

Post-Soviet Energy Wealth: a Comparative Study of Azerbaijan and Kazakhstan

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Abstract

The issue of oil politics is certainly complex and multi-faceted. This thesis will focus on analysis of economic development of oil-rich countries, because it is one of the broad and important topics due to the vital role of natural resources for every country. In particular, I find it necessary to focus on particular examples of two countries from the same region. This thesis seeks to explain why Kazakhstan and Azerbaijan have not had a similar path in developing economically regardless of their similarity in abundance of natural resources, undiversified economies, political structures based on colonial legacies, and types of political regime. It is important to write on this topic because relatively little has been written on the issue. This thesis uses qualitative method of comparative analysis of the development of the oil and gas sectors and regime maintenance in Azerbaijan and Kazakhstan as a case study.

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Introduction

Natural resources and their effect on economic development is one of the most topical issues explored by scholars and practitioners in the field of International Relations. In particular, oil and natural gas are so important because they are one of the driving forces of the industrialization. Some of the most prominent authors in the field of international relations as Terry L. Karl, Hazem Beblawi, Giacomo Luciani, Richard Pomfret, Auty and others have been analyzing the issue of oil and its politics.

The issue of oil politics is certainly complex and multi-faceted, this thesis will focus on analysis of economic development of oil-rich countries, because it is one of the broad and important topics due to the vital role of natural resources for every country. In particular, I find it necessary to focus on particular examples of two countries from the same region. This research project seeks to explain why Kazakhstan and Azerbaijan have not had a similar path in developing economically regardless of their similarity in abundance of natural resources, undiversified economies, political structures based on colonial legacies, and types of political regime. It is important to write on this topic because relatively little has been written on the issue of the development of the oil and gas sectors and regime maintenance in Azerbaijan and Kazakhstan as a case study.

It is necessary to identify key definitions which are related to the research question and which would help us understand the puzzle better. Often oil-rich countries are referred to as 'rentier states'. There are different definitions for the term, but when put into a general explanation, a rentier state would refer to a state whose main source of the budget is rent from

natural resources such as oil, gas or even diamonds. A rentier economy generates short-term expenditure rather than long-term investments, as it was first proposed by Hossein Mahdavy in 1970, and further systematized by Beblawi and Luciani in 1987.¹ For Beblawi rentier state has three main characteristics. First, the rents come from abroad. Second, the rents accrue to the government directly. Third, only few people are involved in the generation of the rent, the majority just distributes and utilizes them.² So, in this framework the following question can be asked. Are Kazakhstan and Azerbaijan rentier states?

In order to set up a theoretical framework for the thesis, most of the sources I am going to review focus on the development of oil economies in Arab states, because of the abundantly available literature on them, and some similarities to the cases of Kazakhstan and Azerbaijan which makes the cases comparable. For example, Giacomo Luciani shows how oil has conditioned outcomes in both oil-rich and oil-poor states³. Oil matters because it helps to determine the regional balance of power and the behavior of external powers towards the region. The concept will be useful because in my research I will look into the question of power of elites as well as at bargaining power distribution between the oil companies and the state authorities.

Terry Lynn Karl's phenomena of the 'paradox of plenty' will be the bone of my references because she looks into many important issues from political economy of oil-rich countries⁴. That includes the Dutch disease, which is high currency appreciation as a result from oil revenues, and which has, in her opinion, spill-over effect and can distress other sectors of the economy. She also looks into frameworks for decision making and why they vary from case to case. While attempting to answer her main puzzle of why most oil-exporting countries

¹ <http://www.alternativesjournal.net/volume1/number1/akuru.htm>

² Beblawi 1990, 87-88

³ International Relations of the Middle East, Louise Fawcett, 79-104

⁴ The Paradox of Plenty: Oil booms and Petro-States, Terry Lynn Karl, University of California Press, 1997

suffered from economic deterioration, she makes a contribution, which translates into four main points: petrolization of the policy environment, private vested interests as barriers to change, the rentier state as a barrier to change, and the boom effect. She also gives a thorough explanation of a dependence on a particular commodity and how it shapes not only regime types, but also institutions of the state, framework for decision-making. So, how decisions are made when it comes to the oil revenues distribution is another very important question in explaining the effect that natural resources have on economic development. As I look into the rentier state concept, as well as into private interests it would be useful to see a different approach into those terms.

Sally N. Cummings writes about the connection between the changes within the state and the power of the authorities. She accounts for variation between types of authoritarian regimes in Central Asia and ascribes this variation to a number of factors, including leadership effectiveness, the impact of the Soviet Union, etc. The main novelty concerning the political changes is the following: it is likely to come from three sources – from the government structures, from mass mobilization, or from foreign influence.⁵ So, it will also contribute into seeing the connection between such factors.

My main research question is why do rentier states develop one way or another, but not the same way, even if they have the same preconditions? Why and at what stage do oil economies turn into rentier states? Are oil-rich regions rich? These are some of the questions that I will try to answer in my thesis, relying on relevant authors in the field. Oil is a major factor in shaping politics of Kazakhstan and Azerbaijan. Paul Rivlin and Shmuel Even look at often thought as a dangerous strategy that Arab states developed: delay and react rather than initiate

⁵ Power and change in Central Asia, edited by Sally N. Cummings, Routledge, 2002

reform.⁶ Due to the lack of reforms and positive improvements in oil sector in cases of Kazakhstan and Azerbaijan the strategy might be present as well as investigated in this thesis.

One of the methods that will be useful for this analysis is primary sources, such as personal communication, secondary sources, such as books, scholarly journals, articles, analytical reports, and new agencies. The sources demonstrate the dynamics and progress of oil and gas production in domestic politics, policy trends and economic forecasts, which can be valuable for assessing, analyzing and testing the main puzzle of the research.

The problem that I might encounter while using the sources is the divergence of the data provided by the governmentally owned oil and gas companies, and the sources of the privately owned ones. It is one of the consequences of the lack of transparency in natural resources deals between the governments and foreign companies. Another possible explanation is the changes in legislative documents, which does not allow grasping a consistent development and dynamics of the deals, as the conditions for the foreign investors change.

Another methodology used is a comparative analysis, since two countries are compared in this thesis: Kazakhstan and Azerbaijan. This methodology will be particularly useful for my thesis, because it will help to demonstrate how two countries take different paths despite of the similarity in the political governance, abundance of the natural resources, and lack of the diversification of the economies. Dependent variable of my thesis is the economic development and political stability in Azerbaijan and Kazakhstan and independent variables are clan politics through which the elite manages to maintain its power.

The research will also make use of the qualitative methods. Since the thesis is not just looking into numbers and their indications, it will be necessary to use secondary sources for

⁶ "Political stability in Arab States", Paul Rivlin and Shmuel Even, Tel Aviv University, 2004

setting up the theoretical frameworks, identifying key terms and phrases that are useful for better comprehending the whole concept of a puzzle. Also, journals would be of a valuable source, as they often have up-to-date views and opinions of scholars on the issue. That will allow avoiding repetition of the main conclusions and points.

While analyzing many independent variables the aim of my thesis is to contribute to the debate of divergence in adopting development strategies despite similarities. The topic is of a great personal interest for the author and contributes to the understanding of world politics not only because of the scarcity of natural resources around the world, but also because it is indeed one of the vastly used sources in wars as well as appeasements in the international arena. Thus its mismanagement may lead to many complications and difficulties when dealt on the governmental level.

The chapter break down is planned to be as follows. After the introduction, chapter 1 will set up a theoretical framework for the empirical chapters of political and economic implications of oil. Various debates and arguments are viewed in the chapter, such as concepts of rentier state, rentierism, rentier economy. The main authors are Terry Karl and Hazem Beblawi. Chapter 2 will provide a historical background of Azerbaijan and Kazakhstan to give a better prospective into the issue. Chapter 3 will look at the economic implications of oil, such as the “Dutch Disease”, attraction of investors, as well as alternative sectors to the oil economy. Chapter 3 will look at the political implication of oil in the two countries. The chapter will show how the elite managed to stay in power through oil politics. Conclusion will follow.

1. Theory of rentierism and rentier economy

The aim of this chapter is to set up a theoretical framework and background for better understanding political stability through the main component of rentier state, the prevailing revenues from oil exports in the state budget. I will look into main concepts of theory of rentierism, rentier state, and economy presented by different authors in the first part of the chapter. I will rely on these concepts because it is one way of viewing oil dominated political and economic structures. This will be useful for the empirical chapter of oil implications both economically and politically, as I will be able to test the theory according to the factors that I will set up in this chapter. Another aim for this chapter is to find out what are the proxies for rentierism which would be applicable to countries of Kazakhstan and Azerbaijan.

1.1. *Why is oil so important?*

It is necessary to outline why oil is such a controversial and yet vital resource for most of the countries around the world. Oil is highly important to each and every country, and it is often perceived as a political tool for leverage both in domestic and foreign politics. To give an example of oil importance, it is a highly strategic energy supply and the MENA (Middle East and North Africa) countries are in a central position for providing it. The region controls about 68 percent of world reserves, and it is estimated to export over 75 percent of the world total by 2020.⁷ For the people in the region, oil has been a mixed blessing. Oil accounts for 75 percent of the national income in the Gulf economies, and the budgets of most of oil states have huge

⁷ MENA includes both oil-rich countries in the Gulf, and resource-poor countries, such as Yemen, Morocco, and Egypt. The region's economic situation has been affected by two factors over the past 25 years: the oil price and economic policies of the states. Full list of countries is available at the World Bank website: <http://web.worldbank.org>

deficits and internal debt. The result is that population growth could offset any increase in oil revenues. For example, Saudi Arabia, for the period 1980-2000, saw its population grow from 9.9 million to 22 million, a rise of over 120 per cent. But its per capita income went down from \$21245 to \$3000, or a seventh of what it had been two decades earlier.⁸ This shows a direct connection between oil and the population growth, which is one of the factors that diversify oil trends.

Various scholars have tried to establish a link between oil and politics, mainly in the Middle East as well as in the Caspian Sea region. One side of the politics and oil analysis is the link between oil and pipelines, authors who wrote on the issue are Fiona Hill, Bahgat Korany and others. One of the central studies for this thesis is how Azerbaijan and Kazakhstan have managed to reduce the rise of political opposition by capturing key elites. Authors like Alec Rasizade, Kuru and Ottaway wrote on authoritarianism and regime maintenance in post-soviet countries. This framework will be taken into consideration in the section of political implications of oil in Azerbaijan and Kazakhstan.

1.2. *Rentierism theory and rentier economy*

1.2.1. Theory of rentierism

In order to start the explanation of the theory of rentierism, we need to see how this issue has caused debates and what authors have written regarding this issue. There are many different debates about the theory of rentierism and its applicability to various countries. So, rent is generally understood as the income derived from natural resources. Numerous scholarly articles, books and journals have been discussing the issue of rentierism and its theory. Most of the authors put their emphasis on the oil-rich countries of the Arab states in the Middle East. The

⁸ Richards, A. and Waterbury, J. (1998), *A political economy of the Middle East* 2nd edition, London and Boulder: West view Press, 59

probable reason for this is because of the countries' vast share of natural resources, primarily oil, in the world share. In my case, I will review the literature which describes various aspects of the economy in the Arab states as this will help me to set up the framework for the rest of my research thesis. My focus of interest will shift to the countries of Kazakhstan and Azerbaijan in empirical chapters because relatively little has been written about these two countries in comparison with each other and by reviewing the literature on the Arab states I will see if certain measurements of rentierism are applicable for these countries in order to find out if the countries can be called 'rentier'.

The theory of rentierism was first introduced by Hussein Mahdavy in 1970 and further systematized by Beblawi and Luciani in 1987. Central statement of this concept is a country's vital part of a budget comes out of rents from natural resources, whether it is oil and gas or minerals. Rentier states are resource-rich countries, and often resource abundance is considered as a 'curse', which is why often in the literature this phenomenon is called the resource curse.⁹ Related to the mentioned factor, Beblawi and Luciani claim that after being used to the easy money from oil rent, people do not easily accept the notion of hard work, so it is not only the economy that is rentier but also the rentier attitude itself transfers to the society structure and even to the individual mindset. Therefore, in this context, reward does not depend on work or productive efficiency, and it leads to laziness and effortless spending both by the government officials, and the general population. There is a problem if the 'easy money' decreases.¹⁰ This is a fairly important point when it comes to the case studies of Kazakhstan and Azerbaijan because in the first case the oil extraction is predicted to increase. Thus, can we make an assumption that as oil extraction increases, the inefficiency of the economy will decrease? In this chapter I am

⁹ Pauline Jones Luong and Erika Weinthal, "Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in the Soviet Successor States and Beyond", *Comparative Political Studies*, 2001

¹⁰ Beblawi, H. and Luciani, G, 'The rentier state', London: Croom Helm, 1987, 1-21

going to review some of the most prominent authors' ideas, assumptions and conclusions about rentierism, rentier economy and issues that involve it.

1.2.2. Concept of a rentier economy

The main finding of the study of Terry Karl regarding oil-rich countries is that countries dependent on the same export activity are likely to experience great similarities in their way to develop, even if the institutions are different in all respects. So, the expectation should be the common degrees of 'stateness' in countries that are dependent on the same leading sector as long as strong political institutions were not established there before the development of the leading sector.¹¹ An excellent example of this would be Norway, which already had strong political institutions prior to finding out the abundance of natural resources. It is generally perceived that natural resources cannot harm the country because it is 'easy money' and it can contribute to the budget by a great amount, but it seems that if the strong institutions are in place before the discovery of natural resources can the country experience further development and economic growth. For the country cases of Kazakhstan and Azerbaijan it would be exactly this, because of the weak institutions inherited from the soviet times. I will use political parties as a unit of political institutions. Therefore, the political parties are weak because of the underrepresented opposition.

Another way of understanding a rentier economy is by looking at the phenomenon that is called 'Dutch Disease'. According to Karl's definition, it is a process where favorable price changes in one sector of the economy distresses other sectors, such as agriculture and manufacturing. This happens because of the large-scale petroleum related capital inflows from oil sales result in a long-term sectoral reallocation of capital and labor resources. If Dutch

¹¹ Terry Lynn Karl, *ibid.*

Disease remains for a long time, it can lead to a rapid and distorted growth of services, transportation, and other non-tradable goods, and simultaneously upsetting industrialization and agriculture. In addition, the oil sector creates high wages, which serve as an attraction for employees from other sectors of the economy. However, by the mid-2000s, it was perceived by the international observers and economists, that during the first decade after the independence Kazakhstan was inclined towards Dutch Disease, but that assumption is not valid presently due to a relatively growing diversification of the economy.¹² This shows that a country had a history of being suspected in having a Dutch Disease, which means it can happen again, if the country will keep its politics trends.

As Herb outlines in his work, a rentier state should not be mistaken for state where rent-seeking prevails in economic and political elites. Rent-seeking might be present in rentier state, but it is not a necessary component of rent-seeking. There is also a connection of rentierism and dependence on natural resources, although, the author states that these are not the same thing and cannot be interchangeable. Usually dependence on natural resources can be measured by their exports as a percentage of GDP per capita, as was mentioned earlier. Rentierism, on the contrary, focuses on rents in government finances and is the way of measurement, which is used in the theory of rentier state. In reality, rentierism almost always follows dependence on natural resources.¹³

However, Beblawi adds that there is no pure rentier economy. He states that a country might have an element of a rentier economy, but cannot have all of the elements. A rentier

¹² Richard Pomfret, 'Kazakhstan's Economy since Independence: Does the Oil Boom offer a Second Chance for Sustainable Development?', *Europe-Asia Studies*, Vol. 57, No.6, September 2005, 859-876

¹³ Michael Herb, 'Does Rentierism Prevent Democracy?'. Annual Meeting of the American Political Science Association, September, 2002

economy generates short-term expenditure rather than long-term investments,¹⁴ which then has a negative effect on economic development in the long run. For Beblawi the theory of a rentier economy has three main implications. First, the rents come from abroad. In other words, rents have to be external. Second, the rents accrue to the government directly. Third, only few people are involved in generation of the rent majority just distributes and utilizes it.¹⁵ So, using this framework, we need to find out if we can state that Kazakhstan and Azerbaijan are rentier states by these parameters. It would be necessary to first find out what are the measurements for the rentier economy.

1.3. Paradox of Plenty?

1.3.1. Concept of “Paradox of plenty”

Rentierism and rentier economy has been extensively described in Terry Karl’s “Paradox of Plenty”, which will help me outline theory of rentierism in this chapter. The idea behind the paradox is that countries, which are rich in natural resources, lag with the economic development behind by being yet developing countries. Karl comes to various conclusions about this issue. One of her statements claim that dependence on a particular export commodity shapes not only social classes and regime types, as other mentioned authors have demonstrated so well, but also the very institutions of the state, the framework for decision-making, and the decision calculus of policymakers.

The general argument of Karl is following. Growth caused by commodity creates changes in notions of property rights, the relative power of interest groups and organizations, and the role of a state versus market. These institutional changes define the revenue basis of the state,

¹⁴ Ahmet Kuru, “The Rentier State Model and Central Asian Studies: The Turkmen case”, *Alternatives*, Vo. 1, No. 1, Spring 2002

¹⁵ Beblawi 1990, 87-88

especially the tax structure. How these states collect and distribute taxes creates incentives influences the organization of political and economic life and shapes government policies. Therefore, long-term efficiency is either helped or hindered, and the diverse development trajectories of nations are initiated, modified or sustained.¹⁶ This approach is going to be useful for me because I will talk about political parties as institutions in the post-Soviet Azerbaijan and Kazakhstan. She justifies the understanding of the interaction between economic development and institutional change in oil-exporting countries by the following reasons, which are quite convincing. As the price of international oil is linked to stability of oil-exporting countries, their internal dynamics have global implication. Further she refers to the Gulf War as a prominent example of this.

1.3.2. Criticism to the “Paradox of Plenty”

On the other hand, the article of Matthias Basedau and Wolfram Lacher suggest that in fact there is no “Paradox of Plenty” regarding the possibility of instability and violence in oil-producing countries.¹⁷ Evidence shows that there are countries which have high incomes but are full of conflict and violence, while others have less income per capita, but are more politically stable. Matthias Basedau and Wolfram Lacher look at the countries of Africa and other oil-rich countries. They raise some very simple questions that are at the same time very provocative and multi-faceted. Such questions as why are some oil-producing countries prone to violence and instability while others are not? Are certain resource-specific and non-resource conditions in oil and gas-producing countries systematically linked to violence or instability? However, the article suggests that country-specific context conditions play a vital role in the way that the oil revenues

¹⁶ The Paradox of Plenty: Oil booms and Petro-States, Terry Lynn Karl, University of California Press, 1997, 7

¹⁷ A paradox of plenty? Rent distribution and political stability in oil states. Matthias Basedau and Wolfram Lacher. Working paper #21, April 2006

are distributed. This is also very useful for the empirical chapter as oil revenues distribution will be discussed and Azerbaijan and Kazakhstan have some specific traits, which have to be taken into consideration. Authors find in their work that there is no relationship between the extent to which a country is resource rich or dependent and the regime of a country. That is challenging to the “Resource Curse” theory.

The proxies for political stability of a country are found in the following way. First, they find income per capita as a better indicator for abundance than dependence is. However, the problem that the authors have encountered is the accurate data of the amount of revenues that the government earns, which leads to incorrect estimates about the disparity in incomes, which is another very big and important issue. Also, the measure does not take into account the relative wealth of countries.¹⁸ If we look closer, we should notice that the abundance in oil and gas does not lead to instability and violence, usually the opposite – the authors claim that there is strong empirical evidence that the higher per capita incomes prevent a country from violent conflict and instability. Further, authors claim that the data on resource revenue management system should be the most prioritized when collecting data. Another point, as there is no available data for patronage and clientelism and patronage networks and the corruption indicators are difficult to measure, indicators as estimates of bribes and oil money siphoned from the budget of the government, and income inequality would be more reliable to measure. Moreover, they find strong correlation between revenue quantity and governance quality, meaning that the higher oil revenues, the better is quality of governance. The question that follows is whether the rentier mechanisms cause such development of high governance.

¹⁸ Basedau and Lacher, *ibid.*

It has been found that Kazakhstan as well as Libya and Saudi Arabia is an exception in terms of the income level from the typology that shows the relationship between incomes per capita and the presence or absence of the political conflict. Kazakhstan is an exception in this case because it challenges the general observation of low-income countries to have political conflicts, which is not the case in Kazakhstan. The opposite can be said about Libya and Saudi Arabia, which have high income but are not necessarily politically stable. That is a puzzle indeed, of why Kazakhstan scores badly on the control of corruption and government effectiveness, experience high oil dependence and low income per capita, and yet experiences no conflict. So, going back to the first proxy of political stability, income distribution, we should see what other authors say about this factor. Paul Ravin puts the issue slightly in a different term, mentioning a weak middle class in economic and political terms which has been a key feature in the economic and political development in Arab countries.¹⁹ To illustrate how the income distribution played a role in Egypt, he gives an example of ‘why is Egypt poor four millennia after building the pyramids? Why didn’t an industrial revolution happen under the pharaohs? Some quick back-of-the-envelope analysis provides an answer: income distribution...So prosperity for the few has lasted for millennia, but prosperity for the many remains elusive in Cairo today.’

1.4. *Rentierism and political stability*

Bahgat Korany, through the literature, identified twenty six factors of political instability ranging from the proliferation of weapons of mass destruction, to over-urbanization and desertification. The accumulation of deficits, economic, political and social will make it difficult to differentiate between internal and external conflicts. For example, decline of water per capita

¹⁹ “Political stability in Arab States”, Paul Rivlin and Shmuel Even, Tel Aviv University, 2004, 24

in MENA is greater than the world average.²⁰ By and large economic development in a country in general depends on what sector in the country is leading. It has been described by Michael Shafer that different sectors of export – mining, agriculture, manufacturing, and services - shape the strategies adopted by the states differently.²¹ I will not take this aspect of the chapter into consideration because Kazakhstan and Azerbaijan's leading sectors of the economy is primarily oil and gas, but it is not any less important factor when viewed through other oil-rich countries around the world and can be used for further studies and research.

It is necessary to explore the connection of the authorities in the oil and gas sectors with the political stability. The task of having a grip on power through natural resources has been seemingly growing by looking at the latest trends with the oil companies and changes in legislation. The constitution changes declared that the stake share of the national companies would be bigger along with the presidential extension to one more term, which would only apply to the current president. Once again, oil is inescapable: it has influenced the regional relations in the world, notably with the major powers, it affects domestic politics and stability within oil-rich countries some of which if not for oil would probably survive through the political instabilities and uprisings, wars, etc. In other words, even if it is commonly considered a curse, quite often it is a blessing for many countries. Moreover, for the case of Azerbaijan and Kazakhstan oil has been a tool for regime maintenance.

1.5. Conclusion

To sum up the chapter, I outlined main concepts and views of scholars about oil politics, rentierism, rentier economy from different authors. When the state's main income of budget is

²⁰ Bahgat Korany, *ibid*

²¹ D.Michael Shafer 'Winners and losers: how sectors shape the developmental prospects of the states', Cornell University Press, 1994

rent from the natural resources then it is considered to be a rentier state. Rentier state has some economic implication on a state, such as the effect of the “Dutch Disease”, which is the national currency appreciation and distraction of other sectors of economy, primarily agricultural sector. What has not been tested in the literature is the applicability of a theory to Azerbaijan and Kazakhstan as these countries have not been compared in this framework. I will use the tool of a rentier economy measurements to test whether the states of Azerbaijan and Kazakhstan are rentier or not and if they are turning into that trap. The second part of the theoretical framework about institutions and the power elite will be useful for the chapter of political implications of oil in both countries. The following historical chapter should give a background of both post-Soviet Azerbaijan and Kazakhstan in their state formation, and challenges in economic and political spheres in order to understand why these two cases are comparable.

2. Historical background of oil-rich Azerbaijan and Kazakhstan

‘Azerbaijan and Kazakhstan urgently need measures that guarantee accountability, transparency, and public oversight in their oil industries. Only then will the two countries stand a chance of using oil and natural gas revenues to raise living standards for their people and lay the basis for healthy, long-term economic growth.’
- Caspian Revenue Watch

Since the break-up of the Soviet Union in 1991 both Azerbaijan and Kazakhstan took different ways in developing their economies. The two countries are highly dependent on extraction of natural resources such as oil, gas and other minerals. As large reserves of oil were discovered under the Caspian Sea, many foreign investors are lured into the region for the profit from the extraction of black gold. The Caspian Revenue Watch foretells us that perhaps these two countries will never be able to benefit to their full extent from the revenues. The given reason is the “Resource Curse” phenomena, which has occurred in many of the oil-rich countries such as Venezuela, Nigeria, Iran, and others.²² There has been much research done on both countries in the form of interviews from the politicians of leading positions, so called elites of the government. Authors show how easy to get caught in the vicious circle of pure oil extraction and to bear the consequences of it in the form of corruption, patronage, clan politics and eventually undiversified economy as the biggest consequence. This chapter will outline main

²² Joseph E. Stieglitz, Svetlana Tsalik, Caspian Oil Windfall: who will benefit? Caspian Revenue Watch, 2003

challenges of a state formation such as economic, political and cultural. Focus will be on the economic ones.

2.1. State formation of Azerbaijan and Kazakhstan

The creation of Kazakhstan as an independent state goes back to 1991, when by decision of Moscow to withdraw its maintenance from the Soviet Union this country was born ‘by default’. ²³ Kazakhstan is the ninth world largest country with the population slightly over 15, 5 million inhabitants,²⁴ which are very few people for such a large territory. Geopolitically Kazakhstan is located between two major powers in the region: in the south of Russia and east of China, and it is also a northern border to other Central Asian countries as Kyrgyzstan, Uzbekistan and a little bit of Turkmenistan and it has experienced one of the most rapid recoveries from the economic collapse caused by the fall of the Soviet Union. The president Nursultan Abishevich Nazarbayev has been in power since gaining independence. He has been re-elected three times since the independence and recent amendments to the Constitution let him to be in power for life. ²⁵

On the map you will be able to find Azerbaijan to the west of the Caspian Sea, north of Iran, and south of Russia. It also borders with Georgia and Armenia, which, together with Azerbaijan, is known as the Southern Caucasus. The population of Azerbaijan is slightly less than 8.5 million people, and it is another rich in natural resources, oil and gas country. From a low income per capita as \$1,240 in 2005, the country has been making progress, to \$6,480 in 2007. ²⁶ The country had to make a transition from the command system to a market system.

²³ Kazakhstan was the last country to get its independence from the Soviet Union on the 16th of December, 1991. Sally Cummings, ‘Kazakhstan, power and the elite’, I.B.Taurus and Co Ltd., New York, 2005

²⁴ Statistics Agency of Republic Agentstvo Respubliki Kazakhstan po statistike, www.stat.kz

²⁵ “Nazarbayev to Reign in Kazakhstan for Life”, Kommersant, Russia’s Daily Online, www.kommersant.ru, May 18, 2007

²⁶ World Bank country profile, direct link: <http://web.worldbank.org>

Growth rates have been accelerating since 1995, with the first two quarters of 1998 showing respective of 8.2 and 9.9 per cent on the previous year. The flow of foreign investment in many ways underpins the growth for many years.²⁷ In 1999 the State Oil Fund (Sofaz) was created in Azerbaijan for collecting and managing all oil revenues. After October, 15 2003, Azerbaijan experienced a turning point in its history. It was connected with the election of a new president of the country, the son of the former president, Heydar Aliyev, who 'passed' his position to his son Ilham Aliyev. The president has been in power since October 2003. Hopes for the better presidency by the son have not been proved. The gap of incomes between the richest and the poorest families is constantly growing and is about 10 times.²⁸ This is both economic and political challenge that country is currently facing.

2.2. *Main challenges in economical, political and social areas*

2.2.1. Economic challenges

Kazakhstan is a country, which after the 1992 has been attracting billions of dollars in foreign investment in the oil and gas industry. The region had the most rapid privatization program and prevailing atmosphere of corruption, which is why most foreign investors in other sectors found it difficult to make investments. As the country is receiving massive amounts of foreign investment, legal protections for foreign investors and Kazakh property remain inadequate. Even though Kazakhstan had the smoothest transition from the SU among other Central Asian countries, thanks to the resources it has, still the economy suffered in the mid-1990s when the agriculture went through a period of decline, and the collapse was noticeable in

²⁷ Edmund Herzig, 'The New Caucasus: Armenia, Azerbaijan, and Georgia', Royal Institute of International Affairs, 1999, 125

²⁸ Alec Rasizade 'Azerbaijan after Heydar Aliev', Nationalities Papers, Vol.32, No.1, March 2004

the defense-related sectors. Kazakhstan recognizes that it has to diversify the economy in order to provide long-term benefits for its citizens and gain importance in the international arena.

Soaring prices of oil in the late 1990s helped Kazakhstan to display a growth in the economy. The country's average per capita rose to \$1,780 in 2003 and this can be seen as an example of a steady growth. The rise of per capita made Kazakhstan second after Russia in the Commonwealth of Independent States (CIS)²⁹, and in 2007 estimates the number rose to \$10,660.³⁰ There were a few reforms that the country went through, such as tax reform in 2003 and the pension system reform, which led to some surpluses in 2002 and 2006 in the state budget. Although Kazakhstan is not perceived as a high-income country, it has the full capacity to develop a strong economy and has the fastest growing GDP in the region. The Kazakh government issued new state program for the development of the oil sector of the Caspian Sea. Also, the government has increased pressure on foreign investors in the Kashagan field when dealing with the contracts.

2.2.2. Political challenges

The corruption that is present in many oil-rich countries lead to mistakes in governance, as the oil riches go to the elite without the rule of law, or social conscience. It may result in political instability³¹ By the late 1990s Kazakhstan's presidential system started to overwhelm independent political institutions. No institution in Kazakhstan is able to provide legal protection or balance the power that president holds. Much of the elite consolidation of power has been justified as restoring Kazakh nationhood.³² Political challenges include strengthening weak inherited institutions, such as political parties, in which the opposition is underrepresented and is

²⁹ The World Bank's World Development Report 2005: A better investment climate for Everyone, New York: Oxford University Press, 2004

³⁰ International Monetary Fund, Kazakhstan profile. Direct link: <http://www.imf.org>

³¹ Daniel Heradstveit 'Democracy and oil: the case of Azerbaijan', Reichert Verlag Weisbaden 2001

³² Martha Brill Olcott, 'Central Asia's second chance', Carnegie Endowment for International Peace, 2005, 22, 30

constantly shut down. Violations of human rights and the rule of law are other main political challenges, which are widely discussed in the news and reports. Kazakhstan won the bid to chair the Organization of Security and Cooperation of Europe (OSCE) in 2010, which caused a few disagreements from other countries, but which on the other hand, is looked at as a chance to justify the bid.

Perhaps the starting point for the country's recovery was that Azerbaijan signed an oil contract worth \$7.4 billion with the Western consortium in 1994. However, the war over Nagorno-Karabakh should be mentioned as well, as it slowed down the economic growth.³³ The recovery of the country has not begun until 1996, as the prices of oil helped to stimulate development in oil-related sectors. Political stability of a country depends on a fair management of oil and gas resources. Distribution of revenues is a struggle between the few rich and the rest of the population, which is relatively poor. In 1997 there was macroeconomic stability, but the dramatic fall of the oil price in 1998 cause much pessimism in the country. Azerbaijan is still facing many challenges in its governmental system, education, but most importantly it is running out of oil, which is tragic, since the country does have neither resources nor time to get out from the vicious circle of oil-dependent economy.

2.3. Conclusion

It is true that every country with an economy dominated by oil is corrupt and dictatorial. One of the major challenges in the oil industry is to stimulate forces that can counteract the clan system and corruption. By being passive it will only lead the countries to become a source of foster of the political elite that is not a fair power of managing the people's black gold.

³³ World Bank website, country profile, ibid

Kazakhstan and Azerbaijan, after the break-up of the SU, faced similar challenges with the state and nation building. Both by being oil-rich countries they could follow the road of path dependence and fall under the definition of rentier state. However, the countries take different ways of development and economic growth. The following chapter will test the theory of rentierism of Beblawi and Karl.

3. The impact of oil rents on the economy in Azerbaijan and Kazakhstan

Using the theoretical approach of Beblawi and Karl, it is further necessary to test the measurements of a rentier economy. Aim of this chapter is to demonstrate how oil impacts the economic development in Azerbaijan and Kazakhstan. First, in order to provide some background on oil and gas, I will outline statistics about main oil extraction sites, oil reserves and main deals with foreign oil companies. This will show the abundance in oil and gas reserves. Second, I will look into the main challenges in the sector of oil and gas resources, such as transparent deals with foreign investors, even distribution of oil revenues because revenues from oil and gas are the more important source for the state budget. Third aim of this chapter is to look into economic implications of oil and gas reserves into a social life of people, such as the unemployment rates, migration within a country, level of education because these are also measurements of economic development.

3.1. *Large reserves of oil and gas in Azerbaijan and more in Kazakhstan*

3.1.1. Oil reserve estimates

Azerbaijan and Kazakhstan are very rich with a lot of natural resources, such as oil, gas, precious metals, minerals, uranium, coal, etc. Azerbaijan has proven to have 7 billion barrels of oil and around 850 million cu meters of gas, out of which the country extracts 934,700 barrels a day of oil and 6.3 billion cu meters of gas. GDP per capita is \$9,000.³⁴ Kazakhstan on the other hand has estimates oil reserves of nine billion barrels and 1.765 trillion cu meters of gas, out of

³⁴ Estimates from April 17, 2007, World Fact Book, www.cia.gov

which the country exports around one million barrels a day of oil, and 10.2 billion cu meters of gas. The GDP per capita is \$10,400.³⁵ This data shows us that the countries have large oil and gas reserves, more so in the case of Kazakhstan, and the GDP has been rising from the flow of oil revenues.

3.1.2. Oil and gas sites and foreign investors in the oil and gas sector

One of the features of a landlocked country is its lack of oil export pipelines. During the Soviet period, the Kazakh oil industry was not exploited for exporting its oil to international markets, unlike Azerbaijan, because of the huge oil exploration and development projects in Siberia. When Kazakhstan became independent, it had only one export pipeline, which began from Atyrau in the far western part of the country, and went to Samara in Russia. Kazakhstan signed a bilateral agreement with Russia in July, 1998 about dividing the northern part of the Caspian seabed along the median lines between the two countries. This allowed Russia to start exploring its offshore potential. In August 1999, the Offshore Kazakhstan Operating Company (OKIOC)³⁶ began to drill its first offshore test well at Kashagan in the Kazakh sector of the Caspian Sea.³⁷ In August 2001, OKIOC was renamed into Agip Kazakhstan North Caspian Operating Company (AgipKCO)³⁸, and it became fully owned by ENI S.p.A. via Agip Caspian Sea B.V. Today it is the single Operator of the development and future production operation in the Kazakhstan sector of the Caspian Sea on behalf of seven international companies and under the North Caspian Sea Production Sharing Agreement (PSA).³⁹

³⁵ Estimates from April 17, 2007, *ibid*.

³⁶ OKIOC, a nine-member international consortium including Mobil, BP Amoco, Phillips Petroleum, etc.

³⁷ B. Brauer, "Oil boom looms in Kazakhstan", the Washington Times, December, 20, 1999. Direct link: www.internationalreports.com

³⁸ Eurasianet. www.eurasianet.org

³⁹ The North Caspian Sea PSA contract area extends over a territory of 5600 square km and includes the giant Kashagan oil field, as well as the Kashagan South West, Aktote, Kairan and Kalamkas discoveries. Direct link: <http://www.agipkco.com/wps/wcm/connect/AgipKCO+EN/Home/About+Agip+KCO/>

The Kashagan field is a very special case because of its large proven reserves of 7 billion barrels, which makes it the largest oil field discovered in the past three decades and the fourth or fifth largest in the world.⁴⁰ The oil field was already known in the 1970s, but exploration began only in 1993 under a consortium of seven international companies and the Kazakhstan national company. In November 2007 the partners signed a production sharing agreement (PSA) which was largely in favor of the foreign companies, to the detriment of Kazakhstan. In August 1998, looking for money, Kazakhstan sold its shares in Kashagan to Phillips Petroleum and Japanese Inpex for \$500 million. The resulting nine participants then formed the OKIOC consortium, which in 2001 became AGIP KCO. A year later, British Petroleum (BP) and Statoil withdrew, leaving Eni, Total, ExxonMobil and Shell with 18,52% of the shares each, ConocoPhillips with 9,26%, and Inpex and KazMunaiGaz with 8,33% each. The surprise selection of Eni, a subsidiary of Agip, as the consortium operator in 2001 reflected both dissension among the Western partners and the wish of Kazakhstan to develop a multi-vector foreign policy.⁴¹ This section shows that Kazakhstan and Azerbaijan's oil and gas sector is attractive to foreign investors.

As for gas, main reserves of it are located at Karachaganak, near the border with Russia. There are also undeveloped reserves of gas near Zhambyl in the south. In order to control the domestic gas industry the government created KazMunaiGaz in 1992. Besides Karachaganak, gas is produced at Tengiz, Uzen, Zhanazhol and Kumkol.⁴² For Azerbaijan the main exploration site for gas reserves is located in the area of ShahDeniz, where production of gas should rise from 16 billion cubic meters in 2007 to 47.5 billion cubic meters in 2015, and oil production will

⁴⁰ Eurasianet, www.eurasianet.org

⁴¹ Nina Bachkatov, Report "Kazakhstan follows GazProm", Inside Russia and Eurasia, Report "Kazakhstan follows GazProm", www.russia-eurasia.net

⁴² Anne E. Peck, "Economic development in Kazakhstan", RoutledgeCurzon, 2004

rise to 65-67 million tons by 2015.⁴³ Main oil reserves in Azerbaijan are in the area of Chirag and Guneshli.

3.2. *Where do oil revenues go?*

As we have found out from the previous section, there is a lot of oil in Azerbaijan and Kazakhstan. This matters because the countries are vulnerable to fall in trap of being a rentier state. The legitimate question to be asked for then is where do the oil revenues, or rents, go? Rent from oil and gas is generated both on export and domestic sales of oil and gas, which are also shared between producers, the owner of the transport infrastructure, the governments and domestic energy consumers.⁴⁴ Power elite in both countries are not using the oil revenues properly, by siphoning the revenues. Distribution policy becomes a struggle between a few rich and the rest of the poor population. The price of oil is also very crucial. The price of oil cannot be always high, despite the rising need for energy resources, or at least, the country should not rely just on rents, because the resources may end sooner than it is expected. It is very important and almost necessary for sustainable economic development of a country to use oil revenues in other sectors of economy, which are more labor-intensive and more productivity-oriented.⁴⁵

For Azerbaijan is of a crucial importance to get the management of the oil revenues in the right direction, even more so than for Kazakhstan. The Caspian Revenue watch suggests three reasons for that. First, the economy in Azerbaijan is more dependent on energy resources than in Kazakhstan. Second, Azerbaijan has less oil than Kazakhstan. The third reason is the long-lasting

⁴³ The Economic Times, www.economictimes.com

⁴⁴ Akram Esanov, Martin Raiser and Willem Buiter, “Nature’s blessing or nature’s curse?”, *Energy, Wealth and Governance in the Caucasus and Central Asia*, Routledge, 2006, 41

⁴⁵

conflict over Nagorno-Karabakh, as a result of which about one million of people were displaced, which creates another burden on the country.⁴⁶

3.2.1. State Funds

In order to manage revenues, or rent from natural resources properly, Kazakhstan's national government set up a special National Fund in 2000, which receives a big portion of national oil revenues. The fund is designed to meet two main objectives: to use oil revenues to ensure stable social and economic development by reducing the economy's vulnerability to oil price fluctuations, and to accumulate financial resources for future generations. One focus for civil society work on extractive industries in Kazakhstan is to monitor the operations of the National Fund effectively.⁴⁷

Azerbaijan's government also created a special national oil fund in 2000, The State Oil Fund of the Azerbaijan Republic (SOFAZ). The initial idea for its use was to finance strategic investments rather than ongoing expenditures. In its first years of operation, the fund's expenditures included funding for an oil export pipeline and resettlement of refugees. In 2003, the president issued a decree allowing money from the fund to also be used to cover national budget deficits, making it harder to monitor the use of those funds and threatening the principle of using them to invest for the future.⁴⁸

3.2.2. Reinvestment in non-oil sectors

Reinvestment in non-oil sector might help preventing falling into trap of a rentier state. In the case of Azerbaijan reinvestment in non-oil sector is a big concern because of the low level of foreign direct investment (FDI) into non-oil economy. According to the Economic Intelligence

⁴⁶ Sabit Bagirov, Ingilab Akhmedov, Svetlana Tsalik, "State Oil Fund of the Azerbaijan Republic", Caspian Revenue Watch, "Caspian Oil Windfalls: Who Will Benefit", Open Society Institute, 2003, 90

⁴⁷ National Oil Fund of Kazakhstan

⁴⁸ Jim Shultz, "Follow the money", Open Society Institute, April 2004

Unit, total gross FDI amount was US\$4.3billions in 2007, but only US\$158million out of it went to non-oil sectors, which is equivalent to less than 1% of GDP.⁴⁹ The low amount shows that there are no sustainable and profitable sectors of economy that foreign investors would be interested investing in or other non-oil sectors of economy have not been yet developed to their full potential, which causes doubts for the future of potential sectors of economy, which again, require foreign investment to a certain extend. FDI inflows into the economy remained negative in 2007, approximately \$4.7billion, because of the foreign companies in the oil sector, which repatriated capital.⁵⁰

Kazakhstan, however, faces different challenges than Azerbaijan. Deficit of a state's budget has quadrupled between 2006 and 2007, totaling from US \$1.9 billion to US \$7.2 billion. Despite the rising oil prices in 2007, which allowed the trade surplus to rise slightly to US \$15.1 billion from US \$14.6 billion the previous year, this little improvement could not prevent increases of US \$2.1 billion and US \$2.7 billion in the services and income deficits, respectively. The largest part of services debits were paid for construction and technical services, which includes geological and other services associated with oil exploration. Construction services imports also reflect oil sector activity in the shape of pipelines but also have been boosted by the construction boom under way in the first half of 2007. The oil sector was also behind the rising income deficit, as foreign investors earned dividends and profits averaging more than US \$2billion per quarter.⁵¹ As seen from the statistics, both countries have not managed to reinvest properly in the non-oil sectors of economy, or done so with a relatively small portion of the total GDP.

⁴⁹ Economic Intelligence Unit country report, May, 2008

⁵⁰ Ibid.

⁵¹ Ibid.

3.2.3. Ownership issues

Regulations for the sale of licenses for the development of untapped onshore and offshore reserves require 50 percent Kazakh ownership of the project, either in the form of partnership with a private Kazakh firm or the Kazakh state oil company.⁵² Latest events in the oil sector prove that it is getting more difficult for foreign investors to invest in the country's energy sector due to a few changes in the regulations concerning the foreign oil companies. One of them is that the President has the right to make any changes in contracts with foreign companies, or even veto the contracts which are not suitable for the government.

The table below outlines the main offshore oil sites which were offered by the Kazakh government to the foreign investors. The number of the oil reserves is substantial, which will give oil investors to extract oil for the future.

Name	Location	Proved reserves (billion barrels)	Current stage
Darhan	Center of the Caspian	11	Negotiations with Chinese CNPC – lasted for several years
“N” (Nursultan)	South of the Caspian	4.65	Royal Dutch Shell, Conoco Phillips competed for the block, KazMunaiGaz is likely to invite a foreign partner
Zhambyl	North of the Caspian	1.26	The government signed a memorandum of understanding with a consortium of South Korean companies: KNOC, SK Corp, LG Corp, Daesung and Samsung
Abai	North of the Caspian	2.8	The government has signed a memorandum of understanding with Norway's Statoil
Isatai	North of the	1.75	Potential project partners have not been

⁵² Martha Brill Olcott, “Central Asia’s second chance”, Carnegie Endowment for International Peace, 2005

	Caspian		named
Satpayev	North of the Caspian	1.85	The government signed a memorandum of understanding with India's ONGC in 2005, but the final agreement is yet to be reached

Table 1: Summary of available offshore oil extraction sites for foreign investment. All numbers were provided by the Kazakh government.

Source: The Reuters News Agency ⁵³

3.3. Oil effects on the social life in the countries

It has been extensively written by scholars, analysts, news agencies, about the effects which oil has on the economy. Economic growth can be created by production of oil and gas. In order to build a ruined economy after the demise of the SU Azerbaijan is dependent on foreign trade and foreign investment. If Azerbaijan is to become a state which oil will only be for the benefit of its people, it must avoid the traps into which other oil-rich countries have fallen, for example, anticipating the oil revenues by taking up foreign loans, which in the end go out of control and require the whole economy to be repaid, or lead to default.⁵⁴

To see social impacts of oil, one should look at the labor regulations at work places, which are poorly controlled in both Azerbaijan and Kazakhstan. Very often workers' rights are violated and their work places do not apply with standards and norms required by law. This often happens in the sector of mining, and in the oil sector of the economy. In the case of Azerbaijan, often in the oil industry double standards are used by foreign investors. When they come to the country and turn away from the democratic values which are respected in the West, that is viewed as a double standards for the human rights. Another fact of the differences in wages can be seen as a violation of human rights. It is perceived by the local people that the foreign employee will earn

⁵³ Reuters, February, 21, 2008, www.reuters.com

⁵⁴ Von Daniel Heradstveit, "Democracy and Oil: the case of Azerbaijan", Reichert Verlag Wiesbaden, 200, 19

ten times as much as the local for the same job done.⁵⁵ Other cases include an environmental damage the oil and gas companies bring, and they do not pay for the damage.

3.4. *Alternative sectors of economy*

Azerbaijan and Kazakhstan both to a different extent have their economies dependent on oil and gas exports. However, soon oil boom will end in the case of Azerbaijan sooner, than in Kazakhstan and this is a big issue for long-run economic development and the issue is how to prepare for that future. The KZ government has made efforts to reinvigorate agriculture, which had slipped badly in the 1990s, and success in this is reflected in the good recent wheat harvests. According to Prof. Pomfret, the following sectors of economy might be a good alternative to the energy sector. Investment in uranium mining may be a rational response, reducing the risk of possible future shifts in energy demand from oil to nuclear. The KZ government is also investing in education, which is better than trying to pick sectors for diversification (as Turkmenistan has done, disastrously); a well-educated population will be able to identify and respond to new opportunities when the time comes. Projections of the oil extraction rates are increasing over the coming years as new fields come into production. The optimum rate of extraction depends upon future oil prices; therefore it is hard to agree upon. If future demand for oil will fall as new energy resources are developed, then KZ should exploit its large oil reserves as quickly as possible (turning oil in the ground into assets in the oil fund); this view may underlie the government's dissatisfaction with ENI over Kashagan. On the other hand it might be decades before the real price of oil becomes low and, if the oil fund is not well managed or you

⁵⁵ Daniel Heradstveit, "Democratic development in Azerbaijan and the role of the Western Oil Industry", Central Asian Survey, 20:3, 2001

expect technological improvements to reduce the cost of extracting oil in future, then it might be better to keep oil in the ground.⁵⁶

Agriculture sector might be a good solution for the diversification of economy in Kazakhstan because of a few reasons. First, Kazakhstan has vast lands, which could be used for planting and harvesting a lot of grain, and wheat, primarily, since it is a staple in their diet for many of the countries in the region, however, lack of high technologies is one of the obstacles for fully implementing development in this alternative sector. Second reason is the specificity of the sector: it is labor-intensive. This is very important since the being an oil-exporting country, Kazakhstan is not using much labor for the energy sector, and expanding on agriculture sector could help to attract more human resources and diversify budget income. Finally, recent trends in the world events show that the food prices went up, and there is a crucial need for grain in many developing countries. It only makes sense now to produce more grain as the demand for it increases worldwide. In the case of Azerbaijan it is a little different due to not so vast lands, and other reasons, such as lack of technologies, and perhaps, the most crucial, the lack of interest in investing in that sector due to too high rents with a minimum investment into it.

3.5. Conclusion

Azerbaijan and Kazakhstan proven reserves will not last long, it is even more so for Azerbaijan. BP estimates that, depending on oil and gas prices, the government of Azerbaijan will earn \$21–\$58 billion by 2024 when current reserves are expected to be exhausted. In that short window of opportunity, Azerbaijan must wrestle with severe poverty problems. A conflict over territory in Nagorno-Karabakh resulted in approximately 800,000 internally displaced people, many of whom are still living in temporary housing in railway cars or with their

⁵⁶ Richard Pomfret, Interview over email, 18 May, 2008

relatives. According to the United Nations Development Program (UNDP), 49 percent of the population lives in absolute poverty. A decision by the government to add \$35 million in military spending to the 2004 budget is unlikely to provide any direct benefit to the poor.

4. Political implications of oil in Azerbaijan and Kazakhstan

As we found out in the previous chapter, oil can have negative effects on a country's economy. Moreover, oil has a significant impact on the domestic political system too. This chapter will seek to present implications of oil on political stability in Azerbaijan and Kazakhstan in the framework of political institutions and grip on power of the national elite in both countries.

First, I will look at the correlation between oil and authoritarian regime in Azerbaijan and Kazakhstan because both of the countries qualify for the state with an authoritarian regime. political parties system as institutions, which are weak and highly dominated by the president's clan members. This will explain causal correlation between oil and authoritarian regime, which is guiding both presidents, in Azerbaijan and Kazakhstan. This will also help to set up the framework for better understanding the incentives behind actions of national elites when dealing with oil sector.

Second, there is a need to view clan politics in Kazakhstan, main divisions, competition between clans because clan politics is one way of explaining the regime maintenance in both countries. Clan politics matters because it plays essential role not only in everyday politics in both countries but also is instead of institutions, which tend to reproduce themselves, and thus, in the politics of Azerbaijan and Kazakhstan simply cannot be ignored.

Third aim of this chapter is to look into political implications of clan politics and challenges in the energy sector, such as corruption in political system as a consequence, as well as deals with foreign companies as an example for corruption. The main finding is that despite listed challenges in Azerbaijan and Kazakhstan, the countries are relatively politically stable. Main explanation to this stability is clan politics.

4.1. Authoritarian regime, political institutions and oil

4.1.1. Authoritarianism and oil

The main impact of oil on political stability is that it helps the national elite to maintain its power. This can be proved by looking at the correlation between oil and authoritarian regime.

In order to explain this connection between oil and authoritarianism, Ross gives rentier effects, which have three mechanisms, which possibly can explain the connection between authoritarian regime and oil. First, is the ‘taxation effect’ suggests that if the government receives a large amount of money from oil, it is likely to tax their citizens less or not at all, and citizens in return will be unlikely to demand accountability and representation from their government. Second is the ‘spending effect’ meaning that oil wealth can lead to a large amount of spending on networks and patronage, which can pressure democratization. Third component is the ‘group formation’ implying that when the government gets a lot of oil revenues, it will use the money to prevent formation of independent social groups that might demand political rights. These effects all together state that the governments that mainly fund themselves by oil revenues, are likely to be authoritarian, and those governments, whose main source of income are taxes, more democratic.⁵⁷ This is an appropriate framework for the cases of Azerbaijan and Kazakhstan, since, they both run under an authoritarian regime.

4.1.2. Authoritarianism and political parties

Another way to test authoritarian regime is by looking at its political institutions. Most scholars view political parties as institutions. In Kazakhstan political parties currently mostly

⁵⁷ Michael Ross, “Does Oil Hinder Democracy?”, *World Politics* 53, April 2001, 332

dominated by the presidential party Nur-Otan. Bowyer classifies parties in Kazakhstan into three categories: pro-presidential parties, ‘soft opposition’ and ‘hard opposition’. ⁵⁸ In Azerbaijan political players can be parted by two: government and opposition sides. There are around ten major parties, New Azerbaijan Party being the main pro-presidential one, and more than forty minor parties and many unregistered small parties, which in total number is a lot more than in Kazakhstan. ⁵⁹ However, the oppositional parties are very weak in both countries and are not really significant. Moreover, the oil money helps to buy-off the loyalty of opposition or shut it down by silencing opposition leaders.

4.2. *Clan politics as an explanation for the power maintenance*

In cases of Azerbaijan and Kazakhstan, clan politics in this chapter will be an essential explanation for the regime maintenance. The two countries are similar in a way that their presidents have a grip on power through their regime maintenance techniques. They control oil funds, contracts with foreign oil investors, buy-off loyalty of the opposition, etc. Thus, this section seeks to explain main divisions of clans, competition between the clans, and how the regime maintenance is done by the clan politics in both countries.

4.2.1. Clan division

Starr proposes division of clans into three different groups. First, is the division by the Hordes or Zhuzes, this concerns Kazakhstan, which embraces Senior Horde, Middle Horde, and Junior Horde. Second is the regional network, largest of which dominated politics for a long time both, in Azerbaijan and Kazakhstan. Third, comes from who has a control and power over

⁵⁸ Anthony Clive Bowyer, “Parliaments and Political Parties in Kazakhstan”, Silk Road Studies, May 2008

⁵⁹ Azerbaijan: background, US Department of State, www.state.gov, last accessed 01.06.08

resources.⁶⁰ Horde-based division is topical and applicable for the case of Kazakhstan in the current politics. However, for Azerbaijan more applicable would be regional network group. The difference between the two countries in clan politics is that in Kazakhstan clans are blood-based kin structures and these are still powerful associations, whereas in Azerbaijan it is less so, it is more important 'who you might know' approach rather than blood-related member.

In the case of the Kazakh clan division it would be impossible to tell by the place of birth the zhuz membership. Since, we are using the first division of the clan of Starr, it was suggested by the elite that the Senior Zhuz is overrepresented, the Middle Zhuz is nearly presented, and the Junior Zhuz is underrepresented.⁶¹ Nurbulat Masanov used to be the most eager proponent of the opinion that the affiliation to certain zhuz of the individual and determine the type and rank of political position. He explains the importance of the zhuz primarily important not only as a symbol, but also as the function. Thus he defines the Senior Zhuz as the horde with low position status but high influence. The Junior Zhuz, acted as a mediator between the Senior Zhuz and the Middle Zhuz, and was appointed to position of low profile, high influence and high status. The Middle Zhuz members, especially the tribe of *Argyn* were placed in posts of lesser influence but then their influence was more likely to grow with the move of the capital from Almaty to Astana.⁶² This probably can be explained by geographical location of the Argyn clan division. Since the representatives of Argyn tribe mostly, but not necessarily, located in the center of the country, transfer of the capital to Astana would only give them opportunities to grow politically, i.e. they would be able to get jobs in Astana, etc.

As Prof. Galm sees the current clan subdivisions, the greatest oil and gas reserves are in areas of the nation controlled by Junior Zhuz members. Great Zhuz tribes have the greatest

⁶⁰ S.Frederick Starr, "Clans, Authoritarian Rulers and Parliaments in Central Asia", Silk Road Paper, June, 2006

⁶¹ Sally N. Cummings, "Kazakhstan: Power and the Elite", I.B.Tauris&Co Ltd, New York, 2005, 85

⁶² Sally N. Cummings, Ibid.

power, for example, the President Nazarbayev is from a Senior Zhuz but the power bases of both the Middle Horde and more recently the Junior Zhuz are growing and cannot be ignored. Since 2001 there has been a rapid expansion of "deal making" between the Zhuzes and multinational corporations and this is not going to end in the near term.⁶³

In Azerbaijan Ilham Aliyev controls every shipment of crude oil. According to Georgian government statistics, SOCAR exports more oil than officially reported, which brings about US\$1 billion into the pockets of presidential clan members. Reports about the members of the president's clan and their million of petrodollars in their accounts are being published by the opposition.⁶⁴ Also, money goes to fancy cars and clothes, gambling, at the same time there is water limit to 2-3 hours a day in Baku, the capital.

4.2.2. Competition between clans

There is a constant competition between the elite, thus the pro-presidential clan members and the opposition, which is being repressed on a regular basis. For examples, the Kazakh opposition leader Altynbek Sarsenbayev had been killed in 2006 by the former law enforcement officer, Rustam Ibragimov. Defendant Rustam Ibragimov is a former law-enforcement officer. He was charged with killing Sarsenbaev, his driver, and a bodyguard at the behest of Erzhan Utembaev, the former head of the Senate administration. Ibragimov pleaded not guilty when he took the stand, then went on to testify of senior involvement in a conspiracy and coup attempt.⁶⁵ There are other people disappear and get found dead as well. For example high officials of NurBank, journalists disappear periodically.

⁶³ Jerry Galm, Professor of Anthropology, Eastern Washington University, interview by email, dated 20.05.08

⁶⁴ Alec Rasizade, "Azerbaijan after Heydar Aliyev", Nationalities Papers, Vol. 32, No. 1, March 2004

⁶⁵ KAZAKHSTAN: BATTLE OF THE CLANS CONTINUES, Daniel Kimmage, 8/14/06

The same situation is in Azerbaijan. Kamaledin Haydarov, who was the head of the State Customs Committee, was appointed as a Minister of Emergency. By many people this was perceived as a downgrade in the position, because this Ministry is considered not as “income generating” place as the State Customs Committee. Later it turned out that Heydarov is still the leading figure in management of the State Customs Committee. In other words, the existing head of the Committee was hired by Heydarov. Thus, Heydarov generates more power than before the new post. He uses his power in the competition with other members of other clans. For instance, in 2006 he stimulated arrest by the government of Farhad Aliyev, the former Minister of Economic Development. Currently Heydarov and Ziya Mammadov, the Minister of Transportation have the greatest rivalry and the competition between the clans in Azerbaijan is increasingly becoming more violent. During the presidency of Heydar Aliyev, the situation was much better as the president could control different clans effectively. However, Ilham Aliyev, present Azerbaijan president, is either uninterested in these issues or incapable of controlling them. It is not excluded that the situation can worsen and the clashes between clans can end up with more violent results (e.g. even armed fights).⁶⁶

4.2.3. Regime maintenance

Schatz mentions the clan politics continuing to be in the heart of the power relations in many countries. The clan politics and the presence of the clans divisions create a big barrier for sustainable development of the country's economy. Kazakhstan case shows us that the intention to eradicate clan identities can translate into practice of sustaining them. Because the institutions

⁶⁶ Musavat, “The war of oligarchs is getting bigger”, website, www.musavat.com

tend to reproduce themselves, and clans are there instead of the weak institutions inherited from the Soviet legacy, as in the case of Kazakhstan, this clans also tend to reproduce each other.⁶⁷ This means that it will be present in the future as a result of reproducing itself.

Transnational oil companies that started thriving after the demise of the Soviet Union, act similarly in Azerbaijan as they act in other Middle Eastern countries. Investments they make only make powerful families of main authorities, who in turn 'vie to see who among them can display the largest portrait of the president in his office'. Current state budget of Azerbaijan is just \$4 billion and since oil revenues are going to raise up to US\$170 billion per year by 2024 the lack of transparency and of any role for the public in decision making suggests that this vast inflow of funds will only strengthen already existing autocratic system.⁶⁸

Perhaps one of the great examples of the regime maintenance through clanship in Azerbaijan was the presidential elections when the former president Heydar Aliyev have passed the ruling power to his son, Ilham, in 2003.⁶⁹ The same applies to the president of Kazakhstan with the re-election for three times since 1991, and with changes in the constitutions, he can stay in power for life.⁷⁰

Moreover, Ostrowski criticizes Luong and Weithal for the case of Kazakhstan, because their analysis does not take into consideration situation in the oil sector. He states that external political factors were not the only determinants for the ruler's strategies; the internal politics mattered as well. His suggestion is to move from tribe-based and clan-based approaches to corporatism and patron-client networks as a regime maintenance technique. His novelty is that he views the regime maintenance through another way of understanding it. He justifies the usage of

⁶⁷ Edward Schatz, 'Modern Clan Politics: the power of blood in Kazakhstan and beyond', 14

⁶⁸ Leila Alieva, "Azerbaijan's Frustrating Elections", *Journal of Democracy*, 17.02.2006, 147-160

⁶⁹ Alec Rasizade, *ibid.*

⁷⁰ Reuters, www.reuters.com

such approach for two reasons. First reason is because this approach was used by economists and political scientists to explain relationship between regime maintenance and business in authoritarian countries. Second, corporatism and patron-client networks were used by Sovietologists, but can be useful when analyzing oil industry in post-Soviet Kazakhstan.⁷¹ Both approaches, Ostrowki's and clan-based approaches could be used when looking at the case countries, however, the above-mentioned approach of clan-based regime maintenance can be used, because it is topical, straightforward, and there is enough data for it. As Karin and Chebotarev put it, 'the republic's political system today is defined by paternal-clientelistic relationships and the division of Kazakhs into three tribal groupings [zhuz] and that zhuz membership is 'used as a mechanism for lobbying its interests in the organs of power'.⁷²

Due to the lack of reliable sources, most of the sources of information are unofficial sources from blogs. The government of Azerbaijan before the Presidential elections in November this year takes precautions by making amendments in election's regulations. The government claims that the Azerbaijani people want Ilham Aliyev as a president for life. However, there is no final decision about this. Some argue that this is also a reflection of the clan politics. As Ilham Aliyev cannot be elected for the third time in 2013, and there are rumors that Mehriban Aliyeva, the first lady, can be president for the other term, the balance between the clans can change dramatically. That is why the clans who have stronger positions in the government now, want to decide Ilham Aliyev as a lifetime president to maintain their positions.

⁷¹ Wojciech Ostrowski, "Regime maintenance in post-Soviet Kazakhstan: the case of the regime and oil industry relationship (1991-2005)", PhD Thesis, University of St. Andrew

⁷² Erlan Karin, Andrei Chbotarev, "The Policy of Kazakhization in State and Government Institutions in Kazakhstan", Middle East Studies Series, No.51, Nationalities Questions in Post-Soviet Kazakhstan, chapter 2

4.3. *Corruption as a phenomenon*

International surveys showed that Azerbaijan and Kazakhstan are one of the most corrupted states in the world.⁷³ Most of the oil-rich developing countries are corrupt; thus, there is a correlation: the more country is rich with natural resources, the more corrupt it is due to unregulated weak institutions. Particularly in the case of post-Soviet Azerbaijan and Kazakhstan, which inherited institutions are from the soviet legacy. Corruption, largely through oil and gas monies, has strengthened at least some parts of the solidified and expanded internal networks, called clans, in recent years. This flow of money shapes the political environment. Corruption prevents economic development and growth, and in the case of Azerbaijan makes the rich richer, and the poor poorer. There is evidence of how the elite in power allocate money to their private funds and foreign bank accounts.

Corruption becomes institutionalized, because people expect to pay and receive bribes under the table payments as "business as usual". It is a great corruption environment for the transnational corporation, because it is far easier to get exactly what they want without reactionary government regulations or interference. This is not good for the long-term economic development because these bribes cause high inflation rates. Thus, culture of corruption becomes institutionalized. As Aliyeva found out, there are two ways of corruption in Azerbaijan. First, sharing bribes via the chain of commands, and second, by buying high positions. One of the locals to the question: "Why despite all bribes in Azerbaijan, there is no Mafia?" expressed his opinion by saying that the state has become the Mafia.⁷⁴

⁷³ Transparency International Index, http://www.transparency.org/policy_research/surveys_indices/cpi/2007, last access 01.06.08

⁷⁴ Alec Rasizade, Ibid.

As both Kazakhstan and Azerbaijan have large reserves of crude oil, they are still different. Estimates show that Kazakhstan has around 14 billion of oil and only five billion is in Azerbaijan's territory. The difference shows that Azerbaijan is more likely to run out of oil if the extraction will continue taking place at the same pace. While oil is treated in both countries as it will never end, the oil sector is a ground for the clan-based competition, thriving of foreign oil companies corruption and breaking of the rule of law, and violation of human rights. It is the main challenge in the oil sector to stimulate the forces which are opposed to authoritarianism and corruption habit.

4.4. Conclusion

The clanship and clan politics remain to be the core of how Azerbaijan and Kazakhstan function. Clan in the case of Azerbaijan is based on informal networks and kinship, and in the case of Kazakhstan it is more based on the blood. Both presidents, Nazarbayev and Aliyev have a strong grip on power, and are trying to extend their presidency for life. The lack of strong functional formal institutions, networking economy has been taking its lead to political instability in Kazakhstan. Corruption becomes institutionalized and since clans are instead of political institutions, they tend to reproduce themselves.

Conclusion

Importance of oil within the theoretical framework of ‘Paradox of Plenty’ and rentierism

Oil and gas play a crucial role for each and every industrialized country. Moreover, oil and gas abundance is a phenomenon, the political and economic effects of which have been studied by different scholars through analyses and testing. However, most of the authors put their emphasis on the oil-rich countries of the Arab states in the Middle East. The probable reason for this is those countries’ vast share of natural resources, primarily oil, in the world share. Thus, this thesis looked at the literature which describes various aspects of the economy and political stability in Arab states and this helped me to set up the framework for the rest of the thesis. Theoretical framework chosen for this thesis is two-fold. First, it captures the theory of rentierism was introduced by Mahdavy in 1970 and further systematized by Beblawi and Luciani. They state that it is easy to get in the trap of getting used to ‘easy money’, which the idea transfers to the individual mindsets resulting in laziness and effortless spending. Therefore, oil is often considered a ‘curse’ in oil-rich countries, except a very few such as Norway or the United States.

Another aspect of theoretical review was Terry Karl’s work on ‘Paradox of Plenty’. The paradox states the oil-rich countries controversially are not well-developed economically. Another aspect of her work is that countries can develop the same way even if they are given different institutions, unless the strong institutions are embedded in the state before the discovery of natural resources of oil and gas. In the case of Azerbaijan and Kazakhstan inherited weak institutions and oil and gas abundance did not lead the countries to develop in similar ways. In fact, Kazakhstan’s economy is more diversified than in the case of Azerbaijan, and has more

potential in the scale of human resources, because there are some substantial in-migration to Kazakhstan from other neighboring Central Asian countries, such as Uzbekistan, Kyrgyzstan and Tajikistan, where political and economic stability is not as promising as in the case of Kazakhstan. Vast lands of Kazakhstan could help to improve agricultural sector, by planting more wheat, which will be helpful in providing more job places especially for the remote areas of the country, where the poor are unemployed.

My focus of interest shifts to the case study of Azerbaijan and Kazakhstan in this work because relatively little has been written about these two countries in comparison with each other and by reviewing the literature on the Arab states I could see that certain measurements of rentierism are applicable for these countries. Kazakhstan was close to the Dutch Disease in the 1990s but after 2000 it gained its recovery and cannot be called a rentier state. In the case of Azerbaijan the recovery has been slowed down by the dispute of the enclave of Nagorno-Karabakh, which is currently frozen but still has negative implications on a social life in the country. In Beblawi's terms there is no state that carries every feature of a rentier state. A state might have some criteria but not necessary all of them. According to Beblawi, the measurements of a rentier state are the following. First, the rent from oil and gas have to come from abroad, thus this makes oil economy external. This is applicable for the country cases of Azerbaijan and Kazakhstan, as large amount of oil is being exported every day.

Economic effects of oil

Findings on economic effects in the cases of Azerbaijan and Kazakhstan are the following. The scale of potential rent flows are substantial in Azerbaijan and Kazakhstan, and could exceed Algeria's and Nigeria's in the 1970s of their oil boom, who mismanaged their

resources, which lead into damaging effects. However, such danger is more on the side of Azerbaijan than on Kazakhstan's side because of the two reasons. First, the amount of GDP comprised of oil rents is substantial, in the case of Azerbaijan than Kazakhstan. Second reason is that Azerbaijan's oil pick is coming more closely and since they have been extracting oil from the 1800s and technologies of drilling extraction have been improving, there is simply less oil left. There are estimates that given the same conditions under a developmental political state, even the medium case scenario could cause doubling GDP per capita, and by 2020 Azerbaijan could reach the level of Greece in the middle of 1990s, and Kazakhstan could reach the level of Ireland.⁷⁵

Attracting foreign investment in the oil field has not been a challenge for both Azerbaijan and Kazakhstan. As Kazakhstan has discovered its large oil field of Kashagan in the west of the country, the extraction has not begun until after the dissolution of the SU due to the harsh weather conditions and uneasiness of its labor conditions. Currently it is the world's fifth or sixth largest oil reserve. Karachaganak is a major gas site in the north of Kazakhstan, near the border with Russia which makes it easy to export it on international markets through Russia. In case of Azerbaijan the oil and gas sites are in the center of the Caspian Sea: ShahDeniz, Chirag and Guneshli.

The countries have to learn how to manage oil revenues better, in order not to fall into trap of becoming a rentier state. SOCAR and NOC have been created in Azerbaijan and Kazakhstan respectively in order to face this task. However, as it was discussed in the chapter of political implications of oil, the elite has the strong grip on power in these states, thus controls management or oil revenues inflow. One of the possible ways to prevent the trap of a rentier

⁷⁵ Richard Auty, and Indra Soysa, "Energy, Wealth and Government into the Caucasus and Central Asia", Routledge, 2006, 74

economy is reduction of the extraction of oil and gas. This will lead to lesser dependence of oil in both countries. Another way is to diversify other sectors of economy. Kazakhstan has made some attempts in investing in the field of agriculture, whereas Azerbaijan has not. In order to develop human resources for both countries young potential is needed. By sending young leaders of the country, Kazakhstan has been investing in developing better cadre since the country's independence through the Presidential program 'Bolashak'.⁷⁶ Young leaders have the opportunity to study abroad through educational grants and upon their return face the challenges in different spheres of the economy. There are not many such programs in the post-Soviet countries, certainly not in Azerbaijan.

Political effects of oil

Different scholars have been trying to establish the link between oil and the domestic politics. One of the finding of Ostrowski is that the Kazakh regime is not static and that the political stability in the country is a result to a prompt respond to the events taking place in the country. Main finding in the chapter of political implications of oil is that the Presidents of both counties have managed to capture the elite and their key members, which helped them to reduce threat of the opposition. As an example a few opposition leaders have been missing for no reason of found killed and accused of the suicide.

Those who are considered the national elite, or members of the clan, also face challenges in the distribution of power. The clanship and clan politics remain to be the core of how Azerbaijan and Kazakhstan function. The most common definition of the clan is informal networks, and institutions where members of the clan do not get to choose the clan belonging

⁷⁶ Bolashak Governmental Program, www.bolashak.edu

and foresee the mutual benefits from the membership. There have been attempts to transform institutions that the country inherited from the Soviet time, alas unsuccessfully. Due to the lack of strong functional formal institutions, networking economy has been taking its lead to political instability in Azerbaijan and Kazakhstan. However it may seem that the elite members are satisfied with their position, they constantly keep being reappointed, and usually serve at the appointed position not long, putting their expertise in the field and the way of getting appointed to the position under question. Constant competition is taking place while the division of clans is different in two countries. In Kazakhstan it is blood-based and in Azerbaijan networks and kinship matters more than blood relation.

Clan competition is getting higher as the oil revenues are increasing from the extraction and export of oil. This may cause political instability in the future. Politically Azerbaijan and Kazakhstan share features of authoritarian regime, where power is concentrated in the hands of a few powerful elites. This weakens political accountability, and political institutions, in this work referred as political parties, which are weak due to the weak opposition. Both Azerbaijan and Kazakhstan are inclined towards lack of political legitimacy and economic and political shocks. The other negative side is that the oil and gas industry is not a labor-intensive one, thus employs a few people. This is not helpful when the unemployment rates are high and many people live below the poverty line.

Oil and gas play a crucial role in shaping both economic and political life in Azerbaijan and Kazakhstan. Despite the similarities of inherited legal institutions from the SU, predominance of oil and gas revenues in the economy, and challenges which countries are facing, different paths of development have been adopted. There is still another chance to change their strategies for the better economic and political development. As both countries are

politically stable, testing political stability measurements of Azerbaijan and Kazakhstan might be explored in depth in the further research of the two countries.

Appendix 1: Map of oil and gas reserves in Kazakhstan and Azerbaijan



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