



ICEG EC



Caucasus & Central Asia (CCA) Review

Vol. 1, No. 1

June 2007



Caucasus and Central Asia (CCA) Review

The Caucasus and Central Asia (CCA) Review is a monthly, online publication in English language. It is a part of capacity building projects within EPIN (Economic Policy Institutes' Network) financed by UNDP (United Nations Development Programme) coordinated by ICEG European Center. The project involves experts from research institutes and universities of the Caucasus (Armenia, Azerbaijan and Georgia) and Central Asia (Kazakhstan, Uzbekistan, Turkmenistan, Tajikistan and Kyrgyzstan) regions in preparing brief analyses of macroeconomic, microeconomic, institutional or structural content. The thematic approach of the publication is directed to capture extraordinary, non-trend macroeconomic developments, as well as social, economic problems that arise from the specialties of the structural and political setup.

Research organizations in partnership:

Caucasus University (*Georgia*)

Center for Economic Research (*Uzbekistan*)

Economic Development and Research Center (*Armenia*)

Economic Policy Institute (*Kyrgyzstan*)

Institute for Economic Research (*Tajikistan*)

Institute for Scientific Research on Economic Reforms (*Azerbaijan*)

ICEG European Center (*Hungary*)

Public Policy Research Center (*Kazakhstan*)

Editor

Tamás Borkó, tborko@icegec.hu

Contact information

ICEG European Center, 6/B Dayka Gábor utca, Budapest, 1118 Hungary. Phone: (+36) 1 248 1160. E-mail: office@icegec.hu

Disclaimer

This document is for informational purposes only. It is not intended as an offer or advice in relation to any investment decision. ICEG European Center and the authors of this document are not responsible or liable for the accuracy, completeness and correctness of the information in this document and cannot be held responsible for any damage resulting from the use of this document. The contents of this document are subject to change without prior notice.

Table of Contents

Pension system in Kazakhstan: from defined benefit to defined contribution	4
The need for export driven economy in Kyrgyzstan	9
The role of the oil fund in the sustainable development of Azerbaijan	13
Inflation stimulating factors in the Georgian budget and the need for treatment	16

Pension system in Kazakhstan: from defined benefit to defined contribution

*Manshuk Nurseitova*¹

A decade ago, Kazakhstan implemented a remarkable pension reform. The identification of accumulated results and problems became current. Thus, this analysis tries to attract not only the attention of domestic and international actors but also to provoke dialogue between professional actors.

Ten years ago, Kazakhstan pioneered a pension system reform among countries of the Commonwealth of Independent States (CIS). By the late 1980s, the Soviet pension system accumulated many problems and parallel, the first signs of ageing appeared. In the mid-nineties, for each pensioner there were less than 2.5 people employed in the economy. Non-payment problem also affected the pension system with remarkable amount of pension arrears and 6 to 8 months delays in payment despite the very low pension benefits.² Effectively the old system has bankrupted. Under unbearable pressure of pension commitments, political decision has been made and the new law "On pension provisions in the Republic of Kazakhstan"³ came into effect on 1 January 1998, which earmarked the transition from the Soviet type Defined-Benefit system to the Defined-Contribution system.

Retirement age was gradually extended from 60 to 63 for men and from 55 to 58 for women.⁴ Most of the privileges of early retirement were abolished. Only employees with sufficient employment history before 1 January 1998 (25 years for men and 20 years for women) were entitled for a full amount of state pension. Pensions for employees with shorter employment history were calculated on proportional basis. On the other hand, a new pension system based on individual (mandatory and voluntary) pension savings was introduced. In the next 30-35 years, this new system should replace the old "Pay as you Go" (PAYG) system. However, a question might be arisen ten years down the line, whether pensioners are better off with the new system.

The new profile

Mandatory pension savings are generated from 10% of employees' wages each month to individual accumulating accounts with one of the accumulative pension funds (APF)⁵ and upon retirement, these savings will serve as a source of pension payments. The voluntary savings are intentionally ignored as insignificant in a number of participants and accumulated amounts. As of 1 January 2007, there were over 8.5 million of mandatory saving accounts compared to some 36 thousand of voluntary saving accounts.

1 A working paper dealing with this issue available in the PPRC publication Policy Studies, # 2-3 (19-20), April 2007

2 Accumulation pension system: results, problems, perspectives. Interview with Grigoriy Marchenko for "The Securities Market in Kazakhstan" Journal, November 2004, No11.

3 Law of the Republic of Kazakhstan "On pension provision in the Republic of Kazakhstan" of June 20, 1997 No 136.

4 Initially proposed retirement age 65 for men and 60 for women were declined given the low life span which during transition period dropped significantly.

5 currently there are 14 APF in Kazakhstan

Assumed that most of people start to work after secondary school, men may participate in pension savings maximum 40-48 years, while women 35-43 years. Rules of Payments limit payments until 83 years.⁶ Thus, payments periods for men and women also differ: 20 years for men and 25 years for women.

Having saving system mechanism of market nature bears financial risks. A saver/future pensioner is exposed to a risk of savings' losses; a pension fund can lose its assets due to unsuccessful investment or a market failure; the state, by guaranteeing contributions made in real terms⁷, absorbs the risk of pension funds losses and overall market failure. Another phenomenon in pension sector is aggravating gender differences. Under the old system, women's pensions were on average by 20% less than of men. Now, women's pensions tend to drop even more: they save less, because they earn less; they have shorter employment history and breaks for maternity leaves, but longer payout periods.

Pension adequacy

An internationally accepted replacement rate is 50-70 %.⁸ Retirees' income in Kazakhstan, over the next few decades, will consist of the state pension, pension benefits from the mandatory pension contributions and a basic pension benefit.

The full amount of *state pensions* is equal to 60% average employee's monthly wages for any three consecutive years irrespective of breaks beginning 1 January 1995. This amount should be topped up for 1% for each extra year of employment (but not more than 75% in total). The income base for pension calculations may not exceed 15 monthly calculation index defined in the republican budget law. Thus, a maximum state pension is rather administered by the budget, than based on employee's earnings. Given the age limits, only those who retired before 2004 (men born before 1941 and women born before 1946) are entitled for a maximum pension. Each cohort of following years' pensioners will lose 1% in pensions, so that new pensioners retiring in 2019 will still receive the state pension in the full amount at its minimum level of 60%. Then the state pension will go down in an accelerated manner⁹, as it is shown in *Chart 1*.

Annual pension benefits from the mandatory pension contributions according to a schedule are defined as the largest of the following: 12 times the minimum pension benefit established by the republican budget law for the relevant fiscal year; KZT 100 000 (around USD 830 at current exchange rate); and the sum of pension savings times the coefficient of present value at the relevant age of the contributor.

Currently, pension accumulations are not large enough, for most of existing retirees the first two options apply, i.e. benefit payments do not exceed KZT 100 000 per year. Mandatory pension contributions are tax-exempted but benefit payments are considered, as taxable income.

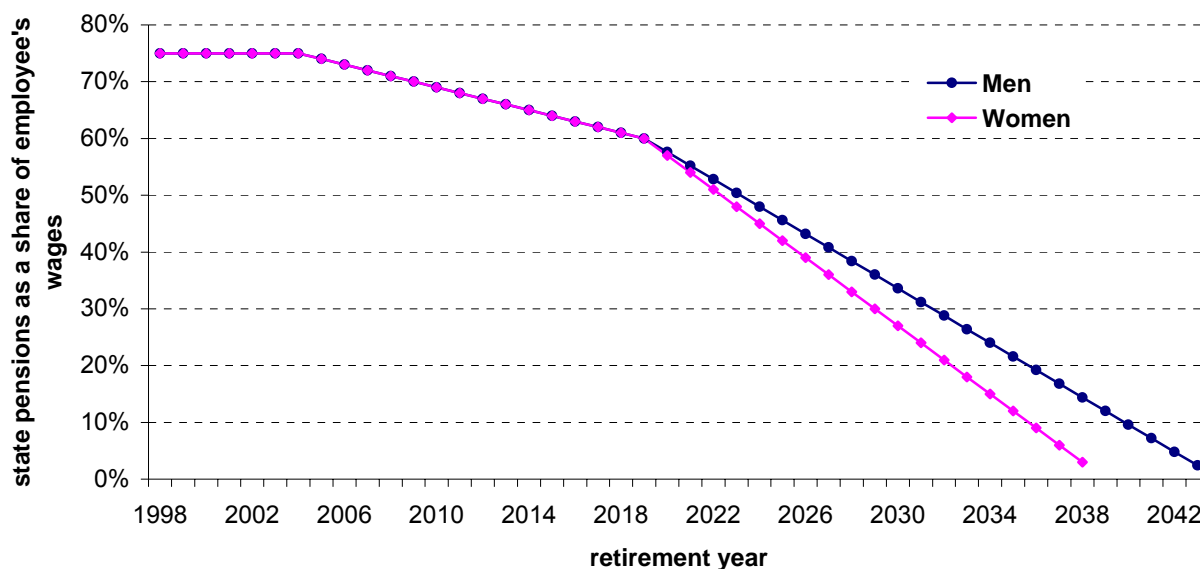
6 Rules for making pension payouts from pension accumulations formed from mandatory pension contributions, voluntary professional pension contributions from accumulation pension funds, Approved by the Resolution of the Government of the Republic of Kazakhstan of July 4, 2003 No 661

7 a legislation amendment adopted recently

8 a ratio of pension income in the year of retirement to employee's income before retirement

9 Assessment of the pension income level during the transition period of the pension reform in Kazakhstan, Nurseitova M.T, Policy Studies, PPRC 2007

Chart 1. Long-run development of PAYG pensions



Source: Agency of the Republic of Kazakhstan for financial market and financial organizations regulation and supervision

In Nurseitova (2007)¹⁰ there were shown that if the salary growth rate exceeds the return rate of pension savings at the stage of accumulations, then the replacement level from pension accumulations will be low even with the constant contributions during the full active working age.

From July 2005, a *basic pension benefit* is to be paid at the expense of the budget to every person achieving the retirement age regardless of work record and pension savings. This amount according to the President's message has to be brought up to 40% of minimum living cost.¹¹

Today 95% of existing retirees receive their state pension benefits in full. The average size of it in 2006 across the country exclusive of defense and law enforcement structures was KZT 8877 (around USD 73). In sum with the KZT 3000 (USD 25) basic pension benefit this amounted to KZT 11877 (USD 98) per month, or 35% of average salary for 2005.¹²

Another 20% could be received through payments from accumulation pension accounts that according to the Law should not be less than the minimum pension established for the given fiscal year (being KZT 6 700 or USD 56 in 2006). The total replacement rate would stand at 55%, which would be quite adequate if payments from pension accounts would be made until death. Yet the savings made within the several years since the pension reform start will not last for long.

Reformers asserted that the new system is a win-win solution. Pensioners will have more generous disbursements out of savings realized during employment. Besides, these savings are private and will be inherited in case of early death. The state will gain from sharing responsibilities for pension provisions with employees and improved transparency of the labor market.

In practice, some problems have come up during the years of reform. First, the low amounts of contributions. Wages of more than 70% of contributors do not exceed 40-times monthly calculation index. At least,

¹⁰ See footnote 11.

¹¹ Message of the President of the Republic of Kazakhstan, Astana. February 28, 2007.

¹² 2006 Yearbook of Kazakhstan, Statistics Agency of the Republic of Kazakhstan

mandatory pension contributions were made according to the State Pension Payment Center (SPPC) from these amounts. Moreover, a significant part of the contributions is made irregularly. According to FSA, about 40% of existing pension accounts has been inactive for the last two years. Another serious issue that low rates of return on pension savings have realized. These returns have scarcely exceeded inflation rates in recent years.¹³ Besides, a large group of people is not covered by the pension accumulation system at all.

Current stance and perspectives

In 2006, 22 thousand people (or 5% of the total pensioners) received their “scheduled payouts” from the accumulations on mandatory pension accounts. In other 16 thousand cases, one-time payouts were made due to outward migration from the country. Savings transferred into insurance companies made only 15 cases by the end of 2005 for the whole country, and 159 in 2006. Pension funds payouts statistics show steady growth of the “scheduled payouts”.¹⁴

However, today this term can be used only conditionally. Savings made during several years of contributions will not influence seriously the pension income. Rather they shall be deemed as one-time retirement payouts, received by the pensioner few times and after the money are exhausted; the pensioner “leaves the list”. Women’s payouts from pension accumulations will cease earlier than of men for the above reasons.

The total payouts for the period by the end of 2006 reached about 5% of the pension accumulations for the period, of which more than a half was made due to outward migration from Kazakhstan. With the current ratio of the payouts to contributions, the accumulation of pension funds can easily fulfill their current obligations: the number of the recipients is small; the majority of the payouts are insignificant in the amount and duration. However, there are evidences that the situation will drastically change in the nearest future.

First, today’s generation of pensioners (males born before 1943 and females born before 1948 are pre-war and wartime children) is very scanty. At present, the system serves minimum number of people. The number of men will remain minimum for another 2-3 years; the females have already overcome this point. When the baby-boomers will start retire, the number of pensioners will increase sharply.¹⁵

Second, rapid increase of salaries, better fiscal position and increase of accumulations period will result in mass payouts with the longer payout periods.

Third, the number of pension bills will be growing every year and stabilize at 200 thousand new recipients (pensioners or their heirs) by 2020. In a Summary Report¹⁶ on pension accumulations and number of contributors as of 1 January 2006, the number of male-contributors of age 59 is 2.5 times larger than of age 63. The number of female-contributors of age 54 is twice as much as those of age 58.

Survival rate does not matter, in case of death remaining savings transferred to heirs, as opposed to the solidarity system, where pensioners only receive benefits.

13 Information on nominal income coefficients of accumulation pension funds, Agency of the Republic of Kazakhstan for financial market and financial organizations regulation and supervision

14 Statistics Bulletin 2002-2006, National Bank of the Republic of Kazakhstan

15 2006 Yearbook of Kazakhstan, Statistics Agency of the Republic of Kazakhstan and “Nation sustainable ageing is observed in Kazakhstan”, information of speech of the First Deputy Chairman of the statistics agency of the Republic of Kazakhstan Yuriy Shokamanov, Information Agency “Kazakhstan Today” March 10, 2006, <http://www.kz-today.kz>

16 Summary Report on pension accumulations and number of contributors as of January 1, 2006, Agency of the Republic of Kazakhstan for financial market and financial organizations regulation and supervision

Table 1. Pension accumulations and number of contributors as of 1 January 2006

Contributors' age (years)	Men		Women	
	Number of people	Amount	Number of people	Amount
50	87 697	10 402 166	83 175	7 969 758
51	82 625	9 909 923	78 613	7 716 183
52	76 378	9 500 949	72 467	7 225 028
53	73 309	9 056 518	67 830	6 836 439
54	70 936	8 910 832	64 298	6 818 131
55	66 773	8 591 563	58 355	6 290 702
56	62 533	8 250 575	55 184	6 024 031
57	55 944	7 574 402	48 437	5 607 694
58	51 103	6 918 202	32 423	3 403 276
59	41 277	5 851 973	-	-
60	24 510	3 400 957	-	-
61	18 165	2 407 330	-	-
62	17 699	2 249 214	-	-
63	17 273	1 972 831	-	-

Source: Agency of the Republic of Kazakhstan for financial market and financial organizations regulation and supervision

Conclusion

High returns during the first years of the reform brought forth overly optimistic expectations about the future pension accumulations. Later the income rate has been low, and the most important, they are significantly lower than the salary growth pace. If such relation will be preserved in the long run, replacement rates will be low. If the subsistence level will be too high against this income, we will face another crisis and the government will be forced to review its policy and rectify the situation, for example, by increasing the basic benefits that, effectively returning to the old system. Proposals to increase the rate of mandatory pension contributions would be unviable in the country where over 70% of the employees receive meager salary and the families' income 80% consists of the salary.

The importance of the pension issue cannot be overestimated. None of the prosperous society can allow old people, who worked through their life, to enlarge the number of the poor, or moreover, to become beggars after retirement. Any decision in this area shall be well balanced and taken after comprehensive analysis and assessment of possible consequences, with consideration of interests of all parties concerned. Yet, many issues remain open and further investigation is needed seeking solutions to avoid unpleasant surprises in the future.

The need for export driven economy in Kyrgyzstan

Samagan Aitymbetov

In May 2007, Kyrgyzstan adopted the new Country Development Strategy for 2007-2010 in order to ensure a comprehensive solution of socio-economic problems of the country. The focal points of the document are strengthening economic growth and creation of job opportunities, particularly focusing on the support of the openness of the economy, on diversification and on increasing the stability of export.

According to the data of the National Statistics Committee (NSC), the trade balance of the Kyrgyz Republic remained in deficit and amounted to USD 920.7 million in 2006, as compared to USD 418.7 million in 2005. In 2007, the persistent trade imbalance is still growing. Kyrgyzstan should concentrate on export competitiveness to finance its import and this requires improving quality of export products, upgrading and promote of trade facilitation.

Economic feature and trade deficit

Kyrgyzstan is a mountainous, land-locked Central Asian country with a predominantly agrarian economy. Cotton, tobacco, vegetables, wool and meat are the main agricultural products. Of these, only tobacco and cotton are exported in some quantity. The Kyrgyz Republic's major export products are gold, textiles, non-precious metals, electricity, footwear, tobacco, alcoholic beverages and mechanical equipment. As much as 50% of the gross domestic product is produced by the informal economy.

Since the beginning of its independence, Kyrgyzstan has adopted a liberal trade policy, which was understandable for a small country with an unfavorable geographic location. The country's trade policy and its unwillingness to choose protectionism were confirmed in 1998 when Kyrgyzstan joined the WTO. Additionally, Kyrgyzstan participates in all regional trade and economic agreements.¹⁷ However, despite positive results of the WTO's Kyrgyz trade policy review, the republic failed to realize its export potential, particularly because of the external barriers to regional trade and of the internal barriers of excessive regulatory system that hampered investment.

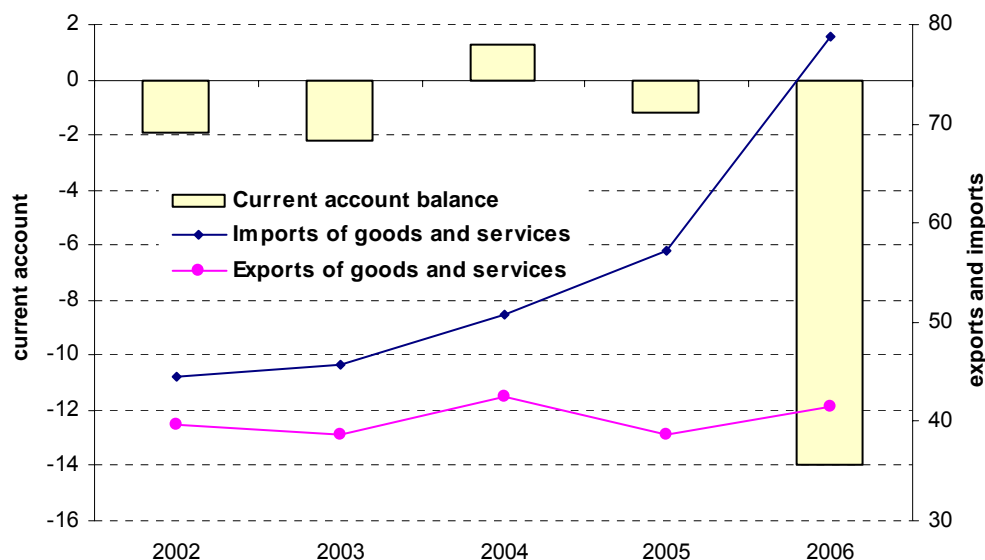
The economy is dominated by gold export. The decrease of the output of Kumtor gold mine caused a 0.5% decline in GDP in 2002, however, GDP growth recovered in the following year. In 2005, after "Tulip Revolution", Kyrgyzstan again experienced a slight contraction in GDP, this time by 0.6%. The government has made steady steps to control its substantial fiscal deficit, virtually balancing revenues and expenditures in 2006. As a result, real GDP grew by 2.7% in 2006, dampened by a gold mine accident. Excluding gold, however, output growth reached 5.1%, driven by industry, construction and services.

According to the data of the NSC, Kyrgyzstan's economic growth was accelerated between January and April in 2007. GDP growth reached record high level of 9.1%. Industrial rate of growth was 102.5%, while construction (143.4%), telecommunication services (149.3%), trade (115%), and hotel and restaurant services (115%) had the largest outputs in GDP. The external merchandise trade turnover was USD 1075.3 million having increased by 52.3% compared to January-April 2006. Export increased by 41%, while import grew by 57.9%, accordingly the deficit of the trade balance amounted to USD 423.5 million compared to USD 243.5 million in the corresponding period of 2006. The continuing growth of remittances is partly

¹⁷ UNDP. Kyrgyzstan at a new stage of development. Bishkek, 2005. p.49

offsetting the trade deficit. Owing to the sharp increase of the imports and an accident-related shortfall in gold exports, the external trade deficit widened to 36.6% of GDP in 2006.¹⁸

Chart 2. Development of the main balance of payment indicators (percentage of GDP)



Source: National Bank of the Kyrgyz Republic

Foreign trade turnover of Kyrgyzstan in 2006 increased by 45% year-on-year and amounted to USD 2610 million, due to the increase in the volume of import of goods. The trade deficit for 2006 grew to USD 1073 million against USD 454.6 million for 2005. Nevertheless, sizable short-term capital inflows (including errors and omissions that partly reflect unrecorded remittances and shuttle trade re-exports) led to a faster-than-expected buildup in gross reserves, to 3.9 months of projected 2007 imports of goods and services by year-end.

According to the Kyrgyz National Bank (NBKR), despite of the foreign exchange intervention, the national currency (som, KGS) appreciated by 8% against the US dollar during the year, but in real effective terms the appreciation was only 1.3%, due to the strengthening of key trading partners' currencies (especially Russia and Kazakhstan). The index of the real effective exchange rate as of the end of December 2006 remained at 92.9% that was conditioned by the real reduction of the exchange rate of som against the Russian ruble and Kazakh tenge. The rate of inflation increased by 5.1% during the year, however it was lower than in Russia and Kazakhstan.¹⁹

The import of goods for 2006 amounted to USD 1732.5 million that is higher by 56.7% than it was in 2005 (the export increased by only 18.2%). The Kyrgyz Republic's major import goods are fuel, natural gas, iron, machinery, chemical products, medicine and food products. Nevertheless, during 2005-2006, the drastic growth (+100%) in imports of consumer durables and investment goods was observed. It was ensured by a substantial increase in deliveries of trucks, communication equipment and telephones, agricultural machines and other equipment. The increase in deliveries of energy products by 64.4% was due to the increase in prices and physical deliveries of oil products.

It is worth mentioning that the Kyrgyz statistical data have contradictions with foreign statistics. For example, according to Trade Ministry of China, the trade turnover between China and Kyrgyzstan in 2006 reached

¹⁸ Kyrgyz Republic: Country Development Strategy (2007 - 2010). IMF Country Report No. 07/193, 2007.

¹⁹ Monetary Policy Report for 2006 Considered by Resolution of the Board of the NBKR № 10/2 as of February 28, 2007

USD 2.22 billion, including USD 2.11 billion for export from China to Kyrgyzstan. But according to preliminary statistical data of Kyrgyzstan, import from China made around USD 244 million (while China refers to USD 2.11 billion), Kyrgyzstan's export to China reached USD 38 million (while China refers to USD 112.9 million). Kyrgyz Finance Minister A. Japarov explained this discrepancy by different method of China's trade turnover estimates, namely that China uses cost-based, while Kyrgyzstan weight-based estimation.²⁰ Taking into account such data disparateness and informal economy, Kyrgyzstan could face much higher export-import volumes and imbalance problems.

The need for export driven strategy

The country's dependence on few goods makes it highly vulnerable to natural or economic shocks. A direct competition with goods made in the developed countries in the near future remains an extremely difficult task for Kyrgyzstan. Nevertheless, the economy of Kyrgyzstan has been adequately responding to the increasing demand from trading partners during the period between 2002 and 2006 (*Table 2*). Based on Kyrgyzstan's export shares, main trade partners' GDP growth averaged at 6.1%, while Kyrgyzstan's export growth averaged at 10.2%. However, it has not affected adequately the growth rate in Kyrgyzstan, which made up only 3.1%. This is due to the fact that significant portion of income goes to purchasing import products.²¹

Table 2. The dynamics of external demand (%)

	2002	2003	2004	2005	2006	Average for 2002-2006
Average growth of GDP Partners	4.5	6.3	7.0	6.5	6	6.1
Export growth in Kyrgyzstan	2.0	18.5	24.2	-6.4	15.9	10.2
GDP growth in Kyrgyzstan	0	6.7	7.0	-0.6	2.7	3.1
Trade balance (USD million)	-80.5	-129.9	-193.4	-454.6	-1073.0	-

Source: NBKR and R.Khasanov. What Hampers Economic Growth in the Kyrgyz Republic?

Diversification of exports is vital for partial improvement of the persistent trade imbalance. Meanwhile, the demand for imported products at the booming neighboring markets of China, Russia and Kazakhstan is constantly growing and the Kyrgyz enterprises could benefit from providing their goods to these states. Tourist services have become another important and rapidly growing source of export proceeds.

Conclusions

In February 2007, the government adopted the Export Development and Import Replacement Program for 2007-2010 declaring that the improvement of export potential, building up production of high quality and competitive goods will be the main purpose of trade policy until 2010. It is positive that the government understands that any actions that support the import replacement and encourage the export by managing exchange rate, subsidies or introducing import restrictions as it infringe upon domestic consumers' interests, should be avoided.

The development of regional cooperation and the removal of existing trade, transport and transit barriers are important in supporting export. For that, the government should continue facilitating the process of accession of neighboring countries to the WTO in order to make trade relations more predictable. Negotiations should result in easier access to their markets for Kyrgyz goods and services and lower cost of transiting goods through their territories.

²⁰ News Agency AKIpress. http://www.akipress.com/_en_news.php?id=21348

²¹ R.Khasanov. What Hampers Economic Growth in the Kyrgyz Republic? <http://www.ipp.kg/en/analysis/429/>

The Country Development Strategy for 2007-2010 also stipulated that measures will be taken to develop and diversify transport infrastructure (automobile, railroads, airways), connecting the country with the rest of the world. Kyrgyzstan will be pursuing simplification, better transparency and harmonization of customs rules and procedures at the borders, eliminating corruption in border and customs services. Measures should be taken to simplify transit through the territory of the countries of the region including transit through the Kyrgyz territory.

Unfortunately, the signed multilateral and bilateral agreements on transit and customs have been largely ineffective, and so regional bodies need to defend nondiscriminatory transit. Expansion of border trade with the neighboring states in Central Asia and increase of the role of Kyrgyz diplomatic missions in export promotion should become an important step. It is planned to review the possibility of joining a group of small countries with small and vulnerable economy, the participation in negotiations on agriculture, the access to the industrial goods markets and the trade facilitation.

The Kyrgyz government assumes that by 2010 foreign trade turnover of the Kyrgyz Republic will increase to USD 5316 million. According to plans the share of export is expected to reach 17.6% per annum, i.e. export of goods and services should increase from USD 1350 million in 2007 to USD 1986 million by 2010 with average annual import growth of 12.8%. In line with that, trade deficit is expected to decline to 28.6% of GDP by 2010.

The role of the oil fund in the sustainable development of Azerbaijan

Namik Tagiyev and Laman Azizova

The State Oil Fund of the Azerbaijan Republic (SOFAZ) is one of the public institutions established to assist Azerbaijan in achieving sustainable development. The main goal of this analysis is to review SOFAZ as a mechanism that substitutes scarce resources with sustainable ones, and to assess the potential of this fund to influence sustainable development of the country.²²

Today a major task of Azerbaijan is to protect, develop and preserve both its acquired independence and its inherited resources for the future generations. SOFAZ was established to assist the government with the second, economic task. Therefore the establishment of SOFAZ in 1999 is a historical event for Azerbaijan similarly to its acquired political independence in 1991. In fact, the activity of SOFAZ activity could be interpreted as a transformation of scarce nonrenewable natural resources into other kinds of resources through the accumulation and appropriate spending of revenues from the oil and gas production. It is important to develop a method that will help assessing the ability of SOFAZ to affect sustainable development of the country.

Sustainable development and SOFAZ

The theory and practice of sustainable development is in the center of the attention of the world's economists and politicians since the end of last century. In 1992, at the United Nations Conference on Environment and Development (in Rio de Janeiro) it was proclaimed that in the 21st century sustainable development should become an issue of high priority on the agenda of the global community.

The emergence of sustainable development as a priority coincided with the independence of Azerbaijan and with radical reforms in the country. As a result, Azerbaijan could concentrate on sustainable development from the very start of forming its independent socio-economic system. As part of this process a number of state programs were developed and implemented.²³ However, the importance of a program for long-term oil-revenue spending and the importance of SOFAZ itself should be highlighted, as it is exactly the efficient use of nonrenewable natural resources that is one of the paramount conditions to allow the increase of competitiveness and to achieve sustainable development of Azerbaijan.

According to the resolution on the oil fund, the main responsibility of SOFAZ is to act in the interests of the current and future generations of Azerbaijani citizens, by accumulating and efficiently managing revenues obtained from development and exploitation of the oil and gas resources.

The economic approach to sustainable development is based on the theory of Hicks and Lindahl, which is a theory on maximizing inflow of total revenue, while retaining aggregated resources used for generating this revenue.

This concept highlights the importance of the efficient use of scarce resources and the employment of resource- and energy- efficient technologies in the production and processing of the raw materials; the creation of ecologically safe products; minimization, processing and disposal of wastes; and finally the fair distribution of resources among the current and future generations.

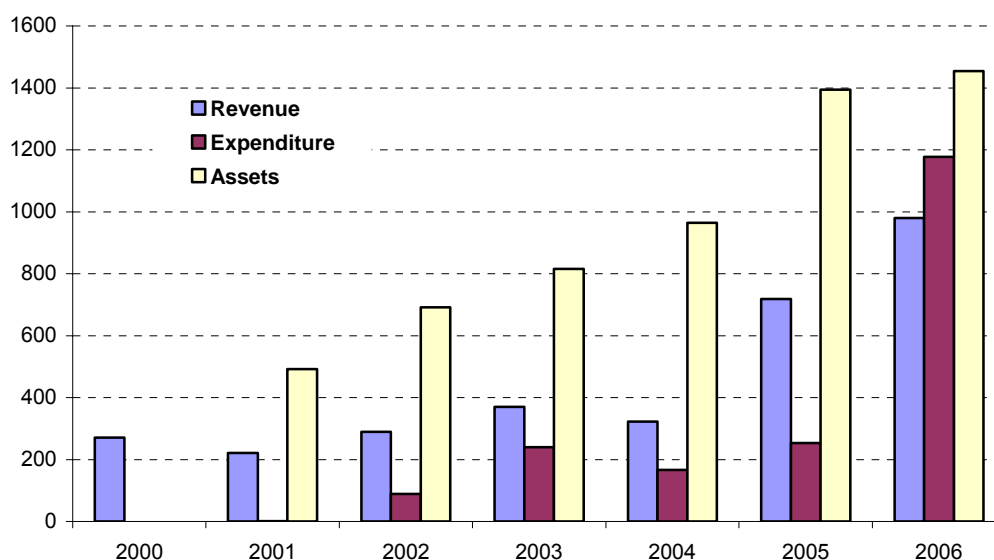
²² Evaluating the efficiency of this mechanism is outside of the scope of our analysis.

²³ Currently there is a program on poverty reduction and on sustainable development of Azerbaijan awaiting its approval.

SOFAZ activities

By 1 January 2007, the amount of funds accumulated in SOFAZ increased by 4.34% from 1 January 2006 – i.e. increased up to USD 1454.5 million. In 2006, SOFAZ revenues comprised USD 980.13 million, which is 36.4% higher than 2005 revenues, and expenditures comprised USD 1177.75 million that is 4.6 times higher than 2005 expenditures.

Chart 3. Development of SOFAZ budget indicators since establishment (USD million)



Source: 2001-2005 SOFAZ Annual Reports; 2006 SOFAZ website

There is no simple way of assessing the activities of SOFAZ. The debate on what should be expenditures of SOFAZ (i.e. with which resources should the substitution be made) continues since its establishment.

The substitution of one type of resources (nonrenewable in this case) with others always raises the issues of misinterpretation and miscalculation that are made while deciding on the following issues: which resources are of highest priority (physical, natural, human or other); to what extent are different types of resources interchangeable; the fairness in proportion of substituting nonrenewable resources with other resources; the cost estimate of nonrenewable resources; and the efficiency assessment of similar substitutions.

Ironically, the most argued question in this case is whether these substitutions are necessary altogether. For example, IMF has repeatedly questioned the necessity of almost each and every item of SOFAZ's budget. Thereby IMF virtually spoke for retaining the oil dollars almost fully for the country's future generations.

However, the government has a contrary opinion. SOFAZ is seen not only as the accumulator and as preserver of a certain part of the oil and gas revenues for the future generations but also seen as a macroeconomic stabilizer. Besides, SOFAZ is charged with solving the social and infrastructural problems of Azerbaijan. The cumulative expenditures of SOFAZ as of 1 February 2007 were directed at: construction of the Azerbaijani part of the Baku-Tbilisi-Ceyhan (BTC) pipeline for AZN 298 million²⁴, the solution of the refugees ('IDPs') social problems for AZN 226 million, the construction of the Oguz-Gabala water pipeline for AZN 82.7 million, the reconstruction of the Samur-Absheron canal for AZN 42.1 million, transfers to the State Budget worth AZN 1013.7 million and financing of the nominal capital of the Azerbaijan Investment company

²⁴ AZN – Azerbaijani Manat

amounting to AZN 90 million.²⁵ In 2007, financing of the Georgian part of Baku-Tbilisi-Kars railway (USD 200 million) were added to all the previous expenditures.

SOFAZ transfers to the state budget of Azerbaijan

A significant portion of the fund's expenditures has been transferred to the state budget. The amended 2007 budget of SOFAZ targets AZN 50 million of additional transfers to the state budget.

The expediency of these transfers raises a lot of debates, particularly concerning the increased money supply and its effect on inflation. In fact, 2007 is already the second year when inflation forecasts made by the International Financial Institutions (IFIs) are by one digit higher than official ones. A separate concern is caused by the long-term appreciation of manat. Due to the weak banking system, the monetary policy of the government is not very efficient.

The social and infrastructural projects of SOFAZ are unarguably called to serve both current and future generations of the country. This responds to the requirements of sustainable development, although some of the projects can be hardly classified either as investment to the production capital or as an investment to the human capital. However, it is hard to precisely assess the efficiency of transforming the natural resources to sustainable ones. This is due to the lack of clear mechanism that would allow to transform one type of resources into another (this is especially true in case with transfers to the state budget) and it is hard to do this assessment due to the lack of necessary data for analysis.

Funding the charter capital of the Azerbaijan Investment Company has to be noted separately. It is the only SOFAZ project, which allows it to substitute directly revenues from non-renewable resources with productive capital. However, researchers note the complexity of assessing the efficiency of the substitution because of the fact that detailed expenditures and projects financed by SOFAZ are not publicly disclosed. Notwithstanding, the revenue side of SOFAZ budget is very transparent. Azerbaijan is a pilot country in the Extractive Industry Transparency Initiative.²⁶

Conclusions

SOFAZ was established seven years ago to assist the country's endeavor towards sustainable development and it currently has a great potential to work towards this goal. The urgent issue today is to develop a mechanism that will allow assessing how well the Fund achieves its goals. This mechanism will predetermine the efficiency of SOFAZ' further activities. The urgency of this issue is especially emphasized if one takes into consideration the World Bank's forecast that by 2011 the assets of SOFAZ will increase by USD 35 billion (assuming USD 43 average oil price).

²⁵ 2007.02.01 official exchange rate 0.8705 AZN/USD

²⁶ In fact during the next EITI summit, Azerbaijan will presumably be presented as the country with the best EITI experience.

Inflation stimulating factors in the Georgian budget and the need for treatment

David Chelidze

The figures of the Georgian state budget have been improving considerably since 2004. This improvement in fiscal performance was realized mainly through increased tax collection leading to a reduction in the budget deficit. However, a considerable part of fiscal revenues have been realized through one-off privatization receipts and unilateral transfers which poses a challenge on inflation developments, and this way on monetary and fiscal policy.

Since the adoption of the first fiscal law (the Georgian State Budget in national currency²⁷ (1996)), targets set in the law have not been accomplished up to 2003. Radically different processes have taken place, however, since 2004. Since that year improvements in fiscal processes are clearly visible: namely a higher level of budget revenues (among them tax receipts), a reduction in both the budget deficit and public debt, and in some additional indicators. However, attention should be paid not only to the quantitative but also to the qualitative improvements of the budget: among them to the enhanced capability of authorities to collect tax receipts. It is worth noting that targets set in the laws on the state budget between 2004 and 2006 were all met, in some cases even overachieved. (Table 3)

Table 3. Developments in the Georgian state budget, 2004-2007

	2004		2005		2006		2007
GDP in market prices (GEL mln)	-	9824.3	-	11624.0	-	13783.9	-
GDP in market prices (USD mln)	-	5166.3	-	6415.8	-	7849.3	-
<i>Budgetary figures</i>	<i>Plan</i>	<i>Fact</i>	<i>Plan</i>	<i>Fact</i>	<i>Plan</i>	<i>Fact</i>	<i>Plan</i>
Total revenues and grants (GEL mln)	1424.4	1773.7	1945.8	2607.9	3068.6	3773.2	3712.3
- relative to GDP	14.5	18.1	16.7	22.4	22.3	27.4	-
Total tax receipts (GEL mln)	1112.5	1322.1	1554.8	1836.1	2263.1	2633.1	2968.1
- relative to GDP	11.3	13.5	13.4	15.8	16.4	19.1	-
Total expenditures (GEL mln)	1731.5	1930.2	2260.7	2618.6	3285.4	3822.5	4077.8
- relative to GDP	17.6	19.6	19.5	22.5	23.8	27.7	-
Budget deficit (GEL mln)	307.1	156.5	314.9	10.7	216.8	49.3	365.5
- relative to GDP	3.1	1.6	2.7	0.1	1.6	0.4	-
State debt (GEL mln)	5755.5	-	5890.0	-	5181.9	-	4511.6
- relative to GDP	58.6	-	50.7	-	37.6	-	-
Volume of state debt (GEL mln)	1600.0	-	1640.0	-	1640.0	-	1490.0
- relative to GDP	16.3	-	14.1	-	11.9	-	-
Volume of foreign debt (GEL mln)	4155.5	-	4250.0	-	3541.9	-	3021.6
- relative to GDP	42.3	-	36.6	-	25.7	-	-

Source: Ministry of Economic Development of Georgia, Georgian National Bank, Ministry of Finance of Georgia

²⁷ Up until 1996 the State Budget was expressed in Coupons (transitional domestic currency), and until 1995 the budget was set at a quarterly frequency.

Besides the above-mentioned positive trends, today it is very important to study the inflationary consequences of sharp increases in budget expenditures. Among them, special attention should be paid to those items, which exhibited sharp rises within a short time period. The need for addressing this problem is straightforward considering the fact that during 2004-2006, the most important sources of state budget revenues were privatization revenues from sales of state property and inflows in the form of assistance by foreign countries (*Table 4*). As figures in the table clarify, between 2004 and 2007 15.1% of total fiscal revenues came from privatization receipts and grants received. The high share of fiscal revenues that are the results of either unilateral transfers (grant, aid, remittances) or one-off inflows (privatization receipts) and not steady real economic processes, poses a challenge for monetary policy, as inflationary pressures increase. Additionally, the predictability of monetary aggregates weakens.

Table 4. The significance of privatization (capital) revenues and grants in the budget, 2004-2007

<i>Budgetary figures</i>	2004	2005	2006	2007
Total revenues and grants (GEL mln)	1773.7	2607.9	3773.2	3712.3
- Capital revenues	67.0	387.0	463.6	200.0
- Grants	124.7	104.5	194.0	249.4
- Total capital revenues and grants	191.7	491.5	657.6	449.4
- <i>Total capital revenues and grants, as a share of total revenues and grants</i>	10.8	18.8	17.4	12.2
Total expenditures	1930.2	2618.6	3822.5	4077.8
- <i>Total capital revenues and grants, as a share of total expenditures</i>	9.9	18.8	17.2	11.0

Source: Ministry of Economic Development of Georgia, Georgian National Bank, Ministry of Finance of Georgia

Considering these and additional inflation-generating tendencies (first of all an increase in the prices of natural resources, particularly fossil fuels), the necessity to launch anti-inflationary measures seems to be unavoidable. One possible solution would be to disregard privatization revenues as a source for covering increased fiscal expenditures. Privatization receipts should be treated separately from other fiscal revenues. Their use should be directed at structural policies for increasing the economic potential of the country and at reorganization the current structure of budget expenditures.

The relevant bodies should begin working on elaborating a program of entrepreneurial character. In the process of the realization of this program, budgetary sources should be used generally in the first stage of projects, and only for giving a starting push for technically and economically well-founded projects that are run by private entrepreneurs after completion. The financial backing of the programs should mainly be provided by the private sector, itself. One of the main criteria for fiscal co-financing (practically on the primary stage) is to prove conditions for mobilization of financial sources from the private sector needed for the realization of projects in the program.

Based on the concept mentioned above, it is expected, that with the help of such a program, a better, more efficient utilization of sources coming from one-off fiscal receipts (privatization revenues and unilateral transfers) could take place, improving transparency, strengthening tax and banking control, and eventually leading to an elimination of additional inflationary pressures.