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PRESENTATION

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THE IMPACT OF CORRUPTION ON BUSINESS: SURVEY OF SOUTH CAUCASUS COUNTRIES

INTRODUCTION

Political stability and security. During more than 10 years of independence, all countries of the South Caucasus have achieved a reasonable, though not identical, degree of political stability and internal security. For example, Azerbaijan is reported to have the lowest rate of violent crime in the whole region,¹ while foreign investors are beginning to believe that Georgia is becoming a difficult place in which to do business. Georgian President Eduard Shevardnadze, speaking in his weekly radio interview on February 24, 2003, admitted that “crime, including kidnapping and attacks against businessmen, was deterring investment”.² Relative stability in Armenia was disrupted in connection with the recent presidential elections and it is difficult at this point to predict developments during the Azeri Presidential elections later this year. In addition, all three countries have subdued internal conflicts: Karabakh, Ossetia, Abkhazia. Anyway, after gaining independence, all three countries had sufficient time to streamline their systems of public governance and economic affairs.

Economic potential. Azerbaijan has an enormous economic potential, especially in the oil and gas sector. Azerbaijan has so far concluded 22 production-sharing agreements with multinational oil and gas companies since the late 1990s. At the moment, foreign investors are recovering their investments, while the government of Azerbaijan is predicted to start receiving about \$200-\$300 million in 2003 from these agreements and close to \$1 billion annually by 2005. However, some analysts predict that, despite Azerbaijan’s natural resource wealth, poverty and unemployment are expected to rise, while the benefits of oil wealth will be reaped by the elite.³ Quite to the contrary, the current Armenian government is reputed to have demonstrated a firm commitment to changing Armenia from a centralized state with a planned economy into a democratic society with a free market economic system. Still, Armenia faces problems typical for all economies in transition, which have been aggravated by Armenia’s relative isolation from international markets due to its geographic position and complicated political relations with two of its neighbors, namely Azerbaijan and Turkey. In addition, donors are not keen to invest heavily in this

¹ According to the survey performed by Intermedia, a US based NGO, among Central and Eastern Europe and CIS Countries, Violent Crime Index of Azerbaijan is 12, while Russia is scored 65 on the scale of 100. Source: Clean Future bulletin, summer 1999, No 3.

² Source: Mark Berniker, Crime and Political Instability Obscure Georgia’s Investment Prospects. In: Business & Economics, Eurasia Net, February 28, 2003. www.eurasianet.org

³ Source: Mark Berniker, Azerbaijan Confronts Myriad Risks in Economic Development, Business and Economic, Eurasia Net, February 6, 2003, www.eurasianet.org.

country, including the Armenian Diaspora. Georgia has an advantage of maintaining good relations with both of its neighbors and thus serves as a focal point for regional projects. In addition, Georgia was the leader of anti-corruption reforms in the region, which considerably enhanced the reputation of this country in the eyes of potential investors. However, despite the demonstrated political will and efforts in Georgia, the anti-corruption campaign failed to have yielded any visible results and ended up in frustration.⁴

Major problems of the transition period. Governments of all three South Caucasus countries declare their adherence to democratic reforms and economic development, as well as their desire to be integrated into the global economy. All three countries are in the process of assuming relevant international obligations, for example, in connection with their recent accession to the Council of Europe and Azerbaijan's anticipated joining of the World Trade Organization as the only remaining non-member among the South Caucasus states. However, many observers doubt the sincerity of the governments' aspirations and hold that all South Caucasus countries have more or less authoritarian regimes with the appearance of democracy. This thesis is supported by numerous reported violations during parliamentary and other elections in the region, the recent Armenian elections being only one of many instances. Anyway, all three countries face numerous problems on the road to democracy, the most poignant being:

- Inertia within government structures;
- Deficiencies of the legal framework;
- Corruption⁵.

Inertia within government structures. There is a whole range of reasons, explaining why the system of public administration is so onerous in the South Caucasus. First, many Government officials are the legacy of the Soviet period – the concept of public service is alien to them. Their method of managing the country is to plan and control.⁶ Second, it is no secret that public posts from top to bottom are for sale. Bureaucrats, who paid for their positions, think least of all of the public good. Thirdly, extremely low salaries in the public sector give moral justification to corrupt practices, especially at the petty level. For example, in Georgia tax inspectors show much less legal and moral awareness of a vicious nature of a bribe than businesses, probably due to the fact that salaries of tax inspectors in Georgia fell short of their expectations by a point of 24.⁷ And last, but not least, bureaucracy in all three South Caucasus countries is cemented by clan ties, leaders of the country being recognized as leaders of respective clans of Karabakh in Armenia, Nakhichevan in Azerbaijan and the Gurian clan in Georgia. Inertia within government structures is one of factors, creating an extremely difficult and corrupt business environment. Out of 200 businessmen surveyed in Armenia, 194 (97%) believed that corruption is initiated mainly by state authorities.⁸ According to an expert survey, conducted in 1999 by the Entrepreneurship Development Foundation, corruption of top government officials and low salaries of all government officials are the two top reasons behind rampant corruption in the country.⁹

Deficiencies of the legal framework. First of all, the legislative framework is not fully developed. For example, the Armenian regulatory system pertaining to business activities, though being one of the most

⁴ Source: Independent Anti-corruption Service: Implementation problems in Post-Soviet Georgia, Tbilisi, Georgia, 2002

⁵ It is difficult to range corruption, as it is both a major problem in itself, hindering business development, as well as the consequence of the deficient legal framework and government inertia.

⁶ Source: Business Environment in Georgia: Selection Discussion Topics, draft document prepared by Nikoloz Loladze (PSI) for the World Bank and available at: www.worldbank.org/vbi/devdebates

⁷ Source: Survey of the Attitude of Businessmen and Tax Inspectors Towards the Problem of Corruption. In: Corruption Research Center: Activities, Plans and Programs, Tbilisi, Georgia, 2000

⁸ Source: Country Corruption Assessment: Public Opinion Survey, Center for Regional Development/Transparency International Armenia, Yerevan, Armenia, 2002

⁹ Source: Survey The Problem of Corruption in Azerbaijan, Entrepreneurship Development Foundation, 1999

developed in the NIS, still lacks some critical laws, such as an anti-corruption law. Second, the legal environment does not offer equal treatment to all businesses. **In Azerbaijan, the consortia of Western oil companies are governed by separate PSAs, approved by the Parliament and having the force of the law. Companies outside these consortia, both foreign and local, face arbitrary application of tax and customs rates and bureaucratic harassment.** Third, the legislation is inconsistent. Many legislative documents are written in a conflicting manner (for example, Georgian Law on Entrepreneurs is based on German analogous law and the Securities Law is based on the US practice)¹⁰, the main reason being incompetence of the legislators. However, many people, for example in Azerbaijan, believe that ambiguous norms have been deliberately included in legislation to enable corruption.¹¹ This perception echoes the position of a Georgian researcher, who believes that the “laws are written in such a manner as to generate the need for corruption and instead of working to promote the rule of law, Georgian legislation and regulations promote the rule of corruption”.¹² Fourth, all three countries suffer from the lack of law enforcement mechanisms. For example, Azerbaijan has an Anti-Monopoly Law, but no mechanisms for its enforcement are in place. Fifth, the population, including businessmen and especially small enterprises, is not very well versed in legal matters. Deficiencies of the legal framework, and dependence of judicial bodies on executive power, in other words, lack of effective mechanisms of law enforcement, were referred to as, respectively, fourth and third reasons for the high degree of corruption in Azerbaijan¹³.

Corruption. A review of the economic development of countries in transition over the last ten years indicates corruption as one of the main factors hindering the establishment of a free market economy and truly democratic institutions. According to the Corruption Perception Index compiled by Transparency International, in 2002 Azerbaijan rated 95 (or had an index of 2.0 on the scale of 10) and Georgia 85 (2.4) out of 102 countries surveyed. In 2000 Armenia rated 76 (2.5) and Azerbaijan 87 (1.5) out of 90 countries surveyed. These fragmentary data allows us to conclude that Armenia’s performance is perceived as slightly the best and Azerbaijan as the most corrupt in the region. Such a high degree of corruption leads to a very dangerous transformation of the public culture. A survey amongst students of Tbilisi State University shows that 75% of students are ready to pay to get a job and 8% would take a bribe if they held an office they had paid for.¹⁴ However, recent data produced by the World Bank shows a considerable shift of the tendency. According to the Business Environment and Enterprise Performance Survey, in 2002 the number of firms saying that they often have to pay bribes in Georgia increased, compared with 1993. That happened at a time when in Armenia and Azerbaijan, the corresponding figure dropped by nearly a point or two over the same period.

BUSINESSES AS VICTIMS OF CORRUPTION

Here we will review forms of corruption under which businesses fell victim to corrupt practices of public officials.

Influence from above over decision making processes. For example, the Japanese Bank of Reconstruction and Development refused to recognize Sumitomo, one of the four Japanese companies bidding on a construction project in Azerbaijan, as winner of the tender. The Azeri newspapers expressed

¹⁰ Source: Business Environment in Georgia: Selection Discussion Topics, draft document prepared by Nikoloz Loladze (PSI) for the World Bank, www.worldbank.org/vbi/devdebates

¹¹ 51% of respondents thought so. Source: Survey The Problem of Corruption in Azerbaijan, Entrepreneurship Development Foundation, 1999

¹² Source: Political Regimes, Laws and Corruption, Presentation by D. Khechinashvili at Balkan/Black Sea Anti-corruption Workshop, Sofia, Bulgaria, October 1-3, 2002

¹³ Source: Survey The Problem of Corruption in Azerbaijan, Entrepreneurship Development Foundation, 1999

¹⁴ Source: Independent Anti-corruption Service: Implementation problems in Post-Soviet Georgia, Tbilisi, Georgia, 2002

their concerns about the existence of informal “arrangements” between Sumitomo and some Azeri high-ranking public officials.¹⁵

Patronage of certain sectors of industry by high-ranking public officials or their participation in economic life using public resources for personal gain. For example, one of the two biggest GSM companies in Georgia is reputed to have been owned by the family of Shevardnadze’s daughter with his son-in-law - Gia Jokhtaberidze president of the MAGTI GSM. Wheat trading is controlled by the father of Nino Burjanadze, Speaker of the Georgian Parliament.

Creation of state monopolies. For example, *Azeurotel*, a joint Azeri-British venture, a leading telecommunications company, accused the Azerbaijan Ministry of Communication of deliberate and illegal cut off the international communication.¹⁶

Kickbacks to public officials in state contracts. For example, according to some sources, in public procurement, kickbacks can constitute up to 30-40% of the project cost,¹⁷ while in Georgia expenses incurred in connection with corruption constitute 6% of all operational costs and 22% for launching a new business.¹⁸

BUSINESSES AS AGENTS OF CORRUPTION

Heavy taxation and the need to make informal payments force businesses to evade taxes. For example, in Georgia amounts paid for bribes are considerably small as compared with taxes payable. Only about half of the entrepreneurs had to pay a bribe for registration.¹⁹

Coordination of pricing policies. In Azerbaijan two private companies, sole operators of the cell phone communication (*Azercell* and *Bakcell*) are reputed to maintain the same pricing policy, thus depriving their customers of a fair choice.

Sales of falsified and uncertified goods. Through the whole region one can find numerous samples of sales of falsified or uncertified goods, especially, pharmaceutical goods.

Violation of copyrights. Lots of businesses in the whole region are flourishing by selling video, audio and print products reproduced without permission of their legal owners. However there some positive chances. An Azeri singer Brilliant Dadashova won a court Litigation against TURKCELL, a Turkish GSM company.

Although the private sector is probably one of the worst affected by the corrupt nature of government officials, representatives of the business sector prefer to remain tight-lipped, while some of them, taking advantage of rife corruption, try to get an edge on their competitors by selling goods and services on state orders. Still, there are some efforts from the civil society to assist businesses to minimize the risk of exposure to corruption.

¹⁵ Source: S.Sultanoglu «The Japanese Bank Said No to Corruption in Azerbaijan», Zerkalo newspaper, Banks and Businesses column, September 15, 2001, Baku, Azerbaijan

¹⁶Source: The e-mail letter sent by Azeurotel to its customers on March 2, 2003

¹⁷ Source: Rashid Gajiev, chapter 4 Corruption and Economy, Corruption, edited by S.Bagirov, publication of Transparency Azerbaijan, Baku, 2002

¹⁸ Source: Business and Corruption Problem. In: Corruption Research Center: Activities, Plans and Programs, Tbilisi, Georgia, 2000

¹⁹ Source: Business and Corruption Problem. In: Corruption Research Center: Activities, Plans and Programs, Tbilisi, Georgia, 2000

BUSINESSES AND CIVIL SOCIETY

Research. Problems faced by businesses require research, including both opinion surveys and desk studies. There are numerous samples of research undertaken in the region, some of which are referred to in this paper. We should make a special reference to the joint regional project aimed at promoting transparency of customs in the South Caucasus.²⁰

Education and Publications. Lack of legal knowledge among entrepreneurs and poor transparency of the state procedures create a niche which is filled by civil society, which organizes training, conferences, roundtable discussions and seminars for businesses, as well as publications on specific areas. In 2002, CRD/TI Armenia, DF and AYEG, published and widely disseminated guides on customs related procedures.²¹ Georgia can boast of a range of NGOs organizing trainings sessions for local government employees (PIKA, Horizonti, Young Lawyers Association, and others). These organizations also publish various magazines and special manuals aimed at improving legal knowledge among public officials and creating transparency in state institutions.²²

Public Awareness Raising Campaigns. In addition to numerous newspaper articles, radio and television interviews, some NGOs lead regular business columns in popular local newspapers, for example, the Azerbaijan Association of Marketing.²³ There have been successful samples of using arts, including for example cartoons, to raise public awareness of corruption. In 2003, CRD/TI Armenia developed three social ads on anti-corruption. One of the ongoing public awareness raising campaigns is being executed by IRIS Georgia. This organization has produced a number of video-clips, illustrating human rights and obligations. Many local NGOs run similar campaigns in the regions.²⁴

Dispute Settlement. There is no international arbitration mechanism in place in the region to resolve disputes between the governments and/or private companies in the region. The existing state arbitration court and the supreme economic court reportedly do not work effectively. Civil society can assist businesses to resolve economic disputes among themselves without applying to the costly and reportedly unfair judiciary system. For example, the legislation of Azerbaijan envisions the establishment of courts of arbitration, consisting of three impartial independent individuals. According to Azeri legislation, rulings of such arbitration courts shall be testified by formal courts and thus acquire legal status. An Azeri NGO (International Commercial Court of Arbitration) is currently working to establish such a mechanism.²⁵ Another NGO (Independent Legal Center) also has the experience of successfully resolving a financial dispute between an employer and employees.²⁶ Georgia also has a good experience of using arbitrage as a dispute settlement mechanism. ACDI/VOCA in cooperation with TERRA Institute has executed a large-scale project in the Gori region, where local arbitrage is reputed to have rendered a considerable impact on local farmers' lives.

²⁰ Source: Promoting Transparency at Regional Customs, publication of Entrepreneurship Development Foundation, Baku, Azerbaijan, 2002. The project was undertaken by CRD/TI Armenia, Association of Young Economists of Georgia and Entrepreneurship Development Foundation, Azerbaijan

²¹ Ibidem

²² For more details see www.advocacy.ge

²³ The Azerbaijan Association of Marketing leads a 4 page column in the Saturday issue of Zerkalo newspaper, where various problems pertaining businesses are discussed.

²⁴ For example, Teachers Association in Kutaisi, Young Scientists Union in Ozurgeti, Young Economists Association of Georgia.

²⁵ Source: NGO International Commercial Court of Arbitration, a project funded by Eurasia Foundation, Azerbaijan branch, e-mail arbitr@box.az

²⁶ Source: NGO Independent Legal Center, e-mail aydin@mail.ru

Declarations of Integrity. In a developed economy in many instances, businesses resort to self-regulation. One of the ways of self-regulation is the adoption of business principles or declaration of integrity. Unfortunately, we can not refer to any concrete cases in the South Caucasus, but such precedents exist in Russia – Declaration of Business Integrity, designed by the St. Petersburg Center of Business Ethics and Corporate Governance.²⁷ In Azerbaijan, such a project is currently being considered by the Association of Entrepreneurs (Employees).

Business Ethics Codes. Another method is the adoption of professional codes of ethics or conduct. To our best knowledge, only few firms in Azerbaijan have codes of conduct or seminar documents (Azerbaijan Electronics, ASPI, RISK). In September 2002, Transparency Azerbaijan conducted a survey among Azeri businesses, which showed that businesses are willing to design and adopt such codes, but due to the lack of necessary skills, they require external assistance. Currently, Transparency Azerbaijan is organizing a series of seminars on Business Ethics for Azeri businesses to be summarized in a Business Ethics manual and a model code of conduct²⁸.

Coordination Councils. Civil society representatives can assist businesses in establishing Coordination Councils comprised by representatives of the key public economic agencies and associations of businesses to lobby for interests of businesses. There is a precedent in Azerbaijan – closed door meetings of the president of the country with foreign and local businesses in spring of 2002, when the head of the state encouraged businessmen to speak of their problems and complaints. These meetings resulted in a number of presidential decrees and considerable reduction of tax rates. However, some observers believe that the meetings may have made for great political theatre and still question whether it will bring any improvements in the business climate.²⁹

Lobbying for change of legislation. It might be difficult for individual businesses to protect their rights, but joint efforts of the business and civil community might lead to positive legislative changes. For example, in Azerbaijan such efforts have led recently to the establishment of the National Fund for Entrepreneurship Development and the Entrepreneurs Council and the adoption of the State Program on Small and Medium Entrepreneurship Sized Development for the years of 2002-2005. In Georgia, IRIS lobbied last year for the adoption of a new Administration Code, considered by international advisors as very modern and effective.

Coalition Building. Armenia provides a successful example of building an Anti-Corruption Coalition. Joint efforts of CRD/TI Armenia, AFIC and several other non-governmental organizations led to the formation in March 2001 of the Anti-Corruption Coalition of Non-Governmental Organizations in Armenia, which has 26 member organizations, including business associations.³⁰ In Georgia, the Anti-Corruption Council was created by Presidential Decree. In spite of having good funding and a PR campaign, the results of their activity are not considered as substantive by the general public. At the same time, many NGOs are engaged in anti-corruption activities, though no NGOs union or coalition is in place. In Azerbaijan two NGOs are also planning to establish an anti-corruption coalition in Baku.³¹

²⁷ See for more details www.ethics.russia.org

²⁸ Business Ethics Seminar and Guide book, project funded by Embassy of Royal Norwegian, for more details see www.transparency-az.org or write to transpaz@azeronline.com or office@transparency-az.org

²⁹ Source: David Stern, Bank Closure Underscores Difficult Business Environment in Azerbaijan, Business and Economies, June 28, 2002, www.eurasianet.org

³⁰ Source: Customs: A Case Study in Combating Corruption in Azrmenia, Presentation by G. Poghossian at Balkan/Black Sea Anti-corruption Workshop, 1-3 October, 2002, Sofia, Bulgaria

³¹ Transparency Azerbaijan and Entrepreneurship Development Foundation

INTERNATIONAL BUSINESS AND ANTI-CORRUPTION EFFORTS IN THE SOUTH CAUCASUS

In this section we would argue that international businesses operating in the South Caucasus should be vitally interested in supporting anti-corruption initiatives of the civil society and promotion of a more favorable business environment for local businesses. We fully support the thesis that international companies shall comply with the principle of political non-interference into internal affairs of the countries they work in, as set forth by their codes of conduct. However, this principle shall not be used as the pretext to avoid responsibility for the future of the countries they work in and their business communities.

Risk for the Reputation. Numerous evidences show that multinational companies, especially in the mining industry, are held responsible, at least by public opinion in their home countries, for rampant corruption of the ruling elite and impoverishment of people in developing natural resource rich countries, like Venezuela or Nigeria. By supporting corrupt and authoritarian regimes, multinationals shall bear part of the responsibility for human suffering and civil wars, the extreme case being the humanitarian catastrophe in Rwanda. There is evidence of the pressure exerted by the global civil community on multinational companies and indications of positive cooperation, for example the global campaign Publish What You Pay joined by over 30 NGOs, including Transparency International, around the globe, which calls for mandatory disclosure of company payments to host governments. In the context of our region, we can refer to the Caspian Revenue Watch project, aimed at monitoring the expenditures of the newly established Oil Funds in Kazakhstan and Azerbaijan and the obligation assumed by BP to make public their payments to the respective governments.

Cost saving. Supporting local businesses can considerably reduce operational costs of multi-national companies. Corruption adds to operational expenditure of local companies and makes their services more expensive, while local companies in a favorable business environment can possibly charge less than foreign subcontractors for similar services, saving, at least, on human resources and transportation costs for materials. We can refer here to BP Enterprise Center in Baku, which aims at supporting local businesses through training and education.

Corporate social responsibility. Multinational companies should expand their notion of good corporate citizenship from pure charity, when they support mainly the arts and social sphere, to contributions to the welfare of the entire community in which they live and work.

Compliance with legislation. Multinational companies working in a corrupt environment face problems with compliance with anti-corruption legislation back in their home countries. This legislation gets more and more strict. For example, even though the US Anti-corruption Act and Business Principles launched by TI and SAI³² do not prohibit facilitation payments, the new UK Anti-corruption Law of February 2001 outlaws such payments.

Anti-terrorism measures. By contributing to the promotion of transparency and a favorable business environment, multinational companies, in fact, narrow down the base of illegal earnings and money laundering and thus cut down the sources of funding of terrorist activities. It is no secret that illegal financial operations throughout Russia, especially in the banking sector, fund Chechen guerrillas.

Long term stability. By helping the countries of the South Caucasus to achieve economic prosperity, multinational companies will ensure long-term stability in the region, required for implementation of their

³² Source: Business Principles for Countering Bribery, launched by Transparency International and Social Accountability International in December 2002, www.transparency.org

long-term projects, for example, the Baku-Tbilisi-Ceyhan pipeline, the global fibro optic cable project, the Great Silk Route transportation corridor, etc.³³

It is the task of the civil society in the South Caucasus to encourage multinational companies to become more supportive of local progress, including businesses.

³³ The BTC project is not without its concerns. For example, in Georgia the pipe line passes through Borjomi National Park. Despite the fact that the pipe line will bring 62 million USD per year to the Georgian state budget, environmentalists and historians still indicate that any minor damage of pipeline will have an enormous negative impact on Borjomi springs and mineral water and resort zone as a whole. **In Azerbaijan the BTC passes through sites of prehistoric men in the region of Gobustan and many potential excavation sites might be lost for research.**