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## Sequential reform strategy: The case of Azerbaijan

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2000 • No. 8

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**Juhani Laurila - Rupinder Singh**

Sequential Reform Strategy:  
The Case of Azerbaijan

Bank of Finland  
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# Contents

Abstract .....	5
List of Abbreviations .....	6
1 Introduction .....	7
2 Strategic Sequencing of Reforms .....	11
2.1 The Framework .....	11
2.2 Initial conditions .....	16
2.3 Macroeconomic Reforms .....	19
2.4 Good Public Governance .....	22
2.5 Emergence of the Corporate Sector .....	28
2.6 Democracy .....	33
3 The Case of Azerbaijan .....	36
3.1 Government Commitment .....	36
3.2 Banking and Financial Markets .....	42
3.3 Commercialisation .....	46
3.4 Corporate Privatisation .....	48
3.5 Land Privatisation .....	52
3.6 Implications of “Good Economic Growth” .....	54
3.7 The Role of Technical Assistance .....	57
4 Conclusions .....	58
4.1 The Testimony from the Literature .....	58
4.2 Priorities in the Case of Azerbaijan .....	59
References .....	62
Other References .....	72
Notes .....	74

All opinions expressed are those of the authors and do not necessarily reflect the views of the Bank of Finland.

Juhani Laurila - Rupinder Singh<sup>1</sup>

## Sequential reform strategy: The case of Azerbaijan

### Abstract

The aim is to review transition literature for evidence that supports sequential reform strategy, as presented in this report. The second part discusses the findings in the context of Azerbaijan, a formerly socialist transition economy with interesting initial conditions. Evidence of the country's current need to focus on improving public services fits well with the sequential reform view.

The authors argue that constraints captured by initial conditions (human resources, administrative capacities, traditions, etc.) necessitate sequencing of reforms and outline general aspects of a sequential reform strategy designed to expedite the transition process. The literature survey supports the Washington Consensus recommendations for starting transition with macroeconomic reforms, but over time initial conditions inevitably constrain and necessitate sequencing. In other words, reform efforts initially need to be directed across the widest possible front, but later in transition the emphasis of reform efforts needs to shift from one area to another. In the later stages, emphasis needs to be laid on improvement of public sector governance to support and promote macroeconomic reforms and formation of a healthy corporate sector. Democratic institutions arise with economic growth generated by the corporate sector.

**Key words:** transition economics, sequencing, governance, macroeconomic reforms, structural reforms, private sector, democracy, and Azerbaijan

**JEL Classification Numbers:** F35, K4, N, P2, P3



## List of Abbreviations

AIOC	Azerbaijan International Operating Company
AZM	Azerbaijani manat
BICEX	Baku Inter-bank Foreign Exchange market
CEE	Central and East European countries
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
GDP	gross domestic product
IDP	internally displaced person
IMF	International Monetary Fund
KGB	Komiteta Gosudarstvennoi Besopastnosti (state security committee)
LDC	Less Developed Country
NASD	National Association of Securities Dealers
NBA	National Bank of Azerbaijan
NGO	Non-Governmental Organisation
NIS	New Independent States
OECD	Organisation for Economic Co-operation and Development
OICEX	Organised Inter-bank Foreign Exchange market
SME	Small and Medium sized Enterprises
SOCAR	State Oil Company of Azerbaijan Republic
SPC	State Property Committee (of Azerbaijan)
Tacis	Technical Assistance for the Commonwealth of Independent States
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USD	United States dollar

# 1 Introduction

Our premise is that “macroeconomic,” “structural,” “institutional” or “microeconomic” reforms can be framed in the context of a “sequential reform strategy.” We review the literature, noting that the reform process can be seen a sequence of measures that focus first on macroeconomic reforms, next on reforms of public governance, then on development of the corporate sector and finally on promotion of democratic institutions. The initial phase of “Big Bang” approaches offer an initial window of opportunity, providing a prudent urgency for reforms to be implemented initially across a wide front at full force. Nevertheless, transition will eventually pass through phases, roughly in the sequence outlined above. An awareness of this sequence therefore may assist the policymaker in exploiting complementarities of reforms (or keeping the window of opportunity open as long as possible). A review of the literature also notes the impact of initial conditions on transition. The case of Azerbaijan illustrates quite convincingly the country-specific nature of both speed of reforms and the details of sequential reform.

Despite the enormous amount of empirical data compiled and analysed in the name of transition studies, one gets the feeling we transition researchers often lose sight of the woods for the trees. Published articles and papers at international conferences cover virtually every imaginable aspect of transition policy: eradication of corruption, introduction of law and order, protecting property rights, lowering unemployment, improving social safety nets, enforcing democracy and human rights, reforming the financial sector and banking, rebuilding infrastructure, improving education, increasing human capital and social capital (i.e. building institutions and developing inter-institutional cooperation) and attracting foreign direct investment. But rarely do these issues get placed in a larger context.

The question, in our view, is whether it is possible to account for the interdependencies and causalities between the above-mentioned elements of the reform process so as to stagger their implementation in a way that expedites the transition process, creates synergies and avoids backlashes. We call this process of deliberately moving the emphasis of reforms from one area to another “sequencing.” The ongoing programming or planning of evolving reform priorities is thus the pursuit of a “sequential reform strategy.”

The theoretical discussion herein refers mainly to the transitions of former

socialist planned economies.<sup>2</sup> It was typical in older LDCs that a partly developed market existed at the outset of transition. By contrast, the socialist economies - hostile to capitalism in many respects - began their transitions to capitalist market economies essentially from scratch. Thus, an awareness of sequencing reforms in the case of socialist planned economies may be useful in keeping attention focused on establishing an adequate microeconomic base and setting the pace of macroeconomic reforms to keep them in step with the emergence of an adequate legal and institutional microeconomic base.

The proponents of gradualism advocate sequencing macroeconomic reforms to adjust *pari passu* with development of supporting commercial, economic and social structures. Gradualists say that the rapid implementation of wide ranging macroeconomic and structural reforms (“Big Bang” or “Shock Therapy”) in the absence of an adequate institutional framework, rule of law and ownership rights, has the potential to inflict considerable social misery without bringing about sustainable growth. Big Bangers naturally argue just the opposite; i.e. maximum initial speed and force of reforms minimises the social costs of reforms, provides the basis for sustained growth, and gives greatest support to institutional and structural reforms (e.g. Dewatripont and Roland 1995).

Clement and Murrell (1999) point out that most early discussion among Big Bang proponents (e.g. Lipton and Sachs (1990), Fisher and Gelb (1991) and Blanchard, Droot and Sachs (1994)) emphasised the rapid destruction of the old system. They downplayed the importance of allowing time for complementary institutions to be built up. Gradualists Balcerowich (1993), Levy (1993), and Winiecky (1993) also wrote at a fairly early stage about the need for adequate organisational capacities, wherein political flexibility was combined with organisational capability in determining the success of trade and investment reform programs. They remark that politicians must both sell the idea of transition as well as implement organisational reforms to liberalise, stabilise and privatise the economy. Kornai (1992) observed the importance of using both sticks and carrots in introducing the rule of law and bringing the grey sector of the economy within the scope of the law.

The joint study of the IMF, World Bank, OECD and EBRD, “A Study of the Soviet Economy I-III” (1991) deserves special mention. The study, which was submitted to the participants in the Houston Summit in December 1990, well envisages the needs for fundamental institutional and structural reforms in socialist states. Starting with a detailed analysis of the Soviet economy, it

advocates urgent macroeconomic reforms based on private ownership complemented with structural, institutional and legal reforms. It incorporates many of elements considered necessary by present-day reformers.

Rapidly implemented macroeconomic reforms and sequencing were seen as mutually exclusive in early discussions. The theoretical debate over the merits of the Big Bang versus gradualist sequencing likely emerged from insecurity over the policies appropriate in the unprecedented and unique situation of socialist command economies seeking to introduce market economies. Because policy advisors realised institutional reforms take time, they tended to recommend proceeding with full speed and force at the beginning when the reform consensus was strongest (Balcerowicz, 1993 and 1994) and while the emerging market economies still enjoyed a “window of opportunity.” As a consequence, there emerged a widespread attitude that problems of sequencing could be put on the agenda later. Since researchers at the EBRD, World Bank, IFF and elsewhere have had time to review the evidence (e.g. Fisher and Sahay, 2000), it appears that certain reforms might have been expedited by taking advantage of available synergies and complementarities. In fact, new models of “second generation reforms” consider the sustainability of first generation reforms. These models certainly warrant discussion (see e.g. Singh 2000a and Singh 2000b, forthcoming), but here we restrict our focus to whether the literature acknowledges the necessities of sequencing the elements of “second generation reforms” to speed transition and minimise its economic and social costs. In the second part of this paper, we discuss the priorities of the transitional development of Azerbaijan in light of priorities derived from the literature survey.

The concept of “initial conditions” is explained and discussed in section 2.2. We find support for the view that initial conditions are crucial in determining the transition process, and specifically that they determine how reforms should be implemented. Reform measures, after all, nominally seek to transform initial conditions to promote development of market conditions. Initial conditions here are taken broadly to include factors such as location, religion, history and tradition, political situation, etc. - literally anything that may somehow determine the starting point or affect the process of transition.

The reasons for sequencing and the design of a sequential reform strategy are addressed in section 2.1. The authors of the Washington Consensus (see Box 1 and Williamson 1994) were fairly astute in designating at an early stage the actions and measures to be taken in an economic transition. The

Consensus specifies the elements of a macroeconomic reform (liberalisation, stabilisation and fiscal austerity), and explains the importance of bringing down inflation and establishing economic growth. In addition, it contains a number of recommendations for microeconomic (privatisation, promoting FDI) and structural/administrative reforms (property rights, replacement of quantitative restrictions, etc.). These same elements have been addressed and analysed in EBRD Transition Reports (1997), (1998) and (1999), as well as the World Bank's Development Report (1996) and "Transition" (1999). Although these reports map initial conditions and assess their impact on transition, they make no explicit recommendations about priorities or forms of sequencing.

### **Box 1**

#### **Summary of Washington Consensus Recommendations**

1. Fiscal Discipline: limits to budgetary deficits
2. Public Expenditure Priorities: redirect expenditure toward building human capital and infrastructure
3. Tax Reform: broaden tax base and cut marginal tax rates
4. Financial Liberalisation: abolish interest rate controls
5. Exchange Rates: introduce unified and competitive exchange rates
6. Trade Liberalisation: replace quantitative restrictions by tariffs and the reduce the tariffs
7. Foreign Direct Investments: encourage and apply national treatment
8. Privatisation: privatise state enterprises
9. Deregulation: regulate only safety, environment and financial sector (prudential supervision)
10. Property Rights: introduce secure enforcement at low cost

*Source: adapted from Williamson 1994: pp. 26-28.*

We follow the reasons for first launching macroeconomic reforms in section 2.3 with a listing of measures for improving the quality of public administration (section 2.4). Next we discuss the shift to private sector development (section 2.5) and finally development of a civil democracy with protected political freedoms (section 2.6). Our discussion also considers the fact that sequential order is "relative" only in the sense only that the stance of reform efforts in relation to the other ongoing reforms shift from one category of

reform measures to another. Order is soft in the sense that the causalities are often recursive ones (“bad institutions create poverty, but poverty creates bad institutions”). Causalities are often difficult to identify and sometimes outside the scope of economics (geography, demography, cultural or political factors; see e.g. Mauro 1995).

We substantiate our case with evidence from Azerbaijan (section 3), examining the dependencies among various reforms. The “grand stages of transition” are set out in Chart 1. Azerbaijan presents a particularly valuable array of initial conditions as they shed light on many areas of our discussion.

Both our review of the literature and the evidence from Azerbaijan argue for continued focus on macroeconomic stabilisation and directing massive amounts of technical assistance towards improving the quality of public administration.<sup>3</sup> This view coincides with the conclusions of Johnson, Kaufmann and Shlaifer (1997). Moreover, in Azerbaijan’s case, the facts argue for substantially increasing technical assistance aimed at improving the efficiency of public administration and continuing assistance for macroeconomic stabilisation. This would include advisory support in streamlining bureaucratic structures, development of legislation, improvement of the law enforcement and public order. Naturally, international agencies may want to put conditions on granting new financing to overcome structural and political obstacles, but basically initiatives to reform public governance should originate from the receiver government.

## 2 Strategic Sequencing of Reforms

### 2.1 The Framework

Transition is historically unique, and despite the large amount of data available to compare this process in various countries, differing initial conditions distort the comparability. The dependencies among reforms are recursive. Positive or negative feedback from specific reform measures may affect the implementation of other reforms. The challenge to policymakers is to determine a critical path based on specific combinations of reforms in their country that, at any given moment, will produce the greatest social welfare based on a market economy and democratic freedom.

Neo-classical economics argues that the optimal approach to transition is to launch as many reforms as soon as possible to gain the critical mass necessary for political credibility of reforms and maintain momentum. On the other hand, given the constraints in time and resources and the friction in implementing economic and social changes, it is clear that little can be accomplished overnight. Sturzenegger and Tommasi (1998) conclude that the aggregate uncertainty about the outcome may make a gradualist approach less costly in the long run than a Big Bang strategy. China is an excellent example here. The gradual approach also allows for a slow crumbling away of the opposition.

The complementarity of reforms has particular relevance in post-Soviet economies (except the Baltics), because the initial conditions were poor and often involved political and social strife. The sequencing of reform efforts with varying emphasis is depicted in Chart 1. Enhanced efforts in various areas of reform are illustrated with additional space and by reducing the space shown for other areas of reform. Areas of reform receive heightened emphasis in the following order:

- \* macroeconomic reforms,
- \* improvement of the quality of public administration governance,
- \* support for private sector emergence, and
- \* promotion of democracy and civil society.

For reform initiatives to reflect the change of mind, attitude, training and behaviour of citizens, they must originate from the inside or from the grass-roots level. Citizens, after all, make civil society. Moreover, rent-seeking citizens, entrepreneurs, businessmen, industrialists, bankers, etc. create the private sector, not government officials. The government can seek to improve initial conditions and promote formal measures (privatisation), as well as allocate budget resources, pass legislation and enforce laws that support an efficient and fair private sector. But if individuals with entrepreneurial initiative and know-how are lacking, not much of a private sector will emerge.

Thus, inside initiatives get results only if

- \* politicians and policymakers are committed to implement and support reforms,
- \* public government employees are motivated to transform themselves

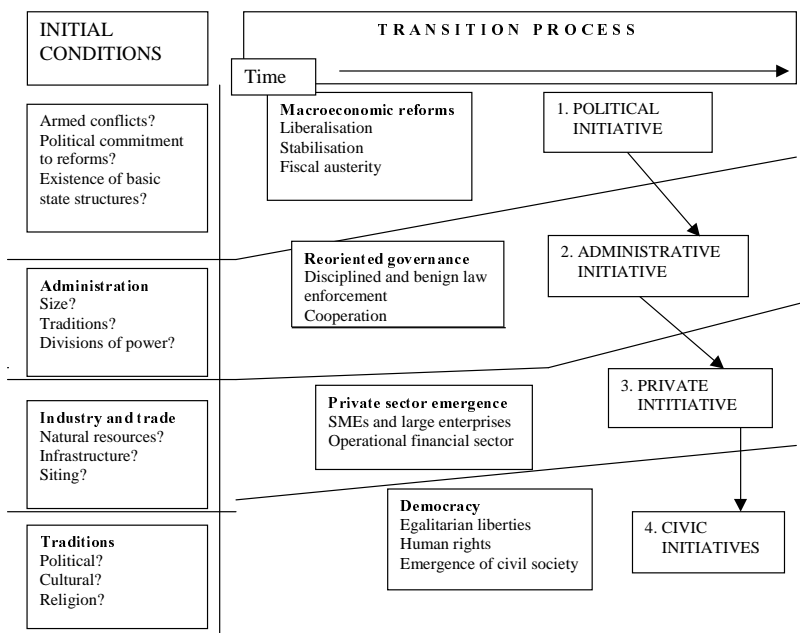
- from acting as administrators to civil servants,
- \* profit seeking risk-takers are allowed to introduce entrepreneurial spark and dynamism, and
- \* socially and politically active citizens get their ideas heard and implemented through democratic process (e.g. labour unions and political parties).

Unfortunately, the continuous, time-consuming process of developing human capital does not lend itself to sequencing. In modelling the Russian economy, Fan, Overland and Spagat (1999) found that Russia's socialist legacy education system was still geared to teaching people skills unsuited for a market economy. Thus, educational restructuring and reorientation must occur early in the transition process or transition will be inevitably delayed along with a massive idling of human capital. The intergenerational transfer of skills is also important in securing future prosperity for any society and there is a very real risk this process can be broken in a transition. Thus, making sure people have skills suited to a market economy is a crucial aspect of policy. The right human capital provides the dynamo for creating private initiatives originating from inside the economy.

Sequencing is country- and history-specific. The sequencing patterns presented in Chart 1 applies to former centrally planned economies. In other developing countries, for instance, the commercial markets often emerged first, followed by the formation of the administrative and democratic structures. In developing countries, commerce and other private sector activities often emerged first, and administration and democratic institutions developed later. However, in countries with a socialist past, the sequence of transitional development is likely to follow the pattern sketched out in Chart 1 as the initial state of affairs - a socialist regime - is common to all of them. The differences in the initial conditions and possibilities to change them explain the differences in speed and other features of transition.



Chart 1 Sequential Reform Strategy



Summing up the dependencies depicted in Chart 1, we characterise four phases of reform.

- 1. Macroeconomic reforms** launched at the start of transition, which
  - \* Seek to bar the possibility of a return of the old system, while introducing a new system conducive to the free interplay of market forces.
  - \* Open the economy to foreign competition.
  - \* Induce austerity in fiscal policy and introduce internal and external balances in monetary policy to initiate market-based GDP growth.
  - \* Can be rapidly implemented and show positive results within 5-10 years.
  - \* Derive from a more solid and universally applicable theoretical basis

of macroeconomics than theories of institutional and democratic development.

2. **Improvements in public administration** must then follow macroeconomic reform, but precede private sector emergence, because
  - \* Sound administration is necessary to sustain macroeconomic reforms.
  - \* The existence of sound administration is a precondition for emergence of a genuine corporate sector.
  - \* Increased public sector efficiency is necessary to crowd out cronyism and corruption.
  - \* The existence of sound public administration is a precondition to a civil society and introduction of sound democratic principles.
  - \* This area of reform is time-consuming and tedious, both politically and technically with respect to creating legislative and institutional infrastructure and training people.
3. **Emergence of a private corporate sector** supported by a sound domestic financial sector is possible after improvement of the public administration, but before development of a civil society and democratic institutions because
  - \* The corporate sector requires a good business climate, which is the result of credible, predictable and transparent public governance.
  - \* The public sector exists to produce public services for the private sector.
  - \* The private sector generates the income and material wealth to finance improvement and maintenance of public governance and democratic institutions.
4. **Development of a democratic civil society** is the last area for emphasis because
  - \* A material basis, produced by the private sector, must exist, i.e. material wealth must be generated before it can be redistributed (income and social policy).
  - \* A higher standard of living frees people to create and participate in a multitude of civic activities. Naturally, most civic activities need some material basis (private and/or public support and financing).
  - \* Political parties need to develop to the point where they represent

viable alternative choices on the redistribution of income and wealth and the direction and intensity of social reforms.

- \* The task is complex and determined by the results other parallel reforms.

To avoid misinterpretation we again note that the above sequence does not represent a mechanistic step-by-step action program. It is merely a listing of dependencies indicating the order in which the stance of reforms should shift.

## 2.2 Initial conditions

Numerous authors have stressed the importance of initial conditions in determining the speed and other qualities of transition. Others, e.g. Berg, Borensztein, Sahay and Zettelmeyer (1999) point to the pre-eminence of liberalisation and structural reforms over initial conditions and cross-country differences in macroeconomic performance. We argue these discrepancies arise mainly from differences in the definition of “initial conditions.”

Observations about the differences in the speed of transition, determined by the initial conditions, have led to classification of economies in transition (Fries, Raiser and Weeks in the EBRD Transition Report 1999, pp. 26-29 and Chart 2.3). China and Vietnam were the only former socialist economies that avoided the recession associated with market reforms, CEE and Baltic economies having the best records in speeding up their transition, whereas reforms in the Russian Federation and many NIS countries lag behind. The EBRD Transition Report 1999 (p. 27) applies the following sub-regional classification of the economies in transition:

- \* Central and Eastern Europe (Hungary, Poland, Czech Republic, Slovak Republic, Slovenia, Croatia),
- \* Baltic states (Estonia, Latvia, Lithuania),
- \* South-eastern Europe (Bulgaria, Romania, Moldova, Albania),
- \* Central CIS (Russia, Ukraine, Belarus),
- \* Caucasus (Georgia, Armenia, Azerbaijan), and Central Asia (Kyrgyzstan, Kazakhstan, Uzbekistan, Tajikistan, Turkmenistan).

The People’s Republics of China and Vietnam should be included, although they fall outside of the EBRD assignments. Furthermore, initial conditions

identified by the EBRD were factored into two dimensions. The first common factor related to legacies from central planning (initial level of GDP, distance to the EU, allocation of employment, period of the central planning and macroeconomic imbalances). The second common factor reflects the trade dependence of the CMEA in terms of initial private sector share in GDP, employment in agriculture and the level of urbanisation (see Fries, Raiser and Weeks, 1999, p. 28).

Non-economic factors such as culture, religion, the inherited legal system and administrative practices, size of the territory, geopolitical location, and climate, should be included in a list of initial conditions. Their effects can be negative, neutral or positive. In their study on Russia, Ryazanov and Sutyurin (1999) draw attention to a factor often omitted in economic comparative studies, namely the geographic size of the territory. A large territory can be expected to necessitate an extensive administration. However, inefficiency, cronyism and corruption often accompany large administrative bureaucracies. Inability to solve conflicting interests may weaken the quality of governance. Berglöf and Vaitilingam (1999), supported e.g. by Treisman (1996), find that Russian fiscal federalism is far from main-market preserving fiscal federalism. Shlaifer and Treisman (1999) see Russian regional governments, the central government including the president and national parliament, the central bank and politically powerful firms as disagreeing stakeholders prohibitively limiting the central reformer's room of manoeuvre.

Authors may refer to a large number of initial conditions or only a couple in their analyses. In some cases, no clear distinction is even made between policy measures and initial conditions. In Chart 1, we give an open-ended list of initial conditions. Martha de Melo, Cevdet Denizer, Alan Gelb and Stoyan Tenev (1997) point out that the inclusion of only one or two initial conditions and ignoring the others may lead to failure in capturing important dimensions of the transition process. It may well be the case that one or two of the initial conditions can be singled out as the most prominent ones, whereas the others can be more or less related ones. Sutela (1999), for instance, points out that the commitment to join Europe explains the differences in speed of transition of the CEEs and the Baltics and Russia. Behind these prominent factors, several related initial conditions such as differences in geopolitical location, cultural affinity, size of the economy and territory can be identified.

Rudiger Ahrend (1999) examines panel data on the Gross Regional Products of 77 Russian regions for the period 1990-1998, studying the impact of variables related to initial conditions, economic reforms and the politico-institutional situation on a region's economic performance. He finds that initial conditions, and more specifically, a region's natural and human resource endowments and the initial structure and competitiveness of its industries, explain a region's economic performance far better than differences in economic reform measures, political orientation of its leaders or political preferences of the populace.

Rafael La Porta, Lopez-de-Silanes, Andrei Shlaifer and Robert Vishny (1999) find empirical evidence that the legal system and administrative traditions, or absence thereof, may determine the speed and sustainability of economic and social development. In this view, centrally planned economies start their economic development from a "sub-zero" situation in comparison to developing economies. For instance, centrally planned economies had industrial sectors overdeveloped in relation to their contribution to total GDP or employment (EBRD 1999, p. 87). Some initial conditions such as rich natural endowments or geopolitical location may be positively charged. In their extensive study, La Porta et alia find empirical evidence that factors such as religion, ethno-linguistic heterogeneity and legal origins can help explain the quality of government, and hence determining the starting point for reforms in this sector.

This definition finds support in a recent book "When the Transition is Over," edited by Annette N. Brown (1999), wherein scholars including Marie Lavigne, Alan Gelb, Anders Åslund and János Kornai provide a examine the question, "When does transition end, if ever?" Lavigne (1999) maintains that the question unanswerable. She further notes that the conditions of the EU pre-accession strategy do not provide an adequate or sensible answer. Åslund (1999) argues that the transition will be over once the rent seeking and corruption has been rooted out from the economy. However, de Melo et alia (1999) note that the initial conditions may change during and due to the transition. Editor Annette Brown finds unanimity that transition is over "when the productive structure (or "initial conditions" in this study) has been transformed from its inherited organisation to a structure that continues to change only slowly with the evolution of the economy" (Brown, 1999, p. 1). Kornai and Gelb initially expect the economies in transition to create market economies similar to those in most industrialised countries, but end up with di-

verging conclusions. Kornai (1999) says that transition is already over in some countries, while Gelb (1999) finds that none of the countries in transition has completed the process.

In this study, we add the further requirement that initial conditions adequately allow democratic practices to operate in shaping the distribution and redistribution of incomes and wealth and guarantee the social sustainability of market reforms.

Brown argues that transition is over when special reform efforts are no longer necessary to convert an economy into a “normal” market economy. It follows therefore that most reform measures can be seen as efforts to transform or relax the initial conditions so that they favour the market economy. As reform efforts are expected to change initial conditions, the initial conditions indicate the level of the transitional progress that can be determined at any time in any transitional economy. Thus, the term “initial conditions” does not need to refer solely to a situation in a country at the specific time the country decides to abandon the centrally planned socialist system (1989-1991 are often cited). Once initial conditions conducive to a market economy exist with potential for full-fledged international trade and financial integration, the transition becomes normal economic development, fuelled by domestic and international competition.

## 2.3 Macroeconomic Reforms

There is wide consensus that macroeconomic reforms need to be the first step in the economic transition of planned economies. Certainly, we find no cases where a planned economy instituted institutional reforms or addressed private sector issues before liberalising and stabilising its economy.

Macroeconomic reforms have the advantage that they can be rapidly introduced. The main actors - the government, finance ministry and the central bank - already exist and in the principles of such reforms are generally accepted, which in turn facilitates cooperation with international agencies such as the IMF. Liberalisation, anti-inflation measures and financial austerity in fiscal and foreign exchange policies were typically in place in socialist countries within 2-5 years. Results such as positive GDP growth, low inflation and stable foreign exchange rates (Charts 2 and 3) have typically been realised in 5-8 years. The EBRD Transition Report 1999 finds substantial evidence that early liberalisation generally led to faster return to growth in most

transition economies. Indeed, few today would seriously question the appropriateness of the measures outlined in the Washington Consensus (see e.g. Williamson 1994, Lavigne 1999, and Havrylyshyn and van Rooden 1999).

The main principles declared in the Washington Consensus remain theoretically solid and universally applicable despite the critical remarks made by, for instance, Stiglitz (1999), regarding their application. In contrast, the theoretical base for political, institutional or microeconomic reforms and introduction of democracy is diffuse, hard to make operational and still disputed at the advent of the collapse of the Soviet system (Milenkovitch 1992, Sutela 1992). Dietz, for instance, sees reform “as a transformation from bureaucratic-centralist control system to a system based on decentralised exchange communication.” (Dietz 1992, p.36). Clearly, the Washington Consensus was a pragmatic starting point. The guidelines of the public sector reforms can be readily derived from the needs from market reforms, whereas philosophical, ideological or system theories challenge debate. Moreover, these latter-phase reforms take time and effort.

The most urgent task of reform in socialist economies was to open them up to the interplay of market forces, and introduce hard budget constraints via stabilisation. This was necessary to eradicate and replace the systems of central planning, collective ownership of the means of production and the ideological and political centralism. By running macroeconomic reforms with liberalisation first, the ties with the past are effectively cut. Vladimir Mau (1999) notes that the high-level achievements in the economic, social and cultural spheres inherited from the past and undertaken from the non-market base with a weak government and public administration may, as in Russia in the 1990s, constitute an obstacle for transition. A lack of political commitment and inadequate institutional frameworks doomed attempts to start transition by developing institutions.

On the other hand, a strong totalitarian government (China, the Soviet Union under NEP) with low-level obligations and ambitions in economic, social and cultural-educational spheres can also allow a liberal and open market developments (Mau 1999). The key here is that there are also few ties with the future. The improvement of public governance should precede the development of private sector and democratic civil society. The third conclusion is that the early availability of good governance should sustain not only macroeconomic reforms but also private sector and civil society reforms.

China’s administrative structures and traditions are very old and based

on loyalty to a central authority. Here the transition towards the modern market economy was enabled by the liberalisation of the economy and commerce through gradual macroeconomic reforms. Solnick (1998) points out that Chinese reforms clarified property rights, aimed at pragmatic solutions and preferred decisive action, which preserved the leadership's reputation for discipline. The Chinese government continues to proceed carefully, promoting a liberalised private sector while wary of accepting social obligations. In contrast, the Russian government has been nailed by former social obligations it has been unable to meet.

De Melo et alia (1997) stress that macroeconomic reform measures are not exogenous, but depend on initial conditions. Unfavourable initial conditions may discourage *ex ante* macroeconomic reforms, but do not necessarily reduce their effectiveness of liberalisation once implemented. The conclusions remain somewhat ambiguous when comparing economies of different sizes and legacies. The inclusion of the initial conditions may assist understanding differences in speed of reform and other qualities.

The "Big Bang vs. gradualism" controversy dominated discussion in the early phases of socialist transition. The Big Bang proponents asserted that all elements constitutive to the market economy should be introduced simultaneously and in a comprehensive way so as to phase out the hurdles of the old system. Partial introduction was feared to eliminate positive effects and disorganise the economy. While the Big Bang was perceived as painful ("shock therapy"), it held out greater credibility and *ex post* sustainability, than the gradualist approach (Martinelli and Tommasi, 1998). According to Keren, Big Bang is preferable because it has to "convince the economic actors about the nature of the future system...otherwise...economic agents will continue to fumble along, mal-investing any resources that are put into their hands" (Keren 1998, p. 74). According to the other camp (Portes 1990, McKinnon 1991 and Dewatripont and Roland 1992), gradualism favours political *ex ante* acceptability of reforms. It allows creating better *ex ante* political support than Big Bang approaches. *Ex post* it would take advantage of the complementarity of reforms, pushing complete reform packages through the political process.

Using equilibrium model analyses, Dehejia (1997) find that shock therapy should be the policymaker's reform strategy of choice provided it is not excessively costly. The gradualist approach is seen as a second-best solution. Less trivial is the problem setting of Castanheira and Roland (1996), who



apply a general equilibrium model to optimise the timing of reforms. They find that an excessively fast transition may lead to strong output contraction and inefficiently slow the transition process. More specifically, overly fast transition may reduce the transition because contraction of national product may reduce total savings. On the other hand, an excessively slow transition may tie up the resources left to the new enterprises, discourage investment and further reduce savings and investment.

Now, when even slow-to-reform countries are showing signs of recovery, the question facing all transition economies is how to build up and maintain the critical mass of reforms to preserve credibility and momentum. It is now widely agreed that unless good public sector governance already exists, it has to be created to warrant the sustainability of the macroeconomic reforms. Still, several authors voice a need for parallel development in all sectors. Shlaifer (1997), for instance, notes that liberalisation and government activities are distinct elements of transition, so failure to apply shock therapy is not necessarily the cause of government failure. He explains that government failures in Russia reflect an absence of credibility, social capital and civil society. In recent years, numerous economists (e.g. Sen 1999) have begun to voice the need for developing democracy along with the emergence of a market economy.

It may well be the entire “Big Bang vs. gradualism” debate is spurious. It is easy to agree, in principle, that as much as possible should be accomplished as soon as possible, as well as fear that the supporting institutional structures are inadequate to accommodate the effects of a sudden, comprehensive liberalisation. The gradualist approach, on the other hand, fails because the economic development cannot be divided into a set of indiscreet steps without any effect on each other. In hindsight, the two approaches seem to be supplementary: a Big Bang is necessary to open the doors for economic reforms, good public governance is necessary to keep the doors open for further economic growth.

## 2.4 Good Public Governance

We now deal with what constitutes good government and why the emphasis should be placed on development of good administrative governance prior to focusing on the development of the private sector and civil society.

In the early years of transition, there were expectations that the market

forces generated by macroeconomic reforms would automatically deliver a modern market economy with enlightened and democratically governed administration - a Phoenix from the ashes of socialism. Keren (1998) asserts that the Big Bang should be preferred because it necessarily triggers correctly oriented institutional and structural development.

Indeed, while institutional reforms seem to matter little during the first years of transition, it should be remembered that institution building is a long-term effort. International experience shows that adequate institutional infrastructure is important for economic growth and prosperity in the long run. The building of market-supporting institutions is a separate and crucial requirement for a successful transition (EBRD transition reports 1997 and 1999, p. 65, Johnson, Kaufmann and Shlaifer (1997), and Shlaifer (1997). More recently, scholars and economists from international organisations and universities have expressed support for this view (e.g. Vito Tanzi (1999), Kane and Starrels (1999), and Havrylyshyn and Wolf (1999)).

The terms “good government” or “good public governance” are frequently cited, but seldom deconstructed for meaning. The task of the public sector administration is to meet the demand for good quality public services on the part of enterprises and the civil sector. La Porta et alia (1998), cited here, describe comprehensively the characteristics and determinants of good government. Many of the determinants seem to derive from initial conditions. For example, religion determines the moral standards for both the ruler and the ruled. Important qualities of “good government” relate to the performance of the administration. In their study on application of bankruptcy laws, Lambert-Mogiliansky, Sonin and Zhuravskaya (1999) suggest that legislative codification does not matter when enforcement is poor or in the absence of an independent judiciary. The concept of government here covers the entire state administration necessary to put the reforms into practice and to warrant their sustainability. The EBRD Transition Report (1999) formulates well the definitions of “government” and “governance” for the purposes of analysis of transition (see Box 2).

## **Box 2**

### **EBRD Definitions of Government and Governance**

Government comprises the mechanisms, processes, and institutions, through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences.

Governance is the exercise of economic, political, and administrative authority to manage a country's affairs at all levels.

Good corporate governance is meant to provide incentives to the board of directors and management to act in the interest of the company and its shareholders.

Whether governance is "good" or "bad" depends on the degree of legitimacy, representation, accountability and efficiency with which public or corporate affairs are conducted.

*Source: Transition, December 1999, p. 6 and the EBRD Transition Report 1999, Chapter 6: "Governance in transition" pp. 115.129*

The strength of the government is considered as an essential element in transition. In his book "The Road to a Free Economy" (1990), Kornai states that only a strong government can implement the economic reform policies. Such strength must not arise from repressive authoritarian administration, but lie in the support of the people. Free elections give government a legitimate popular mandate to set the economy right using a firm hand. La Porta et alia (1998) note that the notion of a heavy government structure does not mean that the government should be smaller. Comparisons among countries show that well-performing governments are relatively large and adept at collecting taxes. Poorly performing governments, in contrast, are small and collect few taxes. Friedman, Johnson, Kaufman and Zoido-Lobaton et (1999,) suggest that bad governments are also small governments due to inefficient, corrupt tax administration that allows firms to go underground. Bad government reduces government revenues and the provision of public goods. Rich nations have better governments than poor nations; common law countries have bet-

ter governments than French civil law or socialist law countries. Political history, economic development, ethnic-linguistic and religious homogeneity also determine the quality of government. Ethnically and linguistically homogeneous countries tend to have better governments than heterogeneous ones. Predominantly Protestant countries often have better governments than predominantly Catholic or Muslim countries. They also found in their extensive empirical study that strong, good-quality government is essential for high level of welfare.

The existence of good public governance is mandatory not only for emergence of private corporate sector, but also in creation of civil society and eradicating corruption. The improvement of public governance must precede efforts to support the emergence of corporate sector and civil society. For instance, extensive cooperative, entrepreneurial and labour organisations and structures existed in the Soviet Union even in the 1980s. There were also state structures such as a parliament, a finance ministry and a central bank with state-owned special banks. As it turned out, of course, they were ill-equipped to serve new economic ideas. The reorientation of these institutions and particularly the attitudes and behaviour of the officials running them require time and training. The reorientation must necessarily be converted into self-reorientation, initiated from the inside. Thus, reform should also change the attitudes of government employees by putting the emphasis on responsibilities instead of powers. Not only institutions, the individual perceptions must be reformed as well (e.g. North 1997). The challenge is to transform the attitudes of government employees from administrators who inspect, control and regulate government subjects to civil servants that serve citizens and assist them in solving their individual problems. In their new roles government employees must discuss and create dialogues (including legal persons, i.e. managers, owners of enterprises and NGOs). The change implies that the law is understood to be instrumental in limiting and checking the use of powers and responsibilities of those in leadership or employed by the state. The laws should not be applied or enforced without concern for the legal or legitimate interests of those governed.

Fiscal policy should also be sensitive to the social and economic needs and situation of individual citizens. According to La Porta et alia, there is general agreement that a central task of governments presiding over a transition to build up conditions favourable to business. For that purpose it is necessary to create good economic institutions, particularly in the public sector,

including “limited government, a relatively benign and uncorrupted bureaucracy, a legal system that protects property rights and contracts, and modest taxation and regulation” (La Porta et alia, 1998, p. 3). Thus, a central question in improving the quality of public governance in transition economies is how to deal with corruption, cronyism, organised crime and other unsound phenomena.

Macroeconomic reforms provide the guidelines for improvement of public governance. One of the difficulties is that bad public governance is the means by which many people earn money. Administrators (customs and tax officials, police) may well have an incentive to maintain bad governance. The sheer absence of certain services prompts activities based on private initiative but often resorting to questionable methods (protection of real estate, law enforcement). Thus, bad public governance contaminates and extends also to the emerging private sector. According to Åslund (1999) and Mauro (1995), bureaucratic inefficiency and corruption are negatively associated with the investment. The macroeconomic reforms are the best prescription against corruption. Inspectors, controllers, regulators and other bureaucrats having much discretionary power and little responsibility nurture the corruption. Having all prices, domestic and foreign trade with accompanying payments and capital movements decontrolled to allow competition, and the exchange rates unified, also the chances for corruption will be minimised. Without proper market-economy incentives (i.e. profit-seeking through competition, payment discipline and hard budget constraints), efforts to minimise bribery and cronyism are pointless. Corruption (specifically, taking advantage of one’s position in the governmental hierarchy for personal benefit) is inextricably part of a transition country’s governance (Shlaifer 1997).

Improving the administrative efficiency can crowd out the corrupted administrative practices. This calls for a clear distinction between legislative, executive and judicial powers and responsibilities. The powers and responsibilities in the law enforcement should be based on transparency and sound legal, regulatory and supervisory frameworks including private ownership and contract laws with sanctions. Transparency is to be achieved through improved governance both in public and emerging private sector. The commonly accepted prescription against corruption is the improvement of administrative efficiency. The list of appropriate measures should include reduction of powers of individual officials and their possibilities for discre-

tion. One should also clarify better their responsibilities, increase transparency, create generally and commonly accepted codes of conduct, and impose the necessity to change attitudes from administrator and controller into a role of civil servant.

Frequently cited advice against corruption is to raise salaries of those employed in the public administration so that there is no incentive to accept bribes to support oneself and the family (e.g. Kuzminov, Smirnov, Shkaratan, Yakobson and Yakovlev 1999). Indeed, La Porta et alia (1998) and Triesman (1999) find evidence that in countries where bureaucrats swing considerable power, they also collect high salaries. Both findings support the notion that strict moral standards, such as those of Protestantism, provide immunity against corruption. Other vaccinations against corruption is the procedural fairness of the common law legal systems, particularly in the former British colonies, and the rationalisation of public and private roles and the spread of education associated with the economic growth. Triesman (1999) also observed that the more effective hierarchies of unitary states were robustly perceived to be less corrupt than the federal states. He questions views that corruption is a “congenital” way of life, and argues that economic growth together with democracy will, almost without regard for cultural or historical factors, crowd out corrupt practices anywhere.

Sometimes the origins of corruption and privately organised services are explained by the absence of public services. For instance, the absence of law enforcement is replaced by protection services offered by unofficial and often criminal organisations, bribes and private collection of money replace official commissions and charges. Charap and Harm (1999) go even further by arguing that, instead of fighting against corruption, one should try to refine private services and incorporate them into official administrative practices. The increase of efficiency and improvement of governance tends to crowd out unofficial and criminal practices and structures. As long as reforms are consistent with the bureaucracy’s evolution to benevolence, rent-seeking may even reinforce this virtuous process. When corruption is systemic, endogenous and a planned aspect of governing, rent payments open the door for “Robin Hood” approaches to redistribution of wealth. Later on, the polity may extract rents no more for private gain, but to improve the probability of election. This can be seen as intermediary stage toward modern democracy, which will finally internalise, legalise and sublimate all public extraction of money from subjects by transforming the into commissions,

fees, tariffs, taxes etc. Inversely, according to Charap and Harm, attempts to abruptly eliminate corruption at early stage may lead to internal nihilism or revolt, because it destabilises the predatory dictatorship or bureaucracy and may bring them out of function.

In a recent article on corruption in the Russian government, Nomokonov (2000) recommends an anticorruption strategy with three elements. First, the government's economic strategies should be geared towards the interest of average citizens. Second, public authority must be legally distributed and taken away from the external financial-industrial groups or clans to leaders and collegial agencies, elected and trusted by the people. Third, the state and its institutions must be strengthened and geared towards disciplined enforcement of laws and civilised treatment of people.

## 2.5 Emergence of the Corporate Sector

Private sector development only has a real chance after public governance reaches an adequate level. This sequencing priority has lately been translated into political urgency.<sup>4</sup> Entrepreneurial attitudes cannot be imposed or enforced from outside, but have to emerge from private initiatives. Entrepreneurs, in turn, are attracted by a favourable business climate. One of the most important factors in creating a healthy business climate is good public governance with reasonable and predictable tax and customs treatment, credibly enforced property rights, free entry and operational and clear bankruptcy procedures, access to domestic financing and well developed payment systems, political stability and economic transparency. Rice notes that to mobilise the resources in Russia "It is up to Russia to make structural reforms, particularly concerning the rule of law and the tax codes, so that investors - foreign and domestic - will provide the capital needed for economic growth" (Rice, 2000, p.58).

Perhaps the most important factor to improve the business climate and assure investors is property rights. Property rights need to be irreversible so as to become credible. They must carry the rights to sell, buy and inherit. Ownership must comprise both chattel and land, because land always lends part of its value to everything that lies on it. In the absence or weak presence of ownership rights, most price distortion will remain no matter how liberalised the economy. The legislative, executive and judicial preparedness to support and protect these rights must exist. The successes or failures of re-

forms (attraction of investments including shareholders rights, financial sector development with collateral values, entry, bankruptcy practices, incentive and deterrent mechanisms) can be logically derived from the status and credibility of property rights (see e.g. Troika Dialog, May 1999). The view that easy access to domestic equity and loan capital attracts domestic and foreign investments is not challenged by preliminary findings of Johnson, MacMillan and Woodruff (1999). They observe that, where credit has not been the important issue in private sector development, the insecurity over property rights has discouraged firms from investing. Retained high profits, earned due to the persistent market distortions in these economies, have been adequate to finance these investments.

The public sector is also expected to design and implement a number of policies to foster entrepreneurship, including privatisation, provision of grants and subsidies, developing development programs and business consulting (OECD 1998 B, pp. 276-285). Even so, overuse of these medicines to impose “industrial policies” should be avoided. The creation of a genuine (disciplined, competitive and law-abiding) private sector seems to depend on establishing new businesses, financed either through domestic or foreign investments as soon as credible public administration warrants stability and continuity. The preconditions for growth in the emerging private sector are competition, hard budget constraints and favourable investment climate (EBRD 1999, p. 133). Access to domestic and foreign financing and trustworthy domestic banking are preconditions for attracting serious investments and financing economic growth.

The 1998 and 1999 EBRD Transition Reports stress the importance of the private initiative, but also appeal to the public sector to create a business climate that fosters growth of small and medium sized enterprises and foreign direct investment. Lengthy lists follow with suggestions to improve public governance and create a better business climate, promote competition, enforce property rights, arrange social safety nets, improve environmental protection, etc. This view bears witness to the primacy of the government’s role in creation of a private sector based on legitimate entrepreneurship. It is widely agreed that the private sector can survive only if supported by a sound, disciplined, and benign public administration with minimal bureaucracy and implementing transparent and consistent law enforcement. According to OECD (1998B), the principal impediments to entrepreneurship in transition economies relate to macroeconomic instability, lack of transparency and continu-



ity in taxation and customs rules and their enforcement, barriers to entry and exit, lack of finance, and insufficient legislation and implementation.

Popov (1999) in his recent study on 28 transition economies finds that the institutional restructuring and level of investments do not necessarily warrant a high rate of the private sector growth. Rather the initial conditions, the marginal rate of return of capital, and the share of exports of the GDP matter. Competition benefited from liberalisation and exposure of the economy for foreign competition only if the initial conditions allow it. Hence there is dependence not only from improvement of the public governance, but also the successful implementation of macroeconomic reforms. La Porta et alia (1998) acknowledge the government's role as provider of a good business climate. If the government fails here it can ruin the results of privatisation and scare off FDI. They note that failures in large-scale privatisation or creation of a non-corrupt competitive private sector result from large, but weak and badly run, public administration. This has been seen in numerous African and former Soviet countries. In contrast, many developed countries with healthy and dynamic private sectors may also have large, but well-run, governments. A healthy and dynamic private sector improves the quality of public governance by lessening the greediness and expropriator features in the exercise of public authority.

As countries with large capital outflows such as Russia demonstrate, when the competitive services of financial sector are unavailable, financial capital moves elsewhere to find them. Those economies where the financial flows by-pass the banking system are typically stationary, because the financial sector does not fulfil its main task, which is to accumulate savings to finance investments that support GDP growth. Borish, Millard and Noël (1995) point out that, beyond the basic function of maintaining the payments system, a smoothly functioning financial sector fulfils two other fundamental tasks. First, it redistributes the financial resources from surplus to deficit sectors and from industrial growth centres to the countryside. Second, it allows investors to seek out the most profitable investments. Banks may also mend the enterprise sector as partners in enterprise restructuring.

The EBRD found in its Transition Report 1998 also notes that bank debt is the most cost-effective source of external financing for small enterprises, while securities markets provide a low-cost source of finance for larger enterprises with an established reputation and tangible, readily valued assets. It is the private corporate sector, which usually suffers most from poorly de-

defined property rights (lack of collateral) and a lack of transparency in corporate finance. Therefore reforms and disciplines for accounting and auditing also need to be introduced rapidly in this context.

There is a growing consensus that privatisation does not necessarily lead to improved corporate governance. Converting a company charter into the form of shareholders' company merely changes the face of value - a necessary, but far from adequate, measure of value. Often restructuring and further development ceases for one or more of the following reasons:

- \* The company's management and employees acquired the shares and assume a defensive attitude to maintain a status quo.
- \* The company is unsalvageable (obsolete, vast over-capacity, legacies of environmental damage or financial loss).
- \* The new owners siphon company assets into other domestic companies or abroad and force the company into bankruptcy.
- \* The most valuable state assets (often enterprises involved with natural resources) are set aside to be sold to a small group of political power elite at discount. Here the owners merely want to hold the investment a while before they sell. They have no intention of developing the company.

On the other hand, privatisation has been successful in small-scale privatisation of small operative firms, where all that the government provided was changes in formal legalisation. Sutela (1998) notes that entirely new enterprises contribute most to economic growth. He admits that successfully privatised firms often operate better than state-owned enterprises, which does not, however, exclude that many state-owned enterprises have been able to improve their competitiveness without getting privatised. Peitsch (1996) stresses that the creation of SMEs has been a key element for the economic transition process and indeed is almost synonymous with transition - especially when they emerge from the break-up of the large industrial complexes that once dominated planned economies. Moreover, SMEs are typically labour intensive, so they mobilise the labour force and give them opportunity to participate in the market economy. Storey (1996) points out that in Europe there are more workers in enterprises with less than ten employees than there are in large enterprises with 500 or more. The writers also remind us that SMEs play a central role in attracting FDI and opening up an economy to

competition.

Black, Kraakman and Tarassova (1999) conclude that privatisation of large firms is no panacea in otherwise badly governed countries. Frydman, Gray, Hessel and Rapaczynski (1999) found improvements in revenue and productivity performance of firms controlled by outsider-owners, but did not find any significant improvements in firms controlled by insiders. And this was the case in the CEE countries having relatively sound business climates! They caution, however, against generalisations. In less favourable business climates, outsiders may represent the corrupt business, but instead of seeking profits by improving their business, they prefer to drain the funds of the firm into their own pockets. In other cases, privatisation is left only with formal promulgation of the company charter. These companies are stalemated their privatised structures, becoming “zombies” from the Soviet era - beyond hope of resuscitation or paralysed by the defensive tactics of the new insider owners. Subsequently, as Black, Kraakman and Tarassova (1999) note, in Russia and most of the CIS republics the privatisation opened the doors to corruption. Privatizatsiya became prikhvatizatsiya, that is, the grabbing of state and other formally privatised property.

The importance of attracting FDI is often referred in the literature. However, the significance from the standpoint of transition remains ambiguous unless the economy has been opened for competition (macroeconomic reforms with liberalisation) and entrepreneurs can be assured of fair and predictable treatment from the authorities (good governance of public administration). This unlocks the quality trap and improves the quality and competitiveness of domestic manufacturing (Duchene, 1999 and Popov, 1999). SMEs enterprises tend to seek fast profits from the service sector and then withdraw. FDI to SMEs and large projects risk tend to get unfair treatment from the host government (e.g. Eliasson, 1998) or their business partners.

Most FDI tends to be directed towards natural resources (oil, gas and minerals), so the profits from them flow back to headquarters or, if reinvested, do not necessarily improve the welfare of the local population. In fact, FDI can exacerbate existing problems (“Dutch disease,” environmental problems and corruption). Liuhto (1998) also notes in his case study of an Estonian foreign-owned enterprise, that the company was slow in adapting know-how of Western management and marketing, and squeezed by the local business climate, which was still strongly tainted by Soviet-era approaches and thinking. Thus, contrary to common belief, FDI does not necessarily

enhance the transfer of Western business management and marketing to transition economies.

Although the external stimuli and formal arrangements (privatisation) may catalyse entrepreneurship, a private initiative based on trust and attractive opportunities and clear rules of conducting business are necessary for emergence of a genuine private sector. Many authors acknowledge the necessity of having non-state institutions watching, criticising and restraining the government. Still, these views really reflect the deficit in trust in the relations between the private sector and the government. The culmination of a sovereignty of private sector could be achieved through ongoing cooperation and dialog between the private sector and government, both parties resorting to self-regulation to minimise the need interventions from the outside. NASD of the U.S. is one of the few examples of private sector independence and self-regulation at present (The UN Survey 1999).

It is important to encourage of introduction of new technologies, commercialisation, promote division of labour, get the production chains established, get the production commercialised and monetised in order to put the market mechanism and money to work. It is also important that endogenous development be based on private initiative. Finally, we should remember that private sector emergence is only possible if there are enough individuals with appropriate capabilities and qualities ready establish and run their own firms.

## 2.6 Democracy

The sequence in the Chart 1 prompts the question: Why does the survival of a democracy with an operating civil society depend on the quality of its public sector governance? Without denying the two-way relationship, there is evidence from a number of countries indicating that a rapid economic growth does not necessarily need democracy, but the economic growth and material wealth constitute the necessary pre-conditions for democracy (e.g. Kornai, 2000). With the exception of land and natural endowments, everything traded in the economy has to be created and made available, before any wealth can be distributed or redistributed. In a market economy, therefore, the commercialised private sector exists essentially to produce and distribute material wealth. The compromises, an essential element of any democratic system, become possible only after conflicting parties feel they will be materially

better off by agreeing to a compromise.

The emergence of civil society and getting its voice heard in the government calls for creation of a party system. Moreover, the conflicting ideas related to the distribution of income and wealth need to be reflected in party platforms. The task of parties is to raise these issues so that the distribution of wealth is democratically mediated, legislated and finally enforced. In order to be politically relevant, the ideology of a party must have relevance in the distribution of income and wealth (left, centre, right or green). Naturally, other parties such as nationalistic ones are tolerated and may gain political relevance, but they not do necessarily contribute to democratic mediation of wealth distribution. In the early stages of transition, there are often factions around politically active leaders with limited goals (such as mothers' movement in Russia). Some parties may have a populist message or less-serious basis (e.g. "The Beer Drinkers' Party" in Russia's 1999 Duma elections), simply adding colour to the kaleidoscopic ideological melee of transition politics.

In his recent case study on creating the framework for a civil society in Kyrgyzstan, John Anderson (2000) identifies five emerging supportive "contexts" for the growth of a civil society, i.e. political, economic, regulatory, informational and cultural. Yet, despite the high-level commitment to create a "civil society" in Kyrgyzstan, it eventually becomes clear that Anderson's concept is not worked out or not even fully understood by Kyrgyz officials. Taking into account the initial conditions, and particularly the distance from Western traditions, Anderson notes, that achieving this goal is extremely complicated process. It also represents the highest level of fulfilment having introduced all the other "contexts" created by institutions and disciplines.

The EBRD Transition Report 1999 finds a clear positive correlation between economic reform and the consolidation of democracy after ten years of transition. It also notes a possible two-way relationship between them. On one hand, the existence of markets assists in developing a robust civil culture. It may teach the benefits of cooperation based on self-interest and is likely to create a middle class confident of its rights. A democratic system is also likely to limit the power of narrow elite groups, guarantee the legitimacy of property rights and introduce transparency into public transactions.

There are examples of economies of rapid economic growth fuelled by a fast mobilisation of their natural resources. In Nigeria and Pakistan, fast GDP growth was achieved with acknowledging the socially and regionally un-

even distribution of income and wealth, which eventually prohibited the emergence of a middle class, civil society and democracy. In Norway and the Netherlands, on the other hand, the negative effects of North Sea wealth remained temporary because these countries were sustained by well developed administrative, private sector and democratic structures.

Kuzminov et alia (1999) point out that the existence of civil society supporting the development of NGOs and turning the citizens from survivor/consumers into active developers can also contribute to the development of high quality administration. To the extent democracy assists in improving the quality of administration, it also relates to higher standards of living. Material improvements increase political support for democracy and instils the understanding that democracy is not only redistributive (zero-sum) system but that both camps, rich and poor, winners and losers, are likely to benefit from compromise. However, the road to positive economic growth is likely painful and austerity programs are inevitably unpopular. Therefore, it takes time to sell the reforms, particularly in large economies (e.g. Rodrik, 1996).

The nurturing of democracy in societies without historical experience of it is likely to be a time consuming process. The new order - and trust in civic initiatives and democratic principles - has to earn credibility in the minds of individual citizens (North, 1997). Political credibility also requires that the melee of ideas and multitude of factions (pressure groups and splinter parties), need to be reconciled down to a sufficiently limited number of socially meaningful alternatives for the voter to choose among.

Kornai (1999) defines three principles for welfare state: individual sovereignty and the right to free choice, solidarity, and commitment to democracy and transparency of public decision-making. He points out that egalitarian distribution of income and wealth would be incompatible with the right of free choices. Solidarity calls for relative or specific egalitarianism as to satisfaction of basic needs.

## 3 The Case of Azerbaijan

### 3.1 Government Commitment

The initial conditions, specific for Azerbaijan, were more dramatic than those of most former Soviet republics.<sup>5</sup> The dissolution of the Soviet system hit small Soviet republics like Azerbaijan asymmetrically, causing them to suffer more than the Russian Federation (see Chart 2). The factor analysis of the EBRD Transition Report 1999 places Azerbaijan with other Caucasus and Central Asian republics in the category of countries that suffered most from historical legacies dating back to the pre-Socialist period and distortions that emerged under central planning.

The small republics were less autarchic because their industries were dimensioned to serve the entire Soviet Union within the framework of the “socialist division of labour.” Once the state orders from Moscow dried up, only a fraction of this capacity was necessary to satisfy local demand, and even then part of the local demand switched to cheap, low quality imports. Over-industrialisation (especially in agriculture), old production machinery and huge environmental problems deepened the economic nightmare. The situation was further aggravated by the heavy losses caused by the Nagorno-Karabakh war, in which Azerbaijan was forced to cede 20% of its pre-war territory to Armenia while taking on 860,000 internally displaced persons living in subsistence conditions. Indeed, Azerbaijan is still, despite the ceasefire, in the state of war with Armenia. Meanwhile, Caspian oil and gas attracted Western and Russian interests into the region, setting off various efforts to manipulate and take advantage of local historical and ethnic disputes (see Laurila, 1999, Goltz, 1998, van der Leeuw, 1999). The promises of the Caspian oil and gas are still determined by opening the pipelines to Poti and/or Ceyhan and the actual availability of energy resources in the Azerbaijani sector of the Caspian Sea.

Last, but not least, the EBRD Transition Report 1999 ranks Azerbaijan as the most corrupt country of all transition economies, as well as the highest governmental involvement to private business, which has virtually no possibilities of influencing the state (Hellman and Schankerman). We conclude that the initial conditions have fairly strong influence to the ability and willingness to get committed and implement the economic and social reforms

leading it towards market economy. By 1999, three-quarters of the central government's budget revenues accrued from international oil consortia. Given the high rate of corruption and weakly developed financial sector, Azerbaijan impresses one as being unprepared to deal with the influx of oil money.

Given the above-described initial conditions, the reformer would intuitively try to launch as many reforms as possible as soon as possible in the widest possible front. Azerbaijan, having already by and large complied with the IMF advice in implementation of macroeconomic reforms, would be well advised to take strong measures so as to improve the quality of its public governance. But one should also feel the need to speed up the coming out of private sector, private initiative, entrepreneurship, good business climate and commercialisation and, last but not least, to promote the growth of political freedoms, civil society and democracy. President Aliyev and his cabinet should be free to make efforts to improve the efficient and quality of the services provided by his administration in order to crowd out the corruption and organised "services." The problem appears to be, however, that the power elite has been imprisoned by its own involvement in corrupt practices so as to bring about the change. Thus, the commitment is insufficient. This is the more worrisome, because there is the risk, that once the big oil money starts really flowing in (during 2005-2010), structural reforms may become more difficult to accomplish. There is also the risk that a sudden inflow of money will strengthen vested interests and further corrupt government. In other words, it might be a good idea to implement essential structural reforms before the money arrives. As money is used to reinforce existing corrupted structures, it may become harder to achieve a "social contract" and agree on sacrifices for the common good.

The improvement the quality of public services and administration could be promoted by rationalisation, streamlining governmental structures by abolishing substantial overlapping and confusion of responsibilities prevailing between ministries and other offices of the administration. The powers for deliberation of individual employees should be eradicated and associated physical controls, regulations and rationing practices should be minimised. The particularly important areas of public administration in Azerbaijan are the customs and tax administrations. The improvement of efficiency seems to be the only way. The increase of salaries of the public sector employees has to be seen as a consequence, not as a precondition of the improvement of public services. For that matter, there are insufficient funds available to raise



salaries.

Azerbaijan has every reason to continue sound macroeconomic policies, as well as follow IMF recommendations to put part of oil revenues aside to finance the future development. Diverting part of the revenues to special funds for future generations would absorb some of the shock of sudden wealth. A number of countries,<sup>6</sup> in accordance with IMF recommendations, follow this practice. Events in the future, such as low oil prices and smaller-than-anticipated oil and gas reserves may well modify views on application of funds and cause recriminations about big-budget projects. The public sector will be faced with the huge task of improving the country's collapsing infrastructure including transport networks and public utilities. Costs of reconstructing of the dilapidated transport and municipal infrastructures and environmental protection may swallow much of the revenues generated during the first 40-50 years of exploitation.

Azerbaijan is a republic with a presidential form of government. Heydar Aliyev was elected to the post of president in June 1993, following an armed insurrection by the elected president, Abulfaz Elchibey. President Aliyev was re-elected in October 1998. He and his supporters dominate the government and the multiparty 125-member Parliament chosen in 1995 elections. The president nominates the Prime Minister and the cabinet of ministers. He also oversees the activities of the National Bank of Azerbaijan. The Constitution, adopted in a 1995 referendum, prescribed the public governance as maintenance of legal state with multiparty elections based on majority and proportional election system. It also established a system of government based on a division of powers among a strong presidency, a legislature with the power to approve the budget and impeach the president, and a judiciary with limited independence.

The Constitution provides for a judiciary with limited independence; however, in practice judges do not function independently of the executive branch. The judicial system is subject to the influence of executive authorities. The President appoints Supreme and Constitutional Court judges, subject to confirmation by Parliament. The President directly appoints lower level judges with no requirement for confirmation. The judiciary is corrupt, inefficient, and subject to executive influence. Corruption continues to pervade most government organs, and it is widely believed that most persons in appointed government positions and in state employment purchase their positions.

Although president Aliyev's rise was first believed to be a Moscow-engi-

neered coup,<sup>7</sup> he has turned out to be a charismatic leader in his own right. He clearly understands oil politics and US and Western interests in Caspian oil. He publicly supports the development of principles of democracy, free market economy and the importance of attracting foreign investments. In practice, power is highly concentrated in the hands of the president and an administrative elite in Baku. Informal connections and kinship to the president matter. There is virtually no delegation of responsibilities within governmental structures. The president issues decrees, even on minor matters.

President Aliyev has assumed his own patriarchal approach to ruling the country. One is the high-profile exposure at public occasions and on the official Azeri TV Channel 1, which meticulously reports each day's meetings chaired by the president, his speeches and important visitors he has received. Occasionally, the president publicly criticises or fires poorly performing ministers or high officials, manifesting his image as a caring, but stern, father of the nation. This image of a strong leader is widely appreciated and considered a stabilising factor in both internal and external politics. Lacking an obvious successor the event of president Aliyev's death might trigger destabilisation fuelled by fight and intrigues related to oil wealth.

Maintenance of political stability to attract the foreign direct investments, comfort Caspian oil investors and strengthen the national unity and spirit get top priority in president Aliyev's politics. Consequently, there is no room for unrest or armed conflicts either internally or regionally. Voices from a part of opposition urging armed intervention to solve the Nagorno-Karabakh question are silenced even at the cost of freedoms of expression and assembly. Police suppress or forbid large-scale peaceful public demonstrations, while allowing smaller ones (of less than 50 participants) to occur. Opposition political parties, unable to mount large-scale public activities, focus on holding smaller-scale meetings and seminars throughout the country. In many cases, opposition attempts to hold meetings in the regions outside the capital initially were refused by local authorities and were allowed only after intervention by the central Government. The Government tolerated the existence of parties of political opposition, although it continued to refuse to register some. According to human rights reports, there are known to be about 30 political prisoners. Prison conditions and examination methods remain harsh, and some prisoners died as a result of these conditions (Country Reports on Human Rights Practices of Azerbaijan 1999, 2000).

The structure of government, both at the republican and local level, is

heavy, bureaucratic and inefficient. It is thoroughly corrupted - from the policeman on the street to the top officials and political leaders, and therefore not able to provide good public services, which would adequately meet the needs of entrepreneurs or ordinary citizen. The republican - or central - government consists of 19 national ministries, 18 state committees, and over 30 state organisations under the Cabinet of Ministers. The administration is organised following economic activities and sectors. Some of the most critical functions, i.e. defence and justice, are reserved solely for the republican administration. The responsibilities of many ministries and committees are ambiguous and overlapping; each strives to autocracy to reduce their dependence on other ministries and committees. In the areas of social activities (health, education, science, cultural activities), responsibilities are diffused across a large number of ministries and committees.

Rent-seeking interventions are protected by a distinct lack of transparency, which makes it possible to extract money from the most promising and lucrative areas and put it in private pockets. In contrast to the transitional developments in the Western Europe, many of the most lucrative strategic key areas (energy, raw materials, telecommunications and alike) were privatised first and then fell into corrupt hands. Interestingly, some of the most important areas for the Azerbaijani economy, including energy and transport, have no ministries.<sup>8</sup> Now it is too late to introduce disciplines and transparency or to save broad public interests to these run-away businesses in order to safeguard broad public interests and prevent the private pocketing of returns that should go to state budget. In addition, the Azerbaijani government has no clear strategies for development of energy, telecommunications, transport (nor ministries, for that matter), manufacturing and agriculture. On the other hand, at the same time, the government exerts direct controls individual commercial and industrial entities that are self-financing but lack any major public policy role.

Azerbaijan represents a clear case, where the first step has been taken and the macroeconomic reforms with liberalisation, stabilisation and fiscal austerity have been introduced with some success (inflation down, growth of GDP up, see chart 3), but where the government commitment to improve the public governance is insufficient. The EBRD ranks Azerbaijan number one on the list of most corrupt countries in the world (EBRD 1999). Should president Aliyev so decide, he could eradicate corruption, for instance, by increasing the efficiency and transparency of the public sector. Furthermore,

he would be advised to cut back the state's role where it clearly impedes than facilitates the functioning market economy. Such measures would include limiting the scope of officials to intervene arbitrarily in activity and for corruption, reduction of controls, powers and room for deliberation. This would also free the capacity to perform other roles vital to a well functioning market economy (Carlin and Fries, pp. 80-81). On the other hand, this it would undermine president Aliyev's own political power, because it would run against vested interests of influential rent-seekers around him. Postponing reforms of public governance obviously hinders the development of private sector and democracy, and results in anaemic economic growth, which will be described below. Thus, this vicious circle is a product not only of initial conditions, but also weaknesses of the ongoing structural reforms that dampen demand for the kind of laws required for a well-functioning market economy.

In Azerbaijan, as in most NIS countries, the private sector is still emerging. There is a grey economy that does not pay taxes and a public sector involved in most economic activities. The big economic challenges now are developing the private sector, commercialising and monetising the economy to bring it under the umbrella of market economy, and renewing relations between the government and the rest of society. Had reforms to this effect been implemented earlier, however, there is a real threat that governmental structures today would be too small to meet their obligations - even without the dynamic changes Azerbaijan must inevitably face.

The business community of Azerbaijan is small and weak. By tradition, private business essentially means trading and services. There are many highly educated citizens, but their skills often do not meet the requirements of market economy. Many not only have a misguided understanding of market economy rules, but may carry negative attitudes inherited from the Soviet era. Practical conduct of business depends, not on efficiency or competition, but on knowing the "right" persons. Because everyone is dependent on the government, political leaders and government officials feel free to use business to serve personal and political objectives. Personal political alliances do not necessarily promote economic efficiency, because regulatory powers are used to create rents for allies or to collect bribes.

The country's relatively high literacy rate and level of education, as well as prospects for a higher standard of living may pave road to constructive discussion and democratic decision-making based on open participation of wide circles of citizens. However, the notion of civil society is vague at best.

It is therefore unreasonable to expect that a genuine democracy, based on middle-class welfare and organised through civil society with constructive and cooperative opposition ready to compromise, could be implemented overnight. Indeed, it may take two or three generations in an enlightened, pluralistic and reform-minded environment supported by sustainable and balanced economic growth before this happens.

## 3.2 Banking and Financial Markets

The Achilles' heel of the Azerbaijan economy is its underdeveloped banking sector. Paradoxically, bank sector attempts to cope with the exceptional challenges of oil money inflow seems to pass by the banking system to grey market or foreign banks, instead of encouraging efforts to develop domestic financial markets. Currently, even the most elementary banking services, like transfer of payments, are not generally available. The broader challenges of the financial sector, like transmission of the future revenues from the oil wealth to non-oil sectors, conversion of domestic savings to finance the investments and economic growth. There are also associated needs to improve banking practices in accounting, auditing, performing loan and financial analyses etc. through training and education as well as through improving the banking supervision. The ability, or lack thereof, to supply funding from surplus to deficit sectors is closely related to regional development, employment and distribution of income and wealth. Oil, gas and related chemical industries tend to be capital intensive and therefore extension of capital to other, more labour intensive industries, would have more favourable distribution effects. Availability of banking services and credits outside of the metropolitan area is also essential for development of agriculture and activities in regional centres.

Based on the literature survey and observations about corporate sector development, we find that

- \* A sound and credible financial sector is necessary for the emergence and growth of a domestic corporate sector.
- \* The development of the corporate sector starts from the SME. To finance SME development, reforming the banking sector should be given priority over development of a securities market. The securities market is better suited to serve large enterprises.

- \* The corporate sector, so as to get access to domestic financing, must have collateral. Collateral, however, is useful only if there is a liquid and credible market for property values and for land and real estate in particular.
- \* For purposes to extend loans to firms, accounting and auditing systems have to be introduced, the corporate transparency improved and property rights more credibly defined and enforced.

The Laws for Central bank (the National Bank of Azerbaijan, the NBA) and the Banking Law form the legal basis for the Azerbaijani banking system. Bank supervision and regulation resides with the NBA. Officially, the NBA is directly accountable to parliament and relatively independent from the government. In practice, the NBA operates under the tight scrutiny of the president and his office. The NBA and Azerbaijani Government together with the IMF, World Bank, EBRD and French Credit Agricole consultants have made considerable efforts to restructure these banks and provide training to the staff.

In the banking sector, Azerbaijan has had a bill from the past to be paid. Four large state banks once dominated the banking sector. Prominvest Bank, Agroprom Bank and Savings Bank have a branch office network covering the regions, the International Bank has relatively large correspondent network abroad. These four largest banks account for over 80% of outstanding loans and household deposits, but only 30% of capital. The lending activities of Prominvestbank, which took deposits and lent them to industrial enterprises, are entirely suspended. Savings Bank (Amanatbank), which took household deposits and lent them on to the inter-bank market, and Agroprombank, which lent to agricultural enterprises, became insolvent.

Since establishment of a two-tier banking system in August 1992, a private commercial banking sector emerged with over 200 banks. At the outset, NBA policy was liberal, i.e. "to let all flowers flourish and then go in later to do the weeding." The new-born commercial banks concentrated on interest rate and foreign exchange arbitrage. Those activities made banking at the outset fairly profitable and attractive, as the experience of the Russian banking indicates (see e.g. Wagner). However, the profitability originated from taking advantage of price distortions in an imperfect emerging markets sooner than from serious banking, that is, from creating and extending credits for investment financing.

On average, commercial banks are small and the banking sector is weak. The activities of most commercial banks are confined to extension of short-term (trade) credits, foreign exchange transactions and money transfers services. Private banks' share of the total credit extended to business and private borrowers was modest (less than 40%), but increased after the four state-owned banks were privatised at the end of 1998. According to the IMF, the total assets of the banking sector amounted to 24% of GDP at the end of 1997. This would amount to average assets of USD 9.3 million per bank. Considering that state-owned banks hold about 70% of total banking sector assets, the actual average for the remaining commercial bank's assets only amounts to slightly over USD 2 million. The share of non-performing loans is about 20% of total loans. However, the private banks continue to expand their lending and attract deposit from the state-owned banks. The increase of lending is remarkable in a situation where banks have difficulties finding creditworthy lending opportunities and acceptable collateral.

The NBA then elaborated its licensing practices and gradually tightened capitalisation requirements to reduce the number of commercial banks. The minimum capital requirement was raised gradually from USD 50,000 in 1996 to USD 1,000,000 at the beginning of 1998. It also set up and organised prudential banking supervision and controls. Presently, the minimum capital requirement for new banks is 5 million US dollars. Existing commercial banks must increase their capital to USD 5 million by 2001. As a result of stricter capitalisation requirements, the number of licensed commercial banks fell from 250 registered banks in 1994 to 99 at the beginning of 1998, when the value of total authorised capital stood at USD 107 million (AZM 414 billion). At the end of June 1998, the number was 84 with authorised capital of USD 118 million (AZM 458 billion). Thus the average amount of authorised capital per a commercial bank has increased from USD 1.1 million to USD 1.4 million. There is a squeeze to raise the authorised capital. It is obvious that the total number of banks must be reduced further, because most are still grossly undercapitalised and unable to meet the minimum requirements.

The manat can be freely exchanged against major currencies. Still, the market is thin and narrow. Despite the monotonous appreciation of manat against the US dollar, confidence in the manat and the banking system is still missing. Manat deposits in banks have not increased. The share of foreign currency deposits is about 25% of manat broad money, notably less than the 60% recorded in 1996. Due to the lack of trust in the banking system, consid-

erable amounts of money are held outside the banking system. The firms also avoid paying through banks to avoid the scrutiny of tax authorities. The currency deposits have increased as a response to the decline of the differential between interest paid on currency and the manat deposits. The share of foreign currency deposits is about 25% of manat broad money, significantly less than the 60% recorded in 1996.

The NBA has introduced, in cooperation with the IMF, a number of operations aiming at further development of banking and the financial markets. The NBA gives high priority to reform of the payments system. The banking supervision regime has been improved through the introduction in 1997 of new prudential regulations backed by sanctions such as fines and loss of banking licence as well as higher reserve requirements. The NBA also introduced Western-type accounting systems to commercial banks and started comprehensive training programs for that purpose in June 1998. The EU's Tacis programs, in co-operation with UNCTAD, have included training auditors in Western accounting standards and methods. The five big audit companies are all now licensed to operate in Baku.

The Treasury (T-bill) market, launched in September 1996, is presently the only market currently operating in Azerbaijan. The NBA acts as an agent for the Ministry of Finance in the market. Azeri T-bills are par-value securities without discount coupons. They are sold in the primary markets via auctions held in the Baku interbank foreign exchange market (BICEX) and organised interbank foreign exchange markets (OICEX). The volume of monthly foreign exchange operations have been averaging about USD 26 million on BICEX and about USD 45 million on OICEX. The BICEX is open to only half of the licensed banks whereas the OICEX, started in September 1997, is open for all licensed banks. Its transaction costs are lower than those of the BICEX.

The volumes remain modest due to the Ministry of Finance's reluctance to borrow at market rates. Consequently, banks are unwilling to participate. Further, non-bank organisations are allowed to participate only through banks. The government has received revenues from oil-production sharing contracts, which have reduced the government's need for raising deficit financing. Two major banks, the International Bank of Azerbaijan and the Savings Bank (Amanat Bank) have purchased a major part of several T-bill issues. Before January 1998, foreigners were forbidden to hold these securities (OECD 1998 A). Due to the limited volume of the T-bill market, a secondary market hardly



exists. The development of other securities markets has been slow due to inadequate legislative framework for issuance and trading of securities. Even with the four largest banks privatised, the commercial bank sector will remain weak and unable to extend medium or long-term loans due to a lack of collateral. For instance, land or real estate do not qualify as collateral due to inadequate legislation, lack of enforcement and the absence of markets for liquidation of such collateral assets. The development of non-financial institutions such as pension, investment and mutual funds is in its infancy.<sup>9</sup> Although the process of establishing stock markets and security exchanges has been slow, the legislation, approved in 1997, exists. The presence of foreign banks is still quite modest (EBRD Transition Report 1998).<sup>10</sup>

### 3.3 Commercialisation

The share of private sector is presently less than half of GDP. It is lower than in neighbouring Armenia or Georgia.<sup>11</sup> On the other hand, the annual value of GDP of Azerbaijan is equivalent of a medium size central European town. However, the material production necessary to support the 7.5 million population of Azerbaijan even at a subsistence level must be larger. However, the major part of the Azerbaijani economy is commercially unorganised, non-diversified and the division of labour undeveloped. Therefore the volume of exchange remains low and the recorded exchange even lower. Here we do not refer only to “grey economy” more or less consciously trying to be not recorded but large number of workshops, farms and households outside of the Baku metropolitan area operating on barter and self-sufficiency basis outside of money economy. By commercialisation we mean developing private sector institutionalisation and creation of structures for production, marketing, distribution and establishment of value-added chains, which brings this part of the economy into monetised exchange economy.

The share of the barter trade -transactions without money transfers - according to some estimates exceeds currently 50% of the GDP of Azerbaijan. A major part of the agricultural trade remains outside of the money economy. This may be due to the low degree of commercialisation (lack of wholesale markets, marketing and distribution services), or avoidance of bank services by firms and private persons for the sake of tax evasion or fear of losing their money. Both barter and mistrust of banks reduce the banking system’s potential for credit expansion. According to recent (end-1998) estimates, about

three-quarters of exchange of goods of the total USD 1,283 million exchange of goods took place outside of registered markets during the first seven months of 1998, i.e. out of reach of the tax collectors. Of the non-registered trade, 80%, or USD 753 million, was conducted by physical persons in local bazaars. The growth of turnover of the non-registered sector continued, while growth in the registered sector fell.

The development of new commercial structures and encouragement of private initiative belong to the main objectives of structural reform. To be successful, government and political leaders need to make room for a private sector led exclusively by commercial interests. In giving up political interference and personal self-interest, they set the stage for development of commercial structures through

- \* privatisation of enterprises,
- \* privatisation of real estate and land,
- \* establishment of the ownership rights, contract laws and institutional set-up to enforce them,
- \* the commercialisation proper including establishment of distribution channels and production chains and contributing to monetisation of the agricultural sector, and
- \* the emergence of small- and medium-sized enterprises.

Commercialisation implies two approaches: top-down and bottom-up. In the “top down” approach the government is expected to initiate measures of items 1-3, whereas the latter measures of measures 4-5 are and should be initiated by entrepreneurs. Here we focus on privatisation, because it depends on government initiative. Privatisation relates to reorientation of government so as to reduce its controls and interventions and let the private sector expand and become independent on a profit basis.

The above complex of structural reform measures need not emphasise development of any specific economic sector. All economic sectors should be provided with equal possibilities to compete and develop. Demands for giving precedence to a certain economic sectors (e.g. serious investments in industrial production) or certain activities such as foreign direct investment, has usually led to government intervention in the form of privileges (tax breaks or subsidies). Such privileges or subsidies must eventually be withdrawn; otherwise, they only hide or postpone problems and distort competi-

tion.

Monetisation can be seen as an outcome of commercialisation. The market economy recorded in GDP statistics leaves out a significant part of the Azeri economy. It is estimated that money transactions not recorded due to the tax evasion or ignorance consist of about half of all money settlements. Further, barter for goods and services are widely applied in the countryside and by the poorest layers of the urban population. In order to monetise the economy, therefore, further commercialisation of the economy is needed. Creation of wholesale echelon in agriculture and other sectors is necessary to establish the chain from the beginning of production process up to sale of the product, i.e. when all members of the chain have been paid for their value-added contribution. Beyond production, cost monitoring, financing, marketing, distribution and sales supported by adequate financial services also have to be created. Any tax reform needs to be based on modern accounting and auditing regimes applied consistently throughout the private and public sectors.

Consider, for example, the role of commercialisation in the reorganisation of agricultural and agro-industrial markets (food processing, packaging, sales and distribution). Azerbaijan's agricultural sector lacks a system with wholesale business contracting of crops from farmers through advance payment, marketing, transport, co-ordinated distribution and selling of products, and formal financing arrangements. A wholesale echelon here would get the agricultural sector commercialised, and is crucial to devising a functional production chain (i.e. growing, harvesting, storing, transporting, further processing, packaging, distributing, marketing and selling). Presently, inadequate marketing services constitute a problem for all parts of the food chain. This adversely affects the competitiveness of the entire agricultural sector.

### 3.4 Corporate Privatisation

According to the sequencing model, the sound and efficient public governance is a precondition for creation of good climate both for market-based business and democratic practices. On the other hand, the private sector will emerge to produce the wealth, out of which decent salaries can be paid also to public sector officials and employees and to those in need, as the democratically decided. An integral part of the basic institutional reform also in Azerbaijan is the introduction of full and irreversible property rights cover-

ing fully also the ownership, right to sell, buy and inherit land and real estate. The privatisation process implies restructuring of ownership, because enterprises cannot function long without a clear set of rules of what belongs to whom (Blanchard et alia 1991, p.32). Second, commercialised markets (selling organisations, advertising facilities, monetised purchasing power) must exist for privatised firms to sell their products and acquire financing (stock markets).

The Azerbaijani evidence about privatisation of the corporate sectors supports the discussion in the literature. Unlike the privatisation of small enterprises, the privatisation of the medium and large entities have not been successful. This entitles to conclude that the most promising way to create a qualitatively sound, dynamic private sector is to start from scratch. In other words, facilitate and encourage private initiative to establish new enterprises. SMEs often have the dynamic and young-minded management and marketing staff better suited to new situations. Privatisation of small and medium sized firms, most often in the services, imply on the legalisation of the existing situation: the corporate governance and sound commercial rent seeking is in place. Their needs for external financing is usually modest and liquid collateral for small loans, such as cars, houses etc. are available. However, even these firms would still need technical assistance and training in establishing modern accounting systems, in assessing profitability and financial feasibility, management and marketing. Some international organisations have been active in this field. The EU's Tacis program has assisted in establishing local "business support centres" for this purpose. The presence of foreign investors and businessmen also support these developments.

A successful privatisation of enterprises and land seem to depend of the fulfilment of other reforms, yet this has not expedited or supported reforms taking place in other areas. On the contrary, privatisation has made the situation worse by increasing voluntarism and corruption. Unlike developments in Western economies, privatisation in Azerbaijan usually started from strategic sectors opening the doors to robbery of national assets. The privatisation did not free these sectors and firms from Soviet legacies, including corruption and cronyism (particularly the energy sector). Also difficulties in separation of the ownership and management, which is often unavoidable in medium-size and large enterprises, caused problems and slowed the process.

Perhaps the most important reason for the slow pace of privatisation has been the government's unwillingness to make available the most valuable

enterprises for privatisation. There were no exhaustive lists of large enterprises to be privatised. The government's enhanced interest in case-by-case privatisation indicated willingness to offer some of the most attractive enterprises "under the counter" to members of Azerbaijan's financial-political elite. For instance, the oil and telecommunication industries fall under this category. Cumbersome procedures favour those knowing the "right" people and the rules of game. On the other hand, if only unattractive investments were left for the holders of vouchers, most might not be interested to use them.

Some of privatised corporations remain beyond repair. Some of them are mummified remnants burdened by environmental disasters (Sumgait chemical factory), bad debts or delivery contracts.<sup>12</sup> Many of the Soviet-era enterprises in machine building, chemical and electronics have discontinued some or all production. They lost their Russian markets and are not competitive with Western production. The privatisation of these corporations is not likely to turn them into profit seekers. Typically, they continue to exist under their respective ministries just to preserve the position and power of the managers and their counterparts in the ministry. Considering the burdens of bad loans, empty order books and environmental damage, foreign investors will hardly be interested. Given the lack of good public governance and competition, the Azerbaijani evidence demonstrates clearly that corporatisation, i.e. the introduction of a shareholding format, is a necessary first step, but by no means a sufficient guarantee of proper restructuring.

Azerbaijan adopted an Enterprise Privatisation Program for 1995-98 in September 1995. Like other former Soviet republics, it issued privatisation vouchers (tradable bearer securities). About 7.2 million of 8 million vouchers were distributed by the end of August 1996 as a booklet of four vouchers (which together were considered as a citizen's share in privatisation or "pai").

The privatisation of small enterprises took place rapidly and successfully. Under the program, small enterprises were to be sold by offering 15% to the personnel and 85% through cash auction, investment tender or bidding. As of 1 July 1998, more than 18,000 small enterprises had been sold, bringing the government over AZM 140 billion (USD 36 million). Combined with sales of shares, options and other sources, the total revenue from privatisation amounted then to AZM 234 billion. One reason for the speed of small-scale privatisation was that the problem of governance was easy to solve through managerial ownership. In other words, privatisation only le-

galised de facto ownership in most cases. The small-scale privatisation was also a qualitative success because most de facto owners of small service firms (barber shops, bakeries, etc.) behaved like profit seekers already prior to privatisation. These “self-made entrepreneurs” could certainly use additional advice in accounting, planning and organising their production and sales management and marketing. Azerbaijan has private consultants offering their services in this area. International organisations have been active in this field. The EU’s Tacis program has assisted in establishing local “business support centres” for this purpose. The presence of foreign investors and businessmen also support these developments.

The Azerbaijani privatisation legislation for medium and large enterprises requires that they must form themselves into joint-stock companies before they can be offered through voucher and cash auctions. Under the law, medium-size and large enterprises must be privatised by selling 15% to personnel, at least 50% through voucher auction, 10-20% through cash auction, and not more than 25% to specialised investment funds. The popularity of insider privatisation serves poorly the purpose of increasing competition and efficiency. Moreover, the absence of markets and market structures undermine these developments. There are a number of firms, though corporatised, where the majority of shares belong to public owners with vested interests in obtaining money from their cronies as rent for letting them keep their posts. These old apparatchiks, afraid of losing their posts, have little idea about how to run a company and improve its performance. These companies, once corporatised, will continue their zombie existence awaiting their final demise.

Subsequently, the progress of the large-scale privatisation has been slow. According the latest “State Programme for Privatisation of State Property in Azerbaijan in 1999-2000” the State Property Committee (SPC) is in charge of issuing certificates confirming property rights of small enterprises. These certificates will be tradable on secondary markets, once a market emerges. To support it this endeavour, a National Depository has been established to maintain a register of joint stock companies and their shareholders. The privatisation programme for 1999-2000 also stipulates that the Council of Ministers must propose a list of enterprises to be privatised in the coming year for presidential approval by 1 December each year. The obvious purpose of this procedure is to expedite the privatisation of medium-size and large enterprises. Beyond the around 800 medium-size firms subordinated to the

Ministry of Agriculture put up to check and cash auctions, no such list has ever been produced.

As of end-August 1998, only 10% of vouchers and 3% of options had been used. The lack of bid collection centres (seven in Azerbaijan as compared with 70 in Georgia) undoubtedly slowed the pace of redemption. Also late approval of legislation to establish voucher investment funds (the first fund “Sigma” began advertising its operations in April 1998) and a limited public information campaign for voucher auctions slowed redemption of vouchers. Due to this lack of information about the purpose of the vouchers and attractive possibilities to use them, the prospects have remained poor for rapid and successful large-scale privatisation. Out of the 32 million vouchers (four per person) that will expire in August 2001, most remain unused. Even if used, still about 50% by number and 80% per value of value of enterprises would remain in state ownership. Thus the expectations about the results of enterprise privatisation in Azerbaijan seem to have been too highly tuned.

Confusion still prevails regarding the privatisation of financial markets. The Ministry of Finance, the NBA and the State Property Committee create conflicting laws and policies due to an unclear division of responsibilities. Officials reportedly exploit the confusion by demanding licences and fees. The procedures are not transparent and actors with insider information can take advantage of the situation. Allegedly, the privatisation process has also led to less equitable distribution of assets, because the purchases of prime assets have concentrated among government officials and clan members (OECD 1998 (A), 147-148). Finally, there is no agreement, how to create the financial sector. Neither the Anglo-American approach to control of managerial behaviour through liquid capital markets, nor the German-Japanese system with large banks, pension funds and other equity stake holders appear to be applicable in Azerbaijan, where the banking system is weak and stock markets non-existent.

### 3.5 Land Privatisation

The Land Reform Law adopted in August 1986 grants full ownership of land including rights to sell, donate, inherit, and use land as collateral. Foreigners are not allowed to own land in Azerbaijan, but are allowed to lease both urban and rural land. The progress of both land reform and privatisation is slow. The land reform, executed by the State Land Committee, (is likely to

be completed in the first quarter of 1999, and about 1.5 million people will be allotted their own lots by then. old?)

The territory of Azerbaijan is 8.67 million hectares (86,700 square km), of which 51% is agricultural land. The rest is pasture, supporting livestock to produce beef, mutton and dairy products. Of the total agricultural land stock, only 22% is presently privately owned, 45% is owned by the state, and municipalities own 33%. Land privatisation was initiated in 1996 and more than 90% of the arable land (consisting of about 35% of agricultural land) has been allocated for privatisation. Over 1 million hectares of agricultural land (still less than 25%) has been distributed to about 800,000-900,000 households or about 3 million people. From January to September 1996, about 486 state farms and 285 collective farms were privatised increasing the number of small farms to about 18,000 in September 1997.

The land reform is still far from completed. Azerbaijani citizens are given rights to own, buy, sell, and inherit land. Foreigners are not permitted to own land. The State Land Committee is in process of creating a land register, but time is required to establish due procedures to establish the ownership rights, launch a credible land market and create a market-supported notion of land prices. Municipal land in urban areas is not privatised and it will subject to a separate decree. The privatisation of municipal land is important because land lends part of its price to all structures (buildings, houses, etc.). Part of their price always derives from the price of land (usually referred as "good" or "bad" location). In post-Soviet economies, one can observe "idle" property even in the centres of cities mainly manifesting the imperfect price formation based on ambiguous property rights and absence of liquid real estate markets. A liquid market is necessary to make the collateral acceptable for creditors. The right to buy, sell and inherit land and other real estate should be warranted. There is no legally binding regional planning institution to prepare blueprints about orderly use of land for the local decision-makers.

The above-mentioned reforms are politically difficult to implement. The resistance is based on the deep-rooted conviction that land, as a life-support system, is holy and indivisible. These ideas were reinforced in the Soviet Union, which criminalised any kind of "speculation," including the buying and selling of land.<sup>13</sup> Even more difficult it is to win acceptance for foreigners' right to own real estate (restrictions to this effect are still common in developed market economies!). Land with natural resources is also left outside the scope of privatisation for the time being. Procedural and legal ambi-



guities and the absence of market-determined information of land prices prohibit the use of land as collateral.

The private ownership of land and real estate would enable the banks to extend medium- and long-term credits to finance investments. Currently, the shortage of collateral that could be easily liquidated is one of the most prohibitive for bank lending and one of the main difficulties to find “viable” projects to be financed. Personal or movable property (cars) is eligible as collateral, but usually sufficient only for small short-term financing related to trading, farming, or establishing small firms. The large amounts of financing necessary to finance major investments for production require real estate for collateral. Establishment of clearly defined property rights concerning agricultural and urban land and real estate, contract laws, and sanctions for their proper enforcement, would release enormous lending potentials, increase the accountability of the banking. Access to medium- and long-term financing, in turn, would enable the banking sector to mobilise the financial resources to support the growth of the economy.

### 3.6 Implications of “Good Economic Growth”

The Azerbaijan government has satisfactorily implemented its macroeconomic stabilisation program agreed with the IMF and the World Bank based on the support of a series of structural adjustment credits and facilities. The pace of legislative and structural reforms has been slow, however, so that the degree of legal transition to a market economy has been one of the lowest among all transition economies. The mid-1997 estimate of the private sector share of Azerbaijan’s GDP was just 40% (The EBRD Transition Report 1997). According to the EBRD, the Azerbaijan economy ranks as one of the most “repressive” in terms of allowing operational freedom within its economic system. In 1998, Azerbaijan ranked 143 out of 150 countries, just above Iran, Iraq, Cuba, Tajikistan and North Korea (Caspian Investor, August 1998, p. 3). A number of foreign firms have left Azerbaijan due to harassment by tax and other authorities.

UNDP Human Development Report defines “good economic growth” indirectly and singles out several categories of “bad” economic growth based on evidence from countries with fast economic growth. Many features of bad economic growth are currently visible in Azerbaijan as a legacy of the collapse of the Soviet Union. Bad growth, for example, might be “jobless” in

the sense that the growth fails in creation of job opportunities. Predominant Azerbaijan industries (oil, chemicals, iron and steel, and large-scale agrobusiness) are capital intensive. Conversely, branches based on small- and medium-size firms tend to introduce new products and services, while food-processing industries and smaller farms such as those specialised in growing vegetables and fruits are labour intensive. Small-scale approaches avoid big capital investments in irrigation, reconstruction and modernisation of industrial complexes with necessary infrastructures. Commercialisation of these activities works against jobless growth in that an efficient wholesale level is created, along with services for marketing, distributing and selling of commodities. Commercialisation creates new jobs and brings the major part of the economy under the market economy umbrella.

The seeds for the other type of bad growth already exist in Azerbaijan. “Ruthless growth” is growth that amplifies disparities of wealth - the rich get richer and the poor get nothing. This dualism exists regionally and manifests itself as a growing gap of wealth and income between the metropolis of Baku and the rest of the country. The 850,000 internally displaced persons (IDPs), mainly farmers and their families from the occupied territory living in the camps, railway wagons and dog-holes, aggravate this situation. For political reasons, the Azerbaijani government is not willing to support the IDPs to settle down where they currently live. The very dynamic grey economy, corruption and underdeveloped social safety net also nourish ruthless growth. Then there is “voiceless growth” where the economy grows, but the vast majority of the population is denied political power to resist unequal economic and social developments. The well to do political power elite of Azerbaijan presently lacks the vision to reduce corruption and introduce disciplined economy open to the formation of a civil society with an enlightened social policy. Whether the influx of big oil money and the rise of a new business elite alters the thinking of the power elite in this respect remains to be seen.

Two other types of bad growth (“rootless” and “futureless”), mentioned by the UNDP report do not exist in Azerbaijan. In rootless growth, the national and cultural identities are deliberately outlawed by the central government or through military regimes. In the futureless growth, the present generation consumes resources needed by future generations. In both cases, the Soviet legacy has created a healthy reaction. The environmental awareness and healthy national self-esteem based on the cultural inheritance appear to

be in place and supported by the government.

Ruthless growth often results from voiceless growth when people are unable to influence the economic and social development. Specific efforts in Azerbaijan are necessary for creation of civil society, institution building and further development of legislation and implementation of laws to implement payment discipline. Introduction of many necessary reforms, such as non-corruptive management practices in the public and private sector, require much time. Such changes require changes in attitudes and possibly profound changes in society, i.e. creation of a civil society and a middle class. Development is a two-way process: development of a civil society requires initiatives, responsibility and proper institutional set-up with credible norms and rules. Creation of those norms, rules and institutional set-up requires continuous efforts from an existing civil society, which at the outset will obviously be weak. In such a situation, favourable development could be assisted through co-operation between international organisations and the more enlightened, less corrupt members of the political and commercial elite, assuming such individuals can be identified if such existed.

Azerbaijan has no middle class, i.e. people who can dutifully pay taxes and other bills while being able to support themselves and their families without accepting a bribe. The well-to-do political and commercial elite does not like to pay taxes or other duties, preferring to pay bribes or otherwise evade its obligations. The poor majority again cannot afford to pay taxes or bribes. Nevertheless, steps towards civil society will need to be taken. Someday there will be a way to organise political opinions and create rational dialogue between the governmental and local authorities and ordinary citizens. Today's political opinions are disorganised into a colourful kaleidoscope represented by over 40 splinter factions. This makes it hard for the ordinary citizen to locate his own political opinions on the ideological map. There is organised dialogue between the existing civilian organisations and public authorities or, between government and opposition. In addition, officials in the public administration do not appreciate such dialogue. Civilian initiatives outside the communist party were unheard of under the Soviet regime. In turn, most civilian organisations feel that there is no point to take up their concerns with the authorities.

### 3.7 The Role of Technical Assistance

The IMF programs have been very much at the core of Azerbaijan's international support. It helped in the successful macroeconomic stabilisation of the economy, and presently (along with the World Bank) contribute significantly to the progress of structural reforms by introducing them as preconditions of disbursements of structural adjustment credits and facilities. Given the continuation of cooperation between the Azerbaijani government and the IMF in its conduct of macroeconomic policy, maintenance of low inflation together with external and internal balance should not be a problem. The real problems are the absence of an institutional set-up required for a properly functioning market economy and the time it takes to build such a set-up.

Perhaps, in view of the shortage of time in the specific case of Azerbaijan, the hard engineering projects in energy and transports should be left more to private commercial capital. Increased efforts could be directed towards advice on soft structural reforms such as institution building and development of human resources, usually less attractive to private capital. Institution building is currently supported by technical assistance from Western governments and international organisations. There is, indeed, a social call for blueprints such as those produced by EU Tacis programs. Tacis is currently the largest donor in Azerbaijan.<sup>14</sup> The technical assistance comes in the form of designed projects within the Tacis program. The experts are chosen and paid by the European Commission. Tacis experts provide advice to the Azerbaijani government on how to develop the institutional framework and how to use the oil-money for the benefit of the whole economy. The EBRD and the World Bank have financed implementations of most projects proposed and designed in the Tacis program. Tacis itself finances training and institution building up to the point the activity becomes self-sustainable. The Business Support Centre, Energy Centre and the Banking School to be established in Baku serve as examples. Banking qualifies particularly well for subjects of international technical assistance because the techniques are universal, technical frameworks exist in the form of ready-made packages.

Institutions do not emerge automatically and spontaneously, even after the creation of favourable macroeconomic conditions. Specific efforts from outside are necessary to expedite them. Despite the efforts of international organisations and the Azerbaijani government, time seems to be running out. The improvement of the public governance needs urgently all the support in

the form of technical assistance the IMF, World Bank Group other UN organisations already active in the country, EU, governments, commercial banks, consulting firms etc can provide. Some recent tendencies to redirect part of the funds available to technical assistance to compete with commercially attractive investment projects are to be regretted to the extent that they would reduce the allocations to the technical assistance aiming at improvement of public governance.

## 4 Conclusions

### 4.1 The Testimony from the Literature

Common agreement seems to prevail that macroeconomic reforms (liberalisation, stabilisation and fiscal austerity) were the correct approach to open the road for market economy and foreign trade. The rapid liberalisation, whenever politically and institutionally possible, has given the best results. The economies in transition differ as to their progress due to a large number of factors and different initial conditions. Many of these factors and conditions go beyond economics and may relate to political situation, culture, religion, and geopolitical or even climatic factors. An increasing amount of empirical data and research is available (the EBRD Transition Reports, La Porta et alia, 1998).

While consenting in principle to the view that reform efforts need to be initiated across the widest possible front from the outset, the constraints imposed by initial conditions eventually necessitate sequencing. While promoting the reform activities parallel in all areas the stance of reform efforts should be shifted. The problem of sequencing is to determine the critical path that takes advantage of available synergies. According to the advice in the literature, improvement of public sector governance calls for a major effort and commitment from the government and public administration, which is expected to reform itself to get the results of the macroeconomic reforms rooted and sustainable. The administrators are expected to turn themselves into civil servants, improve the quality of public goods by improving the efficiency of entire public administration.

A sound and competitive corporate sector will arise only after a favour-

able business climate has been created. Moreover, there must be support and services of benign and cooperative non-corrupt public sector available. As soon as these preconditions exist, the corporate sector will come out through growing SME development and FDI. One specific factor deserves note here. Each enterprise needs a knowledgeable and motivated management, interested in development of the firm and its products. Failures in privatisation reflect often the fairly common situation that the new owners have purchased the firm only to sell it further at profit, or, alternatively, bring it to bankruptcy once they have siphoned off the assets to other firms owned by them.

It should be obvious that mere existence of parliament, ministries, free elections etc. only have a nominal value unless we can analyse how the local NGOs and pressure groups are able to create dialogue with their representatives and officials in the administrative structures. Development of civil society and democracy require stable economic growth. Economic growth, in turn, creates a party system relevant for economic reforms, that is, once there will something to be redistributed, those pressure groups with economic and social goals will be turned into meaningful parties from the view point of democratic choice. The economic growth, created by domestic competitive corporate sector in an open economy will be a source of creation of middle class, one of the pillars of democracy and producing disciplined civil servants. Fast economic growth is possible without democracy and does not need to lead to democracy. However, whether democracy necessarily always would promote economic growth, remains ambiguous in the light of the literature.

Finally, while the literature implies the necessity of sequencing, we were unable to find the sequential reform strategy outlined explicitly. However, as should be obvious from section 2, we have found a number of observations and research results about dependencies, causalities and complementarities, which well support the outlined sequencing of reforms.

## 4.2 Priorities in the Case of Azerbaijan

Azerbaijan's compliance with the IMF advised stabilisation and public sector austerity programs have already brought down the rate of inflation and resulted in several years of economic growth (Chart 3). Development of good governance is now the most urgent task. Unfortunately, having their hands tied by corruption and cronyism, the political leaders and high ranking officials cannot afford to swim upstream against their vested interest to commit

themselves to this task. Nor is the opposition in a position to do this. The inflow of oil money and further postponement only makes improvement the public governance even more difficult.

How should Azerbaijan prepared to cope with the sudden influx of oil revenues so as to create a sustainable as well as socially and regionally balanced “good” economic growth? In the context of macroeconomic reform recommendations and envisaging rapid inflow of oil revenues, the IMF paid special attention to the possibility of and overly strong manat to avoid “Dutch disease” (Rosenberg and Saavalainen, Working Paper of the IMF 98/6). The prospects for rapid inflow of oil revenues have been somewhat modified, but the country still suffers from a strong dualism between oil and non-oil sectors, which manifests itself in the form of large-scale poverty and regional differences between the metropolitan Baku area and rest of the country. Although the concern of the IMF is quite legitimate, the IMF itself admits that over-shooting is not yet on the agenda in Azerbaijan. Even here we note that the foreign exchange policy, which is part of the macroeconomic adjustment, is necessary but not adequate condition for avoidance of the adverse effects of the dual economy. Reforms of the real economy are necessary, including the commercialisation and institutional developments, particularly in the corporate and financial sectors.

The most promising way to create a qualitatively sound, dynamic private sector is to start from scratch. In other words, facilitate and encourage private initiative to establish new enterprises. Small- and medium-sized enterprises often have the dynamic and young-minded management and marketing better suited to new situations. SMEs are usually labour intensive, so they create employment and help bring the unemployed into the money economy. Privatisation of SMEs, active most often in services, only required legalisation to legitimise the existing situation. Corporate governance and sound commercial rent-seeking were already in place. However, these firms still need technical assistance and training in establishing modern accounting systems, in assessing profitability and financial feasibility, management and marketing. To facilitate and encourage entrepreneurs, the government does not need, nor should, grant any privileges or subsidies or provide special protection. The challenge is to abolish excessive red tape and the sweeping discretionary powers of authorities that lead, for instance, to an excess of costly entry permissions and licenses as well as corrupt predatory practices of tax and customs authorities.

Chart 2 Real GDP Growth in Russia and South Caucasus, 1990=1000

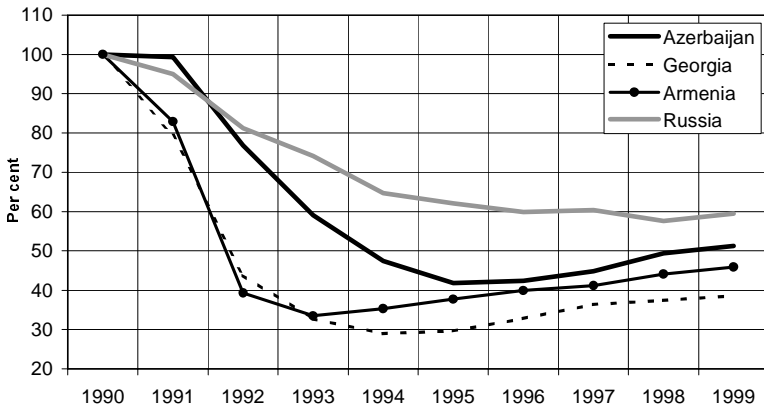
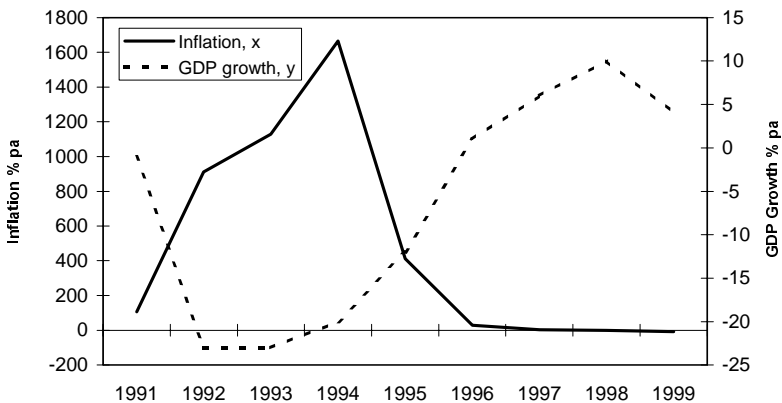


Chart 3 Inflation (CPI annual average) and Real GDP Growth in Azerbaijan, 1991-1999





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## Notes

<sup>1</sup>Juhani Laurila is a Senior Adviser at the Bofit, Rupinder Singh is a Senior Economist at the Economist Intelligence Unit.

<sup>2</sup> See a summary of approaches in Edwards 1989, pp. 8-10, also Agénor and Montiel 1999.

<sup>3</sup> The authors, particularly Juhani Laurila, have had the opportunity to follow developments in Azerbaijan at the grassroots level (see Laurila 1999, Singh and Laurila 1999).

<sup>4</sup> For instance, U.S Treasury Secretary Lawrence stated on 31 Jan. 2000 at the World Economic Forum in Davos that the Russian government had to rebuild its economy around the “rule of law, to combat corruption and revive confidence among both local and international investors.” (Dow Jones International News, 31 Jan. 2000). First Deputy Prime Minister Mikhail Kasyanov of Russia responded that Russia needs better laws and means to enforce them to lift its economy closer to the standards of the industrialised world (Reuters, 31 Jan. 2000).

<sup>5</sup> The cut off date of this section is end-March 1999. For more recent economic developments, see e.g. a recent issue of Economic Trends of Azerbaijan, published quarterly by the European Commission, DGIA, NIS/Tacis services, available from Weststraat 170 Rue de la Loi - B- 1040 Brussels.

<sup>6</sup> E.g. Kuwait, Norway (“State Petroleum Fund”), Oman, Nigeria and Venezuela.

<sup>7</sup> The 75-year-old Aliyev was formerly the KGB chief in charge of Azerbaijan. He served in the Soviet Politburo during the Brezhnev period in the early 1980s. His job was to supervise a crackdown on corruption.

<sup>8</sup> The EU’s Tacis program includes blueprints to establish these ministries.

<sup>9</sup> In 1978, the “Sigma” fund for privatisation voucher operations and the “Co-operation Fund” for extending agricultural credits (from the World Food program funds administered the under Tacis RARP-1 program) were established.

<sup>10</sup> At the end of 1997, only four foreign banks participated with more than 51%: UK (The British Bank of the Middle East), Turkey (Bay Bank, Azer Turk Bank), Iran (Melli Bank Iran) and Russia (Most Bank, Rossiyski Kredit).

<sup>11</sup> According to EBRD statistics, the private sector share in GDP was 50% in Azerbaijan and 75% in Armenia and Georgia 55% at the end of 1998 (EBRD 1999, pp. 188, 192 and, 224).

<sup>12</sup> This chemical factory producing detergents still maintains some production, although its infrastructure is totally corroded and dilapidated. The area is contaminated with chemicals and Sumgait workers have to wear gas masks.

<sup>13</sup> Paragraph 12 in the Soviet constitution legalised the purchase and sale of agricultural land. Speculation was eliminated through a number of limitations stipulating minimum terms of ownership, limiting the use of land (agricultural land could only be used for farming purposes), etc.

<sup>14</sup> At the end of 1998, the EU had provided about ECU 208 million in grants and ECU 51 million in loans to Azerbaijan. The loans are all repaid. The major part, ECU 166 million, of these grants have come through food aid. In 1998, the European Union budgeted ECU 30 million more for humanitarian aid for 1998-2000. Through Tacis programs, the EU has channelled ECU 67 million in technical assistance to implement national projects about ECU 25 million through inter-state projects to Azerbaijan. About half of these funds were used for support structural reforms.

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