

Economic Transition Report on Azerbaijan:

An Issue of Governance

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Introduction

The Republic of Azerbaijan is one of several transition economies trying to systematically move from a centrally planned economy to a market economy. Azerbaijan has become more like a full-market economy in some areas, but poor public sector institutions and corrupt governance have hindered its transition and lead to uneven and inconsistent growth. This report will first outline the initial conditions in Azerbaijan at the outset of transition, including a brief overview of its transition history. Then it will discuss the successes and failures of implementing the European Bank of Reconstruction and Development's (EBRD) transition measures, especially in comparison to other regional transition economies, and examine what factors affected these measures. Finally, it will analyze the impact these measures have had on overall growth and consider the changes Azerbaijan must make to transition fully.

The larger purpose of this report is twofold. First, this report will build upon EBRD data to further contextualize the Azerbaijan's transition. Though the EBRD provides extensive and useful data on transition economies, it does not always integrate information from other sources, such as the World Bank and Freedom House, into its assessments. Thus EBRD reports are sometimes lacking in context. By using data from several sources, this report will help provide a more complete picture of the economic transition in Azerbaijan and the challenges the country faces. Second, this report will contribute to a fuller understanding of effective transition policies. The fall of the Soviet Union marked the first time that a group of governments consciously changed their national economic model. This has been a massive undertaking and sparked new fields of economic and international policy study. Not only did established international institutions, such as the International Monetary Fund (IMF) and the World Bank, create specialized programs to aid these transition economies, but a new multilateral development bank, the EBRD, was created to deal specifically with these countries. Many of the initial transition economies are still transitioning, and many new, non-post-Soviet countries, such as countries in the

Middle East or Southeast Asia, have been added to this category. The challenges that Azerbaijan faces represent challenges that all transition economies face. Understanding the successes and failures of countries like Azerbaijan is key to creating more effective transitional policies for countries in the future.

Initial Conditions

Understanding the initial conditions in Azerbaijan is essential to understanding its transition progress. The Republic of Azerbaijan is a lower-middle income nation that shares borders with Georgia, Armenia, Russia, Iran, and the Caspian Sea; it is the largest country in the Caucasus region. It was incorporated into the Soviet Union in 1920 and regained independence in 1991. Small Soviet republics like Azerbaijan suffered the most after the dissolution of the Soviet Union. Azerbaijan was particularly dependent on Russia. It was used in a chain of production that focused on specific processes in manufacturing goods for the entire Soviet Union. When the Soviet Union collapsed Azerbaijan found itself with large industrial capabilities for specific types of manufacturing; the newly independent nation did not have the demand to meet its production capabilities and over-industrialization and outdated machinery made it difficult for the country to diversify and modernize production techniques. Additionally, in 1988, conflict erupted in southwest Azerbaijan between Armenian secessionists and Azerbaijani troops. From 1988 to 1994, while trying to manage the rapid demise of the USSR and subsequently develop its own economy and government, the country was also fighting a war. By 1994 Azerbaijan had lost money, lives, and 20% of its prewar territory to Armenia in the Nagorno-Karabakh War. The Azerbaijani government estimates that damage from the war had cost the country \$87 billion (BBC 2012; Baku Bureau, 2010; Laurila, 2001). Factors such as these lead the EBRD to conclude in 1999 that Azerbaijan was among the transition economies most impacted by “historical legacies” (EBRD, 1999). Azerbaijan began transition from a difficult position.

Transition Failures and Successes

The EBRD assesses transition based on six areas: large scale privatization, small scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign exchange system, and competition policy (EBRD, 2013b)¹. The bank uses other indicators as well to survey transition economies, but these areas are used to determine a country's overall transition score. A country is scored on a scale of 1 to 4; a 4 indicates that the country operates like a modern, market economy, while a 1 indicates that no reforms have been made. This report focuses on these areas because the EBRD has been tracking data for these measurements since 1989, so there is consistent and reliable data on which to base analysis. In this report Azerbaijan is evaluated individually and in comparison to other transition economies. Most commonly, this report compares Azerbaijan to the countries in the Commonwealth of Independent States (CIS), of which Azerbaijan is a member. This is a common grouping in transition economics literature because all of the CIS states were former Soviet Union members, are geographically near one another, and have had relatively similar transition paths (Turley & Luke, 2011). Therefore comparisons to other CIS countries reveal which problems and achievements are unique to Azerbaijan. Countries in the CIS include: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, and Uzbekistan. Turkmenistan and Ukraine are participating states, not full members, but are included in economic comparisons.

Privatization

Considering its initial conditions, Azerbaijan has achieved substantial success in several EBRD transition categories, but large scale privatization is not one of them. Large scale privatization has been particularly slow in Azerbaijan and lags behind other CIS countries (Table 1). Though large scale privatization is expected to take longer than other reforms, Azerbaijan has made no progress since 2001; from 2001-2012 the EBRD gave Azerbaijan a 2 in large scale privatization (Figure 1). Azerbaijan has

¹ See EBRD's "Transition Indicators Methodology" (2010) for further explanation on the EBRD's scoring system

the third lowest score in this category among CIS countries. Only, Belarus and Turkmenistan, two of the three non-reforming CIS countries, score lower, and Uzbekistan, the remaining non-reforming CIS country, scores substantially higher.

Small scale privatization has been much more successful. Here, Azerbaijan has a higher score than the CIS average (Table 1). These scores reinforce theories that small scale privatization is easier to implement than large scale privatization. Low levels of privatization were often sanctioned in Soviet economies, and Azerbaijan's pre-transition (1989) private share of the GDP was 10%, higher than the CIS average. Thus it was easier to build from this modest foundation of small-scale privatization. Additionally, small-scale privatization is less controversial because it involves fewer parties, less coordination, and smaller sums of money (Turley & Luke, 2011). However, small scale privatization has also stalled in the last few years, much like its larger counterpart; Azerbaijan has received a 3.7 in this category since 2002 (Figure 1). Despite this stall in privatization, the Azerbaijani private sector contributes a greater share of the national GDP than the private sector in the average CIS country (Figure 2).

Privatization, particularly large-scale privatization, is widely regarded as the key element in a successful economic transition. Private ownership is the foundation of capitalist economies. If a country fails to successfully implement widespread privatization, it is difficult to consider it a market economy. Though Azerbaijan showed initial initiative to privatize, this has stalled and there has been no improvement in this area for several years. Azerbaijan's failure in this arena contributes to a cycle of other governmental and economic issues. It encourages rent-seeking and stunts the development of new industries. One possible explanation of Azerbaijan's stalled privatization is that the country suffers from underdeveloped financial and capital markets. The EBRD has long suggested that the major state-owned bank, be privatized to bolster the banking sector and dismantle to system of state-based lending (2013a).

As can be seen from this example, low privatization is a self-reinforcing problem: the failure to privatize the national bank has led to low levels of privatization. The Azerbaijani government has also stalled on implementing further privatization reforms, and many lucrative sectors have been kept in government hands.

Governance and Enterprise

The government has been a barrier to transition in several ways. Governance and enterprise restructuring has not transitioned successfully in Azerbaijan. The EBRD has given Azerbaijan a score around 2 in governance and enterprise since 1995, and the government has shown few signs of reform or improvement (Figure 1). Azerbaijan has an extremely corrupt government. The World Bank Corruption Index gave Azerbaijan a score of -1.07 in 2012, the fourth lowest score among the CIS countries; Azerbaijan ranks only above the three non-reforming CIS countries (World Bank Group, 2013). Azerbaijani government officials rampantly abuse public power for private gain. The government overextends its powers on all levels and this has several negative effects on its economic transition. In the upper levels of government, insiders use their connections to make advantageous business deals and withhold lucrative industries from privatization. This rent-seeking is pervasive even at the highest level of government. In fact in 2012 a corruption watchdog, the Organized Crime and Corruption Reporting Project, named the Azerbaijani president, Ilham Aliyev, Corruption's "Person of the Year" for his secret ownership stakes in many of the country's largest businesses (Organized Crime and Corruption Reporting Project, 2012). Although the Azerbaijani private sector represents a high share of GDP compared to other CIS countries (Figure 2), the fact that the EBRD score for both small and large privatization has not changed for over a decade indicates the government is stalling further privatization. While this benefits enterprising government officials, it is slowing Azerbaijan's progress towards a market economy. In the lower levels of government, officials use Azerbaijan's complex bureaucracy for

personal gain. The government has so many restrictions, forms, and fines that officials often fine or blackmail firms under threat of legal action for personal gain. For example, a business must wait an average of 241 days and go through nine different procedures in order to obtain electricity (World Bank Group, 2014). This long procedure provides ample opportunity for state and utility employees to exploit the process and collect bribes in exchange for expediting the process. Such an environment discourages firms from starting-up or growing both because it is difficult to compete with government-run enterprises, monopolies, and oligopolies and because non-government firms face intimidating bureaucratic hurdles.

Azerbaijanis also lack modern political rights. Azerbaijan is considered one of the more authoritarian post-Soviet states, though it should be mentioned that its political freedoms are normal for CIS countries. Like many authoritarian states, Azerbaijan has been ruled by the same family for over 20 years. Since a 1993 military coup, the country has been run by Heydar Aliyev and then by his son, Ilham Aliyev. In 2009 Ilham removed the two-term limit on the presidency, allowing for his electoral victory in 2013 and a 15 year rule. Human Rights Watch noted in a 2013 report that the Azerbaijani government has severely restricted political expression and civil liberties since 2012. Observers note that the country recently experienced a dramatic decrease in political rights in lead up and aftermath of the 2013 elections (Human Rights Watch, 2013). Additionally, the 2013 elections were riddled with rigging accusations after the Central Election Commission released the election results via their mobile app a full day before the polls closed (Keating, 2013). The 2013 elections are just the most recent example of the country's long history of election problems. Problems with the presidential elections are complemented by corrupt parliament elections, though the fact that the Azerbaijani National Assembly only has nominal separation from the executive branch renders parliamentary elections largely pointless (Freedom House, 2013a). The country also has low Freedom House Scores, indicating people lack basic

political freedoms. Azerbaijan went from “Partially Free” in 1998-2003 to “Not Free” from 2004 onwards. Political freedoms in Azerbaijan have not improved in the 21st century as they need to for a successful transition. Azerbaijan’s political freedoms are generally in line with other CIS countries, most of which saw no improvement or a decline in their political freedoms in the 2000s (Table 2).

Government policies and political rights are critical to a stable economy. Azerbaijan’s rampant corruption is particularly damaging to economic progress. If highest official in the country encourages rent-seeking through his own actions, there is certainly abuse of public power in lower government levels. Corruption is encouraged through restricted political freedoms and fraudulent election processes. Azerbaijanis are unable to express dissent against government corruption (or any other government action) and they cannot rely on the election system to put better officials in office. There is a vicious cycle in Azerbaijan: corrupt officials rent-seek to gain more money and consolidate power, these officials use their political and economic power to limit political rights and obstruct the democratic process, these officials can then remain in office and the process begins again. Since the current officials are personally benefiting from the status quo, there is little reason for them to enact reforms. This is a key reason why many transition indicators have stalled, such as privatization. Further privatization will not benefit the people in power and, if popular opinion is stifled, there is no political motive to continue privatization. As was discussed earlier, without more widespread privatization it is difficult to consider Azerbaijan a market economy. Further, without a more transparent and democratic government, it is difficult to consider Azerbaijan part of the modern, liberal world.

Price Liberalization

In contrast to the failures in governance reform, price liberalization has been a success in the country. The EBRD has claimed that Azerbaijan functions like a full market economy in price liberalization. However, this is a relatively easy reform to institute because it simply involves lifting

price controls; this is evident in the high regional average for this indicator (Table 1). Additionally, the IMF had a strong role in implementing this policy change rapidly in the beginning of transition (Laurila, 2001). Unfortunately, price liberalization often brings inflation. When centrally planned economies abolished their price controls, prices shot up as GDP and national income declined. Like most transition economies, especially former Soviet Union economies, Azerbaijan experienced shocking highly inflation rates in the early and mid-1990s, reaching over 1000% in 1994. However, as the country developed its macroeconomic policy and stabilized prices, Azerbaijan had normal inflation increases. Azerbaijan has recently experienced large swings in inflation rates, but this is mainly due to the huge increase in oil prices and production and the subsequent stabilization of that production (Figure 3) (Adigozalov, 2009).

This is a key reform because it represents a fundamental shift away from a centrally planned economy. In centrally planned economies, prices reflected the decisions of government planners. Queues rather than prices were the primary rationing system. Price liberalization has been key in Azerbaijan and other transitioning economies for determining market demand and distributing goods and services more accurately.

Trade and Foreign Exchange Systems

Likewise, the trade and foreign exchange system is well-developed in Azerbaijan (Table 1). Although this reform is more difficult to implement than price liberalization, Azerbaijan must have considered it necessary. Once the traditional Soviet era trading partnerships dissolved, Azerbaijan was forced to look for other global trading partners. They needed markets for their main export, oil, and they needed to import the many goods that they could not produce with Soviet era infrastructure (Laurila, 2001). To accomplish this, Azerbaijan reduced trade restrictions. Additionally, Azerbaijan's oil wealth made it a popular destination for foreign money, and, if the Azerbaijani government wanted to profit

from this influx of foreign currency, the foreign exchange had to be opened as well. As was shown, several government officials have an immense personal stake in oil trade; this likely encouraged the government to expedite reforms in this area.

Despite its high rating from the EBRD, there are indications of problems within Azerbaijan's trade and foreign exchange systems. As can be seen in Figure 4, foreign direct investment (FDI) has been an important source of GDP growth for Azerbaijan. FDI spiked during the oil boom in the mid-2000s. It has since receded to much lower levels, closer to the regional average (Figure 4). This could indicate that, though Azerbaijan is ostensibly in favor of FDI, in practice it is only in favor of FDI for oil investment. Because Azerbaijan laws recognize the importance of FDI, the EBRD has given it a high score in this region. However, as the U.S. Department of State points out in its Investment Climate Statement on Azerbaijan, "the complex government bureaucracy, weak legal institutions, corruption and predatory behavior by politically-connected elites continues to hinder investment outside of the energy sector" (U.S. Department of State Bureau of Economic and Business Affairs, 2013). This could be why FDI fell as oil production fell; Azerbaijan does not encourage investment in other sectors of the economy. Additionally, Azerbaijan's trade (as a percent of GDP) reflects roughly the same pattern as its FDI: very high in the mid-2000s and much lower after 2006 (Figure 5). In fact, from 2008-2013 Azerbaijan's trade levels were lower than the CIS average.

This problem can be largely contributed to bad and corrupt governance and enterprise. Many government officials have high personal stakes in the oil industry and are thus unlikely to encourage investment and trade in other areas. Additionally, investors who wish to invest in other sectors are discouraged by the large and complicated bureaucracy they must navigate to do so. Implementing an open trade and foreign exchange system in practice, not just in law, is key to integrating transitioning

economies into the modern global economy. Though Azerbaijan has the legal foundation for these systems, it has failed to apply it.

Competition Policy

Competition policy reform lags in Azerbaijan, but this is not unusual. In all transition economies, the competition policy score trails behind the average transition indicator score. The EBRD offers several reasons why this happens in many states. First, competition policy enforcement requires an enforcement agency. Since this agency is new it will have to engage in power struggles with other types of regulators (telecommunications, energy, etc.) who may try to protect their industry from new regulators. Second, since competition law enforcers are trained quickly in an effort to catch up, they often apply the law “creatively” and ineffectively. Finally, many countries have a political culture where government regulators are seen as political instruments that can be used to enact political ends rather than protecting competition in a way that is best for the economy (Petersen & Kjetil, 2013).

However, though all transition economies tend to lag in this area, Azerbaijan has performed particularly poorly. Regionally, it scores better than only Turkmenistan. Again, this problem is likely caused by government corruption. In the higher government levels, policymakers have private interests in certain sectors and thus want to prevent competition in those sectors. On lower levels it is likely easy to bribe and sway competition policy officials in fledgling competition regulation agencies in a government environment that does not value competition.

Strong competition policy is key to preventing monopolies and oligarchies and encouraging diverse business development. Because it lags in this category, Azerbaijan struggles to diversify its economy, a problem that the EBRD believes could lead to a large economic decline after oil production slows in the near future (EBRD, 2013a).

Impact on Economic Growth

Though observing individual transition factors is important, it is equally important to analyze the broader picture. The simplest way to do this is through the GDP. Azerbaijan's GDP experienced painful decreases after the fall communism. The country had negative GDP growth for six years (from 1990-1995), and did not see significant growth until 1997. Azerbaijan's GDP also experienced more extreme swings than most CIS countries; the Azerbaijani GDP dipped lower in the mid-1990s and swung higher in the mid-2000s than any other country in its region. In fact, Azerbaijan's growth rate in 2006, 34.5%, was the world's highest (Figure 6). Azerbaijan is a major oil exporter and high oil prices certainly contributed to this high growth rate, but the other major oil exporters in the CIS saw much more modest growth rate increases during this time. Azerbaijan's relatively open system of trade and foreign exchange likely boosted the GDP growth above that of other oil producers. Recently growth has slowed significantly in Azerbaijan; in 2012 the GDP growth rate was 2.2%. Though this increased to 5.8 in 2013, the International Monetary Fund predicts that growth rates will fall in the coming years (2013a).

Azerbaijan has experienced exponential growth in the past decade, and this growth is caused both by high oil prices and expanded oil production. The government has helped to expand the non-oil private sector with some of this money, but growth in this sector is not sufficient. Even if the government pours money into the non-oil private sector, there will likely not be substantial change in Azerbaijan's level of privatization unless the banking and finance sector is developed and governmental corruption decreases. The government needs to continue to improve the business environment and relinquish non-essential public holdings to the private sector, but this remains unlikely considering the current levels of entrenched government corruption

Though Azerbaijan's economy has expanded substantially from oil production, the growth is not distributed evenly. Wealthy insiders profit disproportionately from the economic growth and inequality

in the country has likely increased. Gini index data supports this assertion. Though Gini index information has not been consistently reported for the last several years, it appears that inequality has increased. Between 2002 and 2005 the Gini index ranged in Azerbaijan between 16 and 19, but by 2008 the index had nearly double to 33 (in the Gini index total income equality = 0) (The World Bank Databank, 2013c). Because Azerbaijanis have insufficient political rights, there are few viable ways for citizens to protest or fix this increasing inequality. Additionally, the economically elite mainly reside in Baku, and thus the capital has been developed much more than other areas of the country (EBRD, 2013a). Government officials have clearly not prioritized expanding public sector or private sector services beyond Baku. These priorities are unlikely to change as long as political freedoms are repressed in the country and marginalized populations lack a political outlet.

Azerbaijan still has a lot of progress to make in its transition to a market economy. Unfortunately many of the necessary changes hinge upon uncorrupting the government and liberalizing the political process. The fraudulent elections in 2013 and its unchanging Freedom House scores (Table 2) indicate that the government does not intend to make any liberalizing political changes in the near future. Further, remedying entrenched corruption in a political system is a difficult process that often requires radical or revolutionary change. However, there are changes that Azerbaijan can enact more easily to progress its transition. For example, the government should begin more stringently enforcing the foreign investment policy it has codified. Azerbaijan already has laws that allow for foreign investment, but ensuring these laws are practiced beyond the oil industry will increase FDI and diversify the economy. Additionally, the government should expand social and financial infrastructure development beyond Baku. The government has begun to extend more services beyond Baku (EBRD, 2013a), but there is still more progress to be made, especially in regards to expanding financial and banking services. This will

positively impact inequality by increasing access to wealth and aid in diversifying the economy by providing capital to new people and regions.

Conclusion

Regrettably even these minor changes to policy could easily be hindered by government corruption. As long as influential government officials have interests in focusing the economy on certain industries and public bureaucracies remain convoluted and easily manipulated, it will be difficult to enact any changes that alter the status quo. Thus, though Azerbaijan has made some promising progress towards a market economy, its government is standing in the way. Azerbaijan exemplifies how bad governance can hinder several aspects of transition. It is crucial that governance and enterprise reform are treated as an imperative, if not the essential, aspect of the transition process in all countries.

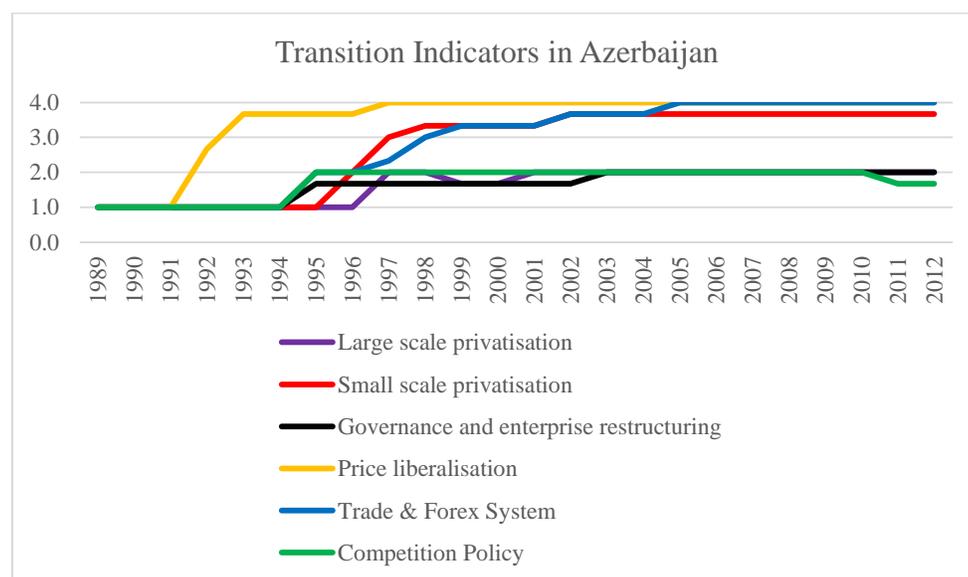
Table 1

EBRD Transition Indicators for CIS Countries

	Armenia	Azerbaijan	Belarus	Kazakhstan	Moldova	Russia	Tajikstan	Turkmenistan	Ukraine	Uzbekistan	CIS Average
Large scale privatization	3.7	2.0	1.7	3.0	3.0	3.0	2.3	1.0	3.0	2.7	2.5
Small scale privatization	4.0	3.7	2.3	4.0	4.0	4.0	4.0	2.3	4.0	3.3	3.6
Governance and enterprise restructuring	2.3	2.0	1.7	2.0	2.0	2.3	2.0	1.0	2.3	1.7	1.9
Price liberalization	4.0	4.0	3.0	3.7	4.0	4.0	4.0	3.0	4.0	2.7	3.6
Trade & Forex system	4.3	4.0	2.3	3.7	4.3	4.0	3.3	2.3	4.0	1.7	3.4
Competition Policy	2.3	1.7	2.0	2.0	2.3	2.7	1.7	1.0	2.3	1.7	2.0

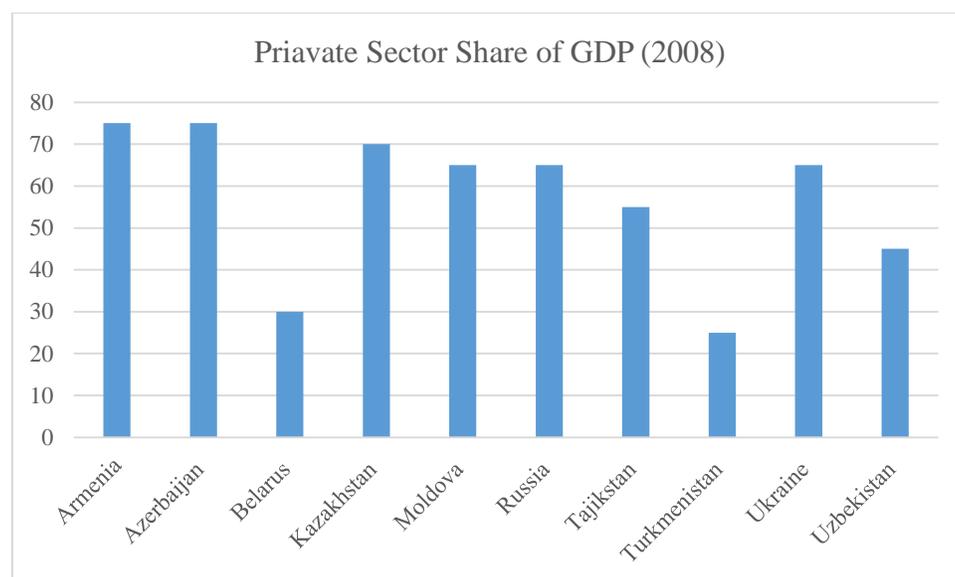
Source: EBRD, 2013b

Figure 1



Source: EBRD, 2013b

Figure 2



Source: Turley & Luke, 2011

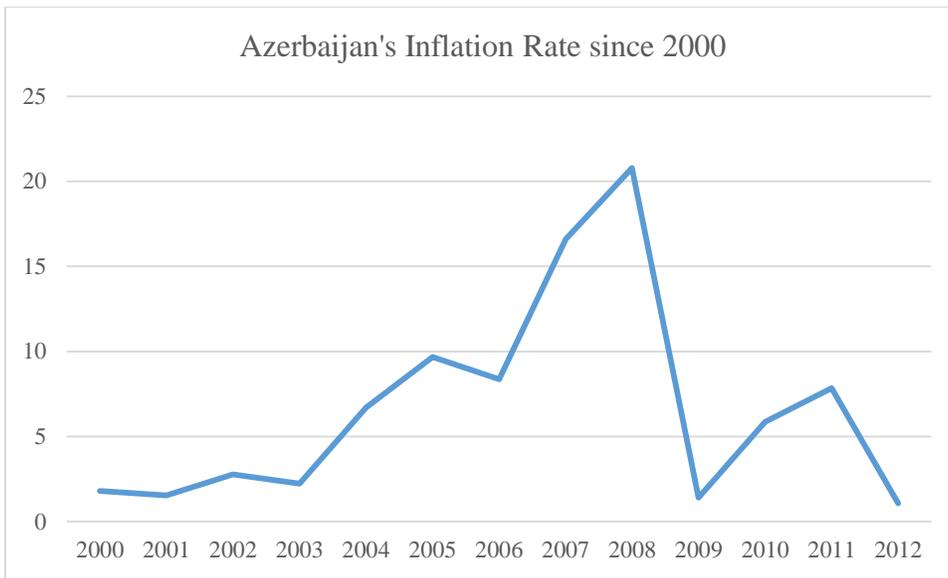
Table 2

Freedom House Freedom Ratings

	1998	1999	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Armenia	4	4	4	4	4	4	4.5	4.5	4.5	4.5	5	5	5	5	4.5
Azerbaijan	5.5	5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Belarus	6	6	6	6	6	6	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Kazakhstan	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Moldova	..	3	3	3	3.5	3.5	3.5	3.5	3.5	3.5	4	3.5	3	3	3
Russia	..	4.5	5	5	5	5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Tajikistan	..	6	6	6	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	6
Turkmenistan	..	7	7	7	7	7	7	7	7	7	7	7	7	7	7
Ukraine	..	3.5	4	4	4	4	3.5	2.5	2.5	2.5	2.5	2.5	3	3.5	3.5
Uzbekistan	..	6.5	6.5	6.5	6.5	6.5	6.5	7	7	7	7	7	7	7	7
CIS Average	5.25	5.1	5.25	5.25	5.25	5.25	5.35	5.3	5.3	5.3	5.4	5.35	5.35	5.4	5.4

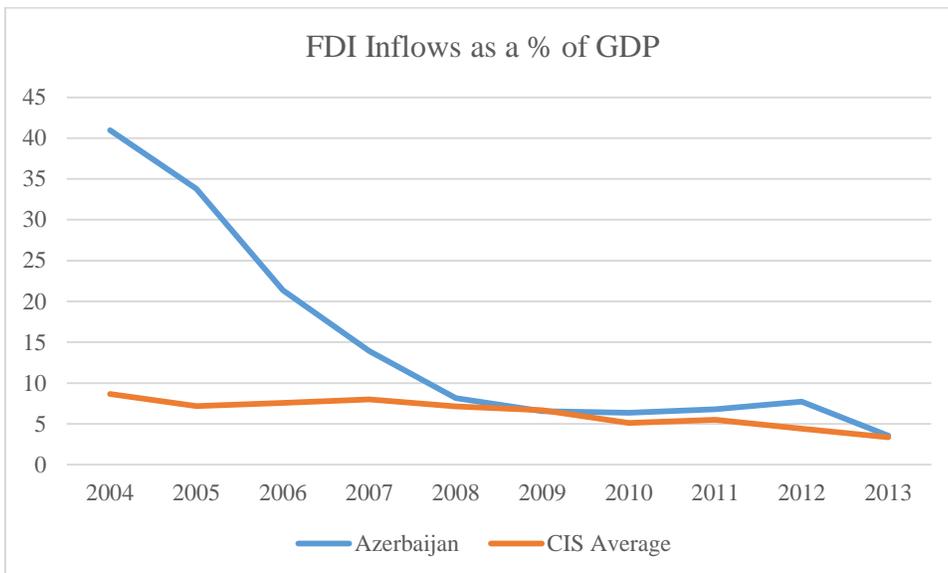
Source: Freedom House, 2013

Figure 3



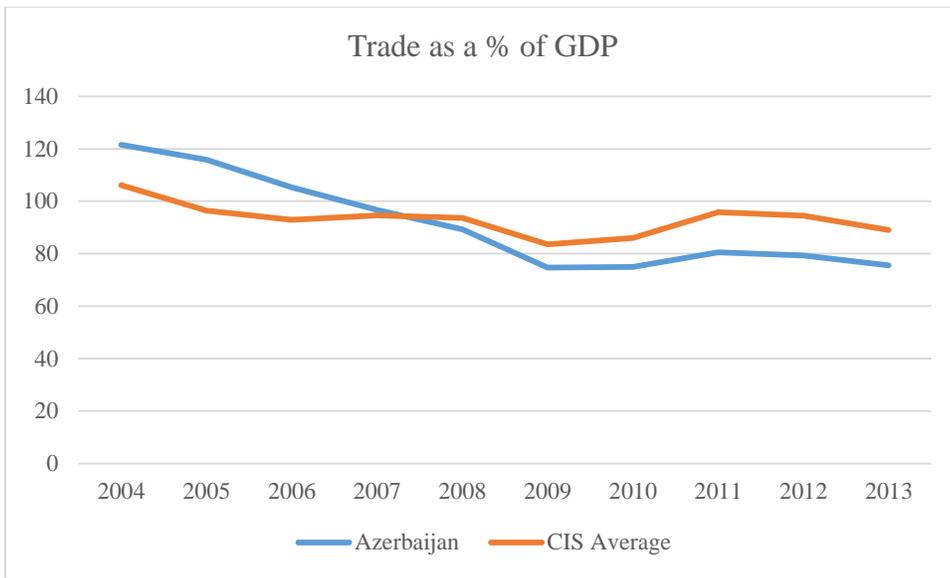
Source: The World Bank, World Development Indicators, 2013

Figure 4



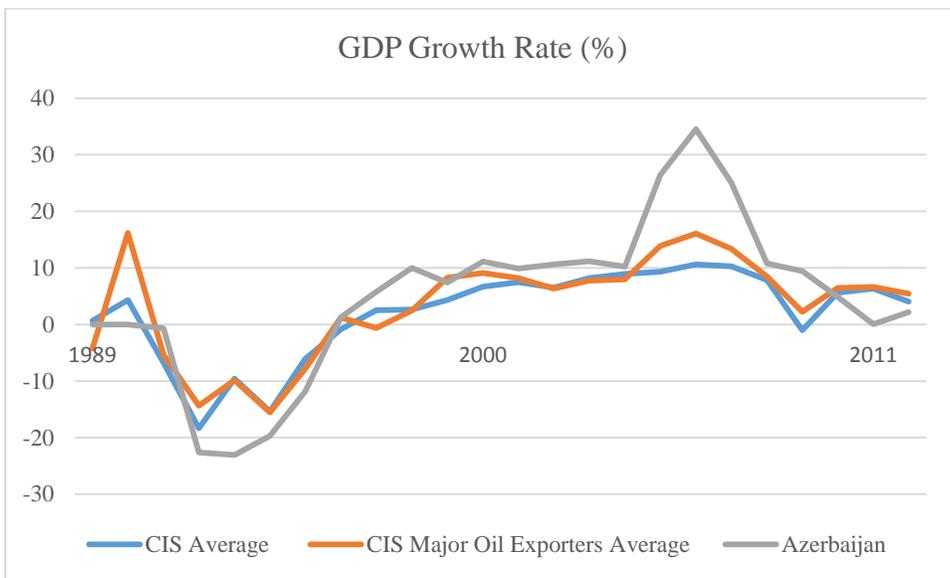
Source: The World Bank World Databank, 2013a

Figure 5



Source: The World Bank World Databank, 2013d

Figure 5



Source: The World Bank World Databank, 2013b

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