



# The Eurasian Union: Undermining Economic Freedom and Prosperity in the South Caucasus

*by James M. Roberts, Ariel Cohen, PhD, and Jonathan C. Blaisdell*

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## About the Authors

*James M. Roberts is Research Fellow for Economic Freedom and Growth in the Center for International Trade and Economics (CITE) at The Heritage Foundation.*

*Ariel Cohen, PhD, is Senior Research Fellow for Russian and Eurasian Studies and International Energy Policy in the Douglas and Sarah Allison Center for Foreign Policy Studies, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, at The Heritage Foundation.*

*Jonathan C. Blaisdell is a graduate student in National Security Studies at California State University, San Bernardino.*

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**The Heritage Foundation**  
214 Massachusetts Avenue, NE  
Washington, DC 20002  
(202) 546-4400 | [heritage.org](http://heritage.org)

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# *The Eurasian Union: Undermining Economic Freedom and Prosperity in the South Caucasus*

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## **Abstract:**

*Russian President Vladimir Putin is seeking economic and political alliances to counterbalance the influence of the U.S., the European Union, China, and transnational Islamism. Putin is determined to strengthen Moscow's hegemony in the "near abroad"—the post-Soviet space. One of the instruments he has created to achieve that strategic objective is the Russia-dominated Eurasian Union (EAU). In 2011 Russia, Kazakhstan, and Belarus signed an agreement creating the EAU with the goal of making it fully operational by 2015. Putin has been pressuring Armenia, Azerbaijan, and Georgia, as well as other Eastern European and Eurasian states, to join.*

*Azerbaijan has in the past rejected EAU membership, while Armenia—already heavily dependent on aid from Russia, and with Russian troops stationed on its soil—is joining. Georgian ex-President Mikheil Saakashvili, a strong proponent of EU membership and NATO enlargement, has lost popularity, as Prime Minister Bidzina Ivanishvili, a billionaire tycoon, has become the country's most influential politician. Ivanishvili's candidate, Giorgi Margelashvili, won the presidency on October 27, 2013.*

*EAU membership would not only undermine the South Caucasus's Western-oriented path, further eroding Armenia's, Azerbaijan's, and Georgia's sovereignty, independence, and political orientation, but could also have negative spillover effects on European security, trade, and investment. It will affect an area of the world that is vital to the economic and national security interests of the West. The U.S. and Europe have little time, then, to form a common strategy and cooperate to balance Russia's geopolitical offensive and protect their interests.*

The Southern Caucasus—Armenia, Azerbaijan, and Georgia—is in Russia's geopolitical crosshairs. Russian President Vladimir Putin, who once called the demise of the Soviet Union “the greatest geopolitical catastrophe of the [20th] century,”<sup>1</sup> is seeking economic and political alliances to restore Russia's power in what then-President Dmitry Medvedev called its traditional “sphere of exclusive interests.”<sup>2</sup> Moscow also wants to counterbalance the rising influence of the U.S., the European Union, China, and transnational Islamism in the post-Soviet space.<sup>3</sup>

One of the instruments that Moscow has created to achieve that strategic objective is the Russia-dominated Eurasian Union (EAU). In 2011 Russia, Kazakhstan, and Belarus signed an agreement creating the EAU with the goal of making it fully operational by 2015. Meanwhile, Putin has been urging the former Soviet states in the South Caucasus (Armenia, Azerbaijan, and Georgia) to join.<sup>4</sup>

While Azerbaijan has in the past rejected EAU membership, Armenia—already heavily dependent on aid from Russia—is in a weaker position and has Russian troops stationed on its soil. Its President,



**THE EURASIAN UNION:  
UNDERMINING ECONOMIC FREEDOM AND PROSPERITY IN THE SOUTH CAUCASUS**

MAP 1



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Serge Sargsyan, has committed his country to join the Customs Union, the precursor to the Eurasian Union, while suspending the Associate Membership agreement with the EU that Armenia negotiated for three years.

Georgian ex-president Mikheil Saakashvili and his pro-Western United Democratic Movement, a strong proponent of EU membership and NATO enlargement, have drastically lost influence. The former Interior Minister Irakli Gharibashvili and Giorgi Margvelashvili have won the country's prime minister's office and presidency, respectively. They are viewed as protégés of former Prime Minister Bidzina Ivanishvili, a billionaire tycoon, who made his fortune in Russia.

EAU membership would not only undermine the South Caucasus's Western-oriented path, further eroding Armenia and Georgia's sovereignty,

independence, and political orientation, but could also have negative spillover effects on European security, trade, and investment. It will affect an area of the world that is vital to the economic and national security interests of the West.

EAU membership would undercut the EU and other Western outreach efforts in the South Caucasus. The U.S. and Europe have little time, then, to formulate a common policy to balance Russia's geopolitical offensive and protect their interests.

It is in the national interests of the three South Caucasus countries to uphold their sovereignty and independence; firmly reject Russia's 19th century-style sphere of influence; and look instead toward Western and other democracies for their security, economic freedom, property rights, future investment, economic growth, and institutional and social development.

## Will the Eurasian Union Become the USSR 2.0?

The EAU builds on the Eurasian Customs Union (ECU) formed by Russia, Belarus, and Kazakhstan in 2010, with the stated purpose of reducing tariff barriers, facilitating trade, and allowing the free movement of goods, services, and capital across a single market of 165 million people.<sup>5</sup> The “idea of the Eurasian Union has produced far more problems than it proposed to solve.... [The EU’s] successes can be attributed to one key feature that Eurasian Union lacks—the desire and willingness of each member to share responsibility and to delegate power,” write Russian analyst Anton Barbashin and his American co-author, Hannah Thoburn.<sup>6</sup>

Citing a history of shared values as well as Europe’s current economic anemia, Putin claims that the EAU will be a modernizing alternative to the EU. Putin also promises that regional integration will be achieved on an equal footing. So far, the terms of the EAU appear to be a one-way street benefitting Russia at the expense of the former Soviet republics.

Zaur Shiriyev, a research fellow at the Center for Strategic Studies in Azerbaijan, argues that “Putin’s plan to integrate post-Soviet countries is a trap. If either Baku or Tbilisi joins the Customs Union and Eurasian Union, it would signal the end of European access to Central Asia.”<sup>7</sup>

According to the World Bank, the EAU “creates an opportunity for Russia to expand its exports and its presence in Central Asia at the expense of exports from other countries, such as the European Union and China.”<sup>8</sup> Russia has benefitted by limiting Kazakhstan’s and Belarus’s ability to import higher-quality European goods. Chinese exports to Kazakhstan have also declined significantly in response to the higher external ECU import tariff. “To date, the Customs Union appears to have had tariff-related trade creation effects only for Russia, as reduction in external tariffs have [*sic*] been associated with higher imports from selected trade partners outside the Union.”<sup>9</sup>

For example, 100 percent of the revenues derived from the export of Russian crude oil to EAU member states must be returned to Moscow, including value-added profits on products that Belarus and Kazakhstan refine and sell themselves. The votes in the ECU are weighted 57 percent for Russia and 21.5 percent each for Belarus and Kazakhstan.<sup>10</sup>

Moreover, in order to “persuade” Belarus to comply with the common economic space agreements of the EAU, Russia has been restricting exports from Belarus to Russia. Minsk has until 2017 to eliminate completely its free economic zones that might benefit investors from Western nations.

Russia and Belarus are engaged in a series of trade wars over various types of products from milk, meat, beer, pipes, city buses—even tubes of toothpaste.<sup>11</sup> Membership in the EAU has not helped; a dispute between Russia and Belarus regarding Russia’s export duties was resolved—not through EAU institutions—but by a bilateral agreement between Moscow and Minsk. South Caucasus countries suffered plenty in their trade relations with Russia. Georgia, for instance, was under severe Russian trade sanctions that targeted its principal productions, including produce, wine and liquor, and mineral water. Political leaders in the South Caucasus must understand that Azerbaijan and Georgia would likely find themselves in a similar situation as Belarus if they join the EAU.

Additionally, opaque governance and corruption are pervasive. As Barbashin and Thoburn write:

[A]s it is a Russian vision, the Eurasian Union would bear the flaws of modern Russia: neglect of human rights, selective justice and omnivorous corruption. As compared to the European Union, the example on which Putin wanted to base his Union, Russia also lacks the tradition of following established rules.<sup>12</sup>

Trade has also suffered in EAU member countries other than Russia. The common external tariff agreed to by EAU members in January 2010 was based on Russia’s external tariffs before joining the World Trade Organization (WTO). Therefore, while Russia saw little impact, Kazakhstan was affected greatly. Its tariff rates have approximately doubled in recent years. As Lúcio Vinhas de Souza of the World Bank argues, the EAU is “a GDP-reducing framework [for members other than Russia] in which the negative trade-diversion effects surpass positive trade-creation effects.”<sup>13</sup> Armenia, Azerbaijan, and Georgia could expect their GDPs to contract and most of their industries to be negatively affected by joining the EAU.

The current liberal external tariffs and trade policies of the South Caucasus nations outweigh the preferential trade arrangements and trade generation offered by EAU membership. Constantine Michalopoulos and David Tarr argue:

If a country such as Armenia..., with a lower external tariff, were to substitute the Russian tariff [proxy for the EAU external tariff, which currently stands at 11.5 percent<sup>14</sup> and exceeds the level allowed by Armenia's WTO treaty] for its own tariff structure, it would increase its un-weighted average tariff to 13–14 percent. Thus, for selected products highly protected in Russia, the tariff [in Armenia] would increase significantly... [T]he Customs Union would virtually result in pure trade diversion.<sup>15</sup>

Further damage will likely be inflicted on South Caucasus members through the EAU's implementation of a mixed value-added tax (VAT) system and the allocation of VAT revenues. Even if the VAT rates are harmonized (that is, within the EAU), countries

with a trade deficit in the ECU and a trade surplus outside the ECU will experience an adverse transfer of VAT revenues toward ECU partners with the opposite trade pattern.

Moreover, if Azerbaijan wanted to negotiate its own WTO accession commitments, it would have to be in compliance with the common external tariff of the EAU. EU Enlargement Commissioner Stefan Fuele has noted with respect to the EU and EAU that "the reason for incompatibility is that we cannot make legally binding agreements with partners that are not in charge of their external trade policies."<sup>16</sup>

Unlike with the EAU, the South Caucasus could expect positive effects to arise from multilateral trade integration through WTO accession and free trade areas with the EU. Therefore, it is in the best interests of Azerbaijan and Georgia to finalize negotiations on Association Agreements with the EU and refrain from EAU accession. Armenia may be better off reconsidering its decision on the Customs Union.

The following sections analyze each of the three countries in greater depth.

## Armenia

Armenia has become the first South Caucasus country on track to enter the future Eurasian Economic Union (EEU). In early September 2013, President Sergey Sargsyan announced that Armenia will join the ECU,<sup>17</sup> the Russian-dominated economic zone, throwing away years of negotiations with the EU on an Eastern Partnership for an Association Agreement. This is a major step for the entire South Caucasus region, as pressure will increase now on Georgia, and eventually, Azerbaijan, to join the Eurasian Union.

Ironically, unlike Georgia or Azerbaijan, Armenia does not border Russia and yet has become economically and politically dependent on Russia. Nevertheless, the Kremlin is pressuring Armenia to join the EAU.<sup>18</sup>

Although the EU currently accounts for 32 percent of Armenia's trade turnover (\$1.5 billion)—edging out Russia by 12 percentage points<sup>19</sup>—growing Armenian dependence on Russia is evident in almost every sector of society. Russia owns two of Armenia's power stations (one hydroelectric, one nuclear)<sup>20</sup> that were acquired in exchange for writing off Armenian debt. The Russian company Gazprom owns 80 percent of Armenia's energy infrastructure through its Armenian subsidiary ArmRosGazprom, thus ensuring that Armenia cannot become an independent transit country should Iranian gas ever reach European markets.<sup>21</sup> The Russian airline Sibir owns 70 percent of the Armenian airline Armavia; the state-controlled Russian bank Vneshtorbank owns 70 percent of the Armenian Savings Bank.<sup>22</sup> The Russian government also bought the Armenian national railway network with a \$570 million investment and controls the majority of mining operations in Armenia.<sup>23</sup> In addition, Moscow has a 49-year basing agreement for the stationing of Russian troops at Gyumri in northern Armenia.

**Heavy Political Price.** Armenia's dependence on Russia has significantly slowed democratization and weakened the rule of law. In the pursuit of preserving their own power, Armenian leaders seem to have adopted some policies that would insulate and isolate Armenia from the influence of democratic governments or pro-democracy nongovernmental organizations (NGOs). The Armenian legal system, including the prosecutor's office and courts, is at the beck and call of the Russian government. Proponents of the pro-Russia status quo in Armenia

TABLE 1

### Armenia: Key Indicators

PROJECTED PERCENTAGE CHANGE	2013	2014
Real GDP	4.3%	4.1%
Consumer Prices	4.2	4.0
Volume of Imports of Goods and Services	5.3	4.5
Volume of Exports of Goods and Services	9.6	11.2

**Sources:** Republic of Armenia and International Monetary Fund, "Republic of Armenia and the IMF," <http://www.imf.org/external/country/ARM/index.htm> (accessed September 25, 2013).

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are attempting to label proposed democratic reforms as unsuitable, given the cultural and historical context of the South Caucasus. This labeling is part of a disinformation campaign aimed at perpetuating the autocratic status quo and a close alliance with Russia, and is misleading the Armenian people.

President Sargsyan has ordered the creation of a Public Council, modeled on Russia's consultative Public Chamber, to deal with NGOs. Some analysts worry that the Public Council might eventually seek to suppress civil society by regulating all NGO financing, especially donations from abroad. As Anna Borshchevskaya writes, "State control would mean more funding for so-called GONGOs—government-organized NGOs. These groups support the government authorities, mimic a genuine civil society, and stifle real democracy by crowding out legitimate independent voices."<sup>24</sup> The Eastern Partnership Civil Society Forum notes that the Public Council seeks to "consolidate" civil society, "regulate" foreign funding, and closely "watch" and audit the activities of charitable organizations.<sup>25</sup>

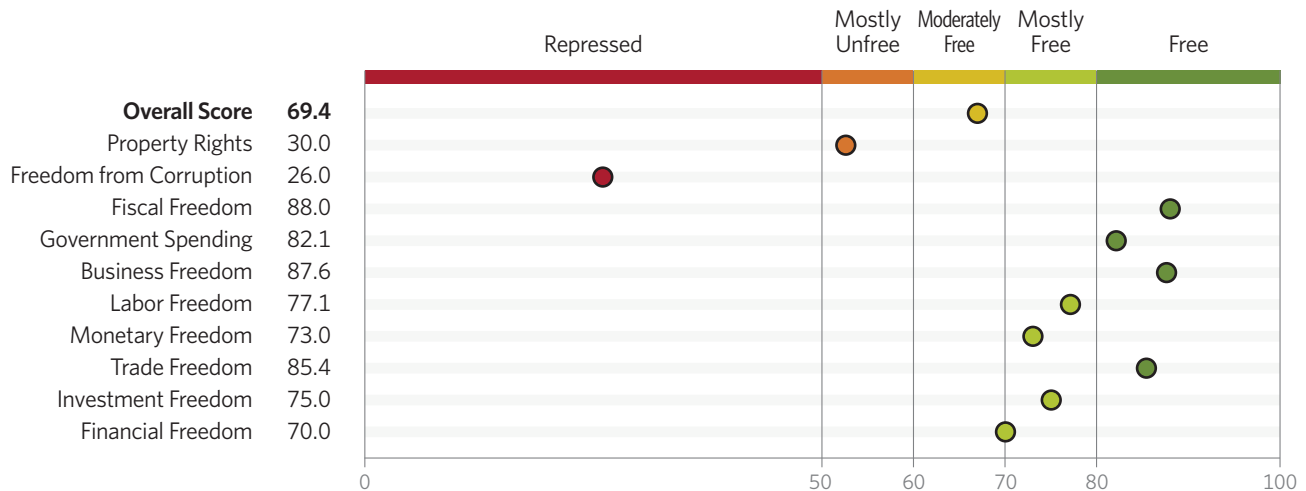
For Russia, "a successful democratic transition within close proximity represents an ever-present symbolic threat of the possibility of regime change."<sup>26</sup> In this context, it is reasonable to speculate, then, that Moscow and Yerevan are coordinating their efforts to weaken democratic movements in the region by promoting and reinforcing norms that discredit political change.<sup>27</sup>

Armenian politicians and analysts believe as much. According to Richard Giragosian, director of the Regional Studies Center based in Yerevan,



CHART 1

**Armenia: 2013 Index of Economic Freedom Scores**



Source: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2013 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>.

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Armenia is “in grave danger of becoming little more than a Russian garrison state, marked by significant overdependence on Russia and, at times, political submission to Russia’s interests.”<sup>28</sup>

Styopa Safarian, head of the Armenian opposition Heritage Party, echoed Giragosian, arguing that the EAU is a response to “CIS [Commonwealth of Independent States] countries getting too carried away and deepen[ing] their relationships with the West, which might lead to less dependence [on Moscow]” and warns that if Armenia joins the EAU “we will once and forever be out of that [EU] value field and, consequently, will also be left out of major investment projects.”<sup>29</sup>

Prime Minister Tigran Sargsyan has noted that Armenia’s reluctance to join the EAU is rooted in the absence of common borders with member states and that “the structure of the Armenian economy is very different from that of the economies of the Customs Union’s countries that have substantial deposits of energy resources and pursue a policy of supporting domestic manufacturers through quite high customs duties.” He further noted that “on the whole, the level of such duties in the Customs Union is twice as high as those levied in Armenia,” adding that as “Armenia was one of the first CIS countries to join the World Trade Organization” (WTO), such a switch to the Russian-dominated ECU would be very complicated, if not impossible.<sup>30</sup> Apparently,

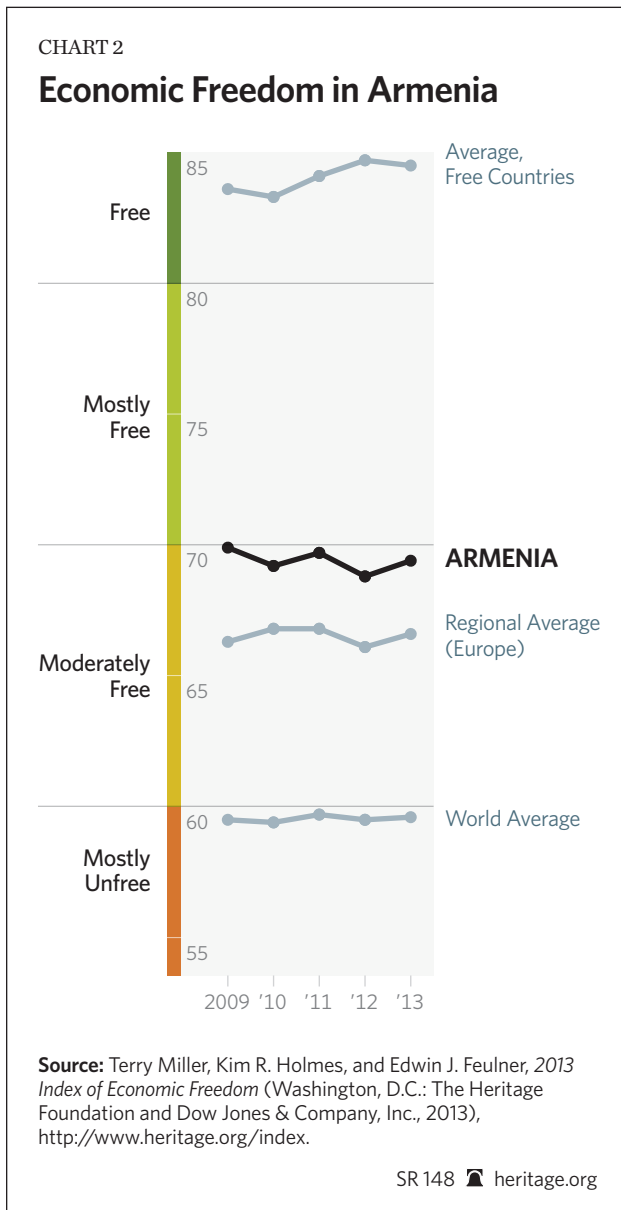
the president did not pay attention to these warnings.

However, Prime Minister Sargsyan recently praised the EAU, claiming that it shows “perspective” and “goes with the times.”<sup>31</sup> Most likely, political pressure at home and in Moscow is responsible for the turnaround.

A pro-Russian member of the Armenian parliament, Tigran Urikhanian, argued in July 2012 that Armenia’s membership in the Collective Security Treaty Organization, a Russian-dominated military alliance, should serve as a basis for Armenia’s membership in the EAU.<sup>32</sup> Public opinion on the issue of integration with Russia remains hard to measure. The Eurasian Development Bank stated in September that

67 percent of Armenia advocate[s] this decision [joining the EAU].... An interesting fact is that Georgian citizens also express significant support for the country’s joining the [Eurasian] Customs Union and the SES [Single Economic Space]: the share of positive answers has doubled over a year to 59%. This suggests that cooperation between Georgia and the Customs Union countries should be stepped up.... Azerbaijan has demonstrated the lowest level of support for joining the Customs Union and the SES (37%).<sup>33</sup>

However, different polls and different questions often produce opposite results.



If Armenia were to join the EAU, it is likely that the country's political opposition parties and the influence of its diaspora in the U.S. and EU would be further weakened. The EAU thus would further undercut any prospects that Armenia could achieve a truly independent political and economic stature. Maia Kocijancic, a spokeswoman for EU foreign policy chief Catherine Ashton, has said that Armenia cannot sign a far-reaching Association Agreement with the EU if it joins the Russian-dominated EAU.<sup>34</sup> In fact, Traian Hristea, head of the EU delegation to Armenia, made it quite clear that "Armenia must decide who it wants to be with in the future—the European Union or the Eurasian Union."<sup>35</sup>

Apparently, after receiving some not-so-subtle pressure from the Russians, Armenia has made its choice. In June 2013, Gazprom announced a 50 percent hike in the price of Russian natural gas exports to Armenia. Just before the ECU membership announcement, Yerevan was negotiating with Moscow to subsidize by 30 percent the price<sup>36</sup> of its gas purchases, and thereby increase the country's dependence on Russia even more.

The Heritage Foundation/*Wall Street Journal* 2013 *Index of Economic Freedom*<sup>37</sup> reports that Armenia's progress toward diversification of its economic base—progress that would be undermined by EAU membership—has increased economic dynamism in Armenia and helped to spur a decade of strong economic growth that reduced poverty and unemployment rates. The regulatory framework, which has been facilitated by a broad simplification of business procedures, is relatively efficient. Better management of public spending has helped limit the cost of government. Armenia's scores for property rights and freedom from corruption, however, are well below world averages. According to a recent study by the Organization for Economic Cooperation and Development (OECD), "The results in investigations and prosecutions of corruption crimes are very limited."<sup>38</sup> In addition the judicial system suffers from underdevelopment and corruption, which substantially impedes the enforcement of contracts. Protection of intellectual property rights is poor. State subsidies distort prices in sectors such as public transportation, electricity, and gas.<sup>39</sup>

The leaders of Armenia should build on the progress already made toward economic freedom and reject membership in the EAU that would pull the country in the wrong direction.

The Armenian government should:

- **Abandon** or retract the announced membership in Russia's ECU, finalize negotiations on the Association Agreement with the EU, and sign a Deep and Comprehensive Free Trade Agreement (DCFTA) in the near future.
- **Continue** diversification of the Armenian economy.
- **Reduce** reliance on the World Bank, the International Monetary Fund, the Asian Development Bank, and Russia and, instead, rein in government budget deficits through spending cuts.

- **Strengthen** the rule of law, specifically with respect to individual property rights and freedom from corruption. Develop and implement broader and stricter anti-corruption measures.
- **Increase** judicial independence and government transparency to eliminate the cozy relationships between political and business circles.

## Azerbaijan

Strengthening ties between Azerbaijan and Russia has become a top priority for Putin, who visited Baku in August 2013.<sup>40</sup> Azerbaijan and Russia signed a protocol in July 2013 for the reconstruction of the existing bridge at their border and to construct a new bridge across the Samur River.<sup>41</sup> In June 2013 Azerbaijan agreed to a \$1 billion weapons purchase from Russia, refitting the Azerbaijani military with updated tanks and armored vehicles.<sup>42</sup>

In addition, SOCAR and Rosneft—Azerbaijan’s and Russia’s respective leading oil-producing companies—have begun negotiations on increasing energy cooperation. The two companies are considering resuming and expanding oil supplies to Europe via the Baku–Novorossiysk pipeline.<sup>43</sup>

Russia’s primary interests in the South Caucasus are to dominate the region militarily and strategically and to prevent or control the export of hydrocarbons to the West from the Caspian region through the Transcaucasian energy corridor,<sup>44</sup> which rests outside Russian control. Moscow is particularly concerned by the 2012 agreement between Turkey and Azerbaijan to build the Trans-Anatolian Natural Gas Pipeline (TANAP)—and its extensions, the Trans Adriatic Pipeline (TAP) and Nabucco West—which would connect Turkey, Greece, Albania, and Italy; and Turkey, Bulgaria, Romania, Hungary, and Austria; respectively, and ease Europe’s dependence on Russian gas.<sup>45</sup>

Azerbaijan’s President Ilham Aliyev’s father—Heydar Aliyev—was a KGB general and Soviet Politburo member who ruled Azerbaijan for many years until he died in 2003 and was succeeded by his son. In all, the Aliyevs have ruled Azerbaijan for roughly 38 of the past 44 years. Under both Heydar and Ilham Aliyev, Azerbaijan has pursued a mostly pro-Western policy to date. The country was instrumental in the transit of U.S. military materiel and personnel through the Northern Distribution Network—a vital railroad and sea lane link from the Caucasus across the Caspian Sea and Turkmenistan into Afghanistan.

With U.S. support thus garnered, Azerbaijan fiercely protected its sovereignty. In 2012, Aydin Aliyev—head of the Azerbaijani State Customs Committee—joined the Georgian government in declining to enter the Eurasian Customs Union and announced that Azerbaijan is in the process of implementing its own customs code. Azerbaijan

TABLE 2

### Azerbaijan: Key Indicators

PROJECTED PERCENTAGE CHANGE	2013	2014
Real GDP	4.1%	5.8%
Consumer Prices	3.4	6.8
Volume of Imports of Goods and Services	30.3	12.7
Volume of Exports of Goods and Services	0.8	4.5

**Sources:** Republic of Azerbaijan and International Monetary Fund, “Republic of Armenia and the IMF,” <http://www.imf.org/external/country/AZE/index.htm> (accessed September 25, 2013).

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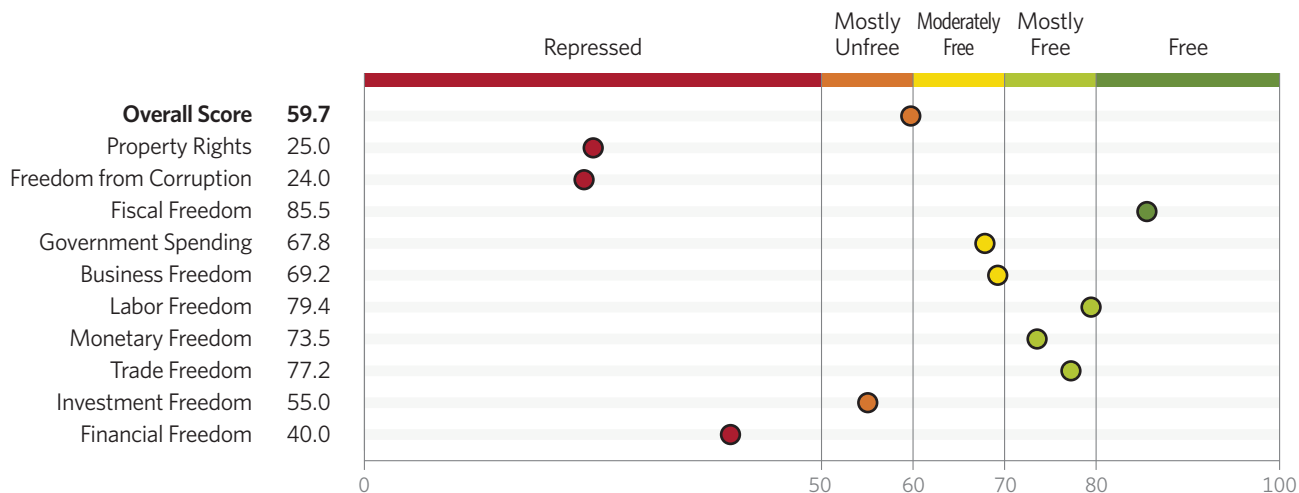
also refused to sign the Treaty on the Free Trade Area, signed in October 2011 by the presidents of eight CIS countries.<sup>46</sup>

Since Aliyev has not shown interest in EAU membership, Putin has attempted to create a counterweight to Aliyev’s internal political and economic dominance in Azerbaijan. So far, he has failed. The Union of Azerbaijani Organizations of Russia (UAOR)—also known as the Billionaires’ Union—has been cited as a new instrument that allows Putin to meddle in Azerbaijan’s internal affairs. Georgian ex-president Mikheil Saakashvili believes the UAOR was created with the nefarious purpose of overthrowing the Aliyev government, while Vafa Guluzade, a former senior foreign policy aide to the late President Heydar Aliyev, claims to “see it as one of the forms of pressure against, and intimidation of, the Azerbaijani government, which could be used when Putin needs it.”<sup>47</sup> However, the Billionaires’ Union failed to launch a viable political alternative to Aliyev, and Putin paid a friendly visit to Baku in August 2013. Yet, there is a strong lobby in Baku, including in the corridors of power, which advocates abandonment of the Western orientation and cozying up to Moscow.

The *2013 Index of Economic Freedom* reports substantial challenges that continue to block the diversification needed to put Azerbaijan on the path toward sustainable and broad-based economic growth. Despite some improvements, property rights are weak and the level of corruption continues to be high. Government regulations add to the

CHART 3

**Azerbaijan: 2013 Index of Economic Freedom Scores**



**Source:** Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2013 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>.

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costs of foreign investment, and monetary instability adds to uncertainty.

The judiciary is burdened by political meddling and extensive non-transparent regulations. Azerbaijan lacks dependable enforcement of the rule of law. So long as the judiciary and police are susceptible to bribery and are free to harass private businesses, they facilitate the insiders’ ability to gain monopoly control of major industries. As long as this is the case, foreign investment and non-energy growth will be limited.

Despite progress in streamlining the process for launching a business, other time-consuming requirements reduce regulatory efficiency. Completing licensing requirements currently takes more than 150 days. The tax system is reported to include non-transparent requirements for businesses. The property registry is corrupt. Labor regulations have become more flexible, but enforcement of the labor code remains uneven. Inflation has risen, partly as a result of customs restrictions that limit import competition.<sup>48</sup>

It is likely that the eventual opening of the Southern Gas Corridor, and the TANAP, TAP, and Nabucco West pipelines, connecting Azerbaijan, Turkey, and Western Europe, will provide an additional source of revenue from gas exports. However, unless the country transitions to innovation-based growth and begins modernizing non-energy sectors

of the economy, Azerbaijan’s economic potential, like that of many other energy-rich countries, will remain limited. Fluctuations in world oil prices weigh heavily on the level of the nation’s prosperity from year to year.

Moreover, the decades-old stalemate with Armenia over the contested Nagorno–Karabakh region continues to impede economic progress, as military budgets remain high. In order to promote lasting growth, Azerbaijan must move toward a free, open society in order to transition from investment-based growth to innovation-based growth.

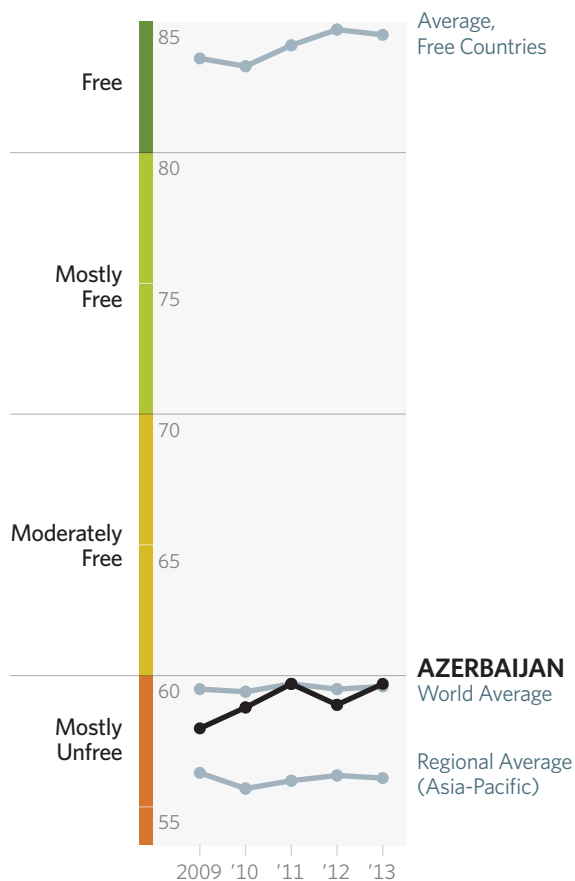
The EAU would force Azerbaijan off the path of modernization and economic diversification. According to Anar Valiyev, “CIS exports to the EU between 2000 and 2010 increased by approximately 160 percent, including an 882 percent growth from Azerbaijan. Moreover, EU exports to the CIS grew by 266 percent during the same period. And Azerbaijan, in particular, saw its imports from the EU rise by 550 percent.”<sup>49</sup>

**Russia Threatens Azerbaijan’s Non-Hydrocarbon Energy Diversification.** The EAU is expected to harmonize the energy policies of member states, which would require a uniform internal energy policy among members and external policy towards non-members.<sup>50</sup> Russia would be able to dictate the levels of natural gas and oil revenues for the EAU members. Azerbaijan’s inability to dictate



CHART 4

### Economic Freedom in Azerbaijan



Source: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, 2013 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>.

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its own energy policy would make it hard for the EU to consider it a reliable partner. Harmonizing its energy strategy through the EAU with at least two other energy suppliers—Russia and Kazakhstan—would have other adverse consequences for Azerbaijan.

According to Anar Valiyev, “[N]on-oil exports, including agriculture, make up only 8–10 percent of Azerbaijan’s economy. Opening Azerbaijani markets to cheap products from Russia, Ukraine, or Belarus may harm Azerbaijan’s agriculture sector and the burgeoning related industries, such as food processing.”<sup>51</sup> Azerbaijan would become the victim of a “resource curse” under which the majority of the

country’s revenues would be spent on imports, and, consequently, government salaries would be unable to keep pace with rising consumer inflation.<sup>52</sup>

Putin does not have Azerbaijan’s best interests at heart. Eventually, he may use a wide variety of tactics to pressure Azerbaijan into joining the EAU. Putin’s potential arsenal to force Azerbaijan into the EAU and the EEU “includes deportation of labor migrants, a border blockade based on accusations that Azerbaijan aides [*sic*] Islamist radicals in the North Caucasus, an escalation of tensions around Karabakh as well as military threats to Azerbaijan either on the Caspian Sea or along the land border.”<sup>53</sup>

It is not in Azerbaijan’s interest to join the EAU, which will mostly consist of authoritarian regimes harsher than its own. Instead, enacting further market-based economic reforms would allow more Azerbaijanis to prosper and make Azerbaijan more attractive to foreign investors from outside the EAU area. The country will not truly flourish until Azerbaijanis are free to unleash their full entrepreneurial, intellectual, artistic, and productive energies in the global marketplace. In order to build a stable foundation for long-term economic growth, economic freedom is a necessity.

The government of Azerbaijan should:

- **Strengthen** individual property rights and reduce corruption in order to encourage innovation-based growth.
- **Minimize** governmental regulations and non-tariff barriers, such as arbitrary customs administration, to increase foreign and domestic investment. Continued openness to global trade, tax reform, and improvements in regulatory efficiency will allow the growth of a well-educated labor force and the broadening of the production base.
- **Redirect** some resources from the energy sector to other sectors—diversification will allow sustainable growth. Inflation has risen, partly as a result of customs restrictions that limit competition from imports.
- **Finalize** WTO accession negotiations, and negotiations with the EU over an Association Agreement, to succeed the current Partnership and Cooperation Agreement. If Azerbaijan is to

diversify its energy-based economy, it will need the EU and the U.S.—not Iran or Russia—for technology, investments, and know-how. Unless the government in Baku improves its governance and judicial system, Azerbaijan will struggle to attract firms and foreign investors into sectors other than extraction industries.

## Georgia

Since gaining its independence from the Soviet Union two decades ago, Georgia has been a regional leader on the path to economic freedom and growth in the South Caucasus. Georgia ranks 9th in the World Bank’s 2013 “Doing Business” survey (Russia ranks 112th).<sup>54</sup> Yet, as Michael Totten noted, Georgia is located at “the edge of the West.”<sup>55</sup> This is a tough neighborhood. A former U.S. ambassador to the Soviet Union, the late George F. Kennan, famously said that “Russia can have at its borders only enemies or vassals.”<sup>56</sup>

Moscow seeks to undermine Georgia’s role as an energy transit hub that links neighboring Azerbaijan to Turkey and Europe, thereby bypassing Russia and its energy monopoly in Eurasia. Almost five years after the Russian invasion of Georgia in August 2008, Russia has recognized the independence of the Georgian provinces of Abkhazia and South Ossetia while approximately 10,000 Russian troops continue to occupy them.<sup>57</sup> The Kremlin is anxious to ensure that Georgia can never again use its sovereignty as a security lever for the West against Russia.

Just as Joseph Stalin, himself a Georgian, drew Georgian borders in order to exploit and exacerbate ethnic differences, Russia’s current occupation of South Ossetia and Abkhazia reflects Moscow’s desire to divide and conquer Georgia, as it supports Abkhazia’s and South Ossetia’s resistance to joining Georgia as full autonomies.

Marlène Laruelle notes that “in Georgia, Moscow has soft power instruments that it could activate.”<sup>58</sup> The Georgian Dream Party of Bidzina Ivanishvili, the Conservative Party of Zviad Dzidzigouri, the Worker’s Party of Shalva Natelachvili, the New Right, the Democratic Movement–United Georgia of Nino Burjanadze, and the Georgian Party of Irakli Okruashvili all call for a rapprochement with Russia in one way or another.

Georgia’s presidential election on October 27, 2013, took place during a time of profound domestic and foreign policy changes. President Mikheil Saakashvili intensified the efforts of his predecessor, former USSR Foreign Minister Eduard Shevardnadze, and sought to counter Russian influence by cooperating militarily with NATO and economically with the U.S. and EU. Saakashvili believes the EAU represents “the most savage idea of Russian nationalists”<sup>59</sup> and is unambiguous in his criticisms of Putin’s attempt to “resurrect the Soviet corpse.”<sup>60</sup>

TABLE 3

### Georgia: Key Indicators

PROJECTED PERCENTAGE CHANGE	2013	2014
Real GDP	6.0%	6.0%
Consumer Prices	0.9	4.6
Volume of Imports of Goods and Services	4.2	4.5
Volume of Exports of Goods and Services	8.8	9.5

Sources: Georgia and International Monetary Fund, “Georgia and the IMF,” <http://www.imf.org/external/country/GEO/index.htm> (accessed September 25, 2013).

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The election was won by Prime Minister Ivanishvili’s protégé, Giorgi Margvelashvili, and now the Georgian Dream Party controls both the presidency and the government for the first time. More important, another Ivanishvili protégé, Interior Minister Irakli Gharibashvili, was elected prime minister on November 3.

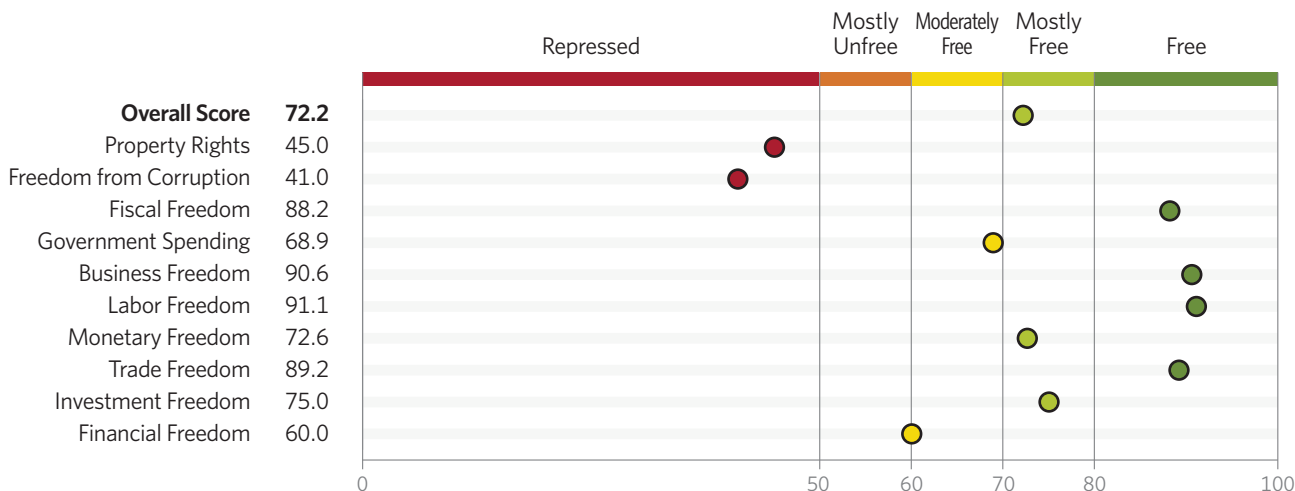
Even the Russians recognized Saakashvili’s achievements. The Russian publication *Kommersant* noted that “Saakashvili did a lot of good. Georgian police do not take bribes. Whole districts of Tbilisi and whole cities like Batumi are being restored, modernized, built into ‘brands.’”<sup>61</sup> *Komsomolskaya Pravda*, a pro-government tabloid, praised the departure of Saakashvili and celebrated Russia and Georgia’s “common orthodox faith and shared heroic past.”<sup>62</sup>

By pursuing classic liberal economic policies and fighting low-level corruption, Georgia’s gross domestic product (GDP) grew at a rate of about 10 percent per year between 2005 and 2008. The number of registered companies rose dramatically from 36,000 in 2005 to 51,000 in 2007.<sup>63</sup> As GDP growth and foreign investment slowed down during the Great Recession and in the aftermath of the Russo–Georgian war of 2008, however, Georgia began to enact new restrictions against foreigners with respect to visas and the sale of agricultural land. The significant influx of migrant workers and entrepreneurs from China, Egypt, India, Iran, and Turkey has fueled a revived ultra-nationalism, often supported by the Orthodox Church.

Running on a campaign platform of fighting the abuses of the law enforcement and jail system and

CHART 5

**Georgia: 2013 Index of Economic Freedom Scores**



Source: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2013 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>.

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strengthening ties with Russia, Ivanishvili was elected prime minister in 2012 and has gained popularity in Georgian politics. Since his accession, Georgia has resumed trade with Russia and is discussing opportunities for increased cooperation on everything from energy to transport. Ivanishvili has not ruled out membership in the Eurasian Union.

Trade with Russia represents a significant portion of Georgia’s small economy and raises concerns of Georgia potentially falling squarely again under the aegis of Russia. The return to the Russian sphere of influence and economic frameworks would be a step backward for Georgian independence.<sup>64</sup>

According to the *2013 Index of Economic Freedom*, the Georgian government’s persistent efforts to eliminate corruption and restore fiscal stability have born fruit. Despite this progress, however, momentum for comprehensive reforms to limit government spending and restrict the growth of economic regulations has flagged. True, the government has arrested abusive former officials and policemen, radically downsized bureaucracies, and cracked down on smuggling in order to bring down post-Soviet corruption. However, both the Saakashvili and the Ivanishvili administrations committed numerous violations of the law.

Yet, there is much of which Georgia can be proud. Several new Public Service Halls quickly deliver inexpensive legal documents such as birth

certificates, passports, and property titles. The competitive regulatory framework is conducive to entrepreneurial activity, but reform of bankruptcy and licensing requirements has slowed. Inflation has decelerated. Prices are generally set in the market, but the state maintains some price controls. The growing banking sector offers improved access to financing, although the stock exchange remains small and underdeveloped.<sup>65</sup>

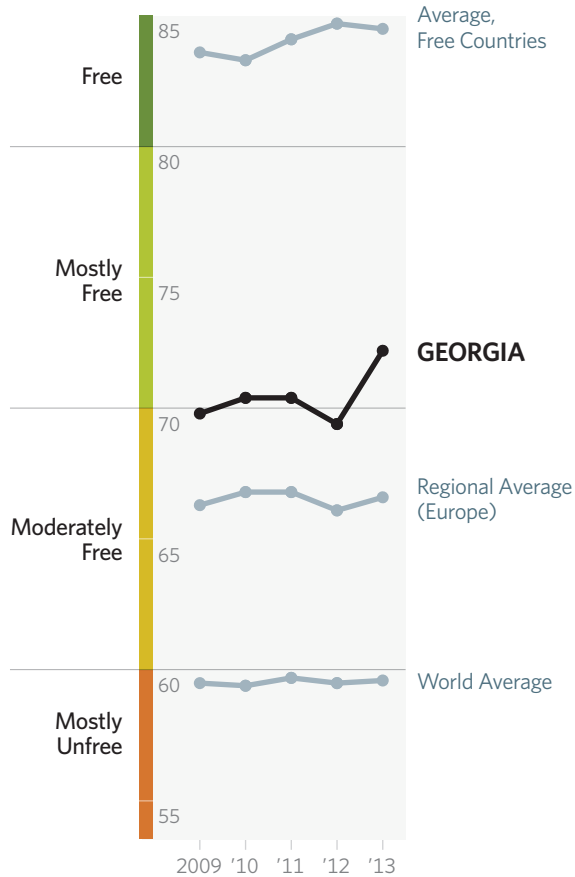
This progress toward greater economic freedom in Georgia would be in jeopardy were it to join the EAU or otherwise tie itself closer to Russia.

The government of Georgia should:

- **Hold fast** to pro-market reforms and improve democratic governance while resisting pressure to over-regulate, which breeds corruption, and avoid a return to the failed business opacity of the past.
- **Refuse** to join Russia’s Eurasian Customs Union or the Eurasian Union.
- **Strengthen** the protection of intellectual property rights, deepen institutional reforms to enhance judicial independence and effectiveness, and expand the stock exchange to encourage a further innovation-based economic growth.

CHART 6

### Economic Freedom in Georgia



Source: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, 2013 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>.

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- **Quell** ultra-nationalist sentiments that can impede economic growth by discouraging new foreign investment and entrepreneurship in Georgia.
- **Ratify** a DCFTA with the EU, and accelerate Free Trade Area negotiations with the U.S.





## Conclusion

Actual membership, or even the prospect of membership or Associate Membership, in the European Union has spurred greater democratization and economic liberalization in Eastern and Central Europe. EU members such as Poland, the Baltic States, Slovakia, Croatia, the Czech Republic, and Romania have made impressive progress over the past two decades of post-Communist transitions. The European Neighborhood Policy (ENP), launched by the EU in 2004, is intended to promote prosperity, stability, and peace along the EU's borders by offering a privileged relationship to non-EU neighbors.<sup>66</sup> Unfortunately, the eurozone crisis has adversely affected Georgia's membership prospects.

The concept of Eurasianism, on the other hand, which is based on the contraposition of Russia to the West in the sense of culture, religion, power, economics, the rule of law, and human rights, does not provide a unified solution to the problems facing the post-Soviet states. Rather, Eurasianist ideology is a tool of Russian power projection onto Eastern Europe, including the Caucasus and Central Asia.<sup>67</sup>

If the U.S. and EU do not undertake a stronger role in market liberalization, transparency, and good governance with respect to Armenia, Azerbaijan,

and Georgia, Russia will gain a strategic advantage over the West in the crucial geopolitical region—the South Caucasus. Russia is using its military, political, and economic influence to pressure those three countries to join the EAU. The U.S. and EU should cooperate with the South Caucasus nations in strengthening rule of law and enacting legal reforms in order to maximize economic growth beyond the state-managed sectors.

Since the end of the Cold War, globalization has greatly changed the Eastern European and Eurasian cultural landscape. New generations of Armenians and Georgians prefer to speak English, while in Azerbaijan the youth prefer Turkish as well as English and Russian. Travel between the Caucasus and Europe and the U.S. has continued to increase.

The EAU is an anti-Western civilizational project being pushed by leaders whose world outlook was formed in the Soviet era and who seek to return the region to the past. Armenia, Azerbaijan, and Georgia would take a step backward if they were to join it.



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