

BTI 2010 | Azerbaijan Country Report

Status Index	1-10	4.85	# 84 of 128	
Democracy	1-10	3.92	# 101 of 128	➔
Market Economy	1-10	5.79	# 61 of 128	↗
Management Index	1-10	4.07	# 94 of 128	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Transformation Index (BTI) 2010. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 128 transformation and developing countries are evaluated.

The BTI is a joint project of the Bertelsmann Stiftung and the Center for Applied Policy Research (C•A•P) at Munich University.

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Please cite as follows: Bertelsmann Stiftung, *BTI 2010 – Azerbaijan Country Report*. Gütersloh: Bertelsmann Stiftung, 2009.

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Key Indicators

Population	mn.	8.6	HDI	0.79	GDP p.c.	\$	7831
Pop. growth	% p.a.	1.1	HDI rank of 182	86	Gini Index		36.5
Life expectancy	years	67	UN Education Index	0.88	Poverty ²	%	<2
Urban population	%	51.8	Gender equality ¹	0.43	Aid per capita	\$	26.3

Sources: UNDP, Human Development Report 2009 | The World Bank, World Development Indicators 2009.

Footnotes: (1) Gender Empowerment Measure (GEM). (2) Percentage of population living on less than \$2 a day.

Executive Summary

Azerbaijan's development in the past two years can be characterized by three main elements: rapid economic development; the strengthening of the constitutional power of the president; and the transformation of Azerbaijan into a regional power.

The country has continued to reap the benefits of oil and gas projects agreed to a decade ago, and with skyrocketing revenues from the export of energy products, GDP has been increasing at an annual rate of 25% to 30%. This has allowed for massive investments in infrastructure projects, such as the construction of some 1,500 new public schools, more than a dozen new hospitals and diagnostic centers, thousands of miles of highways and other public infrastructure needs. At the same time, the government's attempt to diversify the economy by investing in the IT, tourism and agriculture sectors has proceeded apace.

Azerbaijan's growing economy also made possible the realization of large-scale regional projects, such as the construction of the Baku-Akhalkalaki-Kars railway project, funded in part by the State Oil Fund of Azerbaijan, and a new port in Baku for handling goods from Central Asia. Such investments have established the foundation for new prospective projects to handle the transit of energy from Central Asia to Europe, such as the Nabucco pipeline. All of these projects have turned Azerbaijan into a locomotive of regional economic development. The government's vision is to transform Azerbaijan into a hub for regional transportation networks. This vision was nevertheless challenged by the growth of Russian influence and decrease of Western influence in the region, culminating with the invasion of Georgia in 2008.

At the same time, the political landscape of the country has become less competitive. With a stronger economy, President Ilham Aliyev has become even more popular and more confident in his power. This state of affairs has significantly diminished the strength of the government opposition, has decreased political competition in the country and has opened a way for Aliyev to abolish presidential term limits. That said, within the highly heterogeneous governing elite, economic growth has allowed entrenched power interests to consolidate further, restricting the president's practical policy options.

History and Characteristics of Transformation

The real foundation for Azerbaijan's economic development and the transformation of its political system was established in 1993, when late President Heydar Aliyev came to power. Between 1991 (when Azerbaijan became an independent country after the collapse of the Soviet Union) and 1993, though a time of political freedom, the country was mired in civil war, faced huge economic challenges and was ruled ineffectively and suffered frequent political coups, all while conducting a bloody war with neighboring Armenia.

The collapse of the Soviet Union broke up trade and economic ties among the former Soviet republics. As a result, Azerbaijan as well as other newly independent states suffered massive unemployment, high inflation, a shortage of goods and a rapidly decreasing GDP. The country was on the brink of collapse. The rule of Ayaz Mutalibov, a former Communist party leader and the first president of independent Azerbaijan, lasted only several months into the country's independence. Heavy military losses in the war with Armenia led to internal chaos and Mutalibov's subsequent overthrow by the Azerbaijani Popular Front party. The party leader, Soviet-era dissident Abulfaz Elchibey, was elected as president, but Elchibey himself lasted no more than a year before being overthrown by Russian-supported insurgent leader Colonel Suret Huseynov.

Huseynov's rise to power was eventually eclipsed by long-standing Communist-era leader and former Soviet Politburo member Heydar Aliyev, whom Elchibey amid the turmoil invited to the capital Baku to help govern the country. Aliyev managed to end the civil war by reaching an agreement with Huseynov and appointing him prime minister. After that, Aliyev signed a cease-fire with Armenia (by this time Armenia occupied 17% of Azerbaijani territory, with close to a million refugees and internally displaced persons in the country), suppressed several new rebellions in the army and in ethnic separatist regions in the north and south of the country and brought loyalists into key government positions. Aliyev then began to consolidate power, creating a strong presidential republic, establishing stability and laying the foundations for economic development and prosperity.

In 1994, Aliyev signed a contract with major Western oil companies for the exploration of oil and gas fields in the Azerbaijani sector of the Caspian Sea. This was a major victory for Azerbaijani diplomacy, as the contract started the flow of Western investment into the country. This happened despite enormous pressure from Russia and Iran, countries which openly objected to the deal. The first oil from the Caspian Sea to Western markets started flowing in 1997. In 1999 and 2003, Azerbaijan scored two other major geopolitical victories with the construction of the Baku-Supsa (Georgia) and Baku-Tbilisi-Ceyhan pipelines, projects which have linked Azerbaijan both politically and economically to the European Union. Such foreign policy direction was nearly unanimously supported by the population.

Aliyev pursued a balanced foreign policy that aimed to consolidate Azerbaijan's independence, a goal which required integration with Western structures. Aliyev nevertheless sought to normalize relations with all regional powers, such as Russia and Iran. At the same time, he cultivated an alliance with Turkey and built relations with the United States, NATO, the European Union and the Council of Europe, resulting in Azerbaijan's membership in Council of Europe in 2001 and the country joining the U.S.-led coalition against terrorism after 9/11.

Aliyev's iron rule slowly but steadily weakened opposition parties in the country and made possible the transfer of power to his son, Ilham, in 2003. Ilham Aliyev has ruled the country in a similar style, allowing little room for political opposition. At the same time, Aliyev has further liberalized the economy and has continued a balanced and careful foreign policy course.

Transformation Status

I. Democracy

1 | Stateness

Azerbaijan has made significant progress in the state-building process. Although most power is concentrated in the hands of the president and the executive branch, other government branches are clearly defined and function well, though a separation of powers needs to be implemented in practice. The government effectively reversed the near-collapse of the state in the early years of its independence and unified the different regions of the country under centralized control. Thus, the establishment of the state's internal as well as external sovereignty is no longer a question, with the stark exception of the unresolved Nagorno-Karabakh conflict. The fact remains that Azerbaijan does not control approximately 17% of its territory, which remains under Armenian occupation.

Monopoly on the use of force

With the exception of Armenian-occupied territories, the state enjoys full monopoly over the use of force. A clear example of state's effective functioning in recent years has been the state's fight against the negative impact of the global financial and economic crisis; the ability to suppress radical or terrorist groups such as the Forest Brothers in the north; and Azerbaijan's foreign policy achievements, specifically its emergence as the only truly independent state in the region. Azerbaijan, unlike both its neighbors, is not dependent on any foreign power, a key element of statehood. The main challenge to its state-building efforts is the government's apparent failure to prevent corruption from growing as the inflow of hard currency accelerates.

All attempts by radical religious groups, paramilitary groups or terrorist organizations to use force against the state have been repressed. Likewise, post-election disturbances involving the limited use of force by the political opposition have also been repressed.

Nevertheless, it should be noted that most of the country's borders still need to be defined and demarcated in agreement with neighboring states. Unclear international borders, especially in mountainous areas, pose a threat to Azerbaijan's national security and enable the flow of radical terrorist groups into the country. In the past

two years, such cases have become more frequent, especially from the North Caucasus. Rumors reported in the local media claim that powerful oligarchs within the ruling elite maintain small paramilitary groups, consisting mostly of sportsmen; likewise, some leaders in law enforcement such as the interior minister may enjoy the personal loyalty of some of their forces. There has not been a single instance when these paramilitary groups have posed a challenge to the central authority. The government appears fully aware of the strength and capacity of these groups, but has decided not to fight them to preserve the political stability in the country. Often, these groups have helped the government in the fight against opposition parties. Thus, it is doubtful that these paramilitary groups will pose a significant threat to the state's monopoly on the use of force, because they are closely intertwined with official law enforcement bodies.

The concept of a national Azerbaijani identity has been in the process of formation since independence. There are constant debates in the local media on whether a unified Azerbaijani identity would be able to attract and represent all civic and ethnic groups in the country.

State identity

Azerbaijan is a multiethnic and multi-religious country, and its national identity, based on citizenship, is open and inclusive. The central government tries to incorporate all existing minorities under the general concept of citizenship, and minority representatives are integrated into governing structures. The cultural and social rights of ethnic minorities are also protected, in an attempt to prevent separatist sentiments. Refugees and IDPs are also well integrated into society.

The Azerbaijani nation-state is hence fundamentally accepted by the population of the territories under state control. The exception is the vehemently secessionist Armenian population of Nagorno-Karabakh, which constitutes approximately 1% of the country's population, but remains the country's most significant problem, as the region's residents refuse to accept Azerbaijani citizenship and the rule of law under the Azerbaijani constitution. Ironically, Armenians living in Baku (some 30,000 people) are well integrated and there have been almost no reports about social discrimination against them.

Azerbaijan is a secular state, yet the state and religious officials coexist in a carefully orchestrated balance. The official clergy does not interfere with the affairs of the state. It is forbidden by law to involve religion in political matters, such as in election campaigns or in the work of state bodies. Nevertheless, the Azerbaijani state officially celebrates several religious holidays. There is a state committee on the affairs of religious organizations. The president often attends religious events, both for Muslim and other religious groups. New churches and synagogues were built in 2007 – 2008 to accommodate the needs of the religious minorities.

No interference of religious dogmas

Religious radicalism has been on the rise in the past several years, particularly because of a weak and corrupt official clergy. Prominent maverick imams, who act independently from the official Spiritual Board, have emerged. Religious rallies and protests in the streets of Baku have been also on the rise.

Azerbaijan's state administration is well-developed and is established in all of the country's territories (with the exception of the occupied territories). In the regions, the executive offices clearly and orderly execute instructions from the center. Law and order is maintained by a considerable police force. Attempts on the violent overthrow of the government are minimized. However, the administration's ability to govern has been limited by financial constraints, a problem that is gradually disappearing with the country's growing wealth.

Basic
administration

2 | Political Participation

International and local observers have characterized past elections as fraudulent. The executive branch has controlled the media and has manipulated the voting process to ensure the victory of its own candidate or candidates. Opposition parties were often repressed. Yet, the latest presidential election in October 2008 was judged as a step forward, the process offering citizens a normal, civil and quiet environment to vote. The OSCE, the Parliamentary Assembly of the Council of Europe (PACE) and the European Parliament in a joint statement characterized the election as having "marked considerable progress, but did not meet all of the country's international commitments." The statement further described the election as "conducted in a peaceful manner." Still, public trust in the election process remains very low, despite technical improvements.

Free and fair
elections

At the national level, the president exercises control over the governance of the country. Yet his power is limited by entrenched interests in the state elite, often holdovers from the Communist period that constitute an impediment to reforms. The president would likely be able to override or remove any single one of these actors, but refrains from doing so because of the destabilizing effect it would have on the balance between the country's elite groups, a situation which effectively provides these groups with de facto veto powers. The understanding of this problem is limited by the opaqueness of these networks.

Effective power to
govern

As for parliament and local municipalities, despite being nominally elected by the people, these entities remain passive participants in the governance process. Most are afraid to challenge the executive branch and prefer not to exercise their legislative power. Others blame the constitutional shortcomings in the divisions of power between the branches of government. There is little opposition in parliament to the ruling party.

Opposition parties and associations critical of the government exist and operate, have the means to communicate their message and run media that offer vociferous

Association /
assembly rights

criticism of the government. Yet these groups face systemic constraints on their ability to be relevant players and effectively challenge the authorities.

Azerbaijan has recently made some progress in terms of providing NGOs and initiative groups with freedom of activity for their organizations. The registration process of NGOs has become much easier in past years, and today there are some 1,500 NGOs in the country. In 2008, for the first time, the state has started providing grants to them.

At the same time, freedom of assembly has been limited since the violent demonstrations in 2003 that were subsequently repressed by the government. Police prevented attempts to hold demonstrations in 2007 and 2008. Critics of the government and opposition parties are regularly harassed. Trade unions remain very weak and are not in a position to challenge the authorities or to effectively organize members. The authorities tightly control any gatherings of people in regions outside of Baku.

Generally media freedoms vary, as print media and Internet publications are completely free from censorship while television and to some extent radio remains under state control. Recently media freedoms have become even more of a troublesome issue, following the closure of foreign-language radio stations such as the Voice of America (2008), the closure of the popular Web site Day.az (2009), the arrest of several journalists (2007) and the closing of the only TV station that operated on a somewhat independent basis.

Freedom of
expression

Opposition parties and critics of the government have little access to address the general public, with the exception of during the election campaign period.

3 | Rule of Law

Power within the government administration is distributed vertically, leaving little independence in the operations of local municipalities and executive offices in addition to a weakened parliament, judiciary branch and bureaucracy. Most strategic decisions are made at the level of the president's office. Reforms are underway to improve the efficiency of the judiciary and legislative systems, such as: establishing test-based elections of new judges (starting in 2006); establishing a training program for judges; establishing training programs funded by the European Union and the United States for members of parliament; providing a legislative assistant for each member of parliament; and providing funds for members of parliament to open district offices as well as the means to travel to their representative districts on a regular basis. While modest, these are signs of gradual progress in the country's democratic culture. Thus gradually the parliament is developing a culture of debate and gaining legislative experience.

Separation of
powers

The judiciary is highly corrupt, inefficient and under the control of the executive powers. Yet, in the past two years, judiciary reforms have begun and the first exams for judges were held. Some 50 judges were selected, trained and appointed to new positions.

Independent judiciary

Office holders are rarely prosecuted for corruption or for other abuses, although prosecutions do occur, as was with the case of the head of the anti-monopoly committee in 2008. Government officials have de facto immunity from prosecution. The law is often ignored when it comes to the actions of powerful ministers and their affiliates.

Prosecution of office abuse

The government tries, in principle, to uphold general principles of law and order in the country and has taken some measures to ensure that the police too obey the rule of law. However, the country is faced with an official culture that does not respect the rights of citizens. Police forces, security forces and the army often violate citizens' civil rights and are very rarely brought to justice for such offenses, resulting in a culture of impunity. The limitations on civil society organizations and an independent media, the lack of an independent judiciary as well as widespread corruption remain the main problems in the improvement of civil rights in the country. Another problem is the individual citizen's limited awareness of his own rights.

Civil rights

4 | Stability of Democratic Institutions

Democratic institutions, such as political parties, media groups, civic groups and initiative groups, exist but are weak and practically unable to influence decision-making. Often, political decisions are adopted and implemented in a rushed manner, without proper consultations with either the public or corresponding democratic institutions.

Performance of democratic institutions

Most officials accept the workings of democratic institutions in theory, as a long-term goal for the country. However, the government employs methods to reduce their efficacy and to manage the political climate. At the same time government opposition often finds it convenient to boycott elections and the work of parliament, as was the case in 2005 and 2008, when it instead called for civil disobedience. While the opposition boycott may be understood in the context of a difficult political climate, such actions don't necessarily help promote democracy in the long term, as the opposition's boycott only hurts its own standing with the public and deprives the public of an alternative voice in the political process. The boycott of the election in 2008 also prevented opposition parties from having access to public television stations. Azerbaijan is a country where the democratic political culture has not yet matured.

Commitment to democratic institutions

5 | Political and Social Integration

There are more than 40 political parties in the country. Most of them are small and insignificant. The ruling YAP (New Azerbaijan) party is the largest and strongest, claiming to have close to 350,000 members. The opposition claims four to five major parties, each having some 25,000 members. Azerbaijan's major political parties are fairly stable; opposition parties can trace their beginnings back to the Popular Front era of the early 1990s.

Party system

Yet the general situation of political parties is very weak. Parties have been chaired by the same leaders for more than 15 years and experience little internal development. Parties are afraid to challenge the authority of the president but at the same time do little to improve their own internal structures. In 2008, the government proposed to start funding opposition parties from the state budget.

Interest groups have been on the rise in Azerbaijan, both in the form of NGOs and initiative groups. They are using the Internet to communicate and spread their message. In 2007-2008, alumni from Western University organized several such groups which have been powerful enough to draw the government's attention. Overall, however, the population outside of the capital Baku remains passive in the process of establishing interest groups.

Interest groups

Generally, consent to democratic norms is high and accepted by the population. However, the idea to hold a referendum in 2009 and abolish term limits for the presidency was regarded by the opposition as a setback in democratic norms as well as an attempt by the ruling party to establish a quasi-monarchy in Azerbaijan.

Consent to democratic norms

Some radical religious groups also disrespect democratic norms and would prefer to establish Shari'ah law. Some surveys show that the number of people following such religious ideas is rising.

In the capital city of Baku, a network of associations, civic activists and NGOs is very well-developed. They organize various activities and inform the population about political developments and social problems. The quality of these associations remains weak, however, and outside Baku, such activities are few.

Associational activities

In most instances, social capital exists in the specific characteristics of Azerbaijani culture, found in the relations between closely knit families, strong local communities (mahallas) and centuries-long traditions at the local level that offer help to friends and relatives.

II. Market Economy

6 | Level of Socioeconomic Development

Azerbaijan's economy has been developing at the fastest rate in the world in the past few years, with a rate of GDP growth of 26% in 2006 and 35% in 2007. This rate fell to 11% in 2008 from the effects of the global financial crisis, but has remained in the double digits. Currently the country's GDP is \$33 billion. The government has succeeded in reducing poverty in past years, and has cultivated the conditions needed for all segments of the population to acquire a stable income and improve their social welfare. According to government statistics, the official poverty rate was reduced from 49% to 13% between 2004 and 2008. Income has been slowly rising and unemployment has fallen somewhat as the government has created jobs. However, the extent to which this reduction is sustainable is doubtful, as Azerbaijan struggles with conditions similar to the so-called Dutch disease. No official barriers exist for people to engage in business activity. Business registration was simplified to allow for more entrepreneurial activity, although informal problems with corruption and red tape remain significant.

Socioeconomic
barriers

At the same time, strong monopolies which are tied to the government prevent business from flourishing in the country. Most IDPs and refugees still struggle with poverty. Perhaps most importantly, inequalities in society have grown rapidly as economic growth is unevenly distributed. In 2008 Azerbaijan ranked 98th in the UNDP Human Development Index.

Economic indicators		2004	2005	2006	2007
GDP	\$ mn.	8680.4	13245.4	20982.2	33050
Growth of GDP	%	10.2	26.4	34.5	25.0
Inflation (CPI)	%	6.8	11.6	8.3	16.7
Unemployment	%	-	-	6.8	6.5

		2004	2005	2006	2007
Foreign direct investment	% of GDP	41.0	12.7	-2.8	-14.4
Export growth	%	11.7	48.9	40.9	43.3
Import growth	%	23.8	10.9	14.3	14.0
Current account balance	\$ mn.	-2589.2	167.3	3707.6	9018.9
Public debt	\$ mn.	1372.2	1278.0	1446.3	1748.4
External debt	\$ mn.	1948.8	1814.9	1986.4	3021.4
Total debt service	% of GNI	2.9	2.0	1.3	0.6
Cash surplus or deficit	% of GDP	-	-	-	-
Tax Revenue	% of GDP	-	-	-	-
Government consumption	% of GDP	11.4	10.4	10.8	10.4
Public expnd. on edu.	% of GDP	-	2.3	2.0	2.6
Public expnd. on health	% of GDP	0.9	1.0	1.1	-
R&D expenditure	% of GDP	0.3	0.2	0.2	0.2
Military expenditure	% of GDP	2.6	2.3	3.4	2.9

Sources: The World Bank, World Development Indicators 2009 | UNESCO Institute for Statistics | International Labour Organization, Key Indicators of the Labour Market Database | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security.

7 | Organization of the Market and Competition

Azerbaijan is still in transition from a command economy to a full-fledged market economy. Monopolies, price setting, state subsidies and corruption still plague the domestic economy. While there are clear legislative and procedural norms and laws regulating market competitiveness, often these rules and laws are ignored.

Market-based competition

Azerbaijan's economy is heavily based on profits from oil and gas, and only initial steps have been made to generate income from other industries, such as textiles, agriculture or heavy industry. Almost half of the state budget (\$12 billion in 2008) is subsidized from the State Oil Fund (SOFAZ).

At the lower levels of the economy (small enterprises, factories and retail), the market economy is fully established and developed. At higher levels, such as large factories, wholesale trade, construction, energy and mining industries, monopolies still exist and prevent the development of market-based competition. State orders

Anti-monopoly policy

are also often made based on personal relations and not through competition. Monopolies are tied to certain ministers and state officials and these groups set the price of goods in the country. Thus, price setting is often artificial and not reflective of market rules.

In 2007 and 2008, the government tried to establish farmers' markets in Baku. Yet, monopolies have not been weakened significantly by this. There is a state anti-monopoly committee with very little power and almost no effective control over domestic monopolies.

Parliament has passed laws that deal with the protection of foreign investments, but foreign trade is influenced by local monopolies, which set strict barriers on custom duties and prevent the free flow of goods from other countries into Azerbaijan and vice versa. Nevertheless, Azerbaijan's trade has grown, and the country trades with more than 136 countries, the biggest of which are Russia, Italy, Turkey and Iran. In 2007, a memorandum on energy cooperation was signed between the European Union and Azerbaijan, and in 2008-2009, it was agreed that Azerbaijan will start selling gas to EU member states, such as Greece and Bulgaria.

Liberalization of
foreign trade

Azerbaijan has been lately pushing for membership in the WTO, and in 2007 President Aliyev signed a decree to establish a state commission aimed to speed integration. Azerbaijan currently has observer status within the WTO, but membership negotiations are now in the final stage.

The country's banking system in the country is developing rapidly. More than 20 banks are in operation and most of them meet international standards. Banks with foreign capital comprise a minimal share of the market. Some Azerbaijani banks are partially owned by foreign banks. In 2007-2008, Azerbaijani banks significantly expanded network branches in rural areas.

Banking system

Nevertheless, the Azerbaijani banking system is also dominated by large, state-owned banks, which control the lion's share of the market. Other issues include non-transparent loan issuing mechanisms and the interference of political actors in decision-making.

8 | Currency and Price Stability

The government in past years has been increasing the state budget and government expenditures, and as a result inflation has risen from low single digits in 2005 to almost 25% in 2007. Many experts express serious concerns about the state of the economy.

Anti-inflation /
forex policy

The government has also been concerned about rising inflation, as it affects the income of ordinary citizens and creates social tension. One way in which the

government sought to limit inflation was to spend the country's oil revenues abroad. In 2007-2008 the government started purchasing industrial assets in other countries, such as in Georgia, Turkey, Romania and Russia.

Maintaining macroeconomic stability has been a primary goal for the government. The global economic and financial crisis of 2008 has yet to affect Azerbaijan significantly. This is because the government has been subsidizing the state budget and artificially maintaining the strong value of the local currency to avoid macroeconomic instability. GDP growth is a source of pride for the Azerbaijani government, as officials often refer to such statistics to show that the government has been doing an effective job in running the country. In 2009, a group of 26 civil society leaders appealed to the president to stop using economic indicators when talking about the country's development, and also to do something for the democratic development of the country.

Macrostability

9 | Private Property

Property rights are well-defined and regulated by national legislation. However, in practice, property rights are occasionally violated. Sometimes these cases are political, such as the case of the Azpetrol Oil Company, which was confiscated from a former economy minister who was under arrest, or the Day.az Web site, which was forced to be sold as a result of informal media censorship. Property rights are also occasionally violated as a result of large oligarchic interests and competition between members of the political elite. Many gaps remain in legislation in terms of registering property.

Property rights

Privatization has been an ongoing process since 1995. Efforts have covered the privatization of land and small enterprises and to a large extent, large industrial assets. Private companies are regarded as important for the market economy, but are often harassed by tax officials.

Private enterprise

To improve the situation the government in 2008 adopted a "one window" registration system for businesses. This has affected the overall business climate in the country positively, and the 2008 World Bank Doing Business Report recognized Azerbaijan as the "most reformed country in the world."

10 | Welfare Regime

Provisions for pensions, illness compensation, disability, unemployment and maternity leave exist in national legislation and the rights for which are generally respected. Pensions and illness compensation, however, are low and create significant difficulties for senior citizens or for families without a primary wage earner. The insurance system is still under development and is not widely used.

Social safety nets

Priorities for the government include the improvement of health care, the eradication of poverty and the repair of orphanages and clinics. The minimum salary in Azerbaijan has been increasing and is currently \$90 per month. It is the intention of the government to make the minimum salary equal to the level of the minimum living requirement as set by the regime.

No official barriers or legal obstacles exist in Azerbaijani law for employment or other activities. Sometimes, however, representatives of ethnic minorities are declined jobs on the basis of poor knowledge of the Azerbaijani language. Personal connections also matter in terms of acquiring a job. Women were disproportionately affected by the economic downturn in the 1990s, as was the case across the former Soviet Union. Women are now returning to the workforce, but social and cultural factors have slowed this process.

Equal opportunity

Soldiers and officers in cease-fire zones get paid higher salaries. In 2008, the government proposed that teachers who work in mountainous areas or rural and border zones should be paid more than their counterparts in large cities, to prevent talent from leaving the villages for better opportunity in the cities.

11 | Economic Performance

Azerbaijan's GDP is strong and growing at the fastest rate in the world. The economy however is heavily dependent on oil, which poses a challenge to the long-term sustainable development of the country. The global financial crisis has hit Azerbaijan's state budget, forcing the government to reduce the budget's expense side. At the moment, the budget stands at around \$12 billion, showing impressive growth from \$2 billion just five years ago. GDP will likely continue to rise because of the increasing production volumes in oil and particularly gas and as prices rebound, but macroeconomic stability will depend on such factors as inflation, non-oil economy growth and taxation policy. The government has done a good job curbing the super-high inflation of early 1990s to a minimum of 2% in 2004. In 2007-2008, however, a growing GDP led to high inflation rates of 20% to 25%. At the time of writing, inflation rates appear to have fallen again.

Output strength

In 2006, Azerbaijan's trade turnover was more than \$11.1 billion, with \$7.1 billion in exports and \$4 billion in imports. Azerbaijan trades with more than 136 countries, its biggest trading partners including Russia, Italy, Turkey and Iran.

According to official statistics, total investment in the country's economy in 2005 was equal to \$6.2 billion. Of this, \$4.4 billion was foreign investment, the major share of which was FDI. The energy sector received 98% of these investments. Total FDI in the post-Soviet period was above \$25 billion.

12 | Sustainability

The government is taking environmental problems seriously, and has been working on several projects. A state program on environmental cleanup over the next 10 years was adopted. A separate project has been established to preserve forests and national parks. Oil-polluted areas are being cleaned up. New water pipelines are under construction to supply clean drinking water to Baku. Yet many problems remain in terms of garbage collection, car pollution and the general environmental education of the population.

Environmental
policy

The government has been investing large sums of money into education over the past several years. In 2007-2008, more than 1,000 new public schools were built and many others were repaired. In 2007, the government adopted a state program to send 5,000 Azerbaijani youth abroad to study, and 200 students went abroad in the first year of the program. Support for the Forum of Azerbaijani Students in Europe (FASE) was also adopted by President Ilham Aliyev. New universities, such as the Azerbaijan Diplomatic Academy, the Azerbaijan Tourism Institute, the Baku branch of Moscow State University and others educational centers were opened. The installation of computers and the Internet in high schools started in 2007. Baku State University, the Azerbaijan University of Languages and the Azerbaijan State Economic University have opened new branches. New research centers, such as the Center for Strategic Studies under the President of the Republic of Azerbaijan, were opened alongside the already existing and independent institute of Strategic Studies of the Caucasus (ISSC).

Education policy /
R&D

Transformation Management

I. Level of Difficulty

Three important constraints limit politicians' governing ability. One, the country's economy is dependent on oil exports (the domestic budget, for example, has been hit by the global financial crisis). Two, the country's proximity to Russia and Iran makes Azerbaijan's foreign policy as well as its oil and gas projects constant targets of attack. And three, the country is experiencing an increasing level of activity of foreign terrorist and radical religious groups. So far, the government has been able to manage these problems. However, should the world economic crisis be prolonged or should Russian pressure on Azerbaijan for its pro-Western energy policy stance become untenable, as in the issue over the construction of the Nabucco gas pipeline, the Azerbaijani government could face a serious challenge.

Structural
constraints

Azerbaijan has very weak civil society traditions. Seventy years under Soviet rule, 200 years under Czarist rule and the historic legacy of Shahs and Khans have left a clear mark on Azerbaijani society. Citizens in general show a dependence on or a submission to authority, display weak political initiative and limited awareness of their own civil rights or responsibilities and an overall unwillingness to engage in community projects or to put private interests above communal ones. Many newly created NGOs and initiative groups often become hostage to internal mismanagement or the abuse of power by chairpersons. The concepts of local governance, exercising control over the executive branch of government and political initiative at a community level is only now entering Azerbaijani culture.

Civil society
traditions

Azerbaijan at the time of writing is a stable country, with the major exception the country's war with Armenia over Nagorno-Karabakh. Although a cease-fire was signed in 1994, no peace agreement has been reached following 15 years of negotiations. Azerbaijan and Armenia exchange fire across the cease-fire line on a regular basis, resulting in dozens of deaths per year. At times, the intensity of cease-fire violations has been high, as was the case in March 2008.

Conflict intensity

Aside from the Karabakh issue, Azerbaijani society is fairly peaceful. . The growing economy has reduced the risk of internal political instability. Political opponents of the regime have been weakened and social unrest has decreased. The police occasionally do clash with religious demonstrators, groups which have gained in relative power as the secular opposition has lost influence.

II. Management Performance

14 | Steering Capability

In terms of social and economic development, the government is focused on long-term goals. Strategic programs geared toward the development of tourism, the IT and educational sectors have been adopted. The government has also invested in the country's transport networks and in other projects to ensure the sustainable development of Azerbaijan after its oil boom period. The government's vision is to turn "black gold into human gold," making sure that the country's non-oil economy also develops. It must be noted, however, that this vision often clashes with the short-term interests of powerful oligarchs and monopolists who seek rapid, high revenue at the expense of the further economic development of the country.

Prioritization

In terms of democracy, the government has openly adopted a gradual and cautious strategy, emphasizing the need for political reforms to follow the country's economic development to avoid instability. Yet the government's commitment to this gradual political reform is questionable, as recent years have witnessed certain negative developments. While the 2008 elections were considered a step in the right direction, the referendum proposal of the same year to abolish presidential term limits appeared aimed at keeping President Ilham Aliyev in office. Although in the short term this might be good for the country's stability, in the long term this will weaken the republican foundations of the state. Likewise, issues of media freedom have not been improved.

The flood of oil and gas revenues into the country allows the government to implement its reforms rather successfully, especially in the fields of economic and social development. A new pension system was developed in 2007, with all pensioners receiving their monthly paychecks through the banking system and individualized accounts. The introduction of computers to the country's schools started in 2008. Business registration was simplified in 2008, and tax reporting was made available over the Internet. Many other reforms of this type are taking place. In a way, President Ilham Aliyev has made it fashionable for ministers to pursue new reforms and then to implement them, to show the president positive results.

Implementation

Yet when looking at the bigger picture, these reforms have had little impact on the nature of governance and on the structure of the economy. The government is still bureaucratic, and the economy remains oil-dependent. The major exception is the policy for the recruitment of cadres for government services, where genuine changes have been observed and clear and transparent procedures for job applications have been established.

The government is thus able to implement reforms effectively, which it has done in the economic sphere. In building democracy, however, the same reformist zeal is not yet evident.

Azerbaijan actively participates in international training activities and is willing to learn from the experience of international organizations. Often, international consultants share their know-how with participants in the capital Baku, and their experience is then implemented in the rest of the country. This is especially true in terms of technology development, construction, e-governance implementation and legislative reforms, as well as the training of doctors, teachers and economists.

Policy learning

President Ilham Aliyev has generally continued the course set by his father and has never admitted the mistakes made by the previous government. In practice, however, Aliyev has softened some of his father's policies, such as on business registration, and has allowed more private entrepreneurship as well as eased the registration of NGOs and civil society actors.

15 | Resource Efficiency

The question of how to use oil revenues appropriately has hung over the Azerbaijani government for years. Although some steps were made, such as establishing the State Oil Fund, keeping transparent income records on oil revenues (for which the State Oil Fund has received numerous international awards) and separating oil revenues from the state budget, the expenditure of oil revenues (once transferred from the Fund to the state budget) raises serious concerns among citizens and experts.

Efficient use of assets

The government has undertaken numerous projects for the betterment of the economic and social situation in the country. Massive investments have been to construct new roads, schools and hospitals as well as purchase new police cars and medical and agricultural equipment. Yet, little transparency exists in this process, and many believe that government officials artificially increase the budget of such projects, allowing room for the misappropriation of funds.

The government generally tries to coordinate the policies of different ministries. In practice, this is done either poorly or not at all. At times, various state ministries openly struggle with each other. Institutional and personal interests prevail over the interests of the state. Such fights are common between the Customs Committee and the Ministry of Economic Development; between the Water and Electricity Networks; and between the State Committee for Religious Affairs and the official clergy, represented by the Spiritual Administration of Muslims of the Caucasus.

Policy coordination

Poor coordination of policies leads to the wasteful use of oil revenues. For instance, roads are paid for and fixed by the Ministry of Transportation, but not long after the roads once again dug up by the Ministry for Water Resources for new pipes to be laid.

The power of cabinet ministers and oligarchs is too significant for the government to launch an effective anti-corruption campaign, even if it should desire to do so. At times, there are reports that certain mid-level officials or municipal heads have been arrested on grounds of corruption. Such events are often related to political issues, and the allegations of corruption are conveniently used to arrest the people in question. But on a larger scale, anti-corruption policies are ineffective. A law geared to help combat corruption was adopted in 2005 but brought few changes to the situation. The country's leadership does not seem highly motivated in its desire to combat corruption. As oil revenues have led to a rapid increase in the budgetary allocations to government ministries and agencies, the amount of money embezzled has grown rapidly in the outflow sector. However, on the resource inflow side, important steps have been made. Azerbaijan was a pilot country in the Extractive Industries Transparency Initiative (EITI), and was positively assessed by international partners. Azerbaijan was assessed as EITI compliant in February 2009.

Anti-corruption
policy

16 | Consensus-Building

Most significant political actors in Azerbaijan agree that a market economy and a democratic system are the only alternatives for the future of the country. In that respect, the ideology of most of the opposition parties is the same as the government. Practically no political party in Azerbaijan actively promotes the ideals of communism, totalitarianism, religious extremism or a command economy.

Consensus on goals

Yet, differences remain on how to get to this common goal. Major opposition parties believe that democracy should come first and that all foundations of the state should be based on transparency and an effective system of checks and balances. The government believes that stability, security and social order should be developed prior to democracy and that the democratization process should be gradual, cautious and based on the cultural progress of the people. Many in the opposition accuse the government of monopolizing power and using the "stability factor" as an excuse to turn the republic into a monarchy.

There are also radical religious groups who believe that democracy and a Western model of governance is unacceptable for the country, and that governance in Azerbaijan should be based on Shari'ah law.

There are no clear-cut divisions in Azerbaijan's political landscape regarding who is a reformer and who is anti-democratic. Generally, it is believed that the old guard, the support base of late President Heydar Aliyev, are more conservative and thus more inclined to support a tough position vis-à-vis the West and oppose the reform agenda. These entrenched "barons" are powerful and some can wield effective veto power over reforms. President Ilham Aliyev, however, is believed to be more moderate and more inclined to conduct reforms, especially concerning the

Anti-democratic
veto actors

economy. Indeed, President Aliyev keeps appointing growing numbers of younger, Western-educated technocrats to key positions. Yet generally reforms are conducted cautiously and even the so-called reformers must work in tandem with the old guard. A worrying element, however, is that the old guard is imparting of some of its behavior to members of the younger elite.

In parallel, the opposition is characterized by a similar cleavage between stagnant leaders who with little regard for democratic practices are keeping control over their party apparatuses, and younger leaders who pose a challenge to their hegemony and are willing to take over.

The political leadership as a high priority seeks to maintain stability and order. For this reason, measures are taken to prevent conflicts from erupting. This applies both to politically driven conflicts, such as during elections, between the opposition and the ruling party; as well as socially driven conflicts, such as between communities, which are deprived of utilities, social protection and income, and the police force. Thus, the government invests money in needed social projects to prevent social unrest, as did erupt in Nardaran village in 2002.

Cleavage /
conflict
management

The government also has acted to prevent the eruption of military action in the front in Nagorno-Karabakh. Negotiations have been conducted for 15 years to prevent the escalation of this conflict, and the government is exercising restraint when compared to the public mood on this issue.

Religious groups are closely watched and controlled so as to not give rise to social tensions. In 2008, a local journalist was arrested after he insulted the Prophet Muhammad, partly to ensure that religious groups did not try to kill the journalist or incite violence in the communities. Similar steps were taken in 2009, when a religious group threatened the prominent Azerbaijani poet Sabir Rustamkhanli.

At times, cabinet ministers and oligarchs have also been arrested or sent to ambassadorial positions abroad to prevent open conflict with other ministers.

Generally, pro-government civil society actors are invited to conferences, round tables and other events and their opinions are taken into consideration. The same applies to media outlets and initiative groups. But opposition forces, independent NGOs and youth groups are usually excluded from this process.

Civil society
participation

The government feels quite confident in its actions and has only limited interest in listening to independent reviews, reports and proposals from NGOs. At times, such reports are received defensively.

The ruling party still uses the media to accuse political parties that were part of the government in 1992-1993 for their mistakes and shortcomings. These actors, now in opposition, are portrayed as irresponsible, inexperienced politicians who brought

Reconciliation

instability and turmoil to the country. Exiled President Ayaz Mutalibov was accused of selling lands to Armenians; exiled parliament speaker Rasul Guliyev was accused of corruption. Little is done to seek reconciliation with previous leaders, although former President Abulfaz Elchibey was able to freely travel in the country some time after his resignation.

The same applies to Armenians, who are often used as scapegoats for most of the country's problems. Often, media outlets portray Armenians as enemies, instead of seeking to heal the wounds of the war and show commonalities between the two nations.

17 | International Cooperation

Generally, Azerbaijan welcomes international aid, both in the form of financial aid and as business or political know-how. But this was more so in the early years of independence, when much aid was needed for refugees and IDPs, as well as for general nation-building.

Effective use of support

Now that Azerbaijan has plenty of financial resources, international aid is often looked upon as a burden, as it comes with certain requirements, such as demands toward increased democratization or liberalization. In 2007, the European Union gave Azerbaijan €90 million to spend on political and economic reforms, but very little was used. The same situation applies to World Bank or IMF credits.

Generally, the international community trusts the Azerbaijani government. Unlike Russia or Kazakhstan, the Azerbaijani government has never sought to renegotiate oil contracts and has stayed true to contracts signed in 1994, despite the somewhat negative terms of the contract for the government.

Credibility

The investment climate of the country is generally safe. At the same time, investing in Azerbaijan is considered risky, because local oligarchs can put pressure on foreign and domestic investors who are not affiliated with the government.

Azerbaijan is a very active player both at the international and regional level. It participates in many international organizations, such as the United Nations, the OSCE and the Council of Europe and cooperates actively with NATO and the European Union and is even a co-founder of many regional organizations, such as the GUAM group (Georgia, Ukraine, Azerbaijan and Moldova), CIS, the Black Sea Economic Cooperation (BSEC) organization, the Eurasian Cooperation Organization and others.

Regional cooperation

Strategic Outlook

Azerbaijan is walking a tightrope. Its balancing act between Russia and Iran and the West, necessary for consolidating its independence, is fraught with numerous challenges which have worsened as the Western presence, which was a cornerstone in the country's foreign policy, has receded in the region. So far, the Azerbaijani political leadership has been handling this balance of power very carefully.

On the domestic front Azerbaijan faces the challenge of restarting a stalled political reform process, but there are strong forces lobbying against such a scenario. Viewing evidence of foreign support for oppositional movements that seek to alter the state structure in neighboring countries, the Azerbaijani governing elite is concerned that Iran or Russia could interfere in its domestic politics by proxy. This situation bolsters the existing, and often self-serving, opposition to reform held among the ruling classes. Yet the most challenging of all domestic issues is not the pressure from opposition parties, which can hardly threaten the ruling elite's position as long as government revenues remain high, but the pressure from powerful ministers, oligarchs and heads of influential informal "clans." President Ilham Aliyev's government faces challenges ranging from legitimate political opposition to foreign-supported subversive groups as well as elements of his own ruling elite – and these three categories intermix, pressing Aliyev to ensure the stability and loyalty of his power base. This in turn limits the political reform agenda, which has been set as a low priority by the lack of Western engagement in the region, which has traditionally been the main driving force of positive reform in the entire Black Sea region, ranging from Romania in the 1990s to Turkey and Georgia in the 2000s.

Over the next several years, Azerbaijan will be facing several, difficult choices. One is between democratizing, if even gradually, and joining the European family of nations, or drifting toward the consolidation of a Middle East-type, semi-authoritarian regime. Another is properly using the country's oil and gas revenues and diversifying the economy, or succumbing to the corrupt management of investment projects. A third is balancing between regional powers and building independence, or aligning the country with one or another of these powers. Finally, a fourth challenge is whether to resolve the conflict over Nagorno-Karabakh by military means or to continue to engage in peace talks.

At the moment, it is likely that Azerbaijan will continue the same cautious and sometimes indecisive path without making any drastic changes. Continued oil revenues will make it somewhat easier for the ruling party to maintain stability in the country and perpetuate the same governance style.

But after 2030, when oil revenues are likely to fall, the country will face a real challenge of governance. Whether current investments to diversify the economy will produce results will determine the country's future stability.

The government of Azerbaijan should keep these potential threats in mind and work on them continuously to prevent them. One area where risk reduction is failing is in work with religious youth. Government agencies feel inadequate in addressing the threat of religious radicalism, and rely increasingly on repressive methods to fight these groups. Engaging the radical youth, investing in education, allowing places of worship, reducing attacks on the religious and involving the media in religious education would be more appropriate.

At the same time, the Azerbaijani government needs to seriously tackle corruption. Otherwise, oil and gas revenues will continue to flow into the pockets of the oligarchs that coalesce into bastions of anti-reform, while little impact is felt by the local communities. President Aliyev needs to ensure that businesses are free from harassment and that the investment climate in the country is free from bribes, barring which the non-oil sector will never develop. The government should not look at businessmen as a potential threat; businesses will help to diversify the country's economy and ensure its sustainable development. Finally, serious effort is needed to start public diplomacy with Armenia and work to resolve the conflict by peaceful means; yet that will require the involvement of the international community at a level not seen so far.

For international actors, it will be crucial to understand that Azerbaijan has generally been responsive to engagement, and that the level of reform in the country is directly related to Western engagement in the country and its affairs. Hence Western policies will be important. Further finger-pointing and the isolation of Azerbaijan will only strengthen the regressive forces in the government, which seek to align Azerbaijan with the emerging Russian-led authoritarian block ranging from Belarus to Kyrgyzstan; and conversely undermine the progressive forces that exist in Azerbaijan's society and government institutions. On the other hand, patient but principled engagement that seeks to include Azerbaijan in international mechanisms to gradually change its political system will in the longer term lead to a more responsive reform agenda, especially if this engagement is multifaceted, involving issues of interest to the Azerbaijani government such as security and economic relations while maintaining an important focus on governance issues and political reform.