

# An assessment of the thirty year post-Soviet transition quality in Azerbaijan from an economic and social liberalization perspective

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## Abstract

Since the fall of the Soviet Union, Azerbaijan has faced numerous economic, political and administrative difficulties. One of them has been oil dependency of the national economy. The impact of the oil industry on the macro-economic indicators such as the Gross Domestic Production (GDP) and inflation has been a popular theme in the case of the Azerbaijan economy. However, evidence of the extractive industry's growing influence on Azerbaijan's national economy in terms of the quality of the transition from a command economy to a market economy is sparse. In this study, we compare Azerbaijan's transition process with other post-Soviet nations in terms of privatization, international trade and the social sphere, despite dominance by the oil sector. Poor economic diversity is said to be harming institutional quality and impairing long-term sustainable growth. Overall, it seems that Azerbaijan's transformation is not yet complete. Its pace and quality are greatly influenced by oil prices and the domestic oil boom: when prices are high, the Azerbaijan government eases off and focuses on spending oil cash. When international commodity markets decline, Azerbaijan's revenue drops, and the government increases its reform efforts. This approach induces economic unpredictability and underperformance and threatens its long-term growth and development. This vicious cycle-forming tendency should alert government bodies and decision-makers to be aware of the country's excessive oil dependency and the need to diversify the country's fiscal revenue. However, without political will and strategic planning, this cannot be achieved.

**Keywords:** Azerbaijan economy, international trade, oil boom, privatization, transition process

**JEL codes:** O52, P27, P28, P30

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## 1. INTRODUCTION

In 1991, Azerbaijan became an independent sovereign country following the collapse of the Soviet Union. A severe economic crisis began soon after independence. Azerbaijan's economy declined by 63% between 1989 and 1995 (IMF, 1995); the cumulative real GDP declined by 61% (World Bank, 2003); and hyperinflation measured by the Consumer Price Index (CPI) rose by 1,664% in 1994 (IMF, 1995). Also, with the beginning of independence in Azerbaijan, the political struggle of the ex-communist leaders (such as Ayaz Mutallibov and Haydar Aliyev) and the new political elite formed by the People's Front of Azerbaijan ignited a political and administrative crisis, and the country was paralyzed by strikes and demonstrations. This led to governmental inability to coordinate the reformation process (Swietochowski, 1999). In addition, the war with Armenia intensified, leading to territorial, human and economic losses in 1993 (Lussac, 2010). Azerbaijan suffered from the loss of territorial integrity, political instability, severe economic recession, and short-lived administrative governments between 1991 and 1994. Moreover, the population became aware of how the administrative command system had eradicated the entrepreneurial skills of the citizens over the course of 70 years (Cornell, 2015) because the transition from the socialist system to the free market capitalistic mode of economic production was restricted during the early years of independence. The labor markets and labor resources did not know how best to utilize their knowledge and skills, and the supply chain and distribution networks were disrupted. The transition process from the socialist system to free-market mechanisms necessitated not only the rejection of the Marxist-Leninist mindset but also the harsh reforms and development of knowledge needed to cope with the new post-Soviet world order (Zaostrovsev, 2016). All these led to painful first steps in the transition process from the command economy to the free market economy, and this delayed the macroeconomic stabilization and stimulation of Azerbaijan's national economy.

Both socialist and capitalist systems tend to induce certain properties into society that become

hard to change when a transition process is inevitable. Kornai (2000) listed four causes of trouble in the systemic changes. In other words, there might be four reasons why great sacrifices and time are needed when reforms are made. First, it is about the pre-transition level of economic development. Clearly, both advanced and developing economies fall short of their previous levels of economic growth following the systemic collapse and the beginning of the transition. Second, deficiency in the experience of management of market economies (innovation, institutions, new supply and demand structures, etc.) makes the transition process painful, but it is temporary. Third, Kornai (2000) mentions that there are system-specific challenges in both capitalism (chronic unemployment) and socialism (chronic shortage). Lastly, there are errors and misdeeds that are being implemented by politicians, government officials, political parties, etc. that lag behind the quality of the reforms (see also Kornai (2008) for the other aspects of the transition process from socialism to capitalism). In fact, if this is not handled well, it could make people in the transition countries unhappy with their lives (Easterlin, 2009). Azerbaijan's transition was not an exception to the above-mentioned challenges that have been extensively discussed in the literature.

The countries in the post-Soviet space shared similar patterns in their economic and social development during the transition period (mainly between 1991 and 2005). This similarity was mainly due to the fact that a destructive process of economic realities where large monopolistic conglomerates dominated domestic output production (Burawoy, 2001). Pejovich (2003) claimed that this is related to the so-called "transaction costs," which determine the success level of the transition and transformation of Former Soviet Union (FSU) nations. Burawoy (2001) argued that the main reason for all the pain during the transition period was the rapid transformation desires of the post-Soviet nations, including Russia. On the other hand, Central and Eastern European (CEE) countries such as Hungary, Poland, and the Czech Republic have adopted a more gradual approach to privatization, liberalization and social protection. Hence, considering

the experience of the other FSU and CEE nations, Azerbaijan's transition also shares some similar and distinct features with them that are worth detailed analysis.

Here, we contribute to the economic literature by analyzing the case of Azerbaijan. We integrate the most crucial aspects of the transition process, such as oil-led economic growth and development, privatization, international trade, and developments in the social sphere. The political and economic decisions affected by the oil industry's dominance and role in the economic structure of Azerbaijan strongly determined the speed and quality of the transition process in Azerbaijan. Guliyev (2005) argued that to graciously accept the Western foreign direct investments for the oil industry, the political establishment agreed to have a semi-free press, opposition, and civil society in the late 1990s. This fueled the early stages of the transition process to accelerate the transition process, but as soon as high oil revenue started amassing in 2005 and 2006, interest in privatization and international trade declined, and this was reflected in the social dimensions of society. Similarly, Laurila (1999) argued that the power of politics and oil are the main determinants of the transition process because oil and politics shaped the reforms and the willingness of the government to cooperate with the international entities to help complete the transition. Not surprisingly, the first 10–12 years of the transition process were brutal, incomplete, and full of explosive social divisions (Rasizada, 2003).

In this article, we argue that the transition process in Azerbaijan has not yet finished in an efficient and anticipated way. Compared to the other post-Soviet countries, Azerbaijan's institutional and regulatory gaps in the transition process have led to oil-dominated industrial production, uncertainties in regulatory frameworks, and numerous barriers to integrating the country into the international cooperations like the World Trade Organization (WTO). The economic literature related to the transition process in the case of Azerbaijan is still sparse. However, this topic still needs to be discussed. To assist this process, the analysis of the rise of the oil industry, the transition indicators provided by the European Bank of Reconstruction and Development (EBRD), the

focus on the failures in its accession to the WTO, and mismanagement of the social protection system (or welfare safety net) have been examined in this paper. An incomplete transition process and a lopsided industrial structure undermine the long-term sustainable growth and development in Azerbaijan. Although various studies have been carried out to assess the transition process in Azerbaijan (Laurila, 1999; Siegelbaum et al., 2002; Holley et al., 2004), the literature still needs scholarly contributions, especially when the share of the public sector is large, the non-oil private share of the national economy is small, and social welfare has not responded to the real needs of the population even after thirty years of independence. By focusing on the oil industry, privatization, international trade, and social protection, the current paper addresses the following research question: How was the quality and extent of the transition process related to the privatization practice, international trade reforms, and social protection against the backdrop of the oil industry in the Azerbaijan economy between 1991 and 2020—following the collapse of the Soviet Union?

In this study, we look at the transition process of Azerbaijan and track economic, political, institutional, and social decisions made in its economic development. In doing so, oil-led economic development was used as an analytical background. This study is explorative in its nature, which is based on EBRD's transition scores and the State Statistical Committee of the Republic of Azerbaijan's (SSCRA) macroeconomic data. The authors sought to fill the research and perspective gap by analyzing the most important themes in Azerbaijan's transition issues and utilizing critical-comparative assessment techniques in a descriptive and systematic way. Thus, some of the other post-Soviet countries (Belarus, Moldova, etc.) had to overcome similar economic problems in the transition process, and by shedding light on the case of Azerbaijan, the authors think that future studies may argue that the privatization process should be the ultimate goal of the FSU countries.

## 2. THE AZERBAIJAN ECONOMY: AN ASSESMENT OF THE TRANSITION QUALITY

### 2.1. The Rise of the Oil Industry in Azerbaijan

Prior to the start of the transition process, Azerbaijan's performance was lagging behind that of neighboring Armenia and Georgia. For instance, in 1989, the GDP per capita in purchasing power parities (PPP) was \$5,530 in Armenia and \$5,590 in Georgia. From 1985 to 1989, the average annual growth was 2.7% in Armenia and 2.4% in Georgia. Although the level of industrialization in Georgia (43%) was lower than in Azerbaijan, the corresponding figure in Armenia (55%) was higher than that in Azerbaijan. Meanwhile, the GDP per capita of Azerbaijan in terms of PPP was \$4,620 in 1989; the average annual growth was 0.8% in 1985–1989; and the share of industry in the GDP was 44% in that period (De Malo et al., 2011).

After the collapse of the Soviet Union, the first decade of Azerbaijan's 30-year independence was characterized by a transition economy. During this period, the GDP declined, then revived; prices rose sharply, then stabilized; and major structural changes occurred due to an increase in the share of services. The share of the private sector in the GDP also increased; investment initially declined, then rose, and unemployment and poverty increased. Azerbaijan was not a unique country in this respect, and similar things were documented in other post-Soviet countries as well. However, these countries differed in the speed and format of their transition to a market economy. So, while the initial share of the private sector in GDP was 10% in Azerbaijan, 15% in Georgia, and 30% in Armenia in 1991, this figure was 70% in Georgia, 75% in Azerbaijan, and Armenia in 2007 (EBRD, 2021). In 2008, the figures for Azerbaijan, Georgia, and Armenia remained unchanged, but the share of the private sector in Belarus increased by 5% compared to

the previous year and reached 30%. In terms of quantity, Azerbaijan does not differ from other post-Soviet countries in the transition economy. The main features that distinguish Azerbaijan from other post-Soviet countries are the country's rich natural resources and the fact that the main oil and gas fields were put into operation jointly with foreign companies on September 20, 1994. In this regard, the first Production Sharing Agreement (PSA) signed for the development of the Azeri-Chirag-Gunashli (ACG) field over 30 years ago has played an invaluable role in attracting foreign investment, increasing production and increasing export earnings (source: BP).

From the date of the signing of the PSA up to January 1, 2021, over \$95.1 billion was invested in Azerbaijan's oil industry (source: BP). At the same time, from the beginning of industrial oil production in Azerbaijan up to January 1, 2021, over 2.11 billion tons of oil and over 900 billion cubic meters of gas have been produced (APA, 2021a) and about 40% of oil production and more than half of gas production account for the country's large share since the country's independence. The total revenue from the ACG field from 2001 to September 1, 2021, amounted to \$152,893 million (SOFAZ, 2021). Oil revenues in Azerbaijan are divided into three parts. Specifically, 1) SOFAZ's direct revenues; 2) Revenues from foreign oil companies to the state budget in the form of profit tax; and 3) SOCAR's revenues for share participation.

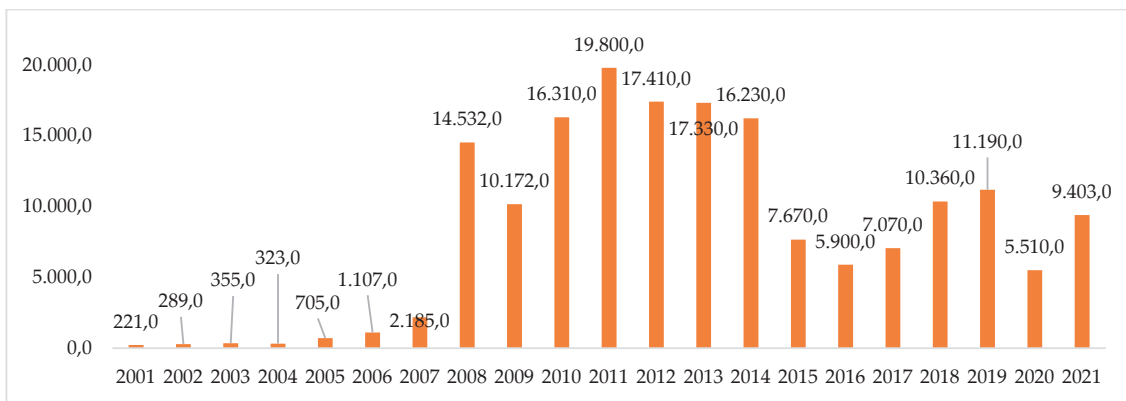
The inflow of oil revenues to SOFAZ mainly occurred in 2008–2014. By September 1, 2020, the State Oil Fund received \$149.2 billion from ACG. From 1995 to June 30, 2020, SOCAR earned \$14 billion 188.2 million from ACG. During this period, foreign oil companies participating in the ACG paid a profit tax of 25% to the state budget, which came to \$17 billion in total. Ibadoghlu (2020) says that foreign oil companies made a total of \$68 billion from the ACG field.



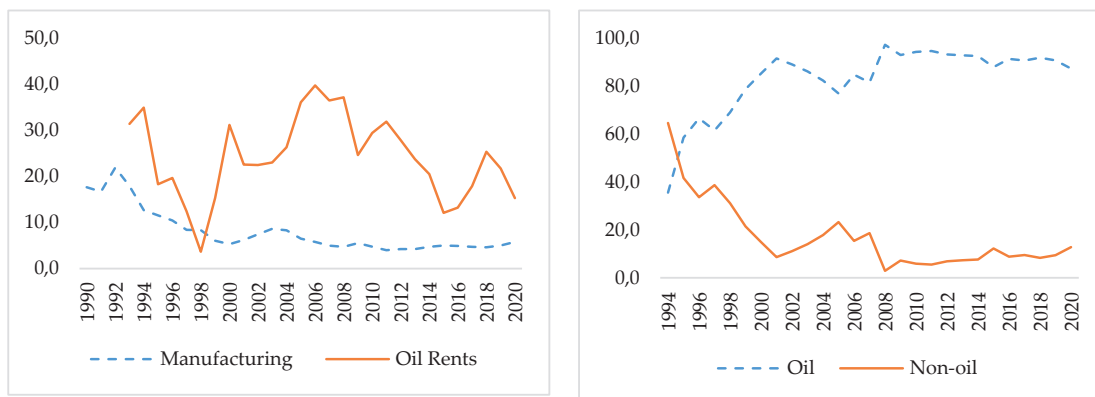
Hence, in 2001–2021, SOFAZ’s direct oil revenues amounted to more than \$165 billion, of which over two-thirds, \$112 billion, were earned in those years (Ibadoghlu, 2021; see Figure 1 below). The development of the extractive industry in Azerbaijan coincided with the high international oil prices, excessive government spending, and foreign investment inflows that boosted GDP, infrastructure development, and the accumulation of foreign currency reserves (Ciarreta and Nasirov, 2010). The other positive effect of the oil industry boom was less poverty and higher pensions. However, the contribution of the oil sector to employment was low—a mere 1%, while agriculture had a 50% share in overall national employment—and non-oil sectors had a low share in the generation of value added (Ciarreta and Nasirov, 2010). Despite Azerbaijan’s oil boom, independent institutions have not yet been set up to control rampant corruption, and the business climate for the non-oil manu-

facturing sectors remains unattractive (Ciarreta and Nasirov, 2012). This changed slightly after the devaluation of the national currency when Azerbaijan entered a post-boom period, but the intended effects did not quite materialize as expected.

In panel *a* of Figure 2, we can see how manufacturing value added as a share of GDP started to decline from 8.6% in 2003 when oil rents started to gain a bigger share of the GDP. Similarly, oil exports had a 90% share of total exports between 2008 and 2019, while non-oil exports had a mere average share of 7.63% between 2008 and 2019 (see Figure 2, panel *b*). These economic indicators tell us how Azerbaijan’s economy became industrially lopsided. This lopsidedness manifests itself in the transition quality as well, because some transition quality indicators negatively correlate with the oil sector’s rise, as our analysis will show.



**Figure 1.** SOFAZ’s oil revenue, in millions of US dollars  
 Source: Report Archive of State Oil Fund of Azerbaijan (2001–2022)



*a.* Manufacturing value added and oil rents as a percentage share of GDP, 1990–2020

*b.* Oil and non-oil exports as a percentage share of total exports, 1994–2020.

**Figure 2.** The changing roles of the oil and non-oil sectors in the Azerbaijan economy  
 Source: World Bank and State Statistical Committee of the Republic of Azerbaijan

## 2.2. The Quality of the Transition Process

Starting from 2008 until 2014, when substantial oil revenue was generated, there was a slow-down in Azerbaijan's transition to a market economy. The trend of transition indicators defined by the EBRD given in Table 1 shows that Azerbaijan's position has deteriorated compared to the Eastern Partnership (EaP) countries (except Belarus, see Table 1).

As can be seen in Table 1 and the dynamics of the EBRD's generalized transition indicator presented in the table, during the peak period of oil revenues (2008–2014), the pace of Azerbaijan's transition to a market economy slowed. To find out how and why this happened, let us look at the structure of transition indicators for 1989–2014 prepared by the EBRD. Based on the EBRD's latest six-component transition assessment indicators published in 2014, Azerbaijan's position compared to the other EaP countries is shown in Table 2.

In Table 2, the worst aspect of Azerbaijan in terms of the components of the transition to a market economy is its competition policy. In this area,

Azerbaijan ranks last compared to the EaP countries. For Azerbaijan, the other weak links in the transition to a market economy are large-scale privatization and governance and enterprise restructuring, on which the Azerbaijan Investment Holding (AIH) is currently working (more details on AIH are provided later on). This suggests that effects in this area have been significantly delayed. The situation with the transition to a market economy in Azerbaijan via small-scale privatization, price liberalization, and the trade and foreign exchange system is satisfactory. Compared to the EaP member states, Azerbaijan is only ahead of Belarus in terms of both large-scale and small-scale privatization, price liberalization, the trade and foreign exchange system, and governance and enterprise restructuring. This allowed Azerbaijan to attain the same level as Moldova in 2014 in the transition to a market economy on the last three components.

Although significant steps have been taken in Georgia to move from an administrative-command system to a market economy following the collapse of the USSR, the country does not yet have an adequate competition policy on the

**Table 1.** EBRD Generalized Transition Indicator (TI). Here, a value of 1 is considered low, while a value of 5 is considered high.

	1990	1995	2000	2005	2009	2014
Armenia	1.00	2.10	2.60	3.20	3.18	3.44
Azerbaijan	1.00	1.60	2.40	2.80	2.63	2.89
Belarus	1.00	2.10	1.50	1.90	2.07	2.20
Georgia	1.00	2.00	2.90	3.10	3.11	3.50
Moldova	1.00	2.60	2.70	2.90	3.00	3.30
Ukraine	1.00	2.20	2.50	3.00	3.09	3.30

**Source:** EBRD (1990; 1995; 2000; 2005; 2009; 2014). **Notes:** Reports on transition economy for different years; According to the EBRD Transition indicators methodology 1989-2014, the indicator is rated between 1 and 4, and 1 is the starting point for all countries. <https://www.ebrd.com/transition-indicators-history>

**Table 2.** EBRD Component Assessment of Transition Indicators (TI) in 2014. Here, a value of 1 is considered low, while a value 5 is considered high.

	Large-scale privatization	Small-scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and forex	Competiton policy
Armenia	3.70	4.00	2.30	4.00	4.30	2.30
Azerbaijan	2.00	3.70	2.00	4.00	4.00	1.70
Belarus	1.70	2.30	1.70	2.70	2.30	2.00
Georgia	4.00	4.00	2.30	4.30	4.30	2.00
Moldova	3.00	4.00	2.00	4.00	4.30	2.30
Ukraine	3.00	4.00	2.30	4.00	4.00	2.30

**Source:** EBRD (2014)

first five components. In the area of competition, along with Azerbaijan, there is still work to be done in Belarus and Georgia, which makes it necessary to strengthen antitrust policies in Azerbaijan.

Following a modification of the transition concept in 2016, the EBRD created a new method for measuring transition progress. The new methodology evaluates changes based on six characteristics of a sustainable market economy: competitiveness, good governance, sustainability, inclusiveness, resilience, and integration (EBRD, How we assess transition qualities). Therefore, in terms of the quality of the transition, Azerbaijan's position using these indicators, calculated by the EBRD for the period of 2017–2021 on six components, is satisfactory compared to the EaP member countries. The recent situation for 2019 and 2021 can be seen in Table 3.

As can be seen from the table, Belarus is in front in terms of competitive, inclusive, and green development components among EaP countries, Georgia is the leader in well-governed and integrated development components, and Armenia is the leader in the resilient development component. Although Azerbaijan's position is relatively high regarding integrated and well-governed development components, it is less satisfactory

in terms of other components, especially resilient development. One of the main reasons why the resilient development component is worse than the others is its dependence on oil and gas and the fact that the expected results have not been achieved in 30 years owing to the failure to have a more diverse national economy. During the reported period, the share of the oil sector in GDP in 2019 was 38.3% (SOFAZ annual report, 2019).

### 3. SPECIFIC CHALLENGES

#### 3.1. The Greatest Challenge for Azerbaijan: Privatization

One of the key obstacles of the transition to a market economy was the denationalization of property, as well as the liberalization of prices, trade and markets. Although Azerbaijan took rapid and comprehensive steps in the transition to a market economy in the first decade, the transition in the next two decades faltered, and sometimes it went backwards. So, although most prices have been liberalized, there is still administrative control over some prices. At present, the prices (tariffs) of goods (works, services) are regulated by the Resolution of the Cabinet of Ministers of the Republic of Azerbaijan No. 178 dated September 28, 2005, through the Tariff Council, and their total has risen to 49 in the last 15 years (Tariff Council, 2005).

**Table 3.** Quality of transition to market economy in 2019. Here, a value of 1 is considered low, while a value of 5 is considered high.

	Competitive		Well-governed		Green		Inclusive		Resilient		Integrated	
	2019	2021	2019	2021	2019	2021	2019	2021	2019	2021	2019	2021
Armenia	4.97	4.82	5.78	6.22	5.72	5.11	5.97	5.88	6.40	6.56	5.45	5.83
Azerbaijan	4.39	4.30	5.79	5.61	5.35	4.83	4.94	4.92	3.97	4.34	5.59	5.70
Belarus	5.17	5.03	5.15	5.25	6.22	5.53	6.63	6.82	4.16	4.18	5.43	5.91
Georgia	4.98	5.18	6.40	6.53	5.32	4.90	5.14	4.94	6.19	6.04	6.35	6.47
Moldova	4.36	4.75	4.81	4.88	4.68	3.81	5.58	5.64	5.82	5.74	4.94	5.12

Source: EBRD (2019)

**Table 4.** Domestic credit to private sector, in % of GDP.

	Competitive		Well-governed		Green		Inclusive		Resilient		Integrated	
	2019	2021	2019	2021	2019	2021	2019	2021	2019	2021	2019	2021
Armenia	4.97	4.82	5.78	6.22	5.72	5.11	5.97	5.88	6.40	6.56	5.45	5.83
Azerbaijan	4.39	4.30	5.79	5.61	5.35	4.83	4.94	4.92	3.97	4.34	5.59	5.70
Belarus	5.17	5.03	5.15	5.25	6.22	5.53	6.63	6.82	4.16	4.18	5.43	5.91
Georgia	4.98	5.18	6.40	6.53	5.32	4.90	5.14	4.94	6.19	6.04	6.35	6.47
Moldova	4.36	4.75	4.81	4.88	4.68	3.81	5.58	5.64	5.82	5.74	4.94	5.12

Source: World Bank

Since a number of steps have been taken to denationalize property, which is one of the most important reforms of the transition period, since independence, according to official data for 2020, the share of the private sector in GDP was 80.8%. However, in 2019, 84% of the value-added was created in the private sector (SSCRA 2022). As the COVID-19 pandemic limited the activities of the private sector, the share of the public sector again increased in 2020 and 2021. In 1995, when privatization began in Azerbaijan, the share of the private sector was 34%. As privatization in agriculture, trade and catering was completed by 2000, the dominance of the private sector emerged here. In the same year, the share of the private sector in GDP increased by 70.8%, while 99% was recorded for agriculture and it was 98.3% for trade and services. In the first decade of independence, the private sector had the largest share in agriculture and trade due to the fact that the process of privatization of state property involved small and medium enterprises.

The increase in oil exports allowed the share of the private sector to increase and reach a maximum by 2008. As most of the companies operating in Azerbaijan are private under international agreements, this has also had an impact. The share of the private sector in the industry, which is the leading sector of GDP, is 85.6%. This figure is 84.6% in construction, 80.8% in communications, 80% in transport and 53.2 % in social and other services. The share of the private sector in these areas lags behind the national average because state-owned enterprises (SOEs) have continued to operate in the last 30 years through subsidies, as in the Soviet era. During this period, a reduction in credit and subsidy policies weakened the financial discipline at the level of these enterprises, and efforts to develop corporate governance were weak. One of the reasons for this is the poor implementation of bankruptcy legislation and the lack of measures to strengthen competition and corporate governance. No significant and sustained measures have been taken in SOEs to tighten budget constraints and effectively promote corporate governance (World Bank, 2017). Due to the lack of corporate governance in SOEs, these enterprises have not been able to lure significant new investments at the enterprise level

and in increasing transparency and accountability, as they face a shortage of willing financial investors. Thus, due to the increase in losses in the activities of the SOEs and the continuation of their debt obligations at the expense of the state budget, by the Decree of the President of the Republic of Azerbaijan dated November 5, 2020, the list of SOEs and enterprises, as well as economic societies with a state share, to be transferred to the management of the AIH was approved (Aliyev, 2020a). The main task of the AIH is to improve the management systems of these companies and restructure them. The list consisting of the companies under the management of the AIH includes the State Oil Company of the Republic of Azerbaijan, Azerbaijan Airlines CJSC, Azerbaijan Railways CJSC, the Azerbaijan Caspian Shipping Company CJSC, Baku Metro CJSC, AzerGold CJSC, etc.<sup>1</sup> The actions of the AIH so far have been the establishment of Supervisory Boards in the above-mentioned SOEs.

Currently, 70% of employment is provided by the private sector, and the share of the private sector in total tax revenues exceeds 72%. The majority of new jobs are also created in the private sector. In 2020 alone, 96.3% of new jobs created were in the private sector. All this means that the expected results of the efforts of the SOEs have not yet been realized in Azerbaijan's 30 years of independence. Along with the privatization of small and medium-sized businesses, the increase in revenue from natural resources helped the budget to have easy revenue and slowed the pace of the remaining privatization programs (Alirzayev, 2013). This discouraged innovativeness among the private agents of the economy, which is quite crucial to having a smooth transition process. It has been argued that the main difference between underperforming and successful FSU and post-communist nations is related to their innovativeness (Ahmadov, 2020a; Ahmadov, 2020b). This eased the reforms and made the firms in the manufacturing tradeable sectors dependent on public investments (Ahmadov, 2022a).

Although the state's control over exports and imports in the area of foreign trade regulation has been largely eliminated, the policy of export subsidies by the state has recently become more



popular. On January 18, 2016, the Presidential Order on Additional Measures to Stimulate the Export of Non-Oil Products (Aliyev, 2016a) and the Presidential Decree on Additional Measures to Promote Investments (Aliyev, 2016b) were signed. "The Rules for Issuing Investment Promotion Documents" were approved by the Presidential Decree (Aliyev, 2016b). According to the statement of AZPROMO, 27 million AZN of export incentives were paid by 2021 (Azertag, 2021).

However, Azerbaijan still lacks the necessary momentum to develop a stronger private sector. For instance, compared to Armenia and Georgia, where domestic credits account for 72.70% and 79.88% of GDP, respectively, in Azerbaijan this indicator was 26.08% in 2020. Belarus and Moldova in 2020 also had high levels of domestic credit for the private sector, namely 33.11% and 27.78%, respectively. Moreover, the expected diversification of the Azerbaijan economy due to increased private sector participation remained sluggish. The World Bank's "Doing Business 2004" report showed that starting a business in Azerbaijan took on average 106 days, while only 25 days and 30 days were needed in Armenia and Georgia, respectively (Doing Business, 2004).

AIH was founded by a Presidential Decree on August 7, 2020 for the purpose of managing SOEs and economic societies with a state stake on a cohesive basis, enhancing their performance, increasing the transparency and economic efficiency of their investment programs, increasing their competitiveness and enhancing their financial well-being and establishing a supervisory board (Aliyev, 2020b). SOEs, as well as economic societies with a state share, are to be rehabilitated (22 enterprises in total), 5 of which were subordinated to the Ministry of Transport, Communications and High Technologies of the Republic of Azerbaijan, and they were transferred to the management of Azerbaijan Investment Holding by Presidential Decree dated November 5, 2020 (Aliyev, 2020c).

Then, by the Order of President Ilham Aliyev dated January 23, 2021, on measures to improve the management of the State Oil Company of the Republic of Azerbaijan, the Supervisory Board

of SOCAR was established to exercise general management and control over the activities of the State Oil Company of the Republic of Azerbaijan. On March 30, 2021, a Presidential Decree approved the composition of the Supervisory Boards of Azerbaijan Airlines CJSC (Aliyev, 2021a), BakuBus LLC Company (Aliyev, 2021b), Azerbaijan Railways CJSC (Aliyev, 2021c) and Baku Metro CJSC (Aliyev, 2021c).

Furthermore, AIH was also ordered by the president to help develop corporate governance standards for the management of these joint-stock companies within six months, as well as a system for evaluating the activities of its governing bodies, in order to ensure the diagnosis of the results of the companies' activities in the legal, financial, tax, and commercial spheres. This means that the establishment of corporate governance norms and institutions in the companies where the supervisory board is established will take at least 6 years. Afterwards, decisions will be made on the commercialization and partial privatization of these enterprises. However, Article 14 of the Law of the Republic of Azerbaijan on the State Budget of the Republic of Azerbaijan for 2021 states that the financing of the state budget deficit should be carried out through privatization and revenues from other sources. According to the information on the implementation of the state and consolidated budget of the Republic of Azerbaijan for 2020, 61.5 million AZN of last year's state budget deficit were covered by revenues from privatization (Ministry of Finance of the Republic of Azerbaijan (2021). The opinion of the Chamber of Accounts of the Republic of Azerbaijan on the Draft Law of the Republic of Azerbaijan on the State Budget of the Republic of Azerbaijan for 2021 states that the funds received from the privatization of state property as one of the sources of financing the state budget deficit in 2021 amount to 111.0 million AZN, which is 17.3 million AZN, or 18.5% more than the relevant performance indicator in 2019, and 49.0 million AZN, or 79.0% more than the forecast for 2020 (Chamber of Accounts, 2020). It should be noted that, according to the Budget Envelope, the total revenue from privatization in 2020 was 25.0 million AZN. The amounts for the following years were 111.0 million AZN in 2021, 66.0

million AZN in 2022, 62.0 million AZN in 2023, and 64.0 million AZN in 2024, respectively. The expert opinion also says that given the measures taken to privatize state property, which form the basis of property reforms, the importance of their results and the sharp differences in the projected amounts for these revenues for 2021–2024, they are not fully justified.

Turning these sums into economic assets depends on the decision of the relevant executive authorities, who were supposed to declare new enterprises open for privatization in 2022 and transfer them to the Ministry of Economy for this purpose, carry out preparatory work, and sell them. However, even at the end of the first quarter of 2021, no steps had been taken and the work is pending.

The opinion also says that new enterprises that may be open for privatization in other areas of the fiscal policy of the Republic of Azerbaijan in 2021–2024 include the organization of stimulating measures in the privatization of state property, increasing their efficiency through the application of advanced corporate governance methods in state enterprises and increasing the amount of taxes and dividends in the state budget (APA, 2021b).

The main directives of the budget and tax policy of the Republic of Azerbaijan in 2021–2024 state that special attention will be paid to stimulating the privatization of state property and creating more favorable conditions for investors next year. However, the projected revenues from privatization in 2021–2024 (111.0 million AZN in 2021, 66.0 million AZN in 2022, 62.0 million AZN in 2023, and 64.0 million AZN in 2024) mean that this source will receive more funds this year than in the next few years. The current circumstances do not provide grounds for saying that more SOEs will be privatized this year. This can be achieved only by the sale of state-owned shares of the Dashkasan Filizsaflashdirma OJSC, which has over 270 million tons of iron ore reserves, in an investment competition (State Service on Property Issues, 2019). However, the shares of Dashkasan Filizsaflashdirma OJSC were repeatedly offered for investment competition but were not sold due to their unattractiveness to

investors.

The case of the privatization of the Dashkasan Filizsaflashdirma OJSC shows that it will not be easy to attract a healthy investor to the privatization of SOEs in the current situation. The independence of the courts and the judiciary, which guarantees the inviolability of property, is not ensured. There are no economic freedoms, and tariffs (prices) and currency liberalization have not yet been carried out. All this should pave the way for effective privatization. Facilitating this process depends on the speed and frequency of the steps of the transition from regulated tariffs to market prices, from unified centralized management to corporate governance accountable and transparent to shareholders, from monopoly to competition, from a stable exchange rate to a floating exchange rate, and most importantly, from a transition to a corruption-free and independent judiciary (Ibadoghlu, 2021).

### **3.2. Reflection of Transition Process on Foreign Trade**

In the transition from a planned to a market economy, the scale of foreign trade has increased in Azerbaijan, but numerous challenges and barriers to joining international trade organizations like the WTO remain. During the Soviet Union era, trade was subservient to the plan. As imports were a residual source of required inputs, exports, instead of being viewed as a source of demand, growth and foreign exchange earnings, were considered a necessary evil to pay for imports (Gregory and Stuart, 2001). The main reasons for the rise of foreign trade were foreign trade liberalization (i.e., prices of goods and services) in the trading sector in line with international prices, resource endowments, and openness to foreign trade during the transition period in Azerbaijan. The effect of foreign trade liberalization was to remove barriers to entering the market, reduce the dependence on the Common Independent States (CIS) market by increasing trade flows with EU member states, Turkey and China, and, ultimately, increase the integration of the national economy into the world economy. According to the State Customs Committee, the results of 2020 showed that Azerbaijan exchanged goods and services with 183 countries

(The State Customs Committee of the Azerbaijan Republic, 2020). During this period, the number of foreign trade participants was 45,462, of which 81.8% were natural persons and 11.2% were legal entities. Only 3.23% of legal entities were in the public sector.

Even though on June 23, 1997, the WTO Secretariat received Azerbaijan's application to become a member and then the Commission on Preparations for WTO Membership was established by the Order of the Cabinet of Ministers No.175 dated August 22, 2003, the country is still not a member of the leading institute for foreign trade liberalization, which includes 164 countries (WTO. AZ). With over 95% of international commerce governed by the WTO today, this organization is critical to the functioning of the modern global economy (Gasimli, 2007). Azerbaijan should join the WTO as a robust and diverse trading partner with a competitive national economy, capable of attracting foreign investments as well as exporting its products globally (Gasimli, 2007). However, oil-dominated industrial production and an unstable national currency are domestic factors that hinder the effective development of international trade. In studies by Ahmadova et al. (2021), Hajiyev and Rustamov (2019), and Hasanov (2013), the authors stated that exchange rate appreciation, external shocks, inflation and Dutch disease signs restrict the export capacity in Azerbaijan, which could be resolved with appropriate institutional and regulatory measures. Instead of structural reforms to overcome the above-mentioned issues, the government still

applies shallow measures and decisions that do not serve to speed up accession to the WTO.

The national currency, which has an important place in foreign trade, has a stable exchange rate and is regulated by the state. However, the macroeconomic and monetary conditions do not allow for the stable and progressive role of the national currency. Chubrik and Walewski (2010) warned about the low competitiveness and non-oil external trade deficit that may arise from the appreciation of the national currency. The Azerbaijani manat has been in circulation since August 15, 1992, and it has been the exclusive method of payment since January 1, 1994. It was denominated in 2006 (Aliyev, 2005), and devalued twice in 2015 (CBAR, 2015a; 2015b).

The strengthening of monopolistic tendencies in Azerbaijan since the second decade of independence and the strengthening of dominant positions in the third decade has led to the creation of barriers to entry into numerous markets. Monopoly or unfair competition is a big problem that firms in the country have to face (Suleymanov and Yusifov, 2014). Economic development and effective resource usage are hindered by monopolies in several private sector domains (Suleymanov and Yusifov, 2014). As a result, prices sometimes rise in a jerky manner (Suleymanov and Yusifov, 2014). Therefore, the lack of an effective competition policy strengthens the dominance of monopolistic companies in the markets, and this restricts the capability of the national economy to participate in global value chains.

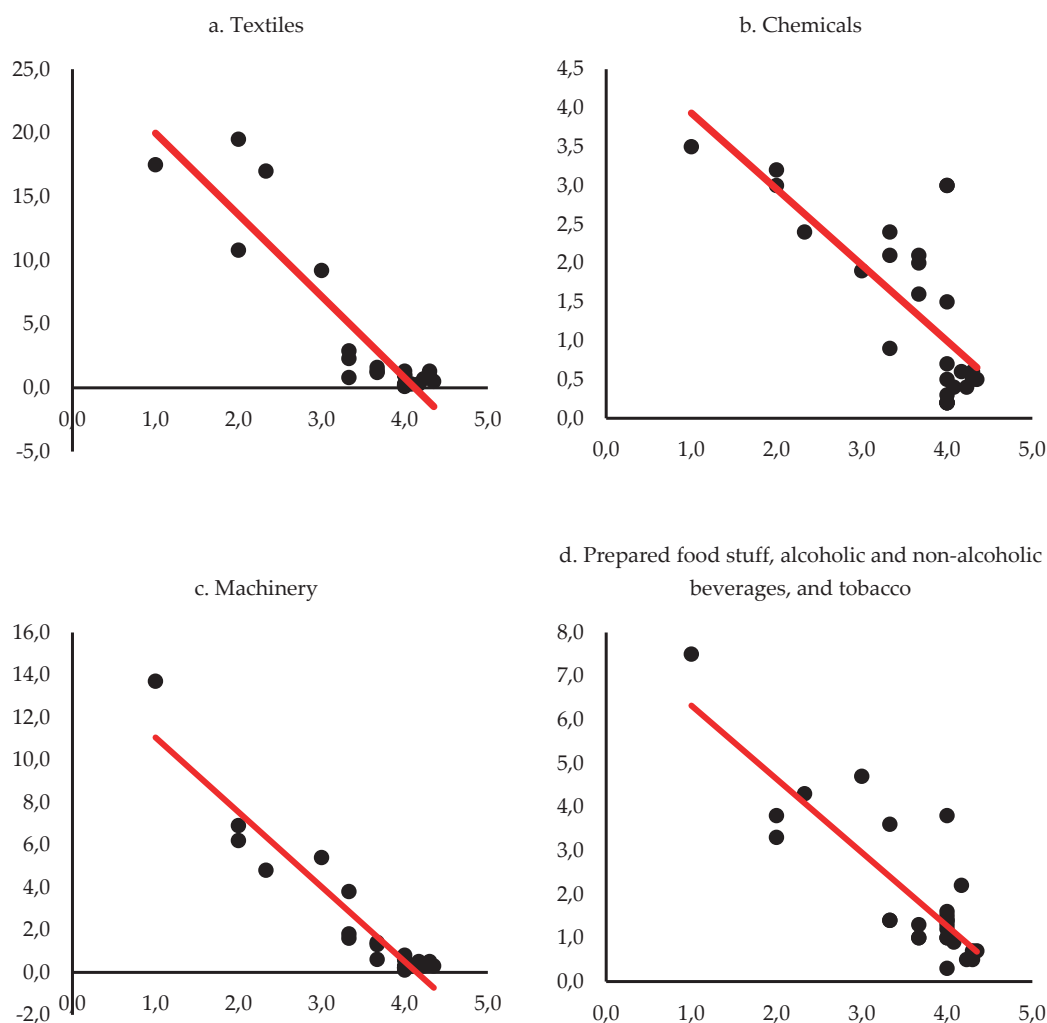
The Competition Code submitted by the President to the Milli Majlis in 2006 has not yet been adopted (The Milli Majlis, 2009), and the State Service for Antimonopoly and Consumer Market Control, a state body specializing in the fight against monopolies, was not able to rid itself of the dependence of the central executive power during this period. Thus, from all panels of Figure 2, it can be seen that although transition scores improved in Azerbaijan between 1994 and 2020, it was not reflected in the export shares in specific sectors like textiles, chemicals, machinery and foodstuff products, as in each case, the trendline is negative (see Figure 3).

### 3.3. The transition Process in the Social Sphere

When the oil boom was in full swing, both the non-oil economy and the social system profited from government investments of oil money. As

a result of expanded state investment policies, access to newly created jobs has improved and poverty has been steadily declining. However, decreased oil prices in 2009 and double devaluations in 2015 have affected not only the banking sector but also the social circumstances of the population. According to a recent study by the World Bank, the poverty rate in Azerbaijan in 2016 was 30% among those living in rural areas, 16% among those living in Baku, and the national average was 16% (World Bank, 2019). According to independent experts, the official 2020 unemployment rate was 4.86%, not 16.51% (Mashalli, 2021).

Although 30 years has been enough time for Azerbaijan to become a prosperous state and Azerbaijan's economy has been secure in terms of special and attractive resources for over two



**Figure 3.** The share of exports of certain sectors (Y-axis, in %) against the transition score (X-axis, values between 1 and 4, a combination of the components such as trade, the forex system and competitiveness), 1994–2020.

Source: EBRD and the State Statistical Committee of the Republic of Azerbaijan.



decades, initiatives to reduce poverty and unemployment have not yet materialized. The official figures on inflation, unemployment, and poverty do not fully encapsulate the real situation, and the dynamics show that even official data confirmed a sharp decrease in unemployment and poverty in 2020. The number of people unemployed in Azerbaijan in 2020 was officially 376,000, which is 125,000 or 50% more than in 2019 (SSCRA, 2022a). This meant that the unemployment rate reached its highest level since 2003.

As for poverty, according to official data, while 4.8% of the population lived below the poverty line in 2019, this figure rose to 6.2% and worsened in 2020 (SSCRA, 2022b). This means that in 2020, the number of poor people increased by about 30%. The poverty rate in Azerbaijan has reached its highest level since 2011.

Although Paragraph 1 of Article 15 of the Constitution of the Republic of Azerbaijan (1995) states that “the development of the economy in the Republic of Azerbaijan based on various forms of property serves to improve the well-being of people”, after the amendments made during the referendum in 2009, Paragraph 2 states that “the State of Azerbaijan, based on market relationships, creates conditions for the development of a socially-oriented economy, guarantees free enterprise and prevents monopolies and unfair competition in economic relations” (the words “socially oriented” were added to this paragraph; E-qanun, 2009).

Azerbaijan, which has had a decentralized social security system for 70 years, has not been able to complete the implementation of the pension insurance and compulsory health insurance systems based on solidarity during its 30 years of independence following the collapse of the USSR (The State Agency on Mandatory Health Insurance). Rzayeva (2013) argued that as a result of oil incentives and donations from foreign financial organizations, the new healthcare system was built on the rule of a tiny elite that controlled both the political and economic spheres in the country. The new government of the new oil economy did not perceive the necessity to develop a large pool of workers, as the previ-

ous administration did. It was not a matter of the people’s approval, either. It was easier to get new loans and get international approval for the IMF’s suggested welfare cuts than to try to improve the welfare of the citizens.

A comparison of Hungary and Azerbaijan in terms of social protection and employment revealed that the universal welfare state that Hungary acquired during the socialist period has been maintained (Ahmadov, 2022b). In addition, unemployment insurance and income assistance were implemented to ease the socioeconomic challenges of people affected by the transition. Azerbaijan, on the other hand, could not afford social protection, so most people who lost their jobs had to take informal jobs that were risky and did not pay much (Ahmadov, 2022b). In fact, during the oil boom period, the social protection system of Azerbaijan was not efficient enough to play a major role in the total consumption of poor households despite decreasing overall poverty (Habibov and Fan, 2007). Hence, the current situation is not much different when it comes to social protection policy, and this allows us to mention some pessimistic notes about it.

There are serious problems in the state pension system as well, which should be based on consensus. The lack of reforms in this area, as well as the lack of a legal framework for the operation of private pension funds for over 30 years, has placed a financial burden and social responsibility on the state. Currently, the government considers the ratio (1.5 people in 2020) of the number of insured and pensioners unsatisfactory (at least 3/1 is considered acceptable in terms of the sustainability of the pension system). An increase in the share of the elderly population in the long run and the expected life expectancy, along with the fact that the current pension regulations do not allow for an effective replacement rate and an appropriate increase in the amount of salaries are the main challenges facing the pension system (Ministry of Finance, 2021). All of these point to the incomplete transition in the social sphere in Azerbaijan when it benefited from the large oil revenue during the oil boom period.

#### 4. CONCLUSIONS

The transition to a market economy in Azerbaijan since its independence is not quite over yet. Also, there is a need for comprehensive reforms to address the challenges of large-scale privatization, governance and enterprise restructuring, and most importantly, competition policy. Due to the complex nature of the post-Soviet transformation, the academic literature does not cover the issues related to this at a deeper level. Hence, we attempted to answer the following research question: How was the quality and extent of the transition process related to the privatization practice, international trade reforms and social protection against the backdrop of the oil industry in the Azerbaijan economy between 1991 and 2020—following the collapse of the Soviet Union?

The most obvious development of the Azerbaijan economy since 1991 has been oil-led economic growth and development. The oil revenue rose in Azerbaijan throughout the commodity super-cycle and it discouraged the government from continuing the reforms that had been initiated since 1995. Between 2008 and 2014, the transition quality of Azerbaijan became weak, which coincided with the accumulation of a sizeable oil revenue. Compared to countries such as Armenia, Georgia, Belarus, Ukraine and Moldova, Azerbaijan's private sector gets smaller credits, and there have been no major and consistent steps to tighten budget constraints and enhancements in terms of the efficiency in corporate management of SOEs. Moreover, most foreign trade is mainly dominated by oil exports, and macroeconomic instabilities hinder the growth of domestic manufacturing. This is reflected in the social sphere as well. Consequently, Azerbaijan's large oil revenue and its oil dependency have inadvertently created a socially vulnerable population that is unemployed or lives below the poverty line. Temporary improvements in poverty and unemployment do not meet the criteria for long-term economic growth and development, especially when the level of well-being and the speed of reform in Azerbaijan are tied to the price of oil.

The sustainable transition from a command economy to a market economy, from administra-

tive regulation to social security systems based on consensus, depends on the establishment and operation of modern institutions in the political, economic and social spheres. Although steps have been taken towards institutionalization in Azerbaijan over the 30 years since its independence, most of them, including state bureaucracy and courts, have played the role of pseudo-institutions and merely serve to centralize public administration and concentrate absolute power in the hands of a few. This suggests there is a need for significant and continued institution-building to gradually overcome the above problems and challenges in the Azerbaijan economy, and the popular opinion seems to be that the transition from the socialist to the capitalist system is over. Further studies should be carried out to shed more light on the quality of the transition process in Azerbaijan in order to capture more explicit differences with the other post-Soviet countries and also to document the clear nexus between the role of the oil sector and the transition quality.

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