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THE EMPTY BUCKET OF THE STATE OIL FUND OF AZERBAIJAN

PROFITS AND PROFITEERING

BY GUBAD IBADOGHLU AND CRUDE ACCOUNTABILITY

2020

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About the Authors

CRUDE ACCOUNTABILITY

Crude Accountability is an environmental and human rights nonprofit organization that works with communities in the Caspian and Black Sea regions, who battle threats to local natural resources and the negative impacts on their health. Crude Accountability works on the local, national, regional, and international levels in partnership with active communities and organizations committed to a just and environmentally sustainable world. Based in Alexandria, Virginia, Crude Accountability also collaborates with environmental organizations in the United States working on similar issues.



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Executive Summary

Over its 28 years of independence, Azerbaijan has become known in the world market for its oil and gas. 2019 marked two important milestones in the modern history of Azerbaijan: 25 years since the country signed a ground-breaking Production Sharing Agreement (PSA) with the company BP to develop oil fields in the Azerbaijani sector of the Caspian Sea, and 20 years since the State Oil Fund of Azerbaijan (SOFAZ) was established.

Although Azerbaijan has generated enormous wealth from the development of its oil and gas reserves, the benefits have eluded the ordinary people of the country. Without effective, transparent, and accountable management of oil revenues, Azerbaijan has suffered from crippling corruption, stratification of society, stifled economic growth, and an increase in poverty. Money has been spent on buying civil servants' loyalty, glamorous sports and entertainment events, high end but not profitable real estate abroad, and western support.

The objectives of SOFAZ are to support socio-economic development, and to collect and save oil revenues for future generations to ensure cross-generational equality. Unfortunately, savings are slim, and the lack of transparency and accountability throughout the entire hydrocarbon revenue

management system in Azerbaijan is an issue of major concern. The most concerning issue is how public investments from the state budget, which draw on SOFAZ funds, are managed. Transparency is an issue both in the accumulation of oil revenues, and spending of oil revenues.

According to SOFAZ regulations, when incomes from oil and gas revenues peak, at least 25% of revenues must be saved. This rule was violated four out of five peak years from 2011 to 2015, when spending of revenues was much more than 75%. As of January 1, 2019, SOFAZ received \$138.3 billion from the main oil reservoir of Azeri-Chirag-Gunashli (ACG) alone. As of September 2019, the Fund had only \$42.5 billion in its reserves.¹ Thus, the question arises: what have the citizens of the country gained from the spending of nearly \$100 billion in oil revenue?

Taking into account payments coming from The State Oil Company of the Azerbaijan Republic (SOCAR), total proceeds from oil production accounted for 65.3% of the state budget revenues between 2003 and 2018. As hydrocarbons comprise such a high percentage of the state budget, Azerbaijan can be classified as a rentier state: the level of influence that citizens of the country have on government decision-making is significantly reduced because oil and gas

¹ <https://www.oilfund.az/en/report-and-statistics/recent-figures>

development by foreign investors plays such an important role in economic stability of the state. The role of taxpayers in the budget process is decreased, and so is public participation.

SOFAZ's investment portfolio performs much worse than other international sovereign wealth funds. In 2018, SOFAZ's investment portfolio included fixed income and money market instruments (76.5%), equities (12.8%), real estate (5.3%), and gold (5.4%). The total average profit of the Fund in 2018 was only 0.35%.² The average annual profits of SOFAZ's investment portfolio from 2010 to 2017 amounted to 1.53%. In comparison, profits amounted to 7.6% for the Norwegian Pension Fund, 9.7% for the Alaskan Fund (USA), 11.5% for the Alberta Fund (Canada), and 15.5% for the New Zealand Sovereign Fund. Corruption and lack of transparency of SOFAZ investments hinder Azerbaijan's economic growth.

Whereas other funds may profit from real estate, SOFAZ has been losing money from its investments. Especially large losses were revealed for London and Moscow properties owned by the Oil Fund.

Over the past few years, Baku has hosted a number of over-the-top sporting and entertainment events under the guise of modernization: Eurovision song contest, the First European Games, Islamic Solidarity Games, Formula 1 Grand Prix, and others. All of these came with inflated price tags paid for by oil revenues. The Operating Committee of the Baku 2015 European Games was allocated 950 million AZN (\$609.2 million). In comparison, Belarus hosted the European Games in 2019, which cost \$180 million, for which the president of Belarus was widely criticized.³ Low transparency and accountability standards, combined with the high potential for corruption in the country, encourage economic interest in these lucrative projects.

At least 1 out of every 3 dollars from the 2008 to 2015 state budgets was allocated to industry, construction, and minerals extraction, while up to 99% of the investment budget was directed into the construction sector, which has had a high corruption risk since the Soviet era.⁴

A significant share of Azerbaijan's state budget is spent supporting government employees who participate in repression and falsification of elections. In September

² <https://www.oilfund.az/en/investments/information>

³ <https://www.fairobserver.com/region/europe/european-games-2019-minsk-belarus-human-rights-sport-europe-news-12221/>

⁴ <https://www.cbar.az/page-41/macroeconomic-indicators>

1, 2019, salaries of government employees increased on average by 40%.⁵ Monthly salaries of Central Election Committee (CEC) employees grew significantly, making the gap between their wages and the nominal average salary in the country even larger than it had been previously.⁶

Teacher salaries increased by 20% on average starting September 1, 2019 – also a politically motivated move.⁷ The majority of members of the Constituency and Precinct Election Commissions are heads and employees of state schools. Election falsification is mainly conducted with their direct participation. Despite the fact that health workers received a smaller base salary than teachers, it was the education sector that received an increase in pay. Pro-government journalists have received apartments and law enforcement employees got salary increases of up to 40% in government efforts to tighten control.

Oil and gas revenues over the past 10 years created unprecedented opportunities for Azerbaijan to invest in lobbying to hush

critical voices from both inside the country and abroad, and to improve relations with the west. Azerbaijan was listed as one of the top 10 countries spending significant money on the services of lobbying companies in Washington, DC, including BGR Group and Podesta lobbying firm.⁸ The government of Azerbaijan also spent oil and gas revenues on the Azerbaijan America Alliance (AAA), the US Azeris Network, and the Assembly of the Friends of Azerbaijan (AFAZ), all registered as non-profit organizations in the US, but which promote Azerbaijani interests in the US.

A hike in oil revenues from 2010 to 2015 in Azerbaijan coincided with a rapid increase in the country's spending on its defense sector. However, with no transparency of defense contracts, it is difficult to track the use of military funding, another risk of corruption in spending.

Although over \$100 billion of oil money has already been spent, 24% of the people of Azerbaijan still suffer from poverty⁹ and lack basic services. There has been a decrease in GDP per capita since 2014, from \$6,072 to

⁵ <https://novator.az/2019/06/19/maas-artimi-s%C9%99r%C9%99ncamlari-2/>

⁶ <https://president.az/articles/33594>

⁷ <https://banco.az/az/news/muellimlerin-maaslari-20-faiz-artirildi>

⁸ <https://sunlightfoundation.com/2014/05/08/what-countries-spent-the-most-to-influence-the-usa-in-2013/>

⁹ http://documents.worldbank.org/curated/en/614351556553124178/pdf/South-Caucasus-in-Motion.pdf?fbclid=IwAR0pAnKBEgBklUn_8gSkWQKKs1Zlb5VwFVTCNgIZqas-5vHIHcjTPH2vHk

\$5,769 in 2018. Cancer related illnesses are on the rise in Azerbaijan. Environmental issues are also pressing.¹⁰ Quality of life in Azerbaijan has worsened over the past 10 years.

Corruption is rampant, and in 2019 and 2018, Azerbaijan received low ratings in Transparency International's Corruption Perception Index and in the Open Budget Index. Interestingly, Azerbaijan's ranking in the Corruption Perception Index correlates strongly with annual oil revenues, with the country scoring the worst during peak oil years.

The government of Azerbaijan signed various international conventions and joined

different global bodies before the country's economy started to benefit from the returns from oil and gas, but once oil money started flowing, it began disregarding its international obligations.

The research conducted for this report concludes that the revenues from the sale of Azerbaijani oil have not reduced the unemployment rate, have not alleviated poverty, and have not liberalized, diversified, or modernized the national economy. In fact, in many areas the situation has gotten worse. The report presents concrete recommendations to increase transparency and accountability in spending of Azerbaijan's oil and gas revenues.

¹⁰ <http://deyerler.org/361786-azjrbaycanda-eie-xjstjlikljri-artdr-v-hjkimljrdjn-sos-xjbjrdarldddd.html>

Introduction

Azerbaijan regained its independence 28 years ago - a third of the life expectancy of the average Azerbaijani. During this time, Azerbaijan has become known on the world market for its oil production and exports.

2019 marked two important milestones in the modern history of Azerbaijan. It has been 25 years since the country signed a ground-breaking Production Sharing Agreement (PSA) with the company BP to develop oil fields in the Azerbaijani sector of the Caspian Sea, and 20 years since the State Oil Fund of Azerbaijan (SOFAZ) was established. An analysis of political and economic data over this time period is critical to understanding how management of oil revenues through SOFAZ have impacted the country.

On September 20, 1994, Azerbaijan signed a PSA with BP to jointly develop oil fields in the Azerbaijani sector of the Caspian Sea: the Azeri, Chirag and the Deepwater portion of the Gunashli field (ACG). This agreement was later called the "Contract of the Century" because of its social, political, and economic impact. The PSA guaranteed oil and gas production for 30 years,

becoming the first significant international investment into Azerbaijan's economy.¹¹

Ten major foreign oil companies representing six countries formed the consortium (US Amoco, McDermott, Unocal, and Pennzoil; British BP and Ramco; Russian LUKoil; Norwegian Statoil; Turkish TPAO; and Saudi Delta Nimir) comprising the shareholders in this agreement.¹² On December 12, 1994, a few months after the PSA was signed, a constitutional act of the National Assembly (parliament of Azerbaijan) ratified the Agreement.¹³

Since that pivotal contract, Azerbaijan signed 26 more contracts (of which only 18 are operational) with 41 oil companies from 19 countries. The Contract of the Century remains the most significant influence on the country's economic, political, and social trajectory.¹⁴

The government of Azerbaijan proclaimed that the goal of the Contract of the Century was to direct the benefits derived from oil – political, economic, and any other – to serve the current and future welfare and prosperity of the Azerbaijani people.

¹¹ https://www.bp.com/az_az/caspian/operationsprojects/ACG.html

¹² https://www.bp.com/az_az/caspian/aboutus/legalagreements.html

¹³ Ibid

¹⁴ <https://president.az/pages/11/print>

In order to manage prospective wealth from a finite resource like oil, in 1999, then-president Heydar Aliev signed a decree establishing The State Oil Fund of Azerbaijan (SOFAZ) with the mission of ensuring cross-generational equality of hydrocarbon profits.

Azerbaijan began to see significant profits from oil production in 2008. Since then, SOFAZ has been a strong influence on, and the main contributor to, the country's budget. Moreover, SOFAZ also has significant domestic, social, and political influence.

This report describes that influence, focusing on the economic, social, political, and geopolitical impacts of oil revenues in Azerbaijan, and presents concrete recommendations for the future.

The research conducted for this report provides sound evidence that the revenues from the sale of Azerbaijani oil have not reduced the unemployment rate, have not alleviated poverty, and have not liberalized, diversified, or modernized the national

economy. Despite the heavy spending of oil revenues, at least 24% of Azerbaijani people suffer from poverty,¹⁵ and the majority are still waiting to see the socio-economic progress associated with developed countries.

In addition to the economic effects of mismanagement of oil revenues, political impacts seen in Azerbaijan include the rentier effect, political repression, barriers to modernization, over-militarization, corruption, and a lack of accountability, among others.

In the absence of a liberal economy and the rule of law, the increase of expenses in line with the growth of oil revenue--that is, the spending of "easy" money without observing the principles of responsibility, efficiency, and transparency in the non-resource focused sectors--has also led to increased corruption, which further inhibits development and accelerates inflation, harming the welfare of the Azerbaijani people.

¹⁵ https://www.bp.com/az_az/caspian/operationsprojects/ACG.html

I. The Ins and Outs of the SOFAZ Budget

Twenty-Five Years Since the Production Sharing Agreement with BP



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Twenty-five years have passed since Azerbaijan signed a ground-breaking Production Sharing Agreement (PSA) with BP to jointly develop oil fields in the Azeri sector of the Caspian Sea-Azeri, Chirag and Deepwater portion of the Gunashli field (ACG). This agreement was later called the “Contract of the Century” for its social, political, and economic impact.

The bulk of the confirmed 500 million tons of oil in the ACG field has already been produced. As of July 31, 2019, Azerbaijan's total income received since 2001 from the PSA for the development of the ACG field amounted to \$143,366 million.¹⁶

Twenty five years provide us with sufficient data to conduct a comprehensive assessment of the outcomes of the contract, including political and economic impacts. Politically, the agreement played an important role in connecting the Azerbaijani economy with the West. At the same time, this agreement put an end to Russia's dominance over Azerbaijan's oil-rich sector of the Caspian Sea. The Russian company Lukoil, having received only a 10% share in this agreement, lost its ability to influence any major decisions. The agreement also led to Iran's withdrawal from the process. Because of US sanctions, Iran failed to receive a share of the PSA in the development of ACG.¹⁷ Moreover, the export of crude oil from ACG to the European market via the Baku-Tbilisi-Ceyhan pipeline was a crucial part of developing economic ties among Azerbaijan, Turkey, and Georgia.¹⁸

The agreement's economic benefits include attracting tens of billions of dollars worth of investments to Azerbaijan, with transnational companies bringing new technologies to Azerbaijan's oil industry. According to The State Oil Company of the Azerbaijan Republic (SOCAR) President Rovnag Abdullayev, investment into Azerbaijan's oil and gas industry between 1995 and 2019 amounted to \$80 billion, which comprised 60% of the total investment in the country's economy during those years.¹⁹ The data provided by the State Statistics Committee demonstrates that of the total of \$81.9 billion invested into the country's economy between 2000 and 2018, about 85.5% or \$70.0 billion of foreign direct investment was in the oil and gas sector.²⁰

Another noteworthy economic outcome of the past years is the use of oil revenues to balance the state budget. Most of the revenues coming from the ACG field and collected by SOFAZ were transferred to the state budget. Indeed, between 2003 and 2018, SOFAZ transferred 88.6 billion AZN or \$93 billion to the state budget, approximately 55.9% of the total budget.

¹⁶ <https://oilfund.az/en/fund/press-room/news-archive/1411>

¹⁷ <https://www.the-american-interest.com/2019/10/03/america-and-azerbaijan-five-reflections-on-the-contract-of-the-century/>

¹⁸ https://www.eia.gov/international/content/analysis/countries_long/Azerbaijan/background.htm

¹⁹ <http://www.azerbaijan-news.az/view-167255/Yeni-neft-strategiyas%C4%B1n%C4%B1n-banisi>

²⁰ <http://nhmt-az.org/frontend/pages/oil-income-inner.php?id=170>

The total amount of transfers during the mentioned period comprised 86.9% (102 billion AZN)²¹ of the total budget expenditures of SOFAZ. Taking into account payments coming from SOCAR, proceeds from oil production accounted for 65.3% of the state budget revenues in the reported period.²²

Despite Azerbaijan's income from the Contract of the Century the country's social inequality continued to grow.

The ACG PSA has not lost productivity. On September 14, 2017, shareholders decided to extend the development of ACG fields until 2050, which led to some changes in the PSA. In the new contract, SOCAR's share in ACG increased from 11.6% to 25%, while the Azerbaijani government's share in profitable oil was fixed at a stable level of 75%.²³ According to estimates, by 2050 an additional \$40 billion will be invested in ACG.²⁴

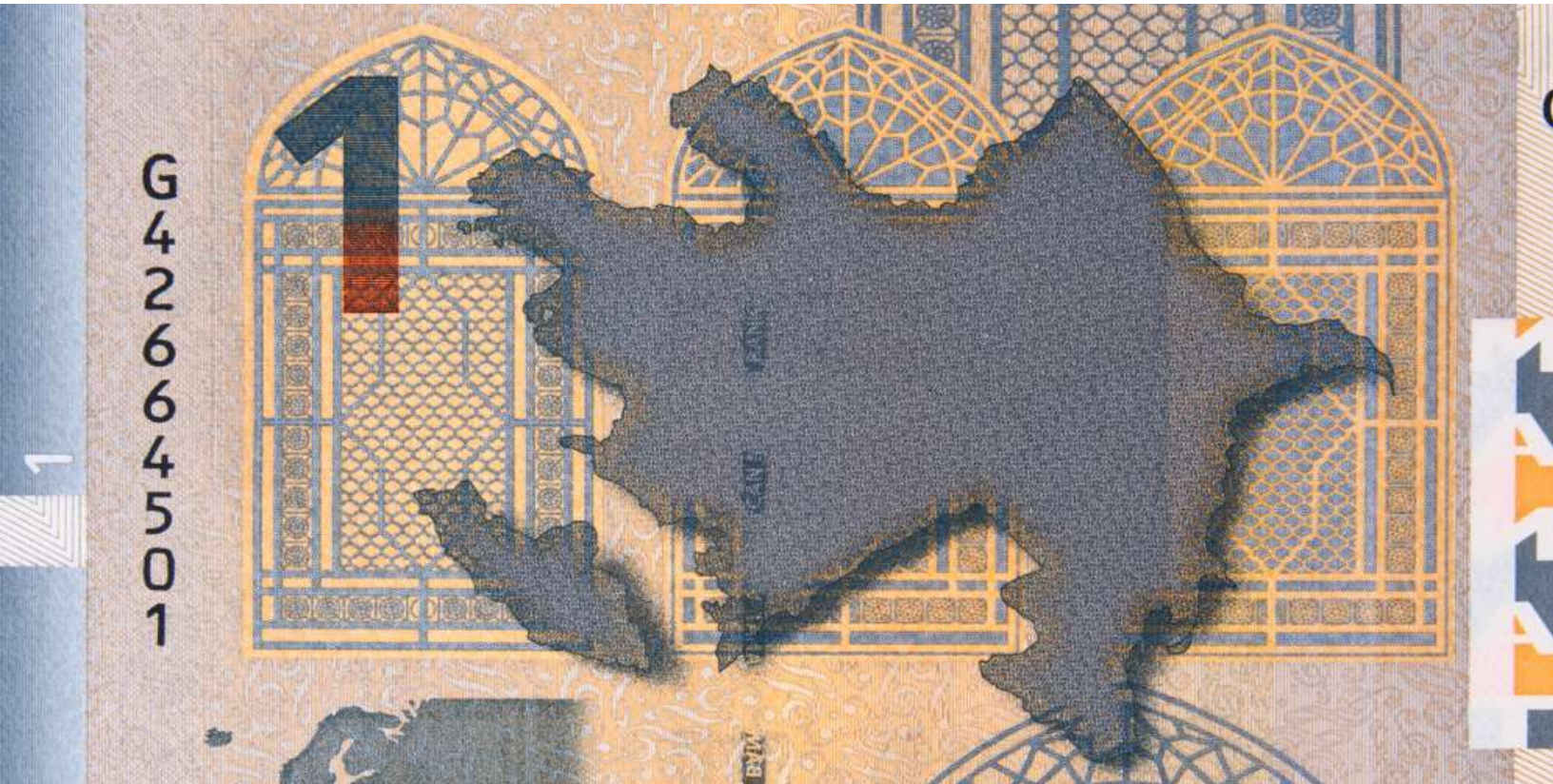
²¹ <https://oilfund.az/en/report-and-statistics/report-archive>

²² <http://nhmt-az.org/frontend/pages/oil-income-inner.php?id=170>

²³ https://www.bp.com/content/dam/bp-country/az_az/PDFs/legalagreements/PSAs/EN-AZ-Restated-ACG-PSA.pdf

²⁴ <https://www.oilfund.az/report-and-statistics/report-archive>

A Rentier State Budget



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What is a rentier state? A rentier state is a state that derives most or all of its wealth from renting its indigenous resources to external clients. Often the term refers to countries exporting natural resources, such as oil, to external clients, but it can include other revenue-generating sources as well.²⁵

In a rentier state, the level of influence that citizens of the country have on government decision-making is significantly reduced because the renter plays such an important role in economic stability of the state. The role of taxpayers in the budget process is

decreased, and so is public participation. Azerbaijan spends its budget like a rentier state, with little accountability and transparency, and with no public participation.

²⁵ https://en.wikipedia.org/wiki/Rentier_state

Where Does the Money Come From?

As of today, roughly 60% of the state budget of Azerbaijan is created from oil revenues.

The annual sum of the State Oil Fund of Azerbaijan's transfer in 2019 amounted to 11.364 billion AZN (\$6.67 billion), almost 50% of the budget. With direct tax payments from the State Oil Company of Azerbaijan Republic and Azerbaijan International Operating Company (AIOC), the total share of oil revenues in the budget is 59.1%.

The Ministry of Taxes of the Republic of Azerbaijan contributed 31.9% of the budget, the State Customs Committee of the Republic of Azerbaijan contributed 15.1%, and only 3.9% came from other sources.²⁶ This breakdown shows how dependent the country budget is on oil revenues, and how little the country receives from other sources. Taxpayers have very little say in the budgeting process.

SOFAZ is Not Saving for the Future

The objectives of SOFAZ are to finance strategic projects for advancement of socio-economic development and to collect and save oil revenues for future generations in order to ensure cross-generational equality. Despite the fact that strategic projects are funded without any parliamentary oversight and are not transparent, they ultimately play a positive role in economic development.

However, it seems that the government does not pay attention to a fair division of oil revenues among generations. Instead of saving money and directing it to long-term development projects, spending the funds has become a priority. This has led to violation of the provisions of the Long-Term Strategy on Use of Oil and Gas Revenues, which states that when the revenues from oil and gas reach their peak, at least 25% of them shall be saved.²⁷

The peak of oil and gas revenues is still a matter of dispute. According to the existing information, peak revenues were reached

²⁶ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3514311

²⁷ <http://www.e-qanun.az/framework/6336>

between 2011 and 2015. In 2011, 61.4% of revenues were spent,²⁸ 78% in 2012,²⁹ 90.4% in 2013,³⁰ 79.4% in 2014,³¹ and 118.9% in 2015.³² SOFAZ has observed the requirement to save 25% of annual revenue only once, in 2011, and violated the Strategy during the other 4 years.

For instance, if we look at planned 2020 SOFAZ spending, we notice that along with massive transfers to the state budget, the Fund also plans to fund several other programs. Among them are:

- social welfare and housing of internally displaced people costing 200 million AZN (\$117.6 million)
- and about 10 million AZN (\$5.8 million) for the "State Program on increasing international attractiveness of higher education in Azerbaijan Republic for 2019-2023".³³

This means that SOFAZ plans to spend 93.34% of its forecast revenues for 2020,

saving only 6.6% of the generated income for future generations.

Such expenditures leave SOFAZ with limited capacity to accumulate savings over the years. According to forecasts, no significant changes in savings are expected in the medium term (2021-2023).

Highs and Lows of the Budget

Azerbaijani oil made its way to the global market in 2006 through the main export route, the BTC pipeline, and significant profit started arriving in the country in 2008. From 2008 to 2017, SOFAZ budget revenues comprised \$125.089 billion total, averaging \$13.898 billion annually taking into account the exchange rates.³⁴ This annual average is roughly the same as the expenditure of the 2019 Azerbaijan state budget.

As oil prices dropped and the AZN was devalued by 34% in February 2015 and by 48% in December 2015, SOFAZ revenue in

²⁸ <https://www.oilfund.az/en/report-and-statistics/budget-information/12>

²⁹ <https://www.oilfund.az/en/report-and-statistics/budget-information/15>

³⁰ <https://www.oilfund.az/en/report-and-statistics/budget-information/8>

³¹ <http://caspiabarrel.org/az/2015/06/dovl-t-neft-fondunun-2014-cu-il-budc-sinin-icrasi-t-sdiq-edildi/>

³² <https://www.oilfund.az/en/report-and-statistics/budget-information/3>

³³ <https://oilfund.az/en/report-and-statistics/budget-information/41>

³⁴ The average exchange rate of 2008-2014, 0.78 AZN = \$1 is taken as a benchmark.

dollars decreased three fold compared with the previous year, amounting to \$4.951 billion.³⁵ In 2016, the AZN exchange rate decreased to a historic low³⁶ and since the oil prices on the global market remained the same, SOFAZ budget revenue in 2016 was \$5.223 billion. An increase in oil prices, along with stabilization of the AZN exchange rate,³⁷ led to an increase of SOFAZ budget revenue to \$7.127 billion in 2017.

Thus, from 2008 to 2017 SOFAZ revenue totaled \$125.089 billion. During this period, the peak of annual SOFAZ revenue occurred in 2011, at \$19.893 billion.³⁸

In 2018, SOFAZ budget revenue was \$9 billion, while in 2019 it was to be \$9.164 billion. Generally, Azerbaijan’s oil revenues from 2006 to 2019 can be viewed in the following graph.

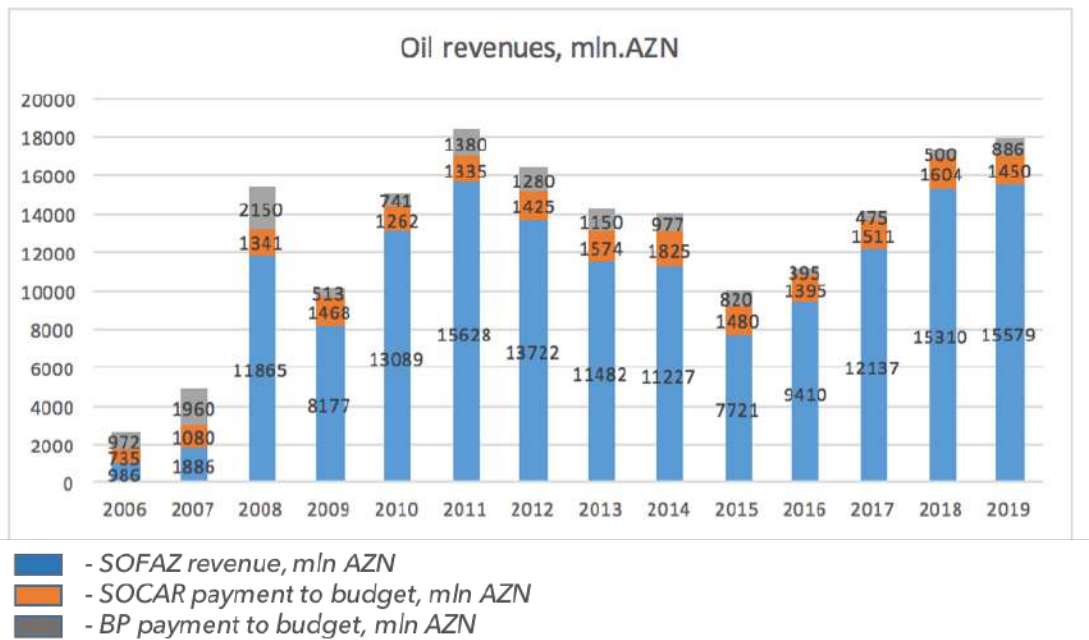


Figure 1. Oil revenues, mln AZN
 Source: State Oil Fund of the Republic of Azerbaijan and state budget documents

³⁵ This calculation was made based on the annual average exchange rate of 1.5593 AZN= \$1.

³⁶In 2016 the average exchange rate was 1.8016 AZN = \$1.

³⁷ In 2017 the average exchange rate was 1.7029 AZN = \$1

³⁸ This calculation was based on the average exchange rate of 0.7856 AZN = \$1

As of October 1, 2018, SOFAZ transferred \$90.487 billion to the state budget.³⁹

According to calculations, 2 out of every 3 dollars of oil revenues of SOFAZ were transferred to the budget and spent between October 2016 and 2018.

We can observe the portion of SOFAZ transfers in the state budget revenues in the following graph.

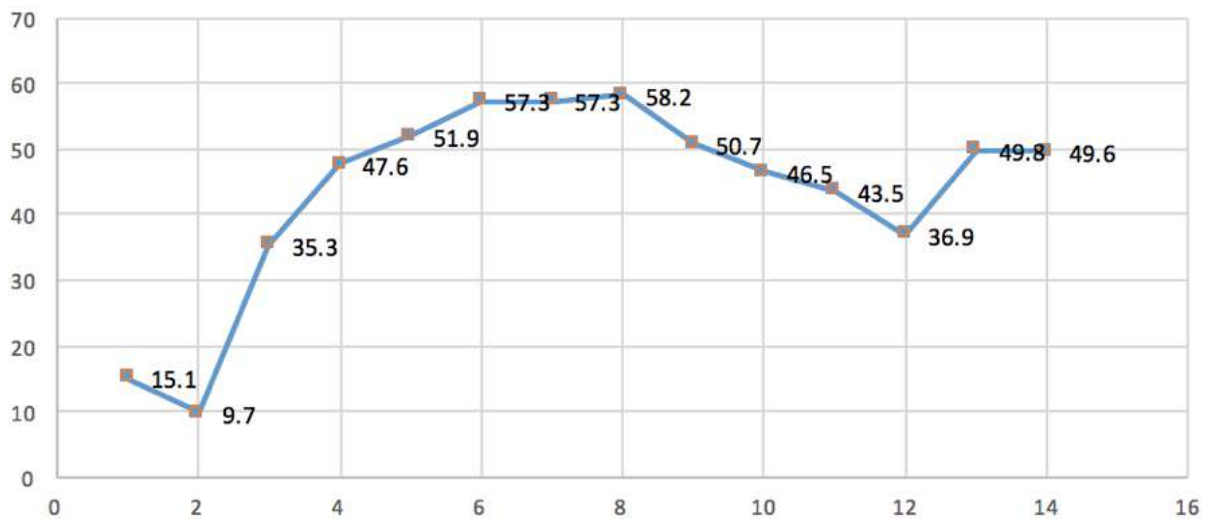


Figure 2. Share of transfer of SOFAZ to state budget revenues, in percent

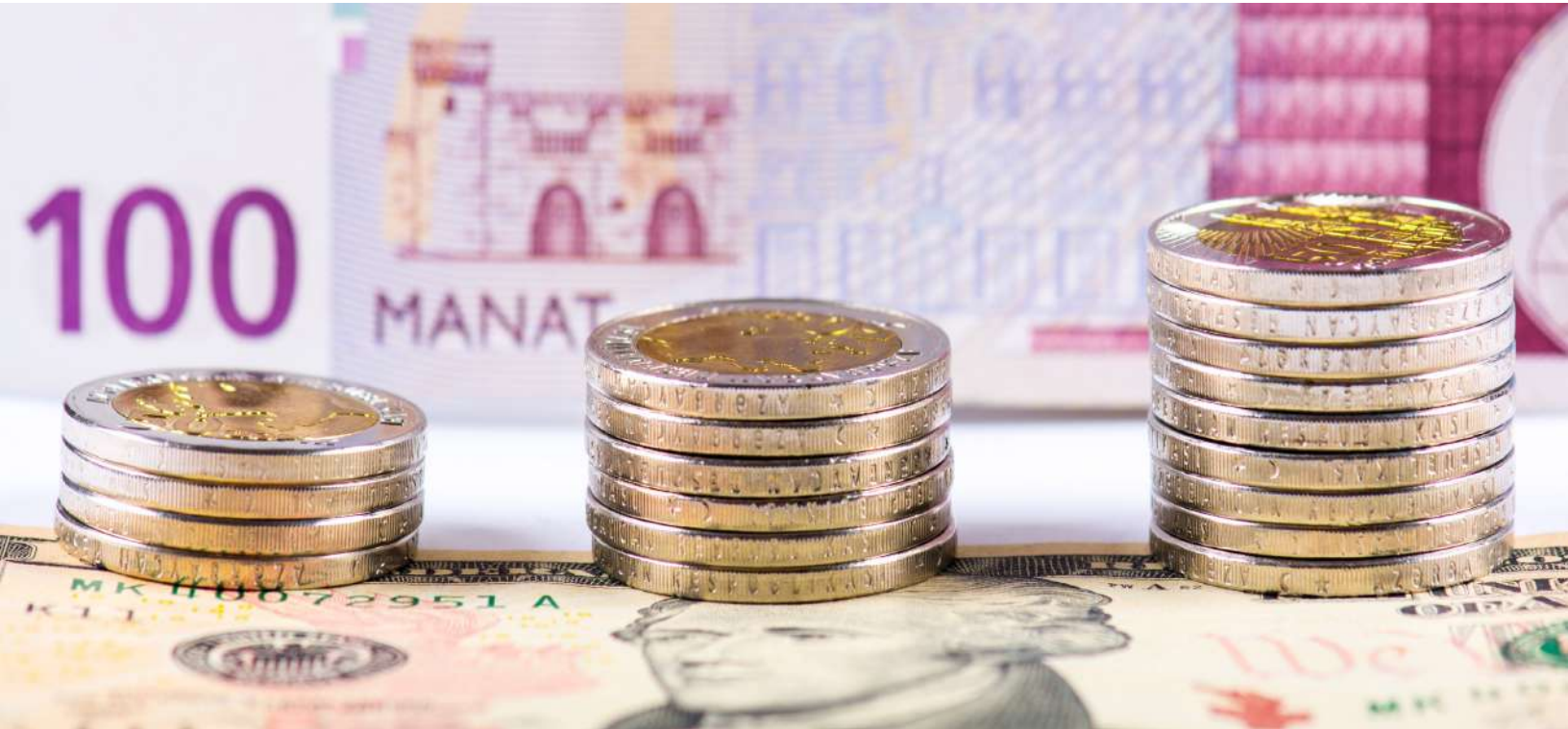
Two trends are visible in oil revenue management in Azerbaijan. First, in order not to overspend revenues from the sale of oil, the funds are used to create state budget revenues. Second, budget expenditure has a cyclical character: when revenues increase, expenditures increase,

when revenues decrease, expenditures decrease as well.

This analysis shows that state budget revenues in Azerbaijan mainly emerge through rentier payments, with minimal taxpayer involvement and oversight.

³⁹ <https://www.oilfund.az/en/report-and-statistics/recent-figures>

Analysis of the SOFAZ Portfolio



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This chapter analyzes SOFAZ's 2018 report on revenues, expenditures, and assets;⁴⁰ and the Fund's performance, comparing it to other sovereign wealth funds.

Decrease in Assets, Decrease in Revenues

The analysis of the latest SOFAZ report shows that by January 1, 2019, Fund assets decreased from October 1, 2018.⁴¹ On October 1, 2018, SOFAZ assets equaled \$38.988 billion, while on January 1, 2019,

assets decreased by \$472.5 million, for a total of \$38.515 billion.

Further, according to the latest SOFAZ report, on January 1, 2019, revenues from managing SOFAZ assets drastically decreased from October 1, 2018. On October 1, 2018, profit from management of SOFAZ assets was 995.6 million AZN

⁴⁰ <https://oilfund.az/en/fund/press-room/news-archive/1385>

⁴¹ Ibid

(\$585.6 million); by January 1, 2019, it decreased by 815.5 million AZN to 181.1 million AZN (\$106.5 million).⁴²

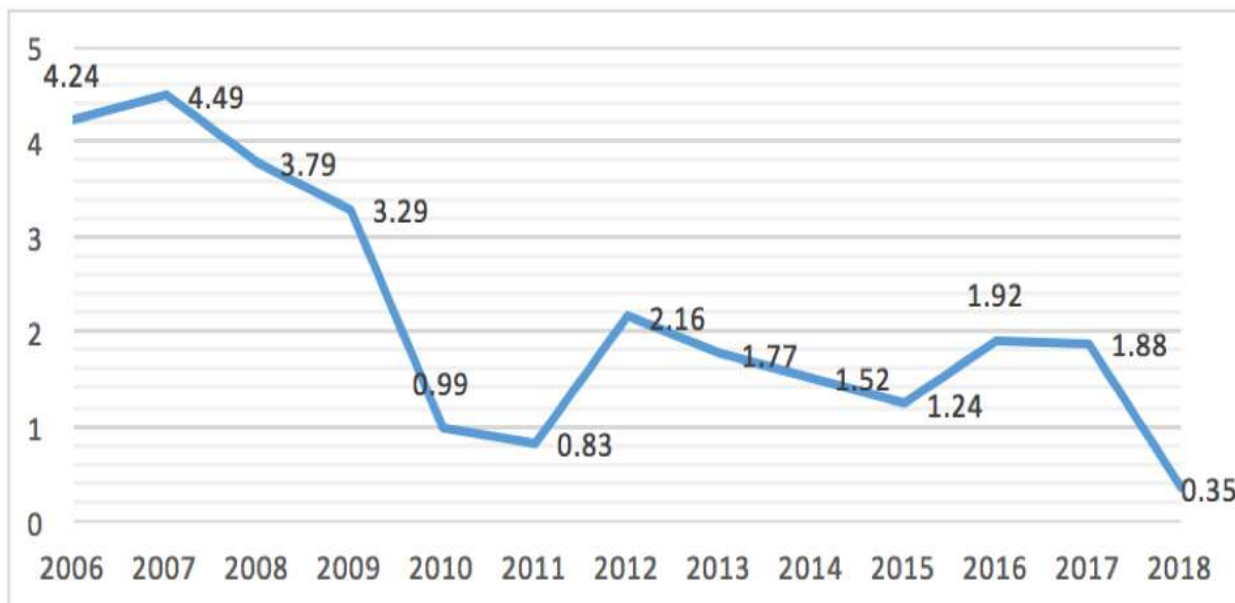
Thus, in 2018, revenues from managing SOFAZ assets decreased six fold from 2017.

The Fund has been profiting from the management of monetary assets since 2006. Graph 3 demonstrates the changes in profits from the investment portfolio:

lowest in 2018, even lower than after the 2009 global financial crisis.

What is in the Portfolio?

In 2018, SOFAZ's investment portfolio included fixed income and money market instruments (76.5%), equities (12.8%), real estate (5.3%), and gold (5.4%). The total average profit of the Fund in 2018 was 0.35%.^{43 44}



Graph 3. SOFAZ Profits from 2006 to 2018 from the investment portfolio, by percentage

It is evident that the indicators of SOFAZ revenue peaked in 2007 and were the

The highest annual profit of 0.68% in 2018 came from fixed income and money market instruments.

⁴² Ibid

⁴³ <https://www.oilfund.az/en/investments/information>

⁴⁴ <https://oilfund.az/storage/uploads/iz7latygs.pdf>

The annual profit from the real estate market investment portfolio was 0.54%. It is impossible to assess why the levels of revenues are low, as rent contracts are not publicly available.⁴⁵ Increase of investment in gold in 2018 decreased the efficiency of SOFAZ's investment portfolio management.

One of the biggest areas of SOFAZ losses in 2018 was equities. Comprising 12.8% of the Fund's investment portfolio, equities total \$5 billion. In 2018, the Fund lost \$42.9 million (-0.87%) in shares.

The Fund explained poor results in 2018 as connected to an overall difficult year for the global stock market. The majority of economies demonstrated negative profits in the stock market against the background of weakening global economic growth in the last quarter of the year.

Factors such as tension due to Brexit, weakening of Chinese economic growth, increasing concerns in connection with the rate policy held by the US Federal Reserve System, and pessimistic predictions regarding profits of companies against the background of increasing interest rates in the US caused a negative impact on profits in the stock market.

Comparing SOFAZ to Other Sovereign Wealth Funds

Global market trends have negatively impacted other long-term institutional investors, such as some leading sovereign wealth funds. For example, in 2018 the Norwegian Sovereign State Pension Fund demonstrated a loss of 6.1% in profits. Alaskan and New Zealand sovereign funds demonstrated, respectively, 1.1% and 2.18% of profits in 2018.

During this period, the investment portfolio profits of the Oil Fund in local currency were 0.35%. The average annual profits of investment portfolios of other funds referred to by SOFAZ from 2010 to 2017 were significantly higher than those of SOFAZ. Let us take a look at Figure 4 to compare profits over a longer term:

⁴⁵ <https://www.oilfund.az/storage/uploads/lepdmqpngs.pdf>

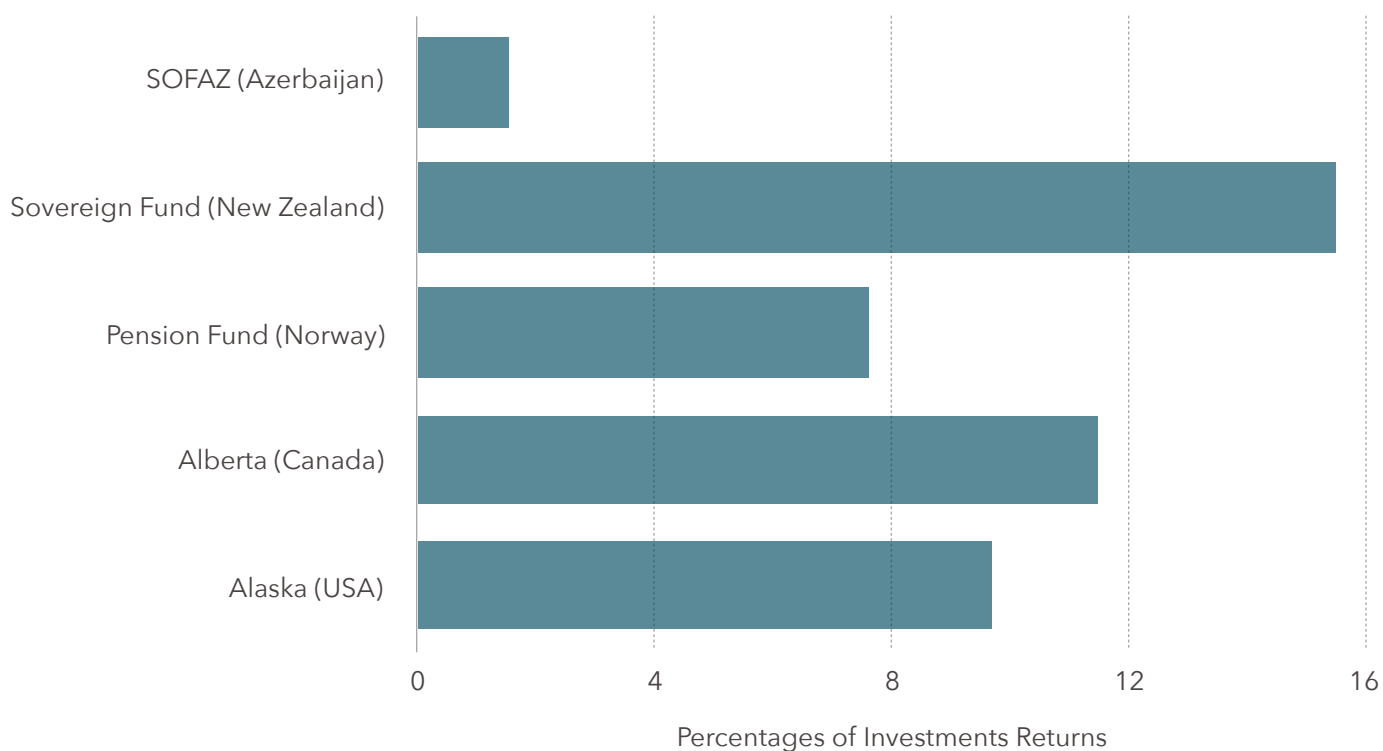


Figure 4. Average annual profits of the investment portfolios of the Funds in 2010-2017, in percentage.

The average annual profits of the investment portfolios from 2010 to 2017 amounted to 7.6% for the Norwegian Pension Fund, 9.7% for the Alaskan Fund (USA), 11.5% for the Alberta Fund (Canada), and 15.5% for the New Zealand Sovereign Fund. The average annual profits of SOFAZ's investment portfolio equaled 1.53% for the same period: 5 times less than the Norwegian Pension Fund, 6.3 times less than the US Alaskan Fund, 7.5 times less than the Canadian Alberta Fund, and 10 times less than the New Zealand Sovereign Fund.

Azerbaijan's 2020 Budget Remains Vulnerable to External Shocks



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The 2020 state budget remains highly dependent on oil revenues, which is not sustainable, and hinders SOFAZ's ability to save and invest for future generations. The government continues to pump oil revenues into the state budget in violation of the existing fiscal policies.

Analysis of the 2020 Budget

The recently disclosed 2020 draft budget of Azerbaijan reveals the projected budget

expenditure level at \$15.07 billion - \$251.5 million more than in 2019.⁴⁶

Budget forecasts projected the state budget revenues at \$14.4 billion by 2020 - \$774.1 million or 5.7% more than the current

⁴⁶ http://maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/news_files/5d7b8f2899635.pdf

revenue level. Of those budget revenues, approximately 57% will be from the oil sector.⁴⁷

At the same time, the Ministry of Economy released a different forecast for the coming three years (2020-2023), projecting that only 34.2% of the GDP would be coming from the oil sector and 65.8% would be coming from the non-energy sector.⁴⁸

Such an increase of the oil sector share in budget revenues resulted from a \$6.92 billion transfer from SOFAZ to the state budget by 2020. In comparison, in 2019 the SOFAZ budget transfer amounted to \$6.68 billion: \$237 million or 3.55% less than the 2020 projection.

The “Strategic roadmap for the development of national economy of Azerbaijan Republic” aims at a 15% reduction of the SOFAZ transfers’ share of the state budget by 2025.⁴⁹ However, actual and forecast data analysis shows that this target cannot be met with the current government policies. Instead, in the next four years the state budget will be highly dependent on oil revenues.

Forecasts for the 2020 state budget define the share of the oil and gas sector in budget revenues at 57% (\$7.96 billion). Transfers from SOFAZ will constitute about 83.9% of this amount or 47% of the budget (\$6.68 billion).⁵⁰

The rest of the funds from the oil and gas sector will come from State Oil Company payments (10.7 %), and the taxes paid in accordance with PSAs - 5.4 percent (Figure 5).⁵¹

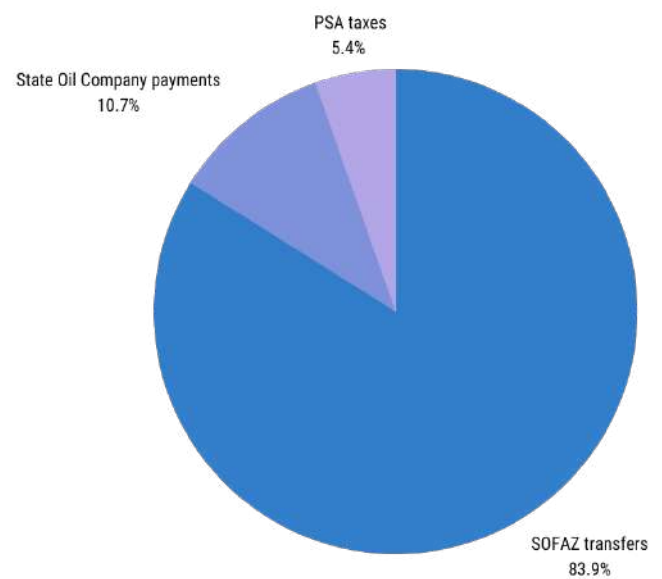


Figure 5. The structure of oil and gas contributions in the 2020 budget forecast

⁴⁷ Ibid

⁴⁸ Ibid

⁴⁹ <https://static.president.az/pdf/38542.pdf>

⁵⁰ http://sai.gov.az/upload/files/2020_REY.pdf

⁵¹ Ibid

Data presented in Figure 5 and Figure 6 demonstrates that SOFAZ transfers continue to form the majority of oil sector revenues in the state budget.

2005 and 2014, when expenses increased from \$2 billion to \$24.33 billion.

The rapid depreciation of crude oil on the

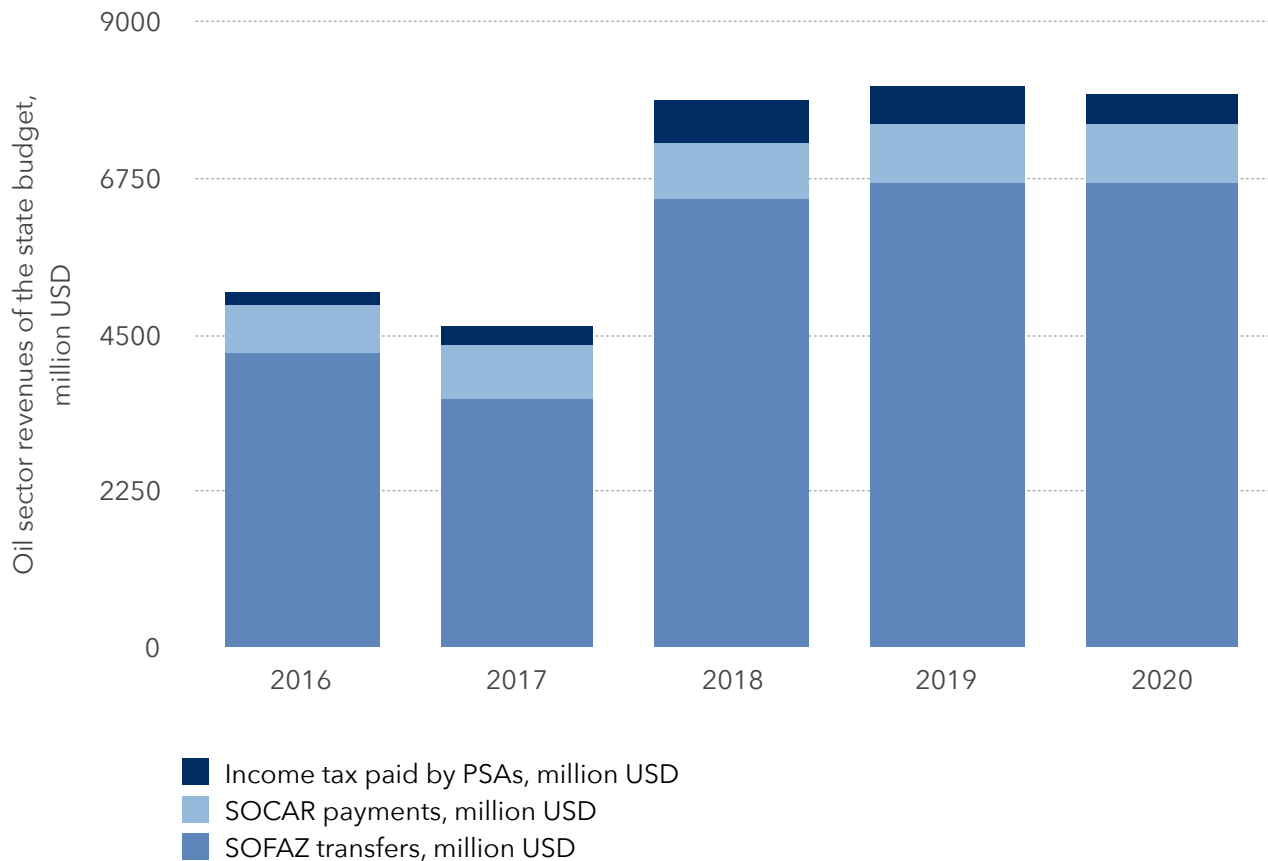


Figure 6. Contributions of the oil sector into the state budget in 2016-2020

Source: Chamber of Accounts

Note: 2019 and 2020 reflect forecast numbers

Fiscal Regulations

The increase in budget expenditures in Azerbaijan is directly dependent on world oil prices.

This surge is demonstrated by the dramatic increase in budget expenditures between

global market led to the double devaluation of the national currency in 2015, and dramatically reduced the dollar equivalent of budget revenues.

Studies have shown that in order to ensure macroeconomic stability and protect the budget from the surges of the global market, the state needs to have restrictive fiscal rules and policies to break the balance

between budget expenditures and oil revenues.⁵²

While most oil-rich countries usually introduce fiscal rules prior to gaining oil revenues, such rules were adopted in Azerbaijan 17 years after first oil revenues started flowing, in 2016, when the administration developed “The Strategic roadmap for the development of national economy of Azerbaijan Republic”.⁵³ The Roadmap defined the need to develop fiscal frameworks to address potential challenges caused by global macroeconomic trends, and to study their impact and unpredictable external shocks in order to create financial reserves for future generations.

Amendments to the Law on the Budget System, dated June 29, 2018, incorporated fiscal rules into the existing legislation.⁵⁴

According to the fiscal rules, annual oil expenditure should amount to the difference between 30% of net financial assets accumulated in the beginning of the forecast budget year and the oil revenues; and adding 20% of this difference to the lowest number of the indicators.⁵⁵

⁵² <https://openknowledge.worldbank.org/bitstream/handle/10986/24577/9781464804953.pdf?sequence=2>

⁵³ <http://www.e-qanun.az/framework/34254>

⁵⁴ <http://www.e-qanun.az/framework/39838>

⁵⁵ 20% of the difference between oil revenues and 30% of the net financial assets is added to the net financial assets

⁵⁶ <https://static.president.az/media/W1siZiIsIjIwMTg0MDg0MjcvMjI0ODFuN2NnYi9fRE9WTEVUX19CT1JDVV9TVFJBVEVRX1lBXY5wZGYiXV0?sha=67f1b296c90ca1f2>

Moreover, one of the chief strategic goals of the “Medium and long-term public debt management strategy of the Republic of Azerbaijan,” endorsed by the Presidential Decree of August 24, 2018, is to set the upper limit of the national debt with a ratio not exceeding 30% of the GDP from 2018 to 2025, and dropping that limit to 20% by 2025. The Strategy determines that the share of service expenditures will constitute less than 15% of the total public debt by 2025.⁵⁶

An initial presentation of the 2020 draft budget demonstrates that while it was possible to achieve an increase in expenditures through the non-oil sector, the government of Azerbaijan continued its policy of pumping oil revenues into the state budget even though current fiscal policies limit transfers from SOFAZ to the Azerbaijani state budget.

II. Where is the Oil Money Spent?

SOFAZ Real Estate Market Investments



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SOFAZ invests in luxury real estate abroad, but the country does not profit from these highly lucrative investments. In this chapter, we investigate why there is a decrease in profits from the Fund's investments in real estate abroad.

According to SOFAZ's Investment Policy, real estate should comprise up to 10% of its investment portfolio.⁵⁷ As of January 1, 2019, up to 5.25% of total SOFAZ

investments were in the real estate market (\$2.02 billion).⁵⁸

⁵⁷ <https://www.oilfund.az/en/investments/investment>

⁵⁸ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

According to SOFAZ's 2019 Investment policy, approved by President Aliyev, the main reason to invest in real estate is that it maintains its value for a long time and has a high mid- and long-term profit potential.⁵⁹ With appropriate and transparent policy, it is possible to achieve both.

According to the State Oil Fund of the Republic of Azerbaijan Annual Budget Execution Report, 47.4% of SOFAZ's real estate portfolio is direct investment, 2.7% is an investment into debt funds, 34.5% is in fund investment, and 15.4% is in joint investments.⁶⁰

In general, profit from the SOFAZ real estate portfolio averages 9.9% without considering the currency exchange difference.⁶¹ Despite the fact that the share of direct investment (47.4%) is higher than other sub-portfolios, its profit percentage is significantly smaller (3.83%). Profit from other sub-portfolios, especially from joint investment, was higher and equaled 42.03%; fund investment profit was 15.76%, and profit from debt funds was 13.81%.

Whereas other companies profit from real estate, SOFAZ has been losing money from investments in the office buildings it owns.

⁵⁹ <https://www.oilfund.az/storage/images/6c92ernmvq.pdf>

⁶⁰ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

⁶¹ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

⁶² <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

⁶³ Ibid

Especially large losses were revealed after reassessment of London and Moscow properties owned by the Oil Fund.

London Real Estate

There is a building on St James Street in the West End of London in a business block surrounded by numerous historical buildings. It was built in 1845 and repaired in 2003 with the condition that the facade would be kept intact, and is categorized as a class A office building. Its total area is 11,018 m,² its annual rent equals £9.65 million, and the net annual profit level is 4.5%. It is rented out to HSBC Bank, which currently uses the building as the central office of HSBC Personal Bank in Britain.

SOFAZ purchased this office building unit, worth £177.35 million (\$285.6 million), in 2012.

Of £34.74 million earned from the rent of this building, only £2.02 million (5.83% of the sum) was transferred to the budget. The Fund explained that the amount was so small because money was being transferred for restoration work on the building.⁶²

Currently, this property's market price is £120 million.⁶³ That means that the Fund's

London assets have decreased by £57.35 million or \$121 million. In other words, the Fund's property has lost 32.3% of its value.

Moscow Property

The Galleria Actor is a mixed-use office and retail building in the center of Moscow, an area with prominent hotels, offices, and luxurious shopping boutiques. The building is at the intersection of Tverskaya Street and Strastnoy Boulevard, close to the Kremlin and Red Square. The building was opened as a theater building in 1881 and was renovated in 1995 with the condition that the historic facade of the building would be maintained. The total area of the building is 18,075 m².

SOFAZ purchased the Galleria Actor in 2012 for \$133 million.⁶⁴ As of December 31, 2018, the property had lost \$47.1 million of its market value and currently is valued at \$86 million.⁶⁵

When the Oil Fund purchased this building, it claimed that the monthly rent of the building would be \$9.6 million.⁶⁶ However, SOFAZ only profited \$66,000 from the rent of the building last year, earning \$5,500 per month.

Even this sum was not transferred to the budget. Instead, it was used for expenses. Further, up to \$62 million was lost in the difference between the purchase value and the market value, which dropped by \$205.5 million as of December 31, 2018.⁶⁷

Opaque Investment Management

SOFAZ investments in real estate are carried out through subsidiary institutions of the Fund. The expenses for maintaining these subsidiary institutions are covered through real estate profits. At first glance, it seems like the real estate investments made by these subsidiary institutions aim to decrease the direct responsibility of the Fund and create possible tax benefits, but in reality, information about the work of these companies exposes hidden agendas.

Another indicator of poor oil profit management is a low level of profits from investment in the property market. While individuals may profit from the market operations of SOFAZ, these operations have no relation to the Fund or the budget. This may be the reason that information about those who profit, especially owners of subsidiary institutions, is kept hidden from the public.

⁶⁴ <https://www.swfinstitute.org/news/9218/sofaz-buys-actor-gallery-in-moscow>

⁶⁵ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

⁶⁶ Ibid

⁶⁷ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

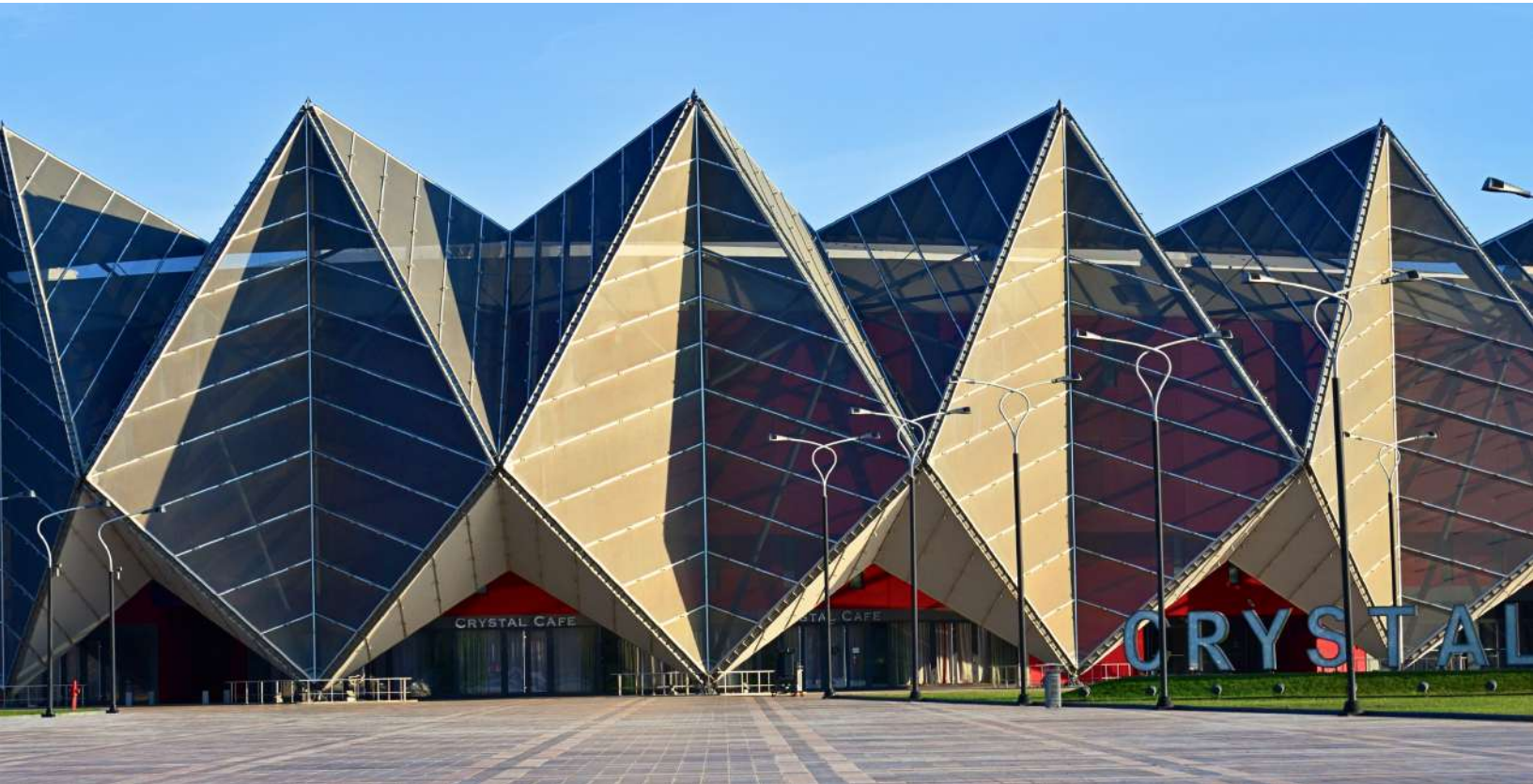
In general, data analysis demonstrates that there is a pressing need to develop regulatory and accountability mechanisms to manage SOFAZ real estate investments.

Unlike Kazakhstan, in 2020, Azerbaijan plans to increase the volume of transfers from SOFAZ to the state budget by 3.55% despite the forecast 2.4% growth of GDP in Azerbaijan.

Effective functioning of fiscal regulation is possible not only through proper selection of mechanisms and norms, but also requires a responsible approach to budgetary policy. In particular, this entails ensuring conservative budget planning and sustainable economic stability, and establishing a common institutional environment for the rules.

In summary, sustaining the current high level of the state budget's dependence on hydrocarbon resources in 2020 will increase the national economy's vulnerability to periodic jolts of the world markets. This tendency will subsequently lead to lower savings for future generations in Azerbaijan.

Corrupt and Flashy Events Disguised as Modernization



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Azerbaijan hosts a number of over-the-top sporting and entertainment events under the guise of modernization. Instead, the events lead to spiraling corruption and whitewashing the country's image on the global stage.

One of the political effects of natural resource development is an increase in state budget resources directed at modernization. However, in Azerbaijan, infrastructure modernization has taken an odd turn. The government has been

funding special interests rather than public needs. Instead of creating and updating much-needed electric, water, and gas infrastructure. The government is financing flashy sporting and cultural events and inflated entertainment infrastructure.

Flashy Events and Outrageous Expenses

Over the past few years, Baku has hosted a number of events: the Eurovision song contest, the First European Games, Islamic Solidarity Games, Formula 1 Grand Prix, and others. All of these came with inflated price tags.

The first relevant example is \$134 million taken from the 2011 state budget for construction of the Baku Crystal Hall - the sports-entertainment center that was built to host the Eurovision 2012 music contest.⁶⁸

In 2015, Baku hosted the first European Games. Related infrastructure cost \$1.2 billion and included an Olympic stadium (\$600 million, according to initial calculations), the Water Sports Center and Shooting Halls, the National Gymnastics hall, the Sports village, and temporary construction to house a triathlon, basketball, and other sports.⁶⁹

However, an independent assessment demonstrates that over \$2 billion was spent on the event because resources were allocated from the budgets of 2015 and

previous years.⁷⁰ The 2013 budget allocated \$440.6 million for the construction, reconstruction, and repair of sports facilities for the European Games: the Water Sports Center, the Gymnastics Complex, and repair and reconstruction of the Tofiq Bayramov Republican Stadium.⁷¹

In addition, the Presidential decree on the application of the Law on the 2014 state budget demonstrates that \$589.45 million was allocated from the state budget for infrastructure, preparation, and other organizational matters for the First European Games in Baku.⁷²

Finally, \$1.134 billion was allocated from the 2014 budget for social services focusing on youth housing construction, including reconstruction and repair of sports facilities such as the Water Sports Center, Gymnastics Complex, football stadium, European Games Park, eleven regional Olympic sports complexes, and nine regional youth houses. Along with that, Azerbaijan paid for all transportation and living expenses of the international athletes who attended the event.⁷³

⁶⁸ <https://www.occrp.org/en/investigations/1499-presidents-family-benefits-from-eurovision-hall>

⁶⁹ <https://www.bbc.com/news/world-europe-32977924>

⁷⁰ https://musavat.com/news/olimpiya-oyunlarina-budceden-3-5-milyard-AZN-ayrilib_262520.html

⁷¹ <http://maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/static-pages/files/5ae9becbeda88.pdf>

⁷² <http://maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/static-pages/files/5ae9d1d8ae562.pdf>

⁷³ <https://www.theguardian.com/sport/2015/feb/26/azerbaijan-european-games-baku-athletes-bill-human-rights>

According to a statement from Azad Rahimov, the Minister of Sports and Youth of the Republic of Azerbaijan, the budget of the Baku 2015 European Games consisted of two parts. "The first part is within the investment program approved before 2018. Along with other spheres, some allocations were also made to sports. The second part is the budget of the Baku 2015 European Games Operating Committee... 950 million AZN (\$609.2 million) was allocated just to this." The second part constituted "expenses for salaries, technological systems, temporary equipment, communication, promotion, and daily expenses," according to the statement.⁷⁴ In comparison, Belarus hosted the European Games in 2019, which cost \$180 million, for which the president of Belarus was roundly criticized.⁷⁵

In 2017, Azerbaijan hosted the IV Islamic Solidarity Games. The report on the expenditures of the 2017 budget demonstrates that the Ministry of Youth and Sports spent \$1.25 billion to organize and prepare for the Games.⁷⁶

Since 2016, Azerbaijan has hosted the Formula 1 Grand Prix. The budget for this event is not disclosed. This prominent event is organized by the son of the Minister of Sports and Youth of Azerbaijan, Azad Rahimov. Rahimov's son owns Baku City Circuit Operation Company. No information has been provided about profits from the event. However, based on independent research by the international audit company PricewaterhouseCoopers conducted in late 2017, we can conclude that the first two Formula 1 events brought \$277.3 million in profit to the country.⁷⁷ A contract extending the Formula 1 in Baku until 2023 has been signed.⁷⁸

In 2017, it was officially announced that the finals of the Europa League (an annual European soccer competition) would be held in Baku. While Seville and Istanbul were among other cities that applied to host the finals, Baku was selected as the host of the match.

Azerbaijan intends to host a number of other sporting and entertainment events in the near future, including Expo 2025.⁷⁹

⁷⁴ https://www.bbc.com/azeri/azerbaijan/2015/06/150625_european_games_budget

⁷⁵ <https://www.fairobserver.com/region/europe/european-games-2019-minsk-belarus-human-rights-sport-europe-news-12221/>

⁷⁶ <http://maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/static-pages/files/5b1f722f85964.pdf>

⁷⁷ <http://marja.az/news/41482>

⁷⁸ http://cbc.az/az/az/v_story/2023-c-l-qdr-baki-formula-1-yarilarina-ev-sahbly-edck

⁷⁹ <https://www.azernews.az/business/141486.html>

Corruption and Whitewashing

Azerbaijan is interested in hosting international sporting and entertainment events for two reasons: economic interests linked to corruption, and political interests.

Low transparency and accountability standards, combined with the high potential for corruption in the country, encourage economic interest in these lucrative projects. Azerbaijan scored only 25 out of 100 points on the Corruption Perception Index and is currently ranked 152nd among 190 countries.⁸⁰ In the Open Budget Index the country scored 34 points out of 100, and is currently ranked 78th among 115 countries.⁸¹ In the Resource Governance Index, Azerbaijan scored 47 points out of 100, and was placed in 47th position out of 87.⁸² Azerbaijan's membership in the Open Government Partnership was suspended,⁸³ and its membership in EITI was first suspended and later the country refused to take part in the organization's work.⁸⁴

Under the guise of modernization, more budget money was allocated to the construction sector, which has had a high corruption risk since the Soviet era.

At least 1 out of every 3 dollars from the 2008 to 2015 state budgets was allocated to industry, construction, and minerals extraction, while up to 99% of the investment budget was directed into the construction sector.⁸⁵

The drop in oil prices in the world market in 2015 negatively affected budget expenditure in the construction sector. Then, the 2018 rise in oil prices made the construction sector a budgetary priority. An estimated 1 in 4 dollars was spent in the construction sector in 2019.⁸⁶

This sector is leading in misappropriation of budget funds. The money allocated to the construction sector is mainly directed at financing infrastructure projects with significantly inflated costs. The final authority for allocation of funds in this sector lies with the executive authority or the presidential administration, rather than with

⁸⁰ <https://www.transparency.org/country/AZE>

⁸¹ <https://www.internationalbudget.org/open-budget-survey/results-by-country/country-info/?country=az>

⁸² <https://resourcegovernance.org/analysis-tools/publications/2017-resource-governance-index>

⁸³ <https://www.opengovpartnership.org/members/azerbaijan/>

⁸⁴ <https://eiti.org/azerbaijan>

⁸⁵ <https://www.cbar.az/page-41/macroeconomic-indicators>

⁸⁶ author's prediction

the Parliament. Further, contracts are not won in open and competitive tenders, but rather are given to companies owned by high-ranking officials. Thus, billions of dollars are misappropriated every year under the guise of modernization and with corrupt interests.

The government tries to whitewash its damaged image in the international arena by “paying attention to modernization” and by creating connections with global leaders in the sphere of sports and culture. However, rather than varnishing Azerbaijan’s image, sporting and entertainment events highlight Azerbaijan’s democratic failures in the world media.

Greasing the Civil Service Wheels



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A significant share of Azerbaijan's state budget is spent supporting government employees who participate in repression and falsification of elections. Thus, the regime puts these groups under its control and increases the repressive impacts of oil revenues.

The 2019 state budget was projected to receive \$6,684 billion (11,364 million AZN) from the State Oil Fund. With taxes paid by the State Oil Company of the Azerbaijan Republic (SOCAR) and the Azerbaijan International Operating Company (AIOC), oil revenues make up 60% of the total state budget. What are these funds are spent on?

The largest portion - about two thirds - of the state budget of Azerbaijan is spent on investments, social protection, administration, and defense. In 2019, a significant part of the budget was allocated to social programs. Let us examine these programs and who are they benefitting.

According to an official statement, the total value of 2019 social programs in the country

was \$1.35 billion (2.3 billion AZN) and will increase to \$1.77 billion (3 billion AZN) in 2020.⁸⁷

The Chamber of Accounts statement about the annual report on the execution of budget for 2018 of State Oil Fund of the Republic of Azerbaijan demonstrates that \$4.23 billion (over 7.196 million AZN) was allocated for social expenses in 2018: 7.6% more than the previous year.⁸⁸

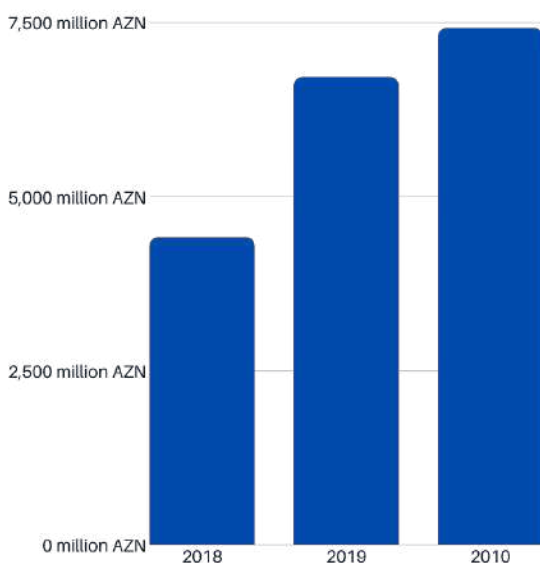


Figure 7.
Azerbaijan's budget spending on salaries.

Salaries amounted to 61.3% of these expenses. Every year since 2017, expenditures related to public salaries have steadily grown.

In 2019, the expenses related to salaries increased by 52.1% in comparison with 2018, while in 2020 this figure will increase by 68%.

In 2019, the minimum salary increased approximately two-fold, growing from 130 AZN to 250 AZN.⁸⁹ Who is benefitting from the increase?

Government Workers

Starting September 1, 2019, salaries of government employees increased on average by 40%.⁹⁰

Monthly salaries of Central Election Committee (CEC) employees grew significantly, making the gap between their wages and the nominal average salary in the country even larger than it had been previously.⁹¹

The vast majority of employees of the Central Election Committee and the Constituency Election Committees are representatives of the ruling party. Thus, it is

⁸⁷ <https://president.az/articles/33941>

⁸⁸ <http://sai.gov.az/upload/files/NeftFondu-REY-2019.pdf>

⁸⁹ <https://fed.az/az/dovlet/prezidentin-kecirdiy-i-musavire-tam-metn-61250>

⁹⁰ <https://novator.az/2019/06/19/maas-artimi-s%C9%99r%C9%99ncamlari-2/>

⁹¹ <https://president.az/articles/33594>

easy to believe that there are political reasons behind these large salary increases. These committees are perceived to have falsified elections throughout the 26-year rule of the Aliyev family at all levels: municipal, parliamentary, and presidential.⁹²

Teachers

In compliance with the presidential decree, teacher salaries increased by 20% on average starting September 1, 2019 – also a politically motivated move.⁹³

The majority of members of the Constituency and Precinct Election Commissions are heads and employees of state schools. Election falsification is mainly conducted with their direct participation.

In contrast, healthcare workers have not seen an increase in salaries. According to the State Statistics Committee, on January 1, 2018, the average monthly salary of those working in healthcare and social services was \$130.50 (222.50 AZN), while the average salary of education workers was \$190 (322.2 AZN). Throughout 2018, there

was no registered salary increase in either group financed from the state budget. Despite the fact that health workers received a smaller base salary than teachers, it is the education sector that received a 20% increase in salaries in September 2019.

Journalists and NGOs

The State Council on State Support of NGOs spent \$17.4 million (29.5 million AZN) to finance 3,906 NGO projects between 2008 and 2017.⁹⁴

From 2010 to 2015, \$44.7 million (76 million AZN) was allocated to the media by the Reserve Fund of the President through the State Fund on Development of Media Outlets (SFDMO).⁹⁵

In 2010, Ilham Aliyev signed a decree on measures to strengthen the social protection of media workers of Azerbaijan.⁹⁶ On National Media Day, July 22, 2013, fifteen journalists and newspaper editors received apartments as gifts in a 17-floor, 2 block, 156-unit building, which was built with State resources.

⁹² <https://www.osce.org/odihr/elections/azerbaijan>

⁹³ <https://banco.az/az/news/muellimlerin-maaslari-20-faiz-artirildi>

⁹⁴ <http://www.cssn.gov.az/index.php?lang=az>

⁹⁵ <http://kivdf.gov.az/>

⁹⁶ <http://www.e-qanun.az/framework/19901>

In 2013, the president signed a decree on the construction of a second building for journalists. *Contact.az* reported that a 255-apartment building was to be built within two years.⁹⁷ Currently, 411 journalists live in that building. The construction of a 3rd building, which will provide free housing for journalists, has started and is expected to be completed in 2020.

According to the SFDMO report, \$13.17 million (22 million AZN) was spent on construction of the first building, while \$20 million (34 million AZN) was allocated for construction of the second building.⁹⁸

Court Personnel and Police

On September 1, 2019, salaries of court, law enforcement, and special services employees increased by 40%. This increase tightened the binds of law enforcement and special services employees to the State government.

The State Statistics Committee does not reveal information about average salaries of law enforcement and special services. However, based on personally received information, it is possible to say that the average salary of a policeman in Azerbaijan is 1.5-2 times higher than the salary of a

State university professor and at least 5 times higher than the salary of a doctor.

The increase of salaries of law enforcement and security forces can be linked to their pivotal involvement in repression against the opposition, independent experts, independent journalists, and bloggers, because those who receive high salaries, awards, and rewards could be more vested in prolonging the life of the current regime.

These salary increases allow the government to claim that a large portion of the budget from oil revenues is spent improving social welfare, when in fact it can be seen as entrenching the current regime. In this way, the regime puts certain public workers under its control and increases the repressive impact of oil revenues.

⁹⁷ <https://d9mc3ts4czbpr.cloudfront.net/az/article/mediaya-xerclenen-budce-pullari-azerbaycan-prezidenti-metbuati-nece-satin-alir/?ref=article-related-artciles>

⁹⁸ <http://kivdf.gov.az/>

Azerbaijan Spends Unprecedented Resources on Lobbying



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More than \$150 billion in oil and gas revenues over the past 10 years created unprecedented opportunities for Azerbaijan to invest in lobbying to hush critical voices from both inside the country and abroad and to improve relations with the west.

The Sunlight Foundation placed Azerbaijan in the top 10 countries spending significant money on the services of lobbying companies in Washington, DC.⁹⁹ According to the Foundation, the country spent about \$2.3 million on lobbying in 2013. During the

years of peak oil revenues (2010-2015) spending on lobbying remained very high.

In 2015, investigative journalists discovered that the Azerbaijani Embassy in the United States pays hundreds of thousands of

⁹⁹ <https://sunlightfoundation.com/2014/05/08/what-countries-spent-the-most-to-influence-the-usa-in-2013/>

dollars to its main lobbying organizations, the Podesta Group.¹⁰⁰

On April 30, 2014, the Podesta Group signed a bilateral agreement with the Embassy of Azerbaijan in the US.¹⁰¹

According to this agreement, the Podesta Group would receive a fixed monthly payment of \$50,000, plus additional expenses for managing public relations for the Azerbaijani government. Fact-finding teams revealed records of hundreds of engagements between the Podesta Group and congressional offices, executive agencies, media members, and research centers.¹⁰²

Another investigative report, The Laundromat, issued by the Organized Crime and Corruption Reporting Project (OCCRP) in 2017¹⁰³ revealed that billions of dollars were used to hide the truth about human rights abuses in Azerbaijan.

OCCRP obtained leaked bank documents showing that \$2.9 billion were laundered through shell companies by Azerbaijan's ruling elites. Part of the sum was used to

hush critics and to buy the loyalty of Western organizations.

According to the report, three European officials, a journalist favoring the regime, and businessmen promoting the government received payments. These individuals at times even managed to mobilize such organizations as UNESCO and PACE to promote Azerbaijan, while the government of Azerbaijan was simultaneously conducting a massive crackdown on journalists and civil society between 2012 and 2014.

In addition, the Azerbaijani Embassy in Washington, DC invested a total of \$1.48 million to gain support from another lobbying organization – the BGR Group. The organization received \$390,000 in 2019,¹⁰⁴ \$600,000 in 2018,¹⁰⁵ and \$490,000 in 2017.¹⁰⁶

Moreover, the government of Azerbaijan spent oil and gas revenues on the Azerbaijan America Alliance (AAA), the US Azeris Network, and the Assembly of the

¹⁰⁰ <https://foreignpolicy.com/2015/06/11/how-azerbaijan-and-its-lobbyists-spin-congress/>

¹⁰¹ <https://efile.fara.gov/docs/5926-Exhibit-AB-20140430-41.pdf>

¹⁰² <https://medium.com/@ralakbar/azerbaijan-pays-extra-fee-to-podesta-group-following-aliyev-s-washington-trip-4261b9ab1f07>

¹⁰³ <https://www.occrp.org/en/azerbaijanilaundromat/>

¹⁰⁴ <https://www.opensecrets.org/federal-lobbying/firms/summary?cycle=2019&id=D000021679>

¹⁰⁵ Ibid

¹⁰⁶ Ibid

Friends of Azerbaijan (AFAZ), all registered as non-profit organizations in the US.

The Center for Responsive Politics (CRP) issued a report releasing the expenditures made by the American Alliance of Azerbaijan (AAA) between 2011 and 2015 to protect the interests of the ruling elite of Azerbaijan in the United States. The AAA spent \$1.72 million in 2015,¹⁰⁷ \$2.88 million in 2014,¹⁰⁸ \$2.88 million in 2013,¹⁰⁹ \$2.92 million in 2012, and \$2.26 million in 2011 for a total of \$12.66 million spent altogether between 2011 and 2015. These were the peak years of oil profits for the country.

While continuing to use rising oil revenues to invest in non-transparent and unaccounted-for projects, the elites in the administration paid for lobbying efforts to hush the media and political opposition within the country, and the critical voices coming from abroad.

European countries, as key purchasers of Azerbaijani oil and gas, as well as the United States, should not turn a blind eye to the human rights violations and imitations of reforms in the country, regardless of Azerbaijan's lobbying efforts.

¹⁰⁷ <https://www.opensecrets.org/federal-lobbying/clients/summary?cycle=2019&id=D000064546>

¹⁰⁸ Ibid

¹⁰⁹ Ibid

What Azerbaijan Spends on Defense



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A hike in oil revenues from 2010 to 2015 in Azerbaijan coincided with a rapid increase in the country's spending on its defense sector. However, with no transparency on defense contracts, it is difficult to track the use of military funding. The lack of accountability of military expenditures has also increased the risk of corruption in spending.

Azerbaijan's military spending depends heavily on the country's oil revenues. When oil revenues peaked in 2010 to 2015, the largest amount of money that the State Oil Fund transferred to the state budget was used to fund social and military projects.

Between 2011 and 2015, the costs of maintaining the military equaled US \$16.06 million, 56.5% of the overall financial resources spent on the military between 1995 and 2018. The graph below demonstrates the dependence of the military budget on oil revenue transfers to the state budget between 2008 and 2019.



Figure 9. Correlation between the oil revenues transfer to the state budget of Azerbaijan from the oil fund and the military expenditures during the period of 2008-2019

Russia, Israel, Turkey, Ukraine, Belarus, Pakistan, the Republic of South Africa, and China play a significant role in providing arms and military technology to Azerbaijan.¹¹⁰ In this way, the Azerbaijani government, which spends oil revenues for weapons acquisition, gives preference to political allies while choosing its partners for military trade.

Military Cooperation with Russia

Russia is Azerbaijan's main partner in arms trading. According to Azerbaijani and international media, Azerbaijan purchased billions of dollars' worth of arms and military ammunition from Russia. In his September 2018 interview with the Russian *Ria-Novosti* channel, Azerbaijani President Ilham Aliyev stated that the equipment and arms purchased by Azerbaijan from Russia reached \$5 billion and that Russia would continue to provide Azerbaijan with ammunition and military equipment.¹¹¹ According to the Stockholm International Peace Research Institute (SIPRI), military equipment purchased by Azerbaijan using the state budget between 2011 and 2015 comprised 5% of Russia's exports.¹¹²

¹¹⁰ <https://news.lent.az/news/116123>

¹¹¹ <https://ria.ru/20180901/1527658900.html>

¹¹² <https://www.ipinst.org/?s=azerbaijan&facet=&year=&page=20>

According to local Azerbaijani media, ammunition purchases from Russia coincided with the hike of oil revenues between 2010 and 2015.¹¹³

The Russian newspaper *Kommersant* confirmed that military cooperation between Azerbaijan and Russia is ongoing.¹¹⁴

In November 2019, Azerbaijani media reported that another agreement worth \$5 billion is expected to define Russian-Azerbaijani military cooperation.¹¹⁵

Without official records of Azerbaijan's military trade with Russia, it is difficult to determine the specifics of this trade, as it is carried out without the necessary transparency.

Trade with Israel and Belarus

Israel is Azerbaijan's second largest military trade partner. Referencing the Israeli newspaper *Haaretz*, Azerbaijani media reported that Israel sold \$5 billion in arms and military equipment to the Azerbaijani government.¹¹⁶

In 2005, Azerbaijan began purchasing ammunition and military technology from Belarus, including various optical devices from the Belarusian optics company, BELOMO.¹¹⁷ This cooperation is ongoing.

In conclusion, as with other state budget expenditures, the country's defense sector needs clear and accessible transparency mechanisms, especially when it comes to contracts.

¹¹³ <https://www.meydan.tv/ru/article/bes-ilde-rusiy-a-azerbaycana-5-milyard-dollarliq-silah-gonderecek/>

¹¹⁴ <https://bit.ly/3aL1gQt>

¹¹⁵ <https://ordu.az/az/news/157912/azerbaycan-rusiyadan-yeni-silah-sursat-alacaq>

¹¹⁶ <https://d9mc3ts4czbpr.cloudfront.net/az/article/haaretz-qezeti-azerbaycan-israilden-silah-dasiyir/>

¹¹⁷ <https://azvision.az/news/166668/azerbaycanin-12-ilde-belarusdan-aldigi-silah-ve-herbi-texnikalar-fotolar-.html>

III. Poverty and Corruption: Nothing Gained for Azerbaijan

Huge Spending and Overwhelming Poverty



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In 2019, SOFAZ celebrated its 20th anniversary. However, there is little to celebrate: despite huge spending, the country's role as an economic leader in the region is declining and people are suffering from poverty and poor social services. Oil and gas revenues have brought neither improved welfare nor democracy to Azerbaijan.

As of January 1, 2019, SOFAZ has received \$138.3 billion from the main oil reservoir of Azeri-Chirag-Gunashli (ACG). As of September 2019, the Fund had only \$42.5

billion in its reserves.¹¹⁸ Thus, the question arises: what have the citizens of the country gained from the spending of nearly \$100 billion in oil revenue, which the government

¹¹⁸ <https://www.oilfund.az/en/report-and-statistics/recent-figures>

has received from the ACG oil reservoir alone?

Indicators of Poverty

In a country that spent nearly \$100 billion from 2001 to 2018, citizens still suffer from unemployment and poverty. Many are forced into labor migration and must leave the country in search of work. The overall quality of public healthcare and education is low, and to receive good service in these spheres, one must pay a high price.

Residents of major cities often do not have access to quality roads, potable water, or a working sewage system. Despite the fact that the majority of oil revenues were spent in remote regions, primarily on infrastructure projects, the situation there is even worse.

According to official reports, 95% of the country has access to natural gas. However, in reality some provincial areas are not supplied with gas. Gas provision is of low quality and is often interrupted. There are numerous citizen complaints about this service.

Another problem is carbon dioxide poisoning, which takes dozens of lives every year due to unregulated heating devices and brick stoves, which are used in the absence of regular and central heating

provision. According to an Associate Professor at the Azerbaijan Medical University, medical toxicologist Ismail Afandiyev, "In recent years, there has been a tendency for an increase in carbon dioxide and combustion products in Azerbaijan. If in 2007 the number of such hospitalizations in the center of toxicology was 173, in 2017 this figure was 4 times higher."¹¹⁹

Cancer related illnesses are on the rise in Azerbaijan. Environmental issues are also pressing.¹²⁰

Only 4.2% of the budget is allocated to healthcare, and a mere 0.06% is allocated to protecting the environment.

According to the State Statistics Committee, due to decreased purchasing power, the quality of life has worsened over the past 10 years. Two devaluations of the *manat*, which were the result of dropping global oil prices in 2015,¹²¹ continue to impact Azerbaijan's economy and the quality of life of the Azerbaijani people. Since then 13 banks have closed, and the number of overdue credits is on the rise. As of January 2020, the overdue debt owed by people to commercial banks is more than 1.4 billion AZN (\$823.5 million), which comprises 9.3% of the country's credit portfolio. Along with that, the average salary in USD has significantly decreased. Azerbaijanis earn

¹¹⁹ <http://femida.az/az/news/71529>

¹²⁰ <http://deyerler.org/361786-azjrbaycanda-eie-xjstjlikljri-artdr-v-hjkimljrdjn-sos-xbjrdarldddd.html>

¹²¹ <https://www.adb.org/sites/default/files/publication/421611/adbi-wp842.pdf>

\$252 less per month than they did four years ago. The average monthly salary in 2018 was \$318.

Barriers to Growth

On December 28, 2018, President Aliyev signed a Decree approving the budget of the State Oil Fund of the Republic of Azerbaijan for 2019, including 15.45 billion AZN (\$9.09 billion) in revenues. 122 Expenditures of the Fund were approved at 11,595,238.4 thousand AZN (\$6.82 billion).

In reality, the numbers depend on the oil prices in the global market. Current projections only work if the price per barrel of Azerbaijani oil is \$60. However, current oil prices are below that. According to the IMF, the average oil price this year will drop to \$55.¹²³

Despite this, even if the price is \$60, Azerbaijan will earn \$1 billion less than the previous year due to a decrease in extraction. Even if last year Azerbaijan maintained extraction rates equal to the previous year, this year the country will not be able to do so due to increasing costs of production. Thus, it is expected that, although the oil revenues will drop, the scope of corruption will increase and freedoms will be further restricted.

Azerbaijan ranks low among the Commonwealth of Independent States countries in terms of the growth rate of the Gross Domestic Product (GDP). Further, there has been a decrease in GDP per capita since 2014, from \$6,072 to \$5,769 per capita in 2018.¹²⁴

The last year Azerbaijan led the economies of the South Caucasus was 2018. According to the economic growth rate presented by the World Bank 2019 Global Economic Perspectives of the World Bank, Azerbaijan will trail Georgia in GDP per capita this year and Armenia in 2021, making Azerbaijan the poorest country in the Caucasus by 2021, not only in terms of freedoms and democracy, but also economically.

Therefore, as long as these problems persist, Azerbaijan will fail to realize the dreams its citizens have had since independence. There were times when everyone thought that if citizens managed their own wealth, the country would become the Switzerland of the Caucasus. Despite 27 years since the restoration of independence, people in Azerbaijan still cannot control their oil wealth. A country with an excess of money is turning into a country of poor people.

¹²² <https://www.oilfund.az/en/report-and-statistics/budget-information/40>

¹²³ <https://oilprice.com/Energy/Oil-Prices/IMF-Predicts-55-Barrel-Through-2018.html>

¹²⁴ <https://tradingeconomics.com/azerbaijan/gdp-per-capita>

When Oil Peaks, Corruption Soars



CORRUPTION

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In 2019 and 2018, Azerbaijan received low ratings in Transparency International's Corruption Perception Index and in the Open Budget Index. Low ratings harm the country's image and make investments into the country more difficult. Interestingly, ranking in the Corruption Perception Index correlate strongly with annual oil revenues, with the country scoring the worst during peak oil years. Legislative protection of civic oversight of budget transparency and other independent corruption-related monitoring is imperative to improve Azerbaijan's image and international corruption ratings.

There is a strong, positive correlation between the scope of corruption and oil revenues. The Corruption Perception Index of Azerbaijan in the following table demonstrates that Azerbaijan scored the worst during the peak years of oil revenues

(2008-2012). This deep dive of the country's corruption index is linked to non-transparent expenses of the state budget, which is mainly comprised of oil revenues.

Even though up to 40% of the state budget expenditure is not classified, the final use of these expenses is not known during budget creation. This allows for a high risk of corruption in oil money expenditures which, in turn, negatively affects other indices, including the World Bank Governance Indicators.

Since Azerbaijan left the Extractive Industries Transparency Initiative in 2017, access to information about the management of oil revenues and transparency and accountability standards has dramatically decreased.

Azerbaijan has refused to participate in international initiatives such as beneficial ownership, project accountability, contract transparency, and transparency of purchase contracts on raw materials.

Why Should We Care About These Indices?

Lack of transparency and a high degree of corruption in Azerbaijan harm the image of the country, damage the reputation of the state, and worsen its credit rating, making investment into the country riskier for international investors.

Corruption entrenches the Azerbaijani citizens in poverty. Inequitable division of oil and gas revenues and wealth leads to severe stratification of the population. Thus, corruption risks related to oil revenues create dangers to the country's stability.

What Needs to Be Done to Improve Corruption Indicators?

The fight against corruption in Azerbaijan must be significantly strengthened in order to ensure independence of judiciary, freedom of the press, and space for independent civil society.

Unfair trials and restrictions on independent civil society and independent media damage the country's ability to combat corruption.

Legal protection for whistleblowers is imperative, and relevant legislation should be adopted in the Competition Code to prevent conflicts of interests.

Application of the code of honor for State officials should be enforced, including the declaration of family revenues and property of the president, the prime minister, members of the Cabinet of Ministers and Parliament.

Public participation and civic activism must increase to effectively fight corruption. Civic social audits must be legally protected through relevant working mechanisms and legislation. Only then will it be possible to obtain any success in the fight against corruption with the participation of the society as a whole.

Azerbaijan Signs International Agreements but Fails to Meet Their Obligations



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The government of Azerbaijan has signed onto various international conventions and different global agreements, but still refuses to meet its obligations related to independent civil society, free press, transparency, accountability, and anti-corruption measures.

Often, oil-rich countries join international conventions in order to present themselves to the western world as modern and progressive. However, once petrodollars begin flowing into the country, these governments forget their international

obligations. Azerbaijan's experience in this regard is no exception.

Azerbaijan has failed to fully implement the recommendations of the Venice Commission¹²⁵ and the Organization for

¹²⁵ https://www.venice.coe.int/webforms/documents/by_opinion.aspx?country=41

Security and Cooperation in Europe (OSCE/ODIHR) Bureau of Democratic Institutions and Human Rights,¹²⁶ as well as the Group of States against Corruption (GRECO).¹²⁷

In March 2018, Azerbaijan received 21 anti-corruption recommendations at the GRECO plenary session and has implemented only 13 of them fully, five only partially, and has failed to implement three recommendations altogether.

GRECO's recommendations require the government of Azerbaijan to disclose the assets and property of all of the members of Parliament, judges, and prosecutors, which are important steps in preventing further corruption in the management of Azerbaijan's oil and gas reserves.

The government of Azerbaijan clearly lacks the political will to operate disclosure regulations for its assets and revenues. Yet, property and income declarations by civil servants and state officials (members of parliament, judges, and prosecutors) are critical measures in preventing corruption in the direct and indirect expenditures of oil and gas revenues.

Subsequently, GRECO has called on the Azerbaijani authorities to take decisive measures to implement its recommendations and finalize the important anti-corruption reforms. The organization agreed to wait for additional information on the measures taken by Azerbaijan, giving them a deadline of December 31, 2019.¹²⁸ The deadline passed, but no measures have been taken at the time of writing this report. In January 2020, a delegation of the Parliamentary Assembly of the Council of Europe (PACE) traveled to Baku to assess the climate of the early parliamentary elections. They recalled that a number of recommendations by GRECO to improve campaign finance have not been addressed.¹²⁹

Further, Azerbaijan has not fulfilled its commitments under the Open Government Partnership (OGP), which the country joined in 2012,¹³⁰ and the Extractive Industries Transparency Initiative (EITI), of which Azerbaijan was a member between 2003 and 2017.¹³¹

During the 2016 OGP Steering Committee meeting, Azerbaijan lost its full membership

¹²⁶ <https://www.osce.org/odihr/elections/azerbaijan>

¹²⁷ <https://rm.coe.int/fourth-evaluation-round-corruption-prevention-in-respect-of-members-of/168094f9b1>

¹²⁸ <https://www.turan.az/ext/news/2019/6/free/politics%20news/en/81771.htm>

¹²⁹ <http://assembly.coe.int/nw/xml/News/News-View-EN.asp?newsid=7752&cat=31>

¹³⁰ <https://www.opengovpartnership.org/members/azerbaijan/>

¹³¹ <https://eiti.org/azerbaijan>

due to its failure to meet the important commitments of the Civil Society Standard—a set of requirements ensuring an enabling legal and operative environment for civil society organizations.¹³²

Even though Azerbaijan was given one year to undertake the obligations and create a favorable environment for civil society, a full two and a half years later those conditions have not been met. During the OGP Steering Committee meeting on December 5, 2018, the organization gave Azerbaijan another chance, requesting that five conditions be fulfilled during the following two years.

According to the first condition, by March 1, 2019, Azerbaijan must prepare a roadmap for the development of a new action plan in line with at least the minimum requirements outlined in the OGP Participation and Co-Creation Standards. The second requirement was to appoint, by June 1, 2019, a high-level government representative (ministerial level or above) to lead the OGP process in Azerbaijan. The third condition was to start developing an OGP action plan through an inclusive process that engaged a wide array of actors beyond the OGP Forum and included reforms to address the civic space constraints highlighted in the updated

recommendations and other domestic priorities. The deadline for this demand was also June 1, 2019.¹³³

The Azerbaijani government partially executed the first and second requirements. However, it did not even start working on the third, more important, condition of development of an action plan for the next year, including the consultation with and wider engagement of civil society.

Although the government failed to meet the set deadline, Azerbaijan remains a member of the OGP, maintaining a suspended membership.

As for the Extractive Industries Transparency Initiative (EITI), Azerbaijan was among the first four pilot countries to join this initiative in 2003, and received membership status in 2009. At the highest point of its oil revenues, however, Azerbaijan refused to meet its EITI obligations for open management and accountability in the production of oil, gas, and other mineral resources.

After receiving multiple reports of government-exerted pressure on civil society in Azerbaijan, on April 15, 2015, EITI deprived Azerbaijan of “full membership,” replacing it with a “candidate” status.¹³⁴ On March 9, 2017, the international governing

¹³²https://www.opengovpartnership.org/wp-content/uploads/2018/12/Azerbaijan_SC-resolution_12052018.pdf

¹³³ <https://www.turan.az/ext/news/2019/6/free/Interview/en/81710.htm>

¹³⁴ <https://eiti.org/news/azerbaijan-downgraded-to-candidate-country>

body of EITI decided to suspend Azerbaijan's membership.¹³⁵ On March 10, 2017, Azerbaijan made a statement announcing its departure from the organization.¹³⁶ On August 8 of the same year, Transparency Azerbaijan, which had operated in the country since 2005, announced that it had closed its office in the country.¹³⁷

The government of Azerbaijan signed various international conventions and joined different global bodies before the country's economy started to benefit from the returns from oil and gas. When petrodollar revenues peaked, it became obvious that the Azerbaijani government joined international conventions and organizations only for the sake of membership, and it started playing the imitation game to create an image of democracy without actually establishing it.

¹³⁵ <https://eiti.org/board-decision/2017-15>

¹³⁶ <https://eiti.org/document/azerbajjans-notice-of-withdrawal>

¹³⁷ https://www.transparency.org/news/feature/azerbaijan_closing_down_civil_society

Recommendations

Based on analysis of the information, this report recommends implementing changes that would improve transparency of oil revenues, reduce waste and corruption, and ensure the intergenerational equality of hydrocarbon profits. These changes include:

1. Increasing public and parliamentary oversight of the state budget by publicizing information about SOFAZ's activities and lifting restrictions on independent civil society and free media.
2. Improving the country's political reputation, especially ratings in international corruption perception indices and other human rights indicators by lifting restrictions on independent civil society and independent media, and promoting independence of the judiciary.
3. Ensuring legal protection for whistleblowers fighting corruption through adoption of legislation, including in the Competition Code, to prevent conflicts of interests.
4. Requiring civil servants to declare family revenues and property assets.
5. Including representation by independent civil society organizations on the Supervisory Board of the Oil Fund to promote public participation and more effectively fight corruption.
6. Compliance by SOFAZ with its founding goal of saving money and directing it to long-term development instead of spending the funds as a priority.
7. The Fund should follow fiscal provisions to reduce transfers from SOFAZ to the state budget.

8. With regard to SOFAZ's real estate portfolio, SOFAZ should implement clear and transparent policies, including:
 - a. Providing public access to information on subsidiary involved in managing SOFAZ real estate assets. Managing investments through affiliated subsidiaries companies reduces the direct liability and accountability of the Fund and creates possible tax deductions that do not benefit the budget;
 - b. SOFAZ should publish lease agreements on property management;
 - c. SOFAZ should withdraw its investment from the Russian real estate market and VTB Bank due to low profitability and losses;
 - d. Developing regulatory and accountability mechanisms to manage SOFAZ real estate investments.

9. SOFAZ should increase the transparency of its investment portfolio by exposing the source revenues in greater detail on an annual basis.

10. SOFAZ should publish timely and detailed information on the management of assets in its investment portfolio. This information would help increase the awareness of ordinary Azerbaijani citizens about oil and gas revenues and assets management.

11. To improve the effectiveness of the Law on Access to Information, an Information Ombudsman should be established, as envisioned in the transition VII provisions of the last chapter of the Law of the Republic of Azerbaijan on Access to Information.

12. The Laws on Commercial Secrets, Tax Code, Criminal Code, and other normative legal acts, which define regulations protecting commercial secrets, should require access to information about beneficial ownerships of commercial companies.

13. Effective fiscal regulations should be enforced in order to improve the balance between budget expenditures and oil revenues; and, ultimately, to decrease the country's dependency on oil revenues and to increase its economic stability and resistance to external shocks.

14. SOFAZ should stop directly financing public projects: all appropriations should be directed through the normal budgetary process and approved by parliament.

15. All existing public investment projects should be subject to public and competitive tendering; auditing of financial-budgetary examination should be conducted by the Chamber of Accounts, and civil society organizations.

16. The Chamber of Accounts should prepare recommendations on financial operations of the Oil Fund, and those recommendations should be discussed at the Parliament.

17. To improve efficiency of the budget process, the Government of Azerbaijan should consider:

- a. Proportional limits on resource revenue items;
- b. Limits on the non-oil budget deficit;
- c. Complete budget disclosure and justification of individual expenditures of all items not involving national security.

18. High cost public investment projects must:

- a. Appraise all projects with a cost-benefit analysis that includes social and environmental costs and benefits, not just financial costs and benefits;
- b. Prioritize projects that will have the largest development impact as measured by a sustainable rise in incomes and standard of living;
- c. Monitor the construction of all projects to ensure quality delivery on cost and on time;

- d. Budget for operations and maintenance of investment projects;
- e. All of these documents and budgets should be made public on government websites.

Conclusion

The lack of transparency and accountability of the entire hydrocarbon revenue management system in Azerbaijan is an issue of major concern. The most concerning issue pertains to the management of public investments from the state budget that draw on SOFAZ funds. Transparency is an issue both in the accumulation of oil revenues, and spending of oil revenues.

Accountability is critical to ensuring the sustainability of revenue management systems by encouraging adherence to rules and principles of efficient economic policymaking and effective management of public resources on timelines beyond officials' own tenure in power.

This report has exposed how a critical rule governing the management of SOFAZ has been ignored. According to SOFAZ regulations, when incomes from oil and gas revenues peak, at least 25% of revenues must be saved. But for the last few years we have seen the Fund spending more than 75%, violating this important principle.

Azerbaijan's public finance decisions are made in a discretionary fashion rather than according to determined regulatory processes. Problems arise when revenues from petroleum sales are deposited into SOFAZ. From there, the funds are allocated between saving and spending, and distributed among different expenditure items through an opaque process managed by a small group of people. SOFAZ budget transfers are significant and grow every year. Some hydrocarbon revenues are spent

directly on specific projects without transparent and public explanation.

The President of Azerbaijan is the sole person responsible for saving and spending decisions, without internal or external checks and balances. According to the Fund's statute, Article 4.1, "The Fund's assets are utilized in accordance with the main directions (program) approved by the President of the Republic of Azerbaijan." That is the only rule involving revenue allocation and there are no specific indications, which would stipulate how funds are to be withdrawn.

Further, there are no regulated ceilings of annual revenue withdrawal. As a result, Azerbaijan has procyclical spending and overspending, in addition to expenditures serving political purposes.

In addition, Azerbaijan lacks regulation in the formation of the government budget, which results in large, volatile transfers from SOFAZ to the state budget. The draft budget is prepared by the Ministry of Finances for approval by the Parliament, where large investment projects are usually not detailed. Most governments set a fiscal

envelope - the maximum they can spend in any given year - prior to deciding on specific expenditure items. This process relies on stable forecasts of tax revenue. However, resource rich countries must rely on more advanced practices that estimate stable taxes separately from volatile resource revenues. This does not happen in Azerbaijan.

The Parliament and Chamber of Accounts do not conduct any real thorough and transparent budget oversight and analysis. In 2020, parliament held its shortest debate yet on the state budget, with only 5 days of discussion, indicating a dire need for a more serious approach to budget regulation.

Without effective, transparent, and accountable regulation, the spending of oil and gas money in Azerbaijan has yielded crippling corruption, stratification of society, stifled economic growth, and an increase in poverty. Money has been spent on buying civil servants' loyalty, glamorous sports and entertainment events, high end but not profitable real estate abroad, and western support. Unfortunately, the people of Azerbaijan have seen little to no impact from the inflow of petrodollars.

Crude
Accountability
2020