Limits of Externally Backed Institutional Reform and Development in Azerbaijan

Nahmadova, Firuza

Baku Research Institute

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From the moment Azerbaijan opened itself to international markets after the fall of the USSR, many regional and international actors have shown interest in its economic development and democratic governance. Aside from their direct interest in securing oil and gas resources, international actors involved in Azerbaijan have also recognized the importance of how the country is governed. As a result, these actors have made efforts to shape the country's institutional framework by pushing for specific sets of reforms and creating incentives to adopt these reforms by withholding investment or by investing money via grants and development projects. Many international organizations, such as the UN, the World Bank, and the Asian Development Bank (ADB), have shown support for social and economic reforms and projects, as well as institutional changes to create better governance. However, when analyzing non-economic related reforms, such as anti-corruption and governance effectiveness, international organizations have failed at considering the contextual limits of the formal and informal institutional framework in place.

This paper discusses Azerbaijan's experience with foreign-backed reforms and projects initiated by USAID and the World Bank and argues that failure in such efforts is related to the way in which these reforms are designed. These international organizations have failed to consider the contextual limits of the country and have inadvertently incentivized international best practice compliance only as a signal for attaining short-term support (Andrews 2013). Such behavior is clear in Azerbaijan as, despite the many projects initiated, its governance, corruption, and regulatory compliance indicators have worsened in the past decade. After a discussion of Azerbaijan's experience with externally supported reforms, the paper reviews the most recent strategies from the United States of America International Development (USAID) and the World Bank (WB) to determine how likely future initiatives and efforts are to succeed.

Part 1: Better government and foreign-backed institutional reform

The World Bank's Worldwide Governance indicators are among the most commonly used to assess a government's capabilities in supporting citizen's voice and accountability, ensuring political stability and safety from violence and terrorism, as well as the government's overall effectiveness, regulatory quality, respect of the rule of law and control of corruption (World Bank 2021a). Governance is then defined as "the traditions and institutions by which authority in a country is exercised," including the way governments get into power, design and implement policies, and a government's relationship with its citizens (Kaufmann, Kraay, Mastruzzi 2004).

The Organization for Economic Co-operation and Development (OECD) defines good public governance as embodied by a government that designs and implements evidence-based policies to "respond effectively to diverse and disruptive economic, social and environmental challenges and deliver on government's commitments to citizens" (OECD 2022a).

The United Nations Human Rights Office (OHCHR) defines governance as "all processes of governing, the institutions, processes, and practices through which issues of common concern are decided upon and regulated" (OHCHR 2022). In turn, good governance indicators' objectives are to assess how likely political and institutional processes within a country are to achieve their development goals (OHCHR 2022).

On the other hand, USAID's definition of governance focuses on the promotion of democratic governance as an essential component of "sustainable development and lasting peace," and draws correlations among a lack of respect for democracy and ineffective governments, high levels of corruption, and a weak rule of law (USAID 2021). USAID also makes an assumption about the role of democracy in government effectiveness because the aid organization emphasizes the importance of free and fair democratic elections.

Based on these broad definitions of good governance, international organizations work conjointly with national governments on the establishment of new rules, regulations, and institutions, as well as the implementation of policies to achieve better governance. As of the end of 2021, the total amount spent on development aid by member countries of The OECD reached a peak of 178 billion USD (OECD 2022b). Considering the amount of financial investment made by different international organizations and the analysis that goes into the design of the institutional reforms supported by these projects, one would assume that a large majority of these lead to long-term improvement in government effectiveness. After all, they must believe they are achieving something if they continue to invest in development.

However, there is no consensus as to whether development aid truly affects government effectiveness. Results of such initiatives are mixed and while in some cases, governance improved in developing countries, in others it did not have the expected long-term effects, or worse, development aid has had a negative effect. For instance, rule of law reforms pushed by international organizations in different developing countries have rarely ended in effective implementation of change (Andrews 2013). Furthermore, the amount of aid a country receives in institutional reform does not automatically correlate with more functional governments).

In particular, foreign aid can harm democratization and liberalization efforts by producing new sources of external rents, which are exempt from accountability from the domestic population. This is especially so in resource-rich countries with rentier economies and a strong political elite with control over the natural resources sector, such as Azerbaijan. In turn, this additional source of revenue decreases the need for tax reform which would otherwise force the authoritarian state into a bargaining process with the domestic population to raise more government revenue (Moore 2004).

Some researchers have combined social conflict theoriesof institutions with rent-seeking theories to determine a window of opportunity for meaningful institutional change in rent-seeking economies. This type of approach views institutions as social choices where rent-seeking groups with higher bargaining or political power maintain the institutions from which they most benefit (Khan 2015). As such, countries with economies depending on high rents from natural resources, such as Nigeria, Venezuela, and Mexico, do not positively benefit from foreign aid as it only deteriorates the incentive of the ruling elite to pursue institutional reform. The window of opportunity for institutional change to happen appears when the rent-seeking groups in power are incentivized to change towards a more efficient institutional framework.

Studies also show that oil-rich countries receive more foreign aid from donors depending on oil imports (Couharde et al. 2019). Donors' political motives behind foreign aid are readily apparent as G7 donors favor their bilateral trade partners in the oil sector, particularly when the oil market is unstable. We can see how donor countries pursue their self-interest in securing oil supply in the correlation between foreign aid to oil exporters and oil imports from a given country: the higher the amount of foreign to a given oil exporter, the higher the share of that country's oil exports are found in the donor country's oil imports. In turn, the energy security policies of both donor and recipient countries are relevant to the allocation of foreign aid and the incentives for institutional reform.

The oil-rich recipient country is in turn incentivized to use institutional reform as a signal for securing external support and investment. That signal is without substance, for it does not require real will to install a more efficient institutional framework. This perverse incentive explains why reform designs often follow a one-size-fits-all scheme where results are less than satisfactory and implementation is lacking. The true objective is to make the government look good to external actors (Andrews 2013).

Part 2: USAID-backed reforms

As is common with foreign aid, USAID's inflow of foreign aid and assistance in Azerbaijan has been unstable over the years. However, there has been a clear change from a pure oil security view of foreign aid to the country to more focus on socio-economic reforms, at least in terms of discourse.

USAID's Country Development Cooperation Strategy 2011-2020 for Azerbaijan states three main interests: security, energy, and internal reform. The overall goal of the organization's assistance over the same period is to support the country's reform process and promote competition and pluralism for a more sustainable market-based democracy. This goal was to be realized through the attainment of three objectives: an improved investment climate, the participation of diverse actors and institutions in the democratic process, and access to quality health care and targeted social assistance.

The activities listed at the top of the 32-million-USD budget in 2011 were Azerbaijan Competitiveness and Trade (9,9 million), Azerbaijan Strengthening Health Systems (5,9 million), and Azerbaijan Socio-Economic Development (5,76 million). In comparison, out of the 18 million USD allocated in 2020, 5,76 million went to Private Sector development activities and 1,8 million to civil society, while operating expenses amounted to a total of 4,5 million (US Foreign Assistance 2022).

As claimed by USAID in its 2011-2020 strategy paper, the organization's working relationship with the Azerbaijani government is assessed as positive. In particular, the strategy mentions how the local government's decision to co-finance (a near one-to-one match) portions of USAID development programs since 2009 has further helped increase the influence of USAID.

However, an analysis of the budget allocation of all United States Foreign Assistance shows that all US development aid in Azerbaijan, including USAID, is largely focused on securing energy. This includes a discourse centered around the protection of physical resources and assets (US Foreign Assistance 2022). At its peak of 79 million USD in 2011, out of which 57 million were allocated to governance-related matters, the US invested over 50% of total foreign aid (42 million) into security, threat reduction, and military training and equipment projects. The total amount invested by the US was 32 million USD in 2020 in a more varied set of projects, mainly conflict, peace, and security programs (17 million), and government and civil society activities (5,8 million).

The US foreign assistance budget as a whole has a strong focus on energy security and counterterrorism objectives, which haven't changed much despite the clear risks that oil revenue dependence represents to Azerbaijani socio-economic stability. Economic reforms, particularly those targeting the private sector and foreign trade facilitation, have shown positive results as can be seen from improvements in Azerbaijan's Doing Business rankings (World Bank 2022b) over the years. However, these results are limited and natural resources still dominate the economy (IEA 2021).

Figure 1: US Foreign Assistance, including USAID, investments in Azerbaijan (2001-2022). Source: US Foreign Assistance 2022.

Development organizations, including USAID, tend to overlook the local context and assume, wrongly, that the introduction of external ideas, international best practices, and institutions is sufficient to improve the recipient country's institutional framework and unlock its growth potential (Andrews 2013). For instance, within healthcare-related reforms, some progress has been made over the last decade. However, Azerbaijan is one of the lowest performers in the post-Soviet region, particularly in infant mortality rates (19,4 out of 1000) which are higher than those of neighbors Armenia (10.9 per 1000) and Georgia (9.4 per 1000).

It is worth noting that USAID evaluation and analysis reports from the early 2010s to today have changed in the methodology used to design reforms. This is apparent when looking at more recent USAID evaluation reports on Azerbaijan, such as the Political Economy Analysis of the Health System in Azerbaijan (USAID 2022). The report recognizes the organizations' overlooking of the full local context before the drafting of policies, which in turn, might have stalled the implementation of these reforms. Efforts put into better understanding this local context is clear because the same report analyzes contextual factors that can affect the implementation of institutional reforms within the healthcare sector, such as the legacy of the Semashko system, formal and informal out-of-pocket payments, or the difficulties that vulnerable populations face when accessing healthcare.

Furthermore, the US's focus on military aid first and socio-economic reforms second inadvertently incentivizes the Azerbaijani government to use socio-economic reforms as signals. No matter how relevant or irrelevant a reform is to the local context, the government is incentivized to accept and implement it to some extent to show its willingness to cooperate, gain short-term support (Andrews 2013), and attract more investment in the future. The 2018-2022 primary goal was yet again "an independent and stable Azerbaijan capable of addressing security threats and contributing to international security" (USAID 2018), once more signaling to the local government the true objectives of US foreign assistance.

Part 2: World Bank and EU-backed reforms

As of February 2022, the World Bank together with the European Union signed a 5,25 million USD partnership agreement, the Administrative Agreement for the Azerbaijan Rapid Technical Assistance Facility (AZTAF), with the Azerbaijani government. This three-year program targets the provision of "advisory and analytical support and capacity building [...] in line with Azerbaijan's 2030 National Priorities" (World Bank 2022). One of the outcomes expected of this project is the construction and development of 'smart villages' in rural areas (EU 2022).

As defined by the World Bank, smart villages focus on using technology, private sector development, and good governance to enable communities to create opportunities and solutions based on demand (World Bank 2022). To achieve this outcome, several intermediate objectives are listed, including support for digital inclusion and competitiveness, enhanced energy efficiency policies and legal framework, and increased innovation in rural areas. This project goes alongside the EU's Economic and Investment Plan for Azerbaijan which allocated over 2 billion USD in foreign assistance to the country in 2021 (EBRD 2022).

The smart-village development plan was initially proposed by the World Bank in October 2021 (World Bank 2021c). The WB's readiness analysis is comprised of five criteria to decide which regions of the country would most benefit from the creation of smart villages: 1) total population, 2) the area in square kilometers, 3) percentage of rural population and 4) agricultural employment, 5) average income, 6) number of Small-and-Medium-Sized Enterprises, and 7) the number of financial institutions in the region. The readiness indicator is thus based on just a few metrics that do not analyze the full local context, particularly disregarding the informal one (e.g.,).

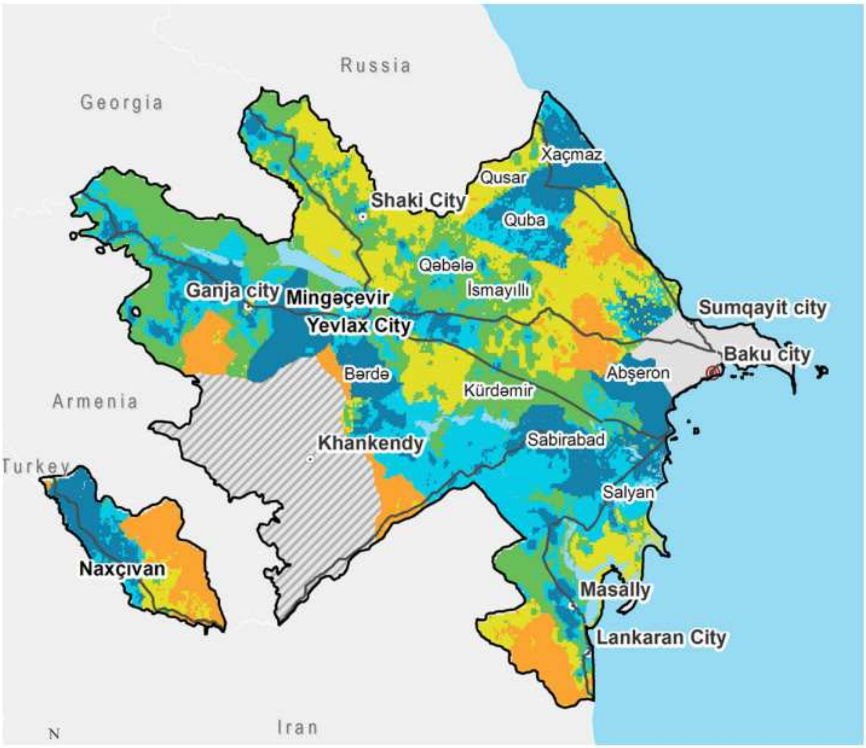

Figure 2: Smart village readiness in Azerbaijan. Legend: Blue is most ready, yellow least. Source: World Bank, 2021b.

The guiding principles for a successful smart village as listed in the WB report are communities, local entrepreneurship, digital and social innovation, rural-urban links, cross-sector solutions, cooperation between different actors, data-drivenness, "good connectivity", and digital literacy, strong funding from government and external sources, as well as the existence of appropriate governance structures. However, the smart-village project is an example of what Matt Andrews (2013) describes as "over-specified, over-simplified reform."

The first shortcoming appears when examining the readiness indicator, which consists of seven numeric metrics. While the content required to yield positive results is much more complex, the readiness score would initially suggest otherwise. As each of these smart villages would require multiple institutional reform projects, particularly when it comes to "appropriate governance structures and data-driven decision-making" (World Bank 2021c), a readiness score based on basic statistics reflects a simpler image than reality.

The second shortcoming is the significant disagreement between World Bank discourse and that of the Azerbaijani government on the purpose of smart villages. The WB report states that the government seeks to implement and build smart villages to develop rural economies and lead the way to economic diversification. On the other hand, national discourse is centered around the idea of using smart villages as the main resettlement areas for Karabakh returnees (Aliyev 2021). This is again clear from the Azerbaijani President's speech during the recent opening ceremony of the first stage of the Smart Village project in Zangilan district where Aliyev discussed how most former Internally Displaced Persons want to return to their homes and the importance of smart villages in achieving that (Azertag 2022).

While it is true that financial inclusion, digital literacy and connectivity, and access to sustainable energy are objectives that should be targeted within the rural regions of Azerbaijan, the context of the 2020 war in Karabakh and that of the formerly displaced persons should have been considered before launching such a large project. The World Bank discourse and analysis overlooks this local context and the specific needs that go with the resettlement of returnees. Furthermore, some of the biggest challenges that the smart-villages concept face in Azerbaijan include digital and financial weakness, ineffective and centralized governance, as well as the lack of trained human capital which could participate in the development of such villages (Valiyev 2021).

As a result of these shortcomings, the WB-backed smart-village projects start at a serious disadvantage where the requirements for success are not met or can't be met in the timeframe of the project.

Conclusion

Institutional reform and development projects backed by external organizations such as USAID and the World Bank have been involved in Azerbaijan for years, yet, despite decades-long experience, the content of these reforms is often misguided or misaligned with the country's national interests. Because international organizations tend to overlook critical local context features before designing the reforms, the influence of these reforms and projects is often limited. Two specific issues have to be considered if institutional reforms are to be taken seriously by the local government to then implement them effectively. The first is to deprive the local government of the incentive of using institutional reforms and other related projects as signals. The second calls for a better understanding of the local context and national interests before designing a project or reform, such as in the case of the smart villages.

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