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The Economy-Wide Effects of the 1st and 2nd Generation
Reforms in Azerbaijan: The Role of International Public
Organisations

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The Economy-Wide Effects of 1st and 2nd Generation of Reforms in Azerbaijan: The Role of International Public Organisations

Ms Nigar Baimova¹

ABSTRACT: *During the past five years Azerbaijan has experienced one the world's highest GDP growth rates, signifying an increase in economic opportunities. The country's challenge is to maintain its development and transform itself into an upper middle-income economy by stabilising oil revenues and developing new engines of growth. The global financial crises impacted the economy. Though the 2009 growth rate was 9.3 %, this is well below the 2001-2008 average of 16.4 % and it reflects very low non-oil growth. The development of the oil and gas sector since independence in 1991 allowed Azerbaijan to combat poverty and develop a sustainable economy. However further reduction in poverty remains a challenge as does reducing regional imbalances, improving social conditions and governance at all levels.*

Public organisations, such as World Bank, IFC, ADB and others have been playing an increasingly important role in the process by providing a source of finance. The relationship between these institutions and the government has been complex mainly due to a set of conditions the institutions come in with. The value propositions have included assistance in articulating a comprehensive development strategy, transfer of customised knowledge, capacity building and discipline in project implementation, including competitive procurement and providing diversified financing for the country's development needs.

The proposed paper looks at 1st and 2nd generation of reforms in Azerbaijan and at some of the risks associated with macroeconomic management; namely potential mismanagement of oil revenues, delays and waning consensus in implementing key elements of the reform program, state capture, corruption, implementation of capacity risk and the role the international agencies have been playing through policy dialogue, technical cooperation, and financial support. The paper further analyses the impact of this role for various players and on how risk connects these two generations of reforms.

Executive Summary

Post the collapse of the Soviet Union in 1991, Azerbaijan has been categorised as a third-world nation transitioning from communism to capitalism. The conversion

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The findings, interpretations, and conclusions expressed in this document are entirely those of the author and should not be attributed in any manner to any international organizations or the Government of Azerbaijan.

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from a state-controlled economy to an open market oriented economy has been extraordinarily difficult. The policies chosen for this difficult transition have been similar to many other countries in the former Soviet Union. The main programs included stabilisation measures (price liberalisation, introduction of national currency, and establishment of an exchange rate stabilisation fund); introduction of new legislation on privatisation, foreign investment, and employment; fiscal and monetary reform (including introduction of VAT and controls on government expenditures); civil service reform; and development of the banking sector.

The country's economic progress has been good in many ways. Due to impressive economic growth since 2006 the country achieved significant reduction in its poverty levels, stemming in part from oil and gas production. However, Azerbaijan's oil production is projected to reach its peak in 2014 and then decline through 2024². As a result, a limited window exists for Azerbaijan to put in place policies and institutions for a thriving non-oil economy. If it can succeed in this endeavor, Azerbaijan will be able to transform itself into a sustainable higher middle income country.

This paper presents the current economic picture for Azerbaijan and assesses the policy issues for the pursuit of the next generation of reforms. It also argues that as in many other developing countries, the development policy discourse in Azerbaijan has been strongly affected by the discourse and perspectives of international organisations providing development assistance. It is said that International Monetary Fund (IMF), the World Bank and other public institutions through their policy based lending, recommendations and development programs shaped the socio-economic structure in Azerbaijan by playing a major role in the establishment of macroeconomic stability. The assistance with tax, legal and sectoral reforms have resulted in the creation of a social safety net. Along with their financial and technical assistance, these organisations have also been in a strong position to require, as a condition of funding, the implementation of anti-corruption measures and have presented Azerbaijan with new ways of thinking about development and the reform process. It is necessary to take into consideration the role of the institutions in the implementation of first-generation reforms and analyse how risks connect first and second-generation reforms.

Based on the lessons learnt, two main categories of risks need to be identified. First, there are the risks associated with clear government demand and ownership, "political will", governance and corruption. Second, there are implementation performance risks associated with government readiness for the implementation.

The paper argues that sound social, political and economic institutions are a necessary, if not sufficient, condition for sustained implementation of macroeconomic policies. Therefore, Azerbaijan needs to strengthen ownership of the reform policies, and discuss how mechanisms for knowledge sharing can be developed and how policy dialogue can be enhanced for successful implementation of second-generation reforms.

Years of experience have demonstrated that stabilisation policies or structural reforms are truly effective only when the government, and even more

² US Energy Information Administration (2009) *Country Analysis Briefs*, October.

importantly, the people are committed to change. This paper suggests that although conditions and program agendas set by international organisations are often challenged; the involvement of international actors is vital in combating corruption and creating a favourable environment for the development of dialogue between the private and public sectors. Reform process, supported by international public organisations opens up opportunities for profitable investment and motivates investors.

Second-generation reforms include large-scale privatisation, competition policy, banking and security market reform, foreign trade, all necessary for creating an innovative and flexible private-sector environment. The economy needs to build its reform programs based on lessons learnt over the past years. Only then can it build adequate capacities that will allow it to develop a competitive non-oil economy and successfully transform into a sustainable higher middle-income economy.

Country background

Azerbaijan is an independent republic of approximately 86,600 square kilometres, which borders Armenia to the West, Georgia and the Russian Federation to the north, Iran to the South and the Caspian Sea to the eastern border. The capital Baku consists of 11 administrative districts. The current population is over 9 million people (July 2010). For almost 70 years, Azerbaijan was one of the republics of the former Soviet Union and became independent on October 1991, following the collapse of the Soviet Union.

After the collapse of the Soviet Union, social services and infrastructure in Azerbaijan deteriorated and poverty increased sharply. Due to the conflict with neighboring Armenia, nearly one million people or 12 % of the population became refugees or internally displaced persons. About 20 % of Azerbaijan's national territory is currently under Armenian occupation, including the Nagorno-Karabakh area.

Azerbaijan traditionally has had a diverse economy with agriculture, manufacturing, and textiles as some of its main sectors; however the economy deteriorated during the early years of independence. From 1991- 1996, the real gross domestic product (GDP) declined by about 60 %. Exports declined from \$789 million (25 % of GDP) in 1996 to \$678 million (16 % of GDP) in 1998. Azerbaijan's reliance on oil exports increased from 50 % in 1996 to 78 % of total exports in 1999³. Between 2005 and 2008, the non-oil deficit increased in magnitude from about a third of total public spending to about two-thirds of total public spending. By 2008, high growth rates came alongside increasing oil dependency and the early phases of Dutch Disease were visible. Due to an increase of foreign exchange, the real exchange rate appreciated by nearly 60 % from 2005 to 2009. By 2003 close to 3.7 million people or about 44 % of the total population, lived in poverty, consuming less than \$36.50 per capita per month.⁴ The result of policy and institutional reforms implemented during the first years of independence had been mixed.

³ Asian Development Bank Country Classification <http://www.adb.org/Documents/Policies/Azerbaijan/AZB.pdf>

⁴ Asian Development Bank Azerbaijan Country Gender Assessment, 2005

Many international public organisations are active in the country. The main ones are the World Bank Group, International Monetary Fund (IMF), the governments of Germany and the United Kingdom, the United Nations Development Programme (UNDP), the European Bank for Reconstruction and Development (EBRD), the European Union, the United Nations Children's Fund (UNICEF), the World Health Organization (WHO) and United Nations High Commissioner for Refugees (UNHCR). These organisations have played an important role in the establishment of macroeconomic stability and have been committed to achieving the Millennium Development Goals (MDGs). A World Bank assessment notes that Azerbaijan has made good progress on first-generation economic reforms⁵. The most significant reforms include establishing a State Oil Fund, strengthening governance in the banking sector, small-scale privatisation, internal trade and price liberalisation, financial transparency in the utilities sector, improvements in the structure of the public sector; modernisation of the tax code, adoption of a transparent budget execution and accounting and strengthening the internal and external audit capacity.

As of October 1, 2009, Azerbaijan's total foreign debt was \$7.39 billion, which was 8.7 % of GDP⁶. The majority of government-secured loans have been for investment projects. The Azerbaijani government has tripled investments in core infrastructure – power, roads, water and energy. The loans for economic reforms stood at \$326.91 million or 9.55 % of foreign debt in total (\$61.96 million from IMF and \$264.96 million from the World Bank)⁷. There is widespread recognition that Azerbaijan faces an important challenge in improving governance and fighting corruption⁸. International watchdogs have consistently ranked the country as one of the world's most corrupt countries⁹. Various surveys provide evidence of the seriousness of this challenge, while also highlighting areas of improvement. Causes of the corruption in Azerbaijan include unclear, complex and contradictory laws and regulations and their inconsistent and unfair enforcement, lack of transparency and accountability, lack of competition and low public sector wages. The inflow of large amounts of donor funding has created additional incentives for corruption. Some legal loopholes, such as allowing state bodies to withhold information on domestic tenders worth less than 10 million AZN (\$12.5 million)¹⁰ – and the resultant lack of transparency -- has led to allegations of corruption in the awarding of many state contracts¹¹ and allegations business with political connections has achieved control of several lucrative sectors of the economy and facilitated inequality¹². Lack of effective information sharing and absence of systematic dialogue and networking, in addition to cross-sector partnerships between business, government and civil society organisations have been challenging. According to World Bank evaluations:

⁵ Azerbaijan Country Partnership Strategy Report, 2010

⁶ Minister of Finance, Samir Sharifov, <http://www.news.az/articles/economy/2124>, 8 January 2011

⁷ Minister of Finance, Samir Sharifov, <http://www.news.az/articles/9294>, 17 February 2010

⁸ World Bank CPS Azerbaijan, 2010

⁹ In its 2009 Corruption Perceptions Index, Transparency International ranked Azerbaijan 143rd out of 180 countries.

www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table

¹⁰ “European Neighbourhood Policy: monitoring Azerbaijan’s anti-corruption commitment”, Transparency International Azerbaijan, May 2010, p.40

¹¹ Crisis Group Interview, local economist, June 2010

¹² The Heritage Foundation: 2011 Index of Economic Freedom <http://www.heritage.org/index/country/azerbaijan>

*The pace of public sector governance reform and private sector development has been slow...Layers of regulations and corruption impose a high cost on new domestic and foreign investors, impeding investment and growth*¹³

In response to recommendations provided by the Istanbul Anti-Corruption Action Plan¹⁴, the government of Azerbaijan began developing anti-corruption reforms. Fighting corruption has been declared a political priority at different levels of power and has resulted in the State Programme for Fighting Corruption (2004 – 2006), adoption of a new National Strategy on Increasing Transparency and Combating Corruption (2007) and an Action Plan for 2007 – 2011; all viewed as important achievements in the development of anti-corruption policy. However, Enterprise Surveys conducted in 2009¹⁵ stated that the private sector in Azerbaijan continues to be one of the most widely corrupt in Eastern Europe and Central Asia.

Worldwide evidence suggests that a capable state with strong and transparent government institutions produces strong income growth, national wealth and social achievements¹⁶. In its Global Monitoring Report (2004), the IMF and the World Bank recommend improving the climate for private sector activity by strengthening capacity in the public sector. The quality of governance remains the biggest challenge for many countries including Azerbaijan. Further scaling up investment in infrastructure and ensuring its effectiveness would enhance the effectiveness of service delivery in human development.¹⁷ There is a growing awareness within government ranks that an environment in which the private sector can flourish is a must for achieving market-oriented economic growth.

Macroeconomic performance and economic growth

In the European Bank for Reconstruction and Development (EBRD) Transition Index from 1995, the quality of Azerbaijan's economic management institutions has been much worse than that of other Commonwealth of Independent States (CIS) countries. GDP declined 60 % from 1990 to 1995 and the government has had to take urgent measures such as implementing the reform process and allowing the inflow of massive donor assistance.

The IMF backed a comprehensive stabilisation program that started in late 1994. Both monetary and fiscal policies have been tightened. The program has been "extremely successful"¹⁸ in achieving macroeconomic stabilisation and has achieved a rapid reduction in inflation. Price stability has been achieved by adjusting domestic utility prices, which were previously subsidised by the Azerbaijan government. The liberalisation of the exchange rate mechanism and a rapid accumulation of foreign reserves helped achieve monetary stability. The privatisation process began in 1996 and the first wave of small-scale privatisation was completed by 1998. Although the government has taken steps to ease regulations and restrictions on foreign investment, Azerbaijan can still be a difficult place to do business because of the high

¹³ Privatisation and Corruption: The World Bank and Azerbaijan, P 9

http://www.whistleblower.org/storage/documents/Privatization_and_Corruption.pdf

¹⁴ Anti-Corruption Action Plan for Armenia, Azerbaijan, Georgia, the Russian Federation, Tajikistan and Ukraine <http://www.oecd.org/dataoecd/60/59/12593443.pdf>

¹⁵ Azerbaijan Country Profile 2009 <http://www.enterprisesurveys.org/documents/EnterpriseSurveys/Reports/Azerbaijan-2009.pdf>

¹⁶ World Development Report 1997

¹⁷ *Global Monitoring Report 2004*, The International Monetary Fund and World Bank, 2004.

¹⁸ <http://www.imf.org/external/np/sec/pr/1995/pr9558.htm>

level of corruption, a non transparent and arbitrary regulatory environment, a heavy handed bureaucracy and a large state sector that monopolises many areas of the economy¹⁹. In the first years, externally established institutions faced the danger of being used to extract money and resources, rather than having their resources used for sustainable institutional growth.

Post 2001, the situation has been improving and the reform process has accelerated. Various donors and development credit agencies have supported the implementation of first-generation reforms. The areas of structural reforms have been well chosen and improvements have been achieved but progress remains slow because of Azerbaijan's rapid expansion in oil revenues, corruption and weak implementation capacity.

Some highlights of first-generation reforms taken by Azerbaijan include:

- The design and management of a State Oil Fund, to preserve wealth for future generations and transparency in revenue flows and preventing "Dutch Disease".
- Establishment of some business facilitating mechanisms, such as the one stop window for licensing for companies.
- Improvement in health and basic education funding, infrastructure and approaches.
- Establishment of a well targeted social assistance program.
- Improvements in Government wages and institutions.

According to a 2010 World Bank survey²⁰ the poverty rate dropped significantly from 49.6 % in 2001 to an impressive 15.8 % in 2008 and living standards "improved considerably". In 2010, the official poverty rate was 11 %²¹. According to that same survey, by 2008, unemployment rate reached 9 %.

During this period Azerbaijan experienced one of the world's highest GDP growth rates, which has resulted in increased economic opportunities. The booming economy helped usher a significant number of women in the labour force. The country's economy was among the fastest growing in the world for the fourth consecutive year in 2008 with growth rates peaking at 34.5 % in 2006 before returning to 25 % in 2007²². The country improved its ranking in the 2009 World Bank's "Doing Business" report from 97 in the previous year to 33 and was considered a "Top Reformer". Azerbaijan was a front-runner in the Extractive Industry Transparency Initiative (EITI), and received the UN Public Service Award in 2007.

Industry experts suggest that total oil reserves of the Caspian Sea may approach those of the North Sea. As a result, virtually every major oil company in the world has an interest in Azerbaijan. In total, 29 production sharing agreements have been signed with a consortia consisting of the major oil companies, such as BP, Chevron,

¹⁹ EStandardsForum, p 2 <http://www.estandardsforum.org/system/briefs/345/original/brief-Azerbaijan.pdf?1274130135>

²⁰ "Azerbaijan: Living Conditions Assessment Report", World Bank, 1 March 2010, p.7

²¹ "Republic of Azerbaijan: 2010 Article IV Consultation", p.3, Table 7.

²² "Republic of Azerbaijan:2010 Article IV Consultation-Staff Report", International Monetary Fund (IMF), May 2010. p14. Table 1. www.imf.org/external/pubs/ft/scr/2010/cr10113.pdf

Statoil, Itochu, ExxonMobil and others. As a result of these agreements, the Azerbaijani government will gain approximately 80 % of the total profits from a combination of royalties and State Oil Company's share. The remaining 20% of profits will be divided among the consortia.

Currently the country produces over 1 million barrels of oil daily (bpd)²³. Roughly \$350-\$400 billion over the next two decades²⁴ will allow the government to maintain an exceptional public spending campaign. Public investment has increased from \$0.5 billion in 2005 to \$4.6 billion in 2009. However, the economy's heavy dependence on oil is causing concerns among the international public organisations.

The 2009 crisis impacted Azerbaijan resulting in moderate reduction of oil revenues, freezing of global credit and depressed economic activity in the region. Non-oil GDP growth slowed from 15.7 % in 2008 to 3 % in 2009, with falling output in construction and non-oil manufacturing sectors, further depressing demand for credit and further causing loan portfolios of banks to deteriorate. The IMF expects overall GDP growth to slow down to 2.7 %²⁵

The government's strategy to overcome the crisis has included cutting public spending in 2009, ensuring that foreign obligations were met and enhancing access to credit by lowering key interest rates and supporting small and medium enterprises in addition to reducing corporate tax rates for 2010.

Given the estimations that oil production will no longer be the main source of growth, IMF urges Azerbaijan to accelerate economic diversification and use the oil revenues to strengthen the institutional foundations for market economy and to develop a human capital base that is flexible and will enhance the country's prospects during and beyond the oil boom. While important actions towards development of non-oil sector such as creating a state program of social-economic development of regions for 2009-2013 took place, non-oil exports make up only 5 % of Azerbaijan's overall exports²⁶.

The next generation reform programs envisaged by IMF and World Bank could substantially improve Azerbaijan's investment climate. Effective implementation of the goals – set in collaboration with the institutions -- will be the key to developing a rules-based economy able to attract investment.

Corruption vs. economic development

Despite good progress, as mentioned earlier, corruption remains a serious issue. Azerbaijan is still ranked as one of the world's most corrupt countries²⁷. The Transparency International Corruption Perception Index ranked Azerbaijan 143 out of 180 in 2009, marginally better than in 2008 when it was ranked 158 out of 180. In 2010 Azerbaijan was ranked 134th among 178 countries surveyed with a score of 2.4 (on a scale from 10 -very clean to 0 -very corrupt), which is an improvement from

²³ "OPEC increases Azerbaijani oil production forecasts", www.today.az. 17 June 2010

²⁴ Crisis Group Europe Briefing N50, Azerbaijan: Defence Sector Management and Reform, 29 October 2008, pp.4-5

²⁵ <http://www.imf.org/external/pubs/ft/scr/2010/cr10113.pdf>

²⁶ <http://www.imf.org/external/np/sec/pn/2010/pn1058.htm>

²⁷ Transparency International Report, 11 January 2011

http://azerireport.com/index.php?option=com_content&task=view&id=2564&Itemid=43

the previous year²⁸. Social services have been prone to corruption and key economic sectors continue to be captured by a closed circle of actors.

Corruption at all levels continues to be a widespread phenomenon and is viewed by many as normal and inevitable. A World Bank study of corruption in Eastern Europe provides a useful definition, which clearly describes the situation in Azerbaijan. The authors develop a distinction between two types of corruption, “administrative corruption” and “state capture”.

“Administrative corruption” relates to the *implementation* of existing laws, rules and regulations and most commonly involves paying a bribe, either to obtain special treatment or simply to encourage an official to carry out his/her job. Also, “state officials can simply misdirect public funds under their control for their own or their family’s direct financial benefit.”

As for “State capture” it involves *taking control of institutions*, such as ministries, the judiciary or regulatory agencies, informal influence, and other ways of extracting rents. It often involves overlapping business and political interests of state officials, “which has been a particularly prominent characteristic of many transition countries” notes the World Bank study²⁹.

Azerbaijan has widespread forms of both “administrative corruption” and “state capture”. Although in the early years of independence the international donor community tended to avoid explicitly addressing and criticising the existence of corruption in Azerbaijan, in the past few years, the issue has taken centre-stage between policy dialogue between donors and the government of Azerbaijan. International donors have been pressing an array of conditions and safeguards on the government to improve frameworks for private investment and partnerships, especially ensuring the rule of law and measures to tackle corruption and red tape and bureaucracy.

According to the Global Integrity Scorecard of Azerbaijan 2009³⁰, the key corruption risk areas in Azerbaijan are education, health care, courts and public utility services. The judiciary is perceived to be among the most corrupt institutions in Azerbaijan; it is still a challenge to have an independent judiciary and framework of company laws to enforce contracts, or define property copyrights, and create a honest and efficient administration to undertake equitable and efficient tax collection among other tasks. The US Department of State 2009 Azerbaijan Human Rights report indicated, “*law enforcement corruption is problem. Police often levy spurious fines for traffic and other minor violations and extract protection money from local residents*”³¹.

The Azerbaijani government is often accused of being an authoritarian regime with no independent and critical press and an increasingly serious issue of “political prisoners”. Freedom House has designated Azerbaijan as “not free” and assigned it a

²⁸ Transparency International <http://www.transparency.az/news.php?item.27>

²⁹ Stephen Knack, Measuring Corruption in Eastern Europe and Central Asia: A Critique of the Cross-Country Indicators <http://info.worldbank.org/etools/acportal/docs/KnackMeasuringCorruptionE%20EuropeAsia.pdf>

³⁰ Azerbaijan: Integrity Indicators Scorecard <http://report.globalintegrity.org/Azerbaijan/2009/scorecard>

³¹ 2009 Human Rights Report: Azerbaijan <http://www.state.gov/g/drl/rls/hrrpt/2009/eur/136020.htm>

rating of 6 out of 7 for political rights and 5 out of 7 for civil rights³² (the lower the rating the higher the degree of political and civil liberties).

The Bertelsmann 2010 country report for Azerbaijan said *“strong monopolies which are tied to the government prevent business from flourishing in the country...inequalities in society have grown rapidly as economic growth is unevenly distributed. Monopolies, price setting, state subsidies and corruption still plague the domestic economy”*³³

At the time of the writing of this paper (March 2011), the Azerbaijani government has started an anti-corruption campaign. A meeting of the Anti-Corruption Committee has been held under the chairmanship of the Presidential Administration on Jan. 27, 2011, where the President called for an increase in the struggle against bribery and corruption *“In early 2011, I ordered to increase this struggle in Azerbaijan, because bribery and corruption must be overcome even more seriously than before. We have relevant laws and signed orders and instructions for this. These negative facts must be eradicated”*³⁴

Observers note some progress in efforts to eliminate corruption. There has been a recent presidential decree mandating that all fines imposed by traffic police be paid through banks and allocating one-quarter of the amount to the salaries of police officers. Several state institutions announced numbers of employees dismissed for corruption. There have been cases of high-ranking officials who have been dismissed or jailed, and notary offices have started to work in accordance with the letter and spirit of the law. According to the State Anticorruption Commission a new legislation is being prepared to boost anticorruption efforts. *“This fight against corruption will reach its logical end.”* said the head of Azerbaijan's presidential administration.

In response to this, the head of the IMF mission on Azerbaijan, Nadeem Ilahi at a press conference in February 2011 welcomed *“the authorities’ recent campaign to target monopoly practices and public sector corruption”*, and highlighted the *“need to be pursued in a comprehensive manner to remove economic distortions and public sector inefficiencies”*³⁵. The U.S. Ambassador to Azerbaijan, Matthew Bryza said *“We are ready to support the intensification of these reforms and believe Azerbaijan may become an exemplary country by implementing democratic reforms”*³⁶. It is still early to determine whether this well-publicised anticorruption campaign is a reflection of the government’s sincere intentions or the result of foreign influence.

³² Freedom House Report http://www.freedomhouse.org/uploads/press_release/JW_testimony_3countries_11jul07.pdf

³³ BTI, Azerbaijan Country Report <http://www.bertelsmann-transformation-index.de/156.0.html?L=1>

³⁴ AzPress New Report, 11 Feb 2011 http://contact.az/topics_en.asp?id=1606&pb=2&vr=en&yr=2011&mn=2&day=10&mdn=1

³⁵ APA News Report, 15 Feb 2011 <http://en.apa.az/news.php?id=140753>

³⁶ Trend News Report, 17 Feb 2011 <http://en.trend.az/news/politics/1831341.html>

Managing oil revenues

An increasing number of World Bank-supported industry projects feature revenue management funds as an important component of the project. The international community has been optimistic about the ability of these funds to receive revenues from natural resource extraction and accordingly disburse them towards developmental needs, in a manner that is transparent and relatively immune to political influences. The IMF and the World Bank insisted that creation of the State Oil Fund of Azerbaijan (SOFAZ) has been an effective instrument for oil revenue management. As prudent management of natural resources is decisive for maintaining macroeconomic stability, the establishment of the oil fund has significantly reduced the risk of the government's vulnerability to unpredictability of world oil prices.

The Oil Fund, founded in 1999, was set up to preserve the nation's wealth for future generations, to prevent adverse effects from excessively rapid transfers of oil revenues into the economy, to reinforce sound fiscal policy and provide for fiscal stabilisation (*"collection and effective management of foreign currency and other assets generated from the activities in oil and gas exploration and development as well as from the Oil Fund's own activities in the interests of citizens of the Azerbaijan Republic and their future generations"*)³⁷.

The ultimate authority over all the aspects of the Oil Fund activities rests with the President, who is empowered to liquidate and re-establish the Fund, approve the Fund's regulations, and identify its management structure. The members of the Supervisory Board, which generally oversee the composition of the Oil Fund's assets and compliance to expenditure rules, have also been appointed by the President and all but one member are government officials. The IMF reportedly originally wanted expenditures from the oil fund to be subject to parliamentary approval, but agreed to subject expenditures only to presidential approval.

The provision of SOFAZ to ban credits, whether to governmental agencies and enterprises or to private businesses has been supported by international agencies. This provision is a risk-aversion strategy that precludes the channelling of oil revenues into the non-oil sector in support of diversification and regional development. SOFAZ has become an important source of financing for socioeconomic and investment projects. As of January 2010, SOFAZ reported assets of 12 billion Manat (\$14.9 billion). These assets constitute a 32 % increase over SOFAZ's January 2009 reported assets (\$10 billion)³⁸. Transfers from SOFAZ constituted 47.6 % of total state revenue in 2009, up from 35.3 % in 2008, as the government used them to finance the fiscal policy. The share of such transfers in total revenue has been growing since 2006³⁹.

Given that production and exports in Azerbaijan are expected to grow rapidly over the next decade, there is an acute need for adequate mechanisms to manage oil revenues and design long-term public expenditure strategies. Prudent oil windfall management in Azerbaijan requires the accumulation of large savings in the form of financial assets abroad, in order to avoid excessively rapid growth in government

³⁷ Charter of the State Oil Fund of Azerbaijan Republic, Section 2.

³⁸ US Department of State, Background Note: Azerbaijan <http://www.state.gov/r/pa/ei/bgn/2909.htm>

³⁹ Asian Development Bank Outlook 2010 <http://www.adb.org/documents/books/ado/2010/AZE.pdf>

expenditures and deterioration of competitiveness of non-oil sectors. The government of Azerbaijan is aware of the difficulties and risks associated with managing the oil windfall.

Yet the empirical evidence points to a “natural resource curse” – small oil-rich economies like Azerbaijan tend to have less economic growth and worse development outcomes than countries with fewer natural resources as well as issues with declining total factor productivity. The abundance of “easy money” during the oil windfall creates mounting political pressures to spend inefficiently and creates incentives for corruption. It is possible that Azerbaijan’s high public expenditures today will most likely lead to low standards of living in the future. There is a lack of public awareness about the consequences of wide expansionary policies and it is necessary to learn from the lessons of other oil-rich countries.

There is a need to continue building good institutions, increase fiscal transparency and establish good budgetary systems for successful macroeconomic management and in order to minimise risks. This is a reason why SOFAZ is getting increasing attention from international institutions. Experts of international financial institutions, including the IMF and the World Bank regularly visit SOFAZ to exchange views with respect to the growth patterns of the Oil Fund's assets and macroeconomic regulation policy as well as the possibilities and options of using modern regulatory and financial mechanisms and the Fund's investment policy⁴⁰.

Lessons from best practices suggest that transparency of operations in the form of accessible public reports, regular audits available in published form (both on the internet and paper), and meritocratic human resource practices constitute essential components for good governance of a fund. Both the IMF and the World Bank continue to emphasise the need to coordinate the budget planning process to integrate a medium-term spending framework with financing plans and the government's broader oil-revenue management strategy.

However, some experts claim that despite the efforts of the World Bank, IFC and IMF the desired function of the oil fund may not eventuate due to political forces. The government's control over oil revenues has considerable political implications, according to Sabit Bagirov, the head of Baku-based Center of Economic Studies. A former head of Azerbaijan's State Oil Company, Bagirov says that *"the Government wants to control the situation in Azerbaijan as it is. We have to say openly that the oil revenues make this task easier. The country's vast wealth is a resource that the government can use to reduce socio-economic tensions and solve problems in the country."*⁴¹

The strong control by the executive branch has allowed uses of the fund that are contrary to its purposes. Instead of being used as a social fund, used to develop the non-oil sector, it has been used to finance the state oil company's share of the Baku-Tbilisi-Ceyhan (BTC)⁴² pipeline, claims Carol Welch in her policy brief⁴³. After

⁴⁰ Oil Fund's International Relations <http://www.oilfund.az/en/content/9>

⁴¹ <http://www.eurasianet.org/departments/insight/articles/eav092006.shtml>

⁴² BTC is a 1,768 kilometers (1,099 mi) long crude oil pipeline from the oil field in the Caspian Sea to the Mediterranean Sea. It connects Baku, the capital of Azerbaijan, Tbilisi, the capital of Georgia; and Ceyhan, a port on the south-eastern Mediterranean coast of Turkey, hence its name

⁴³ Oil Funds: Answer to the Paradox of Plenty? *A Policy Brief on Oil Revenue Monitoring Plans: Comparison Across Countries* commdev.org/files/1866_file_oilrev.pdf

the IMF and the World Bank expressed concern over the use of the oil fund for this purpose, the Azerbaijani government agreed that funds would be taken from a separate fund of oil bonus money awarded prior to SOFAZ's creation that exists within the Central Bank of Azerbaijan.

The role of the international public organisations – interference or empowerment?

Development of national policies in the contemporary world can hardly occur in isolation and without the interference of policy advisors, experts or observers from international bodies. The international public organisations play a powerful role in framing normative frameworks that circumscribe and justify courses of action. Together with funds, their technical advice advances the knowledge and information of the involved actors. It also encourages recipients to develop certain ideas around a problem and facilitate resources for putting them into practice. Many knowledge-related activities can, in fact, affect key actors' perceptions and policy-makers' decision in the implementation of certain policies at the domestic level. The power relations in some cases reinforce and in other cases limit the implementation of the policy reform. This is specially the case in sensitive policy areas, mainly governance-related reforms, in which the leverage of the organisations to advance reform rests not only on their financial power, but also on their capacity to articulate broader agreement with local actors. Sources and channels of knowledge sharing, the mechanisms through which the knowledge is shared and distributed importantly affect policy.

The early years of Azerbaijani independence in the 1990s after the collapse of the Soviet Union have been marked by the war with Armenia over Nagorno-Karabakh. Over one million or 12 % of the population abandoned their homes and Azerbaijan has been bearing the burden of nearly 4 % of the world's displaced population - an extraordinarily high ratio for a country of its size. Much humanitarian aid was needed. Many international organisations showed active interest in social policy issues and expanded their activities into Azerbaijan. The country has been receiving aid through a range of instruments and modalities, from debt relief to technical assistance, from specific projects to sector programmes and general budget support. Despite the very different nature of these actors, they all had a similar motive for policy intervention and in the early years of the independence, Azerbaijan has welcomed international aid, whether it was a financial aid or political know-how.

The initiatives and the programmes of international public organisations have not only supported the private and non-governmental sector but have also helped create interplay between different actors. Networking activities with local experts, civil society representatives, government officials and other key actors have allowed growing access to policy-makers and key actors who directly affected policy processes. Often the participation of external actors has been viewed as an opportunity for better governance and more transparency. In addition to the assurance that the institutions would absorb many of the potential risks, including political risks. The programs that have been initiated aimed at strengthening the

role of the private sector and civil society organisations, encouraging them to play a critical role in amplifying the voices of citizens in decisions that affected their lives. However, the important factors also affected the role of the external organisations; these were different agendas, corruption, centralised government, lack of a political will among key decision-makers and lack of support. The early years of the reform process have been accompanied by the reluctance of the main domestic actors at the centre of the decision-making process. Often their reluctance had to do with the conditionality and the level of interference.

Conditionality refers to the conditions attached to funds disbursed by international institutions and donors. In the early years the major share of the national budget in Azerbaijan has been financed by foreign aid. There were weak systems and ineffective institutions in Azerbaijan and conditions were inevitable for purposes of ensuring national responsibility, leadership and ownership. Moreover, widely recognised corruption was deeply institutionalised throughout Azerbaijani society and posed obstacles to both social and economic development in the country. Therefore, the donor programs implemented in Azerbaijan included a comprehensive governance action plan of political accountability and disclosure through strengthening institutions performing checks and balances.

Although it is understandable that conditionality has been critical for the advancement of first-generation reforms in Azerbaijan, these reforms were insufficiently owned by the country and have been perceived as overtly excessive and intrusive. By not meeting the donor conditions, the government of Azerbaijan could risk loan receiving or face the withholding of disbursement of committed funds. The government has been eager to accommodate donors' views rather than consult with political parties, civil society and general public in the policy-making process. Many donors argue, that the programs helped the young and independent Azerbaijan build improved systems and improved cadre of management staff and even embedded capacity building in most projects.

There has been a change in how these external influences on the government's policy-making process are been viewed. Now as Azerbaijan has oil money, the international aid, which comes with certain requirements and conditions, is considered a burden. In effect, oil revenues have effectively undermined foreign aid. In 2007, the European Union gave Azerbaijan €90 million to spend on political and economic reforms, but very little was used because of certain conditions put forward. The same situation often applies to some of the World Bank or IMF credits⁴⁴.

While experience with economic reform suggests that progress cannot be achieved merely by conditionality imposed by external actors, donor have tried to encourage and enforce policy reform, controlling corruption, using expatriate consultancy, promoting donors' market, promoting democracy and others. The Government of Azerbaijan has been urged to improve frameworks for private investment and partnerships, especially ensuring rule of law and measures to tackle corruption and unnecessary red tape and bureaucracy. In fact, there is plenty of

⁴⁴ The Bertelsmann 2010 Azerbaijan Transformation Index report <http://www.bertelsmann-transformation-index.de/156.0.html?L=1>

room for a discussion on the appropriateness of conditionality, its scope, nature and timing and moreover there is a never-ending discussion on the impact of conditionality on the ownership of the reform programs.

The implementation of first-generation of reforms in Azerbaijan have taught valuable lessons regarding different approaches to be used in achieving the same objectives and not undermining the government leadership when choosing the appropriate approach to be used. In the initial years after the collapse of the Soviet Union, Azerbaijan had no established policy track record, and many donors had little country knowledge, either basic, economic or practical country operational knowledge to inform its lending decisions. The lessons of the 1990s show that generalised policy prescriptions often fail, and that there is no single model of development⁴⁵. Even experienced donors such as the World Bank in many post Soviet countries initially approved substantial volumes of adjustment lending to support ambitious programs of stabilisation and structural reform. The early results were not good in comparison with overall Bank averages. In six of ten countries evaluated (60 %), the early outcomes of Bank assistance were unsatisfactory compared to a Bank-wide average of 30 % unsatisfactory outcomes in recent surveys⁴⁶.

Although international aid organisations in Azerbaijan continue to make a significant contribution towards the erosion of corruption, it is clear that the level of commitment to reform within the government is crucial. Challenging institutional reforms such as privatisations and trade reform are unlikely to be successful unless there is strong political commitment combined with wider public understanding of and support for the process. The implementation risk resulting from weakness in coordination among line ministries and multiple agencies in charge of the implementation of policies and programs is an important factor to take into the consideration. The lack of ownership is the cause of the poor implementation of conditionality. In the first-generation of reforms in Azerbaijan, many donors took the lead with little national leadership involvement thus putting the ownership of the programmes at risk. For example, this has been partially acknowledged by the World Bank in one of the assessments of the first World Bank-financed support to the Azerbaijani education sector development project⁴⁷. For a long time the program was called the World Bank Education project by the stakeholders. In the initial programs, due to the lack of ownership, the decisions on the projects have often been delayed and the process has not been very transparent, making it difficult for the donor to intervene. For example, in the Railways Project supported by the World Bank, the Bank team thought they had a consensus on the size and composition of the railway investment program, only to find out later that such a consensus did not exist. Better access to top decision makers in government could have limited the delays the project experienced. In its recent report the International Crisis group claims that despite the efforts of the international organisations, the Azerbaijani government “*developed effective methods for keeping political forces, non-partisan*

⁴⁵ The Review of World Bank conditionality, p10 <http://siteresources.worldbank.org/PROJECTS/Resources/40940-1114615847489/webConditionalitysept05.pdf>

⁴⁶ 2003 Annual Review of Development Effectiveness, The Effectiveness of Bank Support for Policy Reform, p 17

⁴⁷ Azerbaijan Country Assistance Evaluation, 2000, Document of the World Bank Report No. 21459

civil groups, media, religious communities and independent business alike from becoming self-sustainable challengers"⁴⁸.

There have been a number of Presidential decrees and government decisions on implementation of institutional reforms, including decrees banning unfounded inspections of private companies, increasing the salaries of executive and judicial branches, setting up the State Oil Fund of Azerbaijan and government resolutions on implementation of privatisation. Given that Azerbaijan's inflow of oil wealth is anticipated to peak around 2014 and decrease by 2025 to approximately 20 % of that peak, the government needs to initiate capital investments to develop the non-oil sector.

As mentioned earlier, although the conditions of the donors in Azerbaijan have performed crucial legitimising and have played risk-mitigating roles, many have argued that there has been very little or even no ownership from the government in implementing the first-generation reforms. Ownership of the reform process became a secondary goal to actual compliance of donor conditions in order to get the financial aid.

The implications of the lack of stakeholder ownership of the proposed reforms has brought about serious issues like resource-allocation to implement proposed policy reforms or lack of capacity to carry out such a massive reform initiative in Azerbaijan.

⁴⁸ Azerbaijan: Vulnerable Stability Report, 3 September 2010 <http://www.crisisgroup.org>

Way forward

Based on lessons learnt from first-generation of reforms the Government's approach has changed gradually. The actions taken by the government have included closer monitoring of projects on a sustainable basis, accelerating achievement of development results and building project management and most importantly monitoring capacity.

Although Azerbaijan adopted policies to foster enterprise restructuring and privatisation of assets, more decisive institutional solutions are needed to create conditions for a business environment that favours competition, respects property rights, protects creditors, and treats equally all participants in the market. Advancing these second-generation reforms would encourage investment (both domestic and foreign) into productive ventures and promote sustainable growth in the region. Fundamental market institutions that protect firms from anticompetitive structures and conduct need to be strengthened.

Both positive and negative inter-institutional externalities are very important and must be recognised and dealt with in any attempt at improving the quality of the public sector. A holistic approach that addresses problems in different institutions at the same time is likely to be necessary. However, such an approach must be guided by a clear strategy and by proper sequencing of changes made.

The biggest challenge facing the second-generation of reforms is how to maintain macro-economic stability in the face of the oil boom and keep the same pace in reducing poverty. Improving social conditions, health care and education reform remains a challenge to be addressed in the second-generation reforms, especially as education reform outcomes have been poor during the first reform phase, particularly at the post-secondary level.

There are few important areas of risk associated with the implementation of second-generation of reforms. It is undeniable that the possible mismanagement of oil revenues and Dutch Disease would slow down the implementation of reform programs, therefore the involvement of international public institutions, policy dialogue and advisory services on macroeconomic issues would help Azerbaijan to ensure macroeconomic and fiscal stability. Since the progress of the first-generation reforms has been accompanied by delays, international organisations need to continue to support an active outreach process centered on poverty reduction strategy. Corruption still continues to be a persistent problem in Azerbaijan and there is a need for reform programs to continued to mitigate this risk

For progress to be made, a political commitment to "good governance" is crucial. As defined by Transparency International it is necessary to put in place a "National Integrity System", which includes elements such as an independent judiciary, political pluralism with healthy opposition, "working" anti-corruption legislation, effective monitoring and auditing systems, structures to ensure integrity in the awarding of public contracts and the encouragement of the monitoring role of civil society through the establishment of an independent press. For institution building to be successful it is essential that there be political commitment in the government.

Thus cultivating local ownership and commitment to policy reforms within the government and the wider community and taking into account local factors such as the political economy is crucial for the successful implementation of proposed policy reforms. The need to identify and establish access to key decision makers, influential in policy formulation is necessary. It is vital to appreciate capacity gaps in civil service and the necessity of introducing a phased approach to complex policy issues.

To maintain sustainable economic policies the government needs to

- a. Safeguard oil revenues and maintain a sustainable fiscal policy
- b. Strengthen the efficiency of its expenditure management framework and the management of fiscal risks
- c. Strengthen the financial sector, and attract foreign investments
- d. Strengthen alignment of expenditures with priorities
- e. Strengthen financial management, procurement, and external audit and sector priorities
- f. Build a new platform for coherent government decision-making and lay the foundations for upgrading public sector institutions to make them supporters of private sector activity and of civil society.

Abbreviations

CIS	Commonwealth of Independent States
ABD	Asian Development Fund
IFC	International Finance Corporation
EBRD	European Bank for Reconstruction and Development
MIGA	Multilateral Investment Guarantee Agency
SOFAZ	State Oil Fund of Azerbaijan
BTC	Baku-Tbilisi-Ceyhan (oil pipeline)
BEEPS	Business Environment and Enterprise Performance Surveys/World Bank, EBRD, Enterprise Surveys
IDP	Internally Displaced Persons
CIS	Commonwealth of Independent States
GDP	Gross Domestic Product
IDP	Internally Displaced Persons
NGO	Non governmental organisation

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