IS THERE A CASE FOR FRONT-LOADED FISCAL CONSOLIDATION IN AZERBAIJAN?

A Growth and Employment Perspective

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Is there a case for front-loaded fiscal consolidation in Azerbaijan? A growth and employment perspective

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Introduction and overview

This paper critically reviews the case for fiscal consolidation in Azerbaijan by adopting a growth and employment perspective. It commences with a global and comparative context in order to point out that, since 2010, fiscal consolidation has become a major feature of the global policy agenda. This development has been shaped by the experience of the Eurozone countries. Hence, there is much that Azerbaijan can learn by revisiting the European experience.

The paper then discusses the case of Azerbaijan. It notes that fiscal consolidation is a perennial feature of public policy discourse in Azerbaijan. Such a discourse is often driven by international financial institutions. The paper assembles both analytical arguments and relevant empirical evidence to suggest that front-loaded fiscal consolidation on a significant scale will impose costs in terms of reduced growth momentum and employment prospects. These negative consequences are unlikely to be compensated by long-run gains in terms of enhanced macroeconomic stability and private sector-led economic diversification. The paper concludes by offering policy recommendations.

The global context

Fiscal consolidation entails the use of multiple instruments to reduce the fiscal deficit and bring down public debt accumulation. It is often guided by the need to meet specified fiscal targets pertaining to debts and deficits over a given time period. Governments can use a combination of tax increases and spending retrenchments to achieve such targets.

Fiscal consolidation became a core part of the global policy agenda after a sovereign debt crisis engulfed Southern Europe in 2010. Fears of large-scale defaults and concerns about a European-wide contagion that could trigger yet another major recession led European policy makers to swiftly move away from a global initiative in which systemically important nations and regions were united in their resolve to use expansionary fiscal and monetary policies to cope with the adverse consequences of the global recession of 2008-2009.

While fiscal consolidation as a major policy agenda emerged in 2010 in Europe, the penchant for fiscal prudence has always been a preoccupation of European leaders. As is well known, the Maastricht treaty – which was enacted in the early 1990s - has enshrined the pursuit of pre-determined fiscal targets for Eurozone members (a budget deficit limit of 3 % of GDP and a public debt ratio of 60%) as the hallmarks of prudent macroeconomic management. The G20 leaders at the 2010 summit in Toronto called for a unified global approach to fiscal consolidation – although subsequent summit declarations on fiscal policy have adopted a more circumspect tone.

The pursuit of fiscal prudence by observing prudential norms have typically been endorsed by premier international institutions. Indeed, in 2015, the OECD has issued new guidelines on the need to observe fiscal targets by adopting balanced budget and expenditure rules.[1] Thus, for high income countries, the OECD calls for 70 to 90% debt thresholds; for Eurozone countries, the corresponding number are 50 to 70%; for emerging economies, the debt threshold is set at 30 to 50%. The OECD goes even further and calls for setting debt limits that are, on average, 15 percentage points below the afore-mentioned thresholds. This will enable policy-makers to avoid 'overshooting' of debt thresholds due to adverse shocks.

Why are fiscal targets as a means of instituting prudent macroeconomic policy advocated? Once again, invoking the 2015 OECD guidelines is highly pertinent here. The key point is that '…beyond a …threshold, government debt can undermine economic activity and the ability to stabilise the economy' (OECD: 1, 2015). This happens because at 'high' debt levels (defined in relation to the threshold), governments lose market confidence and can see their borrowing costs increase sharply. This deters private investment and spending in general and paves the way for a recession. In such circumstances, fiscal consolidation can, according to its advocates, paradoxically turn out to be 'expansionary', that is, growth and employment can increase even in the presence of tax increases and spending cuts. Such a salutary outcome is possible because a credible and front-loaded fiscal consolidation strategy can restore market confidence and reduce borrowing costs to sustainable levels. Spending by the private sector is accordingly stimulated thus creating the enabling condition for growth to take place.

How robust is the case for fiscal consolidation both in analytical and empirical terms? There is, by now, a large literature on this topic. There is a growing realization that that the case for fiscal consolidation based on fiscal targets and fiscal rules is overstated (Islam, 2014; Ray,

[1] OECD (2015) 'Achieving prudent debt targets using fiscal rules', Economics Department Policy Note No.28, July, www.oecd.org/eco/Achieving-prudent-debt-targets-using-fiscal-rules-OECD-policy-note-28.pdf

Islam and Velasquez, 2015).[2] Indeed, the experience of the Eurozone countries has shown that fiscal consolidation on a significant and large-scale imposes major costs in terms of lost output and jobs without any commensurate increase in ex-ante benefits in terms of long run growth and reduced debt levels. In a widely noted 2013 paper, the IMF conceded that its initial optimism pertaining to the salutary impact of fiscal consolidation in Europe relied heavily on an assumed value of the fiscal multiplier associated with fiscal austerity measures (the negative impact on GDP of a given percentage reduction in the fiscal deficit) that has turned out to be too modest (Blanchard and Leigh, 2013).[3] A revised and significantly higher value of the fiscal multiplier yields much more pessimistic outcomes in terms of lost output and jobs.

IMF's *mea culpa* has been endorsed in a more recent study (Ranenberg, 2015).[4] The study notes that, between 2011 and 2013, '…the Eurozone turned progressively more restrictive'. Tax increases and spending cuts amounted to about 4 % of annual Eurozone GDP. Estimates suggest that '…fiscal consolidation lowers GDP by between 2.5% and 3.5%'. The cumulative fiscal multipliers for the 2011-2013 period turn out to be between 0.7 and 1.0. If one assumes an employment elasticity of 0.5, then employment growth would have fallen by 1.75% as a result of fiscal austerity measures over the 2011-2013 period.

Ironically, the key objective of reducing Euro area debt through a comprehensive – but costly - fiscal consolidation exercise towards Maastricht treaty levels has not been met. Thus, in 2014, Euro Area (19 countries) government debt-to-GDP ratio was 92.1%, while in 2011, it was 86.0%[5].

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[2] Islam, I (2014) "The Rise and Decline of the Fiscal Austerity Doctrine: Implications for the Euro Area Crisis" in Papadakis, K and Youcef, G (eds) *The Governance of Policy Reforms in Europe*, Geneva: ILO, 2014
Ray, N, Velasquez, A and Islam, I (2015) 'Fiscal rules, growth and employment: a developing country perspective' ILO Working Paper No.184, Geneva, http://www.ilo.org/employment/Whatwedo/Publications/working-papers/WCMS_377810/lang--en/index.htm

[3] Blanchard, O and Leigh, D (2013) 'Growth forecast errors and fiscal multipliers', IMF Working Paper, 13/1, www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf

[4] Ranenberg, A (2015) 'The consequences of Europe's fiscal consolidation', World Economic Forum, November 16, https://www.weforum.org/agenda/2015/11/the-consequences-of-europes-fiscal-consolidation/

[5] http://ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables

Lessons learnt

In retrospect, the large literature on fiscal consolidation, especially in the wake of the Eurozone experience, has led to a number of important lessons. First, the impact of fiscal consolidation is closely linked to the business cycle. Fiscal austerity measures pursued during a downturn worsens and prolongs the downturn. There are long-term ramifications, especially in terms of the 'scarring effects' on young people who become unemployed during a recession. Experience and evidence suggest that spells of joblessness during recessions have long-lasting and negative consequences of earnings and career prospects for young people.

Second, a preoccupation with fiscal targets, especially in terms of point estimates is counter-productive. The relationship between growth and debt targets is not robust. Hence, one cannot claim with any degree of confidence that crossing a particular debt threshold will pave the way for economic disaster. It is possible to propose, as the OECD guideline does, that there is a range within which debt thresholds might lie. This suggests that using specific debt thresholds is, to some degree, a matter of discretion and judgement.

Third, a lot depends on how public indebtedness is financed. If countries borrow in credible national currencies and if the monetary authorities are willing and able to act as a lender of last resort, default risks are unlikely to emerge despite high debt-to-GDP ratios as the experience of advanced economies, such as USA and Japan, have shown. On the other hand, members of the Eurozone, especially in Southern Europe, got into a debt crisis because they relinquished control over their national currencies by adopting the Euro. The ECB was also not prepared to act as a lender of last resort for some of these economies, or at best sent mixed signals to international creditors, at least during the early stages of the debt crisis.

Third, the contractionary impact of fiscal consolidation can be counteracted by expansionary monetary policy and competitive devaluations. However, the former can be nullified or its effectiveness blunted if economies become vulnerable to a 'liquidity trap', that is, when nominal interest rates approach zero even when slack economic conditions persist. This makes it difficult for monetary authorities to push down such interest rates lower than the 'zero bound'. One could argue that advanced economies have been subject to a liquidity trap in the wake of the global recession of 2008-2009. This has worsened the adverse consequences of fiscal condition as monetary policy offset was not effective, despite attempts by the monetary authorities to engage in policy innovations, most notably quantitative easing and forward guidance.

The ability to pursue competitive devaluations depends critically on the ability to have policy autonomy with respect to the exchange rate. Once again, the experience of the Euro Area countries that experienced a debt crisis in 2010 is highly instructive. Given that they gave up policy autonomy with respect to the exchange rate by adopting the Euro, the opportunity to engage in competitive devaluations was not available to member states. The alternative was a costly process of 'internal devaluation' in which real wages declined over a protracted period to engender cost competitiveness.

Fourth, the role of market confidence in counteracting the contractionary consequences of fiscal consolidation has been misinterpreted. Credit markets care about the fiscal stance of governments, but they also care about growth. If growth prospects are low and are made lower still by fiscal consolidation, credit market markets are unlikely to view such developments favourably. The result is paradoxically a situation in which the dogged pursuit of fiscal consolidation is penalized rather than rewarded by creditors.

Of course paying heed to such lessons on the promises, pitfalls and perils of fiscal consolidation does not mean that one can simply ignore the fiscal situation of a country if it becomes unsustainable. Then fiscal consolidation is unavoidable and can bring in long-term benefits, despite short-term pain, in terms of higher growth and better employment prospects. On the other hand, one should not succumb to fiscal fetishism and advocate spending restraint and tax increases without undertaking due diligence with respect to the particular circumstances of a country.

Fiscal consolidation and the case of Azerbaijan

In light of the global context discussed above, what can one say about fiscal consolidation and its relevance to Azerbaijan? What strikes one is that the topic of fiscal consolidation is a perennial part of the policy discourse in Azerbaijan. It has been, and continues to be, driven by international financial institutions.

The historical context

When Azerbaijan started its life as an independent state in 1991 after the dissolution of the Soviet Union, it did so under traumatic circumstances. As an ADB report puts it:

'Azerbaijan's diversified economy collapsed with the breakup of the Soviet Union, and by 1995 the gross domestic product (GDP) was only 37% of what it had been in 1989'.[6] It was wracked by intra-regional conflict and faced with large cohorts of internally displaced persons (IDPs). The government, inheriting a rather large public sector, found itself facing acute fiscal challenges. At the time, the government did not have access to the financial largesse of the oil and gas sector. Fiscal consolidation was unavoidable in such circumstances. Azerbaijan found itself under the tutelage of the Bretton Woods institutions and embarked on a stabilization-cum-adjustment programme. Inflation was brought down, budgetary pressures were eased and the country could look forward to the resumption of growth.

Since then, Azerbaijan has experienced a remarkable turnaround in its economic fortunes. A sovereign wealth fund was set up in 1999. Under this vehicle, the government embarked on a front-loaded strategy of using its wealth embedded in the non-renewable natural resources sector to provide general budgetary support, invest in infrastructure and finance social policies.[7] Some observers have noted that, at least in the initial stages, there was a bias in favour of infrastructure investment and against health and social sectors (European Commission, 2011).[8] Nevertheless, Azerbaijan is now a relatively prosperous, upper middle income economy. The 2000s witnessed double digit growth. Poverty, which was as high as 50% in 2001 fell to 5% by 2008. Inequality declined and there was noticeable improvement in non-income dimensions of poverty. Hence, in many respects, Azerbaijan has approximated key features of inclusive growth (Onder, 2013, IMF 2012, EC, 2011).[9]

Labour and employment[10]

[6] ADB (2015), 'Azerbaijan Country Partnership Strategy, 2014-2018', http://www.adb.org/sites/default/files/linked-documents/cps-aze-2014-2018-ea.pdf

[7] Aslani, K (2015) 'Fiscal sustainability and the state oil fund in Azerbaijan', *Journal of Eurasian Studies*, 6, pp.114-121

[8] See bibliographic details in footnote

[9] See bibliographic details in footnote 10.

[10] Solid accounts of the Azerbaijan labour market can be found in ILO (2012), IMF (2012), European Commission (EC) (2011), Onder (2013), Allahveronov and Huseynov (2013). See ILO (2012), 'Azerbaijan: Decent Work Country Profile', http://www.ilo.org/wcmsp5/groups/public/---dgreports/---integration/documents/publication/wcms_175754.pdf; IMF (2012), 'Republic of Azerbaijan: selected issues', IMF Country Report No.12/6, www.imf.org/external/pubs/ft/scr/2012/cr1206.pdf; EC (2011) 'Social Protection and Social Inclusion in Azerbaijan', http://ec.europa.eu/social/main.jsp?catId=89&langId=en&newsId=1045&moreDocuments=yes&tableName;=news; Onder, H (2013) 'Azerbaijan: Inclusive growth in a resource-rich economy', World Bank,

If one considers labour market indicators, there is evidence of considerable progress. In quantitative terms, the unemployment rate has come down sharply, while the employment to population ratio has gone up (Figures 1 and 2). Real wages have increased significantly, although they have slowed down considerably in recent years in tandem with the reduced GDP growth rate (Figure 2) . In line with these developments, the government has substantially adjusted minimum wages. Social protection measures have been made more diverse and comprehensive, with some studies arguing that these measures have played an important role in reducing poverty.[11]

Figure 1: Azerbaijan, unemployment rate, 2000 to 2014

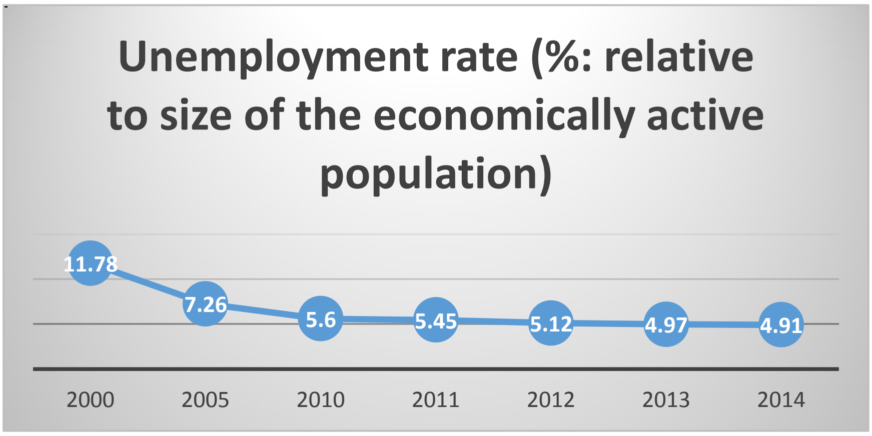
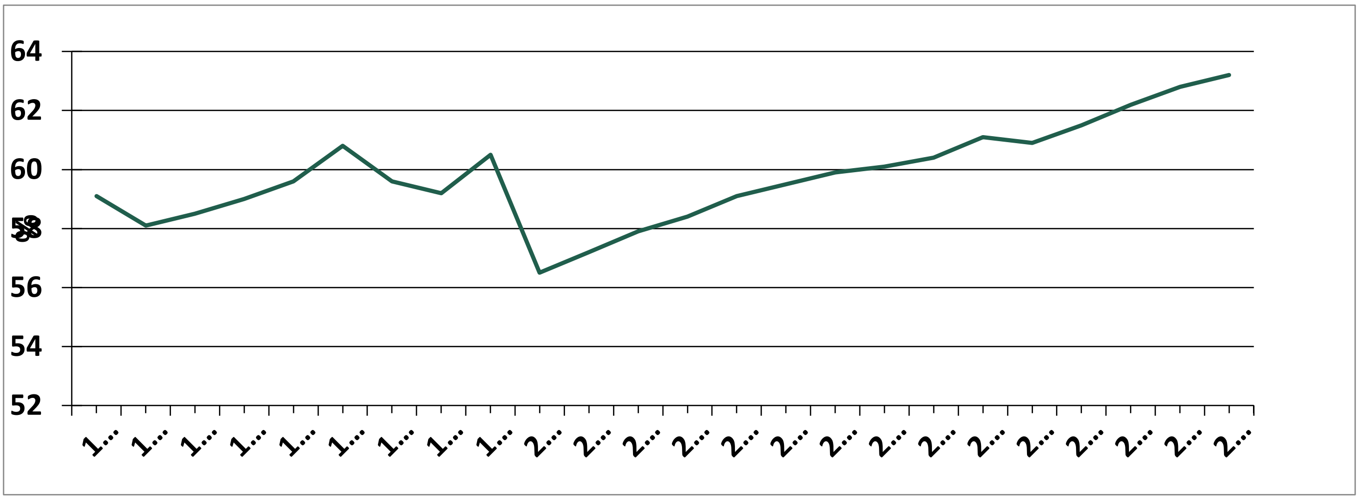


Figure 2: Azerbaijan, long run trends in employment to population ratio, 1991 to 2014



Source: knoema.com from national and international sources

www.openknowledge.worldbank.org/handle/10986/12228; Allahveranov, A and Huseynov, E (2013) 'Country Report: Azerbaijan', CASE, CEU, IZA, LSE

[11] Onder (op.cit)

Figure 3: Azerbaijan, real wages, 2000 to 2014

Source: Derived from data provided by the State Statistical Committee of the Republic of Azerbaijan

Of course, concerns remain about the slow pace of employment growth and low employment elasticity. At 0.8 per annum, employment growth in terms of full-time and permanent jobs is barely enough to keep pace with labour force growth. Judged by regional standards (East Europe and Central Asia), employment growth appears rather low (the regional average is 4.0 %). [12]. Estimates of aggregate employment elasticity suggest that a doubling of the economy will only translate into a 12% increase in employment (Onder, 2013).[13]

Youth employment is nearly three times the overall unemployment rate. Concerns have been expressed about the kind of skills young people possess that do not, in general, seem to be aligned with labour market needs. Some have argued that, if one allows for faltering labour force participation rates, the unemployment rate is significantly higher than what is reported (World Bank, 2015).[14] While working poverty has come down in tandem with the decline in income poverty, well over 30 % of the work-force are stuck in low productivity agriculture. The most productive sector of the economy – mining and utilities – provides

[12] These estimates are available in the 2013 World Enterprise Survey, www.enterprise.org

[13] Onder (op.cit)
[14] World Bank (op.cit)

minimal employment opportunities for the vast majority of the work-force. The manufacturing sector is rather small and it is unlikely that the historically entrenched process of de-industrialisation can be reversed. Hence, providing broad-based, productive and durable employment for its citizens remains a perennial challenge for the government.

The case for fiscal consolidation

The discourse on fiscal consolidation in Azerbaijan is disconnected from such labour market concerns. Yet, international financial institutions regularly exhort the government to engage in fiscal restraint (see Table 1). The case for fiscal retrenchment is built on the premise that the Azerbaijan has finite natural resources that will run out by 2034. Furthermore, oil prices have tumbled in recent years making the country vulnerable to further declines in oil prices. The fiscal framework should, therefore, be modified to respond to such vulnerabilities. This means spending less and saving more.

Table 1: Advice on fiscal policy in successive IMF Article IV consultations, 2008-2014[15]

Year	Nature of advice
2008	The government is urged to '…moderate the 2008 fiscal expansion and tighten fiscal stance in 2009'
2010	Additional oil fund should not be used to increase spending in 2010
2012	The government is urged to '…restrain budgetary spending and commit to medium-term fiscal consolidation'
2013	The government is urged to '…commit to a… front-loaded fiscal consolidation'
2014	The government is encouraged to pursue '…growth-friendly fiscal consolidation strategy'

[15] Article IV consultation documents are available at: http://www.imf.org/external/country/AZE/

There are also broader concerns that, as a resource rich country, Azerbaijan is exposed to the 'Dutch disease' whereby a booming natural resources sector can 'crowd out' other tradable sectors such as agriculture and manufacturing. This can happen through the exchange rate channel as the inflow of resources and foreign exchange reserves leads to an appreciation of the real exchange rate that can impair international competitiveness. A natural resources boom can also create incentives for the government to expand the public sector whose size can become unsustainably large.

The Azerbaijan government seems to have responded, at least partially, to the advocacy for fiscal restraint. In 2014, for example, consolidated expenditure was 4 % lower than in previous years and the investment programme was 10 % lower. This led to a budget surplus of 2.8 % of GDP (World Bank, 2015, p.3). It is plausible to suggest that the 2014 fiscal consolidation reduced employment growth by a modest amount. This is based on an estimated fiscal multiplier of 0.55 as reported in Hasanov (n.d),[16] an employment elasticity of 0.12 as reported in Onder (2013) and spending restraint amounting to 4 %.

More budgetary restraint is foreseen for 2016 and beyond. Indeed, media reports suggest that the government is so concerned about future developments that it toyed with the idea of entering into a 1990s style stabilization-cum- structural reforms programme with the Bretton Woods institutions buttressed by a four billion US dollars emergency loan.[17]

Fiscal consolidation in Azerbaijan: a critical appraisal from a growth and employment perspective

The case for significant and front-loaded fiscal consolidation should ultimately rest on careful analytical deliberations and sound empirical evidence. One study by two IMF economists (Koeda and Kramarenko, 2008) describes the government's fiscal strategy as one in which there is a rapid scaling up of public expenditure to make the most of a temporary oil production boom followed by an equally rapid scaling down of such expenditure as the grim reality of the exhaustion of the oil boom materializes. Their model-based estimates carry a striking forecast (p.12): by 2024, 'the level of real GDP will decline

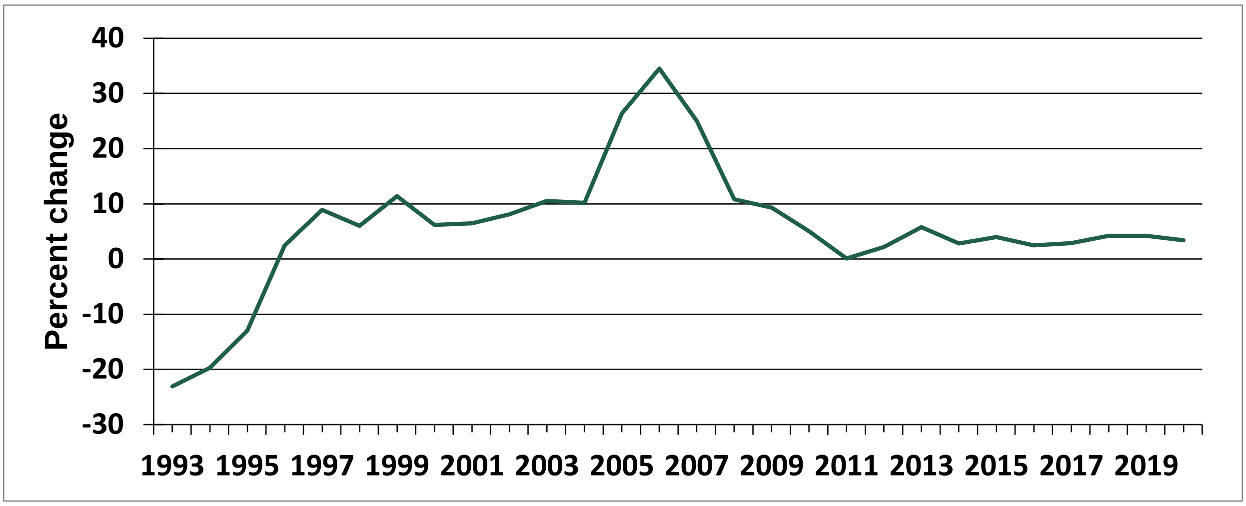
[16] Hasanov, F (n.d.) 'The role of fiscal policy in the development of the non-oil sector in Azerbaijan, Qafqaz University

[17] http://www.bloomberg.com/news/articles/2016-01-28/imf-starts-talks-with-azerbaijan-on-possible-financial-aid

by about 20 % from its peak in 2010'.[18] The clear message is that the government should change course and smooth the path of fiscal adjustment rather than oscillating between boom and bust.

This seemingly alarmist scenario is unlikely to materialize. Admittedly, growth in Azerbaijan has slowed down sharply in recent years. The government has admitted that the growth slow-down has reduced the job creation rate. While more than 100,000 jobs have been created in 2014-2015, government estimates suggest that 40,000 jobs have been lost over the same period.[19] One is unlikely to see the return of double digit growth which, in any case, is unsustainable for long periods for any economy. Despite this, none of the recent growth forecasts by a variety of agencies foresees such a sharp deceleration of growth that the level of GDP by 2024 will be 'about 20 %' below the 2010 level. Indeed, the IMF's own forecast is that, by 2020, the economy will be growing at 3 % or more as figure 4 pertaining to long run growth and its projections to 2020 show.

Figure 4: Azerbaijan, long run GDP growth and projections to 2020



Source: knoema.com drawing on IMF and World Bank sources

Is the Azerbaijan government spending too much and saving too little to deal with the temporary oil production boom? IMF, in its 2014 Article IV consultations offers, an affirmative answer. It points out, using a 'permanent income rule under a conservative

[18] Koeda, J and Kramarenko, V (2008) 'Impact of government expenditure on growth: The case of Azerbaijan, IMF Working Paper no.115, www.imf.org/external/pubs/ft/wp/2008/wp08115.pdf

[19] Azernews, October 8, 2015

scenario of oil and gas production' (p.5), that the current level of non-oil primary deficit as a percent of non-oil GDP is 10 percentage points higher than what is sustainable. Hence, the implication is that significant fiscal adjustment over the medium term is required. This fiscal adjustment, together with necessary structural reforms to improve the business climate and boost private investment, especially in the non-oil sector, will bring about much-needed economic diversification and reinforce Azerbaijan's inclusive growth.

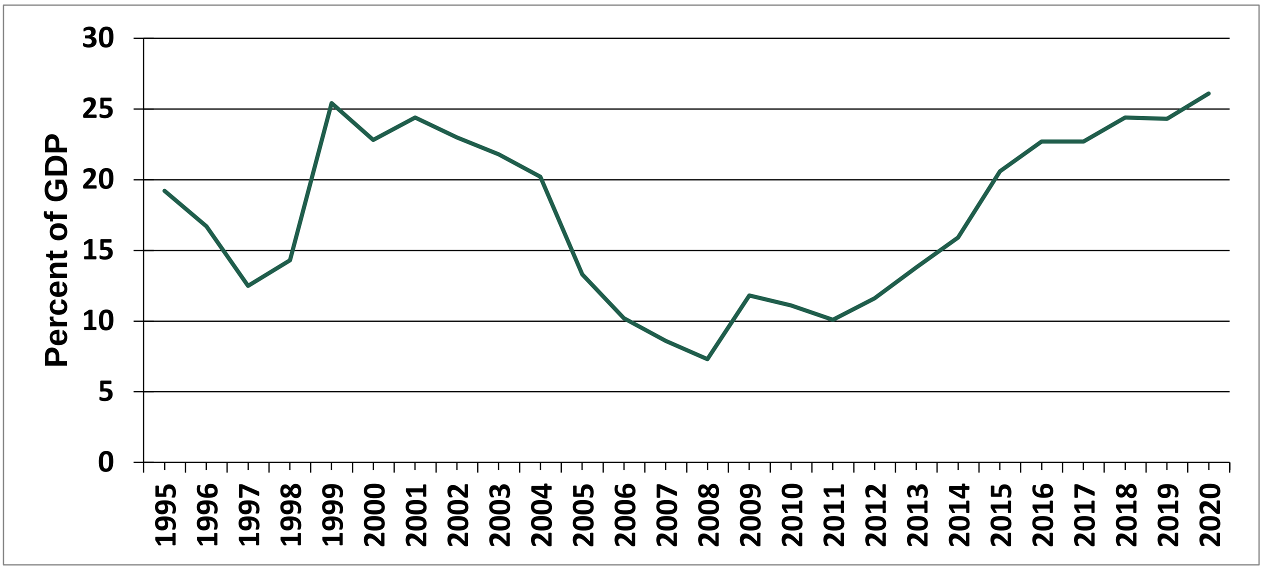
Critics have questioned the robustness of the 'permanent income rule' to establish benchmarks for fiscal sustainability. This rule '…limits each year's spending to the real return' on financial assets a resource-rich government builds up through the vehicle of a sovereign wealth fund. The aim is to construct a '…financial asset of equal value to the reserves that have been depleted and, from a theoretical perspective, achieves inter-generational equity' (Heuty and Aristy, 2010:7).[20] The permanent income approach might well be valid for capital-rich high income countries, but less valid for capital-poor developing and emerging economies. The social returns to investment in education, health and infrastructure in resource-rich developing economies may well be higher than the returns on financial assets sterilized abroad. Spending the oil wealth upfront on activities with high ex-ante social returns is likely to be a better way of transferring wealth across generations than the one implied by the permanent income rule.

A permanent income rule is not the only way to assess the fiscal sustainability of an upper middle income economy. As the previous discussion has noted, current OECD guidelines suggest that there is a range of debt thresholds that one can use to assess whether a country is on a fiscally sustainable path. The suggested range is 30 to 50 % debt to GDP ratio. Even if one takes the lower limit of this range, public debt to GDP ratio is well below that range as figure 5 shows. Hence, based on current OECD guidelines, it is difficult to argue that Azerbaijan is saddled with unsustainable public indebtedness. Furthermore, despite the fact that in 2015 foreign reserves fell significantly in the wake of the central bank's attempt to defend the fixed exchange rate, the country has amassed enough foreign exchange

[20] Heuty, A and Aristi, J (2010) 'Fool's Gold: Assessing the performance of alternative fiscal instruments during the commodities boom and the global crisis'
http://www.revenuewatch.org/files/RWI_Fools_Gold_Heuty_Aristi_FINAL.pdf

reserves to finance 26 months of imports.[21] This is more than eight times the prudential threshold set for foreign exchange reserves (as measured in terms of import coverage) to guard against external shocks that can threaten macroeconomic stability.

Figure 5: Azerbaijan, long run trends in public debt to GDP ratio



Source: knoema.com derived from IMF sources

There is also the issue of whether Azerbaijan has become the victim of the 'Dutch disease'. For a long time, Azerbaijan operated a fixed exchange rate regime. There have been bouts of appreciation, but this has been juxtaposed with episodes of depreciation. In mid-2015, the exchange rate was substantially devalued (by 25 %) after the government abandoned efforts to defend the fixed exchange rate regime. Hence, there is no clear-cut evidence that Azerbaijan has suffered from the 'Dutch disease' through the exchange rate channel.

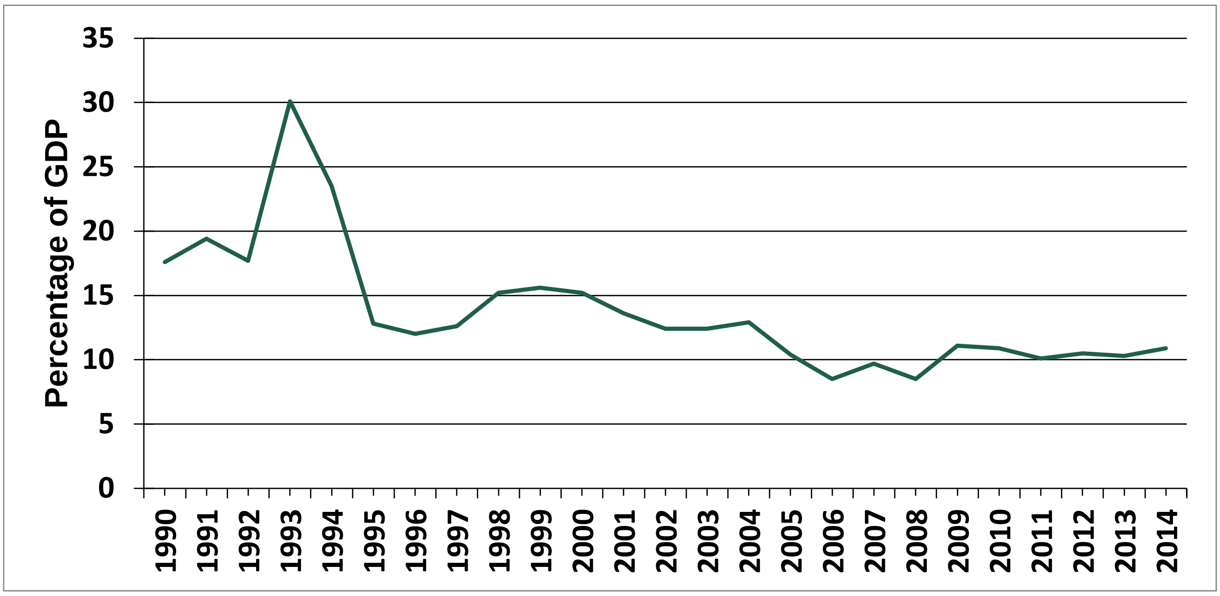
What about the critique that the public sector becomes unsustainably large in resource-rich economies that in turn 'crowds out' the private sector? Does the Azerbaijan experience conform to this critical view?

[21] EBRD, Regional Outlook 2015, www.ebrd.com/documents/comms-and-bis/rep-final.pdf

1.

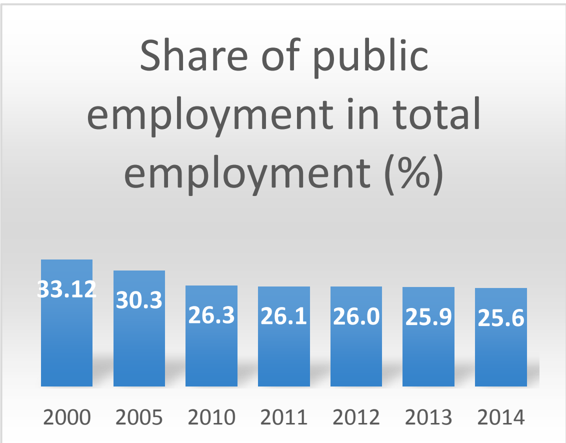
Trends in the size of the government as measured by current government consumption expenditure relative to GDP and public sector employment do not suggest that Azerbaijan has either an unsustainably large public sector or is moving in that direction. Indeed, as figure 6 shows, the relative size of the government, as measured by current consumption as a percentage of GDP, has come down steadily and significantly over time. Public sector employment too has fallen by 7.5 percentage points between 2000 and 2014 (see figure 7). The magnitude of public sector employment is also within regional norms. There has been, as expected, a commensurate increase in private employment between 2000 and 2014.

Figure 6: Azerbaijan, Long run trends in government consumption expenditure (% of GDP), 1990 to 2014



Source: knoema.com drawing on IMF sources

Figure 7: Azerbaijan, trends in public sector employment, 2000 to 2014



Source: Author's estimate based on data provided by the State Statistical Committee of the Republic of Azerbaijan

Of course, one can always argue that the size of the government should be reduced even further. On the other hand, this proposition should be justified on sound analytical and empirical grounds rather than being asserted on the basis of prior beliefs. Private sector-led growth is certainly a desirable aspiration, but this cannot emerge in a vacuum. A flourishing private sector needs to be underpinned by a productive public sector. A weak and emaciated public sector can paradoxically end up being an impediment to private sector-led growth. Hence, there needs to be further deliberations and research on the appropriate size of the government in an upper middle income country like Azerbaijan.

There is the issue of efficiency of public expenditure. One might argue that resource-rich countries pay little attention to waste and inefficiency in public spending given that the financial largesse bestowed on governments by a natural resources sector boom reduces fiscal discipline. Hence, cutting down on such waste and inefficiency should be a goal of fiscal consolidation. Greater efficiency in public spending means that one can finance desirable social goals despite a reduced fiscal envelope. Is this really the case for Azerbaijan?

Table 2 provides some estimates of the efficiency of public spending in Azerbaijan in health, education and social protection for the 2003 to 2006 period which also coincides with the peak of the oil price boom. The estimates suggest that, among a sample of 15 countries, Azerbaijan had the most efficient level of public spending in health and substantially improved its relative ranking in the sphere of education. In social protection, there is evidence of increased inefficiency, but even here Azerbaijan was the fifth most efficient (as measured by relative rank) in terms of public spending. If the estimates reported in Table 2 are accepted, one could argue that Azerbaijan does not fit the stereotypical case of a resource-rich country that is characterised by large-scale waste and inefficiency in the use of fiscal resources.

Table 2: Efficiency score and rank, public expenditure in health, education and social policy, Azerbaijan (vis-à-vis 15 countries), 2003 to 2006

	2003	2006
Health		
Score	1	1
Rank	1	1
Education		
Score	0.89	0.92
Rank	5	3
Soc pol		
Score	0.92	0.66
Rank	2	5

Source: Adapted from Esanov (2013, Table 6, p.21.) Note that 1.0 represents the score for the most efficient performance. See Esanov, A (2009) 'Efficiency of public spending in resource-rich post-Soviet States, Revenue Watch Institute, http://www.resourcegovernance.org/analysis-tools/publications/efficiency-public-spending-resource-rich-post-soviet-states

Beyond fiscal consolidation

Perhaps the biggest deficiency in the advocacy of fiscal consolidation is that it does not respond to labour market challenges represented by the fundamental goal of providing durable and productive employment opportunities for all. While one can readily agree – and the Azerbaijan government certainly does[22] - that private sector-led economic diversification holds the key to realizing such a goal, it is by no means obvious that simply relying on fiscal retrenchment measures will automatically engender economic diversification. Not surprisingly, the advocates of fiscal consolidation emphasize that fiscal consolidation should be complemented by structural reforms that encompass labour, capital and goods markets. The aim is to boost market confidence by improving the business climate that in turn is expected to spur private investment in the non-oil sector and create broad-based employment opportunities. The emphasis in this approach is monitoring the extent to which Azerbaijan improves its ranking in 'doing business' surveys of the World Bank and 'global competitiveness' surveys of the World Economic Forum. Both the Doing Business surveys and the Global Competitiveness surveys show that Azerbaijan occupies a

[22] See, for example, the government's vision 2020

middling rank which is consistent with regional norms. Relative to previous years, there is either a modest improvement or no change.

This approach, while useful, often does not investigate the binding constraints that hold back private sector-led job creation capacities. The role of the government is to alleviate those binding constraints to enable private sector-led growth and employment. This is where another survey undertaken by the World Bank – world enterprise surveys – provide important insights. Table 3 shows the major binding constraints as perceived by the private sector with respect to particular variables: corruption, taxes and business regulations, labour regulations, infrastructure (as represented by availability of reliable electricity supply, transport networks), access to finance, availability of a skilled work-force. It is access to finance appear to be regarded by many firms as key constraints. Labour regulations hardly rate a mention. Somewhat surprisingly, lack of a skilled work-force is not considered to be a major impediment by the majority of firms. Similarly, corruption is not considered to be a major problem, which is unlike the situation in Eastern Europe and Central Asia. Taxes and regulations too are not considered to be binding constraints by the private sector.

These findings have important implications. They suggest that regulatory reforms, especially reform of labour regulations, are unlikely to have a major impact in terms of improving the business climate. What matters is access to finance and that is an area that deserves attention by the government. Furthermore, fiscal consolidation, even if diligently pursued, will be ineffective in dealing with the binding constraints as perceived by the private sector.

Table 3: Azerbaijan, highlights from the 2013 enterprise survey

% of firms identifying a major constraint	Azerbaijan (2013)	Eastern Europe and Central Asia
Corruption	4.1	22.4
Lack of access to finance	22.1	17.2
Lack of reliable supply of electricity	0.7	0.8
Lack of reliable transport network	3	1.2
Tax rates	4	24.1
Tax administration	4.7	14.8
Business licensing and permits	3.4	5.5

Inadequately educated work-force	0.4	13.7
Labour regulations	0.1	4.8

Concluding observations and policy recommendations

The case for front-loaded and significant fiscal consolidation cannot be substantiated. The government has already embarked on some degree of fiscal adjustment and it is no means obvious that it needs to do much more than that. The Eurozone experience between 2011 and 2013 has clearly shown that front-loaded and significant fiscal consolidation can lead to adverse growth and employment effects in the short run without any tangible gains in the long-term even in terms of reducing public indebtedness. Azerbaijan should learn from the European experience.

Advocates of fiscal consolidation rely heavily on the 'permanent income rule' to suggest significant fiscal adjustment over time to accommodate the current decline in oil prices and to prepare for a not-so-distant future when oil and gas reserves will be fully exhausted. The grim notion suggested by one study that without fiscal adjustment per capita GDP as projected for 2024 will be 20 % lower than its 2010 level cannot be corroborated by recent growth forecasts.

The fiscal adjustment that the government undertook in 2014 has taken its toll on the labour market by slowing down the rate of job creation which is already quite sluggish (0.8%) relative to the regional norm (4%). Further fiscal retrenchment on a large scale will simply inflict more pain without any tangible long-term benefits.

The strategy that Azerbaijan has adopted with respect to the use of the financial largesse from the oil and gas sector is broadly correct. Wealth from the oil and gas sector should be invested upfront in activities with high social returns pertaining to infrastructure, health, education and social protection. They have engendered tangible benefits to the broader population to the point where various studies agree that Azerbaijan is a good example of inclusive growth. This development strategy should be continued and should not be derailed by concerns about lack of fiscal sustainability.

An overly cautious approach to fiscal management of natural resources might create what might be called the Timor Leste paradox. Timor Leste, a much poorer country than Azerbaijan, heeded the advice of international financial institutions and decided to operate a sovereign wealth fund using the permanent income rule. The irony is that this has brought little benefit to the population at large. Poverty went up even as Timor Leste amassed a great deal of wealth from its non-renewable natural resources sector and sterilized it in a sovereign wealth fund.[23]

If one moves away from a preoccupation with the permanent income rule, a much more positive picture emerges on the fiscal front. Based on current OECD guidelines pertaining to ranges for prudent debt thresholds, Azerbaijan appears to be in a fiscally sustainable position. Its debt to GDP ratio is one of the lowest in the world. Its foreign exchange reserves, despite recent declines, are capable of financing 26 months of imports – which is eight times more than prescribed prudential norms.

Azerbaijan does not appear to be a victim of the 'Dutch disease' through the exchange rate channel. During the long period of the fixed exchange rate regime, episodes of real appreciation have been juxtaposed with periods of real depreciation. The fixed exchange rate regime has now been abandoned and the government has undertaken a major devaluation of the national currency. Over time, this should feed into enhanced international competitiveness of the non-oil sector.

There is no clear-cut evidence that, as a resource-rich country, Azerbaijan is characterised by wasteful and inefficient public spending. The reverse seems to be the case based on its comparative ranking of efficiency of public expenditure in health and education.

There is some evidence of an increase in the inefficiency of public expenditure with respect to social protection. The government should seek to improve the efficiency of public spending in this sphere while pursuing the goal of developing a comprehensive social protection system.

One also cannot argue that the oil and gas boom has supported an overly large public sector that has 'crowded out' the private sector. Recent trends suggest that the relative size of the government (as measured by current government consumption as a proportion of GDP) has declined significantly as has the relative size of public employment. There has been a commensurate increase in private employment. There is a case for further examination of what is an appropriate size of the public sector for an upper middle income country with the characteristics of Azerbaijan. One cannot simply assert that downsizing of the public sector

[23] Heuty and Aristi (op.cit)

will automatically engender private sector-led growth. The private sector needs to be supported by an adequately resourced and productive public sector.

Advocates of fiscal consolidation readily agree that, on its own, fiscal retrenchment cannot bring about private sector led economic diversification that Azerbaijan needs in order to respond to the aspiration of productive and broad-based employment opportunities for all. Hence, the typical advice is that Azerbaijan should improve the business climate to spur private investment in the non-oil sector. This will require undertaking regulatory reform. Yet, the latest enterprise survey undertaken by the World Bank (2013) suggests that taxes and business regulations are not a major concern of the private sector. Furthermore, labour regulations are simply not considered to be a binding constraint by the private sector. Hence, from a growth and employment perspective, an agenda that focuses largely on regulatory reform is unlikely to produce substantial pay-offs.

Policy recommendations: financial inclusion

What emerges from the enterprise surveys is that lack of access to finance is considered to be a major constraint by many firms. Hence, this is an area that needs attention from the government. One way ahead lies in the vigorous promotion of an agenda of financial inclusion. Azerbaijan has made significant progress in enhancing financial inclusion but it has a long way to go. It lags significantly behind its comparators.

The government – and in particular the Central Bank – has shown a commendable capacity to seek external assistance to promote the agenda of financial inclusion. It has embarked on financial literacy programmes and enabling legislation to enhance financial inclusion and has efficiently leveraged postal finance through Azepost to reach underserved segments of the population. The next step is to set up a major but feasible goal – such as reaching the standards of financial inclusion in upper middle income countries within 10 years – and increasing the legislative framework to create mobile banking and banking agents that can become a new source of productive self-employment. **A supplementary briefing note on the topic of 'financial inclusion in Azerbaijan provides more details on these issues.**

Policy recommendations: the role of ALMPs

One area that deserves considerable attention is the financing and implementation of active labour market policies (ALMPs) ranging across support to public employment services, funding to support self-employment, training programmes, public works and/or employment guarantee schemes, wage subsidies and so forth. They are designed to respond to specific employment challenges, such as skills mismatches, insufficient labour demand and so forth – see table A1.

Allocating adequate budgetary resources to active labour market policies are desirable as studies have shown that this can improve employment outcomes. Estimates from the 2000s suggest that Azerbaijan, in common with other Central Asian countries, generally allocate a modest amount (less than 0.5 % as a proportion of GDP) to ALMPs. However, care should be taken not to indiscriminately fund ALMPs, as multiple evaluations show that the effectiveness of ALPMs depend on the type of intervention and the particular economic circumstances that a country faces. For example, one study that covers 152 impact evaluations across developed, developing and transition economies, arrives at the following conclusion for the latter.[24]

- Employment services and skills training had the most positive impacts, both on employment probability and earnings
- Results from public employment programs are mixed
- Wage and employment subsidies may have negative effect[25]
- There is insufficient evidence to arrive at credible conclusions pertaining to self-employment/small business assistance programs.

Table A2 lays out some key findings from a range of countries in Eastern Europe and Central Asia that policy-makers in Azerbaijan can learn from. It appears that some ALMPs seem to work better than others. Although such evaluations are not infallible, their implications should not be ignored when designing ALMPs.

Policy recommendations: fiscal incentives, growth and employment

When fiscal policy instruments are used to boost growth and employment outcomes, they can be interpreted as 'fiscal incentives' that seek to meet specific growth and employment targets. ALMPs represent a particular genre of instruments that fall within the domain of

[24] Betcherman, G (2008) 'Active Labor Market Programs: Overview and International Evidence on What Works', World Bank, April

[25] Experience of Scandinavian and some other countries of implementation of active labour market programmes after 2008 shows positive effect of wage subsidy programme on employment promotion in case of targeting particular groups. More detailed information can be found in the following studies: Caliendo, M and Schmidl, R (2015): Youth Employment and Active Labour Market Policies in Europe. IZA DP No. 9488, November 2015; Hardoy, (2003) Effect evaluation: Methods and Applications. Accepted PhD thesis (dr. polit) at the University of Oslo, Norway.

fiscal incentives. A broader interpretation of fiscal incentives would entail a discussion of a wide range of policy measures that can be used to enhance growth and employment outcomes.

There is an influential view that cutting labour and corporate taxes, lowering the tax wedge and cutting social benefits can strengthen work incentives, increase labour supply and encourage private investment. While this might be true in principle, the impact might be modest in practice. Indeed, as a review of enterprise surveys has shown, the tax burden is not regarded to be onerous by the private sector in Azerbaijan. Cross-country evaluations, drawing on OECD economies and multiple country studies cutting across both high, middle and low income countries, do not suggest that tax cuts necessarily boost growth and employment on a significant scale. For example, cutting both labour income and corporate taxes can yield, at best, a 0.05 per cent reduction in the 'employment gap', that is the gap between actual employment and potential employment when the economy is at full capacity. Furthermore, 63 per cent of episodes of tax reform across a range of countries are not accompanied by sustainable growth accelerations. Table A3 in the appendix provides pertinent details.

The preoccupation with tax reforms as a way of boosting growth and employment overlooks the critical role that public expenditure plays in such a process. For example, a 1 per cent increase in current government expenditure as a proportion of GDP can boost employment by 0.4 percentage points, which is significantly more than the impact that follows tax reforms – see Table A3 in appendix. In addition, as Table A3 shows, tax and related reforms – such as a freeze on public sector employment, adjustments to pension benefits – can worsen inequality and thus impair the goal of inclusive growth.

Fiscal incentives to promote growth and employment should also take account of efficient public investment, especially in infrastructure that can raise the economy's productive capacity and create employment opportunities. It is also well known that equitable access to education and health care contributes to human capital accumulation and hence growth and employability.

The lesson that one learns is that the approach to fiscal incentives to promote growth and employment should be holistic in nature combining both an appropriate tax regime and spending initiatives. Tax cuts per se, or even providing subsidies to employers to induce more hiring, are unlikely to yield substantial dividends. One should also realize that fiscal policy is only one factor out of many that drives growth and employment.

Final remarks

The orthodox combination of fiscal consolidation and regulatory reform is unlikely to engender substantial growth and employment dividends for Azerbaijan. Of course, this does not mean that fiscal consolidation on a significant scale will never be required. Economic circumstances might change in an unanticipated fashion necessitating an appropriate fiscal response. However, based on conditions as they prevail and likely to prevail, Azerbaijan will be better off with a policy framework in which the government continues with upfront investments in infrastructure, health, education and social protection while ensuring that budgetary allocations are transparent, efficient and equitable. This investment strategy needs to be complemented by greater attention to financial inclusion and adequate support for appropriately designed active labour market policies. Wage subsidies should be applied to the particular groups. In this case they can have positive effect. Tax cuts are unlikely to play a major role in boosting employment.

Table A1: ALMPs - typology

Barrier to Employment	Type of ALMP	Program objective
Skills mismatches	Training (on the job, in class)	Enhance employability
Information asymmetries	Intermediation services, job search assistance, counselling	Enhance employability, promote job creation
Insufficient labour demand	Wage subsidies, public works programs/employment guarantee schemes, self-employment, work-sharing	Promote job creation

<u>Source:</u> adapted from Angel-Urdinola, D.F and Leon Solano, R.E (2013) A reform agenda for improving the delivery of ALMPs in the MENA region, *IZA Journal of Labor Policy*, 2:13

Table A2: ALMPs in Central and Eastern Europe and Commonwealth of Independent States (CIS) (summary of findings from multiple studies)

Country	Small business/self-employment assistance (statistically significant?)	Employment services (statistically significant?)	Skills training (statistically significant?)	Wage subsidies (statistically significant?)	Public works (statistically significant?)
Bosnia-Herzogovina	Indeterminate	Yes	Yes	Indeterminate	Indeterminate
Bulgaria	Yes	Not for men	Yes	Yes	Yes, but lowest positive impact
Estonia	Yes	Indeterminate	Yes	Indeterminate	Indeterminate
Hungary	Yes	Yes	Yes	No, except some target groups	No to indeterminate depending on target group
Kosovo	Indeterminate	Indeterminate	Yes	Indeterminate	indeterminate
Poland	Indeterminate	Indeterminate	Yes	Not for women	No
Romania	Yes	Indeterminate	Indeterminate	Indeterminate	Yes
Russia	Indeterminate	Yes	Indeterminate	Indeterminate	Indeterminate
Slovakia	Yes	Yes	Yes	No	Yes
Slovenia	Indeterminate	Indeterminate	Indeterminate	Indeterminate	Yes, but only in short run
Ukraine	Indeterminate	Indeterminate	Yes, but short run	Indeterminate	No

Source: compiled from Spevacek, A (2009) Effectiveness of Active Labor Market Programs: A Review of Programs in Central and Eastern Europe and the Commonwealth of Independent States, USAID, December 23.

Table A3: Fiscal incentives, growth and employment

Fiscal instrument	Ex-ante transmission mechanism	Empirical evidence: impact on growth and employment	Implications for inequality
Reduce taxes on labour income and reduce corporate taxes	Induces work incentives and increases labour supply; induces private investment	Impact on employment modest. 'Employment gap' likely to reduce at most by 0.05% 63% of episodes of tax reforms do not lead sustainable growth accelerations	Reduces progressivity of tax system and thus inequitable
Grant tax credits or deductions to R&D	Promotes technical progress	Less effective for developing economies with insufficiently developed R&D regime	Neutral with respect to impact om equity
Rationalize social benefits by reducing social transfers, such as unemployment benefits and pensions, reduce or freeze public employment	Induces work incentives and increases labour supply; induces private sector employment	Impact on employment modest	Inequitable with considerable evidence that such measures hurt vulnerable groups by reducing their purchasing power Higher inequality can retard growth and thus growth gains from such fiscal reforms
Enhance access to education and health care by spending more at lower levels, increasing cost recovery for tertiary education but providing financial support to low income HHs, addressing supply side barriers in less developed countries	Supports increase in human development	Current expenditure on such items can boost employment significantly, e.g. 1 per cent increase in GDP of current government expenditure can boost employment by 0.4%	
Invest in infrastructure and make such investment efficient by improving governance of investment process	Supports investment in physical capital and improves productivity of private sector	Capital expenditure does not boost employment in short run but has long term growth gains When spending initiatives are combined with appropriate tax reform, 60% of cases from multiple country studies show sustainable growth accelerations	Promotes equity if investment in infrastructure geared towards improving basic services, such as transport and communications, including digital networks, water supply and sanitation

Source: Adapted from Bova, E et al (2014) 'A Fiscal Job'? An Analysis of Fiscal Policy and the Labor Market, IMF Working Paper No.216 and IMF (2015) 'Fiscal Policy and Long-Term Growth', April 20