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Problems of Good Governance in Extractive Industries

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Abstract

This study argues that the best way for Azerbaijan to avoid its oil revenues having an adverse effect on its economy, and for the income to be distributed in a fair manner to more Azeris, is to ensure the good governance of these revenues. The paper examines the state bodies responsible for collecting and distributing these monies, before assessing the risk factors involved with the current administrative arrangements. Most notably, these include a weak legal infrastructure, an absence of effective anti-corruption measures, and an underdeveloped independent media and civil society. Based on a critical survey of existing legislation and in-depth interviews with government officials, NGOs and the media, the author argues for specific changes to the legal framework. The boosting of the potential of civil society and the mass media to monitor the process of revenue management, as well as increasing people's awareness that they are entitled to a share of the oil revenues, is also considered crucial in reducing the associated risk of the Dutch Disease. Finally, this policy paper offers a critical assessment of the role international institutions might play in helping the Azerbaijani government maximize the long term benefits of its oil revenues.

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The views contained inside remain solely those of the author who may be contacted at bagirov@policy.hu. For a fuller account of this policy research project, please visit <http://www.policy.hu/bagirov/>

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Contents

Executive Summary.....	4
Introduction.....	6
1 Oil and Gas Revenues are Only an Opportunity	7
2 State Bodies Gathering Together Oil Revenues	7
3 State Body Spending on Oil Revenues	8
4 Risk Factors Associated With the Ineffective Management of Resources	10
5 Some Ways of Reducing the Risks	14
5.1 <i>Modernizing the legal framework for managing oil revenues</i>	14
5.1.1 <i>Adoption of the law on the Oil Fund and oil revenue expenditure</i>	14
5.1.2 <i>Alternatives to the adoption of a new law</i>	17
5.1.3 <i>Improving the legal acts pertaining to public service</i>	18
5.2 <i>Boosting the potential of civil society and the mass media</i>	18
5.3 <i>Boosting citizens' interest in oil revenues</i>	20
6 Anticipated Difficulties, and Ways of Overcoming Them	21
6.1 <i>Adopting the Law on the Oil Fund, and managing oil revenues</i>	21
6.2 <i>Improving the potential of civil society organizations and the media, and citizens' interests in oil revenues and expenditure</i>	25
6.3 <i>The role of international institutions</i>	25
7 Conclusions and Recommendations	26

Executive Summary

The present research concerns some ways of developing an effective policy to manage the revenues acquired from the development of Azerbaijan's hydrocarbon resources.

In 2006, Azerbaijan will embark on a full-field development program of two gigantic hydrocarbon fields: those of Azeri-Chirag-Gunashli and Shah-Deniz. Calculations show that the Azeri-Chirag-Gunashli contract alone will fetch about \$170 billion in revenues for the country before 2025, provided that the crude price is \$45 per barrel. Besides this, in peak years of production (2008-2012) the country's revenues may reach \$10-15 billion a year. For a comparison, Azerbaijan's *state* budget in 2005 was \$2.4 billion.

In order to prevent an adverse impact of the revenue windfall on the country's economy, and to lower the risk of the economic phenomena of Dutch Disease,¹ the government decided, in late 1999, to set up an Oil Fund. This fund will gather together the bulk of oil revenues. However, revenues also come into the state budget both in the form of taxes and transfers from the Oil Fund. The financing of a number of state programs has now begun via use of Oil Fund revenues.

This research provides a brief description of the situation, involving ways of managing the growing oil revenues of both the Oil Fund and the state budget. And it looks at the main risks involved in losing any portion of the revenues, which would include the fact that:

- the government is inexperienced in managing revenue windfalls;
- laws are imperfect;
- the judiciary is dependent on the executive branch;
- the legislature is dependent on the executive branch;
- democratic institutions are weak;
- civil society is underdeveloped;
- independent media are weak.

The author's research into existing statutory acts pertaining to the management of oil revenues and the State Oil Fund, in-depth interviews with government officials and experts, as well as focus group meetings held with leaders of key NGOs and the media all lead to the following suggestions as regards

¹ Dutch disease is an economic theory that holds that a sharp increase in revenues from natural resources will deindustrialise a nation's economy by raising the exchange rate, which makes the manufacturing sector less competitive.

reducing the risk of ineffective usage of the country's hydrocarbon revenues, namely that there is a need:

- to modernize the legal framework for managing oil revenues;
- to boost the interests of civil society as regards monitoring the process of managing oil revenues;
- to boost the capacity of civil society and independent media.

Modernization of the legal framework in which the management of oil revenues is taking place can be implemented by way of replacing existing, non-coordinated legal acts with a special law for the Oil Fund and the managing of oil revenues. The law might be based on the following principles:

- Parliament's exclusive decision-making rights as regards spending SOFAZ resources;
- Parliament's exclusive decision-making rights on imposing restrictions on storage and the placing of SOFAZ resources;
- Rejection of the current SOFAZ budget concept, whereby the fund's assets can also be used to finance different state projects and programs;
- Distribution of a portion of oil revenues among citizens;
- Targeted use of SOFAZ resources;
- Establishing a parliamentary commission to observe SOFAZ's investment policy;
- Having the SOFAZ executive director appointed by parliament, with a presidential motion;
- Attracting foreign managers to SOFAZ portfolio investment and in connection with locating its assets.

Boosting civil society's interests as regards monitoring the process of managing oil revenues is an important factor for the good governing of revenues. A government will be more responsible if it is responsive to civil society. Many citizens of the country do not realize that they, too, are entitled to a share in oil and gas revenues. Numerous opinion polls reveal that many treat these revenues as something belonging to the government elite only. Such a situation can only be changed by large-scale and comprehensive campaigns of a cyclical nature, ones lasting several years. This research will thus provide recommendations on how to organize such a campaign. For instance, one suggestion would be this: to dedicate a certain day during the year to different activities with the motto "oil revenues belong to all". On such a day, a talk-show could be organized on a popular television channel, special films might be shown by all regional television channels, conferences could be held, special posters would be put up in streets, pocket calendars might be printed and handed out to people, etc.

In an effort to boost the capacities of civil society and the media, this research suggests that training sessions be given to persons regarding the differ-

ent aspects of oil contracts and the Extractive Industry Transparency Initiative. Another suggestion is that annual competitions are held for the best journalistic investigations into ways of using oil revenues.

Introduction

Azerbaijan is an oil country. Oil used to be bought from different countries long ago. This has been confirmed by well-known European and Middle Eastern travelers and historians. The country has experienced several oil booms: the first occurred in the first half of the 19th century, while the most recent one is going on at the present time.

Starting from 1994, the country has signed 25 PSAs. Although eight of them have now been stopped due to exploratory failures, work on other PSAs continues. Exploration work has revealed the existence of gigantic oil (the Azeri-Chirag-Gunashli field has 5.3 billion barrels of oil) and gas (Shah-Deniz has 700 billion cubic meters of natural gas) fields.

The role the oil sector plays in the country's economy (not to mention politics) today is confirmed by the following indicators for 2005:

- the share of the oil sector in GDP was 42%;
- the share of oil and oil products in exports was 84%;
- the share of the oil sector in total investment was 64%, and in foreign investment 87%;
- the share of the oil sector in state budget revenues was 40%.

With the full-field development of the ACG oil fields and the Shah-Daniz gas condensate field now going ahead, the importance of this resource will grow even more. Whereas in 2005 a little over 20 million tons of oil and around 6 billion cubic meters of gas were produced, in 2010 these indicators are expected to reach 60-65 million tons of oil and 15 billion cubic meters of gas.

Therefore, the country is on the threshold of gaining major oil revenues.

Calculations made by the author show that the ACG contract alone will fetch between \$30 and 20 billion for the country before 2025, depending on the crude oil price (calculations of anticipated revenues are based on a price range of \$15 to 50 per barrel).

What might such huge revenues actually *mean* for Azerbaijan, though?

1 Oil and Gas Revenues are Only an Opportunity

The revenue windfall expected to begin with the development of Azerbaijan's hydrocarbon resources will provide the Azerbaijani people with a historic opportunity to lay the foundations for the sustainable economic development of the country, a solution to poverty and the formation of a new competitive generation. Yet this is only an *opportunity*. It is possible to take it, and make use of it - though this opportunity might also be missed, that is, not taken advantage of. For the practices of many resource-rich countries show us that not all of them have been able to make use of such opportunities! There is a "resource curse" notion, which has struck many countries rich in mineral resources.

So the problem facing Azerbaijan is as follows: will there be good governance of oil and gas revenues? And what does this mean exactly? Of course, it is a method of governance whereby revenues will be wisely located, invested and spent - and certainly not embezzled. Yet how can we save these revenues from suffering at the hands of ineffective governance or embezzlement? Before we attempt to answer this question, let's take a look at where hydrocarbon revenues actually go, who disposes of them and what the risks involved are.

2 State Bodies Gathering Together Oil Revenues

The main recipients of oil revenues in the country are the State Oil Fund, the State Budget and the State Oil Company. Revenues will also go to the State Social Protection Fund and a number of state enterprises, banks and other organizations. All of these are state bodies, so it is very important to ensure that good governance exists in all of these locations/bodies.

Revenues of the State Oil Fund are formed by:

- sale of the state share of the profit oil;
- bonuses;
- per-acre payments;
- transit fees;
- lease
- other items.

State Budget oil revenues come from:

- taxes taken from the State Oil Company from profits;

- tax taken from the profits made by foreign contractors;
- tax taken from the incomes of subcontractors providing services to contractors;
- tax taken from the salaries of foreign company staff.

Revenues for the State Oil Company come from:

- the independent production and sale of oil;
- the production and sale of oil products;
- participating shares for oil contracts;
- other sources.

Oil revenues for the State Social Protection Fund come from deductions of 22% from the salaries of oil company staff and subcontractors dealing with oil contracts. While different state companies, banks and other organizations providing services to oil companies also profit here.

3 State Body Spending on Oil Revenues

Oil Fund resources are spent according to presidential decree. This is stipulated by the Oil Fund Regulations, which were approved by presidential decree. Oil Fund expenditure has a place in a consolidated budget that has been approved by parliament.

Prior to 2006, Oil Fund resources were used for:

- Financing the share of SOCAR in the Baku-Tbilisi-Ceyhan oil pipeline project;
- Improving the social status of refugees and IDPs;
- Increasing state budget revenues.

The Oil Fund's expenditure plan for 2006 envisions:

- a financing of activities aimed at addressing different social and domestic problems of refugees and IDPs – 110 million manats (about \$120 mln);
- a share of SOCAR in the Baku-Tbilisi-Ceyhan oil pipeline project – 38 million manats (about \$42 mln);
- 2006 state budget (transfers) – 585 million manats (about \$641 mln);
- a Oguz-Gabala water pipeline construction project – 90 million manats (about \$99 mln);
- reconstruction of the Samur-Absheron irrigation system – 37 million manats (about \$40 mln);
- charter capital for the State Investment Company – 90 million manats (about \$99 mln);
- activities of the State Oil Fund – about 4 million manats (about \$4.4 mln).

Thus, a little over 954 million manats will be spent in these several areas (about \$1,046 mln).

Apart from transfers into the state budget, all other expenditures are specific and have a specific addressee. Thus, the money allocated from SOFAZ for:

- solutions to refugee problems will be spent by the state committee for refugees and IDPs;
- the oil pipeline will be spent by BTC Co;
- the water pipeline will be spent by the winner of a tender procedure;
- reconstruction of the Samur-Absheron irrigation system will also be spent by the winner of a tender;
- creation of a charter fund will be spent by an investment company;
- activities undertaken by SOFAZ will be kept in the fund's accounts.

This knowledge of specific addressees will make future monitoring and auditing of these expenditures a lot easier; yet, at the same time, money transferred into the state budget (585 million manats) will become spread among other budgets and used for resources, so it will be impossible to keep track of it; i.e. unspecific transfers of oil money into the state budget are *diluted* and are gently distributed to different ministries and government agencies.

The next question is, therefore: how does one go about keeping track of this money? Today, such a thing would be possible only by means of a total monitoring of *all* budget expenditures – though this is a more or less impossible task; for even the resources of the Chamber of Accounts wouldn't be sufficient to do this. The Chamber of Accounts conducts inspections in strict accordance with an annual program approved by parliament - though this program covers only a handful of state agencies and state projects. Indeed, according to the Chamber's reports for 2005, the Chamber managed to keep control of only about 8% of state expenditure.

So the best way out of this situation is by stopping open-ended transfers into the state budget - and by using oil money to finance only *specific* projects, especially if we take a look at the proposed principles of the new law on the Oil Fund and on related management of oil revenues.

4 Risk Factors Associated With the Ineffective Management of Resources

The risk factors associated with ineffective management of oil revenues in Azerbaijan are:

- the government is inexperienced in managing major revenues;
- laws are imperfect;
- the judiciary is dependent on the executive branch;
- legislature is dependent on the executive branch;
- there are no effective tools via which to fight corruption;
- democratic institutions are overly weak;
- civil society is too weak;
- independent media are too weak;
- others.

The government's lack of experience in governing major revenues can be explained by the fact that everything was decided by Moscow in Soviet times. The local government could not dispose of oil and other products on its own. For instance, it had no right to sell national resources on foreign markets, had no right to form its own hard currency reserves and, consequently, did not need to govern such reserves - all this was taken care of by the central government. In addition, the close proximity of the Soviet economy, and its isolation from global economic processes, stock and commodity exchanges did nothing to 'train' local specialists as regards making transactions involving securities, financial analyses of investment processes, etc. Today, Azerbaijan is trying to solve these problems by training its own specialists and via attracting foreign managers to manage the assets of the State Oil Fund and hard currency reserves of the National Bank.

Imperfect laws. The laws of the country (which gained independence 14 years ago) have practically been formed anew; and this process was complicated because the country had to change its development course from a socialist and centrally-managed Soviet system to a market-oriented, liberal-democratic one. Another difficulty came via the fact that, in parallel, a whole team/school of lawyers and law-makers needed to be formed in the country. In Soviet times, laws were decided upon in Moscow and, of course, it has not been an easy task to create, over a short period of time, a system of perfect laws based on completely different attitudes towards private property and other relations between economic players. (Such a situation is characteristic for all post-Soviet republics.) Ambiguous and unclear definitions of certain provisions of laws precondi-

tion arbitrary interpretations of them on the part of government officials – which then lays the foundation for methods of bribery. Quite often, therefore, laws do not meet the requirements of international organizations in terms of transparency, accountability and other good governance criteria.

- on public service;
- on state procurement;
- on the Chamber of Accounts;
- on access to information;
- on state secrets;
- on fighting corruption;
- on declarations of income by public officers.

Dependence of the judiciary on the executive branch. So far, Azerbaijani laws and government traditions do not ensure the independence of the judiciary. Under article 99 of the Azerbaijani Constitution, executive power in the Azerbaijani Republic belongs to the president. Also, under article 109 of the Constitution, judges of the Constitutional Court, Supreme Court and Appeal Courts are appointed by parliament on a presidential motion; while judges of all other courts are appointed by the president, who also appoints the country's prosecutor-general with the consent of parliament. In other words, legislative realities are such that judges effectively operate under the direct control of the presidential administration. The main criterion in such appointing of judges is, thus, their loyalty to presidential authority.

Dependence of the legislative branch on the executive one. In the period of Azerbaijan's independence, three parliamentary elections have been held: in 1995, in 2000 and 2005. All of these elections were marred by major irregularities and were described by international organizations as being non-free and non-democratic. Many politicians and political analysts are convinced that the executive branch won these elections after having prepared beforehand lists of future members of parliament! The opposition managed to get about 5 per cent of seats in the parliament. The process of voting was accompanied by numerous irregularities, as a result of which the country ended up with a parliament that always obeyed the executive. For all of these years, the parliament simply adopted laws whose drafts had been earlier prepared either by the presidential administration or different cabinet ministries. Very rarely were drafts of new laws actually initiated by parliament.

Weak mechanisms for fighting corruption. Azerbaijan cannot boast of having 'good governance indicators' at present. In fact, in 2005, Transparency International ranked Azerbaijan 137th-143rd (jointly together with Cameroon, Ethiopia,

Indonesia, Iraq, Liberia and Uzbekistan) out of 159 countries for a 'corruption perception index'. A high level of corruption in the country was confirmed in a sociological survey recently (May 2004), one commissioned by Transparency Azerbaijan, with 1,000 respondents. According to the survey, more than 86.9 per cent of those polled see the level of corruption in the country as being quite high (52.2 per cent) or very high (34.7 per cent).

In the past two years, the government has taken a number of measures to reduce corruption in the country:

- a law on fighting corruption has been adopted;
- a state program to fight corruption has been adopted;
- a law on declarations of incomes for public workers has been adopted;
- a state commission to fight corruption has been set up;
- a department to fight corruption has been established within the Prosecutor-General's Office;
- and other measures have also been resorted to.

Punishment figures for corruption-related crimes have increased - though the fight against corruption has not become a priority state policy as yet.

Weak democratic institutions. Democratic traditions in Azerbaijan date back to 1918, when, after a revolution in Russia, the Azerbaijani Democratic Republic was formed. It existed for only two years. Then, Soviet Russia annexed Azerbaijan (again) and established a Bolshevik dictatorship here. The new era of democratic transformation began after Azerbaijan gained independence in 1991. The first election, which was quite close to having democratic standards, was held in June 1992, when Abulfaz Elchibay was elected president of the Azerbaijani Republic. The fact that the election had broken the Soviet tradition of supervised voting and falsified vote counts was confirmed (at least) by the fact that the president got around 59 per cent of votes, while the runner-up got about 35 per cent. All subsequent elections in the country were marred by major irregularities, though, which were registered by international organizations. The country's parliament, elections to which were held in 1995 and 2000, was actually *formed*, not elected – for the process was managed by the presidential administration. The presidential election held in 1993 (early election), 1998 and 2003 were marred by certain irregularities that were reflected in the reports of international organizations, too. It needs to be acknowledged, though, that Heydar Aliyev really did have the highest popularity rating in the country (which was also confirmed by numerous sociological surveys). There are more than 50 political parties in the country, now, but the vast majority of them are very small-sized. Thus, the conditions of political struggle in the country are far from being democratic ones.

Weak civil society organizations. There are about 2,000 non-governmental organizations in Azerbaijan, and most are not registered. Until several years ago, registering an NGO was an extremely complicated procedure. The situation has slightly improved over the past two years, however. Existing NGOs operate in different areas: human rights, ecology, legal awareness, social support, etc. The weakness of civil organizations can be mainly explained by the fact that they are very still very young, and their financial status is not stable. Civil organizations, with only a few exceptions, have yet to become an effective instrument for monitoring government operations.

Weakness of the independent media. There is independent print media in the country, being represented by a handful of newspapers. There are many more newspapers expressing the opinion of the authorities or the opposition. The daily print-run of independent newspapers is negligible, accounting for about 0.5 per cent of the capital city's readership (where there is a population of 3m people); while the print-run of the opposition press is slightly bigger, serving around 2 per cent of the population of Baku. Such low print-run figures can be explained by the poor purchasing power of the population. Thus, the main source of information for the country's population is that of the six television channels, two of which are state-owned, three are owned by people close to the authorities, and the one other (private) channel is owned by people who are less affiliated to the government but who do come under their influence nevertheless. The channel expresses the opinion of the government much more frequently than that of the opposition in politically active periods.

According to article 57 of the Constitution, Azerbaijani citizens have the right to criticize the work and activities of state bodies and their officials, political parties, trade unions, other public organizations, as well as individual citizens. Yet, according to the same article, insult and slander cannot be classed as criticism. Legal norms - where explanations as regards insult and slander can be sought after - are contained in articles 148 and 147 respectively. Censorship in the country is legally banned. According to article 6 of the Law on Freedom of Information (adopted by the Azerbaijani parliament on June 19, 1998), state censorship of the media is unacceptable; and the unacceptability of media censorship is confirmed by article 7 of the Mass Media Law. In practice, however, the presidential administration enforces unofficial censorship onto pro-government and independent media. Opposition newspapers criticize the government systematically; and independent newspapers do so quite often as well. Nonetheless, no matter what types of scathing article they publish, it does not perturb the

authorities too much – for there is practically no reaction to critical articles, and this significantly weakens the role of the media in the fight against corruption. Opposition and independent newspapers also publish articles about corruption quite often, though in many cases these articles are not a product of in-depth journalistic investigation. Besides this, their readership amongst the electorate is insignificant. Television channels broadcast programs about corruption very rarely, and even those few that *are* televised are selective. And there have been many cases where journalists have been punished via a charge of slander.

5 Some Ways of Reducing the Risks

Suggested ways of reducing oil revenue losses (discussed above) do not cover *all* possible measures via which to improve monitoring effectiveness - for such measures are likely to have been designed on the basis of *current* legislation and decision-making practices. (It should also not be ruled out that some of the proposed measures will have been implemented by the time this policy paper comes out.)

The author's analysis of existing legal requirements pertaining to the management of oil revenues and of the activities of the State Oil Fund along with interviews with government officials/experts and focus group discussions with leaders of key NGOs and the media, give rise to the following ideas as regards reducing the risk of ineffective hydrocarbon revenue usage. It is suggested that there is:

- modernization of the legal framework for the managing of oil revenues;
- a boosting of the capacities of civil society and independent media;
- and a boosting of the interests of citizens when it comes to oil revenues.

5.1 Modernizing the legal framework for managing oil revenues

5.1.1 Adoption of the law on the Oil Fund and oil revenue expenditure

The activities of SOFAZ and policies relating to the spending of oil proceeds are regulated by the following statutory documents:

- Presidential decree dated December 29, 1999 establishing the State Oil Fund;
- Regulations of SOFAR approved via a presidential decree dated December 29, 2000;

- Rules of storing, placing and managing hard currency reserves of the State Oil Fund. The rules were approved by a presidential decree dated June 19, 2001;
- Rules for developing and executing the annual budget of the State Oil Fund, approved by presidential decree dated September 12, 2001. Subsequently, the rules were amended, twice: on February 7, 2003 and March 1, 2005;
- The “Long-term strategy for managing oil revenues”. This strategy was approved by a presidential decree on September 27, 2004.

In previous research, we noted the important provisions of these documents - and the norms in them that could serve to increase the risks inherent in *ineffective* expenditure of oil revenues.

Improvement of the legal framework within which oil revenue management occurs might be implemented via replacing the existing, uncoordinated legal acts with a special new law on the Oil Fund and on the handling of oil revenues.

The law should reflect the following principles:

- Parliament’s exclusive decision-making rights with regard to spending SOFAZ resources;
- Parliament’s exclusive decision-making rights on imposing restrictions on storage and placement of SOFAZ resources;
- Rejection of the current SOFAZ budget concept, whereby the fund’s assets can also be used to finance different state projects and programs;
- Distributing a portion of oil revenues among the people; in doing this, it is necessary to ensure that citizens get their fair share of oil revenues;
- Targeted use of SOFAZ resources;
- Establishing a parliamentary commission to monitor SOFAZ’s investment policies;
- Having the SOFAZ executive director appointed by parliament, via presidential motion;
- Attracting foreign managers to the SOFAZ portfolio investment, and getting their help when locating its assets.

The decision-making monopoly of parliament with regard to spending SOFAZ’s resources. The use of this principle in the new law would mean a transfer of decision-making rights as regards spending SOFAZ resources *from the president to parliament*. According to the existing Regulations of SOFAZ, the spending of oil revenues comes via annual presidential decrees on priority expenditure directions (paragraph 4.1.). The transfer of this right to parliament, though, would enable decision-making to occur via a broader spectrum of stakeholders, i.e. as parliament represents not only different political forces but also many other sectors (business, education, health, etc.), regions, ethnic groupings, etc.

A Parliamentary monopoly as regards restrictions on the storage and placing of SOFAZ resources. Today, decisions about storage and SOFAZ resource placements are made by the SOFAZ executive director on the basis of rules for keeping, locating and managing the hard currency resources of the State Oil Fund (which have been approved by the president). The new law should reflect all the norms pertaining to these rules.

Rejecting the concept of the SOFAZ budget, which, in addition to expenditure relating to the fund's current activities, also contains spending on different state projects and programs. According to the above-mentioned rules for developing and executing the annual program (budget) of the State Oil Fund, the fund's expenditure, in addition to expenses associated with the fund's current activities, also envisions expenditure on various state projects and programs. Dealings as regards the fund's expenditure, according to the said rules, is performed jointly with the Finance Ministry. Yet it might be appropriate to exempt SOFAZ from having to make forecasts about spending on such projects/programs; for this work needs to be done within the framework of a single budgetary process.

Distribution of a portion of oil revenues among citizens. A high level of oil revenues for a number of years and with peak levels of hydrocarbon production will make it possible to distribute a portion of them among the people. *In doing so, it is necessary to ensure that all citizens are entitled to a share of such revenues.* By allocating funds towards, say, finding a solution to the social problems of refugees and IDPs, the government is actually violating the rights of other citizens to a natural form of wealth which might be considered common to *all*. Such a policy would also lead to the growing discontent of other citizens, and perhaps conflict. Such conflicts do exist, in fact, though are not widespread (even though the level of discontent has been on the increase lately). Calculations show that with a world market price of oil at \$50 per barrel, the country's revenues could reach \$15 billion in 2009. If \$8 billion is divided among citizens, this would mean that each person would get \$1,000 – which is good money for a country in which almost 40% of the population live below the poverty line! The *annual* income of these people does not exceed \$600, so one can understand how glad such people would be. Also in this connection, the attitudes of many people towards oil contracts would then change – for sociological surveys have shown that many see them merely as a means of self-enrichment for the government elite.

Targeted use of SOFAZ resources. The implementation of this principle would mean the rejection of meaningless transfers from the fund to the state budget. Such transfers become negligible in total budget expenditure, and it is impossible to keep track of them afterwards. Yet targeted use of resources used for *specific projects* would enable one to monitor how this money was being spent.

Establishment of a parliamentary commission to observe SOFAZ's investment policy. According to the Regulations on SOFAZ, there is an Observation Council that is formed by the president. This council has to be made up of representatives of the government, parliament and public organizations. Although three years have passed since the passing of this law, civil society representatives have yet to be included in the Council. Under its regulations, the fund is not accountable to parliament, which means that discussion of the fund's work is limited. When forming the parliamentary commission to monitor the fund's investment activities, the experience of Norway was used: in Norway, this commission consists of MPs representing opposition parties. Yet even if the commission had a mixed composition, it would still have a positive effect.

Appointment of the SOFAZ executive director by parliament, on a presidential motion. According to the Regulations on SOFAZ, the executive director is now appointed by the president, i.e. as is the case with ministers; though as regards the nature of the work, this position is similar to that of the National Bank chairman, i.e. who is appointed by parliament via a presidential motion.

Attracting foreign managers towards SOFAZ portfolio investments, and the locating of its resources in foreign banks. This was taken into account by existing rules with regard to storing, placing and managing the State Oil Fund's hard currency resources. Such norms should also be present in the new law.

5.1.2 *Alternatives to the adoption of a new law*

If there is stiff resistance to the adoption of the new law, or if its adoption is delayed, it might be worth - as an alternative to adoption of such a law - amending the above-mentioned legal acts pertaining to SOFAZ and to the management of oil revenues. The essence of, and a list of proposed amendments could be defined on the basis of the previous study, i.e. which revealed the loopholes in the said statutory acts.

5.1.3 Improving the legal acts pertaining to public service

We have now looked at a number of drawbacks in the existing laws, namely:

- on public service;
- on state procurement;
- on the Chamber of Accounts;
- on access to information;
- on state secrets;
- on fighting corruption;
- on declaration of incomes for public officers.

The elimination of drawbacks in these laws would lower the risk of corruption at the stage of expenditure of oil revenues.

5.2 Boosting the potential of civil society and the mass media

Measures aiming at both quantitative and qualitative growth for NGOs are appropriate for the country at the present time – yet existing procedures for the registration of NGOs are too complicated, and need to be simplified. It is important to amend the current law on public associations and funds or to adopt a new law dealing with non-commercial organizations. The existing law does not provide for the establishment of any non-commercial organizations other than NGOs and foundations. For instance, an attempt to establish a non-profit Think Tank could not materialize, which is why such institutes are established in Azerbaijan in the form of Ltd. Companies. It does not make sense to set up an NGO due to ‘membership issue’ concerns.

Even if the existing law is left unchanged, then at least the legal acts of the Justice Ministry pertaining to registration will have to be reconsidered, for they do make the registration procedure extremely complicated and leave room for ministry officials to deny or delay the registration of an NGO. And there are numerous provisions in these acts that are meaningless and/or with no foundation.

There are still cases when ministry officials consult presidential administration ones on whether to register an NGO that has taken a critical stance towards incumbent authorities. For example, Transparency International–Azerbaijan was registered only in late December 2005, i.e. registration was granted five years after the organization was set up; and it also happened only with the assistance of the US ambassador.

Boosting the potential of civil society and, more importantly, NGOs dealing with the monitoring of oil revenues might be possible by providing training and having roundtable discussions among relevant persons.

Such measures are part of the action plan of the Coalition of 67 Azerbaijani NGOs, "To Improve Transparency in the Extractive Industry", for 2006-2007. The Coalition was established in May 2004 and aims to monitor oil revenues within the EITI framework. (Azerbaijan is one of the EITI pilot countries.) The establishment and work of the Coalition are a good example of NGO public policy in Azerbaijan. The Coalition is also a signatory to an MoU signed on November 24, 2004 between the government, 22 petroleum companies and the Coalition proper. This Memorandum signaled the launch of the EITI in Azerbaijan, as a result of which the country's revenues and all payments made by petroleum companies become transparent. The Coalition also strives to improve public awareness of oil contracts and country revenues, and to conduct 'roundtables' and training sessions for NGOs and the media. The Coalition's plan for the next two years has been prepared with the participation of the author of this present research, who happens to be the coordinator of the Coalition. The plan proposes the implementation of different projects, including projects concerning such areas as:

- increasing public interest and capacity,
- boosting the capacities of the Coalition,
- improving legislation in order to advance the cause of transparency in the extractive industry,
- cooperating with other countries and public associations involved in the EITI,
- cooperating with international financial institutions,
- exercising control over the use of extractive industry revenues,
- actually *increasing* oil revenues (by way of reducing ineffective expenditure).

It is also important to ensure that NGOs operate in a coordinated fashion because, over the past few years, several NGOs have been engaged in issues of increasing budget transparency and monitoring expenditures in different areas (education, health, etc.).

The focus groups and in-depth interviews with heads of a number of media outlets and journalistic associations held by the author of the research give important signposts as regards being able to improve journalists' awareness of oil contracts, anticipated revenues, legal acts pertaining to the management of oil revenues and government expenditure of such revenues. Alongside this, focus groups and interviews show that it is also vital to make journalists more inter-

ested in monitoring the spending of oil revenues while carrying out journalistic investigations. Therefore, the following measures could be instrumental in improving the effectiveness of the media in the area of monitoring oil revenues:

- training journalists;
- providing a series of lectures at journalistic faculties;
- conducting a special roundtable for the editors of leading mass media;
- arranging competitions for the best journalistic investigations into how oil revenues are spent;
- arranging competitions for the best short film;
- creating special documentary films, and broadcasting them on television channels.

All of these measures would certainly enhance the potential of the more active part of Azerbaijani society with regard to publicizing the issues.

5.3 Boosting citizens' interest in oil revenues

Many citizens do not yet fully realize that they, too, are entitled to a share of the oil and gas revenues. Opinion polls show that people treat these revenues as something belonging to the government elite, not to ordinary people. The reason for this is that people do not know enough about oil contracts, about how much the country is earning now, how much it will earn in the future, and how this money is being spent.

This situation can only be changed by large-scale and comprehensive campaigns with a cyclical nature, and which would last for several years. It might be worth conducting public activities capable of attracting the public's attention to the theme of oil revenue spending. This could be done with the aid of the mass media and via contacts with the broad public. For instance, one suggestion (as already mentioned) is to dedicate a specific day (or week) in one year to different activities under the motto "oil revenues belong to all". On such a day (or week), the following activities could be done:

- a talk-show could be organized on a popular television channel;
- special films could be shown by all regional television channels;
- conferences could be held;
- special posters could be put up in the streets;
- pocket calendars could be printed and given to people;
- special books, brochures and booklets could be printed and distributed;
- other activities.

Boosting civil society's interest in monitoring the process of managing oil revenues is an important factor with regard to the good handling of revenues, for a government will be more responsible if it is aware of civil society.

6 Anticipated Difficulties, and Ways of Overcoming Them

6.1 Adopting the Law on the Oil Fund, and managing oil revenues

Transfer of presidential powers to parliament

The principles of the new law proposed in paragraph 4.1 deal with presidential powers. The suggestion here is to hand presidential powers concerning the spending of oil fund resources over to the parliament. What will the president's reaction be? Mostly likely, he will be opposed to the move, but he might also treat the suggestion positively.

The president will almost certainly take a negative stance towards the hand-over of such powers to parliament, for such powers are an important component of his political authority. Being able to use such a resource, the president can easily deal with different waves of public disquiet about issues, or solve problems via emergency-situation financing. And the president effectively controls the current parliament: the opposition is too weak, so the ruling party has absolute power in it. This factor alone could prompt the president to succumb to the pressure of those politicians who are urging him to hand over powers to parliament.

What's more, the president may be tempted by the idea that such a hand-over of power would relieve him of the responsibilities of decision-making, although he would still have the ability to have any decision adopted by parliament. In other words, the same result could be achieved without there being any visible damage to democratic principles.

How strong are the positions of the president's confidantes and consultants who are in favor of giving *parliament* the right to dispose of oil revenues? The analysis done by the author shows that there are several people in the president's entourage who would agree with such a move - though the vast majority of his assistants are ardent supporters of authoritarianism and the unlimited power of the president in many issues, including anything that has to do with oil revenues.

What can be done, therefore? What instruments of persuasion and pressure does civil society and the media have? How effective can opposition activities be? And is it possible to count on the assistance of international institutions with regard to such issues?

The situation in the country is such that the efforts of international institutions, the World Bank, the IMF and others might prove to be most effective. It was persistent recommendations coming from these institutions that eventually yielded fruit: i.e. the State Oil Fund was established. And it is also thanks to these institutions that changes were made to the law on the budgetary process, when the Oil Fund expenditure became part of a consolidated budget.

Of course, it would be wrong to deny that the media, civil society and political parties can also have an impact - for such an idea would get major support from opposition MPs, and others. Many MPs would be interested in acquiring powers to dispose of oil revenues. For all such bodies to get to support the idea of handing over expenditure powers to parliament, some work must, nevertheless, occur in their regard, i.e. via roundtables, publications, analytical reviews, etc.

Rejecting the current budget concept of SOFAZ

Rejection of the SOFAZ budget concept (which, in addition to expenses related to the Fund itself, also envisions expenses on different state projects and programs) will come from the president's readiness to hand over his powers to dispose of the fund's resources to parliament. Yet even if the president decides *not* to do this, it will still be possible to give up the existing concept. To do so, it is necessary to put oil revenue-based expenditure on different state projects and programs onto a list containing all other state budget expenditures, and specify the exact funding source. By doing so, the government would ensure that a concept of forming a state expenditure *plan* is observed. This work could be vested only in the Ministry of Finance. The Oil Fund would still be left to perform its functions of placing and storing resources and making portfolio investments; and, under such circumstances, the Oil Fund's budget would then only include expenses regarding its *own operations*.

Distribution of a portion of oil revenues among citizens.

This idea will not go down well with some ministry administrations or the National Bank. Some of them (especially the National Bank) would be wary of the macroeconomic repercussions of such a move - while others will worry

about the subsequent reduction in oil revenue expenditure, which would mean less money for the ministries obtaining such resources under different programs and projects. Yet involved persons will have to understand that oil revenue expenditure through the budget or via distribution to citizens basically means the same thing from the standpoint of increasing cash circulation; the difference is that, in one case, this is done by citizens, while, in the other, by government officials (who also manage to misappropriate a portion of this money!).

For the president, such an idea may seem attractive because his team would be able to start a good PR campaign - which may come in handy ahead of the 2008 presidential election.

Targeted use of SOFAZ resources

Who might oppose this?

Direct transfers from the Oil Fund into the state budget reduce tensions for the state bodies responsible for budget revenues - and these, of course, are the Ministry of Taxation and the State Customs Committee. The Finance Ministry, which is responsible for the drafting of a subsequent year's budget, feels more at ease if there is an opportunity to take required amounts from the Oil Fund; so this ministry, too, will also oppose the principle. Other opponents may include major state companies that are large taxpayers - for with Oil Funds being transferred into the state budget, delayed payments of (their) taxes might not be so noticeable to the powers-that-be. And, in fact, *a lot of* state bodies are interested in Oil Fund transfers because, with this situation, they are likely to receive a portion of them. Other supporters of the idea of non-specific transfers entering the state budget also include those who get their salaries from the state budget - and, with this situation, it is easy to convince ordinary citizens that the existing practice is correct and is socially-orientated.

The president, nonetheless, will probably stick to the practice of the last few years, i.e. when specific amounts were transferred from SOFAZ into the state budget; for this practice ensures the stability of budget revenues.

What can be done in such circumstances? How can the president eventually be persuaded to give up the idea of non-specified transfers into the state budget? How is it possible to convince ordinary people that the seeming social 'orientation' of such transfers, first of all, breaches the principle of equal entitlement for all citizens (whether public workers, refugees, etc.) as regards oil revenues - and, secondly, creates risks of oil revenues being embezzled by government officials?

There is one effective remedy: educational and explanatory work with citizens and those in the state administration who might, potentially, become allies. Of course, explanatory work must first of all be held with representatives of the other branches of power, namely the judiciary and legislative bodies. It will be a lot easier to find allies there than in the executive branch. However, the author of the present research does know a number of high-ranking officials who would unconditionally be in favor of suspending non-specific transfers of SOFAZ money into the state budget.

Establishing a parliamentary commission to monitor SOFAZ investment policies

The establishment of such a commission puts the executive branch 'in the hot seat' at all times and in all countries! But this is what is required by democracy and in the interests of reducing the risks of losing natural resource revenues. The question is, then: who could act as an ally given the establishment of the parliamentary commission? There will be both overt and covert allies – and also non-allies - in other bodies; and there will be some in the executive branch too.

Appointing the SOFAZ executive director by parliament, on a presidential motion.

Here, we can express the same suppositions as above. The president will perhaps be less inclined to agree with this principle because he has the right (established via presidential decree) to appoint the executive director. Yet there are several arguments which might convince him to give up the existing practice. First of all, the right of the president to personally appoint the SOFAZ head is rather dubious; while, secondly, the possession of such a right means that the president has a share of responsibility for possible mistakes made in the managing of oil revenues.

Possibilities for attracting foreign managers to portfolio investments and the placement of SOFAZ assets.

This principle is unlikely to have any major opponents because many people understand that this is a necessary measure, something explained by the fact that Azerbaijan does not yet have enough experience with regard to the independent management of revenue windfalls.

6.2 Improving the potential of civil society organizations and the media, and citizens' interests in oil revenues and expenditure

The main problem in this area is *financial*. The cost of activities listed in section 4 depends on the number and nature of activities (roundtables, training sessions, journalistic competitions, short films, special TV programs, etc.) and the number of areas they cover. The more money is spent, the higher the effect. (Though we also have to keep it in mind that, starting from a certain amount, the effectiveness will start declining in spite of a growing expenditure.)

Is it possible to expect obstacles on the part of the authorities, therefore? This is unlikely to happen, especially if these activities are carried out by the NGO Coalition (mentioned above), which is the government's partner in the EITI.

6.3 The role of international institutions

International financial institutions such as the WB, IMF, EBRD, ADB, as well as the European commission and development agencies from a number of leading countries (such as USAID, DFID, etc) have been playing an important role in facilitating the country's shift towards being a democratic society and liberal economy. By providing technical and financial assistance, they have actually acted as partners of the government for many reforms. Although this relationship is not always smooth, and is at times even tense, the country *is* undergoing reform, slowly but surely.

The role of international institutions and different international and national NGOs in developing civil society in Azerbaijan is important. Thus, all this leaves hope that international institutions will help both the government and civil society organizations with regard to ensuring that there is good governance of oil revenues.

The roles played by international institutions can make the good governance of oil revenues easier, though they would cover quite an area. Assistance from international institutions could come in the form of:

- technical assistance to the government and civil society organizations;
- financial assistance to civil society organizations.

The NGO Coalition of Azerbaijan intends to conduct a roundtable, attended by representatives of the Oil Fund and international financial institutions, to

discuss key principles of the new law for the Oil Fund and with regard to the handling of oil revenues.

7 Conclusions and Recommendations

An analysis of the situation surrounding the management of oil revenues and of government policy being implemented in this area shows us that there is room for improving management by means of reducing the risk of losing portions of such revenues. These reserves can be overseen and protected via the country's adopting a new law for the Oil Fund and for managing petroleum revenues, and also by stepping up the activities of civil society. However, every suggestion has its supporters and opponents – though many persons are not firm in their convictions, so it is possible to win people over from the other camp. In other words, the degree of success will depend on how thought-through the action plan is, who implements it, and what finances will be involved.

Some of the recommendations made by the author of this Policy Paper have already been included in the Action Plan of the Azerbaijan NGO Coalition. Also, approval has come from a number of international donors who are involved in financing different aspects of the plan. And there are reasons to believe that the MoU signed on November 24, 2004, between the government commission, oil companies and the NGO Coalition, will go to create a constructive environment for the discussion of many recommendations.