Tough Choices
Observations on the Political Economy of Armenia, Azerbaijan, and Georgia

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I. OVERVIEW

ECONOMIC REFORM IN THE SOUTH CAUCASUS

The paper which follows presents an analysis and discussion of the problems confronting and prospects for continued economic reform in the three states of the South Caucasus region of the Commonwealth of Independent States (CIS): Azerbaijan, Armenia and Georgia. Although differentiated by language and religion, in many important ways more unites the three Caucasian states than divides them, at least in terms of the economic and political challenges they face as they attempt to move beyond their Soviet pasts and the difficult experiences which afflicted them in the 1990s.

In all three states, the key ingredient for further progress will be the commitment of the national governments and ruling elites to pressing ahead with reforms. All three states have made significant progress in reforming their economies since the fall of the Soviet Union, but to a great extent they are now confronted with even more difficult and politically painful choices.

Reform is an intrinsically political process requiring the distribution of costs and gains; each state has its own internal strengths and weaknesses which will shape its ability and willingness to adopt various types of changes. For the international financial institutions and donors who seek to facilitate and expedite these reforms, an understanding of the political costs and risks confronting local decision-makers is crucial in determining the ultimate success – or failure – of the reform campaign. As donors attempt to support reform elements in governments, they would be well advised to pay closer attention to the political economy of reform.

For ruling elites, economic reform is a high-risk proposition, reckoned not only in the cold units of currency and balance sheets written in red or black ink, but in terms of the abilities of powerful individuals and interests to maintain their positions and influence, and sometimes their lives. Therefore, neither reforms that would hurt large parts of the population in the short run, like energy price increases, nor reforms that threaten the interests of powerful parties that benefited during the first years of transition are easily implemented even if they are ultimately necessary. Corruption and weak administrative capabilities will act to erode the credibility and the implementation of such reforms as are pursued.

Finally, the Caucasian states are small, and both geographically and institutionally distant from the glittering, developed democratic societies of Europe and North America. Where reformers in Central and Eastern Europe could look to a neighboring Western Europe as partner and standard, Russia, Turkey and Iran are the main trading partners for the Caucasian states; wealthy and powerful relative to the Caucasus, yes - although the 1998 economic shock in Russia, and the Turkish crisis of 2002 – but ambiguous and uncertain as examples of stability and prosperity. So great are the disparities in size and population between the Caucasian states and their neighbors that to a great extent their destinies depend as much or more on the outcome of the political and economic changes
taking place in Russia, Turkey and Iran as on the decisions made and policies implemented in Baku, Tbilisi and Yerevan.

A NOTE ABOUT CORRUPTION

Corruption in general is a richly varied phenomenon, encompassing a broad range of behaviors which may or may not affect the prospects for successful economic development. In the Caucasus, which has a reputation for being corrupt even by Soviet and CIS standards, corruption includes not only administrative corruption – the securing of special treatment by private actors through the payment of bribes and favors to government officials – but state capture – the suborning of state decision-making to systematically favor the interests of particular individuals, groups and entities.\(^1\)

While corruption is never a positive phenomenon, it is far from being an unalloyed evil in the South Caucasus.\(^2\) The “tax” imposed would tend to be regressive overall – the poorest and weakest wind up paying a larger share of their incomes to corrupt officials than do the wealthy and powerful. However, those who extract funds in low level corruption (local police officers, district tax inspectors, and the like) are not particularly wealthy themselves. The sources of corruption cannot only be found in the generally weak state administrative, legal and police capacities, but also in more mundane problems like low salaries in the public sector and the lack of social safety nets to support poor families. As a consequence, some of the low level corruption can also be regarded as a copying mechanism for underpaid public employees.\(^3\)

Similarly, in the absence of an effective court system and given the reality of police forces which do not see their primary or even secondary missions as crime control and law enforcement, graft can and does play an important role in mediating disputes, providing security and enforcing contracts.\(^4\) Graft is not necessarily an evil – from a

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1. AntiCorruption In Transition: A Contribution to the Policy Debate. (World Bank: Washington, DC, 2000), p.8. The World Bank’s BEEPS project indicates that the highest levels of corruption in the CIS were found in Ukraine, the Caucasus and the Kyrgyz Republic, while other CIS countries were within norms for Central and Eastern Europe. The latest BEEPS in 2002, however, did show an almost uniform improvement of the business climate, with the exception of infrastructure.

2. It is perhaps useful to remember that there is in effect almost no history of non-corrupt (as the term is understood today) government in the South Caucasus. Institutionalized administrative corruption was a feature of Soviet, Imperial Russian, and Imperial Persian rule in the region dating back several centuries. This does not mean that corruption cannot and should not be eradicated, but does serve to underline the magnitude of the task which the Caucasian governments and their partners in the donor community are assuming.


On the state of the judiciary and the police, see Transition, p.61-64; Anticorruption in Transition, p.14 (box 1.5).
business point of view - if it permits the purchase of real goods and services by the payee at a reasonable cost. Indeed, the problem with corruption as a business issue in the Caucasus may be less the fact of its existence than its uncoordinated and predatory character, which confuses local and foreign businessmen and entrepreneurs alike when they attempt to locate and pay for a provider of effective protection.

From the point of view of liberating the state from capture by private interests, the most pernicious practice found in the Caucasian states is the widespread practice of selling offices; that is, interested candidates are expected to pay varying sums for appointments to government positions. These can range from several thousand dollars for an appointment as district head in a sleepy agricultural province to tens of thousands of dollars for a lucrative customs post and millions of dollars for a cabinet position giving control of important state assets. Ambitious candidates sometimes assemble networks of investors to raise the necessary funds for appointments; in any event, once appointed the official must make back his or her investment and will also wish to recoup a profit for himself and his backers. The consequences of failure can range from years wasted in an unprofitable post and the loss of political and financial support to considerably more extreme penalties from disgruntled investors. This system effectively raises millions of dollars a year, even in poor and backward economies, and is a vital lubricant for government and social operations. However, it also means that public officials are generally more sensitive to the needs of their patrons and supporters/investors than they are to the public or national interest.5

None of this is meant to argue that corruption is acceptable, only that anti-corruption programs which do not take these social insurance, contract enforcement, and security provision functions into account are doomed to fail. Administrative corruption in particular not only further impoverishes the poor – who are the most vulnerable to demands by corrupt officials – but penalizes disproportionately the privately-owned small and medium-sized enterprises whose growth offers the best chance for employment and security for the poor. Corruption among tax and customs officials who take payoffs in exchange for charging lower fees deprives states of considerable revenues which might otherwise go towards meeting necessary public spending needs. Perhaps most seriously, this form of corruption quickly erodes public trust in the legitimacy and credibility of government, which in turn constrains the ability of the state to sell potentially painful economic reforms to the population at large.

No amount of technical assistance and carefully-designed legislation can substitute for domestically-generated desire for clean government, and the spread of this desire throughout the ruling elites of the states in question. Absent a strong domestic

5 Patronage has been an issue not only for the transition economies but also for almost all other economies – developed and otherwise. There is an inherent tension between the ideal of technocratic, disinterested management on one hand and the practical necessity of rewarding supporters and asserting control over state machinery – which requires the appointment of trusted followers to sensitive positions, however these are defined – on the other, which few if any societies have succeeded in permanently resolving. See AntiCorruption in Transition, p.52-53; 80 (box 6.1)
consensus on this issue, there is a point beyond which anti-corruption reforms will not be able to make any real gains.

**WAR**

All three countries in the Caucasus have been deeply scarred by violent conflict during and after the attainment of independence from the Soviet Union. Armenia (through its support for ethnic Armenian secessionists) and Azerbaijan fought a four year battle for control of the region of Nagorno-Karabakh, a war which left between ten and twenty thousand dead. The war left both countries with a large population of refugees and Internally Displaced Persons (IDPs) totaling perhaps 250,000 in Armenia and close to 1,000,000 in Azerbaijan. Georgia fought two wars with secessionist groups in the territories of Abkhazia and South Ossetia, leaving it with close to 300,000 displaced persons and refugees, many of them concentrated in urban centers. None of these conflicts have been definitively settled and the threat of a resumption of fighting in any or all of the Caucasian war zones continues to hang over the future of the region.

The effects of warfighting on development are as yet not well understood, either in general or in the specific context of the way in which war was waged in the Caucasus between 1989 and 1995. The Caucasian wars had some notable features, such as the displacement of large civilian populations and the organized looting of their possessions for sale on domestic and international markets, which served to at least partially subsidize the conflict but which also crippled the future productivity of the lands in question. Battlefield developments played a critical role in determining who controlled national power in all three states; the demands of the war effort took precedence over reform in all

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6 Compare, for example, UNHCR Global Report 2000.

Other studies have noted that different styles of war-making may have implications for state development; for example, in Africa, a style of warmaking which emphasizes the sponsorship of guerrilla organizations in opposing states, rather than the creation of mass armies, is held to have complicated the process of state formation in some countries. See

Herbst, Jeffrey, "Responding to State Failure in Africa," International Security 21:3 (Winter 1996/97), 120-144
Herbst, Jeffrey, "Correspondence: The Author Replies" [re: Joseph], 22:2 (Fall 1997), 175-184.

8 The wars in the Caucasus in the early and mid-1990s bear some resemblance to the wars which attended the breakup of Yugoslavia, as well as the partition conflict between Pakistan and India in 1947-48. As in the Caucasus, these conflicts featured the dispossession of large, ethnically and/or religiously distinct minority communities and the seizure of their assets, as well as military operations conducted by private as well as state-organized forces, financed only partially by state revenues.
three states. One of the great tragedies of the decade of the 1990s for the Caucasian states lies in the fact that the great explosion of popular enthusiasm and support for the first post-Communist governments in Armenia, Azerbaijan and Georgia was directed into the military sector. Ten years on, weighed down with the costs and casualties of the military conflicts of the early-and mid-nineties and the corroded credibility which resulted from military defeat and widespread corruption, all Caucasian governments are struggling to obtain a sufficiently strong mandate from its stakeholders for continued economic reforms.  

The prospect of renewed conflict and/or further secessionist movements remains a great influence on government behaviour and may have a significant effect on various reform programs. While war has obvious costs – military procurement, the need to provide relief for displaced civilians, pensions and medical care for soldiers and their families, for example – it also may offer some benefits: strengthened administrative capacities, capital inputs (loot), and infrastructure enhancement. In all three Caucasian states government efforts to raise funds and manpower for war led sometimes not to strengthened local infrastructure but to deals with powerful domestic interests – often regional politicians, political entrepreneurs, and managers of industrial concerns, and even unabashed criminal enterprises involved in smuggling – which have been difficult to terminate.

**OBSTACLES TO REFORM**

In general, the obstacles to reform in the south Caucasus may be summarized as:

- endemic corruption
- war - both the after-effects of war and the threat of its resumption
- weak state capacity – meaning limited administrative and regulatory capabilities, and limited abilities to engage in policy planning or to implement policy,
- impediments to inter-regional and international trade (both as a result of war and protectionist/autarkic impulses).

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9 *Transition*, p.xxv, 13.
10 For example, both the Georgian and Azerbaijani governments justify their practice of appointing local and provincial governors in terms of national security --although the sale of these offices is also a potent revenue stream -- by pointing to risks that locally elected officials might seek to win power by appeals to local ethnic or religious chauvinism, which in fact is how some ethnic conflicts began.
One of the few good treatments of the economic aspects of the civil and ethnic wars of the 1990s on their host societies (although it focusses on Africa and Asia) is *Jean, F., & Rufin, J-C., Economie des Guerres Civiles*, (Paris: Fondation pour les Etudes de Defense, 1998).
12 It will be appreciated that the lines drawn between these factors are to some extent artificial; in fact, each influences the others to a considerable extent. The distinctions are made to assist in establishing a degree of analytical clarity.
Although all of these four obstacles were present in all the three countries of the South Caucasus and provide a useful framework for analysis, it is important to note that there are some important difference between the countries with respect to those obstacles as is discussed later in the paper.

Endemic Corruption, as discussed previously, refers both to administrative corruption on the part of state officials as well as the problem of state capture. Some types of corruption may be more dangerous to reform than others – for example, predatory taxation which targets small and medium-sized enterprises (SMEs) prevents these from growing and soaking up unemployed and poor workers.

War not only has imposed great costs on the Caucasian states in the form of damaged and destroyed infrastructure, military spending, and the costs of supporting refugees and displaced persons, but continues to exact a toll in the form of bargains struck with special interests to facilitate war financing which continue to hold, distorting and restraining the state’s ability to reform, denying governments access to customs and tax revenues from occupied territories, and crippling the growth of regional trade.

Weak State Capacity arises from both a shortage of trained and skilled personnel to develop, implement and monitor policy as well as a shortage of fiscal resources. It also means a limited ability on the part of the state to gather information within its own borders about economic realities and a limited ability to disseminate that information about new rules and regulations throughout its territory, leading to confusion and ignorance on the part of government personnel and private citizens alike as to the central government’s intentions and actions. Finally, and perhaps most seriously, it encompasses the lack of a viable judiciary, which in turn renders the defense of property rights problematic, creating severe barriers to investment and growth.

Impediments to Trade are barriers to trade within the republics themselves, as well as within the region and with the surrounding world. Internal trade is frequently complicated by corruption, especially demands for bribes by police and other officials (such as railway officials) and poor infrastructure (especially roads). Inter-regional trade is complicated by borders closed by military conflicts as well as customs corruption and lingering protectionist inclinations. International trade is constrained due to foreign perceptions of risk due to corruption and military conflict, as well as difficulties in access due to an absence of ports (Armenia is land-locked and Azerbaijan has access only to the Caspian Sea; only Georgia has international maritime access via its Black Sea ports) and poor infrastructure (roads, railways and ports).

The international community cannot promote reforms if the citizenry and the national leadership are not interested or are actively hostile to the reform process – and popular feelings toward economic reforms are mixed in all three Caucasian countries. While publics are generally supportive of the need for change, there is also considerable cynicism and suspicion about the process, particularly with regard to privatization, which
has often been seen as a thinly-disguised way of transferring public assets to friends and supporters of whichever political faction is in power at the time. To some extent, economic reforms are also held responsible for the massive decline in living standards in all three Caucasian countries; the failure of the first wave of reforms to appreciably better the lives of most Caucasians is a significant political obstacle to further efforts. The problem is compounded by the dramatic growth of inequality in all three countries, so that while most Caucasians have seen their lives grow immeasurably harder, they are also keenly aware that some persons have become much wealthier (a problem exacerbated by the open display of wealth on the part of some members of the new elites). It is also the case that the two countries most successful in maintaining Soviet-era GDPs are those which have explicitly forsworn the kinds of reforms prescribed by the international community, ie. Uzbekistan and Belarus.

For reasons of both limited mandate and resources, and problematic local interest, lasting change may come only slowly. Time, and the generational change associated with it, may well do more to advance the reform agenda in the Caucasus than any particular set of policies and programs adopted by the international donor community.

POSSIBLE SOLUTIONS: WHAT INTERNATIONAL DONORS CAN DO

FIGHT CORRUPTION

As stated above, there is no substitute for a strong domestic consensus in favor of combatting corruption in the public sector if anti-corruption initiatives are to succeed. However, international pressure and assistance can still achieve some gains. International donors can provide assistance in developing some capabilities and outlining strategies through which corruption in general can be attacked; at the same time, focussed, carefully directed efforts can be made against particular types and forms of

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13 Transition: The First Ten Years, p.5-7.
14 The World Bank notes that Belarus’ GDP in 1999 reached 89 percent of its 1990 level, well above the CIS average of 62 percent, even though the EBRD ranks Belarus 25 out of 26 in overall progress in economic reform. Transition: The First Ten Years, p.46-47 (box 4.3.); also p.35, (box 4.1), which discusses the relevance of the Chinese experience. CIS decision-makers are well aware of these alternatives, and others; until the collapse of the Suharto administration, President Nazarbayev of Kazakhstan frequently cited Indonesia and the political and economic model for his country. Author conversation with Kazakh businessman, June 17, 2000.

Belarus’ success has been cited by several left-wing Armenian politicians and intellectuals who have argued that Armenia should join the Russia-Belarus Union, although this has been rejected by President Kocharian and the leaders of most mainstream political parties. See, for example, “Communist Party Leader Charges Armenia is Pro-Western”, Armenia This Week, 5 February 1999 (published by the Armenian Assembly of America and available at www.aaainc.org).

15 Anticorruption in Transition, p.72, (box 5.6). Citing the example of Azerbaijan, the study notes that international pressure did succeed in getting anti-corruption initiatives on the government’s agenda, but that progress had been uncertain and resistance to reforms had been strong and effective. More recently, the 2002 BEEPS found that the business climate in Azerbaijan has improved significantly.
corruption that are especially damaging. It bears repeating, however, that significant reform is unlikely without strong support from the government and population. The development of such a consensus may take considerable time.

An important area for reforms is customs administration. Graft among customs agents is harmful along at least three important dimensions: it acts as a constraint on the growth of trade, deprives the state of much-needed revenue, and contributes to public cynicism about the intentions and character of the government, insofar as almost all members of the public crossing a border will have to pay bribes.\(^{16}\) A focused drive against corruption in customs might involve studying such corruption (how much is being extorted, by whom) by sponsoring local civil groups to collect the information, and publicize the results within the country; stationing monitors at customs points to gather first-hand data and provide active surveillance of customs officers on duty; encouraging the introduction of higher pay and merit-based promotions within the customs service; and credible and effective sanctions – reductions and/or terminations of aid - against regimes which fail to make progress in controlling graft.

More generally, encouraging the formation and activism of trade groups, business associations, and other institutions linking individual actors affected by corrupt public officials, and improving the dissemination of information to the public about what rights individual business owners actually have when confronted by demands for bribes would help create a community of interests and organizations that could serve as the basis for making control of corruption a serious political issue, which in turn could attract ambitious political entrepeneurs.

A potentially productive sphere might involve local officials – provincial and district administrators and executives. As noted above, many of these individuals will have had to pay for their positions; almost all are appointed by the national executive and serve at his pleasure, meaning that they have little security and in theory at least, will be concerned with maximizing revenues from their positions due to the insecurity of their tenures. In some cases, however, these officials do have a certain degree of security and may be receptive to moderating and restricting some types of corrupt activities if it can be demonstrated that the resulting gains from freer trade and economic activity outweigh the political and monetary costs.

Critical in any anti-corruption effort is the attainment of visible success within a reasonable time frame. Anti-corruption efforts must have achievable, clear signposts for success with reliable and valid indicators of progress. Realistically, in the Caucasus this will require the adoption of quite modest goals, and very focused efforts. However, the value of being able to point to some concrete achievements, however modest, will be of great political value in making further progress seem possible and worth pursuing.\(^{17}\)

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\(^{16}\) One Azerbaijani customs officer of the author’s acquaintance claimed to have made $112,000 USD in a single year (1996). Even allowing for exaggeration, the sum is illustrative.

\(^{17}\) *Anticorruption in Transition*, p.73, 77.
AUGMENT/SUPPLEMENT STATE CAPACITY

Increasing state capacity involves improving the state’s ability to develop policy, disseminate that policy, and monitor its implementation. This will require reforms in the civil service aimed at professionalizing personnel, introducing higher pay and merit-based promotions, and improving internal discipline and controls. As with corruption control, this will be a long, drawn-out process, with many small victories and frequent defeats. In some cases, it may be possible for international donors to assist directly – for example, by supplementing the pay of skilled personnel in critical positions so as to ensure they remain in government service. Foreign donors could also assist by encouraging and subsidizing the dissemination of information between state bureaucracies – thus undercutting the infamous “silo system”, in which state organizations function in near-total isolation from one another – as well as from state bureaucracies to the population at large and especially to local government officials and SMEs. Offering younger civil servants and students opportunities to travel abroad for specialized training and exposure to public service in developed states might serve to inculcate western norms of clean government before these individuals become active players in administration-as-usual in their home countries.

EASE TRADE BARRIERS/ENHANCE REGIONAL COOPERATION

Given the small size of each of the South Caucasian states, it is clearly necessary for them to have access to each others markets and even more importantly to the much larger economies in the region: Iran, Turkey and Russia; indeed, access to the Turkish and especially the Russian market is absolutely critical for all three Caucasian states.

Recent political history does much to complicate these important relationships. Armenia’s borders with Turkey and Azerbaijan are closed. Georgia has good relations with Azerbaijan, Armenia and Turkey, although infrastructure and customs problems remain; but relations with Russia, Georgia’s most important trading partner, are extremely difficult, colored by Georgian resentment of Russian assistance to secessionist movements in South Ossetia and Abkhazia, and Russian anger at the presence of Chechen guerrillas on Georgian territory. Azerbaijan, as mentioned above, has severed its economic ties with Armenia since 1991, with considerable effect, particularly on the supply of energy products to Armenia. Azeri-Iranian relations remain clouded over mutual fears of subversion: Azerbaijan fears Iranian religious subversion while Iran fears Azerbaijani encouragement of secessionist tendencies among the predominantly Azerbaijani population of northern Iran.

Given this tangle of conflicts and resentments, bilateral agreements between Georgia and Armenia and between Georgia and Azerbaijan which aim at reducing and streamlining customs procedures may offer the most productive path. Efforts to reform

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18 The Armenian government prefers to describe the severance of relations with Armenia by Azerbaijan “blockade” while the Azeri government prefers to describe the current state of affairs “suspension of economic ties prompted by aggression”.

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the tortuous Georgian-Azerbaijani and Georgian-Turkish border crossings would be a useful step, as would further opening of the Russian-Azerbaijani border.

It is beyond the power of the international donor community, however, to do much about the broader political disputes which hamper the other border crossings. In all three countries – but particularly Georgia and Azerbaijan – further efforts aimed at curbing the numbers of the road police would remove a major impediment to internal and regional trade. A number of international financial institutions, including the EBRD and the World Bank, have made significant investments in upgrading transportation infrastructure – road, rail and maritime – in the Caucasus to facilitate both North-South and East-West trade flows; these are valuable and should be continued, if not expanded.

**PROMOTE STRATEGIC REFORMS**

In some cases, the international donor community may wish to consider taking a strategic approach to reform initiatives – that is, delaying the pursuit of reforms in cases where the political costs to the pro-reform movement are high and chances of success are low, and concentrating resources on issues where costs are lower and success more likely. This could be particularly valuable in those states which are set to undergo transitions from the initial post-Communist regimes of the 1990s in the coming years.19

As noted above, being able to point to credible reform successes – cases where privatization and other changes have led to perceptible improvements in quality of life – is extremely important for the future of the reform process. Ultimately the success or failure of the overall reform program will depend on a strong domestic consensus favoring it; the current identification of reform with declining living standards and abundant corruption could make the development of such a consensus virtually impossible. Pro-reform political leaders must be able to convince ordinary voters, as well as influential members of the political and business elite, that further reforms will bring more prosperity and better living conditions and that progress is being made in controlling corruption.

Strategic timing and selection of reform initiatives might also help to build domestic support for further reform – and increase the chances of success in the specific reform effort itself – by capitalizing on competitive tendencies between the Caucasian states.

For example, working with management and labor to start up smaller businesses that soak up the excess workforce – ultimately paving the way over several years for a rationalization of employment that will not involve throwing thousands of workers onto the mercy of a severely tattered or non-existent safety net – might be a better approach; although it increases the costs to the buyer of the privatized plant, it greatly reduces

19 Armenia and Azerbaijan are scheduled to have presidential elections in 2003. In Georgia the presidential election is scheduled for 2005 and the Georgian constitution bars President Shevardnadze from seeking a third term.
political risk by reducing local hostility; and it also breaks up the large bloc of threatened workers into a more varied group with heterogenous interests, ensuring that they will be less likely to act as a cohesive bloc if and when layoffs are enacted.\textsuperscript{20} To the extent that the spin-off business are successful, moreover, their managers and workers can be expected to become supporters of further reforms aimed at improving the climate for business operations – for example, corruption reduction programs.

**THE GENERATED POWER SECTOR: HANDLING HIGH RISK, HIGH PROFILE REFORM**

The transmission and distribution of generated power is a critical resource for all three Caucasian governments, who treat it as a form of public good. The provision of electricity is not only a tremendously valuable subsidy to political allies and loyalists but is also vital to maintaining social peace in urban centers and so a national security interest as well.\textsuperscript{21} No Caucasian government can quietly contemplate reforms to this sector that might result in the cutting off of power supplies to large numbers of enterprises and citizens, or which would deny the government the ability to distribute subsidized or free power to particularly important supporters. Progress made in reforming and privatizing power generation, transmission and distribution can be expected to be slow at times, politically painful and highly controversial among industrial and private consumers alike.\textsuperscript{22}

The power sector is a classic example of a potentially high-cost, high risk reform, forcing a government to take great risks of alienating powerful political interests and the general population with arguably little hope of quick or measurable success. If

\textsuperscript{20} See IBRD/World Bank, *Transition: The First Ten Years – Analysis and Lessons for Eastern Europe and the Former Soviet Union*, (Washington, DC: IBRD/World Bank, 2002), p.35. The adoption of tactics like these has been a precursor of success in several highly successful privatizations; for example the operations of the Batumi Oil Terminal in Georgia.

\textsuperscript{21} *Transition: The First Ten Years*, p.29, 48. The distribution of effectively free power – that is, power for which payment is never collected or even seriously pursued – is a major source of subsidization for cash poor CIS states. Large, politically important but commercially non-viable enterprises also tend to have large tax arrears. The Caucasus as a region ranks highest for soft budget constraints in the CIS and CEE. *Transition: The First Ten Years*, p.53-54.


undertaken during a political transition, it may also serve to help mobilize support for political leaders and movements which reject the advice of the international community. Industrial users – who are generally tremendously important sources of political support due to their financial assets and their influence over large blocs of workers – that depend on cheap or even free generated power will be receptive to political leaders who promise to maintain their supply of this vital resource. So too will individual consumers. If international financial institutions force the pace of power sector reforms during periods of transition they risk creating a trap for political leaders. Challengers will seek to win the support of large power customers by promising to protect them from paying for their power supplies; even otherwise pro-reform politicians will be forced to compete by coming out with public criticism of firms involved in privatization and perhaps even the entire process.

None of this is to say that privatization and rationalization of the generated power sector is not critically important in the three Caucasian countries. Quasi-fiscal deficits arising from the below-cost or “free” distribution of power are a significant budgetary issue in all three Caucasian states; the failure to raise energy prices to realistic levels and enforce payment has helped contribute to a rapid accumulation of public debt, which is growing to levels that may be unsustainable in the near future without debt relief. Privatization is also the only way to ensure that new investments and upgrades of existing generation/transmission capacity necessary for future economic growth take place.

In order to lessen the pain for the reforming government, and increase the probability of successful implementation of a reform package, the IFIs involved must make an effort to identify the consumers who will be negatively affected by the proposed reforms and devise ways in which these negative effects can be ameliorated. This may include not only the individual citizen, but possibly also powerful industrial consumers. Indeed, in political terms this latter group can be critical. Identifying several important industrial consumers who are also close supporters of the reforming government, and helping these individual enterprises develop plans to cope with increased costs arising from power supplies may be generally helpful to the reform cause. While this suggestion may appear to be a recipe for even more corruption and favoritism, it is very much in line with common government practice both in the US and Europe to offer favors to one’s political power base of key corporate and other special interests.

To the extent that the coping strategies devised for these businesses enable them to handle the stress of power sector reforms, the political costs of implementing such reforms to the ruling government is lowered; by the same token, the success of these firms in surviving – and, one may hope – thriving as reforms are enacted will serve as a

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23 Petu(?), Taube & Tsyvinski, “Energy Sector Quasi-Fiscal Activities in the Countries of the Former Soviet Union”, IMF WP/02/60; *Transition: The First Ten Years*, p.54.

In Georgia, at least, one political leader dismissed a discussion of the effects of the mounting debt by stating that Georgia’s importance to US strategic goals vis-a-vis Russia and the war on terrorism would ensure that US support would be forthcoming in securing new credits and concessionary financing, if and when a liquidity crisis developed. Author interview, Tbilisi, 21 August 2002.
useful example for other firms which might otherwise react conservatively and oppose reforms out of fear of the unknown consequences. The power of example could also be a potent factor; identifying and publicizing successful reform in one country may help to encourage similar reforming efforts in the others.
II. ARMENIA

Armenia is the smallest of the Caucasian states, ranked by population, and in some ways faces uniquely difficult circumstances arising both from its geographical situation as well as from its recent political history. Armenia benefits from a relatively disciplined and effective post-Communist government, as well as a highly-motivated and wealthy Armenian diaspora in North America, Russia and Europe which was able to function both as a source of capital and as a potent lobby among foreign governments and agencies for aid to the newly independent Armenian republic.

Unfortunately, Armenian independence was accompanied by a rapid slide into outright war with neighboring Azerbaijan. While Armenia was largely able to avoid the devastation of combat operations on its own territory – with the exception of some fighting along the border with Azerbaijan – the war nonetheless had serious consequences. The most prominent of these was the imposition of a ban by Azerbaijan on exports to Armenia; this cut off Armenia from what had been the source of up to 90 percent of its energy imports, as well as severely disrupting rail and road connections with the rest of the CIS. Adding to Armenia’s difficulties, neighboring Turkey – which under other circumstances would have been Armenia’s largest trading partner – closed its border in sympathy with Azerbaijan and declared that it would not be re-opened until the Karabakh war was settled on terms satisfactory to the government of Azerbaijan. The effect of these measures was increased by the fact of Armenia’s physical separation from Russia – its primary military ally and trading partner – by Georgia. As that state fell into near-chaos in the early 1990s Armenia’s communications with Russia suffered accordingly, and although conditions have much improved they remain somewhat problematic. Armenia also became the home of a fairly substantial number of ethnic Armenian refugees from Azerbaijan, as well as from affected border villages and from Armenian-populated areas of Karabakh.24

The Armenian economy has enjoyed seven consecutive years of growth in spite of several external shocks, notably the 27 October 1999 attack on the Armenian parliament which caused the deaths of the prime minister and speaker of parliament, among others. The assassinations and the political uncertainty which followed severely compromised the ability of the government to move forward with reforms, not least because it may have made international investors more aware of possible political risks. Armenia is

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24 The Armenian government estimated that approximately 72,000 people were internally displaced as a result of the fighting with Azerbaijan between 1989 and 1994; this figure includes ethnic Armenians from communities within Azerbaijan. Some 28,000 of these are believed to have returned to their homes following the 1994 ceasefire; a significant number of these are located in areas of Azerbaijan currently occupied by Karabakhi and/or Armenian military forces. The total IDP population remaining in Armenia is thought to be around 45,000-50,000.

heavily dependent on external financial assistance, both from the Armenian diaspora, individual foreign states, and international financial institutions. The current account deficit of 14.9 percent is the highest in the CIS. Inflation is stable. Efforts by the government to attract foreign direct investment have been moderately successful in areas such as telecommunications, energy, transport, diamonds/jewellery, brandy, and IT. Tax collection remains difficult and in 2000 revenues from taxes and duties were 12 percent below target. The government has responded to revenue shortfalls by cutting expenditures (including allowing arrears in payments to public sector workers) and increased reliance on external support, notably diaspora remittances. Most of Armenia’s state assets have been privatized, but the pace of privatization has slowed since 1998.

**Political Power in Armenia**

The demands of supporting the fighting in Karabakh had significant effects on Armenian politics. Political leaders from Karabakh assumed prominent posts within the Armenian governments and there is some concern that as a result developments in Karabakh receive disproportionate political attention.

Under the leadership of President Ter-Petrossian (1991-98) almost all of Armenia’s state-owned enterprises were sold off, albeit with many complaints that the privatization process had been corrupt and that members of President Ter-Petrossian’s administration and their family members had received preferential treatment; land ownership was legalized and the state made energetic efforts to attract foreign investors, both from the Armenian diaspora as well as from the international community at large.

**Obstacles to Reform**

Obstacles to further reform in Armenia are in some respects similar to those found in Azerbaijan and Georgia; chief among these are corruption, deficient infrastructure, and the after-effects of war. In Armenia the latter stem not from property destruction but from the sanctions imposed by Azerbaijan and Turkey, which cuts off Armenia from what would otherwise be its major trading partners.

**Corruption**

Government corruption in Armenia is ubiquitous and deep-rooted. While the government has passed legislation threatening severe penalties for corruption among government personnel, it seems unlikely to have great effect, particularly when pay arrears to civil servants are chronic, forcing even those inclined towards honesty to seek graft to survive. Particularly damaging in Armenia’s case is judicial corruption, which renders the enforcement of contract and property rights problematic, leaving foreign

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investors at the mercy of local partners.\textsuperscript{26} Armenia continues to suffer from a lack of foreign direct investment and this form of corruption is particularly damaging in that respect.

Foreign enterprises are often asked to take on local partners with government connections who contribute neither capital or any real business acumen to the enterprise.\textsuperscript{27} While these local partners are sometimes effective in facilitating business operations, in other cases they serve largely to divert a share of revenues to political and bureaucratic actors. The impact of corruption on locally-owned firms appears to be varied, but heavily colored as much by the geographical location and size of the firm in question as by the quality of the political protection purchased by the firm’s owners. Large firms (mostly privatized industries) in rural and urban areas and enterprises of all sizes located in urban areas seem to suffer more from both demands for bribes from state inspectors, tax officials and other bureaucrats than do SMEs located in rural areas.\textsuperscript{28} This may be the result of an uneven surveillance capability on the part of a predominantly urbanized bureaucracy, resulting in a preference for going after a small number of large taxpayers (rather than a large number of small potential taxpayers).

\textbf{War}

The war for Karabakh severely distorted the normal apparatus of tax collection within Armenia. The war required the import of fuel and the purchase of weapons, ammunition, vehicles and other goods not easily available within Armenia, as well as the payment of salaries and the purchase of sundry other services. Appeals to the diaspora and the revenues realized from looting captured Azerbaijani territory met only a fraction of the need. As a result, the infant state was forced to make a series of working accommodations with various private groups in order to raise funds. These arrangements in effect functioned as licenses for the import of commodities as varied as cigarettes, diesel fuel, vodka, farm produce, vehicle tires and spare parts, and so forth; emergency requests for loans of funds and materials from state-owned enterprises in exchange for various concessions – notably the right to import and export raw materials and various capital outputs without taxation - were also an important part of war finance.

Although the fighting ended with the May 1994 ceasefire, many of these informal arrangements continue to operate in Armenia today. The net effect has been the development of a two tier system of taxation and customs fees, with imports by a number of domestic actors effectively tax free while other firms – foreign investors and Armenians without the proper connections – face a variety of customs, VAT and corporate taxes. Attempts to protest such treatment often meet with retaliation from the

\textsuperscript{26} One businessman in Yerevan reported that the average payment (in his experience) requested by a judge for a favorable ruling was $5000 USD if the law supported the payer; $12000 if it did not. Author interview, Yerevan, 15 August 2002.

\textsuperscript{27} The Armenian government has recently passed anti-corruption legislation, but it is too soon to judge how effectively the law will be implemented.

\textsuperscript{28} Author interview, Armenian and European businessmen, Yerevan, 18 August 2002.
relevant ministries; reforms to the administration of tax collection have in some cases had the unintended effect of making such retaliation even more punishing.  

**Impediments to Trade**

Armenia suffers considerably from its isolation within the region. The only completely land-locked state in the South Caucasus, Armenia’s geographical disadvantage is augmented by its political isolation – both Azerbaijan and Turkey have closed their borders to trade with Armenia in retaliation for its military and political support of the ethnic Armenian secessionists in Nagorno-Karabakh. Turkey has declared that it will not lift its sanctions until a settlement of the conflict satisfactory to Azerbaijan has been reached; the failure of successive rounds of peace talks between the Armenian and Azerbaijani governments gives little cause for optimism that this may happen anytime soon.

A peculiarity of Armenian political life is that there is no discussion of the cost of the conflict – especially the closing of the Turkish and Azerbaijani borders - and the subsequent failure to sign a peace treaty; in effect, the war has been elevated beyond political discourse. While there are a number of reasons which may be responsible for this: the dominance of Karabakhi politicians over Armenian political life, the pride in the military victories won by Karabakhi forces and a natural disinclination to trade them for what may seem to be mercenary commercial advantage, and the frequently-referred to fear of a second genocide if any concessions should be made to Azerbaijan – it is nonetheless striking to see how little acknowledgement there is of the economic costs of the war to Armenia’s development. The decision by President Ter-Petrossian to agree to an OSCE-brokered peace treaty in 1998 – a decision which led to his forced resignation shortly thereafter – was driven in part by the fear that Armenia’s isolation would weaken it over time relative to Azerbaijan such that it would not be able to maintain itself or its support for the Armenian regime in Nagorno-Karabakh.

Ter-Petrossian’s ouster appears to have ended public discussion of the costs of the war; Armenians today are more likely to blame corruption rather than the aftermath of war for their difficulties. The silence is further reinforced by the importance of the Armenian diaspora and diaspora-funded parties such as the Armenian Revolutionary Federation, which view the outcome of the Karabakh conflict in triumphal terms and reject efforts to call for a negotiated peace with Azerbaijan.

The border with Georgia remains open, and a good deal of Armenian trade moves across it, but road and rail infrastructure problems constrain the growth of trade, as does corruption at customs posts and – on the Georgian side – among the road police. The

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29 Previously, VAT taxes were collected from industries by regional tax authorities. Disputing an assessment could lead to various forms of retaliation in the district. After the centralization of tax collection in Yerevan, retaliation would be applied nation-wide. For firms relying on sales to the domestic consumer base, this could be devastating; one firm recorded a 70 percent decline in sales in a single quarter after government officials ordered the company’s products off the shelves of Armenian stores. Author interview, Yerevan, 18 August 2002. The government claims to be making efforts to stop such retaliatory practices.
Georgian failure to alleviate the infrastructure problem is partially due to a lack of funds but also partially due to suspicions about Armenia’s intentions towards the Armenian-populated districts of southern Georgia.

Relations with Russia are good but the two countries are separated by Georgia, making transit relatively costly and somewhat unreliable (Georgian customs are prone to seizing cargos destined for Armenia). Russian firms are relatively heavy investors in Armenia, a position which has been increased due to debt-for-equity swaps between the Armenian and Russian governments, in which debts owed by the Armenian government to the Russian state (particularly for shipments of natural gas as well as military goods and services) are forgiven in exchange for the handover of Armenian state-controlled enterprises.\(^{30}\)

Trade does go on with Iran – notably in generated energy, with Armenia supplying power to Iran from its hydroelectric plants in the summer and importing it in the winter.\(^{31}\) Shortages of capital have hampered efforts to expand road communications or build rail infrastructure.

Armenia’s main asset is an educated, low-cost workforce. The export of Armenians is the country’s major hard-currency earner, as demonstrated by the importance of diaspora remittances in financing the state; about 12 percent of Armenia’s GDP is estimated to come from transfers from Armenians working abroad.\(^{32}\) Armenia’s own domestic market is small, impoverished, and continues to diminish due to heavy

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\(^{30}\) The most recent such debt-for-equity swap took place in July 2002, and saw the forgiveness of $98 million USD in Armenian debts in exchange for 5 state-owned companies; these have not been finalized but are likely to include several electronics firms which manufacture military supplies, as well as the Hrazdan thermal plant. While the deal brings immediate fiscal relief to Armenia – interest on the Russian debt was charged at commercial rates considerably higher than those offered by international financial institutions like the World Bank – and offers the promise of Russian investments in the swapped enterprises, unease has been expressed within Armenia as to the political effect of giving Russia a dominant stake in Armenian economy. As well, Armenia has only a limited number of state-owned facilities remaining for such swaps.


\(^{32}\) “Report on Factors Inhibiting Foreign Direct Investment in Armenia”, by the staff of the Investment and Export Policy Directorate and the Ministry of Industry and Trade, Gov’t of Armenia, 30 January 1999. Funded by USAID and UNDP. In a survey of 40 foreign-owned firms active in Armenia, this report found that Armenia received the highest marks for attitudes towards foreign investment, labor costs, and workforce qualifications. The strongest complaints were about poor road and railway infrastructure, difficult and opaque import procedures, and a lack of available insurance. P.44-45.

Concerning the dependence on diaspora finance, “Armenia’s current account deficit is the highest in the region and is only sustained by substantial remittances from the large diaspora”.

outmigration to Russia, Europe and North America – estimated to currently run at 30,000-50,000/yr, down from a peak of perhaps 150,000/yr between 1993-95.\(^\text{33}\)

**POSSIBLE SOLUTIONS**

**Corruption**

Efforts to combat corruption in Armenia suffer from the same problems which dog such campaigns elsewhere in the CIS – a lack of fiscal resources, poor organization, a lack of coordination, and in particular, a lack of political commitment. All too often pressure for corruption control comes chiefly from international organizations and is seen as an imposition rather than a legitimate national priority.

Moving effectively against Armenian corruption will require targeting two areas: customs administration (especially import procedures and charges), and management of the civil service. Concerning the latter, reform of the service would require, as a beginning, an end to the practice of payment arrears as a way of cutting government expenditures, and some effort to increase salaries while reducing the numbers and discretionary authority of bureaucrats. As a practical matter, these reforms are unlikely to be adopted; the state has neither the funds nor the administrative resources to enact them. Nor is it practical to reduce the number of civil servants given the high rates of unemployment which afflict the work force.

Addressing customs administration is rather more straightforward but no less politically difficult. Dismantling the two-tier system of customs charges will require rewriting bargains made with powerful interests during the 1991-94 period for the purpose of helping to fight the Karabakh war; some of these also benefitted significantly from the privatization effort of the Ter-Petrossian administration up to 1998 and remain important supporters of the present administration. These groups and individuals will presumably resist change and the ability of the state to compensate them is limited by its general poverty.

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After several delays, the results of Armenia’s 2001 census were released on 15 February 2002, showing that the national population was 3,020,768, very close to the 3.1 million figure shown in the Soviet census of . The new figure has been received with considerable skepticism in many international and domestic quarters; the census noted that 950,000 Armenians had left the country since 1991, but many of these were counted nonetheless, as “temporary departures”; other irregularities in the count were also reported. A low population count would have been seen as a vote of no-confidence in the country’s future by ordinary Armenians and as such would have been politically embarrassing for the Armenian government.
Ease Trade Barriers

Without a solution to the Karabakh dispute, little can be done about trade with Azerbaijan and Turkey. In light of this, infrastructure improvement to lower transport costs between Iran and Armenia, on the one hand, and Georgia and Armenia on the other, would be useful. Further improvement of the Burgas(Bulgaria)-Poti(Georgia)-Armenia-Iran cargo transportation corridor, particularly the opening of a direct railway connection, would simplify some transportation issues, as would further improvement of the road and rail lines linking Armenia with Georgia (the port of Poti).

The international donor community could also attempt to educate the Armenian diaspora about deficiencies in the economy and how diaspora capital could remedy them. At present, much diaspora capital comes to Armenia in the form of charitable donations rather than as investments. This is entirely understandable; most members of the diaspora are small businessmen/women and professionals with little skill or indeed interest in the arcane art of profitable investing in a less-developed economy. However, the diaspora represents a pool of capital which is at least favorably inclined towards considering Armenian investments, a not-inconsiderable asset given the generally unpromising circumstances in the country; and it is also a politically important constituency for the Armenian government, a status which gives it considerable potential influence. In particular, diaspora activism may be a powerful spur for economic reforms and anti-corruption initiatives. For example, the Lincy foundation in provides financial support in the form of credit lines to Armenian SMEs, administered through local banks.

III. GEORGIA

GEORGIAN POLITICS

In a region with more than its share of instability, Georgia is perhaps the most unsettled of the three Caucasian states. Following the gaining of its independence from the Soviet Union, Georgia elected a Soviet-era dissident, Zviad Gamsakhurdia, as its first president. Gamsakhurdia, unfortunately, was not equal to the job and his policies rapidly alienated almost all of Georgia’s ethnic minorities as well as a substantial portion of ethnic Georgians as well. After a disastrous war against a secessionist movement in South Ossetia, Gamasakhurdia was overthrown by a coalition of warlords and opposition groups after a series of running gun battles between his foes and supporters in downtown Tbilisi (the so-called Tbilisi War). Shortly after this, a second territory, Abkhazia, seceded from Georgia after Georgian paramilitaries attacked it in 1992; and when the bulk of Georgia’s military forces were committed in Abkhazia, Gamasakhurdia


35 The Lincy Foundation was established by American billionaire Kirk Kirkorian with a $44 million USD donation. Loans from $100,000 to $1 million are being provided in $10 million tranches.
supporters in the western Georgian region of Mingrelia rose up and mounted an effort to capture Tbilisi. They were ultimately put down by Russian naval infantry and pro-government forces, but not before the Georgian army in Abkhazia had largely disintegrated.

Georgia’s fortunes reached their nadir in 1993. Torn by secessionist movements and civil war, the central government had essentially ceased to function and the country appeared to have fallen into chaos; perhaps the only asset remaining was Eduard Shevardnadze, the Gorbachev-era Soviet foreign minister who was an ethnic Georgian and who was invited to take over the government in 1993 by a coalition of warlords. Between 1993 and 1995 Shevardnadze worked something of a miracle in Georgia, jailing most of the warlords, dissolving their armies, restoring civil peace, and reasserting the authority of the central government. Although he was unable to bring about the reintegration of the departed territories of Abkhazia and South Ossetia, by 1996 Georgia had become sufficiently calm as to become an acceptable transit state for oil pipelines from Azerbaijan and in general began to experience something of an economic recovery. Although there have been periodic assassination attempts against Shevardnadze he has managed to maintain Georgia’s internal peace while establishing close relations with the West. Relations with Russia have been troubled by allegations from Georgia of Russian involvement in several assassination attempts against Shevardnadze as well as charges of Russian support for the Abkhaz and South Ossetian secessionist regimes. For its part, Russia has charged that Georgia has permitted its territory to be used as a safe area by Chechen guerrillas, and that Georgia’s pursuit of an alliance with the United States threatens Russian security.

The violent and chaotic period of the early- and mid-nineties had a devastating effect on a Georgian economy already reeling from the breakup of the Soviet Union; the period from 1991 through 1994 was something of a lost era. The government moved energetically to begin reforming the economy in 1995, however, reducing inflation to single-digit levels by 1997 and significantly reducing Georgia’s chronic budget deficits.\footnote{World Bank, \textit{Georgia: Portfolio of Operations}, June 2002, p.1-2. In the opinion of almost all the Georgian businessmen and citizens interviewed by the author, the government’s greatest accomplishment has been the maintenance of a stable currency and the defeat of inflation, which has permitted savings and investment.} The lari is the most stable currency in the region. Georgia’s GDP has continued to grow slowly throughout the late 1990s and 2000/2001. The government has launched an ambitious privatization program for transportation, telecommunications, and power, while a number of other initiatives are aimed at reducing administrative interference and corruption.\footnote{Ibid., p.2.} The government has also made significant efforts to increase tax collections and reduce spending, with some results; the deficit has fallen to 4.6 percent of GDP in 2000. However, official reserves are low and arrears on external debt payments are high. Georgian debt was rescheduled in March 2001. Foreign direct investment has grown slowly, discouraged by corruption, inadequate legal protection of property rights, and ineffective public administration.\footnote{EBRD \textit{Georgia Investment Report 2001}, EBRD Country Promotion Program, March 2001. Georgian businesses pay the highest proportion of revenues in bribes in the Caucasus.} Predatory tax enforcement and difficult and opaque
business licensing requirements have encouraged the growth of a substantial shadow economy, estimated at 85 percent of the official economy. 39

Shevardnadze’s rebuilding of the Georgian government rested heavily on his construction of the Citizen’s Union of Georgia (CUG), which until recently controlled the Georgian Parliament and ensured the passage of the President’s reform legislation. 40 The party brought together westernized reformers, Soviet-era bureaucrats, former Communist Party regional bosses, and representatives of the many ethnic minorities which remained within Georgia. While the party existed, it not only gave the president firm control over the legislature, it functioned as a patronage machine, allocating government appointments, privatization contracts, government spending, and other goods to the various elements of the coalition of interests which supported the Shevardnadze regime. This patronage was critically important, and remains so; Georgia has a very weak executive and severely compromised administrative capability. Actual implementation of laws and decrees in Georgia is extremely problematic, and frequently involves informal negotiations between local, regional, and central officials. Edicts which are costly to local or particularistic interests are frequently ignored. Georgia seems likely to be entering a period of slowed reform and a degree of domestic political paralysis, until and unless a reformist successor to President Shevardnadze emerges with a strong mandate.

**OBSTACLES TO REFORM**

**Corruption**

Perhaps the major obstacle to further economic reform in Georgia is the ubiquitous corruption. While the nature of these practices is not substantially different from that found in Armenia or Azerbaijan, they are distinguished to some degree by the degree and enthusiasm with which they are practiced in Georgia. Arbitrary and capricious tax collection, opaque and unpredictable customs import and export charges, and an unreliable judiciary and police are a constant problem for both domestic and foreign-owned businesses operating in Georgia; their effects are exacerbated by a weak executive which is unwilling or incapable of reacting to complaints or monitoring bureaucratic behavior. The scale of corruption in the customs service is startling; according to one Georgian report, illicit customs revenues may amount to almost 1 billion lari – roughly equivalent to the national budget. 41 Corruption in the Customs department

39 Eilat & Zinnes, “The Shadow Economy in Transition Countries”.

40 The CUP disintegrated in 2001 following charges of corruption and infighting among the leadership over the succession to President Shevardnadze.


In 1999 a British firm, InterTek Testing Services won a tender to undertake pre-shipment inspections, calculate customs duties on shipments over US $2500, and train customs officers. The company’s tenure in Georgia was extremely turbulent. Their contract with the Georgian government ended in April 2002 and was not renewed.

has been identified by the World Bank as the single largest administrative barrier to foreign investment in Georgia.

Corruption is particularly pernicious in Georgia due to the weakness of the Georgian executive branch. This weakness means that there is no one person or office capable of resolving disputes between government agencies and investors or businessmen; dispute resolution requires a drawn out process of assembling support from a variety of different parties within the government. Frequently it is impossible to have decisions made in anything resembling a timely fashion; or to ensure that when decisions are made, public as opposed to private interests dominate in the process.

Weak State Capacity

The overall administrative weakness of the government has been compounded by two factors: first, the increasing instability of government appointments in the last year. Maneuvering for advantage in the contest to eventually succeed President Shevardnadze may have been one of the causes for frequent ministerial shuffles at the cabinet level and a corresponding number of changes within various ministries, disrupting ongoing initiatives as well as preventing the buildup of knowledge and experience among bureaucrats. This instability has exacerbated a second, pre-existing problem in Georgia, the difficulty the government has experienced in recruiting and retaining trained staff to brief government officials on the implications and costs of various initiatives and programs. There is frequently an unclear understanding within the government of the nature of the obligations and commitments which have been made to Georgia’s international partners, or even of the advantages these agreements confer. For example, when Georgia was granted General System of Preferences (GSP) beneficiary status by the U.S., the European Union, Switzerland, Czech Republic, Slovakia, Canada, Japan, and Poland, a lack of knowledge of the advantages of GSP resulted in companies exporting goods to the U.S. and Europe without taking advantage of GSP benefits.

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42 In many – although not all – cases assembling this support requires paying off the relevant officials. In Armenia and Azerbaijan there is generally one official capable of solving whatever problem confronts the businessperson; in Georgia the assent of several is required. This makes for a slower, more expensive system but maximizes revenues and patronage possibilities.

43 It is unclear to the author to what extent the recent shuffles have been driven by succession politics and to what extent they have been driven by revenue-seeking – that is, the desire to collect a new round of payoffs from office-seekers hoping to fill vacated positions.

44 While smaller investors complain about corruption, poor infrastructure and fragmented executive power in Georgia, major investors – those building large infrastructure projects and the like – were most struck by the poor staff support for Georgian ministers in their negotiations with multinationals and international institutions. Several reported being asked for help and advice by ministers and other high ranking officials on policy issues that had nothing to do with their own commercial activities, and contrasted Georgian deficiencies in this regard with Kazakhstan and Russia. One Georgian official admitted to the author that there had been little understanding within the government of the implications and costs of membership in the various international organizations Georgia had joined (most recently the WTO); these were only becoming clear after the fact, with WTO membership in particular looking like a very costly move. Author interviews, 31 July, 22-24 August 2002.

War

Georgia’s two campaigns against South Ossetia and Abkhazia lumbered the state with the need to support large (250,000-300,000) populations of internally displaced persons, many of whom have been concentrated in urban areas (in large part because these were the only locations where housing was available). According to one study, social assistance for internally displaced persons is the second largest social protection program in the country, constituting about 6% of total public spending and 1% of GDP. The state budget also suffers from the lost revenues which would have otherwise accrued from the seceded territories, both of which bordered on Russia and controlled major transportation arteries (the Black Sea coastal road and railroad in Abkhazia, and the highway through South Ossetia to Russia). The failure to reach a settlement of either conflict contributes to the perceived high risk environment in Georgia, and has also caused Georgia to maintain larger military and police forces than it can perhaps afford.

Impediments to Trade

Georgian trade is constrained by some of the same factors which work to limit Armenian and Azerbaijani trade: corruption in the customs service which makes import/export more expensive and time-consuming, and infrastructure shortfalls in road, rail and maritime transport that impose costly delays and limit growth.

A unique difficulty for Georgia stems from threats to its access to the Russian market. Georgian relations with Russia – which remains Georgia’s main trading partner – are problematic, mainly due to Georgian resentment of Russia’s support for the Ossetian and Abkhaz separatists and Russian anger over the presence of Chechen guerrillas on Georgian territory. The power in this relationship lies almost entirely on the Russian side; access to the Russian economy is a critical issue for Georgia. Exports of Georgian agricultural and manufactured goods to Russia, and remittances from the hundreds of thousands of Georgians working in Russia, are indispensable to the continued functioning of the Georgian economy. As Russia’s imposition in December 2000 of visa requirements on Georgians wishing to visit Russia showed, this lifeline is highly vulnerable to disruption. A more amicable relationship between the two countries would be in Georgia’s best interests; failing this, an agreement which codified transit requirements and prevented either side from making sudden changes might be valuable, if it could be attained.

Possible Solutions

Ease Barriers to Trade

http://www.bisnis.doc.gov/bisnis/country/020930GGCCG.htm

Georgia’s geographical location make it a critical transit state for east-west and north-south trade; this role is significantly enhanced by Armenia’s self-imposed isolation. Over the long term, Georgia’s national interests would be well-served by building upon this advantage. While some of the challenges which flow from this prescription are beyond the scope of the international donor community – chiefly a settlement of Georgia’s differences with Russia and with its seceded provinces which would remove obstacles to cross-border transit and finance – others are at least conceptually straightforward.

Enhancing Georgia’s physical infrastructure in order to increase the country’s role as a transit state would be an important step. Several such programs, such as the Silk Road project and the North-South corridor, are already underway; these should be further pursued. Upgrades to Georgia’s own internal road network – particularly those connecting rural areas producing agricultural produce to urban centers – would also be useful. Improving the administration of Georgia’s railways, as well as providing for much-needed capital improvements (the Georgian railway system is short of locomotives, spare parts, and other critical components) would be an important step in facilitating the movement of oil and other cargos from Azerbaijan (and by extension Central Asia). Continuing to reduce the number of police checkpoints on internal roads in Georgia would significantly lessen the costs of internal and regional trade.

Streamlining customs procedures at the Georgian-Turkish and Georgian-Azerbaijani borders would be advantageous, although in practical terms interfering with the illicit revenue streams generated by these posts would be politically difficult (see Control Corruption, below). This would also be true for crossings at the Russian and Armenian borders, but in those cases security concerns are likely to make improvements difficult. Improvements could also be made in the cargo handling capacity of Georgia’s ports, although here care must be taken to avoid problems of overcapacity.

Anything which could be done to smooth Georgian-Russian relations, or at least insulate Georgian access to Russian markets from the up-and-down changes in the political relationship between the two countries, would be tremendously valuable. Some Georgian grievances against Russia are well-founded, and it is difficult not to sympathize

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47 By the author’s count, a farmer attempting to take a cargo of melons or potatoes from southern Georgia to the Tbilisi market must expect to make between 11 and 19 payoffs to Georgian road police officers during the day-long trip, at a cost of roughly 5-10 lari per payoff. When the cost of the bribe required for the farmer to be allowed to sell his product out of the back of his truck at a city market is added in, there is little hope that any profits will accrue from the trip. Russian military convoys from Russia’s remaining bases in Javakheti and Adjaria are an eagerly pursued means of export because Russian military vehicles are officially exempt from Georgian police inspection and do not pay bribes.

48 For example, the oil terminal at the port of Batumi, which has been extensively modernized and upgraded by a private company operating the port as a joint venture with the government of the autonomous region of Adjaria, has a capacity to handle up to 12 million tons/year of crude oil; currently traffic amounts to approximately 7 million tons. In spite of this, the Georgian government has been attempting to build a completely new oil terminal north of Poti, rather than improving Batumi. The reasons behind this decision are complex but are driven in part by fears that Adjaria’s independent-minded chief executive, Aslan Abashidze, has possible secessionist leanings and is too close to Russia.
with Georgia’s efforts to remain aloof from the Russia’s war in Chechnya. That said, Georgia needs access to Russia more than Russia needs access to Georgia; and it is incumbent upon Georgia to do all that it can to secure unfettered access to Russian markets. It is not immediately obvious what international institutions can do to improve the situation.

**Control Corruption**

Corruption control in Georgia poses a particular challenge in light of the relative weakness of the state executive; at the current time, moreover, Georgia’s internal turmoil and the declining popularity of the Shevardnadze government mean that there is little political capital available for a meaningful effort to crack down on most forms of corruption. Real progress may have to await a post-Shevardnadze regime with a mandate for aggressive action.

As is the case in all the Caucasian countries, reforming customs administration would be a tremendous advance. While the usual nostrums of civil service reform, increased pay, professionalization and merit-based hiring and promotion remain valid, international donors could play a useful role by encouraging and (if necessary) subsidizing the distribution of information to businesses and individuals crossing the borders concerning exactly what their obligations and rights are, as well as the schedule of fees for which they may be liable. In addition, donors could fund NGOs or other entities to gather better-quality information on how large a problem customs corruption is and how profits from such graft are distributed. If and when the political will for a strong reform effort materializes such information will be of great value.

**Improve State Capacity**

Reforming Georgia’s administration is a gargantuan task, given the problems with which it is afflicted and the limited political, fiscal and managerial resources available. An important and productive area of reform would be to improve contacts and dissemination of information between bureaucracies within the state as well as communication between bureaucracies, civil society organizations (individual citizens as well as non-governmental organizations) and business groups. Creating occasions for members of these communities to meet on a regular basis and develop relationships, as

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49 Russian charges that significant numbers of Chechen guerrillas have been using northern Georgia as a safe area for rest and recuperation were confirmed in the fall of 2002 after Georgian security forces moved into the Pankisi Gorge area in northern Georgia, near the border with Chechnya.

50 In 2000 President Shevardnadze created a special anti-corruption commission by decree, headed by the Chairman of the Supreme Court and charged with the task of developing measures against corruption. The commission’s strategy calls for liberalization of the business environment, strengthening public finances, streamlining of law enforcement and the judiciary, improving selection criteria for judges, and reforming the civil service. Short term measures included legal changes to allow confiscation of assets received from criminal sources, monitoring public officials’ sources of funds, and reducing the number of roadside police checkpoints. It remains to be seen how thoroughly these measures will be implemented and how effective they may be. *EBRD Georgia Investment Report 2001.*
well as encouraging (and perhaps subsidizing) the collection and publication of useful and relevant information by the bureaucracies could help to break down the barriers between administrative entities which do much to detract from government efficiency and effectiveness.

**Strategic Reform**

Finally, there is the issue of electricity privatization and provision. This is further advanced in Georgia than elsewhere, but it may be worth reconsidering the schedule of further privatization. Generated power is the only practical means through which the government is able to subsidize the operations of industry and agriculture. Reforms, however well-intentioned, which impair the government’s ability to keep such enterprises functioning (and so able to continue providing whatever rudimentary social assistance and employment they offer) may be ill-advised at this point in time. The lack of adequate supplies of fuel, heat and electricity is a pressing issue in Georgia, both in urban and rural areas. Further movement on reforming this sector at a time of political uncertainty and regime change in Georgia could produce a backlash in the form of support for anti-reform political movements which would be highly counterproductive for the international donor community in the short and medium term.  

Before further reforms go ahead – particularly aimed at enforcing payment orders on large customers – effort should be made to help at least some of these consumers rationalize their businesses and enact reforms which will help them survive the increased costs of doing business that will come with having to pay for power, through the provision of high-quality consulting advice and where necessary, credits. The political calculus of power privatization will be affected positively if donors can point to some cases where such changes have not meant bankruptcy for the firms in question.

A failure to address the interests of politically powerful interests directly may lead to a sharp reversal in the fortunes of the reform program in general. In the 2000 presidential election, President Shevardnadze’s main opponent – until his withdrawal less than 24 hours before the polls opened – was Aslan Abashidze, the chairman of the Autonomous Region of Adjaria. Part of Abashidze’s appeal rested on his success in maintaining order and Soviet-era employment levels in Adjaria, a goal he achieved by maintaining state control of most of the Adjarian economy; his policies are seen as a viable and even attractive alternative to the reform policies adopted under President Shevardnadze. While it is impossible to know what Abashidze’s policies would be if he were ever to become President of Georgia, or even if he wants the job, it is important to realize that Adjaria is seen as an attractive alternative to the current state of affairs.

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51 Raiser/Kennedy/Frankhauser, “Low Pressure, High Tension”. These authors note that poor payment discipline has persisted among large customers due to an unwillingness on the part of the transmission company to implement disconnection orders. This lack of action on the part of the transmission company reflects a political reality in Georgia (which also exists in the other Caucasian countries) – some consumers cannot be forced to pay. Even regime change would not necessarily change this situation, if the management of the firm in question moved quickly to establish connections with the new regime, or was replaced by allies of the new regime.

52 98 percent of all enterprises in Adjaria remain under the control of the local state.
IV. AZERBAIJAN

Since gaining independence, Azerbaijan’s political system has been shaped by three factors: its oil and gas sector, the war against ethnic Armenian secessionists in the autonomous territory of Nagorno-Karabakh. The largest of the three Caucasian states (by population), Azerbaijan has the potential to be the economic giant of the south Caucasus, thanks to rapid growth and high levels of foreign investment attracted by its large reserves of oil and gas.

Azerbaijan experienced considerable instability after gaining independence; two Azerbaijani presidents, Mutalibov and Elcibey, were overthrown following military defeats in Karabakh; in the former case by anti-government mobs in Baku, in the latter case after a rebellious warlord marched on Baku after being relieved of his command. After President Elcibey’s fall in 1993 former KGB general and ex-Chairman of the Azerbaijani Communist Party Heydar Aliyev became speaker of Parliament and subsequently President. A man who is in many ways larger than life, Aliyev survived a string of coup attempts, assassination plots, terrorist campaigns, and one additional secession attempt in southern Azerbaijan while outmaneuvering and suppressing domestic political opponents, negotiating contracts with various international oil companies which guaranteed the development of Azerbaijani oil and gas reserves while ensuring a large western presence to counterbalance Russia’s ambitions, and restoring effective central government control over the country. Aliyev’s credibility has waned somewhat in the wake of parliamentary and presidential elections in 2000/2001 that were severely criticized by international observers, as well as charges of extensive corruption within his government and family; but he remains identified with stability and order in the minds of many, if not most, Azerbaijanis. The prospect of his passing from the scene – he is in his late 70s and has undergone surgery for prostate and heart problems – is viewed with dread.53

Azerbaijan recorded 11 percent growth in GDP in 2000, driven by high oil prices and growing Russian demand for Azerbaijani products, and 9.9 percent in 2001.54 The national currency, the manat, has remained stable for several years. High levels of foreign direct investment - $500 million USD in 2000, and approximately $700 million in 2001 – have been dominated by investments in developing oil and gas reserves, and associated transportation infrastructure.

As a result of a series of privatization drives by the government, in 1995, 2000 and 2001, the private sector’s share of GDP has increased from 29 percent in 1994 to 68 percent in 2000.55 Azerbaijan has not pressed its privatization programs as far as have

53 News that Aliyev had suffered some kind of health emergency in January 1999 – the President was sent to a Turkish military hospital in Ankara via air ambulance for 2 weeks – led to panic buying of food and other supplies in Baku.
Armenia and Georgia. The government appears to desire to avoid potentially destabilizing reforms in the short- to medium-term, which is to say the privatization of large enterprises which might lead to the unemployment of tens of thousands of urban workers, in the hopes that large oil revenues expected after 2005 will enable the state to maintain a generous cushion for unemployed workers. This plan is an understandable reaction to Azerbaijan’s recent history – large urban mobs made up of unemployed workers and Azerbaijani refugees from Armenia overthrew one Azerbaijani government and were also implicated in bloody urban riots in 1990 – but almost certainly overstates the size of the revenues which Azerbaijan can expect to receive, as well as distorting the timing of their arrival; most of Azerbaijan’s oil revenues will accrue after 2010 when the investments made by western firms between 1994 and 2004 have been paid off.

The energy sector dominates the Azerbaijani economy. Crude oil and refined products accounted for 85 percent of Azerbaijani exports in 2000 and more than 90 percent in the first half of 2001. Agriculture is the next largest sector, producing 18.1 percent of GDP in 2000 and employing 35 percent of the labor force. Agriculture exports showed surprisingly strong growth in 2000/2001.

In late 2000 the Azerbaijani government created the State Oil Fund (SOFAZ) as a way of stabilizing macroeconomic development by acting as a cash reserve against fluctuations in the price of oil, and a way of channeling oil revenues into other sectors of the economy, including infrastructure development and social programs. The fund, with assets of approximately $627 million USD in the third quarter of 2002, receives all oil bonus payments as well as a selection of other oil and gas revenues. The fund charter sets forth clear management guidelines intended to increase transparency in how Fund resources are used, and also mandates that the Fund be audited regularly by outside firms.

**OBSTACLES TO REFORM**

**Corruption**

The chief obstacles to reform in Azerbaijan are essentially those which also hamper further development in Georgia and Armenia. First among these is widespread corruption, which runs the full gamut from the sale of appointments up to the cabinet level to petty corruption by low-level police officers and other government functionaries. Government policy-making is extremely opaque, and unexpected declarations of new fees and regulations are not uncommon, while predatory taxation cripples the growth of small and medium sized enterprises; successful business owners often prefer to invest profits in several small businesses in hopes of avoiding catching the attention of tax inspectors or other government officials, or invest in the shadow economy. Cartels and

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56 Transition: The First Ten Years, p.14 (figure 2.1).
57 Ibid., p.8.
59 Transition: The First Ten Years, p.31 fn.2
private interests often seek to use state power to protect and enforce monopolies in various sectors of the economy.\(^6\)

**Impediments to Trade**

Azerbaijan suffers from several characteristics which hamper the growth of trade within the region as well as internationally. These include arbitrary and corrupt tax and customs administration, a weak and compromised judicial system, and endemic corruption at all levels of government. Transportation and cargo handling infrastructure – roads, rail and port facilities – are generally in poor condition. Turkey and Russia are Azerbaijan’s major trading partners, while the value of trade with Iran fluctuates considerably from year to year.

Since the outbreak of war in Nagorno-Karabakh, Azerbaijan has imposed an embargo on trade with Armenia which has ended oil and gas exports to that country while also terminating rail service. Peace talks aimed at achieving a mutually acceptable settlement of the conflict have thus far failed to produce any significant results, and the Azeri-Turkish sanctions on Armenia seem likely to be maintained well into the future.

**War**

Azerbaijan paid a high cost for the war in Karabakh and and continues to suffer from the unresolved status of the conflict. Azerbaijani military spending, although technically a state secret, has been reasonably restrained – indeed, criticism of the government’s allegedly lackadaisical approach to building up the military has been a constant refrain of one of the more credible opposition parties, the National Independence Party led by Etibar Mamedov – although this is in part a product of the ceasefire which ended combat operations in the spring of 1994. Azerbaijan’s territorial losses were extensive, amounting to approximately 20 percent of the national territory including several major cities (Agdam and Stepanakaert/Xankendi) and some of the richest farmland in the country. Associated civil disruptions in Baku, Sumgait, and Ganje (formerly Kirovabad) led to the mass flight of most of the Armenian population and considerable disruption of commerce and administration in those areas.

An associated cost of war has been the maintenance of the enormous population of refugees and internally displaced persons (IDPs) from Karabakh and Armenia, totalling perhaps 940,000 persons. While a significant fraction of the cost of supporting these people has been born by international aid organizations, the Azerbaijani government provides them with a variety of social assistance payments as well as arranging for access to local services such as education and especially electricity; the lost revenues which would otherwise have been provided by the refugees had they been able to stay in their homes is also significant.

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\(^6\) Countries which enjoy significant deposits of high-value natural resources, like Azerbaijan, are particularly vulnerable to state capture by interests associated with the extraction and shipment of these resources. *Anticorruption in Transition*, p.xx.
As in Armenia, prosecution of the war in Azerbaijan led the state to strike a number of deals with special interests between 1991 and the 1994 ceasefire in order to secure munitions, manpower, and other vital supplies. These deals not only represented the diversion of significant revenues from government accounts without any controls, but also led in some cases to the entrenchment of special status for a number of individuals and organizations. While the political transition Azerbaijan underwent in 1993 from the Elcibey regime to that of President Aliyev caused some of these arrangements to be unraveled, networks of patronage and influence established during wartime remain in being.

Weak State Capacity

Azerbaijani public administration is marked by disorganization, weak management, and a lack of transparency (both with regard to other bureaucracies as well as to the private sector and the general public), as well as frequent allegations of corruption, particularly with regard to the administration of justice and the assessment and collection of taxes and fees. While legislation has been passed aimed at remedying some of these problems, the extent to which the new rules will be implemented effectively remains open to question.

POSSIBLE SOLUTIONS

Controlling Corruption

Bringing corruption under control will be critically important for Azerbaijan’s future, both in terms of the development of domestic industry but also for Azerbaijan’s development as a transit state for Central Asian trade with Europe. Tackling the intertwined networks of corrupt officials, businessmen, and bureaucrats in Azerbaijan will be difficult, especially with the upcoming presidential elections in 2003, and the associated political infighting.

Augmenting State Capacity

Azerbaijan must be able to compete with Russian and Iranian ports and facilities on an equal basis; the management skills and planning capabilities of the relevant Azerbaijani enterprises – the port of Baku, the government-controlled shipping line, and to a lesser extent the state railway – could be greatly improved.

The creation of business groups and NGOs to collect and disseminate information about new government rules and regulations to group members and the public would help to break down the monopolization and compartmentalization of information which hampers business activity and increases the scope for extortion by corrupt officials. Given the highly centralized nature of Azerbaijan’s presidential republic, a particularly useful innovation would be the creation of an Investor’s Council, which would provide foreign investors with direct access to the President at regular intervals to discuss
problems and issues affecting the business climate. Similar institutions have proven effective in Kazakhstan.

The same is true of the government’s planning and staff capabilities in general. As is the case in Georgia, the government has significant difficulties in attracting and keeping skilled personnel with a sophisticated understanding of the markets and industries critical to Azerbaijan’s future; the problem is even more pronounced in Azerbaijan than it is in Georgia, given the presence of a relatively large number of international firms drawn by the prospect of business in the Azerbaijani oil sector.

The lack of good advice has a direct impact on the ability of the government to plan the use of oil revenues in an effective manner. International advice (and pressure) was an important influence in the creation of the Azerbaijani oil fund; additional efforts need to be made, along with an effort to improve the overall competence and calibre of the upper reaches of the administration.

While administrative competence is a critical skill for any state, the stakes for Azerbaijan are particularly time-sensitive; Azerbaijan needs to succeed in establishing a critical mass of competence in public administration and management before major oil revenues begin to accrue to the national budget. Large oil assets have more often proven a curse rather than a blessing to less developed countries; if properly managed, Azerbaijan’s oil and gas reserves may provide the capital inputs needed to drive not only Azerbaijan’s development but that of Georgia as well.

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