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Are Resources a Curse?

Rentierism and Energy Policy in Post-Soviet States

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Part III: Implications on Transit Issues

Preface

Anja Franke/Andrea Gawrich/Jana Windwehr

This book is one result of the interdisciplinary research project *"Political and Economic Challenges of Resource-Based Development in Azerbaijan and Kazakhstan"*, called RAZKAZ. The project has been realized by the Institute of Social Sciences, Department of Political Science at the Christian-Albrechts- University of Kiel, and the Kiel Institute for the World Economy and was financed by the German Volkswagen Foundation. The major focus of this project has been to analyze the political and economic challenges of the resource-based development in post-Soviet states, especially in Azerbaijan and Kazakhstan. Looking back at the development in other resource-rich countries during the last 30 years, most of them have experienced economic and political stagnation ("resource curse") as well as deficient political systems in which the process of modern state formation is being undercut ("rentier state") as well as economic structures in which sectors that provide strong incentives for the accumulation of physical and human capital are underrepresented ("Dutch disease"). This is very much the same in many of the post-Soviet states with high resource incomes since the mid 1990s.

Instead of taking advantage of the opportunities rent incomes offer, many of the rentier states present authoritarian regimes with high levels of corruption, minimal political freedom and rent-seeking elites. Most of the post-soviet states correlate with the typical rentier state features.

RAZKAZ tried to contribute deeper insight into the post-Soviet space to the rentier-state literature and debate. There is still a significant research deficit especially in analyzing the political challenges of post-Soviet rentier states on a deeper case study basis. Some of our research results can be found in this book (see the contributions of Gawrich/Franke; Lücke/Seuring and Wiebelt).

Yet, this book contains more than that – it collects contributions from outstanding scholars, with whom we established fruitful scientific exchange during the work at this project. In fact it is primarily a compilation of papers presented at our second international workshop on "Post-Soviet Rentier States and Energy Policy in Autocratic CIS-states", which took place in Berlin 16th to 17th October 2008.

After a short introduction by *Andrea Gawrich* and *Anja Franke* on Post-Soviet Rentierism, energy policy and Geostrategies, the first part of this book on "Rentierism in a Superpower – the case of Russia" delivers deep insights into the nexus between Russian energy and power politics on a rather anti-democratic basis on the federal as well as on the regional level. The article by

Christian A. Nygaard focuses on the development and reforms in the Russian oil and gas industry since the late Soviet period. He clearly shows that oil and gas policy continues to play a defining role in shaping the federal-regional relations and state-civil society interaction that form the basis of state building. He further argues that, in this respect, oil and gas policy developed primarily as a governance tool for these interactions, rather than as a tool for optimizing industry development.

The contribution by *Julia Kusznir* addresses the question of how economic elites influence regional politics and achieve their goals in Russian energy policy on a regional level. It examines the interests these elites pursue, the methods they use and how they affect Russia's economic and political development in the oil and gas industry as the most influential economic branches in Russia. She presents a case study from the Khanty-Mansii Autonomous Okrug as well as a second one from the Yamalo-Nenets Autonomus Okrug and finds that the power structures have been changing significantly to the benefit of the federal centre under the rule of President Putin.

The second part of this book on „Between Europe and Asia – the Caspian region" starts with a contribution by *Andrea Gawrich* and *Anja Franke* on autocratic and neopatrimonial regime stability due to oil revenues which provides insight into the characteristics of regime mechanisms of post-Soviet rentier states, especially Azerbaijan and Kazakhstan. They argue that this kind of post-Soviet autocratic regime stability is based on neopatrimonial rentierism, rent-seeking-orientated power circles and strategic alimentation of society.

Manfred Wiebelt presents a recursive-dynamic computable general equilibrium (CGE) model for Kazakhstan. In his paper he examines how public infrastructure investment generates intertemporal productivity spillovers, but in a potentially unbalanced, sector-specific manner. His results suggest that while it is certainly possible to identify configurations of parameters and policies such that public investment leaves the economy worse off than without oil windfall revenues, this requires very low values for the productivity of public expenditure and high values of the learning-by-doing externality and/or a high level of operating and maintenance expenditure.

Based on the assumption that Turkmenistan is a classic rentier state, *Michael Denison* concentrates on the relationship between governance and the energy sector. He states that the sultanistic style of governance *is* the structure of governance rather than being a feature of it – as it is typical of the Central Asian region. As a consequence, domestic business 'players' or foreign energy companies cannot really influence policy-making as it flows downwards through the system. The state remains the sole manager of the domestic energy sector.

Matthias Lücke and *Till Seuring* examine the role of stabilization and savings funds for natural resource revenues in supporting a sustainable use of government oil revenues in Kazakhstan and Azerbaijan. They review the operational rules and performance of the two funds and compare these to the Norwegian petroleum fund, which is often viewed as a benchmark for good fiscal practices in this field. They conclude that the resource funds do not (and cannot ever) provide a magic bullet to deal conclusively with the twin temptations to decision-makers of spending too much resource revenue too soon, and of diverting expenditures to suit private interests rather than the public interest.

The third part of this book on "Implications on transit issues" examines the vibrancy of oil and gas policy as well as rent-seeking interests in post-Soviet rentier states on the nearer surroundings. Two cases have been examined under this focus: the energy policy of the transit state Ukraine as well as some political implications of the Nord Stream pipeline project in the Baltic Sea, especially concerning Poland.

Inna Melnykovska concentrates on energy policy in Ukraine after the Orange Revolution. In her article, she seeks to define the reasons behind the minor progress in decreasing energy dependency and the delay in market reforms since then. With reference to the "rentier states"-explanation, she especially assesses the influence of political factors on policy-making in the energy sector.

Stefan Bouzarouvski tries to shed further light on some of the public discourses, power relations and geopolitical dynamics related to the construction of Nord Stream, through a case study of the Polish state's and public's reaction to the pipeline. In particular, he looks at the pipeline's role in the articulation of national security interests, international relations strategies and transformation of energy priorities.

We are grateful to Niklaas Haskamp and Karen Reinfeld from the Barbara Budrich Verlag for the trustful cooperation as well as to Michael Holldorf for helping with the layout, Dr. Paul Kramer for helping with language corrections and last but not least our colleagues in the research project, Dr. Joachim Krause, Gourban Alakbarov, Dr. Matthias Lücke, Dr. Manfred Wiebelt and Dr. Natalia Trofimenko for the fruitful debates in this project.

Kiel, September 2010

Andrea Gawrich Anja Franke Jana Windwehr

Introduction

Andrea Gawrich/Anja Franke, University of Kiel

Most of the countries of the post-Soviet space, especially in the Caucasian and Central Asian region, are blessed with natural resources. They generate high levels of revenue from their natural resources in relation to their GDP. This natural endowment brings many challenges for the ongoing economic and political transition. In contrast to the Central and East European (CCE) countries, post-Soviet states have been reformed rather slowly and very often remained authoritarian. This book explores the impact of natural resources on political and economic development in the post-Soviet space. The following contributions mainly draw upon the concept of rentier states to explain the management and utilization of – mostly oil – resources by the state. Particular attention is paid to the influence resources have on the respective economic development, the domestic energy policy and the political situation in the country. Vice versa, how the political situation in these countries does influences the use of resources.

In this book, we selected the cases of Russia, Kazakhstan, Azerbaijan, and Turkmenistan as obvious post-Soviet rentier states,[1] as well as Ukraine as a semi-rentier state, due to its position as an important transit country. According to Mahdavy's (1970) concept of the rentier state as well as Beblawi and Luciani (1987) external rents, which are eponymous for the rentier state concept, are received through the exploration of natural resources, foreign financial aid, and transit rents for pipelines. The main features are the externality of rents, the state as the main recipient, and the fact that only a small group decides on the allocation of rents. Accordingly, the case studies in this book present a selection of different types of post-Soviet rentier states. Furthermore, they offer some insight into different elites' behavior, according to the management of related economic and political challenges in a rentier situation.

Whereas political elites in Russia, the Ukraine, and Kazakhstan transformed the centralized Soviet market system into a neoliberal market economy, political leaders in Azerbaijan focused more on a state controlled economy, which has been partly privatized. Nevertheless, all resource rich states underwent degrees of privatisation and nationalization. This is one basic tool for the ruling elite's maintenance of power in post-Soviet rentier states.

One focal point in rentier state analysis is the nexus between rentierism and the way of ruling i.e., regime quality. The combination of both, natural re-

1 See for more on the regional subtype of rentierism Franke et al 2009.

sources and non-democratic ruling, is very often regarded as fatal as it gives the ruling elites considerable space for rent-seeking behavior. One core question is, therefore, „Does oil hinder democracy?“[2] Recently, there has been an increasing number of studies focusing on the relation between natural resources and negative institutional development (e.g. Herb 2005; Luong 2004; Tsui 2005; Ramsay 2006). There is also a basic hope that in transition countries resource rents might be used to promote national welfare and to increase the state budget. In fact, it is more likely that rents are used by predatory and egoistic political elites for personal enrichment.

As the exploitation of natural resources is in the hands of the state in most countries, resource rents are very often regarded as a tool for consolidating autocratic power. As a consequence, plentiful natural resources become a curse not a blessing for the economy, the society, and the national polity.

This mostly implies autocratic regimes with egoistic elites. These elites are mainly characterized by a so called *rentier mentality* (Beblawi 1987:52), which consists of short-term and near-sighted egoistic use of rents. Following Luong (2004), we can assume that the legal property distribution in the resource sector is very much decisive for the danger of the resource curse. If the resource sector is in the hands of the state – which is rather common in the post-Soviet area – public tasks like acquisition, management, and distribution of resource rents follow the logic of maintaining power (Beblawi 1987). This is even truer, if only a small group of people controls external rents, as in Kazakhstan and Azerbaijan. In fact, oil is "attractive to dictators" (Tsui 2005:5). In this context, Auty distinguishes between *benevolent* and *predatory* autocracies. According to his categorization, the post-Soviet states belong mostly to the predatory autocracies ruled by oligarchic groups. The main intention of these groups is to achieve maximum profits through the exploitation of resource rents. Turkmenistan, for example, can be regarded as an extreme negative example of an autocratic predatory state (such as Nigeria, Ghana or Algeria) (Auty 2006). Russia, Kazakhstan, and Azerbaijan are somewhat moderate examples.[3]

Rent-seeking elites tend to accrue capital for their own benefit and show low interest in welfare issues. Therefore, it might be assumed that rents are blocking socio-economic developments, as the recipients of the rents – mostly state institutions – are not forced to reinvest them, which has certain effects on the economy. Resource rich countries very often ignore the fact that they, in the long term, need diversified branch structures, in order to be prepared for the time after the resource windfall. We see a lack of strategies to avoid branch asymmetries, which might lead to the *dutch disease*-phenomenon.

2 See the respective article by Ross (2001).

3 As Ukraine belongs to the group of semi-rentier states, it is not relevant here.

If resources are in private hands (as in Kazakhstan and Russia), and in those of domestic investors, incentives for branch diversification are comparably higher, which, according to Luong, can be understood as the „rational-choice of ownership structures". Yet, very often, the requirements of enormous investment in the resource-related sectors hinder private investment in weak transformative economies as in the post-Soviet space.

These features might lead in the long run to severe problems in the national economies. Governments use rent revenues to buy political support and thus create surrogate legitimacy (Schmid 2001; Esanov et al. 2001; Moore 2004; Basedau/Lacher 2005). This is often done by building up various layers of cronies or functional, tribal, religious, and other social groups that either actively support the system or develop political or religious ideologies legitimizing it. Instead, well developed democracies like Norway might avoid these risks (Ross 2001; Dauderstädt 2006).

If incentives for capital accumulation are small, because competing for control over resource rents offers higher rewards, resource rents may be appropriated by small groups and consumed rather than invested. Under these circumstances, a resource-rich country (or at least the majority of its population) may end up worse off than a resource-poor country where incentives for productive investment are well developed and the economy grows due to capital accumulation.

In addition, the rapid expansion of a resource-extracting sector as well as the flows of resource rents into the domestic economy entail a pattern of long-run structural change that differs sharply from most of today's developed countries (Leamer 1987; Wood/Berge 1997; Wood 1999). In this way, more narrow economic factors may also contribute to the resource curse.

Furthermore there are different types of resource-rich countries. In some rentier states the ruling elite seeks legitimacy and political stability by buying support and therefore distributes resource rents to a sizeable part of the population. But even in these states the benefits from resource revenues are heavily skewed in favor of a small elite (Chaudry 1994; Auty 1990; Tsalik 2003). Other rentier states have become penetrated by criminal structures or one ethnic group maintains political control by using rents to suppress competing groups (Schmid 1999). In yet other cases former revolutionary elites turned into a new state class and wasted enormous amounts of resources on deficient industrial and infrastructure investment projects that benefited primarily members of the ruling elite and their cronies (Garon 1994; Dillmann 2000).

Despite the fact that the use of rent incomes is non-transparent in all post-Soviet states, they use national stabilization and savings fund (oil funds) for saving incomes and avoiding inflation. Such funds serve a dual function as they seek to stabilize government expenditures (i) in the short to medium run in response to fluctuating export prices, and; (ii) in the long run in response to limited absorptive capacity and the decline of resource revenues, when reserves are exhausted (Mayer et al. 1999). They raise many institutional and economic issues. From an institutional perspective, the relationship between the fund and the annual budget should be controlled by national parliaments. Instead, the distribution of the oil-fund money is controlled by non-democratically selected elites in the public sector.

Apart from these factors, rentierism affects the relationship between state and society. A majority of the country's population has to wait passively for the distribution or use of rents (see, for example, Moore 2004; Yates 1996). The main consequence of a rent situation is that the state is freed from the need to extract income from the domestic economy or from local citizens through taxes. The government can then embark on large public expenditure programs without resorting to taxation (Moore 2004; Sandbakken 2006; Schmid 1997). Oil revenues, therefore, give the state a certain autonomy in relation to society—a point that is aptly surmised by Michael Herb in the slogan, "no taxation – no representation" (Herb 2005). Such a rentier state is, as Luciani notes, an "*allocation state"* and is distinguished from a "*production state"*, which relies on taxation and the domestic economy for its income.

This elite autonomy is especially relevant in the post-Soviet area:

> „[...] state leader are sovereignty maximizers. Particularly in newly independent states, state leaders prefer more rather than less sovereignty, which translates into more rather than less control over their natural resources." (Luong 2004:7)

Oil rents accrue directly in the hands of the state, which creates loyalty to the state through patron-client networks and increases the political stability of the country, giving the government a certain degree of legitimacy (Smith 2004). However, apart from this, resource-related wealth creates a social structure that is not favourable to democracy. Following modernization theories, independent middle and labour classes are important sources of democratic transition and a pillar of political opposition. In a rentier state, the middle classes, in particular, are missing. Instead of the middle class and traditional elites, there is an egoistic 'rentier class' of civilian technocrats in public administration (Sandbakken 2006:139). In the post-Soviet societies, in particular we face a lack of middle-class structures as a legacy from Soviet times, which makes the emergence of a rentier class easier. Douglas Yates views the development of a 'rentier class' with a 'rentier mentality' as reflecting the fundamental difference between earned and unearned incomes. Rewards and wealth in the rentier class are regarded as the result of rent opportunities, not of work (Yates 1996:22). This is why rentier states are particularly vulnerable to the problems of patronage and corruption, as well as bribery and nepotism (Sandbakken 2006:138).

In an allocation state resource rents may be transferred to particular social groups not only directly, but also through a variety of policies whose distributive effects may not be obvious. These include tax privileges, subsidies, trade barriers, or the creation of jobs in the public sector. Such indirect transfers of resource rents may cause spiraling state intervention in the economy, with ultimately profound economic distortions and resulting instability (Auty/Gelb 2004). Whether resource rents are used to promote economic growth and reduce poverty clearly depends largely on who controls the decision-making process. Therefore, deficient political systems are widely viewed as one major cause of the “resource curse”.

All of the post-Soviet rentier states lack a good regime quality. They are defined not only by control over large resource rents, but also by the Communist legacy of these former Soviet republics. During the 90s, hopes that non-democratic states in the CIS area might become at least *democracies with adjectives* (Collier/Levitsky 1997) were disappointed, as most of them became presidential autocracies. The CIS autocracies ranged from hard forms with no perspectives of immediate change to soft or competitive authoritarianism with mild changes occurring from time to time (e.g. Means 1996; Levitsky/Way 2002). The autocratic presidentialism with one strong person at the top of the state is regarded as a very important indicator for autocracy in this area.

In comparison to newly democratized states in Central East Europe, the post-Soviet states lack responsive political institutions, mostly have no pluralistic party systems, a low level of democratic conscious among important societal groups, and a weakly developed civil society.

As a consequence, there is mostly no or low demand from the society for more transparency concerning rent income and rent distribution. This makes the emergence of post-Soviet rentier states with a rentier mentality among the ruling elites far easier.

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Part I: Rentierism in a Superpower – the case of Russia

Russia's Oil and Gas Policy

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Russia controls a significant portion of the world's remaining oil and gas reserves and is a major oil and gas exporter. During the first decade of the 21st century buoyant oil prices enabled Russia's federal government to significantly reduce foreign debt and thus (re)create the basis for an autonomous foreign policy and for autonomous international relations (Appel 2008). At the same time, domestic energy policy has played a defining role in the functioning and restructuring of federal-regional relations and state-industry relations.[1] Beyond its economic and fiscal importance, oil and gas policy in Russia is instrumental in shaping the emerging politico-economic parameters of a resurgent post-Soviet Russia.

Throughout the 1990s the privatization of Russia's oil industry helped define the institutional and organizational structure of Russia's economy and contributed to the emergence of powerful industrial groups capable of narrowing state autonomy. Similarly, the gradual, and sometimes forceful, re-creation of state autonomy since the early 2000s has helped define the post-Yeltsin era. Contestation and competition for oil and gas resources and policy have been at the centre of both these processes and is characteristic of Russia's (continued) modernity dilemma. Modernity in this respect refers to institutions that are capable of overcoming economic, political and social obstacles to economic growth and the state's capacity and autonomy to incentivize, either through market institutions or more state-centred policies, economic actors to invest in high value production or generate higher labour productivity (Robinson 2009). Where such institutions have not evolved organically, modernity is engendered concomitantly with state building as the state substitutes for the social action of economic agents that effectuate organic development by creating institutions that ensure the balanced direction of investment resources to productive, rather than consumption, ends (Robinson 2009). Russia's modernity dilemma lies in the balancing of state building, incentivizing the organic emergence of economic institutions that can deliver equitable prosperity – in particular where organic developments conflict with short-term state building objectives – and the establishment of a

1 Oil and gas policy critically influences the relationship and structure of federal-regional relations. Throughout this chapter, a distinction is therefore made between federal-regional relations that articulate meta-political (or political-economical) relations and state-industry relations that articulate the relationship between industrial actors (frequently private entities) and the meta-political structures, whereby the latter relationship does not necessarily obtain at any precisely defined level in the meta-political hierarchy. See also the article by Julia Kusznir in this volume.