October 8, 1993

HOW RUSSIANS CAN TAP THEIR ENERGY WEALTH WITH MARKET REFORMS

INTRODUCTION

Russian President Boris Yeltsin has put down an armed rebellion of communists, fascists, and other extremists led by former Vice President Alexander Rutskoi and Parliament Speaker Ruslan Khasbulatov. While the political crisis in Russia is not over, Yeltsin has struck a powerful blow for democracy. As the democratically elected leader of Russia, Yeltsin had no choice but to use force to foil this attempt by his opponents to derail his reform program and to restore a totalitarian order.

While Yeltsin's attention is now rightly focused on the streets around the Russian Parliament building, or White House, his government must not lose sight of the need for continued economic reform. If Russia is ever to rise above the cycle of reform and violent backlash, it must move quickly to create a working market system. In last April's referendum, Russia's voters, by a clear majority, expressed their confidence in Yeltsin and his economic reform program. One of Yeltsin's most formidable challenges in achieving his goal will be to reform Russia's hugely inefficient and ineffective energy sector.

A growing and dynamic energy sector is central to the health and well-being of the entire Russian economy. Endowed with enormous and untapped energy resources, Russia is the world's largest exporter of energy and second only to Saudi Arabia in the production of oil.[1] Energy exports, moreover, are the single largest source of Russian hard currency earnings and government revenue.[2]

1 "Oil Production Fell 30 Percent," *World Bank News*, June 24, 1993, p. 5.

2 "Oil and gas exports are responsible for some 60 percent-70 percent of the Russian foreign-currency earnings from exports." "Tapping Into New Profits," *Commersant: The Russian Business Weekly*, April 7, 1993, p. 27. And "oil is Russia's only source of hard currency, accounting for 46 percent of budget foreign exchange revenues." "Raw Materials Export: The State Tightens Its Grip," *Commersant*, May 5, 1993, p. 4.

Yet, at a time when world energy consumption is growing at an estimated annual rate of two to three percent,[3] Russian energy production is declining and shows no signs of rising any time soon. Oil production alone, for instance, has declined by more than 30 percent since 1987.[4]

The Clinton Administration and the World Bank would like to address this problem through Western foreign aid. Foreign aid, however, cannot solve this problem. In fact, quite the contrary: by relieving the pressure for fundamental reform, foreign aid actually will perpetuate and even deepen the crisis in the Russian energy sector. The problem with the Russian energy sector is not a lack of money; rather, it is a problem of structure, organization, and ownership.

The Russian energy sector is dominated by huge and highly inefficient monopolistic state enterprises that have few incentives to maintain production at current levels, let alone to increase production. And it is heavily burdened by rules, regulations, and taxes that disrupt the workings of the free market, that fail to protect private property rights, and that cripple entrepreneurial activity.

If Russia is to take full advantage of what is perhaps its most important natural resource—energy reserves—then it must rapidly restructure its energy sector through privatization and the abandonment of state controls. Impelled by the profit motive, the private sector has a direct financial interest in producing the most energy in the most efficient manner. Unlike a government monopoly, it has every incentive to halt the decline in Russian energy production, revamp the energy sector's structure and operations, and search for and invest in new, but as of yet unexplored, sources of energy.

To revitalize Russia's energy industry, the Russian central government should:

✔ **Free domestic energy prices.**

✔ **Eliminate the existing multitude of taxes** on energy production and exports and levy instead a single low flat tax of 25 percent or less on energy producers and exports.

✔ **Establish a clear and unambiguous legal framework** that secures and protects private property rights in the Russian energy sector.

✔ **Radically reduce and simplify the regulations** governing the energy sector.

3 Richard L. Holman, "Postscripts...," *The Wall Street Journal*, October 1992. However, according to the U.S. Department Energy, world energy consumption is increasing at an average annual rate of only 1.6 percent. *International Energy Outlook 1993*, Energy Information Administration, Office of Integrated Analysis and Forecasting, U.S. Department of Energy, Washington, D.C., April 1993, p. 19. Moreover, reports *The Wall Street Journal*, European demand for natural gas could rise by as much 50 percent over the next two decades. Because of its proximity to the European continent, Russia already provides Western Europe with as much as one-third of its natural gas supply. It is, therefore, well-positioned to meet Europe's increasing demand for natural gas. Bhushan Bahree and Elisabeth Rubinfien, "Disruptions in Flow of Natural Gas From Russia Give Europe Jitters," *The Wall Street Journal*, October 22, 1992.

4 *World Bank News*, *op. cit.*

✔ **Privatize the energy sector by:**

— Fully incorporating the energy sector into its mass privatization program;

— Contracting with foreign investors and private-sector companies for the development of new oil and gas fields;

— Directing Russian local and city governments to privatize unrelated social and municipal services that are now being managed by energy-sector enterprises.

RUSSIA'S ENERGY CRISIS

Many attempts are already underway to reform Russia's energy sector. One of these is through foreign aid. The Clinton Administration's Russian aid package, for example, includes some $125 million in credits to promote sales of U.S. environmental technology, including equipment for Russia's giant oil and gas industries.[5] And according to the Russian business weekly, *Commersant*, the World Bank recently approved "a $1 billion investment project in Russia's oil and gas complex."[6]

This is a mistake. Foreign aid will do nothing to promote the necessary restructuring and privatization of the Russian energy sector, and thus will do nothing to resolve the deeper and more intractable problems that exist within this key area of the economy. To be sure, by enabling state energy companies to purchase horizontal drilling equipment, mobile well workover units, and other more advanced extraction technology, foreign aid may well result in a temporary increase in Russian oil and natural gas production.[7] Such assistance, however, actually will work to keep the energy sector in crisis by relieving much of the pressure for fundamental reform.

That is because the problems with the Russian energy sector lie much deeper than a lack of money and investment. Some 70 percent of all incremental industrial investment in the former Soviet Union, after all, was earmarked for the Soviet energy sector.[8] And today, some 46 percent of Russia's industrial investment programs are, likewise, designed to boost Russian energy production.[9] Nonetheless, the Russian energy sector is now in the midst of a financial and technological crisis.

If there is one area where the Russian economy ought to be booming, it is in its energy sector, where Russia has a natural comparative advantage with the rest of the world. More than 40 percent of the world's proven 4.9 million billion cubic feet of natural gas

5 Doyle McManus, "Administration Reworks Russian Aid to Promote U.S. Business," *Los Angeles Times*, June 3, 1993.

6 "Raw Materials Export: The State Tightens Its Grip," *Commersant*, May 5, 1993, p. 5.

7 Even so, however, any potential increase in production would be minuscule. According to *The Wall Street Journal*, for example, the $1 billion aid package would boost Russian oil output by only 3 percent. Richard L. Holman, "Russian Energy Help Advances," *The Wall Street Journal*, April 26, 1993.

8 Julie Corwin, "The Soviet Union's new energy crisis," *U.S. News & World Report*, November 26, 1990, p. 48. Historically, approximately 50 percent of all industrial investment in the former Soviet Union was earmarked for the Soviet energy sector.

9 "Some Sectors Swimming in Investments, Others Wither," *Commersant*, May 26, 1993, p. 18.

reserves, for instance, lie in the Commonwealth of Independent States (CIS).[10] And it is estimated that as much as 90 percent of CIS natural gas reserves lie in the Russian Republic.[11] Russia is also reported to possess some 90 percent of the CIS's proven 57 billion barrels of oil reserves[12] and 45 percent of the world's total proven coal reserves.[13]

Energy exports, moreover, are the single largest source of Russian hard currency earnings and government revenue.[14] Russia exports more than 40 percent of its energy production,[15] which in the late 1980s accounted for some 40 percent of total hard currency earnings.[16] In 1992, Russian exports of fuel amounted to nearly $21 billion;[17] revenues gained from oil exports alone reportedly have topped $600 billion over the past twenty years.[18]

Russia's Troubled Energy Sector. Despite its enormous potential, the energy sector is one of the most troubled areas of the Russian economy. Oil production is declining at a rate of more than 1.5 million barrels per day on an annual basis, and has fallen by an estimated 30 percent since 1987, from 570 million tons in 1987 to less than 400 million tons in 1992.[19] Production is projected to drop even further over the next few years, perhaps to as little as 260 million tons of oil in 1994.[20] If present trends continue, by 1995, Russia could well be a net importer of oil.

According to the World Bank, simply revamping the Russian oil sector to the point where it could produce as much oil in the year 2000 as it did in 1991 would require an initial investment of $25 billion and an additional annual investment of $6 billion to $7 billion.[21] And according to Russian Energy Minister Yuri Shafranik, simply to maintain the present depressed level of oil production in Russia would require a sustained annual investment of at least $4.5 billion.[22]

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10 *Oil and Gas Journal*, December 28, 1992, pp. 44-45.

11 *Oil and Gas Journal*, January 4, 1993, p. 56.

12 *Ibid.*

13 "Energy Industry wins World Bank support," *Petroleum Economist*, September 1992.

14 *World Bank News, op. cit.*

15 World Bank, *Russian Economic Reform: Crossing the Threshold of Structural Change," A World Bank Country Study*, Washington, D.C., August/September 1992, p. 175.

16 International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), European Bank for Reconstruction and Development (EBRD), and Organization for Economic Cooperation and Development (OECD), *The Economy of the USSR: A Study Undertaken in Response to a Request by the Houston Summit*, December 1990, p. 42.

17 *Eastern Bloc Energy: A Monthly Review of Oil and Energy in the CIS and Eastern Europe*, Eastern Bloc Research Ltd., United Kingdom, Volume VI, No. 1 (March 1993), p. 10.

18 Farman Salmanov, an academician and member of President Yeltsin's Expert Consultative Commission, as quoted in Alexei Frolov, "Salmanov tackles chaotic industry," *We: The First Independent Russian-American Newspaper*, Special Report: Oil and Gas, April 19-May 2, 1993, p. 4.

19 *Oil and Gas Journal*, December 28, 1992; *World Bank News, op. cit.*

20 Sergei Seninsky, "CIS threatened by energy crisis," *Moscow News*, March 19, 1993, p. 6.

21 Otto Storf, "Russia's energy industry - a factor of uncertainty for the reform process," Deutsche Bank Research, *Focus: Eastern Europe*, January 6, 1993, p. 4.

22 John Lloyd, "Russian ministers differ on energy," *Financial Times*, March 5, 1993, p. 3.

Clearly, such investment will not be coming any time soon. In 1992, the World Bank estimated that international oil companies allocated approximately $54 billion for exploration and development worldwide, and that, given a favorable investment climate in Russia, upwards of 10 percent of that amount could be invested in Russia.[23] In fact, however, very little has been invested in the Russian energy sector. Experts estimate that less than $350 million in foreign energy-sector investment flowed into Russia in 1992.[24] And according to the *Petroleum Economist*, there are now only six joint ventures actually producing oil in Russia.[25] Many of the foreign investors in these projects say that Russian government rules and regulations make it impossible for them to turn a profit.

A recent study by two banks, Daiwa Europe and Bankers Trust, found that at the beginning of 1992 less than one percent of Russian oil output was produced either in whole or in part by foreign companies.[26] The reason: Highly confiscatory and prohibitive rates of taxation on energy production and exports, as well as a rapidly changing and uncertain legal environment that fails to protect private property rights, make investment in the Russian petroleum sector extremely risky and imprudent.

The situation is better in the Russian natural gas sector, where production has remained constant, but even there recent trends are ominous. The World Bank reports that the world's largest on-shore deposit of natural gas, in the western Siberian province of Urengoy, has been significantly damaged by use of antiquated and wasteful extraction practices that are endemic to the Russian energy sector.[27]

"Increasing water encroachment is causing problems and raising costs," says the Bank, which notes that "much new information and investment" will be needed to remedy this situation.[28] The Bank predicts a "fall in gas extraction through 1995 and only moderate growth till the end of the decade." Some experts, however, think that Russian natural gas production "might even shrink in the further course of the 1990s."[29]

Russian coal production has fallen as well, from a high of 426 million tons in 1988 to 353 million tons in 1991—an amount roughly equivalent to all of the Russian coal mined in 1970.[30] And the shortage of electricity-generating capacity in Russia is now estimated to be 25,000 megawats.[31] All told, combined production of oil, gas, and coal fell 6.1 percent in 1991 and 5.6 percent during the first half of 1992.[32]

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23 Storf, *op. cit.*

24 Interview with Sheldon R. Stoughton, European Energy Group, Bankers Trust Company, London, May 1993. Moreover, according to Yuri Shafranik, Minister of Fuel and Energy, in 1992, joint ventures with Western firms invested a "mere $150 million" in Russia's oil and natural-gas sectors. Joint ventures are the principal means by which foreign firms invest in the Russian energy sector. Seninsky, *op. cit.*

25 Isabel Gorst, "Taxing oil to death," *Petroleum Economist*, March 1993, p. 3.

26 Bankers Trust and Daiwa Europe [Bank], *New Policies and Structures for the Russian Oil Industry*, a report prepared for Rosneftegaz Corporation, July 1992, p. 41.

27 Leslie Dienes, Istvan Dobozi and Marian Radetzki, *Energy and Economic Reform in the Former Soviet Union: Implications for Production, Consumption and Exports and for the International Energy Markets* (Washington, D.C.: The World Bank, February 1993), p. 52.

28 *Ibid.*

29 Storf, *op. cit.*, p. 3.

30 World Bank, *Russian Economic Reform, op. cit.*, p. 178.

REFORMING RUSSIA'S ENERGY SECTOR

The problems with the Russian energy sector are systemic and structural. What is needed is privatization of the Russian energy sector, whereby Russia's huge state energy conglomerates would be restructured into private joint stock companies and shares of company stock issued to the public.

When the Yeltsin government's mass privatization program was designed and implemented last year, the energy sector was excluded. In November 1992, however, President Yeltsin issued a decree ordering all state petroleum companies to sell shares of company stock to private-sector buyers.[33] Nevertheless, it was not until August 1993 that Russia launched its first official privatization of oil companies; even then, only an 8.3 percent company stake was proffered for private purchase.[34] The Russian central government recently announced plans for the privatization of Gazprom, the Russian natural gas monopoly.[35] And in accord with a December 1992 presidential decree, most state coal associations have been transformed into joint stock companies.[36]

Nonetheless, under the terms of the plans now being considered by the Russian central government, private-sector holding in the state petroleum sector will be limited to no more than 60 percent of natural gas and to a similar share of oil.[37] Gazprom will remain a state-sanctioned monopoly.[38] And it will be at least three years before Russian state oil and natural gas companies are privatized.[39] In the meantime, the Russian petroleum sector will continue to deteriorate, new fields will remain unutilized, and production will continue to fall well below what is optimum.

The Yeltsin government, therefore, needs to speed up privatization of the Russian energy sector. Privatization alone, however, is not sufficient because even most private-sector companies will fail if they are hobbled by the rules and regulations of the old system. To make privatization work in the Russian energy sector—and indeed, all sectors of the economy—the Russian central government must create a legal regime conducive to new private-sector growth and development. Specifically, the Russian central government should:

☞ Free domestic energy prices.

The Russian central government freed prices on nearly 90 percent of goods and services in January 1992. However, it retained price controls on energy products and

31 Estimate made by officials of the U.S. Department of Energy.

32 Fred Hiatt, "Siberia's Exploited Mines Losing Production," *The Washington Post*, October 9, 1992, p. A32.

33 "On Distinctive Features of Privatization and Corporatization of State-Owned Enterprises and Production and Science and Production Amalgamation in the Field of Oil Production, Oil Refining and Oil Product Supplies," Presidential Decree No. 1403, November 17, 1992, reprinted in *Commersant*, December 1, 1992, pp. 22-23.

34 Leyla Boulton, "Russia launches oil privatization," *Financial Times*, August 18, 1993.

35 Keith Bush, "Gas Industry to be Privatized," *RFE/RL Daily Report*, April 6, 1993, p 1.

36 *Eastern Bloc Energy*, March 1993, p. 8.

37 "Gas monopoly survives reform," *Petroleum Economist*, December 1992.

38 *Ibid.*

39 "Russia too sluggish on oil privatization," *Oil & Gas Journal*, November 23, 1992, p. 17.

other so-called essential goods such as bread and milk. Russian fuel and energy prices were, instead, administratively increased, by a factor of 80 in 1992.[40]

President Yeltsin has tried to remedy this situation by issuing a decree that ostensibly will liberalize coal prices;[41] he reportedly would like to free oil prices as well.[42] Nonetheless, coal, oil, and other domestic energy prices remain far below normal, market levels. The Russian domestic price of oil, gas, and coal, for instance, is but 15, 5, and 4 percent respectively of what it is internationally.[43] In part, this is because of the precipitous decline in the value of the ruble that has taken place this past year, which has largely offset administrative increases in the prices of energy products in Russia.

Nonetheless, administrative price increases, no matter how great, are no substitute for free market prices, which have a number of advantages, particularly in the Russian energy sector:

✔ **They would help eliminate domestic energy shortages and increase Russian energy production.**

Free market prices on energy products would help eliminate domestic energy shortages and increase Russian energy production because they would allow producers to reap profits from energy exploration and production. If producers are not willing to invest their time and money in energy exploration and development, then energy production will decline and shortages will develop.

Certainly, this is the case today in the Russian energy sector, where price controls make it unprofitable for producers to invest even in the rehabilitation of existing energy fields. Oil prices at the wellhead, for instance, barely cover operating costs on average, according to the World Bank.[44] And more than 30,000 oil wells are reported idle as producers hoard their output in anticipation of greater future profits when price controls are released.[45] More ominously, price controls have stymied the development of new oil fields since producers lack both the capital and incentive necessary to finance additional oil exploration. This is a real problem because 75 percent of Russia's most highly productive oil reserves have been exhausted.[46]

✔ **Free market energy prices also would encourage more efficient use of energy within Russia.**

Free market prices on energy products would raise Russian energy prices to world market levels. The resulting higher energy costs would cause Russians to make more efficient use of energy. As a result, energy once wasted on inefficient internal consumption would now become available for export to the West. These exports would

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40 "Gas Exports Lead the Energy Industry," *Commersant*, February 9, 1993, p. 4.
41 Erik Whitlock, "Coal Prices to be Freed," *RFE/RL Daily Report*, June 22, 1993, p. 1.
42 "Politics as Usual: Yeltsin Frees Oil Prices," *Commersant*, June 2, 1993, p. 27.
43 Sheila Marnie, "Russia's Energy Sector to Increase Exports?", *RFE/RL Daily Report*, June 29, 1993, p. 1.
44 World Bank, *Russian Economic Reform, op. cit.*, p. 175.
45 "Tapping into New Profits," *Commersant*, April 7, 1993, p. 26.
46 "The state of Russia's fuel and energy complex," *Commersant*, March 23, 1993, p. 27.

earn Russia valuable and much-needed hard currency and would strengthen the entire Russian economy.

For example, energy conservation alone could result in a tripling of Russian oil exports.[47] According to Russian government officials, a decrease of domestic oil and gas consumption through conservation of only 10 percent would increase Russian energy export revenue by $15 billion.[48]

Similarly, a December 1991 study by the International Monetary Fund (IMF) found that if oil and gas prices were merely doubled—in which case they would still remain far below world market levels—and the energy saved as a result were channeled to export at the world market price, Russian export revenue would grow by at least $8 billion annually in the short run (one to five years beyond the price doubling) and at least $25 billion annually in the long run (five or more years beyond the price doubling).[49]

Regardless of the exact amount, however, the potential gain certainly would be substantial. Price controls have dramatically lowered the cost of energy for Russians, who, as a result, make far less efficient use of energy than do most people in the world. Consequently, energy consumption relative to economic output in Russia is now roughly twice what it is in the economically advanced countries of the West.[50] Indeed, the Russian economy produces only 30 percent to 50 percent as much as the economy of the United States, yet it consumes three-fourths as much energy.[51]

Vouchers. Many Russian officials are loath to free domestic energy prices because they fear that doing so will destroy Russian industry and impoverish the populace. It is true that liberalizing energy prices will impose temporary economic hardships and dislocations on Russian enterprises and the Russian people. However, if these are deemed too severe, they can be dealt with successfully through compensating vouchers.

For example, vouchers could be issued by the Russian central government and earmarked for those individuals and enterprises most hurt by the impact of market prices on energy products. Voucher recipients should, of course, be allowed to sell and trade their vouchers, which would be redeemable for a specified quantity of energy. Their use, however, should be only a short-term measure aimed at helping Russian enterprises and the public at large adjust to energy-sector price liberalization.

In accordance with this end, the Russian central government should announce ahead of time when use of the vouchers will be proscribed and when they will be withdrawn from circulation. On the one hand, the time period in which the vouchers are issued and used should be sufficiently large so as to allow voucher recipients time to adjust to market prices on energy products. On the other, it should be sufficiently brief so as to

47 "Russia: Privatise or be damned," *Petroleum Economist*, August 1992, p. 26.

48 "Gas Exports Lead the Energy Industry," *Commersant*, February 9, 1993, p. 4.

49 Manmohan S. Kumar and Kent Osband, "Energy Pricing in the Soviet Union," *IMF Working Paper*, December 1991.

50 Istvan Dobozi, "Prospects for Energy Consumption in the Former Soviet Union: The Impact of Market Reforms," December 1992, p. 3. Paper presented at the Association for Comparative Economic Studies Meetings, Allied Social Science Association Annual Meeting, January 5-7, 1993, Anaheim, California.

51 William U. Chandler, "Investment Guarantees Needed in Russia's Energy System," *Policy Memorandum*, Advanced International Studies, Battelle, Pacific Northwest Laboratory, Washington, D.C., February 10, 1993, p. 1.

minimize the inflationary effects of a new (voucher) currency. In developing countries and countries now making the transition from socialism to capitalism, vouchers typically are used as an alternative form of currency and thus contribute to the inflationary effect of too many monetary units (rubles in the case of Russia) chasing too few goods.

☞ Eliminate the existing multitude of taxes on energy production and exports and levy instead a single low flat tax of 25 percent or less on energy producers and exports.

Taxes on energy production in Russia are highly punitive and, therefore, greatly discourage private-sector entrepreneurial activity in the Russian energy sector. Total cumulative rates of taxation amount to 80 percent to 85 percent of gross revenue valued at world prices, according to the World Bank.[52] No other country in the world taxes its energy sector at such a high level.[53] When coupled with other Russian central government taxes—the export tax of $5 per barrel on oil, for example, and the 60 percent income tax on foreigners—Russia's tax system is crippling foreign investment in Russia. Indeed, tax rates are so high that, according to the Petroleum Advisory Forum, it costs a Western company 22 percent more to produce oil in Russia than to sell it.[54]

The unpredictable and complex nature of the Russian tax system also works to stifle new investment and new private-sector entrepreneurial activity in the Russian energy sector. At present, for example, oil producers in Russia are subject to a 32 percent tax on "profits,"[55] an 8 percent tax on royalties, a 10 percent minerals replacement tax, a 4 percent road-use tax, a 1 percent mandatory conversion tax, and an export tax of roughly $5 per barrel of oil.[56] Frequent and abrupt changes to the Russian tax code, moreover, make it extraordinarily difficult for prospective investors to analyze investment opportunities in the Russian energy sector.[57] This, of course, raises the perception of risk and thus discourages potential investors.

Thus, replacement of the existing Russian tax code on energy with a single flat tax of 25 percent or less on energy producers and exports would achieve a number of important objectives:

✔ It would fuel new foreign investment in the Russian energy sector.

Russia's economic environment is now one of the least hospitable to investment in the world, and this is especially true as it concerns the Russian energy sector. For example, according to Farman Salmanov, a member of President Boris Yeltsin's Expert Consultative Commission, less than 10 percent of Soviet oil profits were reinvested in the country's oil sector.[58] And up to 95 percent of Russian oil profits are taken by the

52 World Bank, *Russian Economic Reform, op. cit.*, p. 180.

53 "Internationally, total tax rates vary from the mid-30 percent range to the mid-80 percent range. The top of this range is relatively rare, and is found in countries where there is a high degree of political stability." Bankers Trust and Daiwa [Bank], *op. cit.*, p. 31.

54 Irene Ertugrul, "Oil producers press for better investment climate," *We*, March 22-April 11, 1993, p. 6.

55 This tax does not actually apply to profits; rather, it applies to company revenues.

56 Interview with Sheldon R. Stoughton.

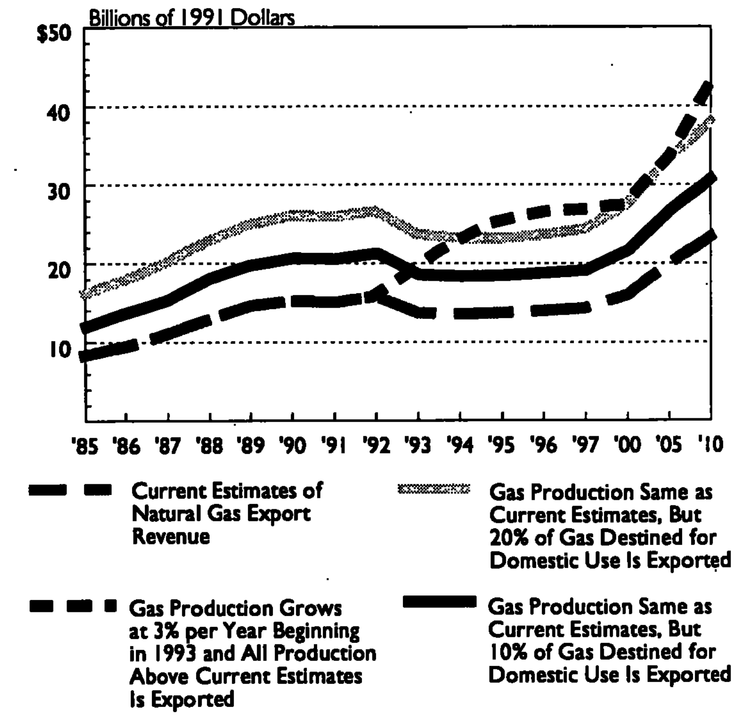
57 Bankers Trust and Daiwa [Bank], *op. cit.*, p. 27.

central government in the way of taxes.[59] Consequently, energy companies in Russia often lack the capital and resources necessary to invest in new, more up-to-date technology and equipment through which they can increase Russian energy production. Because it would allow energy companies to keep more of, and make better use of, their earnings, a flat tax of roughly 25 percent would help remedy this problem and, therefore, would fuel new foreign investment in the Russian energy sector.

✔ **Radically reduced and simplified taxes on energy production and exports would strengthen and enlarge Russia's contracting tax base.**

A dramatic reduction and simplification in Russian tax rates on energy production would reverse the present shrinking of Russia's energy-sector tax base. That is because tax reduction would put investments back into the private sector, where they would be used to fuel rapid growth and expansion of the Russian energy sector. This will enable Russia to increase energy production and exports and earn billions of dollars in export revenue.

Revenue from Russian Natural Gas Exports: Current Projections vs. Alternative Scenarios



Sources: Heritage calculations based on PlanEcon, Inc., *Energy Outlook for the Former Soviet Republics*, June 1993; Energy Information Administration, U.S. Department of Energy, *International Energy Outlook: 1993*, April 1993.

Heritage DataChart

It also will provide producers with a strong incentive to avoid working through the "black" or informal market, in which they are able to escape government taxation. With tax rates so high, energy producers now have a strong incentive to operate illegally. Many already do; as much as 40 percent of Russian export oil, for example, is exported through "black" market channels and thus escapes taxation by the Russian central government.

Because modern economies are so heavily dependent upon energy for their growth and development, new private-sector investment in this sector would spur new growth

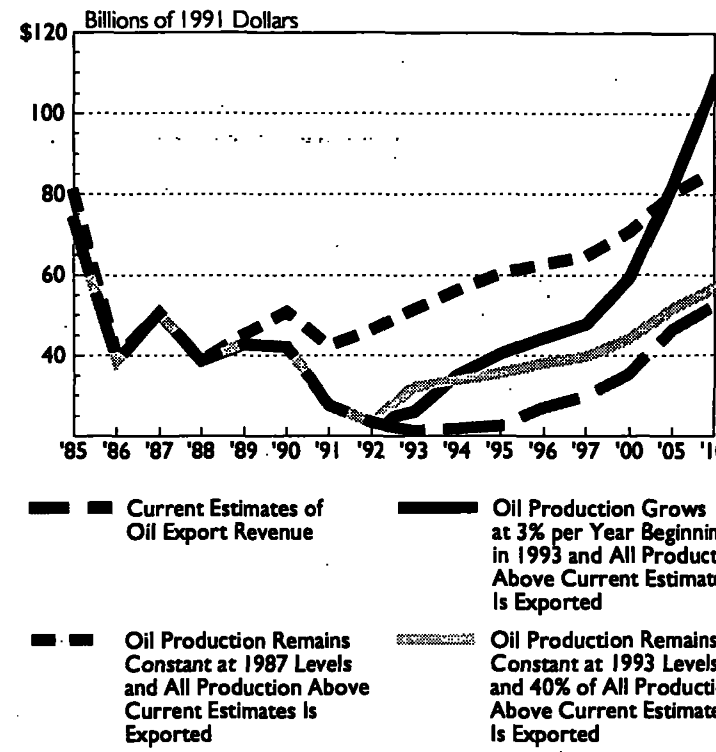
58 Frolov, *op. cit.*

59 "Oil Producers Complain About Their Lot," *Commersant*, May 12, 1993, p. 13.

throughout the entire Russian economy, and with that, new tax revenue as well. It also would strengthen Russia's capacity to export energy. This is important because the revenue gains from increased energy exports are considerable and could be used to revive Russia's collapsing energy sector.

For example, an increase in Russian oil exports of between 40 percent and 50 percent would earn the Russian Federation at least $4.8 billion—more than enough to put its some 30,000 oil wells back on line.[60] Meanwhile, during the time in which the wells are being revived, Russia stands to lose between $3.5 billion and $4 billion in lost energy exports.[61]

Revenue from Russian Oil Exports: Current Projections vs. Alternative Scenarios



Sources: Heritage calculations based on PlanEcon, Inc., *Energy Outlook for the Former Soviet Republics*, June 1993; Energy Information Administration, U.S. Department of Energy, *International Energy Outlook: 1993*, April 1993.

Heritage DataChart

Russian energy exports currently are increasing. Oil exports, for instance, grew by an estimated 40 percent during the first half of 1993.[62] This is not, however, because the Russian oil sector is beginning to recover; rather it is because the Russian economy is collapsing and as a result, has less need for energy. Also, because administrative price increases have raised the cost of energy to enterprises and consumers, they are making somewhat more efficient use of oil, coal, and natural gas. Consequently, producers have more energy available for export; hence, the rise in Russian oil exports.

Nevertheless, Russian energy exports are still well below what they otherwise would be in the absence of high and prohibitive rates of taxation on Russian energy production and exports. Witness, for example, the fact that Russian oil exports are rising even as Russian oil production is falling.[63]

60 "Tapping Into New Profits," *Commersant*, April 7, 1993, p. 26.

61 *Ibid.*

62 Interview with Matthew Sagers, Energy Analyst, PlanEcon, Inc., Washington, D.C., August 1993.

63 Charts on pages 10 and 11 show the potential revenue gains from Russian oil and natural gas exports.

A dramatic reduction and simplification in Russian tax rates on energy production also would provide entrepreneurs and businessmen with the money and flexibility needed to invest in new, more up-to-date extraction equipment and technology with which they can increase Russian energy production. Energy extraction practices in the former Soviet Union are antiquated, wasteful, and inefficient. For example, on average in Russia, only 7 percent of oil is extracted from the oil field.[64] In the United States, by contrast, the comparative figure is closer to 35 percent.[65] Seventy percent of drilling rigs in the former Soviet Union were built in the 1950s.[66] With tax rates so high, producers cannot afford to purchase better equipment.

✔ **Radically reduced and simplified taxes on energy production and exports would help reduce Russia's high deficit spending.**

The Russian central government spends billions of dollars to subsidize its energy sector. Recently, for example, the Russian energy sector was awarded hundreds of billions of rubles worth of low-interest investment credits.[67] With trillions of rubles of additional subsidies still needed by the energy sector,[68] more such credits are on the way. Russian energy-sector enterprises, moreover, are owed more than three trillion rubles (approximately $2.8 billion) by consumers.[69] To make matters worse, the central government heavily subsidizes many industries, such as animal husbandry and agriculture, that are heavily reliant on energy.[70]

Such massive financial support is necessary because the Russian energy sector retains very little of its profits and revenues, turning most of them instead over to the Russian central government in the form of high taxes. Yet, high taxes are a major reason so many energy-sector enterprises in Russia lose money. Some 75 percent of Russia's oil companies, for example, operate at a loss and survive only because of special government support and "black" market exports.[71] Because it would lessen these companies' need for government financial assistance, radically reduced and simplified taxes on energy production and exports would help reduce Russia's high deficit spending.

✔ **Radically reduced and simplified taxes on energy production would help reduce Russia's high and hyper rates of inflation.**

Unlike the economically advanced countries of the West, which can and do finance high deficit spending mostly by raising taxes and by drawing upon the reserves of international capital markets, Russia can finance high deficit spending only through the excess printing of rubles.[72] This, of course, inflates the ruble currency and causes infla-

64 Vladimir Kvint, "Eastern Siberia could become another Saudi Arabia," *Forbes*, September 17, 1990, p. 131.
65 *Ibid.*
66 Dienes, Dobozi, and Radetzki, *op. cit.*, p. 56.
67 Erik Whitlock, "More Financial Preferences to Russian Energy Industry," *RFE/RL Daily Report*, March 23, 1993, p. 3.
68 "Tapping Into New Profits," *Commersant*, April 7, 1993, p. 26.
69 "Spring oil output turns out higher than expected," *Commersant*, June 30, 1993, p. 5.
70 "Gasoline Prices Follow a Winding Path Upward," *Commersant*, June 2, 1993, p. 13.
71 *Eastern Bloc Energy*, March 1993, p. 7.

tion, which in 1992 alone was more than 2,000 percent in Russia. Therefore, to the extent that it reduces Russia's high deficit spending, tax reduction in the Russian energy sector would help reduce Russia's high and hyper rates of inflation.

☞ Establish a clear and unambiguous legal framework that secures and protects private property rights in the Russian energy sector.

Establishment of such a legal framework and accompanying market-oriented institutions would, of course, benefit the entire Russian economy. However, because in its energy sector Russia has a natural comparative advantage with the rest of the world, most of the benefits of private property rights protection would become manifest there first.

Foreign investment will never materialize in large amounts unless foreign investors are confident that their investments are legally secure and well-protected. This requires a legal framework to allow for unfettered foreign private-sector investment in the Russian energy sector. This would include full ownership rights for foreign investors, as well as their right to fully repatriate profits.

Fears that this will lead to a foreign "buy out" of Russia are unfounded and misdirected. With roughly one of every five Russian oil wells idle, for example, Russia is losing an estimated 30 million tons of oil a year.[73] This is costing the Russian economy approximately $3.6 billion,[74] and there is no possibility that domestic Russian investment can put a halt to this decline.[75]

Indeed, the real potential danger in Russia today is not that its energy plants and facilities will be "bought out" by foreigners; it is that foreign businessmen and entrepreneurs will invest their money elsewhere, and that, consequently, energy production will continue to decline. A well-established and well-protected system of private property rights is essential for private-sector development. Thus Russia needs:

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72 Theoretically, of course, it also could raise taxes. However, this is not a viable option for two reasons: first, because Russian tax rates, particularly on energy production, already are too high. Raising them further would simply weaken an already weak economy and thus reduce economic output. Far from raising revenues, this would reduce them over the long term. Second, because the Russian government simply does not have the administrative means at its disposal to ensure taxpayer compliance. Higher tax rates, therefore, would simply accelerate and perpetuate the process whereby productive entrepreneurial activity would be driven underground into the black market where it would escape all taxation.

73 Interview with Matthew Sagers. According to Sagers, Russia is losing somewhere between 15 and 50 million tons of oil/year because of idle oil wells. Most analysts estimate that the actual loss of oil is closer to 30 million tons of oil/year.

74 According to PlanEcon, Inc., Russian oil costs approximately $120/ton. Thus, at a loss of 30 million tons of oil/year, Russia is losing approximately $3.6 billion.

75 Foreign investment, however, can. Western investors are eager to invest in the Russian energy sector. For example, a recently published report by the United Nations Economic Commission for Europe found that as a result of deals signed between 1990 and early 1993, the former Soviet Union's oil, gas, and mineral sectors could realize upwards of $85 billion in foreign investment. Frances Williams, "Oil boom in CIS may attract $85 billion," *Financial Times*, May 5, 1993. Russia, significantly, stands to gain the lion's share of this investment, with 22 of the report's 39 projects located on its territory. But again, none of this potential foreign investment will ever materialize unless foreign investors are confident that their investments are legally secure and well-protected.

- ✔ a system of contract law that clearly defines the various types of legally protected contracts and which actions are permissible;
- ✔ a titling system that establishes a citizen's claim to ownership rights and responsibilities;
- ✔ a system of tort law to protect owners from civil infringements upon their property;
- ✔ commercial codes governing the sale of goods and services;
- ✔ an independent system of adjudication that arbitrates contractual disputes fairly and objectively, on the basis of the contract in dispute and other relevant case law;
- ✔ an independent private banking system that provides ordinary citizens and entrepreneurs with loans and credit, on the basis of sound market principles;
- ✔ systems of collateral that allow ordinary citizens and entrepreneurs to leverage their existing assets for business and wealth creation.

☞ Radically reduce and simplify government regulation of the energy sector.

Streamlining state rules and regulations that govern the energy sector will help make it a more attractive investment to investors. That is because it would eliminate and reduce in scope bureaucratic hindrances and obstacles that make the cost of new private-sector entrepreneurial activity in the Russian energy sector prohibitive.

Russian regulatory policy, particularly with regard to the energy sector, ought to be guided by three essential principles:

1) **Everything not expressly forbidden is permitted.**
2) **A given regulation is to be imposed only after conducting a careful cost-benefit analysis of its effect on private business and only after it is found that its anticipated benefits outweigh its anticipated costs.**
3) **Retroactive regulations and taxes are forbidden.**

Adherence to these principles would mark a decided change in Russian regulatory policy. As things now stand, foreign investors in the Russian energy sector often are subject to arbitrary seizure of their hard currency revenues and must cope as well with a discriminatory customs structure.[76] Because of these and other punitive regulations,

76 The Oil and Gas Working Group of the U.S.-Russia Business Development Committee published a two-page memo that lists the specific difficulties Western firms have doing business in the Russian energy sector. "Investment and Trade in Russia's Oil and Gas Sectors: Concerns of United States Investors," March 31, 1993, Energy Division, investors are loath to invest in the Russian energy sector. Other countries such as Kazakhstan and China are addressing this problem and, consequently, are succeeding in attracting energy-sector investments that otherwise might go to Russia.[77] As one observer explains:

> The difference between Kazakhstan's rapid deal-making and Russia's lagging performance is that the latter subjects companies to an excruciating set of bureaucratic layers, while Kazakhstan has streamlined the process down to a few government officials.[78]

☞ Privatize the energy sector by:

✔ Fully incorporating the energy sector into its mass privatization program.

The Russian energy sector must be opened up to private-sector capital investment and restructuring, with an emphasis on privatization. Privatization is far advanced in Russia. More than 60,000 of Russia's estimated 196,000 state-owned enterprises, for instance, have been privatized, with many more soon to be privatized.[79] These include 60 percent of small-scale enterprises,[80] 70 percent of light industry, and 50 percent of Russian construction firms.[81] In addition, more than 3,000 large-scale enterprises—nearly 20 percent of the total—have been privatized;[82] and more than 20 percent of Russia's industrial work force now work for privatized firms.[83]

All told, by the end of 1992, more than 18 million people—some 30 percent of all workers in the Russian non-agricultural state sector—had participated in this historic process;[84] and with six to seven hundred enterprises being privatized each month through voucher auctions, thousands more will soon participate.[85]

The Russian government ought to build on this success and fully incorporate the energy sector into its mass privatization program. This will benefit Russia economically because, as a growing body of empirical evidence from other countries shows, private-sector energy companies are far more productive and efficient than their state-run counterparts. For example, Argentina's state oil company, *Yacimientos Petroliferos Fiscales*, saw a five-month jump in crude oil production of 12 percent within a year of its partial privatization in 1991 and 1992.[86] Crude oil production by private-sector

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United States Department of Commerce, Washington, D.C.

77 Kurt S. Abraham, *"Kazakhstan rises to top of FSU heap,"* *World Oil*, January 1993, p. 31.

78 *Ibid.*.

79 Anatoly B. Chubais, "Russia: Birth of an Entrepreneurial Nation," *The Wall Street Journal*, June 16, 1993.

80 A small-scale enterprise is defined as one that employs fewer than 250 people; a mid-sized enterprise is defined as one that employs between 250 and 10,000 people; and a large-scale enterprise is defined as one that employs more than 10,000 people.

81 Interview with Jeffrey Gayner, Director of The Heritage Foundation's Moscow Office, September 1993.

82 Interview with Adrei Shleifer, Professor of Economics, Harvard University, August 1993.

83 *Ibid.*

84 The State Committee of the Russian Federation for the Management of State Property, *Annual Report 1992*, Moscow.

85 Interview with Adrei Shleifer.

86 "Argentina's Energy Sector Sell-Offs Reap Rewards As Investment, Output Grow," *Oil Market Listener*, Energy

companies grew even more dramatically, by some 340 percent.[87] All told, the Argentine government expects to achieve a 50 percent increase in crude oil production by the year 2000 through energy-sector privatization.[88] It also expects to net some $8 billion in new revenue.[89]

A recent World Bank study confirms that Argentina's experience with privatization is typical.[90] The study examined twelve instances in four countries (Chile, Malaysia, Mexico, and Great Britain) in which government enterprises were privatized and found that, taken together, the twelve privatizations resulted in an average increase in enterprise wealth of nearly 26 percent.[91] In eleven of the twelve cases studied, privatization had a beneficial impact on domestic welfare,[92] which, on average, grew by 33.25 percent. And in nine of the twelve cases studied, privatization had a beneficial impact on enterprise productivity, which also grew, by an average of 14.6 percent.

The Russian central government has taken several important steps toward privatizing its energy sector, most recently by announcing a plan for privatization of the Russian state gas industry. According to the plan, the Russian natural gas monopoly, Gazprom, will be converted into a joint stock company in which 15 percent of its shares will be sold to Gazprom workers, 28.7 percent of its shares will be sold to people living in Russia's gas-producing regions, 5.2 percent will be sold to residents of Yamalo-Nents, Gazprom's home region, and 10 percent sold to the public. The government will retain some 40 percent of the company's stock.[93]

Similarly, the November 1992 presidential decree required all state oil companies to convert themselves into joint stock companies by January 1, 1993.[94] As a result, 38 percent of all shares in Russian state oil companies have been distributed to workers. And a December 1992 presidential decree required that all state coal associations convert themselves into joint stock companies.[95] Conversion into joint stock companies represents a necessary first step toward privatization. The process of restructuring, however, is proceeding slowly. It will be at least three years, for example, before Russia's oil sector is privatized.[96] And since the present distribution of oil shares is confined solely to workers, it will not significantly change the Russian oil sector's

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Information Limited, New York, New York, September 23, 1992, p. 1.

87 *Ibid.*

88 *Ibid.*

89 "Argentina to fully privatize state owned YPF," *Oil & Gas Journal*, October 5, 1992, p. 46.

90 Ahmed Galal, *et al.*, *The Welfare Consequences of Selling Public Enterprises: Case Studies from Chile, Malaysia, Mexico and the United Kingdom* (Washington, D.C.: The World Bank, June 1992).

91 In this instance wealth is defined essentially as the percent increase in the firms' turnover that resulted from privatization.

92 Domestic welfare is measured in this report by changes in costs and benefits for all the economic actors affected by the privatization—that is, buyers, governments, consumers, workers, and competitors.

93 "Gas Industry to be Privatized," *RFE/RL Daily Report*, *op. cit.*

94 "On Distinctive Features of Privatization and Corporatization of State-Owned Enterprises and Production and Science and Production Amalgamation in the Field of Oil Production, Oil Refining and Oil Product Supplies," Presidential Decree No. 1403, November 17, 1992, reprinted in *Commersant*, December 1, 1992.

95 *Eastern Bloc Energy*, March 1993, p. 8.

96 "Russia too sluggish on oil privatization," *Oil & Gas Journal*, *op. cit.*

present antiquated structure. In addition, most state oil companies affected by the decree missed the January 1 deadline for submission of their plans for restructuring. Thus, it remains unclear how and when they will convert themselves into joint stock companies. Gazprom, moreover, will remain a state-sanctioned monopoly even after privatization.[97]

✔ Contracting with foreign investors and private-sector companies for the development of new oil and gas fields.

As part of Russia's privatization program, development rights over underutilized and unutilized energy fields would be put up for bid to foreign investors and private-sector companies. This would help put new market forces at work in the Russian energy sector and thus would spur competitive market pressures throughout the entire industry—pressures that would help to transform Russia's huge state energy conglomerates along market-oriented lines.

This could be done through a competitive contract, whereby the Russian government would solicit bids for the right to explore and develop a specific energy field. These bids should be solicited from entrepreneurs and private-sector companies and ought to be evaluated fairly and impartially on the basis of objective criteria. The entrepreneur or company whose bid most closely matches the stated criteria should be awarded the right to explore and develop the energy field being put up for tender.

Here, too, the Russian central government has experience and thus need only build upon what it is already doing. Last June, for instance, it announced its intent to award an international tender for the right to prospect for, and extract gas in, the Magadan sector of the continental shelf of the Sea of Okhotsk.[98] Oil and gas fields off the far eastern island of Sakhalin also are being put up for tender.[99] And, according to the Russian business weekly, *Commersant*, "a wave of international oil tenders continues to sweep Siberia."[100]

Anti-Monopoly Policy. By opening the Russian energy sector up to competing companies, none of which have exclusive development rights over the entire sector, international tenders are an important part of anti-monopolization policy.

Anti-monopolization policy is essential to Russia and other countries now making the shift from socialism to capitalism. It is especially important in the early stages of the transformation process when industrial enterprises retain close ties to the state and are only just beginning to restructure themselves along market lines. Indeed, in the absence of an effective and coherent anti-monopolization policy, there exists a real danger that former Soviet enterprises will conspire amongst themselves to raise prices and hurt consumers.

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97 "Gas monopoly survives reform," *Petroleum Economist, op. cit.*

98 "Tender Announced for Magadan Oil-and-Gas Deposits," *Commersant,* June 16, 1993, p. 11.

99 John Lloyd, "Russian oil and gas fields out for tender," *Financial Times,* September 29, 1992, p. 7.

100 "The Verkh-Tarkskoye Oil Field Put up for Sale," *Commersant,* March 11, 1993, p. 9.

Thus far, there is scant evidence that this is happening in Russia. Most enterprises are finding it so difficult to survive that they have neither the time nor the ability to act in collusion with like-minded firms against consumers. Moreover, although not steady and consistent, the liberal thrust of the Yeltsin government's economic reform program has nonetheless spurred a host of new competitive market pressures in the Russian economy that are serving to check its generally monopolistic tendencies.

Indeed, sweeping and broad-based market reforms are the most effective anti-monopolization policy since they foster fair and unfettered market competition through which monopolies seldom develop and almost never last. For example, in the U.S. during the 1970s, International Business Machines Corporation so dominated the American computer market that it could be argued that it was a monopoly. However, because the U.S. has a relatively free and open market, IBM's hold on the American computer market did not last. By the early 1980s a number of small-scale competing firms had emerged to challenge IBM's dominant position. Among them was Apple Computers, founded by a young college drop-out in his early 20s, Steven Jobs. As a result of the challenge from these entrepreneurs, Americans have a wide choice of personal and home computers, and the once-small challengers dominate the market.

The lessons for Russian government officials are clear. They must persevere with a sweeping and broad-based economic reform program. This program must create a free and open market in which new entrepreneurs can easily and fairly compete with existing firms.

Toward that end, the Russian government must not empower any monopoly or monopolistic enterprise with the sanctioned force of law. If a monopoly emerges, it should be because of its success in the free and open market and not because of special favors and protection from the government. Private-sector monopolies tend to be temporary and fleeting since they are subject to the vagaries of the market. On the other hand, state-sanctioned monopolies tend to be permanent since they are backed by the full force of state law. As concerns the Russian energy sector, this would mean ending Gazprom's privileged legal status as a state-sanctioned monopoly and allowing subsidiary state oil and gas companies to become independent.

For these same reasons, business licensing ought to be made nearly automatic and the Russian central government ought to move as quickly as possible to eliminate trade barriers that isolate Russia economically from the rest of the world. When the Russian people and Russian enterprises are able to import energy freely from anywhere in the world, it will pressure domestic Russian energy companies to reduce costs and lower prices so as not to lose business. Moreover, to spur competitive market pressures in the Russian energy sector, foreign investors and private-sector companies ought to be granted the right to explore and develop new oil and gas fields.

Only when these and other like-minded policies are pursued in earnest will Russia have an anti-monopolization policy worthy of the name. All other approaches to this problem, such as state controls on the prices charged by monopolistic enterprises, risk creating a worse problem than the one they purport to resolve. In the case of price controls, for instance, shortages and queues will develop such as were common in the Communist era. Full-fledged market reform where all enterprises can compete freely and fairly in an unencumbered market is the only effective answer.

✔ **Directing Russian local and city governments to privatize unrelated social and municipal services that are now being managed by energy-sector enterprises.**

In many towns and cities, many social and municipal services, such as housing, schooling, agriculture, and the building of roads and bridges, are subsidized by the earnings of energy-sector enterprises. These often are the only enterprises with the wealth and financial resources necessary to subsidize needed local services. Indeed, they typically are more wealthy than the local government.

But while these services are important to the local community, they are a costly burden to those that must pay for them. Therefore, before the Russian energy sector can be fully privatized and opened up to foreign investment, it must shed itself of these services, which are unrelated to the production of energy.

The Russian central government can help solve this problem by directing Russian local and city governments to privatize each of these services on a case-by-case basis, with the aim of making them independent services paid for either by the local government or service recipients, not the energy sector enterprises.

With regard to many services, such as housing and agriculture, privatization can be achieved relatively quickly since the Russian private sector already is a well-established service provider. For example, according to U.S. government estimates, some 25 percent of Russia's housing stock has been "financed privately by citizens and was never part of state inventories."[101] And more than 25 percent of Russian agricultural production is grown by Russia's private-sector farmers,[102] who now number more than 250,000, up from less than 1,000 only three years ago.[103]

With regard to other services, however, such as building roads and bridges, privatization will prove more difficult. The reason: the Russian private sector is only in its infant stages and thus is not well-established. Consequently, in many instances, when a Russian local government attempts to privatize a given service, it will be unable to find an indigenous private-sector service provider.

This can be remedied, in part, by allowing foreign private-sector companies to compete for the right to provide social and municipal services. Privatization is a well-established tool of government economic policy in the West, where there exist a multitude of private-sector service providers in many different fields. Moreover, by implementing a formal privatization procedure for social or municipal services, Russian local and city governments will encourage the development of indigenous Russian private-sector companies able to provide social and municipal services.

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101 Central Intelligence Agency, "Measuring Russia's Emerging Private Sector," *Intelligence Research Paper*, November 1992.

102 Roy L. Prosterman and Leonard J. Rolfes, Jr., *Status Report on Russian Agrarian Reform*, RDI Reports on Foreign Aid and Development #80 (Seattle, Washington: Rural Development Institute, March 31, 1993), p. 2.

103 Interview with Konstantin A. Mezentsev, International Development Head, Association of Private-Sector Farmers in Russia (AKKOR), Moscow, June 1993.

CONCLUSION

What is remarkable in Russia today is not that turmoil and violence have broken out in Moscow. Few expected that Russia's road to democracy and a free market economy would be a smooth one. Rather, it is that, for the first time in Russian history, a democratically elected government favoring market reforms has used force against political opponents who sought to establish a dictatorship.

Despite the progress Yeltsin has made in economic reform, there is one area in particularly where Russia has made little headway, and that is in reforming its energy sector, where production is either stagnant or declining. This need not be the case, because if there is one area where Russia can readily attain Western-style free-market prosperity, it is in its energy industry. Russia is blessed with enormous and largely untapped natural energy deposits, including 10 percent of the world's oil reserves, 40 percent of its natural gas reserves, 10 percent of its hard coal deposits, and 20 percent of its brown coal.

Yet, despite this natural comparative advantage with the rest of the world, Russian production of oil and coal has declined precipitously these past several years and continues to decline. Moreover, Russian natural gas production has stagnated and likely will decline in the latter part of this decade. Russia is suffering as well from an acute shortage of electrical generating capacity.

This can easily change, but only through privatization. Russia's energy industry must be fully privatized. Central to this process, of course, is the elimination of bureaucratic rules and regulations that act to impede private-sector entrepreneurship in Russia's energy sector, which not only is dominated by huge and highly inefficient monopolistic state enterprises, but which is burdened as well by a wide array of bureaucratic rules and regulations that act to hobble entrepreneurship.

Indeed, an increasing number of countries worldwide are now privatizing their energy sectors—and with very good results. Nonetheless, the Clinton Administration and World Bank are trying to solve Russia's energy problems with Western foreign aid. But putting good money into a bad system will not solve these problems. In fact, by relieving much of the pressure for fundamental reform, Western foreign aid actually will make the situation worse.

A better and more cost-effective alternative is private-sector investment, which is nearly absent in the Russian energy sector. If Russia's energy sector were privatized, the amounts of foreign investment coming into Russia could easily dwarf any amount of Western foreign aid. Such investment will never materialize, however, until the Russian government removes the bureaucratic obstacles to entrepreneurship in the Russian energy sector and pushes ahead with privatization of its state energy complex. The benefits of doing so will accrue not only to the Russian energy sector, but to the entire Russian economy and indeed, to all the people of Russia.

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