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## “After Us, the Deluge”: Oil Windfalls, State Elites and the Elusive Quest for Economic Diversification in Azerbaijan

By Farid Guliyev, Bremen

### Abstract

Despite the officially stated goal of economic diversification and the billions of petrodollars in government expenditure, Azerbaijan has made slow progress achieving non-oil growth and remains heavily dependent on oil revenues. Why have Azerbaijan's efforts to reduce dependence on energy export revenue not borne fruit? Two factors seem crucial. First, various public investment projects, mostly on infrastructure, implemented under the banner of diversification were actually exploited by the elites to convert growing public funds into elite assets under their private control. Second, the peak in oil production (in 2010) and the expected depletion of oil reserves over the next two decades seem to have shortened elite time horizons, causing the authorities to spend about 65 percent of the overall savings from the state oil fund. In sum, elite financial interests and short time horizons deflected economic diversification and put Azerbaijan's long-term development at risk.

### Introduction

Ten years into the oil boom, Azerbaijan's economy remains as reliant on petroleum exports as in 2003, when the incumbent President Ilham Aliyev took the reins of the presidency: oil and gas constitute 95 percent of the country's overall exports, contributes 74 percent of government earnings and accounts for 70 percent of state budget revenues. High levels of fiscal dependence on oil indicates that the Azerbaijani state effectively is a rentier state deriving most of its revenue from oil rents, rather than taxes. Having realized the risks of oil dependency, in 2012 the administration of President Aliyev announced its strategic development outlook for the future. The development concept “Vision 2020” recognized the need to overcome petroleum dependence and its corollary of becoming a “raw material appendage for the world economy.” The document also highlighted diversification away from oil as the key path toward this goal. The economic development minister said that by 2020, the Azerbaijani economy is expected “to rid itself of its dependence on the oil sector.”

In more tangible ways, however, diversification was understood by the authorities to imply massive public expenditure on infrastructure projects using oil wealth. In a pattern familiar to scholars of the resource curse, billions of dollars were directed from the state budget toward construction of new bridges, highways, parks, residential towers, convention centers, sport complexes, and the world's tallest flagpole. However, has the government's diversification plan been a success? Has it laid down solid foundations for sustainable growth for the future when oil runs out?

The International Monetary Fund's (IMF) staff mission in Azerbaijan said that progress towards economic diversification has so far been “elusive.” The government has been slow to implement reforms with respect to

improving the climate for private business. Corruption was cited by the IMF mission as a key obstacle. Similarly, the European Bank for Reconstruction and Development (EBRD) stated that in 2014, non-oil growth was largely stimulated by government investments, while the prospects for long-term and sustainable non-oil private business growth without constant government stimulus seem “unclear.” Conditions for doing business outside the oil sector remain “difficult,” discouraging foreign investments in the non-hydrocarbon sector. Notably, the pursuit of diversification based on infrastructure projects has so far failed “to translate into pronounced non-energy exports growth,” the EBRD noted.

Why has Azerbaijan's progress towards economic diversification been so unremarkable? In this article, I argue that two sets of factors contributed to slow improvement. First, state control of oil allowed the state elites to use, or sidetrack, various government projects undertaken under the banner of diversification to capture rents on a larger scale. Second, the awareness of oil peak production (2010) and expected depletion dates of oil deposits might have shortened the ruling elites' time horizons (namely, how much they value the future relative to the present) creating incentives for higher public spending for their own benefit today over saving for future generations.

### Oil Wealth into Elite Private Profit

High public spending in the political economy context of Azerbaijan operates as the mechanism to reward the close-knit network of cronies loyal to the president. Although oil revenue collection has been transparent, corruption proliferated in public expenditure as the government largely concealed data on how it spent the oil revenues. Rents are captured by the elites on the spending side through the opaque public procurement pro-

cess, awarding of contracts to regime cronies and elite-connected companies, and other machinations to divert public funds. In the absence of clean procurement rules and efficient oversight of public finances, public money is likely to be wasted or plundered. As a result, the state elites and the oligarchs around President Aliyev have become extremely rich and now seek to secure their new wealth and property.

According to Leiden University political economy professor Anar Ahmadov, increases in public expenditure have worked to channel national oil wealth into the portfolios of elites, turning public funds into private assets. In apparent neglect of the social welfare of their citizens, the ruling elites have focused on acquiring large chunks of oil wealth for personal consumption rather than investing these funds into long-term sustainable development.

Large business in Azerbaijan is owned by ministers and senior officials in the presidential administration. As the government increased oil-fueled public expenditure, these state officials-turned-oligarchs have become very rich. The same system is replicated at the local level where medium-sized businesses are either owned or controlled by regional governors, who are in turn connected to the power holders in the center. Kemalladin Heydarov, who was the head of the state customs committee before being appointed the minister of emergencies, is one of the most powerful Azerbaijani oligarchs. His corporate empire includes a business conglomerate Gilan Holding which comprises about 300 firms and subsidiaries and employs more than 12,000 people. Heydarov's family also "supervises" the Gabala district although the head of the local executive authority of the district is a different person, who is officially appointed by the president. The 2014 Bertelsmann Transformation Index (BTI) describes these informal networks as follows:

"key cabinet members have their own private economic interests that often involves a near monopoly on a certain sector of the economy. As a result, an informal understanding exists as to what sector is control[led] by what oligarch."

According to the Asian Development Bank (ADB), most of the state-owned enterprises in Azerbaijan "operate as monopolies in their respective markets, such as electricity and gas, agriculture, and sea and air transport," and "most operate inefficiently."

### Infrastructure Spending

Why have most of the public expenditures been directed to large infrastructure projects? Such projects make it easy for the government and closely allied contractors to siphon off billions of dollars. Government infrastructure expenditure also works as a convenient way

for what Russians call *raspil* (carve up), meaning the distribution of budgetary funds among state elite and bureaucratic groups. Investigative journalist Khadija Ismayilova concurs, noting that infrastructure projects represent "the best way to transfer money from the state budget to personal pockets." Independent expert Vugar Gojayev believes that in the Azerbaijani system of institutionalized corruption, large infrastructure outlays have become

"a resource waste and a means of personal enrichment for the ruling elite. The tenders in such giant projects were awarded to politically connected monopolies. The government spending on hosting mega-events and expenditures on 'white elephant' projects and other public contracts have served as a means to funnel money to well-connected companies that in many cases were owned by senior officials or persons close to them."

Since the start of the oil boom in 2004, oil exports have generated more than a hundred billion US dollars in revenue for the state coffers. The administration of Ilham Aliyev decided to spend most of the oil money, rather than save it. In Azerbaijan, the bulk of the state's share of oil revenue is accumulated in the state oil fund SOFAZ. Of about US\$108 billion windfall revenue over the last 10 years, the government spent US\$70 billion from the oil fund or nearly 65 percent of its overall assets. The oil fund's reserves today stand at US\$37 billion. SOFAZ expects to receive an additional US\$200 billion in the coming years. But the amount of actual income will likely depend on the price of oil. With the price at US\$80 per barrel, the total revenue is estimated at US\$100 billion and the Shah Deniz-II gas deposit will be unlikely to provide huge profits considering its high extraction costs.

Middle East Technical University political science professor Suha Bolukbasi believes that by spending lavishly on construction projects while being cognizant of approaching oil depletion the government acted "irresponsibly."

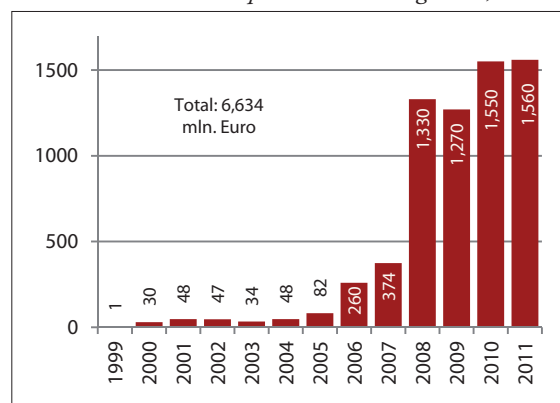
According to calculations by Azerbaijani political opposition leader Ali Karimli posted on his Facebook page, if the government is to pay its share according to various contracts—including acquisitions and investments in the Turkish energy sector (where total investments are estimated at US\$20 billion), the state's share in construction and expansion of pipeline capacities for the TANAP and TAP gas pipelines to carry Shah Deniz-II gas to Europe, construction of a new Oil and Gas Processing and Petrochemical Complex (OGPC) in the Garadagh rayon of Baku (at an estimated cost of US\$17 billion)—the total amount needed to cover

these expenses equals more than US\$32 billion. SOFAZ already invested US\$2.2 billion in the Southern Gas Corridor Closed Joint Stock Company to manage the development of Shah Deniz-II gas and the expansion of gas pipeline infrastructure. The rest of the sum is expected to be taken from the oil fund, whose savings will be around US\$32 billion by the end of 2015, just enough to cover the government contract commitments and investment plans. Based on these calculations, Karimli concludes that the amount currently held as reserves in the oil fund can “only formally be called savings.” In fact, these funds have already been earmarked for specific projects.

Since 2009, direct transfers from the oil fund accounted for more than a half of the country’s year-on-year budget increase. In 2013, SOFAZ received US\$17.3 billion (at the current exchange rate) in revenue. The Fund’s expenditures were at US\$15.7 billion or 91 percent of the earnings. In violation of the requirement to hold a minimum of 25 percent of revenues in reserve, the president decreed to withdraw about US\$14.5 billion (or 84 percent of that year’s revenues) from the oil fund as budget transfers. In 2014, the amount of transfers was US\$12 billion. The 2015 state budget envisages a transfer of US\$13.1 billion, which is 11.3 percent up from the previous year and makes up 53.4 percent of the total budget revenue of US\$24.8 billion. A lack of checks on executive discretion over the Fund and the refusal to adopt fiscal rules has enabled the government to indulge in uncontrolled public spending.

Government priorities are set clearly: close to 35 percent of the state annual budget is invested in infrastructure and construction projects, which according to investigative reporter Ismayilova do not bring any sustainable development for the non-oil sector. Investment in infrastructure increased enormously in recent years (see Figure 1). In the period 2005–2009, infrastructure investment was US\$9 billion, of which US\$4.5 billion was in road construction and renovation. Investment in the modernization and construction of new roads and other physical infrastructure for the 2010–2015 period was expected to be around US\$13 billion. At this rate, infrastructure development consumed about US\$22 billion of public expenditure. This amount represents 31 percent of the overall oil revenue spent via the state budget. The costs of roads are artificially inflated in investment projects. Consequently, it turns out that Azerbaijan builds some of the most expensive roads in the world. For example, the government allocated 620 million AZN (US\$790 million) for the reconstruction of the Baku–Guba highway, but the road still needs repair, according to journalist Ismayilova.

Figure 1: Investment in Road Infrastructure (in million Euros, current price and exchange rates)



Source: OECD/International Transport Forum (2013) *Spending on Transport Infrastructure 1995–2011: Trends, Policies, Data*. Paris: OECD, pp. 26–27, available at: <http://www.internationaltransportforum.org/pub/pdf/13SpendingTrends.pdf>.

A policy paper written by Azerbaijani economic expert Gubad Ibadoglu and his colleagues argues that an increase in oil revenue leads to public investments on large projects “with little developmental value” in a pattern of resource allocation that can generally be seen as “wasteful spending.” SOFAZ Executive Director Shahmar Movsumov disagrees; he said in an interview that the oil money is indeed “invested in future generations.” With reference to the Gulf states, he justified the Azerbaijani government’s expenditure on infrastructure: “The Gulf is a very interesting place, and similar to us. It is flush with money and it understands infrastructure.” Rather than creating state-sponsored factories and plants, it is better to invest in infrastructure and “let the private sector create jobs instead,” he said. However, uncertainties remain as to whether excessive infrastructure investment has been a boon for reducing oil dependence.

Agriculture remains underdeveloped and constitutes only 5.3% of GDP (in 2013) even though this sector employs almost 40% of the labor force. By comparison, the oil sector, which accounts for half of the country’s GDP, employs only 1 percent of total workers. While it has become easier to start a business and register property in Azerbaijan, there are still serious obstacles for firms in getting construction permits, access to credit, and cross-border trade, according to the latest World Bank Doing Business Report. Elite-connected monopolies create market distortions. The endemic practice of bribe-soliciting tax inspections hampers the development of small and medium-sized private enterprises that operate independently from elite monopoly interests. According to the U.S. State Department investment climate assessment (June 2014):

“[a]lthough Azerbaijan has continued to welcome and attract significant foreign investment to further develop its energy sector, inefficient government bureaucracy, weak legal institutions, requests for illicit payments for cross-border transactions, and predatory behavior by politically-connected monopolistic interests hinder investment outside of the oil and gas sector.”

### Time Horizons

Politicians' time horizons, or expected stay in office, seem to be a relevant predictor of elite behavior in relation to the management of oil profits. In petroleum-reliant states, the probability of a leader continuing to serve in office is influenced by forecasts of oil peak dates and resource depletion prospects. Leaders with shorter time horizons generally have greater incentives to engage in short-term predation, rent-seeking and consumption of state resources, rather than prudential management, investment in productive sectors or saving.

Azerbaijan has 7 billion barrels of proved oil reserves. The U.S. Energy Information Administration (EIA) estimates that Azerbaijani crude oil exports already peaked in 2010, and have gradually diminished since the peak year as production continued to decline. If oil production is to continue at the current rate and no new discoveries are made, Azerbaijan will run out of oil in 22 years from now. Based on BP data, natural gas reserves are 0.9 trillion cubic meters, and the reserves-to-production (R/P) ratio for Azeri gas is 54.3 years. Natural gas constitutes 7 percent of total exports and revenue from gas exports will not generate as much revenue as oil has. The IMF economists estimated that natural gas exports, expected to increase over the next decade or so, will over time become a larger share of total exports, but generated wealth is estimated at only one-third of the profits from oil exports given lower gas prices relative to oil.

There are currently no apparent expectations of leadership change in Azerbaijan as the incumbent president is relatively young and the removal of term limits in 2009 allows him to stay in office indefinitely. However, the timing of the peak oil production (which hit the mark around 2010) and the expectation of oil reserve depletion, rather than insecurity in office, appears to have influenced President Aliyev's choice between spending and saving oil income and might have altered his time horizons. According to journalist Ismayilova, the Arab Uprisings and the Maidan events in Ukraine sent a warning signal to post-Soviet authoritarian regimes

and raised the costs of buying people's loyalty. As a result, the Azerbaijani leadership possesses “very little faith in the sustainability of their regime. So, they try to spend as much as possible as quick[ly] as possible.”

With shorter time horizons, Aliyev's elites had more incentives to spend a larger portion of oil revenue as a means to accumulate greater private and personal wealth, rather than preserving it for future generations. As a source of fiscal revenue, oil differs from taxes. So long as oil reserves are available, there are weak incentives in rentier states to foster productive business sectors to harness them for taxation. An approaching end of the oil wealth thus might trigger the incentives to funnel oil profits into elite private assets quicker through increases in government outlays and directing the oil money towards large infrastructure projects.

### Conclusion

Diversification is believed to threaten the status quo benefiting wealthy elites who would try to avoid or resist it. Moving away from a reliance on hydrocarbons requires considerable effort and commitment on the part of the political leadership, especially in the absence of well-developed alternative sectors prior to oil, as is the case with Azerbaijan. Moreover, promoting private business threatens the ruling elites interested in holding onto power.

Here I have argued that diversification can also be conveniently exploited by elites in ways that increase their financial gains. In Azerbaijan, huge public investments into infrastructure, justified through the discourse of economic diversification, were channeled through informal networks to benefit the economic interests and privileges of regime cronies connected to state elites. Moreover, having observed their economy passing the peak oil stage and being aware that the country will run out of oil over the next two decades, the elites might have developed shorter time horizons putting a premium on short-term expenditure over the privileges of holding public office in the longer term with less certain payoffs. As a result, the nexus of state-business elite—formed around shared kin, patronage, or regional lineage—deflected economic diversification in Azerbaijan and subdued it with the narrower interests of converting public funds into economic assets under elite private control. In sum, the private financial interests of the Azerbaijani elites and their short-term interests have led to stagnation in the non-oil sector and set in motion a pattern of unsustainable economic development.

#### *About the Author:*

Farid Guliyev successfully defended his PhD in Political Science at Jacobs University Bremen in December 2014.