Economic Research Center

Oil and Gas Revenue Management in Azerbaijan

Policy Paper on Revenue Management in Azerbaijan
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CURRENCY EQUIVALENTS

(as of 01 November 2013)

Currency Unit	–	New Azeri Manat (AZN)
$ 1.00	=	0.7845 AZN

ABBREVIATIONS

ACG		Azeri-Chirag- Guneshli
BTC		Baku-Tbilisi-Ceyhan
EITI		Extractive Industries Transparency Initiative
SOCAR	–	State Oil Company of Azerbaijan Republic
SOFAZ	–	State Oil Fund of the Republic of Azerbaijan
SWF		Sovereign Wealth Fund
RROR	−	Real Rate of Return
RWI	−	Revenue Watch Institute
ACG	−	Azari-Chirag-Gunashli
PSA	−	Production Sharing Agreement

NOTE

(i) In this report, "$" refers to US dollars.

Table of Contents

Executive summary

This policy paper is an assessment of the current situation in management of oil revenues in Azerbaijan in order to find solutions for improving it. This policy paper is the result of research conducted by the research team of Economic Research Center with the financial support of Revenue Watch Institute in 2013. In the paper, analysis was carried out on the macroeconomic environment, fiscal rules and legal bases for the management of oil revenues in Azerbaijan, policy of the management of oil revenues was evaluated, assessment was done on participation of policy makers, especially national oil fund, in the decision making process on the management of oil revenues, and their influences. In some instances the comparative analysis of superior and inferior features of oil revenues management was done taking Kazakhstan and Norway as the reference countries.

The main aim of this policy paper is to assess the current situation of management of oil revenues in Azerbaijan, unfold its weaknesses and strengths, identify key problems and prepare alternative policies for solution of these issues.

The first part gives the general assessment by describing Azerbaijan's revenue management system; the second part diagnoses the problems; the third part analyzes the problems created by the inefficiencies in the legislative system; and the fourth part describes four possible futures depending on the choices taken today.

This paper does not just diagnose the problem; it also offers solutions. It suggests specific fiscal rules that could be adopted by the Government of Azerbaijan to reduce volatility and improve the quality of public spending. It provides options for enforcing these fiscal rules. And it makes recommendations on improving the credibility of fiscal policy through enhanced transparency and accountability.

The readers of this policy paper will be informed about the outcomes of retrospective analysis of oil revenues in Azerbaijan as well as various options in management of oil revenues within the scope of current and perspective opportunities.

Key words: oil, revenue management, State Oil Fund of the Republic of Azerbaijan, volatility, non-oil deficit, fiscal rules

Introduction

Few countries in the world are as resource-dependent as Azerbaijan. 92,6 percent of total exports of Azerbaijan is composed of oil and oil products while 73,1 percent of its state budget is made of oil revenues in 2012. At expected rates of production and given proven reserves, government oil revenue collection will be 1,5 times more than the revenue that is accumulated till 2013 in just 11 years if price of oil stays on the same stage as it`s now.

Research by the Revenue Watch Institute (RWI) on how countries have used oil or mineral wealth to generate robust non-resource sector growth has identified several prerequisites for economic diversification: relatively open trade and investment policies; investment in education; political stability; private sector access to financing; government-private sector partnerships to spur investment; prudent and stable macroeconomic situation; and a stable business environment.

While some of these prerequisites may be self-evident, why are prudent and stable macroeconomic policy and a stable business environment required? In short, because exchange rate, financial sector and government spending instability prevents both the government and the private sector from accurately calculating risk and planning in advance, leading to overspending on legacy projects and consumer goods in good times – in other words, poor investment decisions – and painful cuts and under-investment in bad times. Three specific channels linking oil revenue shocks (prices or production dramatically rising or falling) to ups and downs in economic growth or output have been identified by econometric studies. First, revenue shocks cause foreign capital to flow in and out of the country, which in turn causes the exchange rate to appreciate or depreciate or inflation to increase or decrease. Since businesses that import or export parts or final products must absorb the high cost of uncertainty and volatility, private sector development and growth is harmed. Second, shocks cause the financial sector to lend more or less as bank balance sheets expand and contract, harming private sector access to credit, a necessity for private sector growth. Third, shocks cause the government to spend more or less which affects the broader economy. These three channels combine to contribute to growth volatility. In the long-run the result is lower growth and poor investment decisions.

This paper will present evidence that oil prices and production (hence revenues) are highly volatile, which makes Azerbaijan particularly susceptible to shocks. It is therefore absolutely crucial for Azerbaijan to control government budget and macroeconomic volatility if it is to effectively diversify its economy. Furthermore, given the expected drastic decline in oil revenues, macroeconomic policy must become more prudent. This means committing to a credible long-term fiscal policy and prudently managing petroleum revenues.

What do we mean when we refer to ‘prudent macroeconomic policy’? Essentially we are talking about effective, transparent and accountable revenue management. For example, saving and spending decisions should be governed by long-term credible and appropriate fiscal rules. According to IMF and academic studies, fiscal rules can help contain political pressures to spend surplus revenues in good times by keeping them out of reach of the political process. They can also help maintain financial sector credibility when running budget deficits during downturns. Thus, if the country has a sovereign wealth fund, its objectives should be clear, it should have rules for which revenues must be deposited and how much can be withdrawn in any given year, investment risk limits should be clear and domestic investments by the fund should be prohibited in order to prevent bypassing parliamentary oversight. Management structures and responsibilities should also be clear, managers and staff should be held to high ethical and conflict of interest standards and there should be penalties for misconduct. Finally, there should be public disclosure of fund activities, independent audits and formalized oversight to ensure that the government is complying with the rules. Similar standards should apply to state-owned companies and fiscal transfers to subnational entities. The future of Azerbaijan’s economy and its people – whether they thrive or suffer once oil is depleted – is dependent on whether these rules are adopted and enforced.

I. Azerbaijan's Revenue Management System

The history of oil production of Azerbaijan dates back to ancient centuries. However, it is worth to mention that the production of oil with mechanical methods launched at the end of 19th century. So, Azerbaijan took the first place in the production and processing of oil in 1899 and accounted for 50% of the global oil production. At the beginning of last century the oil sector of Azerbaijan experienced the first boom of oil revenues. The oil production has had increased in Azerbaijan during Soviet regime. In addition, Azerbaijan accounted for 75% of oil produced in the Soviet Union during the Second World War.

After declaration of its independence Azerbaijan was able to implement oil production jointly with foreign companies. In 1994, September 12 Azerbaijan took first step in this direction and thus signed Production Sharing Agreement (PSA) with renowned world companies for joint exploitation of Azari-Chirag-Gunashli (ACG) - the biggest oil well in the country. According to PSA agreement, the first production of oil had occurred in 2006.

In November 1997, Azerbaijan began producing oil under the agreement on the "Joint Development and Production Sharing for the Azeri and Chirag fields and the deep water portion of the Gunashli field in the Azerbaijan sector of the Caspian sea"[1]. On the following figures oil and gas production from 2000 till 2012 are given:

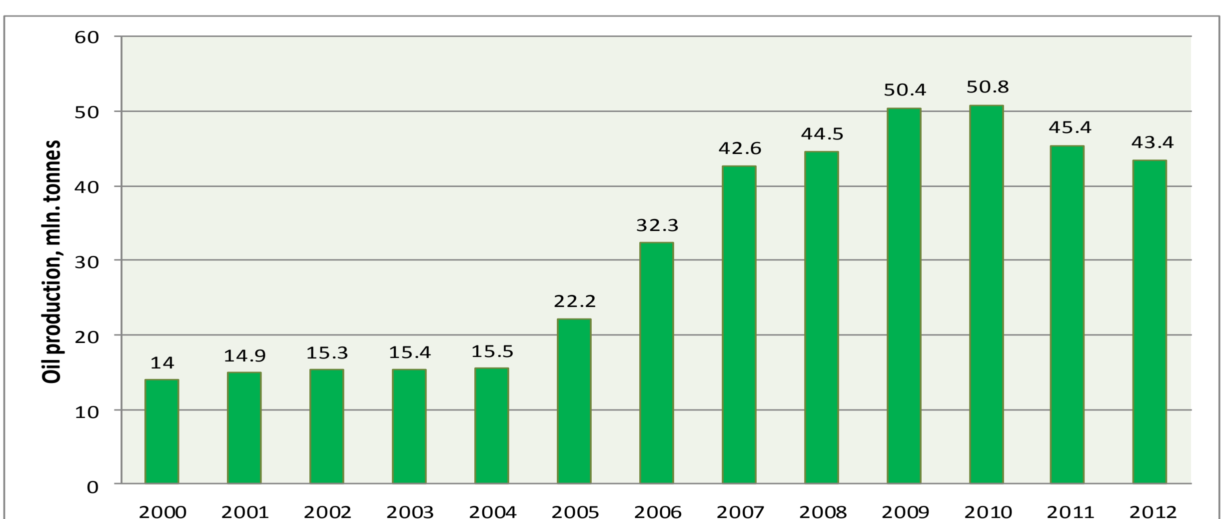
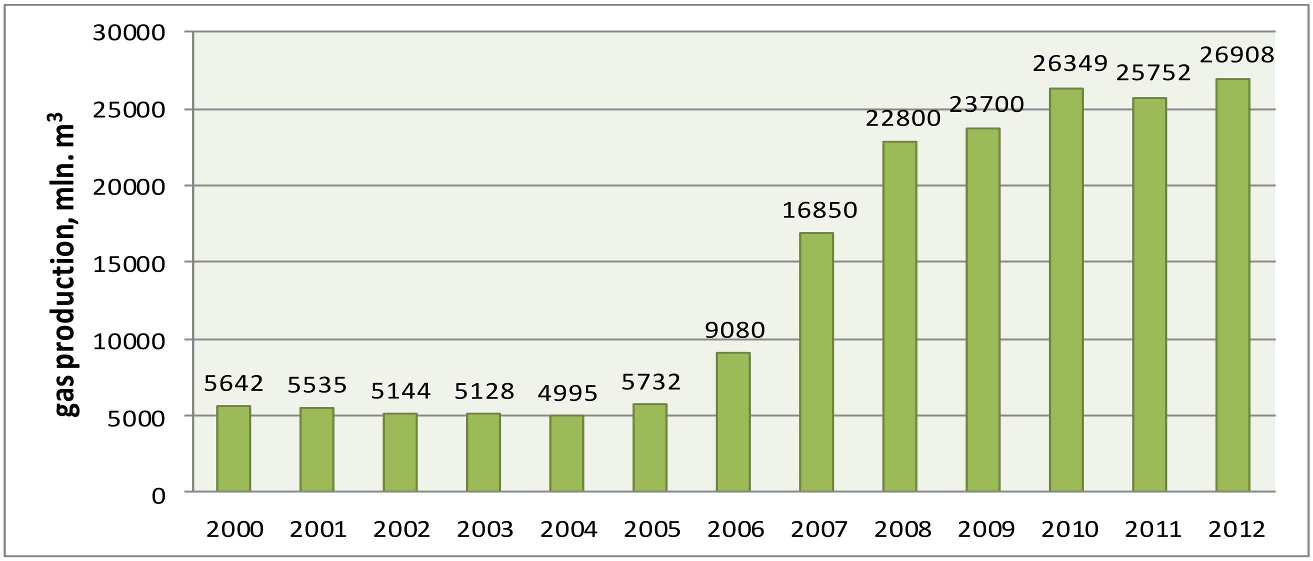


Figure1. Oil production 2000-2012, Azerbaijan

As it is shown on the figure1 oil production increased rapidly by 2005 and peak level of oil production was reached in 2010. In this year, 50,8 million tons of oil were produced. After that year we observe declining tendency in oil production, and according to the results of 2012, the oil production has decreased and estimated 43,4 million ton



According figure 2 after 2004 we observe positive trend at the level of gas production, and the biggest growth happened in 2007, the level of growth was 86,7 %. However, the highest amount of gas production was observed in 2012, that was 26,9 billion cubic meter.

According PSA contract profit oil revenues are divided between Azerbaijan and companies, State Oil Company of Azerbaijan Republic (SOCAR) also take parts as company in this contract. Calculations on covering expenses (exploitation and capital) and sharing profit oil are carried out on a quarterly basis. After the volume of profit oil is determined, the financial indicator that was of importance to the contractor at the end of the previous quarter – Real Rate of Return (RROR) – is calculated. If the preliminary oil scheme becomes a reality and the overall transportation expenses are not higher than 3 US dollars per barrel, in this case profit oil is divided on the basis of the table below, depending on the RROR[1]:

Table 1. Division of the profit oil based on RROR

[1] The relevant method of calculation is shown in the contract

	Azerbaijan's share in profit oil	Contractor's share in profit oil
RROR<16,75%	30	70
16,75%<=RROR<22,75%	55	45
22,75%<=RROR	80	20

Division of the profit oil was calculated accordingly to the first row (30/70) of table1 till the first quarter of 2008. By the first half part of 2008 the second row (55/45) of the table1 was used for division of profit oil. As in 2008 oil revenues covered its` expenses, and reached to "zero level" the last row of table1 was taken for calculations of division, and also, now this correlation is used. However according to our analysis correlation has to be 75/25 rather than 80/20 as we calculated that transportation expenses are higher than 3 US dollars, it is, approximately, 6 US dollars.

This was soon followed by profit oil collection and sale of this oil, generating billions of manat for the government. But even before the oil money entered the country, International Monetary Fund (IMF) and World Bank (WB) were among the first involved in discussions on the efficient and transparent use of these oil revenues with the Government of Azerbaijan. They suggested creating a separate non-budgetary fund which would make it easier to monitor the collection and management of the revenues. Initially, the revenues from oil sales were collected in the accounts of the National Bank (now Central Bank) and that made the public supervision of the revenues almost impossible.

In 1999, December 29, the Presidential Decree #240 formalized the establishment of the State Oil Fund of the Republic of Azerbaijan (SOFAZ). The main objective of the Fund is to ensure the accumulation and effective management of foreign currency and other assets generated from the implementation of oil and gas exploration and development agreements as well as from the Fund's own activities, in the best interest of citizens and future generations of the Republic of Azerbaijan.

The State Oil Fund in Azerbaijan was established as the legal entity with separate management structure and not as special account in the central bank. This is one of the distinctions of the State Oil Fund. Connection between Oil Fund's revenues and expenditures, and state budget is built only within bounds of summary revenues and expenditures of public administration sector and pursues a goal of following a single macroeconomic policy. The assets of the Fund could not be used for lending to state authorities, state and non-state organizations and as guarantee for the liabilities of any subject.

According to the Statute, a Supervisory Board consisting of the representatives of relevant government and public organizations is responsible for the general supervision of Fund activities. The Executive Director, appointed by the President, carries out operational management of activities. Currently, SOFAZ is headed by the Executive Director, who is appointed and dismissed by the President of the Republic of Azerbaijan. The Fund's Executive Director represents the Fund, carries out operational management of the Fund's activities, appoints and dismisses employees of the Fund in a manner as determined by the legislation, ensures the management and investment of the Fund’s assets in accordance with the Guidelines approved by the President of the Republic of Azerbaijan. SOFAZ’s Executive Director prepares an annual program on the utilization of SOFAZ’s assets and presents it to the President of the Republic of Azerbaijan for approval. Thus, the final decision regarding revenue spending and its location was given by the president. The observation activity of SOFAZ is of formal character. The executive director of SOFAZ plays as a representative role.

Fund is an extra-budgetary institution, a legal entity which has a settlement account and other accounts at banking institutions (all over the world), so the resources are deposited directly into the Fund’s own accounts without any reservation.

The source of revenues of Oil Fund is generated by the followings:

- *Net revenues generated from the sale of the share of the Republic of Azerbaijan in hydrocarbons;*
- *The bonuses paid by investors;*
- *Acreage payments;*
- *Dividends;*
- *Revenues generated from oil and gas transported over the territory of the Republic of Azerbaijan;*
- *Revenue management;*
- *Grants and other inflows.*

Data about volume of revenue and assets of State Oil Fund by 2001 to 2012 that was generated through above mentioned sources can be found on the following table:

Table 2. Revenue and assets of State Oil Fund

Years	**Revenue of State Oil Fund (mln. AZN)**	**Assets remaining at the end of year (mln. USD)**
2001	248.0	492.0
2002	295.0	692.0
2003	364.0	816.0
2004	317.0	964.0
2005	660.0	1394.0
2006	986.0	1454.0
2007	1 886.0	2475.0

2008	11 865.0	11219.0
2009	8 177.0	14900.0
2010	13 089.0	22767.0
2011	15 628.0	29800.0
2012	13673.7	34129.4
Total	67188,7	

SOFAZ has an independent budget. The expenditure items of the Oil Fund’s budget will comprise the following:

- *Expenditures to finance the projects in compliance with the main directions (program) of the Oil Fund's assets utilization; The expenditure items of the Oil Fund's budget within the Fund's asset utilization program shall envisage only financing of the most important nation-wide projects, construction and reconstruction of strategically significant infrastructure facilities for the purpose of the socioeconomic progress of the Republic of Azerbaijan.*
- *The Oil Fund's operational expenditures, including administrative (staffing), involving external consultants and other expenditures.*

Amount of withdrawals those were incurred to expenditure items of budget of State Oil Fund from 2001 to 2012 is given on the following table:

Table 3. SOFAZ withdrawals January 01, 2001 – 2012

Expenditure items	Amount, mln. AZN
Financing the participation of the Republic of Azerbaijan in Heydar Aliyev Baku-Tbilisi-Ceyhan (BTC) Main Export Pipeline Project	297,9
Settlement of the problems of refugees and internally displaced persons	1 157.8
Construction of the Oguz-Qabala-Baku water supply system	779,6
Reconstruction of the Samur-Absheron irrigation system	895.5
Transfers to the state budget	35 085.0
Formation of the statutory capital of the State Investment Company	90,0
Financing "Baku-Tbilisi-Kars railway"	341.5
Financing "The state program on the education of Azerbaijan youth abroad in the years 2007-2015"	54.8
Repayment of State Oil Company's share in the project on joint exploration and development of Azeri, Chirag and Guneshli oilfields	87,6
Total	38702,1 AZN/ 49254,4 USD

Production sharing agreement signed with the foreign companies for operation of “Azeri-Chirag-Guneshly” (ACG) oil field, which provides good funding for Azerbaijan, has been in implementation for 19 years. As of July 01, 2012, the Government of Azerbaijan earned 60618,4 million manats from this agreement. 56,4% of this amount has already been spent. 30457,5 million manats or 92% out of the spent 33109,3 million manats have come through January 01, 2008 to July 01, 2012 so that this means the spending of average 6768,3 million manats over the last 4,5 years. According to the predictions by the State Oil Fund, the expenses of the Oil Fund’s budget for 2013-2016 years will comprise of 424379,3 million US dollars or 33367,5 million manats per the rates of July 25, 2012. So, to the predictions, the average spending of the state oil fund for the next 4 years will comprise of 8341,8 million manats. As seen, the predicted spending of the oil fund are expected to be 1573,5 million manats or 23,2% higher than its actual spending during the last 4,5 years. If both spending for the last 4,5 years and the predicted spending for the next 4 years are assumed as a basis, it will be clear that the average annual spending of oil revenues during 8,5 years comprises 7555 million manats. If the Government of Azerbaijan will not make a change in its policy regarding its spending, then the expected oil revenues in the amount of 145,3 billion US dollars could have been spent in 15 years based on the calculated predictions in the rate of one barrel oil in 80 US dollars. Keeping on this policy serving the balancing of the state budget in the next 15 years will make a serious problem with the implementation of recommendations made by IMF on reduction of the share of non-oil budget deficit in non-oil GDP. So, IMF recommended by 2017-2018 years the special weight of non-oil budget deficit in non-oil GDP should decrease up to 20%. The current policy excludes the major changes to happen to this direction. On the other hand, such fast spending of oil revenues will lead to the break of inter-generational equity principle. Thus, the scenario ‘status quo’ will make serious challenges for efficient use of oil revenues.

Besides, the implementation of spending through the budget of oil fund, which is not subject to the recommendation by the Chamber of Accounts, and financial auditing, as well as parliamentary debates will ruin the opportunities of supreme auditing and parliamentary control and keep the decisions on spending again under monopoly of the executive power. Furthermore, no representation of civil society organizations at Supervisory Board of the Fund, in case the article 5.4 of the Regulations of the Oil Fund is not observed, will restrict the opportunities of civic participation and social control over its management. The Supervisory Board will keep on acting formally.

So, fast spending of oil revenues in preserved status quo condition will make impossible its fair distribution among future generations, and meantime leaving aside the Chamber of Accounts, Parliament and civil society organizations out of the process will lead in one hand to keeping decisions on spending under monopoly of executive power, and on the other hand to the increased transparency and no providing social control.

Despite of the Fund annually publishes its financial and audit reports. Apart from that, quarterly numbers are disclosed in the press. All of those reports can be taken from the official website easily. Once a year, external auditing is conducted the report of which is again available on the website. But they are not enough for increasing transparency and accountabilities.

II. Problem description

a. Volatility

One of the biggest concerns in resource-dependent countries is revenue volatility, which mostly originates from short-to-medium term price volatility of the commodity. As mentioned in the introduction, since oil and mineral revenues are volatile, reliance can incentivize 'pro-cyclical fiscal policy'. This is a tendency to spend a lot when revenues are high and cut spending drastically when revenues drop. In countless examples, resource-rich governments have treated temporary rises in revenue as permanent, spending lavishly on ill-conceived legacy projects like fountains and fancy government buildings when they have received 'windfall' revenues rather than saved or taken the time to plan public investments that will promote sustainable economic development and serve the population for years. When oil prices have dropped, cuts have left roads half-finished or buildings unmaintained. Since spending volatility and poor investment decisions affect the private sector as well, the long-term effects are low non-oil sector growth and poor investments even in the private sector.

Governments can adopt fiscal rules to deal with this volatility by reducing everyday discretion and leading to more consistent and stable spending. A consequence of establishing a fiscal rule is the creation of a Sovereign Wealth Fund (SWF) like SOFAZ which could accumulate and release the resources whenever necessary.

Has the Government of Azerbaijan used SOFAZ to achieve the first objective, preserving macroeconomic stability? To answer this question, we will ask specifically:

- Does the Government of Azerbaijan experience expenditure volatility over the very short-term?
- Has the Government of Azerbaijan delinked expenditure volatility from revenue volatility over the medium-to-long term?
- How does Azerbaijan's expenditure volatility compare to other oil-dependent countries?

In order to understand these issues, it may be worth examining the path that oil revenues take when they enter government coffers. While the SOCAR retains a share in the profit oil and gas, the majority of profit oil (75% or 80% depending on the transportation cost) and gas collected from the sales of the Azerbaijani government's share are deposited directly into the SOFAZ. After oil revenue reaches the SOFAZ, the government must divide it between expenditure and saving, for which there is currently no specific rule or guidance. It has been shown in "Long-term strategy on the management of oil and gas revenues" when the proceeds from oil and gas revenues reach to the ceiling more than 25 % of its portion is being directed to saving. Nevertheless, the peak level of proceeds from oil and gas revenues is still controversial topic and subject to discussion. Despite the fact that Azerbaijan obtained the highest revenues in 2010-2013, however, the expenses were 78 percent in 2012. Similarly, this indicator is predicted to reach 116 percent in 2013.

Withdrawals from the Fund are made through annual transfers to the state budget, for which we have monthly observations, therefore government budget is the key to analyzing the volatility issue and whether that is affecting (rather distorting) the economy. Of course, one should be cautious with this, as the Fund has another way of injecting money into the economy via ***extra-budgetary spending*** directly authorized by the President, but this is much smaller compared to transfers to the budget, therefore we leave it aside and concentrate on the budget instead.
As Figure 3 shows, the quarterly budget revenues and expenditures are very volatile and pro-cyclical which is mostly due to differences intra-annum. Considering that the sample size (starting from the 2005 structural change in the economy) is not large for Azerbaijan, we had to use a parametric method and derive the annual volatility (here meant to be standard deviation, as in financial theory) from quarterly volatilities, which are 1,33 and 1,46 billion manat and taking into account inter-temporal covariance's those translate into volatilities of 4,63 and 4,64 billion per annum. From here, annual volatilities for revenue and expenditure parts are the same, but comparing to the size of the budget itself, that is 25-35% of the budget. So, spending volatility is high in terms of budget size.

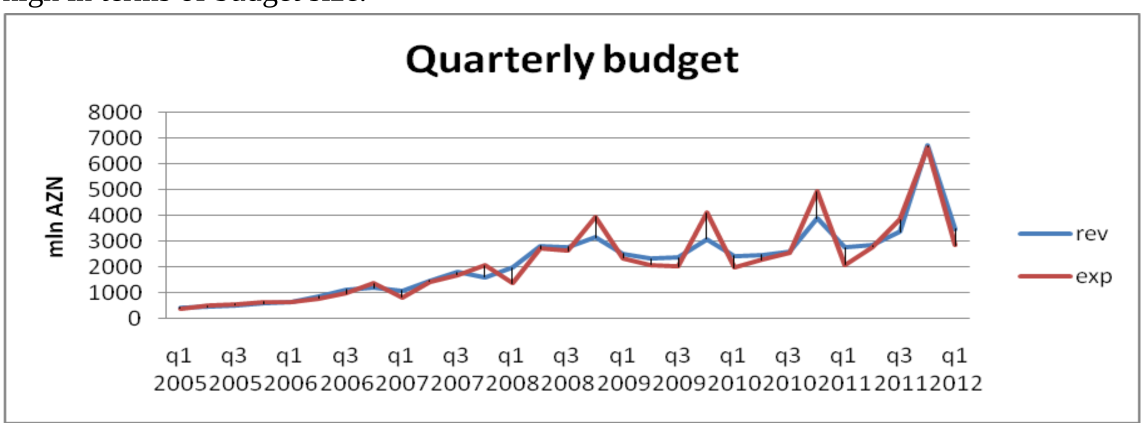


Figure 3 . Quarterly budget volatility

Perhaps more concerning from a public policy point-of-view is the year-to-year variation in public expenditures. After all, it is year-to-year changes that incentivize poor investment decisions. As we can see in Figure 4, Azerbaijan's government revenue growth has mirrored oil price growth. When oil prices have risen, government revenue has risen. When oil prices have declined, government revenue has declined. This is unsurprising given the Azerbaijan government's reliance on oil revenues. What is surprising is that volatile revenues are strongly correlated with expenditures. There is basically no delinking of revenue from expenditure streams. This seems to indicate that SOFAZ is not complying with its mandate to "preserve macroeconomic stability".

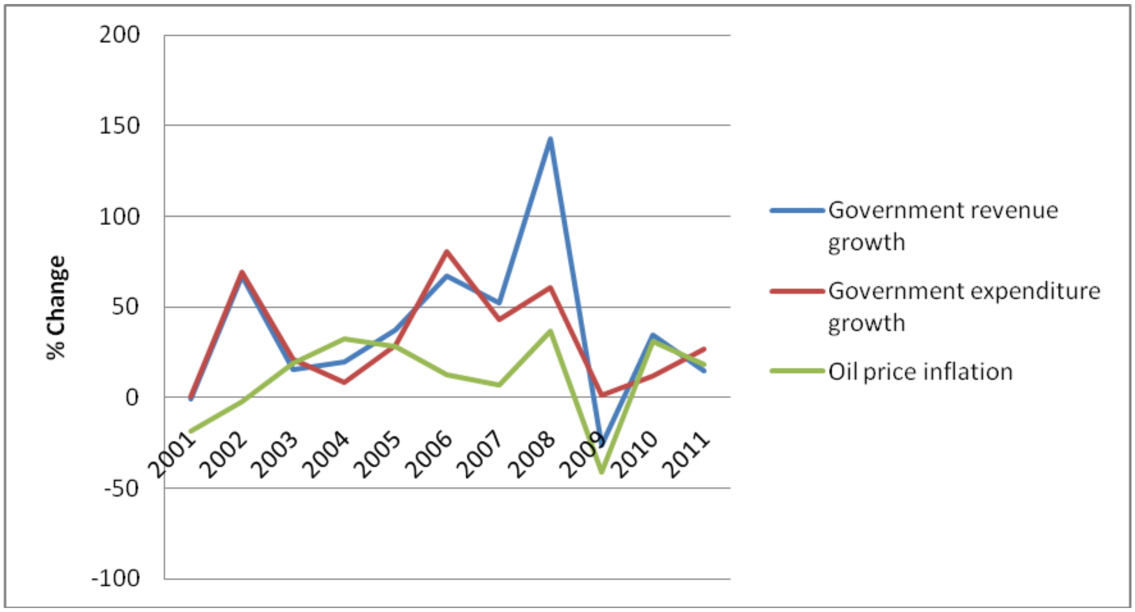


Figure 4: Percentage changes in government revenues, expenditures and oil prices

How does Azerbaijan's budget volatility performance compare to other oil-dependent countries, either those considered to follow best practices (in our case, Norway would be the best example) or those most comparable (Kazakhstan would be the best candidate because of our similar history and reliance on oil)?

For starters, budget expenditure growth can be graphically compared in those three countries which show that Azerbaijan has considerably higher budget volatility than Norway and slightly more volatile budget growth than Kazakhstan (see Figure 3). Over the last decade, the standard deviation of expenditure growth in Azerbaijan is 26 compared to 16 in Kazakhstan and 2 in Norway. In some years (e.g. 2009), Azerbaijan had almost no budget growth while in others it grew by 60 or 77 percent. Norway, on the other hand, has stabilized expenditure growth between 3-9% despite high revenue volatility on par with Azerbaijan.

How has Norway managed to delink expenditures from revenue volatility? The short answer is that it has implemented a fiscal rule that says that the structural non-oil budget deficit should equal the annual real return on Norway's sovereign wealth fund investments, estimated at 4 percent per year. This rule essentially limits the expenditure growth rate to the growth in non-oil revenues plus the interest on oil revenue deposited and invested in the sovereign wealth fund. While this rule may be inappropriate for Azerbaijan given its public investment needs, it has successfully mitigated expenditure volatility.

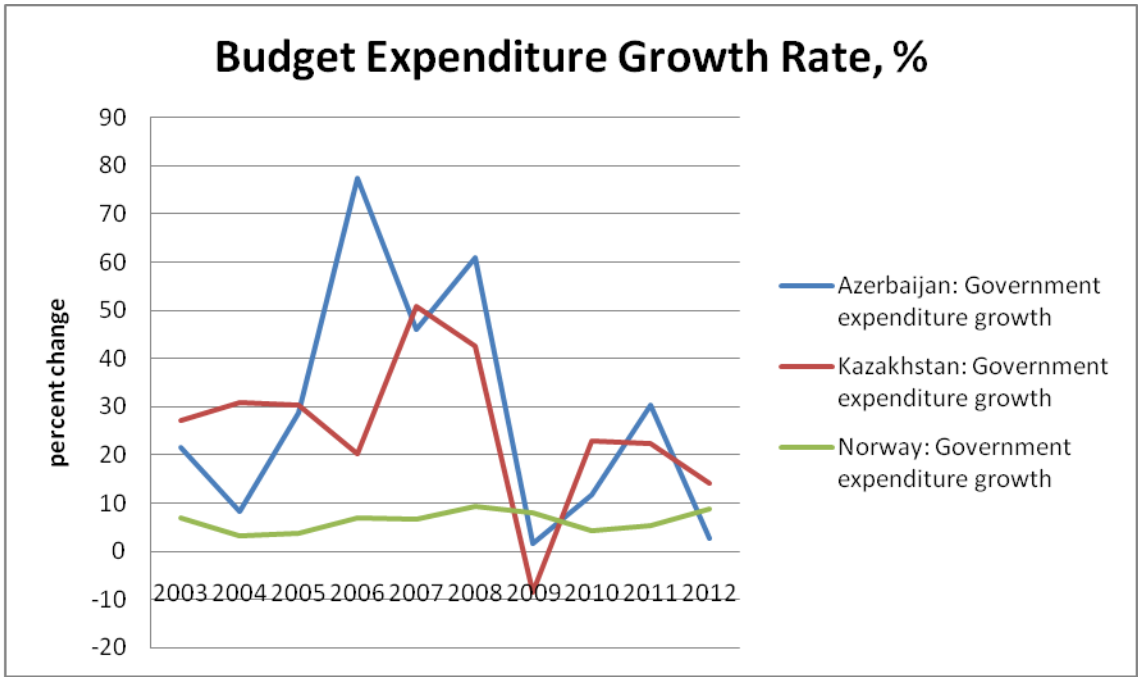


Figure 5. Comparative budget expenditure growth rate (national currencies; data from the IMF)

While SOFAZ does not seem to be preserving budget stability, is it preserving other types of macroeconomic stability? The Central Bank of Azerbaijan has fixed the exchange rate, which ensures exchange rate stability, but is SOFAZ helping to mitigate inflation volatility? Figure 6 seems to indicate that it is in fact not helping to preserve this volatility either. Inflation is more volatile than either Kazakhstan or Norway.

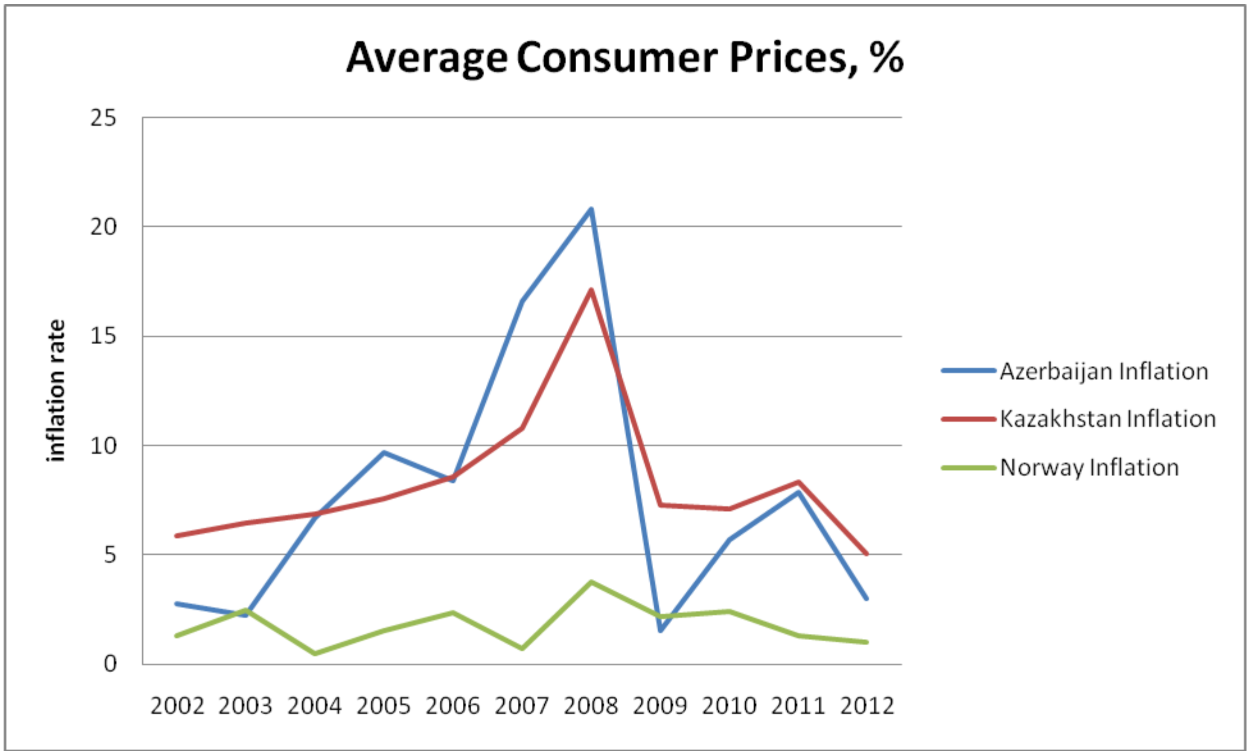


Figure 6. Average consumer prices in Azerbaijan, Kazakhstan and Norway

What is the consequence of all this volatility on the Azerbaijan economy and public spending? While more research would need to be done to prove the link between in volatility and low-growth and poor spending decisions in Azerbaijan specifically, based on the evidence previously cited from large econometric cross-country studies and well-known anecdotal evidence showing that spikes in oil revenues lead to spending on large projects with little developmental value, it may be safe to claim that this volatility has severely hampered economic growth and contributed to wasteful spending.

b. Sustainability (over spending)

As previously mentioned, SOFAZ's second and third objectives are: 2) Financing major national projects to support socio-economic progress; and 3) Ensuring intergenerational equality with regard to the country's oil wealth and accumulate and preserve oil revenues for future generations. With regard to objective 2, Table 4 shows that, notwithstanding that these funds have been appropriated without parliamentary oversight and that spending is generally non-transparent, the objective has been more or less met. However objective 3 – ensuring fair allocation of oil wealth across generations – has been neglected so far. Priority has been given to spending resources instead of accumulating or investing them for long-term growth.

Let us examine the figures. $34 129.4 mln. have been accumulated since the establishment of the fund as of January 01 of 2013. Table 4 gives more detailed information about revenues and assets of the Fund since 2001. From 2001 to January 01, 2013, Azerbaijan collected over $83,86 billion USD revenue (including management revenues) from oil and gas sales obtained from PSA. Calculations show that 59.3% of petroleum revenue was spent during this period. According to Table 4, in some years as much as 99.5% of petroleum revenues were spent. In fact, in spite of peak production in 2012, the government's rate of spending could lead to a violation of the principle of saving a minimum of 25% of revenues envisaged under the "Long-term management strategy of oil and gas revenues".

Table 4 . The level of spending of oil revenues by years

Years	**Revenue of State Oil Fund (mln. AZN)**	**The level of spending oil revenues**
2001	248.0	0,3 %
2002	295.0	32,1%
2003	364.0	99,8%
2004	317.0	90,8%
2005	660.0	99,5%
2006	986.0	99,5%
2007	1 886.0	56,2%
2008	11 865.0	36,2%
2009	8 177.0	64,8%
2010	13 089.0	48,9 %
2011	15 628.0	61,4%
2012	13 721.8	78,4%

Spending a large percentage of oil revenues is not necessarily a bad thing. After all, oil is a finite resource and, like any asset, it is worth depleting if (and only if) turning it into cash and investing it leads to higher income in the long-run. The question in Azerbaijan is whether revenue is spent on projects and in sectors that will lead to higher long-run national income. If not, it may be worth saving a larger proportion of revenues. After all, if citizens will not benefit from long-lasting roads, electricity, clean water, access to credit, education and health services, not to mention a growing non-oil economy that floats all boats, then future generations should at least benefit from the financial returns of investing oil revenues.

Unfortunately, according to the WB's Governance Indicators, Azerbaijan invests relatively poorly. In fact, the Government of Azerbaijan ranks in the 22nd percentile in terms of government effectiveness. In comparison, Kazakhstan ranks in the 45th percentile and Algeria ranks in the 34th percentile despite higher per capita income. Poor public investment would justify higher savings and less public spending.

Similarly, the IMF's "State Investments Management Index" that measures public financial management practices across four stages (project appraisal, selection, implementation and evaluation) ranked Azerbaijan 43rd out of 71 mainly low and middle-income countries. Among the neighboring states, Armenia was ranked 8th, Kazakhstan 9th and Turkey24th. Azerbaijan weak position in comparison with neighboring states indicates serious problems in implementation of the state investment projects. Azerbaijan's poor showing was mainly due to poor implementation of projects and inadequate assessment of their execution.

While high oil revenue spending is not necessarily a problem, dependency is. It is very difficult to cut spending once it has risen so far so fast. Also, when oil production starts declining or global oil prices decline, either the government will be forced to run a budget deficit or draw more funds out of SOFAZ. These options are unsustainable; they could lead to a debt crisis, which would lead to high costs and lower standard of living for future generations, or a return to pre-oil levels of development and poverty. Even now with near record oil prices and with Azerbaijan near peak production, government debt levels keep rising though they are still manageable (see Figure 7). Public debt seems to rise with oil revenues. That said, it is hard to say whether the increase in the debt is due to oil revenues or some independent trend since we only have a 10 year sample. Further visual analysis is provided in the graph below (outlier is mostly due to BTC opening).

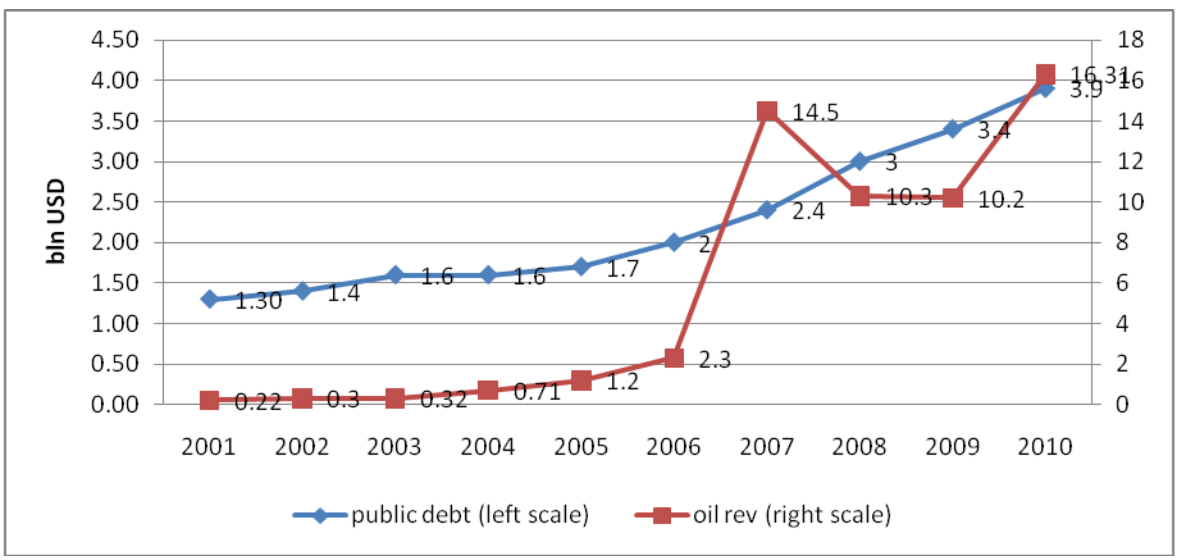


Figure 7. Comparing oil revenues and public debt in Azerbaijan

Beyond borrowing and drawing money from SOFAZ, a third option would be to raise tax revenue from the non-oil sector, but to date this has proven difficult since non-oil non-government growth remains weak and non-oil tax revenue remains steady around 8,6 % of GDP, much lower than the 30-45% in most developed countries. Table 5 shows that not only has the government spent more than it has received, but the share of the state budget financed by petroleum revenues has increased every year since 2007 from 9.7% to 60.5%. The Government of Azerbaijan is now highly dependent on oil revenues.

Table 5 . Transfers from SOFAZ to the state budget (million AZN)

Years	Transfers from SOFAZ to the state budget (million AZN)	Growth rate	Share of the State Budget	Share in the expenses of SOFAZ Budget
2003	100	--	8.2%	41%
2004	130	30.0%	8.6%	77%
2005	150	15.4%	7.2%	70%
2006	585	290.0%	15.6%	59.6%
2007	585	0.0%	9.7%	55.1%
2008	1100	88.0%	35.3%	88.5%
2009	4915	346.8%	40.4%	92.8%
2010	5915	20.3%	51.4%	90.5%
2011	9203	55,6%	59,7%	92.6%
2012	9905	7,6 %	60, 5 %	93,7%
2013 (planned)	11.350	14,6 %	59,3%	

Dependency is a particularly severe problem when oil revenues begin declining permanently. According to SOFAZ, the Fund's income from Azeri-Chirag-Guneshli and Shahdeniz deposits will decrease from USD 13.1 billion in 2012 to USD 9.2 billion in 2024 (see Figure 3). Peak income from the two fields is expected in 2015 (USD 16.1 billion). Using an average price of 80 USD per barrel for Azeri Light Crude, the Azerbaijan government will collect approximately $13 billion USD per year on average over the next 12 years from sales of profit oil from the Azeri-Chirag-Guneshli field and gas sales from the Shahdeniz deposit. Oil revenues in 2024 will be about 8 billion USD less than in 2015. Increased gas revenues will not cover the loss of oil revenues. 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.

SOFAZ calculated forecasted revenues based on 3 scenarios. These calculations were carried out in 2 directions: oil revenues acquired from ACG and gas revenues from Shahdeniz. The calculations regarding to estimated oil revenues are presented in Table 6.

Table 6. Government revenue from the profit oil of ACG, years of 2014-2024. In billion USD (oil price 80, 90 and 100 USD per barrel).

Years	$80	$90	$100
2014	12,1	14,0	15,9
2015	12,0	13,9	15,8
2016	10,3	12,0	13,7
2017	13,0	15,0	17,0
2018	12,9	14,8	16,7
2019	13,1	15,0	17,0
2020	12,4	14,3	16,1
2021	10,9	12,6	14,2
2022	9,5	11,0	12,5
2023	8,2	9,6	10,9
2024	7,6	8,8	9,9
Total	**122**	**141**	**159,7**
Average	**11,09**	**12,81**	**14,5**

This table demonstrates that the minimum amount of oil revenues projected by SOFAZ for 2014-2024 on the basis of 3 scenarios is 122 billion dollar, whereas the average amount constitutes 141 billion and the maximum amount is 160 billion dollar. In other words, the average annual amount of forecasted revenues for that period estimated as more than 11 billion dollar and less than 14,5 billion dollar. Naturally, the level of revenues for this period will be dependent on the world market prices along with production as well. It is worth to mention that the forecast of SOCAR, which is the only source in this direction, is optimistic by each 3 scenarios. Although information inquiries were submitted to alternative sources - BP and SOCAR, it is disappointing to highlight that they did not desire to publicize their projections with us.

The calculations of SOFAZ based on the same scenario over the gas revenues gained from Shahdaniz are depicted in Table 7.

Table 7. Government revenue from the profit gas of Shahdeniz deposits, years of 2014-2024. In billion USD (oil price 80, 90 and 100 USD per barrel).

Years	$80	$90	$100
2014	0.545	0,749	0,831
2015	0,538	0,605	0,672
2016	0,546	0,613	0,680
2017	0,582	0,655	0,728
2018	0,638	0,718	0,798
2019	0,924	1,1	1,2
2020	1,2	1,3	1,4
2021	1,5	1,7	2,2
2022	2,0	2,2	2,4
2023	1,9	2,1	2,3

2024	2,0	2,2	2,4
Total	**12, 3**	**13, 94**	**15,6**
Average	**1,12**	**1,26**	**1,41**

The table clearly describes that the projected minimum total gas revenues estimated 12,3 billion dollar for 2012-2024, in average it will reach to 13,94 billion dollar and the maximum amount is 15,6 billion USD. This allows us to forecast that the average gas revenues will be fluctuating between 1,12 and 1,41 billion dollar.

The perspective analysis conducted in this direction leads to 3 significant outcomes:

Firstly, revenues obtained from oil in the future can exceed the incomes received until now. Obviously, this process mainly depends on price factor.

Secondly, if the forecasted price level holds, then in this case projected gas revenues will constitute maximum 10 percent of expected oil revenues. In a nutshell, this refutes the assumptions made over gas revenues will replace the declining oil revenues in the future.

Finally, if the volume of expenditures transferred from SOFAZ to the state budget will continue to be as in 2013 (in average 14 billion dollar), then expected oil revenues will be depleted in 10-12 years. It is certain that during this period the increase of expenditures can be prolonged and its decrease might be shortened.

Let is mainly focus on the latter outcome by taking into account its significance. Currently, it is possible to find endless arguments in regard to the increasing pace of expenditures. Thus, Azerbaijan is planning to spend more funds for establishment of sport infrastructure and meet the demands of Olympia due to hosting 2015 First European Olympic games. Additionally, the establishment of large-scale “White City” infrastructure requires state expenditures. It should be also noted that the non-oil revenues is eligible to finance only 52 percent of current expenditures from state budget in 2013 and the transfers from SOFAZ to state budget will be continuing until the increase of non-oil revenues at least2 times. In this case, the relevance of the management of the Fund's assets increases. Furthermore, SOFAZ was not able to acquire fundamental revenues from this source until now and thus, the total amount of revenues gained from management of assets since the management of oil revenues until now has not exceeded 2,3 billion dollar. This means annually 2,85 percent or 328 million dollar revenues within 7 years. SOFAZ has realized cautious investment policy till 2012 and directed its assets mainly towards low-risky and low-income projects. However, it has gone to significant changes in investment policy since last year. The new investment policy allowed SOFAZ to forward its 5 percent of assets to property market, 5 percent to gold market as well as the same percentage to the market of developing countries. Consequently, SOFAZ purchased 20,5 ton gold in 2012 and simultaneously invested to property markets of the United Kingdom, France, Russia, Luxemburg and Jersey islands. Apart from this, the Fund allocated 444,19 thousand manat as to the banks of developing countries (Turkey, Ziraat Banka, Akbank and “Ish” Bank, Gasprombank and VTB of Russia) together with BNP Paribas and Jefferies Bache banks. The deposits are hold as dollar, euro, fund sterling, Australian dollar, ruble, lira and manat at the Fund’s bank accounts. In general, the assets 50 percent of the Fund are deposited as USD dollar, 40 percent Euro, 5 percent fund sterling and the remaining 5 percent as Australian dollar, Russian ruble, Turkish lira and Azerbaijan manat.

According to the information of 2012, SOFAZ has deposited its 24,12 billion dollar financial assets mainly in the securities of foreign countries (45,6 percent), companies (28,45 percent) and international financial institutions (23,07 percent).

In generally, it is also important to note that the asset management practices of the Fund clearly do not exhibit a good track record. Rather, SOFAZ has made a small return on investment (Table 8), so asset management clearly is not an option when it comes to generating alternative revenues given yields in today’s global economy.

Table 8. Comparative investment Policy of Oil Fund

Year	Fund’s assets, Billion. USD		Percentage investment return, %	
	Azerbaijan	Kazakhstan	Azerbaijan	Kazakhstan
2012	34,2	55,6*	2,2	2,8*
2011	29,8	43,7	0,8	1,4
2010	22,7	31,0	1,0	3,0
2009	14, 9	24,4	3,5	7,3
2008	11,22	27,4	3,8	-2,3
2007	2, 47	21,0	4,5	9,9
2006	1,39	14,1	4,2	8,7
2005	1, 45	8,1	-	3,3
Average percentage investment return, %			2,85	4,26

Due to this reason, Azerbaijan gains less revenues coming from management of assets in comparison with Kazakhstan. In other words, the Oil Fund obtained 4,5 % in 2007, 3,8 % in 2008, 3,6 % in 2009, 0,8% and 0,7 % in 2010 and 2011 profits respectively emanating from management of oil revenues. However, the same indicator estimated 9,9 % in 2007, 2,3 % in 2008, 7,3 % in 2009, 3 % in 2010 and finally 2,4 % in 2011 in Kazakhstan. Given this, the average percentage rate obtained from management of oil revenues based on above mentioned years was 4,6 percent - 2 times more than Azerbaijan.

In summary, the government is highly dependent on oil revenues, more oil revenue is spent than saved despite declining revenues in the near future, and the government invests poorly. Specifically:

- 59.3% of oil revenue was spent from 2001 to January 01, 2013. However in some years, the government has spent 99.5% of oil revenues.
- The share of the state budget financed by petroleum revenues has increased every year since 2007 from 9.7% to 60.5% in 2012.
- Oil revenues in 2024 will be about 8 billion USD less than in 2015.
- Even as oil revenues are increasing, are likely at their peak, and are expected to start declining in 2016, public debt is increasing.
- According to the World Bank Governance Indicators and the IMF's Index of Public Investment Efficiency, the Azerbaijan government is an extremely poor public investor.
- The return on SOFAZ investments is between 0.75-4.5 percent, therefore the interest does not compensate for significant public spending out of SOFAZ.
- Non-oil growth in Azerbaijan is high at 10%, but driven by government expenditure rather than private sector investment and, with declining oil revenues in the near future, is therefore unsustainable.

It is obvious from the evidence that there is overspending (relative to saving) and the current level of expenditure growth cannot be supported by actual or projected revenues. Considering the amount of petroleum remaining, slow growth in the non-oil non-government sector, and weak non-oil revenue generation, the aggressive budgetary expansion in Azerbaijan cannot be justified. Azerbaijan must learn from the histories of other countries with declining resource bases, like Nauru and Yemen, that have faced tough public spending choices, debt crises and conflict. Public finances must be put onto a sustainable path and public investment must improve.

c. Lack of transparency & accountability

Transparency of management processes and the flow of resource funds – defined as clarity of roles and responsibilities, public availability of information, and open budget preparation and execution – can provide a number of tangible benefits to resource-rich countries. First, transparency aligns public expectations with government objectives, builds public trust and reduces internal conflict by creating a consensus around the role of extractives and their revenues. Second, public disclosure requirements can improve the quality of data the government gathers and maintains, thereby making the jobs of ministries and regulatory agencies easier. This can improve the efficiency and effectiveness of government policies. Third, according to the IMF, it can help to highlight potential risks, resulting in an earlier and smoother fiscal policy response to changing economic conditions and thereby reducing the incidence and severity of crises.

Finally, transparency can improve public accountability, which is the obligation of public officials to explain and justify their conduct and make decisions based on a concept of public service. A well-informed public with the capacity to act can engage in a constructive discussion around policy formulation and government oversight of revenue management processes. Through public scrutiny, officials can be deterred from acting unethically and held accountable for abuses of power for private gain.

Accountability is critical to ensuring the *sustainability* of revenue management systems in particular because it encourages adherence to rules and principles of efficient economic policymaking and effective management of public resources on timelines beyond officials' own tenure in power. That said, accountability can be both internal and external. For example, staff of a sovereign wealth fund can be accountable to their managers such that the managers can verify their conduct and take action against staff for poor conduct. Alternatively, staff can be accountable to an external agent, like a public accountability committee or the judiciary.

Lack of transparency and accountability of the whole revenue management system of Azerbaijan is a major issue of concern. The most important issue is about the management of state budget public investments that draw on SOFAZ resources. Transparency is an issue both in the accumulation of oil revenues (1), and spending of oil revenues (2).

Revenue Collection by SOFAZ and SOCAR: Azerbaijan's oil revenues are accumulated by SOFAZ (1.1.) and SOCAR (1.2.). SOFAZ regularly shares the information on the receipt of oil revenues to the Fund both as part of the Extractive Industries Transparency Initiative (EITI) and with the public of its own initiative. SOFAZ also publishes this information annually as part of EITI country reports. SOFAZ also organizes quarterly press conferences to disseminate information on oil incomes and expenditures of the Fund to a wider audience and publishes its own quarterly and annual reports and auditor's opinion. SOFAZ has its own web-page, and official accounts on social media web-pages like twitter and facebook. Letters of inqury sent to SOFAZ are answered adequately and on time.

In recognition of SOFAZ's public disclosures, Azerbaijan was ranked 10th out of 44 sovereign wealth funds on the Truman Sovereign Wealth Fund Scoreboard that measures SWF governance, transparency, accountability and behavior. SOFAZ is also the winner of 2007 UN Public Service Award in the category of "Improving transparency, accountability and responsiveness in the Public Service".

As regards SOCAR, general information on its income and expenditures are published in its annual financial reports. SOCAR considers this disclosure as adequately satisfying transparency requirements. SOCAR usually does not respond to inquiries for any information by civil society organizations. Those requesting information are usually directed to its web-page, where little information is available. SOCAR does not regularly hold press conferences to share information on its financials.

Petroleum Revenue Spending: With regard to transparency on oil revenue spending, expenditures are made by three separate entities: Some socio-strategic projects are financed directly by the SOFAZ budget (2.1.) (see: Table 1), SOCAR spends directly on corporate and social projects (2.2.), and there are state budget expenditures, the main source of which is SOFAZ (2.3).

2.1. The vast majority of annual withdrawals from SOFAZ is the transfer to the state budget, which is approved by the President every year. However SOFAZ also financed strategic project directly, like construction of the Oguz-Qabala-Baku water supply system. There is no access to any detailed information on these other expenditure items. All information on cost estimates or tenders for these projects is secret.

2.2. There is only general information available on social expenditures by SOCAR in Azerbaijan and abroad. Since there is no systematic access to detailed information, it is impossible to state whether spending is efficient or effective.

2.3. With regard to the state budget, it is not possible to identify which expenditures are financed by oil revenues. That said, we can make several general statements on budget transparency. There is broad access to information on social, education, and health expenditures, average access to information on governance expenditures, and limited access to information on defense, law enforcement agencies, judicial power, prosecuting bodies and the investment budget. The International Budget Partnership's Open Budget Index gave Azerbaijan a score of 43 (some budget information publicly available), above Kazakhstan and Venezuela but below Georgia and Russia.

The Parliament and Chamber of Accounts have failed to improve budget transparency. The National Budget Group notes that the expertise of reviews of the Chamber of Accounts and observation of procedural requirements during budget discussions revealed that the supreme control body over the state budget is still conducting only a superficial analysis of the budget figures. There is still no real control over the budget execution. Finally, in 2011, parliament held its shortest debate yet on the state budget. Only two days of discussion on the budget in parliament indicates an increased need for regulation of budget process in the Azerbaijan Republic.

III. Diagnoses of the problems

a. Rules not followed

Several rules governing the management of SOFAZ have not been followed. These include:

- "**Rules of designing and implementing the annual incomes and expenses program (budget) of State Oil Fund of the Azerbaijan Republic" approved with the Decree N: 579 of the President of the Azerbaijan Republic dated on September 12, 2001:** Article 4.4 reads: "The Budget of the Oil Fund is subject to approval no later than December 01 every year". Unfortunately, this demand of the legislation has not been observed since the establishment of SOFAZ. As seen in Table 5, the presidential decree on the approval of budget of the Oil Fund was delayed even for 4 months to the third month of the following year.
- **"Internal Statute of the Chamber of Accounts of the Azerbaijan Republic" N: 269-IIQ dated on March 05, 2002:** The Chamber of Accounts should provide an opinion on the Oil Fund budget. Article 12 of section 4 of the statute (state financial-budgetary supervision by the Chamber of Accounts) states that "Giving an opinion on the draft budgets of the state budget and the budget of the off-budget state funds (institutions)" as one of the main supervisory responsibilities of the Chamber of Accounts.
- **"Regulations on State Oil Fund of the Azerbaijan Republic" approved with the Decree N: 434 dated on December 29, 2000**:Article 1.3 states that "the Fund is the off-budget institution". Therefore, the Chamber of Accounts should provide an opinion on the budget of the Oil Fund. The "Open Budget Index 2010" report aslo notes this discrepancy, highlighting that opinions and audit reports of the Chamber of Accounts should cover all off-budget funds and the Chamber of Accounts should prepare and disclose opinions on the budget of the State Oil Fund which is not done. As well, the structure of the management board of the Fund also does not match the description in the above-mentioned documents. Article 5.4 of "Management of the Fund" section reads as follows: "Advisory Board is formed of the representatives of the relevant government bodies and civil society organizations, also other persons in order to provide general guidance over the Fund's operations". Unfortunately, the current composition of the Advisory Board has no representative from civil society organizations. Sometimes, the government authorities present the president of the National Academy of Sciences of the Azerbaijan Republic, who is a member of the Advisory Board, and Deputy Speaker of the Parliament, as the representatives from civil society. However, since the National Academy of Sciences and the Parliament are fully financed by the state budget and a dependent body on the government, they do not fit to the commonplace description of civil society organizations.

Table 9. Approval dates for the Fund's budget

Year	The Decree of the President of the Republic of Azerbaijan on the Approval of the Budget of the State Oil Fund of the Republic of Azerbaijan	The Decree of the President of the Republic of Azerbaijan on the Amendments to the Budget of the State Oil Fund of the Republic of Azerbaijan	The Decree of the President of the Republic of Azerbaijan on the execution of the State Fund of the Republic of Azerbaijan
2001	-		
2002	-	1.11.2002 (25/11/2011	
2003	(27/01/2003)		
2004	(31/03/2004)	(01/10/2004)	
2005	(01/03/2005)	(28/12/2005)	
2006	(28/12/2005)	(07/06/2006)	
2007	(28/12/2006)	(28/06/2007)	
2008	(26/12/2007)	(11/07/2008)	(30/06/2009)
2009	(26/02/2009)	(07/10/2009)	(22/07/2010)
2010	(25/12/2009)	22/07/2010, 30/09/2010	(14/07/2011)
2011	(28/12/2010)	14/07/2011	(02.07.2012)
2012	(29.12.2011)	09.02.2012, 02.07.2012	

[While important, these are considerably minor issues compared to what is happening with withdrawals from the fund. According to strategy, when incomes from oil and gas revenues peak, ***at least 25 percent of them shall be saved***. But for the last few years we have seen the fund spending more than 75% of the revenues which means that this important rule is not followed. There are a few more rules which are not followed:

- when forecasting the amount of long-term expenditures from oil and gas revenues, the „constant real expenditures" principle shall be used as a basis and annual limits shall be set for these expenditures that are to be made within the period covered by the strategy – *we do not see any limits on any expenditures*
- the regulations adopted for spending oil and gas revenues shall remain unchanged during the effective period of the long-term strategy on management of oil and gas revenues and the expenditure limits projected on the basis of the constant real expenditures principle shall be observed – *which is not the case here*
- the volume of 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) and taking account of the long-term expenditure limit. Sharp year to year fluctuations in expenditures are undesirable and the non-oil deficit may not be abruptly changed – *the non-oil deficit is around 40% which is not advised or meant*

- investment expenditures shall be made in the framework of the medium term State Investment Program that is drafted annually – program is being changed multiple times in a year and not much detail is available on the program to see whether the expenditures are in line with it.]

b. Lack of Rules

Legislated or constitutional fiscal rules can help protect governments from political pressures to spend or borrow unsustainably. By committing to a permanent revenue, expenditure, balanced budget or debt rule, governments can essentially bind their own hands. Fiscal rules can have the added benefit of improving fiscal policy consistency and credibility, reducing macroeconomic instability and making Azerbaijan a more attractive place to invest. This is one reason why Central Banks all over the world prefer rule-based monetary policy as opposed to discretionary policymaking. Similarly, Germany, Switzerland and Poland have amended their constitutions to prohibit over-spending. In fact, most advanced economy governments have enacted some fiscal rule.

Although discretionary decision-making can be more flexible than rules, in general some constraints may in fact make policymaking easier by constraining the number of decisions needed to be taken and forcing a long-term vision onto public finances. As well, having a fiscal rule can protect policymakers from criticism. Those in power are easy targets of public judgment, especially where revenue management is controlled by a small group of people. This means, even if policymakers' intentions are good, citizens always remember bad events, causing embarrassment or worse for any government. A better option may be some sort of long-term rule, which would relieve the people in power from direct responsibility.

The recent financial crisis proved that there are times when revenues can decline suddenly due to price and other shocks (e.g. technological developments; terrorist attack). If the negative shocks persist for some time, the government is forced to reduce expenditures. Thus the government will be subject to a "fork" situation, like in chess: if it continues along the previous expenditure path, it will have to save less and this would contribute to debt or budget crises in the near future, but if it cuts expenditures, the results are political or social unrest. Therefore it is better to have some predefined rule, say, limiting spend to a percentage of oil wealth (the so-called 'permanent income hypothesis' rule), which the government could easily follow and that would only be subject to changes in case of environmental or social crisis.

These rules are especially important in oil-rich countries. Over the longer-run, oil and gas will run out. Azerbaijan must plan for that inevitability if it wants to maintain its standard of living. Otherwise, severe cuts and economic contraction will result.

Why do we need fiscal rules in Azerbaijan specifically?

Azerbaijan public finance decisions are very discretionary. As described in the previous sections, budget transfers from the Fund every year are large and growing and Fund resources are spent directly for specific projects without thorough public justification. Problems with the revenue management system of Azerbaijan arise once revenues from petroleum sales are deposited into the State Oil Fund of Azerbaijan (SOFAZ). From here, the funds are allocated between saving and spending and among different expenditure items through an opaque process managed by a small group of people. According to the statute of the Fund, Article 4.1, *“The Fund's assets are utilized in accordance with the main directions (program) approved by the President of the Republic of Azerbaijan”.* That is the only rule involving revenue allocation and there is no specific rule which would stipulate how funds are to be withdrawn. The President of Azerbaijan is therefore the sole person responsible for saving-spending decisions without internal or external checks and balances.

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

The first and foremost problem, as mentioned above, concerns the process of withdrawal from the oil revenues from SOFAZ, the only fund where the nation’s petroleum wealth is accumulated. There is no rule or document that stipulates:

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

As a result we have procyclical spending and overspending, as stated in the previous sections, in addition to expenditures serving popular political purposes.

The second problem for Azerbaijan would be the lack of rules in the formation of 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. In most countries, this process relies on stable forecasts of tax revenue. However resource rich countries must rely on more advanced practices that estimate stable taxes separately from volatile resource revenues.

Azerbaijan seems to have completed lack of rules in this regard which results in huge and volatile transfers from the SOFAZ to the budget. The draft budget is prepared by the Ministry of Finances for approval by the parliament. Large investment projects are usually not detailed, which is a point that Parliament has criticized. To improve efficiency of the budget process, the Government of Azerbaijan may wish to consider:

- Proportional limits on resource revenue items;
- Limits on the non-oil budget deficit;
- Complete budget disclosure and justification of individual expenditures of all items not involving national security

Public investment is a crucial component of the development process. After all, roads, electricity, water, sanitation, education and health services are required to "crowd-in" private sector investment. However, the World Bank has noted that while budget implementation is working well, prioritization and medium-term investment budget are lacking. Given the high cost of public investment projects, the government must:

- 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 maintenance of investment projects.

The third issue relates to the lack of rules governing SOCAR's social expenditure. SOCAR is a huge actor in Azerbaijani revenue management system. In fact it is fast becoming the biggest actor in the Azerbaijani economy in general. Therefore, there must be some rules guiding the social expenditures of SOCAR so that spending supports national development aims rather than a political agenda or that scare resource be wasted. There should be clear rules on what expenditures SOCAR can finance, full disclosure of these expenditures and parliamentary oversight of SOCAR's activities.

According to the foreign experience, the following fifth rules are used in revenue management and budget balancing:

1) **Budget balance rule-** Recurrent expenditures must equal revenues "over the cycle"; primary non-oil balance. This rule is applied in following countries: *Ecuador, India, Mexico, Nigeria, Pakistan, Peru, Switzerland.*
2) **Expenditure rule-** Limit on total or recurrent expenditure in absolute terms, in terms of expenditure growth, or as a percent of GDP. This rule is applied in following countries: *Argentina, Botswana, Brazil, Costa Rica, Israel, Japan.*
3) **Debt rule-** Limit on public debt as a percent of GDP. This rule is applied in following countries: *Argentina, Australia, Ecuador, New Zealand, Peru, Sri Lanka*

4) **Revenue rule**- Floor or ceiling on revenues entering the budget. This rule is applied in following countries: *Ghana, Mexico, Nigeria, Timor-Leste*

5) **Withdraw rule** – Limit on withdrawals of accumulated capital of fund . This rule is applied in research reach countries and appreciated highly. The following formulas are considered measuring the level of limits:

- Permanent Income Hypothesis[2];
- Absolute variable transfers *(Due to Norwegian experience, the revenues gained from management should be spent up to 4 %)*
- Transfers based on fixed level with variable diapasons *(Due to Kazakhstan experience, the average annual transfers should be 8 billion USD +/-15 %)*
- Constant transfers updated periodically *(this indicator is calculated as following: current year, 5 past and 5 upcoming years[3]).*
- Transfers related to non-oil GDP growth rate *(The relationship between non-oil |GPD growth and the level of oil revenues).*[4]

[2]According to the calculations of World Bank, the permanent expenditures should be in average 5,9 billion dollars as 2008-2012 with constant prices of 2007.

[3] According to the calculations of experts of the Economic Research Center made on the basis of this methodology, the amount of transfers should be 9684 milion manat for 2014.

[4]The increasing pace of non-oil sector in 2011 was 9,4 and in 2012 it reached to 9,6 percent.

IV. Policy Recommendations

Based on the findings of research the following policy suggestions were developed:

4.1. **<u>For resolution of over spending and pro-cyclical fiscal policy problems</u>**:

- SOFAZ's objectives should be rationalized and clarified. SOFAZ should have two objectives: Saving for future generations and stabilizing short-to-medium term fluctuations in oil revenues entering the budget.
- A fiscal rule should be enacted that limits petroleum revenue spending to 4% of petroleum wealth (the net present value of all proven reserves plus the value of SOFAZ). This is known as the Permanent Income Hypothesis (PIH) rule.
- A fiscal rule could be adopted that a maximum of 30% of a 11-year average of hydrocarbon revenues can be deposited into the State Budget in any given year. The remaining amount would be directed to SOFAZ for stabilization and savings purposes. Revenue projections to determine the 11-year average would be determined by an independent agency. Exceptions may be made to the rule if parliament declares an emergency (e.g. environmental catastrophe; violent conflict).
- The non-oil budget deficit should be reduced over the near term until it reaches 4%.
- The government should only borrow to finance public projects with a net positive real financial return; all other projects should be financed out of government oil and non-oil revenue

4.2. **<u>For resolution of poor spending problem:</u>**

- SOFAZ should be prohibited from directly financing public projects; all appropriations should be directed through the normal budget process and approved by parliament;
- All public investment projects should be subject to public and competitive tendering; auditing of financial-budgetary examination should be conducted by the Chamber of Accounts, and social auditing by civil society organizations;
- [Investment projects financed by the Oil Fund should be implemented within interim Public Investment Program, which is designed per each year, and reports should be given to the public on their implementation;]
- The government should 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, and budget for operations and maintenance of investment projects. All these documents and budgets should be made public on government websites.

- The Chamber of Accounts should prepare recommendations on financial operations of the Oil Fund, and those recommendations should be discussed at the Parliament
- Clear rules should be enacted that rebalance SOCAR's reinvestment-transfer to the state budget-cost ratio; SOCAR should transfer more revenues to the state budget, retain less revenue and be subject to more parliamentary oversight
- SOCAR should publish all activities and financial information; SOCAR should be subject to same level of disclosure as a publicly held traded stock company

4.3. <u>For resolution of 'no compliance with the rules' problem:</u>

- Principles under "Long-term strategy on management of oil and gas revenues" should be followed;
- Presidential decrees on approval of Fund's budget should be conformed to the Regulations;
- Representatives of civil society organizations should be represented at Supervisory Board of the Oil Fund;
- Recommendation should be provided by the Chamber of Accounts to the draft budget of Oil Fund**.**

V. References

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5 Rules on management of foreign currency assets of the state oil fund of the Republic of Azerbaijan, http://www.oilfund.az/uploads/Investment%20Guidelines_nov3.pdf

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