

Contents

SUMMARY	3
1. INTRODUCTION	5
2. CORRUPTION LEVELS IN AZERBAIJAN ARE HIGH COMPARED WITH OTHER COUNTRIES	13
3. GENERAL ECONOMIC BACKGROUND	19
3.1. Recent history of production decline and growth	19
3.2. Inflation history and stabilisation policies	27
3.3. Poverty and the macroeconomic development in Azerbaijan	28
4. INSTITUTIONAL BACKGROUND TO THE PRESENT CORRUPTION	31
4.1. Underground economy	31
4.2. Financial arrears, bartering complexes and the interaction between soft and hard money	34
4.3. Taxes and corruption	41
5. SOME CHARACTERISTICS OF THE CORRUPTION IN AZERBAIJAN	45
5.1. The incidence and character of corruption in Azerbaijan	46
5.2. The location of corruption	52
5.3. Why corruption levels are so high during the economic “transition” – some political reasons	57
6. RECENT HISTORY OF CORRUPTION IN AZERBAIJAN	62
7. CLANS AND CORRUPTION	69

7.1. Azeri clans and their Soviet roots	71
7.2. Clans and corruption: The sale of public positions	73
7.3. How centralised is corruption in Azerbaijan?	77
8. THE OIL INDUSTRY AND CORRUPTION IN AZERBAIJAN. A RISK ASSESSMENT	81
8.1. Briefly about the oil industry background in Azerbaijan	82
8.2. Corruption and the PSAs in Azerbaijan: the lower level corruption risks	84
8.3. SOCAR and the difficulty of understanding middle-level corruption	89
8.4. Corruption risks at the higher levels	92
9. CONCLUSION	94
REFERENCES	98

Summary

This research report presents an analysis of corruption in Azerbaijan. We have mainly relied on secondary sources. Since data on observed corruption are scarce and unsystematic, we had to give much emphasis on background data that have important impact on corruption levels in general and for which quantitative observations exist: The relative size of the underground economy, the rate of tax collection and the degree of poverty. We draw background data from a sample of countries that belonged to the former Soviet Union, the FSU countries. The countries chosen we consider to be the most relevant for a study of corruption in Azerbaijan, either because they are the largest among the FSU countries or because they are at similar economic level as Azerbaijan, share borders or language. Practical considerations, such as available statistics also play a role.

An important assumption of the study is that the institutional heritage of central planning, such as the networks of the Communist Party and the old supply organisations play an important role in the present corruption in Azerbaijan. Moreover, the change of the monetary system during the transition from the soft accounting money of central planning to the hard money of market economies is also important, we believe. We construct a kind of verbal, institutional model in order to explain the high level of corruption in those countries, where the ability to collect taxes is a crucial variable. This model we consider applicable to most former FSU countries and, with some modifications, countries like China and Vietnam. By the help of these assumptions we bring in data collected from other countries to indicate corruption-generating mechanisms also at work in Azerbaijan.

One of the research problems we address is to assess how the international oil industry can manage to operate in social and economic environments where extensive corruption is the rule of the day. Initially we expected that somehow those surroundings had to determine the frequency of corrupt acts in the oil industry itself. Being confronted with scraps of evidence, the legal arrangements, interviews with people in the industry, we had to adjust our expectations downwards when it comes to the daily operations of the oil industry. We now believe it may not differ much from the

level in the international oil industry in general. In a separate chapter we present a risk assessment of the problem in different operations in the development of oil extraction in Azerbaijan where we freely mix theoretical considerations and small bits of information about single events.

Nevertheless, the conclusions of the report are rather negative in the sense that we believe Azerbaijan will remain stuck in an equilibrium with a high corruption frequency in the foreseeable future. Even if the oil industry in the narrow sense operates fairly honest and task-oriented, the spill-over to the rest of the economy are fairly weak or non-existing. The present situation is too profitable for the present competing elites to really make them want a change. To make “transition” permanent are in their best interests. The ambitious plans made by the World Bank and the IMF to create an anti-corruption strategy and a modern governmental apparatus, are likely to be very selectively implemented, fitting into schemes of short-run political interests

It is difficult to be optimistic even for the longer run, when the present regime is gone. Econometric studies seem to indicate clearly that countries which are “lucky” and develop a large natural resource base at a time when their government is weak and corrupt, are more likely to become more corrupt and stay so, and for that reason also to experience lower long run growth than comparable countries.

Such negative conclusions as presented above, are based on a large number of uncertain assumptions and beliefs. There exists some evidence to the contrary. The probability of having reached a wrong conclusion is fairly high. We hope we have done so.

1. Introduction¹

Hundred years ago the Baku area of Azerbaijan was one of the major oil extracting centres of the world. As late as in 1940 Azerbaijan represented more than 70% of the total oil supply in the USSR. In 1980 the republic contributed less than 3% of the oil supply in the Soviet Union. There was still much oil left, but a combination of the in-built slow technological change of the planned economies (Berliner, 1976) and the priority given to oil development of Siberia, left considerable scope for renewed oil extraction when the Western oil companies were allowed to enter the area around 1990. Oil resources were not alone in presenting Azerbaijan as an extraordinarily promising site of investment. Its abundant resources of technically competent oil workers and engineers, constituting a large fraction of the stock of human capital involved in the former Soviet oil and gas industry was another important asset.

By 1990, however, Azerbaijan had also become a politically unstable area, deeply marked by an economic and political system quite different from the ones ruling in the OECD area. Violent conflicts were developing of which the one in Nagorno Karabakh was the most important. Altogether, the country stores some 800 000 refugees and internally displaced persons, roughly 10 % of the population, both groups living as refugees in the country today.

When the break-up of the Soviet Union allowed Azerbaijan to become an independent country, a new governmental apparatus had seemingly to be built up from scratch. A large number of reports on extensive corruption and frequent violations of human rights indicate that the process of state building has been problematic. Although the use of violence has for the time being receded to low levels, it still is.

¹ I will like to thank Sefa Yürükel for an enjoyable visit to Baku, Oleh Havrylyshyn, IMF, Arne Melchior, NUPI, Kalle Moene, Department of Economics, University of Oslo and Iver Neumann, NUPI for general and encouraging comments; but in particular Helge Blakkisrud, Daniel Heradstveit and Arne Jon Isachsen (NUPI) for detailed and critical ones. Katia Rozina has made me aware of the possibility that my use of Azeri may be interpreted as politically offensive in ways not intended. If so, I have to make an apology, but I have been unable to change it now.

Moreover, large amounts of social, human and physical capital have been wasted during the change to a more market-oriented economy. A frail physical infrastructure continued weakening, approaching the level of a severely underdeveloped country. While production is now increasing, mostly due to oil developments, GNP is still at low levels compared to what it was during Soviet rule. Poverty and economic inequality have increased. The economic environment is constantly changing, but still very different from any OECD country.

In sum, the oil companies have to operate in a very difficult social, economic and political environment in Azerbaijan. However, unlike most other technologically complex industries, but like the construction industry, the oil industry has proved itself capable to operate fairly efficiently in difficult environments, operating at very different levels of development and with very different types of political regimes. It differs from construction in that when it goes into a country, it has to stay for an extended period. As such it is forced to get involved with politics of the country in more lasting ways. It will be exposed more strongly to political forces and have stronger impact on the political system. That is certainly the case in Azerbaijan where oil investment at its peak may constitute about half of the recorded GNP and the oil industry paying half of the country's tax income.

Moreover, the international oil industry has already more or less implicitly built in a considerable knowledge about how to cope in different and difficult environments. Since it is already committed to stay in Azerbaijan for a considerable period, the industry has particular interests in trying to cope with events and developments taking place in that country.

The present report focuses on the problem of corruption in Azerbaijan. Corruption pervades the public sector and has a great impact of how the public sector operates. It will have important consequences for the likely political, social and economic effects of the growth of the oil industry, if corruption persists at its present levels. Corruption appears so far to have had only minor consequences for that growth itself, but this is mainly due to the overwhelming impact of the large macroeconomic shocks the county has been exposed to.

The extensive corruption in the country does not appear to have major impact on the oil operations as such. Neither have we found any direct indication that the oil companies have been involved in active corrupt practices. While this result is uncertain, and might be contradicted after more extensive research, the overall evidence is such as the interesting research question to raise in the last part of the report are: How and why is it possible to avoid such involvement in the daily operations in a high corruption area? How do the oil companies try to protect themselves and cope with the problem?

Some protection is certainly needed since the companies otherwise would have to involve their employees in difficult role conflicts that would follow if they had to engage extensively in corrupt transactions in order to make their companies receive normal services and complementary decisions from the public sector.

Recently, these role conflicts would tend to become more severe as there is a general trend toward more interest in ethical issues in management, encompassing the issue of corruption. For example, if we compare the strong crusade against corruption in Shell's recent, influential management primer, *Dealing with bribery and corruption* (1999) with Marsh's (1989) cynical textbook of the mid 1980s that gives recipes for how to bribe in bidding competition without being caught, the change in moral climate is striking. The rise of the issue on the agenda of multilateral public organisations such as the OECD, IMF and the World Bank is another indicator. The same applies to the renewed interest in corruption in international organisations representing private industry such as the International Chambers of Commerce. Recently a non-governmental organisation, Transparency International, TI, focusing on corruption as an international issue, has made an important impact. An account of the early stages of this rise in attention is given in Andvig (1996) and will not be pursued here.

Together with the rise in attention and concern goes a widespread feeling that international corruption in fact has become a more widespread behaviour pattern. Whether this is due to what in fact is happening or due to the increased attention as such, is still an open question. For a sceptical account, see Andvig (1996).

However, the major problem discussed in this report is neither the changing attitudes towards corruption and the changing frequency perceived in the international business community nor international corruption directed against the oil industry in particular. As already emphasised, this form of international corruption working in Azerbaijan does not differ substantially from that of other areas of oil development neither in forms nor scale as the one described, for example, in Andvig (1995).

The major problem analysed in the first part of the report deals rather with the issue of corruption in “transition” countries; how the transition from the old planned economy to a more market oriented one has given rise to the present corruption problems in the whole former Soviet Union – the present FSU countries – of which Azerbaijan is a case. The report outlines the economic and political factors which may explain the present corruption and some of its consequences. Given an assumption that Azerbaijan is rather typical, we may bring in empirical information from the other FSU-countries. The reason why we had to choose this approach is that no empirically based, extensive quantitative research on corruption in Azerbaijan has to our knowledge been published till now.² The same applies to several of the more important background factors.

Thus, the major part of the report is an attempt to understand the workings of local corruption in the FSU-countries. Even if not directly involved, this form of corruption is likely to be decisive for the final economic impact of the oil industry also in Azerbaijan.

What we do here is to construct a kind of verbal model of what we believe are the essential mechanisms that generate the high corruption levels in those FSU countries

² World Bank researchers have performed such work, we have been told, but their work has so far not been published, and we have not had access to it. Within the time restraints of the present report, we had to rely on secondary sources. In winter 1999 we had the opportunity of visiting Azerbaijan and were receiving some first-hand information. It was mainly based on interviews and not on observable consequences of concrete actions, and therefore has to be treated with care. When the report is nearing completion, Transparency International has published its corruption perception index for 1999, where Azerbaijan is included for the first time.

where governments have been substantially weakened during the transition towards a more market-based economy. It does not, for example, apply to countries like China or Vietnam where the traditional communist parties have not lost control, although corruption is a significant problem also in those countries.

We emphasise four features:

- (1) The way the former communist party had controlled the Soviet economy through the so-called nomenklatura system for hiring and firing management in order to simplify the control of an industrial system too complex to handle through central command (Andvig, 1992). The party was destroyed around 1990 in most sub-areas of the Soviet Union, but the system reappeared in many FSU countries and regions of Russia, but in different guises. In Azerbaijan even more traditional forms of social and economic control are believed to play a role and the new system of underground management has been called the “clan” system. Control is kept in the traditional Soviet way through the underground management’s ability to control appointments. The control rights appear to have become profitable through fairly standardised sales of public positions. Old behavioural codes in the public apparatus allowed such decisions to be made fairly undisputed. To apply, some reestablishment of central control is a condition since sellers must have some protection of their property rights to the public positions.
- (2) The problems connected with keeping partly alive the low-productivity complex of large enterprises in many areas of the former USSR, most of which could not compete in the world market, but nevertheless had been able together to produce enough surplus to keep people alive in a bearable way. The enterprises had now to try to co-ordinate themselves in decentralised ways to survive. That proved possible to do only at low activity levels through an informal economy where bartering now lost its central direction. Central “planning” went underground. This created a large number of bribe-givers and situations where payment of bribes has been extraordinarily difficult to detect. The difficulty of taxing the underground production has had further spill over effects on corruption.
- (3) The growth of market transactions that reduced the transaction costs involved when acquiring a bribe at the same time as it increased the motivation. The rea-

son for the high transaction costs of realising bribes in the Soviet period , was that enterprises under central planning were not paid in all-purpose money, but in book-keeping money that could only be “spent” on the goods in question. It was only the buyers of goods who had incentives to pay and they could mainly pay with the goods they made themselves. In the case of Azerbaijan this growth towards a market economy had partly started several decades before, but then circumscribed by its very illegality. After the formal dissolution of USSR the markets went into “the upper world” and could in principle expand. In fact, when more markets become legal and the economy opened up, the basis for many of the old illegal market disappeared. These developments support Wiles’s (1977) intuition that there exists some “optimal” mix of markets and central planning that makes severe corruption most likely in mixed economies.

- (4) The increased opportunities for converting goods into money and money into goods had their strongest and most immediate effect on the level of corruption through the new opportunities and incentives it offered for tax collectors. They now knew that enterprises would earn a large share of their income in general-purpose money which, when collected, they might easily use themselves. On the other hand, the enterprises now would have a strong interest in keeping the income themselves and not handing it over to the tax authorities. Both circumstances, together with the development of the barter chains, caused a decline in the public tax collection, which starved the public apparatuses and forced through a kind of private tax collection at all points where it was possible for public employees to demand payment. It was the decline in public tax collection that had forced through corruption at all levels of the society.

Our approach presupposes that the interesting countries for comparison in explaining the corruption in Azerbaijan, are the FSU countries. as we proceed. Even when it comes to the specific indicators of corruption the similarity is striking. They all rank high on TI’s corruption perception index. This similarity in outcome does not only apply for corruption. Most international research agencies have chosen the same grouping for all kinds of economic analyses.

This does not preclude that when it comes to look at corruption in the really long run, other countries might be used for comparison. For example, some would claim that Islamic countries have a different attitude to corruption than countries where Christian religious beliefs are the dominant ones. To understand the more general causes for corruption in Azerbaijan we should rather compare it to Iran and Turkey than Georgia and Latvia. Others would believe that cultural factors are so dominant that Azerbaijan should rather be compared to other Turkish countries. Others again would claim that it should be compared with the set of countries at the same economic development level wherever they are located, that is compare it to Zimbabwe, Mauritania or Ghana and Pakistan (1996). Maybe even more appropriate for a study of the long run, would be to compare Azerbaijan to other countries for which oil will play a leading economic role. For the shorter run, which is the focus of our report, we believe our choice of county grouping is the most fruitful one.³

In most of the report the approach is rather standard one and we can to a large extent rely on statistical studies which may be more unreliable in this area than for the OECD countries, but the information is second hand. The reasons for applying the data borrowed from other FSU countries are firm.

When we come to the part about the oil industry and corruption in Azerbaijan, the basic information is much more uncertain, and we have therefore resorted to a kind of risk analysis where we make theoretical considerations point to decision areas where corruption is most likely to arise. When we come across some concrete reports on corruption (for example journalistic ones) in such an area, we would increase the subjective probability with a larger factor than if it was reported to take place in a low risk area. We have avoided all names and recognisable incidents that are not public knowledge in Azerbaijan.

While the study is rather broad we had to leave out several important areas for exploration. The most serious one is the lack of analysis of the privatisation issues. We

³ There are, for example, no obvious difference in this respect between the Christian country Georgia and Muslim Azerbaijan. Researchers who emphasise the level of development have been tempted to apply strange claims, for example that Azerbaijan is lacking a middle class. The essence of that matter is that Azerbaijan has had a large middle class of highly educated people, but a middle class that now is partly eroded.

kept it out for the simple reason that we could not agree upon the best way to attack it within the existing time limits. The interrelationship between privatisation, corruption and the speed of transition is very complex.

In addition, we should have had a more explicit discussion of the economic effects of the extensive corruption. Compared to most other countries corruption in Azerbaijan appears to be rather centralised. Shleifer and Vishny (1993) argue that centralised forms of corruption have less harmful effects than decentralised forms. We present evidence that suggests that corruption in Azerbaijan is less harsh towards businessmen than in many other countries. Does this mean that the evidence from Azerbaijan supports their thesis? We believe not, but because the steep decline in production that was taking place at the same time as the increase in corruption, any relationship is likely to be blurred by this macro development. We have not really made an effort to see whether there is a causal mechanism at work here, although we believe as a first approximation that the causal effects of corruption on production decline must have been rather weak. The reason for doubting Shleifer and Vishny is rather that the centralised character is likely to go together with an increasing scope for doing corrupt transactions, something that is likely to increase their overall harmfulness. Centralised control goes together with sale of public positions which we believe is exceptionally harmful for the construction of efficient public organisations .

Among the issues demanding more attention than we have given them, is the relationship between corruption issues and violation of human rights. Often it makes moral life simpler if all moral “goods” and moral “bads” go together. It does so only partly in this case. An empirical regression of the number of violations of human rights and an indicator of corruptness is likely to support such scepticism. For example, corruption was probably less extensive and the violation of human rights more severe before the political independence of Azerbaijan.

2. Corruption levels in Azerbaijan are high compared with other countries

There has been little empirical research published about the specific problems of corruption in Azerbaijan.⁴ This has been the most difficult problem in writing this report, since we have been in no position to make a serious, empirical exploration on our own. A few commercial firms dealing in risk studies and a couple of NGO institutions interested in questions of political freedom and human rights have distributed questionnaires to international operators that also deal with questions relevant to corruption in Azerbaijan (Shor 1997). Rough evaluations are made, inter alia, by the Economists Intelligence Unit, the consulting firm Control Risks Group and the semi-public Freedom House. After several drafts of this report have been made, Transparency International's Corruption Perception's Index (CPI) for 1999 has for the first time included Azerbaijan and her neighbours in the tables.⁵ What do these different indexes and studies tell?

They all agree that the corruption levels in Azerbaijan are exceptionally high. The Control Risks Group has asked 50 US. and 50 European companies of how corrupt they considered 40 developing market economies to be. The result was the following when we look at the columns below the CRD-headings:

⁴ As part of the preparations for their plans for a revolution in the Azeri public sector operations the IMF/ World Bank might have made some research that still is unpublished. In addition to all the other reasons why the issue is sensitive, Armenian pressure groups use the corruption problem as one more reason why Azerbaijan still should not be allowed to receive official aid from the United States..

⁵ There might be others. Since much of this research is expensive to buy and is often superficial, we have not made any attempt to survey it. Together they document, however, that corruption is perceived by international businessmen and experts to be an important issue in Azerbaijan. Freedom House, but not the Control Risk's index are among the one explored by the World Bank for their mutual compatibility. The overall result is a surprising degree of compatibility (Kaufmann et al. 1999a).

Table 1. Corruption levels in a sample of developing market countries

	<i>CRD</i>	<i>TI</i>		<i>CRD</i>	<i>TI</i>
Russia	8.2	7.6	Indonesia	6.6	8.3
Nigeria	8.1	8.4	Egypt	6.5	6.7
Azerbaijan	7.9	8.3	India	6.5	8.7
Ukraine	7.9	7.4	Peru	6.4	5.5
Uzbekistan	7.9	8.2	The Philippines	6.2	6.4
Kazakhstan	7.8	7.7	The Gulf states	6.2	--
Ghana	7.8	6.7	Thailand	6.2	6.8
Bulgaria	7.6	6.7	China	6.1	6..6
Iran	7.5	--	Hungary	6.1	4.8
Yugoslavia	7.5	8.0	Turkey	6.0	6.4
Cambodia	7.4	--	Malaysia	5.9	4.9
Burma	7.4	--	Czech Republic	5.9	5.4
Romania	7.4	6.7	Saudi Arabia	5.8	--
Pakistan	7.2	7.9	Mexico	5.8	6..6
Algeria	7.2	--	Brazil	5.5	5.9
Colombia	7.1	7.1	Argentine	5.4	7.0
The Baltic States	6.9	4.3 –6.6	Chile	5.2	3.1
Vietnam	6.8	7.4	South Africa	5.0	5.0
Slovakia	6.6	6.3			

The level of corruption increases with increasing numbers in both the CRD and TI indexes as we present them here. We only use Transparency International's 1999 index for comparison since this is the first year numbers from our area of interest are. The numbers are not directly comparable, however, since the series only indicate rankings. Higher values indicate higher perceived levels of corruption.⁶

We see here that Azerbaijan shares the rank as the third most corrupt in the CRD sample of countries with fairly high incidences of corruption. While the result of this ranking of countries appears quite reasonable to us, its empirical basis (phone questionnaires among managers in 100 multinational firms) is somewhat thin. The empirical basis for Transparency International's is also in the case of Azerbaijan more solid,

⁶ In order to the TI-index to indicate the same type of ranking we filled in the table with 10 – published TI-value, since TI publishes their numbers so that 10 is the value of the least corrupt country and lower values indicate more corruption.

based on 5 different questionnaires. In TI's sample, Azerbaijan is the second most corrupt. In the larger sample of 99 countries in TI's index from 1999 it is the third from the bottom.

Freedom House publishes a report, *Nations in Transit*, that presents fairly detailed evaluations of various aspects of political and economic freedom in each of the transition countries, including Azerbaijan. The focus is more on democracy and human rights, but an evaluation of corruption problems is also included. Each country is evaluated by a country expert who writes a report. The evaluation of the country expert is then discussed by a board of experts before a final verdict is given. While the setting is somewhat ideological, the country experts and scientific board of Freedom house are competent. Again Azerbaijan gets a D – the highest level of corruption also on their scale – but so did most of the other countries we will focus on for comparison in this study: Armenia, Georgia, Kazakhstan, Poland, Russia, Turkmenistan, Ukraine and Uzbekistan.⁷ The exception was Poland, that got an A and partly Uzbekistan that got a C/D. How reliable are these evaluations?

One way to answer this is to compare these studies with the Transparency International's index for the case of overlapping countries, since that is so far the most reliable one of this kind of studies. Overall, the rankings appear compatible.⁸

⁷ We have chosen these countries among the FSU countries partly because of close neighbourhood or because they are better researched such as Ukraine and Russia, but sharing many of the same problems and characteristics as Azerbaijan, we believe. Poland is included by way of contrast – a country that from a similar starting point apparently solved many of the problems that bedevil the developments in Azerbaijan. We should note that Poland ranks fairly high on TI's corruption index (No 44). Of the FSU countries both Estonia and Mongolia ranked better.

⁸ Going into details, discrepancies in the ranking of the single country are sometimes striking, however. For example, in the Transparency International's index for 1999 the perceived corruption level in Indonesia (that is ranked as the 96th most corrupt among 99 countries) is higher than in Russia (no 82). In the Control Risks Group's ranking Russia is the most corrupt, while Indonesia is ranked as no 20 among the 37 countries in the table. The Transparency International's index is the one that is most commonly used in econometric work on corruption, and is constructed with some care. It is a composite index of several surveys of different types of agents' perceptions, some risk analysts', businessmen's and the general public's perception of the incidence of corruption. To make the indexes comparable, quite extensive statistical transformation of the original data was necessary. (See TI's web page) where each index have results that highly correlate with the other ones). Some of these surveys are somewhat old (3 years) and give the index some inertia, that may make it underestimate changes. On the other hand, some of the respondents' positions, and the lack of definite setting of the questions, may make them overreact to public scandals. The way Tanzania suddenly became one of the most corrupt countries in the world in the 1998 index)

The World Bank is now developing a more refined index based on the information available, showing that most of these indexes are showing a surprising degree of compatibility, that may be used for creating even better general indexes. Kaufmann et al, 1999a and 1999b).

Let us first state more precisely what we will mean by corruption, since it is an ambiguous word. The main form of action I have in mind may simply be described as bribery and extortion. These are in both cases *illegal transactions taking place between a member of an organisation, usually a hierarchy, and an agent outside it. The member of the organisation somehow exploit his decision-making power or local information which has economic value for the non-member in order to gain some kind of economic rent.*

This definition embraces both voluntary bribes and forced blackmailing and members of both private and public hierarchies. In the case of blackmailing the official actively frames the situation in such ways that it has economic value for the non-member to get out of it. It also embraces corruption at the highest levels and corruption of the most innocent sort. A teacher who receives practically no pay, but demands money for a student entering his class, exploits his decision-making power to the benefit of a non-member of his organisation. In this case it could also be considered as a kind of private taxation.

The definition points to what may be consider the main aspect of corruption: It is the application of market forces on areas of public decision making, market forces which may only work illegally. That also implies that the public officials are not supposed to tax the market to their own personal advantage, which they will do through their framing power, if this kind of market for decisions is allowed to operate.

is difficult to explain otherwise. Given the possibility that all these observers are linked by living in social environments with considerable overlapping, I believe that the danger of shared rumours may weaken the reliability of this index of perceived frequency of corruption as and indicator of the actual frequency of corrupt acts. That danger may be enhanced by the abstract and general nature of the questions. This is one of the major reasons why I believe that the World Bank research of the Brunetti group is more fruitful in highly corrupt environments.

One theoretical starting point of this report is the one outlined in Andvig & Moene (1990), the idea that corruption levels have a tendency to sustain themselves because high corruption makes corrupt acts profitable and easy to implement, while low rates makes corruption costly, difficult to do and often not so profitable. This theoretical starting point implies that more or less random events may drive corruption levels up. But if the cause is random, it does not mean that corruption levels may return to lower levels when the random cause has spent its force. Rather, it is likely to remain on the new higher levels.

In this case we do not believe that the high level of corruption is explained by some kind of random shocks, however. Somehow it appears to be related to the economic “transition”.⁹ It is striking that seven among the ten most corrupt countries in the Control Risks Group’s list belong to the group of former socialist countries. Of the 24 most corrupt countries in TI’s larger sample, 9 were FSU countries. 2 more (Albania and Yugoslavia) have experienced similar transition process.

So, while corruption in Azerbaijan has some idiosyncratic features, to which we will return, an important starting point is that in order to understand its high rates of corruption, we need to understand some of the common economic and political changes that take place with most economies trying to transit from command economies to regular market economies.

The plan in the following is first to bring to attention those features of the transition economies most likely to stimulate corruption, always indicating how Azerbaijani data, where available, relate to those broad historical processes. We will then present some of the empirical research of those economies that deal with corruption directly, giving that more structure.

⁹ In the following we will follow common language and call the process that is taking place in the countries that have dismantled their command type of economy for “transition” although we are not certain what kind of economic and political systems they are moving towards. To believe that they all are heading for some kind of Western market economy with developed, strong restraints on the rulers, has been a rather naïve belief difficult to hold by anyone familiar with the economic and political system of the former USSR. The “transition” may be a long-lasting point towards where they stay.

Finally we will focus on corruption in Azerbaijan. The indigenous bribe systems will be sketched. We will describe the prevalence of economic blackmailing, and note the ease by which political power might be converted into economic income. Here we will touch upon the clan system. When this has been done at a general level, we will zoom in on the oil industry. What kind of protection against blackmail is built into the so-called product-sharing agreements (PSA) with the Azeri authorities? At which points of their activities can the oil companies be drawn into serious moral dilemmas? And what kind of risks will this expose the companies to?

Even if they do nothing harmful or unethical, given the environment, the oil companies may be exposed to public scandals mainly caused by the homeland's public not understanding the Azeri moral environment. This risk is also assessed in the following.

Corruption should be linked to some of the other economic policy problems in the Azeri transition in their relationship to the oil industry: What is likely to happen when an Azeri type of government is meeting the international oil industry? Do the financial resources that the industry bring into the area by necessity fuel the indigenous forms of corruption or do they mitigate the tax crisis that stimulate the corruption. Do there exist ways to spend them that may reduce the problem rather than stimulate it?

The report is mainly based on secondary sources, statistics either collected in Azerbaijan or countries that share many of the same characteristics. In addition, we have performed 29 informal interviews with open-ended questions. About half of the informants had a background in international oil industry, working in Azerbaijan. While often guarded in their responses, the informants could often bring insight into either the background of or into corrupt transactions they have found evidence of in their economic neighbourhoods, although nobody could tell anything from direct experience. We have tried to handle this information with care. It has been applied in formulating hypotheses about the levers and handles that connect or disconnect the foreign oil companies to the country of Azerbaijan.

3. General economic background

Azerbaijan has become a poor country. While not rich during the Soviet rule, the living standard was for the average Azeri then significantly higher than it is today. Maybe even more important from a social stability point of view; their living standard was on the whole not much lower than the one of their most likely reference group at that time: the Russians. This has changed dramatically recently. The rich life style of upper-income groups in the Western countries has become their target for private consumption while the reality of yearly production has dropped, and so has the resulting income and consumption. Only a small minority, most living in Baku, has moved into Western riches. Will more people follow, or are the doors closed? The answer to that question is likely to be the crucial one for the future economic and political stability in the area. It will also become important for the expectations directed towards the international oil companies, their decisions and the social impact of their operations.

While often subtle, the social influences that determine the strength in peoples' drive for becoming rich and avoiding poverty may also determine the moral and economic risks they take. When the only instruments for achieving private wealth are the wrong ones, that drive leads to corruption, not productive investment.

3.1 Recent history of production decline and growth

Let us take a brief look at the major economic background developments. In order to understand them we are mainly looking at the situation in the countries that constituted the former Soviet Union, the FSU countries, but we have added Poland, that has gone through a similar transition, but a more successful one, in order to have a contrast. Among the FSU countries we have chosen the neighbouring states and the most important ones, such as Russia and Ukraine.

Table 2. Indications of economic development levels at the end of the Soviet period (1989–90)

<i>Country</i>	<i>Per cap GNP at PPP US\$ 1989¹⁰</i>	<i>Urbanization (% of population) 1990</i>
Poland	5150	62
Armenia	5530	68
Azerbaijan	4620	54
Georgia	5590	56
Kazakhstan	5130	57
Russia	7720	74
Turkmenistan	4230	45
Ukraine	5680	67
Uzbekistan	2740	41

Source: de Melo et al. 1997.

We note that an Azeri earned roughly 60 % of an average Russian. A catch-up in the near future was in sight, if not already achieved. The informal economy's share was significantly higher in Azerbaijan than in most other areas of the FSU, and so was the illegal share of their income.

If we look at the present situation as indicated from the tables in the World Development Report 1998–99, Azerbaijan GNP per capita is lower than India's and only 5% of the US per capita income, the average income of the new reference group. Now any catch-up to the reference group is out of sight.

¹⁰ PPP means purchasing parity prices, that means in this case that when the value of the currency of, let us say Poland, is determined, the nominal exchange is left unused. Instead one determines how many *zloty* is needed to buy the same amount of goods as one could for one 1989 US\$.

Table 3. GNP per capita, 1997, PPP estimates

Economy	Purchasing Power Parity (International dollars)
Poland	6,380
Armenia	2,280
Azerbaijan	1,520
Georgia	1,980
Kazakhstan	3,290
Russia	4,190
Turkmenistan	1,410
Ukraine	2,170
Uzbekistan	2,450

Source: World Development Report, 1998–99.

How has this situation come about?

While among the countries that have experienced the greatest declines in production, Azerbaijan is by no means exceptional. Some of its neighbours have been even worse off. In addition to the civil war conditions in the first half of the period and the large refugee population in the second half, Azerbaijan was among the countries that had both to build up its own public apparatuses at the same time as it accepted, partly for international policy reasons, to go for a fairly swift change from central planning to the market mechanism as the major instrument of economic co-ordination.

The mechanics of the movement we can see from the following table:

Table 4.R ecent growth in real GDP of Azerbaijan and some comparable countries:

<i>COUNTRY</i>	<i>1989</i>	<i>1990</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9
Armenia	14.2	-7.4	-17.1	-52.3	-14.8	5.4	6.9	5.8	3.3
Azerbaijan	-4.4	-11.7	-0.7	-22.1	-23.1	-18.1	-11.0	1.3	5.7
Georgia	-4.8	-12.4	-13.8	-44.8	-25.4	-11.4	2.4	10.5	11.0
Kazakhstan	-0.4	-0.4	-13.0	-5.3	-9.2	-12.6	-8.2	0.5	2.0
Russia	3.0	-4.0	-5.0	-14.5	-8.7	-12.6	-4.0	-2.8	0.4
Turkmenistan	-7.0	2.0	-4.7	-5.3	-10.2	-19.0	-8.2	-7.7	-25.0
Ukraine	4.1	-3.4	-11.9	-17.0	-14.2	-22.9	-12.2	-10.0	-3.2
Uzbekistan	3.7	1.6	-0.5	-11.0	-2.3	-4.2	-0.9	1.6	2.1

Source: Havrylyshyn et al., 1999.

From the table we observe that the production declined in Azerbaijan until 1996. If we note that the rate of decline for Azerbaijan was 4.4% in 1989 and use 1988 as base, simple calculations from this table show that the output level of 1995, when it was at its lowest, was only 36.5% of the 1988 level. Since then output has been increasing again, 1.3% in 1996, 5.7 % in 1997 and around 10 % for 1998 (IMF consultation, June 30, 1999). The growth rates of the two last years give some reasons for optimism, but if it is calculated on the size of the old 1988 economic base, the rates are less impressive, 2.1% for 1997 and 3.1% in 1998. It is too early to tell whether the recent rapid growth will continue or not. IMF is somewhat pessimistic and expect GDP to increase only with 3.9% in 1999. The growth is clearly oil-based, which gives reason for continued worry. It is not likely that what drives the Azeri growth is any happy new mix of institutions that has laid the foundations for a lasting self-sustained growth.

This question may seem to be far removed from the problems raised in the beginning. In fact it is crucial for assessing the likely social impact of the oil industry in Azerbaijan, including the expected net profits of the companies involved. As one of the transitional economies, Azerbaijan is bound to become an efficient market economy or

will it stay indefinitely in a low-growth equilibrium where predators in public offices are able to collect such a large share of the investible surplus so that growth is stifled? So far, evidence collected about these economies, if we include China and Vietnam, may suggest that both high-growth and low-growth paths equilibria may be self-sustaining (see Johnson *et al.*, 1997). We will return to this question when a larger part of the economic landscape of the FSU countries has been outlined.

Some of the sharpest rates of production decline in Armenia, Georgia and Azerbaijan have occurred during civil war like conditions and are easy to understand. The cause of years of persistent but varying rates of production decline among most FSU countries is less clear, and disputed. The basic IMF-World Bank view has been, roughly put, that a fast and thorough change in the basic institutional make-up towards the one ruling in democratic market economies is necessary for economic growth in the longer run. Such change will cause a rapid decline in production, but is basically a necessary cleansing process. A delay may well postpone the production decline, but make it more protracted and greater in the longer run. Against this view is normally presented a view that argues that a slower change would cause less disruption and less economic suffering.

Andvig (1992) argues a somewhat different view. In that paper the old Soviet economy is regarded as a large bureaucratic organisation where the political drive (or the lack of it) determines the activity level. The positive role of the planning apparatus was to economise on the search costs involved in co-ordinating the enormous multi-lateral bartering system that constituted its economic base. When hit by the policy shock of the August 91 coup, the system fell down to low activity levels, and the resulting dismantling of the planning system increased the search costs.

The speed of the shock was not an economic choice variable, however, which made the subsequent discussion of the optimal speed of the transition somewhat unreal. It was created by uncontrolled political events that could impact the economic system so strongly because of the centralised properties of both the basic motivational system and the high degree of technical inter-linkages in the input-output structure. That structure was built upon strong ideological beliefs in increasing returns to scale and a

practical need to ration on the scope of central control, both which made for the large plants that characterised Soviet manufacturing.

Command economies that were not hit by political shocks, such as China, could realistically afford the luxury of discussing optimal speed, and had the option of developing a so-called “dual track” system where they could keep up the activity levels in the old command input-output structure giving at the same time scope for a market-oriented new industry. The old industry was clearly not efficient, but as an input-output system it had at least proved able to generate an economic surplus. After all, the fact that people could consume a decent amount of consumer goods in a basically closed economy was a proof of its ability to generate surplus.

In order to survive at former activity levels, not only would the old politically based motivational system be kept, this old industry had to be shielded from full-blown international competition.

In most FSU countries, however, the political situation did not allow for a dual track, partly because of the national fragmentation of the old Soviet political structure, partly because of the loss of power of the local communist parties. The simultaneous demands for both market economy and democracy created confusion in the bureaucracy that had organised production, and production rates declined.¹¹

The resulting production decline was reinforced by the huge dimensions of the major firms that were interlocked in the input-output system of the planned economy of the whole Soviet Union. In Azerbaijan, for example, the oil supply industry was dimen-

¹¹ The experience of Uzbekistan, which the IMF/ World Bank economists have difficulties in explaining (see Zettelmeyer, 1998) is easy to explain along these lines. The old political structure with all its harsh authoritarianism was left virtually intact, and therefore a dual track solution was partly possible there. The result was a harsher treatment of the opposition than anywhere else, but also a smaller decline in production. Keeping more of the old structure did not preclude that it has been possible to have fairly rapid rise in new firms. The share of new (private) firms in GDP is 30% in Uzbekistan compared to 20% in Russia and 25% in Azerbaijan (Havrylyshyn & McGettigan, 1999), countries that are much more pro-market in ideology. For a contrary opinion of Azerbaijan, claiming there is an exceptional level of new starting, see Askerov *et al.* (1998).

sioned for the demand of the whole Soviet Union, so when that demand fell away the sustainable activity level of the industry was drastically reduced. As measured by its exports the trade with the FSU area also declined more strongly than the average, but according to the official statistics it was not exceptional, however. Its export to the FSU countries was in 1996 only 7% of the 1990-level, while it was 5% for Georgia. The other countries appear to have been better able to increase its exports to the FSU after the initial shock (Havrylyshyn & Al-Atrash, 1998, table 2).

The major reason for the decline in Azerbaijan's (official) trade with the FSU area is the general decline in production in the whole area. In addition, we have the situation that the major demander of the oil supply industry, the oil and gas extraction industries in the other FSU countries, has had its specific problems and is not likely to turn to Azerbaijan's oil supply industry when re-equipping before that has modernised. The ability of oil production to earn multi-purpose money should make, let us say, the Russian oil companies less interested to go into the complicated barter deals that otherwise have become so common throughout the FSU countries. It could import its needs by paying cash for the import of Western technology. Difficulties involved in changing technology should cause the barter demand to be above zero, however. While such barter chains are able to cross national borders, such crossing makes the operations more difficult, for example by making it more difficult to pay taxes to the proper national authorities in the enterprise's own goods or services.

It is difficult to estimate the relative position and rate of change in Azerbaijan's FSU trade on the basis of the trade statistics with the FSU countries, however. One reason is that smuggling is extensive everywhere, but still likely to vary in intensity, and we are not aware of any estimates of its cross-country variation.

Azerbaijan has had a large underground industry during the late Soviet times,¹² for example in textiles, that used to copy Western brands. When opening up to inter-

¹² The definition of the underground economy will differ between the old and new regime. According to the old system any economic activity that was not included in the official, quantitative plan with its material balances, was underground or unofficial. Most of it would be illegal, except the sale of agricultural products from the small, private plots. Today the underground economy, as it is usually estimated will include the share of the production of the enterprises that is left unregulated and untaxed by the public authorities. This is the definition applied in the following tables

national trade, a large part of that underground economy lost its markets to illegal Turkish copying of famous international brands. The import from Turkey has shown a rising trend since the early 1990s while export to Turkey has been stagnating (TACIS, 1998). The agriculture of Azerbaijan had a large share of the grey market in fruit and fresh vegetables of the former Soviet Union. Parts of it remains, but the one that relied on heavy public subsidies of air transport could not survive. Nevertheless, the Caucasian countries have kept a large share of the vegetables and fruit markets in the other FSU countries.

On average, the economies in East Europe that went most quickly for a market economy organisation also made the institutional overhaul more thoroughly, and after a while has also achieved better economic performance. We believe that a large part of this better result may be explained by the inherent efficiency of the different bureaucratic machines. When the aim was market economy, the countries with more efficient bureaucracy, having also the highest economic performance levels initially, were therefore likely to meet the new bureaucratic task of creating the most efficient framework for a market economy most efficiently. In other words, if one sets up different indicators of the degree of market maturity at the right hand, and the output on the left hand the positive correlation that shows up after a while, might be due to some common factor of organisational efficiency or political stability.¹³

During the last couple of years the Azeri government has gone far in the direction of following the prescriptions given as necessary for developing markets. Output has been growing. The question remains whether these institutional changes have started to bite and prove their efficiency or whether the market reforms remain a kind of Potemkin's villages. That is, are the last years' growth rates likely to last, or are they only the result of a positive shock coming from the oil sector, that will subside, or even create a Dutch disease – an economic contraction in the other parts of the economy – before the external stimulus has spent itself?

and figures. This constitutes, however, only the unofficial, private sector. Ideally we should add an unofficial, or underground public sector financed through bribes and embezzlements, but as far as we know the overall size of this sector is left unknown.

¹³ We should underline that this is our opinion, not the accepted view of the majority of economic experts of the transition.

3.2. Inflation history and stabilisation policies

Serious inflation started in the FSU countries in 1992. In Azerbaijan it lasted until 1995. Again, this form of economic disturbance was not exceptionally strong but strong enough to wipe out most of the value of savings, for those who kept it in local currencies. We may compare Azerbaijan with the other countries:

Table 5. Inflation rates in Azerbaijan and some other FSU countries 1992–96 in %

<i>Country</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>
Armenia	1,241.4	10,896.1	1,884.5	32.1	5.8
Azerbaijan	...	1,293.8	1,788.0	84.5	6.7
Georgia	1,178.5	7,484.1	6,473.6	57.4	13.9
Kazakhstan	2,960.7	2,169.0	1,160.3	60.4	28.7
Russia	...	841.6	202.7	131.4	21.8
Turkmenistan	1,328.5	1,261.5	445.9
Ukraine	2,001.0	10,155.0	401.1	181.4	39.7
Uzbekistan	910.0	884.8	1,281.4	116.9	64.4

Source: Ghosh (1997), Table 1.

In 1997 inflation was down to 4%. In general, the monetary side of the stabilisation policy of Azerbaijan has been successful, even more successful than most of the other FSU countries, which also have succeeded in bringing down inflation. The poorer sections of the population are likely to have been hit relatively hard by this policy sequence. They were likely to experience greater difficulties in moving into real assets or foreign currencies during the inflation, and larger difficulties in getting decently paid jobs during the stabilisation.

Recently, Azerbaijan has actually moved into a deflationary situation where consumer prices fell nearly by 11% in the 12 months to April 1999. Deflation of this kind is likely to put a strong brake on private investment and increase unemployment.

Nevertheless, the successful stabilisation is an important achievement that may make it easier to develop a functioning market economy. It is likely to make most economic

transactions more transparent and thereby be part of a framework that may make it easier to bring down corruption levels.

The combination of a negative trade balance and positive direct investment in the oil industry makes it difficult to read from the national income statistics whether there are tendencies among the Azeri elite towards financial or real estate investment abroad, as is the case for many other elites of the other FSU countries. Moreover, given the possibility of getting into a “Dutch disease” situation, an eventual capital flight might have positive economic side-effects by preventing an appreciation of the *manat*.

3.3 Poverty and the macroeconomic development in Azerbaijan

The decline in production has been a major cause of the increased poverty. It has also translated into a stagnation in wage levels. Here we may observe that Azerbaijan has fared worse than most of the other FSU countries.

Table 6. Monthly dollar wages in Azerbaijan compared, 1992–96

<i>COUNTRY</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>
Poland	226	214	240	296	325
Armenia	9	10	6	18	23
Azerbaijan	17	17	13	15	20
Georgia	7	24	3	8	17
Kazakhstan	26	43	38	86	105
Russia	38	55	109	111	164
Turkmenistan	18	53	165	94	12
Ukraine	38	16	28	58	81
Uzbekistan	13	30	26	35	58

Source: Koen & De Masi (1997) Table A2.

Wage developments may signify future tension in Azerbaijan. While this table shows that there is a great “noise” in the wage statistics in the FSU countries it also indicates that the workers in the periphery of the former Soviet empire has fared even worse than the Russians, and the distance in living standards is likely to have increased sig-

nificantly and stay so in the longer run. This may create serious political problems for the smaller states and their economic and social stability.

In addition to these macroeconomic developments there were many institutional changes during the transition, not all well understood, that may cause the increase in poverty. The war with Armenia has caused a major influx of refugees – internally displaced persons (IDPs) – who now constitute 13% of the population, is, of course, another major reason. The estimates of the share of the poor in the total population vary between 60% and 80%. According to the World Bank, around 20% are extremely poor, while the UNDP's poverty index indicates that around 27% may be extremely poor (UNDP, 1998: 22). The regional variation inside Azerbaijan is considerable.

After a steady worsening, the economic situation in Azerbaijan has shown a modest improvement in 1997, and a stronger improvement in the first half of 1998. Since then the ups and downs of oil prices combined by a crisis in Russia has made the prospects more uncertain again. The international investment commitments in the oil sector are sufficiently firm, and the share of this sector so large in the economy, that growth in the economy in the near future is almost bound to happen. The most recent information indicates an overall growth in GDP of 10%, but a fall in non-oil production of 4% for the last year has occurred (verbal communication). Azeri export to Russia has clearly been hurt by the recent Russian devaluation.

When comparing the income level of Azerbaijan to the other FSU countries, one should be aware that the size of the underground economy is larger than most. This might be part of the explanation of the fact that the average real consumption expenditures per capita in Azerbaijan were higher than, for example, in Uzbekistan in 1995 while the monthly wages were much lower.

In any case, income has become more unequally distributed (Milanovic, 1998, Falingham, 1999) the average income has gone down and, consequently, the number of the poor has increased in Azerbaijan in recent years. What are the consequences of

these general macro developments for the incidence of corruption. Do they have any direct relevance?

Summing up much of the empirical research so far done on corruption, Gray & Kaufmann (1998, p.9) found that poverty is one of the important causes of corruption. Increased inequality is also likely to contribute. Hence, the fact that poverty has become more widespread in all transition countries, including Azerbaijan, is not only a deplorable fact in itself, but also an aspect of the macroeconomic development that is likely to have increased the incidence of corruption significantly. Gray and Kaufmann's result was based upon a cross-section study of poverty levels. We will expect that a drastic *increase* in the incidence of poverty, such as what has happened in Azerbaijan, will be a separate, contributing factor. When public employees are experiencing that their traditional living standards are eroded, they are likely to resort to actions such as demanding bribes for services that did not elicit such demands before.

4. Institutional background to the present corruption

So far we have mainly dealt with the general economic background. In this chapter we will deal with the rise of economic institutions that clearly stimulates corruption and /or are caused by it and thus also may signal the existence and frequency of corruption itself.

4.1. Underground economy

In most of the transition economies, as the size of the official economy shrank, the unofficial (underground) one increased or at least declined less. In any case, the unofficial economy's share of total output and income increased. Azerbaijan has been one of the countries where this development has been most pronounced. Using a somewhat disputable method based upon the idea that the electricity consumption should follow the GDP development, so that if the latter declines more steeply, the underground economy's share is rising, Johnson *et al.* (1997) presents the following table:

Table 7. The share of the unofficial economy in Azerbaijan compared 1989–95

Country	1989	1990	1991	1992	1993	1994	1995
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6
Azerbaijan	12.0	21.9	22.7	39.2	51.2	58.0	60.6
Georgia	12.0	24.9	36.0	52.3	61.0	63.5	62.6
Kazakhstan	12.0	17.0	19.7	24.9	27.2	34.1	34.3
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9
Uzbekistan	12.0	11.4	7.8	11.7	10.1	9.5	6.5

Source: Table 1 in Johnson *et al.*, 1997.

We should note that a large number of theoretical assumptions are underlying these calculations, some of which we know are unrealistic. For example, the assumption that the unofficial economy's share in total output was the same in all FSU countries in 1989 is wrong. We know, for example, that the unofficial economy's share in Azerbaijan and Georgia at the outset was much higher than the one in Estonia (also

initially set at 12%, but not shown in the table). Azerbaijan today has the highest share of the unofficial economy of all except Georgia according to these estimates. As oil income goes in, that will quickly change with the GDP measures, in the case of Azerbaijan, but not with the share of underground employment. Again, Uzbekistan's development is remarkable, but here the numbers are too uncertain to make for any conclusion.

Roughly, the unofficial economy may be divided into three parts. (1) Private individuals that do some economic services for other individuals unregistered by the (tax) authorities. (2) Economic activities by firms that are unregistered by the authorities. Some of these may be subgroups of employees of registered enterprises. Most of these firms would normally be paid with multi-purpose money. (3) Unregistered activities of registered, regular enterprises. These will often receive payment in goods, not money. While (1) is well-known from OECD countries, (2) and particularly (3) exist on a much larger scale in the FSU countries compared to anything known from the OECD area.

It is generally accepted that the increase in the size of the unofficial economy in the transition economies, unlike the one in the developed market economies, cannot be explained by the enterprises paying much in taxes, at least not *ex post*. Tax income as share of national income has decreased in all transition countries, including Azerbaijan. Looking at the push-out mechanisms working on the firms established under the socialist order it was "rather the high level of regulation, bureaucratic discretion, and corruption" (Johnson & Kaufmann, 1999:2) that drove them underground. This does not mean that tax rules have been unimportant. On the contrary, the tax penalty system, combined with the lack of anonymity of bank deposits, has been a driving force, particularly for the recent rise of form (3) of the informal economy in Russia and Ukraine. If an enterprise is behind in tax payment, it loses control over its deposits and any incoming payment would in principle go to paying taxes, which implies a marginal tax rate of 100%. No wonder that enterprises in such situations would like to go "underground", if possible.

On the demand side we may point to the state of disorganisation of the public apparatuses, the complete change in government organisation, that made it possible to hide. A normal enterprise working within the planned economy had often developed in a conglomerate way. Due to the input supply uncertainty of that economic system, it made life easier for the enterprise if many inputs could be supplied in-house. In the old situation most lines of production became profitable financially after prices had been adjusted (through the price plan), but a few were all the time not. As long as the system worked, it did not matter much anyway since most prices were only for accounting purposes. Positive profits were only a bureaucratic convenience.

In particular, it didn't pay for the financially profitable parts of the enterprise to break loose; on the contrary, being part of a larger enterprise may give better political protection and ease its ability to grab input. Since the enterprises were operating in a situation with excess demand, since the matching could not be done from above, most of the active search was done by the enterprises that demanded the input. Suppliers needed only to wait for the customers.

When able to operate on real markets where prices gave immediate source to income, the matter changed overnight. The financial incentives for break-ups sometimes became overwhelming, when markets became effective and money hard. By hiding, some of the break-away sub-enterprises could gain the initial capital inputs more easily, and one could avoid sharing the income by many. The remaining parts of the enterprises would in the worst case only be organisational shells unable to generate any economic surplus, and unable to pay any taxes, anyway. These had to go underground in the sense of (3) if they were to continue at all.

How could corruption stimulate an increase of the underground economy? Bribes, considered as random taxes, are not only paid by official firms. On the contrary, all empirical investigation indicates that informal firms have to pay more bribes than formally recognised ones (De Soto, 1989). So, extensive corruption should make it less attractive to become informal, because then one might become more easily plundered by public officials?

That is to make it too simple. Firstly, a firm of type (2) cannot be hidden from the public officials in the longer run, so in order to operate underground for a longer period, the availability of public officials open to bribes is a precondition for survival. Secondly, a corrupt bureaucracy may for that reason – that firms are willing to pay more underground – making legal life unbearable. Hence, we see that corrupt officials may work to increase both the supply and demand for firms to go underground. The empirical correlation established between corruption and underground economy makes economic sense, much sense from a bribe-seeking public official's point of view. It is quite obvious that a rise of enterprises of (2) type and a direct increase in the levels of corruption is rather straightforward. When it comes to (3) the connections are more complicated. A surprising development in most FSU countries is that not many more break-aways occurred, that the share of the (2) type of supply did not increase more when markets were, supposedly, liberalised. Instead the share of large enterprises that went underground in the (3) type manner was unexpectedly large.

4.2. Financial arrears, bartering complexes and the interaction between soft and hard money

One of the aspects of the transitions that makes them sometimes so confusing, is the interaction between what we may call the hard and soft parts of the financial system. In the old days the dividing lines were pretty clear. Wages were paid out in hard money, consumer goods had to be bought with hard money. The rest was book-keeping money, money that could make nobody rich or poor. The financial claims and debts between enterprises were likely to be wiped out by the financial part of next year's plan.

Taxes were also paid by the firms in book-keeping money and the rates might vary from enterprise to enterprise and from one year to another without bothering the firms too much.¹⁴ In order to understand how the firms were allowed to cumulate large ar-

¹⁴ The public employees (who worked in the non-enterprise sector) had to be paid in hard cash money, and the basic financial planning problem was to try to ensure that this demand when added to the hard cash income of the enterprise sector did not exceed the value of the output of consumer goods. This was mainly a macro problem, but it demanded that the enterprises were not given the right to pay too much out in wages and hard cash bonuses. When the regime softened and was more willing to yield to democratic demands this financial balance tended to break down and economic inefficiencies became more severe, making people even more dissatisfied. Stalinist planning demanded tough monetarism in order to work.

rears to the tax authorities in the transition this historical legacy of arbitrary and not so important taxing of the enterprises is essential.

The enterprises were interlinked in input-output chains where prices were slowly changed and profits told little about performance, so claims and debts could cumulate for a while until new prices were fixed in the next price plan. Normally the change in relative prices would move in a direction where financial claims were not so easily cumulated.

When the transition to a market economy was signalled as definite, the economic agents knew that both taxes and inter-enterprise debts and claims as book-keeping devices had somehow to change. This has proved both difficult and painful.

Waiting for the definite change, in order to keep at least some of the industrial network structure going, the enterprises that built up claims were not all allowed to convert the claims to hard money. From the point of view of the debt firms, arrears built up. If the tax authorities insisted on the same and cashing in on the basis of often arbitrary rates, the result would often be similar.

With the considerable element of disorganisation in the process, wise financial management meant to everyone that they should try to cash in claims and let the debts stay soft. This was, of course, impossible to do in the aggregate, so arrears cumulated and even the enterprises that were able to settle their debts in hard money tried to avoid it.

Unlike the situation before, the workers in the public sector were often unable to settle their wage claims in hard money, and no credible financial instruments were developed on which they could borrow on their registered claims. The enterprises could not pay them because they only got claims themselves and often had to cumulate arrears to their input suppliers, including their workers.

This cumulating of arrears meant in practice that many enterprises could acquire goods and services for free, and immensely complicated bartering complexes could develop which could convert cheaply “bought” goods into hard money income. The very complexity made it often difficult to determine which hands the profits reached in the end. In most cases these bartering complexes needed intimate co-ordination with a multiplicity of public offices for fixing prices and payment conditions that could make the entrepreneurial activity of breaking the borderlines between the hard and soft money “markets” profitable. Enterprises struggling to survive have to do the same.

On the other hand they make it possible for speculators to exploit anomalies in the prevalent price structure and the ruling allocation of soft and hard money to accumulate large fortunes of hard money in non-transparent ways. They may allow some of the sellers to skim large parts of eventual profits that have arisen somewhere along the barter chain established to convert the goods into cash or usable inputs.

These complexes are, of course, not bartering in all directions, but sell some of their goods or services on hard money markets. Much bartering is also one-time, improvised deals, but long-time relationships are also preferred in barter chains, probably even more so than in ordinary sales.¹⁵

Sometimes the price structure anomaly consists in the low-paid or non-paid labour in parts of the bartering complex. Pure financial speculation based upon the specifics of the transitional state may also be an important part of some of the bartering schemes. Knowledge of likely future policy changes may, for example, tell the speculators which enterprises that are likely to wipe out their soft debt, and which are able to convert soft claims into hard cash.

Some of the bartering conglomerates are mixes of public agencies and productive enterprises. The basic business idea may even often be based upon this mix, for exam-

¹⁵ In an interesting empirical study of 328 Russian enterprises Hendley, Murrell and Ryterman (1999), show how important long-standing customer relationships are at present for Russian enterprises for ensuring contract fulfilment.

ple, when the agencies internal to the complex may apply their regulatory powers to keep the complex in a monopoly position in some of the hard cash markets.

The largest share of the so-called unofficial economy is precisely these kinds of transactions performed through barter or through private supply of money substitutes. This bartering is not a marginal, exotic aspect of the economies undergoing transition. In Russia, for example, the standard estimate is that the share of bartering in total sales has increased from about 20% in 1995 to 50% of total sales in 1998 (Ledeneva and Seabright, 1998).¹⁶

The basic, underlying reason why barter has developed into such large-scale undertakings was the institutional heritage mix of central planning which in fact was a large multilateral bartering scheme in itself (Andvig, 1992). In addition, both the strong inflation in the early period and the tight monetary policy in the later have contributed. A simple lack of purchasers missing cash may force an enterprise to be paid in the goods of the purchasing company and somehow turn it into good use by possessing a different network. Note, however, the gaming that starts when every enterprise expects difficulties in getting cash which may trigger an initial shortage to a much more serious one.

The specific punishment rules for not paying taxes in the transition period combined with the non-anonymity of bank accounts have been an important stimulant in some countries.

There are also factors working in a more positive way to stimulate the increase in bartering. Compared to central planning many instruments for co-ordination are missing, but in the new situation both the suppliers and demanders of inputs would be interested in search efforts, reducing somewhat the difficulties in getting the matchings

¹⁶ Like them we believe that the extent of bartering in the early years of the transition has been seriously underestimated. Unlike most, we consider much of this bartering not as any undesirable development, but a necessity of survival when one had chosen to dismantle the planning apparatus and expose the inefficient (but productive) industrial structure of the old Soviet Union to international competition with a minimum of protection.

needed in order to complete the barter deals.¹⁷ It is also clear that there is some kind of increasing returns to scale in barter transactions in general. For example, when many other firms are bartering, it becomes less difficult to get rid of your own products that way too, and to acquire something of what you need.¹⁸ The entrepreneurial ability needed to succeed in completing transactions is often considerable. A supplier of complex machinery may, for example, be able to pay for its input of metal through acquiring roof tiles received as payment from a railway company needing that type of machinery. The railway may have received the tiles as payment for transport of tiles. The metal supplier needed the tiles for a new building. To complete transactions of this type, often much more complex, a considerable amount of efforts and time is needed.

We know the main ways of how the bartering complexes operate from Ukraine and Russia. (e.g. Commander and Mommsen, 1998). Theoretical analyses are also attempted (e.g. in Ericson & Ickes, 1999 and Gaddy & Ickes, 1998). As we have indicated, the bartering complexes are often organisationally and ethically complex entities. At one side they organise complex multilateral bartering between enterprises that sometimes prevents shut-downs of worthwhile economic activities, using procedures reminding of the ones under planned economy. In order to understand the real side of the present workings of the FSU countries we need to understand the interaction between the bartering complexes and the market-based parts of their economies. This interaction is often taking place inside the same company, of which SOCAR, the huge oil based company in Azerbaijan is an example.

As far as I know, no scientific study of bartering complexes has been made for Azerbaijan. It is then not clear whether the scale of barter operations is larger or smaller in Azerbaijan than in Russia. On the one hand, if we may believe table 7, the unofficial

¹⁷ As soon as we regard the economic history of the market economies in the Depression of the 1930s, the importance of the institutional heritage of central planning becomes obvious. Despite the strong monetary shock and production decline in that period, bartering remained a very marginal phenomenon even in California, where it had its strongest response. The few years with inflation rates bordering on hyperinflation were also likely to stimulate bartering as it did in a few European countries just after World War I.

¹⁸ The increasing returns to scale have also been noted by Ickes in several works.

economy's share in total production is significantly higher in Azerbaijan. On the other hand, it is reason to believe that enterprises there are less financially constrained and have more easy access to foreign currency through foreign investment in the country. Being a smaller country should work in the same direction since there should be fewer economies of scale in bartering, although bartering in this case will be able to cross the new country borders, but border crossing will increase the transaction costs of bartering even further.

Our guess will be that bartering is somewhat less extensive inside Azerbaijan although Kaufmann's estimates of the size of the unofficial economy should indicate the opposite. Maybe the (2) and (1) type of informal economic transaction are more common in Azerbaijan than in Russia. In any case, barter transactions are important phenomena with important links to the present day workings of Azerbaijan society, including its corruption and the so-called clan operations.

While we have not come across any direct estimates of the extent of bartering transactions in Azerbaijan, the IMF has made an estimate of the so-called inter-enterprise arrears and found that they constituted about 70% of GDP in June 1998 (IMF, 1999). Corresponding numbers for Russia in 1996 was above 40% and Ukraine close to 100% in 1996. While not directly linked to bartering, this kind of cumulation of arrears is likely to reflect the same type of dealings in the old industrial structure. This indicates that we may apply the analyses of the bartering processes in Ukraine and Russia on Azerbaijan.

For people working in the oil sector in Azerbaijan, SOCAR is the best known private-public complex that organises recurring barter operations both inside and outside the organisation. It is a conglomerate based on oil activities that has employed as much as 80 000. At the same time it has a considerable portfolio of market-based activities and extensive foreign currency earnings. It has tax-collecting duties at the same time as it pays taxes itself. It speculates in its own holdings of debts and claims and their likely changes from soft to hard varieties on changing terms.

We may here cite from an IMF-report, where SOCAR is mentioned: “In 1996, the actual revenues compared to notional liability on the royalty was only 8%, on the strategic export tax 35%, on the road fund 26%, and on the petroleum excises was 132%. The main reason for this was the law on repayment of tax arrears of October 1996. This law made it advantageous for SOCAR to settle tax arrears on profits and petroleum excises but not on royalties”. (IMF, Fiscal Affairs Department, 1998, 35).

How is bartering linked to corruption? It is a rather complex issue. On the one hand, the existence of extensive corruption is one of the main reasons why enterprises often may avoid cash deals. Cash invites predators in this economic environment. Given this fact the rent-seeking in monetised transactions may raise their transaction costs above their level in barter (Guriev and Pospelov, 1998). Like what happened in the former central planning system, barter restricts corruption in some ways. Furthermore, predators who demand cash is one reason why enterprises need cash income, and cannot be satisfied with only barter deals. Corruption restricts bartering. Both are arguments indicating that the bartering frequency should be inversely correlated to corruption. Why is apparently the opposite the case, at least if we look at the society in toto?

First of all, the mechanisms indicated only apply to the enterprise sector, but even at this level some counteracting forces are present. Bartering assists in creating a kind of semi-public infrastructure that makes it possible for a larger share of the enterprises’ activities to stay underground. Bartering also increases the economic value of developing large personal networks, networks that may also be used in completing corrupt transactions. Here we may observe that old Soviet administrative ties appear to be more important than party connections, that generally was one step removed from direct economic dealings.¹⁹

¹⁹ Hendley et al. (1999) report that 88% of the sales directors in their sample of Russian enterprises believe that contacts with former officials of the old Soviet supply organisations have facilitated customer relations, while only 1 of the 328 companies had sought help from any party official in their transactions with other firms despite the old tradition of the communist party as the universal fixers.

Both corruption and bartering make it easier to avoid taxes. As previously indicated, one of the major reasons for barter is not to pay back tax arrears. If paid in money, the payment will be claimed. If paid in goods, the seller is more likely to keep the payment. The complexity of the environment where enterprises may be paid in goods or money, makes it easier to hide eventual bribes paid to the tax administrators in a situation where their goodwill is a condition for survival. It supplies both incentives and opportunities for bribing when the alternative is to pay regular taxes.

The main reason for why bartering goes together with corruption is likely to be indirect, however, through the decrease in tax collection that results. The lack of tax revenue forces the public employees that have no direct connections to enterprises to do their own private taxation instead, i. e. to demand bribes for their services. The Azeri government has been less able than most to tax its population and thereby pay its public sector workers. This situation will be illustrated in the following section.

4.3. Taxes and corruption

In the old system corruption in the tax administration was a minor problem for the obvious reason that it was collected in book-keeping money that could not be spent by the corrupt official. Since the incentives for the enterprises to avoid taxes were not strong either, this was not in general a highly corrupt area of public administration in the Soviet area. High taxes might mean less (book-keeping) profit and may have a small negative impact on the (hard cash) bonuses the enterprise was allowed to grant. At the hard cash end of the industry – final consumption and external trade – the incentives and possibilities were stronger, but still limited in the case of profit tax.

This had, of course, to change during the transition. The more the enterprise has to pay in taxes, the less hard cash profit it will get. If the taxman could be bribed, the incentives to do so now are strong. The arbitrariness of the tax rates makes it frequently legitimate and a condition for economic survival. Seeing the expansion of market economy, the taxman not only has more to offer the firm in terms of advantages, a larger share of the enterprises have more to offer the taxman. They receive, after all, a larger share of their income in cash than they did under central planning.

Even in the cases where tax rates are moderate, firms relying on bartering and often not paid in cash from the public sector, may cumulate considerable amounts in tax arrears. This has often given the tax collector a formidable threat point from which he can bargain.

The result of this bargaining between enterprises and tax administration under the expansion of hard currency transactions, has been a decreasing power of the state to tax, at least until recently.

In the case of Azerbaijan we see this from the following table:

Table 8. Fiscal revenue trends in Azerbaijan (in per cent of GDP)

1992	1993	1994	1995	1996	1997	1998
51.2	40.5	33.8	17.6	17.6	19.7	17.3

Source: IMF, 1998, 1999 (Consultation).

The movement in taxes after 1999 is strongly influenced by oil taxation that is, for reasons explained later, outside the regular tax game. As late as of summer 1999, IMF describes revenue performance to be “poor”, although the predicted income for 1999 is up. New tax arrears are still building up.

We should also note that the declining share of taxes was taking place during a period when GDP itself was in decline. The result was a serious incapacity of the public sector to finance its employees. Even in this difficult situation the IMF estimated that only about 50% of tax due were actually collected in Azerbaijan (IMF, 1998: 15).

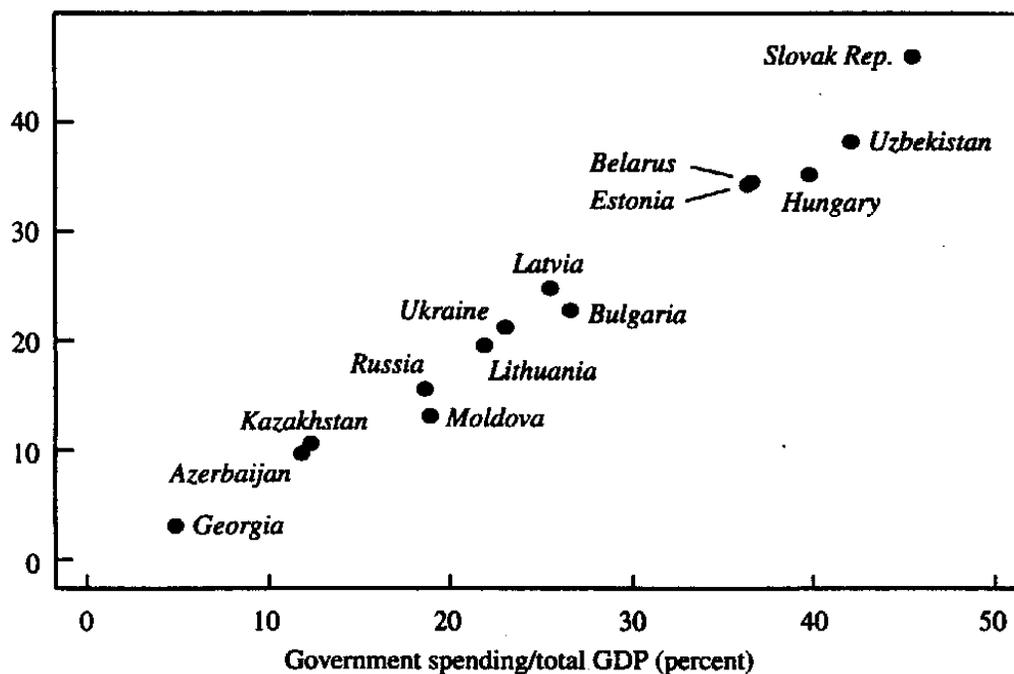
The consequence was that public employees to a larger extent than before started to do their private taxation, i.e. to bribe or blackmail as well as they could from their positions in the public sector. A corrupt system of income generation in the public sector came about: In order to pay their medical bills, partly resulting from illegal blackmailing, teachers would start to demand bribes for granting (good) examinations

papers. In order to pay their children's exams, the doctors would introduce illegal fees and blackmail, and so on.

Each person's corrupt income source was a condition for the ability of each group's "clients" to pay. In addition to undermining the economic efficiency and destroying its capability to deliver public goods and services, the result was a highly skewed distribution of income in the public sector lacking any kind of legitimacy.

We believe it is no exaggeration to claim that corruption in the tax administration has been the kingpin of the problem of corruption in the transitional economies. We see from the following figure that Azerbaijan has had a more serious problem with its tax administration than most:

Diagram 1: Tax revenue and government spending, selected transition economies



(Note that the tax data is different from the table.)

The diagram also shows that the public sector's capacity to perform tasks that demand spending has been reduced more strongly in Azerbaijan than in most other transition countries. Again we may note Uzbekistan's exceptional development.²⁰

²⁰ Here we need to make a caveat: Statistics in Uzbekistan are likely to be more upwards biased than elsewhere because of stronger political pressures to make positive impressions.

5. Some characteristics of corruption in Azerbaijan

We started out by showing that according to international observers corruption in Azerbaijan is a significant empirical phenomenon. The corruption levels were high compared to most other countries. From there we backtracked into a general presentation of economic problems in countries leaving the command system for a market economy and indicated how these developments could lead to corruption. Without this broad description it would be difficult to understand the present high levels of corruption and its role during the transition. For several variables there is established fairly firm general empirical evidence of their impact on corruption. There is also fairly firm evidence of the effects of corruption on important variables such as the share of underground economy (Kaufmann et al. 1999). Nevertheless, the information is still not so precise that it makes it meaningful to establish any general, econometrically specified equation system where corruption perception is included as both a right hand and left hand variable, plug in Azeri data where they are available and predict the value of the remaining variables.²¹ Since this was not possible we had to resort to the less compact description and analysis presented in the preceding chapters in order to explain the high corruption levels in Azerbaijan.

To claim that corruption levels are perceived to be high, does not tell that much about the phenomenon, however. Is it possible from the basis of empirical evidence to give the corruption phenomena more structure and, for example, to indicate where corruption arises more frequently than elsewhere, and what kind of problems it gives rise to in the various arenas of people's daily life?

²¹ In systems of so extensive corruption a simple regression with a corruption frequency indicator at the left side will simply not do. The feed-backs from corruption to the other variables are likely to be too strong. For example, when so large share of the public officials' income is corruptly acquired, corruption rates influence the country's registered income levels, taxation rates and so on. This makes it difficult to isolate and identify the both the causes and consequences of corruption in any precise way. We are aware of only two econometric studies that takes account of these feed-back loops. One is (Treisman, 1998). He uses a 2SLS procedure His results are not very exciting, however, but he does find that GNP per capita has a negative impact on corruption. The same applies to being a member of the former British empire, while a federal government structure has a positive impact. The second study is Leite and Weidmann (1999) who also are using a 2SLS procedure. Their results are more interesting, and we will return to their work in the conclusion.

While there is not much empirical research that can be identified as being made in Azerbaijan, we have some World Bank questionnaires where some of the respondents are from Azerbaijan. Furthermore, other investigations have been made from countries that are sufficiently alike it to make it reasonable to imply that they are valid for that country too, or rather this is our assumption.

5.1 The incidence and character of corruption in Azerbaijan

In household surveys made by the World Bank in countries like Albania and Georgia, we get a detailed picture of how corruption may have impact on people's daily life. However, so far only a brief report from this research is published (Kaufmann, Pradhan & Ryterman, 1998) to which we will return. The other strand of research is well documented (see Brunetti *et al.* 1997) and has focused on private business experience.

Unlike other surveys with comparative intentions, the Brunetti surveys focus on national business operators, not international ones. This has the advantage of asking people who have better inside understandings and who are closer to the country's political and public administration. Furthermore, they are less exposed to international rumours, and likely to be more representative with respect to political protection, than foreign investors who either may be less or better protected politically than the representative local entrepreneur. The questions of Brunetti have also been more detailed and less general than the ones used for the Transparency International's indexes.

On the other hand, local businessmen know less about the circumstances in other countries, which implies that a higher rating of, let us say, corruption frequency in country A than B may not imply that the actual rate is higher, but rather that businessmen in country B are emotionally more strongly involved with the phenomenon, maybe because it is less common. Biases because the interviewers are more concerned with the issue in some countries than others may also arise.²²

²² Commenting the results reported in Kaufmann *et al.* 1999 on governance, the authors mentioned at seminar in the World Bank in July 1999 that the Brunetti results correlated less well with the other comparative surveys and believed this might be caused by this bias. The other possibility is that the other indexes reflect common international opinions about countries, some of rather subjective nature.

The survey reports the answers from almost 4 000 business enterprises distributed across 74 countries, including Azerbaijan. The results were not, however, reported at the country level, probably mainly because of the political sensitivity of the results. Hence, the answers from Azerbaijan are reported together with the results from Georgia and Armenia under the heading of Caucasus. We find no reason to believe that the results here are biased in the direction of overestimating the corruption problem in Azerbaijan. As we have already noted, Azerbaijan was ranked higher on TI's corruption perception index than both Georgia and Armenia.

One of the major results from the Brunetti survey is that it confirms the results from the general perception indexes that the countries undergoing a transition from central planning to a market economy have a high incidence of corruption. Even in the socially more stabilised Visegrad countries almost 40% of the enterprises asked, reported that they had to make irregular payments regularly (Brunetti *et al.*, 1997, no. 1809) . In Caucasus this applied for about 70% of the enterprises , as we can read from the following table:

Table 9. Indicators of corruption levels in the FSU area

	<i>Baltic countries</i>	<i>Caucasus countries</i>	<i>Central Asia countries</i>	<i>Slavic countries of the FSU and Moldova</i>
“It is common for firms in my line of business to have to pay some irregular ‘additional payments’ to get things done.” This is true				
- 1 always	4.3	22.8	19.4	15.3
- 2 mostly	15.1	26.4	25.4	26.2
- 3 frequently	20.3	20.1	21.6	17.8
- 4 sometimes	23.4	17.0	21.7	21.0
- 5 seldom	21.5	6.7	5.6	10.5
- 6 never	14.7	6.7	2.7	9.2
“Firms in my line of business usually know in advance about how much this ‘additional payment’ is.” This is true				
- 1 always	6.6	17.0	9.8	9.4
- 2 mostly	18.1	29.5	33.4	34.3
- 3 frequently	16.0	13.6	20.1	15.6
- 4 sometimes	18.0	22.5	20.1	18.2
- 5 seldom	20.3	9.2	8.2	11.2
- 6 never	16.2	7.4	4.7	10.9

Source: Brunetti et al. 1997, no. 1809.

The second question is also an indicator of corruption frequency, because high frequency gives rise to standardisation of corrupt contracts, prices for them develop and become known. We see even among the set of countries undergoing transition, that the Caucasus (including Azerbaijan) is a high corruption area. The first question in the table was also posed in a world wide survey, where the CIS area (including Caucasus) scored highest of all the major economic areas:

Table 10. World wide indicator of corruption levels

	<i>Corruption Index</i>
All countries	3.86
High income OECD	5.04
South and South-East Asia	4.12
Middle East and North Africa	4.01
Central and Eastern Europe	3.82
Latin America and Caribbean	3.79
Sub-Saharan Africa	3.55
Commonwealth of Independent States	3.16

Source: Brunetti et al., 1997, no. 1760. Lower values of the numerical indicator indicate a higher corruption frequency. These regional numbers are simply the arithmetic mean of the national average response to the first question in Table 9 with the numerical weights presented there.

In other words, Caucasus may be the area with the highest incidence of corruption in the world. Does that imply that the corruption problem there also is the most serious?

Brunetti's survey also presents data on other interesting attributes with corruption that may shed light on this question. We see that the corrupt transactions in the area contain a fairly high degree of unpredictability in the sense that about half of the time the enterprises must expect that when they have made a payment, another agency will come forward and claim its share. Brunetti considers this blackmailing. This we may read from the following table:

Table 11. Some characteristics of corrupt transactions in the FSU-area

	<i>Baltic countries</i>	<i>Caucasus countries</i>	<i>Central Asia countries</i>	<i>Slavic countries of the FSU and Moldova</i>
<p>“Even if a firm has to make an ‘additional payment’ it always has to fear that it will be asked for more, e.g. by another official.”</p> <p>This is true</p> <ul style="list-style-type: none"> - 1 always - 2 mostly - 3 frequently - 4 sometimes - 5 seldom - 6 never 	2.7	12.6	14.6	5.3
<p>“If a firm pays the required ‘additional payment’ the service is usually also delivered as agreed.”</p> <p>This is true</p> <ul style="list-style-type: none"> - 1 always - 2 mostly - 3 frequently - 4 sometimes - 5 seldom - 6 never 	12.9	14.6	8.4	10.9
<p>“If a government agent acts against the rules I can usually go to another official or to his superior and get the correct treatment.”</p> <p>This is true</p> <ul style="list-style-type: none"> - 1 always - 2 mostly - 3 frequently - 4 sometimes - 5 seldom - 6 never 	6.0	7.4	2.7	3.5
	25.7	11.1	10.3	9.2
	11.9	15.2	10.5	8.3
	24.4	20.7	28.2	24.6
	24.1	31.7	35.8	33.8
	5.9	13.0	8.8	17.8

Source: Brunetti et al., 1997, no. 1809.

I read a low incidence of positive answers to question 1 and 3 and a high incidence to question 2 in this table to imply that corruption is highly organised in the sense that when other officials realise that a corrupt transaction has taken place only in a third of the cases are superiors willing to look it up. Brunetti *et al.* interpret question 1 to indicate the extent of blackmailing. A positive aspect of corruption in Caucasus is that a surprising number of officials appear to keep their promises when having made a corrupt deal. As Shleifer & Vishny (1993) have argued, decentralised bribing systems where each public official may try a hold-up may be exceptionally harmful to economic development. In such situations even honest bribe-takers are unable to keep their side of the deals.

While corruption is high on the list of obstacles to business in the area, and while its incidence in Caucasus may be the highest in the world, corruption is considered a less serious obstacle to business here than in other, less corrupt areas in the world. Both in sub-Saharan Africa and Latin America is corruption considered a more serious obstacle to business than in the CIS area, although not only is the incidence lower, but they also score lower on most of the other negative attributes of corruption. The only exception is that corrupt promises are more often broken in Africa (Brunetti, 1997, no. 1759), but the difference here is not very striking. The largest difference between these two areas was in the degree of predictability of corruption. While only about 35% of the enterprises in Africa knew in advance the size of the bribe, almost 70% of the enterprises in the CIS area did.

These surveys did not only look at corruption but also at other factors like crime, violence, unpredictable judiciary, political instability, and so on, as obstacles to business. For most of these variables (crime excepted) the same pattern emerged: Caucasus had a high incidence of the problem, but scored surprisingly low when considered as an obstacle to business (Brunetti *et al.*, 1997, unpublished).

This is somewhat puzzling. A possible explanation may be that fairly strong pro-business attitudes are held both among officials and in the population. Corruption does not always mean the creation of roadblocks, but also their removal. While the first type of consequence is probably the most recurrent one also in Caucasus, a larger

share may be of the second type, making it possible for business enterprises to avoid regulations that are harmful for them.

What applies to Caucasus, applies probably even more so to Azerbaijan. *The Economist Intelligence Unit* (22 March, 1999) is summing up somewhat subjectively what can be read from Brunetti's tables:

“Reliable corruption. A tricky one this. Azerbaijan is certainly a chronically corrupt country. But Baku-based executives have learned to live with corruption better than their colleagues elsewhere in the CIS. Unlike in Russia or Ukraine where the businesses are deluged by requests for hand-outs from all sides – officials, business partners, complete strangers – things in Azerbaijan tend to be well-ordered. The fact that the country is tightly controlled tends to mean that there is just one person to pay off, and a single payment generally ensures good treatment. In Azerbaijan corruption is not a cancer on the system; it is the system, and to an extent it works.”

5.2. The location of corruption

Brunetti's surveys give not any direct information about where the corrupt transactions are taking place, – but maybe indirectly so. In the ranking of major obstacles to business in Caucasus 69% of the respondents ranked taxes and tax regulations as a very strong obstacle, while only 51% considered corruption to be so (Political stability – or rather the lack of it – was only the third-ranked obstacle, 39%, despite the fact that there recently have been two major ethnic wars in the area).

As pointed out in Johnson & Kaufmann (1999), tax rates in most CIS countries – at least ex post – are fairly low, so it is tax regulations (including customs regulations) that are likely to create the largest problems. Cumulated tax arrears are not likely to be a problem for foreign firms and a motive for going underground.

This does not imply that the reported tax obstacles are not closely interwoven with the high incidence of corruption in Azerbaijan. There are two basic ways through which they are used to generate illegal income.

- (1) Tax officials may warn firms working in the official economy that they have violated some of the many detailed rules for filling in forms and threaten with actions that they know will harm the enterprise severely if no bribes are paid. Customs officers may, for example, confiscate a shipment temporarily, and refuse to give it away before bribes are paid or some impossible rule is complied with.²³ The IMF has estimated that for a number of taxes, the Azeri authorities are only able to collect 50% of the flow of new taxes due. We may safely assume that parts of it are collected as bribes instead.²⁴
- (2) The threat of applying these rules may drive the whole line of activity or the whole enterprise underground. There these rules may be avoided, and at the same time it becomes easier to collect bribes from the activities of the enterprise. This approach is not easy to apply for foreign firms, however, but the first one is. A further complication is that legal enterprises may be exposed to the competition from unpredictable underground lines of activity tied to the manipulation of tax rules.

An example of this was much talked about in the community of foreign businessmen in Azerbaijan. Fairly stiff import taxes and heavy regulation had been imposed on imports of tobacco. This had given rise to extensive smuggling, i.e., the activity was driven underground, and brought considerable income to the customs officers and, presumably also to the illegal importers. A foreign businessman calculated that if smuggling was stopped, the manufacturing of cigarettes in Azerbaijan was a profitable line of activity. After being promised that smuggling would be stopped, he started up a plant with a couple of hundred employees. The customs fought back, however, and smuggling was continued. The foreign businessman had to leave Azerbaijan with a heavy loss, or so the story goes.²⁵

²³ A colleague was, for example, refused by customs to enter Azerbaijan with a train from Georgia with his luggage unless he either paid \$50 or was able to produce a valid transfer pass for his stay in London. As a Norwegian he would not have such document.

²⁴ According to the last issue of *Monitor*, a government-critical magazine in Russian, anonymous experts had calculated that bureaucrats extorted as much as 80 million US dollars a month. That is roughly 3800 billion manats a year, 50% more than the total above the board income of the government. If true, all the tax not paid according to the IMF would end in the private pockets of the tax officials – not very likely, if IMF has set the amount of taxes actually due correctly.

²⁵ Whether true or not, it does illustrate the problematic ways the underground sector of the economy interacts with the official one in a system with strong, political inter-linkages.

Again, we see how parts of the tax administration often will create severe obstacles – like heavy import taxes on tobacco – because these obstacles may create corrupt income opportunities. Indirectly, the result of the Brunetti survey that tax rules are the most severe obstacles to business, may just underline the importance of corruption as the underlying problem.

Our informal interviews confirmed this impression for Azerbaijan. The part of the tax administration with the worst reputation in Azerbaijan is the *customs*. Our informants told that for good sites, but at fairly low administrative levels, new entrants to a position are expected to pay 100 000 \$. They were expected to be able to pay this money back within half a year.²⁶

As pointed out in the discussion of the bartering system, the interface between public administration and markets, where transactions are performed with hard money is a crucial site for corrupt transactions. During Soviet rule international trade (even more than goods and services delivered to consumers, that also were transacted in hard cash, but with non-convertible roubles) was such a site. The customs today have had the possibility to build on old investments in informal networks to do their trade, not having to build up the illegal transaction network from scratch, as was the case for many of the newly established, hard money-using markets.

Unlike these international surveys, the country studies on households, enterprises and officials – directed by the World Bank – report more directly on concrete situations and prices. They have been parts of public, political campaigns directed against corruption and have presupposed some support from political authorities.²⁷ So far, no such campaign has been launched in Azerbaijan, but the situation at least in Georgia

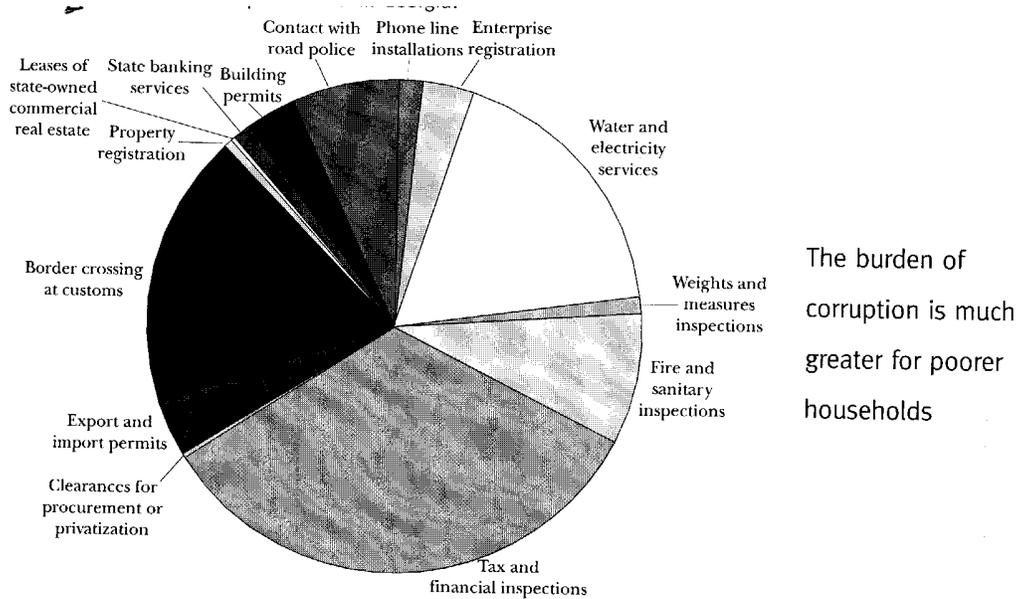
²⁶ Even long before the Soviet regime the customs administration was reputedly corrupt in the Russian empire. The second time the most famous embezzler in Russian literature, Chichiev (Gogol, *Dead Souls*) became rich, it was as a customs official on the border between Russia and Poland. Gogol had constructed the story of the embezzler on the basis of observations made in the 1830s.

²⁷ We have not enough information about how the surveys actually were done to tell whether the campaigns themselves might have created biases. Some of the numbers from Latvia may be in the upper end. Viewed on the basis of other indicators – such as the share of taxes in GDP - the difference in corruption levels between Latvia and Georgia should be larger than this survey suggests.

is sufficiently similar to make the results there relevant for Azerbaijan. Although the research has not been reported in full, we have at least a brief note reporting on it (Kaufmann *et al.*, 1998).

Bribes constitute a significant share of the official enterprises' expenses. In Albania and Latvia bribes account for 7% of revenue in firms that admit paying them, in Georgia 15%. 12% of households in Latvia admit paying bribes and 14% do so in Georgia. Bribes constitute a larger share of expenses in poor households, but they pay less. A summary of where corruption is located can be read from the following figure:

Diagram 2: Where does corruption occur in Georgia?

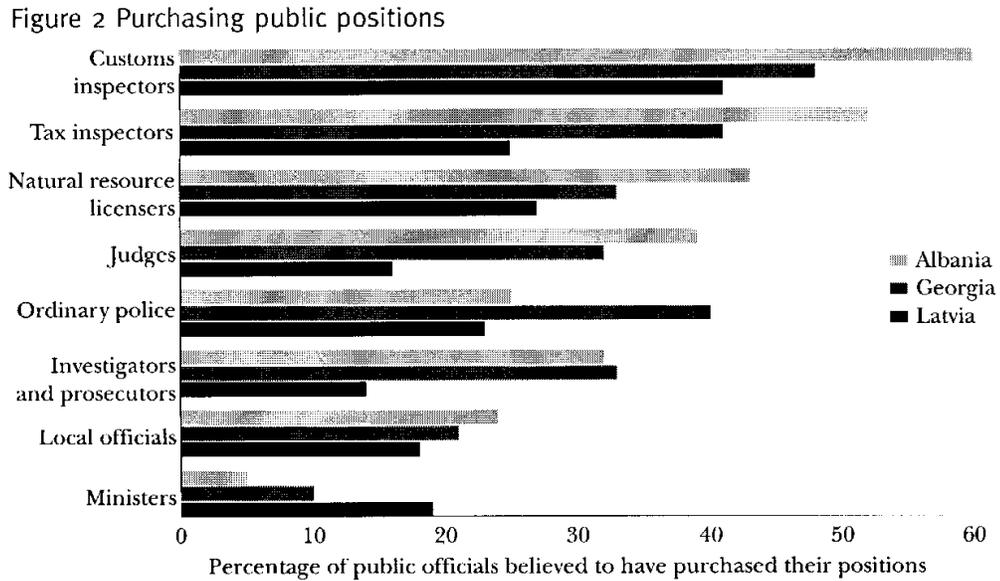


Source: Kaufmann *et al.*, 1998.

The pattern in Azerbaijan is likely to be fairly similar. Like the rumours about customs inspectors in Azerbaijan, public positions appear to be frequently purchased and sold in many parts of the administration. The capitalising of corrupt income streams is an important phenomenon with many consequences. For example, it obviously makes a return to low corruption levels more difficult since a sudden change implies a large

capital loss for many powerful agents. The distribution of public positions with capital value across administrative areas is also significant. We may get a rough impression from the following diagram:

Diagram 3: Purchasing public positions



Source: 1998 World Bank surveys of 218 public officials in Latvia (with Latvia Facts), 350 public officials in Georgia (with GORBI), and 97 public officials in Albania (with ACER).

Source: Kaufmann *et al.* 1998.

Finally we may get a very concrete understanding of the transactions involved from a comparison of Russian and Ukrainian data:

Table 12. 'Unofficial' payments for official permits in Ukraine and Russia

'Unofficial fee' type of licence/'favour'	<i>Ukraine</i>		<i>Russia</i>	
	Average 'unofficial' fee required for favour*	% of enterprises admitting need to pay 'unofficially'	Average 'unofficial' fee required for favour*	% of enterprises admitting need to pay 'unofficially'
1 Enterprise registration	\$179	66%	\$288	44%
2 Each visit by fire/health inspector	\$42	81%	\$67	23%
3 Tax inspector (each regular visit)	\$87	51%	\$250	21%
4 Each phone line installation	\$894	78%	\$1,071	100%
5 Lease in state space (sq. meter per month)	\$7	66%	\$26	39%
6 Each export licence/registration	\$123	61%	\$643	43%
7 Each import licence/registration	\$278	71%	\$133	50%
8 Each border crossing (lump sum)	\$211	100%	(na)	(na)
9 Each border crossing (% of value)	3%	57%	5%	48%
10 Domestic currency loan from bank (preferential terms)	4%	81%	8%	38%
11 Hard currency loan (preferential terms)	4%	85%	23%	53%

* Average among those that admit making unofficial payments.

Source: Kaufmann, 1998.

While not so specific about details, the stories told by informants in Azerbaijan indicate that the situation is basically the same.

5.3. Why corruption levels are so high during the economic "transition" – some political reasons

So far we have argued that several of the changes in the economic structures and institutions have created an institutional mix that has contributed to increasing the cor-

ruption levels in most FSU countries, including Azerbaijan. We believe there are political and ideological reasons as well.

We have seen from our definition of corruption that it is a form of illegitimate intrusion of market forces on the way organisations operate. One of the major reasons why a democratically oriented capitalist system is efficient is precisely this: It separates the spheres of market-oriented and public-oriented decisions. In order to be able to do so, many constitutional safeguards have to be brought in and be respected. By itself the system may not be institutionally stable. Martin Weitzman has recently drawn a striking metaphor:

The capitalist system is a two-ring circus. In ring one are the lions of capitalism – competitive, aggressive, mean-spirited. In ring two are the lambs that represent good government, a civil society, and a kinder, gentler life. The circus act is better when the lions are pumped up and really hungry. But this sets up a tension, because the hungry lions are not supposed to cross over the line drawn in the sand, separating them from the lambs resting in ring two. It is an implausible, potentially explosive, contradictory situation when a society wants a ring full of ferocious lions but expects them not to transgress the weak and seemingly artificial boundary on the circus floor (Johnson *et al.*, 1997, 233–34).

To stretch the metaphor a little: In the old socialist system, no such lines were drawn. It was against that system's conception of democracy. The lions were kept at both sides of the rings, but to some degree they were caged. In many countries they were let loose after the transition while in practice the lines of separation have not been policed, sometimes hardly drawn.

We see the effect of this historical lack of boundaries in diagram 3. When the corrupt income of judges, policemen and investigators/prosecutors has become capitalised so easily in almost publicly known list prices, it is, of course because their decision-making powers are valuable, but also because they may so easily be bought. One important reason for that again, is that in the Soviet system it was never strongly estab-

lished as a moral norm that they should be independent. Rather it was their democratic duty to use their powers to serve the people through its instrument, the communist party. When that party's power crumbled, why not then let money dictate? We should add that even before the transition started, the judiciary was considered more corrupt than the average area of administration in the Soviet state (Simis, 1982).

It is a striking characteristic of the Azeri society that the judiciary has been both politically controlled and highly corrupt. A large part of that fact can be explained as adaptation of the Soviet system to new opportunities for gaining money as markets opened up.

Moral confusion caused by the transition is another general reason for the spread of corruption. In the old system the formal norm was a planned distribution of goods and services. Production and distribution of goods were performed with the same apparatus that also made purely political and bureaucratic decisions. The establishment of markets for the distribution of goods was in most cases criminal acts, a corruption of the system. In extreme cases, like in Albania, even tips in restaurants were legally a bribe. Seen from the point of view of the old Soviet law and norm system, the largest part of the transition itself was a proposal for making large-scale corruption legal.

Now officials are told that markets are not corrupt, on the contrary, they are the most efficient way to organise a society. Why then not also buy and sell political decisions and regulatory powers? Why introduce these particular restrictions on which markets to open that only forbid the open sales and purchases of that subclass of public decisions that did not involve the supply of individual goods and services?

The old system has often been criticised in superficial ways for bringing about corruption. The critics have, for example, often forgotten to note the formidable transaction costs involved, and the rather low living standard expected of the elite that made it difficult fully to enjoy too successful bribes.²⁸ Nevertheless, the Soviet system had at least two features that have facilitated the recent rise in corruption in the

²⁸ The frequent enumeration of the petty privileges of access to foreign currency stores in this literature just confirms our point.

FSU countries: (1) a *legacy of repression* and (2) the *habits of secrecy*. The first inheritance has mainly created corrupt income opportunities, the second has made it easier to get away with it.

It is clear that when people are accustomed to a situation where they could easily be sent to jail or receive other forms of punishments in rather arbitrary ways, they will also be more willing to pay if threatened. Given a large underground economy, and a legal framework in flux, it is obvious that a large number of both intentional and unintentional illegal actions are taking place. With a repressive apparatus that is feared and secretive, it is no wonder that the willingness is high among both enterprises and persons to get away with a bribe when having performed a possibly illegal act.

This was, of course, the case even under Soviet rule, but then less hard money passed through the enterprises. The legacy of repression stimulates both high and a low corruption while the habits of secrecy probably facilitate grand corruption the most. It is likely that the present regime, in fact, is much more reluctant to apply force, but the public might not know that for sure. Then officials in the repressive apparatus may exploit the public's lack of information to their own advantage.

It is often claimed that corruption levels during the old regime were even higher than today. It is true that whole branches of corrupt activity existed then that are gone now. Foremost here was the incentives to bribe officials who were in a position to report the results of the enterprises to the (planning) authorities. The interest for such plans today is minor since they don't exist. Secondly, the illegal enterprises supplying the illegal markets had to buy political protection. When these markets became legal, that need disappeared.

It is fairly well established empirically that corruption was exceptionally high in Azerbaijan already during Soviet rule, but even in Azerbaijan we believe corruption was overall more contained than what is presently the case. What then kept the lions caged?

As pointed out in Andvig (1985), the major brake was the large transaction costs normally involved when bribes were to be paid in the planning system. Put simply, that was due to the missing cash nexus between the socialist firms. An enterprise that produced some specific type of machines to a plant making cloth had no incentives to bribe in order to deliver, but the cloth maker had, due to the excess demand system that ruled. It was easy to sell, but difficult to buy. However, if he wanted to bribe he disposed of practically no money, so before he eventually could bribe, he had to deliver some cloth to a manufacturer of, let us say, dresses. If the dressmaker was able to keep aside some dresses illegally, selling them to a store, the store could get hold of some cash that only ruled at the end of the pipeline of production.

Only when such illegal market chains were established could corruption reach any significant proportions. This happened to some degree during the Brezhnev era, but still the possibilities were limited and the elite lived on the whole fairly modestly. Azerbaijan was, however, an area where such illegal networks were more frequent and dense than elsewhere in the empire and some members of the elite were rich also according to the standards of a market economy.

6. Recent history of corruption in Azerbaijan

There were probably three major factors behind the exceptionally high density of corrupt acts in Azerbaijan during the Soviet period: *oil*, “*clans*” and other cultural factors, and the *cumulative* character of corruption.

There are several indications that Azerbaijan had one of the highest, if not the highest incidence of corruption in the Soviet period:

(A) Simis (1982) reports that students at the medical school at the University of Baku had to pay a higher bribe than anywhere else, 30 000 roubles. Georgia was the only one that came close with 15 000 roubles. The fact that this bribe was higher indicated that the capitalised value of the corrupt income earned as a medical doctor was higher in Azerbaijan than elsewhere.

(B) In the period 1965–90, 21.85 officials per one million inhabitants were convicted for economic crimes in Azerbaijan. The only area that was close was again Georgia with 15.00, then followed Armenia with 7.27 (Clark, 1993, 88). These statistics could of course be misleading because convictions could be mainly caused by political campaigns such as Heydar Aliev’s own anti-corruption campaigns in the late 60s and early 80s in Azerbaijan, both of which gained him political promotions. Azerbaijan and Georgia were also the two republics where sale of public positions is known from this period (Grossman, 1982, 152).

How could oil induce corruption? Basically, because it could reach a market with hard money – it could be exported or it could reach the consumers directly. If any of the oil could be sent out illegally, large private fortunes might be generated. Several methods of embezzlement were possible. One scheme was the following: Power plants could either use oil or gas as input. Gas was practically free and almost non-controlled. By supplanting oil with gas in the power plants and keep it as oil in the accounts, fairly large amounts of oil could be siphoned out of the planned, official economy and moved along networks of Turkish (or maybe Irani) businessmen, some which may even belong to related clans of the original embezzler. This business

probably increased in scale as it became less dangerous to have irregular contacts abroad. Other more complicated underground networks from the later Soviet period are also known.²⁹ Vaksberg (1991) tells a story where the whole supply of petrol to cars in Baku was controlled by one such network.

While there was not much oil left compared to the 1940s, it was still sufficient to make oil an income basis for which also public officials such as the police³⁰, and politicians could feed upon. In addition, Azerbaijan had fairly large consumer-directed industries which were close enough to the cash-based demand to make illegal transactions easier to organise (Grossman, 1982). Large-scale operations certainly needed political protection; 15-20% of the irregular profit had normally to be spent on this kind of expenses (Simes, 1982). To risk such action under the harsh penalty system under Soviet rule close co-operation between briber and bribee was needed. In addition, co-operation was needed between buyers and sellers all along the illegal chains of commerce or bartering complexes needed to bring hard money into the pockets of the embezzlers, or the organisers of the illegal production.

Mars and Altman (1983) have pointed to a number of cultural factors in Georgia that contributed to the development of these irregular networks that were necessary for developing the scale of the black economy during the late Soviet period: The emphasis on i) risk-taking, ii) predominance of trust in personalised networks, most often based on family and therefore, (iii) a sense of honour and shame and (iv) a distaste for formal hierarchies. While based on fieldwork among Georgian émigrés, similar characteristics appear also to apply to the Azeri population. This is a kind of culture that may easily accept corruption.

However, it is not so easy to distinguish genuine cultural acceptance from the workings of a third factor, the cumulative nature of corruption: When the number of corrupt acts increase, they become more easy to organise, their search costs go down and

²⁹ We should add at that we have less reliable information about the late Soviet underground economy in Azerbaijan than we do about Georgia due to Mars & Altman's large questionnaire studies of 5 000 Georgian emigrants going to Israel.

³⁰ The increase in the number of irregularities was probably one of the reasons why KGB's and some other police organisations' power seem to have increased during this period. They were in a position to observe them and to gain from that information either economically or politically.

the risk of being discovered reduced for each individual violator (Andvig and Moene, 1990). More corruption increases the scale of activities possible to organise underground. That expansion again could make more extensive corruption viable. That left a cultural legacy of corruption that made it relatively easy to organise it in most situations of life. As it becomes more common, the moral costs of getting involved go down, and the task of fighting it may appear more difficult or nonsensical. The end result may look like a cultural acceptance. To distinguish the factors, a political shock is needed.

For both types of transactions – illegal sales of goods and bribing of public officials – the existence of personalised networks made the organisation of illegal transactions easier on a fairly large scale. Here one could build on ancient codes for identifying agents in which one should have higher degree of trust. These codes could easily be generalised so one created on the basis of school cohorts or any other situation where strong feelings of us and the others may be produced – an important part of the behavioural codes in the area, it seems. Friends are friends in almost any situation.

To really develop large-scale corruption and a large underground economy, not only bottom-up developments such as the one just sketched, were important. What happened at the political top was equally important. It is documented both for Georgia³¹ and Azerbaijan (Yürünel, 1997, Holmes 1993, Voslensky, 1986) that leading party positions were bought and sold in the late 1960s. In Georgia one had an interesting two-stage auction of the positions. In the first stage each patron nominated his own candidate, and received a bribe. In the second stage part of this bribe had to be spent on gaining support for the candidate. However, the outcome was not determined by the size of the bribe. The power of the patron was also important. In Georgia the price for becoming a minister varied between 100 000 and 300 000 roubles. Among the preconditions for making this a system were (1) that the personalised networks themselves had grown into a kind of hierarchy, but a personalised one, (2) that the local elite had developed sufficient blocking power to make the area difficult to rule from

³¹ The documentation has come from Shevarnadze's anti-corruption campaign in 1972-73 in Georgia. The numbers and information of the purchase and sale of public positions in Azerbaijan is coming from Aliev's 1969 anti-corruption campaign.

Moscow without its consent and was allowed to keep it by not threatening the central system of power.

The implication of the capitalising of a corrupt income stream implied by the selling of a position is that the seller has acquired sufficient property rights in the position to be able to sell it, i.e. he has to be sufficiently protected politically. That was the case in Azerbaijan and Georgia during a large part of the Brezhnev period. Without such protection the risk involved when investing in a position would be extremely high from the buyer's point of view.

The very profitability of developing clandestine networks stimulated the development of clans and made the members of the successful ones comparatively rich. In other words, the Soviet period left Azerbaijan with a number of clandestine business and political networks partly overlapping a clan structure, and a large share of public officials was possible to buy. Jewish networks were also quite important in developing the Soviet underground economy, not only in Georgia as documented by Mars and Altman in a series of works, but also in Azerbaijan.

Not everything is structural, however. It should be added that while part of the motivation for Aliev's anti-corruption campaign was his own political ambition, it was also partly successful in reducing corruption. During the early 1970s Aliev was given fairly free hands in firing the old politicians and install his own men. Partly to mitigate corruption, partly to prevent anyone to build up competing networks to his own, he started to rotate his subordinates across positions. He emphasised discipline. The result was that production and productivity levels in Azerbaijan increased significantly and corruption levels probably went down (Willerton, 1994).³²

After a while, there were serious indications that corruption started to increase again by the late 1970s (Holmes, 1993), and this time Aliev's men were in charge. Accord-

³² Aliev's results were probably an important motivation of Andropov's discipline campaign, also pursued by the early Gorbachev. Economists are often surprised by the effects of such discipline campaign. An explanation of why they might sometimes work for socialist economies, see Andvig, 1992. Vaksberg (1991) is sceptical of this campaign, however, and implies that production only increased on paper.

ing to Clark (1993) Aliev himself started a new campaign against corruption in Azerbaijan that went on in the period 1977–1982, while Andropov led a similar campaign at the central level, probably directed against Brezhnev. How successful these campaigns were is unclear. In any case, it made it possible for Aliev to remove people who were capable to build up their own independent networks. Aliev appeared by many to have been too closely involved with Brezhnev, and after a brilliant career under Andropov, he lost power in 1987 (Willerton, 1994).

Vaksberg (1991) is very critical to Aliev's performance, and believes it was so skewed in favour of hunting down his political enemies and furthering his own "mafia" organisation, that the corruption-fighting was secondary. In particular, Vaksberg claims that he has reliable evidence that Aliev's organisation was in control of the illegal distribution of oil and petrol, the "petrol mafia" considered to be strongest of mafia organisations in Azerbaijan (*ibid.* 174–175). The basic technique was simple: petrol destined for government use and therefore only paid with book-keeping money, was sold to private citizens instead and therefore paid in cash. The embezzlement was said to embrace all petrol stations in Baku.

When the transition arrived, new and increased opportunities for the bureaucracy and politicians to do their private taxing of the enterprises when they were allowed to supply the (now) legal markets arose, together with the new structure of the underground economy. Presumably, a large number of the former underground enterprises would now become unprofitable. For example, it is difficult to believe that the large structure of illegal textile export out of this area to other parts of the Soviet Union could survive when imports from the world market were allowed. That export was based upon its very illegality inside the old Soviet system. Although not illegal, the widespread Azeri trade in fresh vegetables and fruit also became less profitable. It is likely that some of these extensive trade networks were more thickly fed with drugs instead and in that way could be held together.

Knowing the drastic change in the economic system that was taken place, a considerable reshuffling of networks in the underground economy must have occurred since 1992. The old illegal ties of the underground enterprises were not needed any longer, as the enterprise itself had become legal, or maybe gone out of business. On the other

hand, the old legal ties that joined the enterprises in the old Soviet supply system could now sometimes be turned around and used for illegal or semi-legal purposes: to assist in the bartering inside the new small country and maybe assist in the smuggling across its borders with other FSU states.³³ The same applies for the bureaucracies that are in a position to feed on them. For example, since Azerbaijan had become a country in its own right, the illegal income opportunities for the customs must have increased considerably.³⁴

In those parts of the Soviet Union where underground economic activity reached a large scale, such as in Azerbaijan, mafia-like activity also arose and Simis (1982, 109) tells how underground businessmen in Georgia and Azerbaijan sometimes were murdered for not fulfilling contracts. The clandestine networks full of agents lacking mutual trust raised a demand for justice. The public administration in Azerbaijan could not supply it, partly because of its illegality, partly because of its trans-Soviet character. Hence the competition for the private supply of justice, i.e. a demand for mafia-like organisations. The existence of family networks might have made it easier to meet the organisational challenge. The political instability in the period between when Aliev lost power in 1987 till he regained it in 1993 also contributed.

After the transition it appears that the mafia-like activity in Azerbaijan has declined – or at least their competition has done so, while it has had a rapid growth in countries like Russia and Ukraine.³⁵ This cannot be explained by the peacefulness of the Azeri people,³⁶ but is likely to be a rather temporary outcome of political processes in Azerbaijan, that have caused a centralisation of power, maybe combined with the ability of

³³ Hendley et al. (1999) show convincingly that in case of Russia, old Soviet distribution ties were the most important expeditors for enterprises also in the new situation, and more important than former Communist party officials or members of the new mafia-organisations

³⁴ This deduction is supported by much anecdotal evidence. Not only did the private income of customs officers increase. The nice new offices of the customs administration in Baku when so many other public buildings are dilapidating, are one of the talks of the town.

³⁵ Hendley et al. (1999) supplies interesting data that throw doubt on the widely held belief that mafia-like organisations have penetrated the daily transactions of ordinary enterprises in Russia. Less than 3% of the enterprises had used such a kind of organisation to ensure private contract fulfilment.

³⁶ In Phil Williams (1997, 233) it is reported that among the ethnic groups in Moscow, the Azeri had the highest number of organised crime groups, 32, while Dagestani were second with 20. However, when it come to actually committed crimes Georgians appeared to be the most productive, but less organised. To some extent the high number of organised ethnically based gangs may reflect prejudices of the Russian police. Inside Azerbaijan the yearly number of violent deaths is modest.

the present formal police and judiciary of being sufficiently corrupt³⁷ to be able to supply protection even to illegal deals in the underground economy and elsewhere. A comparable mix of centralisation and crookedness is likely to be rare even among the FSU countries.

The absence of visible mafia activity may not last. It was clearly present in the early 1990s when the political situation was more unstable. In addition to the likelihood that a considerable amount of regular economic underground activities will go on also in the near future, drug dealing gangs are also likely to continue their operations in Azerbaijan, having an old history in the area. If the present rulers lose their grip on the underground, more violent confrontations are likely to reappear, or so we believe.

³⁷ Traffic police corruption is the most visible to anyone visiting Azerbaijan. They charge, for example, 1000 manats a night for protecting a car. If you don't pay they normally empty your wheels for air. They openly "fish" for money by taking aside cars at random and demand some payment. If you refuse, they will formally charge you for a much higher amount. Driving against a red light (the signals are sometimes deliberately made difficult to see to make for richer catch) is more expensive and may cost a couple of hundred dollars - about 4 months regular salary. If you don't pay at the spot, you will have to pay twice of that amount above board at the same time as you have to leave the car until your case reach the courts. - One might hope that this kind of private taxation will have some kind of re-distributive effects since car owners should have above average income. This effect is at least partly nullified by the police making it a rule not to catch to expensive-looking cars. They may hide drivers with power.

7. Clans and corruption³⁸

During our interviews with public and private officials in Baku³⁹ the issue of clans was repeatedly raised. Some strongly expressed that clans exist and are extremely important in the workings of the Azeri society, others claimed they were unimportant, bordering on fiction. Even when the importance of clans was strongly believed in, it was not clear what a clan was or what it meant to be a member of a clan.

The only two bits of “hard” evidence about the existence of clans we discovered were (1) the fact that there apparently ruled a kind of inter-subjective agreement about which person belongs to which clan, when different people were asked about clan memberships of different public persons. This evidence is obviously not very hard, however, since rumours are normally shared. Another, more important bit of evidence was the fact that some international companies and aid organisations were willing to describe what kind of measures they took in order to ensure that not all their Azeri employees were members of the same clan and in that way could create a secret, competing organisation that might influence the formal organisation’s way of operating. Some even hired local lawyers to do the discrimination and was thus willing to support their beliefs in clans with money. What kind of clan organisations did these international organisations have in mind?

³⁸ Reliable secondary sources are missing. Our primary interview data are somewhat anecdotal and rarely stated precisely enough to discriminate sharply between theories. Our field stay was also too short for us to really get a critical grasp of the roles. On the other hand the issues we are dealing with are obviously important, yes, crucial for understanding the political economy of the country and for gauging the impact of the international oil industry. Since most of the persons who are supposed to know about the clans rarely state their views explicitly, but assume that their readers (or rather listeners) know about the system too, it is surprisingly little to gain from the existing literature. The authorities deny its existence. The political discussion of clans in a broader perspective is treated more extensively in another NUPI-report, Yurukel (1999). Here we focus on the role of clans for corruption. While the data are not good enough to discriminate sharply between the different conceptions of a “clan”, they should be sufficient for gaining a rough understanding of their modes of operation.

³⁹ The interviews referred to in the following were made by Jens Andvig and Sefa Yurukel together. Sefa speaks Azeri and understands some Russian. Both corruption and clan structure are somewhat touchy subjects. To supply information could conceivably hurt the respondents, so we often had to leave questions unanswered. It would be both inappropriate and unfruitful to be aggressive in forcing the respondents to be precise.

The standard anthropological definition of a clan is “a unilineal descent group whose members do not trace genealogical links to a supposedly founding ancestor”. By not having to trace such links, clans may become fairly large organisations. Clans are considered to be traditional organisations, often used for collective defence where the state apparatus is either weak or absent. The size of the expected conflict may determine the size of the clans. In fact, the growth of public administration and apparatuses has sometimes given this type of organisation new life by creating the need for larger organisations that may have the capacity to influence policies and redistribution taking place through it. It is in the wide sense of kin-based semi-secret pressure groups that clans have some interest in Azerbaijan. We have not heard much about mythical ancestors. Following the Turkish family system (Stirling, 1965) family and locality are likely to be closely inter-linked, so in the present context it might be difficult to differentiate between kin-based and locality-based groups. Without fairly extensive research, it is difficult to decide how elaborate and distinct the kin-based “clans” are.⁴⁰ For most purposes it is not too important to know whether clans are based on kinship or, for example, Komsomol membership twenty years back.

The focus of the public interest in clans now is not any interest in the village organisation in the Azeri countryside, but the way public organisations and business operate. So what has more direct interest for an analysis of corruption is that clans as informal, multi-purpose organisations of people showing a higher propensity of performing reciprocal acts to each other than to individuals outside the organisation, exist. Many members are also employed in public positions whose decisions clans may influence. These informal organisations have also a kind of ranking order where members are ranked into higher and lower positions in more or less formal ways. Our problem then is to formulate hypotheses about how they operate and what kind of evidence we have of their operations. How are they possibly linked to the high corruption frequency?

⁴⁰ Personally, I am somewhat sceptical about the existence of large, elaborate clan structures in Azerbaijan. As pointed out in Stirling (1965) the basic lineages in the Turkish culture area are fairly narrow to begin with, and most area specialists agree that clans in a more narrow sense are likely to be stronger in former Central Asia. It is difficult to have a firm opinion in the matter. The political vacuum and social instability after the demise of the Soviet state together with the prospects of shares in the oil wealth, may have increased the scale of kin-based organisations.

7.1. Azeri clans and their Soviet roots

We certainly have “clans” that operate in the public rhetoric, like the leading Nakhichevan clan. As such it may appear traditional, where most of the members are said to come from the same area, but our guess will be that most clans in Azerbaijan are not deeply rooted in cultural traditions but rather variations of a Soviet type of clans,⁴¹ networks that to a large extent were developed in the Soviet period (Matthews, 1992). Except for the reference to Heydar Aliev’s close family, there is rarely given any precise kinship mapping of (alleged) members of the Aliev clan when they are brought into public limelight (Shorokhov, 1996). Even if the clan members are coming from the same family or region it does not imply that they are furthering the interests of this region or their kin at home, but rather that they constitute a defined side group with identifiable characteristics.⁴²

The overrepresentation of Nakhichevan in the elite is probably not a myth. The most likely explanation, however, is rooted in recent Soviet history of public administration, and not in changing kinship systems. According to Willerton (1994), during Aliev’s consolidation of power in Azerbaijan in the early 1970s he made a systematic changeover in personnel in almost all areas of administration. To keep a firm grip, he promoted administrators from the Soviet governmental apparatus in Nakhichevan and employees from the republican KGB into key positions of the party and other jobs far above their former positions, so they owed their positions wholly to Aliev. In that way he could use his inside knowledge to screen good candidates at the same time as he could create a group of people that were likely to share a common political destiny, in other words; the nucleus of a “clan”. His political machine held power fairly undisputed in almost two decades, and became a strong network branching out in all directions of the Azeri society. Whether these local administrators were closely related to Aliev or not, he knew their characteristics fairly well. The same applied to the colleagues in KGB.⁴³ Competing politicians tried to build up similar networks, also

⁴¹ The “Gazprom” clan based on energy and three major banking clans, including the Berezoskij-clan - a Jeltsin sub-clan - are such modern clans (Walker, 1998), if they really exist outside the newspapers.

⁴² As shown in Haugland (1999). Nakhichevan is still the poorest of all districts in Azerbaijan. If the leading clan really had been traditional and strongly oriented towards its home area, that outcome is less likely.

⁴³ A much more critical presentation of Aliev’s consolidation of power is given in Vaksberg (1990). Supporting our contention that it was not a question of traditional clans, he tells how during this consolidation period, ambitious bureaucrats started to live in Nakhichevan for half a year or so to get the stamp in their passports: “anyone who decided to employ this manoeuvre was giving a sign that he understood the rules of the game and would serve honestly and truly.” (ibid., 179).

partly based on regional associations. When the Communist Party in the Soviet Union allowed regional party secretaries to make so extensive changes in local party apparatuses, they also created the political basis for clans.

Also when understanding the “clans” ways of operation, not only their origin, we believe it more fruitful to go back to the Soviet period, not the kinship systems of the 18. century. That governmental structure was based upon three hierarchies, at least two with partly overlapping areas of authority: The Soviet administration that roughly corresponds to our formal government, the Party administration and the KGB. The head of a territorial unit of the Party was the nexus of a large network of party members and Soviet managers and could follow most of the economic and political activities in the area. In principle, the party should stay outside the Soviet apparatus and inspire it and control it from there. While not so important at the enterprise level, it was dominant at the republican level.

Controlling all kinds of activities, the party was a multi-task organisation, and for that reason had to focus on the administration of personnel as the only way to keep control. It was the Party that administered the so-called nomenklatura system, fired and hired people in important positions – also in Soviet bureaucracies and thereby was in control (Andvig, 1992). As a network it branched out both in broad local networks dealing with many tasks and upwards towards Moscow. The enterprises, on the other hand, had more limited networks, and for the larger enterprises mostly branching out of the region. In addition to the rather centralised official network connecting it to the planning command structure, enterprises had informal horizontal networks with suppliers and “buyers”.

As a unified structure also the Party broke down after the demise of the Soviet empire, but in many local areas it kept its reins on power or even strengthened it as Moscow could not any longer intervene directly, and in a surprisingly large number of the new countries the final power-holder had been a leading local member of the Party. That was certainly the case for Azerbaijan where we have seen that the present president has been a high-ranking member of the Communist Party in the USSR, and for almost two decades the dominant power-holder in the republic.

The KGB had in one sense less decision-making powers, but was supposed to monitor both the wide set of enterprises and public activities in the region as well as the party members themselves. The information the KGB collected could easily destroy both managers and party officials. As more party members lost the political motivation and became more involved in illegal economic transactions, KGB's (and the other police organisations') power increased. It was no coincidence that both Aliiev, Andropov and Shevardnadze had risen to power through anti-corruption campaigns starting out from a police organisation. We see that, when combined, KGB and the regional party could function in many ways like any kind of clan (or mafia organisation) except that it was completely legal under Soviet law. Unlike independent clans both the Party and KGB had an imperial hierarchic structure and through their control of personnel were more powerful than the formal Soviet administration.

Hence it was no coincidence that most of the present leaders in the smaller countries in Central Asia and Caucasus⁴⁴ after the breakdown of the USSR, had been central in the local Party-KGB nexus. They were the ones who knew how to operate the power structures. As leaders of "clans" they could just continue the work at this nexus. To make decisions outside the formal, administrative apparatus of the government was just the natural old way of doing it. The major change was that one tried to supplant the ideology of the Soviet system with its formal institutional structure of parallel organisations, one which could control the others, with a formal institutional superstructure patterned on a Western model with an informal parallel organisation to control it, the "clan". The clans could operate on both the leftovers from the Soviet formal structure and the formalised Western parts of the administrative structure.

7.2. Clans and corruption: The sale of public positions

The conclusion then is that the central tasks of the "clans" in the economies of transition are to appoint and remove people from positions in the public sector. When one 'clan' dominates like what appears to be the case in Azerbaijan for the moment, the system is in many ways very close to the old one. When there is open competition, as

⁴⁴ Kyrgyzstan was an exception.

is the case in several parts of Russia, the result becomes more complicated and private systems of law enforcement, mafias, may develop to a greater extent.

The obvious link between this aspect of the clan's power and corruption is the selling and buying of public positions. Let us here take a look at the little information we possess.⁴⁵ Nowhere may we find a clear description about who is actually selling the positions, but if the clan theory is correct, it will be the appropriate rank level of that outside agency, the clan.⁴⁶

The position of local prosecutors is said to be sold for 2 million US dollars, prosecutor general 5 million, tax minister 2 million. A regular customs officer at a fairly "fat" site has to pay 100 000 US dollars. The purchase of a position is normally financed by the incumbent borrowing from family and friends, or his clan. The customs officer is supposed to have earned enough for recouping the investment after 6 months. After that (?) he is supposed to send 85% of what he gains on corruption upwards (through the formal hierarchy (?), or the clan(?)).⁴⁷ In any case the selling member of the clan needs to have close contact with his superior or others in the tax administration who are able to gauge how much he is earning on aside.

⁴⁵ The following is based on the unstructured interviews made by Andvig and Yürükel in Baku, February 1999.

⁴⁶ In the only empirical study we have come across where selling of positions or rather transfers is described, the sales were done by insiders, however. The study dealt with a large irrigation system in South India (Wade, 1982). There it was the superior inside the administration two levels above the engineer to be transferred who actually sold the transfers. The reason for the sale was that some of the positions controlled water in villages that could pay higher bribes to get the water. Only at the top was this system controlled by politicians (the Congress Party) outside the formal hierarchic system. - If the clan system is really operative in the way it is publicly perceived in Azerbaijan, the clan organisation is much more fine-grained and involved in the employment of persons at the very lowest level. However, even if a clan is in control in this way there is likely to be a rather strict correlation between rank in clan and rank in the public hierarchy, so it may sometimes be difficult to decide whether a clan is a myth or a working organisation. When it comes to access to positions in foreign companies, the clan organisation should be easier to identify.

⁴⁷ These pieces of information are internally consistent. The corrupt income potential of the position is 200,000 on a yearly basis if it can pay back 100,000 in half a year. To demand a normal rate of interest on the investment of 20% implies that the incumbent should have at least 20 000 on a yearly basis. He may then receive 5% for his work, 30 000 altogether. On the other hand, if he is allowed to keep 15% of 200 000 as his share, this will also be 30 000. If we compare this with what would have been his official pay, probably around 800 US\$ yearly, he will become rich and has no interest in rocking the boat despite the large share he has to pay the "clan".

In order to be willing to buy public positions they must generate sufficient earnings for incumbents to make it worthwhile. Most positions in the public sector, however, are presently earning too low or uncertain an income to make for capitalisation.

We have evidence not only of the capital value of a few positions. We also have such information about a few of their income items: A driver's licence may cost 400 US dollars, to enter the country passing the customs (poor passengers), 15–20 (Cullen, 1999), crossing on red light 100–200, nightly payment for the police not letting the air out of the wheels of parked cars 0.25, and being stopped by the police for no reason at all 2,5–5 US dollars.

The selling of positions represents, of course, a capitalisation of future corrupt income. The more secure the clan can make the position, and the higher the corrupt income, the higher its capital value. The larger the share to be sent upwards, the lower the value of the position at the lower levels and the higher for the higher levels.

By having the ability to sell positions the clan may refrain from detailed monitoring of the decisions actually sold, which otherwise is needed in order to fix the shares going upwards. In this way the clans economise on control in much the same way as the Party did. When this is exceptionally difficult, for example when decisions are complex and difficult to monitor it will make sense to collect all the rent from the capital value of the position. This might be one reason why prosecutors have such a high capital value compared to high-ranking tax officials.

The risk of capital loss should make incumbents of such positions be interested in keeping the ruling clan in power. During periods with clan competition positions should become more insecure and their capital value should decline. This should make most incumbents interested in peace, but if it is broken, clan competition is potentially very violent. There is much to lose. Peace may come through one clan keeping central control, like the Party once did.

However, there exist some other possibilities of truce and some sharing of power that will not reduce the capital values strongly. Normally, that would happen through some kind of partition of the public bureaucracies between the clans, each having the monopoly of selling positions in “their” part of public administration, which might have been what took place in parts of Russia, although the political instability might be too unstable there to make capitalisation of future income lucrative. An easy way to partition public bureaucracy is to do it along geographical lines. Seen from a ruler’s point of view, this is the most dangerous way to decentralise, however, because it allows competitors to build up a denser network of interlinked, personalised relationships.

The partition solution is not likely to be stable in the longer run. At the political level there will always be some superiors to the head of any partitioned bureaucracy. It is difficult for politicians above the highest level of positions allocated to a competing clan, not to interfere and thereby trigger off competition that reduces capital values since such income is likely to build up the political strength of its political competitors in the somewhat longer run. In the end, normally, in a Hobbesian equilibrium, there is only one government on any territory.

Despite the likely fact that some of the larger clans in the early 1990s coalesced around drug smuggling (Bezanis, 1996), the clans don’t appear to have developed substantial independent armed forces, but rather to rely on networking with parts of the public instruments of violence to achieve their “security” goals. That happened in both the 1993 coup (Bezanis, 1996) and the 1995 coup (Ochs, 1996). In neither of these cases was it likely that political motivation was decisive. It was rather attempts to cash in on the possibilities gained by the independence. Being politically too weak, these groups would need some kind of external patron.

We should add that the drive towards selling and purchasing public positions may not be wholly caused by social forces at the top of society. It may also be cultural drives coming deep down from the core of local culture: When you buy a position you are formally at the social level of the seller. You are equal and may not feel the loss of honour of being a subordinate. The feeling of equality is likely to be a fiction, how-

ever. As we have understood the system, if the incumbent leaves the position he is not free to resell it to anyone of his liking. The right of selling returns to the “clan”.

It may be too obvious to be worth mentioning, but it is important: To sell positions is incompatible with any kind of merit system. If you acquire a position on the basis of merit no one can have a property right to it.

7.3. How centralised is corruption in Azerbaijan?

From one point of view, the corruption in Azerbaijan appears exceptionally centralised, as noted by the country specialist in the *Economist*. The major reason is simply that one “clan” appears to have won control over the official, public apparatus. We are not aware of any recent systematic empirical work into its membership and modes of operation, however, but it is likely to be a mixture of members of a traditional clan with basis in Nakhichevan and a personalised network around the president with members consisting of former leaders of the communist party and the KGB. Using underground personnel policy patterned on communist party experience, personnel policy has remained an efficient way of controlling a large number of decisions (Andvig, 1992). Cross-institutional networks based on inter-personal interaction (not bureaucratic forms of communication) are at the centre of the clans’ functions. When combined with the centralised character of the personalised system of firing and hiring it may explain why corrupt contracts are so often kept in this area and not have to be redone by other agents in the bureaucratic chains.

Montias and Rose-Ackerman (1980) noted about the old Soviet system that if corrupt transactions were taken place there existed “multiple enforcement possibilities” – several different bureaucracies that could detect and act upon it, in principle. Since all bureaucracies were controlled from a common centre, the Party, the enforcement possibilities were not independent, so the centre could protect against all kinds of detection, if it so desired. This organisational feature appears to have been kept in Azerbaijan., which makes corrupt deals more easy to enforce and less risky..

The fact that control of personnel has to be made underground without the glue of any shared ideology is likely to reduce the scope of central control, however. The leader’s

age may work in the same direction. If true, the episode referred to above where a foreign investment into the manufacturing of cigarettes failed because particular interests connected to customs became threatened, may be an indication of weakened central control. Here the centre would know that such an event would both cause a loss of jobs badly needed for its overall legitimacy among people and create problems for its “impression management” vis-à-vis OECD countries. Furthermore, the resulting decline of foreign investment in other sectors than oil would not only be harmful for the long-run development of the country, it would also mean that there would be less for the national elite as a whole to feed on. Therefore this outcome may indicate a loss of central control. Whether it, eventually, was a slip or a sign of declining power, is too early to tell.

If the regime is so much in control, why not move the personnel policy up from the underground and into public parties? Why not then let the tax administration collect taxes on behalf of the formal government and pay the supporters decent salaries? After all, this is what partly happens in the traditional democracies, although here the number of positions open for political hand-outs are more or less limited by meritocracy.

This is also the core in the present World Bank – IMF proposal for reforming public administration in Azerbaijan and fighting corruption, except for their insistence on merit systems of public employment which implies that the profitable personnel policy has to be lifted out of the clan system.⁴⁸

Let us first state that the centralised control in the country makes such a (peaceful) revolution at least thinkable. The present elite’s long-run interests are likely to be ser-

⁴⁸These proposals are not yet made public at the time of the writing this section. A brief description may be found in *News, the World Bank Group*, scissoring an article in *Zerkalo* newspaper, 27 March, 1999. In addition to the tax element we may mention its insistence on merit systems. Here the plan is also based on solid ground. In a so far unpublished work, but a work that has had some impact on empirical corruption research, James Rauch & Peter Evans (1999) have argued strongly that merit systems (that is, the non-political employment of the bureaucracy) is the key to keep corruption levels low in the public sector. Since there exist strong traditions for buying good grades at the university level in Azerbaijan even formal merit systems may be partly undermined.

ved this way. Some parts of the “clan” organisations have moved into public parties.⁴⁹ The president may feel he is in sufficient control not to need all the extra levers created by the underground personnel policy system. There are also some trends in the economic and institutional developments that may indicate that Azerbaijan is heading this way. The most of important indication is a certain increase in the income on customs that has been able to collect for the formal government recently.⁵⁰ Privatisation of key enterprises might also be realised in the near future and may work in the same way, but again many decisions are delayed.⁵¹

Here it is worth noting the potential divergence in interests between tax corruption and privatisation. We may consider privatisation and personnel policy based upon private taxation as two alternative paths for enrichment of the elite. If a fully rational (and selfish) transition policy were possible, an optimal path would be for the internal elite *first* to rely on personnel policy and extract most of the potential profits in the enterprises through private taxation (i.e. corruption). Thereby the capital values of physical capital are kept down and remain affordable for the (relatively) poor internal elite until it has acquired sufficient financial means to be able to buy a large share of the physical capital through privatisation in which it often will be in control. Even when sold on public auction much capital will stay cheap because of the informal taxation and harassment. When sufficient private capital has reached the hands of the elite, it is time to end the private taxation. If successful, the private capital owners are

⁴⁹ In one sense this is an improvement. It is also interesting in the sense that it shows the clans' orientation towards the public sector. These are not mafia organisations mainly organising independent private business like drug distribution and private supply of means of violence, but organisations for acquiring shares of the public spoil systems, mixed with different brands of political ideology. Some parties are, of course, not of this kind, but represent some genuine public interests.

⁵⁰ According to TACIS (Quarterly , July- September, 1998, 64) the income from the customs tax increased from under 40 billion manats in 1996 to about 430 billion manats in 1997. I am uncertain of how reliable these numbers are, however. In TACIS (Monthly, December ,1998, Table 5.1) the number for 1996 was adjusted to more than 270 billion (!) manats. If the latter number is correct, the positive development in customs collection has been more sustained and even more promising. As pointed out before, it is still an open question whether tax collection has shifted into a better track.

⁵¹ It is a weakness in our analysis of corruption in Azerbaijan that we haven't dealt with the issue of privatisation systematically. We have found it a rather complex issue to disentangle. In an important paper Kaufmann & Siegelbaum (1996) argue strongly for a swift privatisation as an important instrument in keeping corruption under control and to create lasting pressure groups that may fight it.

now in a position to reap the windfall increase in value capital that follows a decline in private taxation.

Even under the best of circumstances it will be difficult to reach such co-ordination of many divergent individual interests, however. The individuals who will gain the windfall increase in the value of physical capital are not the same who will lose the capital value of public positions if their prospects for private taxation decrease. Even more difficult is it to control such policy sequence when the elite remains comparatively poor and several groups of foreign investors are out there having the capacity to buy the capital stock when it stays cheap. The Russians in particular have rather detailed knowledge of the real value of Azeri assets and possess the needed information. It is less risky, then, to continue selling the capital value of future corrupt income streams of public positions, where no international investors have access. External pressure may, however, force the elite's hands and make it privatise before itself has accumulated sufficient capital to keep control of the real capital stock of the country.

There are thus both empirical and theoretical indications that point towards the survival of a clan-oriented nomenclatura system well into the future: The son of the president might become his successor (*Economist*, 6th March, 1999), but whether this succession will take place or not, is still too early to tell. It is in the nature of a spoil system that it is dangerous to lose power, since the economic stakes are so high. It is difficult to imagine that the powerful members could get anything close to their present income, if their allowance of private taxation is withdrawn. The only possibility would be if they were allowed to acquire permanently valuable chunks of the state's property outside a public auction system.

Furthermore, even when not fully merit-oriented, if the spoil system becomes public, the number of positions controlled by the party has to be reduced and the income between the different positions evened out. This again may well reduce the leaders' political survival probability in a socially unstable situation, which gives another reason why it is difficult to believe that the public road will in fact be the one chosen in the near future.

8. The oil industry⁵² and corruption in Azerbaijan. A risk assessment

We have, as mentioned in the introduction, found little evidence of exceptionally high incidence of corruption in the oil industry in Azerbaijan compared to what happens in the oil industry in other, less corrupt countries. On the other hand, the evidence of extensive corruption in Azerbaijan in general is overwhelming. The underlining theme of this chapter is to explain that paradox. It is a paradox because both empirical information and theoretical considerations show that there are clear spill-over effects of corrupt behaviour from one sector of society to another.

This said, we could not expect to find firm evidence either way on the basis of interviews made in Baku with people working in the oil industry. That would be rather naïve. The fact that several larger construction projects have been implemented in the area without being plagued by delays, we have considered more convincing evidence of the oil industry being somewhat protected against local corruption. While it is possible to find some theoretical situations where bribery may speed up activities (Lui, 1985), empirical evidence and most theoretical analyses point to the opposite conclusion: extensive corruption goes together with extensive delays, a slowing down of all bureaucratic processes (Wei, 1999). The absence of delays increases the probability of a relatively low rate of corruption in the major projects.

A low rate does not mean a zero rate. Dealing with large projects, big money and complex technical solutions where improper influence is difficult to detect, the oil industry is known to be exposed to corruption risks. Some aspects are described in Andvig (1995). Most of the information we possess about oil activities in Azerbaijan and eventual improper influence on them are so uncertain and the risks that we inadvertently might harm private individuals by describing bits of behaviour and present

⁵² With oil industry we will in the following mean the broad set of activities that range from geological research to the local petrol station. Hence, the oil industry will, for example, include construction firms when they are doing some oil-related activities. With oil companies we will mean mainly international companies that do major extraction of hydrocarbons, either in Azerbaijan or other countries, but SOCAR will also be considered an oil company.

them as facts, that we found it more proper to present this chapter as a kind of risk analysis. That is, rather than describing and analysing actual behaviour, we will look at and describe potential problem areas; institutions and arrangements that make corruption more likely. It is important then when reading the following, that when certain areas look more exposed, it does not imply any accusation of any persons.

When looking at the oil industry's behaviour in Azerbaijan, it may be useful to remind oneself that this industry has a fairly long *history* of operating in such areas. We are here not thinking of the specific history of involvement in the Baku area 130 years back, but the general history of the industry. An essential part of that experience has been to develop mixes of involvement and isolation from the social, political and economic environments in which it is operating. The particular mix chosen or developing will depend on the particular society in question, however.

While both the issues of corruption and human rights have become more important concerns for multinational companies in their areas of operation, these issues are actually pulling the companies in opposite directions. Human rights are drawing them into the area, the issue of corruption is drawing them away. It makes for isolation, ways of organising their interaction with local authorities that protect them and their employees against involvement in corrupt deals. In the following we will describe some of the instruments of protection which by and large leave the impression that the companies have succeeded in protecting themselves from any serious involvement in the web of corrupt transactions that characterises public management in Azerbaijan.

8.1. Briefly about the oil industry background in Azerbaijan

When the international oil industry got access to Azerbaijan in the early 1990s, oil and gas extraction in the area had for long been stagnating. While Azerbaijan extracted more than 70% of total Soviet demand in 1940, the republic contributed less than 3% in 1980 (Nassibli, 1998). Within the Soviet area Azerbaijan had become more important in oil construction industry and in the supply of educated oil workers and engineers than in oil extraction. Azeri oil specialists were working all over the former USSR.

Internationally, however, Azerbaijan's official economy had been basically a closed area within the Soviet Union, although many Azeri families had kin relations stretching far into Turkey and Iran. Some of these relations had probably been activated when part of the oil extracted had been embezzled and sent into the international markets without the (official) knowledge of the central Soviet authorities. Caviar probably followed some related networks. The fairly large Jewish community in Baku also possessed an international network before the opening of the country.

While the Soviet leadership could afford to leave the Caspian oil resources undeveloped for a while, that option was closed for an Azeri elite anxious to get rich and to stay politically independent of Russia. The existing possibilities of drug trade and taxing a declining set of old industries trying to survive on mutual barter, were not promising. Fish resources had dwindled. To bring in modern Western oil industry and to develop oil and gas extraction on the basis of new offshore oil technology offered great new prospects. It was likely to create new, decently paid jobs for workers. A development of the oil industry would also generate income that might directly or indirectly be taxed back to the elite through the system described above.

From the late 1980s it was already clear for the leading international oil companies that a significant development of oil extraction in the country, based on Western offshore technology, was possible. In the autumn 1994 the first large agreement, "the contract of the century" between Azerbaijan and some Western oil companies about the development of the Azeri, Chirag and the (deep water) Gunnashli fields was made. Together the fields are expected to hold 500 million ton crude oil and 155 billion cubic metres gas. The expected investment costs were around 8 billion US dollars, but the costs will be stretched out in time (TACIS, Quarterly 1998).

Technically the operation has run smoothly until recently and the first production could start in the autumn of 1997. Today many new, similar contracts, most often called production-sharing agreements (PSA's) about oil development fields have been concluded. Most of these fields are, however, much smaller with a higher degree of uncertainty about the size of the oil and gas reserves. In some, exploration has started.

Foreign investment in the oil sector was around 1 billion dollars in 1998,⁵³ and is expected to decline somewhat in the near future, but to increase again from 2001. This constitutes around 15 % of the GDP in Azerbaijan, a significant force in the Azeri economy, but that economy is rather small. International media have tended to give an exaggerated impression of the scale of investment from an international point of view. The size of the investment rate in Azerbaijan is only about 15% of what has been the normal rate of investment in the Norwegian sector of the North Sea oil development. When considering Statoil's engagement in Azerbaijan we also get somewhat exaggerated impression from Norwegian media. Statoil has been more actively involved in the past, however, and is likely to become so in the future.

Just as what happened in many other economic centres in the former Soviet Union after the political opening, Baku attracted its share of risk-loving Westeners, some genuine entrepreneurs, others crooks and con men. After a while many of the information brokers operating in the North Sea have also been observed in Baku.⁵⁴

The early history of this "contract of the century" appears to have been an introduction to Azerbaijan's personalised politics. The process was stalled several times as new groups possessed the central power in Azerbaijan.⁵⁵ It was clear to anyone that this contract and the income resulting from it would be central to any power holder and his ability to stay in power. Both changes in foreign policy and the allocation of personal and political advantages were involved. In the specific terms of the contract. Finally Heydar Aliev, the present president, gained power in late 1993, and a contract was finalised.

8.2. Corruption and the PSAs in Azerbaijan: the lower level corruption risks

Production sharing agreements (PSAs) are common in most areas of offshore oil and gas extraction in the world. What is somewhat exceptional for Azerbaijan is that each

⁵³ The numbers here are mainly used to indicate the major dimensions of an issue, so we will round off roughly. The exchange rate of dollars and manats applied in this chapter is 4000 manats a dollar, whatever the actual rate.

⁵⁴ For an attempt to describe and analyse their behaviour, see Andvig (1995).

PSA has a status of a special law to be voted for in parliament, since the country did not have general laws that could be adapted to the coming oil activities foreseen.

A production sharing agreement is a contract between a number of international oil companies and the Azeri government about the exploration and eventual extraction and production of oil and gas of a certain area. The contract contains provisions about minimum levels of seismic exploration, tax rates and rules of production sharing (Anderson , 1998), and so on. Furthermore the contract specifies which companies are in, their shares, and which organisation should be the *operator*, having the main responsibility for the construction work in the area to be performed. It determines also in other ways a decision structure for the field. In most contracts, including this one, Azerbaijan's state oil company, SOCAR, is granted a key role and represents its government in many roles. Despite being a law, the details in a PSA are secret with many elements even unknown to the members of the parliament.⁵⁶ Each PSA differs with respect to detail. The one we will discuss here is considered to be more advantageous for the international oil companies than later ones, but the details will not matter for our presentation.

The major aim of a production sharing agreement is to spread the heavy risks between the government and the private companies involved. For that reason normally several companies will join an agreement. Not only is the uncertainty about the size and the quality of the finds considerable, also the price risks and technical risks are significant. This is the reason why a large portion of taxes paid by the companies is fixed as shares in the production.

From our point of view, however, the difference in risk-sharing properties of the tax arrangements is less important. The major question is how the PSAs may protect em-

⁵⁵ We should add that difficulties arose at the other end, too, where the international companies and their governments made a lot of manoeuvring that also delayed the negotiations at times.

⁵⁶ We had not access to any PSA either, so our understanding of these documents are vague at points. The tax aspects are treated in a general way in Anderson (1998) but we had no access any precise description of their decision structure. A series of protocols on various aspects of the tax rules applied to the different fields are published on the internet at ELDIS. However most of the following is based on interviews and some popular newspaper articles.

ployees in the companies against being involved in corrupt transactions, which we believe to be a major effect of them, and where they may not give that protection – their risky spots.

The most important aspect of the tax deal is that for work included in the PSA contract, services and goods should be exempted from a number of taxes, including VAT and import taxes. By this the major constructions were protected against the regular types of harassment and blackmail, to which they otherwise would have been extremely vulnerable. This clause is an important reason why it has proved possible to engage foreign investment in the oil industry in the longer run.⁵⁷ Almost every informant we met in Baku emphasised these exemptions from taxes and customs as the reason why they considered corruption only to be a minor problem in the oil industry. They felt protected. Enterprises not dealing in oil development envied them.

This protection is not waterproof, however. It will in many cases be a question of interpretation whether some expenses should be counted as being a part of the PSA agreement or not.⁵⁸ While in principle subcontractors were granted the same exemptions⁵⁹, several informants told that sub-contractors were in practice more vulnerable. The scope of interpretation – whether some economic activity was a “result of Hydrocarbon Activities” or not, and therefore should be granted tax exemptions or not – may give rise to higher-level corruption of various forms. Any given subcontractor may have much to gain if his work is classified under the PSA. Companies not in favour may then be pushed out. The motives for bribing the decision-makers to reach a favourable classification are obvious. The arrangement may also be open for power

⁵⁷ Recently more than 100 Turkish firms are said to have left Azerbaijan because of corruption and the continuous changes in the tax system (*RFERL*, 4 May, 1999). A very clear result of Wei (1999) is how harmful extensive corruption is for foreign direct investment. In an earlier work he has shown (Wei, 1997) that 1 US dollar paid to corrupt bureaucrat has about the same negative effect as 2 UD dollars paid in regular taxes. The only FSU countries that have received significant FDI were Azerbaijan, US \$406 per capita and Kazakhstan, US\$ 312 per capita. For comparison, Georgia received US\$ 37 and Armenia, US\$ 64 (IMF, World Economic Outlook 1999, 75). Outside oil, the FDI in Azerbaijan is likely to behave in the same way as in the other FSU countries, being discouraged both by the economic instability and the extensive corruption.

⁵⁸ Having no access to any PSA agreement we can, of course, not be very specific here.

⁵⁹ See the protocol about VAT and the protocol about customs for the “Azeri and Chirag fields and the Deep Water Portion of the Gunashli Field” where the tax and customs exemptions are stated quite clearly when the input use is a result of “Hydrocarbon Activities”.

struggle with the tax authorities (outside SOCAR) wanting to make the PSA understanding narrow and SOCAR wide in scope. SOCAR's strong political standing may be as important as the formal rules in any PSA in the actual protection against tax harassment and possible attempts of its avoidance by paying bribes.

The flip side of the arrangement is that employees and enterprises that are protected by a PSA might misuse the tax exemptions and smuggle goods for others and earn a commission, perhaps build up their own import agencies under the cloak of a subcontracting construction firm. The tax authorities may then not only be pure predators, but also sometimes have legitimate reasons for concern. We should add that we found no proven cases of major misuse, but the risks inherent in these situations are rather obvious.

This second-order effect is not surprising. It is just one example of a situation where economic agents have to pay different prices for the same good or services depending on the outcome of public classification. As argued, for example, in Andvig (1991), different prices for the same goods or services are a strong inducement to corruption.⁶⁰

Another area where oil development is likely to stimulate local lower-level corruption, but in this case not necessarily getting directly involved, is in the companies' employment policy. This is again a situation with two prices for the same good or services: The wage levels are much higher in the international firms (and they are almost always actually paid.)⁶¹ One obvious method here is patterned on the standard method of clan control: To sell positions to, for example, ordinary SOCAR employees to jobs

⁶⁰ A well-known example in Norway, where corruption has occurred, is classification of properties into farming or vacation house areas. Here the economic stakes involved in reclassification are large and the local planning authorities have at times been offered bribes.

⁶¹ SOCAR has at times declared itself unable to pay large number of their employees for longer periods. It would be tempting for an economist to presume that this problem could be solved simply by the foreign firms giving Azeri workers and engineers lower pay. This create another difficult problem, however. As it is, an Azeri gets paid only a fraction of what an expatriate does for similar jobs. This, naturally, gives rise to serious dissatisfaction and feelings of injustice. One way to approach this problem could be to make the international companies "tax" the Azeri, and spend the money on some visible items, such as international scholarships and support of Azeri colleges and universities.

(or maybe only queue positions) in the international companies. Although the extra income is not earned through corruption, it is still extra income and valuable to control.

The persons who are in the position to influence the line-up of SOCAR employees are here able to cash in on their position, or use it to gain political support. In this way the ruling “clan” also moves into a position to develop invisible methods for influencing the operations of the international companies. This kind of pressure is probably stronger in Azerbaijan than in most other countries, but is generally well-known. In SHELL’s web site on corruption employees are warned about it. If an international company is not in complete control of the employment of locals, it may become much more involved in local corrupt transactions of various kinds. It is easy to lose that kind of control, since it often demands fine-grained local knowledge to become effective. While some international companies operating in Azerbaijan make large efforts to avoid hiring people from a single clan, others are either naïve or complacent and accept a situation where all their locals may belong to the ruling clan.

Since they have weaker political support, sub-contractors or international humanitarian aid organisations are more vulnerable to pressures of this kind. Some even admit that they let the SOCAR side determine which person to hire because of their better knowledge of the candidates’ technical competence. We discovered cases where companies even kept local employees who after their employment admitted that they had only fake competence, but close ties to local power holders.

In other cases the international company is free to hire local employees at will. In this case it is, of course, also possible for expatriates inside the international company to take charge of the rationing of jobs and auction out the jobs, i.e. receive bribes for employing people. This is an obvious reason for not paying local employees wage rates far above the local market rate.

Managers with considerable experience from the former USSR will be aware of the tendency of local organisations to infiltrate and try to mitigate it by hiring people who

are not members of the same political or geographical network. In order to be able to do so, they must hire people with detailed knowledge of the country to assist in personnel management.⁶²

8.3. SOCAR and the difficulty of understanding middle-level corruption

A PSA does not only contain a tax agreement. It also specifies a decision structure for the development of the field(s). In the case we are looking at, “the contract of the century”, the operator of the field was the whole consortium of the engaged international investors, Azerbaijan International Operating Company, AIOC, including SOCAR. The number of investors is fairly high, and has varied between 10 and 12. They have a varying national background. SOCAR, the state oil company of Azerbaijan, holds only a 10% share, but has decisive power in many cases since there is a Steering Committee overseeing AIOC where 50% of the votes are with the foreign oil companies and 50% are with SOCAR and the government of Azerbaijan (*Azerbaijan International*, Summer 1995). It is chaired by the president of SOCAR. All decisions are supposed to be unanimous. The highest decision level inside AIOC is the “Contractor Management Committee”, which makes proposals for the Steering Committee. It is a commonly held view among knowledgeable people that above the formal decision structure in SOCAR exists a more informal one with direct ties to the president of the country. The really important decisions concerning oil development are brought up to the president himself.

Most of the oil and gas development is in practice taking place through various forms of co-operation between SOCAR and the international company or companies which have the operator responsibility. It is here that most of the middle-level corruption risks should arise. These risks are difficult to understand, however, because SOCAR is an exceedingly complex organisation, and we are aware of no research that has tried to grasp its workings. It is, as mentioned, still a very large organisation with around 60 000 employees. It may be considered as a mixture of a large conglomerate of different productive enterprises, combined with sections of several ministries such

⁶² We have, of course, not found proofs of the Aliev clan rationing jobs this way, but we know of cases where management in international firms have done considerable efforts to avoid such situations, evidently believing that such rationing is taken place.

as the Ministry of Energy and the Ministry of Finance (having the responsibility of collecting taxes from other economic units, and some of the responsibilities of a Central Bureau of Statistics for collecting energy statistics, and so on).

Since the prices of energy are likely to move from low levels and closer to world market prices in Azerbaijan as well as the other FSU countries, SOCAR should be in a strong position to profit from the transition, but some parts of the company are geared to the former USSR “market” and operate with large losses when confined to cash transactions. Many of the customers are also stuck with their old energy-demanding technologies and are unable to pay the new market rates. At the same time, it is politically impossible to cut them off as customers. The electricity market price is tied to the oil price. Ordinary consumers would be ruined if faced by the market price and receive electricity for about 1/3 of the prices enterprises pay (*Black Sea Energy Review –Azerbaijan*). Thus we see that in SOCAR, maybe even more around it, different prices for the same goods have developed which may stimulate corruption. For example, an enterprise has much to gain if it may persuade the “Azerenergy” to pretend it is a private consumer.

Another result is that some parts of SOCAR tend to build up credits, while other parts are building up debts, and have even been unable to pay their workers. Overall SOCAR has cumulated more credit (6.29 trillion manats in April 1999) than debts, (1.8 trillion manats),⁶³ and a large part of SOCAR is involved in the barter transactions described for the FSU countries in general. While such transactions may, as we have argued, reduce some corrupt acts they may also give rise to other, partly because of the lack of transparency they often give rise to.⁶⁴

Its debt/credit position is not only influenced by its own use of input and supply of output, but also by its role of tax collector and tax payer since SOCAR must some-

⁶³ According to *Caspian Business Report*, no. 9, 1999.

⁶⁴ In this connection it may have interest to note that president Heydar Aliev himself some time ago accused a leader in SOCAR for having performed a \$ 10 million illegal barter deal, where an undisclosed amount of products from SOCAR’s refineries have disappeared. (Lukianov, *Sptimes*, Ru-archives.) Recently local newspapers, quoted by BBC, Nov. 19, 1999, claim that more than 1 million tonnes of fuel, worth more than 200 million US. dollars have disappeared, maybe entering illegally petrol stations of Baku, as Vaksberg claims it did in old Soviet times. If true this a story of a big embezzlement operation, but an operation likely to be protected with corruption.

times accept other enterprises delaying their tax payment, at the same time as itself may deliberately accelerate or postpone payment. We cannot see any reason why tax collection when performed by SOCAR offices should be less corruption risky than other forms of tax collection.

While some sections of SOCAR are loss-making and will go bankrupt if exposed freely to the new set of relative (internationally influenced) market prices, others are extremely competitive. Given the public exposure of the oil industry in Azerbaijan, it is probably difficult for these parts to go openly underground and stay that way by bribing public authorities. In principle, however, something quite similar may take place inside SOCAR where sub-units are granted greater autonomy on the condition that they transfer some of their profits into SOCAR's quasi-public coffers, and, possibly, some money into the middle-level management's private purses.

One way to be granted autonomy is when SOCAR employees are permitted to establish joint ventures with smaller international companies. Given reasonable demands for Azerbaijan to become more independent of international companies, such joint ventures have obvious advantages. The risk of a growth in corrupt transactions among them, SOCAR and the operator is considerable, however. The decision structure of AIOC as an operator appears also vulnerable. Such a development would harm the oil companies in more direct and harmful ways than the other corruption risk areas. Extensive corruption here would increase costs, cause delays and also inferior technological solutions. Expedite technological development of the offshore field is in many ways the core of international oil companies' activity in Azerbaijan. Is it only a risk or a real problem? It is a question we are unable to answer with direct, proper documentation. It would, of course, be somewhat naïve to accept the words of a former president of AIOC, that "we follow the procedure of open competitive bidding" at face value. The same applies to all the denials we have received during our interviews

The reason why we in the end believe his words to be roughly right is the simple fact that the offshore development of the Azeri, Shirag, Gunashli fields technically have gone exceptionally smoothly and according to the time plan. While delays may have many other causes, extensive corruption is normally causing extensive delay, induc-

ing manoeuvring to get into the right position, increasing willingness to pay through hold-ups, and so on.⁶⁵

8.4. Corruption risks at the higher levels

At one hand it is likely that the Azeri top management has felt the urgency to successfully complete the larger constructions so as to ensure the political survival of the regime, by forcing middle-level management to show restraint and making handouts, rather than technical and economical considerations to be the major criteria for choosing the contractors.⁶⁶ Top management of the leading international companies will also have much to lose. Lower down the opportunities are greater, both between units of SOCAR and interfacing international firms whether they have established joint companies or temporary alliances, but also inside SOCAR.

The same applies to the very top when it is to decide which among all very competent companies that is allowed to buy a share in a field. Eventual hand-outs to the top leadership of the country might increase the likelihood of gaining a contract with small risks of harming the technical development of the field. As part of the risk- and income sharing package in a PSA-deal the companies have to pay up front a set of tax advances, *signature bonus* payments to the government. These are large amounts and there is much publicity around them, which make it less likely that they will be collected in a private way. Nevertheless, the high publicity also creates suspicion, and in several cases these money are suspected to be stolen when PSA agreements have been made in FSU countries.⁶⁷ If this had been with the consent of the oil companies,

⁶⁵ Evidence that corruption on average causes delays is, for example, presented in Kaufmann & Wei (1998), and Wei (1999).

⁶⁶ This does not imply that there has been no corruption at a high level. Some of the companies that have received larger contracts are known for not being as strict as others. Security experts tell that most of the information brokers who operate illegally in the North Sea, has been to Baku too. Given the high corruption propensity of the country, we would expect at the outset that the use of bribes and illegal selling and buying of bid information will not be less in Baku than in London. (See Andvig, 1995.) Here as elsewhere it is likely that the middle level management will be most exposed. In the questionnaire from the Control Risk Group we referred to in the first chapter., the international firms believed that the local expatriate managers are the ones most likely to be involved with corruption (58.8%), then middle-level management, (30.9%) while only 4.1% believed the senior management and 6.2% of the junior management to be most exposed.

⁶⁷ It is widely believed that a part of the first installment of the first signature bonus has disappeared into the top leadership's private pockets. We argue in the following that this procedure is not likely to, eventually, be followed in the future.

it would be bribing at a high level. If it may have happened, it is not likely to be repeated. The amounts and the process are too public. If bribes are paid directly to top level politicians they are more likely to be paid before or during the negotiations about which company should receive which share of any given field. Not after the contract has been made. These negotiations are naturally not public, bribing could be difficult to prove, and the incentives should be strong. We have no proof that they have actually occurred, and the cost by loss of reputation for a major oil company to have indulged in it, if discovered, would be considerable.⁶⁸ Any serious risk assessment could not neglect this possibility, however.

Another area where local top management of the companies might be tempted is to buy secret local geological information before getting involved with the bidding for shares in the various offshore fields. If so, the temptation was stronger in the early days of exploration before the companies got more local information on their own. Again, we have no evidence of such behaviour.

When it comes to the motives at the other side, the top leadership of Azerbaijan, it is a question of the nature of the regime. Should it be considered as a form of kleptocracy or a country ruled by a benevolent autocrat (Coolidge and Rose-Ackerman, 1997), eventually an autocrat trying to move the country in a democratic direction? Expert opinions differ, but kleptocracy appears more likely to us.

⁶⁸ Such an operation would not in any case be made by the company itself. It would hire a consultant or small firm to do this job (Marsh, 1989, 46-50).

9. Conclusion

While the oil sector in Azerbaijan certainly is not immune to corruption, the main conclusion must be that it is on the whole protected by a legal framework of production-sharing agreements, laws that also are implemented. The reason is mainly, we believe, that it is considered crucial for the survival of the independence of the state of Azerbaijan. That independence is sought not only for nationalist and patriotic reasons, but also for the elite to get rich through its political control.

The major dilemma for the oil industry is then not whether it should pay out large amount of bribes and by its own actions contribute to a moral decay in the public sector, or not. It is rather whether it should or should not support a centralised elite that is taxing its population corruptly. Is it possible to stay without supplying support? If not, is it correct to stay?

Nevertheless, even from the point of view of enlightened self-interest there are *some* reasons to worry about corruption and violation of human rights in the areas of operation, and more specifically in their relation to the own company. The violation of rights and association with corruption or fraud may create *scandals*. Today information about such “bads” travels faster and is also likely to have greater impact than before. Scandals imply that the management has to spend much time and attention on basically unproductive tasks. Furthermore, they may cause a reduction in the political support in the home country, a support that oil companies often may need more than most. A scandal may cause direct economic loss. In an empirical study of the effects of major fraud scandals, it has been estimated a capital loss of 1.58% over a period of 200 days for some American firms accused and convicted for fraud (Karpoff & Lott, 1995, 211).

In addition, the usual forms of corruption directed specifically against the companies’ purchasing of inputs may increase costs, and in the worst case influence quality in a negative direction. Possible undermining of the working ethics in the company is maybe even more serious. The emphasis of this report is not on corruption directed

against the companies themselves, however, although we try to deal with it briefly. Their own narrow self-interest is not the only reason why companies should deal with the issues, and is not likely to be their only concern. When the Control Risks Group asked a selection of managers in a group of multinational companies whether they would choose to stay out or enter into highly corrupt areas if they had promising projects to implement, 20% of American and 34% of European companies said they would rather stay out. Transparency International, however, gives the advice that an ethical responsible firm should stay out, and by doing so may teach the social environment that it is unnecessary to bribe in order to reach its aims.

Just now it may be an historical possibility to change the system in Azerbaijan, paradoxically through the very centralised character of the present political leadership. That political conjuncture is not likely to stay that way for long. If the regime considers it essential for political survival to reduce the level of private taxation, it might be able to do so. The increase in international moralising about political and economic structures displayed by leading Western powers may make it worthwhile. The proposals from the World Bank/ IMF are touching the heart of the matter.

Due to the cumulative character of corruption (Andvig & Moene, 1990), an intensive anti-corruption campaign from the top is likely to be assisted by decentralised, rational behaviour. Seen from the point of view of the leadership, it is a risky gamble, however. The increased international standing by following it might be bought at the cost of a crumbling of the internal machine of power. So far, IMF economists will not have empirical models for guiding such a process of power decline. The outcome might be violent and unpredictable.

It is in line with the state-building sought for Azerbaijan that it wants to orient itself towards a Western form of capitalist market economy combined with political democracy. It seeks its political patrons in that direction. The elite has dropped its pretence of being part of the Socialist Worker's State, and is now trying to put on a mask of political democracy. For the present day elite, it is only a mask, we believe. The best

one may hope for, is that when the mask has stayed on for a while the face behind it will to some degree be shaped by it, allowing more democratic forces to gain strength.

So far, we doubt that the revolutionary World Bank/ IMF proposal will be implemented in the near future. We fear it more likely that history will repeat itself and that the present leader will use this proposal to consolidate his regime and as a weapon to fight political enemies. According to Vaksberg (1991) that has happened twice before during the Soviet period. Certainly, the present press has greater capacity to expose misuse of power, but in the Soviet times the risks were greater that well-informed patrons had the powers to interfere on behalf of (some of) the victims.

The major short-run problem for the oil companies when it comes to the issue of corruption is not that they have to engage in corrupt transactions themselves. We have seen they are not. It is rather that they to some degree are forced to support the ruling authority and will thereby be identified with it. They then risk being blamed for a steady cumulation of corruption and the growth of economic disparities. If the dissatisfaction develops in an Islamic direction, as suggested in Heradstveit (1999), a random bribe from a major company might then trigger a similar political process as the one that downed the shah in Iran.

In the longer run we may disregard the specific features of the present political leadership in Azerbaijan. They will disappear in any case. It becomes rather a question of whether the development of a technically efficient, modern energy-producing sector is likely to turn the Azeri society into a desirable direction in the longer run. That is, of course, a question too difficult to answer in any decisive manner.

In theory we may note that the sector is easy to tax and the taxes may reduce the corruption caused by the lack of tax income. On the other hand, compared to other sectors of the economy, the rents earned are large. In other sectors the fight for becoming rich has caused a considerable waste in unproductive, rent-seeking activities, includ-

ing corruption. Is there any reason to believe that oil rents will lead to some other result?

Leite and Weidmann (1999) have made a regression analysis where they study the impact of natural resource abundance on the countries' corruption levels and rates of growth. They found that capital intensive natural resources are a major determinant of corruption. They may have particularly negative effects when developed when the country is undeveloped and have a weak governmental apparatus. Due to the increase in corruption level, the positive shift in output due to the discovery of the natural resource is dominated by a negative shift in the growth rate due to the increase in corruption that the increase in the natural resource has caused. While results like this should be met by some measure of healthy scepticism, they certainly give no strong reasons to believe that the oil income will cause Azerbaijan to follow a much better track than its neighbours.

In the shorter run the best way to avoid doing harm, is as much as possible to refrain from paying political support to the present regime, stick as much as possible to the technical task one is set to solve, try to understand the society around and try to develop a modest lifestyle among expatriates. Here it is better to stop. The scholarly basis in economics for recommendations of this nature is, alas, weak.

References

- Anderson, Gerard, (1998) "The oil tax regime of Azerbaijan". Unpublished.
- Andvig, Jens Chr. (1985), "Korrupsjon i Sovjetunionen – økonomisk teori og erfaringer", *NUPI notat*, no. 334, November.
- Andvig, Jens Chr. (1992), "Transitions to market economies, output drop and bureaucratic supply mechanisms", *NUPI Working Paper*, no. 469, Oslo.
- Andvig, Jens Chr. (1995), "Corruption in the North Sea oil industry: Issues and assessments", *Crime, Law and Social Change*, 289–313.
- Andvig, Jens Christopher (1996), "International corruption – is it on the increase?", *NUPI Working Paper*, no. 567.
- Andvig, Jens Chr. & Moene, Karl Ove (1990), "How corruption may corrupt", *Journal of Economic Behavior and Organization*, 63–76.
- Askerov, Ismail Horton, Scott & Moody, Alastair (1998), "Azerbaijan's privatization program", *CIS Law Notes*, no. 29, Patterson, Belknap, , Webb & Tyler, March.
- Azerbaijan economic trends*, Quarterly Issue, (1998), July–September, TACIS.
- Berliner, Joseph S. (1976), *The Innovation Decision in Soviet Industry*, the MIT Press, Cambridge, Massachusetts.
- Bezanis, Lowell (1996), "An enlarged golden crescent", *Transition*, vol.2, no.19.
- Brunetti, Aymo, Kisunko, Gregory & Weder, Beatrice (1997), "How business see government. Responses from private sector surveys in 69 countries", Unpublished.
- Brunetti, Aymo, Kisunko, Gregory & Weder, Beatrice (1997), "Institutional obstacles to doing business: Region-by-region results from the worldwide survey of the private sector", *World Bank Policy Research Paper*, no. 1759
- Brunetti, Aymo, Kisunko, Gregory & Weder, Beatrice (1997), "Credibility of rules and economic growth: Evidence from a worldwide survey of the private sector", *World Bank Policy Research Paper*, no. 1760.
- Brunetti, Aymo, Kisunko, Gregory & Weder, Beatrice (1997), "Institutions in transition: Reliability of rules and economic performance in former socialist countries", *World Bank Policy Research Paper*, no. 1.

- Clark, William A. (1993), *Crime and punishment in Soviet officialdom*, M.E Sharpe, Inc., Armonk, New York.
- Commander, Simon & Mumssen, Christian, (1998), "Understanding barter in Russia", *EBDR Working Paper*, no. 37, December.
- Coolidge, Jaqueline & Rose-Ackerman, Susan (1997), "High-level rent-seeking and corruption in African regimes: Theory and cases", *The World Bank*.
- Cullen, Robert (1999), "The rise and the fall of the Caspian Sea", *National Geographic Magazine*, May.
- de Melo, Martha et. al. (1997), "Circumstance and choice: The role of initial conditions and policies in transitional economies", The World Bank, International Finance Corporation, October.
- De Soto, Hernando (1989), *The Other Path: The Invisible Revolution in the Third World*, Harper and Row.
- Economist Intelligence Unit (1999), "Business Eastern Europe", March 22.
- Ericson, R.E. & Barry W. Ickes (1999), "A model of Russia's 'virtual economy'", Department of Economics, Pennsylvania State University, June.
- Falkingham, Jane (1999), "Welfare in transition: Trends in poverty and well-being in Central Asia", Centre for Analysis of Social Exclusion, London School of Economics, February.
- Fiorentini Gianluca & Sam Peltzman (eds) (1995), *The economics of organised crime*, Cambridge University Press, Cambridge UK:
- Gaddy, Clifford & Barry W. Ickes (1998), "To restructure or not to restructure: Informal activities and enterprise behavior in transition", Department of Economics, Pennsylvania State University, May.
- Gambetta, Diego (1993) *The Sicilian Mafia The Business of Private Protection*, Harvard University Press, Cambridge, Massachusetts.
- Ghosh, Atish R. (1997), "Inflation in transition economies: How much? And why?", *IMF Working Paper*, no. 80, European II Department, July.
- Gogol, Nicolai (1842) , *Dead Souls*.
- Gray, Cheryl W. & Kaufmann, Daniel(1998), "Corruption and development", *Finance & Development*, March.

- Grossman, Gregory (1982), "The second economy of the USSR", chapter 15 in Vito Tanzi (ed.), *The Underground Economy in the United States and Abroad*, Lexington Books, Lexington, Massachusetts.
- Havrylyshyn, Oleh & Al-Atrash (1998), "Opening up and geographic diversification of trade in transition economies", *IMF Working Paper*, no. 22, European II and Policy Development and Review Departments, February.
- Havrylyshyn, Oleh, Izvorski, Ivailo & Rooden, Ron van (1998), "Recovery and growth in transition economies 1990–97: A stylized regression analysis", *IMF Working Paper* no 141, European II Department, September.
- Havrylyshyn, Oleh & Mcgettigan, Donal (1999), "Privatization in transition countries: A sampling of the literature", *IMF Working Paper*, no. 6, January.
- Hendley, Kathryn, Murrell, Peter & Ryterman, Randi (1999), "Law, relationship and private enforcement: Transactional strategies of Russian enterprises", (Unpublished), university of Maryland, January 24.
- Heradstveit, Daniel (1999) *Nation-building in Azerbaijan*, NUPI-Report No
- Hessel, Marek & Murphy, Ken (1999) "Stealing the state and everything else. A survey of corruption in the postcommunist world", *Transparency International Working Paper*.
- Holmes, Leslie (1993), *The End of Communist Power*, Cambridge, Polity Press.
- IMF (1997) "Payment arrears in the gas and electric power sectors of the Russian Federation and Ukraine", European II Department, December.
- IMF(1998): "Azerbaijan republic: Recent economic developments", *IMF Staff Country Report*, no. 83, August.
- IMF (1998), "Evaluation of taxes and revenues from the energy sector in the Baltics, Russia, and the other former Soviet Union countries", Fiscal Affairs Department, March.
- IMF (1999a) "Azerbaijan. Enhanced structural adjustment facility. Policy Framework Paper, 1999, 2001", January 8.
- IMF (1999b), "IMF concludes article IV consultation with Azerbaijan Republic", *Public Information Notices for 1999*, no.72.
- IMF (1999c) *World Economic Outlook 1999*, Washington D.C.

- Johnson, Simon, Kaufmann, Daniel & Shleifer, Andrei (1997), "The unofficial economy in transition", *Brookings Papers on Economic Activity*, No.2.
- Johnson, Simon & Kaufmann, Daniel (1999), "In the underground", Unpublished, January 21.
- Karatnycky, Adrian, Motyl, Alexander & Graybow, Charles (eds) (1998), *Nations in Transit 1998*, Freedom House, Washington.
- Karpoff, Johnathan & Lott, John R. (1995), "The reputational penalty firms bear from committing criminal fraud", in Gianluca Fiorentini & Sam Peltzman (eds) (1995), *The economics of organised crime*, Cambridge University Press, Cambridge UK:
- Kaufmann, Daniel (1998) "Corruption in transition economies", article in Peter Newman (ed) *The New Palgrave Dictionary of Economics and The Law*, Macmillan Reference Limited, pp. 522–530.
- Kaufmann, Daniel, Kraay, Art & Zoido-Lobato, Pablo (1999a) "Governance matter", *The World Bank Policy Paper*, no. 2196.
- Kaufmann, Daniel, Kraay, Art & Zoido-Lobato, Pablo (1999b) "Aggregating governance indicators", *The World Bank Policy Paper*, no. 2195.
- Kaufmann, Daniel, Pradhan, Sanjay & Ryterman, Randi (1998), "New frontiers in diagnosing and combating corruption", *PREM-notes, Public Sector*, no 7, October.
- Kaufmann, Daniel & Siegelbaum, Paul (1996), "Privatization and corruption in transition economies", *Journal of International Affairs*, 420–458.
- Kaufmann, Daniel & Wei, Shang-Jin (1998), "Does 'grease payment' speed up the wheels of commerce?", World Bank (unpublished).
- Kechichian, Joseph A. & Karasik, Theodore W. (1995), "The crisis in Azerbaijan: How clans influence the politics of an emerging republic", *Middle East Policy*, 57 – 71.
- Koen, Vincent & De Masi, Paula (1997), "Prices in the transition: Ten stylized facts", *IMF Working Paper*, no. 158, Research Department, November.
- Ledeneva, Alena & Seabright, Paul (1998), "Barter in Post-Soviet societies: What does it look like and why does it matter?", Cambridge, December 10.
- Leite, Carlos & Weidmann, Jens (1999), "Does mother nature corrupt? Natural resources, corruption and economic growth", *IMF Working Paper no. 85*, July.

- Lui, Francis Tingming (1985), *Essays on the Economics of Corruption*, Ph. D. in Economics, University of Minnesota, July.
- Mars, Gerald & Altman, Yochanan (1983), "The cultural bases of Soviet Georgia's second economy", *Soviet Studies*, 546–560.
- Marsh, P.D.V. (1989), *Successful Bidding and Tendering*, Wildwood House, Aldershot, England.
- Matthews, Rob (1992), "'Clan' warfare", *Living Marxism*, May.
- Milanovic, Branko (1998) "Explaining the growth in inequality during the transition", *Policy Research Working Paper*, no. 1935, the World Bank, February.
- Montias, J. M. & Rose-Ackerman, Susan (1980), Corruption in a Soviet-type economy: theoretical considerations, *Kennan Institute Occasional Paper*, no. 110, Washington D.C.
- Morgan, Dan & Ottoway, David B. (1998), "Azerbaijan riches alter the chessboard", *Washington Post*, October 4.
- Nassibli, Nasib (1998), "The independent Azerbaijan's oil policy", Lecture at UC Berkeley, April 15.
- Ochs, Michael (1996) "Azerbaijan: Oil, domestic stability and geopolitics in the Caucasus", *CSIA*, John F. Kennedy School of Government, Harvard University, March 4.
- Rauch, James & Evans, Peter B. (1999), "Bureaucratic structure and bureaucratic performance in less-developed countries", University of California, San Diego.
- Rose-Ackerman, Susan (1978), *Corruption. A Study in Political Economy*, New York, Academic Press.
- SHELL (1999), "Dealing with bribery and corruption A management primer", Shell International Limited.
- Shleifer, Andrei & Vishny, Robert W. (1993), "Corruption", *Quarterly Journal of Economics*, 599–617.
- Shleifer, Andrei & Vishny, Robert W. (1998), *Thee Grabbing Hand*, Harvard University Press, Cambridge, Massachusetts.
- Shor, Boris (1997), "Nations in transit 1997 Freedom House rankings", www.worldbank.org/html/prddr/trans/mayjun97/art2.htm.

- Shorokhov, Vladislav (1996) "Energy resources of Azerbaijan: Political stability and regional relations", *Caucasian Regional Studies*, Issue 1.
- Simis, Konstantin (1982), *USSR: Secrets of a Corrupt Society*, J. M. Dent & Sons Ltd, London.
- Stirling, Paul (1965) *Turkish Village*
- TACIS (1998), "Economic trends, Quarterly Issue, Azerbaijan July–September 1998", European Commission, Brussels.
- TACIS (1998) "Azerbaijan economic trends, Monthly update, December 1998", European Commission, Brussels.
- Tanzi, Vito (1998), "Corruption around the World", *IMF Staff Papers*, Vol. 45, no.4, December.
- Transparency International*, Web Page as of October 29,1999.
- Treisman, Daniel (1998), "The causes of corruption: A cross-national study", Department of Political Science, University of California, Los Angeles.
- Troy, Clark (1999) "Shadow economy takes over oil sphere in Azerbaijan", *BBC Monitoring Service*, 12 May.
- UNDP (1997) *Azerbaijan Human Development Report 1997*, Baku.
- UNDP (1998), *Azerbaijan Human Development Report 1998*, Baku.
- Vaksberg, Arkady (1991), *The Soviet Mafia*, New York, St Martin's Press.
- Varese, Federico (1994), "Is Sicily the future of Russia? Private protection and the rise of the Russian Mafia", *Arch. Europ. Sociol.*, 224–258.
- Voslensky, Michael (1986), *Nomenklatura*, Oslo, Atheneum.
- Wade, Robert (1982), "The system of administrative and political corruption: Canal irrigation in South India", *Journal of Development Studies*, 287 – 328.
- Walker, Martin (1998), "After Yeltsin: Russia faces free-fall", *Transitions*.
- Wei, Shang-Jin (1997), "How taxing is corruption on international investors?", *The National Bureau of Economic Research Working Paper*, no. 6030, May.
- Wei, Shang-Jin (1999) "Corruption in economic development: Beneficial grease, minor annoyance, or major obstacle?" Harvard University and the World Bank..

Wiles, Peter (1977) *Economic Institutions Compared*, Basil Blackwell, Oxford.

Willerton, John P. (1994) *Patronage and Politics in USSR*, Cambridge, Cambridge UP.

Williams, Phil, ed. (1997), *Russian Organized Crime*, Frank Cass & Co Ltd, London.

Yürükel, Sefa Martin (1997) "Nationalisme og dannelse af national identitet i Azerbajdjan", *Afdeling for Etnografi og Socialantropologi, Aarhus Universitet*.

Yürükel, Sefa (1999), "Klansystemet i Aserbajdsjan", *NUPI-Rapport* nr. 250, september.

Zettelmeyer, Jeromin (1998), "The Uzbek growth puzzle", *IMF Working Paper*, no.133.