

Azerbaijan

Status Index (Democracy: 3.80 / Market economy: 5.21)	4.51	Management Index	3.50
HDI	0.729	Population	8.3 m
GDP p. c. (USD, PPP)	3,617	Population growth¹	1.4%
Unemployment rate	10.7 (ILO)	Women in Parliament	10.5%
UN Education Index	0.89	Poverty²	ca. 50%
		Gini Index	36.5 (2001)
Source: UNDP: Human Development Report 2005. Figures for 2003 – if not indicated otherwise. ¹ Annual growth between 1975 and 2003. ² Population living below national poverty line (1997-2003); source: World Bank 2004.			

A. Executive summary

Democratic transition in Azerbaijan has progressed only marginally. While strong presidential rule was instrumental to stabilizing the country in the past, it now presents a barrier to further democratization. The fact that steps leading to real control of the government via parliamentary bodies and an independent judicial system would endanger the authority of the circles associated with the presidential regime creates objective barriers to any political progress. In view of the country's vast social problems, the inefficiency of administrative machinery and the political system's inability to consolidate power, there is a potential for instability in the medium-term.

Of crucial importance to the future of the country is a lasting solution to the Nagorno-Karabakh conflict. The evolution of the transition to a market economy is truly noteworthy. The decision makers were able to stabilize the macroeconomic development. The transformation toward a market economy has made substantial progress concerning the institutional framework while conditions surrounding economic reality are poor owing to lacking infrastructure, massive corruption, an inadequate banking sector and the hitherto unaddressed inefficiency and incompetence in most areas of government administration.

With respect to developing a market economy's welfare system there is virtually no activity. This may change with the growing income from oil and an oil fund created to secure a sustainable development strategy. Economic development that focuses exclusively on the energy sector and a few limited regions of the country is a great risk; one that can only be averted by decisive policy.

The actors' relative management performance is mixed. While the reversal of the economic downtrend during the first half of the nineties and the stabilization of macroeconomic conditions must indeed be regarded as management achievements, the scant progress surrounding democratization and the only rudimentary creation of a functioning economy must largely be attributed to the failure of those in power, be it the late President Heydar Aliyev or his son and

successor Ilham Aliyev (who has been in power since autumn 2003).

The country's integration into the international community was relatively successful. Unfortunately, this achievement found no counterpart in domestic policy. Here, the collision course with the opposition and undemocratic behavior in a number of areas - such as massive repression after the presidential elections 2003, massive pressure on the media, forceful suppression of local protests, election fraud and strengthening of the presidency by amending the constitution - dominated.

B. History and characteristics of transformation

The 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 former Soviet Republics. It demanded national sovereignty, democracy and that Nagorno-Karabagh remain under the jurisdiction of Azerbaijan.

The internal conflict surrounding Nagorno-Karabagh, however, a region predominantly inhabited by Armenians, has had far-reaching negative effects on the political and economic development of the still-young state of Azerbaijan. To date, the conflict has produced more than 18,000 casualties and more than a million refugees on both sides. Notwithstanding the efforts of international mediation, there appears to be no solution to this conflict. With the violent overthrow of Abulfaz Elchibey, President of Azerbaijan and leader of the Popular Front, Heydar Aliyev, the former chairman of the KP and KGB, assumed power. He ruled the country from 1993 until 2003, and was succeeded by his son, Ilham Aliyev. The fact that both Aliyevs' base of support comes primarily from former KP officials, regional power clans from the enclave of Nakhichevan and Azerbaijanis originating from Armenia imposes structural constraints on the democratization process.

Previous elections, (e.g. the presidential elections of 1993, 1998 and 2003; and parliamentary elections in 1995 and 2000), which rated by Western observers as thoroughly undemocratic, only reinforced existing conditions. Coupled with government oppression, sustained political disinterest among the population has left the opposition largely marginalized. It has, however, been relatively successful in maintaining a degree of flexibility for its *modus operandi*. External actors such as the OSCE, the Council of Europe and Western embassies have also played a positive role in this context. Amendments to the constitution, which the population approved by a referendum of dubious legitimacy in 2002, have only reinforced the presidential nature of the constitution and, in so doing, improved the legal framework 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-Karabagh conflict - is incapable of utilizing widespread social discontent in its favor. Increasingly, protests occur outside the legal spectrum of political parties.

Ayaz Mutallibov, the first post-independence head of state (1990-92), was instrumental in initiating the country's transition to market economy. He was, however, unable to develop any lasting dynamism in the early years of independence owing to turbulent internal political strife that lasted until 1994 and the military conflict surrounding Nagorno-Karabakh (a ceasefire was reached in May 1994). Crucial for the economic development of the country was the transfer of former Soviet-owned industries into private ownership, particularly in the petroleum and petrochemical sectors in January 1992. One of the great mid- to long-term challenges for the country is the lack of economic development beyond the oil and natural gas industry, which is the only one that receives significant foreign investment. The Manat - the country's new currency, introduced in 1993 - has stabilized and the national debt has been reduced, though this can be attributed almost exclusively to the export of oil and - increasingly - natural gas, the continuous rise in crude oil prices on the international markets and a restrictive fiscal policy.

The post-Soviet deterioration of the country's industrial basis, however, has yet to be reversed. The majority of small enterprises and a number of medium-sized enterprises have been privatized, while the 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 general population's standard of living has declined alarmingly. This decline has coincided with cuts in social welfare spending. In line with 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 negative spillover effects of the Russian economic crisis of 1998/99, the implementation of the late President Heydar Aliyev's rigorous economic plan has reversed the general trend toward economic decline, which began in the early nineties.

Corruption, which has been widespread for years (in 2004, Transparency International ranked Azerbaijan as the sixth most corrupt country in the world), remains a significant hurdle to economic development. Of great significance with respect to consolidation have been loans and grants provided by international financial and donor organizations.

During 2004-05 several macroeconomic indicators like inflation indicated that the

country was about to experience yet another change for the worse. Several areas of the law continue to require substantial reform, including legislation regarding elections and political parties, the judicial system and property rights. Azerbaijan joined the Council of Europe as a member on January 25, 2001 amidst persistent criticism of its human rights record. Still, the authoritarian presidential system and manifold repression of the opposition and the media prevent Azerbaijan from becoming a truly democratic country.

The parliamentary elections set to take place in the fall of 2005 will provide decisive proof of whether the ruling elite is willing to implement democratic reforms. Without substantial pressure from democratic countries and international organizations like the Council of Europe, there is little chance that elections will be truly democratic.

C. Assessment

1. Democracy

1.1. Stateness

Azerbaijan is experiencing significant problems with stateness. On the one hand around 17% of its territory is occupied by Armenian forces. On the other hand, Caspian Sea border demarcation has not yet been determined between Azerbaijan, Iran and Turkmenistan and no multilateral agreement has been concluded among the five littoral states. Apart from this, conflicts related to smaller segments of the border between Azerbaijan and Georgia remain unresolved. However, the state's unrestricted monopoly on power extends over all its unoccupied regions.

In theory, the basis for defining citizenship and who qualifies as a citizen has been established. In reality, however, there are considerable problems surrounding the right to citizenship for Armenians of Nagorno-Karabakh, the displaced Armenians from Baku and other unoccupied regions of the country in addition to smaller groups of migrants and refugees (e.g. Chechens and Meshketians). All citizens enjoy equal civil rights. State and religion are separate institutions. Political processes are largely secular, although Islam as a religion is increasingly becoming a political factor.

The state provides basic infrastructure throughout the entire unoccupied national territory, but exhibits great shortcomings, particularly due to corruption and inefficient administration. Law and order are maintained by and large.

1.2. Political participation

Universal active and passive suffrage does exist, although it is de facto frequently violated. Western observers have judged the great majority of elections held so far as unfree and unfair, fraught with very grave deficiencies. There is no evidence of real improvement over the past few years, during the constitutional referendum in 2002, the presidential elections in October 2003 and the municipal elections in December 2004. The presidency or rather the government is continuously reaffirmed through the course of elections, disregarding principles of open and competitive election processes in a great number of cases. Thus there has been no changeover of power since 1993, apart from the election of Ilham Aliyev as president after his father's death in 2003.

The effective power to govern lies with the president and the government. There are no veto powers or political enclaves in the hands of the military or other influential groups. However, the presence of non-legitimized power structures related to the president and his entourage do influence the course of politics.

Independent political and civic organizations are entitled to form, but experience occasional problems with registration and encounter state repression. There are a number of non-governmental organizations (NGOs) along ethnic lines, which restrict their activities to the humanitarian and cultural fields. Ethnic groups such as the Lezgians close to the Northern border are discouraged from forming organizations for political reasons. So-called "non-traditional" religious groups (e.g. evangelical missionaries, Wahhabites, non-conformist Shi'i groups) encounter difficulties with registration and find that their activities are in part prohibited, which is in no small part due to pressure from the media and Islamic organizations. Utterly in line with Soviet tradition, union activity largely remains state-controlled, thereby preventing the formation of independent unions and any effective participation of unions in determining wage levels. Freedom of assembly is possible only on a very restricted basis and was not conceded after the elections of 2003 for nearly one and a half years.

State-run media and electronic media owned by members of the ruling elite are subject to government control. Dissident private media face considerable financial and legal pressure at times, apart from incidents of intimidation and killings of critical journalists. Thus, freedom of opinion is limited, despite some positive legal steps such as a newly formed Press Council (March 2003) and a law on the Public Broadcasting Service (passed September 2004, presidential decree November 2004).

1.3. 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 in fact the president and his apparatus play the principal role. Due to the dubious election processes and the domination of forces close to the president, the parliament is limited even in exercising its monitoring function, provided for in the constitution.

In theory, the institutionally separate judicial branch and the constitutional court, established in 1998, are independent, but in fact largely subordinated to the executive. Judges are appointed by the president (in the case of the courts of first instance) or by the parliament on the basis of presidential recommendations. They can also be dismissed on the basis of a presidential decree. To date, the structure of the judicial branch has only been inadequately reformed, thereby preventing it from acting as a counterbalance 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 particularly by external actors such as the OSCE, Council of Europe or U.S. State Departments even necessitated subsequent corrections of anti-democratic decisions by way of 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 (e.g. abolition of the death penalty, ratification of the European Convention on Human Rights), even though legal practices affecting the media in particular continue to be plagued by obvious deficiencies. Despite the release of many political prisoners under an amnesty by the President in spring 2005, the issue of political prisoners remains unresolved.

Political and bureaucratic corruption is regarded as very high by the population and is widely criticized. In a recent opinion poll, corruption was regarded as the fourth greatest problem of the country after the unresolved conflict with Armenia, unemployment and poverty. Only in rare cases is corruption fought effectively by way of a court ruling. Prosecution of corruption is also utilized to authorize the dismissal of high-ranking government officials, without affording them proper legal recourse. Despite several new laws against corruption (Anti-Corruption Law passed January 2004), the situation remains unchanged by and large. The state administration has yet to undergo structural reform. Despite a significant increase in salaries in 2004, staff members of many administrative departments do not earn enough to cover living expenses, which in turn encourages corruption and inefficiency.

In principle, civil liberties are guaranteed by the constitution, but are violated partially and temporarily. One problematic instance is the obligatory registration of religious institutions and congregations at the State Committee for Relations with Religious Organizations, which restricts religious freedom in certain areas.

Legal discrimination of particular ethnic or religious groups or of women does not exist, but women and religious converts do encounter social discrimination.

1.4. Stability of democratic institutions

Democratic institutions have severe deficiencies. With the single exception of presidential elections in 1992, post-Soviet Azerbaijan has yet to witness a democratically legitimized transfer of power. The political system has thus yet to pass the litmus test. With the succession of the late President Heydar Aliyev by his son Ilham Aliyev, which was carried out through unfair and unfree elections in October 2003, the existing power structures remained on the whole unchanged. Large parts of the opposition go for confrontation with those in power, others hope for co-optation into the existing power structure. The parliament plays a de facto negligible role.

The vast majority of political actors formally accepts democratic institutions. But in practice democratic institutions are disregarded and distorted in an undemocratic regime. The sole fundamental opposition to the political system might emerge from the growing Islamist current in the population, which is not yet organized. An opinion poll conducted in Winter 2004-2005 showed that apparently 23.2% of the population support the idea of an Islamic state, whatever this may concretely mean, and another 28.9% would welcome the partial introduction of Shariah-based laws (e.g. in family law).

1.5. Political and social integration

The political party system is highly fragmented, although there are only about five parties of nationwide relevance. The dominating New Azerbaijan Party headed by the president mainly unites government officials and patronage structures without having a clear political program. The high degree of verbal polarization among the key stakeholders has not led to massive social polarization, since the principle of peaceful political contest has largely met with acceptance, and political parties are rather poorly rooted in society, so voter volatility is considerable. The parties reflect patronage-based structures centering on certain public leadership figures and groups rather than on social interest groups.

Due to the hitherto low degree of social differentiation and because of the authoritarian nature of government, there are only very few other organized interest groups representing the interests of individual 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 such as the Islamists, which are currently not integrated into the political system of the country, succeed in articulating the interests of these parts of the population, the possibility of partial mid-term destabilization might arise.

In principle, the majority of the population accepts a democratic system, although in political everyday life, large parts of the population tend toward an authoritarian style of politics. During the last years one can observe a steadily growing disappointment about democracy because of the bad performance of the post-socialist system and the alleged double-standards of Western democracies. In comparison to 2003, when more than 67% of the 1,000 respondents in an opinion poll regarded democracy as best form of government, the percentage dropped to 57% in 2004. In the same poll 63% of the respondents answered that only a powerful leader could change the situation to the better, in contrary good laws gained only 19% and powerful parties even only 3.8%.

Due to politico-cultural and socioeconomic barriers, social self-organization exists only in part and its scope of action and trust among the population is weak.

2. Market economy

Azerbaijan has made progress in the transformation of its economy. The collapse of large enterprises, which dominated the Soviet era, has been compensated in part by small and medium-sized enterprises in food and light industries as well as in the trade and service sectors. Deficiencies exist in the transition to privatization, which has only been partially implemented in the case of medium and large-scale enterprises. There is further widespread corruption, incomplete consolidation in the banking sector, insufficient reform and implementation of economic legislations and their respective regulatory bodies and also in the removal of regional developmental imbalances (concentration on Baku and the Apsheron Peninsula). Highly problematic is the confinement of economic development almost entirely to the energy sector (31% of GDP and 86% of the country's export in 2003).

2.1. Level of socioeconomic development

Most central indicators point to a low level of development. Based on the HDI, the development of the country offers freedom of choice to only a small section of the population. According to World Bank data in 2003, 50% of the population lives in poverty. Those affected above average levels are the nearly 850,000 internally displaced persons (IDPs) and refugees in the country, pensioners and unemployed youths. Poverty is also a cause for social exclusion due to the increasing privatization of higher 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 resulted in the high migration of labor. According to some estimates, there are approximately 1 to 1.5 million temporary or permanent emigrants.

The infrastructure in rural areas is frequently so poor that it impedes the development of other regions beyond the capital city. An important contribution to the income of the rural population comes from household plots used for agricultural production. However, average living standards are improving for parts of the population, which, on the other hand, leads to growing social inequality.

2.2. Organization of the market and competition

Since the mid-nineties, important progress has been made in the transition to a market economy. In 2003, 73% of GDP was obtained by the private sector (1998: approx. 55%). In the meantime, market competition received an institutional framework. However, the economic environment is still negative: widespread corruption, partially inadequate judicial and political settings, arbitrary administration of justice by the state organs and the judicial system, underdeveloped infrastructure and a lack of access to capital. Small and medium-sized enterprises particularly encounter great difficulties. As a result, the informal economy is equivalent to 18-20% of Azerbaijan's GDP according to the State Statistical Committee, though the actual size is probably larger. Pricing has largely been liberalized with the exception of mainly public utilities like electricity, heat, telecommunication, water and domestically sold oil and gas products.

State monopolies command parts of the transportation sector as well as certain areas of the infrastructure (gas, electricity, water), although there have been partial privatization efforts. Foreign enterprises are active in certain areas of the infrastructure. Reforms in the telecommunications sector were initiated, but are not yet completed. In the bank sector, the state-owned International Bank of Azerbaijan tends to consolidate its near-monopoly of power. As the oil and gas sector is of strategic interest for Azerbaijan's future, the central role of the state and the State Oil Company (SOCAR) continues. However, due to the lack of capital and technology, foreign oil companies play an important role. The only relevant legislation in the field of competition is the Law on Anti-Monopoly Activity from 1993.

The government welcomes direct foreign investment in the petroleum and natural gas sector, which is facilitated by a stable and internationally approved investment frame. Hitherto concluded contracts have the potential of yielding investments of over \$50 billion. Foreign trade is formally committed to the principle of free trade and "not less-favored" treatment compared to local investors, but experiences limitations, owing to unreliable customs regulations, non-transparent registration mechanisms and partial restrictions. Azerbaijan applied for WTO membership in 1997, but its accession negotiations are still at an early stage.

The banking sector remains underdeveloped and a bottleneck for the development of the private sector. With the domination of the state banks, accounting for 65%

of all bank deposits at the end of 2001, competition is lacking and most banks are undercapitalized, although the situation is gradually improving due to moderate increases in capital requirements, mergers and closures (1994: 250 banks; 2003: 46), reforms of laws and formalities, as well as increasing professionalism. In January 2004, the government adopted a new law on the banking system that is consistent with the Basel core principles. Small and medium-sized enterprises encounter great difficulties in procuring capital. However, this changed partially with the assistance of foreign donors and international banks, such as the European Bank for Reconstruction and Development (EBRD) and the World Bank.

2.3. Currency and price stability

The period under review was characterized by steady inflation rates and changes in currency policies. In December 2004, the National Bank Law was enacted, giving the National Bank considerable independence to pursue monetary policy. Fiscal and debt policies were oriented towards stability. Beginning 2004, inflation started to rise, which highlights the underlying sensitivity of the macroeconomic environment, caused by factors like the growing foreign exchange inflows from the oil sector and rising prices for several basic commodities such as wheat and oil or natural gas. By December 2004, consumer prices were 10.5% higher than at the end of 2003, and average annual inflation for 2004 reached 6.7%.

The government consequently follows a policy of macroeconomic stability in order to preserve fiscal stability and a low level of debts. In 2004, the government continued to pursue a prudent fiscal policy. The overall deficit at 2% of GDP was somewhat less than in 2003. Over the medium term no major negative change is expected because of the high level of the oil price on which Azerbaijan's economic growth is largely based. There remains, however, a certain pressure on the government to expand public spending in the welfare sector because of widespread poverty and the underfinanced education and health sectors.

2.4. Private property

Private property rights and the acquisition of private property are formally well-defined. However, the implementation of the pertinent laws is deficient and at times experiences state arbitrariness and corrupt procedures.

Privatization in agriculture and of small enterprises has largely been completed. Sections of the medium and large-scale enterprises have to either yet be privatized or could not be privatized for lack of interested parties. Government sources reveal that between 1997 and 2002, the percentage of small and medium-scale enterprises increased from 24.7% to 42.7 of the GDP. In 2003, reportedly, the GDP share of the private sector was 73% (1998: 55%), although independent

analysts estimate much less.

The overall progress of the “second wave” of privatization remains slow. There are still several large and inefficient state companies, especially in the utility sectors. Some hydropower plants and mining enterprises were privatized in 2003.

2.5. Welfare regime

By regional standards, Azerbaijan had a reasonably extensive social safety net during Soviet times. In the meantime, it suffers from considerable underfunding and can fulfill its obligations in only a handful of areas. Health care is inadequate, at least for the poorer sections of the population. In the period from January to August 2004 public expenditure on health care amounted to only 0.7% of GDP (1995: 1.4%). Pensions do not cover living expenses. The development of a modern social security system is still in its infancy. The rural population is less affected by poverty than parts of the urban population, especially in small towns, 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 without work. The state lacks an active employment policy and a functioning system of employment exchange. There is also no state support for the unemployed. Social stabilization constitutes one of the central challenges in the country's future. In 2003, the government launched a State Programme on Poverty Reduction and Economic Development (SPRED).

Equal opportunities exist in theory and are the normative role model owing to the egalitarian attitudes within the population. In practice, however, considerable restrictions do exist due to informal networks, nepotism, financial restrictions in access to education and widespread corruption. Increasingly, women experience discrimination in all social areas, an issue that the government, in spite of verbal acknowledgement, has yet to address. Mechanisms associated with the advancement of women, people with disabilities and the socially disadvantaged are very limited. The state social security network of former Soviet times currently experiences an acute underfunding and hence poses great challenges to its functionality (e.g. the health care system). Institutions to compensate for gross social differences are very limited in scope and quality.

2.6. Economic performance

After the Russian crisis of 1998, the GDP growth has averaged 10% annually. However, one must not be misled by this data, as the low initial level was again reached after seven years of plummeting GDP performance (with an all-time peak

in 1993 at -23.1%). Although macroeconomic data appear largely positive (relatively low inflation, a largely balanced budget, low national debt, a relatively positive trade balance), they do not reflect the actual low economic performance attributed to factors such as the almost total lack of industrial production outside the petroleum and natural gas sector, high unemployment and a low domestic demand due to the general impoverishment of the population. Of singular potential for development is the energy sector with all its uncertainties (2003: 86 % of total exports). There are, however, some positive signs as improving living standards and growing real per capita income, which will soon reach twice the level of 1996.

2.7. Sustainability

Ecologically sustainable growth finds only marginal consideration and is altogether not institutionally anchored, although the creation of the Ministry of Ecology and Natural Resources in 2000 presents 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 positive for the environment. Nevertheless, damage incurred by the production and processing of petroleum and natural gas, poor quality of water, degradation of arable lands, pollution and overfishing in the Caspian Sea, and the threat to nature reserves continue to pose massive problems. In 2003, a National Program on Environmentally Sustainable Socioeconomic Development was developed with the above-mentioned Ministry responsible for the provision of the necessary guidelines and scientific data to support the implementation of the Strategy. Azerbaijan is party to the Kyoto Protocol.

Facilities for education, training and research do exist in key segments, but they considerably differ in quality and show obvious deficiencies in research and development. During the assessment period, the percentage of GDP invested in education grew slightly (2002: 3.6 %; 2003: 3.3 %; first half of 2004: 3.8 %). Overall quality is still declining, funding remains inadequate and the educational sector does not meet labor market needs. Inequity of access to education and the quality gap from urban to rural areas are growing. Neither the recently established private education sector nor foreign endeavors can make up for this. Research and innovation activities are not afforded much attention. The brain drain of recent years has yet to be halted.

3. Management

3.1. Level of difficulty

The level of difficulty of the transformation tasks faced by Azerbaijan's leadership is moderate, though characterized by several structural constraints. This

goes back to the merely pseudo state-run structures inherited from the Soviet era as well as the collapse of economic structures and foreign trade relationships due to the breakdown of the Soviet Union. The formally high level of education crumbles as it suffers from a deteriorating public education, which despite some improvements cannot be maintained by private and international educational institutions. If embedded in an adequate development strategy, the oil and gas reserves of the country may give Azerbaijan a comparative advantage to other transformation countries. An important obstacle for further development is the frozen war between Azerbaijan, Armenia and the Nagorno Karabakh Armenians, which resulted in nearly 17% of Azerbaijan's territory taken out of government control, more than 800,000 IDPs and refugees from Armenia as well as the emigration of a considerable number of professionals with non-Azeri ethnical background.

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. The growing disappointment in the populace about democracy, an outcome of the regular falsification of the elections, is problematic. Consequently, trust in state institutions is declining.

The enduring conflict with the Armenian population of Nagorno-Karabakh and the Republic of Armenia (ceasefire: May 1994), the minority populations in the border regions, rising religious divergence and income disparities as well as growing inter-regional development differences constitute problems for the future stability of the country. With the exception of the Nagorno-Karabakh conflict, the government was successful in containing domestic strife and preventing the emergence of new ones during the period under study.

Profile of the Political System

Regime type:	<i>Autocracy</i>	Constraints to executive authority:	2
		Latest parliamentary election:	04.11.2000
		Effective number of parties:	2.7
1. Head of State:	<i>Heydar Äliyev</i>	Cabinet duration:	1996-2003
Head of Government:	<i>Artur Rasizadä</i>	Parties in government:	1
Type of government:	<i>single party majority</i>		
2. Head of State:	<i>Ilham Äliyev</i>	Cabinet duration:	04.11.2003- present
Head of Government:	<i>Artur Rasizadä</i>	Parties in government:	1
Type of government:	<i>single party majority</i>		
<p>Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional constraints posed by a federal or decentralized state, a second parliamentary chamber, referenda, constitutional and judicial review and the rigidity of the constitution. For presidential/ semi-presidential systems, the geometric mean of presidential election and parliamentary election disproportionality is calculated. Effective number of parties denotes the number of parties represented in the legislature, taking into consideration their relative weight (Laakso/Taagepera index) = $1 / (\sum p_i^2)$; p_i is the share of parliamentary mandates controlled by party i.</p>			

3.2. Steering capability

The political leadership successfully managed the transfer of power from President Heydar Aliyev to his son Ilham Aliyev in autumn 2003. Thereby, it has proven its ability to organize policies according to strategic aims, i.e. the continuation of its rule and the stabilization of the political situation. After the new president came to power, the leadership succeeded in attaining its strategic goal of macroeconomic stabilization without much change to serve their own material and political interests. In recent years, with the support of international organizations and donors, the government defined several long-term priorities, especially for sustainable economic development and poverty reduction (State Program on Poverty Reduction and Economic Development, National Program on Environmentally Sustainable Socio-Economic Development, etc.). However, there is no clear strategy for democratization beyond rhetoric and for a socially responsible market economy.

The government seeks to achieve reforms at least in the economic field, but even there it fails to implement many of them properly. This is especially true for the fight against corruption, which remains inefficient because of the lacking will to pursue a consistent policy, as this could hamper the interests of the ruling elite. Furthermore, privatization in agriculture and of small and medium-sized enterprises has been implemented whereas the privatization of large enterprises has fallen behind.

Following advice from the IMF, the government successfully reduced energy-related subsidies (2000: an estimated 22% of the GDP; 2003: approximately 10% of the GDP; last price increases November 2004). Low collection of tariffs due, which is currently estimated for gas at about 50% or 34% for electricity (2002), poses a formidable challenge. With the creation of a state oil revenues fund (end of March 2005: \$994 million) in 1999, the government has sought to address previously neglected long-term development and sociopolitical objectives. Contrary to the proclaimed goals of the fund in 2003, about \$100 million transferred to the state budget for industrial investments were mainly used for wage rises before the presidential elections.

In addition to measures intended to improve the investment climate, the government proclaimed in August 2002 the ambitious Program for State Support for the Development of Small and Medium Entrepreneurship, which has been hardly implemented so far. Reforms focusing on the judicial system and state administration are only partially realized and lack clear overall objectives. The change of the parliament election system from a mixed majority or party-list system to a majority system in 2002 has shown a negative impact on further democratization because of its even lower capacity for integration. Overall the leadership showed its ability to pursue strategic aims. However, it does not focus on the development of a market-based democracy, and in fact quite often hampers this development especially in the political field.

The paternalistic patronage-based structure, which dominates the political system,

poses a substantial constraint to any kind of coherent and flexible reform policy. The ruling elite has, however, responded flexibly and effectively to the passing of the former president in 2003 by enthroning his son as new president without much inner-elite conflict. In contrary to the expectations of many Western observers, the new president did not change the government's policy towards democratization and the rule of law. It remains unclear whether this is due to a lack of will or a missing ability of self-assertion against persisting forces. On the one hand, as there is no legal barrier against the implementation of reforms, the president and his apparatus is fully responsible for the stalemate in large parts of the reform process. On the other hand, the ruling elite show their ability to learn when economic interests and the pressure plus expertise of international organizations, large oil companies and donors are combined.

3.3. Resource efficiency

The government utilizes only a few of the available human and organizational resources efficiently. The level of red tape remains high, and inefficiency and lack of competency are widespread. In hiring practices at the managerial level, political connections and membership in certain networks play a significant role, hence restricting competitive recruiting practices. Budget resources are used quite efficiently although the need for transparency remains. The overall budget deficit of 2 % in 2004 was somewhat less than in 2003, partly as a result of high oil prices and restrained spending. The non-oil budget deficit stood at 11% of GDP in 2003, which shows the structural problem of the Azerbaijani economy and the deficiencies of the tax system. Reforms affecting some of the ministerial structures noticeably improved efficiency although in administrative practice, especially at the lower and intermediate level not much has changed. In spite of two rounds of municipal elections in 1999 and 2004, local self-administrative bodies do not possess financial autonomy and are in fact subordinate to the executive bodies of the districts appointed by the president. Intermittently, the government engages in accelerated reform. This is characterized, however, by a lack of public discussion, missing transparency 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, experienced a decline in social services and education. With respect to infrastructure, several reforms were initiated in coordination with the IMF (particularly in the energy sector).

Azerbaijan has a presidential system with a strong president and a powerful apparatus, which results in very limited possibilities for the ministries to pursue consequent policies. Together with conflicts among the ruling circles, this leads to an incoherent policy. Because of the centralized system and intransparent decision processes some policies have counterproductive effects on other policies.

In Azerbaijan corruption represents a significant barrier to development.

Transparency International still ranks Azerbaijan as one of the most corrupt countries of the world. Patronage-based networks are able to appropriate substantial state and natural resources of the country for want of transparency in government revenue and expenditure policy, as well as lack of parliamentary and legal controls. To date, it is impossible to assess to what extent anti-corruption legislation passed within the preceding years and the State Program on Fighting Corruption, which covers the period from 2004 to 2006 and the hitherto signed international conventions, will lead to actual improvement. Despite the significant strengthening of the legal framework, the complexity and fragmentation of the counter-corruption system partly explains the limited progress in reducing the level of corruption. It remains an open question whether the ratio of the ruling system is built on corruption. To some extent, the state oil fund is a positive exception as it pursues a relatively transparent policy based on the recommendations of the Extractive Industries Transparency Initiative (2003) and a Memorandum of Understanding between the government, oil and gas companies and some NGOs (November 2004).

3.4. Consensus-building

Government as well as opposition claim to strive for a market-based democracy. Fundamental opposition comes only from the growing, though not yet relevant Islamic opposition. The ruling circles give much more impetus to economic progress than to democratic reforms. The opposition's main criticism targets not the reforms but rather the lack of democracy and reform implementation as well as its slow speed, political patronage and corruption.

There are no relevant veto actors. However, elements within the power structure can thwart reform measures by boycotting them. The main problem is that, at large the government is only interested in reforms in a very limited number of fields.

The positions of the government and the opposition seem irreconcilable, but in principle, a wide range of coalition variants is possible. As most political parties are not based on specific social groups or a distinctive ideology, but are leader-oriented the political development depends very much on personal factors. The population, meanwhile, exhibits indifference towards government policy and internal opposition quarrels. Widespread social discontent has been articulated only selectively. As the state's institutional possibilities for a peaceful reaction on protest and for negotiating solutions are very limited, the government mainly reacts with police methods. It remains open whether the president himself will pursue a more reform-oriented policy after he replaced government cadres of Soviet background with younger technocrats.

The political leadership does nothing to promote social capital and is indifferent with respect to the role of civic engagement and solidarity. NGOs and other self-

organized groups often encounter difficulties in registration procedures and public activities. This is especially true when political or material interests of the ruling elite's clientelist networks are touched upon. In some fields like sports or non-political youth activities some governmental support does exist.

With minor exceptions, the political leadership frequently ignores civil society actors and formulates its policy autonomously. When outside and inside pressure from the Council of Europe and civil actors comes together as in the case of a public TV station the government tries to regain the initiative by occupying the topic and neutralizing possible independent actors. The same is true for some domestic election observer groups, which are founded by forces close to the leadership in order to neutralize independent or opposition monitor groups. There are some slightly positive exceptions as with the state oil fund or the building of the Baku-Ceyhan pipeline. This is mostly the result of combined pressure of powerful foreign actors and societal pressure.

Confronting and dealing with injustices committed during the Soviet and late Soviet era has largely been put to rest, and is equally unpopular among the elite and the population. Cases of torture and the like during the rule of the present regime are not addressed at all. Only one and a half years after the crackdown against the opposition following their violent protests against the manipulated presidential elections of 2003 little signs of reconciliation come from both sides.

3.5. International cooperation

For government and opposition alike, international cooperation with international institutions and organizations, namely the IMF, World Bank, EBRD, Council of Europe, EU, NATO, ECO, Black Sea Economic Cooperation (BSEC) enjoys top priority in all areas (government policies, legal reforms, economic reforms, financial cooperation, infrastructure measures, health and education sectors). International cooperation on multiple levels is indispensable to Azerbaijan's development.

In practice, massive problems continue to resurface owing to an inherent Soviet mentality, paternalistic ways of thinking, corruption, institutional weakness, incompetence and inefficiency. Several problems however, especially during the initial years of cooperation arose due to lack of competence on the part of Western and international partners with respect to country, culture and unspecific programs. Because of the regime's authoritarian character, external advice does not facilitate significant policy learning in many cases, especially in the field of democratic reforms.

The current government is largely a reliable partner in the international arena. Problems emerge with the acceptance of international law when direct material interests of government circles are concerned as was the case in an economic

conflict with Turkey in 2004, which even led to the confiscation of Azerbaijan

Airlines planes in Turkey. In the Council of Europe, Azerbaijan was warned several times because of not fulfilling membership obligations concerning democratic reform.

Regional cooperation is very limited due to the tensions with Armenia, the relatively conflict-laden relationship with Iran, the isolationist policy of Turkmenistan and the economic weakness of the bordering Russian constituent Republic of Daghestan. Despite minor political and economic conflicts Georgia and Turkey remain the main regional partners and relations with Iran have great potential.

Owing to its geographical location, Azerbaijan possesses great transit potential in the Transport Corridor Europe Caucasus Asia or TRACECA, the realization of which requires substantial investment and a solution to the regional territorial conflicts. The opening of the Baku-Ceyhan pipeline in May 2005 is expected to give rise to significant progress in regional development and cooperation. The pipeline is intended to transport Azerbaijani and possibly Kazakhstani oil and natural gas via Georgia and Turkey to the world market.

4. Trend of development

4.1. Democratic development

By 1999, new legislation had replaced Soviet law in almost all areas (penal code, code of civil law, family law, administrative law, labor and employment law, taxation law etc.), which marked a decisive step in the transformation of the legal system. Additional progress in the transition process came about as a result of admission to the Council of Europe in January 2001, as this implied adaptations to European standards at least on a normative level.

During the period of review, Azerbaijan became party to a great number of international treaties and conventions, which improved the situation especially in the field of law. Legal practice exhibits little progress, however, and public administration remains highly inefficient. Stateness, political participation and rule of law stayed at partly low levels. In spite of the aforementioned negative factors, Azerbaijan has made significant progress in the transformation of its political regime since the gaining of independence. The judicial system, the development or rather the reform of government bodies, and judicial and political practices, however, show significant deficiencies, which in some parts have intensified rather than diminished.

The degree of consolidation of this rather rudimentary democratic system has not

changed a lot. Corruption remains omnipresent, and established legal measures to fight corruption are only rarely applied. The engagement of political parties to political and social integration is negligible and in fact declining, especially after the manipulated presidential elections of 2003.

The development of civic organizations progresses sluggishly due to weak civic participation and is largely dependent on foreign subsidies. Labor unions do not have the resources to carry out their activities effectively and do not participate in determining wage levels. Conventional civic participation of citizens declined during the assessment period. A number of indicators suggest a regressive development affecting democratic stability. Currently this development does not pose any serious threats to the system, mainly because of the positive macroeconomic development and the slowly growing oil income. The political system can best be characterized as authoritarian with individual democratic elements.

4.2. Market economy development

During the period under investigation, the fundamental indicators measuring development remained stagnant for most areas. GDP reflects a partial improvement to the low starting level of development, notwithstanding the parallel increase of income disparities. The considerable rise of the HDI since 1997 is only of partial significance, as the purported steady increase in life expectancy accounts for a considerable part of this rating (1995-2003: from 69 to 73.3 years).

The institutional and legal conditions for market-based activity exist in principle. This is due to the merger of five former government ministries into a single entity, namely the Ministry Economic Development, as well as to the fundamental legal reforms of 2000 and subsequent reforms. However, there are problems of implementation. A further impetus to the continued expansion of the framework of commercial law lies in the preparation of a formal request to join the WTO. Reform dynamics are high in spite of formidable deficiencies in implementation. With the admission of Azerbaijan to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) in 2000, the legal security surrounding commercial activities of foreign corporations has improved, at least in theory.

Based on macroeconomic data, the economic development as a whole is indeed positive and will most probably improve even further. This holds true for the stabilization of the national budget as well. In view of the deterioration affecting all fundamentals at the onset of the nineties, and the low base level, the percentage data are nonetheless misleading with regard to the actual level of development. 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. It is problematic that growth in other economic sectors like construction is largely based on the oil sector and will decline after the completion of the main pipelines and infrastructural projects related to it.

Table: Development of macroeconomic fundamentals (2000-2004)

	2000	2001	2002	2003	2004
Growth of GDP in % (fig. from EU Commission)	10.3	9.6	9.7	10.8	10.2
Export growth in %			16.7	-4.4	
Import growth in %			48.4	43.5	
Inflation in % (CPI)	1.8	1.5	3.3 (EU)	2.2	6.7
Investment in % of GDP	23.1	22.9	34.1	50.8	40
Tax Revenue in % of GDP	15.1	14.7	15.4	17.5	16.0 ¹ (IMF)
Unemployment in %	-	Ca. 20	-	10.7 (ILO)	-
Budget deficit in % of GDP	-0.6	-0.4	-0.5	-1.2	-2
Current account balance in million USD	-124	-73	-769	-2,021	-1,266 ¹

Sources: If not stated otherwise, figures are taken from: IMF 2004; Commission of the European Communities, "Commission Staff Working Paper. Annex to: "European Neighbourhood Policy" Country Report Azerbaijan, Brussels 2005; UNDP Azerbaijan, *Azerbaijan National Human Development Report 2003*. ¹ first half of 2004

D. Strategic perspective

Without a regime change and without a peaceful and lasting solution to the Karabakh conflict, there can be no decisive transformational progress. Due to the country's patronage-based power structures, there is a concrete emerging risk of a partially rent-seeking system based on oil income. This peril can only be contained with unambiguous progress in democratization and the creation of a de facto rule of law. In this context, the parliamentary elections of November 2005 bear great importance. However, the lack of capable politicians, administrators and legal professionals is cause for concern.

The central challenges for Azerbaijan are the development of the petroleum and natural gas sector and the utilization of revenues for a sustainable development of the country on the one hand, and balanced economic growth through the development of the non-oil sector on the other. To achieve these goals, the acquisition of foreign capital is vital as is require sustained improvement in the investment climate. The reform and expansion of several areas of the infrastructure (energy, water, transport) 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 indispensable. The offer made by the European Union on June 14, 2004 to develop and deepen its links with Azerbaijan on the basis of the

European Neighborhood Policy (ENP) may be a valuable opportunity for Azerbaijan to enhance its political and economic development. The windfall gains from the export of oil and gas are relatively short-lived as oil reserves are projected to begin declining in 2010 and be exhausted by 2025. As such, a sustainable economic strategy will be of great importance with the state oil fund holding a central position for the country's future. If the political elite of Azerbaijan succeed in overcoming these challenges, the country will have immense development potential.