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# Informed Citizenry, Accountable Government and the Effective Management of Oil Resources



**LEYLA KARIMLI**

## **Informed Citizenry, Accountable Government and the Effective Management of Oil Resources**

### **ABSTRACT**

Attempts at fighting the “resource curse” across the globe have produced few successful results. Most countries affected by a resource curse are trapped in a vicious circle: a transparent and accountable government structure and a democratic political regime – which are necessary prerequisites for avoiding the resource curse - cannot be built precisely because of the resource curse effect. However, cases when the resource curse *has* been avoided (although considered exceptional by some scholars) do offer a certain optimism when one is searching for ways to avoid the curse.

This policy study addresses only one of the variables needing to be employed in the struggle against the resource curse in Azerbaijan, i.e. improved transparency and accountability in the use of oil resources. It suggests making a distinction between the concept of transparency and that related to inform public participation; and it also analyses methods via which to get direct public participation in the management of oil resources in Azerbaijan - as one of possible tools to ensure accountability and thus contribute to avoiding the resource curse.

Three policy alternatives for direct public participation - namely (i) dispensing oil revenues directly to citizens in the form of cash payments; (ii) fiscal decentralisation of the administering of oil resources (through municipalities), and (iii) public hearings - are analysed and evaluated against specific criteria. Results show, however, that none of these policy alternatives, if implemented within the current political, economic and social framework, will produce desirable results – so extensive reforms to see an improving of parliamentary oversight, developing municipalities and a building of social trust are vital for making any one of these alternatives feasible in Azerbaijan.

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The views contained inside remain solely those of the author who may be contacted at [karimli@policy.hu](mailto:karimli@policy.hu). For a fuller account of this policy research project, please visit <http://www.policy.hu/karimli/>.

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*Abundant natural resources can and should be a blessing - not a curse. We know what must be done. What is missing is the political will to make it so.*

Jozef Stiglitz, "The Resource Curse Revisited"

*Azerbaijan's oil and gas resources belong to the people of Azerbaijan. The population has a right to know how much money Azerbaijan is earning, and to be reassured that revenues are being properly safeguarded.*

Laurie Bristow, UK Ambassador in Azerbaijan, in an interview with the Turan News Agency

## INTRODUCTION

This policy study has been developed within the framework of the International Policy Fellowship program. It aims at suggesting policy options for direct public participation in the management of oil resources in Azerbaijan, thus contributing to policy dialogue around issues of transparency and accountability in the use of oil resources in the country.

Azerbaijan's economy is becoming increasingly dependent on oil, as illustrated by "resource dependence indicators". Economic growth, although impressive within the last ten years, does not apply to the non-oil sector. A large number of people still live below the poverty line. Inequality, as illustrated by GINI coefficient, increased from 0.3 in 1989-90 to 0.5 in 2000<sup>1</sup>, reflecting a widening inequality among geographic areas and various social strata. The country has the smallest per capita health expenditure and the highest child mortality rate among former Soviet Union countries<sup>2</sup>. In addition, the country has no strategic plan on how to use oil money to promote sustainable long-term growth<sup>3</sup>. All these are "resource curse" symptoms<sup>4</sup>.

A resource curse refers to an inverse relationship between high natural resource dependence and economic growth rates<sup>5</sup>. Although, in the early 60's, scholars pointed to a direct relationship between resource abundance and economic development, empirical evidence discards such a hypothesis: the per capita incomes of resource-poor countries grew three times faster than those of resource-rich countries between 1960 and 1990<sup>6</sup>; per capita GNP in OPEC members decreased by 1.3% per year, whereas non-oil developing countries experienced an average 2.2% annual *growth* for the period 1965 to 1998<sup>7</sup>. This and other data<sup>8</sup>

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1 UNICEF Innocenti Research Center (2003), Social Monitor 2003. Florence: UNICEF, p.93

2 <http://www3.who.int/whosis/country/compare.cfm?country=AZE&indicator=PcTotEOHInIntD&language=english>

3 Joshua Kucera, "Irrational exuberance around Caspian energy", Eurasianet, 25/09/06

4 For more details on the harmful effects of the resource curse, see Michael Ross, "Extractive Sectors and the Poor" Oxfam America Report 2001, Michael Ross, "The Political Economy of the Resource Curse" World Politics 51 (January 1999), 297-322, Michael Ross, "Does Oil Hinder Democracy", World Politics 53 (April 2001), 325-61, Terry Lynn Karl, "Understanding the Resource Curse" in Covering Oil: A Reporter's Guide to Energy and Development, published by Revenue Watch, Open Society Institute and Initiative for Policy Dialogue, 2005

5 Early theories on the relationship between extractive industries and economic growth are described in Extractive Sectors and the Poor, an Oxfam America Report by Michael Ross, 2001.

6 Andrew Rosser, "Why did Indonesia Overcome the Resource Curse?", IDS working papers, March 2004, p. 1

7 Terry Lynn Karl, "Understanding the Resource Curse"

illustrates that resource abundance does not *per se* lead to economic growth. Indeed, natural resource dependence may actually *impede* economic growth; it can also result in increased inequalities, decreasing child welfare, and a greater vulnerability to economic and political setbacks and upheavals.

Although limitations due to data availability do not allow any testing of the relationship between poverty and oil-dependence in Azerbaijan<sup>9</sup>, the above-mentioned symptoms, together with empirical evidence gained from other countries, are alarming.

To explain the “resource curse” paradigm, economists refer to three main factors, namely (i) international price volatility, which has a negative effect on state budgetary planning and foreign investments; (ii) the “enclave” nature of natural resources, with there being very weak links between the hydrocarbon sector and the rest of the economy; and (iii) and a high risk of the “Dutch disease” occurring, i.e. where there is appreciation of the national currency’s real exchange rate, which damages other tradable sectors of economy. Political scientists point to the negative impact of resource richness on the governance system. Causal mechanisms of this effect are explained via a “rentier effect”, when governments use low taxation and patronage to relieve pressures on them to be accountable, the “repression effect”, which refers to a government’s increases in military spending, and a “modernisation effect”, which prevents oil-rich countries from making the social and cultural changes necessary so as to build democracy<sup>10</sup>.

This policy study will argue that a “resource curse” is not inevitable if we take a look at the experiences of some resource-rich countries that have been relatively successful in avoiding such a curse through macroeconomic policies, economic diversification, the creation of natural resource funds, transparency and accountability, and also in the direct distribution of wealth.

Before going into further detail, it will be acknowledged that attempts to fight the resource curse in several countries have given few positive results (e.g. in Indonesia, Chile and Botswana). The unconvincing outcomes of these attempts can be explained by the fact that all interventions to combat the resource curse presuppose a transparent and accountable government structure and a democratic political regime - which are not present in the majority of developing countries. Although robust political institutions are a necessary prerequisite for avoiding a resource curse, they cannot be built into resource-rich countries precisely due to the resource curse effect. A vicious circle - where “*oil rents reinforce authoritarian regimes and thus*

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8 Michael Ross, “Extractive Sectors and the Poor”, Oxfam America 2001

9 The HDI ranking is available for two years only; poverty assessments based on HBS were introduced only in 2001. In addition, the massive inflow of oil money into Azerbaijan’s economy began only in 2005

11 Michael Ross, “Does Oil Hinder Democracy?”, *World Politics*, 53 (April 2001), 325-61

*prevent political changes*” -has been seen by many scholars<sup>11</sup>. However, cases when resource curse was avoided (although perhaps exceptions) do offer an optimism when seeking ways to deal with the issue.

It will also be mentioned that the pool of studies related to transparency and accountability in the managing of oil resources is small; there seems to be no empirical evidence showing that the transparent and accountable management of oil resources can help one avoid such a curse. Nevertheless, one needs to note that transparency and accountability, as indicators of civil liberties, *do* have a positive effect on the performance of a government’s investment projects<sup>12</sup>.

As said, this study addresses only one of the variables that one might make use of in the struggle against a “resource curse” in Azerbaijan - improved transparency and accountability in oil wealth management. The argument is that analytical methods related to direct public participation in the managing of oil resources could be one tool with which to ensure accountability.

The purpose of this study is not to single out a policy option and develop recommendations for its implementation - instead, it aims at providing a framework for informed discussions via a thorough and comprehensive consultation process.

The paper is organised into three main sections. Section I examines the risks associated with the “resource curse” in Azerbaijan - and outlines some of the challenges related to direct public participation in the management of the country’s oil resources. Section II identifies policy alternatives pointing to direct public participation in the managing of oil resources; and Section III lays down criteria via which to evaluate these alternatives, projects outcomes for each alternative, and provides a comparative analysis of such outcomes against selected criteria. It concludes by giving brief recommendations concerning further research work that is needed in connection with the subject.

## 1 PROBLEM DESCRIPTION

Azerbaijan may fall victim to the “resource curse” if a complex set of measures are *not* taken by both domestic actors and international players. The country can be identified by having heavy dependence on oil, high inequality and poverty rates, low human development indicators, a significant level of corruption and a very centralised decision-making system. As said, even though the limitations of data availability do not allow any testing of the actual

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<sup>11</sup> Joseph E. Stiglitz, Michael Ross (2001), Terry Lynn Karl (1997)

<sup>13</sup> Lant Pritchett, Daniel Kaufmann, “Civil Liberties, Democracy and the Performance of Government Projects”, *Finance & Development*, March 1998, p. 26 - 29

relationship between poverty and oil-dependence in Azerbaijan<sup>13</sup>, we can merely note that the above-mentioned symptoms along with evidence from other countries are causes for alarm.

In its attempt to tackle the issue, the government of Azerbaijan created the State Oil Fund and joined the Extract Industries Transparency Initiative (EITI). However, neither of these attempts to increase transparency and accountability in oil resources' management can be considered fully effective if there is no direct public participation in the system.

### ***Azerbaijan may face the danger of “resource curse”***

Azerbaijan's economy is becoming increasingly dependent on oil (as illustrated in “resource dependence indicators”) – for about 74% of FDI (foreign direct investment) is concentrated in the oil and gas sector<sup>14</sup>. The hydrocarbon sector produces half of the tax revenue, with one third of budget revenue coming from the State Oil Company of Azerbaijan (SOCAR). The oil sector's large share in trade is more than 85% of exports<sup>15</sup>.

Increases in inequality, a decline in growth and the deterioration of social welfare are seen as harmful effects of the resource curse – as mentioned above, inequality in Azerbaijan, as seen in the GINI coefficient, increased from 0.3 in 1989-90 to 0.5 in 2000<sup>16</sup>, reflecting a growing inequality among geographic areas and different social strata. Economic growth is notable, yet this does not apply to the non-oil sector; the average rate of GDP growth for the period 1995–2005 was approximately 13%, with real GDP growth in 2005 reaching 26%<sup>17</sup>. Yet the increased GDP growth in the oil sector has been accompanied by a notable decline in the non-oil sector<sup>18</sup>. About 42% of GDP<sup>19</sup> is concentrated in the hydrocarbon sector - which accounts for only 1% of employment! Thus, one cannot expect the oil sector to help lower the high unemployment rate in Azerbaijan (11% in 2003)<sup>20</sup> to any major degree.

In spite of the considerable amount of GDP growth, poverty remains in Azerbaijan. WB data puts Azerbaijan among those countries that, within the last 20 years, have fallen back from being MIC (middle income) to LIC (low income) status (and Azerbaijan has not yet managed to return to MIC status)<sup>21</sup>. The poverty assessment report of 2002 shows poverty levels that are as

<sup>13</sup> The HDI ranking is available for two years only; poverty assessments based on HBS were introduced only in 2001; while the great inflow of oil money into Azerbaijan's economy started only in 2005.

<sup>14</sup> EU/Azerbaijan Country Strategy Paper

<sup>15</sup> John Wakeman-Linn, Paul Mathieu and Bert van Selm, “Oil funds and revenue management in transition economies: the cases of Azerbaijan and Kazakhstan”

<sup>16</sup> UNICEF Innocenti Research Center (2003), Social Monitor 2003. Florence: UNICEF, p.93

<sup>17</sup> *Country Profile 2006*, Ministry of Economic Development. <http://www.economy.gov.az/>

<sup>18</sup> Rupinder Singh – Juhani Laurila, “Azerbaijan: Recent Economic Developments and Policy Issues in the Sustainability of Growth”, 1999 <http://www.bof.fi/bofit/eng/6dp/abs/pdf/dp0599.pdf>

<sup>19</sup> Asian Development Outlook, <http://www.adb.org/documents/books/ado/2006/aze.asp>

<sup>20</sup> Unemployment data shows significant discrepancies. The State Employment Services has reported an unemployment rate of 1.2%. The SPPRED document refers to census data from 1999, and provides a non-registered unemployment rate.

<sup>21</sup> Achieving the Millennium Development Goals: the Middle-Income Countries, a strategy for DFID: 2005-2008, p. 5



high as 47%<sup>22</sup>. The latest government report says that poverty has gone down to 27% in less than 2 years, however; though such a drastic change in poverty levels might be perceived as contentious - and, indeed, official statistics are being contested both inside the country and by the international community.

In the Human Development Index Azerbaijan is in 101<sup>st</sup> place; here, there is the smallest per capita health expenditure and the highest child mortality rate among former Soviet Union countries<sup>23</sup>. Child mortality and infant mortality rates for the period 1991–2000 were estimated to be as high as 92/1,000 and 81/1,000<sup>24</sup>. The discrepancy between these figures and official statistics is significant,<sup>25</sup> for certain drawbacks in registering childbirth and maternal mortality<sup>26</sup> do allow one to suggest that official statistics may well be underestimating the problem.

Serious shortfalls in government accountability in Azerbaijan prevent poor people from capitalizing on the country's natural and human resources to get themselves out of poverty. Azerbaijan is continually among the most corrupt countries in the world<sup>27</sup>. It has the highest average amount of bribe payments as a percentage of annual revenues among 22 transition countries<sup>28</sup>. As indicated in the Joint Staff Assessment Report, "*the impact of budgetary spending is adversely affected by serious governance problems at all levels*"<sup>29</sup>. (Even though this statement was made with regard to Azerbaijan's health sector, it describes, no less accurately, the state of things in any other sector of the economic and social life of the country.)

### ***Transparency and accountability may help the country avoid the "resource curse"***

A resource curse is curable – and a number of scholars have explained the relative successes of some countries in overcoming a "resource curse", which explanations can be divided into three groupings<sup>30</sup>. The first set of arguments refers to conservative macroeconomic and fiscal policies in relation to when a government accumulates foreign reserves, does not spend budget surpluses on deficit financing and tries to avoid external debt. The second set of

<sup>22</sup> Annual Report (2003) on the State Program for Poverty Reduction and Economic Development, p.17.

<sup>23</sup> <http://www3.who.int/whosis/country/compare.cfm?country=AZE&indicator=PcTotEOHinIntD&language=english>

<sup>24</sup> Reproductive Health Survey; according to the survey, infant and under-five mortality declined in the 1996-2001 period, compared to in 1991-95 (infant mortality from 74.4 to 85.9; under-five mortality from 96.8 to 88.4)

<sup>25</sup> As indicated in the SPPRED Report, official statistics recorded infant mortality in Azerbaijan in 2002 as being 12.8 per thousand live births - and the under-five mortality rate reached 23.1 per 1000 in 2002

<sup>26</sup> Official statistics do not record death from pregnancy and postpartum complications at home as maternal mortality; and they do not register births of infants who die shortly after birth. In addition, early neo-natal deaths and early deaths of premature infants are registered as still-births. For more information see "Primary Health Care Assessment" as developed by USAID, and UNICEF's *Multiple Indicator Cluster Survey*

<sup>27</sup> *Global Corruption Report*, Transparency International

<sup>28</sup> [http://www.worldbank.org/wbi/governance/pdf/quinghua\\_presentation\\_hellman.pdf](http://www.worldbank.org/wbi/governance/pdf/quinghua_presentation_hellman.pdf)

<sup>29</sup> Joint Staff Assessment Report, p. 7 2004

<sup>30</sup> Andrew Rosser, "Why did Indonesia Overcome the Resource Curse?", *IDS Working papers*, March 2004, p. 1

explanations emphasises the role of privatising natural resources, for domestic businesses<sup>31</sup> - as it is believed that private domestic ownership “*would foster institutions that more effectively constrain state leaders, encourage them to invest in institution building, and enable them to respond more successfully to commodity booms and busts*”<sup>32</sup>. The third set of arguments focuses on the quality of institutions (the rule of law, bureaucratic excellence, a low level of government corruption) to explain how other countries have managed to avoid such a curse.

This policy paper addresses only one variable within the “institutional quality” argument - transparency and accountability in the managing of oil resources; and the assumption is that transparent and the accountable management of oil resources is ‘a must’ if one wishes to convert resource abundance into economic and social development.

Certain measures have already been undertaken to ensure the transparent, accountable management of oil resources in Azerbaijan. The State Oil Fund of Azerbaijan (SOFAZ) was created to have stabilisation and saving functions; it publishes a lot of information (including annual revenue reports) on its internet site<sup>33</sup>. Disclosure of information by SOFAZ, albeit commendable, benefits few people, however - for limited internet access, regular electricity shortages and much computer illiteracy among the general population raises questions about its effectiveness in terms of reaching a major part of the country’s population. In addition, SOFAZ’s highly technical financial reports are not accompanied by any explanations and/or analyses, thereby adding to the overall complexity of things. Such concerns thus create major challenges for SOFAZ with regard to its ensuring “transparency in its activities, which are (claimed to be) open to both official and public scrutiny”<sup>34</sup>.

Information disclosed by SOFAZ is restricted to the revenue side only. It is interesting to note that many persons in Azerbaijan believe that oil belongs to the country’s president because they do not know where the oil money is spent<sup>35</sup> - for SOFAZ expenditure is, indeed, entirely at the discretion of the president. Azerbaijan’s State Oil Fund had over US\$288 million in expenditures during the first six months of 2006, of which US\$29.8 million - or just over 10% of the overall funds - was earmarked for infrastructure projects<sup>36</sup>. The country has no strategic plan on how to use oil money to promote sustainable long-term growth; thus, SOFAZ serves as

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<sup>31</sup> Pauline Jones Luong, Erika Weinthal, “Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in Soviet Successor States and Beyond”, *Comparative Political Studies*, vol. 34, No.4, May 2001, p. 367 - 399

<sup>32</sup> Erika Weinthal and Pauline Jones Luong, “Combating the Resource Curse”, *Perspective on Politics*, March 2006, Vol. 4, No. 1, p.36

<sup>33</sup> <http://www.oilfund.az>

<sup>34</sup> SOFAZ, Annual Report 2001, p.45

<sup>35</sup> A local NGO, called Himayadar, conducted a survey among the population in Ali-Bayramli, asking people what they know about oil and the government’s role in the management of oil resources. People were largely concerned about corruption in relation to the distribution in oil revenues, as they did not know where oil revenues actually go. Forty percent of survey respondents said that oil belongs to the president - while fewer than 15 percent of persons said that oil belongs the people (Evaluation Report Part I, by Kate Watters, p.11). We do not have data to verify that such an attitude may be true for the country as a whole, though.

<sup>36</sup> Joshua Kucera, “Irrational exuberance’s around Caspian energy”, *Eurasianet*, 25/09/06

a secondary budget, i.e. “a pot of money to be dipped into when other means cannot be found”<sup>37</sup>.

Azerbaijan has joined the EITI (Extract Industries Transparency Initiative)<sup>38</sup> and the EITI National Commission, which has 5 ministries<sup>39</sup>; SOFAZ, the NGO coalition - consisting of 18 local NGOs, the EITI group and an independent auditing company were additionally established to ensure the transparent and accountable management of oil revenues [N.B. the purpose of the EITI is to increase transparency and accountability in the managing of oil and gas revenues - though it does not take on board the expenditure side]. A recent survey<sup>40</sup> looking at government agency attitudes to the EITI shows that 3 government agencies (officially members of EITI National Commission) were unaware of such an initiative, however. Out of 11 government agencies covered by the survey, only 3 had adopted the practice of browsing the EITI National Coalition’s internet site. Interestingly enough, both government and NGO Coalition representatives assessed existing public oversight mechanisms as being ineffective - though each side saw this as the responsibility of the other – i.e. the government blamed the NGO Coalition for its “inability to offer effective public oversight mechanisms”, whereas NGO Coalition members said that public oversight will be improved if, among other measures, government brings NGO representatives onto the SOFAZ Supervisory Board and finances projects overseen by NGO Coalition members. Unfortunately, the survey does not address questions related to the transparency and accountability of NGO Coalition members as regards their constituencies/constituents.

### ***Direct citizen participation vs. participation through representatives***

Attempts towards increased transparency and accountability in the managing of oil resources in Azerbaijan have predominantly focused on having information about oil revenue management disclosed (although information related to expenditure remains difficult to track). However, as suggested by Richard G. Steiner, the concept of transparency needs to be distinguished from informed public participation<sup>41</sup>: “...*transparency is a necessary, but not sufficient component of informed public participation in a democracy. To have an active voice, the public, or at least a representative body of the public, needs to have a legitimate and formalised role overseeing and interacting with industry and government.*”

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<sup>37</sup> Svetlana Tsalik, Sabir Bagirov, Ingilab Akhmedov, “The State Oil Fund of the Azerbaijan Republic”, *Caspian Oil Windfalls*, p.112

<sup>38</sup> <http://www.eiti-az.org>

<sup>39</sup> The Ministry of Industry and Energy, Ministry of Finance, Ministry of Ecology and Natural Resources, Ministry of Economic Development, and the State Statistics Committee

<sup>40</sup> “Three Views of EITI Implementation”, Economic Research Centre, 2006.

<sup>41</sup> Richard G. Steiner, “Models of Public Oversight of Government and Industry” in *Caspian Oil Windfalls: Who Will Benefit?* p. 71

This distinction is particularly important in countries like Azerbaijan, where systemic problems related to representation, legitimacy and the accountability of structures and institutions - including those within “civil society” - bring up issues relating to *direct* public participation rather than participation via representation in different governmental and non-governmental institutions/structures.

Representation and participation via governmental institutions and structures have been challenged by electoral setbacks. All elections, including the presidential elections of 2003, municipality elections in 2004 and the most recent parliamentary elections from 2005 were plagued by gross manipulations, significant irregularities and fraudulent behaviour – all in favour of the ruling party<sup>42</sup>.

There is endemic corruption in all spheres of life in Azerbaijan. Therefore, it would be naïve to assume that any part of the system, be it government or non-governmental institutions, is completely unbound by characteristics existing in the system as a whole. In this context, civil society in Azerbaijan (the mass media and NGOs) needs to go a long way before becoming truly independent and free.

Most local NGOs in Azerbaijan are far from being fully transparent and really representative. Among other difficulties, civil society in Azerbaijan faces a major challenge with regard to legitimacy [whether NGOs truly represent the interests of poor women and men?] and capacity [whether recommendations developed by the NGO can be supported by evidence – or are they, rather, merely based on specific political preferences?].

Criticism of citizen’s direct involvement in policy analysis has the following three main concerns: (i) rational decision-making requires technical expertise – which is not available to the general public (i.e. problems are too complex for the average person to understand); (ii) citizens are either uninterested in issues, or pursue their own self-interest, rather than observe the general public good; and (iii) direct citizen’s participation is “time consuming, expensive, complicated, and emotionally draining”<sup>43</sup>.

This paper does not aim to recommend the most effective and efficient ways of spending oil money in Azerbaijan; nor does it argue that involving more citizens in debates will automatically improve government spending decisions regarding oil resources. It does, however, rely on two main assumptions - first, transparent and accountable management of oil resources is a significant component in any struggle against the “resource curse”; and, second, in a countries marked with endemic structural problems regarding representation and legitimacy, *direct* citizen

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<sup>42</sup> For detailed information on election irregularities in Azerbaijan, see reports by the OSCE, the Office for Democratic Institutions and Human Rights, the International Helsinki Federation for Human Rights, and Human Rights Watch

<sup>43</sup> J. Aydelotte, and J. Miller, “Putting More ‘Public’ into Policy Analysis”, *Public Administration Review*, July/August 2000, Vol. 60, No. 4, p. 350

participation might be more effective than participation via NGOs and other representative structures<sup>44</sup>.

## 2 POLICY ALTERNATIVES

This section examines three policy alternatives that might involve citizens directly in the managing of oil resources. The three alternatives - deriving from literature reviews as well as discussions with researchers and experts in Azerbaijan - are (1) dispensing oil revenues directly to citizens in forms of cash payment; (2) a fiscal decentralisation of oil resources as regards administration; and (3) public hearings in relation to oil revenues and expenditure.

### ***Alternative I: Directly dispensing oil revenues in forms of cash payment***

Direct public 'participation' will occur via dispensing oil revenues directly to citizens in the form of cash payments. This option, as adopted in Alaska (USA), presupposes that a certain percentage of oil income (which amount is determined either via a referendum or through routine legislative regulations) will be placed in a fund (e.g. the Permanent Fund in Alaska); such a fund will, beyond this, distribute a share of accrued interest to each citizen as a dividend, too.

The fund's revenues may or may not depend on the price of oil or on the state budget (SOFAZ in this regard resembles the Alaska Permanent Fund - for its revenues do not depend on the price of oil or on the state budget). Direct payments to citizens will vary in size depending on the fund's performance at any given time. In Alaska, these dividends are calculated by *"averaging the Fund's net income over the last five years, dividing by two, and then dividing among the eligible recipients. What remains after dividends and inflation-proofing becomes the Earnings Reserve Account, which legislatures may then disperse..."*<sup>45</sup>.

The fund is managed by a separate corporation that has an independent board of trustees; and it is overseen by the legislature. The corporation's mandate is to maximize earnings by investing the principal; while the final say over proposed investments stays with the legislature.

### ***Alternative II: Fiscal decentralization of oil resources***

Direct public participation in the management of oil resources could be promoted via the fiscal decentralization of oil revenues, which might be done in three ways<sup>46</sup>: (i) sub-national government taxes the oil industry directly; (ii) sub-national government receives direct transfers of a share of central government's mineral revenues; and (iii) sub-national government receives

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<sup>44</sup> Unless there is a strong link between these institutions and their constituency members - which is not usually the case in such countries

<sup>45</sup> Natural Resource Funds, Caspian Oil Windfalls, p. 23

<sup>46</sup> Michael Ross, the "How Can a Mineral Rich States Reduce Inequality?" chapter (p. 15)

indirect transfers from central government (revenues allocated according to the national budgeting process).

Within this policy study, the fiscal decentralisation option for the country will be looked at through the municipality structure - though discussion of this issue is made difficult due to confusions existing about what institution might be considered a unit of decentralization: Executive Committees (presidential appointees ruling local units of the executive branch) or municipalities (elected institutions of local self-governance - not subordinated (supposedly) to either the executive or the legislature)?

According to Article 142 of the Constitution of the Azerbaijan Republic, local self-governance is carried out by municipalities via elections. However, local self-governance is exercised, in practice, via Executive Committees, that is, Presidential appointees operating at a local level. Executive Committees manage all financial resources and allocations from the state budget (related to education, health, social assistance, etc.). Indeed, up until 2005, the law defined municipalities as “non-governmental institutions”, although following a recent amendment municipalities are now no longer considered non-government institutions - yet they have not received “governmental body” status either. Hence, we are dealing with an institution of local self-governance that is *not* a part of public administration and which performs duties that are ‘supplementary’ to those undertaken by the Executive Committee.

In Azerbaijan, according to national legislation, municipalities are entitled to levy four types of tax: (i) land use tax levied from physical persons; (2) property tax levied from physical persons; (3) a mineral royalty tax on construction materials having local importance (which might include brick-tile clays, mortar sand, raw materials made from crushed stone); and (4) profit taxes coming from enterprises and organisations owned by municipalities (22%).<sup>47</sup> Thus, given that their roles and responsibilities have been stipulated in law in this regard, municipalities cannot directly tax the oil industry – so this option is neither available nor, at the present moment, feasible.

The option of municipalities in Azerbaijan receiving direct transfers of a share of central government’s mineral revenues is highly questionable due to reasons given by M. Ross<sup>48</sup>: direct transfers from oil income will make municipal budgets fully dependent on oil prices – thus, any price fluctuations on international oil markets will have a very drastic effect on municipalities; and this will have a dramatic outcome given municipalities’ marginal capacities to manage their own funds. In addition, municipalities functioning as village councils in Azerbaijan will not have any capacity to absorb such investments. Indeed, the majority of municipalities in Azerbaijan do not even have basic budget documents, let alone the ability to

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<sup>47</sup> Ministry of Finance, <http://www.maliyye.gov.az/>

<sup>48</sup> Michael Ross, the “How can Mineral Rich States Reduce Inequality?” chapter in the book.

manipulate oil revenue-money. During the preliminary in-country discussions with researchers and experts this option was deemed to be irrelevant and non-feasible for Azerbaijan.

The option of municipalities receiving indirect transfers from the state budget is more feasible – perhaps necessary - given the limited financial resources that are available to municipalities. Currently, the tax-raising capacity of municipalities has its limits – and taxes on the most lucrative assets and activities remain under control of Executive Committees. In many cases, subsidies from the state budget remain the only revenue sources had by municipalities. These subsidies and other forms of allocation from the central state budget are not regulated by any specific mechanisms or procedure. The average municipal budget per capita was as low as US\$ 0.50 in 2004<sup>49</sup>; though there was a slight increase to US\$ 2.4 in 2005<sup>50</sup>. Meanwhile, state transfers to municipal budgets went down from 37.4% (of municipal budget revenues) in 2002 to 10.7% in 2004. Municipalities increasingly complain about the lack of resources making it difficult for them to play their roles and take on board their responsibilities<sup>51</sup>.

However, this option will need to be further ‘refined’ so as to make more clear specific conditions and formulae via which transfer amounts can be calculated. Current legislation defines neither principles nor criteria for any distribution of subsidies and subventions to local municipalities. Changes thus need to be made in the current status quo, i.e. where transfers to municipal budgets are made through Executive Committees’ accounts. Discussions held with the National Advocacy Group<sup>52</sup> - which is engaged in drafting the concept of fiscal and administrative decentralisation in Azerbaijan - can contribute to policy debate pertaining to this alternative.

### ***Alternative III: Public hearings***

The Caspian Revenue Watch has developed recommendations on improving transparent and accountable management of oil resources in Azerbaijan<sup>53</sup> and, among other suggestions, it highlighted the importance of holding public hearings to “gauge public opinion on spending priorities”<sup>54</sup>. The main questions here are: “Who will organize a public hearing - and how? And how will its costs be covered?”

A public hearing - where citizens participate in a deliberative process facilitated/administered by a representative of public administration system - is a tool via which

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<sup>49</sup> “A Needs Assessment of Municipal Services Development”, Weitz Center for Development Studies, 2005, p. 6;

<sup>50</sup> Calculations by Rovshan Agayev in the Economic Research Centre

<sup>51</sup> Information collected via meetings with 40 municipalities in Central Azerbaijan as well conferences having the participation of municipality representatives.

<sup>52</sup> An activity within the municipality development program supported by Oxfam GB in Azerbaijan and ICCO

<sup>53</sup> <http://www.revenuewatch.org/azerbaijan/reports/>

<sup>54</sup> *Caspian Oil Windfalls: Who will Benefit?* Caspian Revenue Watch, OSI/Central Eurasia Project, p. 28

to communicate citizens' direct (albeit 'non-binding') feelings as regards policy making<sup>55</sup>. Public hearings are broadly seen not only as a tool for improving transparency and accountability in the management of natural resources but, also, as a useful technique giving community empowerment. This method has been successfully used in number of countries<sup>56</sup>, and has its benefits, i.e. citizens can communicate their preferences more specifically (e.g. compared to in a referendum); there is a forum for information exchange between the general public and experts (although it often flows in a one-way direction); and thorough deliberative processes give a potential for compromise. Public hearings, however, can be laborious and time-consuming, and if not properly managed may lead to conflicts owing to very contrasting interests being held by participants. There is also a risk of having emotionally heated debates, where the government may then surrender to populist decisions rather than considering long-term strategic objectives. So any agency organizing public hearings will need to be clear about the specific procedures by which one uses the input gained from the public in the decision-making process.

Citizen's involvement in decision-making and input from the general public might serve different purposes: (i) identifying alternatives with regard to a policy issue; (ii) actually assessing public opinion concerning an issue (or set of issues); and (iii) noting the form in which public opinion makes itself heard ("persuading the public to come down on the side of a recommended alternative")<sup>57</sup>. Public hearings can also be utilized to educate the general public about certain issues. In this case, however, a clear distinction must be made between *informing* the public of government decisions and *involving* the public in government decision-making<sup>58</sup>.

Attempts at holding national-level public hearings were made by the SPPRED (State Program on Poverty Reduction and Economic Development) Secretariat in 2004. The town-hall meetings held within the "participatory SPPRED process" achieved very little in terms of identifying country development priorities - for it was difficult to see the links between concerns raised by people during town-hall meetings and activities identified in the SPPRED document. Yet the most recent report published within the State Program on Poverty Reduction and Sustainable Development shows that some progress has been made in this area<sup>59</sup>.

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<sup>55</sup> Term borrowed from T.A. Steelman, W. Asher, "Public Involvement Methods in Natural Resource Policy-Making: Advantages, Disadvantages and Trade-offs", *Policy Sciences* 30, 71 – 90, 1997

<sup>56</sup> Goetz, R. J., "Accounts and Accountability: Theoretical Implications of the Right-to-Information Movement in India", *Strengthening Participation in Local Governance*, IDS, 1999

<sup>57</sup> J. Aydelotte, and J. Miller, "Putting More 'Public' in Policy Analysis", *Public Administration Review*, July/August 2000, Vol. 60, No. 4, p. 352

<sup>58</sup> Taken from M. Berner, "Citizen Participation in Local Government Budgeting", *Popular Government*, Spring 2001, p. 23 - 30

<sup>59</sup> State Program on Poverty Reduction and Sustainable Development (SPPRS), Millennium Development Goals (MDGs), Regional Workshops



The brief experiences had in relation to public hearings held by the NGO do not allow one to arrive at clear conclusions. There is some evidence<sup>60</sup> that public hearings might cost only a little when held at the municipality level - whereas adopting this tool at a national level might imply greater costs and require an elaborate mechanism for processing data and channeling people's 'requests'.

Experience with public hearings at a municipality level shows that there is a very limited amount of participation (3-5% of the total population)<sup>61</sup>. Thus, additional efforts at building social trust, empowering people and strengthening participation are needed to make this policy alternative viable in Azerbaijan.

### **3 ANALYSIS AND RECOMMENDATIONS**

#### ***Projected outcomes***

As mentioned in Section I, direct citizen participation in the management of oil resources is suggested as a possible alternative to the current situation – in which we see corruption, mismanagement, ill representation and a weak civil society. This has informed the choice of projected outcomes and evaluation criteria; and proposed moves will be examined in terms of improved transparency and accountability in decision-making regarding the managing of oil resources.

Transparency is to be judged by (i) a citizen's ability to request and obtain information; and (ii) whether decision-making agencies report to citizens. Accountability will be operationalized through (i) a citizen's power to influence decision-making; and (ii) whether there is a system for taking on board people's complaints.

Seen below are outcomes projected for each of the alternatives listed in Section II; they are outlined in the table and are further elaborated in the text below it. It should be noted, too, that the current situation (i.e. information disclosure by the State Oil Fund and participation via the NGO) is also included in the list of policy alternatives, so that one is able to make a valid comparison.

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<sup>60</sup> Public hearings on municipality budgets were held in 28 municipalities of Central Azerbaijan, covering the Barda, Goranboy, Yevlakh, Agdash and Terter regions. The project was implemented by the Economic Research Centre, with support from Oxfam GB in Azerbaijan.

<sup>61</sup> Municipality Development project implemented by the Economic Research Centre, with support from Oxfam GB in Azerbaijan

PROJECTED OUTCOMES	ALTERNATIVES			
	Status quo	Alternative I (direct distribution)	Alternative II (decentralization)	Alternative III (public hearing)
<b>Transparency</b>	<b>Less</b>	<b>Less</b>	<b>Depends</b>	<b>Greater</b>
<ul style="list-style-type: none"> <li>▪ Potential for citizens to request information</li> <li>▪ Reporting to citizens</li> </ul>	Less	Less	Greater	Greater
	Not regular, indirect	Regular, indirect	Regular, direct	Not required
<b>Accountability</b>	<b>Less</b>	<b>Less</b>	<b>Higher</b>	<b>Higher</b>
<ul style="list-style-type: none"> <li>▪ Potential for citizens to influence decision</li> <li>▪ System to channel citizens' complaints</li> </ul>	Less	Less	Higher	Higher
	Does not exist	Does not exist	Exists	Exists

Alternative I.

Direct disbursement of dividends to every citizen – that is, when all persons will receive an equal and pre-determined share of oil income – will foster further equality in society. *A uniform transfer to all citizens will act like a progressive form of tax (or, more accurately, a negative regressive tax) and will produce a lessening in the rich-to-poor income ratio and thereby reduce the level of vertical inequality<sup>62</sup>.*

Citizens do not own have strong leverage (e.g. via elections, a referendum) to oblige the body managing the oil fund to disclose information publicly. However, legislators could enforce the disclosure of information by making this a legal requirement. The oil fund managing body submits regular reports to the legislative body of government. Certain issues raised in the reports might also be taken to the public, for discussion. There is, however, no direct reporting to citizens at the present time.

Giving each citizen a portion of the state’s oil wealth may lessen demands for increased state spending - which argument is based on the libertarian tenet that an economy will develop more when people are given the freedom to spend their *own* money rather than having the state spend money on their behalf. Actually, the government, particularly in the context of a developing country, will most probably lack the capacity to efficiently absorb oil revenues. Thus,

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<sup>62</sup> Michael Ross, the “How Can Mineral Rich States Reduce Inequality?” chapter

a decentralized form of ‘absorption’, including a direct disbursement of dividends, is something that is necessary. In addition, it is believed that distributing dividends directly to citizens will increase economic demand and thus contribute to developing the domestic, demand-led market economy<sup>63</sup>.

If people receive oil income dividends, they may have more incentive to hold government accountable, and this will promote participation and foster democracy. In addition, keeping oil revenues out of the hands of politicians may reduce corruption, rent-seeking and government inefficiency. Citizens’ potential to influence decisions will be exercised principally through the government’s legislature, although certain issues might be taken to referendum. At the moment, there is no formalized system (apart from resorting to legislators) allowing for a direct communication of citizens’ complaints.

Bearing in mind the high level of corruption and poor governance in Azerbaijan, implementation of a direct disbursement of oil income to each citizen may have significant costs - and be risky, too. It might, for a start, be difficult to ensure the real independence of the oil-fund managing body due to the major risk of “crony appointments” of trustees and the creation of a government-linked oligarchy (similar to that which emerged via the country’s privatization process).

Although direct disbursement of oil revenues will create more incentives for people’s participation in the management of oil resources, it still requires great political reform on the side of government in terms of increasing the overseeing role of parliament and narrowing the gap between politicians and their constituencies. In Alaska, the Alaska Permanent Fund was established after extensive direct consultations with citizens – and, due to constitutional restrictions, it could not be created until the majority of citizens had voted for it. In Azerbaijan, SOFAZ was created via presidential decree, and the country’s president has full discretionary power over SOFAZ; so there is no room for checks and balances in such a situation. In Alaska, the legislature has final say over investment suggestions coming from the APFC; and they actually decide what to do with the Fund’s annual ‘earnings’. In Azerbaijan, the Milli Mejlis (Parliament) plays close to no role here. Thus, expanding the role of parliament is necessary to improve the quality of governance and increase accountability in the management of oil resources. Yet this should be merely one component of many changes occurring within the system overall, including reforms made to the election system.

A question also arises as to how persons will actually be involved in the managing of oil resources. Will it be via referenda and extensive public consultations (as in Alaska) or through political representation (as in other countries)? Also, even if people’s opinions are sought

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<sup>63</sup> Thomas I. Palley, “Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq”, *Foreign Policy In Focus*, December 2003.

through a referendum, notorious electoral irregularities in Azerbaijan raise questions about the efficiency of this instrument. From another point of view, government may use direct disbursement of oil income as a means of “fiscal pacification” of the population; for Azerbaijani society has very little immunity to rent-seeking tendencies - citizens may fall victim to a free-rider attitude, thereby pushing government to spend more on dividends and so impede the “saving” function of the oil fund.

Direct disbursement of dividends could be based on certain conditions (immunizing children, enrolling them in school, etc.), which will make it a means via which to achieve social goals<sup>64</sup>. There will be a certain cost involved in setting up a system that is able to check whether every family is respecting the conditions laid down for the distribution of dividends. The provision of social assistance in Azerbaijan has already faced notable mismanagement problems linked to the poor state of available statistics (e.g. paying pensions to people who exist only on paper<sup>65</sup>); there is also a risk of paying dividends to “non-existing people” or making multiple payments to the same person.

### Alternative II.

The benefits of fiscal decentralization in relation to oil incomes fall within the general belief that decentralization promotes democracy and good governance as people can more easily obtain access to government and thus become ‘empowered’. One might then say that *“local policy decisions reflecting this empowerment will provide a more suitable infrastructure, better living conditions and enhanced economic growth”*<sup>66</sup>. People organize themselves best around problems they consider most important. Local control over the amount, quality and benefits of development activities can enable the process to be self-sustaining. Such arguments might apply to Azerbaijan, where most municipalities cover small villages with 500-1,000 families - so they could thus be seen as types of local council that have very close links with village residents.

Decentralization may well have a positive effect on citizen participation and bureaucratic efficiency<sup>67</sup>. Citizens elect their local government - so they will have stronger leverage when it comes to seeking the public disclosure of information; and they may also be able to enjoy greater influence over decision-making via participatory planning and a regular monitoring of concerns. Empirical evidence points to the existence of a negative relationship between fiscal

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<sup>64</sup> Michael Ross, the “How Can Mineral-Rich States Reduce Inequality?” chapter. Another type of conditionality is described by Thomas I. Palley

<sup>65</sup> Reports developed by the Aran Humanitarian Regional Development Organization, and the Economic Research Centre

<sup>66</sup> Harry Blair, Participation and Accountability at the Periphery: Democratic Local Governance in Six Countries, World Development, Vol.28, No.1, pp. 21-39, 2000, p. 23.

<sup>67</sup> Huther, J., Anwar Shah, *Applying a Simple Measure of Good Governance to the Debate on Fiscal Decentralization*, World Bank Policy Research Working Papers, 1998, no. 1894

decentralization and corruption - i.e. the higher the level of fiscal decentralization, the lower the level of corruption<sup>68</sup>.

Receiving direct transfers from the state budget will significantly expand financial resources available to municipalities, thus enabling them to perform their roles and take on their responsibilities as stipulated in law (*“dealing with local social and economic problems”*)<sup>69</sup>. Deprived of the financial resources necessary for implementing development projects, municipalities lack credibility in the eyes of local citizens. This partly accounts for the low turnouts in municipality elections as well as for problems in collecting municipal/local taxes. Taken as far as it could go, such a policy alternative might contribute to improving the service-providing capacities of municipalities and increase for women, men and children at the local level.

In spite of these assumptions, however, the risks inherent in implementing this alternative in Azerbaijan are high. There is little evidence that the development of local governance can be directly linked with poverty reduction because when governance is decentralized local elites get most of the power and can thereby steer benefits towards themselves... Also, there is no evidence to say whether local elites might be more likely (when compared to national elites) to magnanimously aim government resources at the poor<sup>70</sup>.

Municipality elections (as is the case with presidential and parliamentary ones) have witnessed serious irregularities and fraud. Electoral turnout at the municipality elections of December 2004 was about 46% - compared to 71% in the presidential elections<sup>71</sup>. Owing to irregularities in voting statistics, one cannot, however, entirely rely on voting data to come to the conclusion that there is less citizen participation at a municipal level compared to at a national one. And, indeed, most central government structures seem to be trusted more than municipality ones – i.e. slightly over 30% of the population surveyed by Transparency International said they trust municipal authorities<sup>72</sup>; about 70% of respondents had paid a bribe when purchasing or legalising a land plot (a service provided by the municipality) - and more than 74% of respondents did not believe that it is possible to “purchase or legalise land plots” *without* paying a bribe.

The majority of current municipality leaders used to be in governing positions beforehand - either as Soviet-era “kolkhoz” managers or as post-Soviet senior civil servants; and little has

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<sup>68</sup> Fishman, R., Gatti, R., Decentralization and Corruption: Evidence Across Countries?, World Bank Policy Research Working Papers, 2000, no. 2290

<sup>69</sup> Law on the Status of Municipalities, Republic of Azerbaijan

<sup>70</sup> Blair, p. 25, Manor, The Political Economy of Democratic Decentralization, Washington DC, WB, 1999, p. 91

<sup>71</sup> Central Election Commission of the Republic of Azerbaijan [www.cec.az](http://www.cec.az)

<sup>72</sup> Transparency International Azerbaijan, “Country Corruption Assessment: Public Opinion Survey in Azerbaijan”, 2004, p. p. 22; 27. Here, we use an aggregate figure combining “fully trust”, “trust” and “somewhat trust”.

changed in their attitudes to power (which they see as a means of income generation - thus entailing the mismanagement and misappropriation of public goods). Election irregularities and corruption at a municipal level pose questions about real representation: (i) Are citizens truly represented by municipalities? (ii) Are there safeguards for preventing resource misappropriation at a municipal level? (iii) Are municipalities willing (and able) to give the public direct access to the ways and means of the management of available resources?

Municipalities that have gone through capacity-building programs provided by international organisations have developed certain, though not very elaborate, reporting mechanism with which to inform constituents about municipal revenues and expenditure<sup>73</sup>. However, municipalities benefiting from this type of capacity-building constitute no more than 1% of the total number<sup>74</sup>. In all, mechanisms of popular control to be seen at non-election times are thus marginal - if they in fact exist!

### Alternative III.

Public hearings, if implemented carefully, could serve as a tool for channeling citizen's voices; and if regarded as a deliberative democracy instrument, it might be argued that public hearings not only improve the decision-making process (here related to the management of resources) by making it more *fair* – they additionally positively contribute to the *quality* of any outcome: “public deliberations are concerned with finding the best way of regulating matters of public concern, whereby the ‘best way’ is judged according to standards of rationality that have a certain objectivity”<sup>75</sup>.

Public hearings may be more successful if held by municipalities rather than via the NGO. The link between citizens and the NGO is not conditioned by elections or by reporting requirements, as it is the case with municipalities. In its country corruption assessment, Transparency International held a public opinion survey to examine “public confidence” in various government and non-governmental structures/institutions<sup>76</sup>. And it is interesting to note that local and the international NGO seem to cause the biggest confusion compared to all other government and non-governmental structures and institutions – for around 26% of research respondents, the highest percentage in this category, found it difficult to say whether they trusted or distrusted local/international NGOs. When asked if it is possible to receive assistance or services without paying a bribe, 32% of respondents (again, the largest percentage in this

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<sup>73</sup> In municipalities benefiting from projects supported by Oxfam GB and ICCO, about 46% of respondents (N=30) had participated in municipality budget formulations, about 73% of respondents (N=162) said municipalities are there to serve the people, while 22% see municipalities as serving clan interests only and they are fully subordinate to the Executive Committee. Unfortunately, no data is available to compare these figures with those in municipalities not receiving international aid.

<sup>74</sup> There are 2,700 municipalities in Azerbaijan, out of which only 200-300 benefit from capacity-building programs

<sup>75</sup> Maeve Cooke, *Five Arguments for Deliberative Democracy*, Political Studies, 2000, vol. 48, 947 – 969, p. 952

category) found this question difficult to answer (i.e. they were not sure whether they could get humanitarian aid from a local or international NGO without paying a bribe). Further research would have helped us to understand the causes of this opacity: is it due to a general lack of awareness regarding NGO activities? Does it allow one to draw conclusions about the gap between NGOs and their beneficiaries?

If conducted by the NGO, the costs of public hearing will be covered by the international NGO (i.e. Azerbaijan's government does not give direct grants to NGOs). A local NGO will be accountable to its donor only (which is mostly the case now); and a public hearing will deal with the subject initiated by the donor program. In contrast, if conducted by a municipality, a public hearing might be covered by the municipal budget. A municipality is accountable to its constituencies at least via the electoral process; and the hearing will be held using a municipality budget performance which has major relevance for citizens. Costs of holding a public hearing will be higher if they are held at a national level and covered by an international agency (because it will include administration costs not occurring at a municipal level).

The general political situation in Azerbaijan may make public hearings non-feasible unless directly authorised by a government institution. Currently, Azerbaijan is seen as semi-consolidated, authoritarian regime<sup>77</sup>. Government agencies responsible for budgeting are reluctant to open up to civil society participation despite AzGov's commitment to international agreements with the IMF, WB, Council of Europe, etc. As indicated in the WB's Country Assistance Strategy for the Azerbaijan Republic, one of the major areas to be improved is "*further refinement of costing and a prioritization of actions consistent with annual budget envelopes, within the Medium-Term Expenditure Framework and Public Investment Program*". It is difficult to keep track of national expenditure because there is a vague (if any) link between expenditure choices and reform plans (or declared policy objectives). The lack of linkage between reforms and expenditure implications related to such reforms is also due to the poor cost evaluation of policies/reforms as stipulated in a number of state programs aiming to reduce poverty, develop rural areas, promote entrepreneurship, etc.

Thus, an NGO will need to have a "special liaison" with local government authorities to conduct public hearings that are specifically in connection with the handling of oil resources and other budget issues. In contrast, the municipality, as an institution of local self-governance, is entitled by national legislation to hold hearings and have meetings with its constituents. The main question here, as outlined in the previous policy option, is how closely municipalities are linked to their constituencies and what might be the incentive for holding a public hearing.

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<sup>77</sup> Democracy Score Ranking 2006, Freedom House

<sup>78</sup> Transparency International Azerbaijan, "Country Corruption Assessment: Public Opinion Survey in Azerbaijan", 2004, p. p. 22; 27

The country's political regime gives little room for political contests. However, under the umbrella of this regime, various structures (e.g. NGOs, municipalities) may generate different levels of social trust, and thus allow for different degrees and types of participation. Unfortunately, very limited data is available on 'social trust' in Azerbaijan - for example as related to NGO and municipality structures (and data produced by Transparency International shows that people have very little trust such bodies). Yet there is a methodological question one might ask: what type of trust would generate more participation? For, as said earlier, there is at the present time a generally low social and political participation rate in Azerbaijan – which might be even lower if persons are discussing complex issues, such as the management of oil resources.

Local government, when it is elected, can be seen to be accountable to the public<sup>78</sup>. Thus, elected local government institutions may be in a better position to channel people's voices and to monitor decisions related to the managing of oil revenue and expenditure, or at least the portion of such revenues that are allocated as development funds. One can see that elected local government institutions are best placed to implement at least three out of six activities when monitoring oil revenues and expenditures, namely: (1) simplifying and disseminating information; (2) identifying and setting priorities; and (3) tracking revenues and expenditures<sup>79</sup>. In addition, municipalities are the bodies best placed to hold public hearings to "*gauge public opinion on spending priorities*" (as suggested by Caspian Revenue Watch)<sup>80</sup>.

### ***Evaluating the outcomes of policy alternatives***

Evaluation criteria – when recognizing the problem, and deriving from a literature review and discussions with experts - include the following: (i) direct citizen participation; (ii) decision-makers' accountability to citizens; (iii) political feasibility; and (iv) technical capacity required for the implementation of any policy.

It needs to be acknowledged that a number of noteworthy limitations - a lack of quantitative data, theoretical speculations rather than empirical evidence, etc. - have restricted any attempt to project and evaluate outcomes for each of the policy

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<sup>78</sup> Harry Blair, "Participation and Accountability at the Periphery: Democratic Local Governance in Six Countries", *World Development*, Vol.28, No.1, pp. 21-39, 2000,

<sup>79</sup> These are the main activities suggested for the monitoring of oil revenues and expenditures: (1) simplifying and disseminating information; (2) identifying and setting priorities; (3) influencing revenue policies; (4) identifying trends and providing projections; (5) highlighting best practices; and (6) tracking revenues and expenditures. For more information see Jim Shultz, *Follow the Money: a Guide to Monitoring Budgets and Oil and Gas Revenues*, Revenue Watch OSI, Center for Policy Studies at CEU, International Budget Project

<sup>80</sup> *Caspian Oil Windfalls: Who Will Benefit?* Caspian Revenue Watch, OSI/Central Eurasia Project, p. 28



alternatives described above; so more questions need to be answered and more data is required if we wish to develop specific policy recommendations on the subject.

INDICATORS	POLICY ALTERNATIVES			
	Status-quo	Alternative I	Alternative II	Alternative III
<b>Does it allow for direct citizen participation?</b>	Disclosing information about management of oil revenues does not require the direct participation of citizens	Allows for direct participation if decisions are made via referenda	Given the electoral problems and institutional challenges, direct participation of citizens will vary among municipalities	Allows for direct participation, yet incentives for participation still need to be examined
<b>Does it promote greater accountability of decision-makers regarding the citizen?</b>	There is little (if any) room for citizens to influence decisions. A system by which to channel citizens' complaints is non-existent.	Even though citizens might have more incentives to exercise their rights, greater accountability will need reforms increasing parliamentary oversight.	Citizens elect local government. Hence they have the power to hold it accountable. This, however, is subject to further reforms, ones strengthening institutional mechanisms (reporting to citizens, channeling citizen's complaints, etc.)	Provides citizens with a formalized forum via which to express their preferences and communicate complaints. Yet final decision-making does not lie with the people. Neither do they have any electoral leverage.
<b>Is it politically feasible?</b>	Yes	Major risks of "crony appointments" and mis-management in the absence of a strong Parliament	Yes. Decentralization and the development of local self-governance is one of the priorities had by the current administration	Is feasible if authorization from central authorities is obtained
<b>How easy is it to build up technical capacity?</b>	Technical capacity is in place.	The Oil Fund is already established. Additional capacity and costs will be needed to set up a nation-wide database and hold a referendum. Parliament's overseeing capacities need improving.	Fiscal decentralization will improve the amount of resources available to the country. Continual efforts and substantial aid is vital to help build up the technical capacities of municipalities.	Some technical capacity is available (at SPPRED, NGO and municipality levels). Additional capacity is needed to balance various public preferences with technical or scientific assessments/considerations.

## ***Recommendations***

This list of outcome projections in relation to policy alternatives show that there is a major need for reform in these areas: strengthening parliamentary oversight, improving elections, building up the capabilities of municipalities, gradually devolving more responsibilities to a municipal level, and building up people's trust in the governance structure.

Directly dispensing oil revenues to citizens will promote equality and create incentives for citizens to hold government accountable. This alternative, however, may risk there being many 'crony appointments' in the revenue management body and the creation of a government-linked oligarchy. To address such risks, the political system overall needs to become more transparent and less corrupt. If people's opinions are to be sought via referenda, the electoral system needs to be improved. A robust system of checks and balances is necessary to avoid a direct disbursement of oil income that will be used as a form of "fiscal pacification". Parliament's role in the management of oil resources needs to increase.

A fiscal decentralisation of oil resources will improve municipalities' financial resources and may thus contribute to improving services at a local level. However, when bearing in mind the irregularities that occur during municipal elections, there is high risk of a local elite usurping power and thereby mismanaging whatever resources are allocated from the central budget; and to avoid this risk, further reforms are needed to improve the capacities of municipalities, improve the electoral system here, and build up institutional capacity in relation to participatory decision-making at the municipal level.

Public hearings dealing with oil revenues and expenditure issues may be held at a municipality level and fit in with the participatory budgeting process.

None of the policy alternatives discussed above will, however, have the desired effect if implemented within the *current* political, economic and social framework - though there is a policy vacuum that needs to be filled here with informed discussions and specific policy suggestions. There is a dearth of data and empirical evidence at the moment in relation to what actually exists – i.e. what the system actually *is* - and which alternative might thus be the more reliable; thus, more research is needed so that a really informed decision can be made.

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