Transparency, Accountability and Public Participation as Foundations for Effective Operations of Natural Resource Funds: Implications for the Russian Stabilization Fund

Lada Progunova

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Transparency, Accountability and Public Participation as Foundations for Effective Operations of Natural Resource Funds: Implications for the Russian Stabilization Fund

A Thesis

Presented to the

McAnulty College and Graduate School of Liberal Arts

Duquesne University

partial fulfillment of

the requirements for the degree of

Master of Arts

by

Lada Progunova

March 30, 2006
Lada V. Progunova

Transparency, Accountability and Public Participation as Foundations for Effective Operations of Natural Resource Funds: Implications for the Russian Stabilization Fund

Master of Arts

Thesis

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ABSTRACT

This research argues that in order to operate successfully a Natural Resource Fund (NRF), no matter what its goals are, must be transparent, accountable and open for public scrutiny. Otherwise, a NRF could be useless or even harmful. “Resource curse,” “Dutch disease,” and “rentier” behavior are theoretical rationales for establishing NRFs. Corruption is viewed as a “transmission channel” of natural resource effects on growth.

Guidelines to evaluate NRFs for transparency and accountability were developed. Analysis of selected NRFs’ websites revealed that Norway and Alaska provide directions to incorporate transparency into a NRF. Alberta demonstrates that even if democracy is strong, a lack of transparency and accountability decreases effectiveness of a NRF. Venezuela and Kazakhstan demonstrate a fragility of a NRF when bureaucratic elites keep a NRF from public oversight. Azerbaijan shows that steady disclosure efforts can improve a NRF’s performance, though not by much if public involvement is low.

A variety of mistakes were made in designing the Russian Stabilization Fund: in predicting oil market dynamics and, consequently, in setting the threshold and base prices of oil. The lack of proper legislation and checks and balances blocked a chance to fix these mistakes early on. The research concludes with policy recommendations for the government of Russia: to clarify the Fund’s mission, to strengthen its legal foundation, to diversify its investment strategy, to establish an auditing policy, to create an overseeing public council, to disclose quarterly and annual reports, to maintain a website, and other improvements.
ACNOWLEDGEMENTS

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<table>
<thead>
<tr>
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<tr>
<td>AHSF</td>
<td>Alberta Heritage Savings Fund</td>
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<td>APF</td>
<td>Alaska Permanent Fund</td>
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<td>APFC</td>
<td>Alaska Permanent Fund Corporation</td>
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<td>CC</td>
<td>Consultative Council</td>
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<td>CSF</td>
<td>Copper Stabilization Fund (of Chile)</td>
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<td>EITI</td>
<td>Extractive Industry Transparency Initiative</td>
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<td>FIEC</td>
<td>Investment Fund of Economic Stabilization (of Venezuela)</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>G8</td>
<td>“Great 7” + Russia</td>
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<td>ICRG</td>
<td>International Country Risk Group</td>
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<td>IEP</td>
<td>Institute of Energy Policy (of Russia)</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>NFRK</td>
<td>National Fund of Republic of Kazakhstan</td>
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<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>NRF</td>
<td>Natural Resource Fund</td>
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<td>SOFAR</td>
<td>State Oil Fund of the Republic Azerbaijan</td>
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<td>SFRF</td>
<td>Stabilization Fund of the Russian Federation</td>
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<td>SPF</td>
<td>State Petroleum Fund/State Pension Fund (of Norway)</td>
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1. INTRODUCTION

_Statement of the Problem_

In the last 30 years a variety of Natural Resource Funds (NRFs) were created in different resource-rich countries and territories to help manage their natural resource wealth. NRFs have a variety of forms, ranging from separate institutions to little more that a governmental account. These funds have been expected, through stabilization of fiscal policy and savings of a portion of revenues in their countries, to tackle such negative effects of revenues from natural resources as exploding or volatility of prices, “Dutch Disease” and “Paradox of Plenty.” The funds have also been expected to promote good governance in managing of natural resource endowments through transparency and public accountability of their operations.

In their years of operation it has become evident that the effectiveness of the NRFs as a fiscal policy instrument is mixed, and resource-abundant countries can implement sound fiscal policy just as effectively without a NRF as with one (Davis and others 2001). Some scholars believe that a real value of a NRF is to be a political instrument, especially in new democracies and non-democratic states, that forces governments to be honest about what they are earning and spending.

Natural Resource Funds around the world differ from each other in goals, objectives, organizational structures, and spending patterns. In this paper we do not argue the efficacy of different functions of a NRF. Instead, we suggest that a NFR can be viewed as a complex policy institution that can serve as an instrument of fiscal, financial, social and developmental policies, with substantial political influence. An argument of
this paper is that in order to be successful in any of these functions, a NRF must be transparent, accountable, and open for public participation.

*Theoretical Framework*

Fundamental postulates of democratic governance serve as theoretical bases for this research in general. Access to information and accountability are necessary conditions for effective performance of any financial institution in a market economy. Political institutions in a democratic society do not work without separation of powers, checks and balances, publicity, and freedom of expression. In particular, “resource curse,” “paradox of plenty,” “Dutch disease” and “rentier” behavior will be viewed as theoretical rationales for establishing NRFs.

Special theoretical attention will be paid to the relationship between abundant natural resources and corruption. Some scholars argue that abundant natural resources stimulate the development of corruption. Oil-exporting countries, according to Transparency International’s World Corruption Index, are considered especially corrupt. Moreover, Carlos Leite and Jens Weidemann found that corruption functions as a “transmission channel of natural resource effects on growth” and, consequently, exacerbates the “Dutch Disease” phenomenon (Leite and Weidemann 1999). Based on this theoretical funding we can conclude that NRFs as instruments of public policy must be transparent and accountable to tackle not only Dutch Disease, but corruption itself. Only by being transparent and accountable can NRFs mitigate negative outcomes of the “resource curse” associated with petroleum and other minerals. Without transparency, a NRF could be useless or even have “adverse impacts” (Davis and other 2001:7).
Hypothesis, Variables and an Evaluation Tool

A Hypothesis is as follows: The more transparent, accountable, and open for public governing any NRF is, the more likely this fund will perform effectively in terms of revenues and public spending.

Independent variables: Transparency can be measured as the scope of information about a fund’s operations presented in comprehensible language and available for the broad public. Accountability can be viewed in terms of sound internal and external auditing policies. Level of public participation can be observed through activities of overseeing bodies, outcomes of related public hearings, and forums.

Dependent variables: The dynamics of a fund’s principal and returns on portfolio are determinants of revenues. Addressing budget deficits, repaying foreign debts, implementing social projects, and distributing dividends directly to citizens from NRFs are indicators of a sound spending strategy.

For the purpose of measuring the independent variables, guidelines for Natural Resource Funds were developed. These guidelines do not pretend to be exhaustive, but they represent a policy tool created for the purpose of this evaluation based on analysis of the literature.

However, because of restricted access to information about funds’ operations around the world, the hypothesis is only tested to a limited extent. Strictly speaking, only the level of transparency, as a scope of information presented on NRFs’ websites, is evaluated directly for six selected NRFs. Accountability and public involvement are checked indirectly, as availability of audit and overseeing bodies’ reports on funds’
websites. In addition, accountability lines are analyzed for two selected funds. Independent variables of selected funds are taken from estimates by other scholars.

The primary source of data is official websites of selected NRFs and other governmental and non-governmental agencies.

_Narrow Scope of Analysis and Research Questions_

The narrow scope of this research is the Stabilization Fund of the Russian Federation, which was established in December 2003 by the legislature (Duma). The launching of the Russian Fund reflects the government’s desire to achieve a greater control over oil revenues compared with the preceding Yeltsin period, when most revenues ended up in the hands of a few oligarchs.¹ Scholarly work is far from a consensus on the advantages of establishing an oil fund in a country with questionable budget discipline. Still, other scholars believe that this fund can help to establish some regularity and predictability in the management of resource revenues in Russia.²

The law set a base threshold for the overall amount accumulating in the Fund after exceeding which the government has the right to withdraw money from the Fund. Within just one year, this threshold was surpassed.

Calls for the “easy money” from the Fund have intensified in Russia these days. Several major teams have formed around the issue of tapping money from the Fund. Most regional governors have favored utilizing the oil money for various investment projects. A business lobby has called for distributing funds in the form of developmental loans. There are some exotic ideas as well. For example, one politician, Sergey Mironov, suggested opening a personal account for each newborn in Russia with $10,000 on this

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² Ibid.
account. A child would be able to take this money on reaching 18 years old. Until that time, the money would be used for high-tech infrastructure development in Russia.\(^3\)

In 2005, under the pressure of economists, led by Finance Minister Kudrin, some of the fund’s money was spent for early repayment of Russia’s foreign debt and covering a shortfall in the pension fund.

It appears that effectiveness of the Russian Stabilization Fund as a fiscal policy and financial institution is mix. The Russian Account Chamber calculated that the Fund did not earn, but lost in 2005 approximately $820 million because of inflation and a poor investment strategy (Kipelman 2005:71).

At first glance, the level of transparency and accountability is very low. If this situation continues there will be a risk that the Russian Fund will become a secret account for the Russian elite’s private spending.

In this connection, the first research question is: why did all this happen with the Russian Fund? If the hypothesis is right the second research question will be: What should be done in Russia to increase fiscal transparency, public accountability and participation in managing the Russian Stabilization Fund. Major policy recommendations will be elaborated for the Russian government. Some of them will be interesting for foreign governments and international organizations dealing with natural resources in Russia.

As for the structure of the thesis, Chapter 2 provides the theoretical framework. Chapter 3 is devoted to analysis of NFRs’ practices to test the hypothesis. The topic of Chapter 4 is current developments with the stabilization fund in Russia and policy recommendations.

\(^3\) [http://www.mironov.ru/Position/18275.html](http://www.mironov.ru/Position/18275.html)
2. THE POLITICAL ECONOMY OF NATURAL RESOURCE FUNDS

The purpose of this chapter is to prove theoretically that transparency, accountability and public participation are necessary conditions for any Natural Resource Fund (NRF) to operate successfully as an institution for managing public natural resource wealth. However, they are definitely not sufficient conditions by themselves. Efficient functioning of any NRF depends on many other factors that mostly relate to strict fiscal policy and effective financial performance by a team of professional investors with a fund’s money on the world financial market. An effective spending strategy is equally important as earnings. However, the key point of this thesis is that NRFs must be accountable and open for public scrutiny. Without this, even a perfect financial performance of NRFs will not help people of resource-abundant countries to prevent benefits from their natural resource endowments from being spent ineffectively or from flowing to the private accounts of top bureaucrats.

2.1. “Resource Curse” as a Rationale for Establishing Natural Resource Funds

Negative development outcomes associated with petroleum and other minerals are known as the “resource curse.” This is the phrase used primarily by economists (Gelb 1988; Auty 1997; and Sachs and Warner 1995). Auty (1997) found that the Asian “tigers” (South Korea, Taiwan, Hong-Kong, Singapore, and others), which are poor in natural resources, grew four times more rapidly than resource-rich Latin America and African countries between 1970 and 1993, despite the fact that the “tigers” had half the savings. This phenomenon became known as the “resource curse” hypothesis (Auty and Mikesell 1998:6). A comprehensive study by Harvard economists Jeffrey Sachs and
Andres Warner demonstrates that countries whose natural resource exports composed a high percentage of gross domestic products had abnormally slow growth rates between 1971 and 1989 when compared to non-resource-based development models, drawing on data from 97 developing countries. The negative relationship holds true even after controlling for many variables found to be important for economic growth by previous authors (1995:2). The greater the dependence on oil and mineral resources, the worse the growth performance, a finding that has been confirmed by economists in the World Bank and International Monetary Fund (Leite and Weidemann 1999).

Another broadly acknowledged term to describe the gap between the promise of natural resource wealth and the perversity of its performance is “paradox of plenty,” by Terry Lynn Karl (1997). As Svetlana Tsalik (2003:1) mentioned in the Caspian Watch study, such terminology as “Dutch Disease,” “flawed prosperity,” “economic indigestion,” and even “the devil’s excrement” have been utilized to describe this essential paradox: resource-abundant economies underperformed in almost every area of progress ranging from human development, economic growth, democracy and good governance, and preserving the peace.

From a policy perspective, while it is important to know if a curse exists, it is perhaps more important to know the mechanism by which it casts its spell. Identifying the mechanism of this curse allows for designing not only a policy to cure the problem, but also a policy to prevent the problem.

From the broad literature review, the explanation for poor growth performance on the part of resource-exporting countries can be roughly divided into two categories: the

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4 This term was invented by former Venezuelan Oil Minister and OPEC co-founder Juan Pablo Perez.
economic effects and the institutional impact of natural resources. Some authors label these effects as direct and indirect (Leite and Weidmann 1999:8).

The main economic effects include the Dutch disease and volatility (Gelb and Associates 1988; Hausmann and Rigobon 2002). The Dutch disease is the tendency for the real exchange rate to become overly appreciated in response to positive shocks, which leads to a contraction of the tradable non-resource sector (Sach and Warner 1995:6). Natural resource ownership exposes countries to volatility, because the supply of natural resources exhibits low price elasticities of supply (at least in the short term) (Hausmann and Rigobon 2002:7). It means that oil price shocks do not follow relatively equal shifts in the supply of oil to the world market. Thus, for countries where oil revenues represent a significant percent of GDP, oil price shocks produce income shocks of GDPs which influences investments and income distribution.6

The institutional approach focuses on governance issues such as rent-seeking, corruption, and bloated public sectors (Karl 1997; Eifert, Gelb, and Tallroth 2003, and others). In general, natural resources generate rents that leads to rapacious rent-seeking (the voracity effect7), whose adverse manifestation is felt through a political economy effect (Lane and Tornell 1997) and increased corruption (Mauro, 1995; and Leite and Weidmann, 1999), which adversely affects long-run growth.8

---

5 This is a kind of sweeping generalization for the purpose of this thesis. Each author pretends to adopt his/her own approach to explain the phenomenon of resource curse. For example, Terry Karl in his Paradox of Plenty applied an “eclectic approach” as a combination of “sectoral, Marxist, dependency, rational-choice, organizational, and staple theories without fully espousing any of them. (Karl 1997:xvii)”

6 For example, the standard deviation of oil price changes has been about 30 to 35 percent per year. For a country where oil represents about 20 percent of GDP, a one-standard deviation shock to the price of oil represents an income shock equivalent to 6 percent of GDP (Hausmann and Rigobon 2002:7).


8 See more about a relationship between corruption and economic growth in 1.2.
In the most recently published article on the issue, Isham (2005:7) and others conclude that the relationship between rich natural resource endowments and poor development has been explained by two broad schools of thought: political science and economics. The authors provide a thoughtful, clear summary of the mechanisms of causation identified in economic and political science literature.

According to Isham and others, political scientists generally argue that certain natural resources undermine democracy through what they term “rentier” effects (2005:8). They based their analysis on Ross’s (2001) empirical investigation of consequences when government can easily extract revenues from a few sources. First, the state has less need for taxation, and citizens have less incentive to develop the civil society that is a precondition for democracy.9 This frees resource-exporting governments from the types of citizen demands for fiscal transparency and accountability that arise when people pay taxes directly to the government. Second, with the exogenous revenues, governments can “mollify dissent” by buying off critics and providing benefits for particular groups of the population. Third, the state possesses resources to suppress directly any ideas against the regime. The authors also argue that resource income insulates governments from pressure for institutional reform because their “budgetary revenues are derived from a small workforce that deploy sophisticated technical skills that can only be acquired abroad.” (Isham and others:10)

According to Isham and others, economists usually explain the resource course via two core mechanisms: Dutch disease and “entrenched inequality effect.”10

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9 See, for example, {some other authors}: Lipset (1959), Moor (1966), and Inglehart (1997).
10 The “entrenched inequality” effect argues that divergent growth trajectories [in] South and North America over the last two hundred years can be explained by reference to the types of crops grown, the
Isham and others argue that a combination of both these approaches into “a political economy story” based on “social divisions effects” and “governance effects” provides a more compelling explanation, at least for the divergent growth experience of developing countries over the last forty years (2005:10). They further argue that certain types of natural resources, such as “oil, diamonds, and plantation crops,” can be easily captured by the elite—simultaneously exacerbating social tensions, weakening institutional capacity, strengthening corruption, and thereby undermining the ability and the willingness of governments to respond promptly to economic shocks. Thus, abundant natural resources not only generate poor governance itself through rent-seeking behavior; but poor governance and corruption function as the catalyst of slow development because the government cannot react properly to the economic challenges of natural endowments.

Taking into consideration the political economy approach, we can suggest that a NRF could serve as a mechanism for alleviating a variety of negative outcomes of resource abundance, such as social tensions, weakened institutional capacity and economic shock.

The primary goal of NRFs in many countries is to soften negative macroeconomic outcomes: Dutch disease and volatility through stabilization of fiscal policy from swings in resource revenues, and savings for future generations. A strong and transparent governance climate is an essential underpinning for such revenue management. Without

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11 Many other scholars advocate a political economy approach when studying any oil related topic, and exclude geological issues. For example, Claes used a political economy approach to study the oil-producer cooperation (Claes 2001: 366).
12 Ibid, p.10.
proper publicity and a strict budget discipline, the financial performance of any resource fund cannot be successful because there is always a temptation for a government to spend “easy money” according to political, but not economic reasons.

To alleviate social tensions and create trust between governments and citizens, a NRF could serve as an open public policy institute. Political leaders need to regard their country’s natural resources as national endowments, and provide transparency and public participation in managing these endowments for their citizens because these resources do not belong exclusively to the current government or generation, but to all citizens and generations. As Joseph E. Stiglitz stated, “To use these resources for one’s own benefit, leaving future generations impoverished, is to steal their patrimony.”13 Turning oil revenues into long-term benefits for a state’s people ultimately depends on the quality of public policy. As Karl and Gary (2004:4) perfectly mentioned, “given the right incentives for making good policy choices, petroleum revenues can be “black gold” rather than “the excrement of the devil.”

Under ideal conditions a NRF can force governments to plan ahead and to be transparent about what they are earning and spending, thus strengthening governance and fighting corruption. By providing information to legislatures and citizens about how oil, gas and other minerals are being managed, a NRF can encourage another key component of good revenue management: an educated and active citizenry capable of organizing to demand accountability for government expenditures. Thus, a NRF can also help to develop and strengthen democracy.

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From this theoretical analysis we can conclude that a NFR, as a policy instrument, can help not only to fight the negative outcomes of the resource curse, but can also help to manage natural resource endowments in the interests of all people. To achieve these policy objectives, a NRF should be transparent, accountable and open for public oversight and participation.

However, there is a more deep and threatening correlation between abundant natural resources, corruption, and poor economic performance. Abundant resources not only generate corruption themselves through rent-seeking behavior, but the corruption originating from the resource wealth worsens significantly the negative economic outcomes. The following section sets forth undeniably relevant theoretical and empirical evidence that transparency and accountability are basic initial conditions necessary for operating any NRF. Experience has taught that absent transparency and accountability, these funds will likely exacerbate the resource curse’s negative effects.

2.2 Corruption as a “Transmission Channel” for the Negative Effects of Natural Resources on Growth

The causes and consequences of corruption have received increasing attention from social scientists over the past ten years. As Tanzi argues (2002:19), this is partly because the phenomenon of corruption, itself, has been on the increase these last two decades due to the increased role of governments in internal and external economic relations. Part of the reason for the increasing interest in corruption is the new availability of cross-national data from corruption surveys that began in the beginning of the 1980s, specifically under the premises of the International Country Risk Group
(ICRG)\textsuperscript{14} and then Transparency International.\textsuperscript{15} Also, no doubt, the greater freedom of
the press in former communist countries has increased public perceptions and awareness
of corruption in recent years.

Although there is no universal or comprehensive definition as to what constitutes
corrupt behavior, the most prominent definitions share a common emphasis upon the
abuse of public power or position for personal advantage or gain.\textsuperscript{16}

In a pioneering econometric study of corruption, Mauro (1995) emphasizes that
corruption may constitute a significant obstacle to investments. The other two studies on
the role of investment focus on particular components: Wei (1997) on foreign direct
investment, and Tanzi and Davoodi (1997) on public investments.\textsuperscript{17} Neither Wei (1997)
nor Tanzi and Davoodi (1997) estimate the subsequent impact of corruption on growth.
The only econometric evidence of a direct effect of corruption on growth is provided by
Poison (1998) and Rama (1993).\textsuperscript{18}

\textsuperscript{14} Since 1980, \textit{International Country Risk Guide} (ICRG) evaluates economic, political and financial risk
and warns of major changes in more than 100 countries. http://www.prsgroup.com/icrg/icrg.html.

\textsuperscript{15} \textit{Transparency International} (TI) is the leading global non-governmental organization devoted to
combating corruption. Its mission is to \textit{create change} towards a world free of corruption. TI was

\textsuperscript{16} The succinct definition utilized by the World Bank is “the abuse of public office for private gain.” This
definition is similar to that employed by TI. See World Bank 1997, p. 8. See also Transparency
includes the activities of private agents who subvert public policies and processes for competitive
advantage.

\textsuperscript{17} Wei (1997) uses individual survey responses to construct a measure of corruption-induced uncertainty.
He found that the uncertainty associated with corruption reduces foreign direct investments. Tanzi
and Davoodi (1997) provide cross-sectional evidence that higher corruption is associated with lower quality of
public infrastructure.

\textsuperscript{18} Poison (1998) analyzes the effect of economic security on 53 countries over the period 1984-95. In the
context of a growth equation, this study includes measures on investment, openness and corruption as
exogenous variables, and finds that corruption significantly reduces economic growth rates. Rama (1993)
endogenizes lobbying costs incurred by the firm. Using data for Uruguay over the period 1947-98, and
regressing long-run growth rates on sectoral and aggregate investment rates, this study finds that lagged
values of restrictive regulations decrease growth at the aggregate level.
There are very few studies directly reflecting the impact of abundant natural resources on corruption. The problem arises from the possible impact of windfall gains on rent-seeking behavior. Khan (1994), for example, attributes the pervasiveness of corruption in Nigeria to the oil boom. Lane and Tornell (1997) point out that trade windfall gains may cause a “feeding frenzy” in which competing groups fight for the natural resource rents, thereby inefficiently exhausting the public good. Lane and Tornell based their empirical research on three countries’ windfall experiences during the period of high oil prices between 1974 and 1986, Nigeria, Venezuela and Mexico (22).

Carlos Leite and Jens Weidmann (1999), in their famous paper “Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth,” investigate the two main causality lines: the determinants of corruption with a special emphasis on the role of natural resource abundance, and the growth effects of corruption. Both issues were studied theoretically, within a general equilibrium framework, as well as empirically within a simultaneous equation model with both economic growth and corruption endogenized (3).

As a measure of corruption, they use the ICRG corruption index. The index is scored on a scale of 0-6, with lower scores indicating that “high government officials are likely to demand special payments” and “illegal payments are generally expected throughout lower levels of government” in the form of “bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans.” (Leite and Weidmann 1999:17). The data on natural resource exports as a share of GDP are originally taken from Sachs and Warner (1995).19

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19 They include into the regression equation also such independent variables as “trade openness”, “rule of law” and “political instability” as the rent-seeking literature suggests (19).
Their two main empirical results support their initial hypothesis of the corruption channel’s being an important explanation for the slow growth of resource-rich countries: first, “capital intensive natural resources are a major determinant of corruption”; second, corruption lowers economic growth. Another interesting empirical result is that neither the corruption nor the growth is different in Africa than elsewhere (Leite and Weidmann 1999:30). Thus, this result denies the proposition about cultural roots of corruption.

Analytically, Leite and Weidmann (1999) focus on effects of two instruments of anti-corruption policies: improvements in monitoring technology versus increases in penalties. They found that institution building (improvements in monitoring technology) tends to be more effective in less developed countries, while stricter enforcement (increases in penalties) is predicted to be more effective in more developed countries.\(^{20}\)

As a remedy, Leite and Weidmann (1999) stress the importance of strong institutions in the wake of natural resource discoveries as a way to curb the associated negative growth effects of corruption (31). This is especially true in less developed countries, where natural resource booms and busts have a much higher relative impact on both the capital stocks and the extent of corruption, and confront generally weaker and less adaptable institutions. We can interpret their results as follows: \textit{ceteris paribus},\(^{21}\) a resource-abundant country would generate corruption more rapidly than another country without natural resources wealth.

\(^{20}\) Ibid, 30.
\(^{21}\) A Latin phrase, literally translated as “with other things [being] the same.”
The Transparency International’s World Corruption Index supports this proposition. In 2005, totally 159 of the world's countries are included in the survey. The scores range from ten (squeaky clean) to zero (highly corrupt). A score of 5.0 is the number Transparency International considers the borderline figure distinguishing countries that do and do not have a serious corruption problem. According to this survey, only Norway, United Arab Emirates, and Qatar have corruption index higher than 5.0 among countries with net exports exceeding 1 million barrels per day (Table 1). Other main net exporting countries have serious corruption problems. Such less developed oil-exporting countries as Venezuela, Nigeria, Iraq, Libya, Kazakhstan and Azerbaijan are considered especially corrupt with an index less than 3.0. Russia had a score of 2.4 in 2005 that indicates a high level of corruption.

Table 1. The Level of Corruption Among the Top World Oil Net Exporters

<table>
<thead>
<tr>
<th>Country</th>
<th>Net Oil Exports (million barrels/day)</th>
<th>Country Order of Corruption</th>
<th>Corruption Perception Index 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Saudi Arabia</td>
<td>8.73</td>
<td>70</td>
<td>3.4</td>
</tr>
<tr>
<td>2. Russia</td>
<td>6.67</td>
<td>126</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>3. Norway</strong></td>
<td><strong>2.91</strong></td>
<td><strong>8</strong></td>
<td><strong>8.9</strong></td>
</tr>
<tr>
<td>4. Iran</td>
<td>2.55</td>
<td>88</td>
<td>2.9</td>
</tr>
<tr>
<td>5. Venezuela</td>
<td>2.36</td>
<td>130</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>6. United Arab Emirates</strong></td>
<td><strong>2.33</strong></td>
<td><strong>30</strong></td>
<td><strong>6.2</strong></td>
</tr>
<tr>
<td>7. Kuwait</td>
<td>2.20</td>
<td>45</td>
<td>4.7</td>
</tr>
<tr>
<td>8. Nigeria</td>
<td>2.19</td>
<td>152</td>
<td>1.9</td>
</tr>
<tr>
<td>9. Mexico</td>
<td>1.80</td>
<td>65</td>
<td>3.5</td>
</tr>
<tr>
<td>10. Algeria</td>
<td>1.68</td>
<td>97</td>
<td>2.8</td>
</tr>
<tr>
<td>11. Iraq</td>
<td>1.48</td>
<td>137</td>
<td>2.2</td>
</tr>
<tr>
<td>12. Libya</td>
<td>1.34</td>
<td>117</td>
<td>2.5</td>
</tr>
<tr>
<td>13. Kazakhstan</td>
<td>1.06</td>
<td>107</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>14. Qatar</strong></td>
<td><strong>1.02</strong></td>
<td><strong>32</strong></td>
<td><strong>5.9</strong></td>
</tr>
<tr>
<td>15. Azerbaijan</td>
<td>0.319</td>
<td>137</td>
<td>2.2</td>
</tr>
</tbody>
</table>

*Table includes all countries with net exports exceeding 1 million barrels per day in 2004 excluding Azerbaijan. Azerbaijan produces less than 1 million barrels/day. However, we included Azerbaijan for the purpose of this research.


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22 It is a composite index, drawing on 16 surveys from 10 independent institutions, which gathered the opinions of businesspeople and country analysts. [http://www.infoplease.com/ipa/A0781359.html](http://www.infoplease.com/ipa/A0781359.html).
There are a significant number of grandiose “white elephant” projects in which countries, characterized by enormous corruption in awarding import quotas, industrial licenses, and trade franchises: low-cost credits become the normal way of doing business.23

Finally, it is worth mentioning that the external policy environment contributes to overly centralized power and rent-seeking of oil-producing countries’ governments by outsiders’ pursuit of oil there. The global oil corporations, because of their tremendous power and strength, act sometimes with complete disdain for local norms and regulations, bribing the governments (Levenstein and Wooding 2005). The global oil companies manipulate existing laws and create new laws in their own interest (Karl 1997). For business people it is more effective to deal with mono-powerful local elite than with a democratic polity. International financial institutions also support resource’s perverse development cycle by routinely encouraging development strategies based on the “resource comparative advantage.”

The classic weapons for fighting corruption are “checks and balances,” budget transparency and public participation in policy-making. If the government of a resource-abundant country is not accountable, business lacks transparency, the economy is weak and public participation absent; then rent-seeking and corruption will likely result. In this case, easy petrodollars will continue to pour without restrictions, according to political and personal preferences of local elites, limiting the resources for economic growth.

Governments of resource-rich countries should pay particular attention to “checks and balances” issues when creating new policies and institutions, because a resource-rich

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23 Examples abound: a mountain-top resort in Venezuela, the largest airport in Saudi Arabia, a man-made river in Libya, the Trans-Railway in Gabon, and a new capital city, Abuja, in Nigeria (Karl and Gary 2004:2).
country will more likely generate corruption more rapidly than a resource-poor country with similar politico-economic characteristics.

If a government of any resource-abundant country, especially a less developed one is considering establishing a NRF as a response to its hydrocarbon booms and busts, the first question should be: to what extent will the design of this fund ensure transparency, accountability and public participation in the management of the natural resource endowments. Otherwise, the fund, filled with “oil rent,” will likely contribute to “rentier” behavior of the top bureaucracy and to corruption, even if it performs effectively as a financial institution.

2.3. A Properly Designed Natural Resource Fund as a Policy Instrument to Manage Resource Wealth

There is no generic term for funds of natural resources. Some authors commonly use the abbreviation “NFR,” but decode it differently. For example, Davis, Ossowski, Daniel, and Barnett (2003:273) mean “nonrenewable resource fund” when using this abbreviation. The Caspian Watch analysts means “natural resource fund” when using the same abbreviation (Tsalik 2003). Some authors clearly distinguish between the two main types of NRFs, and label them either Stabilization Funds or Savings Funds (Fasano 2000). Some authors and policy makers specify the type of natural resource relevant for

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24 I prefer to use the term “natural resource fund” for this thesis because it is simpler than “nonrenewable resource fund”. However, I admit that “nonrenewable resource fund” reflects better the bottom line of the phenomenon.
a particular country, when giving the title for a specific fund.\textsuperscript{25} And there are other variations in their titles.\textsuperscript{26}

There is no one broadly accepted definition of a Natural Resource Fund either. This thesis employs the definition by the Caspian Watch analysts. They define NFRs as “a mechanism that some countries have adopted to address the principal challenge facing by budgets dependent to a great extent on revenues from the export of natural resources.” (Tsalik 2003:18). The general justification for such funds is that some share of government revenues derived from the exploitation and export of nonrenewable resources should be put aside for the time these revenues decline, because the price has fallen, the resource has been depleted, or both (Davis and others 2003:273-274). A stabilization fund is designed to stabilize revenue flows and expenditures. A savings fund is designed to create a store of wealth for future generations by converting a depletable revenue stream into a perpetual income flow.\textsuperscript{27} There is one other type of NRF – a financing fund. In the financing fund the operational rules are designed so that it effectively finances the overall budget balance.\textsuperscript{28} Appendix I summarizes the main features of the three types of NRFs.

Rules for accumulation of fiscal resources in NRFs in different countries tend to be price-contingent (accumulation of revenues greater than at a target price), as in the case of the Chile Copper Stabilization Funds (CSF); or revenue-contingent (fifty percent

\textsuperscript{25} Chile’s Copper Stabilization Fund, Oman Oil Fund, Papua New Guinea Mineral Resources Stabilization Fund, Petroleum Fund for Timor-Leste

\textsuperscript{26} Oman’s State General Reserve Fund, Kuwait’s Reserve Fund for Future Generations, Alaska Permanent Fund and others.

\textsuperscript{27} The nomenclature may be misleading. Strictly speaking, it is not possible to “stabilize” flows to the fund as long as oil prices are unstable. The stabilization fund therefore attempts to stabilize the flows to the budget by saving during booms and spending during busts.

\textsuperscript{28} The Norwegian State Petroleum Fund operates on this basis. Recently, The Norwegian State Petroleum Fund was transferred to the State Pension Fund. Since January 2006, the management of the Petroleum Fund has been part of the State Pension Fund.
of the resource revenue), as in the case of the Alaska Permanent Fund; or both (fifty percent of all oil revenue above a reference price), as in the case of the Venezuela Stabilization Fund Rule (see table 2).

Table 2. Rules for Accumulation Fiscal Resources in Different NRFs

<table>
<thead>
<tr>
<th>NRFs with a Price-contingent Rule</th>
<th>The Rule of Accumulation</th>
<th>Revenue-contingent NRFs</th>
<th>The Rule of Accumulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oman Oil Fund</td>
<td>Accumulation of revenues greater than at a target price ($15/barrel)</td>
<td>Kuwait's Reserve Fund for Future Generations</td>
<td>10% of all budget revenues</td>
</tr>
<tr>
<td>Venezuela Macroeconomic Stabilization Fund Rule*</td>
<td>Accumulation of revenues greater than a cut-off price (flexible, can be easily changed)</td>
<td>Alaska Permanent Fund, USA</td>
<td>25 percent of all mineral lease rentals, royalties, royalty sales proceeds, federal mineral revenue-sharing payments</td>
</tr>
<tr>
<td>Chile’s Copper Stabilization Fund</td>
<td>Accumulation of revenues greater than an annually projected price</td>
<td>The Norwegian State Petroleum Fund/ State Pension Fund</td>
<td>All petroleum revenue after the coverage of non-oil budget deficit</td>
</tr>
</tbody>
</table>

* Actually, Venezuela’s Fund represents both methods; 50 percent of all oil revenue above a reference price.

Source: The NRFs’ Legislations.

Withdrawal provisions have tended to be more discretionary than rules-based, in terms of transfers to the budgets as needed (Alberta, Kuwait, and others), with some control and oversight in most cases by the ministry of finance, the central bank, or other government officials (Davis and others 2001; Fasano 2000) (see Table 3).

Table 3. Withdrawal Provisions for Some NRFs

<table>
<thead>
<tr>
<th>NRFs</th>
<th>Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kuwait's Reserve Fund for Future Generations</td>
<td>Financing of the state budget deficit</td>
</tr>
<tr>
<td>Alaska Permanent Fund, USA</td>
<td>Approximately 50% of the fund earnings are paid to the Alaska’s people; other are reinvested. It is determined by the State Constitution.</td>
</tr>
<tr>
<td>Oman Oil Fund</td>
<td>Financing of the budget deficit; investments to the oil industry.</td>
</tr>
<tr>
<td>The Norwegian State Petroleum Fund</td>
<td>Transfers to the state budget based on a parliamentary resolution</td>
</tr>
<tr>
<td>Venezuela Macroeconomic Stabilization Fund Rule</td>
<td>Since 1999 the president is eligible to make a decision about the fund’s spending policy</td>
</tr>
</tbody>
</table>

Source: The NRFs’ Legislations.
Empirically, the effectiveness of funds in mitigating volatility is somewhat ambiguous. An IMF study estimates the impact of commodity revenues on government spending to determine whether the establishment of a fund has a significant impact on government spending (Davis and other 2003:301-302). Based on time-series data for countries with funds, expenditure appears to be less correlated with changes in revenues than in countries without funds, as would be expected if the funds work as they are supposed to; however, this experience is not uniform. In addition, in countries with funds, the establishment of a fund did not have an identifiable impact on government spending. This suggests that countries with a stricter budget discipline tended to establish a fund rather than the fund itself leading to increased expenditure restraint (Davis and other 2003:303).

In the case of specific countries—Chile, Norway, and Oman—funds appear to deliver a number of favorable outcomes: lower levels of volatility in government expenditure, reduced government expenditure, and a higher share of gross fixed capital investment (299).

A number of practical conclusions are drawn from this research:

- A NFR cannot substitute for effective fiscal management in the short run;
- A NRF should be designed properly because there are serious risks of mismanagement of the natural resource wealth.
  - A fund can complicate fiscal policy if not well integrated with the budget.
  - A fund may spend oil revenues inappropriately.
  - A fund can contribute to lack of transparency and corruption.
- A NRF can serve as a political institution, “a compact between governments and citizens” (Tsalik 2003:19) if it is designed as a transparent public entity.
- Country-specific circumstances matter a great deal when establishing a NRF.
A Natural Resource Fund does not guarantee wise management of natural resource wealth, but it can be a useful tool—provided it goes hand in hand with a fiscal policy framework that strikes the right balance between current consumption and investment in development and savings for future generations. The proper design of a NRF is important. By introducing a high degree of transparency and contributing to informed public debate, the fund can bolster broad support for the strategy of managing the natural resource wealth for the benefit of all people, and create trust between government and its citizens.
3. TRANSPARENCY, ACCOUNTABILITY AND PUBLIC OVERSIGHT: MEASURES TO SAFEGUARD WISE MANAGEMENT OF RESOURCE WEALTH

This chapter looks specifically at levels of transparency, accountability and public participation among different NRFs around the world. Related case studies are from North and South America, Europe, and the Central Asia. Best-practice examples, such as Norway and Alaska, both democratic states, provide important guidelines for building transparency, accountability, and public participation into a NRF to make it successful. By contrast, Alberta (Canada) demonstrates that even if democracy is strong, a lack of transparency, institutional rigidity, and lack of public involvement decrease effectiveness of a NRF as a policy institution. Examples such as Venezuela and Kazakhstan demonstrate how vulnerable a NRF is when power is concentrated in the hands of bureaucratic elites, manifesting an absence of democracy and ineffective oversight. The example of Azerbaijan demonstrates that even if corruption is pervasive steady efforts to disclose the fund’s operations can improve the situation for resource wealth management, however, not much if the lines of accountability are weak, and the level of public participation is too low.

The first section of this chapter provides methodological guidelines to evaluate access to information, accountability and oversight mechanisms of NRFs. The second section evaluates the levels of transparency of selected NRFs according to the guidelines provided in the first section. The third section compares lines of accountability in oversight of Norway’s and Azerbaijan’s funds.
3.1 Guidelines to Evaluate Access to Information, Accountability and Oversight

Mechanisms of NRFs

For the purpose of this thesis we will not define precisely the theoretical concepts of transparency, accountability and public participation. Rather, we accept they have been sufficiently developed by political science and organization theory scholars; and we will use the broadly acknowledged meanings of these concepts applicable to policy institutions.

Transparency of any policy institution basically means “access to its information for everyone.” In a broader and related sense, the concept also applies to the comprehensiveness and traceability of presented information. Access to information by itself does not guarantee that the presented information is understandable for the broader population even if it is easily traceable.29

Accountability of the operations of any business or public entity means being subject to “checks and balances” at any time. Practically, the “checks and balances” principle actualizes through the obligation to hold periodic, independent, external audits to control financial operations, and an independent evaluation to monitor performance.

The idea of public participation basically embraces two practical actions: first-public oversight through an officially established oversight body, and second, an opportunity for broad public input into the decision-making process through annual forums, referenda or public hearings. There is a direct correlation between a civil society’s opportunity to participate in the development of a NRF and its level of understanding of the policies, procedures, practices and mechanisms for managing

29 Some authors refer to traceability as a feature of accountability.
petroleum revenue. A lack of understanding hampers the opportunity for the majority of
civil society to be involved in decision-making, and increases the probability of conflict
surrounding natural resource revenue.

There are very few studies that provide insight into the means by which NRFs can
be designed to limit government’s discretion in misallocating or wasting natural
resources revenues, and that provide general recommendations for good management of
NRFs. The Caspian Watch analysts who studied the best design practices among NRFs
found that “checks and balances,” transparency and public involvement are three
particular factors that contribute to the success of NRFs (Tsalik 2003:19).

According to them, several mechanisms exist by which transparency can be
incorporated into a NRF (Tsalik 2003:49). First, all transfers to and from a fund should
be recorded in the budget and treasury accounts. Second, a NRF, as a keeper of a
resource endowment, should have the same commitment to disclosure as a public
company has to its shareholders. Third, a NRF should publish quarterly reports, results of
external audits, and announcements of tenders. Davis and others emphasize that reports
should contain a summary of the asset allocation of the portfolio and summary statistics
on specific activities of the fund during the year (2003:298).

Transparency should apply not only to the NFR’s activities, but to the entire chain
along which natural resource revenues are earned and spent, according to the principles
of the Extractive Industry Transparency Initiative (EITI). Many authors argue that most
misappropriation happens long before oil revenues reach a NRF (Karl 1997, Tsalik 2003,

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30 Most studies analyze the specific case for a particular country and do not provide general
recommendations for establishing NRFs.
31 The EITI seeks to ensure that the revenues from extractive industries contribute to sustainable
development and poverty reduction.
and others). Transparency can begin with a requirement for oil (or other resource extraction) companies to disclose all payments made to host governments.

This, and all other relevant information, should be presented in clear comprehensible form and language suitable for the broader population’s comprehension, and translated into all official languages in any particular country. Government should inform the civil society about its plans for resource revenue management through a variety of media. All information should be accessible on the Internet, presented on radio and television and be available in prescribed libraries.

Multiple lines of accountability should be created within a NRF, between the NRF and the government and between the NRF and the legislature to guarantee separation of oversight (Tsalik 2003:51). The legislative body, the president, the treasury department, the central bank and the economic development department should have some role in overseeing NRF operations, and performance evaluation. These layers of accountability only work, however, if the separation of powers is real. There must be some contestation and independence among the various organizations that oversee the NRF for there to be effective oversight. When legislatures are dominated by the party in power and opposition forces are marginal, then they are unlikely to provide effective oversight, even if they have the formal authority to do so.

A NRF must be audited internally and externally according to the best international business ethics. External audits should include both financial and performance audits and, if relevant, the procedures for the choice of external managers for the fund. The financial audit aims to ensure financial compliance, while the performance evaluation aims to assess whether resources were used in the best possible
way, and adhered to investment guidelines (Davis and others 2003:298). Such audit and evaluation should be done by an independent professional company with no financial interest in the outcome.

Transparency and accountability are necessary but not sufficient components of informed public participation in democracy. To have an active voice, the public, or at least a representative body of the public, needs to have a legitimate and formalized role in overseeing and interacting with industry and government. To create a truly participatory process in managing natural resource wealth, it is necessary to establish “a fully funded, empowered, independent, and aggressive citizens’ institution to provide oversight.” (Steiner 2003:72). This institution functions as a “watchdog” to contribute to an informed public debate and sound management of the petroleum wealth. Such public oversight bodies have been created in some oil-producing countries.32

Jennifer Drysdale (2005) provides some practical recommendations to design such oversight bodies in order to make them effective. She calls them “Consultative Councils, (3)” and posits, first of all, that a Consultative Council (CC) should be proposed in the Law, and ideally should have power of veto over government in the limited NRF area. She goes on to state that a CC should be widely representative, and have appointees from non-government institutions; that a total number of members should be defined, with relevant involvement and participation by women; that it is important that the government provide a CC with sufficient resources; and that the function, role and purpose of the CC be clear.33 Drysdale argues it is better not to limit a

33 For example, a CC could be required to prepare a statement of their purpose and mission in Annual Reports.
CC to advising parliament only on appropriations of amounts greater than “estimated sustainable income” or in a particular period of time. She further recommends that the members of the oversight body be remunerated.

Public hearings and public forums are the most direct forms of involving citizens in the process of bringing transparency to deals between governments and the private sector. Hearings and forums provide the opportunity for many citizens to play a role in the government decision-making process. It is vital that the law allow for an annual forum and/or hearings on issues relating to the NRF.

A combination of the transparency, accountability and public participation features described above is included in the Guidelines for Natural Resource Funds (Appendix 2). The guidelines represent a list of generic features deemed applicable for the creation or evaluation of a Natural Resource Fund. The features are generated from the review of literature on natural resources funds and from various petroleum fund models from other countries. The guidelines have four parts: Part I: Access to Information (Transparency), Part II: Accountability (Audit Reports), Part III: Public Participation (Oversight Mechanisms and Public Input), and Part IV: Crucial Elements of a Good Design Related to Transparency and Public Participation.

We included in the guidelines some additional governance features to be considered which related to transparency, accountability and public participation issues. First, a NRF should be established as an amendment to a constitution, and all of the features of a NRF should be defined by law. The life-span for a fund should be described.

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There can be no misunderstanding should the fund’s existence come into question by future governments. There must be a separation of governance between the relevant institutions for effective management of the natural resource revenue: legislative bodies, treasury departments, central banks and economic development departments. These institutions should have some overlapping roles in overseeing the NRF’s operations as a part of the “checks and balances” concept. All transfers to and from a fund should be recorded in the budget and treasury accounts. Rule changes should be extremely cumbersome (a constitutional amendment or a legislative super-majority) to guarantee compliance with the initial goal, objectives and design. These features, in fact, serve as mechanisms by which transparency and accountability can be incorporated into a NRF.

These guidelines do not pretend to be exhaustive. Validity and reliability were not checked. Nor are the guidelines intended to be a universal evaluation tool to estimate levels of transparency, accountability and public participation of any NRF. They represent an example of a general policy tool based on the knowledge and analysis of literature for the purpose of this policy evaluation. Any feature of these guidelines could be detailed for a particular research purpose, and additional features could be added.\(^{35}\) We use these guidelines to estimate the level of access to information for selected NRFs around the world in the next section of this chapter.

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\(^{35}\) For the purpose of this thesis, we decided to avoid a very detailed breakdown of general features because the narrow scope of this paper is the Russian Stabilization Fund which is relatively new and in fact has not started to operate with all its functions yet. Thus, we are not able to use this guide to evaluate the Russia Fund.
3.2 Evaluation of Transparency Levels among Six Natural Resource Funds through the Comparison of Their Websites

In general, a NRF’s transparency can be measured by the scope of information about the fund’s operations available for the broad population. This information should be generally available on a fund’s website, upon a request, through radio and TV, via prescribed libraries, and so forth. A fund as a public policy institution should conduct periodic outreach activities such as public presentations and press-conferences, and should provide public services such as tours and internships. Some of these outreach activities should be offered through their websites. For example, with the Alaska Permanent Fund’s website everyone can ask questions, share their comments about the fund’s operations, apply for internships, and request publications. Another important component of transparency is the comprehensiveness of presented information, which can be estimated with qualitative and quantitative methods.

Some natural resource funds operate in near total secrecy, and are especially wary of international observance (Tsalik 2003:44). Good examples are the Persian Gulf funds. Some simply do not maintain websites, as, for example, the Chile Copper Fund, the Russian Stabilization Fund, and the Papua New Guinea Mineral Resources Stabilization Fund. This lack of transparency creates difficulties for researchers evaluating funds’ levels of accountability with full objectivity. To be objective, we decided to narrow the research goal and evaluate the scope of information available on

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36 The Oman General Reserve Fund publishes no annual report, maintains no website, and shares no information with the public.
37 There is a temptation to say that if they operate in near total secrecy, that they are not transparent and accountable at all. The truth is close to this, but should be proven.
NRFs’ websites. The idea came from Tsalik (2003:189). She compared four oil funds’ websites. We added two more funds. The scope of evaluation and the scoring system was systemized and developed.

The categorization could be more detailed. For example, “return on portfolio” could be divided by type of stocks, bonds, markets, and so on for the purpose of financial analysis. We do not have the purpose of analyzing the financial performance of NRFs.

Six funds were selected for evaluation of transparency because they maintain their websites in English and, thus, are available for observation by the broad worldwide community. They are the Alaska Permanent Fund (APF); the Norwegian State Petroleum Fund (SPF)/State Pension Fund since January 2006; the Alberta Heritage Savings Fund (AHSF); the Venezuela Investment Fund of Economic Stabilization (FIEC); the State Oil Fund of the Republic of Azerbaijan (SOFAR); the National Fund of Republic of Kazakhstan (NFRK).

The guidelines, presented in section 2.1, are used as an evaluation tool. We first apply Part I: Access to Information/Transparency. For the purpose of applying this first part several general features were developed. The second of these features, “the details of revenue in a fund,” was divided into four categories: inflows by themselves, breakdown by source, earnings benchmarks, and return on portfolio. The third feature, “the details of where and how a fund is invested,” were concretized with such “sub-features” as companies/indexes in which the fund holds assets, market value of holdings in each company, methodology of investment and risk management, and chosen external asset managers. The expenditure feature was broken down by the type of expenditures. Other features were kept as presented in the initial guidelines.

An evaluation scoring system was developed for assessing the transparency of NRFs. The scoring system is as follow. If generic transparency information is presented on a website, this fund would have “YES” indicated. If there was no such type of information at all, the fund would get “NO”. And, if presented information is not...
complete, the fund would get “PARTLY” indicated. “YES” has a value of 1 point, “NO” has 0 point value, and “partly” has 0.5 point value. The higher the score a particular NRF receives, the higher the level of democratic governance this fund has. Thereafter, we will compare the democratic governance score received through the evaluation process with performance results of selected funds, as estimated by other scholars.

The maximum website transparency score theoretically achievable is 22 points. However, no fund can achieve the maximum because no fund entirely commits to the principles of the Extractive Industry Transparency Initiative (EITI), and provides details of any payments transferred from oil companies to government or individuals voluntarily.\footnote{See EITI’s website for additional information: http://www.eitransparency.org/} Alaska Permanent Fund, with 19 points, and the Norwegian State Pension Fund, with 16.5 points, are among the leaders (Appendix 3). The Alberta Heritage Savings Fund and the State Oil Fund of the Republic of Azerbaijan are in the middle, with 11.5 and 13.5 points, respectively. The Venezuela Investment Fund of Economic Stabilization and the National Fund of Republic of Kazakhstan have 4.0 and 6.5, respectively.

This is no surprise for the Alaska and the Norwegian Funds. Both funds were created in developed democracies with great traditions of budget transparency, a strict fiscal policy, checks and balances, and public involvement. The combination of democratic governance in these countries by itself, and the high level of transparency of their NRFs contribute to the success of both institutions.

The success of both funds was studied, and empirically proved by many scholars (Fasano 2000, Davis 2003, Tsalik 2003, Scancke 2003), and the effective functioning of
both these funds can be easily traced by any independent researcher through their websites.

The success of any NRF can be seen in terms of benefits received by its citizens. The stabilization function is also very important.\textsuperscript{41} However, it is a macroeconomic effect of the fund that is not directly appreciated by citizens, but that contributes to the public good in the end. For example, Davis and others empirically proved that in Norway “nonrenewable resource export earnings do not bear a statistically significant positive relationship to expenditure (2003:299).”\textsuperscript{42} This means that the Norwegian fund has been successful as a stabilization fiscal institution. Sterilized oil money becomes savings, and then benefits the people of Norway through covering a non-oil budget deficit, and paying pensions from the Fund.

The Alaska Fund, through income-producing investments and inflation proofing, grew from an initial $10 billion in 1977 to over $30 billion by the end of 2005. Thus, the principal of the APF has grown three-fold since the Fund’s commencement.\textsuperscript{43} The fund also paid out $13.1 billion in dividends to Alaskan citizens since 1982 (APF Annual Report 2005:2).

The Norwegian Fund was established in 1990; however, the first deposit to the fund was made in 1995 because of the severe budget deficit in the beginning of 1990 in

\textsuperscript{41} This effect can be measured as a differential between natural resource export earnings and government expenditure. The stabilization function works if government expenditures grow much slower than earnings from resource exports.

\textsuperscript{42} Davis and others did not study statistically the Alaska Fund.

\textsuperscript{43} Alaska's constitution divides the Fund into two parts: reserved assets (principal) and unreserved assets (earnings). Principal comes from: mineral revenue ($8.1 billion into reserved assets to date); special legislative appropriations from the Fund's earnings ($7 billion total into reserved assets over time); inflation proofing--the annual legislative transfer from earnings to principal ($8.4 billion into principal over time). Earnings come from stock dividends/bond interest/real estate rents, and gains or losses from the sale of any of these investments. The Legislature has used the earnings for several purposes: dividends, inflation--proofing principal, special appropriation to principal and fund-related expenses.

Norway. After ten years, the market value of the Petroleum Fund’s combined securities portfolio was 1183.9 billion krone, or approximately $176 billion. Annually, a part of earnings is deposited after covering the non-oil budget deficit. The amount of deposit is determined by the Norwegian legislature, unlike in Alaska. Since 2006, a significant amount of earnings will go to seniors as pensions.

Transparency is an inherent feature of the Alaska Fund’s operations because the APF is rooted in the belief that Alaskans are the primary stakeholders of their oil wealth. The law on the Fund states that “all information in the possession of the corporation is a public record” (except for confidential commercial information). The Alaska Permanent Fund Corporation (APFC) Board produces an annual report, which must be written in “easily understandable language” and be widely available to the public. The law states exactly what the contents of the annual report must include: audited financial statements, a breakdown of earnings from each investment, and an appraisal of the value of each investment, and other details. All this information is available though the Internet and upon request. Additionally, the APF’s website embraces all legislation and resolutions that apply to the Fund, including papers commissioned for the trustees and archival reports (Appendix 3).

A key reason for establishing the Norwegian Fund was the desire to make more transparent the policy choices available to the country, in the face of a decline in oil revenues and an increase in pension expenses (Davis 2003, 304). The SPF has helped to
provide a long-term framework for the annual process of setting the non-oil budget deficit, and finally, since 2006, has become a part of the State Pension Fund. The Norges Bank, as the manager of the SPF, is required to submit reports to the Finance Ministry four times a year. These reports, as well as the annual reports and external audit reports, are available to the public over the Internet (Appendix 3). The reports provide information on transfers to and from the budget, all of the Fund’s holdings, their value, their returns, risk management methodology, and administrative costs.

The Alberta Fund in Canada was created at the same time as the Alaska Fund, with similar royalty payments and objectives\(^{49}\); however, the AHSF has much less savings compared with the APF. The Heritage Fund’s fair value stands at $13.6 billion as of December 31, 2005, as reported in the Heritage Fund 2005-06 Third Quarter Report, released on February 27, 2006.\(^ {50}\) However, throughout its 30-year history, the Fund has generated over $28 billion in investment income that has improved the quality of life in the province. Unlike the APR, the AHSF was created through the legislative process, and as a result changes could be made with a simple majority vote in the legislature. Thus, the APF has experienced no change in is objectives and structure, while the AHSF has altered many of them in response to shifts in oil revenues and bureaucratic priorities (Tsalik 2003:26). Since the legislature does not need direct public approval, Alberta’s attempts to engage the public in the debate about the Fund have not been as extensive as those in Alaska. The AHSF was managed by the provincial treasury\(^ {51}\) and subordinated to the governor’s cabinet, while the APF was created as a public corporation. As a public

\(^{49}\) They could be compared methodologically because both funds were created by independent territorial units in democratic countries (Alaska State, USA and Alberta Province, Canada), and had similar inflows and goals.


\(^ {51}\) In 2001, management of the AHSF was transferred to the Ministry of Revenue.
corporation, APF allows access to its information to everyone. Because in Alberta the AHSF is a part of the political process, the information it discloses is comparatively more limited (Appendix 3). The Alberta Fund does not have an external audit policy at all. Audits are conducted by a local auditor, and do not include a market value appraisal of the Fund’s position. As the Caspian Watch analysts conclude, “both the APF and the AHSF deserve praise—the former for its endurance and investment success, the latter for its spending on public goods—as well criticism—the APF for its institutional rigidity and the latter for its lack of it.”(Tsalik 2003:29)

In 1999, Azerbaijan created the SOFAZ to collect and manage all oil revenues due to government from production sharing agreements. The assets of SOFAZ as of January 1, 2006, stood at 1.3 billion Azeri manat (approximately $1.4 billion). The level of transparency of the SOFAZ in heavily corrupt Azerbaijan appears to be high, even higher that for the AHSF in democratic Canada (Appendix 3). The SOFAZ maintains its own well-designed website. Information is presented in comprehensible English and Azeri. All main reports are available in their entirety: annual reports, external audit reports, decrees and SOFAZ-related budget issues. Some scholars support our finding that the SOFAZ meet the transparency design criterion (Wakerman-Linn, Mathieu and Selm 2003: 353). The SOFAZ has already had positive effects. Not only has it helped mitigate real exchange-rate appreciation, but it has also improved Azerbaijan’s image among foreign investors. In November 2004, Fitch Ratings upgraded Azerbaijan’s long-term foreign currency rating from a BB-(2002) to BB with “a stable outlook, reflecting

52 Azerbaijan has also signed over 20 other production sharing agreements with approximately 30 companies from 15 countries. http://www.eitransparency.org/countryupdates/azerbaijancountryupdate.htm.
54 Ibid.
macroeconomic stability, low government debt, and development in the oil and gas sector."55 Azerbaijan has also taken significant steps to implement the Extractive Industries Transparency Initiative (EITI), which will promote oil revenue transparency. The Committee on EITI established by the Government of Azerbaijan, on January 27, 2006, announced the release of the Government’s third EITI report, audited by AGN MAK, an independent auditor.56 Despite all these positive effects, a number of ambiguities in the revenue rules were found by another independent audit company, Ernst and Young (Tsalik 2003:109). Criteria of expenditures as diverse as assistance to refugees and funding the Baku-Tbilisi-Ceyhan pipeline are also still not clear. The accountability lines just do not exist. Unfortunately, the President of Azerbaijan has total control of the SOFAZ, and there is a lack of mechanisms for true public oversight.58

Venezuela has repeatedly established special funds to manage its petroleum wealth. The most recent fund is FIEM, established in 1998. The experience with this fund was also disappointing, as it has not resulted in an improved fiscal performance (Davis 2003: 309). The transparency level of the FIEM is close to “zero” (Appendix 3). Very limited information could be found on its website; however, even this information was not complete and there was even no more recent year than 2002. This is an indication that the situation with transparency and accountability is deteriorating. Taking into consideration the low level of democracy in this country, and the concentration of

56 The foundation of one of the most respected accountancy practices, incorporated and developed in the UAE, was laid in 1981. Today, AGN MAK has emerged as one of the top ten multidisciplinary practices in the region.
58 See 2.3 section of this paper.
political power in the president’s hands, we can conclude that the FIEM is hardly able to contribute to fair and wise management of Venezuela’s natural resource wealth.

In August of 2000, the Kazakh Oil Fund was created. The fund received its first deposit of $660 million from the sale of a five-percent share in the TengizChevron consortium. According to the International Monetary Fund, by September 2004 the NFRK balance reached $3.7 billion.

The NFRK operates with some transparency, but with great opportunities for improvement. The National Bank of Kazakhstan produces periodic reports for the finance ministry on the Fund’s investments, but they are not available for public scrutiny. Instead, quarterly and annual aggregated statements in a table format are placed on its website.61 There is no information about the fund’s investment strategy at all. Audit reports, as internal as well as external, are not open for public view. There is a very high probability that oil revenues could be diverted before reaching the Fund. Oil swaps, the export of crude to Russia below market prices, and other similar activities generate net revenues that never make it into the NFRK (Tsalik 2003: 152). Kazakhstan’s national oil and gas company operates in total secrecy and contributes to the lack of transparency in the management of the Kazakh people’s natural endowment.

According to the Caspian Watch analysts, the creation of multiple lines of accountability is a useful mechanism by which transparency can be incorporated into a NRF (Tsalik 2003:49-51). A comparative analysis of accountability lines between the Norwegian and Azerbaijan Funds in section 2.3 provides additional ideas as to why the Azeri Fund has not been successful despite a relatively high level of transparency.

3.3 Comparative Analysis of Accountability Lines in Oversight of Norwegian and Azerbaijan Oil Funds

The results of the evaluation in the previous section make clear that it is not enough simply to disclose information about a NRF’s operations. Rather, transparency should be an inherent feature of a resource fund if it is to work. Many scholars agree that there are several crucial mechanisms for incorporating transparency into a fund’s everyday operations (Davis 2003, Tsalik 2003, Drysdale 2005, Delvin and Lewin, 2005, Fasano 2000). Actually, we already mentioned these mechanisms in Section 2.1, and placed them into Part VI of the Guidelines. We called them “Generic Good Design Features.”

In this section of the thesis we will emphasize the importance of the proper institutional design of a NRF, which can make earnings and spending more transparent. More precisely, we will look at the ideal organizational structure of a fund, which guarantees separation of power, checks and balances, and public participation in managing and overseeing a fund’s operations. Svetlana Tsalik calls the organizational structure of a generic NRF “multiple lines of accountability,” meaning that the proper institutional structure and design encourages fiscal responsibility and prevents possible abuses of fund revenues from despotic political leaders and lobbies (Tsalik 2003:50). As we already mentioned above in Section 2.1, accountability lines should guarantee a share in management and overseeing NRF operations for a legislative body, a president, a treasury department, a central bank, an economic development department, and other institutions involved in management of natural resources. In this regard, several independent oversight and consulting entities must be established.
Two NRFs were selected for comparative analysis of their multiple lines of accountability: the Norwegian State Petroleum Fund/State Pension Fund\(^{62}\) and the State Oil Fund of the Republic of Azerbaijan. The reason for this comparative selection is that the Norwegian Fund is usually referred to as a model of accountability, with a great separation of powers, while the Azerbaijan Fund represents an example of super-presidential authority in managing a national petroleum fund.

The Norwegian Fund is one of the world’s largest natural resource funds in terms of the volume of principal (savings function). Its stabilization function is also widely appreciated by scholars and by its citizens. The broad population of Norway enjoys a high level of transparency, accountability and public involvement, and the citizens directly benefit from the SPF pension program. The success of the Norwegian Fund has many observers asking two main questions: How did they achieve these results? Is the Norwegian Fund’s design suitable for any country with abundant natural resources as a generic model for their NRF?

The Norwegian Fund can be viewed as a successful institutional arrangement (Fasano 2000:4). Formally, the SPF is a krone account with Norges Bank (the Norwegian central bank). The Ministry of Finance is a general manager or “an owner” of the Fund, which has delegated operational management of the Fund to Norges Bank. The bank manages the Fund’s capital in accordance with provisions laid down by the Ministry of Finance. These provisions are set out in a management agreement between the Ministry

\(^{62}\) The Government Pension Fund was established on January, 1, 2006. The Fund is comprised of the Government Petroleum Fund and the National Insurance Scheme Fund. The activities in these two funds will continue. Thus, the National Pension Fund will not have its own board or administration. As of January, 1, 2006 the two parts of the fund are titled "The Government Pension Fund - Global" and "The Government Pension Fund – Norway". [http://odin.dep.no/fin/english/topics/pension_fund/bn.html](http://odin.dep.no/fin/english/topics/pension_fund/bn.html).
of Finance and the bank. Under the agreement, the Ministry of Finance utilizes advice from the bank in its work with the Fund’s investment strategy, and the bank advises the ministry on strategic choices for the Petroleum Fund.

The Ministry of Finance’s choice of investment strategy is the key driver of the Fund’s risk/return strategy. There is a public consensus in Norway that the Fund must act as a professional financial investor.

The Ministry of Finance and the Norges Bank have a right to incorporate changes into the Government Petroleum Fund’s framework based on the consensus between them. Although such changes do not require legislative approval, in practice the Norwegian government has always consulted with parliament and has kept it well informed of any developments concerning the Fund (Tsalik 2003: 38). The Office of Auditor General, which is appointed by and reports directly to Parliament, ensures parliamentary control on Fund operations. In addition, a supervisory council (Norges Bank Supervisory Council) examines the executive board’s annual reports, the bank financial statements, and the auditor’s reports. The Ministry also hires an independent auditor to evaluate all financial results on an annual basis (Appendix 4).

The organizational structure of the Fund has been constantly developed to make the fund more financially effective and accountable to the people. Recently, two new

64 The regulations state that 50-70 per cent of the Fund’s overall portfolio is to be invested in fixed-income securities and 30-50 per cent in equities. Where equities are concerned, 40-60 per cent is to be invested in currencies and markets in Europe, the remainder in other regions. Where fixed-income securities are concerned, 45-65 per cent is to be invested in currencies and markets in Europe, 25-45 per cent in the Americas and the Middle East/Africa and 0-20 per cent in Asia and Oceania.
consulting entities were created to assist the Ministry of Finance in management of the Fund. In 2004 the Ministry established an ethics council to advise itself on any exclusion of companies called for under the Petroleum Fund’s ethical guidelines. The Ministry is responsible for deciding exclusions, based on recommendations from the Petroleum Fund’s Advisory Council on Ethics.\footnote{Ten companies have thus far been excluded from the Fund. A list of excluded companies, along with recommendations from the ethics council, is available on the Ministry of Finance’s website.} In September 2005, the Ministry of Finance appointed a professional advisory council (Investment Strategy Council) to assist the Ministry with investment strategy (Appendix 4).\footnote{The council’s mandate can be seen on the Ministry of Finance’s website.}

Despite the obvious success of the Norwegian Fund in the separation of powers, transparency and accountability, there are some features of the Fund’s design that limit its applicability as a model for other countries, especially for developing ones with a lack of democracy.

As previously mentioned, a NRF should be established as an amendment to a constitution. The SPF was created through the legislative process, and as a result any changes can be made with a simple majority vote in the legislature. To date, Norway has not experienced a sharp decrease in oil prices. However, if oil prices fall there are no impediments to parliament’s authorizing the use of the Fund’s principal, as occurred in Alberta with its democratic governance (Tsalik 2003:40).

As previously stated, the government of Norway has a right to incorporate changes into the Petroleum Fund’s framework based on the consensus between the Ministry and the bank without the legislative body. To ensure accountability, a sophisticated system of checks and balances, and a clear division of responsibilities, were set up between the Ministry and the bank (Scancke 2003:327). It appears that in countries
with a weak system of checks and balances, rule changes should be extremely cumbersome, either through a constitutional amendment or a legislative super-majority.

Unlike the resource funds in Alaska, Alberta, and Venezuela, Norway’s SPF does not specify what share of oil revenues are to be deposited each year as principal. Rather, deposits are determined annually by the legislature. Thus, it is entirely up to the legislature to determine how much to deposit to or withdraw from the SPF. Norway has a long tradition of budget transparency and a strict fiscal policy. In countries like Azerbaijan and Kazakhstan, where budget transparency and controls are still in formation, tighter rules on NRF revenues and expenditures are needed. Ideally, these rules should be defined by law.

The Azeri Fund is an independent off-budget legal entity with its own administrative structure. Foreign oil companies deposit payments to SOFAZ into a special account at the National Bank.69 These deposits do not depend on oil price, but represent a fixed percentage of oil proceeds. In this regard, SOFAZ most resembles the Alaska Fund. However, the Alaska Fund was established as a public company with a great commitment of disclosure and public involvement. In contrast, the Azeri Fund is accountable and responsible to only one person in the country--the President of the Republic of Azerbaijan.70 There are no limitations to the president’s discretion. There are

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70 Regulations of the State Oil Fund of the Republic of Azerbaijan. Article 2.1. Moreover, Section 1.6. states that “except for rights and responsibilities assigned by Presidential Decrees and by these Regulations, the Fund: a) shall not have any rights, responsibilities and shall not bear any commitments in relationships with the Government of the Republic of Azerbaijan, other government bodies, including ministries, state committees, public institutions, enterprises and organizations and financial institutions, as well as in relationships with any social funds, public and other non-governmental organizations under jurisdiction of the Republic of Azerbaijan or of another country; b) shall not bear any responsibility related with commitments or guarantees of the Government of the Republic of Azerbaijan, other government bodies, public enterprises, institutions and organizations.”
no checks and balances to provide oversight. The parliament has no role whatsoever in Azerbaijan. Officially, the executive director operates the Fund. However, he is appointed by, and can be dismissed only by, the president. An investment board reviews the investment strategy of the fund. However, the board consists of the executive director and senior officials of relevant SOFAZ departments. The supervisory council is appointed by, and subordinated to, the president. The only members of the council not directly subordinate to the president are two parliamentary representatives and the president of the Academy of Science. The council is currently comprised of eight members; and no representatives of any public organization sits on the council. 71 Thus, in contrast with Norway, lines of accountability in management of the Azeri Fund are extremely simple (Appendix 5).

Taking into consideration the fact that the fund’s revenues are not incorporated into a state budget, this, in tandem with the absolute power of the president over the fund’s operations, greatly risks that SOFAZ cannot transfer revenues back to the budget in times when the people of Azerbaijan need them.

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4. POLICY CHALLENGES FOR MANAGEMENT OF RUSSIA’s PETROLEUM WEALTH

There is no question but that Russia has tremendous natural resources. Indeed, Russia holds the world’s largest proven reserves of natural gas and has significant proven and unproven reserves of oil. Nowadays, Russia is the world’s second largest producer and exporter of oil and the first producer and exporter of natural gas.\textsuperscript{72} Russia is also rich in other natural resources, including coal, metals and diamonds. The question is to what extent Russia, as a country with abundant resources, is able to provide decent living standards to the majority of its population through distribution of revenues generated by exporting oil and gas. Another key strategic question is what national interest Russia will pursue in the face of high prices on the world oil market. Strategic dilemmas for the Russian energy sector are discussed in Section 4.1, below.

It appears that the latest trend in Russian politics is associated with seeking restoration of a centralized political and economic environment, and utilizing its energy influence on neighboring countries, former republics of the Soviet Union, as a tool for restoring political control on these countries.\textsuperscript{73} The question is to what extent the oil boom of early 2000 contributed to these backward tendencies in accordance with the theoretical framework provided in Chapter 1. An adverse development of the Russian oil sector as a response to high oil prices is the topic of Section 4.2.

The Stabilization Fund of the Russian Federation (SFRF) was launched on January 1, 2004, as a fiscal policy institution to mitigate volatility of hydrocarbon prices. The principal of the RSF is growing very fast, far beyond the initial growth prognosis

\textsuperscript{72} See Table 1 in Section 1.2, above.

\textsuperscript{73} For example, in the Russian-Ukrainian gas conflict of 2005-2006.
because of the fast raising of oil prices. It appears that the Russian Fund operates in nearly total secrecy. It publishes no annual report, maintains no website, and shares no significant financial information with the public. Because of a lack of strict budget discipline, a weak civil society, and a high level of corruption, there is the risk that large numbers of petrodollars will be spent on interests of the Russian bureaucratic elite. This is the point of Section 4.3 of this chapter.

The final section of this chapter provides recommendations to promote accountability and public oversight in the management of Russian’s natural endowment.

### 4.1 Strategic Dilemmas for Russia as a Resource-abundant Country

A country is referred to as being resource-abundant if its budget is largely dependent on revenues from the export of natural resources. It is not enough for the country to be rich in natural resources; the main prerequisite for being resource-abundant is a high budget dependency on income from natural resource trade on the world market. For example, the United States has a very high level of oil reserves and production, higher than that of Norway, Qatar, Oman, Kazakhstan, and other resource-abundant countries. However, the United States is not resource-abundant, by definition, because it does not export hydrocarbons.\(^\text{74}\)

By definition, Russia is a resource-abundant country. In 2005, extraction, refining, and transportation of hydrocarbons comprised 26 percent of Russia’s GDP and 59 percent of its export revenues (Kudrin 2006:30). A Russian state budget experiences high dependence on “crude” income, and this was especially true during the period of soaring oil prices in the middle of 2000. In 2004, when prices were lower than now, the

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oil and gas industry provided 23 percent of budget inflows. In 2005 it was 30 percent. According to Kudrin (2006), a fluctuation of the world oil price in amplitude of 23-50 dollars per barrel creates an alteration of the Russian budget within a range of 16-23 percent of GDP (31).

Russia will never be like Saudi Arabia or Norway. The obvious difference lies in the fact that despite comparable volumes of oil and gas revenues and production and export revenues, Russia has a much larger population.75 Table 4, below, demonstrates that the per capita volumes of hydrocarbon production and exports of the same leave little, if any, prospect for Russia to ensure normal living conditions for the majority of its citizens, based on hydrocarbon revenues alone. It is worth mentioning that, unlike other resource-abundant countries, Russia has an extensive domestic consumption of hydrocarbons. Thus, the ability to sell oil and gas under high international prices is limited.

Table 4. Per Capita Hydrocarbon Production and Export in Various oil abundant countries, 2003

<table>
<thead>
<tr>
<th>Production and Export per capita</th>
<th>Kuwait</th>
<th>UAE</th>
<th>Norway</th>
<th>Saudi Arabia</th>
<th>Venezuela</th>
<th>Russia</th>
<th>Nigeria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual hydrocarbon production, ton of oil equivalent per capita</td>
<td>55.2</td>
<td>51.9</td>
<td>48.6</td>
<td>25.7</td>
<td>7.1</td>
<td>6.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Annual hydrocarbon exports, ton of oil equivalent per capita</td>
<td>27.5</td>
<td>29.4</td>
<td>42.2</td>
<td>15.4</td>
<td>3.7</td>
<td>2.5</td>
<td>0.9</td>
</tr>
</tbody>
</table>


From Table 4, above, we can conclude that Russia, in its capacity as a resource-abundant country is more similar to countries like Venezuela and Nigeria, which also

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have massive populations. The ability of these nations to improve the lives of its citizens significantly through oil wealth is obviously very low. Therefore, the pretension of Russian authorities of being able to establish a successful state purely on redistribution of export oil revenues has no basis in reality and is, in fact, fallacious or at least inaccurate (Milov 2006:5). Even skyscraping oil and gas prices are not able to cover up the hardships of the Russian economy, the weaknesses of its policy institutions and its poor governance. Despite Russia’s resource abundance, Russia cannot become a successful state without structural reforms, democratization and marketization, relying purely on income from oil and gas export.

However, it appears that Russia is now moving back (or, at least, is not moving forward) in terms of democratic and market reforms. A famous emeritus Russian economist, Evgeny Yasin, pointed out that from the middle of 2003 backward political changes in Russia have begun following changes in economic life (Yasin 2005:16).

The dilemma of what path the Russian people should follow has been the subject of popular public discourse in Russia since, probably, Peter the Great. There were always three main options: to study and learn from the West; to look at, and be influenced by, the East; or to follow its own unique Russian path. Nowadays, Russia, in a new political and global framework, is still not quite sure where to go. As Vladimir Milov, president of the Institute of Energy Policy in Russia, points out, on the one hand, the goal of maintaining sustainable development in the globalizing world requires that Russia build a competitive and open economy and a modern democratic state. On the other, Russia is still under the influence of a totalitarian past and has a temptation to seize global influence by sacrificing human rights, openness, economic development, and “promoting of neo-
imperial foreign policy approaches.” (Milov 2006: 1). For example, Russia will hold the
G8 Energy Security Summit later this year (2006) and promises a commitment to
sustainable development and the principles of EITI.76 But, in stark opposition, Russia
engages in “energy imperialism” with neighboring countries. This centralization of
political power is clearly driven by authorities, but it is also largely supported by the
Russian population, according to opinion polls (See Table 5).

Table 5. The Approval Level of Russian President Putin’s Politics

<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Approve</td>
<td>71</td>
<td>75</td>
<td>72</td>
</tr>
<tr>
<td>Do not approve</td>
<td>27</td>
<td>23</td>
<td>26</td>
</tr>
<tr>
<td>No answer</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>


In the Russian energy sector, this dilemma has been particularly visible. After
privatization and restructuring of the oil and gas sector in the 1990s, oil and gas became
the most competitive and rapidly developing sector of the Russian economy. However,
since mid-2003 Russian authorities have been targeting the oil and gas sector to regain
control over it, creating a reversal in the economic policy model.

4.2 Adverse Development of the Russian Oil Sector in Response to High Oil
Prices in Mid-2000

The theoretical discussion in chapter two explained that the negative use of
natural resources can undermine democracy through three major “rentier” conditions
produced by windfall gains and usually manifesting themselves as direct effects which
are extremely strong, negative and persuasive. In the first such possible effect, the state
has less need for taxation, and citizens have less incentive to develop and improve upon

76 Extractive Industry Transparency Initiative
civil society. In the second of these effects, the government, using its exogenous revenues, purchases media and provides benefits for selected members and groups of the population. The third effect, the steady natural resource revenues prevent government from instituting needed institutional reforms. All three effects exacerbate corruption.

Russian authorities have exhibited these behavioral tendencies since the middle of 2003, after oil prices rose sharply from $23 per barrel in May 2003 to $65 in March 2006. During this same period, the government closed several offices of international non-governmental organizations (NGOs), accused them of espionage and took control over major media interests. Legal, housing, military, and administrative reforms have been stagnating. President appointed the Institute of Regional Governors, “Putin’s ears and eyes,” as people call them, three years ago. The TI Corruption Perception Index for Russia decreased from 2.7 in 2003 to 2.4 in 2005. In the energy sector, adverse development appears in restoring ownership in the largely privatized oil sector, banning the construction of private oil pipelines, rejecting the idea of market restructuring of gas giant Gazprom, closing the doors for foreign investors, and using energy as a political tool (Milov 2006, Yasin, 2005, Belton 2004).

In 2003, less than 15 percent of oil production was attributed to state-dominated companies, but at the end of 2005 some 35 percent was so attributed, and experts in the field believe that by the end of 2006 this share may reach 60-70 percent (Milov 2006:1).

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77 During this period of May 2003 to March 2006, Russian export oil taxes increased significantly. On the one hand, this presents an exception to the first rentier effect. On the other, this is an element of rentier behavior to get more rent.

78 By way of other possible examples, there is a “scandal” within the Peace Corps in Russia, and there has been discrete periodic questioning of other global NGOs operating in Russia, including inquiries of the Eurasia and Soros Foundations.

79 They arrested Vladimir Gusinsky, the owner of Media-Most (the biggest Russian independent media network), after he broadcast news unfavorable to President Putin. In fact, the Government actually arrested nearly all of Media-Most’s executives.

80 See more information in 1.2.
The process of oil industry re-nationalization in Russia appears to have started with “the Yukos case.” By early 2003, Mikhail Khodorkovsky, the head of Yukos, publicly criticized the Russian government for its alleged intention to control all of the oil pipelines within Russia.\footnote{During 2002, Yukos was planning to build a new oil pipeline to bring its oil from Angarck, Russia to Datsin, China. The Government postponed the building of the pipeline.} Thereafter, the government took swift and decisive action. They arrested Mikhail Khodorkovsky and accused him of violating tax laws. The government demanded that Yukos pay back taxes owed and fines for not having paid them in the 1990s. It also froze all assets of the company, which prevented Yukos from being able to use its assets as collateral to borrow money for the purpose of paying the taxes. Once it became apparent that Yukos would be unable to pay the $28 billion in delinquent taxes and fines, the government auctioned off Yuganskneftegaz, Yukos’ principal oil-producing unit.\footnote{Yuganskneftegaz supplied about 60 percent of Yukos’ production prior to the Government’s intervention.} Rosneft, a state-dominated company, purchased Yuganskneftegaz. The Rosneft’s takeover meant re-nationalization of 11 percent of Russia’s oil output (Belton 2004).

Did the increase in oil prices in 2003 or Mikhail Khodorkovsky’s rash behavior cause the government to renationalize Yukos? At a glance, the action appears to stem from a conflict of personalities, especially since Mr. Khodorkovsky was financing opposition parties to government incumbents and was being praised outside of Russia by major politicians around the world. On the other hand, if oil prices had stayed low, the government might have wanted a more efficient, independent Yukos to expand production and help the economy. However, with higher oil prices it is more likely the
case that the government saw an easy way to extract higher revenues for itself by simply re-nationalizing the company.  

Additionally, the re-nationalization of companies may become even easier. In April 2005 the Russian Federal Tax Service appealed to the Constitutional Court to remove all remaining protections that tax-evading companies have been, allegedly, enjoying since the 1990s. While curbing tax evasion is commendable, it could be that virtually every major company in Russia is subject to prosecution, not necessarily because of purposeful tax evasion but, as Fak (2005) explains, due to the fact that tax laws in the 1990s were too complex and often contradictory.

“The era of quick recovery and success of the Russian oil sector, led by private initiative and introduction of Western-type engineering and management practices, is over. It is replaced by domination of state companies which experience huge financial difficulties and upstream production challenges” (Milov 2006:7). The theoretical explanation for this phenomenon is Reynolds’ (1999) risk aversion model that explains adverse effects of exploration and development of oil reserves. The main idea of the model is that small private firms tend to be more risk-seeking than the large state-owned companies. In this connection, Russian crude oil production growth has been dramatically slowing recently, which some experts fear may be a plateau of matured oil fields in Western Siberia. In 2003, the growth rate for crude oil production was 11 percent, in 2004 it was 8.9 percent, and in 2005 it was only 2.4 percent.  

At the same time, the geological conditions for exploration and extraction of oil and gas in Russia are deteriorating. The majority of production comes from matured oil

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83 Some international political economy scholars believe that the beginning of “perestroyka” in Russia was attributed to a period of low oil prices in the middle of 1980s.

and gas fields, and further response to growing hydrocarbon demand would require
development of the greenfield area in remote regions (Eastern Siberia, North and Pacific
offshore), but without the existing infrastructure. According to Energy Policy Institute
analysts, Russia’s financial system is unable to provide the financing needed to invest in
such projects, and Russian companies are not equipped with the proper technologies
needed to work in specific exploration areas (Milov 2006:9).

In this environment, an important issue is the access of foreign investors to
Russia’s upstream energy sector and infrastructure. However, it appears that the
government has a plan to restrict foreign equity participation in oil and gas field operators
through a new subsoil law. The last draft of this new subsoil law was submitted to the
Duma by the Russian government on June 17, 2005.85

At first glance, the new law looks to encourage private ownership of oil leases
and free markets because it allows current license holders (controlling 92 percent of
Russian oil and 83 percent of its natural gas) to continue operating under the license
system until their licenses expire. It will also require companies to register those permits
for exploration as “property rights” (the Draft of Subsoil Law 2005). Therefore, a
“parallel universe” of license-based oil and gas development alongside contract-based
development is allowed. While this does create some uncertainty for oil companies, at
least any disputes between the government and the contract holders will have to be settled
in court instead of being adjudicated by government regulators. Since courts are more
independent than the regulatory agencies, this parallel universe may be more favorable
for private ownership than an exclusive license-based system. The only legal problem is

85 It has been under discussion since 2003.
that the Civil Code “lease” contracts have been replaced by “subsoil” contracts, which are completely new, and the courts have no experience with such cases.

On the other hand, items in the draft clearly suggest that the government is reestablishing control of the oil industry and restricting foreign equity participation in the oil and gas sector. For example:

- While the draft does not prohibit foreign investment, it substantially discourages it. The government may simply ban the involvement of foreign companies in future bidding in an ad hoc or makeshift manner. 86

- The Russian government may exclude foreign companies from participating in the development of Russia’s oil and gas reserves even if foreign ownership of a joint venture company is less than 50 percent. “It means that companies with even one percent of foreign participation most definitely will not have access to the auction.” (IEP 2005, p. 6).

- The “temporary operator” clause allows the government the right to select a company to operate an oil or gas field for up to one year. This noncompetitive process is a potential way for the government to transfer control of the oil and gas fields to “trusted,” i.e., state-owned, companies. 87

86 Article 60, part 5, says that the “auction coordinator may introduce restrictions (ban) on the participation of legal entities which form a group with foreign individuals, individuals without citizenship, or foreign legal entities.” (quoted in IEP 2005, p. 5). “The group” that the legislation refers to is defined as “a Russian investor and a foreign company [who] jointly own or operate more than 50 % of a legal entity directly or through third parties,” “a Russian investor and a foreign company [who] have a possibility to determine decisions of other legal entity,” or “a Russian investor and a foreign company [who] are participants of the same industrial-financial group.” (IEP 2005, p. 6).

87 This new legislation does not apply to offshore oil and gas fields. The relevant law is called “On the Continental Shelf of the Russian Federation.”
The whole story of restoration of state control in the Russian oil and gas sectors is similar to the Mexican model with its ineffective Petroleos Mexicanos (Pemex). It has big resources, but troubles with production due to economic inefficiency and entry barriers for foreign investment, unlike, for example, the Saudi Arabian or Norwegian models.

Another possible direction of the new energy policy agenda of Russian authorities in the energy area is to use energy as a political tool. Russia’s recent gas conflict with Ukraine has served as a serious warning to the international community that Russia has the ability and the will to effectuate a cutoff of gas supplies as it deems politically necessary. The conflict associated with Russian gas cutoffs to Ukraine occurred in late 2005 - early 2006, at the same time that Russia assumed the G8 presidency. President Putin, in his welcome speech, emphasized the importance of establishing a reliable system of energy security as a strategic goal for the G8 and the world community as a whole. In this connection, there is still hope that Russia will be able to overcome imperialistic tendencies and become a reliable energy supplier driven mostly by economic motivation, which, in turn, will motivate and improve the stability of Russian energy supplies.

4.3 Poor Design of the Russian Stabilization Fund

The Stabilization Fund of the Russian Federation (SFRF) was created on December 23, 2003, by the Russian legislature. According to law, SFRF becomes a part

of the federal budget when the actual price of oil exceeds the base price of oil. The law set the base price at $20 per barrel of Urals oil, above which revenues start accumulating in the stabilization fund, while the government has the right to withdraw money from the Fund if oil prices fall below the base level. A base threshold to start withdrawing money from the fund was determined by the law as 500 billion rubles (approximately $18 billion). However, within just one year, this threshold was surpassed. By March 1, 2006, the fund had accumulated 1,563 billion rubles (approximately $55.82 billion). The Ministry of Finance calculated that by January 1, 2007, the Fund grows to 2.1 billion rubles (approximately $75 billion).

There are two main inflow, or income, streams for the SFRF: an oil export tax and an oil extraction tax. There is a special formula to calculate the amount of inflows that connects collected taxes to the world oil price. Below, Table 6 illustrates the breakdown of the Fund’s inflows, accumulated to date.

Table 6. The Russian Stabilization Fund’s Inflows, by Types of Taxes (in billions of rubles)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil extraction tax collected by the State Budget</td>
<td>355.1</td>
<td>761.3</td>
</tr>
<tr>
<td>Oil extraction tax transferred to the Stabilization Fund</td>
<td>193.2</td>
<td>525.0</td>
</tr>
<tr>
<td>Oil Export Tax collected by the State Budget</td>
<td>371.3</td>
<td>871.4</td>
</tr>
<tr>
<td>Oil Export Tax transferred to the Stabilization Fund</td>
<td>282.4</td>
<td>705.1</td>
</tr>
<tr>
<td>Total inflows transferred to the Fund</td>
<td>475.6</td>
<td>1230.1</td>
</tr>
<tr>
<td>Urals oil price</td>
<td>34.4</td>
<td>50.6</td>
</tr>
</tbody>
</table>


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90 The federal budget 2006, increased the base oil price to $27 per barrel.
The ratio between these two types of taxes is approximately 40:60 for the extraction tax and the export tax respectively. Thus, the export tax is the major revenue source for the Fund.

According to law, the Fund’s accumulations can be used for financing a budget deficit when oil prices fall below the base level. The accumulations can be used for other purposes, as well. The law does not specify what these other purposes may be. The spending strategy of the Fund is determined by the federal budget law on an annual basis. Thus, it is up to the legislature solely to determine how much to deposit, or to withdraw from, the SFRF.

In 2004 the Fund’s money was frozen. In 2005, 46.5 percent of the Fund’s revenues were spent to repay a portion of the Russian foreign debt ahead of schedule and two percent was spent to cover State Pension Fund deficits (Table 7).

Table 7. Inflows and Spending Strategy of the Russian Stabilization Fund in 2004 and 2005 (in billions of rubles)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at the beginning of the fiscal year</td>
<td>106.3</td>
<td>522.3</td>
</tr>
<tr>
<td>Inflows</td>
<td>415.9</td>
<td>1392.11</td>
</tr>
<tr>
<td>Spending:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Repayment of Russian foreign debt;</td>
<td>0</td>
<td>-677.3</td>
</tr>
<tr>
<td>• Transfers to the Pension Fund</td>
<td>0</td>
<td>-30.0</td>
</tr>
<tr>
<td>Balance at the end of the fiscal year</td>
<td>522.3</td>
<td>1237.0</td>
</tr>
</tbody>
</table>


The organizational structure of the SFRF is similar to the Norwegian model. The revenues of the SFRF are accumulated in an isolated account in the Central Bank of Russia. The Russian Ministry of Finance makes strategic investment decisions and oversees the Central Bank’s financial operations with the Fund’s money. The Central
Bank of Russia is the operational manager. The Ministry of Finance provides quarterly and annual investment reports to the government. Upon review and revision, the government submits these revised reports to the Duma. However, unlike Norway, the law and decree that created the Fund do not suggest the creation of any other consulting or overseeing agency to assist the ministry in management of the Fund. Thus, the lines of accountability appear to be poor (See, Appendix 6).

According to the decree, the Stabilization Fund’s assets can be placed in a form of securities of the governments of such foreign states as Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Great Britain and the United States. The emitter of securities should have a rating of long-term credit status not below a level of “AAA”, as classified by such rating agencies as Fitch-Ratings and Standard and Poors; nor below a level “Aaa” for the rating agency Moody’s Investment Service.

The financial effectiveness of the SFRF is somewhat questionable. After two years of operation, Russian senators have begun asking questions about the Fund’s investment and spending strategies. The discussion became especially hot during the period of time when the budget draft of 2006 was being considered.

The Committee Council of the Russian Federation considered the problem of the Fund’s inefficient investment strategies for the 2005 fiscal year. The Account Chamber calculated that because of inflation the Fund lost approximately 23 billion rubles ($820

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93 Ibid.
94 In 2004 all accumulated inflows were frozen. Thus, monies flowing into the Fund remained stagnant and unused for financial operations during this period.
million) (Kipelman 2005:71). According to the Chamber, the investment strategy was weak. The Deputy Minister of Finance tried to justify this weakness by arguing that the low profitability of bonds in which the Fund invested money, was offset by their high reliability. He said that this careful investment strategy coincided with the main purpose of the Fund to keep a part of oil revenues out of the Russian economy. The Minister of Finance tried to defend the poor financial performance of the Fund and then announced his estimation of a projected savings on percentage of the Russian foreign debt in 2006 because of early repayment of a portion of the Russian foreign debt, amounting to approximately $1 billion (Kudrin 2006:40).

Thereafter, the Russian senators expressed even more concern with the Fund’s spending strategy. In fact, the senators also conveyed their readiness to prove the existence of the Stabilization Fund was illegal. On January 18, 2006, the Committee Council of the Federation discussed the new budget code prepared by the Ministry of Finance. According to the opinion of many senators, the basic financial law of the country has so many “blanks” that it could be possible to show and prove that the government illegally spends about one-half of the Fund’s revenues. This writer believes this assertion to be inaccurate. Rather, the claim appears to arise from citizens’ concerns about the Fund’s ineffectiveness, ambiguities, its lack of transparency, together with its lack of accountability.

95 There is no public information about any investment portfolio of the Fund.
98 Ibid.
Clearly, the effectiveness of the SFRF as a fiscal policy institution, to date, is mixed. The Fund has had some positive effects in curbing an over-appreciation of the ruble, repaying foreign debt and saving money for future generations. However, overall, the investment strategy cannot be viewed objectively and pronounced a success.

It appears that the Russian Fund as a political institution, that should create trust between the legislature, other parts of the government and Russian citizens, is not succeeding well at this task. In the last months of 2005, tensions between the Duma and the administration regarding spending projections for 2006 and the actual expenditures of 2005 grew to the point of creating near political instability. The broad Russian population is not satisfied with the low level of transparency currently being exhibited by the Fund. A lack of transparency creates gossip among the people that oil money is being spent on personal conveniences by top Russian bureaucrats. According to a recent opinion poll by the All-Russian Public Opinion Research Center, 88 percent of Russian citizens would like the government to spend several billions of petrorubles today, thereby avoiding the risk that oil prices will drop and budgetary problems appear, because the simple truth is that the people do not believe the government is able to manage the oil money in their best interests.99

Why did all this happen with the brand new Russian Stabilization Fund?

It is obvious that a variety of mistakes were made in designing the Russian Fund: major mistakes in predicting oil market dynamics and, consequently, related mistakes in setting the threshold and base prices of oil. In addition there was a failure to establish

limits concerning the size of the Fund, together with a failure to account for weaknesses in the law or to create automatic correcting mechanisms.

The Account Chamber has concluded that the major mistake when creating the Fund was the lack of proper legislative input. The law that established the Fund in 2003 was too general and abstract. In fact, the designers of the Fund believed that the threshold would provide “a breathing space” for at least 3-4 years until Fund money could be used. Their hope was that within this time needed decrees and regulations would have sufficiently developed in an addition to the law. Thus, this weakness in the law and the corresponding inherent legal weakness in the Fund was a failed calculated gamble responsible for the mistakes in predicting the oil market.

As early as the middle of 2004 it became obvious that the threshold was passed and that an amendment to the law with a clear investment strategy needed urgent and immediate development. A later decree, on September 30, 2004 amended the law with some articles regarding an investment strategy for the Fund. However, the amendments did not provide sufficient substantive details or other enduring guidance. As of this writing, an agreement between the Ministry of Finance and the Central Bank that is supposed to determine details of an investment strategy (a calculation of the size of the investment portfolio, its currency structure, risk management parameters, and other issues) has not yet been created, even though provided for by the State Decree of September, 30, 2004.100

Just as fundamental, an acceptable level of transparency and accountability, with an opportunity for public oversight and participation in the decision making of the Fund, does not exist. Information concerning the Fund’s operations is difficult to secure for

100 Ibid.
purposes of analysis. The SFRF does not maintain its own website. It is possible to find some eclectic information about the Fund on different governmental websites.\textsuperscript{101} However, the information is not systematized. There are no special sections or archives collecting legislative actions, press releases or other materials concerning the Fund on these websites. Russia does not even list the SFRF as being among its state funds. It would appear that either the government is not sure about the status of the Fund or is not listing the Fund for the purpose of limiting the Fund’s level of transparency even more. Some limited information, such as newspaper and several scholarly articles, about the Fund was published in the media, indicating some minimal level of observational transparency exists in the Fund’s operations.

Apart from these political deficiencies, there are concerns about the source of revenues for the Fund. A group of Russian geologists suggest that an oil extraction tax should not be transferred to the Stabilization Fund because it limits the investment capacity of oil companies to develop new, often more expensive, oil fields (Kipelman 2005: 81).\textsuperscript{102} They also criticize an increase in the oil export tax (30 percent corresponds with an oil price of $20 per barrel and more than 70 percent corresponds with an oil price of $60 per barrel).

Despite the observed weaknesses of the Fund, it appears the government is not going to give up on the Fund (as has happened several times in Venezuela). Recently, some possible changes in the Fund’s structure were discussed in the corridors of power. The government is considering delegating more authority to the Central Bank for


\textsuperscript{102} Or this tax can be transferred to a kind of a state modernization fund to assist companies in developing new oil fields. In this case, the proposed fund should accumulate taxes from an extracting other natural resources as gas, gold, diamonds, metals, and others.
management of the Fund’s investment portfolio as a professional financial institution. Auditing Chamber Chairman Sergey Stepashin is considering auditing the Fund’s operations as one of the key aspects of the Chamber’s work. In his speech at the six Conference of the Association of Controlling and Auditing Institutions of Russia, Sergey Stepashin called cooperation of auditing institutions with law-enforcers “very effective.” According to Stepashin, in 2003, after examinations conducted by auditing institutions, law-enforcers started 240 investigations of suspected criminal cases. And this appears to be just the beginning. “If we want to build an effective democratic state based on the rule of law and want to eradicate corruption in Russia, we need thoroughly elaborated laws and strict observance of them,” said Stepashin. In addition, the government is considering the establishment of an institute of external auditor to evaluate the Fund based upon world-wide practice.

4.4. Recommendations for Promoting Transparency, Accountability and Public Oversight in Management of the Russian Stabilization Fund

Theoretical framework and factual analysis provided in the first two chapters, addressed and proved the hypothesis: that the more transparent, accountable and open for public scrutiny any NRF is, the more likely the fund will perform effectively in terms of earnings and public spending. This final section of the thesis, addresses the main research question: what should be done in Russia to increase fiscal transparency, public accountability and participation in managing the Russian Stabilization Fund?

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Despite the skepticism of some international observers concerning the benefits of setting up an oil fund in a country with an absence of overall budget discipline, the SFRF has achieved several positive results mentioned in the immediate previous section. Even despite tension between senators and the administration, and given Russian citizens’ concerns regarding the Fund’s lack of transparency and accountability, the Fund can be seen in a positive light. This does not mean that Russian society will continue to tolerate the current situation.

According to official statistics, substantial oil money remains in the Fund despite the pressure of special interests, which become stronger each day. Therefore, it is not too late to improve the Fund’s design to guarantee the effective investment strategy, transparency and accountability of the Fund.

Section 3.1, above, provides general guidelines for any NRF to guarantee transparency, accountability and public oversight. Sections 3.2 and 3.3 observe the best practices of accountability for public scrutiny of the funds. Section 4.3 highlights the fragility of the natural resource fund in Russia, given the poor design, the lack of checks and balances in its governance, and the weak legislation. Rather then repeating the recommendations already made, this section will focus on what precisely the Russian Fund should do in the foreseeable future to improve its design and increase its transparency and accountability.

4.4.1. Improving the Overall Design of the Fund

It is fundamental to first clarify the SFRF’s mission and objectives. The law establishing the Fund sets forth that it can be used for the “financing of federal budget

deficits when an actual price falls below the base price, and for other purposes.”105 The first objective (addressing budget deficits) is clear while the second (other purposes) is not. The second objective should be specified with unmistakable clarity. A more specific statement of the Fund’s mission would make it possible to determine what expenditure and investments fall within the Fund’s mandate and which fall outside of it. If the Russian government and architects of the Fund are not ready to formulate long-term objectives, a short-term strategy of five years, for example, could help to create a stable environment around the Fund for at least this period. Otherwise, a smoldering situation, ripe for social revolution, will surround the reading of the federal budget draft each year.

A diversified investment strategy must be established for the Fund. The decree states that the Stabilization Fund’s assets can be placed only in a certain form of securities with governments of several specified foreign states.106 However, the experience of other natural resource funds demonstrates that combining stocks and bonds makes it possible to increase returns while keeping risk relatively low. It is important to develop a long-term strategy for investing in both equity and securities, and to set limits to the various asset classes. The investment strategy should set benchmark rates of return, and should indicate what portion of the assets, if any, may be given to external managers for independent investment.

It appears that no external managers were allowed to manage the Russian Fund’s assets. The experience of other NRFs teaches that it is wise to delegate a portion of a


fund’s principal for management by independent investment agencies. Initially, a portion of the principal can be limited and then increased gradually, should success be demonstrated. However, these agencies should be chosen through a process of a competitive tender.

It must be clearly understood that it is absolutely mandatory that the Fund act as a professional financial investor. The people’s national endowment must not be wasted, and most assuredly must not be wasted because of inflation or poor investment management by governmental agencies. To strengthen a governmental team of investors, an independent investment consulting body could be created.

These and other new, protective design features for the Fund should be carefully defined by law and strongly enforced against violation or circumvention. Currently, the SFRF exists only on the basis of two legal acts that provided a skeletal framework for the Fund’s establishment. The legal foundation of the Russian Fund must be significantly strengthened.

4.4.2 Improving Accountability and Public Oversight of the Russian Fund

Until now, there has been neither an internal nor an external auditing policy established for the Fund. Therefore, an entire auditing system for controlling financial performance must be developed. According to the best international practice, an evaluation of a fund’s overall activity can help to guarantee compliance with that fund’s goals and objectives. However, an independent, external auditor and evaluator should be hired through a competitive process. Audit and evaluation reports must be open in their entirety for public scrutiny.
Lines of accountability for oversight of the Russian Stabilization Fund must be strengthened significantly:

- An agreement between the Ministry of Finance and the Central Bank should be developed forthwith to set a clear division of responsibilities and a sophisticated system of checks and balances between them to ensure accountability of their financial operations.

- An oversight body or council should be created by the legislature with clear statements of goals, objectives and responsibilities. This body or council can function as a “watchdog,” with the aim of contributing to an informed public debate and sound management of the petroleum wealth. It is crucial for the success of such a body that representatives from Russian civil society be included. The law should stipulate procedures for selecting such representatives to guarantee their presence on the body or council.107

4.4.3 Improving Transparency of the SFRF

Since there is currently no financial data publicly available concerning the SFRF, quarterly and annual reports beginning for the year 2004 and thereafter should immediately be made available for public scrutiny and consideration. Ideally, all information about the Fund should be considered property of the Russian people and made available on a website, to all media and upon request.

The best way to make information about the Fund available for the maximum number of people in a short period of time in Russia is to create and maintain a Fund website. Initially, special sections, devoted to the Fund, can be designed on websites of governmental bodies involved with the Fund’s operations: the Ministry of Finance and

107 Part III of the Guidelines provides other recommendations to design an oversight body
the Central Bank. Ideally, a feedback opportunity should be provided so as to provide answers to questions posed by the people.108

Outreach activities by the Fund’s staff, such as press-conferences, briefings, and seminars, as well as public hearings on the Fund’s operations, will be highly appreciated by Russian citizens and will go a long way towards releasing current tensions.

108 Part 1 of the Guidelines under Section 2.1, provides other general recommendations on how to increase people’s awareness about the Fund
Appendix I. Key Features, Advantages and Disadvantages of Different Types of NRFs

<table>
<thead>
<tr>
<th>Type of a fund</th>
<th>Key features</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stabilization fund</strong></td>
<td>✓ Purpose to reduce the impact of volatile revenue on the government and the economy. ✓ The idea is that the fund receives money from the budget when petroleum revenue is particularly strong and pays out to the budget when resource revenue is weak. ✓ Inflows and outflows are typically contingent on whether the resource revenue or price is “high” or “low,” compared to some historical average.</td>
<td>Stabilization funds aim to make budgetary spending more stable and predictable by reducing the uncertainty.</td>
<td>✓ Suffer from the fungibility problem. Government can make payments to the fund when the resource price is high, but may not reduce expenditure if they borrow elsewhere. ✓ Another potential design flaw is if their rules of inflows are based on rigid price thresholds that may become inappropriate.</td>
</tr>
<tr>
<td><strong>Saving fund</strong></td>
<td>✓ Purpose to build up wealth for future generations. ✓ Inflows are typically either a fixed share of the resource revenue or a fixed nominal contribution from the budget. ✓ Outflows are typically discretionary transfers to the budget, but sometimes are also linked to specific situations (recessions).</td>
<td>Savings funds can contribute to long-term management of natural resource revenues</td>
<td>This fund is fungible too. This mean that assets in the savings fund do not necessarily represent genuine savings, since the government could be borrowing. This can lead to inefficient cash management.</td>
</tr>
<tr>
<td><strong>Financing fund</strong></td>
<td>• Purpose to overcome the design flaw of savings and stabilization funds relating to fungibility; • Act as the government’s savings account and can serve as both savings and stabilization fund; • The budget transfers all petroleum revenues to the fund and the fund in turn finances any remaining budget deficit. Thus the net inflow into a financing fund is exactly the overall fiscal balance.</td>
<td>Financing funds transparently show not only how much of the resource revenue the government is saving, but also what the amount saved depends on the government’s fiscal policy decisions.</td>
<td>For such a fund to be a success, it requires decision-making by government and parliament to be informed and long-term. The challenge grows in tandem with the size of the fund.</td>
</tr>
</tbody>
</table>

Appendix 2. Transparency, Accountability and Public Participation Guidelines for Natural Resource Funds

Part I: Access to Information (Transparency)

<table>
<thead>
<tr>
<th>N</th>
<th>Generic Transparency Features</th>
<th>Fund’s Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>An annual report published in entirety and is accessible to anyone</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Details of revenue in a Fund are accessible to anyone</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Details of where and how a Fund is invested are accessible to anyone</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Details of expenditure are accessible to anyone</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Contracts between the government and petroleum companies and details of any payments transferred from oil companies to the Government or individuals or companies are accessible to anyone</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Audit reports are accessible to anyone under the Law</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>All of the information described in points 1-5 is available on the internet</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>All of the information described in points 1-5 is presented on radio and TV, is available in prescribed libraries</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>All the information described in points 1-5 is provided in several languages in all mediums</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>All the information is presented in the comprehensible language</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>A commitment to the principles of the Extractive Industry Transparency Initiative (EITI) is made in Law</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Policies, procedures, practices and mechanisms for managing petroleum revenue are understood by the majority of civil society</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>There are links from the home page to get any information related to an NRF</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Chosen external asset managers</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Statement of disclosure policies</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Daily Fund position is available through Internet</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Possibility of any feedback through the Internet (asking questions, providing comments, internship opportunities, and so on)</td>
<td></td>
</tr>
</tbody>
</table>

Part II: Accountability (Audit Reports)

<table>
<thead>
<tr>
<th>N</th>
<th>Generic Accountability Features</th>
<th>Fund’s Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>A Fund is audited internally (every 6 months)</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>An NRF is audited independently and externally</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>An external, independent auditor is chosen through a process of competitive tender</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>An external, independent auditor will audit all payments relating to management of the resources</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>An external, independent auditor will audit the performance of investments</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>An external, independent auditor will audit the Fund Managers</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>An external, independent auditor will certify the calculation of the withdrawal guideline</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Audits will occur at least annually and be provided in an Annual Report</td>
<td></td>
</tr>
</tbody>
</table>
### Part III: Public Participation (Oversight Mechanisms and Public Input)

<table>
<thead>
<tr>
<th>N</th>
<th>Generic Public Participation Features</th>
<th>Fund’s Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>26</td>
<td>An oversight body is established</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>An oversight body has power of veto over governmental or parliamentary/legislative decisions related to NRF matters</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>An oversight body can report to Parliament or other governmental entities at any time in relation to any aspect of petroleum revenue management</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>An oversight body’s responsibilities include input into expenditure decisions</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>An oversight body is not solely appointed by government</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>An oversight body is widely representative and includes membership from civil society</td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>An oversight body represents women</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Members of the oversight body are remunerated</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>An oversight body is provided with resources to seek information and advice</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>An oversight body is provided with resources to seek advice independent of government</td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>An oversight body is provided with an adequate time frame to provide advice</td>
<td></td>
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<tr>
<td>37</td>
<td>An oversight body’s responsibilities are well defined</td>
<td></td>
</tr>
<tr>
<td>38</td>
<td>The oversight body’s responsibilities include to protect the interests of both current and future generations</td>
<td></td>
</tr>
<tr>
<td>39</td>
<td>Civil society has an opportunity to participate in development of a Fund through an annual forum or public hearings</td>
<td></td>
</tr>
</tbody>
</table>

### Part IV: Crucial Elements of a Good Design Related to Transparency and Public Participation

<table>
<thead>
<tr>
<th>N</th>
<th>Generic Good Design Features</th>
<th>Fund’s Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>A NRF is established as an amendment to the Constitution</td>
<td></td>
</tr>
<tr>
<td>41</td>
<td>All of the features of a NRF are defined by Law</td>
<td></td>
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<tr>
<td>42</td>
<td>Relevant institutions have the capacity to manage the natural resource revenue (separation of power)</td>
<td></td>
</tr>
<tr>
<td>43</td>
<td>A legislative body, a president, a treasury department, a central bank and economic development department should have some role in overseeing NRF operations, and performance evaluation.</td>
<td></td>
</tr>
<tr>
<td>44</td>
<td>A life-span of the Fund is described</td>
<td></td>
</tr>
<tr>
<td>45</td>
<td>A Fund should be professionally managed</td>
<td></td>
</tr>
<tr>
<td>46</td>
<td>A Fund is ‘integrated’ with the budget process</td>
<td></td>
</tr>
<tr>
<td>47</td>
<td>Principles of the Law include protecting the interests of both current and future generations</td>
<td></td>
</tr>
<tr>
<td>48</td>
<td>Rule changes should be extremely cumbersome (a constitutional amendment or parliament/legislative super-majority</td>
<td></td>
</tr>
</tbody>
</table>
### Appendix 3

#### Comparison of Six NRFs’ Websites

<table>
<thead>
<tr>
<th>Type of information provided</th>
<th>FUNDS’ SCORES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Alaska</td>
</tr>
<tr>
<td>1. Annual reports published in entirety</td>
<td>YES</td>
</tr>
</tbody>
</table>
| 2. Details of revenue:  
  • Inflows by itself  
  • Breakdown by source  
  • Earnings benchmarks  
  • Return on portfolio | YES | YES | YES | YESi | YES | YES |
| 3. Details of where and how a Fund is invested:  
  • Companies/indexes in which the fund holds assets  
  • Market value of holdings in each company  
  • Methodology of investment and risk management  
  • Chosen external asset managers | YES | YES | Partlyiv | NO | Partlyv | NO |
| 4. Details of expenditure:  
  • Expenditure by itself  
  • Breakdown by type | YES | YES | YES | YES | YES | YES |
| 5. Details of any payments transferred from oil companies to Government or individuals | NO | NO | NO | NO | YES | NO |
| 6. Reports of external auditor published in entirety | YES | YES | NO | NO | YESvi | NO |
| 7. All the information described in points 1-6 is available on Internet | NO | NO | NO | NO | NO | NO |
| 8. All the information described above is presented on radio and TV, is available in prescribed libraries | n/a | n/a | n/a | n/a | n/a | n/a |
| 9. All the information described above is provided in all official languages in Internet | YES | YES | NO | YES | YES | YES |
| 10. All the information is presented in the comprehensible languageviii | n/a | n/a | n/a | n/a | n/a | n/a |
| 11. A commitment to the principles of the Extractive Industry Transparency Initiative (EITI) is made in Law | NO | NO | NO | NO | NO | NO |
12. Policies, procedures, practices and mechanisms for managing petroleum revenue | YES | Partly viii | YES | Partly ix | NO | NO

13. There are links from the home page to get any information related to an NRF | YES | YES | NO | NO | Partly | NO

14. Chosen external asset managers | YES | YES | NO | NO | YES | NO

15. Statement of disclosure policies | YES | YES | YES | NO | YES | NO

16. Daily Fund position is available through Internet | YES | NO | NO | NO | NO | NO

17. Possibility of any feedback (asking questions, providing comments and so on) | YES | YESv | YESvi | NO | Partlyvii | YESviii

**Total Score:** 19.0 16.5 11.5 4.0 13.5 6.5

The six websites can be found at the following URL’s:
Norway: http://odin.dep.no/fin/english/topics/pension_fund/p10001682/bn.html
Azerbaijan: http://www.oilfund.az
Kazakhstan: http://www.nationalfund.kz

i The last inflow information available is for 2002.
ii The information is not complete and available until 2002.
iii The information is not complete. The breakdown provided is by type of payment (i.e. VAT, royalty) but not by company which made the payment.
iv It has a breakdown by type of market (US, Canadian, Non-American) and by type of asset, but it does not name companies.
v It has an aggregated breakdown by type of financial institutions, but it does not name them.
vi However, the last available report is for 2003 fiscal year.
vii We would prefer not to estimate the level of funds websites comprehensiveness it in this paper. Probably, it should be additional criteria than just our personal judgment.

viii Unlike the resource funds in Alaska, Alberta, and Venezuela, Norway’s SPF does not specify what share of oil revenues are to be deposited each year. Deposits are determined annually by the legislature; they consist of net oil revenues after the non-oil budget deficit has been covered.
ix They provide general rules in the Law, but they do not support it by any additional regulations.

x Anyone can ask a question; however it goes not to fund’s staff directly, but to the Ministry’s of Finance web desk.
xi It goes to the general information service for the Ministry of Finance as with the Norwegian Fund.
xii They provide the contact information on the website, but it does not say that any questions will be answered.

xiii It also goes to the general information service for the Ministry of Finance.
Appendix 4

Lines of Accountability in Oversight of Norway’s State Petroleum Fund

- **Parliament**
  - Determines deposits to the Fund annually
  - General Oversight the SPR

- **Ministry of Finance**
  - Strategic investment decisions
  - Oversees Bank’s management of the Fund

- **Norges Bank (Central Bank)**
  - Risk management/risk control,
  - Accounting
  - Reporting
  - Reports to Ministry of Finance

- **Auditor General**
  - Conduct annual audit and submits to the Council

- **Advisory Council on Ethics**
  - Consult the Ministry on ethical issues

- **Investment Strategy Council**
  - Assist the Ministry with investment strategy

- **External Auditor**

- **Norges Bank Supervisory Council**
  - Appointed by parliament to oversee SPF

- **Management Team**
  - Petroleum Insurance Fund
Appendix 5

Lines of Accountability in Oversight the State Oil Fund of Azerbaijan

**President**

- Controls the SOFAZ, appoints the Executive Director and members of the Supervisory Council

**Supervisory Council**

- Reviews SOFAZ’s annual report and audit’s report, and proposed budget for SOFAZ.
- Reports to the president

**Executive Director of SOFAZ**

- Exercises operational management
- Submit quarterly and annual reports
- Estimates of operational expenses to the president
- Cooperates with auditor selected by the president

**Investment Board**

- Consults the Director with investment strategy
- Consists of the executive director and senior officials of relevant SOFAZ departments
Appendix 6

Lines of Accountability in Oversight of Russian Stabilization Fund

**Parliament (Duma)**
Determines spending strategy of the Fund as a part of the federal budget law
- General Oversight of the SPR

**Ministry of Finance**
- Strategic investment decisions
- Oversees Bank’s management of the Fund

**Auditing Chamber**
- Conduct annual audit and submits to the Duma (a project)

**Central Bank of Russian Federation**
- Risk management/risk control,
  Accounting
- Reporting
- Reports to the Ministry of Finance

**External Auditor** (it does not exist yet, but there is a plan to create.)
BIBLIOGRAPHY


