

BTI 2012 | Azerbaijan Country Report

Status Index	1-10	4.85	# 84 of 128	
Political Transformation	1-10	4.02	# 93 of 128	➔
Economic Transformation	1-10	5.68	# 63 of 128	➔
Management Index	1-10	4.02	# 96 of 128	

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

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2012. The BTI is a global assessment of transition processes in which the state of democracy and market economy as well as the quality of political management in 128 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	9.0	HDI	0.700	GDP p.c.	\$	9943
Pop. growth ¹	% p.a.	1.1	HDI rank of 187	91	Gini Index		33.7
Life expectancy	years	70	UN Education Index	0.671	Poverty ³	%	7.8
Urban population	%	52.2	Gender inequality ²	0.314	Aid per capita	\$	26.5

Sources: The World Bank, World Development Indicators 2011 | UNDP, Human Development Report 2011. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

The past two years in Azerbaijan have been dominated by efforts at crisis management, which the government has managed rather successfully. First, the global financial crisis undermined the country's economy significantly enough that annual GDP growth, which had been in the double digits for several years, fell to between 3% and 4% in 2009. Banks stopped issuing loans, the construction sector froze and massive layoffs resulted. The government was forced to take urgent steps to revitalize the economy. Several banks were bailed out; the government budget began drawing even larger subsidies from the State Oil Fund, with the increases spent primarily for public projects and social welfare programs; and the national currency was kept artificially at a strong level. With time, this set of policies proved successful in preserving macroeconomic stability in the country.

Politically, not much has changed in Azerbaijan. A strong executive authority dominates the system, and informal power brokers remain more important than formal institutions, a fact that reduces the power of the president to control the domestic situation. Presidential term limits were abolished by referendum in 2009, ensuring that succession is unlikely to become an issue in 2013, as had previously been the case.

In terms of foreign policy, Azerbaijan continued to be affected by the lingering negative consequences of the 2008 Russian-Georgian conflict. This included first a more assertive Russian presence in the region, which affected negotiations on the transit of Azerbaijani gas. Secondly, the U.S.-supported efforts to normalize Turkish-Armenian relations and open the border between the two countries took precedence over negotiations to resolve the Nagorno-Karabakh conflict. Thus, negotiations on this latter issue became increasingly deadlocked as urgency within the international arena waned, reducing pressure on Armenia. This led Azerbaijan to further increase its military budget (now at \$3 billion), to intensify rhetoric holding out the possibility of reconquering the occupied territories by force, and to take other potentially

provocative actions such as glorifying the actions of soldier Mubariz Ibrahimov, who violated the cease-fire agreement and killed several Armenian soldiers.

Finally, the revolutions in the Middle East shook the government's confidence. A massive anti-corruption campaign was launched in January 2011, in which hundreds of mid-level and some senior officials were fired. Opposition newspapers predict the government will take further action to prevent a Middle East-style revolution in the country, potentially even calling new parliamentary elections or including opposition members in the government.

In sum, the government has sought with some success to prevent negative developments in and around the country from affecting its position of power or from undermining general stability in the country.

History and Characteristics of Transformation

Azerbaijan's independence from the Soviet Union occurred at a time of economic devastation and of war with neighboring Armenia, and was the result of a movement for national independence led by Soviet-era dissidents in the Popular Front. This group formed the country's first post-communist government in June 1992.

In contrast with the states of Central Europe or the Baltics, Azerbaijan had little history or tradition of independent statehood to fall back on. Its first taste of freedom in 1918 – 1920 does provide a point from which to pledge a symbolic continuity. But in real political terms, that period offered little in terms of insights, precedents or practical guidance on how to run a state. Neither did the much longer period of Soviet rule; yet unfortunately, this latter era left strong marks on Azerbaijan's political culture that linger to this day. Indeed, many if not most of the country's high officials remain products of the Soviet system. While Azerbaijan's tradition of 19th-century liberal intellectuals is unique in the Muslim world, the last half-century offers little in that vein from which to draw. Thus, no strong traditions or institutions exist to regulate the political sphere.

The transition to independence was for most people mainly a negative experience. Generally speaking, the Popular Front government stuck to its democratic principles, but it failed to consolidate democratic institutions, manage the economy effectively or win the war with Armenia. The 1991 – 1993 period did provide a taste of personal freedom, however; the country's first president, Abulfaz Elçibey, never saw his personal integrity or democratic principles questioned. Thus, the period left Azerbaijan with an experience of liberty that most other Central Asian states never had. Yet when the Popular Front government collapsed in 1993, Azerbaijan appeared to be the quintessential "failed state." It had lost a war and seen half of its economic production disappear, while the state had abdicated central tasks including taxation,

defense, the payment of salaries to officials and pensioners, the maintenance of public order, and its monopoly over the use of force.

With the state failing, a parallel system of economic distribution emerged to fill the vacuum. This could be called institutionalized corruption, or more accurately, neo-feudalism. Azerbaijan has come a long way toward institutionalizing state authority and formalizing the institutions of power and governance since those days. However, the formative years of the 1990s created vested interests and forms of social and political interaction that have yet to be undone, and that continue to determine the functioning of political relations in the country. Most crucially, these forms of interaction reflect the continued predominance of informal networks of power.

Azerbaijan's Soviet-era strongman, Heydar Aliyev, stepped in to take control and to rebuild the state, mainly using the remaining Soviet structures and Azerbaijan's oil wealth. He succeeded in normalizing Azerbaijan's economy, building a functioning state and putting the country on the map; but this took place within the framework of a semi-authoritarian system, a controlled political environment that allowed for elements of dissent and pluralism but remained controlled by the executive. This system has remained in place following the transition of power from Heydar Aliyev to his son Ilham, resting essentially on the same power base.

Yet given the salience of informal networks, Azerbaijan has two political systems: a formal one separating government from opposition; and a second, informal system featuring a host of actors, mostly officeholders in the government, but whose interests often diverge so much that they have fought proxy wars against one another and struggled over sectors of the economy. Such a system governed by ad hoc relations rather than rules and institutions presents daunting challenges to the transformation of Azerbaijan into a Western-style liberal democracy.

In the past six years, the president's power has increased dramatically. In 2005, he effectively put an end to any dissent from his ministers, from oligarchs, and from the rest of society. In fact, the president is increasingly taking on the role of an absolute monarch.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 10 (best) to 1 (worst).

Transformation Status

I. Political Transformation

1 | Stateness

Azerbaijan's central authorities have firm control over the country's territory, with the exception of the territories occupied by Armenia. This area, which constitutes about 17% of the country's entire territory, includes the former Nagorno-Karabakh Autonomous Oblast and seven surrounding regions. Most of these occupied territories remain empty, as Armenians have not attempted to settle them – nor does Armenia in fact have the capacity to, in spite of periodic settlement drives. As outsiders have been barred from entry to these territories, allegations of widespread smuggling and drug trafficking there have been made but not corroborated.

There are also small areas in the Caucasus Mountains often used by radical Islamists, such as the Forest Brothers and other terrorist organizations, from which to threaten the security of the country. Government forces struggle with these groups along the border with Russia and Georgia. These groups do not control a given territory, but rather use forests to hide and survive. Azerbaijan's government has made it a priority to define its international borders and strengthen their protection, as in 2010 when a very important agreement was signed with Russia providing the first full determination of the two countries' shared borders.

The Azerbaijani constitution guarantees full citizenship rights to its entire population, irrespective of race, gender, ethnic or religious background. It is generally observed in practice. Even though Azerbaijan is a multiethnic and religiously heterogeneous country, most residents accept Azerbaijani citizenship and the inclusive concept of the nation-state. The only question mark for the future – given the extensive hostility engendered by two decades of conflict between Azerbaijan and Armenia – is the extent to which the ethnic Armenians of Karabakh, nominally Azerbaijani citizens, would be accepted as citizens in practice following a possible peace deal.

Question

Score

Monopoly on the use of force

7

State identity

7

There are some marginal radical groups, which either support a vision of an Islamic state or advocate separation from the country (as is the case with some marginal radical Lezgin groups). Radical Islamic forces criticize the concept of a secular nation-state in favor of Islamic rule, yet this ideology lacks public support outside of marginal groups. One Islamic party chairman who advocated the overthrow of the Aliyev government in 2010 was subsequently arrested.

Azerbaijan is a secular state, and the legal order is defined by civil laws. Religious organizations and members of the clergy are forbidden from participating in elections. However, Islamic traditions often influence the decision-making process, especially when it comes to gender issues or the celebration of some religious holidays. President Aliyev himself attends religious celebrations and sends greetings to Jewish, Muslim and Christian communities on religious holidays.

No interference of religious dogmas
9

In December 2010, major political debates erupted in the country over the issue of headscarves for girls in public schools. Islamic groups staged several major protests seeking permission to wear headscarves in schools, although government officials have banned the practice as not conforming to secular principles. Although tensions diminished somewhat after several weeks of heated debates, most analysts believe that this is a temporary calm. It is likely that religious groups will continue pushing for this issue in the future, with considerable and vocal support from Iran.

Over the past 20 years, the Azerbaijani government has developed fairly detailed and comprehensive administrative structures both at the federal and provincial levels. These provide services to the population ranging from law and order to education, social services, health care and transportation. Due to the Soviet legacy of large and centralized government, most people still expect the government to take care of basic services. Some analysts believe that the scope of government functions is too broad, failing to leave enough room for NGOs or municipalities to exist and operate freely. Moreover, the quality of services provided, while improving, remains uneven and leaves much to be desired.

Basic administration
7

2 | Political Participation

Azerbaijan regularly holds presidential, parliamentary and municipal elections, but over the past 18 years all of them have been marked by serious irregularities and fraud. Although the technical aspects of the elections such as the organization of the voting process and the preparation of polling stations have improved, the campaign period is still characterized by an unequal distribution of power between the ruling party and opposition forces. The latter have restricted access to the media, and are not allowed to stage street rallies, meet voters or campaign in public areas. Ballot stuffing and the fraudulent tabulation of votes are widespread phenomena. The latest parliamentary election in 2010 was no exception. It was criticized by

Free and fair elections
3

international observers and the local opposition as another in a series of unfair, un-free national elections. Thus, the parliament today lacks even a single truly oppositional member. Public trust in the electoral process remains very low.

In Azerbaijan, the ruling party has a monopoly on power, and ensures that opposition candidates do not win election to legislative, executive, municipal or judicial bodies. At the national level, the president exercises control over the governance of the country. However, his power is limited by entrenched interests within the state elite, often holdovers from the Communist period who constitute an impediment to reform, and who bring to mind medieval barons. These have nevertheless been transformed in the past decade; whereas they originally were mainly regionally based interest groups tied to the old regime, they have been transforming into comparatively more modern, business-focused entities that nevertheless remain closely tied to a node of political power, normally a government minister.

Effective power to govern
2

Some 2,000 NGOs are active in Azerbaijan. It has become easier in recent years to form and register an NGO. The government has established a state council for the support of NGOs, which gives financial assistance to NGOs to implement various projects. Many young people, especially in the cities, are involved in some form of association, whether political or focused on broader civic goals. The rights of association and assembly are guaranteed by the constitution. However, there have been informal restrictions on the freedom of assembly since 2003, when opposition forces clashed with police after the presidential elections. Police forces today prevent any attempts by youth or opposition groups to stage street rallies. Most members of the opposition forces are frequently harassed by the authorities, and their activities are significantly hindered. Trade unions remain weak.

Association / assembly rights
4

Azerbaijan abolished censorship in 1997. Citizens are relatively free to express their views, even if these are critical of the government. This takes place especially freely on the Internet through various websites and blogs. TV and radio channels nevertheless remain largely closed to opposition figures and critical debate, although some criticism on social problems does take place. Print media is generally freer, though organizations are periodically harassed. In 2009, police arrested two young bloggers and kept them in prison for over a year. This was considered to be a move against freedom of expression. On several other occasions, journalists have been attacked and beaten. In spite of this, regular citizens do not live in a climate of fear, can express themselves relatively freely and have access to opposition views.

Freedom of expression
4

3 | Rule of Law

The executive branch continues to dominate the other branches of the government, and there is practically no functioning system of checks and balances in the country. Parliament continues to remain a rubber-stamp body, rarely challenging the executive office. What separation of powers exists, remains only on paper. Parliament has spent considerable resources in the past few years building up its internal capacity in terms of hiring and training new staff, building and equipping new offices, and expanding international relations. Yet there is little political will to challenge the executive branch. Thus, the vertical power structure in the country remains strong, and most strategic decisions are made by the president.

Separation of powers

4

The country's judiciary is formally independent, yet this branch's decisions are often heavily influenced by political considerations, especially in political cases, or are influenced by corruption. In 2010, new premises for the Supreme Court were opened, aimed at providing better courtrooms and facilities in which judicial procedures can take place. Some reforms such as the election and training of judges have been aimed at strengthening the judicial branch.

Independent judiciary

4

Traditionally, Azerbaijani law enforcement bodies have avoided prosecuting public officials for corruption, even though a state anti-corruption commission was established several years ago. Following the revolutions in Egypt and Tunisia, the Azerbaijani government launched a public campaign against corruption in January 2011. Dozens of mid-level officials were arrested. President Aliyev himself spoke publicly on TV about the campaign. Public servants have been warned against abusing their powers or ill-treating citizens. However, opposition groups have questioned the sincerity of this anti-corruption campaign.

Prosecution of office abuse

4

Civil rights are protected by the constitution and the rule of law. They are generally observed in practice, though cases of police brutality take place on a rather frequent basis. The Office of the Ombudsman has worked during past several years to detect such cases and seek punishment for the guilty officials. This office nevertheless remains weak. Members of the population remain largely uneducated as to the extent of their civil rights.

Civil rights

4

4 | Stability of Democratic Institutions

Democratic institutions exist on paper, and function well but within the framework of a semi-authoritarian regime. Certain rules and procedures govern these institutions' integration into the decision-making process, such as the necessity for a budget debate in the parliament and parliament budgetary approval. However, all of

Performance of democratic institutions

2

these institutions remain weak. Media groups, NGOs and political parties are more vocal, but are also often ignored by the executive branch.

Democratic political culture is relatively limited. While strong backing for the concept of democracy exists in the population, politically active groups do not consistently respect these principles. In public, the government and executive authorities stress democratic institutions and the building of democracy as a long-term goal, but in practice do not live up to these principles. That said, a generational change is slowly taking place within the governing authority, meaning that Soviet-educated people are leaving government, and that the number of individuals exposed to Western education is gradually growing. This has yet to produce concrete results, but could ultimately change the makeup of the bureaucracy. Similarly, opposition parties are nominally supporters of democracy, but have a practice of boycotting elections. Overall, the existing system of informal rules and informal power continues to prevail, with incentives to create a new democratic system comparatively weak.

Commitment to democratic institutions

2

5 | Political and Social Integration

Azerbaijan has a very fragmented party system. Some 40 political parties exist in the country, of which four to five are major opposition parties that influence the national discourse. The ruling party remains dominant and wealthy. Opposition parties are often harassed and excluded from the decision-making process. Moreover, the character of opposition parties is determined by the personality of their leaders, who command the personal loyalty of party members. These leaders have remained in power in their parties for almost two decades, a period during which ideas have given way to inertia. This has further decreased the parties' legitimacy. In the past several years, opposition parties have fragmented and declined in strength. Most recently, in December 2010, the strongest opposition party, Musavat, lost key members due to differences with the party chairman.

Party system

3

There are many interest groups in the country, focusing on issues including gender, human rights and the Karabakh war, among others. They are active in the media and use Internet resources to mobilize public support. In the past few years, youth groups and alumni groups of various Western countries have been particularly active. Interest groups tend to concentrate in the capital city of Baku. But the ability of these networks to affect the political system is severely limited.

Interest groups

4

Surveys in Azerbaijan conducted by the Caucasus Research Resource Center, as well as recent research by Collins and Owen, show a generally high level of respect for the system of democracy and support for improving the rule of law. Whereas countries like Russia see relatively weak support for democracy, popular support for the concept in Azerbaijan is roughly at the level of Western countries, with over

Approval of democracy

n/a

three-quarters of the population expressing support in principle. However, data is contradictory given the rise in support for Islamic Shari'ah principles, an opinion now held by more than a quarter of the population. Thus the support for democracy is general and shallow, rather than developed.

In the capital city, the population's general level of trust is low, though many people engage in associations and civic groups. These organizations often serve common interests rather than being based on trust, however. In provincial areas, the level of trust is higher, but often at an informal level that does not result in the establishment of civic organizations. More broadly, society remains accustomed to demanding action from the government rather than engaging in self-help.

Social capital
3

II. Economic Transformation

6 | Level of Socioeconomic Development

Question
Score

Azerbaijan has made significant gains in the fight against the poverty. In the past eight years, the official poverty level has dropped from 56% to 9%, and close to 1 million jobs were created, according to official figures. The country's socioeconomic development has been driven by the booming energy sector, but this also trickles down to other sectors such as construction, tourism, services, technologies and transportation. The entire population has been affected by this growth. In 2010, the UNDP office in Baku announced that Azerbaijan made the biggest jump in the world in terms of Human Development Index (HDI) ranking over the past five years. At the same time, oil income has led to a rapid growth in income inequality. This has evidently not yet been properly captured by available data on Gini coefficients, in which Azerbaijan ranks relatively well (with a Gini coefficient of 35 to 40). The only population groups facing specific disadvantages are the refugees and internally displaced persons (IDPs) from the occupied territories. The poverty level among these peoples tends to be higher, but even they have made significant progress in terms of fighting unemployment and poverty. In the 2009 – 2011 period, the government continued funding the construction of temporary housing for IDPs, and all tent camps have been eliminated. Nevertheless, the divide between Baku and the countryside has grown, creating a bifurcated country. Indeed, figures on enrollment in higher education suggests the growing exclusion of people from poorer and more remote regions of the country from educational opportunities that could in turn provide for social advancement. Azerbaijan has not been able to compensate for the relative fall in women's participation in society, economy and politics that was associated with the collapse of the Soviet Union; in fact, the patronage structures that have dominated the

Socioeconomic
barriers
5

country are strongly male-focused. Political power lies mainly in the hands of Azerbaijani Turkish Muslims, but Muslim minorities such as the Lezgins, Talysh and Kurds are well-integrated and represented at the highest levels.

Economic indicators		2007	2008	2009	2010
GDP	\$ mn.	33049.4	48852.5	44291.5	51774.2
GDP growth	%	25.0	10.8	9.3	5.0
Inflation (CPI)	%	16.6	20.8	1.4	5.7
Unemployment	%	6.5	6.1	-	-
Foreign direct investment	% of GDP	-14.4	0.0	1.1	1.1
Export growth	%	47.5	7.8	8.1	24.2
Import growth	%	10.7	14.3	-5.3	1.3
Current account balance	\$ mn.	9018.9	16452.8	10174.9	15040.4
Public debt	% of GDP	8.6	7.3	12.1	10.8
External debt	\$ mn.	3521.5	4262.5	4531.5	6973.6
Total debt service	\$ mn.	187.6	295.2	347.3	410.3
Cash surplus or deficit	% of GDP	-	0.4	-	-
Tax revenue	% of GDP	-	15.9	-	-
Government consumption	% of GDP	10.1	11.5	13.8	11.3
Public expnd. on edu.	% of GDP	1.7	1.9	2.8	-
Public expnd. on health	% of GDP	5.0	4.3	5.8	-
R&D expenditure	% of GDP	0.17	-	-	-
Military expenditure	% of GDP	2.9	3.3	3.4	-

Sources: The World Bank, World Development Indicators 2011 | International Monetary Fund (IMF), World Economic Outlook 2011 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2011.

7 | Organization of the Market and Competition

Azerbaijan has developed rather solid elements of a market economy, such as clear rules for the registration of businesses, a tax code, banking services, anti-monopoly measures, anti-corruption measures, a court for economic affairs, and procedures

Market-based
competition

4

for tenders and state purchases. However, these procedures are often violated by corrupt officials, who seek advantageous positions or contracts for their own businesses. In the past several years, registration of businesses has been simplified, tax functions were placed online and anti-corruption measures have been strengthened. The World Bank's Doing Business report has noted Azerbaijan's significant jump forward. Nevertheless, the informal sector remains substantial, and large contracts are awarded not through competitive bidding but by state order. There have been frequent cases of privatization of large state enterprises or redistribution of ownership that have taken place without reference to legal procedures or market rules.

Azerbaijan has solid laws and legal frameworks in place to combat monopolies, but these rules are not enforced. This is especially true when it comes to awarding state contracts to private companies. Monopolies are often tied to government officials, and have been especially prevalent in the export/import sector. The customs committee is notorious for using customs procedures to prevent unwanted companies from importing or exporting certain products. The country is full of rumors about which ministers control the export or import of certain foods or construction products. As a result, market prices are very high, which causes public dissatisfaction.

Anti-monopoly
policy
4

Azerbaijan is gradually integrating into the world economy, especially in the area of energy exports. Small amounts of agricultural products and machinery are also exported. As for imports, the country trades with most Commonwealth of Independent States (CIS) countries, the European Union and Middle East regions. The only exception is Armenia, with which Azerbaijan refuses to engage in trade and commerce. Significant barriers hinder local entrepreneurs' ability to bring products into or out of the country for sale. In this regard, the customs committee has been very corrupt and a major obstacle to trade. Negotiations between Azerbaijan and the WTO regarding trade liberalization or membership have yet to yield tangible results.

Liberalization of
foreign trade
5

Azerbaijan's banking sector has boomed, with solid international standards and practices in place. Today there are about 40 banks in the country, but the central bank has been trying to decrease their numbers by increasing capital requirements. Retail banking is rather competitive. Large state enterprises often choose banks under order from the government. The International Bank of Azerbaijan, which is still state owned, continues to dominate the market. Another major state-owned bank – Kapital Bank – was finally privatized in 2009. The world financial crisis of 2008 negatively affected the country's banking sector. Most banks stopped issuing loans and the government had to bail out several banks. In the pre-crisis period, banks issued loans for the purchase of cars, household items and technical equipment, as well as for small business operations, the purchase of homes and repair works. The mortgage law passed by the government in 2007 significantly

Banking system
6

boosted the availability of loans for home purchases. In 2010, the law was amended so that only low-income families were eligible. Significant informal barriers hinder the ability of businesses and farmers to win loans from banks, especially low-interest loans subsidized by the government. Few foreign-owned banks operate in the country. Most local banks have expanded the number of their regional branches over time.

8 | Currency and Price Stability

Ever since the 1992 – 1993 period of hyperinflation, the fight against inflation has been the main focus of the government's economic policy. Although rising state oil revenues in the 2003 – 2008 period also caused serious inflation, often reaching 25%, inflation rates have decreased to between 4% and 5% in the wake of the financial crisis. In the 2009 – 2010 period, the central bank took significant actions to prevent the depreciation of the local currency, the manat, by injecting dollars into the market. Some economists estimated that this effort to preserve macroeconomic stability cost the government \$30 million per month. In some instances, the government has also spoken out against monopolies which helped push prices upward. For example, farmers' markets have been created in the capital city in order to prevent monopolies from increasing the price of food products.

Anti-inflation /
forex policy

7

The government has established the State Oil Fund, which accumulates the revenues from oil and gas exports. This institution has helped preserve macroeconomic stability by limiting the flow of oil revenues into the state budget. Currently, the fund has accumulated \$22 billion. Nevertheless, the expanding state budget and often uncontrolled spending, resulting from a lack of proper planning and the need to satisfy popular demand, has caused some inflation and distorted macroeconomic stability. However, GDP has risen by double digits for the past eight years, and broad macrostability has been accompanied by political stability.

Macrostability

6

9 | Private Property

Private property is generally respected in Azerbaijan, but hurdles to the sale, registration and use of property such as land and housing remain. State officials frequently interfere with legal processes in order to extract bribes. There have also been cases of large-scale enterprises being taken away from their owners and given to new owners by government fiat. Thus, politically motivated infringements on property rights remain a problem.

Property rights

4

Private companies are viewed as the primary engine of the economy, and government officials themselves often establish private companies, though through proxies. A solid legal foundation supports the private sector's functioning.

Private enterprise

7

However, private companies are not yet immune from government pressure or interference. If businesspeople are in trouble with the government, they can be subjected to biased and unexpected tax inspections. Privatization procedures are well-defined, but preference is often given to companies with strong government connections. The “one window” registration system has resulted in an increase in the number of businesses over the past two years.

10 | Welfare Regime

The government has recently conducted major improvements in this area, by repairing orphanages and houses for the elderly; building housing for IDPs; establishing personal social security accounts for almost 2 million citizens through the state social protection fund; providing aid to victims of floods, fires and other natural disasters; and constructing hospitals in every region of the country. The poverty rate has been greatly reduced in recent years. In 2010 alone, 45 hospitals and 70 secondary schools were built. Of course, it will take time for human capital in these institutions to be developed. But results are already visible. In 2010, major floods struck central Azerbaijan, and the government was by post-Soviet standards relatively effective in providing assistance. While there were problems in the delivery of financial aid, the government did contribute to reducing casualties, providing temporary shelter and food, and building housing for afflicted families. IDPs and refugees still receive free education, free electricity and gas, and monthly food allowances. Another major area of improvement was the targeting of social benefits. As a result of a 2008 reform, social benefits are now given only to poor families, and not to all as was previously the case. Pension levels still remain low, however.

Social safety nets
6

The constitution guarantees equal rights to all. In practice, all persons generally have equal opportunities for education and work. Yet, religious dogmas often prevent young girls from attending school in the country’s rural areas, and although a class of professional women exists both among the older, Soviet-trained generation and the younger, Western-trained one, government offices are predominantly staffed by men. Ethnic groups who lack a strong proficiency in the Azerbaijani language are at a disadvantage in terms of finding jobs, especially in state agencies, yet ethnic origin does not appear to be a factor hindering hiring more broadly. Personal connections play a huge role in terms of finding employment. Women’s status within society dropped somewhat in the aftermath of the Soviet collapse, and social structures remain male-dominated, though educated women are often found in professional positions in the capital.

Equal opportunity
6

Regional origin has tended to be important in Azerbaijan, as groups from western Azerbaijan and the Nakhichevan exclave have been privileged with access to power and influence. Nevertheless, these regional divisions are gradually becoming less

important as Azerbaijan becomes more unified, regional identities weaken, and abilities and professional skills become increasingly important assets.

11 | Economic Performance

For the past 10 years, Azerbaijan's economy has boomed thanks to oil and gas revenues, general macroeconomic stability has been maintained, and inflation has on the whole been controlled. Trade has been on the rise, nearly 1 million jobs have been created, and the state budget has increased from \$10 billion in 2003 to \$55 billion in 2010. The government has taken additional measures to develop the non-oil sectors of the economy by giving loans to farmers, establishing mortgage loans, and promoting tourism, health care and education. In 2010, GDP grew by 5%, the average household income level by 12%, and currency reserves from \$20 billion to \$29 billion. The country's economy attracted \$15 billion in investment. Foreign direct investment (FDI) remains tightly concentrated in the oil and gas sector, and the attraction of FDI to the non-oil sector remains one of the country's most pressing tasks. However, this is not facilitated by elements of the "Dutch Disease," such as appreciation of the national currency or pervasive corruption.

Some of the national statistics remain troubling: More than 90% of the country's exports continue to come from the oil and gas sector, for example, while more than 90% of the taxes collected come from the capital city of Baku. The state budget remains heavily subsidized by the State Oil Fund.

12 | Sustainability

Azerbaijan declared 2010 as the year of the environment. A new \$1 billion water pipeline was constructed to provide fresh drinking water from the Caucasus Mountains to 75% of Baku's residents. More than 6 million trees were planted, new Euro-2 emissions standards for cars were applied, construction of new waste management plant was begun, and the Balaxani waste ground in the suburbs of Baku was cleaned. President Aliyev announced additional measures to further improve the water situation in the capital city, including the construction of the Takhtakorpu water reservoir and the Absheron-Samur water canal. The water distribution pipe network in the city itself has also been modernized in recent years. Water purification stations, built along the Kura River, benefit 300,000 people. A state program on environmental cleanup was adopted, slated to cover the next 10-year period. A separate project has been established to preserve the forests and national parks. Cleanup of oil-polluted areas is taking place. In 2009, Azerbaijan established a new state agency for alternative energy. There are plans to build wind turbines in the suburbs of Baku.

Output strength
7

Environmental
policy
6

Enforcement of regulations has been a problem, as in other areas, and the legacy of several hundred years of oil exploitation in the Absheron peninsula will take time to reverse, with the effects of Soviet-era polluting industries particularly problematic. But a significant improvement is underway.

Azerbaijani secondary schools and universities remain in very poor shape, plagued by corruption, inefficient teaching, a lack of textbooks and computer equipment, and poor facilities. The general level of education in the country remains low, and spending on education has not taken off. Quite to the contrary, as the country's GDP has grown, spending on education in relative terms has decreased sharply from an average of 18% to 20% of overall state spending in 2005 – 2006 to less than 12% in 2009. Spending on research and development as a proportion of GDP stands at an extremely low 0.2%, and Azerbaijan has the second-lowest tertiary education enrollment ratio among the 15 post-Soviet states. The chief problem is that the Ministry of Education remains unreformed.

Some positive steps have been taken with respect to creating new institutions of higher education. The Azerbaijan Diplomatic Academy, which is in the process of being transformed into a full university, operates outside the auspices of the Ministry of Education and has a reputation for being free of corruption. Similarly, a tourism institute and a branch of the Moscow State University have been opened. However, education remains perhaps the most neglected sector in the country.

Education policy /
R&D
4

Transformation Management

I. Level of Difficulty

Generally, Azerbaijan has favorable conditions for governance, including rich natural resources and an educated population. Yet several factors impede its development. First, the Armenian occupation of a sixth of the country's territory and the constant threat of renewed war puts the country in a difficult situation. In 2010, negotiations between the Armenian and Azerbaijani presidents produced little in the way of results, and Azerbaijan's leader has since resorted to increasingly angry rhetoric holding out the possibility of a military resolution to the conflict. Second, great-power rivalries associated with the country's geopolitical location make things difficult. Russia, Iran and other powers compete for influence over Azerbaijan, and in the 2008 – 2010 period, the regional situation has been extremely fluid. War in Georgia led to a worsening of the security situation, while U.S. efforts to bring about Turkish-Armenian normalization ignored Azerbaijan's interests. In 2010 and early 2011, tensions between Iran and Azerbaijan reached another high point, thanks to growing Iranian interference in the country's domestic affairs. Official Baku continues to walk a careful line in terms of foreign policy, but these rivalries are beyond Baku's control – it can have only a limited effect, but is strongly affected by what others do. Third, transnational criminal groups and terrorist organizations pose another threat to the country. In January 2011, the Israeli embassy was closed for several days due to a terror threat. Finally, Azerbaijan is landlocked, dependent on foreign countries for the export of the oil and gas that comprise the overwhelming majority of its foreign earnings.

Structural
constraints
6

During Soviet times, Azerbaijan's civil society was very weak. Civic organizations such as women's and youth clubs were controlled by the totalitarian state. In the pre-Soviet period, there were some civil society elements such as clubs, municipalities and community organizations, but these were a novelty within Azerbaijani society. For most of Azerbaijan's history, the country was ruled by shahs and sultans. Thus, civil society traditions are fairly young and weak. Most current NGOs have been established by intellectuals in need of funding. Only a few of the country's NGOs genuinely seek to solve a social problem and form voluntary associations in the Tocquevillian sense.

Civil society
traditions
7

The Nagorno-Karabakh conflict, which has ethnic tensions at its roots, remains the only violent conflict in the country. Although a cease-fire has been in effect since 1994, and no major military activities are underway, sporadic outbreaks of violence do take place, as in the summer of 2010. The last year has seen an upsurge of incidents on the cease-fire line, leading to worries of renewed war. Minority ethnic groups such as the Lezgin and the Talysh have in the past advocated for separation, but at the moment remain quiet. Social dissatisfaction and religious radicalism are other potential sources of violent conflict in society. There were several violent clashes between police forces and religious radicals in 2010, with Iranian interference serving to press these groups into action.

Conflict intensity
4

II. Management Performance

14 | Steering Capability

Question
Score

Abundant oil revenues and overall political stability have allowed the government and the president to engage in long-term thinking, and enabled them to start planning major government programs. Low-level officials often try to rush project implementation in order to please the president or meet the demands of the electoral cycle. Nevertheless, several strategic projects have developed a long-term focus, including state programs on youth, ecological cleanup, socioeconomic development and educational reform. Large construction projects have also been begun significant long-term funding attached.

Prioritization
5

Due to the increase in oil and gas revenues, implementation of projects and policies has improved over the past decade. The only real constraint remains the lack of qualified personnel and staff. Government agencies often have good ideas and projects, but are unable to find the right people to implement them. The education sector and the quality of graduates lag behind the country's level of economic development. There have been several examples of the government implementing mega-projects that have partly or completely failed. The construction of the largest flag pole in the world, which later had to be taken down, is one example. In other instances, such as the construction of the Baku-Kars railway or the Baku-Oguz water pipelines, significant delays and overspending have taken place. Government officials often rush project implementation, compromising on the quality of the work.

Implementation
4

The strengthening economy and rising oil revenues have made government officials bolder and more arrogant. With less need for Western money, they often brush aside Western ideas, consultancy and advice. On the other hand, the country has

Policy learning
4

been independent for nearly 20 years, and some local experience has been accumulated. The government continues to work with the World Bank, the United States Agency for International Development (USAID) and other donor agencies on some know-how projects.

15 | Resource Efficiency

Wasteful budgetary spending is very common in Azerbaijan. Little transparency exists with respect to the awarding of government contracts. Government officials care very little for savings or conservative fiscal policy. Mismanagement and the abuse of public funds are also very common. This has partly to do with the mentality of a newly oil-rich country. The sense that there will always be oil and the country will always be rich is pushing government officials toward inefficient spending. The same applies to the way the government treats its Western-educated staff members, who often remain outside key decision-making positions. However, the government has in recent years made considerable investments in infrastructure development and in sending students abroad for education.

Efficient use of
assets

4

Policy coordination is a major problem for the government. Conflicts between the various ministries and ministers prevent effective coordination of state programs. State policies are often developed in such a rushed manner that no time is allowed for coordination with other state agencies. Every minister has the sense of being an independent monarch, lacking responsibility or accountability to other colleagues. There is no sense that the cabinet of ministers functions as a unit.

Policy
coordination

4

For most of the period under review, the government showed very little interest in combating corruption, although the anti-corruption law was passed some time ago, and a state commission on the issue was established with the head of the presidential administration as its chairman. Very few government officials have been arrested, and corruption has a centralized nature. Several state agencies, including the Ministry of Foreign Affairs, the State Exams Committee and the State Oil Fund are fairly scrupulous institutions. However, the large majority of government institutions are badly affected. Beginning from January 2011, the government did take some drastic measures to fight corruption. Many people consider this a policy developed in response to the revolution in Egypt. Many mid-level and several senior level government officials were fired. The president himself spoke publicly on this issue on television. The road police, notoriously corrupt, have been prohibited from taking fines in cash on the streets. Although this campaign does not seem wholly sincere, some improvements have been noticed and appreciated by the public.

Anti-corruption
policy

3

16 | Consensus-Building

In a general sense, all the country's major political parties agree that Azerbaijan must be developed into a market economy and a democracy. Some minor radical Islamic groups and parties do not share this vision. However, the ruling party has its own vision of strategic development toward that end goal, preferring the perpetuation of stability and controlled growth to liberal democracy, free and fair elections, and market-based competition. Government officials often proclaim that democracy was not built in one day in the West, and that gradual development toward that goal is needed. The opposition disagrees.

Consensus on goals
6

At the moment, the ruling party has a very strong grip on power. This has meant that the opposition and liberal-minded reformers within the government have had few opportunities to push through a reform agenda. Opposition parties were excluded from the parliament altogether as a result of the 2010 parliamentary elections. Some state agencies try to hire young, Western-educated staffers to implement policies in a more efficient manner, but power is overall in the hands of policymakers who do not favor radical democratization or market reforms. A worrying trend is that the opposition has incorporated Islamic parties and groups, failing to separate religion from politics.

Anti-democratic actors
3

The government is generally interested in preserving stability. For this reason, all potential conflicts, whether they have a religious, ethnic or social basis, are prevented and suppressed. Members of radical Islamic groups are often arrested. Social programs are implemented to satisfy the demands of the people. Ethnic cultural centers have been established. However, the ruling elite is often viewed as composed mainly of Azerbaijanis coming from Nakhchivan and Armenia. This creates considerable tensions in society, because people from other regions see themselves as lacking equal access to power. Furthermore, the government has often sought to suppress dissent rather than engage in consensus-building.

Cleavage / conflict management
4

Although civil society is rather weak and dependent on government or foreign funding, civil society actors and their opinions are occasionally taken into consideration by the state. This is especially true if civil society actors seek active partnership with the government, refrain from accusations or harsh criticism, and establish trust and some channels of bilateral cooperation. Generally, due to the small size of the country, government officials hear the feedback of civil society groups either in person or via media outlets. These views are not always integrated into the decision making process, but in a general sense, NGOs are able to express themselves and seek influence. The government established state funds for the support of NGOs in 2009 in an attempt to strengthen the civil society sector.

Civil society participation
3

Most of the regime's political prisoners and enemies have been freed. Former President Mutalibov remains in exile, and the ruling party evidently has no intention of allowing him to return to the country. The same is true of former parliamentary speaker Rasul Guliyev, who is in exile in the United States. The parliament has still not adopted a law on former presidents' status, and has done little to recognize the service of former President Elchibey. Some opposition groups have been unhappy that not a single statue has been built in memory of Elchibey or the founder of the Azerbaijan Democratic Republic, Mammad Emin Rasulzade. This fact has created tension between the opposition and the ruling party, and prevents the establishment of societal consensus over the country's past.

Reconciliation
3

17 | International Cooperation

Azerbaijan's government generally cooperates well with international partners, especially in the area of economic development and poverty reduction. The World Bank, the United States Agency for International Development (USAID) and the Asian Development Bank are among the biggest partners of the government, but this cooperation has shown only modest results. In the past few years the government has been more assertive in its actions and negotiation tactics. For example, on the issue of WTO accession, the government has resisted reforming its customs, tax and agricultural procedures, even though this would bring long-term benefits. In January 2011, major agreements were signed between the Azerbaijani government and the European Union in several areas of joint cooperation, including education, capacity building and the reform of state agencies.

Effective use of
support
6

The Azerbaijani government has been rather consistent in fulfilling its promises to the international community. It maintains a strong peacekeeping presence in Afghanistan, sends aid to Haiti, Pakistan, Afghanistan and many other countries, and fulfills its obligations with regard to international law, conventions and commercial and trade contracts. For example, Azerbaijan is the only oil-producing former Soviet state (others include states such as Kazakhstan or Russia) not to have sought a renegotiation of contracts with foreign companies. In some instances, Azerbaijan has canceled pre-agreed NATO activities or other military discussions, due to the fear of reaction from Moscow or other geopolitical circumstances. However, Azerbaijan has actively sought to boost its international presence and strengthen its foreign relationships, and thus tries to respect its international obligations.

Credibility
7

On the one hand, Azerbaijan is a locomotive of regional cooperation, actively investing in Georgia, Russia, Romania, Turkey and the Central Asian republics. It promotes east-west and north-south energy and transport corridors, builds railways, ports, transport hubs and airports, and has expanded its presence in regional organizations such as the Black Sea Economic Cooperation (BSEC), the Economic

Regional
cooperation
6

Cooperation Organization (ECO) and CIS. On the other, Azerbaijan continues to refuse to cooperate with Armenia, opposes the opening of the Turkish-Armenian border, and has been reluctant to engage in public diplomacy or confidence-building measures with Armenia before the occupied territories are freed.

Strategic Outlook

In a rapidly changing world, swept by globalization, democratization, Internet communications, information flows and economic interdependence, it will be increasingly difficult for the Azerbaijani government to sustain its current grip on power. To date, the government has managed to do so by providing its citizens with security, stability and oil money. Yet the revolutions across the Middle East have reminded the country's government that the power of the regime can be shattered if the delivery of social services and economic development stagnate, and if pluralism is too limited. Thus, the government's success will partly depend on whether the recently launched anti-corruption reforms are expanded and institutionalized. Doing so would allow the country to better its economic performance and would provide new energy to the economy, which is currently heavily dependent on the oil and gas sector. If the political will to combat corruption remains high and results in concrete actions, as in neighboring Georgia, Azerbaijan's non-oil economy would benefit greatly. Competition would lower prices and the population would reap the benefits. So far, it is too early to determine whether this trend will continue or whether its early stages are simply cosmetic. Azerbaijan's future depends on the sincerity of this campaign.

On the other hand, democratization efforts must be continued in the area of political rights, NGOs, civil society, public administration and management. The country cannot stand on the border of the European Union and refuse to conduct liberalizing reforms. If Azerbaijan wants to gain the support of the West for the resolution of its conflict with Armenia and the liberation of its territories, it must begin to meet EU values and governance standards. Otherwise, the process of integration will hit a dead end, and the country will fail to forge closer ties with Europe. In this regard, Azerbaijan has made a strategic choice to move toward the Western system of governance, but has not implemented the measures that follow logically from this strategic choice.

Azerbaijan will continue facing considerable challenges in the international domain, primarily from Russia and Iran. While the government has adeptly managed its relationship with Russia, the relationship with Iran is going from bad to worse. Much of this is due to the rise of the radical Islamic movement in Azerbaijan and the apparent support this receives from Tehran. Urgent steps are needed to curb this radical Islamism and prevent the flow of young people into these radical groups. However, this cannot be done solely through restrictive measures.

Overall, Azerbaijan must take steps to build accountability in its state institutions and to reduce corruption, in order to liberalize its political and economic landscape and reduce barriers to effective governance and entrepreneurship. The financial resources and political stability available to the country today provide opportunities for such reforms.