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Azerbaijan's Missed Opportunities

FARID GULIYEV

During its recent oil boom, Azerbaijan experienced more than a decade of fast economic growth. Between 2001 and 2011, gross domestic product grew tenfold, then peaked at $75 billion in 2014. Predictably, though, the bubble burst: in mid-2014, plunging global commodity prices sent the economy into a deep recession. The government increased borrowing and twice devalued the currency, the manat, reducing its value by half relative to the US dollar. GDP fell to $38 billion in 2016, down by half from its 2014 peak. By 2018, it had inched back up to nearly $47 billion.

Azerbaijan's oil-based growth model is lopsidedly dependent on a sector that has very few linkages to the rest of the economy. Petroleum dependency undermines export-oriented manufacturing and agriculture. Moreover, growth is not development, and not all development is inclusive or environmentally sustainable. Oil-led growth not only incurs considerable costs in terms of environmental degradation, it is also temporary, superficial, and unsustainable in the long run. Oil prices are notoriously volatile, and what may look like a boom can turn into a bust literally overnight.

However, the choices that political leaders make matter a great deal, too. Petrostates—countries that depend heavily on oil for government revenue—are more likely than others to be ruled by authoritarian regimes, and tend to pursue shortsighted macroeconomic policies that benefit the interests of their elites.

Just as it was under Russian and Soviet imperial rule, Azerbaijan's economy has remained heavily dependent on oil and gas for export revenue. Crude oil still accounts for more than 90 percent of total exports, akin to other petrostates like Angola, Nigeria, Iraq, and Libya. Azerbaijan has missed the chance to diversify into more sustainable industries. As with other petrostates, its recent oil boom followed the familiar pattern of cosmetic growth leading to an abrupt collapse. And oil wealth has benefited elites' business interests more than the public at large.

Oil wealth is finite. Azerbaijan is projected to run out of oil in about a quarter-century, and more than 70 percent of total oil revenue has already been spent or consumed rather than set aside for future generations or invested in other renewable assets. The consequences of such an inefficient oil-revenue management strategy will be felt in years to come. By prioritizing construction of physical infrastructure—often accompanied by corruption, patronage, and rent-seeking—the government neglected the improvement of human capital through education and research. Human capital is the ultimate source of success in an innovation- and knowledge-driven economic model.

In the 1990s, the breakup of the Soviet Union and the war with Armenia over the breakaway region of Nagorno-Karabakh (which has remained under Armenian control since 1994) shattered Azerbaijan's economy. The population endured a prolonged period of social and economic distress, with large-scale job losses and shortfalls in salaries and pensions. The centrifugal forces of ethnic minority separatism and an intra-elite struggle for power raised the specter of state collapse.

Heydar Aliyev, who had been the Soviet-era first secretary of Azerbaijan's Communist Party from 1969 to 1982 after rising through the KGB, returned to power in 1993 and moved to restore order, signing a cease-fire agreement with Armenia and ethnic Armenian forces in Nagorno-Karabakh in 1994. He installed a semi-autocratic form of rule in which nominally democratic procedures (elections, opposition parties, mass media) coexist with extreme degrees of arbitrary rule, nepotism, and coercion.

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In 1994, Aliyev closed a deal with international oil companies to develop the Azeri-Chirag-Guneshli (ACG) deposit in the Caspian Sea. Multiple oil pipelines became operational beginning in the late 1990s. The biggest one came onstream in June 2006 with the launch of the Baku-Tbilisi-Ceyhan (BTC) pipeline, operated by British Petroleum.

Azerbaijan entered its second great oil boom. The previous one had begun in the second half of the nineteenth century and lasted into the early twentieth century, when Baku belonged to the Russian Empire. That was followed by ups and downs in oil production during the Soviet era.

Before Aliyev's death in 2003, the regime orchestrated a transition of presidential power to his son Ilham. The son continued down the autocratic path laid out by his father, combining the provision of patronage to regime cronies with the repression of opposition parties and a small but (at that time) still vibrant civil society. Ilham Aliyev remains in power today.

The Dutch affliction

Although natural resources, especially oil and gas, tend to be a curse, there are policies a government can adopt to avoid that fate, or at least to smooth out its negative symptoms. But Azerbaijan made all the typical mistakes that have plunged other oil-rich developing countries, like Venezuela and Nigeria, into crisis or even chaos.

Azerbaijan suffers from the most pernicious symptoms of the Dutch disease—the economic term used to describe an outsized expansion of nontradeable sectors, like services and construction, at the expense of agricultural crops and manufactured products that can be traded internationally. This happens due to the influx of foreign exchange (oil is traded internationally in dollars) and the appreciation of the local currency relative to the dollar.

Catering to greedy rent-seeking groups within the elite, Azerbaijan's government prioritized investment in physical infrastructure projects. Since the oil industry is capital- rather than labor-intensive, construction offered the additional advantage of generating new jobs that would provide some relief for social tensions. But once-flourishing industrial plants promoted by Soviet industrial policy, such as those producing petrochemicals in Sumgayit and household air-conditioners in Baku, were completely abandoned. Instead of leaping forward, the economy fell backward and deindustrialized. Meanwhile, agriculture's share of GDP fell from 16 percent in 2000 to 6.2 percent in 2015, as currency appreciation dampened the competitiveness of exports.

Fiscal discipline is necessary to constrain the urge to spend oil revenue too quickly. Many oil-producing countries resort to extra-budgetary spending through national oil companies to avoid public scrutiny. There is a range of fiscal tools available to counter the insatiable appetite for rent-seeking, such as setting up a savings fund or instituting a rule as to what percentage of the annual surplus can be spent. In general, prudent fiscal policy needs to be countercyclical: setting aside a share of the surplus during a boom and drawing down this surplus during a bust. However, many commodity-dependent countries do the reverse and pursue a procyclical policy.

Azerbaijan is a good example. The government adopted a Norwegian-style state oil fund 20 years ago. The idea should have been to use it as a savings pool to stock up reserves for future generations, as the $1 trillion Norwegian fund has done. In Norway, fiscal prudence dictates that only 4 percent of the fund's annual investment returns can be spent annually. However, Azerbaijan is not Norway, and fiscal discipline was of little concern for rent-seeking elites. No formal fiscal rule was adopted until 2019. The government went on a spending spree on large-scale infrastructure projects, which are especially vulnerable to exploitation by corrupt officials and bureaucrats. A construction boom ensued as the newly rich reinvested their profits in real-estate projects that sprang up all over Baku.

Out of a total of $140 billion in revenue that had accrued in the state oil fund (SOFAZ) from the largest ACG deposit, the fund's reserves amounted to $40 billion as of April 2019. Seventy percent of it—$100 billion—had been spent in a decade, largely through transfers to the state budget to finance domestic consumption and inefficient investment.

Neglected human capital

If a petrostate prioritizes investment in physical assets or consumes its oil wealth instead of investing it wisely in productive areas, future generations will suffer when the oil dries up. A better practice is to reinvest natural resources revenue into more sustainable (and renewable) forms of capital: human capital (improving the education and professional capabilities of its citizens), social capital (networks of civic engagement), and physical capital (infrastructure), in reasonably equal proportions—the so-called Hartwick rule.

Azerbaijan has allocated relatively little to education and research. The quality of schooling suffered during the postcommunist transition period and remains poor. The higher education system, in particular, is outdated and inadequate for training young people for the modern job market. Educational expenditures represent a small percentage of GDP (about 2.5 percent on average in recent years), on par with Georgia and Armenia, Azerbaijan's resource-poor neighbors, and below the regional average. The government sought to address growing concerns over declining schools by setting up a state-funded scholarship program to send students to universities abroad, mostly in Britain, Turkey, and Germany.

In health care, while the state preserved some social policies of the Soviet era, including pensions and certain medical benefits, these services remain undersupplied and rudimentary. Although the number of public and private health-care providers has increased, there is a lack of comprehensive health insurance and services at public clinics, which run on out-of-pocket payments. Most families continue to rely on informal safety nets such as borrowing from relatives and friends.

There are few jobs for growing numbers of young people.

To its credit, the government has made great progress in reducing absolute levels of poverty through a targeted social-assistance program. Poverty fell from about 50 percent in 2001 to 6 percent in 2012. Regarding income inequality and wages, however, Azerbaijan's performance has been less impressive.

Income inequality, as measured by the Gini coefficient (where 0 signifies absolute equality and 1 stands for perfect inequality), almost doubled from its low Soviet-era level of 0.27 to 0.55 in 2002, then fell to around 0.33 in 2008, the most recent year for which data are available. These trends are similar to those in Armenia and Georgia. Given its resource advantage, Azerbaijan should have performed better at equitable distribution.

Incremental increases in real wages and pensions were offset by creeping inflation and the double currency devaluation. During the oil boom, the monthly minimum wage was raised twice, from a dismal 1.1 manat in 2000 to 105 manats in 2013. After the oil price decline, it was raised further, to 180 manats.

In June 2019, Aliyev ordered yet another minimum wage increase, to 250 manats ($147), and a raise in the minimum monthly pension from 180 to 200 manats, beginning September 1. Other orders stipulated increases in the range of 20 to 40 percent in the wages of state sector employees, from the police and the bureaucracy to state university workers. But these apparently generous increases are deceptive.

To illustrate the fleeting nature of an oil-fueled economic "miracle," consider the following example. In 2014, before the currency devaluation took place, the average monthly salary was around 440 manats ($564). After wages were raised, the average salary stood at the equivalent of $309. In other words, despite nominal increases, salaries actually fell by nearly half in dollar-value terms and purchasing power.

Living standards ultimately improved very little during Azerbaijan's oil boom. Wages are now lower than in neighboring Georgia, where the average monthly salary was the equivalent of about $396 in 2018.

Carrots and Sticks

When political decision makers are placed in a system without strong institutional constraints, they will tend to concentrate power as much as possible. They may even go a step further by dismantling whatever institutions are in their way. For example, Azerbaijan amended the constitution in 2009 to remove the limit of two consecutive presidential terms, and extended the term from five to seven years in 2016.

The concentration of power in Baku occurred in two ways. The state expanded during good times with the bloating of ministries, government agencies, and quasi-state structures dependent on government subsidies. And high officials accumulated wealth via state-funded projects and turned into oligarchs, securing ownership of business empires and control of monopolies in various sectors of the economy.

Oil wealth enabled the ruling regime to strengthen its control over society with a combination of carrots, sticks, and marketing. The funds generated by the oil boom were injected into the patronage network to co-opt state-linked elites and their cronies. Large infrastructure projects were a key source of this patronage—the carrots—for elite groups.

Oil money also reinforced the ruling regime as revenue poured into expanded budgets for the security services, which have made political opposition very difficult. Today's regime is supported by a formidable array of coercive structures—the sticks—ready to be deployed to suppress any dissent.

Much has also been spent on public relations campaigns within and outside the country. Over the past several years, Azerbaijan has hosted sports and entertainment events such as the European Games and Formula One auto racing to build public support and create the image of a successful, modern country.

At times, public relations veered into outright bribery. There is evidence that Azerbaijan resorted to "caviar diplomacy" by plying members of the Council of Europe's Parliamentary Assembly with payoffs and gifts to block a resolution critical of the government's human rights record. In 2018, the Council expelled 13 members over the affair.

Tightening circle

The tycoons who made their fortunes during the oil boom include the families of Kamaladdin Heydarov, Ziya Mammadov, and the family of the first lady, the Pashayevs, who operated businesses ranging from banking to real estate and construction. Toward the end of the boom, these oligarchic groupings were reshuffled, and some of them lost their fortunes.

Living standards ultimately improved very little during Azerbaijan's oil boom.

As in other post-Soviet countries whose economic model can be described as state capitalism (which the consultant Ian Bremmer defines as "a system in which the state dominates markets primarily for political gain"), many businesses in Azerbaijan receive protection from senior officials or politicians against hostile takeovers. This protection is known across the region as *krysha* (the Russian word for "roof"). When the oil boom ended, several of Azerbaijan's oligarchs lost chunks of their business empires through takeovers. Their *krysha* had crumbled due to their political patrons' falling from grace.

The general belief is that businesses are now being increasingly concentrated under the umbrella of the Pashayevs' group. By squeezing the assets available, the oil crisis may have prompted Aliyev to terminate the generous sharing of rents with oligarchs who had grown too avaricious and unruly. The president has sought to limit rent-sharing to a narrow circle of trusted family members.

Politically, this more regimented wealth dispersal has manifested itself in changes in the constitutional design and an overhaul of the executive branch. The government structure shifted away from the previous French model of semi-presidentialism, in which a prime minister coexists with the president, to an American-style executive presidency. A constitutional amendment adopted in 2016 introduced new vice presidential posts. Aliyev was quick to appoint his wife as the inaugural first vice president (who is second in the line of succession), making it clear that he has no intention of sharing power with potential rivals within or outside the regime.

In recent years, perhaps sensing the inadequacy of the old system to cope with post-oil challenges, Aliyev also appointed a number of younger, Western-educated cadres to ministerial and other senior positions. Some experts believe this signaled a transition from an oligarchic-based system to a more technocratic model, while preserving clientelistic relationships in the upper echelons of power.

New voices

In the political opposition, the older parties—the Azerbaijan Popular Front Party (AXCP) and Müsavat, both with roots in anti-Soviet dissidence and national independence movements—have been emasculated by the regime's targeted repression of their members, the co-optation of several key figures into regime structures, and internal bickering. These parties had a brief stint in power shortly after independence, from 1992 to 1993. Their rule was marked by ineffective leadership, economic decline, and military defeats that left the country near collapse.

Often characterized as fragmented, personality-driven, and old-fashioned, these traditional opposition parties lack ideological appeal to the broader electorate, especially young people. The personal appeal of AXCP leader Ali Karimli among the base supporters, who tend to be older and more conservative in values, keeps the party's brand alive. But even though these parties are small and marginalized, they are real in the sense that they have not been co-opted and keep resisting harsh repression. It is impossible for the regime to fully shut them down because of the pressure it would face from the international community. Previous crackdowns on the opposition and blatant human rights violations drew Western criticism—most notably in the case of investigative journalist Khadija Ismayilova, who was sentenced to seven and a half years in prison in 2015, but was released in response to an international outcry after serving just a year and a half. (She is still on probation and banned from leaving the country.)

A new opposition group named REAL has risen to prominence in recent years, led by younger people who have been exposed to Western democratic and meritocratic values. It calls for democracy, the rule of law, and a competitive market economy. It has advocated a transition to a parliamentary form of government—both Georgia and Armenia switched to parliamentary systems in the past few years, and the model has a domestic precedent in the first Azerbaijan People's Republic in 1918–20. It has also demanded that Baku's mayor be elected rather than appointed by the president, and has argued for deregulation of the economy.

While such appeals are not new, hearing them articulated by fresh voices appeals to younger and more (Western) educated urbanites. Nearly half of the country's population is 29 or younger. According to the leader of REAL, Ilgar Mammadov, the party has about 100 candidates on its preliminary list for the next parliamentary elections, which are scheduled for 2020. Their average age is 36.

Mammadov, who is 49, is barred from running for office for the next six years. He was arrested in 2013 and convicted of organizing riots, though his real "crime" was standing for the civic values of democratic participation and clean governance. He spent five and a half years in prison. That only made him a more popular alternative to the current leadership, though his arrest disqualified him as a candidate for the October 2013 presidential election. (In 2018, Ilham Aliyev won a fourth term, which will last seven years thanks to the recent extension of the presidential term.)

YOUTH BULGE AHEAD

Azerbaijan's labor market is distorted: while oil and gas output accounts for the bulk of the country's GDP (40 percent), this sector employs very few people—about 1 percent of the labor force. The biggest employer is the agricultural sector, which accounts for 37 percent of the workforce, but contributes only about 5 percent of GDP. Services absorb half of the working population. However, there is strong evidence that a large portion of the workforce is employed informally, without official contracts—26.5 percent, according to the International Labor Organization (ILO), or nearly 40 percent by previous estimates—especially in construction, taxi-driving, restaurants and cafes, small-scale trading, and street shops.

According to ILO data, public sector employment fell from 33.1 percent in 2000 to 25.6 percent in 2014. But this does not include quasi-public state-owned enterprises, such as the giant national oil company SOCAR, which employed more than 50,000 workers in 2015.

Keeping people in the public sector provides jobs and allows centralized and top-down command of the wealth-distribution mechanism. Public sector employees are less likely to express dissent, since they would risk losing their jobs.

However, the looming youth bulge and the incapacity of the private sector to supply enough jobs to accommodate better-educated young people is a combination that portends trouble in the future, especially when oil stops providing enough income and social benefits for middle-class households. A youth bulge occurs when 20 percent or more of the population is in the 15–24 age group. When this cohort enters the labor market and finds limited job opportunities, the mismatch results in frustration that is often translated into political instability, as was illustrated by the youth-led Arab uprisings in 2011.

In Azerbaijan, young people from the ages of 15 to 29 constitute 23 percent of the 10 million-strong population, according to official statistics for 2019. The youth unemployment rate is officially 14 percent, but in reality it is certainly higher. Russia has provided jobs for up to 850,000 Azerbaijani labor migrants (circa 2012), or 9 percent of the total population, serving as a temporary safety valve to release some pressure on the domestic labor market. From 2016 to 2017, however, Russia enforced a more restricted policy that reduced the number of labor migrants from ex-Soviet countries. As of January 2018, the estimated number of Azerbaijani migrants living in Russia was down to about 500,000, though it subsequently rebounded somewhat. (It is difficult to estimate these numbers because some Azerbaijanis settle down and obtain Russian citizenship; others go there for temporary work.)

The Aliyev government has eased conditions for the registration of private-sector businesses in areas such as agriculture and tourism since the 2014 crisis. In 2018, the government cut taxes to encourage small businesses. But most sectors are still under the protection of oligarchs, and such minor measures are not enough to diversify the economy. The elites understand that by encouraging more independent entrepreneurship, they risk losing control of economic assets, which in turn could jeopardize their grip on power. Confronted with this tradeoff, their preference still seems to be to retain oligarchic control, while allowing liberalization in only limited areas.

For Azerbaijan, the recent oil boom was, by and large, a missed opportunity. In the economic realm, politically connected oligarchs secured monopolies. In the political domain, oil wealth perpetuated the personalization of power and the continued dominance of the regime elites. Education has been neglected and health care is poor, income inequality is persistent, and little progress has been made in improving social well-being for the majority of citizens. Given the minimal progress toward economic diversification so far, there are (and will be) very few jobs for growing numbers of young people—a dangerous time bomb that may explode at any time.

The consequences of this missed opportunity are serious and will be felt in the not-so-distant future when the oil deposits have drained away. High youth unemployment may lead to violent unrest, and prolonged economic stagnation could end in a societal collapse similar to the ongoing crisis in Venezuela, another wayward petrostate. ■