Natural Resource Charter Case Study

Natural Resource Governance Institute

Diminished Returns: Managing Oil Revenues in Azerbaijan

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SUMMARY

Challenge	Ensuring stable revenues for the current and future generation (precept 7 of the National Resource Charter[1]).
Country and period of focus	Azerbaijan, 2001-2014
Challenge in country	Managing oil and gas revenues that are set to decline in a heavily oil-dependent economy
Core decisions	Setting up a state oil fund
Implications of decisions	The fund was set up to accumulate and effectively manage oil revenue.
Policy decisions, implementation and governance	SOFAZ was established in 1999 by presidential decree. Rules to constrain spending are either not in place or not followed. The Ministry of Finance is responsible for imposing fiscal rules but spending decisions are made within the presidential administration. SOFAZ is not accountable to parliament.
Did it work?	Although savings of about 50 percent GDP have been accumulated by 2014, decisions on how to allocate oil revenues are *ad hoc*.
Lessons learned	Lack of withdrawal rules, poor enforcement of existing rules and little independent oversight undermine the effectiveness of the fund.

ABOUT THE SERIES

This is one of a series of case studies that illustrates the principles of the Natural Resource Charter. The charter is a tool used by governments and societies seeking to better harness the opportunities created by extractive resources.

1 Natural Resource Charter http://www.resourcegovernance.org/approach/natural-resource-charter

INTRODUCTION

Azerbaijan's government established a national oil fund in 1999 to address the challenges associated with oil-rich countries, such as addressing revenue fluctuations, saving for future generations and investing in development. However, as described in precept 7 of the Natural Resource Charter, a fund in itself is no panacea: it can only achieve its aims with clear rules governing its operation, as well as transparency and oversight.

Azerbaijan is heavily dependent on natural resources. The oil and gas sector contributed to more than 90 percent of export earnings and more than three-quarters of the state budget revenues in 2013. The State Oil Fund of the Republic of Azerbaijan (SOFAZ) since held some US $36.6 billion as of July 2014, representing approximately 50 percent of GDP. These revenues are distributed among the state budget, the financing of infrastructure projects, and saved in foreign financial assets. Oil and gas revenue is expected to begin declining permanently in 2015, and while Azerbaijan's savings are large in comparison with other countries, the loss in revenue will not be compensated by the returns on SOFAZ's financial assets. This is a particular challenge for Azerbaijan since the government has not found alternative sources of fiscal revenue. To maintain current spending levels, taxes will have to rise or the government will need to borrow.

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THE CHALLENGE

Following major investments in oil production in the Caspian Sea in the mid-1990s, SOFAZ was established in 1999 to accumulate and effectively manage the country's increasing oil revenues. It was established as a legal entity with its own management structure and entrusted to achieve the following three main objectives, consistent with precept 7 of the Natural Resource Charter:

- Preserve macroeconomic stability by decreasing dependence on oil revenues and stimulate the development of the non-oil sector.
- Accumulate and preserve revenues for future generations.
- Finance major national projects for socio-economic development.

HOW HAS SOFAZ PERFORMED FROM 2001 TO 2014?

On average, 12.7 billion manats (approximately US $16 billion) from the sale of oil and gas have been deposited annually into the fund over the last six years. Azerbaijan has consumed the majority of oil revenues rather than saving for future generations. To date, 43.5 percent of petroleum revenues were saved in foreign financial assets and 56.5 percent were spent. In the last two years, spending has grown relative to savings: 77.3 and 90.4 percent of the petroleum revenues were spent in 2012 and 2013 respectively. In 2014, 98 percent of petroleum revenues are estimated to be spent.

Spending a large proportion of resource revenues is not a problem in itself. However Azerbaijan exhibits poor quality spending, with an emphasis on large projects with questionable returns, for example, concert halls, conference centers and sports facilities rather than on education, health and growth-enhancing infrastructure.

Fiscal sustainability is not the only challenge Azerbaijan faces. Like many resource-dependent countries, it also suffers from high expenditure volatility. Volatility leads to poor investment decisions, as governments and the private sector find it difficult to plan in advance and large spikes in revenue create an incentive to overspend on projects. In Azerbaijan, expenditure volatility has hampered economic growth and contributed to wasteful spending.

The expected permanent decline in oil production presents another challenge. Modest increases in gas revenues will not cover the loss of oil revenue. This means that, barring new large-scale discoveries, the government will be hard pressed to finance recurrent or capital expenditures unless tax revenue is raised from other sectors.

To summarize, the government of Azerbaijan is highly dependent on oil revenues, of which more are spent than saved despite expectations that revenue will decline in the near future. Furthermore, the government invests poorly. These points are supported by numbers, specifically:

- 56.5 percent of oil revenue was spent between 2001 to January 2013. Yet in 2012, the number was 77.8 percent, and in 2013, 90.45 percent.
- Oil revenues in 2024 are estimated to be about $4 billion less than in 2015.
- Oil revenue is likely to peak in 2015 and then decline, yet public debt is already increasing.
- The Azerbaijan government invests relatively poorly based on international indicators such as the IMF's Index of Public Investment Efficiency. In fact, the government ranks in the 22nd percentile in terms of government effectiveness according to the World Bank's Worldwide Governance Indicators.[2]

The current level of expenditure cannot be supported by actual or projected revenues. Considering the amount of oil remaining, slow growth in the non-oil economy, and weak non-oil revenue generation, the current aggressive budgetary expansion in Azerbaijan cannot be sustained. Azerbaijan must learn from the histories of other countries with declining resource bases; Yemen, for example serves as a warning. Sustainable public finances need to be achieved and the quality of public investments must improve.

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HAS SOFAZ ACHIEVED ITS OBJECTIVES?

The large majority of oil and gas revenues collected from the sales of the Azerbaijani government's share are deposited directly into SOFAZ[3] After oil revenue reaches SOFAZ, the government must divide it between expenditure and saving, for which there is currently no specific rule or guidance. Azerbaijan does not adhere to any fiscal rules and decisions around spending and savings are taken by the presidential administration. Withdrawals from the fund are made through annual transfers to the state budget. The fund also allocates money directly to infrastructure projects via extra-budgetary spending authorized by the president, though this is much smaller compared to transfers to the budget. The result is *ad hoc* spending decisions and little long-term planning.

2 http://info.worldbank.org/governance/wgi/pdf/c15.pdf
3 A smaller proportion of "profit oil" is kept with a state owned company involved in oil production.

Rules not followed

While spending policy is *ad hoc* in practice, the government has outlined a spending strategy on paper. The "Long-term strategy on management of oil and gas revenues,"[4] states that when incomes from oil and gas revenues peak, at least 25 percent of them shall be saved. For the last few years however, the fund has spent more than 75 percent of revenues which means that the rule has not been followed.

Several other rules of the strategy are also not followed. For example:

- The strategy states that real expenditure should be held constant and that "annual limits shall be set for these expenditures." No limits on expenditure are currently in practice.
- The strategy states that medium-term expenditures shall be determined based on the non-oil deficit (the difference between revenues and expenditures of the consolidated budget of the country, excluding the oil sector). Sharp year-to-year fluctuations in expenditures are undesirable and the non-oil deficit may not change. In practice, the non-oil deficit is around 40 percent of fiscal revenues and expenditure volatility has a negative effect.
- A state investment program is meant to be drafted annually. In practice, the program is changed multiple times a year and little detail is available to verify whether expenditures are aligned with the program.

Lack of rules

There are three separate revenue management issues that must be addressed:

The first problem concerns the process of withdrawal from SOFAZ, the only fund where the nation's petroleum wealth is accumulated. New legislation is required to stipulate:

- The percentage of revenues that can be withdrawn in any given year
- The principles that govern long-term saving-spending decisions
- Which expenditure items can and cannot be financed from the Fund (notwithstanding vague statements about mid- and long-term development goals).

Without these guidelines, Azerbaijan exhibits pro-cyclical spending and overspending relative to savings (as stated previously) which contributes to wasteful spending in boom years.

The second problem is the lack of rules to formulate the government budget. Most governments set a fiscal envelope — the maximum they can spend in any given year — prior to deciding on specific expenditure items. This process relies on stable forecasts of tax revenue or on a fiscal rule that sets maximum expenditure per year. Azerbaijan does not set a fiscal envelope. The draft budget is prepared by the Ministry of Finance for approval by parliament. Large investment projects are usually not detailed, a point that parliament has criticized. Best practice would entail disclosure and justification of all individual expenditures items that do not involve national security.

Public investment is a crucial component of the development process. For example, roads, electricity, water, sanitation, education and health services are required to

4 http://www.oilfund.az/uploads/5-eng-long-term.pdf

"crowd-in" private sector investment. In order to improve the effectiveness of public investment the government should seek to:

- Appraise all projects with a cost-benefit analysis that includes social and environmental costs and benefits, not just financial costs and benefits.
- Prioritize projects that will have the largest development impact as measured by a sustainable rise in incomes and standard of living.
- Monitor the construction of all projects to ensure quality delivery on cost and on time.
- Budget for operations and the maintenance of investment projects.

The third issue on revenue management relates to the lack of rules governing SOFAZ's own extra-budgetary expenditures, which are often used for projects with questionable returns. There should be clear rules on what expenditures SOFAZ can finance and full disclosure of these.

Oversight

The Resource Governance Index 2013 ranks SOFAZ 14th out of 21 natural resource funds globally.[5] SOFAZ discloses some information on how it accumulates funds and its investments, but partial transparency does not translate into accountability. One reason for this is that there is no parliamentary oversight of SOFAZ's activities.

5 http://www.resourcegovernance.org/countries/eurasia/azerbaijan/overview

KEY LESSONS

The Azerbaijan government seems reluctant to impose rules constraining spending, and instead prefers to manage oil and gas revenues on an *ad hoc* basis. In neighboring Kazakhstan, a similar approach was used up until 2005, when a series of fiscal rules were established. Today, the Kazakh government limits transfers of petroleum revenues from their sovereign wealth fund to the state budget. According to the latest rules, the average annual transfers should be US $8 billion +/-15 percent, depending on the state of the economy.

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The Ministry of Finance is responsible for adopting fiscal rules. Yet in practice the presidential administration is the principal decision-making body. Given that decisions are made by the president of Azerbaijan and SOFAZ is not accountable to parliament, it remains unlikely that fiscal rules will be adopted and adhered to in the near future.

September 2015