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Azerbaijan's Fiscal Policy after the Oil Boom

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Azerbaijan's current fiscal stance is quite strong; however, this stability is completely based on oil-related revenues. In the meantime, the situation with alternative sources of fiscal revenues is uncertain. A large part of fiscal management is built on opacity and an assessment of budget spending efficiency has never been done. It is likely that Azerbaijan will only be able to maintain its fiscal stability through the next ten years or so, i.e. until the end of the active oil-extraction period. In the more distant future, a substantial fiscal correction will be necessary.

Disturbing tendencies

The general fiscal position of Azerbaijan is quite sustainable in the mid-term perspective. However, the long-term future does not look too brilliant. Over the last few years, several disturbing tendencies have been observed. In particular, it is important to highlight at least five of these challenges, which should be closely monitored and analyzed:

The first important point is the steady growth of the non-oil budget deficit. Azerbaijan heavily subsidizes the state budget from the State Oil Fund (nearly 60% of budget revenues). In addition, close to 15% of its own state budget collections are oil-related revenues. All in all more than 2/3 of public spending rely on hydrocarbons. Though this has been a problem for many years, recently it has gotten worse. For the last five years, the non-oil fiscal gap almost doubled from 19.1% GDP in 2008 to 32.0% GDP in 2012. And this trend had been developing against the approaching end of the oil boom. So far the problem is not critical since the State Oil Fund of Azerbaijan (SOFAZ) has impressive assets (55.3% of GDP end of 2011). However, over the next two decades, the non-oil deficit, which is currently only a technical estimate, will become an effective fiscal gap for the country.

The second issue is the size of SOFAZ assets. Though the assets are quite large, they will not be enough to balance Azerbaijan's public finances in the post-oil period. In relative terms, the assets accumulated over the last ten years by SOFAZ are enough to cover only 1.7 years of non-oil deficit[1]. Furthermore, over the last two years, SOFAZ slowed down accumulating oil revenues, spending a major part of them on current needs. In particular, in 2011, SOFAZ assets increased by only 29.0% (after a 51.8% increase a year earlier) and for 2012, the authorities are aiming for only a timid 0.9% assets' growth. Overall, between 2001 and 2011, SOFAZ accumulated in the form of assets about USD 7.1 bn less than it spent for the same period of time. If the current tendency continues, one can expect to see a strong fiscal correction in Azerbaijan at the end of the active oil extraction period (provisionally after 2024[2]).

The third challenge is related to the growing dependence of re-current spending, again, with oil-related earnings. Although the authorities declared their intention to use oil money only for investment needs, through the last years a large part of oil-related funds was allocated for re-current spending. In particular, by 2012, less than 50% of consolidated re-current spending was covered from non-oil fiscal collections. At the same time, the rest is now dependent on hydrocarbon proceeds.

The fourth concern is the lack of transparency of public debt management and quasi-fiscal activities. It is very likely that public debt is not a problem given the relatively high SOFAZ assets. However, only limited information is publicly available; only data for external debt is available, while internal debt and contingent liabilities are not published openly. In such an environment, public debt could become a problem quite unexpectedly and no one can guarantee a timely

[1] For the non-oil deficit, the general budget oil revenues are estimated as the sum of SOFAZ transfers to the budget and tax revenues from oil-related activities (less interest return on SOFAZ assets).

[2] Country Economic Memorandum -- Staying Focused on Diversification, World Bank, 2009.

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detection of risks. For example, in 2011 debt servicing costs increased sharply (almost quadrupling from $118 mn to $445 mn), which indirectly signaled the rapid accumulation of debt stock. Still the sum is probably not critical – but it is only an assumption (as we have no data). A similar situation is observed with quasi-fiscal activities. Azerbaijan has one of the largest quasi-fiscal activities in the region (43.3% of budget spent on economic activities in 2011, which are mainly state investment projects); however, developments in this realm are hardly transparent. The reports about the performance of state enterprises, if available, are quite general.

Finally, it is not clear what will be the source of tax collections after the end of the active oil extraction period. According to the World Bank[3], Azerbaijan only has sufficient oil and gas deposits until 2024 and, to make matters worse, the majority of the deposits has been already extracted. This situation promises economic stagnation followed by a gradual decline in oil earnings, while the perspectives for alternative budget revenues are not clear. Furthermore, the very definition of the non-oil sector that the Statistics Office of Azerbaijan uses is rather embellished: for instance, the transportation sector is treated as a non-oil sector while more than 80% of cargo turnover is related to oil and gas.

Comparative table on key fiscal indictors, 2010-2012

		2010	2011	2012
General government[1] deficit	% GDP	3.0	3.6	4.3
Net general government deficit (excluding all oil-related earnings[2])	% GDP	21.5	29.8	32.0
Net general government deficit , excluding capital transfers	% GDP	9.4	11.2	13.7
General government revenues	% GDP	30.2	39.8	41.2
General government expenditures	% GDP	33.2	43.4	45.4
Transfer from SOFAZ	% GDP	14.2	21.7	22.8
Net balance of Social Protection Fund (excluding transfer from the state budget and revenues from the enterprises financed from the state budget)	% GDP	-1.6	-2.1	-2.4
Re-current spending	% GDP	16.0	18.2	20.0
Capital spending	% GDP	12.1	18.6	18.2
SOFAZ assets	in yearly non-oil general government deficits	2.0	1.9	1.7
Return on SOFAZ assets	%	1.3	2.2	-
Revenues structure				
Total oil revenues	% of total revenues	67.5	71.5	73.2
Non-oil revenues		32.5	28.5	26.8
Spending structure				
National economy	% of total revenues	41.6	43.3	40.5
Social protection		9.5	10.1	10.5

[1] Defined as central budget, budget of Nakhchivan AR and Social Protection Fund.
[2] Oil-related earnings include SOFAZ transfer to the budget and tax revenues from oil-related activities (less interest return on SOFAZ assets).
Source: Own estimates based on data from the State Statistical Committee of Azerbaijan (actual GDP), Finance Ministry of Azerbaijan and SOFAZ (fiscal data), and Ministry of Economic Development of Azerbaijan projections and estimates (GDP in 2011–2012).

[3] Country Economic Memorandum -- Staying Focused on Diversification, World Bank, 2009.

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Preventing a slump

Although the fiscal accounts of Azerbaijan are signaling serious challenges, oil money makes these challenges only hypothetical at this stage. However, as the World Bank points out, the country does not have that much time to enjoy its hydrocarbon earnings. The authorities of Azerbaijan should act quickly to prepare for the day when the estimated non-oil deficit will become the effective fiscal gap. The following should be among the first-order actions:

1) a strategy for non-oil deficit management (with clear targets for the deficit in the post-oil period and a clear plan for reducing the non-oil deficit to a secure level beforehand);

2) an in-depth analysis of the non-oil sector and a system for monitoring non-oil sector development (with a potential state program for non-oil sector development);

3) an efficiency assessment of quasi-fiscal activities (with a possible revision of some quasi-fiscal programs);

4) a strategy for public debt management (with the targets and limits for the post-oil period).

As the country has more than a decade to go before it runs out of oil, Azerbaijan still has time to revise its approach to fiscal risks and develop an efficient set of tools to deal with the outlined problems. At this stage, the country can still avoid pitfalls and create reliable fundamentals for sustainable long-term non-oil growth.

This E-Brief summarises the results of a one week mission of Dmytro Boyarchuk within the CASE Advisory Service Technical Assistance Project in Azerbaijan: Advisory Service on Macroeconomic Management and Institutional Reform at the Ministry of Economic Development (MoED) of Azerbaijan: http://www.case-research.eu/strona--ID-projekty_chronologicznie,projekt_id-32574972,nlang-710.html

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