated profit-based taxation. And the lack of such a capacity has limited Russia's options for further reform. Likewise, export duties, once introduced as a tax instrument, have

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3 been difficult to abandon due to the risks for the federal budget but also for the
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5 Russian economy overall.
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8 The findings of this paper are significant in several respects. Despite a
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10 growing literature on tax regimes in resource-rich countries, not much is know about
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12 what explains their evolution and the particular choices of governments. This paper
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14 presents a case study on Russia by putting its tax reform policies in the country's
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16 broader political context. It illustrates how the concentration of power around the
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18 executive shapes the process of institutionalising the tax relationship between the state
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20 and the oil sector. In terms of policy implications, this study highlights Russia's
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22 inbuilt resistance to profit-based taxation in the oil sector. It also cautions that
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24 Russia's political context makes policy instability a highly likely outcome, potentially
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26 in the form of shifting ad hoc tax policy measures rather than a comprehensive reform
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28 that binds the state's hands.
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