Oil and Political Stability in Azerbaijan: The Role of Policy Learning

By Farid Guliyev, Bremen, Germany

Abstract

This article discusses several mechanisms by which oil wealth has sustained authoritarian rule in Azerbaijan. While the prevailing focus on patronage spending and repression is undoubtedly accurate, it is nevertheless incomplete because it does not account for oil's adverse effects that can potentially destabilize a country's political-economic system. The article argues that the Azerbaijani leaders' ability to draw lessons from the past experiences of other oil-rich countries and to borrow successful policy models helped the government to mitigate the adverse effects of economic petro-dependence. The example of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) illustrates the role that policy learning played in the regime's survival.

Public Spending and Repression

Oil and politics in Azerbaijan are inextricably connected. Over the past two decades oil wealth has sustained the autocratic rule in Azerbaijan. The question is: how? Many observers believe that the main transmission mechanism is greater state spending on patronage and the infrastructure of repression. In other words, oil-fueled state expenditures nurture the patronage network on which the regime is based, while tamping down potential opposition. After the peaceful hereditary transfer of power in 2003, Ilham Aliyev found himself in a situation in which he was less secure and more dependent than his father on the support of the ruling coalition. In order to assert his authority, he had to offer more patronage resources to the entrenched elite and to punish would-be plotters from among the elite. The purging of presumably disloyal members from the elite occurred in 2005, when Aliyev dismissed several ministers he suspected of plotting a coup. In order to secure the support of the remaining elites, oil revenues provided much-needed patronage in the form of government procurement contracts, public sector jobs, subsidies and other state expenditures. Resources distributed through the state bureaucracy based on patron-client relations with low transparency and weak legal oversight provided fertile ground for the proliferation of corruption.

More specifically, the new oil boom beginning in the early 2000s generated large rents that Aliyev used to increase public expenditures. Following the oil boom, total government revenue increased from 2 billion Azerbaijani manats (AZN) in 2004 to more than 19 billion in 2008, according to the IMF. At the same time, total expenditure increased six-fold, from 2 billion AZN in 2004 to almost 12 billion AZN in 2008. Of more than $80 billion in oil revenues accumulated in the state oil fund, 60 percent (about $50 billion) was transferred to the state budget and from there directed to finance various projects (see Caspianbarrel, January 20, 2013, http://bit.ly/VGktb9). The reserves of the fund currently stand at $34 billion. Its budget approved for this year estimates the revenue to be $14.6 billion and the expenses—$17.1 billion (see Trend.az, January 2, 2013, http://bit.ly/VykDo5). If the current spending pattern continues, a new World Bank study estimates that the oil fund's assets will drop to only $1 billion as early as 2016 (see http://bit.ly/YQu5DW).

The government also took measures to strengthen the defense and security establishments, with some of this funding allocated to the internal security forces. The defense budget is expected to rise from $3 billion in 2012 to $3.7 billion this year (Fox News, January 16, 2013, http://fxn.ws/SIGLe9). The Azerbaijan security and police forces are well-paid by average salary standards and enjoy a somewhat privileged status. Well equipped and loyal, these forces are used to curb opposition in society. As the awareness of corrupt transactions in Azerbaijan has risen, societal groups began to demand more transparency and accountability from the government. The government's reaction was to restrict access to free media and to crack down on activists. Journalists, youth bloggers, political and civil society activists have come to be perceived by the government as a threat. These groups are the main target of state repression today (Human Rights Watch, 2010, http://bit.ly/LlWjMR). This focus may be related to the state elites' fear that more transparency and greater openness may reveal corruption and undermine regime legitimacy in the public's eye.

In short, the regime's ability to remain in power to a large extent depends on Aliyev's ability to provide patronage to his elites and to counter the opposition to his rule, which in turn is a function of the amount and stability of oil revenue. The less oil revenues there are, the smaller the chances that the ruler will be capable of retaining his grip on power. Yet, this explanation is insufficient, as it does not account for the fact that oil is a notoriously unstable source of fiscal revenue for the state. Price hikes and fiscal volatility can potentially lead to economic crises, as during the collapse of oil prices in 2008, which, if not properly managed, can lead to regime breakdown. Therefore, to gain a more complete understanding of oil's impact on domestic political stability we need to explain how the Azerbaijani regime was able to withstand the harmful effects of oil revenue volatility.

Policy Learning

Just as ideas spread around the world, so do policy models. In designing solutions, policy makers in one country look for successful models from other countries and draw lessons from their experiences. This process is known as lesson drawing, policy diffusion or policy learning.

Taking advantage of knowledge about how to deal with the problems of natural wealth management, the Azerbaijani regime borrowed policy solutions and innovations drawn from the experiences of other "resource cursed" countries. This useful knowledge about policies was transferred via international organizations (and their economic expert communities), especially the IMF and the World Bank. The most crucial of these was the policy model of an oil fund.

So how did Azerbaijan adopt an oil revenue management fund? As early as 1998, the IMF recommended that the Azerbaijani government create an oil fund to manage the effects of Dutch disease and adverse exogenous shocks. According to the economists at the IMF, the creation of an oil fund helped a number of resource-rich countries to solve problems associated with oil booms, like exchange rate appreciation and inflation, and to shield their economies from potential external supply shocks. Norway's State Petroleum Fund (established in 1990) and Kuwait's Future Generations Fund (set up in 1976), were presented as successful examples. Earlier in the 1980s, Norway and Oman were victims of oil price shocks. This negative experience stimulated the search for a mechanism to protect the domestic economy of oil-rich states and the solution was found in creating oil funds, which, although different in their institutional structure and operational modes, have the same purpose of stabilizing fiscal revenue.

On the IMF's advice, in January/February 2000 the Azerbaijani government sent a high-ranking delegation to Norway to learn from the "Norwegian model." During the trip, the delegation met with Norwegian officials and familiarized themselves with the legal framework and operational mechanisms of the Norwegian oil fund. SOCAR's president, who led the delegation, said after the mission returned to Baku: "We acquainted ourselves with the functions and mission of the Norwegian oil fund, with the goals toward which funds are disbursed, and the sources of replenishment," but added that, "careful study of the Norwegian experience does not mean our fund will use the same scheme. Azerbaijan will work out its own mechanism for administering the Oil Fund."

In a similar vein, the Fund's webpage acknowledges that the experience of other countries was used as "the reference point," but a model that fit local specificities and needs was chosen (see http://bit.ly/XkJl6g). One of the Azerbaijani government's long-standing oil contract partners, Norwegian Statoil, proudly declares its role in transferring the Norwegian model to Azerbaijan:

"Together with Norwegian authorities, we promoted experience transfer from the Norwegian model for administering the petroleum industry to the Azerbaijani authorities and its state oil company SOCAR. We also helped to facilitate substantial assistance from Norwegian governmental bodies, such as the Norwegian Central Bank and the Ministry of Finance, which culminated in 1999 in the establishment of the State Oil Fund of the Republic of Azerbaijan (SOFAZ), based on Norway's own oil fund experience, to avoid overheating the economy and to safeguard the prosperity of future generations." (see http://bit.ly/W5sSTf)

There were three reasons why the Azerbaijani government decided to create an oil fund through policy transfer. First, the government realized that effective revenue management was instrumental to maintaining economic stability. Second, creation of an oil fund was a good way to demonstrate to Western governments and investors, as well as domestic civil society groups, its commitment to transparency. Third, the government wanted to keep good relations with the international financial institutions (IFIs), which provided financial support and policy advice in many other policy areas. The IFIs demanded that the Azerbaijani authorities adopt a set of rules for proper management of oil wealth. In other words, external "conditionality" also played a role.

The Azerbaijani oil fund is held to be transparent. It received the UN Public Service Award in the category of "Improving transparency, accountability and responsiveness in the public service" and was certified as compliant by the Extractive Industries Transparency Initiative (EITI) in 2009. In 2007, the Fund won the highest score for transparency among sovereign wealth funds, setting it on a par with Norway. The Fund's staff is about 70 professional cadres, many of whom were educated or trained abroad.

The oil fund has become a crucial instrument of fiscal policy in Azerbaijan. Consider the impact of the 2008 economic crisis on Azerbaijan. Following the drop in oil prices to around $30 a barrel in 2008, Azerbaijan's fiscal revenues fell by 35 percent in 2009. To cover for the fiscal shortage, the government increased the amount of the annual transfer from the oil fund to the state budget from about $4.8 billion in 2008 to $6.3 billion in 2009. This measure was important to maintain fiscal stability during the crisis years. As a result, in the words of the IMF advisers, although the Azerbaijani economy "was not immune" to the global economic crisis, it withstood its impact "relatively well" (see IMF, May 2010, http://bit.ly/Xq9d0J).

Conclusion

As has been shown in the analysis above, oil rents provided a valuable source of patronage for the regime. Oil revenues allowed the president to increase public spending and to expand the patronage network, which limited the space for political opposition groups. Increased spending on coercive structures as well as an increased use of repression against political activists helped keep societal opposition weak. By keeping monopoly control over the media and restricting access to public information, the regime effectively denied citizens the right to scrutinize government expenditure projects.

But oil was also the source of instability as during the world economic crisis in 2008–2009. In effect, oil-induced external shocks tested the ability of the regime to meet and overcome potential crises. The government managed to respond to oil's adverse effects by setting up a savings fund in anticipation of the oil boom. Moreover, it developed limited capacity (with insulated technocratic staff) in the selected key policy area of oil revenue management, which helped the regime to manage revenue volatility and other adverse consequences of its petro-dependence. Policy transfer was essential for the government's ability to mitigate the pernicious effects of oil volatility.

The challenge ahead for the Azerbaijani elites is to transition to a life after petroleum. Oil production already has started to decline. In 2012, the amount of oil produced was 43 million tons, which is 2.4 million tons less than in the previous year (see CESD, January 18, 2013, http://bit.ly/XTBuOE). The key question now, as Revenue Watch Institute economic analyst Andrew Bauer put it, is: "Once these resources [government oil and gas revenues] dry up and there is no other source of revenue to replace them, how will political stability be maintained?" (see http://bit.ly/QUcKqt).

About the Author

Farid Guliyev is a PhD candidate in the School of Humanities and Social Sciences, Jacobs University Bremen, Germany.

This essay draws on the author's article: Farid Guliyev, "Oil and Regime Stability in Azerbaijan," *Demokratizatsiya* 21:1 (2013): 113–147. For further information on *Demokratizatsiya*, please visit http://www.gwu.edu/~ieresgwu/programs/demokratizatsiya.cfm