Oil and Regime Stability in Azerbaijan

Farid Guliyev
Ph.D. Candidate in Political Science
Jacobs University

Abstract: The recent resource curse literature suggests that oil promotes authoritarian regime stability. Yet the causal linkages underpinning the political resource curse remain less well understood. Using a case study of Azerbaijan, this article first examines how oil revenues benefited the existing regime that has been in power for nearly 20 years. Second, it looks more closely at how the regime managed to survive the adversity of oil effects. Some support is found for three of the conventional causal links derived from existing theories of resource politics: patronage spending, repression, and economic diversification aversion. Historical-institutionalist theories are shown to be less adequate. Finally, to provide a more complete explanation for durable authoritarianism in Azerbaijan, the author proposes one additional factor: policy learning. The Azerbaijani regime's ability to navigate fiscal revenue volatility was predicated upon the decision to adopt a state fund for oil revenue management early on, before the onset of the oil boom. This policy innovation was drawn from foreign models and promoted by international financial organizations. Therefore, leaders' policy choices and their capability to draw lessons and to borrow policies from abroad may be crucial variables mediating oil's influence on regime stability in resource-reliant states, and thus deserve more scholarly attention.

In 1993, the former communist first secretary Heydar Aliyev returned to power in Azerbaijan, aborting the Perestroika-inspired process of political liberalization and ushering in a new era of post-Soviet authoritarianism.[1] Ten years later, in 2003, when oil windfalls were beginning to flood into the Azerbaijani economy, his son Ilham succeeded him as president. Nearly two decades under Aliyev rule, Azerbaijan has developed into a relatively stable autocratic political system.[2] How to account for the persistence of the authoritarian regime in Azerbaijan?[3] While answers will certainly vary depending on one's perspective, this article takes a political economy approach and focuses on the effects of oil on regime survival.[4]

A substantial literature argues that oil promotes authoritarian regime stability, which is one of its anti-democratic effects.[5] Two properties of oil rents, their size and their volatility, generate two principal ways in which oil can influence authoritarian regime survival. First, large windfall profits accruing to the state's coffers make "more things possible" enhancing the ruler's choice set.[6] With more resources at his disposal, the ruler can more easily buy off the loyalty of strategic elites and key constituencies, which appeases would-be coup plotters within the elite and keeps society acquiescent. Oil revenues can also be used to strengthen the state coercive apparatuses, chiefly internal security forces and the military, which helps to placate societal opposition. Second, as a highly volatile source of fiscal revenue, oil can induce economic and political instability, which may arise from the so-called Dutch disease phenomenon as well as from exogenous

---

[1] The author wishes to thank Cory Welt, the editors of *Demokratizatsiya*, and two anonymous reviewers for their helpful comments and suggestions.

[2] While to some analysts the resilience of authoritarianism in Azerbaijan and in the post-Soviet space in general may appear unsurprising or even pre-determined, the wave of the color revolutions that swept away governments, if not regimes, in Georgia, Ukraine and Kyrgyzstan in the early 2000s point to considerable variation in the extent of authoritarian stability among post-Soviet states.

[3] "Regime stability" or "regime durability" is understood here as "the degree to which the political system may be expected to remain in existence." See Samuel Huntington. 1991. *The Third Wave: Democratization in the Late Twentieth Century*. Norman, OK: University of Oklahoma Press, 11. Another, more demanding, approach proposes to define regime stability as the ability of a regime to meet and overcome crises. see Dan Slater and Sofia Fenner. 2011. "State Power and Staying Power: Infrastructural Mechanisms and Authoritarian Durability," *Journal of International Affairs* 65: 1, 15-29.

[4] "Oil" in this article refers to petroleum and natural gas; the terms "oil revenues" and "oil rents" are used interchangeably.

[5] See, *inter alia*, Michael L. Ross. 2001. "Does Oil Hinder Democracy?" *World Politics* 53: 3, 325-61; Jay Ulfelder. 2007. "Natural Resource Wealth and the Survival of Autocracies." *Comparative Political Studies* 40: 8, 995-1018; Silje Aslaksen. 2010. "Oil and Democracy: More Than a Cross-country Correlation?" *Journal of Peace Research* 47: 4, 421-431.

[6] David Waldner. 2003. "States, Markets, and Development: What We Know – and Do Not Know – About the Political Economy of the Modern Middle East," University of Virginia, Unpublished Ms., 8, http://tinyurl.com/cxdbvm8. (Unless specifically noted, all web-based sources were last accessed on April 5, 2012).

supply shocks.

Several studies have linked oil with regime survival in Azerbaijan. According to one analysis, the entrenchment of an authoritarian regime in Azerbaijan went hand in hand with the increase in profits from expanding oil exports, which supplied the regime with a crucial source of patronage.[7] Another study notes that concentration of oil wealth within the narrow state elite facilitated the transition of power from father to son at the high-risk juncture of 2003, when in the wake of assuming the presidency, Ilham Aliyev was facing the challenge of gaining the support of his father's winning coalition.[8] A policy memo published in 2012 concludes: "[t]he influx of oil money has helped the regime of Ilham Aliyev … to solidify his own position and strengthen and feed the system of political patronage he inherited. Ilham Aliyev further consolidated power in the presidency and steered Azerbaijan towards a full-fledged autocracy."[9] Yet, while providing valuable insights, these studies largely ignore the ways the regime leadership has managed to cope with the adverse effects of oil.

Why and how do some autocracies survive the adversity of oil effects whereas others collapse? One proposition drawing from historical institutionalist theory posits that regimes with strong state institutions and/or a robust ruling party in place before the onset of oil are better equipped to respond to the Dutch disease and volatility effects associated with oil than those regimes that have weaker state institutions and rely on shallow, patronage-based parties.[10] Another, actor-centered, line of argument focuses on a dilemma that leaders of resource-dependent states face between the economic benefits of diversification and their survival in office.[11] Leaders may wish to diversify the economy to reduce their dependence on volatile oil revenue. However, the presence of strong societal opposition at the outset means that economic diversification may empower

[7] Farid Guliyev. 2009. "Oil Wealth, Patrimonialism, and the Failure of Democracy in Azerbaijan," *Caucasus Analytical Digest*, No. 2, January 15.

[8] See Scott Radnitz. 2012. "Oil in the Family: Managing Presidential Succession in Azerbaijan," *Democratization* 19:1, 60-77. According to Bueno de Mesquita et al., the "winning coalition" is composed of those members of the elite whose support is required for maintaining the leader in power and who are rewarded with policy concessions and/or personal benefits in return for their support. See Bruce Bueno de Mesquita, A. Smith, R. Siverson and J. Morrow. 2003. *The Logic of Political Survival*. Cambridge, Mass.: MIT Press, 51.

[9] Jana Kobzova and Leila Alieva. 2012. "EU and Azerbaijan: Beyond Oil," European Council on Foreign Relations, Policy Memo 57, May, 2, at http://tinyurl.com/c4pyjdn.

[10] Benjamin Smith. 2004. "Oil Wealth and Regime Survival in the Developing World, 1960-1999," *American Journal of Political Science* 48: 2, 232-46; Benjamin Smith, 2006. "The Wrong Kind of Crisis: Why Oil Booms and Busts Rarely Lead to Authoritarian Breakdown," *Studies in Comparative International Development* 40: 4, 55-76; Benjamin Smith, 2007. *Hard Times in the Lands of Plenty: Oil Politics in Iran and Indonesia*. Ithaca, NY: Cornell University Press.

[11] Thad Dunning. 2005. "Resource Dependence, Economic Performance, and Political Stability," *Journal of Conflict Resolution* 49: 4, 451-82.

groups within society which may later challenge the regime. Prior development of non-resource sectors will also influence the incentives of political leaders as to whether to carry out or to block diversification. This dilemma relates to an even more important tradeoff confronted by political elites in resource-dependent states: choosing between economic efficiency and political survival.[12]

This article finds some support for three of the conventional causal links derived from the existing theories of resource politics: patronage spending, repression, and economic diversification aversion. In addition, it shows that historical-institutionalist explanations emphasizing the strength of pre-existing state and party structures are less adequate to explain the persistence of personalist autocracies like Azerbaijan's. Moreover, the existing explanations of oil's role in authoritarian survival seem incomplete without taking into account factors related to policymaking and the capacity of state leaders to borrow policies from abroad. In the increasingly globalized world, the diffusion of policies has become commonplace. Lesson drawing (policy transfer) is an important component in policymaking of any government. Decision-makers borrow and adopt policy solutions from foreign models. In the particular case of oil-exporting states, the creation of an oil fund as an effective fiscal stabilization and savings mechanism by almost all major oil exporters allowed governments in those countries to respond to and manage a gamut of potentially de-stabilizing effects arising from oil export dependency. As this study shows, Azerbaijan's state oil fund (SOFAZ) created in 1999-2000 was an outcome of policy learning. It notes, however, that the political interests of the ruling elite determine the actual working of the Fund because, same as everywhere else, policy-making in Azerbaijan is shaped by politics.[13] Staffed with technocrats, insulated from the rest of the deeply corrupt bureaucracy, yet subordinated vertically and exclusively to the president, SOFAZ has performed well in managing windfall revenue, smoothing out the adverse effects of oil, and enabling the chief executive to increase government spending, including on public infrastructure expenditure.

---

[12] Anar Ahmadov. 2012. "Political Determinants of Economic Diversification in Natural Resource-Rich Developing Countries," Paper presented at Oxford-Princeton Global Leaders Fellowship Program's 4th Annual Colloquium, Princeton University, May 13-15, 5-6, at http://tinyurl.com/ce49p9k.

[13] "Policies are not adopted and implemented in a vacuum. Rather, they must proceed within the context of a country's political institutions," write the authors of *The Politics of Policies: Economic and Social Progress in Latin America*. 2006. Washington, D.C., Inter-American Development Bank, 7.

Oil and Regime Stability

Large-*N* studies from the resource curse literature have found that oil has a positive influence on regime durability[14] and a negative effect on the likelihood of democratic transitions.[15] Earlier studies associated with the rentier state theory postulated the inherent fragility of petrostates.[16] Oil rents, they argued, fuel rent-seeking among public officials, eroding state institutions and undermining state capacity.[17] The stability of rentier states was linked to changes in oil prices and fiscal revenue volatility. Luciani, for example, observed: "states that do not face a fiscal crisis and enjoy continuing access to exogenous rent will be able to postpone democratization indefinitely."[18] In sum, the rentier-state literature has held that state fiscal autonomy leads to state weakness, which increases the exposure of petro-state regimes to exogenous shocks.

In recent years, however, there has been a growing recognition by scholars of natural resource politics that oil's influence on regime stability[19] and democratization[20] tends to be heterogeneous and conditional rather than uniform and deterministic. Oil's effects are viewed now as dependent on specific historical circumstances, the sequencing of relevant processes or specific political-economic factors. Conditional theories have called scholarly attention to important variations in domestic political-economic contexts[21] and elite choices within time-bound and country-specific situational constraints.[22] Smith, for example, finds that oil-based regimes tend

---

[14] For a recent statistical analysis, see Joseph Wright, Erica Frantz, and Barbara Geddes. 2012. "Oil and Autocratic Regime Survival," Unpublished ms., Pennsylvania State University, April 25, at http://tinyurl.com/c8lfhtr; also see Smith, *Hard Times in the Lands of Plenty*; Kevin Morrison. 2008. "Oil, Nontax Revenue, and Regime Stability," *International Organization* 63: 1, 107-38.

[15] Ross, "Does Oil Hinder Democracy?"; Ulfelder, "Natural Resource Wealth".

[16] See especially Terry Lynn Karl. 1997. *The Paradox of Plenty: Oil Booms and Petro-States*. Berkeley: University of California Press.

[17] See, for example, Hazem Beblawi and Giacomo Luciani, eds.,1987. *The Rentier State: Essays in the Political Economy of Arab Countries*. London: Croom Helm.

[18] Giacomo Luciani. 1994. "The Oil Rent, the Fiscal Crisis of the State and Democratization," in Ghassan Salamé, ed., *Democracy Without Democrats?: The Renewal of Politics in the Muslim World*, London, New York: I.B. Tauris, 134.

[19] Thad Dunning, "Resource Dependence"; Smith, *Hard Times*.

[20] Thad Dunning. 2008. *Crude Democracy: Natural Resource Wealth and Political Regimes*. New York: Cambridge University Press.

[21] Matthias Basedau. 2005. "Context Matters - Rethinking the Resource Curse in Sub-Saharan Africa," Global and Area Studies Working Paper No. 1, at http://ssrn.com/abstract=906983; Naazneen H. Barma, Kai Kaiser, Tuan Minh Le, and Loren Vinuela. 2012. *Rents to Riches? The Political Economy of Natural Resource-led Development*. World Bank, at https://openknowledge.worldbank.org/handle/10986/2381.

[22] Thad Dunning, "Resource Dependence"; Andreas Heinrich and Heiko Pleines, eds., 2012. *Challenges of the Caspian Resource Boom. Domestic Elites and Policy-Making*. Houndmills: Palgrave Macmillan.

to be more stable than their comparable non-oil counterparts, while arguing that whether oil will reinforce or undermine regime stability depends to a large extent on regime consolidation prior to the oil boom.[23]

Supporters of this view must explain how oil exporters overcome the problems created by oil rents. A country's reliance on oil rents exposes its economy to inflationary effects, Dutch disease and external shocks due to oil price volatility.[24] During boom periods, the influx of massive foreign exchange generates the Dutch disease effects with negative ramifications for the entire economy. The booming oil sector in this account leads to the influx of foreign exchange into the domestic economy. This causes the appreciation of the real exchange rate and stimulates inflationary pressures. Currency appreciation raises the cost of exports of products from domestic (traded) manufacturing and other industries producing the "crowding out" effect. As a consequence, export-oriented manufacturing and agricultural sectors become less competitive.[25]

Moreover, fluctuations in the world oil price make oil rents a highly volatile source of fiscal revenue for the state with serious economic repercussions. During bust periods, falling prices lead to fiscal shortage and require difficult financial adjustments to adopted public expenditure programs. In addition, all oil exporters face the challenge of transitioning to alternative, non-resource bases for economic development.[26] To summarize, the challenges faced by oil producers "stem from the fact that oil revenue is exhaustible, volatile, and uncertain, and largely originates from abroad. The exhaustibility of oil raises complex issues of sustainability and intergenerational resource allocation. The uncertainty and volatility of oil revenue complicates macroeconomic management and fiscal planning".[27]

Inflation, price hikes, Dutch disease and other effects associated with oil rents are all possible causes of economic crisis.[28] Economic crisis, in turn, is one of the main predictors of regime change, and authoritarian regimes are arguably more likely to collapse during crisis than democracies.29 Yet cross-country evidence suggests the opposite: oil is associated

---

[23] Smith, "Oil Wealth and Regime Survival"; id. "The Wrong Kind of Crisis"; id. *Hard Times*.

[24] See, for instance, the classic work by Alan Gelb and Associates. 1988. *Oil Windfalls: Blessing or Curse?* New York: Oxford University Press.

[25] W. M. Corden. 1984. "Booming Sector and Dutch Disease Economics: Survey and Consolidation," *Oxford Economic Papers* 36, 359-80.

[26] See John Mitchell and Paul Stevens. 2008. "Ending Dependence: Hard Choices for Oil-Exporting States," Chatham House, July, at http://tinyurl.com/d4ml8qs.

[27] Steven Barnett and Rolando Ossowski. 2002. "Operational Aspects of Fiscal Policy in Oil-Producing Countries," IMF Working Paper No. WP/02/177, 3, at http://tinyurl.com/cws6vqj.

[28] Smith, *Hard Times*.

[29] See Barbara Geddes. 1999. "What Do We Know About Democratization after Twenty Years?" *Annual Review of Political Science* 2, 115-44.

with a reduced risk of authoritarian breakdown.[30] Contrary to rentier state theory, the economic crises associated with the oil booms and busts in the 1970s and 1980s did not lead to regime breakdowns in the oil states. How then can we explain the observation that oil rarely lead to authoritarian collapse? As Smith put it, "the oil-exporting world is home to some of the most durable autocracies in modern history, and we lack an explanation for why that is so."[31]

One view is that, like "manna falling from heaven," oil rents can be easily used by leaders to buttress their incumbency advantages.[32] Another explanation is that oil windfall revenues make it possible for rulers to increase expenditure on patronage and security forces.[33] Increased patronage spending and stronger coercive capacity dampen societal pressures on authoritarians to liberalize. Oil revenues thus provide leaders with enough resources to appease potential intra-elite opponents. Rulers with access to oil revenue do not depend on the domestic productive economy and therefore are less restrained than their non-oil counterparts in restricting free media, transparency, civil liberties, and other public goods that enhance the ability of societal groups to coordinate.[34]

Another explanation, from a historical-institutionalist perspective, argues that oil rents can contribute to regime stability even during bad times as rulers can use oil revenues acquired during booming years to strengthen the political institutions and their support coalitions.[35] The key explanatory factor is the timing of regime consolidation relative to the onset of the respective oil boom. In this view, the robustness of regimes is determined by a set of antecedent historical conditions that shape coalitions and political institutionalization. Regimes are more robust if at the time of consolidation they have no access to windfall rents and face strong organized opposition. During the boom years, institutionally consolidated regimes reinvest oil resources in state and party institutionalization. Regimes with strong state capacity, in turn, have better chances to survive exogenous shocks.

Finally, some scholars have stressed the importance of leader incentives and choices in dealing with the volatility in state fiscal revenue. Economic diversification can reduce the exposure of oil states to exogenous shocks, and it seems rational for leaders to pursue diversification.

---

[30] Smith, *Hard Times*.

[31] Ibid, 36.

[32] Nathan Jensen and Leonard Wantchekon. 2004. "Resource Wealth and Political Regimes in Africa," *Comparative Political Studies* 37: 7, 816-81.

[33] Ross, "Does Oil Hinder Democracy?"

[34] Bruce Bueno de Mesquita and Alastair Smith. 2010. "Leader Survival, Revolutions, and the Nature of Government Finance," *American Journal of Political Science* 54: 4, 936-50.

[35] Smith, "Oil Wealth and Regime Survival"; id. *Hard Times*.

Table 1: Oil and Authoritarian Stability: Summary of Causal Mechanisms

Mechanism	Outcome	Author
Weak state (rentier state)	Fragile authoritarian regime (= Instability)	Terry L. Karl (1997)
Weak state and shallow ruling party coalition (when coinciding with oil boom)	Instability	Benjamin Smith (2007)
More patronage/public spending	Stable authoritarian regime (= Stability)	Michael L. Ross (2001)
More repression	Stability	Michael L. Ross (2001)
Strong state and ruling party coalition (if present before oil)	Stability	Benjamin Smith (2007)
Economic diversification (depending on other factors: strength of societal opposition etc.)	Stability/Change	Thad Dunning (2005)

Diversifying away from resource dependence can also improve the sustainability of economic performance, contributing positively to regime legitimacy. Yet, diversification may be dangerous as it implies that rulers have to concede economic (and potentially also political) autonomy to non-state, private elites. Therefore, if regimes are confronted with strong opposition to their rule and have no viable non-resource sectors to rely upon, there will be very little incentive for leaders to diversify the economy.[36] In fact, rulers may block diversification as a political strategy to thwart the empowerment of political opposition to their rule. As long as

[36] Dunning, "Resource Dependence."

opposition is kept weak, regimes can endure for long periods of time. In sum, while leaders may want to promote economic development as a way to maximize economic returns, they will likely avert equitable growth-promoting policies if they feel such policies may engender serious political risks. As Acemoglu and Robinson put it: "political elites will block beneficial economic and institutional change when they are afraid that these changes will destabilize the existing system and make it more likely that they will lose political power and future rents."[37]

Table 1 provides a summary of the main causal mechanisms discussed in this section.

Context

Heydar Aliyev rose to the apex of political power amidst the political turmoil of the early 1990s. Following the October 1993 election, which he won with 99 percent of the vote, Aliyev acted swiftly to take control of the state. He used a combination of force, strategic cooptation, rewards to supporting elite members, and purges within state bureaucracies to neutralize former allies, rival political factions, and, between 1993-1995, private military groups who were contesting for power. But perhaps the most serious risk to the continuity of the regime was leadership succession when in the run-up to presidential elections in October 2003 Aliyev's poor health condition could disrupt elite unity. But the problem of succession was settled by keeping power in the family. Ilham Aliyev, the son of the ailing president, was nominated as a candidate from the ruling Yeni Azerbaijan Party (YAP) and was running for the presidency together with his father until the latter pulled out of the race in favor of his son. Election monitors concluded that the 2003 vote was rigged in favor of the junior Aliyev.[38]

After assuming the presidency, the junior Aliyev appeared to be enjoying the support of elite loyalists. But he felt less secure in his position as president than his father.[39] In an effort to consolidate his power before the 2005 parliamentary elections, he dismissed the reform-oriented minister of economic development, and the minister of health, who also was one of the founding fathers of the YAP party, as well as a number of high-ranking officials. Nevertheless, the key members of his father's old guard were kept in their positions, and "much of the cabinet is [still] dominated by an old guard of ministers left over from Heydar's rule."[40]

[37] Daron Acemoglu and James A. Robinson. 2006. "Economic Backwardness in Political Perspective," *American Political Science Review* 100: 1, 115.

[38] OSCE/ODIHR Election Observation Mission Report, "Republic of Azerbaijan: Presidential Election, October 15, 2003", at http://tinyurl.com/cw3n5wf.

[39] The Economist Intelligence Unit (EIU), "Country Report: Azerbaijan," February 2004.

[40] Svante Cornell quoted in "Analysis-Despite Azeri protests, Egypt-style revolt unlikely," *Reuters*, March 24, 2011, at http://tinyurl.com/6k9ga6p.

In October 2008, Ilham Aliyev won a landslide 89 percent of the vote in the presidential elections in which the other six candidates each received somewhere between 1-3 percent of the vote. The Azadliq (Freedom) bloc of the major opposition parties boycotted the election, citing the absence of a level playing field. Several months after his re-election for a second term in 2008, a constitutional referendum lifted a two-term restriction on the presidency, most likely aimed at preventing any potential challengers from arising and running for president in future elections.[41]

What are the key elements of post-1993 Azerbaijani politics? Three such characteristics seem to be essential: 1) the personalist-clientelist nature of Aliyev's rule, 2) deficient stateness and endemic corruption, and 3) a marginalized political opposition and weak organized interests (aka civil society).

First, Azerbaijani domestic political life is shaped by competition between patronage-based factions involving loyalty, dependence and rivalry for resources within the political elite.[42] Its main traits can be summarized as a high concentration of political power in the president, the pervasiveness of neopatrimonial administrative practices, and the reliance on patronage rather than rule of law or political ideology.[43] The dynamics of elite behavior in Azerbaijan, and other post-Soviet states, is well captured by the model of "patronal presidentialism." In such a system "political authority [is exercised] primarily through selective transfers of resources rather than formalized institutional practices, idea-based politics, or generalized exchange as enforced through the established rule of law."[44] The underlying mechanism is related to the operation of patron-client networks and their interaction whereby clientelist networks compete among themselves for the spoils of public office in an inherently factionalist politics and the president is able to maintain his regime by adroitly rewarding and punishing his clients through "appointing them or removing them from lucrative official positions."[45] By encouraging

[41] EIU, "Country Report: Azerbaijan", November 2009.

[42] ICG. 2010. "Azerbaijan: Vulnerable Stability," Europe Report No. 207, September 3, at http://tinyurl.com/bmqqptz; Farid Guliyev. 2012. "Political Elites in Azerbaijan", in Andreas Heinrich and Heiko Pleines, eds., *Challenges of the Caspian Resource Boom*, 117-30.

[43] "Neopatrimonial" refers to a type of state administration in which patrimonial practices such as nepotistic appointments are built into the formally structured bureaucratic organization. See Farid Guliyev. 2011. "Personal Rule, Neopatrimonialism, and Regime Typologies: Integrating Dahlian and Weberian Approaches to Regime Studies," *Democratization* 18: 3, 575-601.

[44] Henry Hale. 2005. "Regime Cycles: Democracy, Autocracy, and Revolution in Post-Soviet Eurasia," *World Politics* 58: 1, 138. For an excellent discussion of these concepts, see Marlene Laruelle. 2012. "Discussing Neopatrimonialism and Patronal Presidentialism in the Central Asian Context," *Demokratizatsiya: The Journal of Post-Soviet Democratization* 20: 4, 301-24.

[45] Jonathan Aves, "Post-Soviet Transcaucasia," in Roy Allison, ed., *Challenges for the For-*

competition among the factions, the leader ensures that no one faction becomes powerful enough to challenge his rule.

The current regime's ruling party is a weak political institution to provide either a set of decisional constraints on, or ideological limits to, the president's powers. In practice, the YAP acts as an arm of the larger patronage network, not its central "distributive" pillar: "In 1992 Aliyev set up his own political party, New Azerbaijan, but this is essentially a mask for the patronage networks on which his regime is really based."[46] Two factors can explain why a strong political party has never emerged: the weakness of the opposition parties at the outset, and no incentives for the leader to invest in party development. As Herbst explains in the African context, which seem to apply in our case too, when the state already serves as the main conduit for distributing patronage there is little incentive for political leaders to invest in building their party's administrative capacity and mobilize support through the party.[47]

Second, Azerbaijan has a generally deficient state capacity both in terms of infrastructural power (in Mann's definition, the institutional capacity of the state to logistically implement its policies)[48] and merit-based recruitment and professionalism of its bureaucracy (the "Weberianess" scale).[49] The ability of the Azerbaijani state to design, implement and monitor policy is less than adequate. "Disorganization, weak management, and a lack of transparency" mark state administration.[50] Constant political interference has prevented the development of an autonomous professional bureaucracy as an entity separate from the regime. The regime and the state are effectively fused in Azerbaijan.

Nepotism, cronyism, administrative (petty) and political corruption are endemic. The pervasiveness and extent of these practices becomes clear from reports by investigative journalists.[51] Azerbaijan had the worst score on the state capture index constructed from firm-level survey data

---

mer Soviet South. Brookings Institution Press, Washington, D.C. for the Royal Institute of International Affairs, London, 210.

[46] Jonathan Aves. 1996. "Politics, Parties and Presidents in Transcaucasia," *Caucasian Regional Studies* 1, n.p., at http://tinyurl.com/bte72xr.

[47] Jeffrey Herbst. 1990. "The Structural Adjustment of Politics in Africa", *World Development* 18: 7, 951.

[48] Michael Mann. 1984. "The Autonomous Power of the State: Its Origins, Mechanisms and Results," *European Journal of Sociology* 25: 2, 185-213.

[49] On the distinction between these two dimensions, see Hillel Soifer and Matthias vom Hau. 2008. "Unpacking the Strength of the State: The Utility of State Infrastructural Power," *Studies in Comparative International Development* 43: 3-4, 219-30.

[50] Robin S. Bhatty. 2002. "Tough Choices: Observations on the Political Economy of Armenia, Azerbaijan, and Georgia," Mimeo prepared for the World Bank, December, 33, at http://tinyurl.com/7zkdfmr.

[51] See Khadija Ismayilova's reports: http://www.rferl.org/author/18846.html; Katherin Machalek. 2012. "Corruptistan", *Foreign Policy*, September 4, at http://tinyurl.com/9k5mdkw.

from 1999 by the economists at the World Bank.[52] On Transparency International's Corruption Perceptions Index 2011 Azerbaijan was ranked 143rd of 182 countries included in the survey.[53] Surveys show that between 2006 and 2010 the level of perceived corruption increased while more than half of respondents report having made "unofficial payments and gifts" when dealing with public authorities.[54] According to the Caucasus Barometer survey conducted by CRRC in 2010, 30 percent of Azerbaijani respondents admitted paying a bribe during the previous year.[55] A recent independent investigation described corruption in Azerbaijan as "an integral part of the governance regime:"

> Corruption is considered a significant challenge, not simply as a result of bribe taxes and administrative barriers, which are pervasive, but also through direct ownership and control of large holding companies by political leaders and their families. The deeply dysfunctional organizations of the public sector rest on vested interests, patronage-based incentive structures, and ingrained patterns of behavior that include significant rent extraction, particularly from the non-oil economy, with minimal checks and balances from Parliament, the private sector, and civil society.[56]

Third, there seems to be general consensus that Azerbaijani civil society organizations and political parties remain institutionally weak. The weakness of civil society is the result of "unfavorable" Soviet legacies and restrictive state policies in the post-independence period.[57] The political opposition consists of some 40 small parties, most of which are organized around leaders rather than programmatic party platforms.[58] The largest

[52] World Bank, "Anticorruption in Transition: A Contribution to the Policy Debate", 2000, at http://tinyurl.com/cdq4cqt.

[53] See http://cpi.transparency.org/cpi2011/results/.

[54] See *Life in Transition* survey II, conducted jointly by the European Bank for Reconstruction and Development (EBRD) and the World Bank in late 2010, at http://tinyurl.com/cwtt2un.

[55] The Caucasus Research Resource Centers (CRRC). (2010) "Caucasus Barometer", at http://www.crrc.ge/oda.

[56] Clay Wescott, Raj Desai and Antti Talvitie. 2011. "Azerbaijan-World Bank Country-Level Engagement on Governance and Anticorruption," IEG Working Paper 2011/9, Independent Evaluation Group, The World Bank Group, 6, at http://go.worldbank.org/DQ8DD2SQF0.

[57] Aytan Gahramanova. 2009. "Internal and External Factors in the Democratization of Azerbaijan," *Democratization* 16: 4, 777-803.

[58] Elizabeth Fuller. 1996. "Azerbaijan at the Crossroads," in Roy Allison, ed., *Challenges for the Former Soviet South*. Brookings Institution Press, Washington, D.C. for the Royal Institute of International Affairs, London, 117-53; ICG. 2004. "Azerbaijan: Turning Over a New Leaf?" Europe Report No. 156, April 13, at http://tinyurl.com/bvfsxqb.

Table 2: Elections to the Milli Mejlis (the Azerbaijani Legislature)

	Number of Seats			
	1st call	**2nd call**	**3rd call**	**4th call**
Party Name	**1995**	**2000 - 2001**	**2005 - 2006**	**2010**
New Azerbaijan Party (YAP)	54	75	61	71
Independent/No party affiliation	55	30	46	41
Azerbaijan Popular Front Party	4	6	1	-
Musavat Party	1	2	5	-
National Independence Party	4	2	-	-
Civic Solidarity Party (VHP)	1	3	3	3
Ana Vatan (Motherland) (AVP)	1	1	2	2
Democratic Independence Party	2	-	-	-
Azerbaijan Communist Party (AKP)	-	2	-	-
Social Prosperity/Welfare Party	-	1	1	1
Democratic Entrepreneurs Party	1	-	-	-
Social Justice Party	1	-	-	-
Yurddash (Compatriot) Party	-	1	-	-
Alliance for the sake of Azerbaijan	-	1	-	-
Whole Azerbaijan Popular Front	-	-	1	-
Justice Party	-	-	1	1
Great Creation Party	-	-	1	1
Umid (Hope)	-	-	1	1
Civic Unity Party	-	-	1	1
Azerbaijan Democratic Reform	-	-	1	1
United People's Front	-	-	-	1
National Rebirth Movement	-	-	-	1
Total	124	124	125	125

Note: There might be minor inaccuracies as sources slightly disagree. Data for 1995 and 2010 from IPU Parline database; 2000/01 data from OSCE/ODIHR Final report 2001; 2005 data from Kara 2007 (Table 1, 723)

Sources: IPU Parline database, at http://www.ipu.org/parline-e/parline-search.asp; Republic of Azerbaijan, Parliamentary Elections, 5 November 2000 & 7 January 2001, OSCE/ODIHR Final Report, 2001, at http://

www.osce.org/odihr/elections/azerbaijan/14265; Ahmet Kara. 2007. "The Parliamentary elections in Azerbaijan, November 2005 and May 2006," Electoral Studies 26: 3, 720-24.

opposition parties with some degree of stability have been two Popular Front splinter parties: the Popular Front party (APF) and Musavat. Both parties have been marginalized by government repression, especially in the aftermath of the 2003 presidential and the 2005 parliamentary elections.[59]

The weakness of the political opposition stems from both the short-sightedness of opposition party leaders and regime repression. Despite their ability to mobilize thousands for their rallies in the past, the opposition's organizational capacities have been rather limited. As Ottaway pointed out, the initial APF "had many supporters but was a weak organization."[60] Already in the mid-1990s observers held the view that the opposition was "too weak and divided to mount a serious challenge to Aliyev," and even the return of former president Elchibey to Baku in 1997 after four years of domestic exile was seen as a sign of the authorities' confidence to deal with the "enfeebled" opposition.[61] A National Democratic Institute (NDI) report described opposition parties in 1995 as "tiny organizations with limited resources and organizational strength."[62] Splits within the Popular Front most certainly contributed to that organization's weakness. But most important, it was regime suppression that produced a situation starting from 1995 that although opposition candidates were allowed to compete for political offices, their presence in the legislature has been extremely marginal. Table 2 shows legislative seat distribution in the 125-member Milli Mejlis, the Azerbaijani legislative assembly. The parliamentary election results show a strong tendency toward fluidity of parties and very limited representation of political opposition. Elections are routinely rigged in the incumbent's and the ruling party's favor.[63]

Much has been written about opposition parties and their potential

---

[59] Considering the parliamentary election results, Azerbaijan's party system can be characterized as a "dominant authoritarian party system" in which one-party dominance is maintained by non-democratic means and "alternation in power is only a theoretical possibility." See Matthijs Bogaards. 2004. "Counting Parties and Identifying Dominant Party Systems in Africa," *European Journal of Political Research* 43: 2, 178.

[60] Marina Ottaway. 2003. *Democracy Challenged: The Rise of Semi-Authoritarianism*. Washington, DC: Carnegie Endowment for International Peace, 56.

[61] Selina Williams, "Oil bonanza may force Azeri strongman to ease his grip," *Agence France-Presse*, November 23, 1997, from Factiva database: http://global.factiva.com/ (hereafter, FD).

[62] NDI, Pre-Election Report - The November 1995 Parliamentary Elections, Republic of Azerbaijan, October 31, 1995, at http://tinyurl.com/cskpung.

[63] See the observation missions' reports on the ACE Project website at http://aceproject.org/ero-en/regions/asia/AZ and Freedom House reports at http://www.freedomhouse.org/.

role in bringing about democratic change in general,[64] and Azerbaijan, in particular.[65] However, the political opposition was weak already by the time of the first legislative elections in 1995, in which the APF and Musavat candidates together received only 5 seats in the parliament (see Table 2). The November 2010 parliamentary election results confirmed the dominant position of the ruling YAP. According to poll results, the YAP won 71 seats, "independent" candidates (most of whom are regime loyalists) - 41, and the "official" opposition parties (the APF party and Musavat) gained no seats in the legislature.[66]

In sum, this section presented a brief discussion of the origins and consolidation of the Aliyev regime and pointed to three key characteristics of the post-1993 domestic political system. This domestic environment provides the context for the analysis of the relationship between oil and regime survival in the next section.

Oil and Its Effects

Oil and the Economy

Azerbaijan's economy has traditionally been dominated by petroleum. After World War II, the Soviet policymakers decided to develop the oil and gas fields in Siberia, which became the priority areas for investments. As a result, in 1969 oil production in Azerbaijan SSR declined and the recession lasted until 1985. Since 1985 production stabilized at around 13 million tons per year and dropped further after independence in 1991, reaching the lowest levels at around 9 million tons in 1996-1997 (see Figure 1).[67] In September 1994, the first oil contract was signed between the State Oil Company of Azerbaijan (SOCAR) and a consortium of foreign energy companies. Given favorable prices, it is estimated that Azerbaijan will earn about $200 billion in total revenue.

Today Azerbaijan's oil reserves are estimated at 7 billion barrels (b/bbl) (1 billion tons) and 30 trillion cubic feet (Tcf) of natural gas (compare to Kazakhstan's oil reserves 39.8 b/bbl and Turkmenistan's gas at 265 Tcf).[68] The country's oil and gas reserves account for 0.5 and 0.7 percent of

[64] See e.g. Valerie Bunce and Sharon Wolchik. 2010. "Defeating Dictators: Electoral Change and Stability in Competitive Authoritarian Regimes," *World Politics* 62: 1, 43-86.

[65] Anar Valiyev. 2006. "Parliamentary Elections in Azerbaijan: A Failed Revolution", *Problems of Post-Communism* 53: 3, 17-35; Leila Alieva. 2006. "Azerbaijan's Frustrating Elections," *Journal of Democracy* 17:2, 147-60.

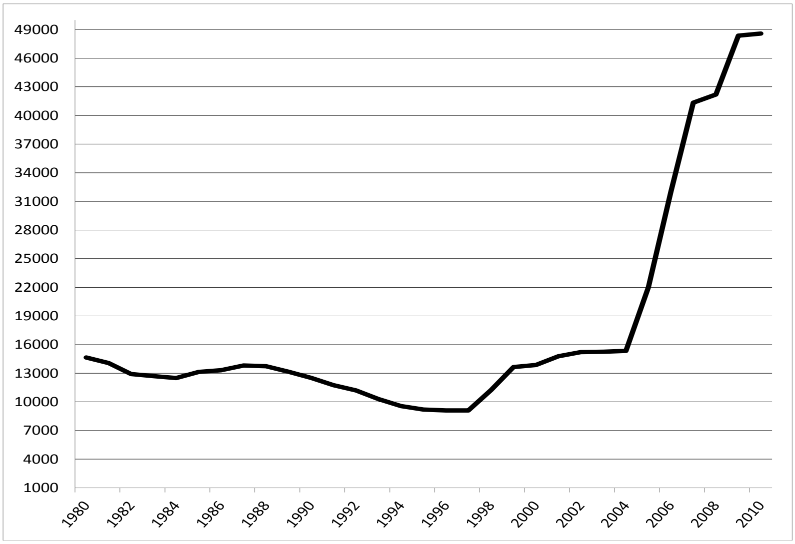
[66] More details are available from the Parline (Inter-Parliamentary Union) database: http://tinyurl.com/d8baw4c.

[67] See Sabit Bagirov, *Oil of Azerbaijan: Revenues, Expenses and Risks (View from 2007)*. Budapest: Central European University, 2007, 173-77, at http://tinyurl.com/d9dv8np.

[68] BP Statistical Review of World Energy, June 2011, at http://www.bp.com/statisticalreview; Energy Information Administration (EIA), "Azerbaijan Country Analysis Brief", January 9,

global reserves of oil and natural gas respectively. Most of Azerbaijan's oil output (80 percent in 2010) comes from the giant Azeri-Chirag-Guneshli (ACG) oil field. The largest natural gas deposit is the Shah Deniz field. Oil production currently stands at 1 million barrels per day (bbl/d) and is expected to peak by 2014 and then start to decline to be completely exhausted in 20-25 years (see Figure 1).[69]

Figure 1. Azerbaijan: Crude Oil Production, 1980-2010 (in thousand of metric tons)



Source: IMF Republic of Azerbaijan Article IV Consultation reports, various years, at http://www.imf.org/external/country/aze/index.htm; The State Statistical Committee of the Republic of Azerbaijan; SOCAR

In the wake of the Soviet collapse, Azerbaijan experienced a dramatic decline in economic performance, which was one of the worst even by post-Soviet standards. The conflict in Nagorno-Karabakh aggravated economic recovery. From 1992 to 1995, the country's real GDP growth was negative. In 1993, the economy declined 23.1 percent (see Table 3). During this time, real GDP fell by more than 70 percent. Government revenues dropped considerably while spending remained high due to military mobilization. As a result, large fiscal deficits accumulated during 1992-1994. To deal

2012, at http://tinyurl.com/cpmb866.

[69] IMF, Republic of Azerbaijan: 2010 Article IV Consultation – Staff Report, May 2010, at http://tinyurl.com/85tgrw5.

with this challenge of mitigating the economic crisis and its ramifications, the government pursued a reform program to establish basic market institutions and partial liberalization. In early 1995, the Aliyev government implemented an economic stabilization reform program guided by the World Bank. Small-scale enterprises were privatized, the fiscal system was modernized, and general macroeconomic conditions were stabilized. GDP began to recover in 1996. But, most important, the government promoted foreign investments in the energy sector.

Table 3: Real GDP Growth (annual percentage change)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Whole economy	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10	7.4	11.1	9	8.1	10.5	10.4	24.3	34.5	25	10.8	9.3	5
Oil sector	-	-	-	-6.7	-6	-1.6	-3.6	23.1	20	2.3	7.9	3.9	0.6	2.5	65.4	62	37.3	6.9	14.8	1.3
Non-oil sector	-	-	-	-22	-14.3	1.8	7.8	7.5	4.7	12.8	10.4	12.3	15.3	13.8	8.4	11.9	11.5	15.7	3.0	4.2

Source: IMF Republic of Azerbaijan Article IV Consultation reports, various years, at http://www.imf.org/external/country/aze/index.htm

The first "new" oil started to be exported in late 1997 through the so-called "Early Oil" Northern Route (Baku-Novorossiysk). The second pipeline from Baku to Supsa on the Black Sea became operational in 1999. Inflows from early oil exports, signature bonuses and foreign direct investments brought in much-needed foreign exchange. Net foreign exchange earnings were substantial already in 1996-1999. The launch of Azeri-Chirag-Guneshli in 1997 marked the beginning of growth in oil output.[70] The first post-Soviet oil was produced from an offshore platform on November 7, 1997, from the $8 billion Azerbaijan International Operating

[70] Natig Aliyev, *Neft' i Neftyanoy Faktor v Ekonomike Azerbaydzhana v XXI veke* ["Oil and the Oil Factor in the Economy of Azerbaijan in the 21st Century"]. Baku: Letterpress 2010, 31, e-book at http://tinyurl.com/d7cns6y.

Company (AIOC) fields, to be transported to Novorossiysk on Russia's Black Sea.[71] A third pipeline to carry oil from the ACG oil field, the Baku-Tbilisi-Ceyhan (BTC) pipeline, was inaugurated in 2005. Exports through this route began in July 2006. The South Caucasus gas pipeline (Baku-Tbilisi-Erzerum) became operational in 2006. The ACG project, the Shah Deniz project, the BTC, and the South Caucasus pipeline attracted $25 billion in total investment as of 2008.[72]

Stabilizing effects: spending and repression

Starting from 1994, Azerbaijan began to receive substantial amounts of foreign direct investment (FDI) and bonuses. The bonuses helped maintain fiscal balance before the oil boom. Between 1995 and 2000, the government received $673 million in oil bonuses from foreign oil companies,[73] covering on average 62 percent of budget deficits in the given period.[74] Between 1995 and 2001, net FDI inflows into the Azerbaijani economy were $3.7 billion.[75] Most FDI went to the state-controlled oil and gas sector and, according to Bayulgen, these inflows "significantly empowered the political fortunes of authoritarian leaders [in Kazakhstan and Azerbaijan] by giving them a symbolic vote of confidence from outside and stimulating economic growth."[76]

Oil prices began to rise in 1999 and reached $64 per barrel in 2006. The Azerbaijani government took full advantage of the rising world oil price. GDP growth was impressive between 2003 and 2008, reaching the world record high of 34.5 percent in 2006. What is clear, however, is that high growth performance was driven largely by the more than 60 percent growth of oil GDP. Thanks to oil revenues, the state budget grew tenfold, from $1.2 billion in 2003 to more than $11 billion in 2010.[77] GDP per capita increased from below $2,000 levels in the mid-1990s to more than $9,000 in 2010 (see Table 4). The poverty rate was reduced significantly, from nearly 50 percent in 2001 to 15.8 percent in 2008.[78]

With the start of the oil boom in 2003, as windfall revenues were flowing in, the government embarked upon massive public spending.

[71] Laurence Peter, "Azerbaijan returns to world stage as new oil boom dawns," *Agence France-Presse*, November 12, 1997, FD.

[72] Natig Aliyev, *Neft i Neftyanoy Faktor*, 56.

[73] IMF Republic of Azerbaijan Article IV Consultation, various years.

[74] Sabit Bagirov, Ingilab Akhmedov and Svetlana Tsalik. 2003. "State Oil Fund of the Azerbaijan Republic," in Svetlana Tsalik, ed. *Caspian Oil Windfalls: Who Will Benefit*. New York: Open Society Institute, 100.

[75] World Bank, "Azerbaijan - Building Competitiveness," November 20, 2003, 13.

[76] Oksan Bayulgen. 2005. "Foreign Capital in Central Asia and the Caucasus: Curse or Blessing?" *Communist and Post-Communist Studies* 38, 63.

[77] Budget.az, at http://www.budget.az/budget/main?content=327.

[78] World Bank data, at http://data.worldbank.org/country/azerbaijan.

Since 2006 the government tripled the level of spending to finance public investment projects in the social welfare sector, public sector salaries and infrastructure projects.[79] As Table 5 shows, government revenue increased from 2 billion manats in 2004 to more than 19 billion manats in 2008. Oil revenues accounted for a large part of this increase. Total expenditure almost doubled from 5 billion manats in 2006 to above 10 billion manats in 2008.

Table 4: Azerbaijan, Armenia and Georgia: GDP per capita at Purchasing Power Parity (PPP) (in current international U.S. dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Azerbaijan	3,433	3,471	2,702	2,091	1,690	1,508	1,539	1,644	1,815	1,960	2,207	2,461	2,746	3,096	3,478	4,496	6,176	7,86	8,714	9,499	9,943
Armenia	2,122	1,955	1,183	1,128	1,243	1,388	1,520	1,619	1,775	1,872	2.035	2,287	2,635	3,070	3,485	4,096	4,782	5,591	6,098	5,320	5,463
Georgia	4,433	3,591	2,005	1,437	1,328	1,431	1,662	1,906	2,011	2,115	2,218	2,394	2,584	2,951	3,220	3,611	4,044	4,687	4,905	4,776	5,073

Source: The World Bank database, at http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD

Table 5: Public Finances

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
						(prel.)	**(proj.)**
Total Revenue	2,288	3,132	5,248	8,007	19,426	14,368	20,073
Oil Revenue	864	1,221	2,667	4,305	14,600	9,461	14,552
Non-Oil Revenue	1,425	1,922	2,585	3,701	4,826	4,907	5,521
Total Expenditure	2,207	2,839	5,134	7,356	11,829	12,027	12,466
Total Expenditure (in percent of GDP)	26	23	27	26	31	35	30

Note: in million of Azerbaijani manat unless otherwise specified.
Source: IMF, Republic of Azerbaijan Article IV Consultation, various years

[79] World Bank, "Azerbaijan Country Economic Memorandum: A New Silk Road: Export-led Diversification," December 23, 2009, ix, at http://tinyurl.com/c9b2xae.

An important role in public revenue management is played by the state oil fund, SOFAZ, whose current assets exceed $33 billion (as of October 1, 2012). Based on the World Bank's estimates, these holdings may reach $100 billion in the next ten years.[80] SOFAZ assets have been used to finance housing for refugees, infrastructural projects, student education abroad and the government's share in the BTC pipeline. But expenditures from SOFAZ consist mainly of transfers to the state budget (78 percent of the total amount). As Table 6 shows, as of 2012 a total amount of nearly $44.7 billion was transferred from fund assets to the state budget. Budget transfers from SOFAZ increased substantially since 2007, from 32 percent of budget revenue in 2008 to 60 percent in 2012.[81] These figures imply an increased budget reliance on transfers from SOFAZ, which may harm taxation.[82]

Table 6: State Oil Fund (SOFAZ) Assets and Transfers to the State Budget (in millions of U.S. dollars)

Year	Assets (at year-end)	Transfers to state budget*
2000	270	-
2001	492	-
2002	692	-
2003	817	127
2004	964	165
2005	1,394	191
2006	1,455	745
2007	2,475	745
2008	11,219	4,838
2009	14,900	6,257
2010	22,767	7,530
2011	29,800	11,469
2012	33,192	12,623
	Total amount**: **33,192**	Total amount: **44,690**

Note: author's calculations; *original data on budget transfers in Azerbaijani manat converted to current (2012) U.S. dollars; 2012 figure projected. ** as of October 1, 2012.

[80] "State Oil Fund's assets to top $100bn - World Bank," *News.az*, August 5, 2011.

[81] Revenue Watch, "Azerbaijan Transparency Snapshot," at http://tinyurl.com/d4j6655.

[82] Kenan Aslanli. 2012. "Managing the State Oil Fund in Azerbaijan," in Andreas Heinrich and Heiko Pleines, eds., *Challenges of the Caspian Resource Boom*, 234-45.

Sources: Statistical reports of the State Oil Fund: http://www.oilfund.az/en_US/hesabatlar-ve-statistika/son-reqemler.asp; SOFAZ Annual Report 2010, at http://www.oilfund.az/pub/uploads/annual_2010en.pdf, SOFAZ Annual Report 2011, http://www.oilfund.az/uploads/annual_2011en.pdf; Budget.az (data on transfers to the state budget), at http://www.budget.az/budget/main?content=526

Vast oil revenues allowed the government to keep a large part of the population employed in the public sector, which is one indicator often used to estimate the extent of patronage possibilities.[83] By this metric, Azerbaijan has a bloated public sector. In 2000, there were 1.3 million employees in the public sector.[84] SOCAR alone had 58,000 employees in 1993 and 65,083 in 2009.[85] The country has a large number of state-owned enterprises. Of 74,534 enterprises that existed in 2007, 11,666 were state-owned.[86] A large part of the country's population is employed in the public sector, including the government sector and state-owned enterprises. In 2008, the public sector employment accounted for 36.4 percent of total employment and 18.5 percent of the total population of more than 8 million people.[87]

Despite a significant reduction in the poverty rate, social inequalities are still high.[88] Disparities in wealth may cause social discontent and the government seems to be aware of this possibility. The availability of extra funds helps. During "bad times" the president taps into the oil fund to finance public spending, which relieves social tensions inherent in societies with high levels of social inequality. As a former presidential adviser remarked: "The government is trying now to decrease tensions by increasing salaries and making life a little bit better. They want to undercut support for the opposition."[89]

Repression is a second mechanism, after patronage spending, linking oil revenues and regime stability. The onset of the oil boom in Azerbaijan was followed by two developments that provide support for the repression effect: increased spending on the coercive apparatuses, and increased

---

[83] Alan Hicken. 2011. "Clientelism," *Annual Review of Political Science* 14, 289-310.

[84] World Bank, "Azerbaijan – Public Expenditure Review," April 3, 2003, 16, at http://tinyurl.com/cp7kdol.

[85] Zohrab Ismayil, Rovshan Aghayev, Gadir Ibrahimli. *SOCAR Financial Flows*. Baku: Qanun, 2010, at http://tinyurl.com/c8mffhy.

[86] World Bank, Country Economic Memorandum, 101.

[87] Based on data from ILO, LABORSTA at http://laborsta.ilo.org/ (accessed December 1, 2010), for details, see Guliyev, "Political Elites."

[88] Katy E. Pearce, "Poverty in the South Caucasus," and Nazim Habibov "Poverty in Azerbaijan," *Caucasus Analytical Digest*, No. 34, at http://tinyurl.com/c4tu267.

[89] Vafa Guluzade quoted in Thomas Grove, "Azerbaijan douses discontent with rising oil funds," *Reuters*, June 5, 2011, at http://tinyurl.com/bvjral3.

violations of human rights (state repression). Budget defense spending increased from about 2 percent of GDP in 2003 to 3.4 in 2006 (see Table 7). In 2006, defense overtook education as the largest expenditure item in the state budget. Details of security-related spending are not available, but it is known that part of the military budget in Azerbaijan is allocated to the internal security forces.[90] The government also disproportionately raised wages for police officers.[91]

Table 7: State Budget Expenditure (in percent of GDP)

State Budget Expenditure	**2003**	**2004**	**2005**	**2006**
General government services*	1.4	1.6	1.3	2.2
Defense	1.9	2.1	2.3	3.4
Public order and justice	1.7	1.9	1.6	1.5
Education	3.3	3.6	3.0	2.6
Health	0.8	0.9	0.9	0.9
Social security	3.0	2.8	2.4	1.8
Agriculture	0.8	0.7	0.8	0.7
Public works, transport, and communications	1.1	2	2.1	5.2
Total expenditure (including investment)	16.4	18.4	16.6	19.9

Note: * includes the Presidency, Cabinet of Ministers, and Parliament.

Source: IMF Republic of Azerbaijan Article IV Consultation reports, various years, at http://www.imf.org/external/country/aze/index.htm

Studies show that oil-exporting states may be more repressive (increased violations of personal integrity rights) than non-oil states.[92] Despite its democratic rhetoric, beginning already in late 1993, the regime used repression, arrests and other means to intimidate opposition activists and to silence regime critics.[93]

---

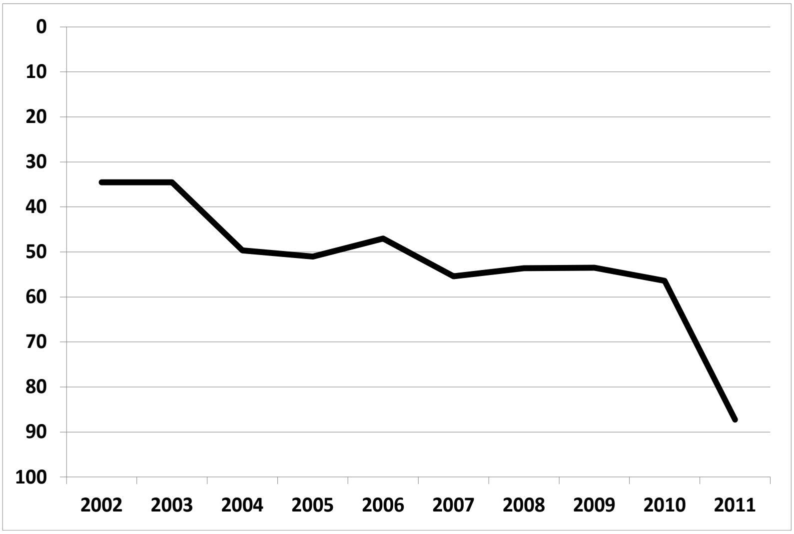
[90] ICG. 2008. "Azerbaijan: Defence Sector Management and Reform," Europe Briefing No. 50, October 29, at http://tinyurl.com/c3ua29o.

[91] Rufat Abbasov, "Azerbaijan: Traffic cops' pay rise unlikely to curb graft," *IWPR*, CRS Issue 306, November 17, 2005 at http://tinyurl.com/d45h7dv.

[92] Jacqueline H.R. DeMeritt and Joseph K. Young. 2012. "A Political Economy of Human Rights: Oil, Natural Gas, and State Incentives to Repress," Unpublished Ms., March, at http://tinyurl.com/d3xuurm.

[93] Fuller "Azerbaijan at the Crossroads," 129-130; "Authorities move to suppress opposition after failed rebellion," *The Associated Press Political Service*, March 22, 1995, FD.

Figure 2. Press Freedom in Azerbaijan, 2002-2011



Note: the higher the score the worse the situation with press freedom for that year is.
Source: Reporters Without Borders, Press Freedom Index, various years, at http://en.rsf.org/press-freedom-index-2011-2012,1043.html

One of the unfortunate observations about human rights in Azerbaijan within the last decade or so is the increasing number of human rights violations, especially rights relating to media freedoms and freedom of expression.[94] Journalists are being intimidated, blackmailed, jailed; bloggers imprisoned on trumped-up charges; political and civil society activists unlawfully detained for participating in protest rallies.[95] In 2012, the Council of Europe's rapporteur Christoph Straesser produced a report on the situation with human rights in Azerbaijan, focusing specifically on "political prisoners." The Straesser report shows a shift in the target group of political repression.[96] If in the past, politically motivated arrests and detentions consisted of para-military opponents and conspiring rivals, since the early 2000s the official opposition, civil society activists, journalists

[94] Vugar Gojayev and Rashid Hajili's essays in "Spotlight on Azerbaijan," Foreign Policy Centre, 2012, at http://fpc.org.uk/fsblob/1462.pdf.
[95] Human Rights Watch. 2010. "Beaten, Blacklisted, and Behind Bars: The Vanishing Space for Freedom of Expression in Azerbaijan," October, at http://tinyurl.com/cs79x5x.
[96] "Report: The follow-up to the issue of political prisoners in Azerbaijan," Rapporteur Christoph Strässer, Draft resolution adopted by the Committee in Strasbourg on 26 June 2012, at http://tinyurl.com/bql66ov.

and bloggers have been the main target groups. The 2011 U.S. State Department Human Rights Report covering 2010 refers to the appalling statistics that "during the year there were 106 incidents involving verbal or physical assaults on journalists, compared with 51 such cases in 2009."[97] In 2011, more than 50 journalists were subjected to harassment.[98]A new assessment covering the first half of 2012 reports that at the time of writing there were eight journalists in Azerbaijani jails, imprisoned on various politically motivated charges.[99] In January 2009, the government stopped radio broadcasts by the BBC, RFE/RL's Azerbaijani Service, and the Voice of America. This decision effectively shut off citizen access to sources of independent news. In addition, as argued by Pearce and Kendzior, the regime feels increasingly threatened by growing numbers of Internet users who can be mobilized for protest activities through online networks and social media.[100]

One reason why journalists and youth activists have become the main target and perceived as a threat in recent years can be related to the governing elite's desire to hide information about flows of oil revenues and the misappropriation of public funds by elite members. Greater transparency may provoke democratic uprisings, if citizens start noticing that the ruler is squandering the nation's oil wealth.[101] The Azerbaijani leadership fears that if journalists, activists and bloggers are allowed to exercise fully their freedoms, including freedom to seek and share information and freedom of speech, stories of grand corruption will be revealed and freely disseminated to the public and regime legitimacy will be undermined, as a result. It is known that a large portion of oil profits is spent through SOCAR, which is far from being transparent.[102] In fact, the state-owned company discloses limited information about its financial flows, and details of how it spends billions remain undisclosed. Further limits to public access to corporate information introduced by parliament in the summer of 2012 also serve this purpose of concealing rent capturing, patronage, and corruption fueled by oil windfall revenues.[103] Indeed, as can be seen in Figure 2, there

---

[97] U.S. State Department, "2010 Human Rights Report: Azerbaijan," April 8, 2011, at http://tinyurl.com/bnq5q3s.

[98] Human Rights Watch, Azerbaijan 2012, at http://tinyurl.com/cmn6j56.

[99] Institute for Reporters' Freedom and Safety (IRFS), "Azerbaijan's Critical Voices in Danger," Semi-annual Azerbaijan freedom of expression report covering the period January 1- July 1, 2012, at http://tinyurl.com/bvo9n8j.

[100] Katy Pearce and Sarah Kendzior. 2012. "Networked Authoritarianism and Social Media in Azerbaijan," *Journal of Communication* 62: 2, 283-98.

[101] Michael L. Ross. 2012. *The Oil Curse: How Petroleum Wealth Shapes the Development of Nations*. Princeton: Princeton University Press, Ch. 3.

[102] Zohrab Ismayil et al. *SOCAR Financial Flows*.

[103] "Azerbaijan moves to restrict access to corporate data," freedominfo.org, June 25, 2012, at http://tinyurl.com/d47lemc.

has been a significant deterioration in the situation with the freedom of the press between 2004 and 2011, which roughly coincides with the oil boom.

In sum, repression has been used extensively by the regime to crack down on its opponents and to restrict media freedoms, which in tandem with increased public spending, has proven to be critical in deflating pressures for political liberalization and democratization from below.

Adverse effects

Already in 1998 there were signs of Dutch disease due to an increase in FDI inflows. These included inflation, real exchange rate appreciation and the crowding out of non-oil industries. The windfall revenues magnified these pressures on the economy. Soviet-era industries, such as agriculture and oil equipment manufacturing, have contracted.[104] Most severe effects were mitigated by saving revenues in the oil fund, which keeps its assets abroad. Despite this, high levels of inflation and high non-oil fiscal deficits were recurrent problems.

Oil price volatility also had a negative impact on the economy. The most serious adverse effect was the impact of the 2008 global crisis. As a result of the crisis, non-oil GDP growth slowed from 16 percent in 2008 to 3 percent in 2009. The crisis caused fiscal oil revenues to fall by 35 percent in 2009, hurting construction and non-oil manufacturing.[105] Despite these effects, Azerbaijan was able to avoid the most serious consequences of the crisis thanks to fiscal resources accumulated during previous years.[106] As economic experts pointed out, "saving commodity windfalls in several resource-rich countries has mitigated the impact of commodity price volatility while it has helped several countries to smooth the impact of the ongoing financial crisis."[107] Another impact of the crisis, it is said, was that that the government realized the importance of diversifying the economy.[108] At the January 2009 forum in Davos Ilham Aliyev said, "In the future this [infrastructure projects] will allow us not to think about the oil price. Oil should just be good insurance and money that we accumulated

104 *Financial Times*, Special Report: Azerbaijan, January 25, 2008, at http://www.ft.com/intl/reports/azerbaijan2008.

105 IMF Republic of Azerbaijan; 2010 Article IV Consultation – Staff Report, May 2010, IMF Country Report No. 10/112, at http://tinyurl.com/85tgrw5.

106 Dima Jardaneh, "Crisis Brings Reversal of Fortune to Caucasus and Central Asia," *IMF-Survey Magazine*, March 10, 2009, at http://tinyurl.com/d9mw9u7; "Growth to Slow Sharply in the Caucasus and Central Asia Region, IMF Says," IMF Press Release No. 09/61, March 5, 2009, at http://tinyurl.com/crmn4fj.

107 Ingilab Ahmadov, Stela Tsani, and Kenan Aslanli. 2011. "Sovereign Wealth Funds as the emerging players in the global financial arena: characteristics, risks and governance," *Sovereign Wealth Funds: New Challenges for the Caspian Countries*. Baku: Public Finance Monitoring Center, 6.

108 "The first Azerbaijan investment summit," *BNE*, December 11, 2009, at http://tinyurl.com/d3m93eq.

in the oil fund should be good protection from any kind of crisis."[109]

Resource dependence and (non)diversification

But what is the government's actual record on progress with diversification?

According to World Bank reports, after independence Azerbaijan had a number of initial advantages its governments could have relied on in pursuing development, if they so wished. These include an educated workforce and relatively diversified industrial and agricultural sectors.[110] For instance, during Soviet times the country was a major center for petroleum equipment manufacturing and supplied 65 percent of the former Soviet Union's demand for such equipment. Despite these initial advantages, however, policymakers chose to focus all efforts on developing only one sector: oil extraction and production. As a result, the country's exports are highly concentrated (oil and oil products) and the economy is highly dependent on oil rents.

Diversification and the development of the non-oil economy have become part of everyday political discourse recently. The development of the non-oil sector is identified as one of the goals in "The Long-Term Strategy on the Management of Oil and Gas Revenues."[111] It was declared a priority of economic policy in 2009.[112] One of the concrete measures taken by the government in 2006 was to set up an investment company with an initial budget of US$100 million to provide loans to non-oil business.[113] However, Azerbaijan's economy remains highly reliant on oil. By the 2000s, given the share of oil in exports, Azerbaijan became a "monocrop" economy.[114] Esanov and colleagues present several indicators showing that resource dependence increased over time (while the incentives to promote private economic activities decreased).[115] Export concentration can serve as a proxy to measure diversification with higher levels of export concentration indicating lower levels of diversification.[116] The share of oil

[109] Taken from Guy Faulconbridge, "Davos-Interview-Azeri president sees 2009 growth at 10 pct," *Reuters*, January 30, 2009, at http://tinyurl.com/d7sms8g.

[110] World Bank, "Azerbaijan Energy Sector Review," December 27, 1993, 1, at http://tinyurl.com/bq8qoyq.

[111] Approved by the Decree of the President of the Republic of Azerbaijan, No. 128, September 27, 2004, at http://tinyurl.com/btn4j3y.

[112] "Aliyev: Azerbaijan needs non-oil growth," *UPI*, February 13, 2009, at http://tinyurl.com/d2kp8yl.

[113] Ahto Lobjakas, "Azerbaijan copes with the oil windfall," *RFE/RL*, November 21, 2006, at http://www.rferl.org/content/article/1072879.html.

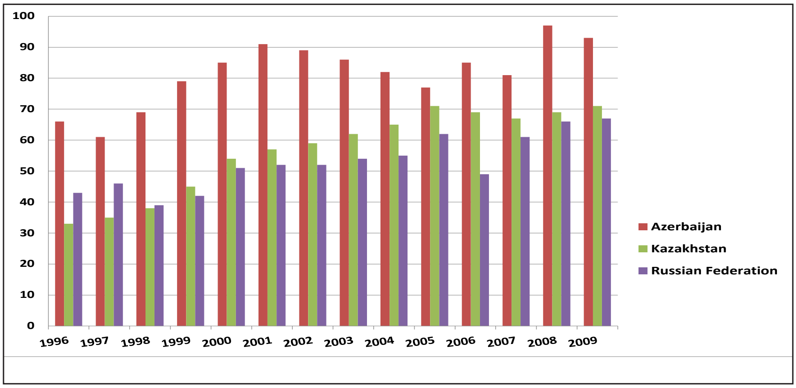
[114] Sabit Bagirov et al., "State Oil Fund," 95.

[115] Akram Esanov, Martin Raiser and Willem Buiter. 2001. "Nature's Blessing or Nature's Curse: The Political Economy of Transition in Resource-based Economies," EBRD Working Paper 66, at http://www.willembuiter.com/curse.pdf.

[116] Aditya Narain, Pau Rabanal, and Steen Byskov. 2003. "Prudential Issues in Less Diversified Economies," IMF Working Paper No. 03/198.

exports in total exports increased from 66 percent in 1996 to 97 percent in 2008. The role of oil rents in the overall economy also increased from around 24 percent of GDP in 1994 to 56 percent in 2007-08 (see Figure 3 and Table 8). On export diversification indicators (measured as "number of equivalent products at SITC 3-digits"), the number of exported products decreased from 2005 to 2009 with the main commodity being fuels.[117] In sum, the level of Azerbaijan's resource dependence has increased in the last 10 years.

Figure 3. Fuel Exports as a % of Merchandise Exports



Source: The World Bank, World Development Indicators, at http://databank.worldbank.org/ddp/home.do

Table 8 – Resource (Oil) Dependence in Azerbaijan

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Oil rents (% of GDP)	19	15	23	24	24	28	33	24	15	27
Fuel exports (% of merchandise exports)	-	-	-	-	-	-	66	61	69	79

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
44	35	34	35	40	56	62	56	56	40	-
85	91	89	86	82	77	85	81	97	93	95

Source: The World Bank, World Development Indicators, at http://databank.worldbank.org/ddp/home.do

[117] OECD, "Aid for Trade at a Glance 2011 – Azerbaijan," at http://www.oecd.org/dataoecd/57/50/48321366.pdf

In relative terms, the share of manufacturing as a percentage of GDP has declined from an average of 17 percent of GDP in the first five years after independence (1991-95) to 8 percent between 1996-2000 and 2000-05 to 5 percent in 2005-10. This drop means that in 2010 manufactures contributed to GDP a third of what they had in the first years of independence. The share of agriculture, once a significant part of the country's economy, also declined dramatically from about 30 percent in the first half of the 1990s to 21 percent in the second half of the 1990s. In the early 2000s, the average was 13 percent and between 2005-10 it fell to 7 percent (see Table 9). Developing agriculture is considered an important component of diversification.118 The agricultural sector employs 40 percent of the labor force. (For comparison, the oil sector employs less than 1 percent of the working population). The agricultural sector's current share in GDP constitutes only 5.2 percent (2010) and during 2010 agriculture performed poorly, contracting by 2.2 percent after 3.5 percent growth in 2009.119 There has been a noticeable decline in the once promising cotton industry as indicated by drop in cotton exports from 502 (1,000 480-lb. bales) in 1990 to a meager 50 (1,000 480-lb. bales) in 2012.120

Table 9: Share of Manufacturing and Agriculture in GDP (percent of GDP), 1991-2010

	Manufacturing	Agriculture
1991-1995	17	30
1996-2000	8	21
2001-2005	8	13
2006-2010	5	7

Note: figures are 5-year averages
Source: The World Bank, World Development Indicators, available at http://databank.worldbank.org/ddp/home.do

What can explain the government's poor record in diversification so far? Three factors provide a plausible explanation. First, the development

[118] World Bank, "Realizing Azerbaijan's Comparative Advantages in Agriculture," 2006, at http://go.worldbank.org/49DDEL1OQ0; UNDP, "Study of Azerbaijan's Current and Potential Comparative Advantage," Baku 2004, at http://tinyurl.com/6lhwdo9.

[119] Swiss Agency for Development and Cooperation, "Agriculture Sector Development in Azerbaijan", n.d., at http://tinyurl.com/czx4u6k.

[120] Statistics on cotton exports is available at http://tinyurl.com/c52ucp7.

of alternative sectors requires costly investments. Second, the status quo elites may resist and subvert the leader's attempts to diversify. And third, genuine diversification will create alternative bases of economic wealth (and power) outside the control of the regime, which is politically risky.

Policy learning

Although Azerbaijan is an old oil producer, it had little experience in managing its oil wealth until after independence in 1991.[121] An important step taken by the government in the direction of effective revenue management was the creation by a presidential decree of an oil fund in December 1999. SOFAZ was established both as a savings fund and a sterilization mechanism against the Dutch disease syndrome. SOFAZ also operates as a deficit-financing source.[122] The Fund accumulates all revenues associated with Azerbaijan's post-Soviet energy production and invests its assets in securities with a good credit rating abroad.

Management of the Fund is composed of the President (of the Republic), the Fund's Executive Director (appointed by the president), and the Supervisory Board (also appointed by the president).[123] The Statute of SOFAZ, approved in December 2000, establishes the accountability of the fund directly to the president. Only the president "assigns" rights and responsibilities (article 1.6). The assets of the fund are "utilized in accordance with the main directions … approved by the President" (article 4.1). Moreover, any changes to the Statute should be approved by the President (article 7), who has the sole power to liquidate the fund (article 8).[124]

But how did the Azerbaijani policymakers actually come to set up an oil fund? Policy learning provides the key to explaining this outcome.

Policy decisions of one country are typically informed by policies and programs implemented by other countries. If a policy was successful in achieving desired goals elsewhere, it is transferred and implemented.[125] International institutions and epistemic communities often work as conduits for policy diffusion by helping transmit positive policy solutions and models. Policy transfer can be defined as "the process by which knowledge about policies, administrative arrangements, institutions and ideas in one political system (past or present) is used in the development of policies, administrative arrangements, institutions and ideas in

[121] Bagirov et al., "State Oil Fund," 90.

[122] World Bank, "Azerbaijan - Issues and Options Associated with Energy Sector Reform," March 31, 2005, 16, at http://tinyurl.com/bn8fj86.

[123] SOFAZ, at http://tinyurl.com/boubekc.

[124] SOFAZ Statute, Approved by the Decree of the President of the Republic of Azerbaijan No. 434, December 29, 2000, with amendments, at http://www.oilfund.az/uploads/status.pdf.

[125] The classic statement on policy learning is Richard Rose. 1993. *Lesson Drawing in Public Policy: A Guide to Learning Across Time and Space*. Chatham, NJ: Chatham House.

another political system".[126] Policy diffusion is often clustered spatially or temporally "such as neighboring countries adopting similar policies or an adoption pattern that is characterized by waves."[127] Weyland explains how countries draw lessons and borrow solutions from other countries: "Given the difficulty of producing viable programs, policymakers are receptive to external inputs and eager to learn from foreign models and experiences. They pay attention to innovations adopted by other nations …[and] international organizations such as the World Bank also serve as 'teachers.'"[128]

The international financial institutions (IFIs), the IMF and World Bank, served as a channel through which the policies were transferred: "The IMF was very active in Azerbaijan from the very beginning of the generation of oil and gas revenues and it has offered many recommendations on this subject to the Azeri government."[129] Already in 1998, the IMF recommended the Azerbaijani government to create an oil fund to manage adverse exogenous shocks.[130] According to the economists at the IMF, the introduction of an oil fund helped a number of resource-rich countries to solve problems related to Dutch disease effects and to shield their economies from potential external supply shocks. Norway's State Petroleum Fund (established in 1990) and Kuwait's Future Generations Fund (set up in 1976), were presented as successful examples. Fluctuations of oil prices were shown as especially destabilizing. Nigeria, Venezuela and Mexico, all suffered from the drop in oil prices in the early 1990s. Earlier in the 1980s, Norway and Oman were victims of oil price shocks. This negative experience stimulated the search for a mechanism to protect the domestic economy and the solution was found in creating oil funds, which although diverging in their institutional structure and operational modes have the same purpose of stabilizing fiscal revenue.

The World Bank provided policy advice as well. When asked in 1998 whether the government of Azerbaijan was prepared to cope with the coming windfall revenue Tevfik Yaprak, the World Bank's Resident Representative in Baku, pointed out the extent of policy input the Azerbaijani authorities received from the IFIs:

---

[126] David P. Dolowitz and David Marsh. 2000. "Learning from Abroad: The Role of Policy Transfer in Contemporary Policy-Making", *Governance* 13: 1, 5.

[127] Fabrizio Gilardi. 2011. "Transnational Diffusion: Norms, Ideas, and Policies," Chapter (draft) prepared for Walter Carlsnaes, Thomas Risse and Beth Simmons, eds. *Handbook of International Relations*. SAGE Publications, 10.

[128] Kurt Weyland. 2008. "Toward a New Theory of Institutional Change," *World Politics* 60, 290.

[129] Ingilab Ahmadov and Kenan Aslanli. 2011. "State Oil Fund of Azerbaijan Republic: Past, Present and Future" in *Sovereign Wealth Funds: New Challenges for the Caspian Countries*. Baku: Public Finance Monitoring Center, 41.

[130] IMF. 1998. "Azerbaijan: Recent Economic Development," Staff Country Report No. 98/83, August, 51-54, at http://tinyurl.com/bo86jdo.

> The current government could not handle such wealth, not because of personalities, but because war and political instability since independence had left the country without the necessary financial structures... The government has done a lot on macroeconomic stabilization and structural adjustment in the last three years. In most cases this has been substantially or wholly done by the International Monetary Fund or the World Bank... Five years down the road when Azerbaijan starts to receive oil money, the policy dialogue between the World Bank and the government will fade away as they will not need support ...But the policy decisions they are facing will become much more complicated. They will lose two of their most important advisers. If they can't develop institutions to deal with this, you can see the outcome.[131]

Azerbaijan followed the IFIs' advice.[132] In January/February 2000, the government sent a high-ranking delegation to Norway to learn from the "Norwegian model." During the trip, the delegation met with Norwegian officials and familiarized themselves with the legal framework and operational mechanisms of the Norwegian oil fund. SOCAR's president, who led the delegation, said after the mission returned to Baku: "We acquainted ourselves with the functions and mission of the Norwegian oil fund, with the goals toward which funds are disbursed, and the sources of replenishment," but added that, "careful study of the Norwegian experience does not mean our fund will use the same scheme. Azerbaijan will work out its own mechanism for administering the Oil Fund."[133] In a similar vein, the Fund's webpage acknowledges that the experience of other countries was used:

> There are similar funds in some other countries of the world with similar to the State Oil Fund of the Republic of Azerbaijan features. At the time of creation of the State Oil Fund, the experience of these funds was used as the reference point alongside with consideration of local peculiarities and present needs. A single model equally accommodating the point of accumulation of oil

[131] Sebastian Alison, "Using oil wealth wisely to test Azerbaijan," *Reuters News*, December 8, 1998, FD.

[132] Kazakhstan and Russia were quick to follow: Kazakhstan created the National Fund (NFRK) in 2000, and Russia launched its Stabilization Fund in 2004.

[133] All quotes are from "Azerbaijani National Bank to administer oil fund," *Interfax Petroleum Report*, 2 February 2000, FD.

> revenues for future generations and use of revenues for the solution of the problems of present generation was selected.[134]

Learning from foreign models and adjusting them to domestic conditions resulted in choosing an institutional design that subordinated the Fund to the chief executive: "The distinctive feature of SOFAZ is its ultimate subordination to a single agent, in the person of the president, in that the establishment, regulatory, and asset management decrees were all determined by the president."[135]

There were three reasons why the government decided to create an oil fund through policy transfer. First, the government realized that effective revenue management was instrumental to maintaining economic stability. Second, creation of an oil fund was a good way to demonstrate to Western governments and investors, as well as domestic civil society groups, its commitment to transparency. Third, the government wanted to keep good relations with the IFIs, which provided financial support and policy advice in many policy areas. The IFIs demanded that the Azerbaijani authorities adopt a set of rules for proper management of oil wealth. In other words, "conditionality" also played a role.[136]

The Fund is held to be transparent. It received the UN Public Service Award in the category of "Improving transparency, accountability and responsiveness in the public service" and was certified as compliant by the Extractive Industries Transparency Initiative (EITI) in 2009.[137] In 2007, the Fund got the highest score for transparency among sovereign wealth funds on a par with Norway.[138] The Fund's staff is about 70 professional cadres, many of whom were educated or trained abroad. One journalist even likened SOFAZ to a Wall Street investment house.[139]

Thanks to the "policy dialogue" between the government of Azerbaijan and the IFIs, ideas about how best to solve problems associated with resource curse challenges were made available to the Azerbaijani policymakers. The oil fund has become a crucial instrument of fiscal policy in Azerbaijan. As SOFAZ's executive, Harvard-graduate, Shahmar

---

[134] From the SOFAZ web site, at http://tinyurl.com/bvmkxe7.

[135] Robert Bacon and Silvana Tordo. 2006. "Experiences with Oil Funds: Institutional and Financial Aspects," ESMAP/ World Bank, 80, at http://tinyurl.com/cjqvuhm.

[136] One of the conditions for a $100 million IMF loan in 2001 was the requirement to establish mechanisms to manage the oil fund's assets. See David Stern, "Baku and IMF back oil fund," *Financial Times*, 13 July, 2001, FD.

[137] See http://eiti.org/Azerbaijan

[138] Kenan Aslanli, "Managing the State Oil Fund in Azerbaijan," in Andreas Heinrich and Heiko Pleines, eds., *Challenges of the Caspian Resource Boom*, 240-41.

[139] Dominic O'Neill, "State Oil Fund of Azerbaijan: Azerbaijan goes the other way," *Euromoney*, 1 January 2009.

Movsumov observed, the Fund functions as "the government's fiscal sustainability buffer."[140] What is clear, however, is that since the government lacked any prior experience, it relied heavily on knowledge from foreign models, such as Norway's, and advice from the World Bank and the IMF.[141] There were no endogenous sources for developing such policy innovations. Lack of experience meant it would be a learning curve for the government. As the Azerbaijani economist Ingilab Ahmadov pointed out in an interview, "Azerbaijan is learning as it goes along, like any developing country, how to spend its new revenues."[142]

To conclude, the regime has been able to respond to oil's adverse effects by adopting a successful fiscal policy (setting up a savings fund) based on accumulated knowledge and lessons learned about the problems associated with Dutch disease and fiscal volatility, as transmitted through the World Bank, the IMF, and EITI, and developed limited capacity (with insulated technocratic staff) in the selected key policy area of oil revenue management, which helped the regime to manage the adverse effects of oil and postpone painful diversification. Policy transfer was essential for the government's ability to mitigate the adverse effects of oil booms and busts.

Conclusion

There are two properties of oil that are politically consequential. First, oil is a source of windfall revenue for the state, "manna falling from heaven." Second, oil is notorious for its volatility. Each of these properties is associated with separate strategies of regime survival. As this study demonstrated, FDI inflows, oil bonuses and oil rents provided a valuable source of patronage for the regime. Oil revenues allowed the president to increase public spending and to expand the patronage network, which limited the space for political opposition groups. Increased spending on coercive structures as well as an increased use of repression against political activists helped keep societal opposition weak. By keeping monopoly control over the media and restricting access to public information, the regime denied citizens the right to scrutinize government expenditure projects.

But oil also induced shocks that tested the ability of the regime to meet and overcome potential crises. How can we explain that the Azerbaijani regime was able to withstand the adverse effects of oil during the boom years (since 2003) and during the revenue shortfall in 2008? Existing explanations focus on state capacity and robust party coalitions

140 Elliot Wilson, "Azerbaijan: Sofaz steps out of its comfort zone," *Euromoney*, February 1, 2012.

141 The IMF's local office in Baku is located in the building of the Ministry of Finance.

142 Nurlana Gulieva, "Azerbaijan debates 'Dutch disease,'" *IWPR*, August 2, 2006, at http://tinyurl.com/7ymtpzs.

(before oil) as well as on strategies of (non)diversification. The evidence here suggests that neither institutional capacity nor the bureaucratic professionalism of the state was improved when revenues became abundant by the early 2000s. Because of systemic clientelism and corruption, state capacity remained deficient. The ruling party was also a weak institution. There were no sufficiently strong state or regime institutions that the regime could rely on to manage the oil-induced shocks.

Confronting the adverse effects was a serious challenge. Here the regime faced two dilemmas: 1) between institutional empowerment and the entrenched patron-client structure; and 2) between diversifying the economy and the political risks associated with economic diversification.

Managing fiscal volatility requires adequate institutions to meet and respond to external shocks. However, stronger institutions will constrain the discretion of the president and limit the scope of patronage. Therefore, comprehensive institutional capacity development was not an option, as it would require the demolition of the established patronage networks and vested interests. That would run counter to the logic of power preservation under personal rule. Personalist leaders are particularly unwilling to develop state and regime institutions, such as governing parties or professionalized bureaucracies, because of the fear that these institutions may turn into autonomous centers of political power that could breed rival elites.[143]

A second dilemma is choosing between the benefits of economic diversification and the political risks that the diversification may entail. The possible resentment from the status-quo elites made diversification a very difficult choice both economically and politically. Promoting alternative sectors requires longer time horizons: benefits are not immediate and payoffs are uncertain. As Geddes put it, "many authoritarian regimes resist to undertake market-oriented reforms if the costs of such reforms fall on members of the government and their close supporters."[144] For the status quo elites, diversification means giving away the goose that lays the golden egg. Because of that, diversification was not promoted.

The regime was able to mitigate the adversity of oil revenues by learning to cope with it. The availability of foreign models as well as expert advice facilitated a policy transfer. The government established an insulated "isle of transparency" in the key policy domain of revenue management. As Chehabi and Linz pointed out, personalist/sultanistic rule is not "incompatible with a certain rationalization of the administration, as long as this rationalization enhances the ability of the ruler and his

[143] Jack Goldstone. 1982. "The Comparative and Historical Study of Revolutions," *Annual Review of Sociology* 8, 196.

[144] Barbara Geddes. 1995. "The Politics of Economic Liberalization," *Latin American Research Review* 30: 2, 206.

cronies to extract resources from society."[145] The oil fund has become the government's key mechanism to mitigate external shocks. The operation of SOFAZ helps the government to maintain macroeconomic stability. But the current equilibrium is hardly sustainable. Hydrocarbon reserves will be depleted in the next 20 years and fiscal balance will begin to decline in 2014.[146]

Finally, this study underlined the importance of lesson-drawing as its contribution to a recent strand of comparative research that argues that dictators are good learners.[147] As Dobson put it: "Modern authoritarians have successfully honed new techniques, methods, and formulas for preserving power, refashioning dictatorship for the modern age."[148] Policy transfers should be added to autocrats' toolkit of strategies of control and survival. This study thus complements conditional theories of the "resource curse" by highlighting policy learning and policy diffusion as an important, yet often neglected, variable underlying authoritarian persistence in resource-reliant states.

---

[145] Houchang E. Chehabi and Juan J. Linz, eds. 1998. *Sultanistic Regimes*. Baltimore, MD: Johns Hopkins University Press, 12.

[146] Elisa Cassinadri. 2008. "Resource Depletion, Dependence and Development: Azerbaijan," Working paper, Chatham House, 14, at http://tinyurl.com/dxwynyk. This prediction does not take into account the launch of the second phase of the Shah Deniz gas project, which is expected to come on stream in 2016-17. See BP Caspian, Shah Deniz, at http://tinyurl.com/99jkqvn.

[147] William J. Dobson. 2012. *The Dictator's Learning Curve, Inside The Global Battle For Democracy*. New York: Doubleday.

[148] Dobson, ibid., 4-5.