Open Access Repository
www.ssoar.info

Lower Oil Revenues, Higher Public Debt: The Fiscal Policy Implications of Low Oil Prices in Azerbaijan

Aslanli, Kenan

Veröffentlichungsversion / Published Version
Zeitschriftenartikel / journal article

Empfohlene Zitierung / Suggested Citation:
Aslanli, K. (2016). Lower Oil Revenues, Higher Public Debt: The Fiscal Policy Implications of Low Oil Prices in Azerbaijan. *Caucasus Analytical Digest*, 83, 11-16. https://nbn-resolving.org/urn:nbn:de:0168-ssoar-89504-0

Nutzungsbedingungen:
Dieser Text wird unter einer CC BY-NC-ND Lizenz (Namensnennung-Nicht-kommerziell-Keine Bearbeitung) zur Verfügung gestellt. Nähere Auskünfte zu den CC-Lizenzen finden Sie hier:
https://creativecommons.org/licenses/by-nc-nd/4.0/deed.de

Terms of use:
This document is made available under a CC BY-NC-ND Licence (Attribution-Non Comercial-NoDerivatives). For more Information see:
https://creativecommons.org/licenses/by-nc-nd/4.0

Leibniz-Institut für Sozialwissenschaften

Mitglied der Leibniz-Gemeinschaft

Table 3: The Structure of Loans to the Economy by Type of Credit Institution (mln. AZN)

	2010	2011	2012	2013	2014	2015	2016/01
Total loans	9,163	9,850	12,244	15,423	18,543	21,718	21,186
State-owned banks	3,902	3,300	4,137	5,300	6,144	7,289	7,707
Private banks	5,070	6,299	7,786	9,689	11,874	13,863	12,884
- with foreign capital	2,306	3,002	3,394	4,613	5,580	6,394	55,944
as % of total loans	25	30	28	30	30	29	26
- with 100% foreign capital	464	586	759	1,035	1,389	1,565	1,546
as % of total loans	5	6	6	7	8	7	7
Non-credit bank institutions	192	251	321	433	525	566	596

Source: The Central Bank of the Republic of Azerbaijan

Lower Oil Revenues, Higher Public Debt: The Fiscal Policy Implications of Low Oil Prices in Azerbaijan

By Kenan Aslanli, Baku

Abstract
This article examines fiscal policy and the main parameters of Azerbaijan's fiscal position in the context of the severe constraints (namely, reduced budget revenues and cuts in government spending) posed by the decline in crude oil prices. Azerbaijan's fiscal balances have deteriorated considerably as crude oil prices have tumbled. A worsening of Azerbaijan's fiscal balance could gradually contribute to an increase in the public debt burden and threaten fiscal sustainability in the long term. The sovereign wealth fund of Azerbaijan, SOFAZ, now has very limited profits from the sale of oil, and will contribute less to the fiscal revenues of the state as a consequence. The national state-owned oil-gas company, SOCAR, temporarily cancelled its plans for a new oil-gas refining and petrochemical complex because of the rapid fall in crude oil prices. However, at the same time, the new low oil price environment also offers an opportunity to boost a new wave of fiscal and public administration reforms in Azerbaijan.

Summary of the Fiscal Implications of Lower Crude Oil Prices

The drop in oil prices and resultant waves of devaluation hit Azerbaijan's economy and fiscal balance especially hard by diminishing oil revenue inflows to the fiscal system and decreasing budget incomes. Oil, gas and mineral revenues accounted for more than 77% of Azerbaijani budget revenue in 2014,[1] and low oil prices affected almost every aspect of the country's fiscal policy. Fiscal policy adjustments made in response to the new reality include changes in governmental budget revenues; changes in the structure of governmental budget spending, including cuts to capital and recurrent expenditures; new sources of financing for the budget deficit; changes in the State Oil Fund's (SOFAZ) assets; and changes in the State Oil Company's (SOCAR) operations. Both revenue and spending aspects of fiscal policy have encountered severe constraints due to low oil prices, namely the shortfall in budget revenues and cuts in government spending. Current fiscal balances have deteriorated amid plunging oil prices.

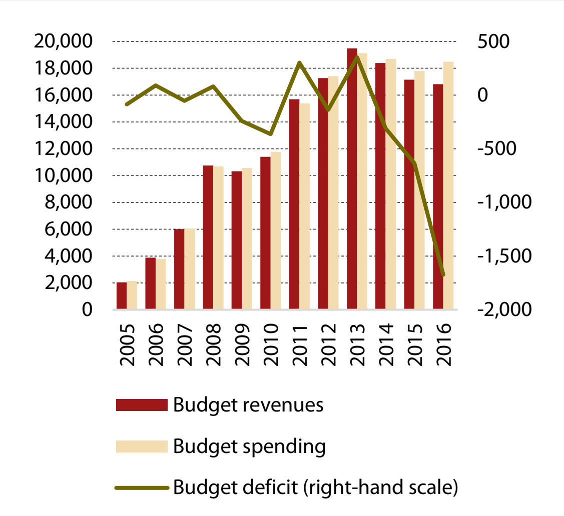
Decreased crude oil and natural gas production coupled with lower crude oil prices led to a contraction of

1 Azerbaijan EITI Report for 2014, <https://eiti.org/files/azerbiajian_eiti_report_2014.pdf>

the country's GDP in 2015 (which declined by 1.1% while it had still grown by 2.8% in 2014). Additionally, the poorly diversified Azerbaijani economy has been particularly vulnerable to the oil-price shock because of its higher fiscal dependence on revenues from hydrocarbon exports. The government has decided to reduce the budget for public investment by 40% from 2015 to 2016 and to halt the financing of new investment projects. Total revenues of the consolidated budget decreased 6% as a result of oil price readjustments (from $50 per barrel to $25 per barrel in the revised budget for 2016) and falling revenues from the national sovereign wealth fund (SOFAZ), which has traditionally played a central role in the country's fiscal policy.

The declining fiscal balance (Figure 1) will gradually contribute to an increase in the public debt burden, thus threatening the country's fiscal sustainability: Azerbaijan's debt-to-GDP ratio is 19.8% (as of January 2016). The government introduced new tax rates for simplified

Figure 1: Budget Revenues, Spending and Deficit (mln. AZN)



Sources: Author's calculations based on data from the Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az> *and Budget.az,* <http://www.budget.az>.

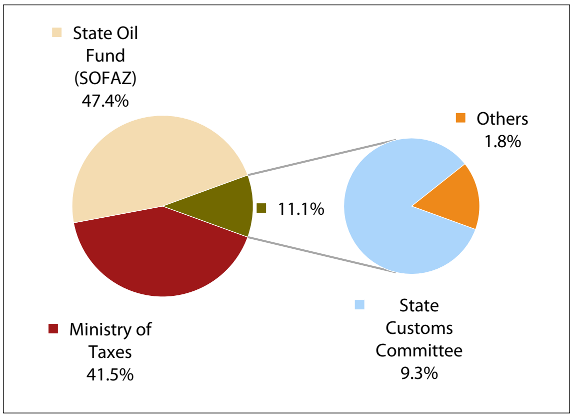
and income taxes as concessions to local entrepreneurs, without any serious changes in the rates of central taxes such as the VAT or the corporate profit tax. In addition to deepening our analysis of the above-mentioned "unexplored" fiscal trends, we need to investigate the fiscal consequences of restrictions on SOCAR's receipts from crude oil sales as well as subsidies to state-owned companies and natural monopolies. Beyond the immediate fiscal consequences, such as budget cuts on both the revenue and expenditure sides, public asset sales, and tax rate changes, the commodity price bust is influencing medium and long-term fiscal plans.

Contraction in State Budget Revenues

Low oil prices in international markets had an immediate adverse impact on national budget implementation: in 2015 budget revenues fell by 12% and state expenditures dropped by 16% compared to figures approved in the previous year's state budget. These figures indicate that actual total budget revenue figures are falling behind initial forecasts. First, SOFAZ was the primary source of budget revenues, contributing 48% to total revenues. These transfers were 21.7% lower than the original approved forecasts. Second, taxes and other mandatory payments collected and transferred to the Ministry of Taxes accounted for 42% of state budget revenues. Income from the non-oil sector constitutes 71% of that amount, which is 17% more than in 2014. Third, the State Customs Committee generated 9% of total revenues, which was 5% more than the previous year in absolute terms.

Finally, Figure 2 demonstrates that three institutions (SOFAZ, the Ministry of Taxes and the State Customs Committee) "carved out" the vast majority of fiscal revenues (98.2%), but the dominance of SOFAZ as a commodity-based extra-budgetary saving and stabilization fund jeopardizes fiscal sustainability in the long

Figure 2: Main Sources of State Budget Revenues in 2015



Source: Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az>*; Budget.az:* <http://www.budget.az>*; author's calculations*

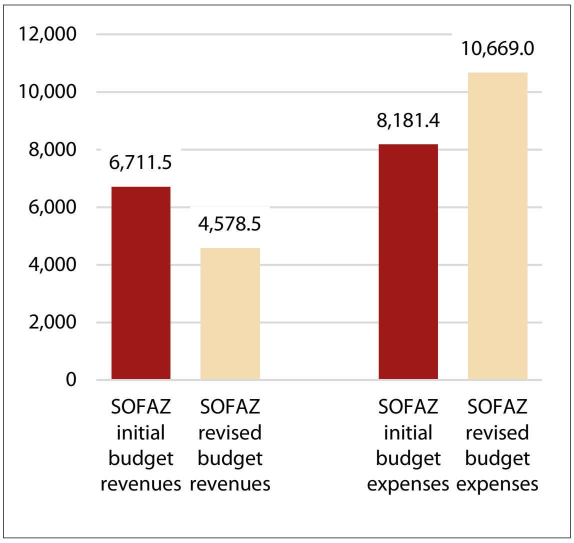
term. According to an independent budget review by a local think-tank, Support for Economic Initiatives, "the amount of transfers to the state budget from the State Oil Fund [has been] significantly reduced. The role of direct payments from the oil sector in the formation of state budget revenues has [been] considerably reduced in both absolute and relative terms".[2]

2 "Review of 2016 state budget (forecast) of Azerbaijan Republic", Support to Economic Initiatives Public Union, 2015, <http://budget.az/en/upload/files/SEI_Budget_Review_2016.pdf>

SOFAZ Will Contribute Less

In addition to making amendments to the state budget, the government has also revised the SOFAZ budget for 2016, decreasing revenues and increasing expenses as compared to the initial version of the SOFAZ budget for 2016 (Figure 3). The amended SOFAZ budget for 2016 envisions 4.6 billion manats in revenue and 10.7 billion manats in expenditures.[3] This is a significant decline in SOFAZ's earnings and a sharp increase in SOFAZ's expenditures compared to the budget implemented for 2015 or the initial version of the budget for 2016.

Figure 3: SOFAZ's Initial and Revised Budget for 2016 (mln. AZN)



Source: Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az>*; Budget.az:* <http://www.budget.az>*; author's calculations*

The lion's share of income for SOFAZ's 2016 budget will come from the sale of profit oil. Table 1 on p. 16 shows that while the main budget expenditure line of SOFAZ for 2016 denoted transfers to the state budget, it will contribute less than that amount to fiscal revenues (<http://www.oilfund.az>). Despite financial difficulties, SOFAZ will continue to finance national and regional infrastructure projects such as the Baku–Tbilisi–Kars railway project, Azerbaijan's share in the Southern Gas Corridor project, the reconstruction of the Samur-Absheron irrigation system and the construction of the "STAR" Oil Refinery in Turkey.

One of the implications of recent low oil prices and currency devaluation for fiscal policy was the appearance of SOFAZ as a seller at the foreign exchange auction of the Central Bank. SOFAZ has stated that it will continue selling currency through CBA auctions. There is no legal rule that regulates SOFAZ's presence at the foreign exchange auctions or its direct transfers to the state budget. It was evident that when oil production begins to decline or global oil prices drop, the government will either be forced to run a budget deficit or to draw more funds from SOFAZ. These options are unsustainable in the long term and could lead to a debt crisis, which would result in high costs and a lower standard of living for future generations; a debt crisis could also return Azerbaijan to levels of development and poverty that preceded the discovery of oil. In addition to borrowing and drawing money from SOFAZ, a third option would be to raise tax revenues from the non-oil sector. However, to this date, this has proven difficult because non-state non-oil growth remains weak and non-oil tax revenues linger steadily at approximately 20% of GDP, much lower than the 30–45% level in most developed countries.[4] But it is very unpopular to raise taxes and as a response people will seek to avoid them, hence the expected growth of the "shadow" economy.

The Public Investment Program Has Attracted Less Public Money

Expenditures of the state budget in 2015 were implemented at the level of 17 billion manats instead of the forecasted 21 billion manats, representing a decrease of 16%. Current expenditures (58% of total expenses) were more than capital expenditures (38%) in 2015. Four percent of all expenditures were allocated to finance related costs for the maintenance of state debts and other commitments during 2015. The public investment program accounted for 28.1% of the expenditures of the state budget (33% in 2014). The state budget of Azerbaijan is socially oriented, and therefore, one-third of its total expenses were allocated to financing social expenses.

The Government Readjusted Its Fiscal Parameters

The government proposed new amendments to the state budget for 2016 and parliament approved these changes. The per-barrel crude oil price was set at $25 in forecasts of revised state budget revenues in 2016. This change increased the income of the state budget by 16% and expenditures of the state budget by 14% in comparison

3 SOFAZ 2016 budget approved, <http://www.oilfund.az/en_US/hesabatlar-ve-statistika/buedce-melumatlari/azerbaycan-respublikasi-doevlet-neft-fondunun-2015-ci-il-buedcesi-tesdiq-edildi-2.asp#sthash.MQcFQTPO.dpuf>

4 Kenan Aslanli, "Fiscal Sustainability and the State Oil Fund in Azerbaijan", *Journal of Eurasian Studies* 6: 2 (2015): 114–121.

with an initially adopted version of the budget (2% less than the implementation of the state budget for 2015).

There is a plan to secure additional revenues for the state budget through more transfers from SOFAZ (27% more in the revised budget than in the initial version) and more tax revenues from the non-oil sector of the economy. However, there is an alternative approach in which the significant increase in the special share of payments from the non-oil sector contributing to state budget revenues is mainly due to decreases in total budget income and in the absolute amount of oil revenues in the budget. Short of state oil fund transfers, state budget revenues will not be able to adequately finance current annual expenses. Substantial cuts to the public investment program for next year have applied also to socially oriented areas such as education and health. In other words, Azerbaijan government has adjusted fiscal policy to the falling oil prices and oil revenues. Public investments have been relatively lowered, but targeted social assistance expenditures have been raised.

The Budget Deficit Raised the Total Debt Burden

After the rapid decline of crude oil prices and after experiencing a relatively high budget deficit, the Ministry of Finance decided to hold regular auctions of state bonds by registered emission prospectus for an amount totaling US$ 500 million until the end of 2016.[5] For the year 2015, government indebtedness stands at just over 12% of GDP. During that period, the country accumulated substantial foreign currency reserves of approximately US$ 39 billion (73% of GDP, although these reserves then decreased to US$ 33.5 billion), which provided a sufficient guarantee against any possible adverse external and internal shocks. However, the situation deteriorated in 2016.

Public debt will increase in 2016, reaching 50.5% of budget revenues and 46% of budget expenditures. Furthermore, Azerbaijan's tax debt is estimated at AZN 2.4 billion. The budget burden for the payment of the national debt increased considerably in 2015 and 2016. "Ricardian equivalence" theory assumes that when the government attempts to stimulate demand by increasing debt-financed government spending, demand can remain unchanged; this is because the public will retain its savings to pay for possible future tax increases that will be applied to paying off the debt burden.[6] This has two implications: (a) debt burden increases make citizens more cautious about consumption; (b) public debt will be replaced by a tax burden on the population in the long run.

SOCAR Faces Financial Challenges

State-owned oil companies such as SOCAR find themselves with fewer financial resources to spend on costly upstream or downstream projects. SOCAR is the key player in Azerbaijan's energy sector, but it does not transfer its total oil revenues to the state budget. In 2015, SOCAR paid 1.48 billion manats to the state budget, which was 20% less than the previous year (SOCAR's total revenue figures for 2015 are not available to compare budget transfers with revenues). Moreover, the company directly finances some energy-related (and in some cases, even non-energy related) projects. Due to low oil prices, SOCAR decreased crude oil and natural gas production in 2015 and suspended some new projects. It announced the termination of its project to build a new oil-gas refining and petrochemical complex. National or state-owned oil-gas companies such as SOCAR seem insufficiently prepared to lower oil price conditions considering the importance of cost effectiveness, efficiency maximization, and their fiscal roles as taxpayers. As in the case of SOFAZ, there are no rules to regulate the portion of revenue that must be transferred or invested by SOCAR. After lower crude oil prices, SOCAR did not cancel any planned major projects including the modernization of an existing main refinery in Baku. However, the company had borrowed 1.86 billion manat from International Bank of Azerbaijan with a state guarantee provided by the ministry of finance.[7]

Some Fiscal Policy-Related Reforms Were Amplified During the Crisis

As part of a series of institutional changes, the Azerbaijani President established a new position and appointed the former deputy tax minister as the President's economic reforms assistant. Azerbaijan began to introduce a BOT (*Build-Operate-Transfer*) model for construction and infrastructure projects to attract alternative financing sources. The government also exempted investors (*investment certificate holders*) from some taxes and customs duties (by up to 50% for 7 years) and prepared anti-dumping duties to prevent import growth. Due to latest changes in the Tax Code, owners of retail service and catering service entities with annual turnover

5 The Ministry of Finance successfully issues state bonds, February 8, 2016, <http://www.maliyye.gov.az/en/node/1885>

6 Robert J. Barro, "The Ricardian Approach to Budget Deficits," *Journal of Economic Perspectives*, 3: 2 (1989): 37–54, <http://faculty.georgetown.edu/mh5/class/econ102/readings/budget_deficits.pdf>

7 "SOCAR в 2016 году привлечет от Межбанка Азербайджана еще 200 млн манатов" [In 2016, SOCAR will attract 200 million AZN more from IBA], Caspian Barrel, April 6, 2016, <http://caspianbarrel.org/?p=41181>

of up to 200.000 manats will pay a 6% and 8% simplified tax respectively.

The fiscal crises made fiscal discipline an unavoidable component of possible reforms. But unfortunately a separate law on state financial control and the Budget Code have not yet been prepared. Despite the fact that the government has already developed medium term expenditure planning, it has not yet transformed the budgeting to the Medium-Term Expenditure Framework that enables to track cyclical changes in main fiscal parameters. SOFAZ as an extra-budgetary sovereign wealth fund and main donor of the state budget needs new regulations or a law defining its saving and stabilization functions with clear deposit and withdrawal rules. The institutional capacity of the government should be improved in order to adopt a counter-cyclical fiscal policy and harmonize different components of the budget system (especially, interrelations between state budget and extra-budgetary funds).

Conclusion

Falling crude oil prices and consequent reductions in fiscal and budget revenues have amplified the government's budget deficit in Azerbaijan. The volatility of crude oil prices in the world market and the depletion of the country's foreign exchange reserves led to massive fluctuations in fiscal parameters. The government is not in the sustainable fiscal position of having a low level of public debt. This is a predictable consequence of Azerbaijan's high dependence on crude oil, which accounted for 78% of total exports and 60% of state budget revenues in 2015. Even if public debt is still relatively low as a percentage of GDP, lower oil revenues compared to previous years imply a less robust fiscal ability to pay down these debts in the future. Accordingly, there is a need to adopt a new fiscal policy and fiscal rules based on medium term budget expenditure planning and a sensitivity analysis to create larger fiscal surplus in order to meet long-term development commitments and to pay down public debt through SOFAZ, which accumulates fiscal surplus. However, at present, despite fiscal stabilization and the availability of SOFAZ as a savings instrument, the country still faces difficulties in fiscal policy. In Azerbaijan, there is no fiscal rule that limits annual spending of SOFAZ's oil revenues.

Despite the fact that crude oil prices remained low for 2015, the government did not adopt stricter fiscal decisions to cut spending or to raise tax rates. The government plans to reduce public investment spending by almost 40% in 2016 compared with the previous year's level, but it also plans to raise social spending. As a result, total budget spending in 2016 has been planned to be 4% more than in 2016, notwithstanding total budget revenues will be almost 2% lower in 2016 compared with 2015. Fiscal policy in Azerbaijan was expansionary and pro-cyclical during the previous years thanks to high crude oil prices. Currently, the government attempts to adjust its fiscal policy to new realities characterized by lower oil prices and revenue volatility without damaging its social obligations and adopting contractionary fiscal policy.

As in other natural resource-rich countries, Azerbaijan has faced all characteristic consequences of lower oil prices, including increased budget deficits and public borrowing, relatively lower capital investments from the budget, and cancellation of some projects by the national oil company. However, this new environment has also boosted a new wave of fiscal and public administration reforms. Azerbaijan scored 51 (on a 100-point scale) in budget transparency (*Open Budget Index 2015*) which is slightly higher than the global average indicator of 45.[8] There is room for improvement here to enhance access to budget data and improve the quality of the budget cycle, including budget forecasting and more efficient medium-term fiscal policy planning. The government can increase the comprehensiveness of the state executive's budget proposal by adding more details to fiscal policy narratives and fiscal performance indicators.

About the Author

Kenan Aslanli is a guest lecturer at the University of Applied Sciences BFI Vienna (Austria) and has been a regular trainer for the Eurasia Hub's training courses in natural resource management. He is also the local contractor of the International Budget Partnership's Open Budget Survey Initiative for Azerbaijan and a senior economist with the Public Finance Monitoring Center in Baku. His recent research article on "Fiscal Sustainability and the State Oil Fund in Azerbaijan" was published in the *Journal of Eurasian Studies* (July 2015), <http://www.sciencedirect.com/science/article/pii/S1879366515000056>

8 Open Budget Survey: Azerbaijan, 2015, <http://www.internationalbudget.org/wp-content/uploads/OBS2015-CS-Azerbaijan-English.pdf>

Table 1: SOFAZ's Budget Transfers (2003–2016, mln. AZN)

Years	Fiscal revenues from SOFAZ (transfers)	The share of SOFAZ's budget transfers in total budget revenues, %	The share of SOFAZ's budget transfers in GDP, %
2003	100	8.2	1.3
2004	130	8.8	1.5
2005	150	7.2	1.2
2006	585	15.1	3.2
2007	585	9.7	2.1
2008	3,800	35.3	9.5
2009	4,915	47.6	14.2
2010	5,915	51.9	14.2
2011	9,000	57.3	18.0
2012	9,905	57.3	18.3
2013	11,350	58.2	19.7
2014	9,337	50.7	15.8
2015	8,130	47.6	14.2
2016 (projected)	7,615	45.3	12.6

Source: Budget.az, <http://www.budget.az/main?content=526>

Azerbaijan: Low Oil Prices and their Social Impact

By Farid Guliyev, Baku

Abstract
This article looks at the impact of low oil prices and the resulting shortfall in oil rents on the Azerbaijani government's social-assistance policies and related expenditures and discusses its implications for social cohesion in the long run. It argues that the deployment of strategic fiscal reserves and citizens' continuing reliance on informal 'safety nets' have cushioned the negative social impacts of the oil plunge. However, there is a risk that the deepening of an economic crisis exacerbated by weak private sector development and missing major reforms in education and social sectors across the board might undermine the social contract. To mitigate the adverse social impacts of the ongoing crisis, the government must conduct a more comprehensive and wide-ranging reform of the labor market, of the access to and quality of education and of the private business sector to stimulate formal job creation, especially among youth and rural populations as well as in health care to provide quality and affordable health care, in education to improve human capacity and domestic labor skills, and in social policies to ensure inclusive and sustainable social welfare provision.

Introduction
The oil price slide that began in June 2014 and continues to this day ended a decade-long oil boom in Azerbaijan. Boom turned to bust. The words "crisis" (*iqtisadi böhran*) and "post-oil era" (*post-neft dövrü*) entered the vocabulary of policy makers, shaping a new public discourse around Azerbaijan's petroleum wealth and apocalyptic predictions about a future without oil. Everyone, from