POLICY BRIEFING 02 | 2020

German Economic Team
BELARUS

The economic impact of the Russian oil tax manoeuvre

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Executive Summary (1/2)

Background

- Each year Belarus receives ca. 24 m tonnes of oil from Russia. As oil imports are exempted from export duties, the import price was approx. 30% below the world market price in 2018
- This exemption constitutes a considerable subsidy to Belarus as:
  - 6 m tonnes of oil are sold by Russia on Belarus' behalf with the difference between world market price and discounted import price (so-called "peretamozhka") transferred directly to the Belarussian budget
  - The remaining 18 m tonnes are processed by Belarussian refineries, with a considerable share of oil products being exported
- **Tax manoeuvre**: A Russian tax reform, which implies that the oil price discount will disappear as oil export duties in Russia are <u>gradually replaced</u> by an mineral extraction tax until 2024

What are the economic effects of the "tax manoeuvre"?

- Based on 2019 data, we simulate what would be the economic and fiscal effects of a <u>complete removal</u> in the long run of the oil price discount <u>without any compensation</u>

Executive Summary (2/2)

Results of the simulation

- The removal of the oil price discount constitute a significant economic shock to the Belarussian economy with the impact felt in three areas:

1. <u>Decline of domestic demand for oil products</u>

   Domestic demand for oil products (petrol, diesel, fuel oil, etc.) will decline by approx. 18% as the oil import price increase translates into higher prices for consumers and companies.

2. <u>Impact on exports and oil processing industry</u>

   Due to the higher oil import price, Belarussian refineries will have to bear additional cost of approx. BYN 2.4 bn. This alone will reduce GDP by 1.5% and severely affect the economic viability of the oil procession sector.

3. <u>Fiscal impact</u>

   The Russian tax manoeuvre will lead to a revenue short-fall of BYN 7.3 bn (5.5% GDP) as budget transfers from "peretamozhka" and profits from state-owned refineries disappear. This is equal to a loss of budget revenues of 15%, which is likely to partly translate into a GDP reduction (demand shock).

Content

1. Background

Russian tax manoeuvre

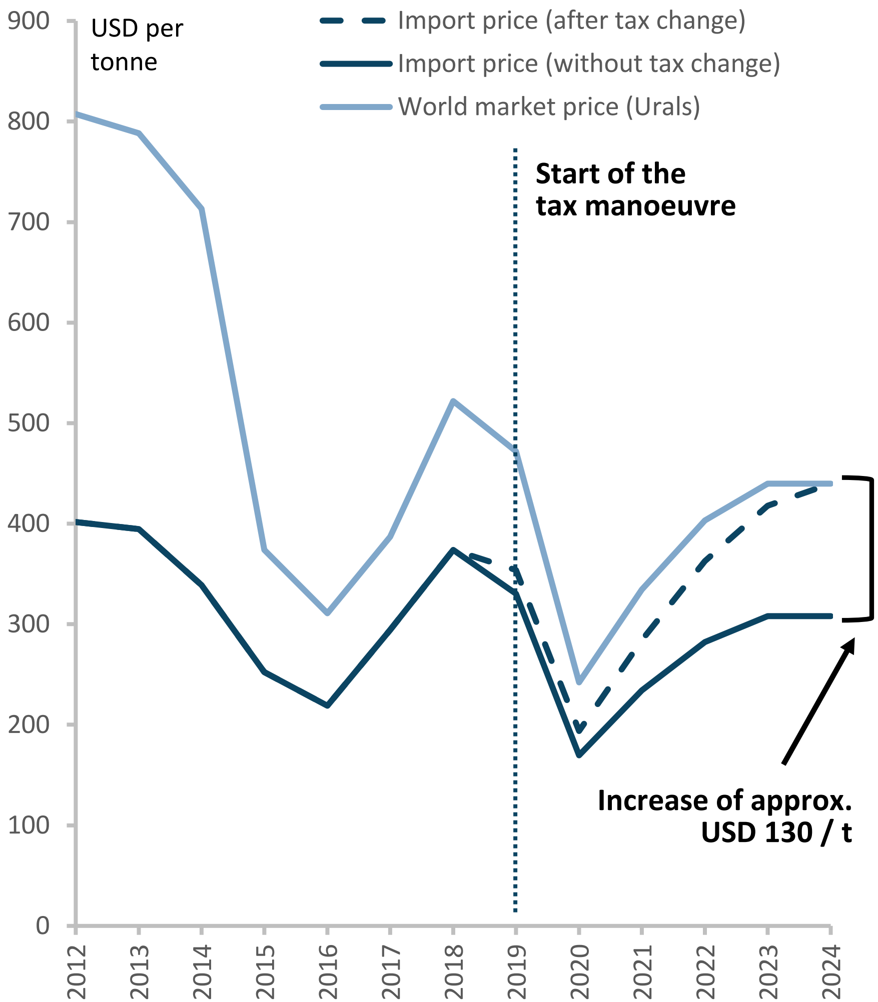
- Starting from 2019, taxation of raw materials through export duties in Russia will be gradually replaced by an extraction tax
- As such, during the period 2019–2024, the domestic oil price in Russia will gradually align with the world market price
- According to Russian officials, the tax manoeuvre is expected to generate about RUB 2 tr revenues for the Russian budget between 2019–2024. After the full implementation, about RUB 500 bn additional revenues (ca. 0.5% GDP) are expected yearly

For Belarus, a significant increase in price for oil imports can be expected

- Oil exported to Belarus is exempted from export duties in Russia. This represents a significant advantage to Belarus, as the price of oil imported from Russia was about 30% lower than the relevant world market price (Urals) in 2018
- Annually, Belarus receives approx. 24 m tonnes of Russian oil under this preferential arrangement. Out of those, 6 m tonnes are sold directly by Russia on Belarus' behalf (with the difference between world market price and discounted import price received as a transfer to the Belarussian budget)
- Further 18 m tonnes are processed in Belarussian refineries. The petrol, diesel and other oil products are mainly exported
- **Proceeds from re-exporting the Russian oil as well as the export of oil-based products are of considerable importance to the Belarussian economy and for the state budget**

Import price to align to international market price

Import price to increase by about 30%



Source: Belstat, EIA forecast starting 2020 , GET calculations

- Between 2019 and 2024, Russia gradually replaces export duties by an extraction tax which, unlike export duties, will also be levied on exports to Belarus
- While the adjustment happens gradually, it will inevitably lead to an alignment of the Belarussian import price with the word market price
- The import price determines the revenues from re-exports of oil as well as the export of oil-based products

➢ **Once completed in 2024, full application of extraction tax will increase the oil import price by about 30%. This corresponds to an increase of about USD 130 per tonne**

➢ **How important is Russian oil for Belarus?**

Status quo: oil demand and supply

Demand and supply of crude oil in Belarus

2019		Volumes (m tonnes)	Value (BYN bn)
Supply	Extraction	1.7	1.7
	Imports from Russia	18.0	13.4
	Total supply	**19.7**	**15.0**
Demand	Exports	1.6	1.6
	Domestic consumption	17.9	13.3
	Total demand	**19.5**	**14.9**

Source: GET calculations based on Belstat; Note: Difference between total supply and total demand due to changes in stock

- In 2019, total oil demand amounted to 19.5 m tonnes worth BYN 14.9 bn
- This demand is covered almost exclusively (18 m tonnes) through imports from Russia
- Belarus own extraction can only supply 1.7 m tonnes
- Demand: Most of the imported oil (17.9 m tonnes) is used by Belarussian refineries and processed into petrol, diesel, fuel oil and other oil based products (see next slide)

➢ **As Russia supplies almost all of Belarus' oil demand, import price change likely to have a significant economic impact**

Current demand and supply of oil products

Demand and supply of oil products in Belarus

2019		Volumes (m tonnes)	Value (BYN bn)
Supply	Own production	16.5	16.8
	Imports	0.2	0.4
	Total supply	**16.7**	**17.1**
Demand	Domestic consumption	4.8	5.6
	Exports	10.5	10.9
	Total demand	**16.5**	**17.1**

Source: GET calculations based on Belstat; Note: Difference between total supply and total demand due to changes in stock

- Total demand for oil products such as petrol, diesel fuel and fuel oil was 16.5 m tonnes in 2019
- Domestic consumption accounts only for 4.8 m tonnes, while the main share of oil products (10.2 m tonnes) is exported
- Remarkably, almost the entire supply of 16.7 m tonnes oil products is produced inside Belarus

➢ **Main share of Russian oil is processed and then exported**

➢ **Based on cheap oil imports from Russia, production and export of petroleum products became an important business for Belarus**

3. Economic impact assessment

What will be the economic impact of higher oil prices from Russia?

Approach:

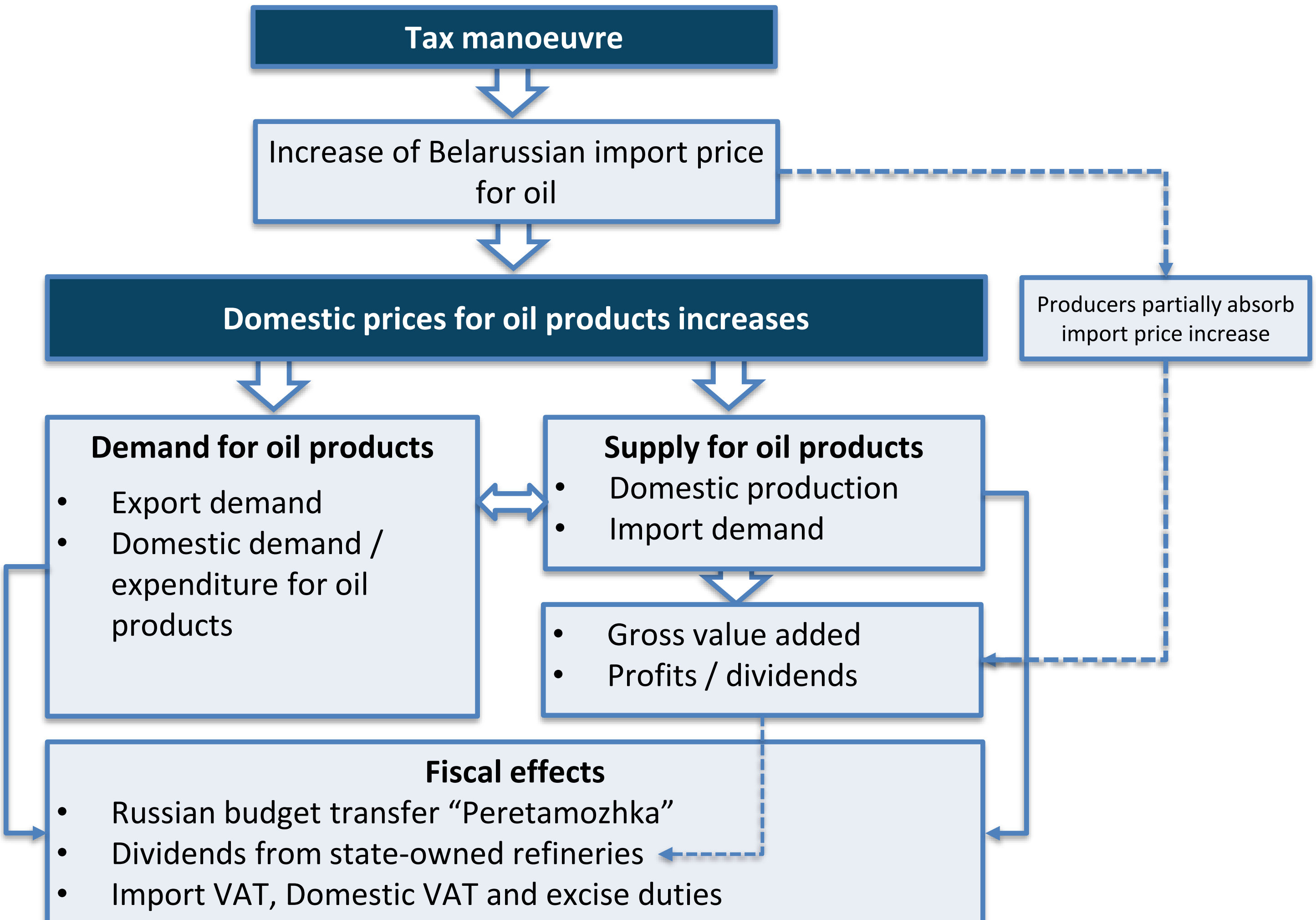
- We simulate what would be the effects after the tax manoeuvre is completed and the current oil price discount is completely removed

	Belarussian import price for crude oil
Basic scenario, 2019	354 (USD / tonnes)
Full implementation of the tax manoeuvre, 2019	472 (USD / tonnes)

Source: GET calculations based on EIA data

- We base our analysis on 2019 data for demand and supply of oil and oil products in Belarus. As such, the results allow to compare what would have been the situation in 2019 without the oil price discount
- While it may well be that Belarus and Russia agree on some compensation measures, the above scenario allows to determine what is at stake

Impact channels on the Belarussian economy



Source: GET

a. Impact on demand and supply for oil products (1/2)

Impact depends on how much of price increase is passed on to final consumers

- How will the increase of oil import prices affect demand and supply (i.e. production) of oil products?
- This depends on how much of the import price increase is passed on to final consumers
- If the import price change is passed on fully to end consumer prices, consumers will face a large price change and adjust their demand accordingly
- If producers absorb some or all of the price increase, the impact on demand will be low, but producers will face a decline of their profits

Assumptions

- **Domestic consumption** for petrol products especially in the short term does not react strongly to price changes (inelastic demand). Literature suggests that a 10% increase leads to a 5% decline of demand. We assume that in the long-run domestic prices will fully reflect the increase of import prices.
- **Export demand** reacts typically much more to price changes as petroleum products are homogenous and have low transport costs. If Belarussian exporters were to increase prices, importers would quickly look for different suppliers. Due to the expected strong demand reaction, we assume that producers will absorb the entire import price increase.

➢ **Based on these assumptions, we can now estimate how demand and supply will react to the change in import prices**

a. Impact on demand and supply for oil products (2/2)

Domestic consumption likely to decline by 18%

2019		Current situation		After tax manoeuvre		Change	
		Volumes (m tonnes)	Value (BYN bn)	Volumes (m tonnes)	Value (BYN bn)	Volumes (m tonnes)	Value (BYN bn)
Supply	Own production	16.5	16.8	15.6	15.9	-5%	-5%
	Imports	0.2	0.4	0.0	0.0	-100%	-100%
	Total supply	**16.7**	**17.1**	**15.6**	**15.9**	**-7%**	**-7%**
Demand	Domestic consumption	4.8	5.6	3.9	6.2	-18%	11%
	Exports	10.5	10.9	10.5	10.9	0%	0%
	Total demand	**16.5**	**17.1**	**15.6**	**17.8**	**-5%**	**4%**

Source: GET calculations based on Belstat data; Note: Difference between total supply and total demand due to changes in stock

- **Domestic consumption:** We expect domestic demand to decline by 18% in volume terms. However, as the price increase is larger than the decline in demand, expenditures for oil products will actually increase.
- **Export demand:** Belarussian exporters are unlikely to pass on higher import prices and instead will absorb the import price increase. As such, export demand will not be affected but refineries will face losses as they will absorb the brunt of the price increase (see fiscal impact).
- **Total demand and supply:** Will only decline by about 5% in volume terms.

b. Impact on Belarussian oil refineries (1/2)

Name	Creation date	Ownership structure	Oil processing capacity	Number of employees
	1963	**99.8% - state** 0.2% - private shareholders	ca. 11 m t	9,967
	1975	**42.76% - state** 42.58% - Private Russian OJSC Oil and Gas Company Slavneft 12.25% - state oil trade company "MNPZ Plus" 2.41%- private shareholders	ca. 12 m t	5,003

Source: Web-sites of oil refineries

- An increasing oil price will significantly affect the profits of oil refineries, as they won't be able to fully pass on the change to their customers
- Beside profits, this will also directly affect the Belarussian budget as the state has a significant stake in the refineries (dividends)
- A decreasing profitability could lead to a lay-off of workers. While the refineries do not have a high share of employment in the industry (1.5%), they are important employers in the respective region

b. Impact on Belarussian oil refineries (2/2)

Significant losses as refineries have to absorb oil price increase

	Current situation	After tax manoeuvre
Export revenues (BYN bn)	10.9	10.9
Export volume (m tonnes)	10.5	10.5
Amount oil used during production	9.9	9.9
Cost oil per tonne (BYN/t)	693	940
Cost oil per tonne (USD/t)	354	472
Cost of oil inputs (BYN bn)	6.8	9.3
Additional cost (BYN bn)	**–**	**2.4**

Source: Belstat, GET calculations

- Exporters are unlikely to pass-on the oil price increase to final consumers as export demand reacts strongly to price changes. Producers will have to absorb increased cost of oil inputs
- Based on 2019 numbers, **cost of oil inputs for refineries would increase by BYN 2.4 bn** if the tax manoeuvre is fully implemented
- As revenue remains unchanged, profits of producers likely to decline by BYN 2.4 bn, which equals **15% of total revenues**

➢ **Direct impact on Belarus GDP which will decline by 1.5%**

➢ **As the state has a 100% stake in Naftan and 43% in Mozyr – direct impact on public revenues (see next slide)**

c. Fiscal impact

Budget revenues to decline by about BYN 7.3 bn once tax manoeuvre completed

Type of budget income	Current value (BYN m)	Value after tax manoeuvre (BYN m)	Change (BYN m)
Export duties from oil products		*no change expected*	
Import VAT charged on imported oil and oil products from Russia	**1,100**	**1,400**	**300**
Transfer from Russian budget of the amount of export duties received from custom clearance of 6 m tones of oil (so- called "peretamozhka")	**5,900**	**0**	**-5,900**
Domestic VAT (20%) motor fuel selling on domestic market	**1,100**	**1,200**	**100**
Excises on fuel sold on the domestic market	**600**	**500**	**-100**
Shareholder income state owned enterprises	**n/a**	**n/a**	**-1,700**
Total fiscal effect (BYN)			**-7,300**
Total revenues 2019 (BYN)			**48,000**
Compared to 2019 budget revenues			**-15%**

Source: GET calculations

- **Severe reduction of budget revenues by about BYN 7.3 bn (5.5% of GDP), which is likely to partly translate into a GDP reduction (demand shock)**

4. Policy conclusions

- A complete loss of preferential access to Russian oil supply would have a significant negative impact on the Belarusian budget and GDP
- While a compensation for the tax manoeuvre might be secured in the future, it is unlikely to be enough to absorb its full impact
  - Especially the state budget will be in need of additional sources of income
  - Moreover, the effect on oil refineries of purchasing crude oil at market prices is not clear
- As the manoeuvre is implemented gradually, it leaves time for policy makers in Belarus to mitigate some of its impact through decisive economic reforms
  - Wide ranged structural reforms, especially privatization, are needed to ensure a robust source of economic growth and public revenues
  - Diversification of exports and imports (also in the energy/oil sector) needs to be considered, in order to better absorb external shocks
- While a gradual implementation may entice a “wait and see” approach, a late reaction to the slowly forming financing gap may endanger fiscal stability

About the German Economic Team

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Team

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

In a continuous dialogue with high-level decision makers of the project countries, we identify current problems in economic policy and then provide concrete policy recommendations based on independent analysis.

In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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