

From Stabilization to Marketization

The Political Economy of Reforms in Azerbaijan

FUAD ALIYEV

Abstract: The author analyzes the process of reform started in post-Soviet Azerbaijan from the political economy perspective. He reviews the literature on the political economy of transition and presents the political-economic history of transition in Azerbaijan in three stages based on political developments. The author introduces and applies relevant indexes to evaluate the progress of different dimensions of reforms throughout the specified period's indexes. Although centralization of power was helpful in one dimension of reforms, it has impeded others. Further progress is impossible without democratization and institutional development, offering a broader approach to understanding, designing, and implementing reform-oriented public policies.

Keywords: Azerbaijan, democratization, institutional development, market reforms, stabilization, transition

Introduction

Since gaining its independence in 1991, Azerbaijan has started to implement market-oriented reform policies. The transition to the new political-economic order has not been smooth, but instead accompanied by political cataclysms and military conflicts. The World Bank classified Azerbaijan as a war-torn country with a semidemocratic political regime.¹

The literature on the political economy of transition has grown considerably in the last decade because of the reality of the problem and uncertainty about the future of market reforms throughout the former Soviet states. Various concepts of interconnection between politics and economic reforms have been developed and regional and country explanations of the transition of post-Communist countries.

The first question I discuss in this article is: What does “market reform” mean? Because of Shafiqul Islam's clear explanation of the market-reform process, I will follow his theory, which claims there are four interlocking wheels in the transition vehicle: macroeconomic stabilization, liberalization, privatization of the economy, and development of market-supporting institutional infrastructure.² The last three wheels he grouped together under

Fuad Aliyev is the executive director of the Azerbaijan Marketing Society. He is also a lecturer at Qafqaz University, Baku, Azerbaijan, and a PhD Candidate in National Economy and Administration at Azerbaijan State Economic University. Copyright © 2008 Heldref Publications

the label of “marketization.” He also discusses other concepts and theories of political economy of post-Communist transition.

However, I focus on how political changes have affected the reform process in Azerbaijan during transition. The trajectory of the post-Communist transition in Azerbaijan can be roughly divided into three stages: (1) first years of independence (1991–94), the state of nature; (2) powerful autocratic regime and stabilization (1994–2003), the state of Heydar Aliyev; and (3) Heydar Aliyev’s death and the election of his son İlham Aliyev as the new president (post-2003), the post-Heydar Aliyev state. I review all three stages of political development in Azerbaijan and their effects on market reforms, particularly the marketization process. Measures of nominal political stability and market reforms are obtained using the mix of qualitative and quantitative methods and then analyzed. In the end, I show how the centralization of power was helpful in one dimension of reforms—stabilization—but has been an impediment for the other dimension—marketization. Moreover, this article claims that once centralized, it is extremely difficult for a political-economic system in transition to undergo decentralization.

Finally, I propose and discuss further public policy steps and examine the “three I’s” approach to addressing issues of a post-Communist transition.

The Political Economy of Post-Communist Transition

First, we must define “market reform” and “transition.” According to Adam Przeworski, market-oriented reforms are reforms that aim “to organize an economy that rationally allocates resources and in which the state is financially solvent.”³ Islam highlights four “interlocking wheels” of market-oriented reforms: macroeconomic stabilization, liberalization, privatization, and institutional reforms.⁴

Joan Nelson has examined an unprecedented case of “simultaneous economic and political transformation” that has characterized transitional reforms.⁵ All newborn countries have had to pass through this dual transformation, but each has chosen various policies and has had different results. In short, economic reforms progressed successfully in countries where wealth was distributed more or less equally and there was political consolidation within the society.⁶

These issues have to do with the role of *ex ante* and *ex post* political constraints in the transition experience. If the former deals with the feasibility and acceptability of reforms, the latter refers to the danger of backlash and reversal after decisions are made and outcomes are observed.⁷ Joel Hellman argues that although post-Communist countries have not suffered from the standard *ex ante* and *ex post* constraints to reform, “they have faced an equally difficult set of challenges from an unexpected source;” the political obstacles were the most challenging.⁸

Another important issue in academic discussion is the question of what type of regime is best suited for the implementation of radical economic reform. According to Nelson, authoritarian governments were assumed to be the most advantageous for reforms at first. However, later studies largely discredit this simple assumption and focused on such issues as electoral cycles and institutional arrangements that give key economic officials substantial authority while insulating them from direct political pressures.⁹ In light of elections in a majority of the Commonwealth of Independent States (CIS) countries—which were reportedly always partly free but never fair—and considering the various measures applied

by their governments to suppress the opposition, this aspect of reforms gains special importance. In making the choice between authoritarianism and democratic consolidation, an understanding of the “Aristotle-Lipset hypothesis” may be helpful. The hypothesis states that if authoritarian regimes succeed in economic reforms, they eventually become victims of their own success, generating social forces that no longer need protection or are willing to suffer the constraints of authoritarian rule.¹⁰

However, when talking about regime types in CIS countries the “gray zone” concept should be applied to give a clear picture of the political-economic situation. The gray zone is somewhere between the different conventional regime types. As Farid Guliyev notes, “Azerbaijan represents a clear-cut case of a political regime fallen into the gray waters of political uncertainty.”¹¹ Further, he blends two approaches by Marina Ottaway¹² and Houchang Chehabi and Juan Linz¹³ in defining the political regime in Azerbaijan as sultanistic semiauthoritarianism.

According to Ottaway, the characteristics of semiauthoritarian regimes are the following: (1) limits on the transfer of power, (2) weak institutions, (3) a disconnect between political and economic reform, and (4) limits on civil society.¹⁴

Thus, a regime that holds elections regularly and has a formal separation of powers, an elected parliament, a supposedly independent judiciary, and an executive is supposed to be checked by the parliament. But in reality, the executive branch overwhelmingly dominates in a semiauthoritarian state.

In turn, Chehabi and Linz argue that a sultanistic regime is “based on personal rulership, but loyalty to the ruler is motivated . . . by a mixture of fear and rewards to his collaborators. The ruler exercises his power without restraint, at his own discretion and above all unencumbered by rules or by any commitment to an ideology or value system.”¹⁵ The conceptual models of transition diverge in their claims about who are the most important actors in opposition to transition. The J-Curve Model identifies the net losers as the culprit, while the Partial Reform Equilibrium Model concludes it is the net winners who are most averse to continuing the reforms.¹⁶ In the light of the aforementioned factors, both political stability and democracy play a central role in the advancement of market reforms.

According to the World Bank, political stability emphasizes the overall capacity of a government to withstand political shock and crises as well as the potential for internally generated shock or crises.¹⁷

I propose an index of nominal political stability that consists of the following main characteristics: degree of political legitimacy among the population; presence/absence of significant antistate radical opposition; level of social, ethnic, or religious tensions; degree of ideological polarization within a party; presence or absence of war or political violence; and frequency and scope of sit-ins, demonstrations, and other forms of direct political action (with the size of population being controlled for) in these countries.

For the purpose of this research I also propose the ranking rubric shown in table 1 for the indicators of a nominal political stability index (NPSI).

Nominal stability may be based on the volunteer or enforced consensus and is “short-term political stability,” paying relatively more attention to the ends rather than means. However, we should keep in mind that today, “enforced stability” can be achieved and kept at the expense of long-term political stability.

TABLE 1. Ranking Rubric for a Nominal Political Stability Index (NPSI)

Indicator	Low (0.0–0.2)	Moderate (0.3–0.5)	High (0.6–0.8)	Extremely High (0.9–1.0)
Political legitimacy among the population (LEGI)	Lack of political legitimacy of the ruling elite and government. Population and interest groups do not support or recognize government or its policies. The nature of government is doubtful and subject to dismissal.	Moderate political legitimacy. However, the government and ruling elite enjoy certain recognition on the part of the population and/or interest groups. Reforms progress with mixed success.	High degree of legitimacy. The nature of the government, ruling elite, and their policies are recognized by the population and interest groups. Elites lack the support of a significant portion of the population and there is some kind of active opposition.	Very high political legitimacy. Government is supported by a significant majority of the population and interest groups. Even if not fully supported, there is no way opposition forces can challenge it.
Significant antistatehood, radical opposition (OPP)	Presence of opposition forces that challenge the existing political system and structure and even statehood as a whole. Active involvement of separatist and terrorist groups.	Presence of opposition forces that challenge the existing political system and structure and even statehood as a whole. Some involvement of separatist and terrorist groups.	Existence of marginalized opposition forces that challenge the existing political system and structure.	Absence of any antistatehood opposition.
Social, ethnic, or religious tensions (TENS)	High level of social, ethnic, or religious tensions.	Low level of social, ethnic, or religious tensions.	Social, ethnic, or sporadic character.	Absence of any serious social, ethnic, or religious tensions.
Party ideological polarization (POLAR)	Political parties are very polarized according to their platforms.	Political parties are not very polarized according to their platforms.	Political parties are partly polarized according to their platforms.	Political parties are not polarized according to their platforms.

table continues

TABLE 1 (continued)

Indicator	Low (0.0–0.2)	Moderate (0.3–0.5)	High (0.6–0.8)	Extremely High (0.9–1.0)
War and political violence (WAR)	Ongoing war and high level of political violence.	Ongoing war or high level of political violence.	There are certain problems related to war and/or political violence, but they are under the process of being solved and ceased. Peaceful situation, in general.	Absence of any signs of war and political violence.
Sit-ins, demonstrations, and other forms of direct political action (ACT)	Frequent and large-scale direct political actions of protest.	Either frequent or large-scale direct political actions of protest.	Infrequent and not large-scale direct political actions of protest.	Absence of any significant direct political actions of protest.

All NPSI characteristics have an equal effect on overall political stability and it is hard to define their weights. Thus this index can be denoted as follows:

$$\text{NPSI} = \frac{\sum (\text{LEGI}; \text{OPP}; \text{TENS}; \text{POLAR}; \text{WAR}; \text{ACT})}{6} \quad (1)$$

I define the dimensions of market reforms using Islam's approach.¹⁸ Thus, macroeconomic stabilization is a variable that employs rigid budget and monetary policy to fight inflation and reduce the state budget, external trade, and payment deficits to sustainable levels. Liberalization is a variable that involves freeing up prices,

“Development of market-supporting institutions encompasses constitutional, legislative, legal, monetary, fiscal, and public administration institutions.”

adjusting interest rates, devaluing the currency level, and managing the exchange rate, making it convertible for the current account, encouraging integration with the world economy, deregulating markets (labor, financial, etc.). Privatization of the economy is understood in two ways: (1) transfer of state-owned property to private owners during a certain period of time, or (2) increase of the share of the private sector in the gross domestic product (GDP).

Development of market-supporting institutions encompasses constitutional, legislative, legal, monetary, fiscal, and public administration institutions. Table 2 operationalizes these variables by using a rubric ranking. The ranking created at the end of this article is based on expert judgments and indexes by the Heritage Foundation and the World Bank.¹⁹

Despite some shortcomings the “economic freedom index” is the only known index that measures economic liberalization in Azerbaijan. Although institutional development includes different dimensions (such as guaranteed property rights, contract enforcement, security and anticipation, bureaucracy quality, fiscal system performance, corruption, and so on),²⁰ the indicators of governance—voice and accountability, rule of law, government's effectiveness, regulatory quality, and control of corruption are the best means through which to demonstrate the level of institutional development in a given country. Thus, we use these indicators as a measure of an institution's developmental performance.

A market reform progress index (MRPI) includes two indicators: macroeconomic stabilization (STAB) and marketization (MAR), which consists of subindicators: institution building (INST), liberalization (LIB), and privatization (PRIV). It is worth mentioning that for the sake of simplicity PRIV does not take into consideration the “quality” of privatization—whether it was good or bad. After considering the importance and achievability of each dimension of the reform process based on expert judgments and various existing indexes, appropriate weights for the given indicators and subindicators have been assigned. Thus, MRPI can be defined as follows:

$$\text{MRPI} = (0.27) \text{STAB} + (0.33) \text{INST} + (0.20) \text{LIB} + (0.20) \text{PRIV} \quad (2)$$

TABLE 2. Rubric Ranking of Market Supporting Institutions

Reform Dimension	Levels of Success		
	Low (0.1–0.3)	Moderate (0.4–0.7)	High (0.8–1.0)
Macroeconomic stabilization (STAB)	Tackling inflation (less than 15 percent) takes more than three years or is not achieved. Remaining high deficits. Current account deficit is more than 6 percent.	Tackling inflation takes two to three years and/or is under 15 percent. Budget deficits cut during three years. Current account deficit is 3–6 percent.	Tackling inflation takes fewer than two years and is kept under 10 percent. Budget deficit cut for less than three years. Current account deficit is less than 3 percent.
Liberalization (LIB)	“Repressed” and “mostly unfree” ranks according to the Heritage Foundation economic freedom index. When unavailable expert opinion is used.	“Mostly free” rank according to the Heritage Foundation economic freedom index.	“Free” rank according to the Heritage Foundation economic freedom index.
Privatization (PRIV)	The share of the private sector in GDP is less than 50 percent.	The share of the private sector in GDP is 50–75 percent.	The share of the private sector in GDP is more than 75 percent.
Institution Building (INST)	The average of selected World Bank indicators of governance is -2.5–1.0. If not available expert judgment is used.	The average of selected World Bank indicators of governance is -1.0–1.0.	The average of selected World Bank indicators of governance is 1.0–2.5.

Note. GDP = gross domestic product. See Heritage Foundation, “Economic Freedom Index” (2006) for more information on liberalization dimensions. See World Bank, “World Development Indicators 2006,” <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20899413-pagePK:64133150-piPK:64133175-theSitePK:239419,00.html> (accessed September 27, 2007) for more information on institutional development indicators.

Marketization subindicators also require certain weighting within the MAR indicator. Based on expert judgments I apply weights and obtain the following:

$$\text{MAR} = (0.46) \text{ INST} + (0.27) \text{ LIB} + (0.27) \text{ PRIV} \quad (3)$$

The importance of institutional development is stressed because institutions create a basis for economic development and flourishing democracy. I define “institution” as follows: the set of formal rules and informal conventions providing the framework for human interaction and shaping the incentives of members of society.²¹ Building and changing institutions can be a slow and difficult process, requiring both significant political will and extensive measures to reduce a particular group’s opportunity and incentive for rent-seeking behaviors.

The importance of institutions is supported by many empirical and analytical studies. According to an International Monetary Fund (IMF) study, countries that experienced a constitutional revolution before an industrial one had a virtuous circle of investment, economic growth, and further positive institutional changes while the opposite was true for countries that experience the industrial revolution before the advent of constitutionalism.²² This is in line with former Estonian prime minister and successful reformer Mart Laar’s approach of combining economic reforms with political ones, which for post-Communist transition meant, first of all, uprooting the Communist nomenklatura.²³

The IMF study also claims that countries with large natural resources tended to have weaker institutions and slower reforms. Because the performance of exports in the resource generating sectors was determined mainly by global demand and price conditions, innovation and investment provided relatively few competitive benefits, making them much more amenable to the expropriation of rents.²⁴

I will now review and analyze three stages of the post-Communist transition in Azerbaijan and attach appropriate measures to the indexes based on this information.

First Stage: The Prereform Chaos and the Febleness of the Government

After gaining its independence in 1991, Azerbaijan faced a huge economic decline and a considerable socioeconomic crisis. Disparities in income and poverty significantly worsened as well. Furthermore, the country has been locked in territorial disputes, ethnic and civil conflicts, and military actions since the late 1980s, which have had strong negative effects on the implementation of reforms. As a result of the military conflict with Armenia over the Dağlig Qarabağ region of Azerbaijan (better known as Nagorno-Karabakh) 20 percent of the republic’s territory was occupied by 1993 and the number of refugees and internally displaced persons reached almost one million. This political instability, paired with a lack of internal and external support for reform, was the principle obstacle for the implementation of market-oriented reforms.

After the resignation of Azerbaijan’s first president, Ayaz Mütallibov, in the spring of 1992, the Popular Front of Azerbaijan (AXCP) government, headed by new president Ebulfez Elçibey, attempted to accelerate reforms to liberalize the economy. Toward this goal, the government made the decision to introduce a national currency—the manat—liberalize most prices, initiate financial sector reforms, and begin developing the necessary legal and institutional framework for these reforms to be carried out. In August 1992, Azerbaijan finally joined the IMF and started its negotiations with the institution.

Elçibey’s presidency was a shining example that being a good orator and ideologue does not mean being a good head of state. Although he was a successful opposition leader who

drew thousands of people for mass protests, he lacked the leadership skills necessary for managing the country. AXCP's short rule was known for an unbalanced foreign policy, internal instability, economic collapse, and hyperinflation. The government was unable to implement any kind of economic reform and suffered from a lack of financial support. Domestic production decreased by 67 percent between 1990 and 1996, the average annual inflation rate was 1,600–1,800 percent, and the manat rapidly depreciated.²⁵

The recession that followed the transition was significant in Azerbaijan even compared to the high recession indicators of other post-Communist countries. According to the World Bank, Azerbaijan had six consecutive years of output decline, which was nearly equal to the average CIS indicator. Cumulatively, output decreased more than 60 percent, which was higher than the CIS average of 50.5 percent. In comparison, for Armenia these indicators were 4 percent and 63 percent; in Georgia, 5 percent and 78 percent; in Kazakhstan, 6 percent and 41 percent; in the Kyrgyz Republic, 6 percent and 50 percent; in Tajikistan, 7 percent and 50 percent; in Turkmenistan, 8 percent and 48 percent; and in Uzbekistan, 6 percent and 18 percent, respectively.²⁶

One of the major consequences of the recession, along with the decline of GDP, was the hasty dissemination of money and credit. An increase in the supply of money, which did not align with the real economic situation or demand, resulted in inflation and caused the paralysis of the financial system.²⁷

During the first stage the structure of the financial system was rather primitive and underdeveloped. Azerbaijan was still in the ruble zone in 1993, even as the ruble was also depreciating. Circulation of the Russian ruble within the country added to the National Bank of Azerbaijan's (NBA) difficulty in implementing exchange rate policies. Thus, because of institutional weakness of the government and the failure of the NBA to create sufficiently effective monetary and exchange rate policies, it was unable to control inflation and the exchange rate of the manat.

Second Stage: Political and Macroeconomic Stabilization in Azerbaijan

Azerbaijan and its circumstances support the necessity of a political component within economic reforms because it is impossible to establish macroeconomic stability without political stability.

Azerbaijan had virtually none of the characteristics needed for stability, which enables me to label this situation a "state of nature"—a situation of almost no control and regulation. There was clearly a need for political stability before macroeconomic stabilization could be successful. Moreover, the situation required strong and charismatic leadership to make and sell unpopular decisions. Azerbaijan, with all its peculiarities (e.g., war, civil unrest, oil fields, geopolitical importance), was doomed to suffer from centralization of power at some point.

Political conditions for macroeconomic stabilization in Azerbaijan were achieved only after Heydar Aliyev came to power in June 1993. He had been the head of the Azerbaijani KGB in the 1960s and the general secretary of the Communist Party of Azerbaijan from 1969 to 1981. Aliyev made his comeback by taking advantage of a military rebellion led by Colonel Suret Huseynov against the rule of the AXCP. He eliminated his main political opponents (including Huseynov) following the rebellion and was then able to establish and strengthen his rule.

A cease-fire in Qarabağ and an agreement with multinational oil giants regarding the oil fields in the Caspian sector of Azerbaijan—which resulted in the signing of a \$7 billion

contract in 1994—contributed to further preparing the environment for radical economic reforms. At the same time, Azerbaijan accelerated negotiations with the IMF about funding the country's economic reforms. The government had not applied for credits from the IMF, but after the resignation of NBA Governor Qalib Aghayev, who was a fervent opponent of borrowing from the IMF and playing by their rules, there was a progress in the negotiations.

Experts of the IMF prepared a stabilization program, which included the distribution of \$46 million in April 1995 to be used for its implementation. This was the beginning of a long and fruitful relationship between the IMF and Azerbaijan.²⁸ This initial program aimed to limit the decline in real GDP to 6 percent, reduce monthly inflation to about 2 percent by the end of 1995, limit the external current account deficit to below 10 percent of GDP, and restore a sound external reserve position to the central bank.

The population, tired of instability, chaos, and military defeats, largely supported and trusted Aliyev, seeing in him a person able to put things in order. They remembered him as a wise and experienced leader. This image was fixed in the minds of the people and "cultivated" through state television. Thus, political capital, and therefore the opportunity to implement radical reforms, was relatively high and reforms were able to commence.

One can argue that macroeconomic stabilization in Azerbaijan was achieved through the coordinated measures of the NBA and the government inspired by the IMF. The consensus suggests, however, centralized power played a crucial role in this successful coordination of public policy. The details deserve to be examined.

The first stabilizing measure by the NBA was the declaration of the manat as the single legal currency within Azerbaijan beginning January 1, 1994, to pursue independent monetary and exchange rate policies. The ruble was removed from circulation. In addition, the NBA was given the right and responsibility of controlling the foreign-exchange reserves, which had been largely allocated to governmental needs from the Unified Foreign Exchange Fund (UFEF) managed by the president. Parliamentary approval of the annual credit plan was also suspended to manage credit allocations. As a result, the NBA was positioned to effectively launch its monetary and exchange-rate policies in the framework of the macroeconomic stabilization program.

The NBA started to implement a rigid monetary policy in the second half of 1994, a main principle of which was to decrease inflation and strengthen the manat's exchange rate by bringing the quantity of money and the distribution of money and credits in accordance with the real demands of the national economy. Simultaneously strengthening fiscal policies by cutting state budget expenditures made it possible to carry out a coordinated financial plan toward one strategic goal: achieving macroeconomic stabilization. Another important component of macroeconomic stabilization was the exchange-rate policy. Stabilization of the manat in respect to the U.S. dollar was conducive to stopping inflation in situations of extreme dependence of the domestic market on critical imports and in the prevention of a reduction in the population's income.

In November 1995, after initial positive signals from Azerbaijan, the IMF approved credits (Stand-by and STF Drawing) totaling about \$132 million to support the government's 1995–96 economic reform program. The goals of this program were to further reduce inflation by tightening the monetary policy, to carry out fiscal adjustment with a reduction of the overall budget, to carry out structural reforms (restructuring the financial sector, rationalizing

the price structure, achieving rapid progress in privatization, and initiating the enterprise restructuring process) as well as reforms of the system of social transfers.

Policy coordination between the NBA and the government was not a serious problem in the case of macroeconomic stabilization. The Ministry of Finance used budget mechanisms (taxation, state expenditures) and the NBA applied the instruments of monetary and exchange-rate policies. This was a positive result of the clearly defined (with the help of the IMF experts) major goal: economic stability.

The fiscal policy, which was implemented by the government at the end of 1994, was rigid in terms of social safety mechanisms. However, it was the only way out of the deteriorating economic situation and huge budget deficit. This fiscal policy was based on tight expenditure controls and on the accumulation of arrears. As mentioned, direct financing of the state budget was minimized to escape the consequences of inflation.

Since 1995 the budget deficit has been almost completely externally financed and this allowed the government to accumulate domestic financial assets. Royalties and other bonuses from the oil companies have contributed significantly to financing the state's budget deficit, which declined from 15 percent of GDP in 1993 to 4.3 percent of GDP in 1995, and then to 1.7 percent in 1997. Revenues from indirect taxes (value added tax [VAT], excises, and customs duties) also increased to 7.2 percent of GDP because of the broadening of the VAT base by removing exemptions and the duty-free threshold for imported goods for personal use. At the same time tax enforcement was improved.

In general, monetary and fiscal policies were rather well coordinated and consistent because the macroeconomic stabilization measures that were implemented by both the Ministry of Finance and the NBA were prescribed by the same "doctors"—the IMF experts—and controlled by the same institution—the office of the president, headed by the charismatic Aliyev.

The NBA has always suffered from a lack of credibility because it did not have actual independence and the perception among the population that "the President decides everything" is often true. This has not only been a problem for the NBA but for all other institutions in Azerbaijan as well.²⁹

The main sources of currency reserve have been external borrowing and revenues from the oil sector. But the oil sector can be a mixed blessing, undermining the stability of the manat (such as through a change in oil prices). The paradox is that the oil richness of Azerbaijan has not had strong positive effect on its domestic currency.³⁰

The share that the oil industry contributed to the GDP increased from 16.4 percent in 1995 to 41 percent in 2005,³¹ which would be good for the economy if not for the simultaneous depression in the nonoil industries.³² Such circumstances threaten to initiate the so-called Dutch disease. As a result there is bias in development—services, transportation, construction, and other nontradables grow at the expense of industrialization and agriculture while there is also the danger of local currency overappreciation.

In general, the presence of mineral resources can have other negative consequences for the economy and the process of reforms, which are pointed out by Terry Linn Karl and can be applied to the case of Azerbaijan.³³ These consequences include an addiction to oil rents and the development of the renter mentality; the joining of political and economic power based on the allocation of rents and decision making about the distribution of financial resources (e.g., soft budget constraints, the presence of "crony capitalism"); high levels

noneconomic expenditures and high absorption and corruption. The newly established Oil Fund, where oil revenues are collected, helps to avoid the perils of oil richness by better controlling the flows of “oil money.” This money is deposited into several foreign banks for future generations. Only the president has a right to use these funds for public needs, and then only by his decree.

Unfortunately, there are no data on the level of corruption that can occur during these first two stages, which undermines any judgment regarding the relationship between macroeconomic stabilization and corruption. Based on one’s own judgment, we may argue that corruption was not so problematic before or during the macroeconomic stabilization process, but increased once the economic environment was stabilized and officialdom within the country strengthened.

Third Stage: Reforms in the Post-Heydar Aliyev Era

In general, thanks to political stabilization and reaching (or sometimes enforcing) consensus among main actors, macroeconomic stabilization in Azerbaijan has been successful. The following factors altogether framed the achievement of macroeconomic stability in Azerbaijan: tackling inflation (average less than 2 percent annually); stabilization of the exchange rate of the manat; GDP growth average annual 8–10 percent (mainly due to the oil boom); surplus in foreign trade balance; and decrease of the state budget deficit (1.5–2 percent of GDP).

However, other dimensions of market reforms—privatization, liberalization, and especially institutional development—have not been as successful. The pace of legislative and structural reforms has been slow and the degree of legal transition to a market economy has been one of the lowest among transition countries. Thus, Azerbaijan is left with continuous “successful macroeconomic stabilization.” The problem in the case of Azerbaijan is the development of the “bad institutions:” high levels of corruption and state capture as well as flourishing “crony capitalism.”

Successful stabilization and the subsequent slow pace of the market reforms in Azerbaijan can be explained by the argument that, at the initial stage, strong executive power or even an autocratic political regime unconstrained by free elections is preferable.³⁴ But when the situation is stabilized, and there is a need for consolidation, will the ruling elite resist the temptation to keep and strengthen their power and the status quo? The case of Azerbaijan supports the view that it cannot. The government has not loosened its policies following macroeconomic and political stabilization while the “winners” have not attempted to consolidate with the “losers.”

Another actor—the IMF—has played an ambivalent role in Azerbaijan’s transition. The IMF-financed reform programs have been at the core of Azerbaijan’s international support. It contributed to both successful macroeconomic reforms and the subsequent “hold back” reforms. It has also encouraged and supported the establishment of the Oil Fund in which all oil revenues are concentrated. The political reasons for the relative success of reforms have prevailed because of the geopolitical competition for dominance in the region and control over Caspian oil deposits and their transportation. But further support—through international financial institutions—for the stabilization program could be a reward from the United States to the Azerbaijani government for its support for American political and economic interests in the region. Such geopolitical issues sometimes make the Western

powers “blind” enough not to see the inconsistency of reforms or the problems with democratic state-building.

However, recently there have been various debates and conflicts between Azerbaijan’s government (especially the Ministry of Economic Development) and international donors on the issues of increasing energy prices, abolishing differentiated tax rates, and privatizing state banks. While in some cases the government may have been making rational arguments, its lack of cooperativeness may be due to the reluctance of the government to accelerate certain institutional reforms that harm powerful interest groups. It is also worth mentioning that with oil revenues rising, the government is no longer dependent on international financial institutions, which is in turn likely to reduce their influence on the direction of policies and the pace of marketization.

The case of Azerbaijan clearly shows the importance of political regimes to the fate of economic reforms and marketization. Despite ongoing changes, the political regime in the country lacks democratic principles and floats in the “grey waters” of something that can be labeled as sultanistic semiauthoritarianism.³⁵ However, the direction of future political development is still not possible to predict. Balancing democracy and authoritarianism will continue in Azerbaijan at least until the next presidential election in 2008. Such political uncertainty makes one uncertain about further developments in marketization as well.

Before leaving the political stage President Aliyev initiated serious institutional changes. A referendum in August 2002 brought about changes to the constitution. Instead of a proportional representation system being used for 20 percent of the seats in the legislature, all 125 seats are now elected on a simple majority or “first past the post” system. Whereas the chair of the parliament would previously have acted as president in the event the president was incapacitated, this responsibility is now designated to the prime minister. This mechanism was used in the summer of 2003 when İlham Aliyev was first appointed prime minister, and then acting president as the health of President Heydar Aliyev deteriorated. Another major constitutional change outlines that the percentage of the electoral vote required to become president has decreased from two-thirds to an absolute majority. These changes were meant to maintain nominal political stability.

Thus one may argue that Azerbaijan became the first post-Soviet country where actual succession of power “from father to son” took place. However, despite some serious violations, İlham Aliyev, who had significant popular support, won the October 2003 elections. İlham Aliyev’s election has not brought significant changes, although there have been indicators of a change in the elite, where young professionals, successful businessmen, and oligarchs have gradually started to replace representatives of the old nomenklatura in power positions. İlham Aliyev contributed to this process, trying to follow his father’s balanced policies and maintain the status quo while making replacements from time to time.

However, nominal political stability does not guarantee actual political stability. On the eve of parliamentary elections in the fall of 2005, the perception of stability within the country began to change. The elections signaled a new developmental stage in Azerbaijan’s political-economic life. At that time, some events involving the ruling elite demonstrated signs of radical change in the country’s political system—namely, that the times of so-called tribal capitalism had passed and that the transition to the “nomenklatura-oligarchic capitalism” had started. The system of interclan relations is no longer based on tribal

(regionalist) identity. Instead an oligarchic system of authority has emerged in Azerbaijan. This is the outcome of İlham Aliyev's presidency. Over this period of time, he has not accepted previously intrinsic tribal segregation as a key instrument for managing political system or the country as a whole.

The emergence of a new set of elites is highly possible in the very near future. The nature of political elites in Azerbaijan is shifting toward a "nomenklatura-bureaucratic" stage and could then move further to include "corporatist" (business) elites. This shift to include business elites will increase their influence in Azerbaijan. All things being equal, such a progression could help maintain political stability in the country and support market reforms.

Another important issue concerning political developments in Azerbaijan is the fact that for the first time Azerbaijan received a "not free" ranking from Freedom House, which accused İlham Aliyev of increasing pressure on opposition and independent media and undermining the little progress that Azerbaijan has achieved in democracy building.³⁶ Institution building and liberalization in Azerbaijan have not gone far and political reforms lag behind pure economic changes. Some authors recently warned about Azerbaijan moving in an authoritarian direction.³⁷ But there is no strong evidence either supporting or refuting these statements. It is still too early to derive any conclusions.

Despite nominal political stability and the pace of reforms in Azerbaijan, the country will never reach its peak efficiency or stability without resolving the conflict with Armenia over the Dağlıq Qarabağ region, restoring control of occupied territories, and returning refugees and internally displaced persons. Heydar Aliyev could not resolve this problem and instead passed it to his successor and son, İlham Aliyev. This "black garden" (Qara Bağ in Azeri) of Azerbaijan has turned into the "black hole" of the country's political economy. As far as market reforms are concerned, lately, Azerbaijan has had a mixed record in its progress toward marketization. Institution building has had both periods of rapid success and periods of deadlock. Great advances have been made in trade and price liberalization, privatization of small-medium enterprises, and land and fiscal reforms. Azerbaijan was the first country in the region to establish an oil fund and join the Extractive Industries Transparency Initiative. However, according to an independent report, the business environment remains difficult, corporate governance and transparency are poor, most state-owned enterprises (SOEs) are at an early stage of restructuring, and the nonoil sector remains underdeveloped.³⁸

Reforms have accelerated since mid-2004 when strategic guidelines for long-term oil revenue management were issued, certain measures to strengthen the banking system and tighten control of SOE spending were carried out, energy subsidies were reduced, anticorruption legislation was adopted, and progress with the World Trade Organization accession negotiations were made. Despite the progress in adopting the necessary legislation, poor enforcement undermines the potentially positive impacts these laws could have on political-economic development in the country.

A report by the Fitch Ratings agency stresses that major progress has been made with structural reforms in Azerbaijan. The tax base has been strengthened through improvements in the collection capacity of the Ministry of Taxes, the VAT base has broadened, and the personal income tax schedule has been simplified.³⁹

However, as already mentioned, resistance from vested interests is still high and it will take tremendous political will to push ahead structural reforms given rising oil revenues and related "temptations."

Measuring Reform Indexes in Azerbaijan

Having discussed and analyzed different aspects of reform and political stability in post-Soviet Azerbaijan, we need to apply the measures of political stability and market reforms discussed in the beginning of this article to understand clearly the whole process and be able to derive our conclusions.

To measure NPSI for each stage I assigned measures to subindicators, based on expert judgments.

LEGI ₁ =0.1	OPP ₁ =0.1	TENS ₁ =0.1	POLAR ₁ =0.1	WAR ₁ =0.1	ACT ₁ =0.1
LEGI ₂ =0.9	OPP ₂ =0.8	TENS ₂ =0.9	POLAR ₂ =1.0	WAR ₂ =0.7	ACT ₂ =0.8
LEGI ₃ =0.6	OPP ₃ =0.7	TENS ₃ =0.5	POLAR ₃ =0.8	WAR ₃ =0.7	ACT ₃ =0.5

The following results have been obtained using equation 1: NPSI₁=0.1; NPSI₂=0.9; NPSI₃=0.6.

Using the same qualitative analytic approach, I obtained the following MRPI indicators for Azerbaijan:

STAB ₁ =0.1	INST ₁ =0.1	LIB ₁ =0.5	PRIV ₁ =0.1
STAB ₂ =0.7	INST ₂ =0.4	LIB ₂ =0.2	PRIV ₂ =0.5
STAB ₃ =0.5	INST ₃ =0.4	LIB ₃ =0.4	PRIV ₃ =0.8

Thus, the progress of market reforms in Azerbaijan can be denoted as follows:

$$MRPI_1 = (0.27) 0.1 + (0.33) 0.1 + (0.20) 0.5 + (0.20) 0.1 = 0.18 \quad (4)$$

$$MRPI_2 = (0.27) 0.7 + (0.33) 0.4 + (0.20) 0.2 + (0.20) 0.5 = 0.46 \quad (5)$$

$$MRPI_3 = (0.27) 0.5 + (0.33) 0.4 + (0.20) 0.4 + (0.20) 0.8 = 0.51 \quad (6)$$

Whereas, the MAR index for these three stages will be as follows:

$$MAR_1 = (0.46) 0.1 + (0.27) 0.5 + (0.27) 0.1 = 0.21 \quad (7)$$

$$MAR_2 = (0.46) 0.4 + (0.27) 0.2 + (0.27) 0.5 = 0.37 \quad (8)$$

$$MAR_3 = (0.46) 0.4 + (0.27) 0.4 + (0.27) 0.8 = 0.51 \quad (9)$$

Let us summarize the obtained results using the ranking described earlier. All the indicators for indexes and subindexes are grouped as in table 3.

Having taken into consideration these results, I was able to construct figure 1, which demonstrates the progress of reforms in post-Soviet Azerbaijan. The good news is that MRPI has been constantly increasing, which in itself is an indicator for the progress of reforms. This would refute some skeptics' speculations about the lack of progress of reforms in Azerbaijan. The question should not be about the occurrence of progress, but about the extent of progress.

As seen from figure 1, only political and economic stability indexes have similar patterns. As far as marketization is concerned, we can see it has been developing smoothly, mainly because of an increase in the privatization subindicator. Actually, the progress in institutional development has been minimal, while liberalization has even regressed slightly because of the concentration of political and economic power during the second stage of transition.

TABLE 3. Indicators for Indexes and Subindexes

Indicator	Stage 1	Stage 2	Stage 3
LEGI	Low	Extremely high	High
OPP	Low	Extremely high	High
TENS	Low	Extremely high	Medium
POLAR	Low	Extremely high	High
WAR	Low	High	High
ACT	Low	Extremely high	Medium
Nominal Political Stability Index	Low	Extremely high	High
STAB	Low	High	Medium
INST	Low	Medium	Medium
LIB	Medium	Low	Medium
PRIV	Low	Medium	High
Marketization Reform Progress Index	Low	Medium	Medium

Note. See Tables 1 and 2 for acronym explanations.

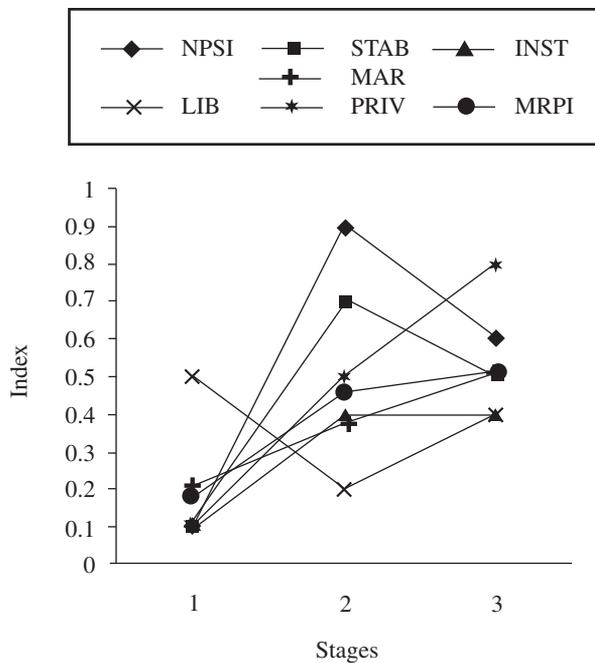


FIGURE 1. Progress of Reforms and Political Stability in Azerbaijan.

In general, institutional reforms have suffered significantly from inconsistency. One should also keep in mind that NPSI demonstrates the level of nominal stability, which can be misleading and fragile if it represents a low level of equilibrium.

It is obvious that the oil factor and the geopolitical situation of Azerbaijan has played a tremendous role in improving and activating its economy despite the shortcomings in democracy building already discussed. The last two presidents of the country have used these factors, in addition to conflicting interests of global and regional stakeholders, successfully in strengthening the economy and their own position of power.

However, because of an incomplete transition from Communism in Azerbaijan and the relative state of key indicators, it is too early to make any final judgments about success and progress. What social scientists and policy analysts are doing is monitoring and evaluating in motion, which is the only possible way to make a difference at the moment. One of the disturbing questions now, however, is: When will this transition be over and what should be done to accelerate the process?

Conclusion

In approaching reforms from a broader, philosophical perspective, one may argue that only the simultaneous impact of the “three I’s”—ideologies, institutions, and interests—can help end this seemingly eternal transition. The “three I’s” model is demonstrated in figure 2.

An ideology sets an ethical and cultural basis for a new system, institutions create the system itself, and interests keep this system developing because actors are interested in it and not in any other system. The combination of the “three I’s” leads to the emergence, development, and strengthening of a new ethical paradigm, which, in turn, influences each component.

Ideologies and institutions are interconnected. An institutionally strong state may resist corruption, and as a result influence the formation of the appropriate ethics. By engaging in

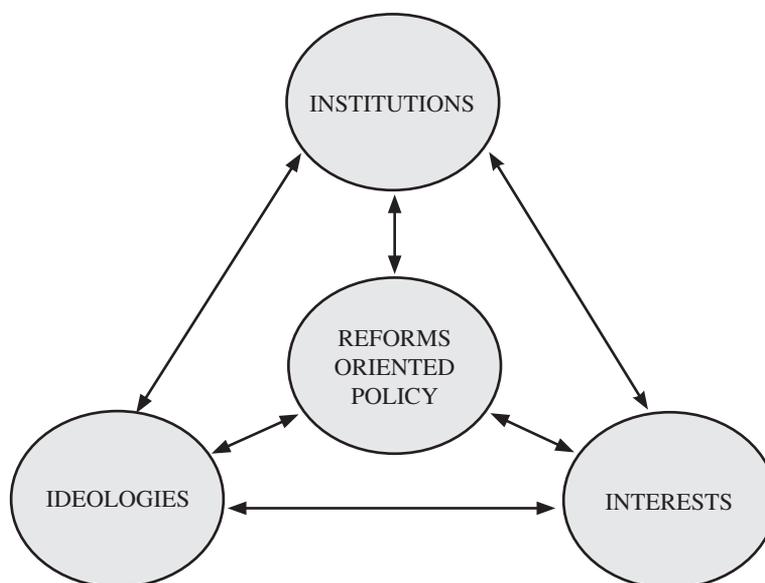


FIGURE 2. The “Three I” Model.

daily life with the right institutions and living under the advocacy of an ideology based on values and morals, both universal and particular to the given society, each citizen will learn how to behave. Proper ethics without proper institutions are impossible. Soviet-style propaganda and cults of personality that accompany existing public policies are not conducive to the progress of reforms because they do not offer the values necessary for the ideological justification of decisions made and policies implemented. On the other hand, it is necessary to remember that interests are one of the main motives of human and group behavior. Social consensus—a certain public agreement between interested groups (political, ethnic, regional, religious, and professional)—is necessary. Such consensus can be made official through a constitution or another similar document. Government, in turn, should ensure that all parties of the contract observe its regulations. The government should take steps to enforce these social contracts if needed and protect the rights of its citizens. Thus, successful symbiosis of a stick with a carrot, when the “marginal utility” of honesty is higher than the “marginal utility” of corruption and improper behavior, is necessary.

A partial reforms model is a principle threat to post-Soviet nations, especially those like Azerbaijan with significant natural resources and huge intrinsic potential for rent-seeking behavior and moral hazard. Because the winners of stabilization are getting richer thanks to the status quo, they are not interested in progress and they definitely are not the bearers and advocates of proreform ideologies. In this case, only the enforcement of institutional development by a committed government and a mobilized and active civil society is capable of breaking the vicious circle and making a difference. That is what has been absent so far in Azerbaijan and many other post-Soviet nations in transition. Thus implementing reforms in the aforementioned dimensions will allow Azerbaijan guaranteed sustainable development and stability in the mid and long-term. However, further marketization will not be possible if accompanied by the development of a regime of sultanistic semiauthoritarianism and accelerating undemocratic trends. Marketization requires democratization. Alternative solutions may have unpleasant and dangerous consequences for the country.

NOTES

1. World Bank, *Transition: First Ten Years: Analysis and Lessons for Eastern Europe and Former Soviet Union* (Washington, DC: The World Bank, 2002).

2. Shafiqul Islam, “Conclusion: Problems of Planning a Market Economy,” in *Making Markets: Economic Transformation in Eastern Europe and the Post-Soviet States*, ed. S. Islam and M. Mandelbaum, 437 (New York: Council on Foreign Relations Press, 1993).

3. Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America* (Cambridge: Cambridge University Press, 1991), 136.

4. Islam, “Problems of Planning a Market Economy,” 437.

5. Joan Nelson, *The Politics of Economic Transformation: Is Third World Experience Relevant in Eastern Europe?* (Mimeo: Overseas Development Council, 1992), 1.

6. Dani Rodrik, “Understanding Economic Policy Reform,” *Journal of Economic Literature* 34 (March 1996): 36–38.

7. Gerard Roland, “Political Constraint and the Transition Experience,” in *Lessons from the Economic Transition: Central and Eastern Europe in the 90s*, ed. Salvatore Zecchini, 83 (Amsterdam: Kluwer, 1996).

8. Joel Hellmann, “Winners Take All: The Politics of Partial Reform in Post-Communist Transitions,” *World Politics* 50 (January 1998): 232.

9. Nelson, *The Politics of Economic Transformation*, 12; Rodrik, “Understanding Economic Policy Reform,” 40.

10. Seymour Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53, no. 1 (1959): 69–105; Larry Diamond and Marc Plattner, *Economic Reform and Democracy* (Baltimore: John Hopkins University Press, 1995).
11. Farid Guliyev, "Post-Soviet Azerbaijan: Transition to Sultanistic Semi-Authoritarianism? An Attempt at Conceptualization," *Demokratizatsiya* 13, no. 3 (2005): 397.
12. Marina Ottaway, *Democracy Challenged: The Rise of Semi-Authoritarianism* (Washington, DC: Carnegie Endowment for International Peace, 2003), 69.
13. Houchang Chehabi and Juan Linz, *Sultanistic Regimes* (Baltimore: John Hopkins University Press 1998), 5.
14. Ottaway, *Democracy Challenged*, 14–19.
15. Chehabi and Linz, *Sultanistic Regimes*, 7.
16. Branislav Slantchev, "The Political Economy of Simultaneous Transitions: An Empirical Test of Two Models," *Political Research Quarterly* 58, no. 2 (2005): 279–94.
17. World Bank, *Transition*, 3.
18. Islam, "Conclusion: Problems of Planning a Market Economy," 437.
19. "Index of Economic Freedom—2008," Heritage Foundation, <http://www.heritage.org/research/features/index/countries.cfm> (accessed February 22, 2006).
20. International Monetary Fund, "The World Economic Outlook: Building Institutions," International Monetary Fund, <http://www.imf.org/external/pubs/ft/weo/2005/02/index.htm> (accessed February 24, 2006).
21. Douglass North, "The New Institutional Economics and Development" (St. Louis Economic History/Economics Working Papers Archive, Washington University, St. Louis, MO, 1993).
22. International Monetary Fund, "The World Economic Outlook."
23. Fredo Arias-King, "'Just Do It': Interview with Mart Laar," *Demokratizatsiya* 11, no. 4 (2003): 495–508.
24. International Monetary Fund, 137.
25. National Bank of Azerbaijan, *National Bank of Azerbaijan Republic 1992–2002* (Baku, Azerbaijan: NBA Press, 2002), 4–18.
26. World Bank, "World Development Indicators 2006," <http://devdata.worldbank.org.libproxy.lib.unc.edu/dataonline/> (accessed March 12, 2006).
27. Juhani Laurila and Rupinder Singh, "Sequential Reform Strategy: The Case of Azerbaijan," *BOFIT Discussion Paper* 8, Institute for Economies in Transition, Helsinki, Finland, 2000, 6–8.
28. Fuad Aliyev, "The International Monetary Fund and Reforms in Azerbaijan," *Local Government Brief* 2 (Spring 2002): 19–24.
29. Fuad Aliyev, "Peculiarities of Legal and Actual Central Bank Independence in Azerbaijan" (in Azeri), in *Compendium of the "Scientific-Technical Progress in Azerbaijan" Conference* (Baku: Azerbaijan Technical University, 2003), 86–94.
30. Karoly Attila Soos, "On the Conditions of Sustained Economic Growth in Azerbaijan: Monetary and Fiscal Policies, Banking and Institutional Reforms in Azerbaijan," *Economic Trends Quarterly* (July–September 2001): 24–27.
31. Statistical Committee of Azerbaijan, "Gross Domestic Product by Industries (per cent)," http://www.azstat.org/publications/azfigures/2006/en/010.shtml#t10_2 (accessed March 12, 2006).
32. "International Credit Analysis: Azerbaijan Republic," Fitch Ratings, January 24, 2006.
33. Terry Linn Karl, "The Perils of the Petro-State: Reflections on the Paradox of Plenty," *Journal of International Affairs* 53, no. 1 (1999): 16.
34. Nelson, *The Politics of Economic Transformation*, 13.
35. Guliyev, "Post-Soviet Azerbaijan," 393–435.
36. Freedom House, "Freedom in the World: Azerbaijan (2005)," <http://www.freedomhouse.org/template.cfm?page=363&year=2005&country=6689> (accessed February 22, 2006).
37. Ottaway, *Democracy Challenged*, 17; Guliyev, "Post-Soviet Azerbaijan," 393–435.
38. Fitch Ratings, "Azerbaijan Republic: Analytical Report."
39. Ibid.

Subscribe Today and Access Content Online!



Whether comparing Montaigne's and Tocqueville's thoughts on skepticism or discussing Nietzsche's political critique of modern science, *Perspectives on Political Science* links contemporary politics and culture to the enduring questions posed by great thinkers from antiquity to the present. Recent articles have addressed Tocqueville's account of religion in modern democracy, liberalism and civic education, Strauss's perspective on modern politics, and the rule of law in the twenty-first century. The authoritative source for reviews of new books on government, politics, international affairs, public policy, and political theory, *PPS* guides scholars, educators, policy planners, and others who require broad, up-to-date knowledge of the literature published within the last twelve months. General readers as well as specialists will find *Perspectives on Political Science* stimulating reading.

Quarterly; ISSN 1045-7097

Regular Annual Subscription Rates:

Individual: \$72 online only, \$76 print and online

Institutional: \$179 online only, \$179 print only, \$214 print and online

Add \$14 for postage outside the U.S.

CALL OR VISIT US ONLINE TO SUBSCRIBE!

Libraries may order through subscription agents.



Subscription Offices:

PO Box 830350

Birmingham, AL 35283-0350

P. 866.802.7059 ■ F. 205.995.1588

heldref@subscriptionoffice.com

www.heldref.org