

Azerbaijan

Status Index 4.4 (Democracy: 1.8 / Market economy: 2.6)		Management Index 3.2	
System of government	Autocracy	Population	8.1 mill.
Voter turnout	controversial	GDP p. c. (\$, PPP)	3,090
Women in Parliament	9 %	Unemployment rate	~20 %
Population growth^a	~1 %	HDI	0.744
Largest ethnic minority	4 % (Russians)	UN Education Index	0.88 (2000)
		Gini Index	36.5
Data for 2001 – if not indicated otherwise. ^a Annual growth between 1975 and 2001. Source: UN Human Development Report 2003.			

1. Introduction

The implementation of perestroika in 1985–1986 under Soviet Communist Party Chairman Mikhail Gorbachev and violent conflicts starting in 1988 in the autonomous region of Nagorno-Karabakh, which is predominantly Armenian, ultimately led to the declaration of sovereignty by the former Soviet Republic of Azerbaijan on 30 August 1991. Like the majority of other post-Soviet states, Azerbaijan faces enormous challenges, as it essentially must start from zero in creating a new state and economic structure.

One of the major hurdles affecting the development and transformation process, still in its infancy, is the unresolved territorial conflict surrounding Nagorno-Karabakh. With the exception of Abulfaz Elcibey, the leader of the national-democratic Popular Front, who was elected president in relatively free elections and held office for one year, all heads of state since 1991 are rooted in the Communist Party of the Soviet Union. In June 1993 the government of Elcibey was overthrown by a military coup which was headed by colonel Surat Huseynov and backed by certain parts of the Soviet Army still stationed in Azerbaijan. Subsequently, Heydar Aliev, a former member of the Politburo of the USSR was called back to Baku and assumed power. His ruling party, New Azerbaijan, has kept a tight rein on the country ever since.

This evaluation concludes that over the past five years progress in meeting the objectives is evident in only a few limited areas, whereas stagnation predominates and some areas are even experiencing regression. Deficiencies exist particularly in

democratization, the rule of law, reforming the economic system and transformation management. Territories under Armenian rule – 17 % of the geographical area – have been excluded from the following report.

2. History and characteristics of transformation

Economic and political transformation in Azerbaijan has been slow to gain momentum. The democratic transition process was precipitated by changes in the political arena associated with the break-up of the Soviet Union. In July 1989, the Popular Front emerged as an informal political movement similar to others in several Soviet republics. It demanded national sovereignty, democracy and that Nagorno-Karabakh remain under the jurisdiction of Azerbaijan.

The internal conflict surrounding Nagorno-Karabakh, however, a region predominantly inhabited by Armenians, has had far-reaching negative effects on the political and economic development of the young state of Azerbaijan. To date, the conflict has produced more than 18,000 casualties and more than a million refugees on both sides. Despite the efforts of international mediation, there appears to be no solution to this conflict. Proposals have included closure of the border with Armenia and hence a possible shutdown of direct trade links with Turkey. With the violent overthrow of Abulfaz Elcibey, President of Azerbaijan and leader of the Popular Front, Heydar Aliyev, the former chairman of the local Communist Party and KGB assumed power and has ruled the country since 1993. The recruiting of Aliyev's power base primarily from former party officials and regional power clans from the enclave of Nakhichevan and Azerbaijanis of Armenian heritage imposes structural limits on the democratization process.

The presidential elections of 1993 and 1998, and the parliamentary elections of 1995 and 2000, evaluated as thoroughly undemocratic by Western observers, only reinforced existing conditions. Sustained political apathy among the population, coupled with government oppression, has left the opposition largely marginalized. Yet it has been quite successful in maintaining a degree of flexibility for its *modus operandi* and the safeguarding of its reputation. External actors such as the OSCE, the Council of Europe and Western embassies have also played a positive role. Amendments to the constitution which the population approved by a referendum of dubious legitimacy in 2002 only reinforced the presidential nature of the constitution and with it the legal opportunities for continued authoritarian rule. The opposition, which essentially agrees with the government on key issues of foreign policy, such as Azerbaijan's orientation to the West and Turkey, its critical position toward Iran and Russia and unwillingness to compromise in the Nagorno-Karabakh conflict, simply is incapable of turning widespread social discontent to its advantage. Increasingly, there

are protests outside the legal spectrum of political parties, including action by war veterans associations, and social unrest expressed with religious slogans.

Ayaz Mutallibov, the first post-independence head of state (1990–1992), was instrumental in initiating the transition to a market economy. He was, nonetheless, unable to develop any lasting dynamism in the early years of independence, owing to turbulent internal political strife until 1994 and the military conflict in Nagorno-Karabakh, where a ceasefire took hold in May 1994. The transfer of former Soviet-owned industries to republican ownership on 29 January 1992, particularly in the petroleum and petrochemical sectors, was crucial for the economic development of the country.

One of the great medium- to long-term challenges for the country is the lack of economic development beyond the petroleum and natural gas industry, the only sector to secure significant foreign investment. Nevertheless, the manat, the currency introduced on 1 January 1993, has stabilized and the national debt has been reduced. This can be attributed almost exclusively to exports of petroleum and, increasingly, natural gas, the continuous rise in crude oil prices on international markets, and finally an altogether restrictive spending policy.

The post-Soviet deterioration of the country's industrial base, however, has yet to be reversed. The majority of small enterprises and a number of medium-sized enterprises have been privatized, while the vast majority of large-scale enterprises have yet to undergo this process. Production figures in the largely privatized agricultural sector have risen significantly. Low productivity, however, necessitates continued food imports, and the food processing industry also operates at a loss.

With the dissolution of the Soviet Union, the standard of living of the population at large declined alarmingly; at the same time, social spending was cut. Like other post-Soviet societies, Azerbaijan has witnessed the creation of a class of newly rich, usually with strong ties to the ruling regime. Leaving aside the damaging spillover effects of the Russian economic crisis of 1998–99, the implementation of the president's rigorous economic plan reversed the general trend towards deterioration, which began in the mid-1990s. Corruption, widespread for years, remains a significant hurdle to economic development. Transparency International ranked Azerbaijan as the fourth most corrupt country in the world in its 1999–2000 report. Loans and grants provided by international financial and donor organizations have had great significance for consolidation.

Several areas of the law continue to require substantial reform, such as legislation regarding elections and political parties, the judicial system and property rights. Azerbaijan joined the Council of Europe on 25 January 2001 amid persistent criticism

of its human rights record. Compared with the majority of other central Asian successor states of the former Soviet Union, the degree of political freedom in Azerbaijan is remarkable. Still, the authoritarian presidential system and manifold repression of the opposition prevent Azerbaijan from becoming a truly democratic nation. No fundamental changes are anticipated as a result of the planned presidential elections in the fall of 2003, as the incumbent president is expected to run successfully for office again. In case Aliyev will not be able to run for presidency again, there might emerge a realistic chance for the candidate of the opposition, but only if the diverse parties agree on a single contestor to the ruling elite's future candidate.

3. Examination of criteria for democracy and a market economy

3.1 Democracy

In spite of the negative factors mentioned above, Azerbaijan has made significant progress in transforming its political regime since independence. The judicial system, the development, or rather the reform, of government bodies, as well as judicial and political practices, exhibit significant deficiencies, which have intensified rather than diminished. A number of indicators suggest a regressive development affecting democratic stability. This development, however, does not currently pose any serious threat to the system. The political system can best be characterized as authoritarian with individual democratic elements.

3.1.1 Political organization

(1) Stateness: Azerbaijan is experiencing significant problems with state identity. Some 17 % of its territory is occupied by Armenian forces, while the legal status of the Caspian Sea, with its vast petroleum and natural gas reserves, remains unresolved. The state's monopoly on the use of force extends over all of the country not occupied by Armenia. In theory, the basis for defining citizenship and who qualifies as a citizen has been established. In reality, considerable problems surround the right to citizenship for Armenians from Nagorno-Karabakh as well as displaced Armenians from Baku and other unoccupied regions of the country, and for smaller groups of immigrants and refugees, such as the Meskhetians.

All citizens enjoy equal civic rights. State and religion are separate. Political processes are largely secular, although religion—Islam—is increasingly becoming a factor. The basic infrastructure of a state exists throughout the unoccupied national

territory, but it exhibits grave deficiencies, due to corruption and incompetence. Law and order are largely guaranteed.

(2) *Political participation*: Universal suffrage and the right to campaign for office exist in principle, although they are frequently violated in practice. Western observers have judged the great majority of elections held so far to be so fraught with the gravest shortcomings as to be unfree and unfair. There was no evidence of real improvement in the parliamentary elections of 2000 or the referendum on the constitution in 2002. The presidency—or rather the government, continuously reaffirmed in elections since 1993—disregards the principles of open and competitive election processes in a great many cases. The effective power to govern lies with the government.

There are no veto powers or political enclaves in the hands of the military or other influential groups. Independent political and civic organizations are entitled to form, but experience occasional problems with registration and encounter state repression. A number of NGOs have been created along ethnic lines, but they restrict themselves to humanitarian and cultural activities. Certain ethnic groups, such as the Lezgi close to the northern border, are discouraged from forming organizations for political reasons.

So-called “non-traditional” religious groups, including evangelical missionaries and Wahabites, encounter difficulties with registration and find that their activities are in part prohibited, in no small part due to pressure from the media and Islamic organizations. In line with Soviet tradition, union activity largely remains state-controlled, thereby preventing the formation of independent unions. Freedom of assembly is very restricted. State-run media are subject to government control and independent private media are at times under considerable pressure, including legal harassment. Freedom of opinion is limited.

(3) *Rule of law*: With respect to state power, Azerbaijan shares similarities with other post-Soviet states, in that the executive branch unmistakably dominates at the constitutional level, while on a normative and real level, the president and his apparatus play the principal role. Parliament is limited in exercising its monitoring function afforded by the constitution, because of dubious election processes and the complete domination of forces close to the president.

In theory, the institutionally separate judicial branch and the Constitutional Court (established in 1998) are independent, but in reality they are largely subordinated to the executive, as the president appoints the judges. To date, the structure of the judiciary has been reformed only inadequately, preventing it from acting as a counterweight to the executive. There is also a clear predisposition to rescind adverse

judicial and political decisions by presidential decree. In some instances, the pressure for democratization exerted by external actors in particular, such as the OSCE, the Council of Europe and the US State Department, even necessitated subsequent corrections of antidemocratic decisions by a presidential decree.

Admission to the Council of Europe in January 2001 mandated that the laws affecting a variety of areas conform to European standards—including the abolition of the death penalty and the ratification of the European Convention on Human Rights—even though legal practices, in particular those affecting the media continue to be plagued by obvious failings. Yet another unresolved issue is political prisoners, the mere definition of which gives rise to considerable difficulty. In October 2001, the Council of Europe classified 23 persons as political prisoners, whereas the independent Human Rights Center of Azerbaijan classifies 700.

The new requirement that religious institutions and congregations must register with the recently created State Committee for Relations with Religious Organizations could restrict religious freedom in certain areas. Legal discrimination against ethnic or religious groups or women does not exist, but women and religious converts do encounter social discrimination.

Political and bureaucratic corruption is regarded as very high by the population and is widely criticized. Only in rare cases is corruption effectively fought by a court ruling. Prosecution of corruption is also utilized to authorize the dismissal of high-ranking government officials, without affording them proper legal recourse. The state administration has yet to undergo structural reform. Salaries in many administrative departments do not even amount to a living wage, which encourages corruption and inefficiency.

3.1.2 Political patterns of behavior and attitudes

(1) Institutional stability: Democratic institutions reveal grave shortcomings. With the sole exception of the 1992 presidential election, post-Soviet Azerbaijan has yet to witness a democratically legitimized transfer of power, so the political system has yet to pass the acid test. Due to the advanced age of the president, who was born in 1923, the problem of his succession has the potential to turn violent at any moment. To date, he has successfully prevented the rise of any realistic candidate who might challenge him or anyone closely related to himself or his political apparatus. If a successor from within the current apparatus rises to power, then large parts of the opposition would opt for confrontation with those in power, while others would hope to be co-opted into the existing power structure. Parliament plays a negligible role in

running the country. The vast majority of political actors formally accept democratic institutions, but often disregard them in practice.

(2) *Political and social integration.* The party system is highly fragmented, although there are only about five political parties of nationwide relevance. The principle of peaceful political conflict has largely been accepted, but the political parties are rather poorly rooted in society, and voter volatility is high. As a result, the marked discord among the main political stakeholders has not led to massive social unrest. The parties reflect patronage-based structures centering on public figures and organizations rather than social interest groups.

Due to the hitherto low degree of social differentiation and the authoritarian nature of the government, there are only a small number of other organizations that might represent the interests of social groups. Large parts of the impoverished and unemployed, or rather underemployed, population, in particular, are unable to articulate their political interests. This clearly constitutes a risk to stability. If groups that are currently not integrated into the political system, for example, Islamists, succeed in articulating their interests, the possibility of partial destabilization might arise in the medium term. In principle, the majority of the people accept a democratic system, although large parts of the population tend toward an authoritarian style of politics in everyday political life. Due to politico-cultural and socio-economic barriers, social self-organization exists only in part and its scope of action and confidence among the population is weak.

3.2 Market economy

Azerbaijan has made progress in transforming its economy. The collapse of large enterprises, which dominated the Soviet era, has been offset in part by small and medium-sized enterprises in the trade and service sectors. The major drawbacks in the transformation are the merely rudimentary privatization of medium and large-scale enterprises, the widespread corruption, the incomplete consolidation of the banking sector, the lack of reform and implementation of economic legislation and of their respective regulatory bodies, and the disparities in regional development, with Baku and the Aspheron Peninsula being the favored areas. Economic development is highly problematic, as it is almost entirely confined to the energy sector, which accounted for more than 30 % of GDP in 2001.

3.2.1 Level of socioeconomic development

Most key indicators point to a low level of development. Based on the Human Development Index, Azerbaijan's development provides freedom of choice to only a small section of the population. According to official data from 2001, 49 % of the population lived in poverty—unofficial data produce estimates of up to 80 %. The nearly 850,000 refugees in the country are the most affected. Poverty is also a cause of social exclusion, due to the increasing privatization of education.

Since women are progressively ousted from positions of leadership and traditionally female professions are extremely underpaid, gender-specific exclusion is evident. Dire living conditions have caused high economic migration. According to some estimates, there are approximately 1 million to 1.5 million temporary or permanent emigrants. The infrastructure in rural areas is frequently in such disarray that it impedes the development of regions beyond the capital.

3.2.2 Market structures and competition

Important progress has been made in the transition to a market economy since the mid-nineties, but the unfavorable economic environment is alarming. It is marked by widespread corruption, partially inadequate judicial and political bases, arbitrary administration of justice by the state organs and the judicial system, underdeveloped infrastructure and a lack of access to capital. The underdeveloped banking sector is a bottleneck for the private sector development. Under the domination of state banks—which held 65 % of all bank deposits at the end of 2001—competition is lacking and most banks are undercapitalized. The situation is gradually improving, due to moderate increases in capital requirements, reform of laws and regulations, greater professionalism and, not least, mergers and closures—the number of banks was reduced from 250 in 1994 to 43 in September 2002.

Small and medium-sized enterprises in particular encounter great difficulties in obtaining capital. At the end of 2001, private loans amounted to a mere 9 % of GDP. State monopolies control the transportation sector as well as some elements of the infrastructure, including supplies of gas, electricity and water. There have been partial privatization efforts, and foreign enterprises are active in some areas of the infrastructure. Reform of the telecommunications sector was initiated but not completed. Pricing has largely been liberalized.

The government welcomes direct foreign investment in the petroleum and natural gas sector, which is facilitated by a stable and internationally approved investment framework. Contracts concluded to date could yield investments of more than \$50

billion. Foreign trade is formally committed to the principle of free trade, but is limited by unreliable customs regulations and partial restrictions.

3.2.3 Stability of currency and prices

The period under investigation was characterized by consistent inflation and currency policies. The national bank is formally subject to strong government control, but was able to implement its currency-stabilization policies without much government interference. Fiscal and debt policies were oriented towards stability. January 2002 saw the first indications of looser spending policies, chiefly in the form of social subsidies.

3.2.4 Private property

Private property rights and the acquisition of private property are well defined in principle. However, the implementation of the relevant laws is defective and at times subject to arbitrary state interference. Privatization of agriculture and small enterprises has largely been completed. Many of the medium and large-scale enterprises either have yet to be privatized or could not be privatized due to the lack of interested parties. Government sources reveal that between 1997 and 2002 the contribution of predominantly small- and medium-sized enterprises rose from 24.7 % to 42.7 % of GDP. The private sector's share of GDP reportedly surpassed the 70 % mark in 2002, although independent analysts favor a 50 % to 60 % figure.

3.2.5 Welfare regime

By regional standards, Azerbaijan had a reasonably extensive social safety net during Soviet times. Since independence, however, it has suffered from drastic underfunding and can fulfill its obligations in only a handful of areas. Healthcare is inadequate, at least for the poorer sections of the population, and pensions do not cover living expenses. The development of a modern social security system is still in its infancy. The rural population is much less affected by poverty than the urban population, as its refuge is the largely privatized agricultural sector. Family networks and money transfers from family members working abroad act as a stabilizing force for parts of the population.

In the absence of reliable unemployment statistics, estimates indicate that up to 25 % of the employable population is unemployed, even though the population is relatively young. The state lacks an active employment policy and a well-functioning system of

job centers. Social stabilization constitutes one of the central challenges to the future of the country. Equal opportunities exist in theory and are the normative role model, owing to the egalitarian attitudes within the population. In practice, however, considerable restrictions exist due to nepotism, financial restrictions on access to education, and widespread corruption. Increasingly, women experience discrimination in all social areas, an issue that the government has yet to address, despite having acknowledged the problem.

3.2.6 Strength of the economy

Notwithstanding the intermittent unfavorable external environment, for example the Russian crisis, the economy shows signs of consistent growth during the period under study. One must not be misled by these data, however, as low baseline conditions were met due to seven consecutive years of plummeting GDP, which shrank by a record 23.1 % in 1993. Although macroeconomic data appear largely positive—price stability, a largely balanced budget, low national debt, a relatively positive trade balance—these do not reflect the actual poor economic performance, caused by the almost total lack of industrial production outside the petroleum and natural gas sector, high unemployment, and virtually non-existent domestic demand, due to the general impoverishment of the population. The energy sector, with all of its uncertainties, has singular potential for development, and accounted for more than 90 % of all exports in 2001 and 2002.

3.2.7 Sustainability

Ecologically sustainable growth receives only marginal consideration and is not entrenched institutionally, although the creation of the Ministry of Ecology and Natural Resources in 2000 shows some degree of improvement. In addition, partial de-industrialization and the modernization of the petroleum and natural gas sector, achieved in cooperation with international consortia and donors, have proven beneficial for the environment. Nevertheless, damage incurred by the production and processing of petroleum and natural gas, poor water quality, the degradation of arable land, pollution and overfishing in the Caspian Sea, as well as the threat to nature reserves, continue to pose massive problems.

Azerbaijan's largely non-segmented society enjoys equal opportunities and equal access to the, admittedly inadequate, public services. Mechanisms associated with the advancement of women, the disabled and the socially disadvantaged are very limited. The state social security network of Soviet times, including the healthcare system, is drastically underfunded and hence faces great challenges to its ability to function.

Educational, training and research facilities exist in key sectors but are for the most part very variable and display obvious deficiencies in research and development. During the assessment period, the percentage of GDP invested in education and training fell, especially in the areas of research and development. Neither the recently established private education sector nor foreign educational endeavors can make up for this. The brain drain of recent years has yet to be halted.

4. Trend

(1) *Democracy*: The adoption of a new legal code in lieu of Soviet law, enacted in 1999, was a decisive step in the transformation of the legal system. It updated legislation in almost all areas, among them the criminal penal code, the civil code, family law, administrative law, labor and employment law, and tax law. Additional progress in the transition process came with admission to the Council of Europe in January of 2001, as this implied achievement of European standards. Legal practice shows little progress, however, and public administration remains highly inefficient. State identity, political participation and the rule of law remained at their low levels.

The degree of consolidation of this rather rudimentary democratic system exhibits little change. Corruption remains quite universal, and established legal measures intended to fight corruption are only rarely applied. The engagement of political parties in political and social integration is negligible and, in fact, has declined somewhat. The development of civic organizations remains progressive but sluggish, due to weak civic participation, and is largely dependent on foreign subsidies. The conventional civic participation of citizens declined during the assessment period.

(2) *Market economy*: During the period under investigation, the fundamental indicators measuring development remained stagnant for most areas. The GDP reflects a partial improvement to the low base level of development, notwithstanding the parallel increase of income disparities. The considerable rise of the Human Development Index since 1997 is only of partial significance, as the purported steady increase in life expectancy from 69 years in 1995 to 72 in 2001 accounts for a considerable part of this improvement.

Table: Development of socioeconomic indicators of modernization

	HDI	GDI	GDP Index	Gini Index	UN education Index	Political representation of women	GDP per capita (\$, PPP)
1996-1999	0.697 (1997) 0.783 (1999)	n. a.	n. a.	43 (1996-1999)	0.88 (1999)	12% (before 2000)	2.587 (1997)
2002	0.741 (2000)	88 th rank (2001)	52 (2000) ^a 0.56 (2000) ^b	n. a.	0.88 (2000)	9% (since 2000)	3.020 (2001)

Source: ^a IMF Study, 1989=100; ^b Azerbaijan Human Development Report 2002, 2003.

The institutional and legal conditions for a free market activity exist in principle. This is due to the merger of five former government ministries into a single entity, the Ministry of Economic Development, along with the fundamental legal reforms of 2000 and subsequent reforms. There are problems with implementation, however. Preparation of a formal request to join the WTO provides a further impetus to the continued expansion of the framework of commercial law. Reform dynamics are high, despite formidable deficiencies in implementation. Macroeconomic data indicate that the development of the economy as a whole is positive. This also holds true for the stabilization of the national budget. In view of the formidable deterioration affecting all fundamentals at the onset of the 1990s, and the low base level, the percentage data with regard to the actual level of development are nonetheless deceptive. In addition, the positive data can largely be attributed to the development of the petroleum and natural gas sector and its resulting oil exports, which were financed by foreign capital. With the admission of Azerbaijan to the 1958 Convention on the Recognition and Enforcement of Foreign Arbitration Awards on 29 May 2000, the legal security of commercial activities of foreign companies has improved, at least in theory.

Table: Development of macroeconomic fundamentals (1998–2002)

	1998	1999	2000	2001	2002
Growth of GDP ¹	10% (GNP) ²	7.2% (of GNP) ³	11.1% (of GNP) ⁴	9.0% (of GNP) ⁵	8.8% (of GDP) ⁶
Export growth, \$ million	677.8 ⁷ (FOB)	1,025.2 ⁸ (FOB)	1,877 ⁹ 40.7% (of GNP) ¹⁰	2,046 ¹¹ 41.0% (of GNP) ¹²	
Import growth, \$ million	1,723.9 ¹³ (FOB)	1,433.4 ¹⁴ (FOB)	1,539 ¹⁵ 38.4% (of GNP) ¹⁶	1,465 ¹⁷ 37.4% (of GNP) ¹⁸	
Inflation in %	-0.8 ¹⁹	-8.5 ²⁰	1.8 ²¹	3.4 ²²	3.2 ²³
Unemployment rate	n. a.	1.2% (off. estimate)	n. a.	n. a.	25% (unofficial estimate)
Budget deficit (Percentage of GDP)	1.9 (Public deficit) ²⁴	2.8 (Public deficit) ²⁵	0.6 (budget balance, overall surplus/deficit) ²⁶	1.5 (budget balance, overall surplus/deficit) ²⁷	1.5 (first half) ²⁸
Current account (in millions of \$ and percentage of GDP)	-1,364.6 (current acc.) ²⁹ 32.6 (of GNP) ³⁰	-599.7 (current acc.) ³¹ 15 (of GNP) ³²	-124.0 (current acc.) ³³ 3.2 (of GDP) ³⁴	-73.0 (current acc.) ³⁵ 0.9 (of GDP) ³⁶	

Sources:

¹ 1995-2001: 7.8%. World Bank, *ICT at a glance. Azerbaijan*, 9/9/2002. 1990-1995: -14.9%, 1996-2000: 7.1% cf.

IMF-Study;

^{2,3,20,24,25,29,31} *Economic Trends 1999*, Annex 8.1;^{4,5,10,12,16,18} World Bank *Azerbaijan Data Profile* (2/5/2003);^{6,28,34,36} Estimate EBRD, *Strategy for Azerbaijan. Approved by the Board of Directors on December 2002*, p. 10;^{7,8} *Economic Trends 1999*, p. 84;^{9,11,13-15,17,21,22,26,27,33,35} World Bank *Azerbaijan at a glance*, 9/23/2002;¹⁹ *Economic Trends 1999*, Annex 8.1. Cf. IMF Study<http://www.imf.org/external/np/eu2/2002/edebt/eng/040202.pdf> Inflation 1990-95: 705.2%, 1996-2000: 3.2%;²³ First half of 2002; Estimate for entire year 2.6%; No information available as to CPI. EBRD, *Strategy for Azerbaijan. Approved by the Board of Directors on December 2002*, p. 10;^{30,32} *Economic Trends 1999*, p. 82.

5. Transformation management

5.1 Level of difficulty

Azerbaijan has achieved a medium level of economic development, but the developmental structure is fraught with difficulties. This is due to the artificial state-run structures left over from the Soviet era and the extensive collapse of economic structures and foreign trade relationships inherited from the Soviet Union. The

outward appearance of the formally very high level of education among the population crumbles in light of the plummeting quality of public education, which in spite of partial improvements cannot be saved by the efforts of private and international educational institutions. Baseline conditions must be evaluated as difficult, owing to the enduring conflict with the Armenian population and the Republic of Armenia, the minorities in the border regions—which constitute at least 10 % of Azerbaijan’s population—rising religious divergence and income disparities. With the exception of the Nagorno-Karabakh conflict, the government was successful in containing domestic strife and preventing the emergence of new conflicts during the period under study. Civic traditions are weak, but growth in the NGO sector is consistent. The rule of law must be considered low, whereas institutional stability has attained an intermediate level.

5.2 Reliable pursuit of goals

The government succeeded in attaining its strategic goal of macroeconomic stabilization and extensive stabilization of the political situation, despite the appalling baseline conditions of 1995. Privatization of agriculture and of small and medium-sized enterprises has been implemented, but the privatization of large enterprises has fallen short. At this point, the majority of investors consider large enterprises unattractive. With the creation in 1999 of a national oil fund—amounting to \$700 million at the end of 2002—in accord with the IMF and the World Bank, as well as the National Program for the Reduction of Poverty and Economic Development, the government is addressing previously neglected long-term development and socio-political objectives.

The fund, financed from oil revenues, is expected to have amassed \$13 billion by 2015. This, together with budget resources and international funding, will be of crucial importance for the sustainable development of the country. In contrast, reforms of the judicial system and state administration lack clear overall objectives and are only sporadic. Reform progress is negligible. In addition to measures to improve the investment climate, the government on 17 August 2002 proclaimed the ambitious Program for State Support for the Development of Small and Medium-Sized Enterprises, which has witnessed only marginal implementation, if any.

Negative payment behavior and the modest oil, gas, electricity and water rates pose a formidable challenge. To balance the lack of revenue, cross-subsidies are utilized, which reportedly exceeded national expenditures for health and education by 50 % in 2001. Reform of these areas has barely begun and will undoubtedly be formidably difficult to implement. The paternalistic, patronage-based structure that dominates the political system acts as a substantial constraint on any kind of coherent reform.

Government policies do, however, guarantee fundamental reliability of expectations pertaining to life, justice and economic activity. The substantial degree of uncertainty within the bounds of politics, as well as judicial and administrative practice, hampers political and economic development.

5.3 Effective use of resources

The government effectively utilizes only a few of its available personnel and organizational resources. The level of bureaucracy remains high, and inefficiency and incompetence are widespread. Political connections and membership of networks play a significant role in hiring practices at the managerial level, thereby restricting competitive recruiting practices. Budget resources are used quite effectively, although greater transparency is necessary. Reforms of some ministerial structures improved efficiency noticeably, although not much has changed in administrative practice, especially at the lower and intermediate levels.

In spite of first-time local elections in 1999, local governments do not have financial autonomy and are subordinate to the presidentially appointed executive bodies of the districts. The government intermittently engages in accelerated reform. This is characterized, however, by a lack of public discussion, opaque procedures and inadequate steps in the implementation of such reforms, namely the training and professional development of the judicial and administrative domains.

Appropriation of public services to date is highly deficient and in fact, declined in the social services and education sectors. With respect to infrastructure, several reforms were initiated in coordination with the IMF in 2002, particularly in the energy sector. Corruption presents a significant barrier to development. Patronage-based networks are able to appropriate substantial state and natural resources for want of transparency in government revenue and expenditure policy, as well as a lack of parliamentary and legal controls. It is as yet impossible to assess to what extent anti-corruption legislation passed within the preceding two years will lead to actual improvement.

Recourse to a common cultural heritage, that is to say constructed identities, such as religion (Islam) or Turkishness, harbors great potential for destabilization and is therefore selective. Traditions of private enterprise were successfully utilized, and, structural corruption apart, there are few cultural barriers to a market-based system. Government and opposition both invoke the period of the first independent republic of Azerbaijan (1918–1921) when justifying sovereignty based on republican traditions.

5.4 Governance capability

In the area of macroeconomic governance, the government has demonstrated a great aptitude for learning. At the very least, the government recognized the socio-political deficit and is intent on addressing this issue by means of the internationally coordinated National Program for the Reduction of Poverty and Economic Development, as proclaimed by the president on 25 October 2002. In contrast, the outlook for democratization and corruption is negative. These areas do not exhibit any signs of insight or changes in behavior by those in power. Pressure from external actors and the government's intention to permanently integrate the country into the international community are of crucial importance. If the government were indeed serious about implementing reform, it would no doubt apply the necessary political power. It remains to be seen whether implementation is possible, given the patronage-based structures.

The opposition also shows great learning ability. Its sustained political marginalization and its rather rudimentary integration into the political system, however, impose huge difficulties with respect to personnel and mobilization. Since the energy sector currently is the sole sector with any viable development potential, the government has no choice but to single-mindedly focus on its development, regardless of the associated perils. At this point, it is impossible to predict to what extent diversification policies heralded in 2002 will be implemented. Development potential often goes unutilized because of the self-interest of those in power. The main problem is not the absence of reforms, but rather the inadequate implementation of these reforms.

5.5 Consensus-building

Both the government and the opposition have made it their professed goal to build a market-based democracy. Serious doubt must be cast on this, in view of the growing although not yet truly relevant, Islamic opposition. The opposition's main criticism surrounds not the reforms, but rather the slow speed or lack of implementation, political patronage and corruption. The positions of the government and the opposition seem irreconcilable, but a wide range of coalition variants is possible in principle.

The population, meanwhile, exhibits great indifference toward government policy and internal opposition quarrels. Widespread social discontent has been articulated only selectively and, if need be, can be addressed by the police and/or the military, but not institutionally. There are no real vetoing actors, but elements within the power structure can thwart reform measures by boycotting them, as long as the government

leadership has no will to break their resistance. Social solidarity can at best be generated against an external enemy, often Armenia. Confronting and dealing with injustices incurred during the Soviet and late Soviet era has largely been put to rest, and is equally unpopular among the elite and the population.

5.6 International cooperation

For government and opposition alike, cooperation with international institutions and organizations—namely the IMF, the World Bank, the EBRD, the Council of Europe, the EU, NATO, ECO, and the Black Sea Economic Cooperation group—enjoys top priority in all areas. Its importance is most notable in government policies, legal reforms, economic reforms, financial cooperation, infrastructure development, health and education. International cooperation on multiple levels is indispensable for the development of Azerbaijan. In practice, massive problems continue to surface, owing to an inherent Soviet mentality, paternalistic ways of thinking, corruption, institutional weakness, incompetence and inefficiency.

In addition, several problems arose, especially during the initial years of cooperation, due to incompetence on the part of Western and international partners with respect to country and culture, or rather their non country-specific programs. The current government is largely a reliable partner in the international arena. Regional cooperation is limited, due to the hostilities with Armenia, the relatively conflict-ridden relationship with Iran, the isolationist policy of Turkmenistan and the economic weakness of the bordering Russian constituent republic of Dagestan.

Georgia and Turkey are the main regional partners, and relations with Iran have great potential. Owing to its geographical location, Azerbaijan possesses great transit potential, the fulfillment of which requires substantial investment and a solution to the region's territorial conflicts. Construction of the Baku-Ceyhan pipeline is expected to give a significant boost to regional development. The pipeline is intended to transport Azerbaijani and possibly Kazakhstani oil and natural gas via Georgia and Turkey to world markets.

6. Overall evaluation

In view of the originating conditions, current status and evolution achieved, as well as the actors' political achievements, this assessment arrives at the following conclusions:

(1) *Originating conditions:* Originating conditions for transition were overall extremely challenging. The constituent republics of the Soviet Union did not possess any functioning government structures, due to the centralized state structure. National identity has yet to be clarified, as various definitions vie for prominence, based on ethnic-national, ethnic-supranational, citizenship, and religious grounds. What does exist is a rudimentary market-based structure and a Soviet *nomenklatura*, which became interested in changing the system only after discovering the potential for personal enrichment. In addition, there is the stream of refugees created by the civil war with the Armenian population in Nagorno-Karabakh, the displacement of Armenians from other parts of the country and the arrival of approximately 200,000 displaced Azerbaijanis from Armenia.

The reasonably democratically elected government of Abulfaz Elcibey was incapable of controlling these circumstances and was in the end forcibly removed from power by a military coup in 1993, leaving a devastating impact on the democratization process. The government of President Aliyev managed to stabilize the situation in 1995–96 and eventually to marginalize all competing political forces or rather integrate them into the political system. Broad political and economic reforms have been initiated in response to hardship and international pressure.

(2) *Current status and evolution:* Democratic transition has progressed only marginally. Whereas the presidential system was once instrumental in stabilizing the country, it now presents a barrier to further democratization. Political progress is blocked, in large part because genuine control of government by parliamentary bodies and an independent judicial system would endanger the authority of those associated with the presidential regime. International organizations such as the Council of Europe play a vital role here. Due to vast social problems and the inefficiency of the administrative machinery, and because the political system has no unifying influence, there is a potential for stability problems in the medium term. A lasting solution to the Nagorno-Karabakh conflict is of crucial importance for the future of the country.

The evolution of the transition to a market economy is truly remarkable. The decision-makers were able to stabilize macroeconomic development. The transformation toward a market economy has made substantial progress in terms of the institutional framework, but conditions are poor, due to inadequate infrastructure, massive corruption, a weak banking sector and the as yet unaddressed inefficiency and incompetence in most areas of government administration. There is virtually no progress toward developing a market economy's welfare system. This may change with the creation of the oil fund, the purpose of which is to secure a sustainable development strategy. The course chosen once the ageing President Aliyev leaves office will be of crucial importance. Development that focuses exclusively on the

energy sector and a few limited regions of the country poses great dangers and can only be restrained by decisive policy.

(3) *Management*: The actors' relative management performance is mixed. While the reversal of the downward economic trend during the first half of the 1990s and the stabilization of macroeconomic conditions must be regarded as achievements, the scant progress in democratization and the merely rudimentary creation of a functioning economy must largely be considered a failure of those in power. The integration of the country into the international community was relatively successful. Unfortunately, this achievement found no counterpart in domestic policy. This arena was dominated by the hostile stance towards the opposition, as well as such undemocratic behavior as massive pressure on the media, forceful suppression of local protests, election fraud, and strengthening of the presidential nature of the constitution.

7. Outlook

Without a change of regime and ultimately without a peaceful and lasting solution to the Nagorno-Karabakh conflict, there can be no decisive transformation progress. Due to the patronage-based power structure, there is a growing risk that a partially rent-seeking system based on oil revenue will emerge. This danger can only be contained by unambiguous progress in democratization and the establishment of the rule of law. The lack of able politicians, as well as administrative and legal professionals, is cause for concern. The central challenge facing Azerbaijan is the development of the petroleum and natural gas sector and the utilization of the resulting revenue for the sustainable development of the country, and balanced economic growth via the development of the non-oil sector.

For this to succeed, the acquisition of foreign capital is vital. It will also require sustained improvements to the investment climate. The reform and expansion of several areas of the infrastructure, especially energy, water and transportation, is urgent as their condition poses a serious obstacle to development. In view of the precarious geopolitical situation of the country, a balanced and lasting foreign policy is essential. If the political elite of Azerbaijan succeeds in overcoming these challenges, then the country will have immense development potential.