Structural Reforms in Azerbaijan

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In order to create favorable conditions for economic development and to ensure dynamic development in Azerbaijan, structural reforms are very important. Although independent experts and international organizations have been saying for a long time that Azerbaijan needs structural reforms (EBRD, 2010, 12), only in 2015 after two consecutive currency devaluations and a simultaneous drop in economic indicators was the need for structural reforms in the Azerbaijani economy recognized and the government began to give more attention to the issue.

It is no accident that documents such as the *Strategic Road Map for the Prospects of the National Economy*, written after the economic crisis had begun, stress the transition to a more effective management system and the sustainability of structural reforms. But where does the need for structural reforms come from, and what should structural reforms include to meet these needs. How can such issues as institutional reforms and ensuring the rule of law, considered as component parts of structural reform, create favorable conditions for economic development? In Azerbaijan, what are the areas where the need for structural forms is most pressing and what are the difficulties which may be preventing their implementation in those same areas? Along with answering these questions, I make the claim that structural reforms include changing the behavior and approach of the system and ensuring transparency and accountability in this process is very important.

Since the beginning of 2019, the process of dissolving several state agencies and merging others began, new appointments were made, and orders were signed to deepen reforms in some areas. Meanwhile, bureaucrats, after the strengthening of the ruling

party, began to communicate with the public more sincerely and directly, something unheard of before (Qafqazinfo 2019), several social and even political problems which had gone unsolved for a long time were resolved, and state officials said that this process would continue. In this context, discussions among the public about structural reforms became widespread. One of the issues which has come to the fore is the question of which of these actions can be considered structural reforms and which cannot.

To provide a detailed explanation, I will explain first of all what structural reforms are and what areas they encompass. Then I will show which issues the implementation of institutional reforms and the guarantee of the rule of law are aimed at solving and which changes they are the cause of. Finally, I will look at which areas are most in need of structural reform in Azerbaijan.

An overview of the literature

A number of international organizations, first and foremost the United Nations and the World Bank, consider a priority of their work to encourage structural reforms and to help countries which are working in that direction. The European Union established the importance of structural reform, making it one of the main conditions for membership. The report by the World Bank's Development Research Group, *Governance Matters*, analyzes various indicators for successful economic and social development, such as voice and accountability, political stability, government effectiveness, rule of law, etc., and shows that one of the most important means of improving these indicators is structural reform (World Bank, 1999, 6)

The Organisation for Economic Co-operation and Development (OECD) has defined structural reform as "policy change directed at improving the static or dynamic efficiency of resource allocation in the economy" (Koromzay 2004, 1). Based

on this approach, first and foremost rents which have been obtained unfairly within the economy must be eliminated. To change this situation, policy alternatives which have been proposed include implementing policies promoting competition which would allow small and medium-sized businesses to go up against monopolistic companies in the market, and lowering tax rates by widening the tax base.

It is noted that there are two big obstacles in the way of structural reforms aimed at a more fair distribution of funds by way of eliminating unfair rents. The first is actions taken against the reforms by those whose interests are threatened, and the second is a lack of support from the public, who will earn more thanks to the changes, but who do not understand the reform's benefits because the positive effects will only be felt in the long-term.

According to the OECD's report, The Political Economy of Reform, based on the experiences with reform of 10 member countries, the main condition for successful structural reforms is to obtain authority from the public in accordance with democratic conventions, thereby simplifying the implementation of reforms. Reforms implemented quietly without the public's support or sprung on them as a surprise can only garner approval if they bring about big changes quickly. While it may be possible to quickly achieve improvement in some indicators, structural reforms implemented in such a short period cannot be the cause of the big changes people expect from them (OECD 2009, 59).

In order to gain the public's support, communication is of great importance. The need for reform must be explained to voters groups that will be affected, and to explain effectively the estimated costs of failing to carry out reforms. To do this, in-depth, comprehensive research and analysis must be undertaken before starting the reforms. One of the conclusions of the research is that structural reforms are more effective in countries experiencing some turbulence,

where there is a lot of socio-political activity in the existing system. In the case of an existing system that is established and in control of everything, it is more difficult to successfully implement reforms.

Issues related to structural reform also play an important role in the activities of various international organizations, regional institutions, and individual economists. Asia-Pacific Economic Cooperation (APEC), for example, classifies the roles played by the state into three groups based on the areas in which structural reforms are carried out (APEC Economic Committee, 2015). The first group includes those areas where the state acts as a judge, such as the state's activities in ensuring free competition. The second group includes areas where the state provides services, including education and health services. The third group includes those areas where the state acts as both a judge and a service provider, examples of which include legal and judicial services.

According to the Turkish economist Mahfi Eğilmez, structural reforms can be characterized as a restructuring of the existing system to become more productive and shock-resistant (Eğilmez, 2015). In his opinion, steps taken to ensure that the economy operates in a more appropriate way within the framework of the economic system, the outside environment, and its own limitations, can be considered to be structural reforms. However, it should be noted that these steps should not be restricted to issues related to the economy, but should encompass closely related areas such as the judicial system, the education system, and political participation as well.

According to Dani Rodrik, who has studied reforms implemented by governments in a number of countries at different times, high-quality government agencies play an important role in achieving development. In order to effectively organize the work of institutions in society, quality government agencies and governance systems are crucial. Accordingly, as part of structural reforms, particular significance must be given to

institutional reforms (Rodrik 2000, 23).

Institutional reforms and improving the quality of governance

In addition to the models applied to economic growth and development issues, societal institutions and government policies should also be taken into account. From this point of view, it is impossible to justify development policies simply by an abundance of capital in the country, or to solve the problem of economic growth simply by loading up on foreign currency. The fact that many countries rich in material resources have been unable to achieve sustainable development is one of the clearest indicators of this (Nye 2011, 4-5).

It is important to emphasize how important it is not to confuse tools and measures used to implement the policy with institutions. Changing tariffs and tax regimes is the easy part of the problem. The more important thing is how to change the patterns of behavior in the public sector and the attitude of the government towards various areas. Therefore, the major changes expected from reforms are not new quantitative restrictions and tariffs, but newly-created rules and expectations regarding how decisions are to be made and implemented in the future. Such reforms are characterized by the emergence of a new approach to what development policies should look like and eventually turn into institutional reforms on a massive scale. It is also crucial that the implemented reforms are targeted at altering behavioral stereotypes that adversely affect economic activity. Institutional reforms should not be limited to policy parameters, but should also alter behavioral stereotypes that currently exist and obstruct development (Rodrik 2000, 24-26).

In their famous book, *Why Nations Fail*, Daron Acemoglu and James Robinson state that a society gets the opportunity to develop when it has inclusive, i.e. pluralist political institutions that are equally fair to all. The opposite are exploitative political institutions that serve the interests

of a small group or elite. “Extractive political institutions concentrate power in the hands of a narrow elite and place few constraints on the exercise of this power. Economic institutions are then often structured by this elite to extract resources from the rest of the society. Extractive economic institutions thus naturally accompany extractive political institutions. In fact, they must inherently depend on extractive political institutions for their survival” (Acemoglu and Robinson 2012, 81).

The authors’ approach is that exploitative political institutions cannot possibly exist in an inclusive economic system, therefore it is futile to expect such a political system to be based on a pluralistic and free competition-based economic system. When political institutions are not inclusive, political power is not fairly divided between different social groups, and these institutions are used in the name of elite interests. It is never possible for exploitative political institutions to carry out the reforms to build an inclusive economic system – otherwise, they may create conditions for the emergence of forces capable of providing economic support to opposition organizations. They are quite convinced that an inclusive economic system would result in the total loss of their political control (Acemoglu and Robinson 2012, 372-373).

Political institutions determine how the economic entities operate and how they will evolve. From this point of view, alongside economic indicators, guaranteeing political freedoms, creating opportunities for media and civil society to work freely, and political participation also become important for economic development. According to this approach, countries’ levels of development are not related to their geographical position, natural resources, or other conditions, but to the quality of their institutions and governance systems. Because inclusive institutions, first and foremost, create equal conditions for society to create the conditions that best reflect the country’s potential.

It is impossible to expect a society, in which property rights are not guaranteed and creative ideas are not supported or promoted, to realize its potential. Therefore, the formation of functional policy mechanisms through institutional reform is one of the most important elements of structural reform. Economist Azar Mehtiyev believes that reform's benefit to society is measured by its ability to create an environment that can provide economic growth: how economic growth is ensured and how sustainable it is. In other words, the criterion of reform assessment is the contribution it has made to the creation of a quality institutional environment in the country (Mehtiyev 2017, 31). One of the most important parts of structural reform is ensuring the rule of law, as legal mechanisms are required to improve the activities of the political structures and institutions concerned.

The rule of law and development

There are many studies on this subject because the interaction of law and economics is a broad topic. The study by Stephan Haggard and Lydia Tiede, "The rule of law and economic growth: where are we?" states that the relationship between the rule of law and development can theoretically be examined in four aspects. The first one is related to individual security. This refers to resolving conflicts without resorting to violence. According to this approach, the main reason for the occurrence of conflicts that threaten individual security is the lack of legal norms or the improper administration of justice, which should have resolved the issue before the stage of violence. One of the main areas of reform in this respect should be the establishment of a legal system that will ensure the safety of individuals, increasing the credibility of the judiciary and forming legal mechanisms that will contribute to the peaceful settlement of conflicts. Ensuring people's individual security and establishing a functioning judicial system are important incentives for increasing their economic activity (Haggard and Tiede 2010, 5-6).

The next connection between the rule of law and development is related to property and contractual rights. The peaceful settlement of conflicts is possible only with the existence of institutional state agencies. In this regard, development and growth cannot reach the desired level in societies where property and economic rights have not been well-defined or guaranteed. The most frequently used argument for the impact of property rights on economic development is the fact that it creates the causes and motivations that shape the economic decisions of individuals. According to this approach, the protection of property rights and the protection of the legal value of contracts between economic entities affects economic incentives in society, and these incentives in turn create individual needs, choices and demands. It is impossible to talk about commercial activities when property and contract rights are not protected because, theoretically, economic exchange represents a transfer of property rights. Another important aspect of ensuring property rights is for individuals and companies to stand up against the unofficial, or shadow, economy (Driscoll and Hoskins 2003).

The next stage of the relationship between the rule of law and development is to limit the scope of the impact of executive power. The liberal approach in which the government follows predetermined rules is one of the classic definitions of this concept (Hayek 1943, 112). It is very important to limit the power of the authorities through law because the negative consequences of political authorities violating established rules and making decisions that are in line with their own interests will affect the socio-economic activity of the whole society. One of the most important issues in this regard is to ensure the independence of the judiciary, because the independence of the judiciary is a prerequisite for limiting the arbitrariness of the executive. Another aspect of the issue, as important as the independence of the judiciary, is its impartiality. This concept implies that, when making decisions, the judiciary should avoid biased thinking and

ideological inclinations (Haggard and Tiede 2010).

The last stage concerns the relationship between the rule of law and corruption. In addition to the notion of nepotism and fraud, the development-related area most affected by corruption is once again the ensuring of property rights. One of the main reasons for corruption in society is the failure to guarantee property rights and the fact that the existence of these rights is subject to the will of the possessor of authority in society (the government). Corruption becomes a part of the economic system when the government agencies responsible for ensuring these fail at their task. Given the adverse impact of corruption on areas such as investments, economic growth, and revenue sharing, we can stress that ensuring the rule of law is one of the most important components of structural reforms.

The areas in greatest need of structural reform in Azerbaijan

Barriers to development are made up of many rings. There are such problems among them that they play a *uniting* (*connecting*) role for other rings. In other words, each *connecting* problem is the main reason for a number of other problems. From this point of view, it is more appropriate to identify such *linking* rings and direct the reform policy to their solution. Experts argue that, when the list of necessary reforms is long, as a rule, those who develop and implement policies try to implement all of them at once, which in turn leads to a loss of control over these processes, which means that some of the reforms can get in the way of others (Hausman et al. 2005, 43). Another danger is that, in some cases, in order to create the illusion of reform, changes that cannot be of crucial importance, that are easy to implement but will not have a significant impact on the economic growth potential of the country, might be preferred (Rodrik et al., 2006).

In the modern economic system, the competitiveness of a country’s economy is a very important indicator. Taking this

into account, we can find answers to our questions by defining the areas in which Azerbaijan is weak compared to other countries in terms of competitiveness in order to determine which spheres need more structural reforms. For this, we can refer to the World Economic Forum's Global Competitiveness Index. According to the results of the index prepared on the basis of 12 sections and 93 indicators, in 2018 Azerbaijan ranked 69th out of 140 countries (World Economic Forum 2018, 83-85). The areas where Azerbaijan had weaker results are as follows:

Freedom of the press – 133
Inflation – 128
Social capital – 123
Market capitalization – 119
Non-performing loans – 118
Budget transparency – 116
Debt dynamics – 111
Scientific publications – 108
Labor tax rate – 106
Incidence of corruption – 102
Domestic credit to private sector – 99
Healthy life expectancy – 90
R&D expenditures – 90
Road connectivity index – 89
Strength of auditing and reporting standards – 88
School life expectancy – 88
Mobile-broadband subscriptions – 88
Patent applications – 87
Quality of research institutions – 86
Airport connectivity – 79

Based on these results, we can summarize the areas where the need for reform is greatest under three headings: political reform, social reform, and economic reform.

Political reform is primarily about the complete guarantee of human rights and freedoms. Creating favorable conditions for

media, civil society and political parties to work better and freely is also a step towards increasing the quality and transparency of agencies. At the same time, the formation of an electoral institution in line with transparent and democratic principles is one of the most important steps for effective development policy.

Another area we can assess within the framework of political reform is political decentralization. Particularly in terms of regional governance, the financial and administrative dependence of the regions on the central government is striking. Factors such as adapting to changing conditions within the framework of globalization, competition, the development of human resources, tracking global trends, flexibility in organizational structures, and financial control make it necessary to switch from a *traditional* regional development policy to a regional development policy within the framework of a *new regional concept*. The most prominent features of the regional development policy developed within the framework of the new regional concept was the emergence of new players in the formation and implementation of policy mechanisms, and the growth of the role of local institutions of self-governance and non-governmental organizations. In this regard, in the new regional development policy, the significance of internal potential has increased and the policy has become more comprehensive. While local governments are technically part of the state, they are physically and psychologically closer to the local community. In this regard, the fact that local institutions of self-governance have a key role in the design and implementation of local economic development policies has a major impact on the successful implementation of this policy.

Experts say that one of the main reasons why local municipalities, recognized as local institutions of self-governance, are unable to participate actively and effectively in the regional economic development process, is that local

executive authorities and other government agencies have broad powers in local matters (Bayramov 2010, 5).

Table: Division of powers between state authorities and municipalities in the implementation of various public functions (Ağayev 2007, 8).

Public service	Governance level of implementation		
State	**Municipality**		
1	Registration of civil status acts	+	–
2	Sanitary and veterinary control	+	–
3	Standards and measures	+	–
4	Geodesy and cartography	+	–
5	Maintenance of public order	+	–
6	Fire protection	+	–
7	Regulation and management of communications, including telephone, postal and telegraph services	+	–
8	Regulation of public transportation	+	–
9	Regulation of the delivery of education services to the population	+	–
10	Regulation of delivery of health services to the population	+	–
11	Regulation of housing management	+	–
12	Management and regulation of communal services, including drinking water, gas and electricity supply	+	–
13	Social policy, including social security of the population, maintenance of social services and boarding schools	+	–

14	Employment stimulation	+	–
15	Regulation of the management of melioration infrastructure	+	–
16	Preparation of events in the cultural sphere and art, management of cultural artifacts	+	–
17	Road management	+	+
18	Land renovation	+	+
19	Preservation of cemeteries	+	+
20	Implementing activities related to ensuring the environmental safety of the area	+	–
21	Separation of land and garden areas for individual housing construction	+	+
22	Preservation of museums	+	–
23	Preservation of parks and greenery	+	+

As can be seen from the table, of the 23 types of public services, state agencies have authorities in all of them, while municipalities have authorities in only five of them. This indicator, along with the limited powers of the municipalities, also shows that there is doubling of some functions. This doubling, as well as complicating the management mechanism, causes more expenditures as it doubles the financial costs of the same work. From this point of view, the importance of a clear division of powers between agencies of the local executive authorities must be emphasized.

In terms of **social reform**, the area which attracts the most attention is the education system. According to the results of the OECD's Programme for International Student Assessment (PISA), out of 65 countries Azerbaijani schoolchildren were ranked 64 (OECD 2010, 11), while in the 9th grade final exams, in 13 regions and cities students received between 20-40

points and in the remaining 60 administrative territorial units they received between 40.1-50 points, indicating the seriousness of the situation (BRI Economics Team 2018).

Along with the education system, the gap between the level of social services and public utilities between the capital and the regions could also be one of the main focuses of social reform. Official figures show that the number of qualified doctors per 10,000 people is 89 in Baku, while it is only 6-10 in Lerik, Yardimli, Masalli, Samukh, Dashkasan, Gadabay, Goygol, Guba, Shabran, Ujar, Zardab, Kurdamir, and Hajigabul. In general, the number of qualified doctors in 48 out of over 60 regions is below 20 for every 10,000 people, which is on average five times lower than in Baku. In 18 of more than 60 regions, less than 20% of the population is served by a centralized sewerage system, while a further 32 regions it is less than 40% of the population (BRI Economics Team, 2018). Solving these problems can contribute to the regulation of internal and external migration, as well as to the improvement of people's quality of life.

Considering that about 90% of the country's export products are crude oil, petroleum products and natural gas (SOCAR 2018), and 75% of GDP and about 95% of tax payments are originate from Baku (Ağayev, 2016), the main objectives of **economic reform** should be to achieve diversification of the economy by developing various industries and to provide a more equal distribution of economic activity around the country. Taking into account the importance of financial resources in activating the economy, and based on indicators such as that overall credit investments fell from 2015 to March 2018 by 46.3%, from 21.7 billion AZN to 11.7 billion AZN, one of the most important issues that must be solved is to increase access to credit resources.

The government's decisions can have a significant impact on the activities of economic agents. According to Mehtiyev, "one of the forms of behavior that must change is decision-making

by the state behind closed doors when the decisions directly impact businesses' expenditures and revenues (for example, tax rates changes, the cancellation of tax breaks, raising energy prices as well as utilities and other service costs) causing business to incur serious losses. Business is unable to properly plan its activities because it cannot get timely information about such decisions. The ability to make long-term projections about business environment is crucial. Therefore, the government must abandon the practice of making decisions in secret, laws and decisions affecting business should be publicly debated, and there should be enough time between these decisions being made and then coming into force to allow business to adapt to the new rules" (Mehtiyev 2017, 30).

Conclusion

Structural reforms are crucial in addressing the problems slowing down economic development and ensuring the sustainability of development. Therefore, it is necessary to differentiate between structural reforms and various regulations. Unlike regulations and policy changes aimed at restoring stability, which address challenges in the short-term, structural reform involves systemic changes in behavior and new approaches and encompasses a longer timeframe.

The most important indicators of the structural reforms often promised and imitated by the government, which would demonstrate its commitment, are ensuring transparency and accountability. According to this approach, the areas encompassed by structural reforms should not be based on populism, but should be based on in-depth research and analysis, and different interest groups should be included in the process.

It should be noted that the extent and scope of structural reform may not be the same in each country. For example, in the countries where democratic institutions are established

and judicial independence and oversight of the executive are ensured, the scale of structural reforms aimed at addressing economic development may be limited to economic issues. However, in countries where the effective functioning of institutions and the rule of law are not ensured, structural reforms aimed at addressing problems in any one area must encompass all these areas.

Factors such as the increase of the ratio of aggregate public debt to GDP from 8.2% in 2014 to 23.9% in 2018 and the fact that more than half of state revenues still come from oil revenues, show the great need for structural reforms in Azerbaijan. Untimely and incorrect implementation of these reforms leads to the deterioration of people's social conditions and their quality of life, as well as the emigration of skilled professionals and a slowdown in the flow of foreign investment.

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