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Energy Sector FDI in Azerbaijan: An Example of Good Governance?

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Can the success of Azeri government in attracting FDI be considered a result of good governance?

Azerbaijan is a country that is richly endowed with natural resources, controlling extensive supplies of both oil and gas. According to the British Petroleum (BP) *Statistical Review of World Energy* from June 2011, Azerbaijan's proven oil reserves amount to around 7 billion barrels, or 0.5 per cent of the world's proven reserves, with proven gas reserves of 1.3 trillion cubic metres, or 0.7 per cent of the world's confirmed reserves (British Petroleum, 2011). However, estimates of the overall potential of the Azeri oil fields suggest its yield to be as high a 40 billion barrels, thus highlighting the importance of the Caspian reserves as one of the largest oil reservoirs in the world, second only to the Middle East (Bayulgen, 1999). The size of the reserves in Azerbaijan makes the country's importance in the world's future energy security, particularly of Western Europe, abundantly clear. Understandably, since Azerbaijan's independence in 1991, foreign investment interests in the country have been extremely high, but foreign interests have mainly focused on investments of a resources-seeking nature opposed to efficiency-seeking investments. Although the presence of natural resources acts as a prominent determinant for Foreign Direct Investment (FDI), it is clear from the general literature on FDI that the presence of natural resources by themselves are not sufficient for FDI to take place (Kudina & Jakubiak, 2008). This suggests that FDI in Azerbaijan is the result of factors beyond that of its resource rich nature, implying the importance of the regime in creating an attractive and flexible investment environment. Azerbaijan stands out as a country that has been extremely successful in attracting FDI and has been labelled by many as the 'former Soviet Unions "showcase" for the art of doing business, the "frontier of global capitalism," and a "united nations of oil."' (Bayulgen, 2010). After the collapse of the Soviet Union and the all Union market in 1991, Azerbaijan suffered a dramatic drop in output between 1991-1997, largely as a result of the 'outdated technology, poor planning and a lack of investment in new drilling and rehabilitation of existing wells' (Ciarreta & Nasirov, 2010). Lacking capital for resource-extraction, the technical skills needed to extract and sell the raw materials, and the presence of poor infrastructure (Kudina & Jakubiak, 2008), Azerbaijan was a perfect candidate for FDI rather than trade. Thus, it can be argued that the recognition of the reality of the country's economic situtation by the Azeri government represents an example of good governance..

This essay will look at the role that the government of Azerbaijan has played in attracting FDI, how it has managed and disseminated the revenue accumulated as a result of its natural wealth, whether or not the government has played and active and effective role in the management of the country's economy, and if it is possible to assess the development of Azerbaijan's political and economic situation with well-established and general political science theories such as the 'resource curse'. This will be done with a view to understanding the nature of the political system in Azerbaijan and whether or not it is a unique development, or one that fits into the broader discipline of transition studies.

Defining the regime

In order to fully understand the part played by the government in attracting, managing and sterilising the revenues of FDI, it is crucial that we understand the nature of the political regime in Azerbaijan. However, this is arguably the greatest limitation of this study due to a lack of literature focusing on Azeri politics, with the work that does exist far from reaching a consensus on how the Azeri regime should be characterised. Assessments of the regime's political nature range from categorisations of it as a 'neo-patrimonial dictatorship, sultanistic, [and] authoritarian', to 'decaying semi-authoritarian', 'sultanistic semi-authoritarian', 'hybrid' and 'partially democratic' (Bayulgen, 2010). Despite a lack of agreement amongst many scholars, it is clear that all of these categories highlight two common themes: low levels of institutional constraints and political competition due to a lack of effective political counterbalances and strong opposition parties. Whilst far from agreeing on a widely accepted label for the type of political regime operating in Azerbaijan under President Aliyev, the similarities apparent between these categorisations offers significant insight into the most important characteristics of the government. With regard to understanding the regimes role in the governance of FDI and the management of the economy, it is widely accepted in literature covering regime types and the management of their economies that independent institutions, accountability and government transparency are all critical in maintaining an efficient market economy (Hübner, 2011). Considering the early stages of development that these factors are currently undergoing in Azerbaijan, suggests that the management of the economy will be negatively affected by the nature of the country's government. However, regardless of these assertions, Azerbaijan's economy has remained extremely stable and has continued to grow throughout the financial crisis where other more developed nations have faltered. So, with this in mind, this essay will show how the government of Azerbaijan has been managing the influx of FDI and the country's economy as a whole, and assess whether these general assumptions from the wider literature on FDI and regime typing bare any relevance to the political and economic development of the country.

Reasons for Azerbaijan's success in attracting FDI and the limitations of their policies

Since the so-called '*Contract of the Century*' in 1994, Azerbaijan has successfully signed 29 Production Sharing Agreements (PSA) (Ciarreta & Nasirov, 2010). The country's success in securing agreements with foreign investors resulted in the total foreign investment in the country during 1993-2010 reaching 54.2 billion USD, 37.6 billion of which was from FDI. This incredible influx of FDI accounted for the highest GDP growth rates in the world during 2005-2009, and allowed the country's economy to rapidly recover and develop after the collapse of the Soviet Union (Hübner, 2011). However, the vast majority of this FDI was primarily motivated by resource-seeking industries, most predominantly from the global oil industry. Despite this, as has already been mentioned, the flow of FDI into countries with an abundance of natural resources is far from a given and Azerbaijan's accomplishment in FDI attraction is the result of aspects beyond that of the presence of natural resources. It is also apparent, however, that much of the FDI in the country has been directed at the energy sector, with the investment environment in the oil industry and the non-oil industry having developed in unique and very different ways.

Management of the Oil Sector

Unlike other resource rich post-communist states such as Russia and Kazakhstan, the government of Azerbaijan has not curtailed the presence of international oil companies in the country and has actively pursued FDI in its energy sector, emphasising the importance of an international presence (Kjaernet, 2010). Whilst there have been a number of general laws and decrees passed concerning the general investment environment in Azerbaijan, such as the *Law on the Protection of Foreign Investments* (1992), *Law on Investment Activity* (1995), *Law on the Privatisation of State Property* (2000), and the *Law on International Arbitration* (2000), the Azeri government has developed a separate legal framework for the oil industry in order to minimise the risk and expedite oil projects with a view to encouraging investment (Bayulgen, 2010). The regime has also developed an effective and world renowned system of attracting FDI through the development of PSAs as the principle mechanism for attracting foreign investment. These PSAs clearly outline the regulatory, financial, organisational, legal and compensatory relationship between the foreign oil companies and the government, with the agreements allowing for the free renegotiation of the terms of the contracts with the consent of both parties as allowed for by the law (Bayulgen, 2010). The PSAs also provide a specialised system of taxation to the foreign oil companies, but not for *The State Oil Company of Azerbaijan Republic* (SOCAR), that is agreed upon with the individual investors, with the tax obligations of each company clearly defined within their contracts (Luong & Weinthal, 2010). The separate tax code developed for the petroleum industry delivers a stable and predictable tax liability for foreign investors, providing a physical mechanism for both rendering the Azeri government its share of the profits and ensuring that the foreign energy companies can recoup their investments (Bayulgen, 2010). Although foreign companies under this tax regime experience a greater fiscal burden than in previous eras of the country's history, with the Azeri government expected to receive 80 per cent of profit oil over the duration of its contract with the *Azerbaijan International Operating Company* (AIOC). Provisions for international arbitration accompanied with the stability clauses provide by the PSAs, reassure foreign oil companies and increase their willingness to undertake the substantial upfront capital investment (Luong & Weinthal, 2010).

It is clear that the flexible and stable environment that the Azeri regime has created in the petroleum industry has played a crucial role the country's successful acquisition of FDI. Whilst there are many forms of PSAs, the government of Azerbaijan has been extremely effective in creating an innovative contractual system that does not depend on a generic PSA law, instead tailoring each agreement to the investor and ensuring that the agreements take precedence over any existing or future laws that may differ or conflict with any of the agreements (Bayulgen, 2010). The development of this system has been fruitful for both the foreign oil companies and the government, demonstrating the regime's ability to adapt and innovate when faced with economic obstacles. The regime has established an all-important rapport with the foreign investors in the oil sector and proven itself, in this setting at least, to be a reliable business partner. However, this ability to create an appealing investment environment has been seemingly restricted to the energy sector. Although there have been a number of 'knock-on' effects in industries such as communications and construction (Business Eastern Europe, 2002), developments in the non-oil sector of the economy, and thus its attractiveness to foreign investors, has been significantly slower.

Management of the Non-Oil Sector

The economic policy of the Azeri government is one that focuses on macroeconomic stability. Whilst the oil industry is an area of the economy in Azerbaijan that ensures the immediate fiscal health of the country, with Azerbaijan currently unable to survive without the revenues from the oil and gas industries (Hübner, 2011), the non-oil sector is not as immediately critical. As a result, the non-oil sector has not received the governmental input that it requires to attract foreign investment on the same scale as the petroleum industry. Of the 37.6 billion USD of FDI injected into the country from 1993-2010, only 4.4 billion USD of it was directed outside of the oil sector. When compared to countries such as the United Kingdom and the United States of America, where almost two thirds of all investments are directed at non-energy related industries, the extent to which Azerbaijan is dependent on its hydrocarbon industry for FDI is clear (Hübner, 2011). The development of non-oil related sectors, or more precisely the lack of, has been further hindered by the success of the Azeri oil industry, with booming oil and FDI revenues undermining the impetus for reform outside of the oil sector (Emerging Europe Monitor: Eurasia, 2004). Unlike the oil sector, non-oil related industries suffer from government bureaucracy, weak legal institutions and predatory behaviour by politically connected monopoly interests, all of which effectively ward off potential investors (Political Risk Services, 2002). Also, the international business perception of Azerbaijan as an autocratic and corrupt regime with high informal market-entry barriers, sector monopolies and unfavourable monetary conditions, plays a major role in the lack of investment interest outside of the independently functioning energy sector (Hübner, 2011).

The problems with the dual nature of the investment environment in Azerbaijan can be clearly seen in the results of the World Banks *Doing Business* survey for 2012. In the report, there are significant differences in Azerbaijan's rank between certain sections of the survey. For instance, in the categories for starting a business, registering property, protecting investors, and enforcing contracts, Azerbaijan is ranked 18th, 9th, 24th and 25th respectively, ranking within the top 15 per cent of the 183 countries scrutinised in the report. On the other hand, when assessed on dealing with construction permits, getting electricity, and trading across borders the ranks are significantly lower with rankings of 172nd, 173rd and 170th (The World Bank, 2012). These results indicate the disparity between the development in oil and non-oil sectors of the economy, showing that the lack of development of the non-oil sector is affecting its overall ranking and ultimately restricting the progress of the country as a whole, both in terms of its actual development and the international community's perception of Azeri progress. The dual nature of the Azeri economy can also be observed when looking at its system of taxation. As mentioned above, foreign investors in the petroleum industry are subject to an extremely stable standalone tax regime, whereas the non-oil sectors are subject to a fluctuating and unstable tax code. This has led to the development of the idea of a hybrid fiscal regime in Azerbaijan.

Despite the introduction of the new tax code on the 1st of January 2001, the implementation of the new regime has not been very successful for a number of reasons. The most prominent of these is the persistent presence of a large informal economy that has significantly undermined tax collection in Azerbaijan. It is the second largest shadow economy of the 23 post-Soviet transition states and accounts for 61 per cent of Azerbaijan's GDP (Luong & Weinthal, 2010). Despite the implementation of a simplified tax code by the Azeri government, it has been unable to reduce the size of the unofficial economy or foster growth in small to medium enterprises largely due to the emphasis the government has placed on indirect taxes such as VAT. This is largely due to the impact that high VAT has had on small businesses that choose to operate outside of the simplified tax regime due to their decision to employ greater numbers of personnel. The high VAT creates a significant amount of disincentive for small business wishing to expand their businesses and has pushed many entrepreneurs into the informal economy, encouraging tax evasion and corruption (Luong & Weinthal, 2010). It is unfair taxation policies such as this which are encouraging tax avoidance and corruption in Azerbaijan, with some observers stating that 'much of the corruption could… be viewed as an alternative tax system' (Bayulgen, 1999). A low level of tax collection is also a major problem and clearly depicts the weak extractive capacity of the Azeri system of taxation, one which is typical of rentier-states (Bayulgen, 1999). However, despite this, according to the World Banks *Doing Business* survey for 2012, Azerbaijan has increased its ranking in the paying taxes category by twenty-four places, from 105th to 81st (The World Bank, 2012). This at least implies that the taxation policies in Azerbaijan are starting to have a greater effect and the regimes management of the system is improving.

However, it does appear that the Azeri government is taking steps to combat the underdevelopment of the non-oil related sectors of the economy and has embraced a number of wide ranging economic reforms. The government has signed bilateral trade agreements, introduced investment stimulating legislation, established *The Azerbaijan Investment Company* to promote the country's investment opportunities through its foundation AZPROMO, reduced corporate tax from 24 to 20 per cent, and removed limits on the repatriation of funds. As a result, FDI in the non-oil sectors has grown significantly over the last four years, however, it still remains far from the levels of that in the petroleum industry and does not encompass the same flexibility and stability that has become expected from the energy sectors PSAs (Hübner, 2011). Government officials have often stated the success of the Azeri government's economic policies in rapidly developing the economy through the attraction of vast amounts of FDI, referring to the country's Investment-Grade-Sovereign-Rating and the reduction they have achieved in the formal poverty rate from around 50 per cent at the beginning of the 21st century, to its current levels below 10 per cent. Whilst this is true, they rarely comment on the relatively low share of FDI in the non-oil sector and this attitude is part of the problem inhibiting the development of the non-oil related industries (Hübner, 2011). A good example of the detrimental difference between the mineral based resource sectors and the non-energy areas of the economy can be seen clearly in a comparison of the FDI attracted by the mining industry compared to that of the agricultural sector. The mining industry in Azerbaijan employs around 1 per cent of the country's working population, or 41,000 people. As a result over the last twenty years FDI in this area of the economy amounted to about 1,000,000 USD per mining employee. In contrast, the agricultural sector, which employs around 1.5 million people from the Azeri working population (or 40 per cent of the total working population), received only 4.5 million USD in FDI (1 per cent of the total non-oil related FDI), amounting to around 3 USD per agricultural worker (Hübner, 2011). This example clearly highlights the emphasis that has been placed on the energy-sector for attracting FDI and paints a clear picture of the country's distribution of wealth.

The policies of the Azeri government towards the non-oil related sectors of the economy have been significantly less effective than the ones directed at the petroleum sector. The lack of FDI in these areas is a clear indication of the poor governance that has taken place in this regard, clearly highlighting the agenda of the regime as one dictated by a rent-seeking mentality. Although currently there is no immediate need for the diversification of the economy to favour more sustainable sources of income, it is clear that without the implementation of a clear and effective strategy to move the country away from its fiscal dependence on the oil sector, the mid to long term stability of Azerbaijan's economy is far from assured. In this sense, the government's failure to adopt a more well-rounded economic approach to developing the country's economy and the resultant negative impacts that it has had on the rest of the non-oil related industries, is a typical example of 'Dutch Disease'. However, it has yet to become and irreparable situation, with a number of clear attempts to reform the non-oil sector offering hope for the future.

Transparency and Corruption

One of the major problems affecting the healthy development of the Azeri economy as whole, is the notably lack of transparency in the country's public sector and high levels of corruption. According to Transparency International's *Corruption Perceptions Index* for 2011, Azerbaijan holds a score of 2.4, with 10 being the highest possible rating, ranking the country as 143rd out of 182 and highlighting the country as being highly corrupt (Transparency International, 2011). In Azerbaijan, corruption is most pervasive in areas in which the management, collection or distribution of capital is central, such as the regulatory, tax, customs, and dispute settlement systems. When looked at in relation to the transparency of these areas, it becomes clear that the transparency of these systems is directly related to the levels of corruption present within them, with low transparency arguably enabling corruption. The regulatory system in Azerbaijan, which is plagued by weak administration, a lack of transparency, and widespread allegations of corruption, provides a clear example of how low transparency in the country has led to higher levels of corruption. The absence of transparent policies in the regulatory system and the resultant high levels of corruption, act as serious impediments to investment and have further damaged the appeal of the non-oil sectors of the economy, preventing the huge levels of FDI seen in the energy sector (Political Risk Services, 2002). Although there have been attempts to increase the transparency of the regulatory system through the simplification of regulations and laws, they still remain exceptionally complex and confusing, with information on the implementation of laws and regulations remaining extremely difficult to obtain (Political Risk Services, 2002). This extensive lack of transparency in the aspects dealing with the non-oil sector can also be seen in the country's tax code. Whilst on paper the country's tax system is on a par with those in developed Western democratic governments in terms of transparency, in reality this is not the case. The system of taxation in Azerbaijan lacks the sophistication of its western counterparts as a result of a lack of instruction leaving the system open to interpretation. The Azeri government has refused to provide clear instructions for the tax system due to the regime not wanting to improve the clarity of the tax code, instead preferring the flexibility to send out tax collectors to negotiate tax payments (Luong & Weinthal, 2010).

It is clear that the ready availability of easy and direct rents from oil and FDI revenues has undermined the necessity of introducing effective reforms to improve transparency and reduce corruption in Azerbaijan. When related to the literature available on the development of states dependant on oil, or petro-states, and the impact of the 'resources curse', the decline of regulatory and extractive systems is a central aspect of these theories (Bayulgen, 1999). The lack of transparency in the Azeri government and many of its institutions, and the resultant high levels of corruption, suggest that the government of Azerbaijan can in fact, to a certain extent, be analysed by the mainstream theory of the 'resource curse'. This is another example of how the Azeri government's management of the economy and the country outside of the energy sector has been far from what could be considered good governance. The impact of their reluctance to reform and improve the institutions outside of the energy sector, thus improving the investment environment surrounding the non-oil related industries, indicates that the regimes success in attracting FDI to the energy sector cannot be used to analyse the quality of governance in the country as a whole.

Government Use of Oil Revenues

Much like countries such as Russia, Azerbaijan has created a fund for dealing with the excess flow of revenue from oil exploitation with a view to both protecting the economy from the potentially hazardous effects of large influxes of capital, and to safeguard the economic security of future generations. The State Oil Fund of Azerbaijan's (SOFAZ) mission statement states that the oil fund is responsible for sterilising part of the projected income from oil revenues in the domestic economy, while saving the rest for future generations and invested in the international securities market (Aslanli, 2010). However, the effectiveness of the fund in fulfilling its mission statement is questionable. A lack of formal operating rules for how and when the revenue accumulated in the fund can be used means that the potential for SOFAZ to be misused is much higher than if it had a rigid and effective set of regulations dictating how it can be used, and more importantly, when it cannot be accessed. However, this is not the case, with authorisation for the use of the funds resting in the hands of one individual, the president (Bayulgen, 1999). Just like the regulatory and taxation systems mentioned earlier, the transparency that is crucial for the effective management of SOFAZ is severely lacking, despite the Azeri government voluntarily opting into the *Extractive Industries Transparency Initiative (Kjaernet, 2010)*. This makes SOFAZ especially vulnerable to misuse by the regime and, at best, undermines the relevance of the fund, and at worst, threatens the economic stability of the country.

The fiscal policies of the government are also flawed in terms of the diversification of the economy. The Azeri regime has continuously failed to achieve its goals of reducing the country's dependence on oil revenues, with Azerbaijan's dependence on oil actually increasing, accounting for 97 per cent of its total exports in 2008 (up from 90 per cent in 2005) and the bulk of the country's fiscal revenues (Luong & Weinthal, 2010). According to the*National Budget Group*, a Baku based budget research and advocacy group, the current national budget implemented by the Azeri government is not sustainable considering the volatility of energy prices in recent years (National Budget Group, 2009). It is clear that the Azeri government lacks effective medium to long-term budgetary policies, essentially spending money when oil prices are high and cutting back when they are low. It is also apparent that the regimes reaction to the financial crisis was inadequate, with budgetary deficits being made up for by the revenue accumulated in SOFAZ to the extent that the majority of revenues saved in SOFAZ are now transferred to the state budget to cover the deficits caused by the economic downturn (Aslanli, 2010).

Whilst the Azeri government created an effective system for attracting FDI into the country's oil sector, its management of the financial rewards have not been as sensible. Whilst the initial attraction of investment to the country is crucial, the Azeri regime seems to have made decisions concerning the windfalls of their success to undermine and threaten the future economic security and stability of the country. This heavy dependence on oil for revenue and the effect it has had in discouraging the introduction of a secure and stable system for accessing the SOFAZ funds, are factors typical of both 'Dutch Disease' and the 'Resource Curse'. It is clear that the governance of the country's oil wealth but the Azeri regime has been severely lacking when compared to the aptitude displayed in their management of the oil-sector.

Conclusion

There is no denying the Azeri government's effective management of the oil sector in creating an attractive and flexible investment environment for foreign oil companies. They have successfully created a system that is both desirable and effective in attracting FDI into the country's petroleum industry. However, while the creation of this investment environment in the oil sector may display the innovation and flexibility of good governance, this is by no means the norm for the entire economy. Corruption, a lack of transparency, inefficient extractive and regulatory institutions, rent seeking, a failure to implement effective reforms, and the misuse of oil revenues, all undermine the positive progress made in the oil sector. The non-oil industries in Azerbaijan have been largely neglected in favour of the development of the oil industry and, as a result, the country has become increasingly dependent on oil revenues. This dependence on oil revenues and the regimes failure to develop the non-oil related sectors with a view to encouraging FDI, does not suggest good governance and is indicative of a ruling elite that has becoming overly dependent on the rents provided by oil and FDI revenues. Despite this, there have been signs of change, and the implementation of new reforms and clear attempts to attract FDI to the non-oil related sectors is apparent. However, the longevity and success of these reforms is unclear, as previous attempts at reform have been slow and ineffective. In order for the country to ensure its long term economic stability, it needs to focus on developing the rest of the economy and reducing its dependence on oil, while maintaining the positive developments that have occurred in the petroleum industries. In short, the Azeri government's success in attracting FDI into the country does suggest good governance when looking directly at the energy industry. However, when looking at the economy as a whole, the massive amounts of FDI directed into the energy sector compared to the relatively small amounts directed towards the non-oil related sectors, highlights the economic policies of the government as flawed and the governance of the economy as poor.

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