

Azerbaijan: Managing Oil Revenues

- Managing oil wealth has proven to be a difficult challenge for many countries across the world. Examples include Ecuador, Mexico, Nigeria, and Venezuela. In Nigeria, for example, oil revenues have led to huge investments in capital and infrastructure in the 1970s and 1980s but productivity declined and per capita GDP remained at about the same level as 1965 ! In other words, accumulated oil wealth over a 35 year period of some \$350 billion did not raise the standard of living but worsened the distribution of income in Nigeria !! Studies show that not only Dutch disease but more importantly waste of capital resources through bad investments and corruption have resulted in this predicament.
- For countries like Azerbaijan where some 85 percent of exports are oil related and where the authorities are still faced with the challenge of transforming the economy to a free market system, this challenge is even more complicated.
- Nonetheless, we believe Azerbaijan has already taken a number of measures to prepare for the prudent management of oil reserves; however, much more remains to be done.
- The establishment of the Oil Fund in 1999 as an extra budgetary institution was the first step. It is designed to manage oil and gas related revenues both as a saving mechanism for future generations and for the development of infrastructure in preparing the non-oil sector for private sector development. Its inflow and outflow rules reflect the primary objectives as stated above – no stabilization objective is envisioned and net flows are not related to developments in the world energy market or to the budget deficit. To reduce political pressures to rapidly spend windfall oil revenues, the Oil Fund was established under direct presidential control. However, there is a supervisory board; an annual audit is conducted; and, the OF publicly reports on a quarterly basis inflows received, expenditures made and interest earned.
- It should be noted that the creation of the OF in Azerbaijan has had a positive impact on fiscal discipline and has contributed to transparency and accountability of oil revenue management. Prior to this, oil-related revenues were used to close gaps in the state budget, undermining expenditure and tax discipline, while funds and their utilization were often not transparent. Oil bonus financing of the state budget was almost 4 percent of GDP in 1998 and off-budget uses oil revenue were also made in the same year.
- In addition, a number of fiscal measures have recently been implemented focusing on the improved handling of public funds: A new Budget System Law has been adopted designed in close cooperation with the World Bank and the IMF. This law requires parliamentary approval of the budget at a much more detailed level, the preparation

and reporting to parliament of an MTEF and greater details in reporting to the public on budget execution on a consolidated basis. In addition, the recent amendments to the BSL already passed by parliament will give parliament the authority to approve the consolidated budget and expenditure ceilings --- including OF spending. The further strengthening of financial discipline in the energy sector, for example, the unification of domestic energy prices to world market prices and making the energy subsidies provided by Socar explicit in the budget will contribute to the efficient use of the country's energy resources.

- While much of the issues relating to macroeconomic management have now been addressed through amendments to the BSL, the IMF still believes an Oil Fund Law would provide a solid legal framework for better management of oil resources.
- Azerbaijan's revenues associated with the development of current oil and gas fields are expected to increase significantly through 2010 but are expected to decline thereafter through 2024. Of course in the absence of any new hydrocarbon discovery. This analysis expects about US \$800 million to accrue annually during 2003-2007 and over \$2 billion every year during the outlying years. Significant revenues but short-lived.
- In view of this, Azerbaijan would be well advised to implement a broad policy agenda for managing this finite resource wealth if it is to avoid the pitfalls experienced by other countries. The IMF recommendations fall into three broad policy areas: Institutional arrangements and capacity; determining the level of expenditures from oil revenues; and, the optimal composition of expenditures.
- For developing institutional arrangements and capacity building, it would be prudent to consolidate oil revenue management and treat oil revenue as one source of financing; develop and maintain a model for long term projections of oil and gas revenues; and develop the capacity to select appropriate projects using competent cost-benefit appraisal exercises.
- To determine the appropriate level of expenditures from the OF, use of the concept of a sustainable non-oil deficit to provide an expenditure ceiling for the use of oil assets is recommended; avoiding large fluctuations in this deficit and increasing expenditures gradually, taking into account macroeconomic stability considerations is also recommended.
- As for the composition of expenditures, these should be guided by the principle that revenues should be utilized for investment rather than consumption. The aim should

be to invest in physical and human capital with the objective of creating an enabling environment for growth in the non-oil sector. Investments should also be prioritized and take into account the need for recurrent maintenance and operation costs.

- Finally, some reductions in tax rates could be viewed as an alternative to increased expenditures. This will encourage business activities while at the same time improving competitiveness, which could be adversely affected, if the negative effects of real appreciation set in (Dutch disease).

In concluding, we believe Azerbaijan has taken the necessary first steps towards sustainable development. However, much more remains to be done and given the finite nature of oil resources, particularly in Azerbaijan, time is of the essence; prudent planning, capacity building, and the continued implementation of strong governance measures are critical.