

The Negative Impacts of the State Capture and Business Capture on Economic Development: The Case of Azerbaijan

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Submitted to
Central European University
Department of Public Policy

In partial fulfillment of the requirements for the degree of Master of Arts in
Public Policy

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Budapest, Hungary
2009

ABSTRACT

This research provides evidence that the high-level state capture and business capture in Azerbaijan have an adverse effect on the economic development and growth. In this path, it studies the shadow economy of Azerbaijan as a negative consequence of grand corruption. The research proves that the shadow economy hinders the attraction of foreign direct investment (FDI), which is considered as a major stimulator of transition period, into Azerbaijan's economy. Additionally, the research considers the attraction of FDI as a tool for fighting against shadow economy and state capture and business capture phenomena.

For the purposes of the above-mentioned studies, the research uses a microeconomic model in which the negative externalities of the shadow economy caused by the state and business capture are explained using microeconomic variables, namely the consumer, the producer, the consumer surplus, the producer surplus, and the equilibrium volume of goods and services. The main hypothesis of the model is that the imposition of indirect taxes (resulting from the state capture and business capture practices) leads to the growth of the shadow economy which adversely affects the growth of GDP and economy as a whole. Another hypothesis is that attraction of more foreign direct investment (FDI) can shrink the shadow economy. But in case of Azerbaijan, the inflow of foreign direct investment to the private sector is insignificant, the main cause of which is the high rate of the state and business capture.

KEY WORDS: STATE CAPTURE, BUSINESS CAPTURE, FOREIGN DIRECT INVESTMENT, SHADOW ECONOMY

DEDICATION

I dedicate this work to my dearest parents – Alihuseyn Ahadov and Bika Ahadova for their endless love, direction, and tireless sacrifice, my sisters - Rugiyya Ahadova, Sevda Ahadova, Zulfiyya Ahadova, and Shehrebanu Ahadova for their constant support and love, and my dear wife - Turkan Ahadova for her patience and understanding that gave me the will to finish my thesis.

ACKNOWLEDGEMENTS

My sincerest appreciation goes to my supervisor, Professor Filippo Pavesi for his patience, valuable suggestions, guidance, and attention to detail throughout my research. He has stimulated my ideas and encouraged me for conducting this research effectively. I also wish to thank Mrs. Eszter Timar, the writing instructor of the CEU Writing Center, for her valuable assistance and important contribution to academic writing peculiarities of the research. Finally, my heartfelt thanks go to my wife Turkan Ahadova for her infinite support, love, and cheerful encouragement.

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Introduction

After eighteen years of independence from the former Soviet Union, Azerbaijan continuously suffers from high level corruption in all economic, social and political spheres. A study by the World Bank Institute (2000) found Azerbaijan to be the post-communist country most affected by 'state capture,' indicating that special interest groups had a major influence on government policy and shaped rules and policies to their advantage. According to the Institute, forty-one percent of businesses have been directly affected by illicit private influence on state institutions.

Simultaneously, the business capture is widely spread in Azerbaijan's economy (Safaraliyeva 2003, Satarov 2003). The level of corruption in Azerbaijan is defined as systematic, not episodic (Safaraliyeva 2003). In this regard, the business capture has a great share in the corrupt profile of Azerbaijan. The absence of the desire to act within the law is a dominating factor in the economy of Azerbaijan. Most businessmen without entering purely criminal zones are functioning in the so-called 'grey market' or shadow economy.

This situation has two main causes. The first cause is that most firms in Azerbaijan have the desire to evade legally imposed taxes in the framework of their short-term goals as long-term goals are risky because they can lose everything in a moment if the government wants. Second, government officials and bureaucrats are themselves interested in tax evasions as they demand from firms a part of legal taxes in exchange for their silence. In general, higher level of taxation and regulation leads to greater amount of corruption "politicians can extract from entrepreneurs in return for excusing them from paying taxes or following regulations" (Johnson et al. 1997, 170).

In this situation the business has two choices: either to pay legal taxes and dismiss the illegal taxes imposed by the government or to pay illegal taxes and get guarantee from the government for further functioning. The first choice is not optimal because the business can make the government angry which can give very negative consequences from the closure of the business to being arrested. Consequently, firms are obliged to continuously evade the law through divergences and gaps in the laws and rules, which is successfully used by state officials for illegal rent-seeking purposes (Safaraliyeva, 2003).

This research has the aim of studying the state capture and business capture problems in Azerbaijan and their economic consequences. More specifically, **the research question** of the study is the following: What are the causes of the state and business capture practices in Azerbaijan and what consequences are there in the economic development of the country? This research question is investigated in line with the following **hypothesis**: The state and business capture adversely impacts the economic development of Azerbaijan through two main consequences: First, they create a shadow economy, which impedes growth, especially the Gross Domestic Product (GDP). Second, the state and business capture reduces the attraction of foreign direct investment (FDI) which is very important for transition economies.

Regarding the methodology, the research relies upon a literature review about the state capture and business capture problems of Azerbaijan and their economic consequences. Furthermore, it uses the expert survey I conducted in Baku, Azerbaijan, with interviewing twenty experts, who have significant experience in the core issues of this research. The purpose of the survey was to obtain more accurate information in the expert level in order to fully understand Azerbaijan's context of the studied topic. Additionally, the research studies different reports and surveys conducted by internationally recognized organizations, namely World Bank, the Transparency

International, and the Freedom House. Finally, the current research builds a microeconomic model through which the adverse impacts of the state and business capture on economic development are graphically explained. The model contains two variables, i.e. shadow economy and foreign direct investment.

Taking into consideration the hypothesis and research question, the first chapter has concentration on reviewing the related literature on ‘state capture’, and ‘business capture’ concepts and several reports and surveys by the influential organizations, namely *the 2008 Corruption Perceptions Index* of Transparency International, *the Nations in Transit 2009* by Freedom House, and the World Bank report - *Measuring Governance, Corruption, and State Capture*. Further, the chapter contains the results of the expert survey conducted in Baku, Azerbaijan, for the purpose of understanding the real nature of the research problem in Azerbaijan’s context.

The second chapter has a specific concentration over economic damages of the state and business capture problem. Initially, it studies the shadow economy as an indirect consequence of the high level state and business capture problems. Secondly, the concluding chapter analyzes foreign direct investment and its positive role in fighting the state and business capture phenomena and the shadow economy.

The third chapter incorporates the findings of the second chapter into a microeconomic model, namely the *Microeconomic Model of Shadow Economy and Foreign Direct Investment Attraction*. In this path, the state and business capture phenomena are considered as an illegal tax levy which is explained in the context of the State regulation through a tax levy on per unit of production. Further, in order to prove that more FDI attraction can shrink the shadow economy

and fight against the state and business capture, the third chapter contextualizes the Subsidies on per production unit through a microeconomic graph.

CHAPTER 1 - BRIEF OVERVIEW AND BACKGROUND

In the initial stages of transition period it was thought that the market will accelerate the development of macroeconomic reforms, bringing a developing market economy and a democratic government. But the unsuccessful practice of the transition period caused many evil institutions like state capture and business capture which are one of the most dangerous forms of corruption.

The aim of this chapter is to analyze the research topic of this thesis in a wider context, coordinating the different literature views into the main question of the research, which consists of finding causes of the high-level state and business capture as two most devastating forms of corruption in Azerbaijan and its direct and indirect affects on the economic development. There are mixed views and conclusions regarding these two variables and the relationships between them. As to be seen later from this chapter, only several of many variables, which have been proposed in the literature as determinants of corrupt practices have statistical and robust significance in relation to the problem in research.

1.1 Theoretical and empirical approach and strands of research

1.1.1. State Capture

According to Hellman et al. 2000, state capture is the sale of public goods and a range of rent-generating advantages to individual firms by government officials and politicians. State capture enables captor firms to derive huge private benefits at an enormous social cost to the economy. The authors argue that a captured economy may lose about 10% of its growth rate within a three-year period. Consequently, state capture was defined by Hellman and Kaufmann as “*the efforts of*

firms to shape the laws, policies, and regulation of the state to their own advantage by providing illicit private gains to public officials” (2001, 1). Vesna Pesic in his article named “State Capture and Wide Spread Corruption in Serbia” considered ‘state capture’ as a negative practice by “any group or social strata, external to the state, that gains decisive influence over state institutions and policies for its own interests, and against the public good” (2007, 1).

For the purpose of this research and taking into consideration the previous definitions and approaches I define the state capture as the ability of a small number of firms and individual actors to influence the executive, legislative, and judicial decisions for the purpose of making illicit private benefits. This definition is more appropriate for studying the state capture and business capture problems in Azerbaijan and their impacts on economic development.

The initial significant contribution to understanding the state capture problem in post-socialist economies belongs to Hellman. In his 1998 research titled “Winners Take All: the Politics of Partial Reform in Postcommunist Transitions”, Hellman gives an important definition to post-communist nations transition to the market economy. The author explains that powerful economic actors in most transition countries prioritized partial reforms in order to maximize the concentration of rents in the economy. However, Hellman abstains from any further study of the forms and mechanisms in which keeping of the partial economic reforms occurs in the transition economies.

Another important source to understanding the state capture problem is the joint studies by World Bank Institute and the European Bank for Reconstruction and Development (World Bank 2000a, 2000b, EBRD 1999, Hellman et al. 2000). Using primarily the empirical data obtained from the 1999 Business Environment and Enterprise Performance Survey (BEEPS) jointly commissioned

by the WB and EBRD, the team of the same organizations consider that state capture refers to influence of the law-making process, decisions of both legislative and executive bodies and other public policies by individuals or businesses both in the public and private sectors in order to secure personal benefits. In these studies three main institutions prone to capture are shown as the legislature, the executive, and the judiciary, which are captured by private businesses, political figures and interest groups. In several countries corruption in its state capture type adversely affects economic development and these countries (especially post-soviet republics) have built consolidated capture measures inclusive of different forms of capture, purchase of parliamentary votes in law-making process, court decisions, giving bribes to top officials etc. (World Bank 2000b).

Despite the positive trends, there are existing gaps and inconsistencies in the related literature concerning the state capture problem. The insufficiency of the study is that the nature of the 'captor actors' is biased toward Small and Medium-Sized Enterprises (SMEs), thus leaving the 'grand captors' out of the focus of the research and prudent conceptualization (Hellman et al. 2000:16). Yet, the WB/EBRD study completely leaves out the conceptualization of the state capture on the highest political and institutional level and only detects the capture largely from a microeconomic perspective while omitting the macro perspective from the analysis.

In conclusion, the state capture phenomenon has been discussed in the related literature with important theoretical and empirical findings. However, further theoretical and empirical research is necessary to cover the gaps and inconsistencies. There is a strong need for more specific country studies where state capture is widely spread. Being one of these countries, Azerbaijan has ranked among the most state captured transition nations. However, this conclusion has been made by researchers only through interviewing the representatives of firms functioning in Azerbaijan.

This approach cannot be estimated as praiseworthy and accurate without explaining the real nature of Azerbaijan's state capture phenomenon which is not the same compared to the similar problem in other transition economies.

1.1.2. Business Capture

The definition of business capture is very short and the literature does not provide any sufficient theoretical backgrounds of this phenomenon. The INDEM Fund of Russia proposes to consider business capture, as more dangerous than the state capture. According to the 2001 report of the Fund, "business capture is a set of strategies and tactics of government by means of which it seeks to maintain control over business through its representatives or, even, structures for the purpose of collective and (or) individual extraction of the administrative rent" (Satarov and Parkhomenko 2001, 5).

Yakovlev (2005) defines the business capture as "the unlawful intervention of the state into affairs of firms and the model of informal submission of private businesses to the state interests" (p.27). The existence of a high degree of state and business captures in any nation impedes economic reforms and weakens improvements on governance quality (Hellman and Schankerman 2000: 1).

There are few definitions seeking to answer the question what business capture is. In this regard, giving proper definition to the phenomenon is a challenging task as the literature does not provide explicit definitions. Despite this, the current research will define the business capture as

the illegal intervention of state officials and bureaucrats into affairs of firms and entrepreneurs for the purpose of seizing private property and/or reassigning their management to loyal persons.

According to Satarov & Parkhomenko (2001), business capture can be observed in different government activities including:

- Struggle of government authorities for blocking and controlling equity stakes;
- Participation of high-rank officials in running firms with their stakes in regional and municipal property;
- franchising and tax abatements to ‘own’ firms;
- participation of officials in struggle for property on behalf of ‘own’ firms;
- participation of government authorities in artificial bankruptcies for seizing properties in favor of ‘own’ firms;
- creation of unnatural monopolies for ‘own’ forms;
- intrusion by officials own representatives to management of companies;
- protectionism for ‘own’ and subsidiary companies;
- posting to leading positions in private companies relatives of authorities (this is a widely-spread case in the CIS);
- pressure by officials with the aim of forcing firms to choose ‘proper’ manufactures or consumers.

In sum, unlike state capture, the business capture problem has not been covered in a sufficient and proper manner. Basic theoretical and empirical research is still missing regarding this important issue. This significant gap causes difficulties in exploring the causes and consequences of business capture. As for the state capture phenomenon, business capture should be covered in the country research context to study the peculiarities of the problem which differ across nations.

This approach is important to understand the business capture problem in Azerbaijan, which suffers seriously from business capture, along with state capture and administrative corruption.

1.1.3. Economic Consequences of State and Business Capture

Different aspects of corruption and economic development have been studied in recent years yielding considerable contributions both theoretically and empirically. Academic research has dealt with different microeconomic aspects of corruption. For instance, Banerjee (1997) has investigated the administrative corruption and bureaucratic rent-seeking through government failures and agency problems. The relation between corruption and political institutions has been studied by Persson et al. (2003), while Besley and Prat (2002) have researched the problem in the context of judicial system and media freedom respectively. Finally, a number of macroeconomic models by Ehrlich and Lui (1999), Mauro (2004) and Blackburn et al. (2006) have sought a joint determination of corruption and economic development which theorize the presence of several development regimes (cited in Freille et al. 2007).

The main finding of these studies is that corruption negatively affects economic development (Mauro 1995 and Treisman 2000). This unanimous view has been proved not only with theoretical arguments, but also by a large number of empirical evidence recently obtained by independent researchers.

Academic researches approaching the problem both theoretically and empirically have made a significant contribution to this idea. Murphy et al. (1991, 1993) have argued that the allocation of resources to rent-seeking activities negatively affects the normal speed of growth. Furthermore, corruption has been viewed as a tax on *ex post* benefits, which can hinder certain forms of investment (Romer, 1994). These theoretical considerations have been statistically evidenced by

the empirical cross-country work carried out by Knack and Keefer (1995, 1997) and Mauro (1995) who endeavor to assess the impact of corruption on investment and economic growth. Many economic variables have been regarded as having potential relations with corruption. Standard variables such as economic development, openness to trade, total public spending, proportion of mineral resources like oil and gas in total exports have been used with several other variables such as, foreign direct investment (FDI), wages of public workers and bureaucrats, trade distance, and the scope of foreign aid (Freille et al. 2007).

Economic variables can cause corruption due to several reasons. One significant reason is that certain economic operations or markets, as for the case of natural monopolies, where the environment for corruption is favorable, are apt to a growth in rent-seeking behavior. Another reason is that certain types of investments, expenses and reimbursements (for instance, restrictions to international trade and special concessions to foreign direct investment (FDI), public tenders to award service or infrastructure contracts) are likely to promote possibilities for corruption.

Most studies dedicated to the determinants of corruption indicate economic development as an independent variable showing a strong correlation between economic development and corruption, meaning that countries with low income are more prone to corrupt practices (La Porta et al. 1997, 1999, Ades and Di Tella 1999, Treisman 2000, and Persson et al. 2003). Only a few researchers (for example, Braun and Di Tella 2004 and Fréchette 2006) have a contradictory viewpoint arguing that the growing economic benefits increase corruption.

According to Kaufmann's position on the impact of state capture on the economy in transition countries, seizing the state for personal purposes is one of the most disruptive phenomena which

causes political corruption, and as a consequence shrinks economic growth. Jakob Svensson (2005) emphasizes the importance of the type of government in transition countries and argues that this factor is the main determinant of the scope of state capture in the economy. He points out that a negative correlation exists between corruption and simplification of laws and rules. So, the structure of government with simple regulations is an inseparable part of governance. Singapore and Hong-Kong can be examined as successful examples in which the mission of the government is to strengthen legal and financial agencies of law enforcement.

Faster economic growth may exacerbate state capture in the short run even if it does not affect the overall level of administrative corruption. State capture is closely embedded in political processes and often benefits those at the highest levels of the social and political hierarchy. Private agents, controlling over a large share of resources in one or many regions, can easily lobby, bribe and intimidate authorities for the purpose of influencing legal, political and regulatory institutions of their regions (Yakovlev and Juravskaya 2006). The effects of lobbying of central governments by domestic and multinational corporations adversely barriers the international trade (Yakovlev and Juravskaya 2006).

In sum, it has been empirically proved that there is a strong connection between corruption and economic development. Being the most adverse types of corruption, state capture and business capture have serious negative impacts on economic development and growth. Despite few theories favoring corruption as a positive factor on economic development, most researches have unanimously found a negative relation between economic development and corruption.

1.2 Understanding the Scope of the Problem in the Eyes of International Organizations and Domestic Experts

1.2.1 Grand Corruption Ratings of Azerbaijan: Reports, Facts and Surveys

Analysis of economic development in transition countries in the last 10-15 years shows that corruption is one of the main factors, which impedes the development of free market economies and proper democratic institutions. Additionally, Azerbaijan is a country known for weak democratic and legal institutions. Numerous reports of international organizations like Transparency International, Freedom House, and the World Bank Institute give Azerbaijan low ranks on corruption, measures of democracy and good governance.

2008 Corruption Perceptions Index (Transparency International)

Transparency International regularly rates Azerbaijan as one of the most corrupt among the roughly 90 countries it surveys. In TI's 2008 Corruption Perceptions Index report on the level of corruption in 180 countries across the world, released in September 2008, Azerbaijan is in 158th place with 1.9 points (scores range between 10-highly clean and 0-highly corrupt). According to the report, corruption in Azerbaijan has become deeper, and as a consequence, it has dropped from 150th place in 2007 to 158th a year later. It means that Azerbaijan's case worsened in 2008 if compared to previous rates.¹

Nations in Transit 2009 (Freedom House)

Another influential report, the Freedom House's Nations in Transit 2009, has scored Azerbaijan 6.25 and ranked 25 among 30 countries from Central Europe to the Eurasian region of the Former

¹ For more details, see http://www.transparency.org/policy_research/surveys_indices/cpi/2008

Soviet Union. Furthermore, the 2008 report has placed Azerbaijan among Consolidated Authoritarian Regimes which have the worst indicators between 6.00–7.00 points.²

Table 1: Nations in Transit Ratings and Average Scores for Azerbaijan (on a scale of 7)

	1999–2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Electoral Process	5.50	5.75	5.75	5.75	6.00	6.25	6.50	6.50	6.50	6.75
Civil Society	4.75	4.50	4.50	4.25	4.50	4.75	5.00	5.25	5.25	5.50
Independent Media	5.50	5.75	5.50	5.50	5.75	6.00	6.00	6.25	6.25	6.75
Governance*	6.25	6.25	6.00	5.75	5.75	n/a	n/a	n/a	n/a	n/a
National Democratic Governance	n/a	n/a	n/a	n/a	n/a	6.00	6.00	6.00	6.00	6.25
Local Democratic Governance	n/a	n/a	n/a	n/a	n/a	6.00	6.00	6.00	6.00	6.25
Judicial Framework and Independence	5.50	5.25	5.25	5.25	5.50	5.75	5.75	5.75	5.75	5.75
Corruption	6.00	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.50
Democracy Score	5.58	5.63	5.54	5.46	5.63	5.86	5.93	6.00	6.00	6.25

Source: NIT 2009 Country Reports: Azerbaijan HYPERLINK
<http://www.freedomhouse.eu/images/nit2009/azerbaijan.pdf>

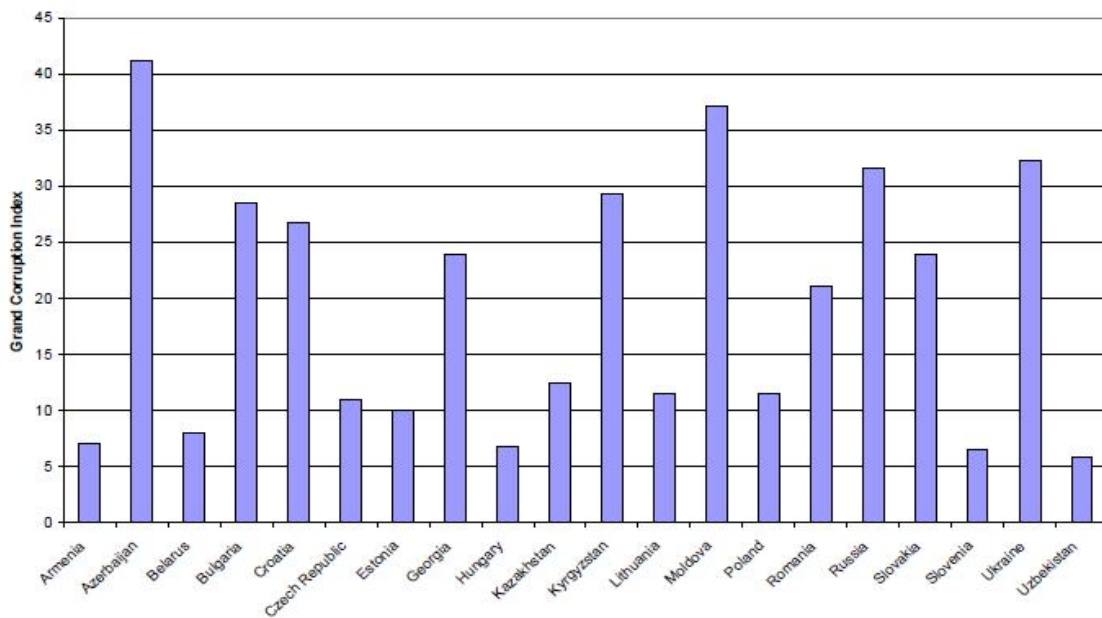
Measuring Governance, Corruption, and State Capture

A study by the World Bank Institute (2000) called *Measuring Governance, Corruption, and State Capture* found Azerbaijan a highly corrupt country mostly affected by state capture. The report considers that special interest groups have a major influence on public policies and the Azerbaijani government has shaped rules and policies to their advantage. The report puts Azerbaijan in a leading corrupt position (as seen from Graph 1) indicating that forty-one percent of businesses have been directly affected by illegal private influence on state institutions.³

² Source: Freedom House, Nations in Transit 2009

³ Measuring Governance, Corruption, and State Capture, 2000

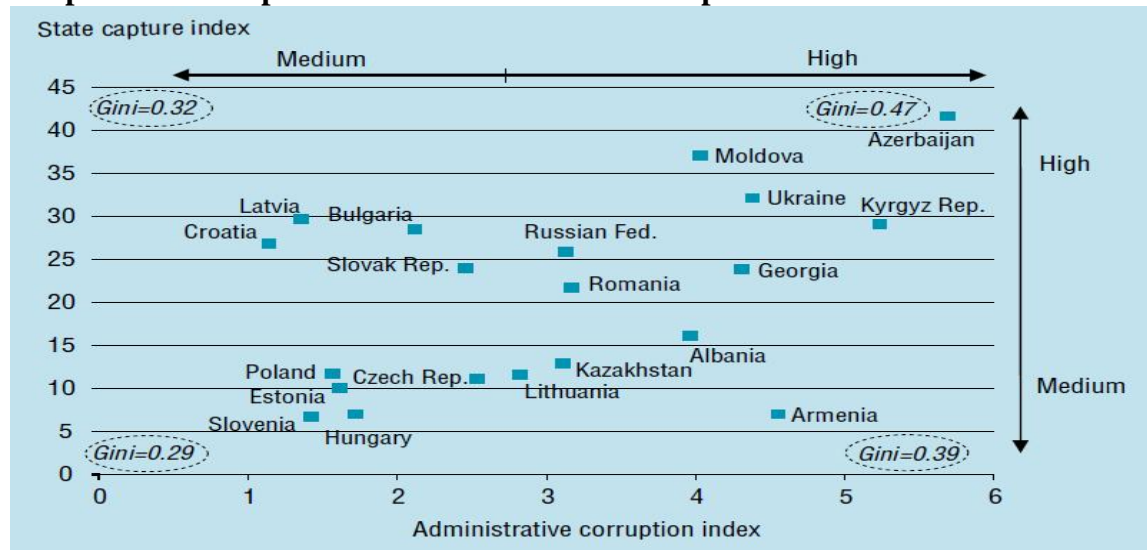
Graph 1: Composite index of State Capture⁴



Source: Measuring Governance, Corruption, and State Capture, 2000

Furthermore, in Graph 2, given by the World Bank group, Azerbaijan is ranked as the highest administratively corrupt country with highest 5.7 points (on a maximum scale of 6 points).

Graph 2: State Capture and Administrative Corruption



Source: World Bank (2000): Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia

⁴ **Composite index of State Capture** was constructed as the average proportion of firms reporting that legislative capture, capture of the Central Bank, legal capture, and non-transparent political party financing as components of grand corruption are a problem.

The indicators of administrative corruption (Graph 2) and state capture (Graph 1) prove that Azerbaijan is a highly corrupt country among European and Central Asian countries.

In conclusion, the above-mentioned reports by influential world organizations measuring different aspects of governance, degrees of freedoms and levels of corruption in different countries have explicitly proved that Azerbaijan has very serious problems in all these parameters and their indicators. The considerations of the reports are important in defining the proper nature of state capture and business capture practices in Azerbaijan. Additionally, the conclusions of the world-famous organizations on the scope of corruption in Azerbaijan will be strengthened with an expert survey carried out in Azerbaijan for the purposes of this current research.

1.2.2. Expert Survey

I conducted this survey between 15 May, 2009 and 10 June, 2009, in Baku, capital of Azerbaijan in the framework of a research trip grant given by the Central European University (CEU). A primary focus during this research trip was on digging into public discourse of corrupt practices and learning the viewpoints of the civil society agents monitoring (anti) corruption in both public and private sectors and on how it affects Azerbaijan's economy. In this regard, the purpose of the survey was to focus on collecting empirical evidence on state and business capture practices in Azerbaijan and its impacts on economic development of the country.

The survey involved three representatives of Transparency Azerbaijan, four MPs (both from government and the opposition), three economists, four public policy specialists, and six civil society representatives. The total number of survey participants was twenty. Among these

specialists eight were directly involved in anti-corruption projects of the government and others were dealing with anticorruption activities.

I conducted the survey for the following purposes:

1. To identify state capture and business capture problems in Azerbaijan's context through empirical research and match them with theoretical considerations on the topic;
2. to define the weight of state and business capture practices in the total corruption practices in Azerbaijan;
3. to find out the exact nature of state capture and business capture of Azerbaijan which differs across countries depending on political, legal, economic, and social factors;
4. to find the relation between state-business capture and economic development of Azerbaijan;
5. to have proper understanding on adverse impacts of state-business capture on economic development of Azerbaijan.

Methodology

I conducted the interviews separately with the participants of the survey. Thereby, I carried out twenty interviews which lasted for about an hour. As the interviewees were from different fields, I did not compile any questionnaire for them. Instead I asked them specific questions according to their knowledge and expertise. This method was efficient in a sense that it enabled me to gather information on the general level of corruption in Azerbaijan, its more dangerous grand types, i.e., state capture and business capture, anticorruption fight in the country, and economic consequences of corruption generally and state and business capture specifically. During the interviews I recorded the interviews into a voice recorder and after conducting the twenty

interviews altogether, I summarized them into a whole document in a sequence of the five main purposes of the interviews provided above.

Importance

The survey was very important to analyze the current situation in Azerbaijan on the practical level and in detail. During the survey the specialists involved revealed their experience and anticorruption work, which is not available on the WebPages or in other sources. Additionally, the survey confirmed the main hypothesis of the current thesis arguing that state and business capture being a more serious form of grand corruption adversely affects the economic development of Azerbaijan. All the agents involved in the survey stressed the importance of rule of law, independent judiciary and free media in fighting against corrupt practices in Azerbaijan.

Summary of Conducted Interviews

The participant experts considered that anti-corruption fight must be a priority in reforming the state administration in Azerbaijan. Thirteen experts of twenty consider that public administration is at a low level and this factor can be defined as the major reason of the state and business capture practices in Azerbaijan. Four experts evaluated the public administration system in Azerbaijan on average level. Only three experts thought that the government does everything to fight against corruption, including the state and business capture.

The state of transparency in both public and private spheres is not in enough level. According to experts in survey, public purchases and public procurement tenders are major sources of state capture in Azerbaijan. These procedures are not carried out through free competition and tenders are awarded to not winners but to ‘own’ firms. Considering the fact most of tenders are held in

oil and gas sectors of the economy, experts expressed their concern fully seizure of them by corrupt network headed by top government officials and bureaucrats.

Among the surveyed experts 75% noted that the initiative in reforming the public administration should be initiated by the president as the head of the executive power in Azerbaijan is the most influential among state institutions. Only 25% percent considered that reforms should come from Milli Majlis (the parliament), the government, NGO's, political parties etc.

Experts in the survey unanimously consider that there are two parallel types of grand corruption taking place in Azerbaijan: state capture and business capture. Nevertheless, as argued by some, these two processes have become a fusion of the state and business capture by the elite, the ex-communists and the so called shop owners who run offices or businesses.

The survey participants unanimously pointed out that corruption is still the most devastating problem of Azerbaijan despite a few reforms in the sphere of public administration, legislation, development of civil society and entrepreneurship and anticorruption fight. According to the experts, corruption affects not only citizens but also representatives of international organizations and business companies. Corruption in governmental circles is regulated with separate relations. It changes the content of laws and regulations, and governs public opinion and social psychology.

As the experts in the survey consider, the most devastating damage of corruption to the national economy is that huge amounts of money earned from corruption and shadow economy circulate in the illegal transactions instead of serving to the economic prosperity of the nation. As a consequence, colossal losses are incurred to all citizens and legal businesses except for corrupted state officials and close to them entrepreneurs. Although the amount of investments, production and sales increases, the public finances shrink. This situation leads to certain negative

consequences both in public and private sectors where wages and salaries are not rising considerably. There is a standstill in the social protection system, education, and healthcare, and artificial obstacles are created in business and production. Such circumstances are advantageous to top government officials and bureaucrats involved in corrupt activities. Embroiling citizens into corrupt relations they make the corruption a tradition and norm of life.

The investigations on the expert level held in Azerbaijan for the purposes of the current research have also revealed precious data on the current situation in the country related to the capture economy and the economy of capture. The experts participating in the survey unanimously agreed that Azerbaijan has serious state capture and business capture problems which impedes the transition of the country to democratic governance and liberal economy. Despite the fact that several experts did not clearly distinguish these two most disruptive types of corruption from administrative bribe, the conclusions obtained from the current survey have been positive in understanding the state capture and business capture problems in Azerbaijan.

CHAPTER 2 - NEGATIVE ECONOMIC CONSEQUENCES OF STATE CAPTURE AND BUSINESS CAPTURE IN AZERBAIJAN

State capture and business capture worsen the investment climate and significantly decrease foreign direct investments into the private sector of the economy. The existence of high level state and business capture forces foreign investors and companies to leave the country as the result of which:

- a) the attraction of FDI to the economy is challenged, and
- b) the reputation of the country is seriously damaged.

This chapter studies the shadow economy problem as an indirect consequence of high level state capture and business capture in Azerbaijan and its negative impact on economic development through analyzing foreign direct investment (FDI) and its importance for economic development and growth. For this purpose, the chapter explains the shadow economy and foreign direct investment with theoretical considerations and empirical examples. Further it builds a microeconomic model in which the minimum and maximum scope of the shadow economy is defined. The microeconomic model studies the benefits of FDI attraction as an efficient tool to shrink the shadow economy and fight against state capture and business capture practices.

2.1. Shadow Economy

The related literature contains many definitions for the shadow economy. However, for the purposes of this current chapter I will use the definition by Friedrich Schneider and Dominik Enste (2002, 2), who argue that “the shadow economy comprises all economic activities that would generally be taxable were they reported to the tax authorities”. This definition is almost in

the same line with Johnson et al. considering the shadow economy as an “activity that is not reported to the state statistical office or the tax authorities” (1997, 173).

The shadow economy functions under two major strategies. The first is state capture, in which business using its resources, money and property seeks to maintain illegal and shadow control over decisions in executive, legislative, and judicial levels. In fact it purchases what it does not possess, public authority. The second strategy is the business capture in which representatives of authorities using their power authorization seek in illegal ways to acquire money and property which they do not have and do not belong to them. In this case the economy is initially damaged and then distorted.

Bribes paid by businesses to authorities both forcedly (business capture) and deliberately (state capture) can be regarded as an ‘illegal tax’ imposed by the shadow economy. In this case, the government appears uninterested in decreasing the shadow economy as it leads to the decrease of corrupt tax base, i.e., the loss of corrupt income of government officials and bureaucrats. For instance, according to unofficial sources, the amount of kickbacks to state officials can reach up to thirty-forty percent of the cost of a project in Azerbaijan (Hajiyev 2002).

As several businessmen in Azerbaijan emphasized (Ismayilova 2003), businesses pay huge amounts of money in the form of bribes and consider it as a certain tax from a shadow turnover. This informal tax is compensated by increasing prices of goods and services and decreasing their quality. For instance, as a result of such illegal tax impositions the quality and weight of bread has worsened recently. Accordingly, we can assume that state capture and business capture are ‘paid’ from the shadow economy. Advance of state and business capture is directly related to the

increase of the shadow economy. Consequently, growth of corruption witnesses to growth of shadow economy.

In particular, a share of shadow economy in the consumer market is essentially high and quite often shadow turnout essentially exceeds legal. In fact, most of small and middle-sized businesses operate in this field. Furthermore, there are cases in which businesses function between the black (illegal) and white (legal) economies, which is called grey sector of economic activities (Satarov, 2003, Safaraliyeva, 2003).

Having summarized the above-mentioned factors, the economic losses from shadow economy can be described as follows:

- Decrease in tax revenues in the budget;
- Deformation of consumption patterns as the money circulating in the shadow economy, first and foremost, goes to those spheres where it is possible to receive high incomes at the minimal expenses in a short term due to the absence of effective monitoring by the state, and the existence of gaps in the legislation.
- As the shadow economy is prone to tax evasions, a part of business incomes is spent for ‘purchasing’ the authorities which is one of the examples of illegal tax imposition from the shadow economy (here, for the purposes of the current research, under the illegal taxes the opposite meaning of the legal taxes paid to the treasury should be understood.

The basis of economic activities in Azerbaijan is a systemic corruption when the economic activities are controlled by a small group of officials that misuse their power to intervene in the activities of businesses, on the one hand, and act as owners of private enterprises, on the other.

Furthermore, it is easy to blackmail a business in the shadow economy. This is a certain kind of

vicious circle in which the advance of the shadow economy ‘ensures’ the increase of the state and business capture development.

According to empirical research carried out by Rose-Ackermann (1997), Dreher (2004), and Dreher and Schneider (2006), shadow economy and corruption are substitutes for each other in the sense that the existence of the shadow economy decreases the propensity of authorities to demand more bribes.

The opposite claim comes from Hindriks et al. (1999), Johnson et al. (1997) and Thum (2005) arguing that corruption and the shadow economy are complements. Hindriks et al. (1999) consider that the shadow economy is a complement to corruption because as the result of collusion between the tax payer and the inspector the latter underreports the tax liability of the former in exchange for a corrupt deal. According to Johnson et al. (1997), there is a negative relationship between the shadow economy and the legal market. In other words, the higher the shadow economy, the smaller is the size of the official market. The authors consider that corruption increases the shadow economy. They argue that corruption is a particular form of taxation and regulation, which pushes firms to shadow.

Dreher and Schneider (2006) accepting the two controversial claims hypothesize. They consider that in high income countries corruption and shadow economy are substitutes while in countries with low and middle income they are complements. According to the proponents of this view, in high income countries bribes in the economic sphere have the main target of engaging in more official economic activities. In other words, there is no corruption necessary or possible to buy the way out of the legal sector of economy. For instance, corruption quite often happens to bribe officials to win a big contract from the public sector (e.g. in the government purchases). This contract is then awarded in the official economy and not in the shadow economy. Furthermore,

the legal sector in high-income countries provides public goods like the rule of law, and independent courts which lack in low-income countries. In this regard, it can be argued that only few businesses in the first group countries have the chance to go underground because of the relatively high risk of being brought to court.

Unlike in high-income countries, in the low-income nations corrupt practices take place predominantly in the unofficial sector of economy due to several reasons. First, in this group of countries the political, economic and legal institutions are weak which distinguish them from high-income countries. The weak institutions make corruption a regular practice which is quite episodic in developed economies. Second, unlike in high-income nations, low-income countries firms are more prone to function in unofficial or illegal sector of economy in the framework of short-term goals.

In the case of Azerbaijan and its high-level shadow economy, the basic assumption of this research is that the corruption and the shadow economy in Azerbaijan are fully complements to each other. Consequently it can be argued that the high level state and business capture is an illegal tax arising from this complementarity. However, in the case of Azerbaijan, the complementarity between corruption and shadow economy does not mean that if firms want to avoid paying bribes they move to the shadow economy. On contrary, the aim of this study is to argue that the shadow economy and the state capture and business capture in Azerbaijan are complement to each other in the sense that businesses function in the shadow economy due to two main reasons:

- a) They deliberately want to avoid taxes and other liabilities in exchange for illegal or unofficial taxes paid to authorities in a form of bribe which costs less than the legal duties;

- b) They are pushed to the shadow economy by the government and the bureaucracy the refusal to which can result in closure of the business or arrests of the management.

Regulation of the official economy, the excessive bureaucracy, inconsistency of legislative documents can be a reason for development of the shadow economy. In this regard, Schneider and Enste consider that countries with higher levels of economic regulation are more prone to shadow economy. Strict restrictions and political interventions are a strong stimulus pushing market participants to an alternative choice.

Heavy state regulations and political interventions, which are closely related to state capture and business capture practices, distort the market competition while undermining economic development and growth. As Stigler indicated in his “The Theory of Economic Regulation” (1971, 3-21), high state regulations and interventions lead to the formation of deadweight loss in the economy.

Schneider (2009) has produced a table (Table 1) in which the size and development of the shadow economy of twenty five East and Central European and Former USSR countries are presented. According to Table 1, in 2006/2007, Azerbaijan has the second highest shadow economy (61.5% of GDP) after Georgia (68.2% of GDP) (p.5). Additionally, as Table 1 shows, in 2005/2006 /Azerbaijan had an even greater shadow economy percentage – 62.3% of GDP.

In world practice, when the scope of shadow economy exceeds 40-45% of GDP, it is considered the critical level. In this regard Azerbaijan’s 61.3 percent shadow economy should be considered as very dangerous in terms of its economic development and growth.

Table 2: The Size of the Shadow Economy in 25 East and Central European and Former Soviet Union Countries

No.	Country	Shadow Economy (in % of official GDP) using the MIMIC and Currency Demand Method						
		1999/00	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
1	Albania	33.4	34.6	35.3	36.1	36.3	37.0	36.0
2	Armenia	46.3	47.8	49.1	50.6	51.2	52.6	52.0
3	Azerbaijan	60.6	61.1	61.3	61.5	61.9	62.3	61.5
4	Belarus	48.1	49.3	50.4	51.2	52.1	53.0	52.2
5	Bosnia and Herzegovina	34.1	35.4	36.7	37.2	38.1	39.0	38.2
6	Bulgaria	36.9	37.1	38.3	39.1	40.0	40.2	39.4
7	Croatia	33.4	34.2	35.4	36.1	37.2	37.3	36.5
8	Czech Republic	19.1	19.6	20.1	20.2	19.8	19.0	18.2
9	Estonia	38.4	39.2	40.1	39.4	38.6	37.2	36.0
10	Georgia	67.3	67.6	68.0	68.2	68.6	69.0	68.2
11	Hungary	25.1	25.7	26.2	26.4	26.1	25.3	24.4
12	Kazakhstan	43.2	44.1	45.2	46.3	47.0	47.3	46.5
13	Kyrgyz Republic	39.8	40.3	41.2	41.9	42.7	43.4	43.0
14	Latvia	39.9	40.7	41.3	40.6	39.8	38.2	37.1
15	Lithuania	30.3	31.4	32.6	31.3	30.4	29.1	28.2
16	Macedonia, FYR	34.1	35.1	36.3	37.3	38.4	39.0	38.3
17	Moldova	45.1	47.3	49.4	50.1	51.2	52.3	51.4
18	Poland	27.6	28.2	28.9	29.2	29.3	27.3	26.5
19	Romania	34.4	36.1	37.4	38.2	38.9	38.3	37.4
20	Russian Federation	46.1	47.5	48.7	49.3	50.1	50.3	49.4
21	Serbia and Montenegro	36.4	37.3	39.1	40.3	41.1	42.1	41.4
22	Slovak Republic	18.9	19.3	20.2	19.6	19.0	18.4	17.4
23	Slovenia	27.1	28.3	29.4	29.0	28.6	27.2	26.4
24	Ukraine	52.2	53.6	54.7	55.6	57.3	58.1	57.3
25	Uzbekistan	34.1	35.7	37.2	38.6	39.8	40.6	39.5
Unweighted Average		38.1	39.1	40.1	40.5	41.0	40.9	39.9

Source: Friedrich Schneider, The Size of the Shadow Economy for 25 Transition Countries over 1999/00 to 2006/07: What do we know? http://www.statbel.fgov.be/studies/ac1272_en.pdf

2.2. Foreign Direct Investment (FDI)

The classic definition of foreign direct investment identifies it “as a company from one country making a physical investment into building a factory in another country. The direct investment in buildings, machinery and equipment is in contrast with making a portfolio investment, which is

considered an indirect investment.” (Graham and Spaulding 2005: cited in the Going Global Web site).

The Organization for Economic Cooperation and Development (OECD) has provided an extensive definition of FDI.

Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an economy other than that of the investor (“direct investment enterprise”). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated (OECD 1999, 7).

According to Havranek, subsidies lead to overprovision of Foreign Direct Investment incentives (Havranek 2008, 2). Consequently, FDI can be regarded as a subsidy to transition countries like Azerbaijan. Transition to a free and competitive market economy requires foreign investment (Perkins, 1995). In this regard, foreign direct investment has a key role in achieving long-term economic success in transition countries as it supports sustainable growth and development.

Another positive feature of FDI is that it creates jobs, technological innovations, advanced infrastructure and new management practices. Due to these and other indicators foreign direct investment has a greater impact on economic development than the simple capital flows. In this sense, taking into consideration the positive role and importance of the foreign direct investment, it can be argued that the attraction of more FDI has a remedial effect on developing economies.

Subsidies are usually granted to develop a certain field of economy. In this regard, due to above mentioned positive peculiarities of foreign direct investments it can be argued that FDI is a kind of subsidy creating favorable conditions for economic development.

In order to attract a significant amount of foreign investment into the transition economy, democratic governance and better protection of foreign companies are two main preconditions. Accordingly, effective corporate governance can be a strong glue to assure foreign investors of possible returns for the risks undertaken.

There is a negative relationship between state capture and business capture and foreign direct investment. The higher the state capture, the lower foreign direct investment (Satarov and Parkhomenko, 2001). In this regard, the level of state and business capture has a decisive role in the scope of attracted FDI. The development level of a transition economy highly depends on whether foreign direct investment is growing or shrinking. The growing FDI implies that the interest of foreign investors in the target country is increasing. This situation attracts new waves of foreign capital to flow into the economy. On the contrary, when the level of FDI is decreasing, it is a signal to foreign investors that there are certain types of dangers that can put their business at risk.

The state capture and business capture adversely affects the attraction of investments, especially foreign direct investment (FDI) due to several reasons. First, the factor of the high level corruption is one of the basic constraints to investment climate and causes adverse conditions for investment (first and foremost, foreign direct investment). Second, corruption leads to substantial growth of the costs of investment projects. The corruption system causes fundamental controversies between what is real or legal and what is the reality of existing regimes, which forms double standards. In this regard, state and business capture discourage foreign direct

investment more than a legal tax. Unlike legal taxes illegal tax is not transparent and creates uncertainty.

The shadow economy mainly arises from excessive tax impositions by governments or unreasonable regulation of economic activities (Nikopour et al 2009). According to the World Bank Institute (2000), corruption significantly decreases the volume of foreign and domestic investments. Considering corruption as a 'tax' on business, the Institute claims that the increase of this illegal tax by 1 percent decreases inflow of foreign direct investments by 5 percents.

Furthermore, foreign direct investment positively impacts economic development. It increases tax revenues and decreases the scope of shadow economy. More investment in the country leads to increase in production, which in turn increases income taxes paid to the treasury.

Additionally, the high state capture and business capture in Azerbaijan leads to decrease the scope of foreign investment which consequently results in lower GDP growth. Loss of tax revenues also leads to lower quality of political, economic, and legal institutions, including less effective courts and a poor law-enforcement system.

Being an important part of this caution, the state capture index of the country (forty-one percent, according to the World Bank, 2000) has a significant negative effect on the growth rate of FDI. Having one of the highest state capture rates, Azerbaijan has faced serious losses in attracting foreign direct investment. These losses have, first and foremost, occurred in the non-oil sector of Azerbaijan's transition economy. Despite the rather high level of FDI attraction to the oil and gas sector, foreign entrepreneurs have considerably lost their interest in investing in the private sector of the economy.

Furthermore, a foreign firm that accepts the terms of the corrupt game in Azerbaijan's shadow and capture economy will exclusively work on short-term fast profit making strategies. The short-term strategy in business means seeking to make profits on consumers at the expense of increasing prices of goods and services (Satarov 2003). This firm will probably increase the prices of its production and will not be interested in maintaining a long-term strategy of quality assurance in production. This situation will also lead to a decrease of new jobs in the economy.

Withdrawal of foreign firms from the national economy results in a set of negative consequences. First, the majority of foreign companies functioning in the public sector of Azerbaijan are engaged in exploitation of its natural resources, i.e., the raw materials, which are far from the production of goods and services. Yet, foreign firms in the private sector deal with the production of final goods, which can compensate the high dependence of the economy on oil and gas revenues. The absence of the second group of foreign firms in Azerbaijan's economy deprives the country from this very important compensation.

Second, foreign firms create new jobs for the population. In this regard, involvement of foreign investments, especially FDI is of great importance for the economy. State and business capture practices in the economy more than sixty percent of which is shadow economy, is far away from a high level FDI attraction.

Third, foreign direct investment brings new technologies which can be considered another important contribution to economic growth. The shadow and captured economy of Azerbaijan deprives the country of this advantage.

Fourth, more foreign investment and more foreign firms mean more taxes paid to the national treasury and higher GDP. This is another big loss that Azerbaijan suffers from state and business

capture. All these are indirect negative consequences of high-level state and business capture practices in Azerbaijan.

CHAPTER 3 - MICROECONOMIC MODEL OF SHADOW ECONOMY AND FOREIGN DIRECT INVESTMENT ATTRACTION

As the impact of state capture and business capture on the shadow economy is unquestionable, it is necessary to study and estimate scales of the shadow market incurred from state and business capture, and to analyze the influence of the two major types of corruption on economic development and growth. For this purpose, I build a microeconomic model in which the negative externalities of the shadow economy caused by state and business capture are explained using microeconomic variables, namely the consumer, the producer, the consumer surplus, the producer surplus, and the equilibrium volume of goods and services.

The main hypothesis of the model is that imposition of indirect taxes (resulting from state capture and business capture practices) will lead to growth of the shadow economy which adversely affects the growth of GDP and economy as a whole. Another hypothesis is that attraction of more foreign direct investment (FDI) can shrink the shadow economy. But in case of Azerbaijan, the inflow of foreign direct investment to the private sector is insignificant, the main cause of which is the high rate of state and business capture.

I consider the state and business capture as an illegal tax imposed on economic actors and common citizens. Additionally, I assume that foreign direct investment is a subsidy granted to producers and consumers. In this path, the model generates the results and implications arising from the hypothesis using the concept of surplus to define the minimum and maximum scopes of shadow economy resulting from tax levies (in our case, illegal tax levies imposed from state and business capture practices). It should be noted that the size of the shadow economy depends on

market prices formulated as an interaction between consumers and producers (buyers and sellers) and the elasticity of demand and supply curves in the given market.

I study the impacts of indirect tax imposition (cost of state and business capture) on secondary redistribution of surpluses among buyers, sellers and government in terms of indirect tax levies. The current study proves that indirect tax imposition does not result in a decrease of aggregate surplus as the levied tax does not curtail the volume of goods and services in the market. The difference between equilibrium volume of goods and services before tax imposition and equilibrium volume of goods and services afterwards does not ‘disappear’ from the given economy but moves to the shadow economy. Accordingly, it is possible to measure the maximum and minimum size of shadow economy resulting from indirect tax levies. These sizes are different depending on the price of goods and services and the elasticity of demand and supply curves.

3.1. State Regulation through a Tax Levy on per Unit of Production

For the purpose of defining the impacts of shadow economy on economic development and growth, I analyze the influence of tax levies per unit of production. For this purpose I assume that the state has imposed tax per unit of production.⁵ In our example, whether the tax is originally imposed on consumers or producers has no importance for the current measurement. The key role in tax incidence is played by the elasticities of the demand curve and the supply curve.⁶ I assume that the tax was imposed on producers. Imposition of this type of tax increases expenditures of producers, so the supply curve moves upwards at the quantity of tax rates.

⁵ Tax per unit is a tax imposed in a fixed amount on per unit of sold (purchased) goods.

⁶ Elasticity indicates the reaction of the demand and supply on fluctuation of one of the determinants (prices of goods, incomes of consumers etc.).

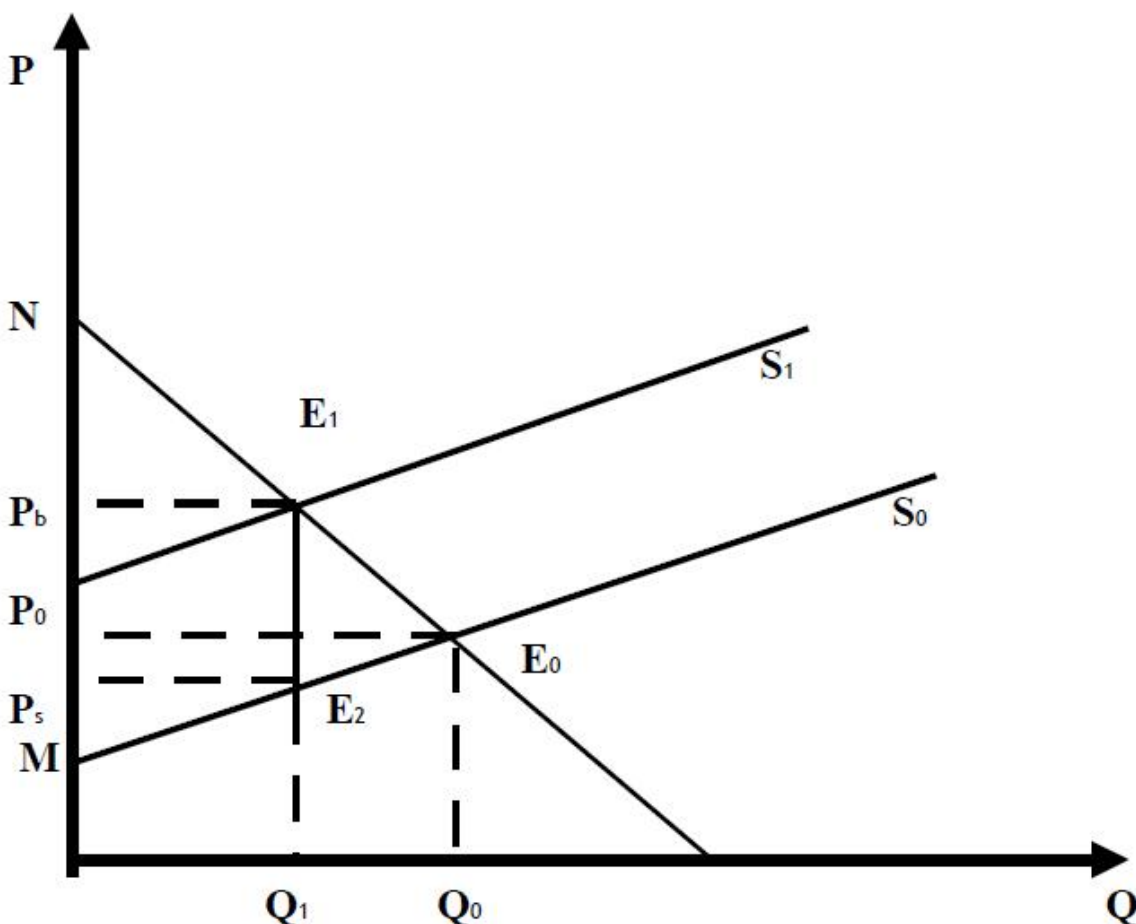
Accordingly, the supply curve shifts from the S_0 outward to S_1 (see Graph 1).⁷ The consequence of such a shift is the variation of equilibrium price (from P_0 to P_b), namely the price to be paid to by the buyer for the purchased product, while the producer receives for per unit of product a given amount with the deduction of taxation rate. Also, the equilibrium quantity of goods is decreasing (from Q_0 to Q_1). As a result, the consumer surplus⁸ decreases from NP_0E_0 to NP_bE_1 . Simultaneously, the producer surplus⁹ falls from MP_0E_0 to MP_sE_2 .

⁷ S – supply, D – demand, t – tax rate, P – price, P_b – price for buyers, PS – price for sellers, Q – quantity, E – equilibrium

⁸ Consumer surplus indicates the difference between the price the buyer is willing to pay per production unit and the actual price which he pays. In the graph, the consumer surplus lies under the demand curve and above the actual price of commodity.

⁹ Producer surplus indicates the difference between the actual price of commodity and the price the producer is willing to sell own commodity (usually, the willingness to sell coincides with production costs). Graphically, producer surplus is shown above the supply curve but below actual price of commodity.

Graph 3: Impact of Indirect Taxes on Size of Shadow Economy



Graph 1 explicitly shows that as a consequence of the tax imposition, the actual price received by the producer for his own product decreases and the volume of production falls. Losses of consumers from tax levies are within $P_b P_0 E_0 E_1$, and losses of producers are within $P_s P_0 E_0 E_2$. A part of these losses goes to the state in the form of cumulative tax levy (T), which is calculated as a tax rate levied per production unit (t), on the quantity of product which is sold after tax imposition (Q_1). In our graph (Graph 1), this part equals $P_s E_2 E_1 P_b$.

As seen from Graph 1, a share of the losses imposed on producers and consumers from the tax levy (the area of $E_1 E_2 E_0$) is received by neither producers nor consumers. This is loss of society

from the imposed tax, which is called deadweight loss¹⁰. Deadweight loss results from decline in production.

It should be noted that the point E_0 is Pareto Efficient¹¹ as neither producers nor buyers are willing to move from this equilibrium. At the equilibrium price, quantity of the goods buyers wish and afford to buy, precisely corresponds to the quantity sellers wish and have the opportunity to sell. The given price satisfies all participants of the market: buyers receive everything that they wish to buy, and sellers sell all the goods they wish to sell.

However, as a result of tax imposition, the equilibrium quantity of the goods sold in the given market decreases the wellbeing of both consumers and producers and the overall society (the proof of which is the decrease in indicators of consumer surplus, producer surplus, and overall surplus). With tax imposition the incomes of the state increase, but tax levies are much less than the overall surplus.

Graph 1 indicates that producers as obedient taxpayers and buyers bear the tax burden from sold/bought goods Q_1 . Herein, the state receives tax levies at a rate of the area of rectangular $P_sE_2E_1P_b$. The product volume ($Q_0 - Q_1$) is also satisfied, as the value of the products for consumers is higher than the costs of producers on their production.¹² However, 37if this money comes from corruption there is no reason to believe that the government will redistribute this efficiently. Therefore a great share of this money is an additional component of the deadweight loss in the form of private benefits to public officials.

¹⁰ Deadweight loss is the decline of total surplus resulting from tax imposition. The total surplus is the total profits made by all market participants.

¹¹ Pareto efficiency (optimality) is a situation in which it is not possible to better off one group of market participants without worsening the condition of another.

¹² The level of demand curve is accepted as willingness to pay, and the level of supply curve is accepted as production costs (or readiness to sell).

In my model the scale of the shadow economy is considered as additional tax ($Q_0 - Q_1$) on commodity price. Depending on risks and penalties for unpaid taxes on per production unit, the price is not above P_b and not below P_s . In case of perfect price discrimination¹³, the deadweight loss of the society disappears, and the size of the $E_1E_2E_0$ triangle goes to the producer as a part of revenues.

Thus, the scale of the shadow economy is defined by the size of producer's sales (which directly depends on the price of the goods). In case of use of the perfect price discrimination, volumes of shadow economy are equal to the area of $Q_1E_1E_0Q_0$. If the perfect price discrimination is not used, scales of shadow economy are reduced and buyers receive additional consumer surplus. However this state does not mean that firms operate in the shadow economy in order to avoid the costs of bribes and corruption. In contrary, as it was argued earlier (in 2.1 Shadow Economy subsection), firms avoid taxes either in the framework of short-term goals or are forced by the authorities to move to the shadow economy.

Consequently, imposition of a tax per unit of production does not lead to formation of deadweight losses, and only promotes shadow economy. The scale of shadow economy in the given situation is connected with tax rates per unit of production, as with other things being equal, the more the tax, the more the difference between sales volumes before or after its imposition.

¹³ Perfect price discrimination is an opportunity of producers to divide buyers into groups, according to value given by them to the goods, and put on different prices for each buyer in line with his/her readiness to pay. In this case, the same commodity is sold to different buyers at different prices which can be considered as price discrimination.

On the basis of the abovementioned it is possible to give formulas for calculation of the maximal and minimal scale of shadow economy in the market with the imposed tax on per unit of production. We assume that supply and demand on production are given by the following equations:

$$Q_d = x - P_b \quad (1)$$

$$Q_s = P_s - y \quad (2)$$

The state imposes a tax per unit of production at a rate of t . In order to calculate the maximal and minimal scale of shadow economy, it is necessary to calculate the equilibrium point up the levied tax, and also the consumer price and producer price, and sales volumes after imposition of the tax.

At the initial equilibrium point the volume of demand for production is equal to volume of the supply, consequently,

$$Q_d = Q_s = \frac{1}{2} (x - y), \quad (3)$$

as the tax in this case is absent; the price for the buyer is equal to the price for the producer.

Proceeding from this,

$$P_b = P_s = \frac{1}{2} (x + y). \quad (4)$$

After imposition of the tax, the consumer price differs from the producer price in accordance with the size of the tax. However, demand volume is equal to supply volume. Accordingly, it is possible to calculate the producer price. In this particular case it is equal to,

$$P_s = \frac{1}{2} (x + y - t). \quad (5)$$

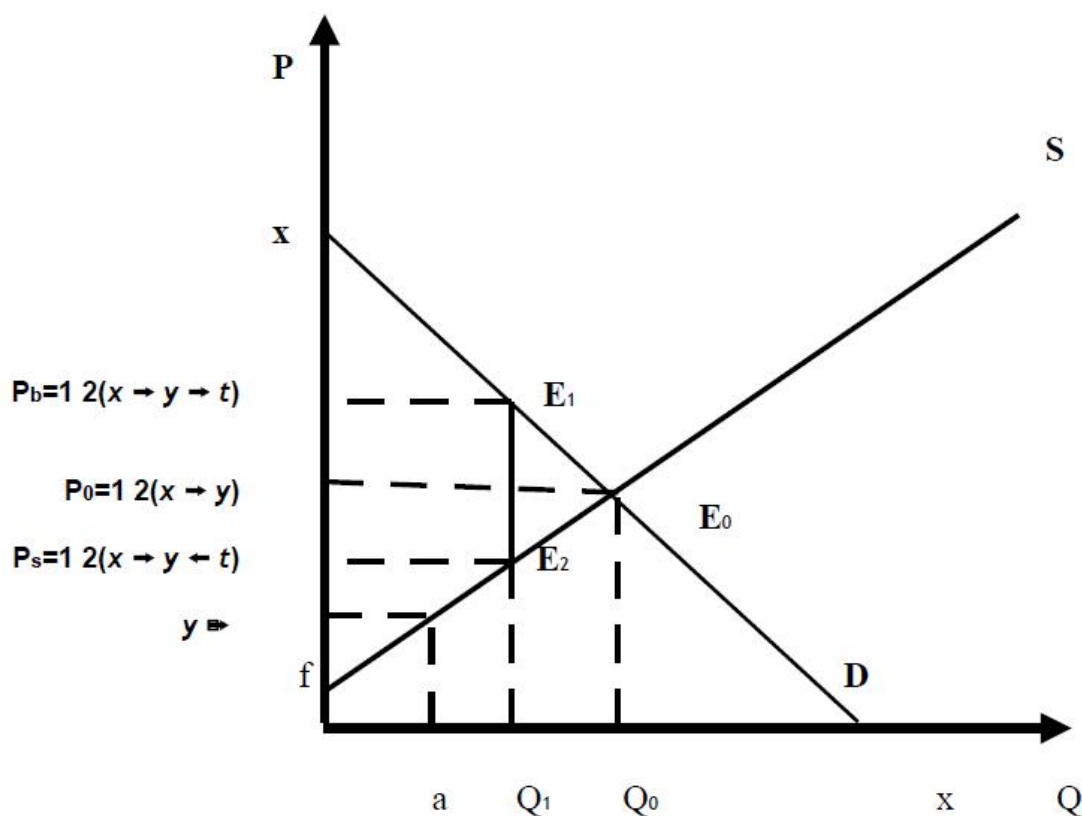
And consumer price is higher than the above-set price solution on the volume of tax levies per production unit.

$$P_b = \frac{1}{2} (x + y + t); \quad (6)$$

$$Q_d = Q_s = \frac{1}{2} (x - y - t) \quad (7)$$

Now we can draw a graph and put the obtained considerations on it.

Graph 4: Maximum and Minimum Size of Shadow Economy



As seen from Graph 2, having calculated the importance of price values for consumers and producers, and also sales volume after imposition of the tax on per production unit, it is possible to calculate the maximal and minimal scale of shadow economy in the given market. The maximal scale of shadow economy is the area of the $E_1Q_1Q_0E_0$ trapeze and is equal to:

$$\frac{1}{4} t (x + y + t/2) \quad (8)$$

The minimal scale of shadow economy is the area of the $E_2Q_1Q_0E_0$ trapeze and is equal to:

$$\frac{1}{4} t (x + y - t/2) \quad (9)$$

Further, we analyze foreign direct investment (FDI) as an important financial tool against shadow economy.

3.2. Subsidies on per Production Unit

I assume that the state subsidizes per production unit.¹⁴ As in the case with taxes, whether the subsidy originally imposed on consumers or producers has no effect on the impact of the policy. The incidence of subsidies is entirely determined by the elasticities of the demand and supply curves.

As seen in Graph 3, I consider the given situation on conditions in which the subsidy has been granted to the producer. Granting a subsidy on sold commodities stimulates producers to sell the

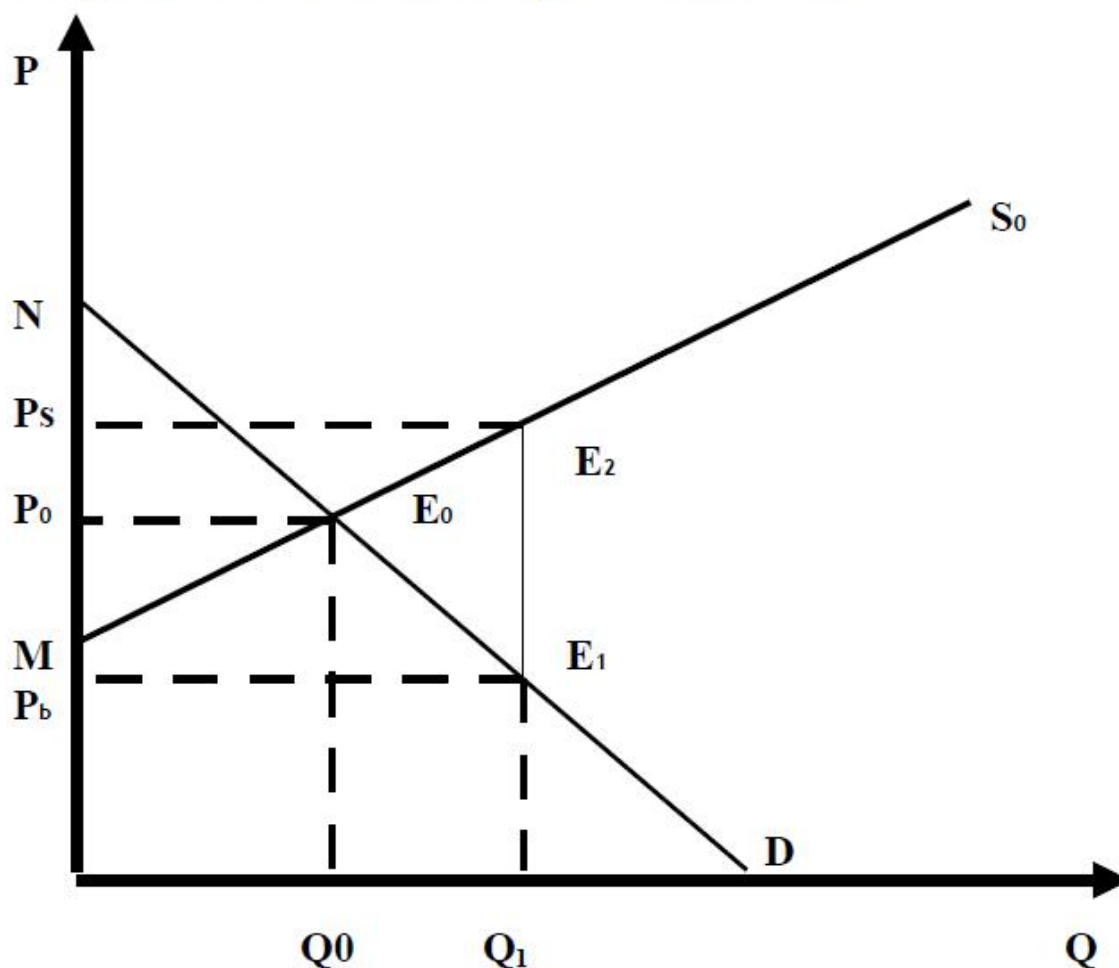
¹⁴ Subsidy per unit is a payment made by the state in a fixed amount on per production (consumption) unit.

goods in larger quantities, which in turn leads to decline in consumer prices up to P_b . However, the producer receives the given price for per unit product and size of the subsidies granted by the state. Accordingly, the producer price goes up to value P_s and equilibrium quantity of the goods increases (from Q_0 to Q_1).

Eventually, as Graph 3 reveals, the consumer surplus increases from the area of NP_0E_0 to the area of NP_bE_1 . Simultaneously, producer surplus increases from the area of triangle MP_0E_0 to area MP_sE_2 .

The granted subsidy stimulates producers to sell their production, and buyers to purchase it. It is essential to note that subsidies are granted to legal or in other words, to tax-paying production. Accordingly, buyers and producers do not have any stimulus for a corrupt transaction in the framework of a shadow economy as the given transactions do not grant them to receive the subsidy. Moreover, in case when subsidies are not granted, the production volume at $(Q_1 - Q_2)$ is not available as production costs of the given production volume exceeds the actual value of the given goods for buyers.

Graph 5: Granted Subsidies per Production Unit



Consequently, grant of subsidies does not lead to formation of shadow economy but, on the contrary, it stimulates market participants to operate in the legal sector of the economy. However, if subsidies are applied only to some sectors this affects other sectors through general equilibrium effects. In this regard, a subsidy granted to one sector and not in another can cause market distortions. Consequently, the issue of what sectors of the economy subsidies are applied is important which should be taken into consideration. The choice of proper sectors subsidizing of which can give more prominent results is important. Accordingly, there is no justification to reject our suggested hypothesis that imposition of indirect taxes leads to formation of deadweight

loss in the economy, and promotes a shadow economy. The opposite state policy, i.e., granting subsidies will not result in formation of the shadow market.

To conclude, imposing a tax on market participants leads to reduction of the prices of goods for producers and rise in prices for consumers, which in turn, under influence of the law of demand and the law of supply, causes curtailing of sales volumes in the market. However, reduction of sales volumes is fixed only in the legal market, where taxes are imposed on bought (or sold) production.

Accordingly, market participants have the only one optimal way –to remain at the former equilibrium quantity of the goods under influence of "rationality", and to pay taxes from those production units which would be made in the market after imposition of the tax under influence of "law-obedience".

Consequently, the surplus of goods (the difference between goods produced and sold in the product market from which taxes are deducted) will rise. Since the given production surplus cannot be sold in the framework of the existing market, (as the levied tax leaves this surplus unclaimed), it will be sold in another market in which the tax will not be levied.

Accordingly, a shadow market will arise since producers and consumers can profitably gain from contracting on the unclaimed surplus of goods. The sizes of the given markets can be considered as volume of revenues, i.e., commodity price times quantity. But it is necessary to consider that in the given market a sole equilibrium commodity price may not be available.

Therefore, depending on the price at which a commodity is sold, it is possible to calculate maximal (if the price is established at a level of willingness to buy) and minimal (if the price is

determined at a level of willingness to sell) size of the shadow market. By granting subsidies per production unit, the formation of the shadow market does not occur, as the subsidies are granted only to legally produced and sold commodities.

CONCLUSION

The decrease of state and business capture in Azerbaijan can significantly improve economic development and growth. Both state capture and business capture are serious deterrence to the inflow of the foreign direct investment (FDI) and to a successful transition to a market economy. In this regard, favorable economic conditions have to be created that will attract new trends of foreign direct investment to the underdeveloped private enterprise sector in Azerbaijan.

The empirical and theoretical findings of this thesis prove that the economic development and growth highly depend on diminishing the shadow economy and attraction of more FDI into the non-oil sector of the economy. Furthermore, the shrinkage of the shadow economy and increase of foreign direct investment can significantly contribute to the GDP of the country. Azerbaijan, which suffers from high level state and business capture practices should prioritize institutional and governance reforms as the former is highly related to the lack of the latter.

The research provides evidence that the shadow economy as an adverse impact of the state and business capture, hinders attraction of FDI into the private sector of Azerbaijan's economy, which is considered an important accelerator of the economic transition from the former highly centralized planned economy into capitalist market. Furthermore, the research conclusively argues that more FDI can effectively limit the scope of the state capture and business capture in Azerbaijan. Finally, having incorporated the two important findings, the research concludes that the shadow economy and the foreign direct investment are mutually interrelated as more FDI shrinks the shadow economy and consequently the shadow economy is a serious impediment to the FDI attraction.

The main hypothesis of the research that *state and business capture adversely impacts the economic development of Azerbaijan* is proved in theoretical and empirical ways. Furthermore, the research concludes that the state capture and business capture have the following two main negative economic impacts. First, the state and business capture have a decisive role in the high level of shadow economy in Azerbaijan. Second, the state capture and business capture seriously reduce the attraction of FDI into the private sector of the economy, which in turn contributes to the scope of the shadow economy and impedes the transition of the country. Third, there is a negative relationship between the shadow economy and the FDI attraction as the increase of the former decreases the latter and vice versa.

The quality and progress of economic development in Azerbaijan can improve with improvement of institutions and decrease of the current high level state and business capture. The level of state and capture depends on the quality of political, legal and economic institutions functioning in the country. Furthermore, the low level institutional governance and high degree of state capture are grave impediments to a successful development of Azerbaijan's economy and serious barrier to foreign capital investments.

In order to succeed in robust and sustainable development, Azerbaijan and its government have to create a more favorable and liberal economic climate that will attract new capital inflows to the lagged-behind non-oil sector. Improvement of institutional governance in Azerbaijan can attract huge foreign direct investment into the private sector of the economy which will lead to more sustainable economic growth and stability. Being a transition country, Azerbaijan has to pay particular attention to reforming its institutional governance if it has a firm will of successful transition to a market economy and integration into the global economy.

Taking into consideration the facts and arguments related to the state and business capture problems of Azerbaijan and the economic consequences arising from these two very dangerous types of corruption, the findings and considerations of the current research have an important significance in filling in the existing gaps in the related literature both theoretically and empirically. However, due to space limitation the more technical details of the microeconomic model built in this thesis require further research.

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