Oil as a Perpetuum Mobile of Azerbaijan

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Azerbaijan is one of the brightest examples of a petroleum-dependent nation in the world. According to preliminary data for 2022, the oil and gas sector (hereinafter referred to as oil and gas, abbreviated as oil), contributed 47,8% of the country's total GDP, with 52,7% of budget resources coming from oil revenues, and finally oil products accounting for 92,5% of total exports. Although these figures have seen slight changes since 2005, the trend has not changed. As a rule, the ratio of oil to total GDP is higher amid high oil prices on the world market, and when prices plummet, it is relatively low thereby creating the illusion of the economic diversification for which many people have longed for years.

Against this background, the government, in particular, claims that they have managed to cut the economy's reliance on oil exports in recent years, and as evidence it indicates higher growth rates in the non-oil sector compared to the oil sector, adding that the added value of non-oil products in the GDP structure is growing year by year. However, observing these dynamics over a longer period of time, for example in the last 10 years, we see that if in 2011, the share of the non-oil sector in the country's GDP was 48.8% as oil prices on the world market were relatively high, then in 2015 it was the crisis caused by the collapse of world oil prices that led to a 69,7% drop in the non-oil sector's share in total GDP. In 2018, it fell to 58,8% as a result of the recovery of the economy and oil prices, then in 2020, the non-oil sector grew again amid tumbling oil prices due to the pandemic, accounting for 70.1% of GDP.

How is it that, although the economic environment has often changed over the last 20 years, we supposedly cannot break this *vicious cycle* at all? Indeed, the simple logic of economic theories dictates that the fairly high growth rates recorded in the non-oil sector over this period should result in the creation of a real alternative economic potential in the oil sector, producing a *spollover effect*. Why is this not happening and how many more years will we be dependent on world oil prices? The paper aims to address this question.

Is the non-oil sector an alternative to the oil sector or its extension?

The sectoral structure of Azerbaijan's economy is unfavorable for the country's sustainable development. While the oil sector, which provides 47,8% of GDP, employs only 39.400 people, agriculture, which provides 4,7% of GDP, employs 36,2% of the total population (1.809.000 people). It turns out that Azerbaijani GDP is mostly generated by a single industry, while employment is generated by another with low productivity. Agriculture tends to be one of the main sectors supported by government subsidies. By contrast, agriculture employed only 19,9 percent of the employed population in 2020 in neighboring Georgia. The agricultural sector accounted for 6,3% of Georgia's GDP, coming to 27% of the country's total export revenue.

In 2021, trade and vehicle repair contributed the largest share (10%) to Azerbaijan's non-oil sector, followed by transport and warehousing (6,9%), manufacturing (6,9%), and construction (5,9%). Interestingly, more than 45% of the manufacturing industry consists of petroleum refining, chemical products, rubber and plastic products, which are directly and indirectly an extension of the oil industry. Plus, a significant portion of Azerbaijan's non-oil exports are petroleum-derived products. Consider the exports of electricity and chemical products. Not coincidentally, even if it sounds paradoxical, the country's fully state-owned national oil and gas company SOCAR is also a leader when it comes to non-oil goods exports.

To sum up everything stated above, we can conclude that our economy, riding high in recent years with high non-oil growth rates, still relies on oil. And the relatively high growth recorded in the non-oil sector amid the challenging oil price environment can largely be attributed to the low value of the oil sector during this period. In other words, the growth recorded in the non-oil sector is more related to the oil sector’s conjunctural volatility than to economic diversification. So, reducing dependence on oil certainly does not seem realistic.

Unfortunately, the above challenge is not the only one in reducing dependence on oil. The other important obstacles are the following.

Rent-seeking

The economic structure of a country is more conservative than the economic policies that shape it. Sometimes it takes decades to fundamentally change an established economic structure. Azerbaijan’s economic structure is more conservative than those of most other countries for a number of reasons, and changing it will require considerable effort and time and encounter resistance. It should be noted that by the structure of the economy we mean, first of all, its sectoral structure and institutional base.

Azerbaijan’s economic system as a whole is based on the principle of *rent-seeking*. This term already found in the literature succinctly indicates that the high profits generated by the excess margins from exploitation of limited natural resources, especially oil, push the government to constantly search for *easy* profits (*windfall*). The size of oil revenues in the form of annuities forces the government and other players to produce competitive goods and commodities in a tight and competitive market. A barrel of *Azeri Light* oil, which is currently trading at about $80 per barrel on the world market, costs an average of $20 to produce. And a margin equal to 60 dollars is the economic rent of oil. Keep in mind that the current prices are still far from their peak. In 2008, oil prices settled above $146 a barrel. No legitimate competitive business is able to make profit more than seven times. Of course, under such conditions, any other alternative investment and development opportunity seems, to put it mildly, uninteresting for both the government and potential investors.

Thus, no matter how much effort the government puts toward diversifying the economy, it reverts back to its previous behavior, as soon as oil prices recover. At present, the government's activity to develop the non-oil sector is mainly supported and financed, directly and indirectly, by the government itself. Investors do not want to share the risk in such an environment. Naturally, it is difficult to ensure the sustainable development of the non-oil sector, and therefore, although it has been more than 30 years since Azerbaijan regained independence, the country's non-oil sector is still fragile.

The driver of the oil economy – government spending

Despite all of the above, the oil economy has positive aspects. First of all, it is associated with ensuring energy security, accumulation of financial resources that act as a safety cushion for the state, opportunities to implement major infrastructure projects and, finally, the solution of social problems at the expense of oil revenues. The positive role of oil in the economy, if I may say so, tends to depend on the state. In this sense, governments of oil-rich countries feel more confident than others in believing that they can withstand any social, economic, or even political threat. Although it is the oil factor that creates this advantage, in practice, the government implements it by managing public spending. Governments of most oil-rich countries can also obtain additional social credits by reducing the tax burden. Thus, a government financial system built on the oil sector tends to become less dependent on the taxpayer. The oil rent, on the one hand, allows the government to focus less on the tax burden. On the other hand, the average taxpayer gets used to paying less taxes for the services he/she receives from the government. Thus, compared to natural resource-poor countries with a tight tax environment, the government acquires a *government – revenue distributor* status rather than a *government-taxpayer relationship*. Although the volatility of oil regularly creates problems for the budget, governments can cope with this problem by creating appropriate savings funds, and they become a central figure in solving existing social problems.

In oil-rich countries, the governments usually assess the budget as a means of addressing the country’s social, infrastructure and defense problems. The multiplier macroeconomic effects that government spending can create in the economy are of secondary interest to such countries’ governments. Azerbaijan’s state budget, together with its Oil Fund, is a gigantic financial system, which has the potential to create a large multiplier effect. According to Keynes, the government can revive the macroeconomic environment through budgetary expansion, especially in the wake of an unfavorable situation and can maintain it, primarily through the implementation of major public investment projects. State investment projects being implemented in liberated Karabakh and adjacent territories can play exactly this role. Therefore, it should not be difficult to maintain the macroeconomic situation in the country in a relatively stable state in the short and medium term. At the same time, the question arises of when is it possible to free the state investment-oriented economy of the *oil needle*? The answer is never. And not just because state finances are limited. The key toxic role here is that the rent-seeking factor, which we mentioned earlier, creates an obstacle to independent and sustainable development of the non-oil sector. It should be borne in mind that oil revenues must first be accumulated for public funds to be spent. The oil part of the budget revenues is not only its direct oil revenues (oil taxes paid to the budget and SOFAZ transfers), but also other indirect taxes from oil. As in the case of the non-oil sector, the bulk of non-oil revenues are again linked to oil, and under the current policy, breaking this *vicious cycle* in the near term seems unrealistic.

As a reminder, according to the Strategic Roadmap for National Economy Perspective approved in 2016, "In the periods of high oil prices and revenues, procyclical economic policy increased the dependence of economic growth on state requirements. As one of the main challenges, it is still important to transform the dependence of economic growth on state requirement to sustainable private requirement." Although the macroeconomic situation has changed several times since then, no serious changes have occurred in this direction.

The main risk associated with public finances lies not only in their dependence on oil. A bigger macroeconomic risk is that those finances are subject to an increasingly heavy social burden. The proportion of government recurrent spending and capital spending has undergone significant changes over the past 20 years. Capital spending will account for only 28,9 percent of the 2023 budget. In return, current expenditures and costs of government debt will account for 68,1 percent and 3 percent, respectively. However, even in the most unfavorable periods previously, the share of capital spending was not so low. Given that rebuilding Karabakh and adjacent districts will be the main beneficiary of these costs, other sectors will benefit less and less from this traditional advantage. On the other hand, capital spending is a key factor in economic growth. Thus, government spending will be sufficient to maintain economic growth at a minimal level at best.

State capitalism model and oil factor

The Strategic Road Map says "Azerbaijan has applied a 'state capitalism' development model, which is followed in the fastest-growing emerging economies in Southeast Asia. which was applied in fast-developing South-Eastern Asian countries. Fiscal policy is the most proactive area of a macroeconomic state capitalist policy. Spending on investment in the state budget acted as the major channel for the government to direct large-volume oil revenues to the economy." The above notes are based on the analysis of the country's economic system formed in 2004-2010.

And, although it was more than 15 years ago, most of the attributes of state capitalism still form the basis for managing the country's economy today. True, the provisions of state capitalism that were once reflected in the official document are no longer in vogue. To prove that it is no longer state capitalist, the government states that private activity now accounts for 82 percent of GDP. But this statistic does not change the situation. Economists are aware that the private sector's high share in GDP under Azerbaijan's production sharing agreements (PSAs) is largely from the contribution of foreign oil companies to the country's economy. Secondly, even in 2016, when the Roadmap was introduced, the private sector comprised about 80% of GDP.

The model of state capitalism is directly related to oil and in a sense has become a mainstay of governance since this model is a more appropriate instrument. Recall that state capitalism is an economic system in which business and commercial activities are carried out mainly under state control through state-owned enterprises. This system is applied in different forms in China, Russia, Singapore, and even Norway. The basic pillar of this system in Azerbaijan is the incomparably greater scale of public finance in comparison with private finance.

State capitalism can act as an original impetus to build a solid foundation for the non-oil sector. At least the institutional environment should be favorable for this. That is, competition and unrestricted access to markets can help gradually build this foundation. Otherwise, the sustainability of the non-oil sector will remain an issue and, as mentioned above, will continue to remain fragile. Therefore, the oscillation of oil will continue to constantly control our economy.

Climate change, energy transition and oil factor

Some economists have expressed great hope that weaning the country from dependence on oil revenue might be achieved as a result of energy transition to counteract climate change. As they say, even if we don't want this ourselves, humanity will abandon conventional energy, switching to renewable energy sources, and then our oil and gas will not be needed. That is an illusion. First of all, the global plans and goals to switch to renewable energy are today's reality. We do not know how this plan will be implemented in the near future. Regional and global geopolitical threats suggest that projections in this direction are very fragile and will change at a serious pace. Secondly, even the transition to renewable energy will not reduce the use of oil and gas resources in the coming decades. Renewable energy will not overtake the use of traditional energy sources in an instant. As a reminder, switching to renewable energy will create new problems rather than solve them. For example, switching to renewable energy could in turn trigger the next dependence. Currently, China already controls an average of 70% of metals (cobalt, nickel, etc.) that are of importance to renewable energy, and this concentration ratio increases every year.

Finally, the oil factor in the economy cannot be measured by the share of renewables in the country's energy portfolio. Even oil hegemon Saudi Arabia's plan to spend $266 billion on renewable energy projects will not prevent it from positioning itself as an oil nation. While climate change objectives are relatively clear for the whole Euro-Atlantic space in the coming decades, other countries are still forced to give preference to conventional energy in the long term. Therefore, Saudi Arabia and other oil-rich nations will long remain the global energy suppliers. Azerbaijan has also announced the launch of renewable energy projects in recent years. Examples could be its 230-megawatt (MW) Garadagh solar PV plant, to be built with UAE-based renewable energy company *Masdar* according to an agreement signed last year; the promising *integrated offshore renewable energy* project; as well as the government's multiple goals in this regard. However, it is still too early to talk about the profitability of these projects. Note that renewable energy sources are not as limited as oil and gas. This business, where the rules of the game are completely different, is carried out in a competitive environment. In any case, there is no linear proportionality between the energy transition and less dependence on oil. At least for oil and gas producing countries, this dynamic will take a different course.

Phantom oil pains

Even with the end of the petroleum era, the high-powered oil factor in Azerbaijan's economy will not be exhausted. Rent-seeking will follow us for a long time to come. The excessive profitability has spoiled not only the Azerbaijani economy's players, but even ordinary citizens. Above all, the government's behavior has focused on constant rent-seeking. For the government, any other field of activity means less profits than it is accustomed to.

It is no coincidence that customs duties and taxes entering the state budget represent the second largest source of state budget revenues after petroleum. In 2022, customs duties accounted for 19,4% of all budget revenues. Indirectly, this may indicate that even the relatively high growth rate in the non-oil sector in recent years does not suggest that this sector is a fertile tax base. The growth of tax revenues in the non-oil sector over the past several years is not tied to substantial developments in this sector and the economy at large, but rather comes from steps to reduce the shadow economy. Put simply, the growth is temporary and technical from an economic point of view.

Thus, as predicted, this sector’s revenues will gradually decline due to oil and gas production cuts in the mid-term, and even then, the economy will not be able to adapt to *the oil-free economy paradigm* for a long time yet. Of course, how painful and time-consuming the process is depends on a large number of factors. Setting aside exogenous factors, much can still be done in the domestic economy to make this process relatively painless and faster. In the meantime, we must adjust, in the short to medium term, our socio-economic targets in accordance with conditions and the environment for our economy created by the oil factor.