

Azerbaijan: Low Oil Prices and their Social Impact

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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

the average person on the street to high-ranking officials, seemed worried about the troubling times ahead. Rising food prices without an equivalent rise in wages worsened people's living standards. During the booming times, many citizens borrowed loans from banks to pay for mortgage (*ipoteka krediti*) or to purchase a car. However, as some loans were issued in foreign currency, the depreciation of the Manat relative to the U.S. dollar made it hard to pay back bank loans. A loss of faith in the Manat forced many borrowers to convert savings into U.S. dollars. Annual inflation in Azerbaijan is fast accelerating and will reach 12% this year, up from 4% in 2015. Fitch predicts a rise in inflation upwards of 14% by year end. All these developments fueled the sense of economic insecurity for many Azerbaijanis. More people today than in the oil-boom decade are questioning government effectiveness in managing the country's oil revenues and the quality of public spending in general. As everyone now realizes, times will never be the same again.

One area that has arguably been particularly vulnerable to the shortfall in resource revenues is the social sphere: (un)employment, poverty, and social welfare. While the oil price fall will have an incremental impact on the government's social assistance policy, there are some early warning signs that the problems of social welfare, unemployment (especially youth unemployment) and quality of education are becoming critical in a time of crisis.

Jobs and Wages

Official statistics reveal no drastic changes in the labor force participation, and the official unemployment rate remains unrealistically low at 5%. However, the true magnitude of crisis-induced unemployment may be higher than official figures suggest. According to media reports, several private and state-run enterprises announced job cuts in the wake of the latest currency devaluation in December 2015. Layoffs reportedly affected the state-run electric power producer Azerenerji, the gas-distribution network Azerigas, the state oil company SOCAR, and a major telecom operator, Azercell.¹ Radio Azadliq reported that, in January, perhaps as many as 250–300 employees lost their jobs in the energy and power supply network (Azerenerji, Azerishiq and Azenco) amid a faltering economy.²

Moreover, the licenses of seven of a total of 42 banks operating in Azerbaijan were revoked, and these allegedly insolvent or illiquid banks were merged. Several major energy companies, such as BP, announced layoffs, and Norwegian Statoil and U.S. oil giant Exxon-Mobil closed their representative offices in Baku. BP announced in January 2015 that it would cut 255 jobs (105 Azeri nationals and 150 foreigners) in Azerbaijan. Considering that oil and mining employs only 41,500 people (or only 1% of the workforce), the impact of the firm-level layoffs is not that big despite its collateral damage on the booming service and construction sectors linked to the oil industry. However, for a small but highly educated segment of the labor force—high skilled professionals and middle classes—this entails the loss of high-paid jobs. For more disadvantaged groups of the workforce—such as agricultural producers and local traders (employing 37% and 15% of the labor force, respectively)—the devalued national currency (together with cumbersome customs procedures) made it difficult for local businesses to sell profitably, as most intermediate goods are purchased from foreign suppliers and transactions are in foreign currency.

Youth will likely remain the most vulnerable group given Azerbaijan's large "youth bulge". Today, young people under 25 years constitute 40% of the total population. Having a relatively young population (the median age is 29 years), youth unemployment remains one of the biggest challenges for an economy that is highly undiversified and where the government lacked incentives, especially during high oil prices, to invest in human capital accumulation, namely investments in educated and skilled labor force. According to the International Labor Organization (ILO), the youth unemployment rate fell from 18% in 2003 to 11% in 2013 and stood at 10% in 2014. A major cause for young people having fewer jobs is that the skills they acquire while at school or university are not the ones demanded by the job market. As the government begins to slash public investments that generated jobs in services, construction and infrastructure in the previous decade (73% of all construction was financed with public money, which itself was 70% sourced from oil revenues),³ there will be fewer jobs for young people, and this will likely drive youth unemployment up. Workers in rural areas have low-paying jobs. Unemployment is a serious problem, as too few jobs are being created outside of the capital city. Internally displaced persons (IDPs), who constitute more than 6% of the total population, are another vulnerable category;

1 Durna Safarova, "Azerbaijan: Unemployment Rises as Economy Teeters", *Eurasianet*, February 24, 2016, <<http://www.eurasianet.org/node/77516>>

2 "Enerji sektorunda kütləvi ixtisarlar" [Mass layoffs in the energy sector], *Radio Azadliq*, January 20, 2016, <<http://www.azadliq.org/content/enerji-isiq-kutlevi-ixtisar/27499713.html>>

3 "Azerbaijan Economy: Sailing Uncharted Waters", Galt & Taggart Research, February 26, 2016, <<http://galtandtaggart.com/research/research-reports/all/all-all/2/>>

IDPs' income level is below the poverty line, and they are employed largely in the agricultural sector. IDP labor force participation is very low given the lack of skills in this part of the population.

The public sector is likely to suffer, too. The president declared the need to downsize the state apparatus by abolishing governmental agencies with overlapping functions and merging them. This may lead to job losses for public sector workers who have traditionally constituted the social base of the regime.

In January, the president ordered the cabinet to prepare a broad privatization plan that will cover the International Bank of Azerbaijan (IBA), the only state-owned bank which holds 35% of banking assets in Azerbaijan. The finance minister urged the government to shift to a "four-year austerity" program to ensure, among other things, "the rational use of state funds, and prevention of squander and useless expenses".

The impact of the Manat collapse on wages has been very negative. As Azerbaijan decided to float its currency and de-peg it from the US dollar, salaries and social allowances paid in Manats lost in value. For example, while the monthly average salary for 2015 increased by some 5% to 462 Manats, it lost almost half of its value in US dollar terms—falling to US\$ 296 (compared to US\$ 597 in 2014)—due to the currency devaluation.⁴ To mitigate this effect, president Aliyev signed a decree on January 18 increasing the minimum pension and salaries of state employees by 10%.

Social Expenditures

Social spending including expenditure on education, health, and social protection remained unchanged, and the government has emphasized its commitment to promoting social welfare. Officials speak of the state budget as socially oriented (*sosial yönümlü*).

There were no cuts in social assistance programs (see Table 1 on p. 21). Total social sector expenditures including salaries, pensions, medicine costs and other supplies are projected at 5.87 billion AZN, representing 36% of total budget expenses for 2016 (a 8.6% increase compared to previous year) and approximately 42 million Manat (or 0.7%) more compared to the previous year's budget.⁵ All education and social assistance lines in the budget expenditure composition were kept at approximately the same level as in the previous year despite the

fact that state revenues are heavily dependent on oil revenues and transfers from the state oil fund (SOFAZ) make up 43% of the overall budget revenues for 2016. In fact, in late February the parliament adopted revisions to the 2016 state budget based on an average oil price of \$25 per barrel. In the revised budget, the share of socially oriented expenditures was increased by 1.7 % (i.e. an additional 1.29 billion AZN) and is now forecasted at 38% of total budget expenses.⁶ Amendments were also made to the budget of the State Social Protection Fund (SSPF) with a projected 7% increase in expenditures totaling 3.3 billion AZN (US\$ 2.12 billion).

However, in a cross-national comparison, Azerbaijan's welfare spending as a percentage of GDP is modest, social sectors are underfinanced, and human capital development is weak compared to other countries with similar economic growth levels or natural resource endowments.⁷ Azerbaijan spends 5% of its GDP on healthcare and only approximately 2.5 % of GDP on education. According to World Bank estimates, Azerbaijan's public expenditure on education was less than 3% of its GDP on average between 2007 and 2011. This is less than that in comparable countries such as Malaysia and Poland, where education spending is 5% of GDP. The quality of education in Azerbaijan is also substandard. Azeri students show poor results on international education tests. Azerbaijan ranked 74 out of 75 countries on the 2009 PISA international education assessment survey (OECD, <<https://www.oecd.org/pisa/46643496.pdf>>).

Labor market specialists believe that Azerbaijan's unreformed education system as well as the outdated system of vocational training fail to provide job seekers with the necessary skills for the job market. For example, there were fewer than 500 graduates to match the specialty requirements for almost 15,000 jobs created in agriculture in the 2007–2011 period. Poor education quality and lack of skilled workers hurt the employment opportunities and life satisfaction for the current generation (and possibly their offspring). The lack of prospects drives many talented people to seek jobs (and better life chances) abroad, which impedes productivity and innovation in the private sector domestically. The economic crisis will likely reinforce this tendency for outmigration.

Over the past years, the government's social assistance projects—through the state budget and SSPF—

4 CESD, "The Economy of Azerbaijan in 2015: Independent View", January 2016, <http://cesd.az/new/wp-content/uploads/2016/01/CESD_Research_Paper_Azerbaijan_Economy_2015.pdf>

5 Ministry of Finance of The Republic of Azerbaijan, "Presentation on the Draft State and Consolidated Budgets for 2016", Baku 2015, <<http://www.maliyye.gov.az/sites/default/files/presentation-2016.pdf>>

6 "Azerbaijani Parliament Adopts Revised State Budget for 2016", *Trend.az*, February 23, 2016, <<http://en.trend.az/azerbaijan/business/2498247.html>>

7 Indermit S. Gill et al., "Diversified Development: Making the Most of Natural Resources in Eurasia", World Bank, 2014, <<http://www.worldbank.org/content/dam/Worldbank/Feature%20Story/ECA/diversified-development-eurasia-full-report.pdf>>

targeted the most vulnerable segments of the population and helped lift many people out of absolute poverty. The poverty rate dropped significantly from 47% in 2002 to the current 6%. Today, about 63% of households receive at least one type of social transfer benefit, such as pensions for elderly people, unemployment benefits, and social insurance payments. Among social transfers, pensions are the largest payment, accounting for 75% of all public spending on social protection.⁸ The Targeted Social Assistance (TSA) Program, introduced in 2006, provides cash transfers to low-income households. In the absence of social transfers, the poverty rate would amount to approximately 25% (Onder 2013).

While the social transfers helped to reduce poverty, the oil price decline put the sustainability of public social expenditures under strain. During the booming times, the targeted social-assistance policies helped raise the basic living standards of citizens to a level just enough to quell social tensions and maintain a modicum of societal cohesion and political stability. This was important considering the rising expectations around the growing wealth and the public discourse around equity in revenue sharing. However, as the drop in oil prices shuttered the balance sheets of oil-producing countries, Azerbaijan's government has found itself in a difficult situation. Dwindling fiscal revenues weakened the government's ability to finance its social welfare programs and the heavy bureaucracy, and the depreciation of local currency has had a negative effect on citizens' perception of government performance. Nevertheless, the state authorities regard social spending as an "ultimate priority". Thus, according to Article 7 of the Law on Budget System (<<http://www.e-qanun.az/framework/1126>>), pensions, wages and social transfers belong to the so-called "protected" category of basic social costs and may not be subject to budget cuts (*sekvestr*) regardless of the level of state budget incomes.

However, citizens' notions and expectations of what is an acceptable level of social welfare are relative, and what ordinary Azerbaijani citizens perceive as a "normal" standard of living may not be the same as the one accepted in Western Europe. Throughout history, Azerbaijanis relied on informal kinship and personal friendship ties, rather than formal state institutions, to cope with poverty and economic distress. Many people still rely on reciprocity-based informal social "safety nets"—extended family, kinship networks and friends—for monetary assistance (cash transfers, remittances or soft loans), patronage and support. Patronage is widespread

in hiring for jobs in both public and private sectors and is not uncommon among the domestically operating international donor community and NGOs. It is a culturally shared belief that wealthier heads of patronage networks who enjoy access to the spoils of the oil sector and other rents should provide for poorer members of the network. If the economic crisis worsens, people will likely tolerate loss of some social benefits and try to compensate by seeking recourse from their kinship group, personal connections and friends, rather than through organizing public demonstrations, given weak organized ties and social trust beyond immediate family and kin group.

Social Tensions

Azerbaijani protests in recent years reveal the tendency for small-scale, localized and uncoordinated actions largely concentrated in rural areas (with the exception of a handful of urban-based protests in Baku) where residents are economically less well-off and want to seek more wealth redistribution toward their rural areas and localities. Although the government allocated over \$30 billion on its regional development program in the period 2004–2014, this has not translated into more jobs or inclusive social development due to poor implementation and rent-seeking at the local level.⁹

Rising unemployment rates and food prices spurred a series of pocket book protests across Azerbaijan's regions with people demanding redress in shrinking employment, income and welfare benefits. The protesters who were arguably apolitical in their demands raised the specter of rising social tensions in society. Demonstrations against price hikes, unemployment and the burden of paying off credits took place on January 10–12 in the provincial towns of Siyazan, Neftchala, Lenkaran, Quba and other regions. The number of protesters ranged from about 300–400 in Siyazan to more than 1,000 protesters in Quba. Scores of protesters and several local opposition activists were arrested after the authorities declared the rallies illegal and blamed the traditional opposition Popular Front (AXCP) and Musavat parties and "religious extremists" for instigating the protest.¹⁰

However, the protests dissipated quickly once there were neither organizational mechanisms nor resources to sustain collective action. The government used the "carrot and stick" approach: employing internal security forces to calm down protesters while at the same time

8 Harun Onder, "Azerbaijan: Inclusive Growth in a Resource-Rich Economy", World Bank, 2013, <<https://openknowledge.worldbank.org/handle/10986/12228>>

9 Zaur Shiriye, "Protests in Azerbaijan: A Political and Economic Watershed", *Eurasia Daily Monitor*, February 1, 2016, <<https://t.co/OrLnlxiiFw>>

10 "Arrests as Azerbaijani Police Use Water Cannons, Tear Gas Against Protesters", *RFE/RL's Azerbaijani Service*, January 15, 2016, <<http://www.rferl.mobi/a/27489831.html>>

cutting bread prices and increasing the salaries of public sector employees by 10%.

Outlook

The government's ability to provide for welfare and basic living standards will depend on a number of variables, most importantly, the duration and intensity of the oil price and production level decline and its capacity to initiate and implement a strategy to overcome the oil-induced economic crisis. The fiscal buffers have enabled the government to maintain a passable level of social welfare since the beginning of the oil decline two years ago. However, the political leadership's weak steering capacity, which manifested itself in a haphazard reaction to economic recession, will put strains on its ability to navigate crises in the longer term if oil prices do not rebound to pre-crisis levels. Thus far, the sense is that the government has chosen to "wait and see" and hope the oil price returns to earlier peak levels, while contemplating a US \$3 billion loan from the IMF and World Bank as a short-term solution.¹¹

Azerbaijani officials also believe that there is a conspiracy to bring oil prices down. President Aliyev said that "reasons for such a difficult situation are outside our country and these reasons are rather political, than economic."¹²

It is clear that in the medium and long term, the crisis will drain state patronage resources. Whether the private sector can provide for jobs and welfare benefits without the usual injection of state money is not entirely clear. Small- and medium-sized enterprises were hard to develop under the Dutch disease. Oil cash inflows in U.S. dollars increased the value of the Manat relative to the U.S. dollar, which hurt local producers. The non-oil sector, which is dominated by nine large holdings (Pasha, Synergy, Ata, Gilan, Azersun, CRA, Garant, AF and Silkway), can hardly survive without crony links to the state. They are largely "subsidized" through state public investment programs and lack financial sustainability (see Table 2 overleaf). As the local economist Azer Mehtiyev put it, "The majority of these enterprises are not competitive and not export-oriented. Using close relations to powerful people, these companies drive out similar imported goods from the domestic market by unfair methods and mostly survive thanks to domestic consumers and state orders."¹³

With a lack of state funds and due to a poor diversification record, there will be more pressure on the government to deliver social benefits in the future while government resources will be further strained by dwindling fiscal revenues from the export of oil. Two aspects of government control will largely determine the outcome: 1) relinquishing control over independent business and 2) enforcing the rule of law over the grabbing hands of rent-seeking officials at all levels and over the informal reign of a handful of state-linked monopolies that dominate all sectors of the economy.

Open protest in the tightly controlled political space of Azerbaijan is an act of desperation. Protesters in Azerbaijan face three main challenges: the repressive state apparatus, the shortage of resources, and the difficulty of oppositional coordination. The outburst of social discontent in January was a series of typical pocketbook protests sprang from uncoordinated efforts by residents of some of the poorest *rayons* and towns beset by extreme levels of unemployment and income decline, and hit hard by the drop in remittances from Russia. (The total volume of remittances fell from US\$ 1.7 billion in 2014 to US\$ 1.18 billion in 2015, according to Central Bank data).¹⁴ As one of the protesters in Quba noted, "Our protest was not organized... We did not have a leader, but about 5,000 people came and protested, because we could not tolerate it any more."¹⁵

Less oil revenues will significantly diminish extensive patronage opportunities in the hands of the incumbent elite and will widen the social gap. This, however, will not necessarily make the regime more vulnerable (relative to the existing political opposition forces) as the elite still enjoys access to oil wealth. True, cheap oil means less revenue, but there are other sources of rent (not just oil) that elites can tap into. While economic crises sometime create a critical juncture for a profound political change, much depends on whether societal actors will have the capacity and ingenuity to make use of this opportunity. Azerbaijani opposition groups, both old and new, are simply too feeble to threaten the status quo. This makes the prospects of political change even more dangerous as unmediated social discontent may result in social turmoil and permanent economic crisis.

See overleaf for information about the author.

11 Jack Farchy and Shawn Donnan, "IMF and World Bank Move to Forestall Oil-led Defaults", *Financial Times*, January 27, 2016, <<https://next.ft.com/content/9759f42a-c51b-11e5-b3b1-7b2481276e45>>

12 Reuters, January 10, 2016, <<http://bit.ly/23m2sUx>>

13 Quoted in: Mina Muradova, "Azerbaijan: The Pipe Dream of Economic Diversification," *Transitions Online*, April 7, 2015,

<<http://www.tol.org/client/article/24753-azerbaijan-the-pipe-dream-of-economic-diversification.html>>

14 CBA Monetary Policy Review, December 2015, <http://en.cbar.az/assets/4059/MPR_-_2015_-_eng.pdf>

15 Reuters, January 18, 2016, <<http://reut.rs/1PJJsR>>

About the Author

Farid Guliyev, PhD (Bremen, 2014) is a research associate and project coordinator with Eurasia Extractive Industries Knowledge Hub (<<http://www.resourcegovernance.org/learning/eurasia>>). His recent publications include a discussion paper (co-authored with Anar K. Ahmadov) “Tackling the Resource Curse: The Role of Democracy in Achieving Sustainable Development in Resource-Rich Countries”, published by Stockholm-based International Institute for Democracy and Electoral Assistance (International IDEA) in March 2016 (<<https://t.co/UPVXbjSORp>>) and a new chapter on social media and political opposition in Azerbaijan (co-authored with Katy Pearce) published in Axel Bruns et al. (ed), *The Routledge Companion to Social Media and Politics* (Routledge, December 2015) (<<https://t.co/HPKYi9VIKF>>).

Table 1: Azerbaijan: Budget Expenses on Education, Health and Social Assistance, 2011–2016 (mln. AZN)

	2011	2012	2013	2014	2015	2016 (proj.)
Education	1,399.8	1,575.9	1,530.4	1,653.4	1,711.2	1,713.5
Healthcare	563.2	662.7	669.3	725.6	777.7	744.9
Social protection and social security	1,611.8	1,781.6	1,813.6	2,072.2	2,040.5	1,896.6

Source: Azerbaijan Ministry of Finance, *Draft Budget Presentations, various years*, <<http://www.maliyye.gov.az/node/1128>>

Table 2: Azerbaijan: Non-Oil Sector Holdings

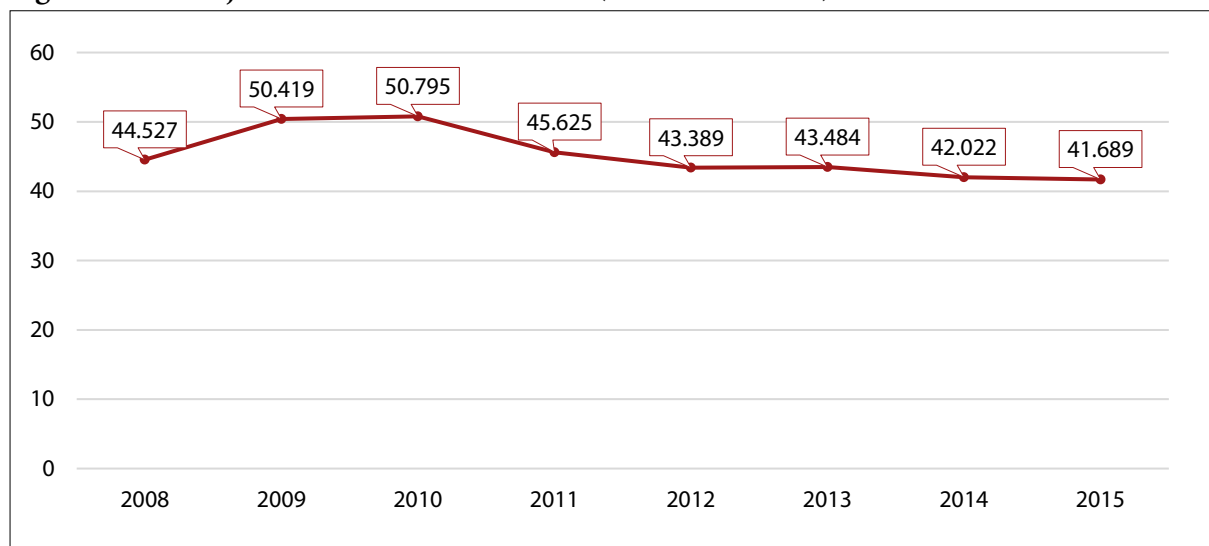
Name	Sector activities
Pasha	Banking, insurance, construction, travel, private equity
Synergy	Construction, construction materials, agriculture, hospitality, finance, tourism, IT services, industrial (food)
Ata	Finance, tourism, hospitality, industrial, IT services, insurance
Gilan	Construction, food, hotels/restaurants, diversified manufacturing
Azersun	Food processing, farming, trade, packaging and paper
CRA	Telecoms, oil services, cement, private equity
Garant	Finance, construction, hotels and real estate services, agriculture, logistics
AF	Construction products, property, retail
Silkway	Travel, airlines, travel-related retail and services

Source: “*Doing Business and Investing in Azerbaijan*”, PWC, 2015 edition, p. 8. <<http://www.pwc.com/az/en/publications/assets/dbg-2015.pdf>>

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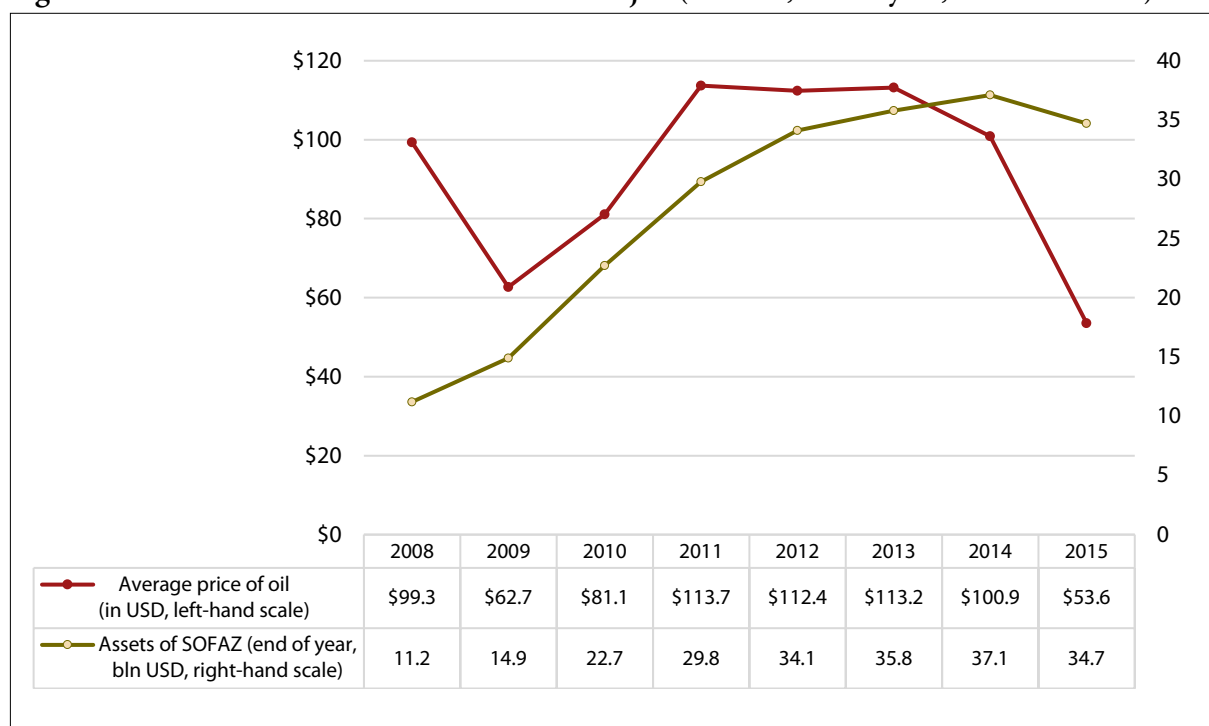
Oil Production and State Finances

Figure 1: Azerbaijan's Oil Production Volume (in million tonnes)

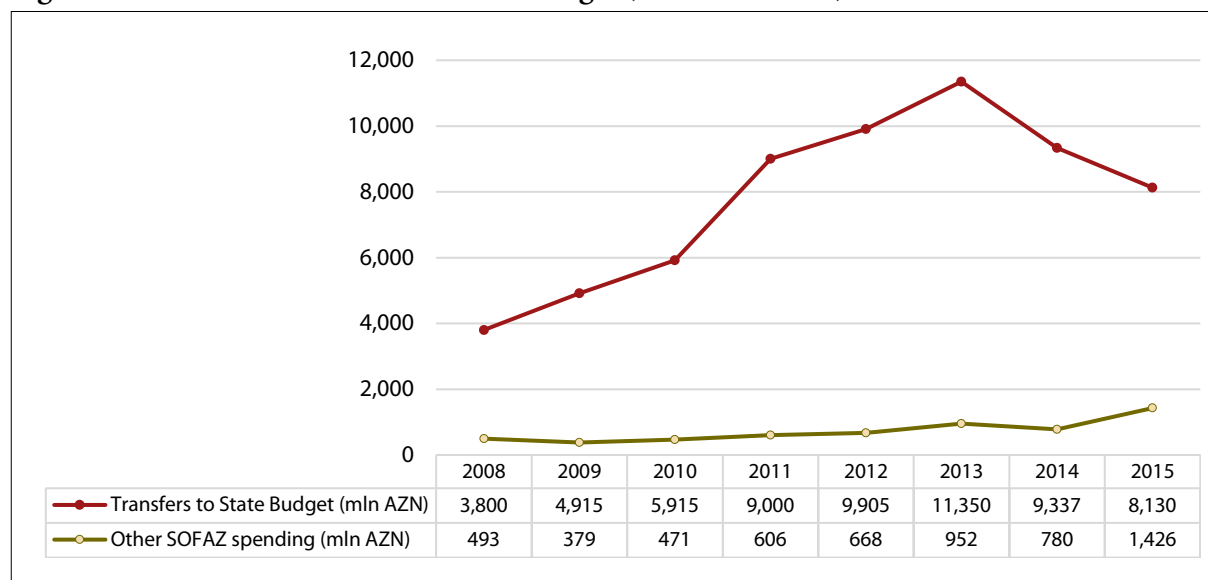


Source: Caspian Barrel and NRGI, 2016, <<http://psaagreement.org/>>. Reproduced with permission.

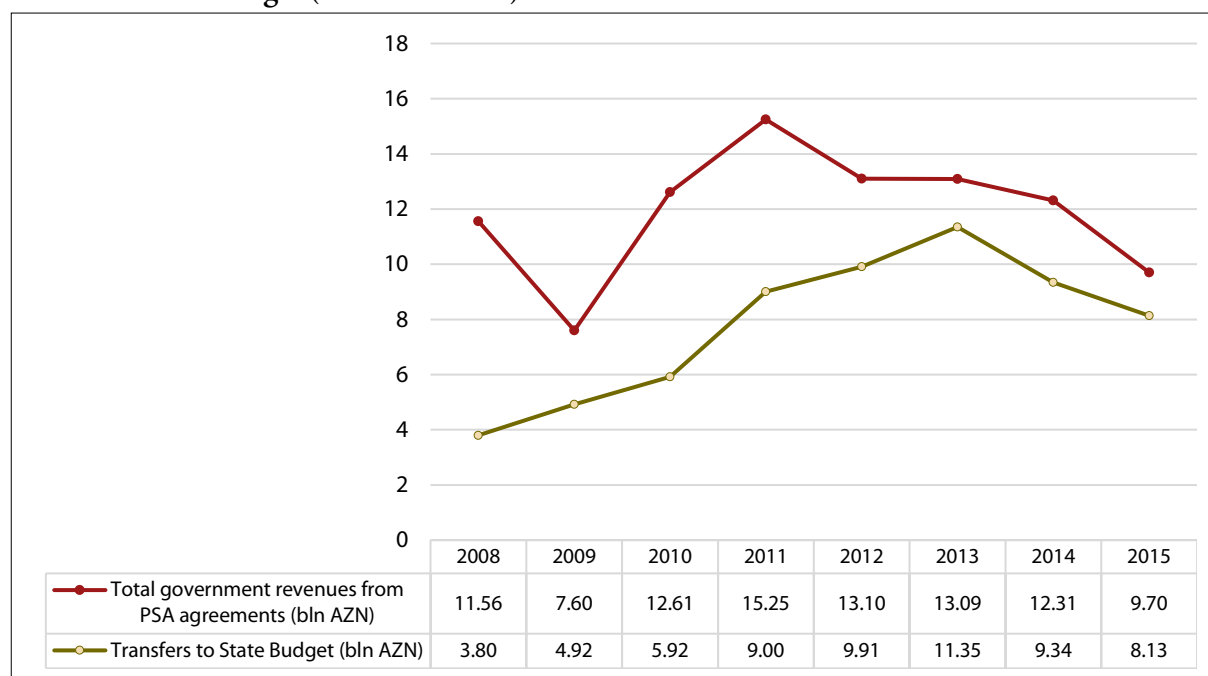
Figure 2: Assets of the State Oil Fund of Azerbaijan (SOFAZ, end of year, in billion USD)



Source: Caspian Barrel and NRGI, 2016, <<http://psaagreement.org/>>. Reproduced with permission.

Figure 3: SOFAZ Transfers to the State Budget (in million AZN)

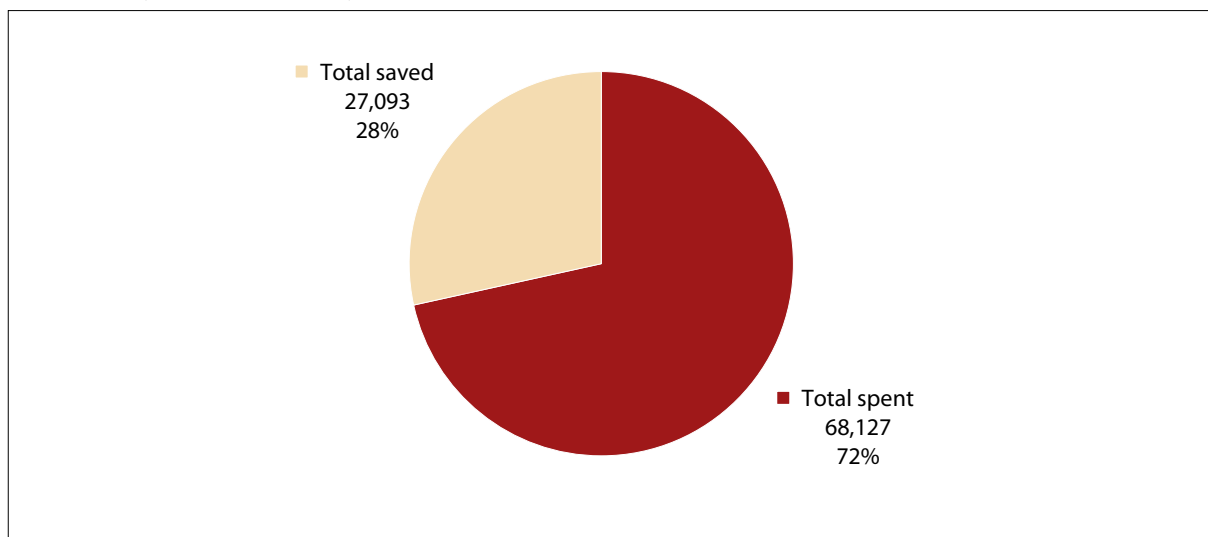
Source: Caspian Barrel and NRGI, 2016, <<http://psaagreement.org/>>. Reproduced with permission.

Figure 4: State Revenues from Production Sharing Agreements (PSAs) and Transfers to the State Budget (in billion AZN)

Source: Caspian Barrel and NRGI, 2016, <<http://psaagreement.org/>>. Reproduced with permission.

*Note: The PSA Agreement (Production Sharing Agreement) is a special form of agreement on the establishment of an enterprise to carry out joint activities. Usually PSAs are signed between a foreign company(ies) (contractor) and the state or the company representing the state (customer) for the extraction of oil, gas and mineral resources. In the period 1991–2015, Azerbaijan signed more than 30 PSAs with foreign oil companies, attracting more than \$55 billion in foreign direct investments. List of on-shore and off-shore PSAs is available here: <<http://psaagreement.org/psa-list/>>. For more on PSAs in Azerbaijan's energy sector, see: Nurlan Mustafayev, "Production-sharing agreements in the petroleum industry of Azerbaijan", *Journal of World Energy Law & Business*, 8:4 (2015): 362–384, <<http://jwelb.oxfordjournals.org/content/8/4/362>>

Figure 5: Total Government Revenues from PSA Agreements: Savings vs. Spending, 2008–2015 (in million AZN)



Source: Caspian Barrel and NRGI, 2016, <<http://psaagreement.org/>>. Reproduced with permission.