



Fiscal sustainability and the State Oil Fund in Azerbaijan[☆]



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ABSTRACT

Azerbaijan, like many resource-rich countries, decided to set up a sovereign wealth fund in order to avoid income volatility, to achieve intergenerational equity and to transform resource wealth into more productive assets. Azerbaijan established the State Oil Fund of the Azerbaijan Republic (SOFAZ) in late 1999 to accumulate income from hydrocarbon exports. SOFAZ has gradually become the leading part of the country's public finance system. Azerbaijan was the first country to fulfill all requirements of the Extractive Industries Transparency Initiative (EITI), an international agreement to implement global standards of transparency in the resource extracting sectors. However, SOFAZ's contribution to an effective resource revenue management and long-run economic development is still questionable: transparency applies only to the income side of Azerbaijan's oil fund while the expenditure side remains opaque. Unlimited and unconditional transfers from SOFAZ to the state budget have threatened fiscal sustainability and the overall macroeconomic equilibrium.

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1. Introduction

Resource-rich countries encounter specific challenges such as intergenerational equity of resource distribution, long-term macroeconomic stabilisation and fiscal sustainability. Institutional responses to the specific fiscal challenges in oil-exporting countries included conservative oil price assumptions in the budget, the establishment of oil stabilisation and savings funds and fiscal rules.

Oil and gas producing Azerbaijan, like many resource-rich countries, decided to set up a sovereign wealth fund (SWF) in order to respond to fiscal challenges, to avoid

income volatility, to achieve intergenerational equity and to transform resource wealth into more productive assets. To realise these goals the fiscal sustainability of such a SWF is of great importance. Fiscal sustainability is given when total public spending equals non-oil revenues plus the return on the present net value of future oil revenues. Oil-rich countries can achieve fiscal sustainability if they develop a fiscal system able to generate enough oil-related revenues to finance the non-oil budget deficit in the long-run.

Azerbaijan established the State Oil Fund of the Republic of Azerbaijan (SOFAZ) in late 1999 to accumulated income from its hydrocarbon exports. SOFAZ has gradually become the leading part of the country's public finance system. But the organizational set up is not the only pre-condition for fiscal sustainability, there is also a need for fiscal policy rules adequately responding to oil price shocks and resulting income volatility. In order to avoid spending inconsistencies and macroeconomic shocks on different production capacity, resource reserves, market price

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fluctuations and erratic spending behaviour natural resource-rich countries have to apply diverse fiscal rules.

These fiscal rules play an essential role for the optimal distribution of natural resource revenues. Notwithstanding that the government of Azerbaijan officially adopted the 'constant real expenditures' principle in 2004, in reality unlimited and unconditional transfers from SOFAZ to the state budget have threatened fiscal sustainability, effective revenue management and the overall macroeconomic equilibrium. In recent years, reckless spending by the government and a procyclical fiscal pattern were major factors jeopardizing fiscal sustainability. The lack of effective management of the increasing oil and gas revenues is still one of the major challenges for the government. That is why the main hypothesis of this article is that SOFAZ's contribution to prudent fiscal policies depends on the overall quality of institutions and the public financial management system in Azerbaijan.

A sustainable fiscal policy must take into account the volatile nature of revenues for safeguarding the national economy and the state budget against external shocks and price fluctuations. The aim of this article is to analyse the spending behaviour of SOFAZ and the government in terms of fiscal sustainability throughout the almost 15 years of SOFAZ's existence. This article investigates quantitatively and qualitatively whether the government's spending of oil and gas revenues – especially through SOFAZ – promotes long-term fiscal sustainability. The article starts with a brief outline of main definitions and indicators of fiscal sustainability. It then explains the analytically distinct patterns of possible links between fiscal sustainability and SWFs. Different fiscal rules applied in oil-exporting countries like 'permanent income hypothesis', 'bird-in-hand' and oil price assumptions are analysed in regard to their relevance for Azerbaijan. A brief conclusion draws out the implications of the analysis for the future of revenue management policy and fiscal sustainability.

2. Definition and indicators of fiscal sustainability

Sturm, Gurtner & Alegre (2009: 18) describe fiscal sustainability for oil-exporting countries as the guarantee that in the 'post-oil period the same amount of public goods or level of expenditure can be provided as in the oil period without resorting to deficit financing of public expenditure.' They distinguish fiscal sustainability and intergenerational equity, because 'if oil revenues are replaced by tax revenues, this would ensure fiscal sustainability but not necessarily intergenerational equity'. According to the OECD (2009: 86), fiscal sustainability 'encompasses government solvency, continued stable economic growth, stable taxes and intergenerational fairness'. In other words, sustainable fiscal policy is a policy that can be realized without any major changes in tax and spending patterns.¹

The development of the primary balance of the state budget (i.e., the difference between primary revenue and primary expenses) is a useful indicator to evaluate fiscal sustainability. Another important indicator is the fiscal gap,

defined as the 'permanent spending decrease or revenue increase that would be necessary at a point in time to ensure a specified debt-to-GDP constraint is met at the end of the projection horizon' (Bell, Blick, Parkyn, Rodway, & Vowles, 2010: 74).

Validating fiscal sustainability for resource-rich countries requires distinguishing between the resource and non-resource fiscal deficits. The size of the non-resource primary deficit and the rules for allocating current resource revenues from the SWF to the budget are very important for resource-rich countries. Fiscal sustainability analysis for these countries means exploring the influence of the non-resource primary fiscal deficit and SWF allocation rules on the distribution of public debt. In the case of Azerbaijan, the share of external debt stock in gross domestic product (GDP) declined while the share of SOFAZ's transfers to budget increased rapidly.

Generally, the problem of fiscal sustainability is especially severe in resource-rich countries because huge revenue inflows from the export of oil, gas or minerals can lead to an increased dependence on a highly volatile source of income creating two problems: (1) income volatility, and (2) exchange rate distortions by the inflow of resource revenues ('Dutch disease').² Therefore, high spending of current resource income converts income volatility into highly volatile expenditure with very serious economic consequences.

Despite the fact that there is no commonly accepted unique model of fiscal rules about optimal spending behaviours of governments of resource-rich countries, different applied models have already been analysed and categorized empirically. Iacono (2012: 2) emphasizes that effective fiscal rules should be 'backed by a strong political will and complemented by administrative reforms, also strong costs of deviations from the fiscally responsible behavior'. Robinson, Torvik, and Verdier (2006: 448) point out that one outcome of a resource boom for the resource dependent economies could be 'highly dysfunctional state behavior, particularly large public sectors and unsustainable budgetary policies'.

There are a number of approaches on how to cope with natural resource revenues (cf. e.g., Economic Research Center, 2009). The most widely used approach to managing volatile resource revenues is the permanent income (PI) approach, under which a volatile revenue flow is used to finance a constant stream of expenditure. This approach states that governments should try to smooth out consumption over time in line with permanent income. As a

² The term 'Dutch disease' broadly refers to the harmful consequences of large, but perhaps temporary, influx of foreign currency into an economy on exchange rates and eventually on trade balances, domestic production, and the availability and costs of credit. A large influx of foreign currency from natural resource exports can have serious repercussions on important segments of a country's economy, as the appreciation of the local currency diminishes the competitiveness of non-natural resource sectors, resulting in their contraction. Real exchange rate appreciation impedes economic diversification and increases dependence on volatile commodity markets, and thus there are likely to be significant adjustment costs in moving back to agriculture or into manufacturing following resource depletion or price slumps (Bornhorst, Gupta, & Thornton, 2009: 439; Davis & Tilton, 2005: 236).

¹ See also Schick, 2005.

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