

## Why 90 per cent of FDI goes to oil sector in Azerbaijan; Institutional reasons of the unsteadiness between oil and non-oil sectors

### Abstract

Keywords; Oil Sector, Political credibility, FDI

This paper is searching correlation between credibility and development in oil sector. The main question of the paper is that why 90 per cent of foreign direct investment (FDI) goes to oil sector. Based on theoretical and practical approaches the paper argued that volume of foreign direct investment (FDI) depends on credibility index of Azerbaijan. Since oil companies "play its own rules" mostly they are interested in investing in oil sector in Azerbaijan. Almost none internationally recognized "non-oil project" has been registered in the country last years. The conclusion is that no protection of property rights, institutional form of the government, government monopoly, and no perfect competition make country's economic credibility lower, it has a strong negative influence to the unsteadiness between oil and non-oil sector and private sector responses to low political credibility.

Why more than 90 per cent of FDI goes to oil sector in Azerbaijan; Institutional reasons of the unsteadiness between oil and non-oil sectors

Lack of political credibility, legal guarantees had scared away investors, had hindered economic development and economic growth. This paper is searching theoretical aspects and methodologies of impacts of "political credibility" as institute on unequal sectoral development in Azerbaijan. However, "political credibility" is very broad term, and there are too many definition which offered by different scholars. But the paper directly focuses on relations and influence among political credibility and FDI.

What is definition of political credibility? This question arises in the context of searching relations between political credibility and economic growth. Borner et al pointed out that there is common and valid answer. In their opinion, political credibility defined as the predictability of the institutional rules of the game (Borner, Silvio Brunetti, Aymo Weder Beatrice, 1995). By using case studies about Latin America and Southeast Asia they determined the sources of political credibility. They confirmed that economic openness and democratic participation are necessary for precondition.

Milton Friedman focused on economic freedom as credibility and he confirmed the relationship between economic freedom and economic welfare; "Each one -unit improvement in a country's civil liberties score was correlated with 34 per cent reduction in infant mortality and a 49 per cent increase in GDP per capita" (Friedman 1988).

Richard F. Doner and Ben Schneider searched institutions as sources of predictability and credibility, and from this perspective they pointed out the affects of credibility to economic growth (Richard F. Doner, Ben Schneider, 1999).

Why is political credibility crucial in engaging FDI to non-oil sector? And what ways it can be established? Our points start with these questions. Many political actors have incentives to extol the virtues of economic reform. Some of these incentives arise because reform promises can bring political and material benefits. If such promises draw political support, then they can bring the rewards of controlling government.

Calvo and Vegh (1999) have presented credibility as main factor for macro-economic policymaking. They also researched Latin America case to determine relations between credibility and macro-economic changes. Calvo and Vegh (1999) showed that macro-economic performance can be impaired by the lack of credibility. They focused lack of credibility from macro-economic aspects.

According to World Bank's surveys, Commonwealth Independent States (CIS) had the lowest credibility, even lower than Latin America's countries (World Bank, 1997). The global survey surrounded 61 countries. It also focused predictability of policies and tried to determine relations between credibility and economic growth.

**Table.1. Responses to World Bank's Investor Survey on Credibility and Predictability of Policies.**

| Region                                | Predictability | Changes  |
|---------------------------------------|----------------|----------|
| Commonwealth Independent States (CIS) | 1.71575        | 2.3746   |
| Eastern Europe                        | 1.873409       | 2.874182 |
| Developed Countries                   | 2.715227       | 3.783636 |
| Middle East and North Africa          | 2.438333       | 3.231333 |
| Latin America and the Caribbean       | 2.204643       | 2.768286 |
| Sub Saharan Africa                    | 2.140795       | 2.408091 |
| South and South East Asia             | 3.035833       | 3.243333 |
| Average                               | 2.187836       | 2.817343 |

**Source:** World Bank, (1997). Values are averages of responses. They are on a scale of 1 to 6 with 1 lower values reflecting inferior outcomes.

Aymo Brunetti et al summarized surveys carried out in 53 countries and determined five sub- indicators of the credibility; predictability of rules, subjective perception of political instability, security of persons and property,

predictability of judicial enforcement and corruption (Aymo Brunetti, Gregory Kisunko and Beatrice Weder, 1997). They used cross-section regression analysis in order to evaluate the hypothesis that high credibility is associated with higher growth rates and higher rates of investment. And they analysed countries with high and low credibility and based changes Gross Domestic Capital (GDP) per capita in various countries.

Aymo Brunetti et al also checked how credibility affects economic growth. Their conclusion is as following; "credibility can influence growth by either affecting the accumulation of capital or by affecting the allocation of capital to different sectors" (Aymo Brunetti, Gregory Kisunko and Beatrice Weder, 1997).

Another seminal work done by Aymo Brunetti et al is that they tried to determine relations between credibility index and investment/GDP. They checked whether credibility has a positive impact on growth through higher rates of investment (Aymo Brunetti and Beatrice Weder, 1995). The conclusion is that; as low credibility index as low investment rate.

Richard F. Doner and Ben Schneider showed that lack of government credibility may also derive from the high information costs to government spending and revenues (Richard F. Doner, Ben Schneider, 1999).

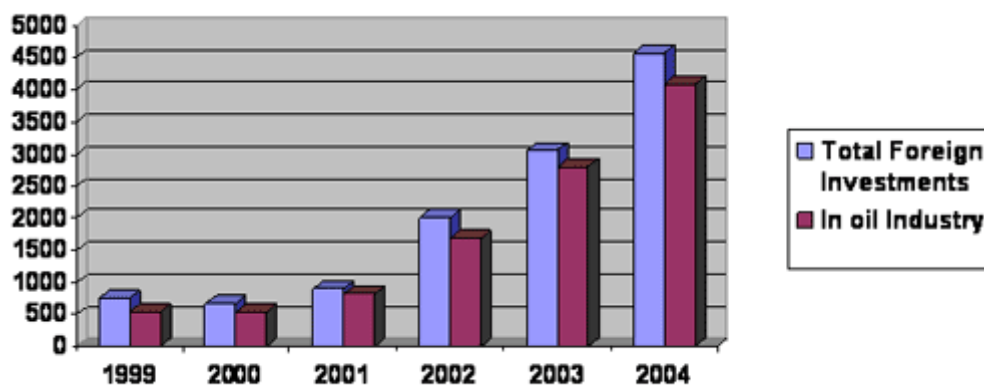
The paper is also connected with the monopoly of state and state control. On the one hand, we focus this dilemma, and on the other hand we make evaluation of property rights in such a system where government does not attempt to establish civil society system, to protect property rights, as well as do discrimination among "good guys" (firms which closely connected with government), and "bad guys" (firms which prefer competition system). As some scholars (Kydland and Prescott (1977), Silvio Borner and Aymo Brunetti (1995) and etc.) agreed that political credibility is a crucial factor for growth. Then we research the credibility of political systems (includes, efficiency Versus Credibility and etc.) Credibility, as well as independency of political systems is key factor for economic development, because of establishing "the same business and economic activity opportunity" for all the actors. And then we meet "transaction cost" issue in political credibility and "political costs" of formal and informal contracts and agreements, as well as growth costs of political credibility, in low political credibility system. Efficiency Versus Credibility developed by Kydland and Prescott, and principles of "Washington consensus" (J. Williamson and some members of neoliberalism) should be considered in such system. However, prisoners' dilemma and of course, game theory create basic to continues and extend the research.

In Azerbaijan the credibility criterion is at the heart of debates over the timing of economic reform. In a country embarking on a transition to capitalism, policy credibility is an especially important issue because of the revolutionary nature of the societal transformation. In this connection, if we see the general situation of the post communist countries, we should research 'shock therapy' reform rather than 'gradualism'. This is because shock therapy is thought to be more credible than gradualism because rapid reform programs send agents uniform, consistent information about the direction of the economy. Shock therapy is also seen to be more efficient-and hence credible-because reformers have an opportunity to implement radical change only in the early moments of a new regime.

The paper considered Azerbaijan as an case of a "noncredible" political system and then I considered some important factors. When should we expect Azerbaijan politicians to keep their promises to reform? And more importantly, given the often complex machinations that determine a political leader's or government's ability to keep reform promises, are analysts looking in the right places for the clues that will help them better anticipate which reform plans will succeed?

Azerbaijan is widely regarded as exhibiting low credibility; in fact, private investment, both domestic and foreign, is extraordinarily low. However, oil investments by private foreign oil companies are high - 90% of FDI. Question is simple; Why? "Legitimacy is a vital concern ... There is a high level of anxiety about Azerbaijan," - said Michael Ochs, staff advisor to the US Congress' Commission on Security and Cooperation in Europe, and referring to the prevailing mood of oil executives. The greatest fear is that if there is not a smooth, universally recognized transition of power in Azerbaijan, contracts concluded during current presidents regime may not be recognized by the country's future rulers. According to Horton, oil companies are aware of the dilemmas surrounding their dealings with current government. In order to protect both their image and their investments, oil companies have been working with non-governmental organizations, including human rights groups, to develop a code of conduct. Such a voluntary code could soon be put into place, Horton suggested.

**Line 01. FDI in oil sector**

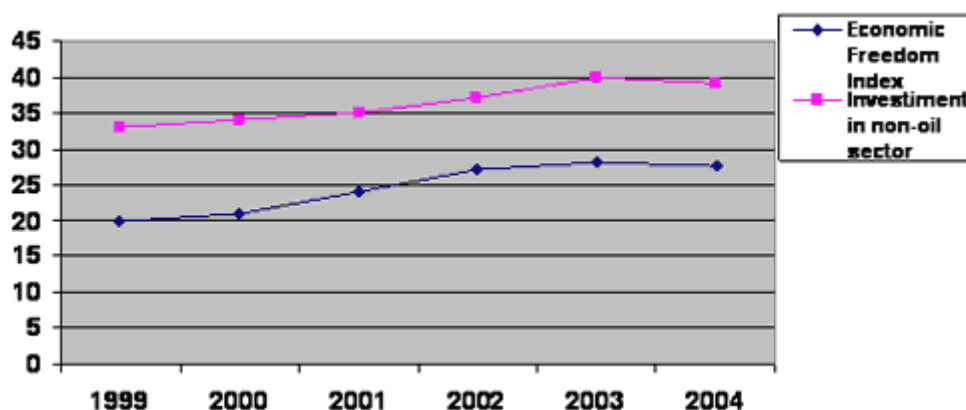


**Source:** Statistical Yearbook of Azerbaijan (2005)

Another fact is that oil sector plays key role in Azerbaijan economy and national economy closely depends on oil sector. "Over one-third of revenue comes from SOCAR [State Oil Company of the Azerbaijan Republic]. The EIU

therefore indicates that revenues from state-owned enterprises are at least 33 percent of total government revenues. The procedure for establishing a business is complicated. According to the U.S. Department of State, "Azerbaijan remains a difficult place to do business given arbitrary tax and customs administration, a weak court system, monopolistic regulation of the market, and corruption." These facts show that government intervention in the economy is high, and institutional form of the government makes no sense to speak about protection of property rights.

Line 02. Correlation between economic freedom index and non-oil investments



**Source:** Economic Freedom Institute and author's own calculations

According to Index of Perception of Corruption of the organization "Transparency International" for 2003, Azerbaijan is on 124-128 place (together with other four countries: Angola, Georgia, Cameroon, Tajikistan) among 133 countries of the world. The poll of thousand of respondents, carried out recently (May 2004) by national Center of Sociological Researches "Sorgu", has also confirmed the high level of corruption in the country. According to the results of this sociological poll, more than 86,9% of respondents consider the level of corruption in the country as rather high (52,2%) or very high (34,7%). According to the results of sociological poll, as the main reason of corruption was called "the corruptibility of leaders". As other important reasons of corruption, the respondents indicated "imperfection of laws", "absence of social control", "ineffective work of institutes of the government". The opinion of overwhelming majority of participants of focus-groups and individual interviews was analogous. This poll shows that respondents do not have credibility law and state institutions.

**Table.2. Transparency International  
Corruption Perception Index, 2004**

| Country Rank | Country    | 2004 CPI Score | Confidence Range | Surveys used |
|--------------|------------|----------------|------------------|--------------|
| 90           | Russia     | 2,8            | 2.5 - 3.1        | 15           |
| 114          | Moldova    | 2,3            | 2.0 - 2.8        | 5            |
| 114          | Uzbekistan | 2,3            | 2.1-2.4          | 6            |
| 114          | Kazakhstan | 2.2            | 2.0-2.5          | 5            |
| 122          | Ukraine    | 2.2            | 2.0-2.4          | 10           |
| 133          | Georgia    | 2.0            | 1.6-2.3          | 7            |
| 140          | Azerbaijan | 1.9            | 1.8-2.0          | 7            |

Source; Transparency International (2005), Explanatory notes

\*CPI Score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (highly clean) and 0 (highly corrupt).

\*\* Confidence range provides a range of possible values of the CPI score. This reflects how a country's score may vary, depending on measurement precision. Nominally, with 5 percent probability the score is above this range and with another 5 percent it is below. However, particularly when only few sources (n) are available an unbiased estimate of the mean coverage probability is lower than the nominal value of 90%.

\*\*\* Surveys used refers to the number of surveys that assessed a country's performance. 18 surveys and expert assessments were used and at least 3 were required for a country to be included in the CPI.

Azerbaijan is at bottom of the economic freedom index with 106th rank, and mostly unfree category in 2004. Personal choice, voluntary exchange, freedom to compete and protection of human rights are key component of economic freedom. According to the Economist Intelligence Unit, "In Azerbaijan the judiciary is the least developed branch of the government. Judicial and police corruption is widespread...." The U.S. Department of State reports that "in Azerbaijan effective means of protecting and enforcing property and contractual rights are not yet assured. While the [government] does not officially interfere in the court system, in practice courts are weak, judges often

inexperienced, and progressive new tax and other economic legislation poorly understood. The Economic Court, which has jurisdiction over commercial disputes, is weak, widely regarded as corruptible, and its decisions are often inconsistent."

Empiric evident shows that the main reason of decreasing of number of foreign enterprises in Azerbaijan is low political credibility. Because political credibility is low and state institutions are weak foreign investors avoid from Azerbaijan. Meanwhile, number of foreign investors run in Azerbaijan has decreased year by year. Statistical figures confirm that foreign investors prefer putting their investments outside Azerbaijan. At the same time, total amount of Azeri investments abroad is getting higher. Azeri investors invested only in Turkey more than their local investments. Surveys confirmed local investors are scared at political risk in Azerbaijan and therefore they prefer funding their money abroad. Structure of foreign investments in Azerbaijan show that mostly Trans-national Enterprises invest their money in the country, last years. Therefore oil industry has a big share in total foreign investments.

Vladimir Popov argued that in 1989-98 \$9.0 billion was invested in Russian economy by foreign companies, and per capita basis this is only about 15 per cent of Azerbaijan and Kazakhstan levels where political credibility is less and business climate is worse than Russia (V. Popov, 2000). In Azerbaijan case, the country receives about \$ 4.0 billion (including financial credits) this period and 98 per cent of the investments were directed to oil sector. Non-oil sector received less than

\$ 100 million. My point is that because credibility played significant role in this process, foreign direct investments avoided non-oil sector. Per capita basis Azerbaijan received more investments than Russia this period, because the country signed 15 oil contracts with multi-national oil companies and foreign money was only directed to oil sector. None contract for working in non-oil sector was signed during this period.

These approaches confirm that Azerbaijan has credibility problem and five sub- indicators of the credibility are applied here. Taking into consideration structure of foreign investments and rate of investments we found that non-oil investments go out from country. During last 7 years the share of annual oil investments in total investments are higher than 90 per cent.

Table.4. Foreign Investments in Azerbaijan (mln. US dollars)

|                           | 1999  | 2000  | 2001  | 2002   | 2003   | 2004   |
|---------------------------|-------|-------|-------|--------|--------|--------|
| Total Foreign Investments | 754.9 | 664.1 | 899.8 | 2011.9 | 3060.3 | 4575.5 |
| In oil Industry           | 544.5 | 546.1 | 820.5 | 1693.0 | 2810.2 | 4088.1 |

**Source:** Statistical Yearbook of Azerbaijan (2005)

Mostly credits are short term credits and it is also factor of credibility. Banks prefer posting short-term credits to avoid political and economic risks. Last survey conducted in Azerbaijan shows that the main reason of preferring short-term credits was less political credibility, because political risk is high in Azerbaijan bank sector does not intend to finance long-term projects.

Another example; with such ways, the Azerbaijan government cannot increase investments or improve economic and political relations with international financial institutions. Even when we look at relations between Azerbaijan and European institutions we can observe a credibility problem.

The paper searched the pressures of the political problems between Azerbaijan and Council of Europe to economic development. In fact CE is political organization, but such relations establish political noncredibility of the government. We discussed similar noncredibility problem when the Azerbaijan government had in the relations with the IMF. In spite of the fact that Council of

Europe is political organization and it especially protect human rights, such a political problems, which Azerbaijan did not keep it promise on political prisons and etc., directly connected with economic development. Because, this is the credibility problem of Azerbaijan it is also a sincerity problem. We argue that the basis for sincerity comes from particular attributes of either the speaker or the context in which he speaks.

To understand better the importance of political credibility in the development of Azerbaijan economy, and discuss the institutions that shape Azerbaijan corporate governance structure. In Azerbaijan we should consider the following facts which are directly connected with creating political credibility. The first point is that the media are not under the direct control of the government, media organizations compete for attention from the audience of enfranchised persons. There exist competitive, adversarial political parties, where the political parties are sufficiently organized and resourceful to gather and distribute reform-relevant information. However NGO's can play significant role of establishing of credibility.

The paper used two hypotheses to determine affects of political credibility to economic growth. First hypothesis is that the literature says that non-democratic leaders with long horizons have an incentive not to expropriate. Future oil investments are likely to be several orders of magnitude larger than current investments - to expropriate current investments is to lose the future investments.

Second hypothesis is as following; though not well explored in the literature, non-democratic leaders need the support of others. Though not in a "democratic" system, Azerbaijan's president needs the support of many people whose horizons are longer than his. Then how do non-democracies with short horizon leaders still manage to protect property rights (even if only oil companies)? Property rights and transaction costs in formal and informal oil contracts is a key part of the paper. Because, under such system, and conditions, we focus protection of property rights, and level of transaction cost in two different kinds contracts.

Richard F. Doner and Ben Schneider focused the rate of transaction costs; the point is that in such conditions information cost is higher. More payments are needed to get information about government activity and even government decisions. Lack of transparency is also main factor for political credibility. Transparency is necessary to protect property rights and reduce transaction costs.

Last survey shows that transaction costs in oil contracts were higher and empiric result was that foreign oil companies paid more money to obtain official information about government activity including government spending. Studies show that when there were more state organizations transaction costs were higher, and reforms in the institutional sector have affected the level of these costs. The change in transaction costs took place for the following reasons. Institutional reforms decreased the level of information and negotiation costs. In the case of many state organizations, oil companies needed to negotiate related issues with not one state organization, but many organizations. Furthermore, oil companies needed to pay various organizations to collect information. At the conclusion of institutional reforms, oil companies need to negotiate with concrete state organizations. Moreover, it affected illegal payments, such as bribes, etc. Institutional reforms have decreased illegal payments.

The conclusion is that no protection of property rights, institutional form of the government, government monopoly, and no perfect competition make country's economic credibility lower, and it has a strong negative influence to the economy, private sector responses to low political credibility. Since no high political credibility, FDI mostly address to oil sector. Almost none major internationally recognized companies invest in non-oil sector because low political credibility increases risks regarding to non-oil investments. In additional, although western oil countries invest huge money in non-democracy countries, such as Azerbaijan, they have weak influence to establishment of political credibility. Furthermore, political credibility has a huge affects to economic growth in Azerbaijan. Credibility is significantly associated with investment in Azerbaijan.

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