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RESOURCE DRIVEN GROWTH IN AZERBAIJAN AND RUSSIA – CHANCES AND RISKS IN TIMES OF ECONOMIC CRISIS

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Abstract

As the examples of Norway, Australia and the Netherlands (etc.) proof, the income from the export of natural resources (oil, gas etc.) can be utilized to generate long-term socioeconomic growth. This is particularly relevant in times of global economic crisis as governments can use resource incomes to cushion the negative impacts by taking adequate counteractions and stimulating economic growth. Therefore, resource rich countries seem to have significant advantages compared to resource poor countries. In fact, however, in most cases, huge resource incomes have turned out to be economically detrimental. There is a huge body of literature on this phenomenon. In this regard, theories of "rentier states" cover a wide range of explanations. Rentier states are states that generate huge incomes from the export of natural resources (oil, gas, timber, gemstones etc). They are exposed to major economic risks due to deficient state institutions, detrimental economic measures taken by their governments and the vulnerability of their national economies to sudden oil price fluctuations.

Given their specific institutional setting and the influx of huge gas- and oil-incomes, the two post-Soviet states Azerbaijan and Russia can be classified as high-grade rentier states (share of rents in state budget more than 40%). At first sight, the two countries seem to benefit from resource incomes. The governments have implemented long-term state programs that are directed towards utilizing natural incomes for the diversification of the national economies. At the same time, the two countries funnel resource profits into inflation-fighting stabilization funds, which are, moreover, currently used to cushion the negative impacts of the global economic crisis. However, despite these far-seeing policy choices, foreign experts remain critical about the future outcomes. For example, as the country representative of an international financial institution in Azerbaijan pointed out to one of the authors (interview in Baku, 14.4.2009), Azerbaijan will most probably lag far behind its economic possibilities, due to mismanagement and rent-seeking by the ruling elite.

The paper raises the following questions: What are the chances and risks of rent-driven growth in Azerbaijan and Russia? And what are the similarities and differences between the two countries in this regard? In a first step the paper creates a sound theoretical framework by giving a general overview on chances and risks of rent-driven growth, particularly focusing on its potential in times of global economic crisis. Section two explains why Azerbaijan and Russia fall into the category of a post-Soviet type of

rentier state and therefore lack many preconditions necessary to initiate sustainable economic growth. Drawing on the results of own empirical researches, section three analyses the rentier systems of Azerbaijan and Russia. The key conclusions on resource-driven growth in Azerbaijan and Russia and its chances and risks in times of global economic crisis are finally presented in chapter four.

Key words: *natural resources, resource driven growth, economic development, post-Soviet rentier states, Azerbaijan, Russia*

JEL classification: Q32

1. Introduction

Incomes from the export of natural resources (oil, gas, gold, gemstones and other mineral deposits) can be used to generate long-term socioeconomic growth. Countries like Norway, Australia and Canada(etc.) have proofed ability to effectively manage natural resource incomes towards the people's well-being. Ideally, resource wealth is a base for fostering equitable growth, promoting human development, maintaining a country's educational sector and welfare system as well as its infrastructure.Moreover, in times of global economic crisis, governments can use resource incomes to cushion the crisis'impacts by taking adequate counteractions and stimulating resource-driven growth.In fact, however, huge resource incomes have regularly turned out to be economically detrimental in many countries in the world.

The phenomenon that "natural resources" (also referred to as "resource abundance" or "resource production", Meissner, 2010, p.9)have detrimental effects(not only in the formof poor economic governance but also in the form of violent conflicts and/or violations of democracy/human rights) is generally known as the "resource curse" (Ross, 2001) or "paradox of plenty" (Karl, 1997). There is a huge body of literature on this, drawing on different causalities. Regarding poor economic governance, a basic distinction can be made between economic causalities and political/state centred causalities (Meissner, 2010: pp. 9).

The trend that most resource-rich countries have performed poorly was first examined in Economic Science, after it became evident that the basic assumption that a state's natural resource wealth would automatically lead to its catch-up development (known as the "staple theory of economic growth", Innis, 1956) had empirically failed.Subsequently, various economic explanation models were developed. In the present case, only two of them deserve more attention: the instability of international commodity markets and poor economic linkages between resource and non-resource sectors.

However, economic causalities do not entirely explain why and how actors reinforce the economic dislocations that are caused by resource production, or why they do not take adequate countermeasures against them. Such explanations are rather provided by political/state-centred causalities. In this context, theories of "rentier states" cover a wide range of models on economic risks. Rentier states are states that generate huge incomes from the export of natural resources (Meissner, 2010, p.9).

Drawing on economic causalities and on rentier state theory this paper analyses chances and risks of resource-driven growth, particularly focusing on the impacts of global economic crisis. The analysis is based on case studies on Azerbaijan and Russia from a comparative perspective.

The paper raises the following two questions: What are the chances and risks of rent-driven growth in Azerbaijan and Russia in times of global economic crisis and in the long-term? What are the similarities and differences between the two countries in this regard? In a first step (section two) the paper creates a theoretic framework by giving a general overview on chances and risks of rent-driven growth, particularly focusing on the impacts of global economic crisis. Section three explains why Azerbaijan and Russia fall into the category of a post-Soviet type of rentier state and are therefore prone to a form of resource utilization, detrimental to sustainable socio-economic growth. Drawing on the results of own empirical researches, the following two sections analyseresource utilization in Azerbaijan (section four) and Russia (section five). The key conclusions on resource-driven growth in Azerbaijan and Russiain times of global economic crisis and in the long-term are finally summarised in chapter six.[1]

2. Chances and Risks of Resource-Driven Growth

The link between "resource abundance" and the impediment of the socio-economic development of countries is sufficiently proved, both theoretically and empirically. Nonetheless, in the proper meaning of the word, a "resource curse" does not exist, as negative impacts do not inevitably occur(Meissner, 2013, p. 27).Asalready indicated, there is a huge variation in the economic outputs of the resource-extracting countries. Whether risks of resource based economic growthoutweigh chances rather"depends" (Brahmbhatt et al. 2010, p.107).

In this regard, the "quality of institutions" is a factor that matters, as state institutions determine the way in which resources are utilized. This conclusion does not only relate to institutions regulating the redistribution of resource incomes, but ratherto all state institutions including the financial sector. Studies have revealed that the state of the institutions at the commencement of resource extraction is decisive. If democratic/participatory institutions have already been consolidated by that point, then it is less likely that the "resource curse" will occur, and, in this case, resource abundance tends to turn out to instead be a blessing (Meissner, 2010, p.15). This was eventually the case in countries like Norway, Australia, Canada and the Netherlands (etc.).

One reason why resource based economic growth is generally viewed as risky, is the volatility of primary commodity markets. In times when the price of natural resources is high, public spending rises as revenues increase. Public spending vice versa decreases in times of global economic crisis, damaging investment and growth (Brahmbhatt et al. 2010: 111, Conceição, 2011, p.7). However, in this case again, the quality of institutions comes into play. As the study of Ploeg and Poelhekke (2009) demonstrates, volatility is a quintessential feature of the resource curse, but also that with well-developed financial sectors the resource curse is less pronounced (Meissner, 2010, p.13).

[1] Except for section five, this paper draws on empirical results from a PhD thesis on the resource curse in Azerbaijan and Turkmenistan (Meissner, 2013) and several associated publications (Meissner, 2010, 2011, 2012).

There are several policies that can be undertaken to cushion the effects of boom and boost cycles. They comprise measures such as hedging volatility in sale prices, creating stabilization funds, reserve accumulation by central banks and reducing inflows during booms (cf. Conceição, 2011, pp.7). Moreover, governments have to actively foster diversification. In resource-driven economies, this will not automatically take place. The research on linkages indicates that a growth in commodity exports has little effect on the performance of the non-export sector, since forward and backward linkages between the resource and non-resource sectors are poor or even missing (cf. Meissner, 2010, pp.9).

The current global economic crisis is an example of all this. At the beginning of the global downturn, commodity prices fell dramatically. Oil prices decreased from $137 per barrel in July 2008 to $35 barrel by the end of the year. However, price returned to 2007 levels by mid-2009 (Revenue Watch, 2013, p.1). Resource exporting countries that had successfully implemented aforementioned policies prior to the global economic crisis, coped with the negative impacts quite successfully. This was the case in most resource rich countries in North Africa and the Middle East. However, resource rich countriesthat had failed to do sowere seriously affected by the global downturn. Some of these countries suffered even more than the highly developed market economies of the western world, as well as the resource poor emerging markets and developing economies (cf. Revenue Watch, 2013).As ananalysis by Revenue Watch (2013, p.2) highlights, these countries were particularly vulnerable due to lagging structural reforms and the government failure to foster diversification.

The lessons from the current global economic crisis show that the performance of governments decides whether chances of resource-driven growth outweigh risks. This leads to the question, whymany governments do not undertake adequate policies. In this regard, theories of the rentier state offer an explanatory model. The core argument can be summarized as follows(Beck, 2007, p.46, Meissner, 2010, pp.10, 2013, pp.34).

In a rentier economy, the state holds a crucial position. The primary sector is dominant and marked by monopolies and cartels. For this reason, rents accrue to the state either directly from the state companies, or indirectly through taxes, duties and concessions. Since socio-economic linkages are missing, the government is in charge of the redistribution of resource incomes. As their future income (in the form of on-going rents) does not depend on wise reinvestment, political leaders can dispose freely of rents. This opens the door for wrong policy decisions and mismanagement. The resource rents finally flow back into the national economy through non-profitable prestige projects, short-sighted public expenditure and public employment policies. Moreover, the ruling elite can spend the rents for their own privileges, for reinforcing their own position of power and access to the rents. In this context, a special form of corruption occurs. It is described as "rent-seeking" as it refers to the private appropriation and consumption of resource profits ("resource rents") by the ruling elite.

However, as Beck (2007, pp.46) points out, the level of the inflowing rents to a high degree determines whether, and to what extent, the effects, as predicted by the rentier state approach, occur. Therefore, the author distinguishes between highgrade-, medium grade-, and low grade-rentier states (share of rents in state budget 40-50%, versus 30-40%, versus 20-30% (Meissner, 2010, pp.12).

The model of the rentier state is an example on how factors such as a certain degree of resource abundance, the characteristics of the national economy, the quality of state institutions as well as leader interests and behaviour interfere with each other, finally leading to a form of resource utilization, detrimental to sustainable socio-economic growth. In conclusion, there is a wide range of factors determining whether chances of resource-driven growth outweigh risks. These factors are interlinked and interacting. Moreover, they are part of a country-specific context. In this regard, there is evidence that the strength of society is another factor witha substantial impact on how political leaders deal with resource revenues (Meissner, 2010, p.15, 2013, pp.178, 286).

3. Post-Soviet Rentier States

As the case of post-Soviet rentier states (such as Russia, Azerbaijan, Kazakhstan, and Turkmenistan) highlights, such factors also have historical roots. These states share similarities and structural parallels not only due to their resource endowment, but also due to their Soviet legacy. With reference to the studies of Franke et al. (2009, pp.110) and Meissner (2010, pp.31, 2013, pp.64), there are five features that determine the post-Soviet rentier state. As a result of these factors, resource rich states in the post-Soviet regionare prone to a form of resource utilization, detrimental to sustainable socio-economic growth.

(1) Resource dependency of the national economies: Although the economic structure inherited from Soviet times varies from country to country, the resource rich successor states to the Soviet Union all share a common structural legacy. The economies of the republics were tailored to Soviet needs rather than to the requirements of the global market. As a result, the demise of the Soviet Union created a grave crisis for the manufacturing sectors, leaving natural resources as one of their very few profitable commodities. This problem is particularly evident in peripheral republics, as they depended on resource extraction already in Soviet times. They were confined to the production of natural resources in exchange for manufactured products from the more highly developed republics in the western reaches of the Soviet Union (Esanov et al. 2004, p.11).

(2) Deficient state institutions: The successor states to the Soviet Union inherited a centralized and hierarchical state structure, with a bloated bureaucratic apparatus. Conversely, supervisory bodies have always been weak. Rules, institutions and procedures are traditionally inefficient and intransparent. As a consequenceof this legacy, political elites can dispose of the rents rather freely. They can spend them for their own privileges and for reinforcing their own position of power.

(3) Elite power in the state and the economy: Through the centralized and hierarchical state structure of the Soviet Union, the old elites held a decisive power base, which they could use in the years that followed the demise of the Soviet Union, to preserve the inherited state structure as far as possible. At the time of national independence, the old cadres still occupied decisive positions in the state and society, including the national economy. Through the state-directed privatisation process, the old elite could also maintain and even expand their control over the national oil sector.

(4) Rent-seeking and non-democratic elites: The Soviet system had produced a socio-political class, striving after the retention of power and related privileges after the breakup of the Soviet Union. Pre-Soviet legacy and the peculiarities of the Soviet system of government favoured the emergence of clientelistic networks. These networks still live on today. They are the basis for the distribution of resource incomes

and for rent-seeking, leading to mismanagement. While the ruling elite are becoming ever richer, the rest of the society remains in poverty.

(5) Weak and passive societies: Post-Soviet societies tend to be weak, not effectively challenging political elites. This holds in particularly true for rural regions, with their traditional population. Due to decades of oppression in Soviet times, oppositional groups are traditionallyweak and inexperienced. Furthermore, they often lack sustainable support among the population. The passivity of post-Soviet societies can be traced back to both pre-Soviet and Soviet determinants. As a matter of pre-Soviet patriarchal traditions and practises, it is still widely accepted in such societies that one should not criticise, let alone challenge, the authorities. However, during the 70 years of Soviet rule, obedience, rooted in cultural traditions, was conserved, if not even reinforced, by totalitarianism, resultant in a fear of voicing public criticism. This is particularly true for the older generation, as a consequence of them having witnessed Stalinist terror. Besides, there is a further aspect worthy of consideration; in exchange for socialist social welfare benefits, the Soviet leadership demanded from the population their non-interference in politics.

4. Resource Utilization in Azerbaijan

Azerbaijan is heavily dependent on its oil sector. In 2008, the oil sector accounted for 52.5% of GNP. In 2009, the export share of the hydrocarbon sector amounted to 96.8 %. In the same year, Azerbaijan had a state budget of 13 billion USD. More than 64 % of it was derived from oil incomes (Meissner, 2013, p.98).For this reason, the country can be classified as high-grade rentier state.

Accordingly, the state holds a crucial position in the production and redistribution of oil and gas revenues. The"State Oil Company of the Republic of Azerbaijan (SOCAR)" is the most important player in the national oil sector. In addition, there are a number of western companies involved in resource production through "Production Sharing Agreements (PSA)" (Meissner, 2013, p.95).

The revenue management is conducted by the "State Oil Fund of the Republic of Azerbaijan (SOFAR)"and by the state budget. The oil profits from the PSA directly accrue to the oil fund, while corporate taxes flow into the state budget. Oil and gas fields that are extracted by SOCAR alone, generate corporate taxes which accrue to the state budget (Luecke and Trofimenko,2008, p.136, Meissner, 2013, p.133).

The SOFAR (since 1999) is the main body governing resource incomes. Its aim is to accumulate assets for the post-oil boom time. Moreover, it carries out public-sector investment. The fund also includes an economic and financial stabilisation function, in the course of which funds are redirected to the state budget. In the third quarter of 2012, the fund's asset amounted to 33.2 billion USD (Meissner, 2013, p.134). In practise, however, the state budget is the primary source for government spending. The reason is that the SOFAR redirects significantly more money to the state budget, than it spends on public investment projects. In 2009, Azerbaijan had a USD 13 billion state budget. The government allocated 40 % of it to the construction sector in order to develop the public infrastructure (motorways, bridges, school buildings etc.) (Meissner, 2013, p.135).

At first glance, Azerbaijan benefits from its oil boom to a large extent. Driven by resource incomes, the country's gross national income grew by 34.5 % in 2006 and by

25.1 % in 2007 (World Bank, 2010). Although Azerbaijan suffered from the global economic crisisas well(cf. Mikayilov, 2009, p.104), the economy kept growing by 9.3 % in 2009and 5.0 % in 2010 (World Bank, 2012). As Hübner and Jainzik (2009, p.12) substantiate, the global economic crisis reached Azerbaijan with time lag and to a much lesser extent than the resource poor peers in the region. The reasons are twofold. Firstly, the Azerbaijani financial sector is small and relatively isolated from the global financial system. Secondly, oil revenues lead to a financial cushion. In this regard, the country also benefited from the fact that the oil and gas production was not yet at its peak which outweighed the oil price downturn (Hübner and Jainzik,2009, p.12).

In order to cushion the effects of the global economic crisis, the government increased the SOFAR transfers into the state budget by 29.3 % in 2009 compared to 2008 (Mikayilov, 2009, p.104). Subsequently, the fund's assets increased only slightly. This provoked criticism among local financial experts in regards to the violation of the fund's saving functions. However, as the country director of an international financial institution mentioned to one of the authors (Meissner, 2013, p.152), it is difficult to assess this policy action, since there is no ideal solution to overcome the crisis' impacts.

However, the question remains whether the country will take benefit from its resource abundance in the long term. Programmatically, the government is committed to diversify the economy and initiate sustainable growth. In order to meet the challenges of the post-oil boom time, the government seeks to develop the information technology and the tourism sector as well as to reform and strengthen the agricultural sector (Meissner, 2013, p.104). As the country representative of an international financial institution in Azerbaijan further pointed out (Meissner, 2013, p.152), this state programme and the oil fund are "significant steps in the right direction." Notwithstanding, he remains critical about the future outcomes, as resource revenues are spend inefficiently. Moreover, as pointed out by Revenue Watch (2013, p.2) the country is already lagging behind in implementation.

Azerbaijan's negative outlook has to do with the structural peculiarities characteristic for post-Soviet rentier states. The ruling elite have all economic power, controlling the redistribution of resources. As a result thereof, they spend the rents for strengthening their own business network and for reinforcing their own position of power and access to the rents. This is independent of the fact that the ruling elite simultaneously tries promote the countryas a reliable supplier on the world market in order to attract more investment and maximise profits(Meissner, 2011, p.8, 2012, pp.137, 2013, pp.138).

The post-Soviet rentier system of Azerbaijan lacks a basic system of check and balances imposing limits on the ruling elite. While the SOFAR is an example of transparency, good practice and efficiency, the state budget is extremely intransparent. As a result of this, the ruling elite can pursue their rent-seeking interests unrestrictedly through public investments. In Azerbaijan, rent-seeking is centred in the bloating construction sector. To siphon off public finances, members of the ruling elite regularly accept tenders from construction companies that are more or less directly associated with them (Meissner, 2011, p.8, 2012, pp.13, 2013, pp.135).

To sum up, Azerbaijan managed to cushion the impacts of global crisis quite well thanks to its resource incomes. In the long-term, however, the country will most probably lag far behind its economic potential due to delayed structural reforms, mismanagement and rent-seeking by the ruling elite.

5. Resource Utilization in Russia

Russia is heavily dependent on its energy sector. Over the last decade, the share of energy in total exports has been rising from roughly 50 % to 67% (Aleksashenko, 2012, pp.40). The importance of the energy sector for the state budget can hardly be overestimated, as taxes paid by the entire sector cover nearly half the overall revenues which the Kremlin has at its disposal (Aleksashenko 2012: 40). Russia is a high-grade rentier state.

The Russian gas industry is dominated by monopoly and rather closed to foreign investments. A few players dominate the Russian oil industry. They are mainly state-owned or have private Russian ownership. Their market share is more than 90 % (Lazko and Nesterenko, 2012, p.12). Besides, there are some foreign companies which have acquired smaller shares in major fields through PSA. However, foreign oil companies have to cope with high political risks (Rutland, 2008, p.9, Heinrich and Pleines, 2012, p.4).

On 1st January 2004, the Russian government installed a "Stabilization Fund" which aimed to compensate future budget problems, should energy prices fall below a certain level. Four years later, the fund was reformed and a "Reserve Fund" and a "National Wealth Fund" were created. Both funds are predominantly managed by the Russian Ministry of Finance (Heinrich and Pleines, 2012, p.5).The revenues from the production and export of oil, natural gas and oil products flow into the Reserve Fund. Its aim is tocover federal budget expenses and to maintain federal budget balance in case oil and gas budget revenues decline (Ministry of Finance, 2010b). The National Wealth Fund takes revenues once the Reserve Fund reaches 10 % of GDP. Its assets can only be spent to cover the expenditures of voluntary pension savings of Russian citizens and to finance and balance the budget of the "Pension Fund" of the Russian Federation (Ministry of Finance, 2010a).

The recent economic and financial crisisaffected the Russian economyseverely. Revenues from energy exports declinedand investors withdrew capital from the Russian market (Sutela 2010). However, the Russian government could cushionthe downturn and its social impacts by using its resource funds. This policy was eased by the fact that these funds have never been set up for a long term purpose (Aleksashenko, 2012, p.45).

The oil and gas industry is the main driver of economic growth in Russia. However, it remains unclear, to what extent the country will take benefit from its natural resource wealthin the long term. Some sectors of the Russian economy are not internationally competitive, as they are sheltered from international competition. They have access to energy at artificially low prices and inefficient production structures are still widespread (Beck et al., 2012, pp.21, 23). In 2003, Russian authorities decided to stop structural reforms. Ever since, the government channels a significant share of revenues into four big "national projects". They aim at enhancing the quality of education, maintaining affordable housing, offering up-to-date healthcare and guaranteeing demographic sustainability. Theseprojectsareregularly criticized as being inefficient and designed to increase public support for the ruling elite (Wyciszkiewicz, 2008, p.42). In the field of healthcare, procurement of hi-tech equipment is often ill-advised and the quality of medical services remains at a low level. In the field of public housing, costs are skyrocketing, as the construction of new homes does not meet demand. In the education system, corruption is rampant while education remains low in quality (Reuters, 2008).

According to the Revenue Watch Index 2010, Russia belongs to the top three countries worldwide in terms of comprehensive revenue transparency. The government regularly publishes information on the aggregate amounts collected by the funds (Revenue Watch, 2010). Despite of this, the country suffers from rent-seeking due to institutional deficiencies (Beck et al., 2012, p.23) and corrupt elites, which is characteristic for post-Soviet states.

The main profit-holder is the group of interests gathered around president Putin (Åslund, 2009, p.4). They have been controlling the energy sector since the beginning of Putin's tenure. These networks are often described as "clans" going back to Soviet times, primarily consisting of retired KGB and FSB officials. The second major beneficiary has been the Russian bureaucracy and military (Rutland, 2008, p.1).As a result, the development of the energy sector depends on the political and financial interests of the ruling elite (Yenikeyeff, 2012). It is only consequent that no independent body is able to scrutinize the energy sector efficiently (Krutikhin, 2011; cf. Heinrich and Pleines 2012, p.6). Under Putin, no serious efforts have been made to remove corrupt elites, except for selective cases when an individual oligarch felt into disfavour with the head of state (Rutland, 2008, p. 1).

To sum up, in the short-term, the Russian government could cushion the global downturn and its social impacts by using its resource funds. In the long-term, however, Russia will most probably lag far behind its economic potentialas a result of lacking structural reforms, mismanagement and rent-seeking by the ruling elite.

6. Conclusion

As indicated by economic models and rentier state theories, states rich in natural resources are often worse off than their resource poor counterparts. This was also visible in the current global economic crisis, when commodity prices dropped dramatically. However, resource exporting countries that had successfully reduced the vulnerability of their national economies prior to the global economic crisis, coped with the crisis' impacts quite successfully.

The two high-grade rentier states Azerbaijan and Russia came away quite lightly. This was first and foremost due to the fact that their governments had set-up national funds, in which oil and gas revenues are directed. They could be used to cushion the global downturn and its social impacts in the short-term.

In the long term, however, both countries will most probably lack far behind their economic potential. While structural reforms are lacking in Russia, Azerbaijan is lagging behind in implementation. Moreover, both Azerbaijan and Russia suffer from mismanagement and rent-seeking by the ruling elites.

It is not surprising that the two countries share many similarities in their negative outlook. The reason is Soviet legacy. As successor states to the Soviet Union, Russia and Azerbaijan have inherited deficient state institutions, resource dependent national economies as well as powerful elites, controlling the state and the economy. Going back to Soviet times, the ruling elites are, moreover, rent-seeking and non-democratic.

At the same time, societies are weak and passive. All these are factors finally leadingto a form of resource utilization, detrimental to long-term socioeconomic growth.

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