



Azerbaijan: Reform Behind a Static Façade

October 17, 2019 **Svante E. Cornell** *The American Interest*

Related Categories: Democracy and Governance; Energy Security; International Economics and Trade; Caucasus

A wave of political dynamism is passing through Central Asia and the Caucasus. Under new leadership since 2016, Uzbekistan has embarked on a major effort to reform and modernize. Armenia's former President's attempt to cling to power launched a Velvet Revolution in 2018 and ushered in a new administration explicitly committed to tackling the country's oligarchic system. Kazakhstan, whose first President engineered a managed succession to a long-term confidant, continues on its path to reform the economy, while pledging a more inclusive political atmosphere.

Less well covered in the Western press are the changes currently underway in Azerbaijan. These shifts have not been the result of a popular revolution, and they are not a result of top-level change: Strongman President Ilham Aliyev remains firmly in charge and could likely even see his rule strengthened by the reforms. The process that is underway should not be confused with political liberalization. Still, the changes afoot do have major ramifications for the future of the country. A long overdue generational change is taking place in Azerbaijan's political system, accompanied by what appears to be a serious effort to wean the country off its dependence on oil and to make its state institutions more responsive to the population's needs. In other words, Azerbaijan is undergoing a classic example of authoritarian modernization.

This raises several questions. Are the reforms real, and could they usher in change that matters? Why are these reforms taking place now? And why does all of this matter to the United States?

Take the last question first: Azerbaijan matters to the United States because of its crucial geopolitical location and its particular national affinities. It is a Shi'a-majority country on Iran's northern border that has a largely pro-Western population and a secular state with a close relationship to Israel. Azerbaijan is the only country that borders Iran, Turkey, and Russia. It is key to the development of a land transportation route linking Europe with China through Central Asia. More than that, Azerbaijan's efforts to build pipelines to market its oil and gas resources to European markets have succeeded in building a beachhead that could help reduce Europe's dependence on Russian gas.

The U.S.-Azerbaijan strategic relationship is therefore much more important than Azerbaijan's size would suggest. It has a direct bearing on American policies with regard to Iran, Turkey, Russia, and even China. And given that the Trump Administration appears to be rethinking the U.S. strategic posture in Eurasia to confront China, Azerbaijan's turn to a reform agenda comes at a propitious time.

The current reform effort dates to the 2015 slump in oil prices, but Azerbaijan had seen reforms before then. The success stories, however, almost exclusively involved the creation of new institutions under executive supervision rather than reform of existing ones. The State Oil Fund was established in 2001 on the Norwegian model, for instance, and is widely considered transparent and professionally run, audited by international companies on a regular basis.

In 2012, Azerbaijan launched the Azerbaijani Service and Assessment Network (ASAN) model of single-window, electronic provision of public services ranging from birth certificates and driving licenses to real estate documents. ASAN eliminated the proverbial middleman, thus reducing interaction between citizens and public servants and decreasing the petty corruption that had plagued the country's public service provision. ASAN remains massively popular, and has been praised by the OECD for "eliminating the conditions that are conducive to corruption" in the provision of public services. But this type of reform could only go so far without infringing on the powerful informal networks that dominate Azerbaijan's economy and administration. President Aliyev was visibly reluctant to confront these networks, which had been in place long before his presidency began in 2003.

By 2015, however, President Aliyev appeared to do just that. As several senior officials relate privately, Aliyev let the country's "oligarchs" know that business as usual could not go on. They were told to stop deriving revenue from unfair competition or the extraction of rents through systematic corruption, and to stop the predatory behavior that had been prevalent in large parts of the state bureaucracy. Since then, Aliyev has made more personnel changes in three years than in the first 12 years of his presidency. And he has sent such signals publicly, too: on October 16, Aliyev blasted members of the government who "blackmail others, denigrate them, and cast a shadow over the reforms." He went on: "There is no alternative to reforms. . . . Whoever is against this and is stealthily trying to interfere with our work, is not with us."

Ilham Aliyev is himself the son of Heydar Aliyev, Azerbaijan's Soviet-era strongman, who returned to power a year after the country became independent and ruled until his death in 2003. He has presided over a system of government that has been widely criticized for its authoritarian inclinations and widespread corruption. So why this sudden interest in reforms?

Grasping the rationale requires a short dive into Azerbaijan's murky politics. The country's political system emerged from the collapse of the Soviet Union and was coupled with a debilitating war with Armenia. Amid considerable domestic political turmoil, Azerbaijan lost over a sixth of its territory. The country was essentially a failed state, and in this void a political system emerged where formal and real power were very different things. While Azerbaijan has a highly centralized presidential form of government on paper, the anarchy and war economy of the early 1990s led to the emergence of independent power-brokers—known, as in Russia, as oligarchs—who established quasi-monopolies over sectors of the economy as well as various state institutions. Heydar Aliyev capitalized on his Soviet-era experience and political acumen to stabilize the country and put it on the road to recovery. But he ailed before mustering the power to deal with these oligarchs.

When Ilham Aliyev took over the presidency in 2003, the constitution granted him enormous formal powers. But in reality, the cake had already been baked: he had to deal with the considerable informal power of the oligarchs, many of whom were 20 years his senior and hardly appeared to consider him their uncontested leader. In fact, some sought to capitalize on the transition to a younger President to expand their influence.

While these oligarchs posed a challenge to Aliyev's rule, a confrontation was avoided because of the enormous windfall oil revenues that started flowing into the country in 2005. There was simply enough money to keep almost everyone happy: Aliyev could build his popularity by presiding over record economic growth, which reduced poverty rates to under 5 percent and allowed tens of thousands to build a middle-class life. In the meantime, his family also managed to build an informal power base of its own to rival that of the oligarchs. But windfall revenues have never generated any urgency for structural reform anywhere. While they did bring positive results in large infrastructure projects and poverty reduction, they also allowed the government to co-opt both political rivals and the opposition, and splurge on vanity projects such as giant flagpoles, European Games, and Formula One races. They also had a less pleasant side, as a variety of real or self-styled Azerbaijani potentates engaged in financial shenanigans at home and abroad, some of which continue to reverberate in the Western media.

The 2014 oil price drop upended this state of affairs. Suddenly, the expansion of Azerbaijan's budget became unsustainable and in 2015, the government's efforts to defend the currency collapsed, leading to a devaluation of the currency by half. Prices shot up, people could no longer service mortgages denominated in dollars, and the country's banks experienced serious liquidity problems. The government managed to rescue the economy by dipping into the country's oil fund and taking on considerable debt. But the crisis led the country's implicit social contract to take a hit: the population had largely supported Aliyev's rule in exchange for political stability and economic prosperity. Now, the government's ability to keep its part of the bargain was in question.

The chaos in the neighborhood provided some respite, as very few Azerbaijanis wanted to take the risk of sparking upheavals that could turn the country into a Syria or Ukraine. Still, President Aliyev needed to restore the legitimacy of his government's stewardship of the economy. Interviews with dozens of Azerbaijani officials in the past five years make it clear the leadership realized that it could not just wait for oil prices to rise again. Diversification of the economy had now become a necessity. The problem? Improving the country's attractiveness to foreign investment required fundamental changes to the country's informal politics, especially the de facto monopolies that various oligarchs had built. For example, an obvious way to diversify the economy was to take a role in Chinese and European plans to develop the land transportation corridor connecting Europe and Asia. But the level of corruption in the Ministry of Transportation made Azerbaijan the bottleneck of the corridor. Similarly, foreign investment would not come as long as the Customs authority charged onerous fees, both formal and informal, to move anything in and out of the country.

For a decade, President Aliyev had largely avoided confrontation with the oligarchs surrounding him. Now, his government's success, and possibly its survival, required that confrontation. For a decade, President Aliyev had largely avoided confrontation with the oligarchs surrounding him. Now, his government's success, and possibly its survival, required that confrontation.

The oligarchs reacted differently to the new rules of the road. Some complied: the powerful Ministry of Emergency Situations, for example, appears to have cleaned up much of the corruption in its ranks. Others, however, failed to read the writing on the wall. The Ministry of Transportation, whose leadership had been implicated in a variety of scandals involving foreign partners like Bombardier and the Trump Organization, was one such entity. The Minister was fired in 2017, and the Ministry itself abolished the following year and merged with IT & Telecommunications. Of course, this does not mean all high officials implicated in shady deals have been purged. For example, the head of the Anti-Corruption department in the Prosecutor General's Office, who was implicated in a financial fraud scheme in 2017, was promoted to head of the state security services this June.

President Aliyev's approach has always been, where possible, to create new institutions rather than overhauling old ones. He used this approach to deal with the entrenched bureaucratic holdovers dating back to the Soviet system that dominated the bureaucracy, including the octogenarian Head of the President's Administration, and the septuagenarian Minister of Interior. Aliyev therefore introduced the institution of a First Vice President through constitutional amendment in 2016, and appointed his wife, First Lady Mehriban Aliyeva, to this position. Mrs. Aliyeva, whose family has considerable business interests of its own, had taken on an increasingly prominent role in Azerbaijani politics. She has chaired the Heydar Aliyev Foundation since 2004, and has been a Member of Parliament since 2005.

Western observers found this appointment unorthodox, if not downright corrupt. But seen in a more charitable light, the appointment served to supersede alternative centers of powers and create a focal body for the coordination of reform policy. In the three years that followed, the First Vice President's office has distinctively emerged as the initiator and flag-bearer of reforms, first in the economic sphere and increasingly also in judicial matters.

The process gathered speed following President Aliyev's re-election in 2018—a foreordained result that nonetheless brought a major government reshuffle. Across the board, a younger generation was promoted to ministerial positions. The 39-year old deputy Minister of Economy Sahil Babayev was appointed Minister of Labor. Inam Karimov, who holds a doctorate from Paris's Sorbonne University and spearheaded the ASAN service centers, was promoted to Minister of Agriculture. Vusal Huseynov, a Harvard graduate, now leads Migration Services, a job with key importance to foreign investors. Even before the election, 42-year-old Mikayil Jabbarov, a member of the New York bar who had been appointed Minister of Education in 2013, was moved to the key position of Minister of Taxation. All in all, 13 of the cabinet's members are now under the age of 50; the average age is 54. The portion of cabinet members with any adult experience of the Soviet Union is rapidly dwindling.

The generational shift in Azerbaijan's government, then, is clear—and it's been accompanied by some real steps to reform the country's institutions.

In 2016, the Presidential Administration hired McKinsey to develop a road map for reforms. The report it produced outlined 11 areas for the development of the non-oil sector, including agriculture, light industry, tourism, and transport. But the report was not developed in meaningful coordination with existing government agencies, weakening its impact. Since late 2017, however, the office of First Vice President Mehriban Aliyeva has coordinated a new drive for reform, targeting the structural problems in the economy and legal system much more directly.

The most serious changes have been implemented in the customs and taxation fields. The long-serving head of the customs committee was fired in 2018, leading to rapid changes. There is now a transparent, electronic customs declaration process, and duties now go directly to the government budget, rather than through the intermediary of the Customs Committee. This means that businesses are, for the first time, able to import and export at will, as long as they pay proper taxes and duties—effectively doing away with the system that enabled influential forces to maintain effective monopolies over entire sectors of the economy by denying rivals a level regulatory playing field.

Meanwhile, the government has begun to target the judicial sector. In April 2019, President Aliyev signed a decree on judicial reforms, which can be termed a warning to the courts: he explicitly urged judges to exercise their profession fairly, and demanded the implementation of concrete reforms to address corruption in the legal system. The document is explicit in identifying the problems in the system, including the lack of transparency and inconsistencies between judgments on similar cases, and specifically seeks to remedy the impediments for businesses. Thus, the decree calls for the oral recording of all court proceedings and the publication of transcripts, a more transparent and randomized system of assigning judges to cases to prevent corruption, the full development of an electronic database of judgments, and stronger measures to prevent interference in judicial affairs and to punish judges for violations of their code of ethics. The decree also called for setting up specialized courts to handle tax and customs matters, and an expansion of the number of judges in the country.

The light industry sector is being developed by way of industrial parks managed by the Ministry of Economy. The city of Sumgait near Baku boasts two: a Chemical Industrial Park as well as a Technologies Park, which involves the production of cables, polymer pipes, and galvanized metal. At the Mingachavir Industrial Park in western Azerbaijan, the focus so far has been on cotton, wool and leather products; whereas Masalli in the south is preoccupied with textiles. The Special Economic Zone at the new Baku port of Alat, run by a young, American-trained professional, should be added to the list. The SEZ was approved by parliament in May 2018, will operate under British law, and all business in the zone is exempt of taxes and duties. Common to these new initiatives are incentives for foreign investors, including a seven-year tax-free regime, as well as waivers on duties for the importation of equipment. Azerbaijan has begun producing automobiles and light trucks and tractors in cooperation with foreign partners, primarily from Iran, China, and Belarus.

The government has created a standalone tourism agency, separated from the Ministry of Culture, to which tourism issues were previously subordinated. Key to the development of tourism is the simplification of visa procedures, which were notoriously complicated. Azerbaijan's electronic visa, now managed through the ASAN system, has been rated the easiest visa in the world to obtain, and citizens of China, South Korea and several Gulf states can receive a visa on arrival. This has led to a significant increase in tourism: Azerbaijan saw 2.6 million visitors in 2017 compared to one million in 2008. The number is expected to exceed three million in 2019. Much of this tourism originates in the Gulf states: Baku, with its cosmopolitan atmosphere and vivid cultural scene, appears to be turning into a breathing space for upper middle-class Gulf Arabs, similar to the role Beirut held before the Lebanese civil war of the 1970s. But as a result of active government efforts, tourists from South Asia, among others, are now common on the streets of Baku.

In terms of transportation, Azerbaijan's plan is to establish the country as the hub of two transport corridors: the East-West corridor promoted by the EU and China, as well as the North-South corridor linking Russia with Iran and India. Key in this regard is the port of Alat near Baku, with its Special Economic Zone. Alat Port feeds into the Baku-Tbilisi-Kars pipeline, inaugurated in October 2017. As a result, cargo arriving to Alat from Russia, Central Asia or Iran can rapidly be shipped on toward European destinations by rail. Moreover, because container trains can be transported to Alat by rail ferry from ports in Kazakhstan and Turkmenistan, Alat enables container traffic from China to seamlessly continue on toward European destinations. The port will have a cargo transshipment capacity of 25 million tons. The transportation route, and Azerbaijan's role in it, holds enormous potential. But the challenges are considerable, as the question whether it can compete with sea and air routes remains to be answered.

These reforms led the World Bank to bump Azerbaijan from 57th place in its "Ease of Doing Business" index in 2018 to 25th place in 2019. The Bank particularly highlighted the ease of starting a business, the one-stop shop system for construction permits, property registration, and the institution of electronic and transparent systems both for paying taxes and benefits, as well as for customs procedures. More reforms are in the pipeline: Azerbaijan is now expanding the use of a "Green Corridor" for customs, in which goods are released immediately without examination to compliant business deemed low-risk. Azerbaijan also removed income taxes for incomes up to \$5,000 in the non-oil sector, and is reforming the migration service to facilitate the issuing of work permits for foreign businesses, hitherto a major problem for foreign investors. In addition, the government has increased the minimum wage and pensions, and plans to introduce compulsory medical insurance in 2020.

A critic would be right in nothing that many of these reforms are declarations of intent that, powerful as they may be, will only prove their worth if properly implemented. Furthermore, many doubt the credibility of these reforms for two inter-related reasons: First, as already noted, President Aliyev has been in power for a decade and a half—why would he suddenly work to transform the country? Second, none of these reforms bears on political liberalization, without which the long-term success of reforms is questionable.

As noted, Azerbaijan's reforms are geared toward making the economy more attractive, and should not be confused with political liberalization. Azerbaijan's reforms are geared toward making the economy more attractive, and should not be confused with political liberalization. If anything, they signify a shift from an essentially oligarchic system of government to a more centralized system, concentrating more real power in the executive. Still, the reform process was coupled with a large amnesty, in which most prisoners considered political by Western governments and organizations were released. Moreover, the reform effort coincides with an effort to rein in the law enforcement agencies. The National Security Ministry, which was feared by entrepreneurs for its predatory behavior, was dissolved in 2015. And in June 2019, the Minister of Interior, appointed in 1994, was moved to the largely symbolic office of the Presidential Security Council. This could signify a major shift, with meaningful change in this key ministry, which has been the government body most clearly associated with the human rights violations that activists have decried in Azerbaijan.

If these reforms do not really serve to open up the political system, how far could they go? While democracy advocates tend to focus strongly on electoral systems and on the promotion of civil society, the fact is that political liberalization in the absence of responsive and well-functioning state institutions does not have a very good track record. A focus on democratization without attending to essential institutions has tended to lead to the development of illiberal democracy or a return to populist authoritarianism, as the trajectories of Russia, Venezuela, and Egypt all attest. The point is that by creating more accountable public institutions and laying the ground for diversification of the economy, the reform process in Azerbaijan generates visible improvements for the country's population, while also developing the prerequisites for successful future liberalization.

In the short term, Azerbaijan's leadership appears determined to proceed with governance reforms that improve efficiency and transparency of government. But as the President himself alluded to in his October 16 speech, these reforms run counter to the interests of relatively strong domestic constituencies, which the President has managed to put on the defensive. It remains to be seen whether these entrenched interests will mount a viable counter-offensive. A key aspect of the Azerbaijani reforms is that they are coupled with a centralization of power and a top-down logic common to projects of authoritarian modernization. This comes with its own obvious challenges: as Jack Snyder has pointed out, it is not clear that authoritarian modernization can help countries past the middle-income level, as "only rule-based institutions can lead the breakthrough to higher levels of economic development." Azerbaijan's rulers want to create enough of a rules-based environment for the economy to develop, but successful modernization processes generate growing demands for reforms to spread into the political realm as well. As Roberto Stefan Foa has noted, many developing authoritarian states have reached a point where the citizenry is demanding greater political rights. Azerbaijan's neighbor Kazakhstan, where popular demonstrations contributed to new President Kassym-Jomart Tokayev launching the notion of a "listening state," is a case in point. It remains to be seen if the Azerbaijani leadership will be willing or able to expand its reforms to the political sphere when that becomes necessary.

While the reforms in Azerbaijan are limited in scope and their outcome uncertain, the process is important to the United States. They do not take place in isolation: the three most populous countries in Central Asia and the Caucasus—Azerbaijan, Kazakhstan, and Uzbekistan—are now in the midst of serious reform processes. Kazakhstan is key because of its location at the intersection of Russian and Chinese interests, and Uzbekistan derives its importance from its large population and proximity to Afghanistan. Yet Azerbaijan has always been the linchpin of the region because, along with Georgia, it provides the only realistic access route for the West to the Caspian Sea and Central Asia. Because of its location and close historical relations with Iran and Turkey, it is also of direct relevance to American interests in the Middle East.

For too long, leaders in Baku, as in Astana and Tashkent, have been suspicious of Western intentions in their neighborhood, often fearing the specter of Western-led "regime change." More recently, the calculus has shifted. Just like in Washington, leaders in these countries have all observed the intensification of great power competition—and its growing volatility at a time when the great powers seem less bound by international norms and rules of behavior than they have been in recent decades. And as these three states look to strengthen their governing institutions in response to both outside pressure and domestic demands, neither Russia, Iran, China, or Turkey have much to offer.

This is an opportunity that America should not ignore. As relatively small countries encircled by great powers, the Central Asian countries are inclined to look positively on an American role in Eurasian geopolitics. Washington has a stake in the success of these reforms, and in assisting the reformists in the government against the more retrograde forces that seek to neutralize the effects of change. The reform effort in Azerbaijan provides an opportunity for the U.S.-Azerbaijan political dialogue to be centered on positive cooperation, and thus to strengthen rather than weaken the bilateral strategic dialogue. This, in turn, would be an important accomplishment in the context of Washington's efforts to devise a coherent strategy toward great power competition in Eurasia.