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Further reading

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Oil and Gas Revenues Management in Azerbaijan: Crude Dependence and Its Consequences

By Kenan Aslanli, Baku

Abstract

Azerbaijan's macroeconomic and fiscal indicators during the global economic crisis reflect the dependence of the Azeri economy on oil and gas. The addiction will continue to increase from year to year. The country's rising oil dependence might upset macroeconomic and fiscal equilibriums, and intensify the risk of civil unrest among vulnerable social groups. Social repercussions are possible if oil and gas revenues are managed poorly or distributed unjustly.

Increased Oil and Gas Dependence in Azerbaijan's Economy

At a time when Azerbaijan's dependence on energy revenue is increasing, the government is spending money in non-transparent ways. Unfortunately, there is little societal oversight to check these tendencies.

Azerbaijan's revenues from oil and gas are expected to total $198 billion in net present value terms through 2024. This sum will flow from the annual growth of oil and gas extraction on the basis of the joint development of oil and gas deposits in the Azerbaijani sector of the Caspian Sea and higher prices in the world oil market. As the mission statement of the State Oil Fund of Azerbaijan Republic (SOFAZ), established in 1999, points out, part of the projected income will be sterilized in the domestic economy, while another part should be saved for future generations, and it will be invested in the international securities market. For this purpose, SOFAZ cooperates with the Reserve Assets Management Program (RAMP) of the World Bank, which has been in existence for more than 40 years. Today, the World Bank manages $114 million of Azerbaijan's money.

In 2009, the strategic currency reserves of the country increased by $1.8 bn., and taking into consideration the assets of SOFAZ, totaled $20 bn. Revenue obtained from foreign exchange assets management totaled $430 million, of which $287.7 million went for national foreign debt servicing. As a result, earnings obtained from assets management exceeded payments for loans by a factor of 1.5. But, at the same time, foreign trade turnover fell to approximately a third of previous levels and exports declined from $47 billion (2008) to $14 billion (2009). SOFAZ has been actively working to provide greater transparency and accountability leading to improved rankings in respected measures, such as the Linaburg-Maduell Transparency Index.

Also, the volatility of the dollar and the euro since early 2010 affected the size of SOFAZ assets. The fund's assets amounted to $14.9 billion in early 2010 (an increase of 32.8% compared to early 2009). By the middle of March, their sum exceeded $16 billion. Despite the increase in assets, SOFAZ has no plans to expand its use of foreign money managers. In 2009, the volume of Azerbaijan's currency market increased by 8.3%. Owing to the flexible regulation of the currency market and thanks to the Central Bank's (CB) intervention, the exchange rate of Azerbaijan's currency, the manat (1 USD = 0.8 AZN), remained stable, falling only 0.26% in relation to the US dollar in 2009. The drop in the Central Bank's currency reserves observed today is connected with a reevaluation of its reserves.

According to the last fiscal statement of the National Budget Group (NBG), a Baku-based budget research and advocacy group, there is serious concern that the country's economy and national budget are not sustainable in the context of the great volatility in energy prices during recent years. The government is not achieving its goal of decreased dependence on oil; to the contrary, Azerbaijan's dependence has increased. In fact, at the end of 2008, approximately 97% of total exports were crude oil and oil products. Even low oil prices during the global financial crisis did not reduce this dependence. Serious changes in the budget indicated the government's lack of an effective medium- or long-term budget policy. In other words, when energy prices are high, the government tends to spend more money, and when prices drop, it simply "controls" this appetite. Most countries stimulated their economy through deficit spending during the global financial crisis, while the Azerbaijani government considers reducing spending in most spheres as the only possible remedy.

Recent Azerbaijani budgets indicated that the dependence of the country's economy on oil and gas will increase in coming years. Generally, these problems are most visible when we observe upwards trends in oil and gas production from the fields covered by Production Sharing Agreements (PSA), and particularly the Azeri-Chirag-Gunashli site. Azerbaijan's budgets during the crisis also indicated that the reaction of the Azeri government to international economic conditions was not appropriate. In 2009, state revenues were 10.3 billion manat compared to a projected 12.2 billion manat (84%). They fell by 4.1%, compared to the same period in 2008. Public budget expenditures decreased by 1.9 percent and made up 10.6 million manat (just 85.5% of a projected 12.4 million manat). The budget deficit totaled 241.1 million manat (just 0.7% of GDP). Also, state budget expenses will decrease in 2010. The drop will be 8.8% in comparison to 2009 and it will mainly affect the social sphere, agriculture, investment, transport, communications, as well as the reserve funds. However several budget items will be increased, such as general funding for public sector personnel, law enforcement and defense institutions, transfers to the State Social Defense Fund, roads, and the Fund for State-Guaranteed Debts. If it makes sense to cut funding for several important social spheres, such as education and health, during a crisis, there is no logic to increasing expenditures on law enforcement and defense institutions by 4.9%. The anticipated reduction in corruption in this sphere after the state increased salaries was not observed; to the contrary, the situation has deteriorated considerably.

According to the 2010 SOFAZ budget, revenue is supposed to be 5.963 billion manat and expenses should be 5.428 billion. This indicates that SOFAZ will spend almost all its revenue – 91%. The majority of its outlays (82%) will be transferred to the state budget. The growing dependence of the state budget on state oil fund transfers is an issue of concern. This means that the state oil fund is turning into the main contributor to the state budget and this dependence is reaching a dangerous level, which will threaten sustainable economic development.

It is not only the increasing amount of transfers, but also the decision of the government to spend the vast majority of the State Oil Fund budget that causes concern. It is worth mentioning that the Presidential decree on the "Long-term Strategy for Oil Revenue Management" of September 27, 2004 states that at least 25% of oil revenues should be saved for future generations at the peak of the oil boom. Unfortunately, the Strategy does not provide a specific mechanism for achieving this goal. The absence of such a mechanism makes it difficult to measure oil revenue management in accordance with the Presidential decree. In any case, the fact that the government is spending a huge portion of oil revenues indicates its intention to address its lack of money in an "easy" way.

To prevent such excessive use of SOFAZ incomes, the legislature should have greater control over the budget. However, transparency and accountability regarding budget expenses have deteriorated. At present, the International Budget Partnership is paying increased attention to the growing number of budget expenditures that are not classified. This lack of transparency will cause a drop in Azerbaijan's ranking in the Open Budget Index (prepared by the International Budget Partnership, USA) for the next period. In such a situation, the relevant state agencies (the Economic Commission of the Parliament and the Chamber of Accounts) should initiate investigations.

Another important point is that the budgets of 2009 and 2010 have unreasonably large deficits compared to the surpluses of recent years. These were 0.7% of GDP in 2009 and 4% of GDP in 2010. In the context of budget surpluses during recent years, these figures seem too high. The current priority for budget expenditures are public investments which lack transparency (unfortunately, international initiatives designed to increase transparency, such as the Extractive Industry Transparency Initiative [EITI] do not cover public investment issues). This expense line should be decreased in the upcoming years. International loans allocated for infrastructure will be added to the budget. Also, the decreasing share of tax revenue in the budget from year to year requires serious reforms in the fiscal system. State-level measures are needed to remove obstacles in the tax system that make investments in the non-oil economy unattractive. Since the share of income tax from the population in the budget is small, society is passive in monitoring the budget process.

Factors Causing Poor Oil and Gas Revenue Management in Azerbaijan

Several factors facilitate the poor management of oil and gas revenues in Azerbaijan. One of the most important ones are underdeveloped democratic institutions. The undemocratic electoral process and the ineffective public administration are weakening Azerbaijan's democratic institutions. The fact that newly created institutions, such as the human rights ombudsman and municipal governments, quickly lose public respect indicates the feebleness of public trust in such elements of democratic governance.

A poorly-functioning division of power also contributes to poor management of oil and gas revenues, as the absence of checks and balances has a negative impact on the budget process. Hence, there is a well-established public belief that the main player in the decision-making process is the Presidential Administration rather than the Parliament. Such concerns are strengthened due to little public participation in the decision-making process. The main reason why people are not actively involved in the budget process is the above-mentioned public distrust and a traditional culture of low participation.

In addition, the present structure of the Cabinet of Ministers (CM) prevents it from managing affairs effectively. Addressing this problem requires an evaluation of the entire structure and a more clear definition of functions. Despite the fact that certain measures have been taken within the various technical assistance projects of the European Union, USAID and World Bank, they did not produce any results. In fact the structural reform of the CM is impossible without clear political will. The CM either does not have a strategic plan or it is not open to public involvement since it was designed to be accountable to a limited group of people. The Cabinet of Ministers' failure to coordinate and define the strategic actions of the economic ministries and committees affects them as well. All this is consequently reflected in the ineffective management of public finances.

The closed classification of numerous budget expenditures and lack of proper fiscal forecasting complicate any control mechanisms. If the first factor that causes a non-transparent budget is the gaps existing in the budget legislation, the second one is the pressure the Parliament faces in this direction. The fact that Azerbaijan ranked 50th among 85 countries included in the 2008 Open Budget Index proves that budget classifications do not fully cover the various types of expenses.

Moreover, the high level of corruption in the country makes all state control measures directed at the budget or other economic fields ineffective. And a market economy has not been completely established yet in the country. Obstacles to liberalization, such as the persistence of monopolies and state interference into the market, prevent the normal functioning of market economy laws. Consequently the "shadow economy" becomes larger and the state budget is deprived of considerable funds. Also, state monopolies, such as the State Oil Company (SOCAR), intensify nationalistic and protectionist attitudes in economy.

Priorities of Public Expenditure

The budget has become more dependent on oil lately. As the state budget becomes increasingly dependent on oil, more of the non-oil parts of the budget are being cut. At least 50% of the 2010 budget is forecast to come from the oil sector. This shift means that the budget relies for its revenue on a few companies and this change has a dramatic impact on the budget process. In particular, it means that citizens play a small role in creating the budget and defining how it is spent.

Moreover, a regional disbalance of the budget can be observed as a result of the oil boom. 90% of the state budget income comes from Baku and the Absheron peninsula. There is also an interurban disbalance, which is found in the frequent change of the expense priorities of the budget.

The share of social protection and provision expenses in the budget as a share of GDP fell from 3% to 1.9% from 2003 to 2007 and then increased again to 3% and 3.7% during 2009–2010. Significantly increased amounts of social protection and provision expenses were allocated to pensioners, refugees and internally displaced persons (IDP); other needy layers of population also received benefits. Overall, the government planned to spend 1,192 million AZN on social expenses in 2010, despite the adverse impacts of the ongoing crisis on the entire economy. 2010 will be a "lost year" for salary and pension raises. We can observe drops in the amount of funds for salaries in comparison with 2009. Taking into account that the 2009 budget will be implemented with a deficit, it becomes clear funds for salaries in 2010 will be at the same level as they were in 2009. This means that there will not be sufficient increases in the salaries of public sector employees. Any increase will come from increasing the minimum wage and only affect citizens receiving extremely low salaries. A 5.3% increase in transfers from the State Social Protection Fund will increase the minimal pension level. In the 2010 budget, allocations to education will be 5.6% less than compared to 2009. The absolute amount of social expenses in the state budget of Azerbaijan is dynamically growing. However, its share in the structure of overall budget expenditures is decreasing. The indicator for 2010 is 10.6%.

The real poverty level is still very high, regardless of official statistics setting it at 11% for 2009. During the crisis, the income of the population grew every year, but prices went up as well. In the long run, there was no change in the real incomes or social welfare level of the population. The large weight of refugees and IDPs in the total number of population (12%) should also be considered.

Income tax from physical persons comprises only 11% of total budget revenue (2008). The tax burden on the economy is 15% (2009). The underdeveloped budget discipline and budget culture should also be mentioned here. The population's lack of participation in budget formation is related to the underdevelopment of small and medium-sized businesses. The coordination and management of oil and gas revenues from a single center is very weak. The first impression might be that a single center controls the management system of an over-centralized state finance system. An over-centralized budget system is undoubtedly a serious obstacle for local financial opportunities and for their producing positive economic outcomes.

Conclusion

Even if oil and gas prices bottom out in the current decade, the forecasted levels of production, if realized, would still make it possible to increase Azerbaijan's revenues from petroleum development. This trend might upset the macroeconomic and fiscal equilibrium, and intensify the risks of civil confrontation among vulnerable social groups. If the government manages its oil and gas incomes poorly and distributes the profits unjustly, there are likely to be some social repercussions.

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