



HAS THE SOVEREIGN WEALTH FUND OF AZERBAIJAN (SOFAZ) BEEN ABLE TO PROMOTE ECONOMIC DIVERSIFICATION?

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Abstract:

Oil-rich countries have often times been confronted with the challenge of diversifying their economies away from oil dependence given the exhaustible nature of these fossil fuels. Investing in sovereign wealth funds has been one of the most ubiquitous ways of preparing for the post-oil period. Investing in sovereign wealth funds rather than directly injecting the oil revenues in the economy not only precludes the outbreak of the Dutch Disease (which is known for giving rise to an exchange rate appreciation, crowding out non-oil industries and keeping the economy reliant on oil), but it also saves for future generations. Yet, in the case of Azerbaijan, the Sovereign Wealth Fund of Azerbaijan (SOFAZ), founded in 1999, has only increased this reliance on oil. Using the rentier states theoretical framework, this paper will argue that the direct control over SOFAZ exercised by the president and the lack of consultation with the NGOs have made corruption easier, making the task of economic diversification more difficult. This has been possible because through corruption the president has often resorted to oil money to buy peace rather than invest it in economic diversification. As a result, since the foundation of SOFAZ, the country is more reliant, not less, on oil.

Introduction

Oil is an exhaustible fossil fuel. The effective utilisation of this “black gold” before it gives out has been one of the intractable developmental conundrums of developing countries. Often times, its role in stimulating economic development has been called into question. Authors such as Sachs and Warner (1995), Karl (2004), and Ross (2001), have argued that oil-based economies face several challenges such as unsustainable economic performance, corruption, and poor management of revenues. Given that at their present-day production levels resources are limited, they have to diversify their economy away from oil in order to better ensure a brighter future. Yet, one of the obstacles to economic diversification has been the “Dutch Disease¹.”

In order to stave off the adverse economic effects of the Dutch Disease, many oil-rich countries started collecting their oil proceeds in special funds, often known under the name of “sovereign wealth funds”. The goal was not only to curb the Dutch Disease, but to also help diversify the economy for future generations so that the economy will be less dependent on oil. SOFAZ, the State Oil Fund of Azerbaijan is one such fund. Founded in 1999 under a presidential decree, the SOFAZ had pretty much the same goals as many of the existing oil funds in the Middle East: reducing Azerbaijan’s dependence on oil, keeping oil revenues for future generations, and funding national socio-economic projects (Aslanli 2010, 8-11). Yet, the level of corruption in Azerbaijan and the exclusive control of SOFAZ by the president of Azerbaijan, Ilham Aliyev, have been hindering effective management of the State Oil Fund, making it difficult to achieve this foundational objective of the SOFAZ. More than 13 years since its foundation, the fund’s ability to reduce Azerbaijan’s dependence on oil has backfired. Azerbaijan’s exports today are more dependent on oil than ever. What is more, although the rate of unemployment and poverty have dropped, this has happened with constant transfers from the oil fund into the state budget (CESD 2012), which indicates that SOFAZ is not adequately meeting its central objective of preserving oil money for future generations.

Why did the establishment of the SOFAZ not reduce Azerbaijan’s dependence on oil? This paper will try to respond to this research question by problematizing the institutional structure of the SOFAZ. As such, our hypothesis is as follows: “The direct control over the SOFAZ exercised by the president and the lack of consultation with non-governmental organizations (NGOs) have made corruption easier, making the task of economic diversification more difficult. This has been possible because through corruption the president has often resorted to oil money to buy peace rather than invest it in economic diversification”. This paper will use the rentier states theoretical framework to explain Azerbaijan’s growing dependence on oil.

Part I will focus on the theoretical framework. In part II we will highlight the importance of oil for Azerbaijan through a historical analysis followed by a synopsis of the SOFAZ and its foundational objectives. Afterwards, by means of the theory of rentier states, we will try to highlight two phenomena: firstly, the oil wealth in Azerbaijan has made the state stronger and

¹ A commonly occurring phenomenon in countries with high resource revenues, the Dutch disease, dubbed after the adverse effects of natural gas discoveries in the Netherlands in the 1960s on the manufacturing sector, refers to economic problems arising from the injection of large mineral resources into the economy. This problem usually arises when the real-exchange value of the local currency becomes over-valued, making exports of non-mineral resources less attractive. As a result, the non-mineral manufacturing sector suffers in what is called the “crowding out” effect of the Dutch Disease (Gelb 1988).

richer. As a result, the state has managed to buy peace in exchange for an increasingly better quality of life and a lower level of taxation. Secondly, as a corollary of the first phenomenon, buying peace through rents has also reduced the accountability of the state to the population, making the state more authoritarian as well as more autonomous from society. Part III will highlight the pervasiveness of corruption in Azerbaijan due to the existing rentier institutional structure.

Part 1: Theoretical Framework

The rentier state theory, introduced by Hossein Mahdavy (1970) and improved by Beblawi and Luciani (1990) suggests three characteristics that determine whether a given state is rentier: 1) the economy relies on a substantial amount of external rents and therefore does not require a strong domestic productive sector 2) only a small proportion of the working population is actually involved in the generation of these rents 3) the state is the principal recipient of these rents (8-11). As a result, the state does not necessarily need fiscal revenues to carry out its functions. As mentioned by Alan Richards and John Waterbury, rents allow governments to avoid heavily taxing their citizens, breaking the vital link that unites governments with taxpayers (1996, 17). This gives rise to a lack of accountability on the side of the government towards its citizenry. Hence, the famous adage of “*no taxation, representation*”.

According to Terry Karl, since these states live from oil rents rather than from direct taxation, they are likely to tax their populations lightly or not at all. Thus, they are unusually detached from and unaccountable to the general population, and their populations, in turn, are less likely to demand accountability from and representation in government. As a result, the state becomes more authoritarian, and represses dissent with force, harming democracy (2004, 667).

Such monopoly of the state on the economy enables it to buy peace and stability through rents. In other words, one portion of the wealth is used to better the lives of the population in order to keep the regime stability intact. In such an atmosphere where the material needs of a population are met to a certain extent, corruption² (rent-seeking) becomes one of the guiding principles of regime stability. According to Karl, corruption contributes to the “resource curse”. Rulers will support policies that produce personalized rents even if these policies result in lower overall social welfare; because they need to share these rents with supporters and subordinates, the level of distortion can be very great (2004, 667). Paul Collier highlights the excessive use of resources to finance election campaigns by directly bribing the electorate or smaller political parties, and consequently having to pay for this after a victory. As a result, the need to find money to pay these expenses can lead to corruption in managing the public finances and the government’s investment projects (2007, 43–44).

Consequently, the state, with the support of its subordinates and supporters, becomes more autonomous from society. As mentioned by Theda Skocpol, Dietrich Rueschemeyer, and Peter Evans, such autonomy refers to the demarcation of state interests from those of society. Natural resources provide the state with the capacity to become more autonomous from society (1985, 9). In the case of Azerbaijan, we will attempt to apply the rentier state theory of Beblawi and Luciani in order to find out whether it satisfies the conditions laid out by the authors. Has the

² Corruption refers to misuse of public power or resources for private gain (Karl 2004, 661).

state become more autonomous from society? Afterwards, the research will analyse how the institutional structure of the SOFAZ —initially founded for a better use of oil revenues in order to accelerate economic diversification— has made corruption inevitable, making economic diversification of Azerbaijan increasingly difficult.

Part 2: Oils and Rents

2.1 Oil in Azerbaijan

Oil drilling in Azerbaijan took off during the second half of the 19th century although the presence of oil during a previous era had already been documented. Oil production was first launched in the country around the Absheron Peninsula where the capital city of Baku is also located. According to Sabit Bagirov, in 1940 Azerbaijan provided 71.5 per cent of the total oil output of the Soviet Union. From the beginning of the 1920s until the beginning of the Second World War, Azerbaijan remained a world centre for oil science and technology. During the period between 1941 and 1945, Azerbaijan provided 63.2 per cent of the output in the Soviet Union. Yet as a result, production slowed down since the resources of the constantly exploited onshore oilfields were exhausted and none of the newly discovered fields could prove their profitability. At the same time, extraction from the known fields became increasingly expensive (1996, 4).

Although the oil production went through a short decline in the immediate aftermath of Azerbaijan's independence in 1991, it was in 1994, with the signature of the *Contract of the Century*³, that oil production in Azerbaijan regained its long-forfeited momentum. According to Oksan Bayülgen, the *Contract of the Century* was unprecedented because not only did it involve more than 33 oil companies from 15 countries, but also the net value of the contract was around 60 billion dollars (2003, 209). Thanks to the positive effects of this agreement, Azerbaijan's oil production reached 1.1 million barrels per day in 2011 (Energy Information Administration 2012), a dramatic increase from its former production level of less than 200,000 barrels per day (Rosenberg and Saavalaninen 1998). Azerbaijan's oil production more than quadrupled, making the Contract of the Century a watershed for Azerbaijan's post-independence socio-economic development. According to Bayramov, by the end of 2009, Azerbaijan, a country with a population less than 10 million people, would make \$30 billion annually from oil sales alone (Bayramov 2009, 7).

However, given such an impressive boost in oil production, oil's limited lifetime at the current production levels also became quite alarming. According to Farid Guliyev, considering that the oil production would peak in 2010, Azerbaijan's oil resources would have been completely depleted in 22 years (2009, 4). That is why a few years after the signature of the Contract of the Century, SOFAZ, the State oil Fund of Azerbaijan, was founded under a

³ Hailed as a great success for President Aliyev, the *Contract of the Century* envisaged the development of three offshore fields Chirag, Azeri and Gunesli, the richest of the oilfields on the Caspian coast, with US\$8 billion foreign investment over the course of 30 years (Bayülgen 2010, 219; Asadov 2009, 94).

presidential decree. To this day, the oil sector remains entirely state-owned. The government owns the resource and the installations (Ciarreta and Nasirov 2012, 17).

2.2: SOFAZ: Foundation and Transparency Initiative

One of the biggest economic hurdles of oil-producing countries is, as mentioned in the introductory section, the pervasiveness of the Dutch Disease. As such, one of the principal objectives of the SOFAZ was to curb the outbreak of the Dutch Disease. Hence, it aimed to keep the windfall oil revenues outside of circulation in order not to heighten the rate of inflation. Simultaneously, it was also tasked with saving the oil revenues for future generations by investing them in projects tailored for socio-economic development and for economic diversification of Azerbaijan.

According to Farda Assadov, a significant proportion of the receipts from oil companies, with the exception of direct tax payments, accumulate in the SOFAZ (2009, 98). In fact, according to Gubard Bayramov and Patrick Conway, as of January 1, 2010, SOFAZ had accumulated \$15 billion, and the SOFAZ Executive Director Shahmar Movsumov predicts that by 2023 SOFAZ's funds may reach more than \$200 billion (2010, 2). However, this abundance of revenues has made Azerbaijan more dependent on oil. According to Ciarreta and Nasirov, the non-oil economy is mainly driven by state expenditures through transfers from the SOFAZ, and its share of GDP is falling as those transfers increase (2012, 284).

Following the approval of the amendments in the state budget in May, 2011, \$12.1 billion was transferred from the oil fund to the state budget in 2011 alone, which is a 41.7 percent increase on the previous forecast and represents 59 percent of total budget revenues (Center for Economic and Social Development 2011). These increasing transfers were also diminishing the savings for the future while raising questions about the transparency of their use. It should be highlighted that transferring funds from the SOFAZ for the purpose of investing it in the non-oil sector is consistent with the foundational objectives of this fund, as this will provide benefits for future generations. However, what is worrisome is the fact that this money was used for expenditures such as salary increases, pensions, and debt payments, which do not result in economic diversification.

Mindful of such developmental hurdles lurking on the horizon, the Azerbaijani government showed goodwill by registering the SOFAZ with the Extractive Industries Transparency Initiative (EITI). Launched by the British government, this initiative seeks to enforce the declaration and certification of money received as revenue by national governments from natural resources extraction. This initiative was made possible through the pressure of a slew of civil society organisations including the Open Society Institute (Asadov 2007, 96). Unlike a number of resource-rich states that showed—and in certain cases continue to show—reluctance to join the EITI, the Azerbaijani government announced it was joining the initiative at the first EITI summit in London in 2003 (Collier 2007, 143). As a result, according to an International Monetary Fund (IMF) report published by Wakeman-Linn et al. (2004, 11), the SOFAZ, although under direct presidential control, has improved the transparency of its reporting since joining the EITI.

Yet, this optimistic picture is not necessarily shared by everyone. According to Guliyev (2009), and Bayülgen (2010), direct presidential control has been the biggest obstacle to the

effective use of the windfall oil revenues. The authors also share the pessimistic view that as long as the institutional structure of the SOFAZ does not change, and civil society is not incorporated into the decision-making body of the oil fund, no meaningful advancement can be attained in the realm of fighting corruption and prioritising economic diversification. According to the Crisis Group, although SOFAZ has joined the EITI in a bid to improve its transparency, the EITI does not cover spending from the fund, and large sums are thereby lost through misappropriation and inefficient spending (2010, 3). As brought up by these sources, has Azerbaijan's dependence on oil diminished since the foundation of the SOFAZ in 1999? If not, is corruption to blame?

2.3: SOFAZ and the Azerbaijani Rentier State

Contrary to its foundational objectives, the SOFAZ has not made Azerbaijan less dependent on oil. Since its foundation, the share of oil revenues has, as a percentage of export revenues, risen steadily. For example, according to Paul Jones Luong and Erika Weinthal, between 2005 and 2010, oil revenues have constituted 90 percent and 97 percent of the revenues, respectively (2010, 219-258).

These revenues have accrued to the coffers of the state directly, making Azerbaijan much richer than ever before. As mentioned by Asadov, since the deep oil is owned by the state, this means a leap in budget credits, of which 60 per cent are already met today by oil revenue. For comparison, in 2002 while the state budget was around \$1 billion US, in 2007 it reached the sum of \$7 billion US, and in 2011 budget predictions indicated an amount of \$15 billion US (2009, 96).

In spite of such a huge share of oil generating government revenues, the percentage of the population working in the oil sector was incredibly low. According to Carrieta and Nassirov, current estimates indicate that the oil and gas industries are only responsible for a little over 1 percent of employment in Azerbaijan, while agriculture employs nearly 50 percent of the country (2012, 283). Consequently, the increasing share of the oil revenues, the control exercised by the state⁴ on the management of these revenues, along with the fact that only a very small percentage of the population is directly involved in the oil industry make Azerbaijan a typical rentier state.

As is the case in many other rentier states, the abundance of oil revenues in Azerbaijan has also curtailed the enforcement of the New Tax Code adopted in 2001. The state has been reluctant to fully implement it, causing the informal economy to flourish in different areas of the country. According to Luong & Weinthal, Azerbaijan is host to a large informal economy. As a result, the state is for the most part devoid of the capacity to properly collect taxes. Referred to as a "shadow economy" by the authors, this informal economy accounts for 61 percent of the country's GDP (2010).

While the windfall oil revenues have directly accrued to the state, they have also enabled Azerbaijan to make some impressive economic strides. Whereas upon independence the poverty rate was situated at 45 percent (Wakeman-Linn 2004), it fell to 11 percent in 2009 (CIA Factbook). Arguably, the most significant achievement has been made in the realm of tackling

⁴ In this case, the president, since the oil revenues accrue directly to the SOFAZ, which is exclusively managed by the president.

unemployment, which fell precipitously from 45 percent in 1995 to only 1 percent in 2011 (IMF 2004). The bulk of these newly created jobs are attributable to an exponentially growing economy. Most of these jobs have been created in the public sector with the help of the oil revenues. For example, according to the International Labour Office (ILO), since late 2003, some 900,000 new jobs have been created in Azerbaijan, of which over 50 percent are permanent. In terms of the sectorial groupings used by Azerbaijan's State Statistical Committee, the largest employment sectors are education (25.1 percent), maintenance of transport networks (19.5 percent) and health and social work (10.1 percent). This is consistent with the Government of Azerbaijan's commitment to 'full employment' (2012).

While the immediate aftermath of the independence era saw an economic contraction in the country, the development of the oil and gas sectors has propelled an immense economic growth after the crisis. This economic contraction was so severe that during the 1989–94 period, the economy contracted by 63 percent. Yet, GDP growth averaged 16 percent a year during 2001–2009. Oil revenues even increased more than predicted due to an upsurge in oil prices on world markets (Ciarreta and Nasirov 2012, 282).

However, at the same time as the seemingly positive economic trends mentioned above, which have been engendered by an upsurge in oil production, there has also been a corresponding deterioration as far as democracy is concerned confirming once again the rentier state hypothesis that posits the adage of '*no representation without taxation*'. As can be seen from Figure 1 obtained from Freedom House, since 2003, there has been a marked and progressive deterioration of Azerbaijan's democracy score. What is eye-catching is that this deterioration has taken place against the background of increasing oil exports (Figure 2), which have accrued exclusively to the government's coffers, reinforcing its autonomy against civil society.

According to Freedom House, civil society has borne the brunt of an intensifying authoritarian crackdown. The restrictions imposed on foreign NGO's have led to the shutting down of the Human Rights House in March 2011. As a result of a harsh crackdown on civil society, Azerbaijan's civil society rating has declined from 5.75 in 2012 to 6.00 in 2012 (2012, 85). The same report also indicates that the opposition has been muzzled with renewed authoritarianism and a more intense crackdown by the government. Consequently, the authorities have serious political rivals. Moreover, civic and political apathy is widespread (Ibid, 92). This civic and political apathy mentioned by the Freedom House seems to be giving greater ammunition to the government to repress dissent.

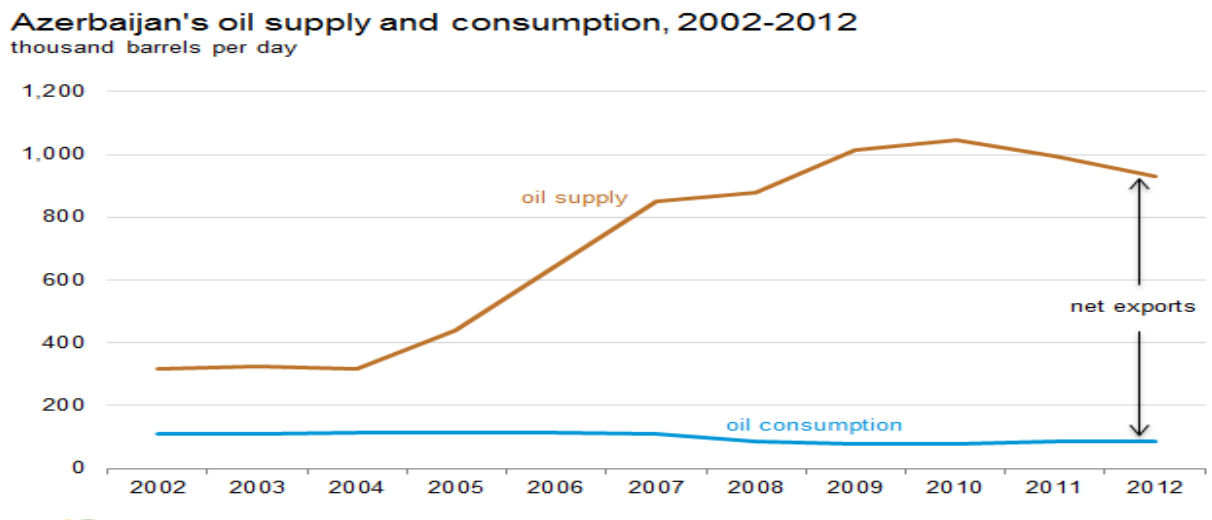
According to Aytan Gahramanova, not only does the state position itself as the only legitimate supplier of public goods, but most of the population also continues to view the state as the main defender of public interests. State authority is viewed as a force beyond the influence of ordinary citizens (2009, 789). Such a level of resignation to state authority has been a factor fuelling social apathy in Azerbaijan.

Figure 1: Nations in Transit Ratings and Averaged Scores: Azerbaijan (Freedom House 2012)

Nations in Transit Ratings and Averaged Scores										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Electoral Process	5.75	6.00	6.25	6.50	6.50	6.50	6.75	6.75	7.00	7.00
Civil Society	4.25	4.50	4.75	5.00	5.25	5.25	5.50	5.75	5.75	6.00
Independent Media	5.50	5.75	6.00	6.00	6.25	6.25	6.75	6.75	6.75	6.75
Governance*	5.75	5.75	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
National Democratic Governance	n/a	n/a	6.00	6.00	6.00	6.00	6.25	6.50	6.50	6.75
Local Democratic Governance	n/a	n/a	6.00	6.00	6.00	6.00	6.25	6.25	6.50	6.50
Judicial Framework and Independence	5.25	5.50	5.75	5.75	5.75	5.75	5.75	6.25	6.25	6.50
Corruption	6.25	6.25	6.25	6.25	6.25	6.25	6.50	6.50	6.50	6.50
Democracy Score	5.46	5.63	5.86	5.93	6.00	6.00	6.25	6.39	6.46	6.57

Reproduced with permission from: "Azerbaijan," in Freedom House's *Nations in Transit* (2012, 85)

Figure 2: Crude Oil and Products Exports and Consumption



Reproduced with permission from: "Azerbaijan," in U.S. Energy Information Administration, *International Energy Statistics Database* (2013).

It can also be argued that the favourable economic situation created by the ruling government has been another factor propelling the political and civic apathy mentioned above by Freedom House. According to a survey⁵ conducted by Shannon O’Lear, less than 35 percent of the population believes that their well-being has worsened over the past 5 years (2004, 217), while 70 percent of the population believes that Azerbaijan has grown more democratic⁶ (Ibid, 219). Moreover, the overwhelming majority of those surveyed believe that the incumbent government has improved Azerbaijan’s international stature. What is noteworthy from the survey is that the public is more concerned with Azerbaijan’s international positioning and the improvement of their material well-being than democracy. As such, the survey also concludes that for the time being, the government enjoys enough legitimacy and support to stay in power.

A 2011 survey commissioned by the Caspian Information Centre in Azerbaijan and conducted by the British Firm, Populus Limited, found results⁷ that more or less converge with O’Lear’s survey findings. The Populus Limited survey found that 79 percent of the population believes that the country is heading in the right direction. The survey also indicated that 54 percent of the population noticed an improvement in their quality of life. Moreover, 75 percent of the respondents stated that they trusted the government while 82 percent thought that Azerbaijan’s international standing was improving (Caspian Information Center 2012).

On balance, the government of Azerbaijan has capitalized on its oil rents to put a lid on social discontent. As mentioned by Jana Kobzova and Leila Alieva, the regime has thus far managed to avoid dangerous levels of instability. Oil revenue has enabled it to placate society through social spending (2012).

Part III: Economic Corruption and Diversification

3.1 The SOFAZ and Corruption

Corruption is a major problem in the Republic of Azerbaijan. According to Revenue Watch, despite a slight improvement, Azerbaijan still remains amongst the top 30 most corrupt countries in the world (2012). Transparency International as well highlights the extent of corruption giving Azerbaijan a score⁸ of 2.7 out of 10, registering a slight improvement of 0.7, yet, just like Revenue Watch, making a caveat about the gravity of corruption in the country (2012). According to the Freedom House, however, the corruption in the country has steadily increased between 2003 and 2012, providing a bleaker picture than Revenue Watch (2012).

⁵ This survey is a sample of 1200 Azerbaijani citizens, 604 males (50.3 percent) and 597 females (49.7 percent). The respondents ranged in age from 18 to 85 and represented 16 different ethnic groups.

⁶ Despite the fact that international organizations, like the Freedom House, indicates the contrary.

⁷ It should be noted that this survey, although more or less confirming the findings of the previous one, should also be taken with a certain grain of salt as it has been commanded by an Azerbaijani government agency. Yet, its inclusion is pertinent as several aspects of it find results that are akin to the Shannon O’Lear’s survey.

⁸ According to the scale of Transparency International, a score of 10 out of 10 indicates the least corrupt regime while a 0 out of 10 is the most corrupt. In this regard, the score attributed to Azerbaijan, 2.7, is patently a very low one, indicating the pervasiveness of corruption.

The extent of this corruption, notably in the oil sector, is particularly alarming. According to a US State Department Report, corruption, cronyism, and other crimes remain key problems for Azerbaijan's oil and gas resources (U.S. State Department, Bureau of Economic, Energy and Business Affairs 2011).

Against the backdrop of such corruption allegations, the government has variously resorted to the oil fund under the pretext of grandiose development projects over the past few years. The SOFAZ contributes to the state budget to finance investments in such realms as infrastructure, education, poverty reduction and other social projects.

Despite its positive contributions to the budget, the institutional structure of the fund has rendered it vulnerable to corruption. According to Farda Assadov, decisions regarding state finances are made in the habitual style of management that has much in common with former Soviet practices (2009, 99). The discretionary power exercised by the president as far as the spending of the fund is concerned makes it less accountable to the public. The fund's governance structure is weak. Although its regulations hold that "the fund shall be accountable and responsible to the President of the Republic of Azerbaijan," there are no checks and balances to limit the president's discretion (Revenue Watch 2012).

Such a weak governance structure coupled with the exclusive powers accorded to the president, raises the necessity of the involvement of NGOs to promote greater transparency. According to Assadov, the SOFAZ investment programme and control over its effectiveness could not be managed without the representative participation of civil society (2009, 99). Thus far, civil society has been excluded from the decision-making process of the oil fund's spending.

Consequently, according to the Business Anti-Corruption Portal, such an absence of civil society has proven very pernicious. In fact, under the Presidential Bureau, headed by the executive director of SOFAZ, Samir Shamirov, top politicians have misappropriated the fund's money. For example, the government spent a large sum of money from the SOFAZ to pay pensions and raise civil service salaries in a presidential election year (2011).

Since independence, no serious privatisation plans were undertaken in Azerbaijan. Partial economic reform went no further than handing some state-owned enterprises to regime cronies (Guliyev 2012, 3-4). In an increasingly authoritarian setting with access to the oil money, a new elite comprised of these cronies close to the president has emerged. Their relationship to the president evokes of patron-client relationships. According to the Crisis Group,

The Azerbaijani elite represents a symbiosis of family networks and bureaucratic/business interests. They can be divided into three groups: the faction led by the president's chief of staff, Ramiz Mehdiyev, which many refer to as the "old guard"; Ilham Aliyev's protégés, often called the "oligarchs", with whom he shares business interests and whom he uses to counterbalance other forces within the elite; and the extended "Family", the president's untouchable relatives (2010, 8).

Mehdiyev's faction is the most consolidated within the ruling elite. According to the Economist Intelligence Unit (EIU), known as the "grey cardinal", Mehdiyev, the head of the presidential administration, played a leading role in the transfer of power from the late Heydar Aliyev to the current President (2006).

As for the oligarchs, according to the Crisis Group, these consist primarily of Kemaleddin Heydarov, the transport minister, Ziya Mammadov, and the president of the State Oil Company, Rovnag Abdullayev. Heydarov has built a large business empire and is widely believed to be the wealthiest person in the country after the president and his family. However, the “oligarchs” biggest disadvantage is that although they earn huge profits from the oil rents allocated by the president, they are still treated as a source for funding his interests and those of his immediate family (2010). Finally, the family of President Aliyev, with his direct access to the oil fund, is by far, the richest in the country (Ibid). According to Radio Free Europe, “Aliyev's family has been tied to numerous suspicious business dealings in the past. First lady Mehriban Aliyeva and her two daughters are believed to control several of the country's largest banks” (2013).

Although the government appears to have pacified the population through rents and better economic conditions, the level of corruption has been causing widespread public dissatisfaction in society. This dissatisfaction is confirmed by the aforementioned surveys conducted by O’Lear. The author confirms that although the government seems to have bought peace through the rents, more than 75 percent of the population is dissatisfied with the way corruption is handled by the government (2007, 219). O’Lear also notes that while there has been a marked improvement in the material conditions of the citizenry, perceptions of inequality —due to an asymmetric division of the oil wealth— have also been running high.

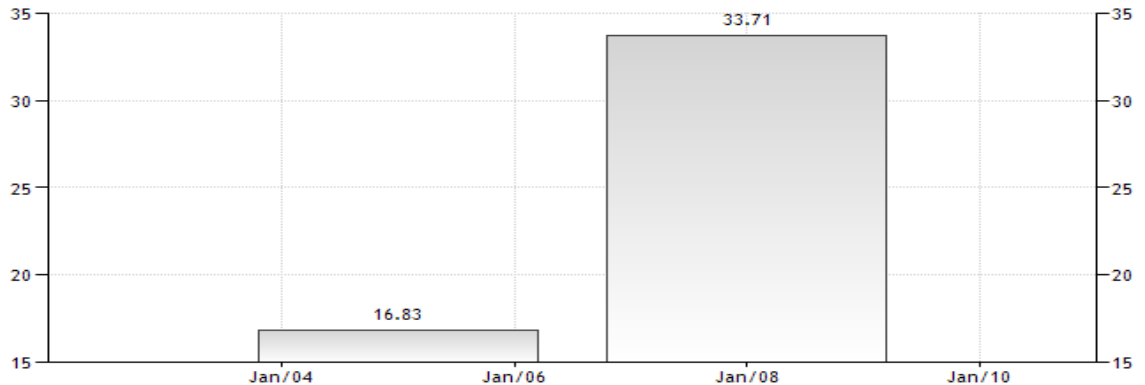
According to the EIU, in 1999, nominal wages increased at over 9 percent from the previous year, and by 2004 they were increasing at an annual rate of over 25 percent⁹. This growth in wages, however, is unevenly distributed in favour of employees in the oil industry and related sectors and has not been realised in the agricultural and social sectors (2004).

The statistics gathered by the World Bank also support the claim that inequality has increased, as the country has grown wealthier. As seen from the following figure (Figure 3), between the period of January 2006¹⁰ and 2008, the level of inequality has risen significantly. In the year 2006, the Gini co-efficient¹¹ value for Azerbaijan was 16,83 whereas within only two years it rose to 33,71. In other words, while the growth rate has been phenomenal, it also expanded the gap between the rich and the poor.

⁹ It is also noteworthy to highlight that this increase in nominal wages has taken place while the inflation rate in Azerbaijan has been at a very insignificant level. According to UNESCAP, inflation did not exceed 2.3 percent in Azerbaijan since 1996 and climbed up to 6.7 percent only in 2004 and was 8.3 percent in 2006 (2007). Yet, according to International Labour Office, wage exponential increases in nominal wages pushed the inflation rate to 16.7 percent in 2007 and to 20.8 per cent in 2008 (2012, 2). This high inflation only started to decline progressively after 2008 (ibid, 3).

¹⁰ The year 2006 is an important one for Azerbaijan as it was in 2006 that Azerbaijan registered a phenomenal economic growth. According to the International Monetary Fund, Azerbaijan registered its highest economic growth in 2006 with a growth rate in excess of 31 percent in one year. The growth is attributable to the oil and gas industry (International Monetary Fund 2007).

¹¹ The Gini co-efficient is the internationally used measure to indicate inequality. Whereas a Gini co-efficient of 0 indicates perfect equality, a Gini co-efficient of 100 indicates perfect inequality. In the case of Azerbaijan, since this value shifted from 16.83 in 2006 to 33,71, the level of inequality has aggravated.

Figure 3: Gini co-efficient in Azerbaijan 2006 versus 2008

Reproduced with permission from: "Azerbaijan," *Through Trading Economics* (2009).

In addition to income inequalities, the concentration of oil in the hands of the president and his cronies has also created regional inequalities. As such, the oil revenues have not been trickling down to all the regions equally. According to David Hoffman, regions outside of the Absheron Peninsula¹² had been for the most part neglected. Amongst them is the second largest city, Gyandja, where even the most basic of government services, such as natural gas supplies or road repair have not been provided in years (1999, 19).

3.2 Whither Economic Diversification?

With a population largely placated by rentier politics, an effete civil society that is not included in the decision-making process of the SOFAZ, a high level of corruption, and the presence of oligarchic figures, is the goal of economic diversification possible?

In 2012, Economic Development Minister, Shahin Mustafayev, asserted in parliament that over 500 industrial facilities would open in 2013 and expand the economy's non-oil-related sectors by more than 18-percent, plus bring in an additional 500-million manats¹³ (\$637.2 million) in tax revenue. However the long-term feasibility of such a promise remains low (Abbasov 2012). Moreover, the rentier characteristics of the economy are not easy to shed.

¹² This is the peninsula that is not only home to the nation's political capital, Baku, but it is also close to the major oil fields.

¹³ The currency of Azerbaijan.

According to the Finance Monitoring Center Director, Ingilab Ahmadov, although the Azerbaijan's construction sector has been booming, tax revenues have not been reflecting this boom as the country is still devoid of the administrative capacity to collect taxes (Ibid). This lack of administrative capacity makes resorting to oil revenues all the more attractive, making diversification a difficult goal to attain.

However, according to Wright, non-oil growth, particularly when government spending funded by oil revenue is excluded, has been anaemic at best. The result is an increasingly unbalanced economy even compared to other petroleum exporters (2011). According to Guliyev, given the excessive reliance of the economy on oil in Azerbaijan, the private sector tends to shrink over time, while the only survival strategy for private companies is to secure access to government contracts for building physical infrastructure and providing services to the oil industry (some of the very few spillovers from the oil sector) (2012).

According to Norio Usui of Asian Development Bank, exports accounted for more than 60 percent of the total GDP of Azerbaijan in 2006, up from 36 percent in 2003. Oil constituted more than 90 percent of the export earnings of the country. Yet, the share of non-oil exports in the GDP stood at less than 5 percent (2007, 6-10).

To make the matters worse, according to an IMF report, following the world financial crisis of 2008, Azerbaijan adopted a series of revenue measures to mitigate its impact. In particular, the authorities reduced the corporate and personal income tax rates, and exempted banks and insurance companies from taxes on profits used for certain purposes. Yet, ever since, these more lenient fiscal policies have been difficult to undo, making it indispensable to resort to the oil fund (International Monetary Fund 2012, 9)

Furthermore, the main obstacle to investment, one way of diversifying the economy, is the high level corruption in the country. According to Aitor Ciarreta and Shahriyar Nasirov, the existing legacy of corruption dates back to Soviet times and currently the huge injections of money from the oil and gas sector are considered as the greatest sources of corruption in Azerbaijan. In recent years the government has established a state commission on anti-corruption measures, e.g. legislation has been introduced requiring public officials to disclose their assets on an annual basis. However, this legislation has not been very efficient (2012).

The inefficiency of this legislation is also confirmed by the Heritage Foundation's study, which blamed the judicial and institutional environment that has impeded foreign investments:

The judiciary is burdened by extensive non-transparent regulations and interference from the executive. Contract enforcement can be lax. Despite some progress, corruption continues to cause concern. The judiciary and police are susceptible to bribery, and businesses abuse their relations with government to gain monopoly control of major industries. The property registration system is awash with bureaucratic requirements... Government regulations add to the costs of foreign investment, and monetary instability adds to uncertainty (Heritage Foundation, 2013).

Consequently, the government has increasingly resorted to the oil fund in order to propel Azerbaijan's socio-economic development. According to Kuralbayeva et al., Azerbaijan started

to consume too much of its revenues between 2001 and 2007, although it took steps that led to a large increase in savings in 2008 and 2009 (2010). Yet, the growing dependence on oil revenues is not likely to subside soon as it is foremost underpinned by corruption that has not shown tangible signs of improvement since 2003, and has become worse (Freedom House 2012).

This increased recourse to oil revenues has also created a vicious cycle of real exchange value appreciation, incapacitating non-oil sectors as is often the case with oil-rich countries. In fact, according to Montague Lord and Vugar Ahmadov, for macroeconomic factors, Azerbaijan's oil sector boom has created a 'Dutch disease' that is undermining the competitiveness of the non-oil sector through an appreciation of the real exchange rate and by raising factor input costs. As a result, the rapid expansion of the oil export sector, which now comprises over one-half of the economy, runs the risk of impeding growth in the non-oil sector and promoting the rapid repatriation of profits from the oil sector, as has already occurred in 2007-2008 (2008).

Conclusion

This paper has emphasised the impressive economic rise of Azerbaijan thanks to its oil resources and the future challenges created by this new wealth. Following its poor economic performance after its independence, Azerbaijan's economy grew rapidly through the signature of the *Contract of the Century* with major investors in its oil fields. It was this contract that enabled the country to amass windfall revenues from the oil sector. Yet, immediately after its signature, Azerbaijan was also confronted with the dilemma that many major oil producers have encountered: how to effectively use its oil revenues in order not only to diversify the economy, but also to improve the socio-economic stature of its population, especially in the light of the fact that the existing resources would only last for a very short stretch of time.

That is why, under a presidential decree, SOFAZ, the State oil Fund of Azerbaijan was founded in 1999. However, more than a decade into its foundation, while Azerbaijan's economy has more than tripled, not only has it become more dependent on oil, but these windfall oil revenues have ushered in a level of corruption. Simultaneously with this increasing dependence on oil, Azerbaijan has become more rentier with a corresponding lag in the development of a fiscal system and a growing authoritarianism.

As a result, while the material needs of the population were met to a certain degree, giving rise to a temporary peace and stability, the government of Haydar Aliyev has also created an oligarchy of his supporters. Since Aliyev has got the final word on the way that the oil fund, SOFAZ, is expended, corruption has continued to remain a major problem in Azerbaijan. As the level of corruption, especially with regards to the management of SOFAZ, has proceeded apace, Azerbaijan has not been able to diversify its economy away from oil and gas. This high level of corruption has had a negative impact on the business climate in the country, making the GDP growth extremely dependent on oil. Yet, this increasing dependence on oil and the frequent use of the oil fund have also created this vicious cycle of crushing non-oil industries by causing an exchange rate appreciation, known as the 'Dutch Disease'.

For the continuity of its economic growth and to better embrace a prosperous future, Azerbaijan needs to seriously tackle corruption, starting with the management of SOFAZ. The

involvement of civil society groups and NGOs into the decision-making process is one of the essential components of such a success.

While the Azerbaijani government appears to have silenced civil society at the same time as it has been investing in social development, and while society appears to be adequately controlled through an authoritarian state, the level of dissatisfaction with regards to corruption remains high. In the face of growing inequalities and an increasing level of corruption, the government's policy of buying peace through rents may run into hurdles in the future.

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