

**Prerequisites to Reboot Resource Cursed Economies: The Case of
Azerbaijan's Economic Diversification Policies.**

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Author's Declaration

I, the undersigned **Orkhan Ahmadli** hereby declare that I am the sole author of this thesis. To the best of my knowledge this thesis contains no material previously published by any other person except where due acknowledgement has been made. This thesis contains no material, which has been accepted as part of the requirements of any other academic degree or non-degree program, in English or in any other language.

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Abstract

Slumping oil prices starting from 2014, thereby, the dropping crude revenues and the ensuing economic crisis reaffirmed the existence of the resource curse in a majority of oil producing economies, including Azerbaijan. Weakening national currency, shrinking economic activities, declining living standards, melting foreign exchange reserves, and more importantly, the skyrocketing debt to GDP ratio signal the urgency to undertake immediate measures to restructure the national economy of Azerbaijan through reduction of hydrocarbon dependence and diversification of the export portfolio. Although the Azerbaijani government is aware of the necessity of bringing down dependence on the oil sector and had determined the diversification as a key direction of the economic development, non-resource sector is not yet within reach of the potential to generate revenues sufficient to substitute hydrocarbon returns. Closely examining the resource curse in the country and analyzing economic diversification strategies, this research aims to investigate policy failures and find prerequisites to reboot the resource cursed economy of Azerbaijan. Utilizing an interpretive mixed research design, the thesis offers budgetary, legal, and institutional reforms as preconditions to reboot Azerbaijan's economy. Successful verification of the hypothesis sets a new framework to follow and achieve long-awaited diversified economy in the country.

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List of Abbreviations

AZN Azerbaijan New Manat

CBAR Central Bank of Azerbaijan

EBRD European Bank for Reconstruction and Development

FDI Foreign Direct Investment

IBAR International Bank of Azerbaijan

LDCs Less Developed Countries

PBB Performance Based Budgeting

SOCAR State Oil Company of Azerbaijan Republic

SOFAZ State Oil Fund of Azerbaijan

SMEs Small and Medium Enterprises

SPDR State Program on the Development of Regions

SPPRS State Program on Poverty Reduction and Sustainable Development

WGI Worldwide Governance Indicators

Introduction

Background

Resource rich economies can be classified as development winners and development losers. While Nigeria, Angola, Sierra Leone, and Venezuela belong to the second category, Canada, Australia, and Norway have made most of their resources and enjoy higher economic development. The major reason behind diverging experiences of resource-rich economies is largely attributed to whether the country has contracted the “resource curse” or not. Resource curse, also known as “the paradox of plenty,” explains the situation when economic growth of resource abundant countries is slower relative to resource scarce economies. Logically, having abundance of natural resources should lead to higher economic development, since it boosts export potential of the countries and provides them with the revenues critical for investment and achievement of the necessary growth rate. In reality, however, resource-rich economies encounter the challenge of significantly suffering from a lack of incentives to develop non-oil sectors; the existence of inefficient bureaucracies; revenue mismanagement; as well as a greater level of corruption—all these are detrimental to economic growth (Sachs and Warner, 1997). These factors prove to be primary reasons for outperforming growth rates of resource-poor countries over economies rich in natural resource since 1960s (Wright and Czelusta, 2004, 6). In order to keep pace, resource cursed countries need to adopt effective strategies to tackle the paradox.

Slump in oil prices exposed the existence of the paradox in the majority of resource-rich countries and validated the fragility of their economies. Azerbaijan though rich in natural resources, once seen as a successful model for most of the developing states with a significant fall of poverty rate from 49% to 5.3%, nearly 20 times increase in the budget revenues, and having debt to GDP ratio of as low as 8% (Aliyev, 2014). However, pressed by declining crude prices, in one year Azerbaijan’s national currency AZN devalued over 100% and was named the world’s

worst currency (Agayev, 2016). Relying for more than 90% of its exports on hydrocarbons, the country experienced a significant drop in budget revenues (Agayev, 2016). As figure 1 illustrates, decreasing budget income along with increasing government spending led to a mounting budget deficit of 1.7 bln. AZN and

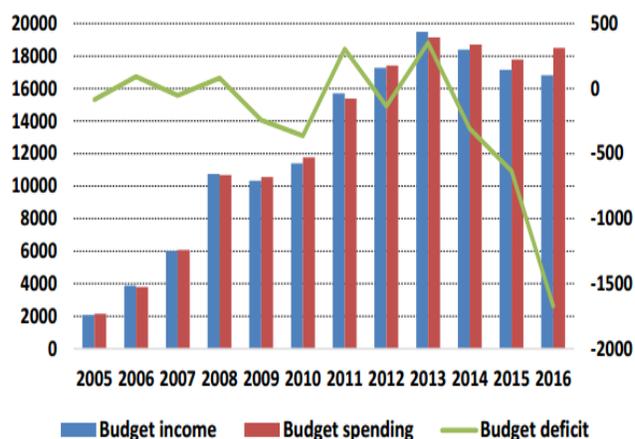


Figure 1 Budget Revenues, Spending and Deficit in Azerbaijan (bln. AZN)
Source: The Ministry of Finance of Azerbaijan

consequent deterioration of the balance of payment (Aslanli, 2016). Failure to diversify economy away from oil and a consequent decline in fiscal balance resulted in a skyrocketing foreign debt to GDP ratio, which as of January 2017 constitutes 24.1% of Gross Domestic Product (Center for Economic and Social Development, 2017).

Even worse is that foreign exchange reserves of the country are in jeopardy. Keeping AZN competitive has cost Central Bank of Azerbaijan (CBAR) and State Oil Fund of Azerbaijan (SOFAZ) together more than \$16 billion (Agayev, 2016). Approved 2017 budget of SOFAZ shows 35% increase in the fund’s 2016 expenditures, introducing a new clause for the transfers to CBAR (State Oil Fund of Azerbaijan, 2017). It is both risky and inopportune to direct the country’s foreign reserves to covering soaring budget deficit and thereby ensuring financial stability. This policy challenges the country’s fiscal sustainability and SOFAZ’s capacity to absorb future macroeconomic shocks. Hence, the existing situation necessitates alleviating resource dependence and achieving economic diversification away from hydrocarbon exports.

Economic diversification is an umbrella term referring to “the process in which a growing range of outputs is produced in the country...domestic economic activities are not primary

determinant of state revenues, and the state is not dependent on few export markets” (Aslanli et al., 2013, 5). Over-reliance on hydrocarbon revenues aggravate macroeconomic volatility in the country. Dependence on one or few particular sectors renders countries vulnerable to external shocks. When a particular country fails to diversify its economy away from the oil sector and oil prices drop, the consequent decline in fiscal activity strains public spending and public employment, which in turn exacerbates the challenge to foster growth. More importantly, since natural resources are exhaustible and dwindling, it is essential to develop new sectors to substitute resource revenues. Hence, economic diversification has potential to boost the resource-rich countries’ resilience and achieve long-term sustainable development.

The government of Azerbaijan also understood the urgency to diversify economy away from oil and undertook necessary measures to increase the share of non-oil sector in the economy. However, achieving economic diversification is not as easy as it may seem. Despite the fact that the government is determined to diversify the economy and implemented a wide range of policies, the country’s export portfolio has not significantly improved and hydrocarbon revenues still constitute a large share of exports. Apart from SOFAZ and SOCAR, there are not any major sources to bring foreign currency revenues to the country. According to CBAR, inflation is still on rise and as of March 2017, reached 13.4%. (CBAR, 2017) Instead of closely focusing each policy and finding the ways to better implement the particular strategy, there is a necessity to closely examine prerequisites and find preconditions to implement successful economic diversification policies and reboot resource cursed economy of Azerbaijan.

Aims and Research Question

Understanding the significance of the issue to achieve sustainable economic development, this research is aimed at closely investigating and finding the prerequisites to reboot Azerbaijan’s

resource cursed economy by implementing successful economic diversification policies. Although there have been several studies conducted to find effective strategies to transform oil dependent countries to more diversified economies, none of the researches has focused on preconditions for successful economic diversification policies in the country. Due to the dearth of data, difficulty to find causation, and being a relatively new case, there is a research gap in relation to Azerbaijan. Since the recent slump in oil revenues, fundamental changes in economic conditions, and soaring state debt to GDP ratio necessitate economic diversification, an analysis of the preconditions to diversify the economy is of utmost importance. Hence, the research is aimed at closing the gap and finding the answer to the following question:

What are the prerequisites to successfully diversify Azerbaijan's economy away from the overreliance on hydrocarbons?

Based on the prior knowledge on untapped areas of the reforms in Azerbaijan and exposure to development of resource cursed economies, I hypothesize that successful economic diversification policies require prior a) budgetary, b) legal, and c) institutional reforms in Azerbaijan. In case of successfully verifying the hypothesis, this thesis will set a new framework to follow for successful economic diversification reforms and achieve long-awaited non-hydrocarbon dependent economy.

Methodology

Since the hypothesis carries three different aspects to be tested and verified as prerequisites to successful economic diversification policies, the research has mixed methodologies to reveal the preconditions. Due to a lack of data and available researches, an interpretive mixed research design was utilized to verify the hypothesis. Hence, existing budgetary as well as legal documents and the state of institutions were closely analyzed to reveal their detrimental impact on diversifying the economy. Multimethod analysis allowed the author to thoroughly analyze the topic and

“measure what s/he is supposed to measure” (Adcock et al., 530). Hence the research has high validity. In order to reveal the relationships between institutional quality and economic diversification policies in Azerbaijan, descriptive analysis was utilized. As a primary source of the data, the thesis utilized “World Governance Indicators,” measuring the governance indicators based on six dimensions; namely, *voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption*.

Although an interpretive approach is widely utilized in qualitative analyses, its major criticisms from phenomenology and hermeneutics school of thoughts may question the effectiveness of the method. However, as an author aware of the problem of subjectivity, potential impact of lived experiences as well as prior knowledge on the interpretations, I put constant effort to remain impartial in my analysis. Due to the fact that world governance indicators are based on perception surveys, validity as well as reliability of the indicators analyzed can also be challenged.

Thesis Structure

Since the existence of “the paradox of plenty” is highly debated, the first chapter of this research closely examines a wide range of literature and analyzes the phenomenon in Azerbaijan. Especially focusing on various perspectives on the resource dependence and resource curse and examining causes and implications of the phenomenon, the paper further proceeds with an in-depth analysis of economic situation and diversification policies in Azerbaijan. Investigating the situation, chapter 3 and consequent each chapter further discusses budgetary, legal, and governance as prerequisites to implement successful economic diversification policies. In conclusion, the paper summarizes the findings and recommends the government of Azerbaijan to consider budgetary, legal and governance reforms as preconditions to successfully diversify economy away from dependence on the oil sector.

Chapter 1: Resource Curse and Azerbaijan

1.1. Background, Causes, and Implications

During the last three decades, the paradox of plenty has been under close consideration from different theoretical approaches and scientific perspectives. The term proves to be valuable to explain why resource poor countries develop more rapidly than resource rich economies. In its simplest sense, the resource curse is conceptualized as “the observation that countries rich in natural resources tend to perform badly” (Sachs and Warner, 2001, 827). Jonathan Di John’s more comprehensive definition explains the term as “the proposition that mineral and fuel abundance in less developed countries (LDCs) tends to generate negative developmental outcomes, including poor economic performance, growth collapses, high levels of corruption, ineffective governance, and greater political violence” (Jonathan, 2010, 1). In other words, natural resources for LDCs turn out to be less of a “blessing” and more of a “curse,” when the countries experience the paradox.

Indeed, this negative perspective on the relationship between resource endowment and economic development is opposite of traditional thoughts on the subject. Historically, scientists have argued for positive association between these two variables in today’s advanced economies (Jonathan, 2010). For instance, Harold Innis’s and a well-known economist Watkins Mackintosh’s “staple thesis” theory highlights the significant role of commodities, or staples in growing resource abundant countries. Watkins (1963) asserts that by bringing initial stimuli to attract more investment and human capital for the development of resource exports, and incentivizing the governments to introduce advanced production methods to be competitive in the market, resource abundance catalyzed the development of today’s advanced economies. Furthermore, resource rents earmarked by the governments can alleviate adverse implications of resource restraints to economic development—namely, monetary as well as fiscal challenges, exchange rate

depreciations, and saving constraints (Gelb and Associates, 1988, 17 Quoted in: Jonathan, 2010). However, the assertion of “staple thesis” theory does not seem to have a decisive role in economic development of today’s resource rich LDCs.

Negative impacts of resource abundance on economic growth has been revealed by several quantitative analyses and cross-section studies. Especially, the “pioneers” of the field, Sachs and Warner (1995) closely examined and proved the existence of the paradox in resource endowed economies. Observing growth patterns of resource abundant and resource scarce countries by analyzing real GDP growth per capita and the share of natural resource exports in GDP for 20 years, Sachs and Warner showed that almost none of the resource rich economies had experienced high economic growth comparing to resource scarce states. (Figure 2) Gustav Ranis (2004) summarized following reasons to explain the paradox; a) unequal income distribution, b) a lack of competition in non-resource sector c) rent seeking behavior, d) having no incentive to diversify economy e) higher level of corruption, and f) authoritarianism.

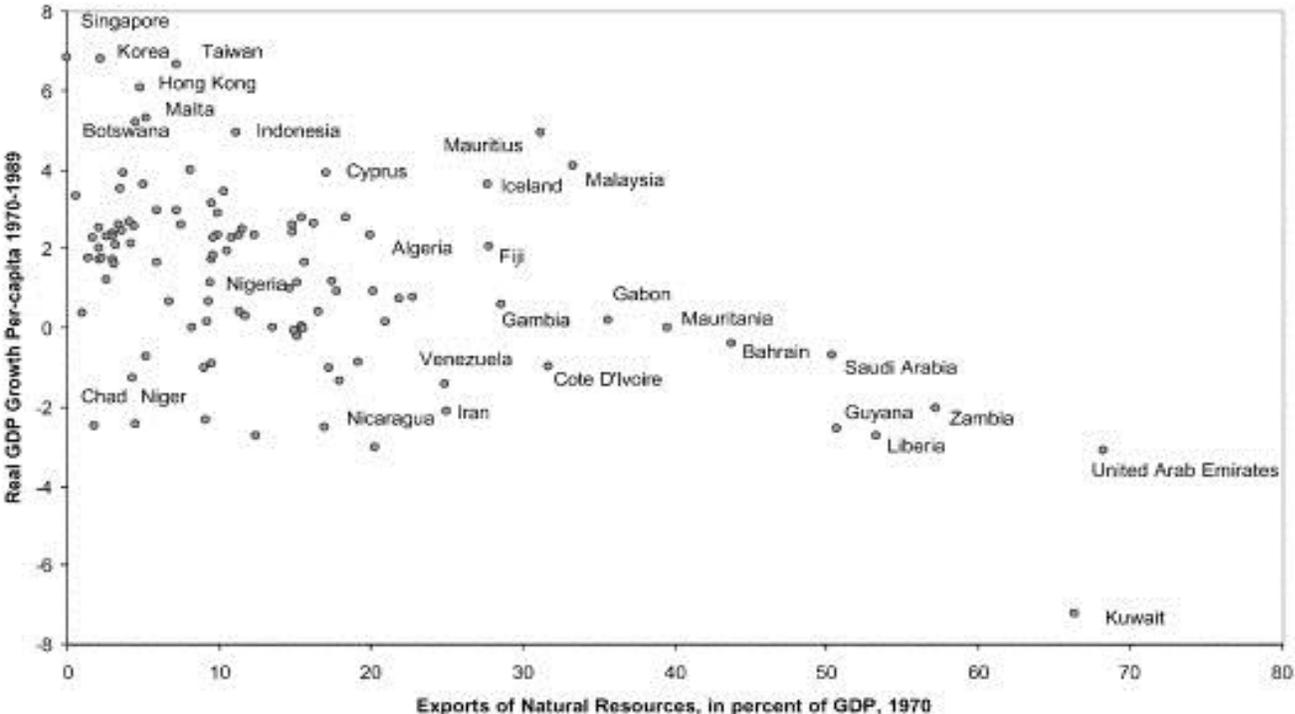


Figure 2 Correlation between Resource Abundance and Economic Growth Source: Sachs and Warner (2001)

One can also observe a rapid economic growth rate in resource rich and “cursed” economies, however, these countries fail to achieve “sustained rapid development” (Sachs and Warner, 2001, 828). Triggered by crude price fluctuations, countries suffering from the paradox of plenty tend to have significant ups and downs in their development path. One of the most apparent harmful impacts of the phenomenon is the elimination of a non-resource sector in the economy. Conceptualized as Dutch Disease, the situation occurs when “manufacturing sector is crowded out by resource sector in the economy” (Zagozina, 2016, 9). Manufacturing plays a critical role in economic development, since it triggers innovations and boost export potential of countries. It also helps the governments to create more labor divisions, increase employment, and achieve a higher standard of living (Sachs and Warner, 2001). However, rapid development of the resource sector leads to a decline in production of other goods and services, causing elimination of workplaces and dependence on hydrocarbons. More importantly, development of hydrocarbon sector is not sufficient “to offset the negative effect of deindustrialization on economic growth” (Torres et al. 2013, Quoted in Zagozina, 2016, 9). Seeming beneficial on the surface, but in reality being detrimental to growth, hydrocarbon revenues can significantly inhibit economic development of resource-rich countries.

One can also argue against the primary rationale behind the resource curse. Indeed, the adverse impacts of resource abundance cannot solely be attributed to one variable itself, which is resource abundance; other independent variables, such as political, economic, and social factors also have explanatory power. As Korhonen et al (2004) asserted, political situation and level of democracy also play a decisive role in development of countries. Hence, it would be more appalling to believe that not resource abundance, but resource dependence deters growth, since countries heavily relying on hydrocarbon exports tend to experience “a weak protection of property

rights, much corruption and poor-quality public bureaucracy” (Torvik, 2009, 245). Additionally, primarily due to their economic characteristics, natural resources, which are very valuable, easy to store, transport, and sell lead to the resource curse problem (Boschini, 2005). In other words, hydrocarbons or precious materials are more prone to causing resource curse problems than agricultural resources.

Mehlum et al. (2006) further verified the presence of the phenomenon in LDCs and attributed its existence to the quality of institutions. Comparing the relationship between GDP growth rate and resource dependency from 1965 to 1990 in 42 countries with good and bad quality of institutions, the authors did not only plot strong indication for the existence of resource curse in countries with high resource abundance, but also revealed the role of institutions in the process. In figure 3, panel a shows that countries with more resource dependency tend to have a lower GDP growth rate compared to less dependent economies. More importantly, as panel b illustrates, resource curse appears to be only in countries with extractive or inferior institutions, while countries with good quality of institutions do not suffer from the existence of this

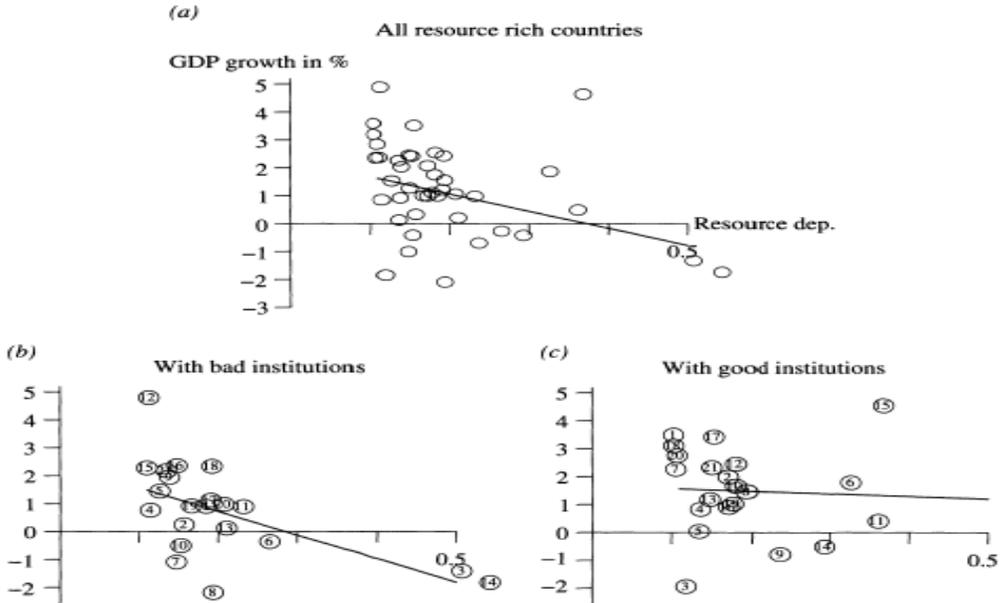


Figure 3 Resources and Institutions a) all resource rich countries b) with bad institutions c) with good institutions Source: Mehlum et al., 2006

phenomenon(Mehlum et al., 2006). Hence, the resource abundance has no harmful impact on economic growth, if it is managed with the principles of inclusion and institutions of high quality.

In the context of institutional quality, Michael Ross (1999) also believes that a type of institution and political factors determine the existence of the paradox. He asserts that resource booms weaken the quality of institutions, which in turn not only creates higher resource dependence, but also hinders economic growth. Apparently, the impact of institutional quality is much larger if the states have never had stable as well as effective institutions. Daron Acemoglu and James Robinson's (2010) classification of institutions being "extractive" and "inclusive," is helpful to label the quality of institutions in a majority of less-developed resource rich countries more of extractive than inclusive. Inclusive institutions secure property rights, preserve functioning lawful environment, and provide "level playing field" for free trade and competition in the market (Acemoglu and Robinson, 2010, 73). On the other hand, extractive institutions are defined as being absolutely opposite. These institutions fail to create rule of law based environment and ensure property rights in the country. "Level playing field" in the economies with extractive institutions is primarily designed for the benefits of minority oppressing a majority of population. Technological innovations and modernizations are primarily obstructed to prevent potential destabilization of regime and control. (Acemoglu and Robinson, 2010) Hence, resource endowed LDCs encounter with the paradox of plenty.

Boschini et al. (2005) further elaborates on the hypothesis and concludes that resource endowments are only harmful for the economies with poor institutions. When high institutional quality is observed, resource abundance has no adverse impact on growth. Ross (1999) attributes the paradox to the state ownership of the reserves, which is primarily observed in developing countries. When private interests are not involved in the resource management, the states fail to

efficiently manage the resources and develop quality of services. Indeed, ownership rights tend to be problematic in resource rich countries with less qualified institutions. Resource rich LDCs unable to enforce property rights and eventually face the paradox of plenty (Ross, 1999). Even worse, the states do not carry out any corrective actions; as Maria Zagozina (2014) asserts, resource endowments make the states lazy and less incentivized to adopt different economic strategies, resolve internal issues, and invest in non-resource sectors. The constant influx of the rents is more attractive than the potential risks and uncertainties of the investment and policies.

1.2.Resource Curse in Azerbaijan

Belonging to the post-Soviet space, the Republic of Azerbaijan has long attracted the world's attention for its rich natural resources. Located on the shore of the Caspian Sea, Azerbaijan not only boasts abundance of oil and gas reserves, but also enjoys rich deposits of other natural resource endowments, such as bauxite, gold, ferrous as well as non-ferrous materials, thermal and mineral springs (Zagozina, 2014). The country is frequently referred to as the birthplace of the industrial development of the oil sector and is cited for being one of the ancient oil producers in the world. In fact, the oil reserves in the country were discovered in 1846 and by 1901 Azerbaijan was providing nearly half of the world's oil supply (Mir-Babayev, 2002). After regaining independence from the USSR and signing production-sharing agreements (PSAs) with a consortium of oil producing companies, the oil sector in the country was enlivened and Azerbaijan became one of the major oil and gas producers.

Although the country suffers from adverse impacts of the ongoing Nagorno-Karabakh conflict and has the highest refugee per person in the world, in early 2000s Azerbaijan managed to become one of the fastest growing economies. Its rapid growth history was largely attributed to the hydrocarbon revenues. Indeed, the influx of foreign investment in oil and gas sectors played a

critical role in shaping the development path of the country. However, the recent drop in oil prices and the consequent economic crisis hit Azerbaijan's economy and revealed the existence of the resource curse.

The presence of the paradox in Azerbaijan has long been analyzed by various scholars. Dayne Lukas Shaw (2013) found a significant impact of the resource revenues on growth and revealed the negative implications of hydrocarbons on development of the non-resource sector. Referring to the development path of the country as "deficient," (Shaw, 2013, 520) the author asserts that though resource-rich, Azerbaijan is not a growth winner. Even if Azerbaijan was a growth winner, as Sachs and Warner (2001, 828) argues, resource cursed countries do not enjoy "sustained rapid development" and the recent crises reaffirmed this assertion. On the other hand, Maria Zagozina not only found the presence of the resource curse in the country, but also discovered a positive relationship between the Soviet legacy and the paradox. Ebru Ihan (2007) analyzed the resource dependence in the country and examined the policies to effectively manage oil revenues in Azerbaijan. According to Ihan's findings (2007), effective energy management of the country requires adopting necessary reforms to establish durable legal system, good quality institutions, and transparent governance.

In fact, Azerbaijan is both blessed and cursed by natural resource endowments. While hydrocarbon reserves provide the revenues critical to develop the economy, they also create the dependence and hinder development of non-resource sector. While in 2003, only 100 million AZN of fiscal revenues had been transferred from State Oil Fund of Azerbaijan (SOFAZ) to the state budget, which amounted 8.2% of total budget revenues, the figure dramatically increased and peaked at 11.35 bln. AZN in 2013, an equivalent of 57.3% of budget revenues (Figure 4). Although

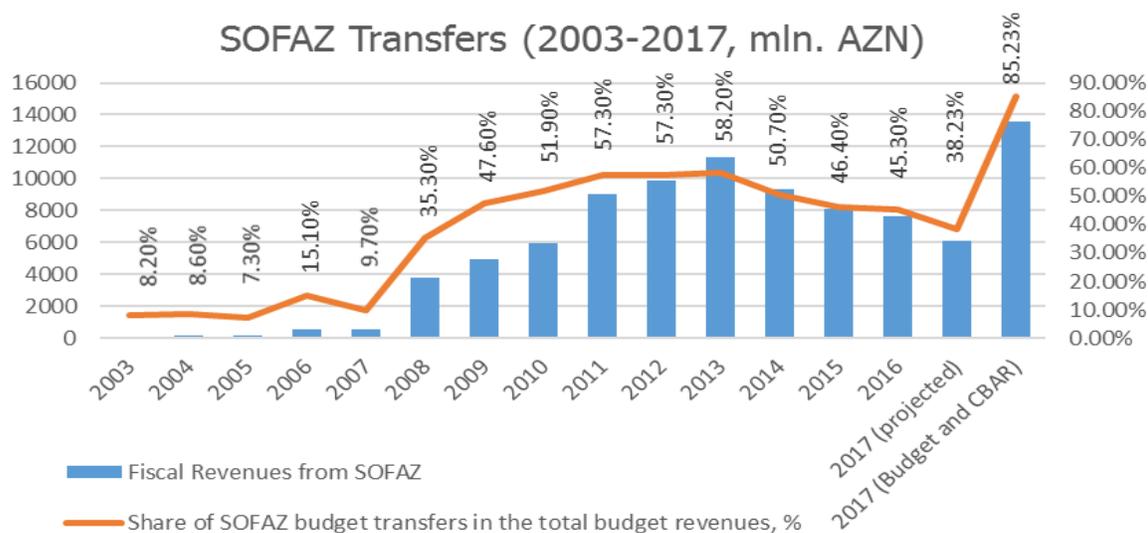


Figure 4 SOFAZ Budget Transfers (2003-2017, mln. AZN)
Source: State Oil Fund of Azerbaijan and The Ministry of Finance

approved budget of SOFAZ for 2017 has 20% decrease on budget transfers, the new budget also introduces a new clause to transfer 7.5 bln. AZN to CBAR to ensure macroeconomic stability in the country. Adding this number to budget transfers means that upper bound of transfers in 2017 will overall cost SOFAZ 13.6 bln. AZN, in other words, 85% of total budget revenues (Figure 4). In case fully implemented, soaring expenditures will melt SOFAZ's assets by 6.1 bln. AZN. (State Oil Fund of Azerbaijan, 2017).

The primary assumption of the paradox of plenty is that resource endowments prevent the development of non-resource sectors become more evident from the export products of the country. Oil and gas exports make up on average 93% of Azerbaijan's exports, while the rest of them is heavily represented by other raw materials and agricultural products (Table A1). Due to the significant hydrocarbon dependence and poor diversification, Azerbaijan's economy proved to be vulnerable to the price shock in the oil market.

The existence of the resource curse coupled with the decline in hydrocarbon revenues adversely impacted every single aspect of Azerbaijan's fiscal as well as monetary policies. The

government was forced to renew its budget revenue plans, cut capital expenditures, introduce new means of financing budget deficit, revise SOFAZ’s 2016 budget and change SOCAR’s operation mechanism (Aslanli, 2016). Due to the swift decline in crude prices, SOCAR had no other choices than temporarily freezing new petrochemical and oil and gas refining projects. Indeed, the national oil company encountered with severe financial challenges and issued bonds worth \$100 million and acquired 1.8 bln. AZN loan from International Bank of Azerbaijan (IBAR) (Aslanli, 2016).

Additionally, the paradox led the government to cut funding for several investment projects and halve public investment expenditures (Aslanli, 2016). In order to finance the deficit, SOFAZ’s 2016 budget was revised and its expenditures were sharply increased, while the income significantly went down (Figure 5). In a revised budget, the deficit was estimated to be nearly 6 bln. AZN, much higher than the forecasted revenues.

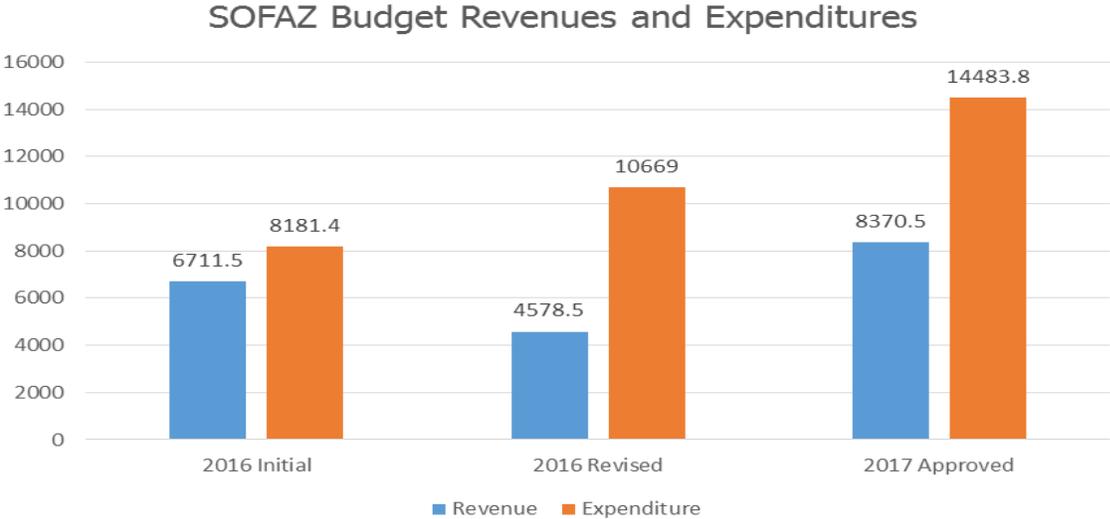


Figure 5 SOFAZ Budget Revenues and Expenditures Source: State Oil Fund of Azerbaijan

Apparently, in the midst of declining oil prices in the market, the government of Azerbaijan would need to either face a soaring budget deficit or inject more funds from SOFAZ to ensure macroeconomic stability. 2017 approved budget of the State Oil Fund is already in line with the

Foreign Debt to GDP Ratio in Azerbaijan

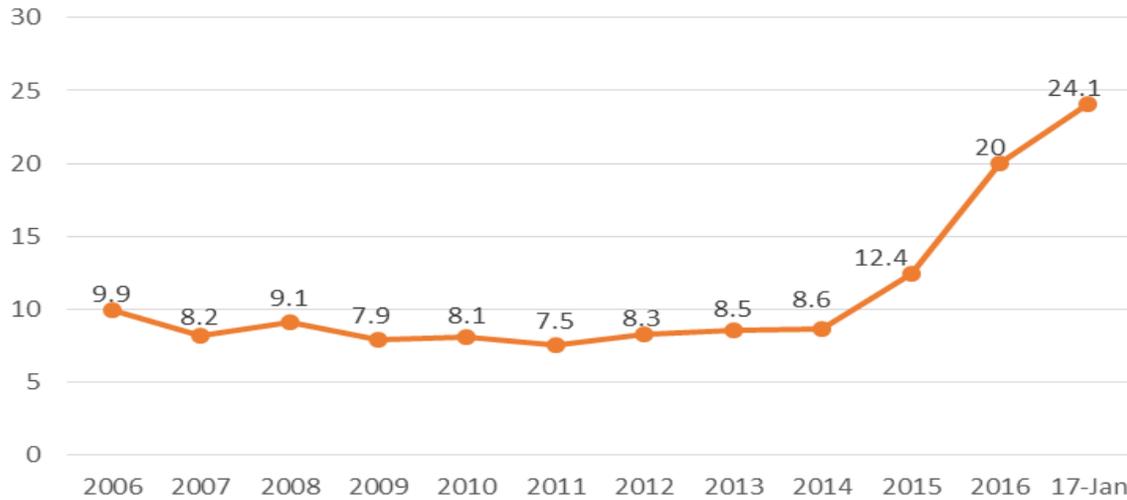


Figure 6 Foreign Debt to GDP Ratio Source: The Ministry of Finance of Azerbaijan

government's policy and shows 36% increase in 2016 revised budget (Figure 5). However, the policy to draw more money from SOFAZ cannot be considered sustainable in the long run period and may cause an increase in budget deficit, eventually leading to a debt crisis in the country (Aslanli, 2016). As Figure 6 illustrates, Azerbaijan's debt to GDP ratio has doubled over the last year and reached an alarming level necessitating immediate measures. The number is forecasted to hike to 44.5% by 2019 (Table A2). Increasing debt will not only lower living standards, but also return the country back to the poverty rate that prevailed prior to oil boom. Volatility of crude oil prices, the expected depletion of hydrocarbon reserves, development of shale technologies, increasing production of non-renewable energies, growing environmental concerns pressing the global demand, and lesser profitability of gas exports necessitate undertaking immediate measures to diversify the economy and tackle the resource curse in the country.

Chapter 2: Economic Diversification Policies: Analysis of Failures

2.1. Implemented Diversification Policies

The government of Azerbaijan has long endeavored to achieve necessary economic diversification in the country. Between 1990 and 2010, more than 20 decrees were signed to significantly increase the share of non-resource sectors in the economy. The decrees include providing financial assistance for SMEs, establishing free trade zones, increasing economic activities in the regions, and introducing tax reductions, as well as subsidies for agricultural products (Aslanli et al., 2013). After the 2007 financial crisis and a consequent drop in oil revenues, the intensity of adopting new strategies and programs for economic diversification has further increased. The crises exposed the vulnerability of Azerbaijan's economy to external shocks and the annual growth rate dropped from what once was 35% in 2006 to 0.1% in 2011 (Ahmadov et al., 2013). In order to handle vulnerability of the state economy, the government of Azerbaijan adopted more than 14 economic diversification programs, targeting the development of agriculture, tourism, and information telecommunication sectors (Table 1).

Table 1 Economic Diversification Strategies and Programmes in Azerbaijan Source: Aslanli et al. and Official Website of President of Azerbaijan Republic

Programme Name	Signed Date	Purpose
Food Security Programme	2001	Increasing local food production, decreasing foreign imports, and providing necessary assistance for production, processing as well as marketing for local products.
2002-2006 Programme on Agricultural Development	2002	Developing agricultural sector by increasing soil fertility, supporting the export of locally produced products, and providing entrepreneurs with financial assistance.

2003-2012 National Strategy on Information and Communication Technologies	2003	Upgrading information and communication infrastructure of the country, supporting application of IT activities in the economy, and promoting IT exports.
2003-2005 State Programme on Poverty Reduction and Economic Development	2003	Stimulating a) agricultural growth by introducing tax breaks, a wide range of financial assistance, and establishing microfinancing organizations, b) enhancing the country's tourism potential, and c) developing alternative energy sector.
2002-2005 State Programme on Developing SMEs	2002	Expanding chemical industry, supporting SMEs on enhancing their production potential, and developing agro-services in the country.
2002-2005 State Programme on Tourism Development	2002	Improving tourism sector by easing visa and custom regulations, building essential infrastructure, and increasing competition in the sector.
State Programme on Social-Economic Development of Regions	2004	Ensuring equal development of regions by improving pre-determined economic activities for a particular region.
Long-term Strategy on Oil and Gas Revenue Management in 2005-2025 years	2004	Setting an expenditure framework for oil and gas revenues, determining spending priorities, and enhancing human development to shift brain-driven economy.
State Programme on Development of Fuel-Energy Complex (2005-2015)	2005	Building as well as developing alternative energy sources and decreasing oil and gas dependence in electricity generation.
State Programme on Employment Strategy in 2007-2010 years	2007	Establishing regional offices to offer consultancy, organizational and other related services, assuring compliance of rules and regulations, and building new incentive mechanisms to trigger investments.

2008-2015 State Programme on Food Security of People	2008	Increasing local food production, assuring compatibility of foods produced with international standards, and enhancing business environment in agriculture.
2008-2015 State Programme on Poverty Reduction and Sustainable Development	2008	Diversifying the economy away from oil, developing tourism, agriculture, and alternative energy production, and creating relevant infrastructure.
2009-2013 State Programme on Socio-Economic Development of Regions	2009	Decreasing hydrocarbon dependence, achieving the non-oil sector development, and securing a sustainable economic growth of the country
2010-2014 State Programme for Developing Tourism	2010	Turning the tourism sector into one of the vital parts of the national economy, building appropriate infrastructure, and increasing SMEs share.
State Program on socio-economic development of regions of the Republic of Azerbaijan for 2014-2018 years	2014	Assuring continuity of economic diversification policies, development of economic activities in the regions, alleviating resource dependence, and improving rural infrastructure.

In fact, as a result of diversification programs, the non-resource sector showed a considerable growth rate and reached its new peak of 60% of Gross Domestic Product (Farch, 2015) Currently, mid-sized corporation in Azerbaijan grow more rapidly than any other segments (McKain, 2015; Quoted in: Farchy, 2015). Compared to the last 10 years, the country's GDP grew 3.2 times, while non-oil sector increased by 2.6 times (The President of Azerbaijan, Decree № 118). Azerbaijan turned out to be an exemplary state for as low as 5% unemployment rate and 5.3% poverty rate (ibid). In fact, as a result of implemented policies, more than 1.2 mln. new jobs, majority of which were permanent, were created (ibid).

However, none of the strategies proved to be successful enough to substitute oil revenues in the economy (Aslanli et al., 2013). Increasing oil revenues after the 2007 financial crisis has resulted in ensuing loss in incentives for diversification programs. Hence, despite their years-long implementation, the programs did not yield long-expected diversification of the economy. More than 90% of the country's exports are still comprised of hydrocarbons. Every 2nd AZN in state budget is transferred from State Oil Fund of Azerbaijan. Even worse, the country is in the midst of the debt crises, which can potentially bring the country back to the economic state of the 1990s and dramatically lower living standards. The recent crisis and existing economic situation confirm the ineffectiveness or insufficiency of implemented policies.

2.2. Causes of Policy Failures

Asian Development Bank (2014) attributed unsuccessful economic diversification of Azerbaijan to a) a limited role of small and medium enterprises (SMEs) in the economic activities, b) the existence of monopolies, c) widespread corruption, d) low institutional capacities, and e) labor difficulties in the economy. It is also believed that a lack of transparency and accountability in the country hampers implementation of effective economic reforms (EBRD, 2014). Zagozina (2014) asserts that Azerbaijan would have a diversified economy, if there were not problems in gaining an access to microfinance, especially, in the regions. Andrew McDevitt (2015) from Transparency International argues that the existence of a large scale corruption undermines the effectiveness of economic reforms in the country.

Bertelsmann Stiftung (2014) closely analyzes existing budgetary system and claims that the spending mechanism, along with a lack of coordination among the institutions are detrimental to implementing successful economic policies. There is little transparency in regard to budgetary spending. It is hard, almost impossible to gain an access to information related to government

contracts with private businesses. Budget organizations are not interested in saving public funds for further usage, since it is not guaranteed that the funds saved will give the particular agency more spending for the next year's budget. We tend to observe misuse of funds allocated to implement economic strategies (Stiftung, 2014). The line of thought in less-developed oil rich countries, which presupposes that there will always be oil to provide the agencies with funding, triggers inefficient spending and inhibits implementation of policies.

The government has long targeted the agricultural sector and pursued various strategies to boost its growth. Indeed, agriculture in the country enjoys a great export potential to significantly substitute oil and gas export shares and provide employment opportunities for the people living in rural areas. Despite the government's heavy subsidies and tax breaks, the sector does not play a critical role in economic diversification yet. Aslanli et al. (2013) believes that failures to ensure efficient allocation of the funds and adopting poorly developed strategy, among others, have led to the current situation. It would be unrealistic to expect significant agricultural development without tackling strategic and budgetary problems.

During the entire process, the government of Azerbaijan also undertook several legal reforms to handle potential conflicts and assure impartiality of the courts. However, implementation and enforcement mechanisms are still problematic (EBRD, 2014) According to European Bank for Reconstruction and Development (2014), legal environment in the country proves to be "complex and uncertain" (15). The major challenge in the country's legal system is a lack of clarity in the rules for transparency as well as disclosure mechanisms. Corporations usually find it difficult to understand the legal capacity of supervisory boards and directors. Additionally, there is also urgency of modernizing the legal system and enacting laws to boost foreign direct investments. There is not a single law for "Code of Competition" (Aslanli et al., 2013). More

importantly, there is not any framework for Public Private Partnerships (PPPs) and concession agreements to attract private investments to the provision of public goods and services. Therefore, the government of Azerbaijan needs to introduce legal reforms in the country.

Ahmadov et al. (2013) believes that natural resources have hindered government effectiveness as well as institutional quality; hence, the implemented policies fail to bring the desired outcomes in Azerbaijan. There is a consensus among scholars that institutional quality and the existence of resource curse are highly interconnected. While hydrocarbon revenues lower incentives to undertake institutional reforms and create effective bureaucracy, poor institutional quality also prevents effective management of resource rents. It is difficult to identify “cause-effect” relationship between these variables.

During the interview conducted by Victor Halberstadt at Davos 2015, the President of Azerbaijan, Ilham Aliyev, reiterated the government’s commitment to economic diversification in the country. On December 6, 2016, the President of Azerbaijan, Mr. Ilham Aliyev, signed a decree to approve “Strategic road maps for the national economy and main economic sectors.” The decree does not only determine the country’s economic development plan for 2020, but also set new visions for 2025. The roadmap aims to decrease SOFAZ’s revenue transfers from 50% to 15% by the end of 2025. However, in order to ensure implemented policies, build a diversified economy and successfully tackle the resource curse problem of Azerbaijan, there is urgency to undertake prior budgetary, legal, and institutional reforms.

Chapter 3: Shifting from Traditional Budgeting

3.1. Existing Budgetary System

Across many LDCs, the governments adopt reforms to innovate their public management system and improve institutional quality by boosting transparency and accountability in every layer of governance. There is a tendency to shift from highly centralized governments to decentralized systems to effectively utilize local knowledge, change a bureaucratic form of communication between local governments and people, and more importantly, better implement public policies (Schaeffer and Yilmaz, 2008). However, at the cornerstone of successful reforms is having robust public budgeting and financing systems. Ahmad et al. (2006) rightly asserts that weak, inefficient, or wasteful financial system in the country tends to inhibit the effectiveness of implemented policies and negate potential benefits. Public budgeting stands at the intersection of all government reforms, including fiscal, economic, and social policies (Schaeffer and Yilmaz, 2008). Since state budgeting is not only a financial statement, but also a critical link to connect government policies with the financial aspects and implementation phase (Schaeffer and Yilmaz, 2008), it is necessary to closely examine economic diversification policies from the public budgeting perspective. Discussing the budgetary approach in Azerbaijan, this chapter closely examines limitations of the existing system and analyzes the introduction of performance based budgeting (PBB) to tackle the resource curse problem.

The current budget system in Azerbaijan is defined by *The Constitution of Azerbaijan Republic*, *The Law of Azerbaijan Republic on Budget Systems*, *The Law on the State Budget*, annually passed and approved by Milli Majlis,¹ international agreements endorsed by the Republic of Azerbaijan, and normative-legal acts (*The Law of Azerbaijan Republic on Budget System*,

¹ The Parliament of Azerbaijan, which exercises the legislative power in the country and comprises of 125 parliamentarians elected by common voting for 5 year terms.

Chapter 1). The budget system is composed of three broad categories: 1) State Budget of Azerbaijan Republic, 2) the budget of the Nakhchivan Autonomous Republic, and 3) local budgets (ibid). According to article 21 of the Law on Budget System, the Milli Majlis and Chamber of Accounts are main two bodies responsible for supervising execution process of the state budget. Executive bodies as well as heads of spending institutions are also in charge of assuring due use of allocated funds and maintenance of expenditure along with revenue reports. In case a particular body violates the rules and regulations and the purposeful utilization of public budget, the corresponding institution will undertake necessary legal procedures (The Law of Azerbaijan Republic on Budget System, Article 21).

Aimed at modernizing an existing system, improving transparency, as well as accountability, the government of Azerbaijan has introduced addendums and amendments to The Law of the Republic of Azerbaijan. In 2016 the Milli Majlis amended several clauses in the Law of Republic of Azerbaijan on Budget Systems to approve the status of Chamber of Accounts as the Supreme Audit Institution and ensure the compliance of its activities with UN General Assembly Resolutions A/66/209 on “promoting the efficiency, accountability, effectiveness and transparency of public administration by strengthening Supreme Audit Institutions” (Republic of Azerbaijan Chamber of Accounts, 2016). Financial accountability also requires comprehensive reporting on the achievements of spending institutions with their expenditures, in other words, performance indicators. However, the existing system does not have any performance indicators.

Despite the government’s modernization attempts and introduction of program aspects, the current budgeting system is primarily based on a line-item budgeting approach. The line item budget approach, which is also conceptualized as “traditional budget approach,” “commodity approach,” “object expenditure or object approach,” “incremental budget approach,” or simply

“line-item,” (Mukhdad, 2013, 88) is the most pervasive budgetary system used in the public sector. Wildavsky (1989) characterizes traditional budgeting with three main concepts: “base year, incrementalism, and fair share” (11). The entire preparation process in the traditional budgeting heavily relies on the base year’s budget, which further defines future expenditures. Secondly, line item budgeting is prepared by making incremental adjustments to the previous year’s budget. Thirdly, the process presumes that in the eve of decreasing expenditures and soaring deficits, budget cuts will be executed based on the “fair share” (Wildavsky, 1989, 11). Due to the limitations of the traditional budgeting approach, governments shift from input oriented line item budgeting to results-driven program or performance budgeting. However, the budgetary approach in Azerbaijan is still heavily based on traditional budgeting.

3.2. Drawbacks of Current Budgetary System

Since the current budgetary system in Azerbaijan reflects line item budgeting, all the drawbacks and criticisms inherent in a traditional budgeting approach are equally applicable to the existing system. Historically, state budgets have been constructed based on traditional budgeting, perhaps mirroring accounting knowledge of public employees and the simplicity of the process (Schaeffer and Yilmaz, 2008). The main orientation of this system is to track expenditures and assure administrative accountability of the spending agency. Compared to other types of budgeting, the line-item promotes political stability (Axelrod, 1995) and enables the entire process to “satisfice, satisfy and suffice...allowing the system to get by, come out all right, and avoid the words” (Folscher, 2007, 112 Quoting: Wildavsky and Caiden, 1997). Despite its simplicity and easy construction, its incrementalism, failure to deliver accountability, and inflexibility hinder implementation of effective policies and necessitate replacing traditional budgeting with its modern counterpart, performance based budgeting.

3.2.1. Incrementalism

The current budgetary system in Azerbaijan is primarily based on incrementalism. During the preparation phase for the next year's budget, instead of analyzing achievements against predetermined benchmarks and comparing performance indicators, budget makers make incremental changes to the base year's budget (Folscher, 2007). The base of a budget is conceptualized as "accepted parts of programs that will not normally be subjected to intense scrutiny" (Wildavsky, 1997, 9). The budgeting process presumes that financial needs of spending agencies remain the same over time and incremental adjustments for inflation and potential budget cuts will suffice, which do not reflect the reality.

In this system, there is an informal rule of the game for the budgetary organizations to increase their share of pie, offset by the strategies of the Ministry of Finance to minimize the budget requests (Folscher, 2007). Discussions between the Ministry of Finance and spending institutions primarily concentrate on inputs, with no remarks to outputs (Schiavo-Campo, 2007, 244). More importantly, public institutions perceive the entire budgeting process as "zero sum game" (Schiavo-Campo, 2007, 244), in which gains of one parts lead to consequent losses of others. Even worse, in the eve of financial challenges when public institutions expect potential budget cuts and shrinking revenues, they tend to overstate their budget requests to protect themselves against losses (Schiavo-Campo, 2007). This fact leads to boosting expenditures and wasteful spending. Due to the drawbacks inherent in incremental nature of current line-item budgeting approach, Azerbaijan's long-term economic diversification policies do not bring expected benefits.

3.2.2. Lack of Accountability

Furthermore, the budgeting system fails to deliver information about the achievements of spending agencies-accountability. In fact, the country has a lower open budget index comparing to its neighbors and global average (Table A3). Both supply and demand sides of accountabilities are not ensured in the current budgetary approach. Supply side accountability refers to “downward financial accountability, which includes strong local capacity for budgeting and public financial management, and standards of control on intergovernmental transfer revenues, among others” (Schaeffer and Yilmaz, 2008, 4). On the other hand, demand aspect of accountability is primarily about social accountability, in other words, public involvement into budgeting process, participatory programs enabling the public to track the state expenditures and achievements (Schaeffer and Yilmaz, 2008). However, the primary focus in the current system is on inputs rather than outputs. Public institutions can only be held accountable for their spending, not achievements. Knowing how much money public institutions spend on salaries, infrastructure, maintenance costs, etc. does not inform the public about the benefits of particular expenditures. Since the agencies do not provide performance assessments, it is hard, if not impossible to compare the achievements of spending agencies and assess properness of allocations of funds among institutions. Consequently, winning and losing spending agencies cannot be identified in the process of implementing diversification policies, which further inhibits effectiveness and efficiency of public funding.

3.2.3. Inflexibility

Ensuring flexibility of current budgetary system in modifications responding to changing state priorities and financial challenges is also problematic in the current budgeting. There are already established line items in a traditional budgeting approach. When budget makers define the programs or lines for the base year, the funding for the particular programs are likely to revolve to

the next year until “it is challenged” (Folscher, 2007, 113). This fact does not only lead to wasteful budgetary spending, but also makes the entire process inflexible to adopt changing priorities. Considering the fact that budgeting process is as political as it is financial, and programs are highly linked to political interests, Wildavsky (1989) rightly asserts that cancelling the existing programs may cause political instability in the country. When the government of Azerbaijan adds a new economic diversification policy to the base budget, the state expenditures increase. Since there are no performance indicators to judge achievements and reallocate the public revenues, the state cannot properly allocate the funding and set clear benchmarks for its priorities. Consequently, the problem of inflexibility negates the effectiveness of economic diversification policies.

3.3. Introduction of Performance Based Budgeting

Introduction of performance based budgeting (PBB) can prove to be a valuable asset bringing long-awaited effective implementation of economic diversification policies. PBB is “...the one which presents the purpose and objectives of the funds for which funds are required, the costs of programs proposed for achieving these objectives, and quantitative data measuring the accomplishments and work performed under each program” (Axelrod, 1995, 281). As table 2 illustrates, performance base budgeting significantly differs from the traditional approach in terms of its content, format, orientation, and associate management. PBB shifts the orientation from inputs to results and brings managerial flexibility. In PBB, expenditures are allocated based on performance indexes not on inputs and resources. Furthermore, the agencies will be supposed to provide comprehensive information about inputs, outputs, and achievements of implemented policies, which in turn will boost accountability in public spending.

Table 2 Features of Traditional Budgeting and Performance Based Budgeting Source: Shen, Chunli. "Anwar Shah." Editorial. "A Primer on Performance Budgeting." 140.

Feature	Line Item Budgeting	Performance Based Budgeting
Content	Expenditure by objects (inputs and resources)	Presentation of a results-based chain to achieve an specific objective
Format	Operating and capital inputs purchased	Data on inputs, outputs, effects, and each by each objective
Orientation	Input controls	A focus on results
Associated management Paradigm	Hierarchical controls with little managerial discretion	Managerial flexibility over inputs and program design, but accountability for service delivery and output performance

Successful implementation of performance based budgeting will bring more “rationality, objectivity, accountability” (Axelrod, 1995, 277) to the existing budgetary system in Azerbaijan. In case the government replaces traditional budgeting with PBB, the performance indicators will play a decisive role in comparing program achievements, allocation of funds, and performance of spending institutions. Changing focus on outcomes, rather than inputs will enable the Ministry of Finance to closely examine the performance indexes and easily identify winning and losing agencies. PBB will not only lead to efficient spending and incentivizes the agencies to develop a strategic plan for long-term achievements, but also will allow the government to reallocate funds and detect the problems in implementation phases of diversification policies. Although as Axelrod rightly claims, preparation of performance based budgeting is a time consuming process requiring additional skills and competences of public employees, due to its flexibility, introduction of performance indexes, and accountability, there is an imperative need to replace the traditional approach with the performance based budgeting in the country.

Chapter 4: Necessity to Undertake Legal Reforms

4.1. Challenges Posed by Legal Environment

The government of Azerbaijan has well understood an imperative need to undertake extensive legal as well as judicial reforms and adopted several strategies to fix loopholes and modernize the legal system in the country. In fact, limitations inherent in the current system prevents the state not only from attracting foreign direct investments (FDIs), but also nurturing domestic industries to generate revenues that would substitute the share of hydrocarbon returns in the economy. As a panacea to the existing legal environment, the reforms have been primarily focused on boosting public trust in legal and judiciary system and enhancing efficiency by a) bolstering the independence of courts and judges, b) assuring transparent composition of judges, c) increasing access, and d) establishing user-friendly legal system, states Mr. Fikrat Mammadov (2013), the Minister of Justice of the Republic of Azerbaijan. Aiming to increase transparency in the process, the Ministry of Justice regularly broadcasts examinations on the internet. Special steps have also been undertaken to increase impartiality of the judges, which has never existed during the USSR period (Mammadov, 2013). The intensity of adopting legal reforms further increased with decreasing oil revenues.

After the drop in crude prices, the government of Azerbaijan amended the Tax Code and gave certain business privileges of not paying taxes with 50% of their revenues. Addendums to the customs tariffs further canceled custom duties for capital equipment imports (The U.S. Department of Commerce, 2016). The state has also applied “one window” principle to eliminate excessive bureaucratic procedures on establishing businesses. It is now easier to receive permission for any research and development activities or build production factories in the country (ibid). However, the policies have not been enough to trigger economic diversification in the country.

In fact, implementation as well as enforcement mechanisms are still problematic. European Bank for Reconstruction and Development (2014) argues that the legal environment in Azerbaijan is also “uncertain and complex” (15). The major obstacle in the legal system remains to assure the impartiality of judiciary system, especially, in the cases when the state has a considerable interest (EBRD, 2014). According to Economic Freedom Report (2017), there are significant challenges, especially on assurance of economic freedom, on implementation of systematic reforms critical to strengthen economic freedom and diversify Azerbaijan’s economy. Azerbaijan ranks 68th among 180 countries in terms of economic freedom (See Table A4). Especially bureaucratic procedures and regulatory barriers obstruct foreign investments and hinder international trade potential of the country. As figure 7 illustrates, the regulatory efficiency belongs to “mostly free” category. Although labor and business freedom rankings are above the world average, in terms of monetary freedom, the country’s rank of 130th out of 180 countries is not pleasing (Miller and Kim, 2017).



Figure 8 Regulatory Efficiency in Azerbaijan
 Source: Miller and Kim. “Economic Freedom Report.” 2017

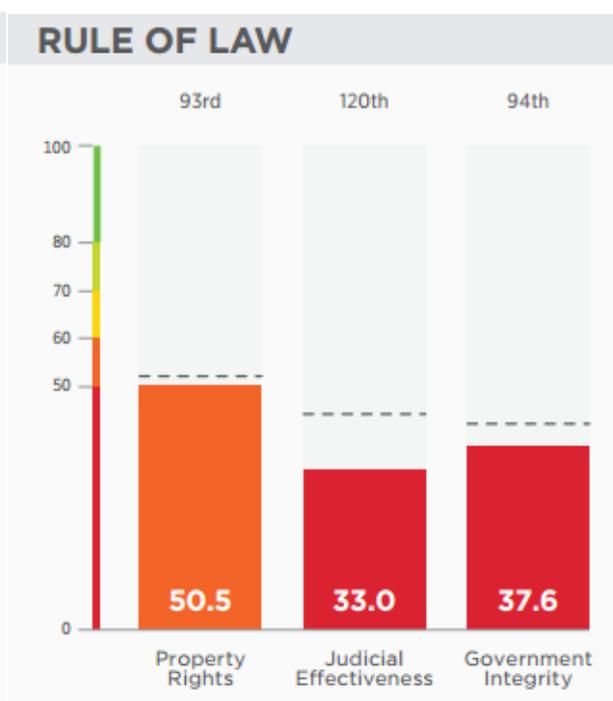


Figure 7 Rule of Law in Azerbaijan
 Source: Miller and Kim. “Economic Freedom Report.” 2017

Current system and enforcement mechanisms do not seem sufficient on assuring rule of law in the country either. The country's rule of law ranking, comprised of property rights, judicial effectiveness, and government integrity, is below the world average (Figure 8). Specifically, the state's ranking on judicial effectiveness is problematic and requires immediate actions to be resolved. Since judicial effectiveness fails to adequately settle business cases and assure enforcements, the policies are not fully implemented on the ground. Introduction of timeframes for enforcement process and increasing fines for incompliances have not significantly changed the situation. For example, many companies do not yet abide by the requirements to reveal their audited financial statements (EBRD, 2014). The Azerbaijani Corporate Governance Standards are not binding and offer only guidance to follow by the companies. Even when the companies are willing to comply with the requirements, a lack of clarity in transparency and disclosure procedures hinders compliance, EBRD country report argues. It is difficulty for companies to understand the legal capacity of directors as well as supervisory boards. The current legal system also lacks a single law on "Code of Competition." (Aslanli, et al. 2013). All of these factors necessitate to fix the legal shortcomings and modernize the entire system to successfully diversify the economy.

4.2. Modernizing the Legal System:

In fact, the current legal system in the country proves to be outdated and fails to respond growing needs of the economy. There is not any law regarding Public Private Partnerships (PPPs) and concessions. Azerbaijan is among few countries that do not have PPB framework (EBRD, 2014). Although the Civil Code and Law on Protection of Foreign Investments mention concession procedures, the laws are not sufficient to practice PPPs as well as modern understanding of the concessions in the country (EBRD, 2014). In the Law on Protection of Foreign Investments concessions are primarily referred to as permits and encompasses mining industry. The scope of

the existing laws is limited to natural resources and for foreign investors. While analyzing the laws it becomes clear that they mainly deal with production sharing agreements (PSAs) and discriminate local investors on fully benefiting the investment potential. By not having a legal framework for PPP agreements, the country deprives itself of the ability to attract private capital into the development of public goods and services. Introduction of PPPs can boost the investments in industrial and healthcare sectors and decrease public expenditures, further enliven the economy.

When the economic crises hit the banking sector and led to the bankruptcy of 10 banks (Abbasova, 2016), the existing insolvency and bankruptcy laws became inadequate to effectively and immediately respond to the situation. In fact, the Law on Insolvency and Bankruptcy on Azerbaijan (1997) was adopted 20 years ago and only defines insolvency and bankruptcy procedures of non-banking companies. As EBRD (2014) asserts, the law is outdated and does not meet international standards and necessitates updating. The Law on Banks adopted in 2004 regulates the insolvency and bankruptcy process for banks. However, the economic crises also revealed the inadequacy of the particular law. In fact, the law is not sufficient and does not clearly state the restructuring process in case of bankruptcy. Consequently, firms that on the verge of bankruptcy encounters challenges to handle the situation.

The impact of economic diversification policies can be further boosted by improving framework for corporate governance. It is essential to admit that Azerbaijan has made huge progress during the last years on corporate governance structures, however, it is not enough to assist private corporations to play a critical role in the economy. The current limitations necessitate improving disclosure mechanisms and clarification of the role of supervisory boards. According to the current legislation, all joint stock companies are obliged to disclose their annual reports. However, the laws do not require provision of non-financial information and fail to provide any

guidance on how the document should be prepared (Cigna et al., 2016). Therefore, it is challenging for shareholders and potential investors to access company information and make the decisions accordingly. This fact hinders domestic and foreign investments. Although the introduction of fiduciary obligations in 2007 is a huge development to enhance board responsibilities highlighting the necessity to act according to the best interests of the company, the fiduciary duties are on the paper (EBRD, 2016). There is no judicial process dealing with the particular case. It would also be beneficial to have case laws in which directors would be held responsible for their wrong decisions and behaviors. In short, as a prerequisite to diversify the economy away from oil, the government of Azerbaijan needs to further intensify legal reforms to assure implementation as well as enforcement mechanisms and fix the loopholes and modernize the current system.

Chapter 5: Urgency for Institutional Reforms

5.1. Situational Analysis in Institutional Quality

From the discussion of the relationship between the resource curse and institutional quality in the first chapter, it became clear that these two variables have a significant impact on each other. There is a growing consensus among scholars that in case an influx of oil revenues is not followed by adoption of substantial institutional reforms, hydrocarbon revenues result in institutions of poor quality (Ahmadov, 2013). Mehlum et al. (2016) classify the institutions as “grabber and producer” friendly and argues that the countries with natural resource endowments tend to have grabber friendly institutions. While in the former type of institutions, “rent seeking and production are competing activities” and concentrating on rent seeking results in a slower economic growth, producer friendly institutions support development of the production sector and push aggregate income upwards in the economy (Mehlum et al., 2016). Since poor quality institutions become a major cause for poor management of hydrocarbon returns and an impediment to transform natural endowments into economic growth, there is urgency to adopt institutional reforms.

Similar to other South Caucasus countries, Azerbaijan also faces challenges into establishing viable institutions (Novruzlu, 2015). Ahmadov (2013) argues that the paradox of plenty mutually interacts with the state of institutions in Azerbaijan. The country needs to enhance the rule of law and advance democratization process in the society. Novruzlu (2015) rightly believes that coupled by Soviet political heritage, Azerbaijan faces similar challenges observed in former socialist republics, namely: building civil society, ensuring accountability and transparency, preserving rule of law, and more importantly, establishing a liberal state with supreme power of constitution. Especially, Soviet legacy is a primary reason to condemn, as it weakened society and deprived it of capacity to forge its own development path. The establishment

of ASAN (Easy) service, utilizing “one-stop-shop” principle on offering government services, has been a remarkable development in tackling above mentioned issues and changing paradigm for delivery of public services in the country. Although it marks the evolution of public institutions, the ASAN state agency does not suffice to ensure effective implementation of public policies in the country.

In fact, Azerbaijan’s World Governance Indicator (WGI) signals urgency to carry out radical institutional reforms. Annually prepared by Daniel Kaufmann and Aart Kraay (2016) and financed by the World Bank, WGI measures governance indicators based on six dimensions; *rule of law, control of corruption, regulatory quality, government effectiveness, political stability, and voice and accountability* (Kaufmann and Kraay, 2016). On a scale of -2.5 and 2.5, higher indicators reflecting better governance and low indexes showing lower governance, Azerbaijan’s ranking fluctuates between -0.98 and -0.67 (Kaufmann and Kraay, 2016). As figure 9 illustrates, the quality of institutions in the country are gladdening over time except for the dimensions of “voice and accountability,” and “rule of law.” However, the indexes are not sufficient for the institutional

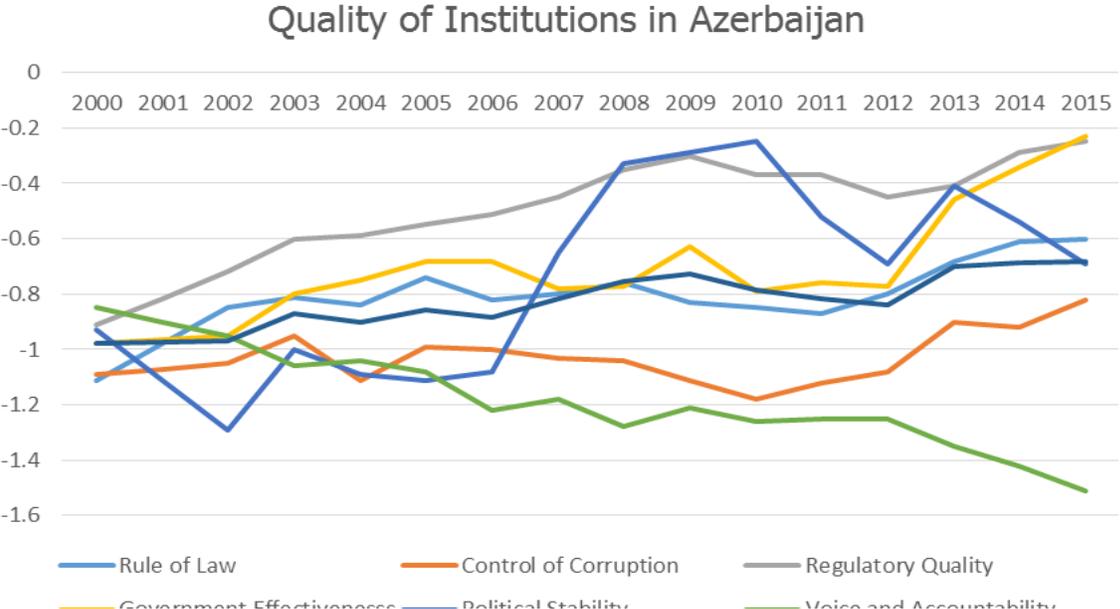


Figure 9 Quality of Institutions in Azerbaijan (-2.5 Worst Governance; 2.5 Better Governance)
 Source: The World Bank, Worldwide Governance Indicators

quality to qualify as “good” and “inclusive.” The trend shows that the country has the highest and lowest indicators for government effectiveness (-0.23) and voice and accountability (-1.51), accordingly (Figure 9). This fact affirms the necessity to boost the quality of institutions.

The presence of resource curse and having low institutional quality are inexorably intertwined and decisive on each other’s progress. Since low institutional quality is conducive to ineffective governance, Ahmadov et al. (2013) closely examined the partial association between government effectiveness and oil rents to confirm the link of the paradox of plenty with institutional quality in the country. For that purpose, he utilized WGI and the partial correlation, which aimed at measuring “the degree of association between the two variables, with the effect of a set of controlling variables excluded” (Ahmadov et al., 2013, 15). As is evident from the scatter plot, oil rents, measured by the share of oil revenues in GDP, are highly correlated with the government effectiveness (Figure 10). Increase in oil rents leads to a consequent decline in effective government. Applying a similar methodology with an addendum of other natural resources also reveal a negative association between the variables. (Figure 11). Although causation can be challenging to disclose, the scatter graphs illustrate detrimental impacts of resource rents on institutional quality.

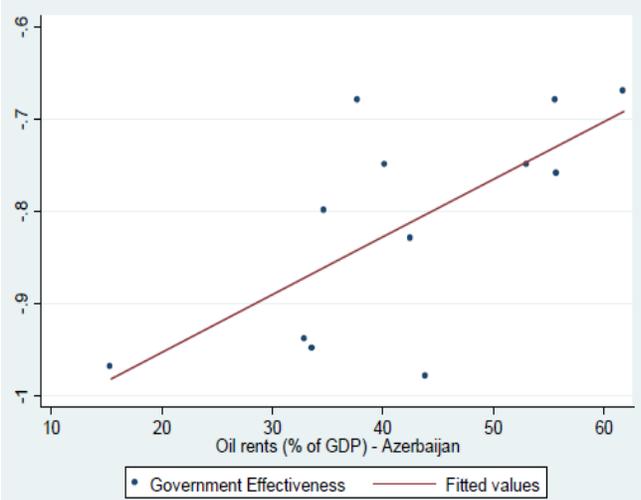


Figure 11 Correlation between Government Effectiveness and Oil Rents Source: Ahmadov et al. 2013

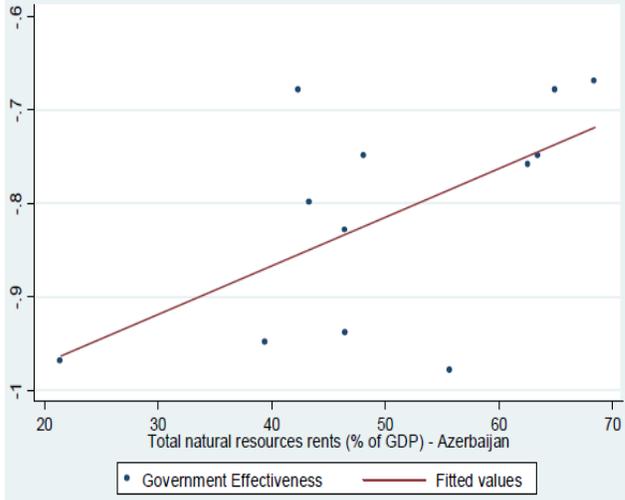


Figure 10 Correlation between Government Effectiveness and Total Natural Resources Source: Ahmadov et al. 2013

5.2 Urgency in Developing Good Quality of Institutions

The existence of higher resource returns from natural endowments and the consequent resource curse discourage as well as prevent the establishment of good quality institutions, and results in institutions of poor quality. The fact undermines successful implementation of economic diversification policies and leads to consequent higher resource dependence; further aggravating the paradox of plenty in the country. This vicious cycle, better illustrated at figure 12, is hard to tackle and necessitates determined actions. A sharp decline in revenues given price volatility in commodity markets has potential to not only depress economic well-being, but also challenge political stability in the country, neighboring fragile and politically unstable Middle East. Hence, the government's economic diversification policies should primarily target the development of "inclusive" and "producer friendly" institutions as a prerequisite to alleviate the paradox of plenty.

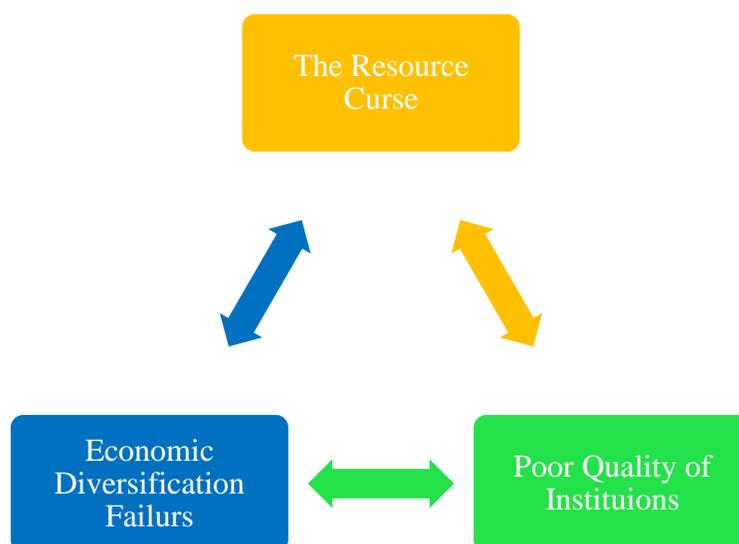


Figure 12 Vicious Cycle of Resource Curse, Poor Quality of Institutions and Economic Diversification Failures

As a post-Soviet country, Azerbaijan also suffers from having engraved Soviet era norms and practices embedded into the formation of institutional designs and establishment of social organization (Aliyev, 2015). This factor has largely influenced individual attitudes and behaviors in the country, where omnipresent impact of dictatorial regime was historically dominant, argues

Aliyev (2015). More significantly, these traits conclusively impact the way public institutions, social and organizational structures work in the state. As direct impacts of the Soviet legacy, there is dominance of informal networks on formation of social capital² and close association of civil society with the state (ibid). The legacy is apparent in hierarchical and very much centralized institutional structure and “patron-client relations” with the government. Predominance of “hierarchical, elitist, utility-oriented informal networks” (Aliyev, 2015, 20) does not only hamper development of social capital, but also hinders the establishment of formal as well as informal relationships between the people and the government. As a result, the institutions fail to ensure check-and-balance mechanisms in the country. Hence, as a prerequisite to diversify the resource cursed economy, the government of Azerbaijan needs to enhance institutional quality.

² “The sum of the resources, actual or virtual, that accrue to an individual or a group by virtue of possessing a durable network of more or less institutionalized relationships of mutual acquaintance and recognition”(Bourdieu and Wacquant 1992, p. 119).

Conclusion

To sum up, the economic crisis unleashed by the drop in oil revenues exposed Azerbaijan had contracted the resource curse and again cast light on the need to diversify the economy away from oil. Although the Azerbaijani government has undertaken extensive reforms to reduce the resource dependence, the revenues of the non-resource sector are far from enough to substitute hydrocarbon returns. Upon close examination of the economic situation and reasons behind the policy failures through an interpretive mixed research design, the research determined the prerequisites to reboot the resource cursed economy of Azerbaijan.

Reviewing the literature on the resource curse to identify primary assumptions of the phenomenon and applying the developed framework to Azerbaijan, in the first chapter, it was found out that the country is both blessed and cursed by the resource endowments. Despite the fact that the hydrocarbon returns provided the country with the revenues critical to develop the economy, they also fostered dependence on the resource sector, which has volatile returns, obstructed the development of the non-resource sector, and prevented the country from achieving “sustained rapid development” (Sachs and Warner, 2001, 828). Slump in oil prices since 2014 has disclosed malaises of Azerbaijan’s dependence on the oil sector with the macro-fiscal stability shaken, living standards declining, and the poverty rate risking to go down back to the figures in the 90s. Analyzing economic diversification policies and reasons for failures in the second chapter, the thesis recommended the government of Azerbaijan to adopt budgetary, legal, and institutional reforms to tackle the paradox of plenty and diversify its export portfolio.

Firstly, it is prescribed for Azerbaijan to replace the current traditional budgeting or line item budgeting with performance-based budgeting to bring more accountability, inflexibility, and to tackle the incrementalism in the budgeting process. Introduction of performance based

budgeting will not only bring more “rationality, objectivity, accountability” (Axelrod, 1995, 277), but will also enable the government to assess program achievements, compare performance of spending and winning agencies, and manage effective and efficient allocation of funds. Secondly, the Azerbaijani government needs to undertake extensive legal reforms to ensure compliance, regulatory efficiency as well as rule of law, and modernize the existing legal system. Finally, the last chapter indicates the correlation between the institutional quality and the resource curse in Azerbaijan. Hence, successful economic diversification policies should entail reforms aiming at establishing “producer friendly” and “inclusive” institutions and alleviating embeddedness of Soviet legacy into the fabric of state institutions.

Appendices

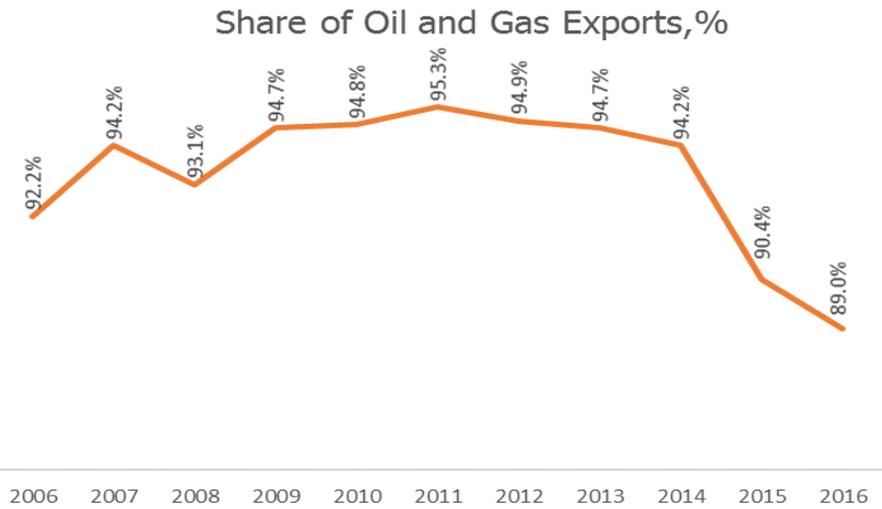


Table A1 Share of Oil and Gas Exports, % Source: Central Bank of Azerbaijan, Annual Reports

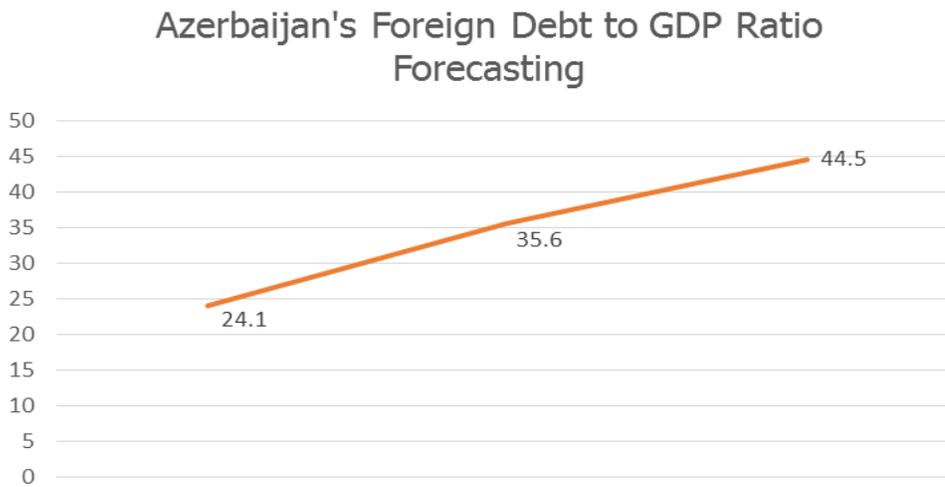


Table A2 Azerbaijan's Foreign Debt to GDP Ratio Forecasting Source: CESD Calculations based on global financial institutes' reports, 2017

Open Budget Index

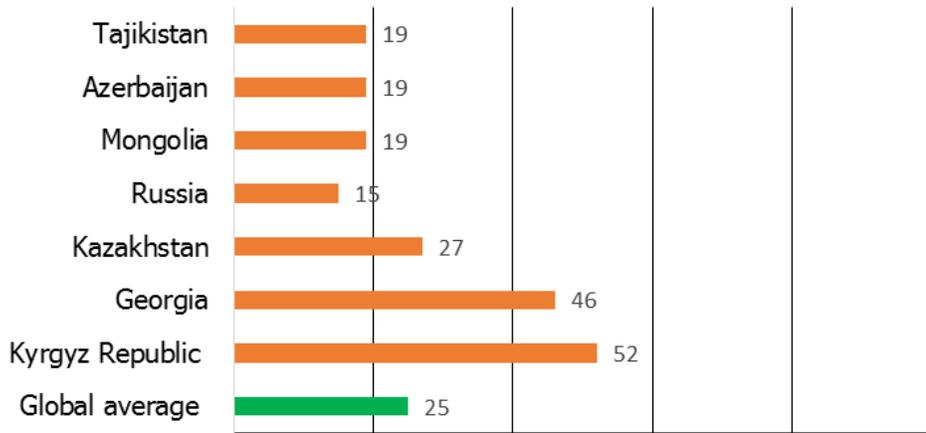


Table A3 Open Budget Index Comparison Source: The International Budget Partnership

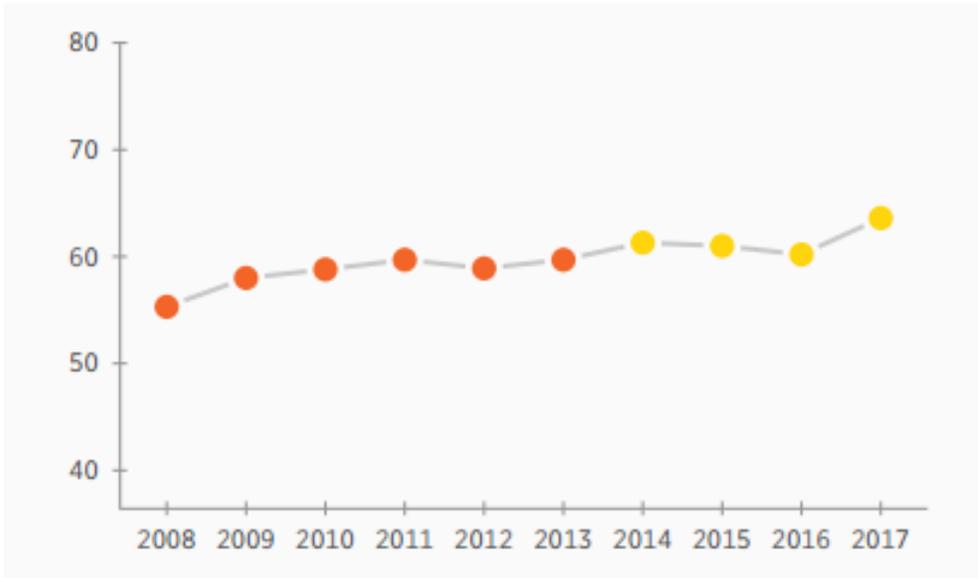


Table A4 Economic Freedom Trend in Azerbaijan Source: Miller and Kim. “Economic Freedom Report.” 2017

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